

ADDING VALUE IN MODEL PORTFOLIOS

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This article is relevant to financial professionals interested in model portfolios. WisdomTree ETF model portfolios are available only to financial professionals, through various portfolio platforms.

The use of third-party asset allocation model portfolios by financial advisors and RIAs is growing rapidly. Industry surveys¹ suggest that 53% of all advisors use prepackaged model portfolios in their overall investment solutions, and 28% plan to increase their use of model portfolios in the coming years. The reasons are varied, and include [increased operational efficiency](#) and delivering an investment solution that can help open up more time to spend in client-facing activities.

There are numerous approaches to building and managing model portfolios, but they can be summarized with the following spectrum:



Let's examine how each of these approaches seeks to add alpha, or value, in the portfolio management process:

1. **Low-cost² "pure beta" model portfolios:** Pure beta products, such as [cap-weighted](#) exchange-traded funds (ETFs), are designed explicitly to track the performance of an underlying index (e.g., the [S&P 500 Index](#) or the [Barclays Capital U.S. Aggregate Bond Index](#), an index used by bond traders, mutual funds and ETFs as a benchmark to measure their relative performance) gross of [expense ratios](#) and [tracking error](#). The manager of a pure beta portfolio, therefore, has only one potential alpha lever to pull—the asset allocation decisions. By "alpha lever" we mean portfolio decisions a manager can make in an attempt to generate outperformance relative to an underlying benchmark.

For example, suppose a global equity model was designed to be benchmarked to the [MSCI ACWI Index](#). The only source of potential alpha in a pure beta portfolio is to make allocation decisions that deviate from the regional and sector weightings of the benchmark, in this case, the MSCI ACWI Index. This is definitionally true since the underlying products are designed to track specific cap-weighted indexes. While this certainly can be a source of alpha, it is somewhat limiting.

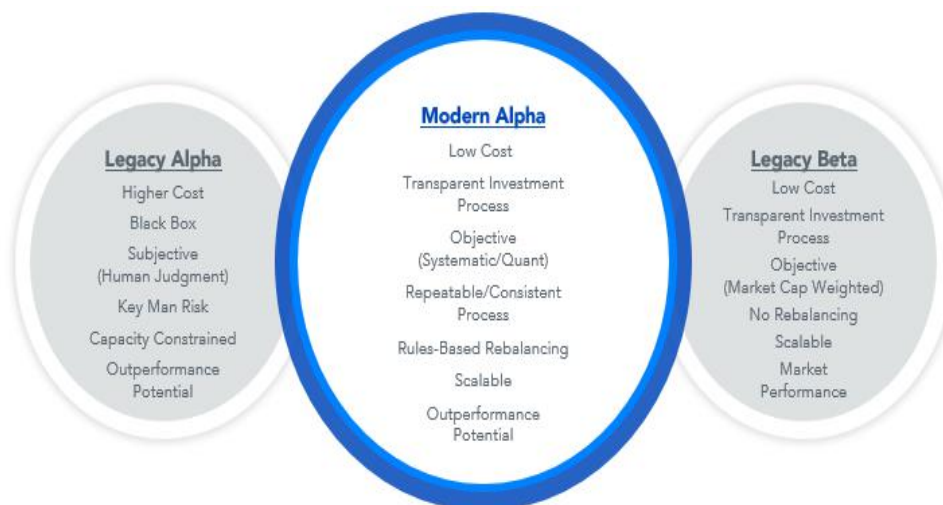
2. **All [active management](#) model portfolios:** In these portfolios, the manager has three potential alpha levers to pull:

1. **Asset allocation:** Similar to a pure beta portfolio, the manager can make allocation decisions away from the underlying portfolio index (in our example, the MSCI ACWI Index);
2. **Portfolio construction and security selection:** Unlike with pure beta portfolios, the manager can select different active management strategies to fit the manager's market views and the portfolio objectives; and
3. **Portfolio construction and security selection:** This, of course, is the potential allure of active management—the potential for the manager to deliver outperformance, net of fees and taxes.

3. **Core/satellite model portfolios:** These portfolios attempt to integrate the "best of both worlds" between the two extreme ends of the spectrum. In this approach, the manager typically builds an underlying core portfolio of low-cost cap-weighted ETFs and then surrounds that core with active management satellite strategies, typically mutual funds or separately managed accounts. The objective is to optimize the cost structure of the portfolio using

low-cost ETFs while retaining the potential for active management alpha.

WisdomTree Model Portfolios fall under the core/satellite approach, with some important distinctions. We refer to our approach as [Modern Alpha®](#), and it can be illustrated as follows:



Source: WisdomTree. *Ordinary brokerage commissions apply. Low cost represents lower expense ratio compared to higher priced investment options and ETFs.

Before describing the WisdomTree approach in more detail, it is helpful to remind ourselves of what active management *is*. An active manager is someone who takes explicit [factor bets](#) in the portfolio that are different (or in different weightings) than the underlying benchmark, and who charges an active management fee for taking those bets. A [value](#) manager takes value factor bets, a [dividend](#)-focused manager tries to identify the optimal dividend-paying securities and so on.

WisdomTree attempts to optimize the core/satellite approach, using [four](#) potential alpha levers:

1. **Asset allocation:** Taking regional and sector bets that deviate from the underlying portfolio benchmark;
2. **Portfolio construction and security selection:** As an “open architecture” portfolio manager, we deploy both WisdomTree and third-party strategies in an attempt to deliver an optimal mix of *asset class* and *risk factor* [diversification](#), to provide potentially more consistent performance through full market cycles; and
3. **Factor tilts:** Like more traditional active managers, all WisdomTree products have built into them explicit factor tilts, except cap-weighted. Our products, by design, are not cap-weighted. Depending on the product, they are all tilted to one or more risk factors—[size](#), [value](#), dividends, earnings and [quality](#) (i.e., strength of balance sheet, stability of earnings, higher operating margins, etc.). Most WisdomTree products are designed to track customized indexes that we create ourselves using sophisticated and algorithmic filtering and security selection protocols. Our products have the potential to deliver performance alpha over cap-weighted indexes, similar to active management, but in a disciplined and rules-based manner; and
4. **Cost and tax efficiency:** Because all WisdomTree models deploy only ETFs, we believe we add [significant cost and tax-efficiency](#) alpha versus the more traditional core/satellite portfolios that use actively managed mutual funds.

In summary, we believe that with our Modern Alpha approach, WisdomTree has “built a better mousetrap” with respect to outsourced model portfolios. We pull all potential alpha levers to potentially optimize portfolio performance, consistency, cost and tax efficiency.

More financial advisors and RIAs are adopting outsourced model portfolios into their practices as they seek to deliver an institutional-quality investment solution in a cost- and operationally efficient manner. The WisdomTree Model Portfolios allow these advisors to focus on core competencies, maximize client-facing activities and deliver a differentiated end-client experience.

¹Ignites Research, “Modernizing National Accounts Strategy for Model Portfolios,” , October 2019.

²Ordinary brokerage commissions apply. Low cost represents lower expense ratio compared to higher priced investment options and ETFs.

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You cannot invest directly in an index.

DEFINITIONS

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Expense ratio : The annual fee that all funds or exchange-traded funds charge their shareholders

Tracking Error : Can be discussed as both the standard deviation of excess return relative to a specific benchmark, or absolute excess return relative to a specific benchmark.

MSCI ACWI Index : A free-float adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets.

Active manager : Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

Factor : Attributes that based on its fundamentals or share price behavior, are associated with higher return.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

Dividend : A portion of corporate profits paid out to shareholders.

Diversification : A risk management strategy that mixes a wide variety of investments within a portfolio.

Size : Characterized by smaller companies rather than larger companies by market capitalization. This term is also related to the Size Factor, which associates smaller market-cap stocks with excess returns vs the market over time.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over time.