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MODEL PORTFOLIOS

Understanding the Asset Allocation Model Landscape

By Cerulli Associates

INVESTMENTS & WEALTH INSTITUTE®

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Understanding the Asset Allocation Model Landscape

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Asset managers are embracing a role as developers of recipes that feature their proprietary strategies as key ingredients.

After facing fee pressure for several years from lower-cost passive products, traditional multi-line asset managers have greater appreciation for the importance of their intellectual capital in the arena of asset allocation. Instead of allowing their products to become commoditized, managers are increasingly offering asset allocation models that aim to optimize advisors' client portfolios across all relevant asset classes.

Many advisors relish their role as portfolio manager of client accounts, but many broker-dealer (B/D) firms have been disappointed by the consistency of returns their advisors are generating on these platforms and are concerned about potential legal liability as a result. Moreover, the scalability and efficiency that models bring to an advisor's portfolio construction process allow them to allocate time to other activities—such as client acquisition—in order to grow their practices. To address these concerns, several B/D home-office teams have made efforts to better support their advisors' portfolio construction processes. They have found mixed results overall, however, because advisors are reluctant to alter habits they have become comfortable with, regardless of the potential benefits that accompany change. Furthermore, advisor time spent on portfolio management undermines efforts to focus on comprehensive financial planning at the advisor practice level.

Table 1

ASSET ALLOCATION CHARACTERISTICS

Model Originator	Marketplace	Economics	Discretion
Broker-Dealer	Broker-Dealer	Explicit fees	Model Provider
Asset Manager	Custodian	Management fees on underlying products	Broker-Dealer
Third-Party Strategist or TAMP	Managed Account Technology Providers	Advisor awareness	Advisor
Advisor	Fintech Marketplaces		Shared
	Paper Models		

As the wealth management industry continues its evolution, the role of model asset allocation provider offers asset managers an unparalleled opportunity to maintain their relevance but will require consistent efforts to generate returns that may be difficult to calculate.

SETTING THE LANDSCAPE

Cerulli Associates characterizes asset allocation models along four dimensions: model originator, model marketplace, economics of the model, and how discretion is exercised over the model (see table 1).

MODEL ORIGINATOR

The first models were created by mutual fund wrap sponsors and third-party turnkey asset management programs (TAMPs) in the early 1990s. Brinker, Lockwood, and SEI pioneered the development of mutual fund models, which paved the way for third-party strategists such as Good Harbor, Clark Capital, and the ill-fated F-Squared to do the same with exchange-traded funds.

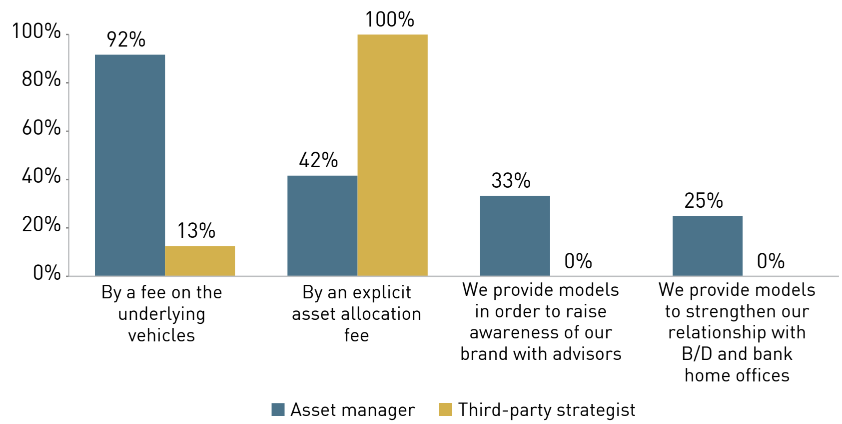
Asset managers also have joined strategists as manufacturers of models. Fidelity, Vanguard, BlackRock, PIMCO, Capital Group, and other large firms with asset allocation capabilities have joined the ranks of model providers. In addition to strategists and asset managers, larger B/Ds such as Merrill Lynch and Morgan Stanley have developed proprietary models for advisors within their networks.

MARKETPLACE

Models are distributed through a number of avenues, including B/D managed account sponsors, custodians and clearing firms, TAMPs, and fintech providers. Firms such as BlackRock, Franklin Templeton, and Capital Group have distributed model portfolios to advisors on printed handouts for years, spawning the term "paper models" as a name for these portfolios. In recent years, firms have posted these models on their advisor websites and started to email changes to advisors who subscribe to their models. Asset managers find it challenging to track the effectiveness of paper models because they cannot link flows and assets to the activity of advisors trading based on model changes in paper models.

Figure 1

ASSET MANAGERS VS. THIRD-PARTY STRATEGISTS: METHODS OF MODEL COMPENSATION, 2018



Analyst Note: Respondents were asked to select all options that are relevant.

Source: Cerulli Associates

ECONOMICS

The methods of generating direct revenue from asset allocation models include an explicit fee for the asset allocation or from the management fees on the underlying investment products. Asset managers also can recognize indirect compensation through increased brand awareness and stronger relationships with their distribution partners. Although those don't generate revenue directly, they better situate asset managers to increase assets in the retail channel, which is currently undergoing long-term product rationalization and platform consolidation, leading to a more limited, concentrated set of distribution partners (see figure 1).

DISCRETION

The term "discretion" has a distinct regulatory meaning: A person or entity that exercises discretion determines when a security should be traded and at what price. Within the model landscape, there are four primary discretion models:

Model provider: Asset managers transmit trades through B/Ds and custodians that support advisors without the intervention of the advisor or the advisor's B/D home office.

Broker–dealer: The investment advisory arm of an advisor's B/D determines whether to implement the initial trades and reallocations received from model providers or their own proprietary models.

Advisors: Advisors can maintain final say over suggestions of third parties or their own practice-level models. Paper models and product recommendations from home-office due diligence teams often influence advisors' portfolio construction methods.

Fintech marketplaces: A new category of distributors enables advisors to subscribe to third-party models by attaching those models to individual client accounts. These "model marketplaces" represent a novel way for advisors to tap into the intellectual property of large asset managers while still controlling the client experience. Platforms offering these marketplaces include Oranj, Riskalyze, and TD Ameritrade.

THE MODEL OPPORTUNITY

Measuring the potential market for model portfolios is dependent primarily upon understanding the degree to which advisors currently employ a variety of inputs in helping them develop client portfolios. To track this topic, Cerulli Associates consistently has asked advisors how they would describe their practice's core portfolio construction methodology, ranging from creating a custom portfolio for each client to fully outsourcing the responsibility to a third party.

COMBINING ADVISORS' PREFERENCES AND CAPABILITIES TO ASSESS THE SEGMENT

The first step in reviewing these results is examining the degree to which discretion is yielded outside the practice (see table 2). Here we find significant distinctions between those who are willing to modify the recommendations they receive (26 percent) and those who are willing to fully outsource portfolio discretion (12 percent). Most notably, wirehouse advisors (8 percent) and independent registered investment advisors (RIAs) (7 percent), are least likely to embrace full outsourcing, while insurance (23 percent) and independent B/D (IBD) advisors (17 percent) are much more comfortable using these services. These results underscore advisors' overwhelming preference for maintaining at least the appearance of portfolio control at the practice level. Even as advisors pivot more toward embracing financial planning and goals-based relationships, they remain reluctant to shirk any elements of their perceived value proposition.

The approach of the model modifier allows advisors to have the best of both worlds. They can show a client that they are still the quarterback of the client's portfolio, and at the same time gain efficiency by leveraging a model asset allocation from a third-party strategist and the due diligence associated with the product selections of that strategist.

MOVING TOWARD OPTIMAL

Recognizing the challenges facing advisors in proficiently running client portfolios and in ceding discretion, Cerulli Associates has used advisors' current portfolio construction preferences in combination with the resources and capabilities across myriad practices to create an "optimal" segmentation for model use moving forward (see figure 2).

Table 2

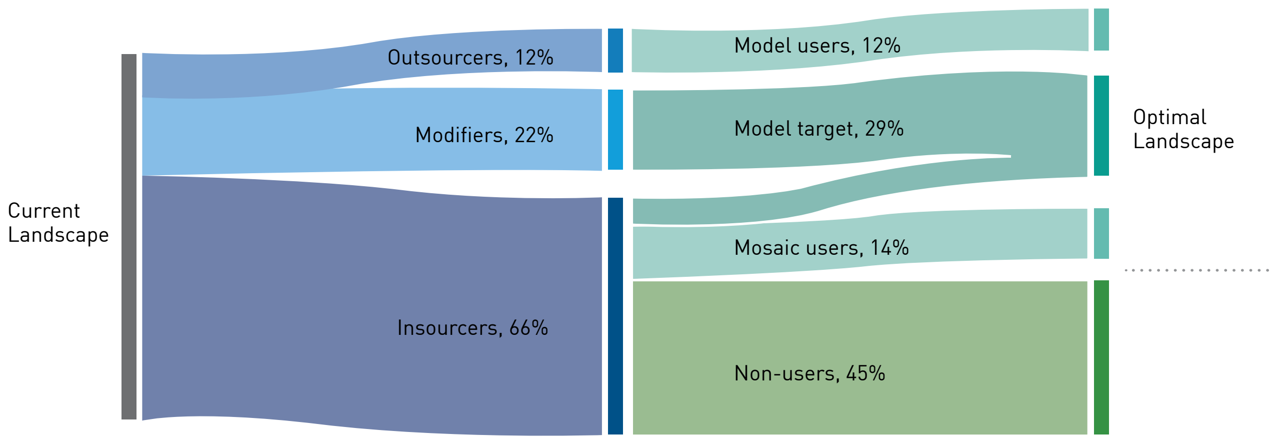
CURRENT ADVISOR HEADCOUNT MARKETSHARE BY PORTFOLIO CONSTRUCTION SEGMENT, 2018

		Channel						
Segment	Description	Wirehouse	National and Regional B/D	IBD	Independent RIA	Hybrid RIA	Insurance B/D	All Advisors
Outsourcers	Cede discretion to home office or third party	8%	12%	17%	7%	15%	23%	12%
Modifiers	Start with others' models, customize to each client	36%	34%	25%	10%	20%	38%	26%
Insourcers	Rely primarily on practice resources	56%	55%	58%	83%	64%	40%	62%

Sources: Cerulli Associates, in partnership with Investments & Wealth Institute® and Financial Planning Association®

Figure 2

CURRENT VS. OPTIMAL ASSET ALLOCATION MODEL MARKETSHARE, 2017



Note: These segments take the same advisor-reported data and bucket advisors into an optimal landscape of model use. The optimal segmentation takes into account several factors, including staffing, assets under management, and current portfolio construction process.

Sources: Cerulli Associates, Meridian IQ, Investment Company Institute, Insured Retirement Institute, VARDS, Strategic Insight/SIMFUND, Investment News, *Judy Diamond, Department of Labor, PLANSPONSOR, S&P Capital IQ MMD,* Financial Planning, Financial Advisor Magazine, Investment Advisor Magazine, *and Cerulli Associates, in partnership with Investments & Wealth Institute®, WealthManagement.com, and Financial Planning Association®*

Model users: Use models suggested by the B/D, custodian, or third-party provider without modification.

Model targets: Rely primarily on external models but make modifications, making them most likely to adopt outsourcing of portfolio discretion.

Mosaic users: Use inputs from a variety of sources but are unlikely to outsource discretion.

Non-users: Larger, sophisticated teams that are qualified to build their own custom models or portfolios for clients.

After comparing advisors' preferences with the realistic capabilities of their practices, Cerulli Associates has developed this optimal segmentation with regard to model asset allocation use. Most notably, the non-users category accounts for 45 percent of advisor-managed assets, down from 66 percent of insourcers. This reflects Cerulli Associates' belief that advisors accounting for almost 22 percent of assets would be better served if they were to increase their reliance on model allocations rather than keeping these responsibilities in their practices. Of this 22 percent, 7 percent were directed to the model target category and the remainder make up the "mosaic" users category. Based on this best-case scenario segmentation, Cerulli Associates believes that 41 percent of advisors' assets are addressable to model providers, though current adoption has remained stagnant at approximately 12 percent over the past five years.

OPTIMAL OPPORTUNITIES

With more than $20 trillion in total advisor assets, there are ample prospects across channels for model providers (see table 3). The scale of the wirehouse channel is certainly evident, but higher addressability levels in the independent B/D (6 percent) and bank (4 percent) channels offer appealing opportunities for model providers hoping to convert model targets. Attributes of advisor practices in the latter two channels more commonly make them model targets; model providers less frequently compete

Table 3

ASSET DISTRIBUTION BY OPTIMAL PORTFOLIO CONSTRUCTION SEGMENT AND CHANNEL, 2017

	Channel							
Portfolio Construction Segment	Wirehouse	National & Regional B/D	IBD	Independent RIA	Hybrid RIA	Insurance B/D	Retail Bank B/D	All Advisors
Model user	3%	2%	2%	<1%	2%	1%	2%	12%
Model target	7%	5%	6%	2%	1%	3%	4%	29%
Mosaic user	3%	4%	4%	2%	<1%	<1%	1%	14%
Non-user	22%	5%	1%	10%	5%	<1%	<1%	45%
Channel assets (%)	**35%**	**16%**	**14%**	**15%**	**9%**	**5%**	**7%**	**100%**
Channel assets ($ billions)	**$7,189.5**	**$3,232.1**	**$2,778.6**	**$2,991.4**	**$1,749.0**	**$927.8**	**$1,453.8**	**$20,322.0**

Sources: Cerulli Associates, Meridian IQ, Investment Company Institute, Insured Retirement Institute, VARDS, Strategic Insight/SIMFUND, Investment News, *Judy Diamond, Department of Labor, PLANSPONSOR, S&P Capital IQ MMD,* Financial Planning, Financial Advisor Magazine, Investment Advisor Magazine, *and Cerulli Associates, in partnership with Investments & Wealth Institute®, WealthManagement.com, and Financial Planning Association®*

with home-office models as they would in the wirehouse channel. With more than $8.3 trillion in the model user and target markets, providers have a wide landscape to address and will need to marshal their resources to identify and deliver their competitive advantages in each segment.

CLIENT PORTFOLIOS ARE A TEAM EFFORT

As trust in teams eclipses individual advisors, models and holistic financial advice take on increased importance. Consider the following:

Models make it easier for advisors to provide value. Generally, advisors like being the ones who create different portfolio allocations for clients, particularly when there is a workable model to start from. However, just 28 percent of investors believe their individual advisor has the highest level of investment expertise, down from 47 percent in 2013. In the past, advisors often would use their portfolio management skills as a basis for their value proposition. Instead of staking their value to outperformance, embracing models can allow advisors to provide value to their clients through more holistic financial planning.

Brand affiliations and their resources are becoming more important. More than one-third of investors (35 percent) believe the dedicated investment team at

Though the individual advisor remains the key touchpoint for clients, the brand advisors affiliate with, and the resources that brand provides, are becoming a more important part of portfolio management.

their primary provider is the more preferred option for portfolio management, up from 27 percent in 2013; and 33 percent of respondents believe professional money managers (18 percent) or objective third-party research platforms (15 percent) are the best option. Though the individual advisor remains the key touchpoint for clients, the brand advisors affiliate with, and the resources that brand provides, are becoming a more important part of portfolio management. Emphasizing these benefits and the level of collaboration that goes into portfolio construction and management will help with client trust and retention.

Models aren't an all-or-nothing proposition. Model providers also should highlight that models do not need to be an all-or-nothing proposition. It is difficult for advisors, especially established and successful ones, to completely change their value proposition and give up portfolio management. However, there are ways for advisors to implement models into their businesses and reap the benefits that they provide. One way to do this is through a core-satellite approach, which allows for liability and strategist management on the part of the advisor. In another approach, firms can implement an "advisor sleeve," where a smaller percentage of the portfolio is managed by the advisor, supplementing the model core of the portfolio. Advisors can retain control, while still reaping the benefits of models in their practices.

SUMMARY

The role of model asset allocation provider offers asset managers an unparalleled opportunity to maintain their relevance, but it will require consistent efforts to realize the potential future addressable market. Asset managers and third-party strategists need to continue to work with their distribution partners to make models available and easy to use, as they also continue to help build advisor awareness about the benefits of models.

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