

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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