John Hancock Investment Management

Building better outcomes

Dispelling common myths of model portfolios

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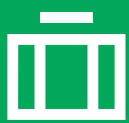
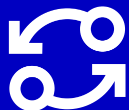
Four common myths of moving to a models-based practice

Model portfolios represent a huge growth area for our industry. Broker-dealers encourage advisors to transition to models in order to streamline their investment process; which in turn will help them free up time to spend with clients and enable them to grow their practices.

However, there are common myths and misconceptions associated with model portfolios that are preventing some advisors from utilizing models.



Myth 1
My clients work with me because they want me to act as CIO



Myth 2
Using models will not add tangible benefits to my practice

Myth 3
Transitioning to models will be an exhaustive and time-consuming process

Myth 4
Transitioning to models is an "all or nothing" proposition for my business

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Myth 1:

My clients work with me because they want me to act as CIO

But do they? In 2021, Cerulli asked investors to rate 16 individual factors in terms of importance when choosing a financial advisor.

We can bucket these factors into 2 groups – relationship management and portfolio management. The first 2 factors fall into the relationship management category:

Relationship Management

1. Transparency in interactions
2. Holistic approach - understands your needs, goals, and risk tolerance

Your clients value these factors the most. The second group, factors ranked 3-5 fall into the portfolio management category:

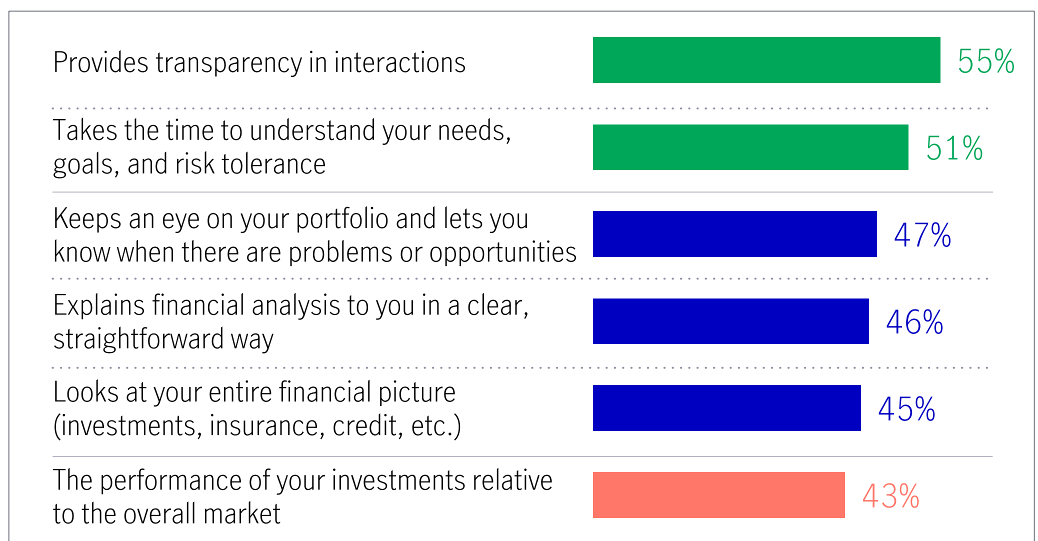
Portfolio Management

3. Keeps an eye on your portfolio
4. Explains financial analysis
5. Looks at entire financial picture

While important, these factors come in second place in your client's eyes. Investors are valuing customized advice above all else when choosing a financial advisor.

Factors rated extremely important in choosing an advisor

This survey suggests that your clients want you spending more time with them trying understanding their unique situations, and less time on portfolio management.



Source: Cerulli, "U.S. Retail Investor Advice Relationships 2021"

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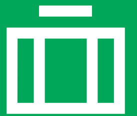
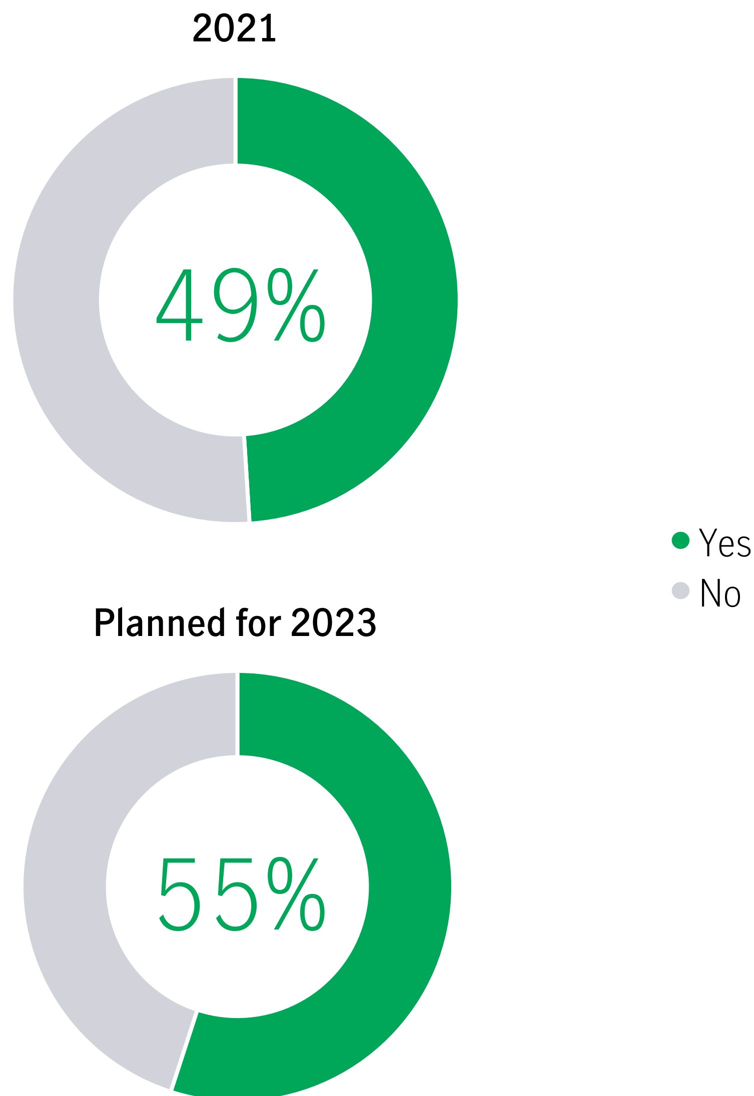
As a result, the advisor value proposition continues to shift toward financial planning



More advisors are making the move to a practice focused on planning. According to a Cerulli study from 2021, of the advisors surveyed, 49% of their clients were receiving financial planning in 2021, and that's projected to grow to 55% in 2023.



Source: Cerulli, "U.S. Adisor Metrics 2021"

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Myth 2 :

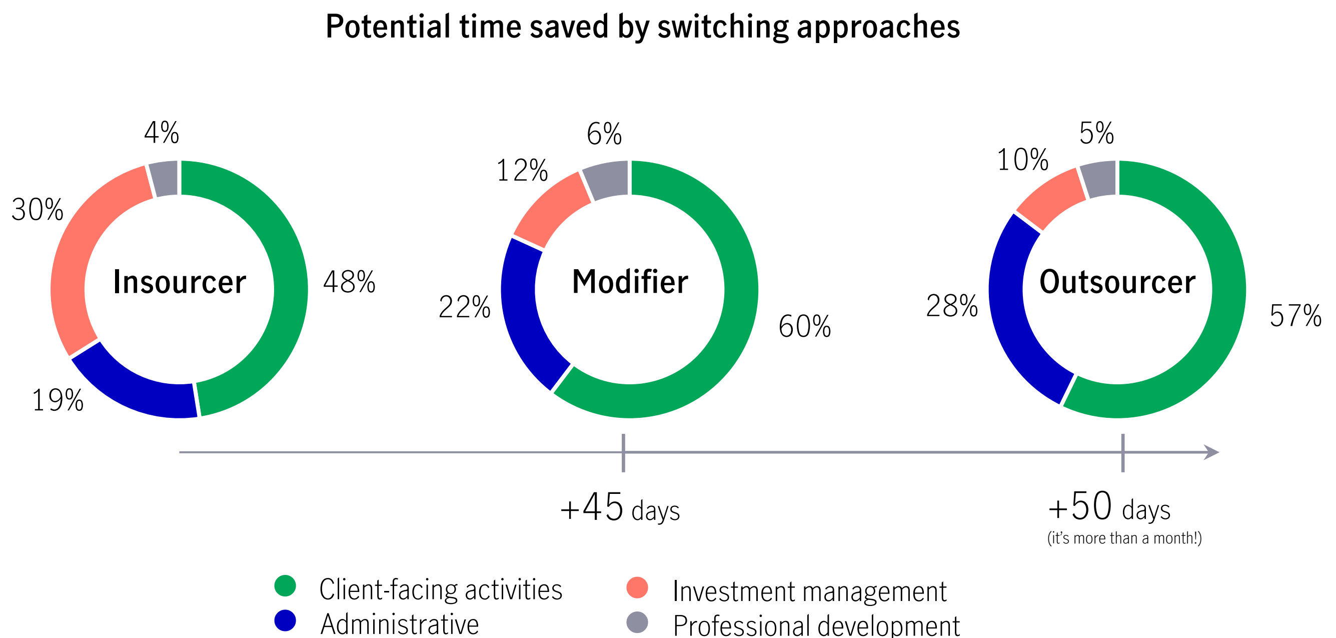
Using models will not add tangible benefits to my practice

Actually, tangible benefits include increase in time, assets, personal income, and a decrease in operating costs.

How much time will you get back if you use model portfolios?

In 2021 Cerulli conducted a study to see how advisors using the three approaches to portfolio management – insourcing, modifying and outsourcing – spend their time across four areas: client-facing activities, administrative duties, investment management and professional development. The pie charts show what the breakdown looks like.

Potential time saved by switching approaches



What can you do with 50 additional days each year?

- Deliver more advanced planning services
- Prospect for new clients
- Translate to actual cost savings

What if you move from one approach to another, how much time will you get back over the course of the year?

- If you move from insourcer to modifier, on average you can expect to get back 45 additional days each year.
- If you move from insourcer all the way to outsourcer, you can expect to get back 50 additional days each year.

Think about what can be accomplished with this additional time – deepening existing client relationships, growing your practice, adding new clients, or translating it into actual cost savings.

Source: Cerulli, "U.S. Asset Allocation Model Portfolios 2021"

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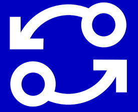
The tangible benefits of using models



What happens to asset levels, personal income, and operating costs if you employ models in your practice?

The below chart shows the result of an AssetMark study called the “Impact of Outsourcing”, and it further helps to quantify the tangible benefits that models can bring to your practice. The survey grouped advisors by the level of AUM outsourced:

	20-49% of AUM Outsourced	50-89% of AUM Outsourced	90-100% of AUM Outsourced
Increase in Total Assets	21%	26%	41%
Increase in Personal Income	17%	25%	47%
Decrease in Operating Costs	13%	16%	25%

Advisors who outsourced 90-100% of their AUM were able to grow, on average, their total assets by 41%, and their personal income by 47%.

Source: AssetMark: "The Power of Outsourcing Investment Management," 07/2020

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Myth 3:

Transitioning to a models-based practice will be a time-consuming process

While some time is required, your biggest decision is up front when choosing model managers. Creating a streamlined model due diligence process will make transitioning more efficient.

After a manager(s) is chosen, only periodic oversight is required, so it's critical that you choose correctly from the outset. There are four key factors to consider when evaluating third-party model managers.

- **Asset allocation credentials:** Since asset allocation is a key driver of total return, it's important to verify that the manager has a long and successful track record of managing asset allocation portfolios. What types of asset allocation portfolios are currently managed? How has the manager performed during prior market cycles and large drawdowns? These are just a few questions to ask. In addition, Morningstar provides analyst ratings and analysis on many asset managers in the universe. These ratings and analysis can function as an unbiased check on your own research.
- **Open or closed architecture**: Closed architecture strategies typically contain only funds managed by the asset allocation provider – essentially all underlying strategies are under the same brand name. Open architecture/multi-manager strategies contain many underlying managers, typically from different firms across both active and passive approaches. Open architecture/multi-manager strategies provide greater diversification and reduce concentration risk relative to closed architecture strategies.
- **Fee structure**: Is there an overlay charge for asset allocation or is the asset allocation charge embedded in the underlying funds? Overlay charges tend to increase overall expenses.
- **Depth of the sales team**: When partnering with a model provider its important to understand what material is available to support your client conversations and business, such as value add material, periodic commentaries, and trade rationales.

Develop a checklist for manager due diligence

1 **Asset allocation credentials**
Asset allocation is a key driver of total returns

2 **Whether the model is open or closed architecture**
Multimanager diversification reduces concentration risk

3 **Fee structure**
Overlay charges increase expenses

4 **Depth of sales & service team**
Strong support builds business and provides a better client experience

Sample model provider due diligence checklist

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Model provider due diligence checklist

1 Characteristics and features
a) Asset allocation style – dynamic ___ , strategic ___
b) Objective – capital appreciation ___ , income ___ , downside protection ___
c) Tax sensitive – Y / N
d) Overlay fee – Y / N
e) Multimanager – Y / N
f) Exposure vehicles – mutual funds ___ , ETFs ___ , single securities ___

2 Expected performance blueprint
a) Performance benchmark – ________
b) Up / down capture – ___ / ___
c) Beta and relative risk – ________
d) Return objective and time horizon – ________

3 Asset allocation manager
a) Manager tenure and turnover – ________
b) Strategy / suite assets – ___ / ___
c) GIPS compliance track record – Y / N
d) Morningstar analyst rating – ________

4 Asset manager support
a) Commentary and trade rationale – Y / N
b) Investment outlook – Y / N
c) Practice management – Y / N
d) Business development – Y / N

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- Remember, when you research individual funds you should be performing this due diligence for every fund in the portfolio. With model portfolios, you only need to perform this due diligence on the model manager.

The investment process described above may change over time. The characteristics set forth above are intended as a general illustration of some of the criteria used in the multimanager process.

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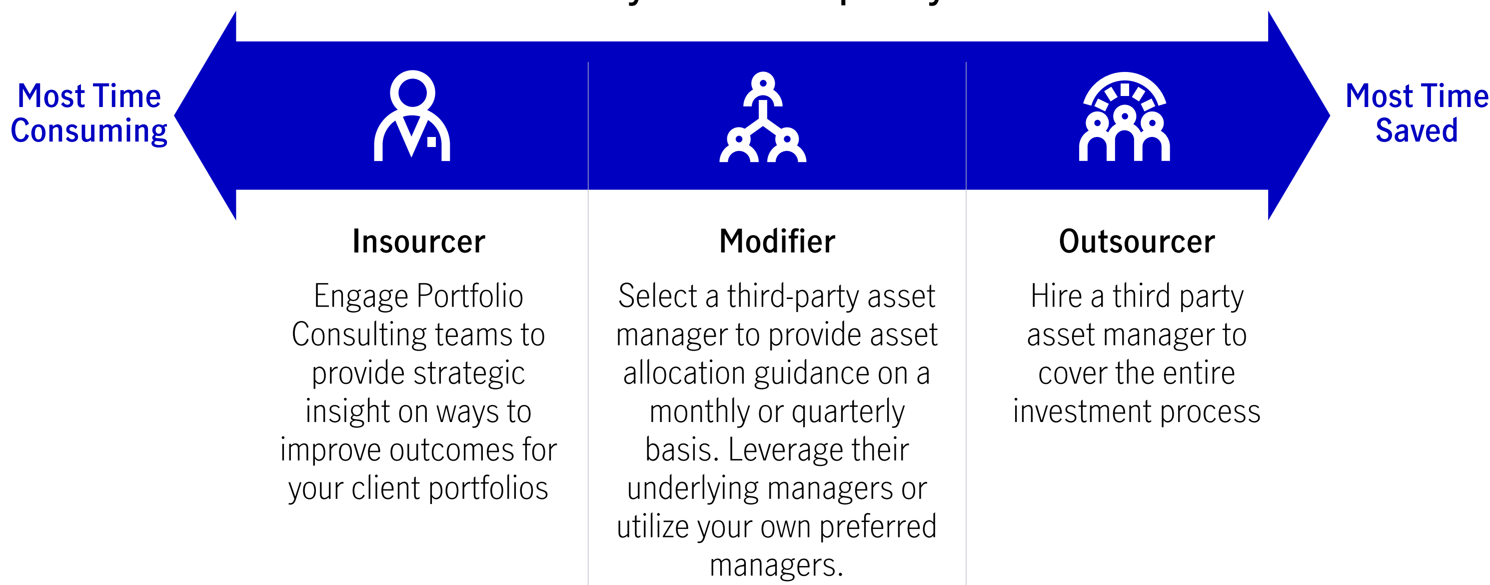
Myth 4:

Transitioning to models is an "all or nothing" proposition for my business

You're in charge! The degree to which you incorporate models is up to you.

The approach you choose depends on two factors – how involved you want to be, and how much time you want to spend on investment management. Of course, in every approach there will be some element of manager selection.

- If you choose the **insourcer** approach, many asset managers have internal Portfolio Consulting groups that offer an unbiased look at your in-house models. These teams can ensure that your models match up with intended risk tolerances, find opportunities to replace underperforming strategies to improve performance, and provide peer group benchmarks on characteristics like fees.
- If you choose the **modifier** approach, you will need to find a partner that can provide periodic asset allocation and manager selection on a monthly or quarterly basis. You can customize this approach, by tweaking the asset allocation or the manager selection to fit your outlook. Importantly, under this approach you will still be responsible for all operations, trading, and portfolio maintenance.
- Through the **outsourced** approach, you can partner with a third-party manager to run all aspects of investments, you will only be responsible for choosing that manager, and ongoing due diligence.



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Implementing model portfolios in your practice

3 **Develop a communication plan.** Help clients understand the benefits of this new approach to them.

2 **Divide and conquer**. Design a plan to transition clients to models in groups based on assets, revenue, goals or sophistication.

1 **Decide what models-based structure best fits** the goals of your clients and your practice.

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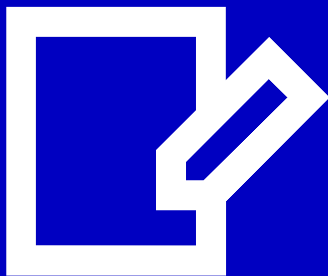
Case Studies



Income scenario

Tax sensitive scenario

Risk aware scenario

Team facing business transition scenario

Successful team looking to grow scenario

Case study

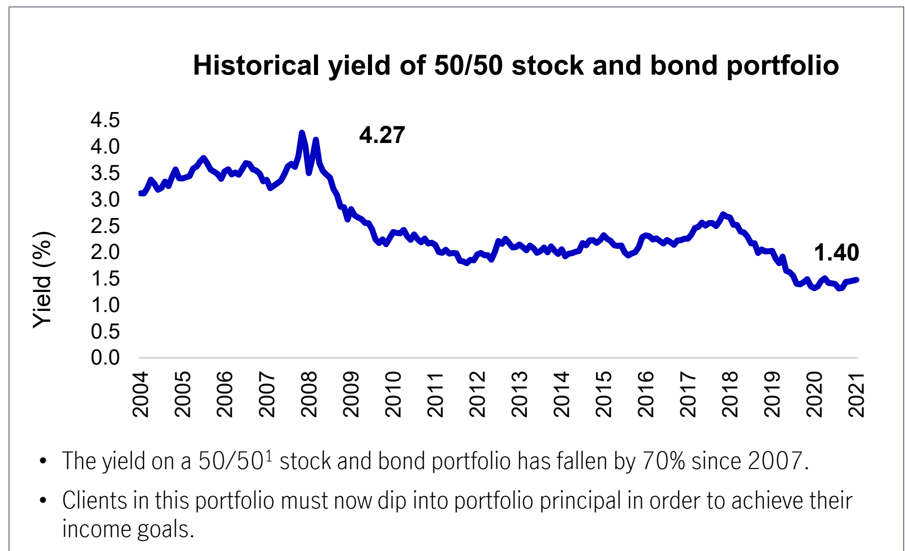
Income scenario

Established, successful team looking to outsource strategies where they do not have expertise

- Currently the team (either FAs and/or Analyst(s)) focuses on building target risk strategies designed for capital appreciation.
- Changing demographics within their client base have shifted goals from capital appreciation to income.
- Goal is to generate 3-4% net of fee income.
- Current construct allows clients in retirement to pull income off of a 50/50 stock and bond portfolio through dividends and principal.

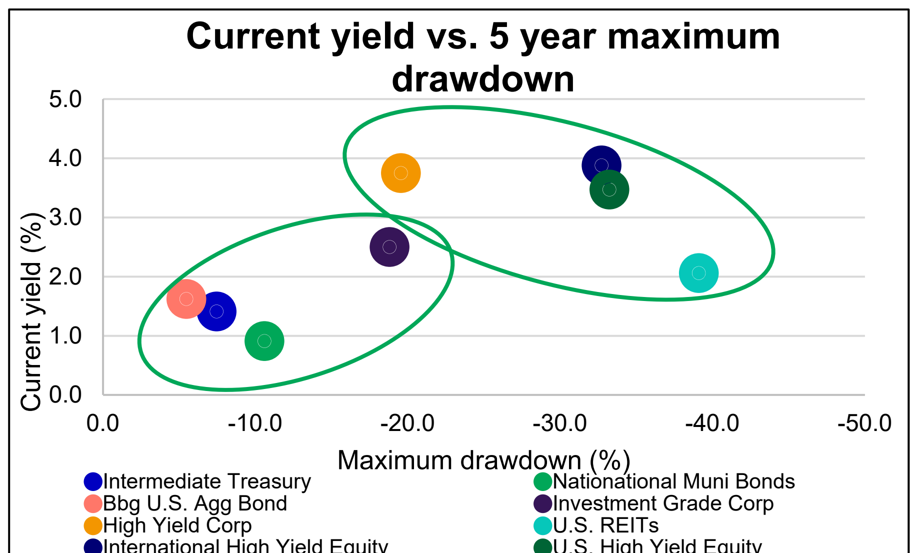
Challenge

- Current 50/50 portfolio no longer produces sufficient income.
- Team does not have the capacity or capability to identify and perform due diligence on income producing asset classes.
- Team does not have the right tools for optimizing income portfolios to achieve yield targets as well as dynamically manage the risk.



- The yield on a 50/50[1] stock and bond portfolio has fallen by 70% since 2007.
- Clients in this portfolio must now dip into portfolio principal in order to achieve their income goals.

Source: Morningstar, as of 12/31/2021.
[1]For the 50/50 portfolio, the equity allocation is represented by the S&P 500 Index, and the fixed income allocation is represented by the Bloomberg Barclays US Aggregate Bond Index. It is not possible to invest in an index. Past performance is not indicative of future results.



Source: Morningstar, as of 12/31/2021. Categories in chart are represented by the following indices: Intermediate Treasury (ICE U.S. Treasury 7-10 Year Bond Index), National Muni Bonds (S&P National AMT Free Muni Index), Bbg Barc US Agg Bond (BBgBarc US Agg Bond Index), Investment Grade Corp (Markit iBoxx Liquid IG Index), High Yield Corp (Markit iBoxx Liquid High Yield Index), U.S. REITs (DJ US Real Estate Index), International High Yield Equity (S&P Intl Dividend Opportunities Index), U.S. High Yield Equity (Morningstar Dividend Yield Focus Index). It is not possible to invest in an index. Past performance is not indicative of future results.

Solution

Outsourcing to a third-party model manager specializing in income portfolios can provide access to higher income sources with a risk-managed framework that allows client to pursue their 3-4% income goal without reducing principal.

Case study

Tax sensitive scenario

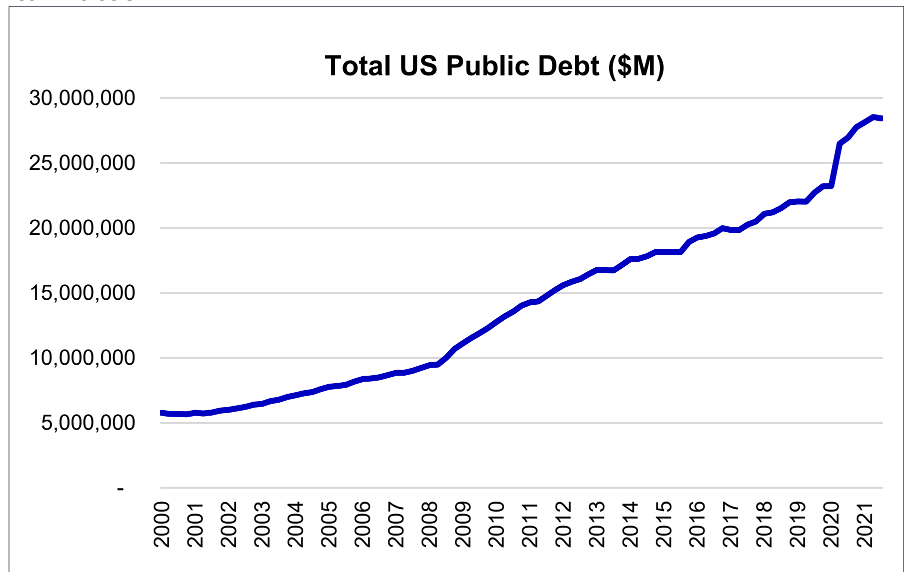
Established, successful team looking to outsource strategies where they do not have expertise

- Currently the team (either FAs and/or Analyst(s)) focuses on building target risk strategies designed for capital appreciation.
- Their higher-net-worth clients need tax sensitive strategies
- Goal is to reduce taxable income by increasing the tax efficiency of portfolios.
- Current construct uses mutual funds for equity exposure and a handful of individual municipal bonds for tax efficient fixed income exposure.

Challenge

- The team would like to increase the use of ETFs for tax efficient exposure but doesn't have the expertise to evaluate options.
- The team values active management and does not want to lose this feature by switching to an ETF, particularly in a rising rate environment.
- The municipal bond portfolio lacks diversification and rising rates will cause bond prices to fall although yields will increase.

Rapidly rising government debt may signal an increase in future tax rates



Source: Federal Reserve Bank of St. Louis, as of 12/31/21

Solution

Outsourcing to a third-party model manager specializing in tax-aware portfolios increased the tax efficiency of the equity portion of the portfolios by incorporating ETFs. Additionally, because the team valued active management, the model manager incorporated strategic beta strategies that seek to outperform market capitalization weighted benchmarks. On the fixed income side, the model manager added both investment grade and high yield bond mutual funds and ETFs to increase diversification and reduce interest rate sensitivity.

Case study

Risk aware scenario

Established team looking to outsource/bolt-on strategies
Risk aware scenario

- Currently the team (either FAs and/or Analyst(s)) focuses on building target risk strategies designed for capital appreciation.
- They want to add risk aware strategies to reduce risk for their conservative clients, particularly HNW clients concerned about capital preservation.
- Goal is to offer risk aware strategies to conservative clients that provide a relatively stable balance of risk/return potential over time.
- Current construct uses a strategic approach to asset allocation with marginal shifts within asset classes (value to growth, U.S. to international) and static allocations between equity, fixed income and alternatives.

Challenge

- The team does not have the portfolio construction tools to build portfolios that target specified levels of risk.
- The team does not have the capability to forecast return expectations that would inform shifts within asset classes and more importantly between asset classes.

Sample invest framework for asset allocation portfolios

Yet, many advisors lack the tools to carry out this research.

Build Expected Return Forecasts	• Forward-looking return expectations • Distinct equity and fixed-income forecasting approaches • Five-year time horizon • Correlation analysis
Asset Class and Strategy Selection	• Tailored search criteria • In-depth quantitative and qualitative analysis • Selection and ongoing monitoring
Portfolio Construction	• Proprietary optimization processes • Multiple quantitative and qualitative factors analyzed • Incorporate fundamental views • Ongoing active management
Risk Management	Ex-Ante • Embedded throughout the investment process • In-depth statistical analysis, forecasting, and review of client objectives Ex-Post • Ongoing portfolio reviews • (performance, exposures, attribution) • Constant evaluation of absolute and relative risks • Beta • Standard deviation • Information ratio • Tracking error • Upside and downside volatility

Source: Morningstar, as of 12/31/2020.

Solution

Outsourcing to a third-party model manager specializing in risk-aware portfolios provided conservative clients the piece of mind that their investments would be dynamically managed with the goal of pursuing capital appreciation while emphasizing active risk management.

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Case study

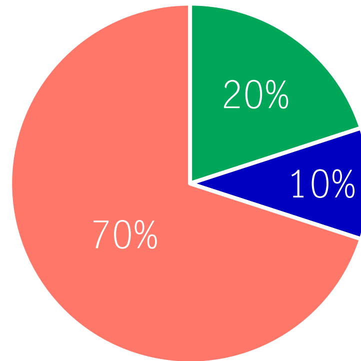
Team facing business transition scenario

- Junior partner recently left the practice to strike off on their own leaving the senior partner as a sole practitioner.
- Junior partner was the lead on portfolio construction/investment management while senior partner focused mainly on client facing activities, financial planning and managing the practice with an oversight role on portfolio construction/investment management.
- Firm AUM reduced by accounts junior partner took with him.

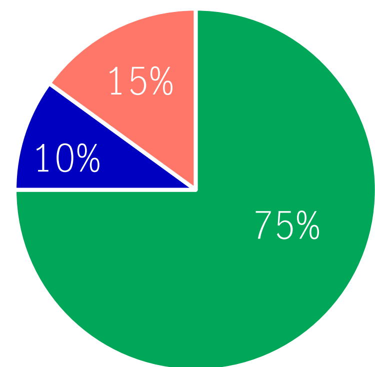
Challenge

- Senior partner must take on the portfolio construction responsibilities of the former partner.
- Senior partner must decide whether to bring on new junior partner or hire additional staff.
- Senior partner and clients are exposed in the interim from a risk/compliance perspective.

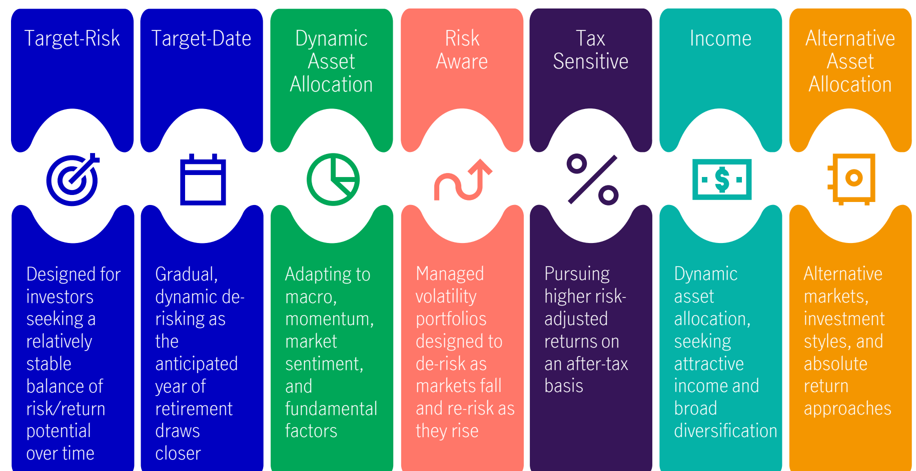
Junior Partner Time Allocation



Senior Partner Time Allocation



Client-facing | Admin | Investment management



Solution

- Rather than bring on a new team member, model portfolios were implemented to create a scalable investment solution across client accounts.
- Reduced the time needed for investment due diligence and portfolio construction.
- Significant time was saved on meeting preparation and compliance activities further reducing the time allocation to investment and administrative duties.
- Allows senior partner the time to consider next steps for the practice.

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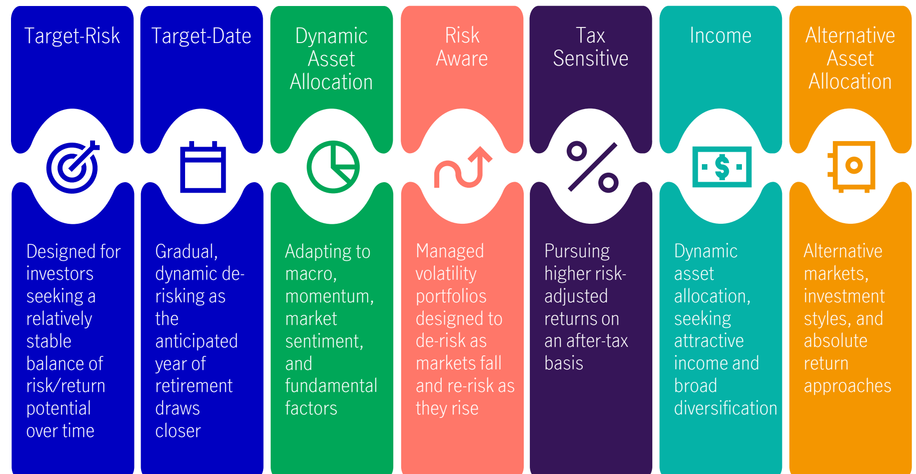
Case study

Successful team looking to grow scenario

- Successful team of advisors, research analyst(s), and customer service associate(s).
- Advisors are focused on client facing activities, client acquisition, financial planning, and oversight of investment analysts and portfolio construction with an increasing amount of time being spent on fiduciary risk and compliance.
- Research analyst(s) time is allocated to investment research, portfolio construction, client reporting, and trading operations.

Challenge

- Analysts are stretched and capacity is becoming an issue.
- Team wants to increase the advanced planning services they offer their clients.
- Realizing that working with the next generation of their client families is critical to asset retention, the team needs an effective solution for next gen accounts.
- Staffing decisions need to be made in order to continue to grow.



Solution

- Model portfolios were implemented as “bolt-ons” to outsource some of the investment management.
- Model portfolios were also implemented as the solution for next gen accounts.
- Team was able to bring on a financial planning associate so the Advisors could offer more advanced planning services.
- Use of model portfolios reduced some of the fiduciary oversight the advisors were engaged in allowing them to spend additional time on client acquisition to continue to grow the practice.

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What you should know before investing:

A portfolio's performance depends on the advisor's skill in determining asset class allocations, the mix of underlying funds, and the performance of those underlying funds. A portfolio is subject to the same risks as the underlying funds and exchange-traded funds in which it invests: Stocks and bonds can decline due to adverse issuer, market, regulatory, or economic developments; foreign investing, especially in emerging markets, has additional risks, such as currency and market volatility and political and social instability; the securities of small companies are subject to higher volatility than those of larger, more established companies; and high-yield bonds are subject to additional risks, such as increased risk of default. Liquidity—the extent to which a security may be sold or a derivative position closed without negatively affecting its market value, if at all—may be impaired by reduced trading volume, heightened volatility, rising interest rates, and other market conditions. Owning an ETF generally reflects the risks of owning the underlying securities it is designed to track, which may cause lack of liquidity, more volatility, and increased management fees. Hedging and other strategic transactions may increase volatility of a portfolio and could result in a significant loss. The principal value of each portfolio is not guaranteed, and you could lose money at any time.

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