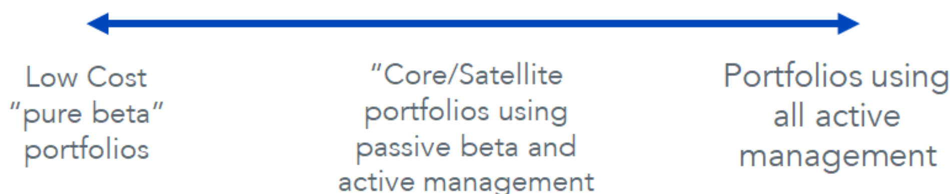
ADDING VALUE IN MODEL PORTFOLIOS

Scott Welch — Chief Investment Officer – Model Portfolios
04/01/2020

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 surveys[1] 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 operatio nal 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-cost[2] "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 Barcl ays 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.

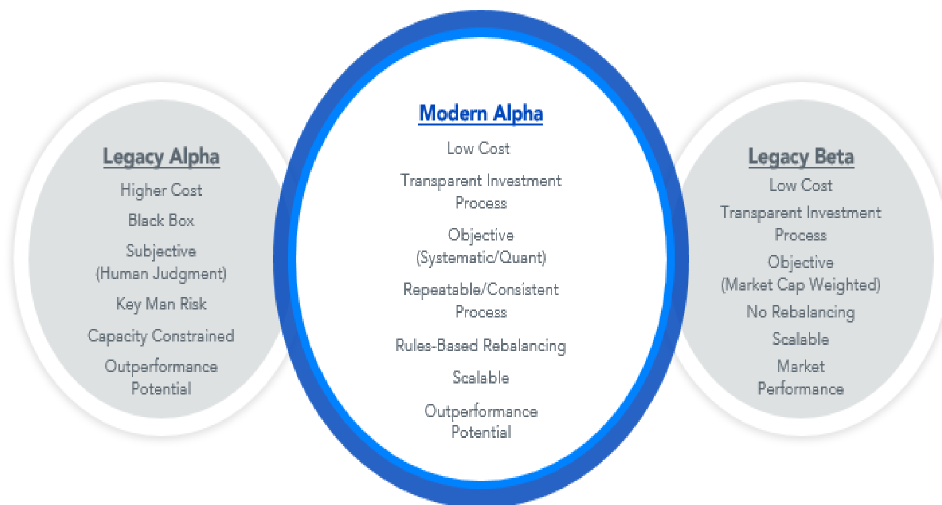
2. **All active management model portfolios:** In these portfolios, the manager has three potential alpha levers to pull:

   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.

[1]Ignites Research, "Modernizing National Accounts Strategy for Model Portfolios,", October 2019.

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

Important Risks Related to this Article

This content is for information only and is not intended to provide, and should not be relied on for, tax, legal, accounting, investment or financial planning advice by WisdomTree, nor should it be considered or relied upon as a recommendation by WisdomTree regarding the use or suitability of any model portfolio or any particular security. This content is intended for use only by a financial advisor as a resource in the development of a portfolio for the financial advisor's clients. The financial advisor is solely responsible for making investment recommendations and/or decisions with respect to its clients without input from WisdomTree, including with respect to investing in accordance with any model portfolio or any particular security. WisdomTree is not acting in an investment advisory, fiduciary or quasi-fiduciary capacity to any financial advisor or its client and is not providing individualized investment advice to any financial advisor or its client based on or tailored to the circumstances of any individual financial advisor or its individual client.

This content has been prepared without regard to the individual financial circumstances and objectives of any investor, and the appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. Investors and their advisors should consider the investor's individual financial circumstances, investment time frame, risk tolerance level and investment goals. Investors should consult with their own advisors before engaging in any transaction. Using an asset allocation strategy does not ensure a profit or protect against loss, and diversification does not eliminate the risk of experiencing investment losses. There is no assurance that investing in accordance with a model portfolio's allocations will provide positive performance over any period. The model portfolios are provided "as is," without any warranty of any kind, express or implied. Information and other marketing materials provided to you by WisdomTree or any third party concerning a WisdomTree model portfolio, including allocations, performance and other characteristics, may not be indicative of an investor's actual experience from an account managed in accordance with a model portfolio's strategy.

This content, and any assistance provided as described herein, including portfolio construction and asset allocation stress testing, assessments, discussions, output or other assistance (whether by WisdomTree personnel or digital tools) (the "Assistance Tools") are for information only and no material or Assistance Tools are intended to provide, and should not be relied on for, tax, legal, accounting, investment or financial planning advice. This content and the Assistance Tools are intended for use only by a financial advisor as a resource in the development of a portfolio for the financial advisor's clients.

Neither WisdomTree Investments, Inc., nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax advice. All references to tax matters or information provided in this material are for illustrative purposes only and should not be considered tax advice and cannot be used for the purpose of avoiding tax penalties. Investors seeking tax advice should consult an independent tax advisor.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our Economic & Market Outlook

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Kara Marciscano, Jianing Wu, Brian Manby and Scott Welch are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

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 tim.

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 tim.

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 tim.