Advisor Portfolio Construction

Building Risk-Conscious Portfolios

CERULLI ASSOCIATES

Research | Analytics | Consulting

About the Research

In summer 2019, Cerulli Associates was commissioned by Rafferty Asset Management, LLC, the advisor to Direxion ETFs, to interview advisors and professional users of ETFs (investment strategists and home-office due diligence functions) about their portfolio construction approach and use of ETFs. Cerulli held approximately 30 conversations with such users, which, in combination with data from surveys of thousands of advisors, provide a view into their allocation practices and preferences.

Summary

After a long run-up in equity markets and given low yields, advisors are focused on risk management—and specifically ensuring that clients avoid a permanent impairment of capital. Strategic asset allocations are increasingly important to these advisors, and they become less likely to make meaningful "tactical" shifts. Cerulli's research finds that advisors may not be fully appreciative of the active nature of some of their decisions, and that their ETF use may be overly reliant on their trust in a couple of the largest firms. Cerulli believes that advisors have the opportunity to expand product use to access more thoughtful exposures in a capital-efficient manner.

Our Key Findings

- Advisors are increasingly risk-focused and place the most emphasis on their strategic asset allocation.
- Strategic asset allocations are developed based on a mosaic of information, including home-office and third-party models as well as newspapers and trade publications.
- It's likely that advisors underestimate the active decisions that go into developing their strategic allocations. Despite stating they are not seeking alpha, advisors use factors, sectors, and international allocations to express views.
- Advisors are most likely to use inexpensive ETFs from a few of the most trusted brands to build a portfolio core, and they are cautious about using fixed-income ETFs and newer, non-passive ETF offerings due to liquidity considerations.
- It's possible that advisors' reliance on models, over-reliance on select brands, and liquidity concerns may be leading them to overlook more tailored ETF products.

Introduction

Take a peanut butter and jelly sandwich. A PB&J sounds simple enough to make, but a number of implicit decisions go into its preparation. Some will place peanut butter and jelly on separate pieces of bread and combine, while others will layer the jelly on top of the peanut butter. A chunky or smooth variety may be preferred—and the sandwich can be sliced vertically or diagonally. Keeping the crust is an entirely separate issue.

The process of advisors building portfolios is in essence similar to that of making the PB&J—advisors are likely to rely on inputs from various sources such as internal and external models as well as recommendations from others including asset managers (recipes), but the final product will be heavily dependent on their available product set (ingredients) as well as the advisor's skill (culinary training) and firm infrastructure and capabilities (kitchen tools). No meal, or portfolio, exists in a vacuum—it is shaped by the environment around it and particularly the palates and experiences of the community (whether hungry seven-year-olds or investors).

In summer 2019, when research calls for this white paper were conducted, the key attributes sought by advisors on behalf of investors were downside risk protection and diversification. After a decade-long run-up in markets and with yields at multigenerational lows—as well as speculation about outright negative rates—advisors were far less focused on excess returns and alpha generation. Instead, they were seeking to build portfolios designed to minimize losses and that clients would feel comfortable holding through fluctuating markets.

As advisors seek to guide investors toward their goals through uncertain markets and an environment of heightened scrutiny, it can be easy to overlook the role that active decisions play in the investment process. For example, in conversations with Cerulli, many advisors report they are passive investors, even while making implicit asset allocation decisions (*e.g.*, equity vs. fixed income and domestic vs. international) as well as factor tilts via their strategic allocations. Building client portfolios is an inherently active process.

For advisors who choose to build their own portfolios, Cerulli recommends that they embrace the role active decisions have in portfolio construction and, where appropriate, broaden the set of solutions they use. While the volume of data can sometimes be daunting, advisors have access to more information and investment options than ever before to help clients achieve their outcomes. This white paper explores how advisors build client portfolios, the tools they rely upon, and the investment vehicles and products they use.

ADVISORS' MOST FREQUENT CLIENT QUESTIONS ON INVESTMENT TOPICS, 2018

KEY POINT: **Clients are seeking income and safety.**

Investment Topic	All Advisors
Income generation	68%
Downside protection	67%
Impact of fees and expenses	47%
Tax efficiency	45%
Outperforming benchmarks	30%
Global diversification	22%
Inflation protection	20%
ESG/SRI	16%
Non-correlated investments	11%

Sources: Cerulli Associates, in partnership with the Investments & Wealth Institute (formerly IMCA) and The Financial Planning Association® (FPA®)

Analyst Note: Advisors were asked, "What investment topics have clients asked unsolicited questions about in the last six months?"

ESG/SRI refers to Environmental, Social, and Governance and Socially Responsible Investments

Everything Begins with Risk

The portfolio construction process takes many forms, but advisors always start in the same place: assessing a client's goals, and just as importantly, their risk tolerance. Across wealth tiers, an advisor's ability to effectively carry these conversations is often a fundamental component of the health and strength of their overall client relationships.

An often-cited reference point is determining how a client would respond to a 2008-type drawdown—understanding how a client will react during periods of calamity allows advisors to fulfill one of their primary responsibilities—helping their clients realize goals. When advisors have established a realistic assessment of a client's relationship to risk and volatility, they are better equipped to keep investors focused on their long-term objectives and avoid selling assets at the worst possible time and experiencing a permanent impairment of capital.

Advisors have extensive conversations and use both qualitative and quantitative methods to get to the heart of an investor's ability to take on risk—while also accounting for their cash needs. One advisor notes the importance of planning for specific transactions (*e.g.*, purchasing a boat, medical emergencies) that may not appear to be a reach relative to existing assets, but can become problematic should markets decline. One advisor explains the challenge aptly: **"When clients seek cash, they want it yesterday."**

Risk Management Toolbox

A number of software tools have emerged in recent years to support advisors in assessing investor risk tolerance. One such resource that advisors frequently cited in conversations with Cerulli is Riskalyze, which provides the client with a risk number that can be used to derive a broader allocation.

SOFTWARE USED BY ADVISORS

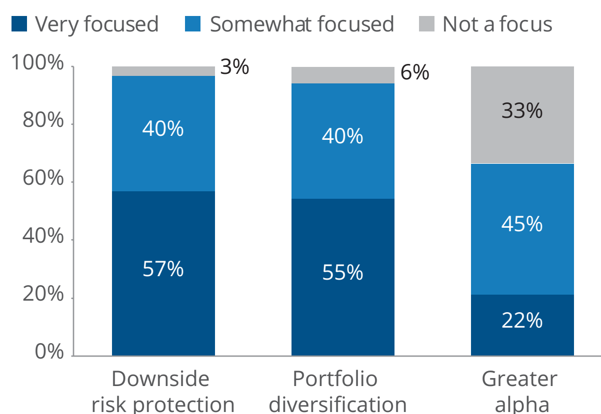
- **Riskalyze:** One of the most popular software solutions used by advisors who value its ability to assess a client's portfolio and provide a risk number.
- **eMoney (Envestnet) & MoneyGuidePro (Fidelity):** Personal financial planning and analysis software that is used by advisors to identify an investor's required rate of return, and to perform Monte Carlo simulations to identify portfolio sustainability, among other tasks.
- **Morningstar Advisor Workstation:** Assists advisors with researching investments as well as client reporting and communications.

Risk tolerance has always been at the heart of portfolio construction, but it appears even more relevant after a broad rise in equity markets and as yields remain low. Across its research, Cerulli notes a broad shift in what advisors are looking for from financial products. Specifically, advisors primarily seek downside protection and portfolio diversification (57% and 55%, respectively, report that they are very focused on these objectives), while alpha generation is a distant goal. The sentiment is also shared by advisors whom Cerulli interviewed, with one summarizing the issue succinctly: **"Alpha is neither a screen nor a criteria for us, so less importance is placed on it."**

> *"Advisors are more risk averse right now because they think recessions happen every five to 10 years, therefore, we are overdue. If you turn on Bloomberg, it's all about risk, which is making advisors risk averse. They're not experiencing irrational exuberance.*
>
> — **Strategist Perspective**

FINANCIAL ADVISORS' PORTFOLIO OBJECTIVES, 2018

KEY POINT: **Advisors are more than twice as focused on downside protection than alpha generation.**



Source: Cerulli Associates

Strategic Allocation Comes First

Once the risk tolerance for an investor has been identified, advisors shift their focus to identifying the asset allocation (largely driven by the equity vs. fixed-income split) that they recognize will drive the client's investment performance. Cerulli research finds that the vast majority of advisors use a strategic allocation approach, either with or without a tactical overlay. The importance that the strategic asset allocation decision plays in an advisor's portfolio cannot be overstated—especially as advisors seek to protect client portfolios (as opposed to generate alpha via tactical shifts) and home offices nudge advisors away from an investment selection role.

When asked, advisors often share that they create custom portfolios for each of their clients, but a far smaller portion actually do so. For large practices that can dedicate personnel specifically to investment management or for smaller practices committed to limiting their client base to a manageable size, building truly bespoke portfolios and using more complex portfolio construction strategies (*e.g.*, absolute return, risk budgeting) is feasible. The reality, however, is that for most practices, a balance must be struck between customization and scalability.

In its latest research, Cerulli finds that only one-quarter of advisors create custom portfolios for each client, while the remainder rely on models developed by their practices, home offices, or third parties. For advisors who choose to build practice-level models, combining the repeatability of strategic allocations

ADVISOR USE OF MODELS, 2018

KEY POINT: Most advisors seek a balance between building custom portfolios and the scalability afforded by model use.

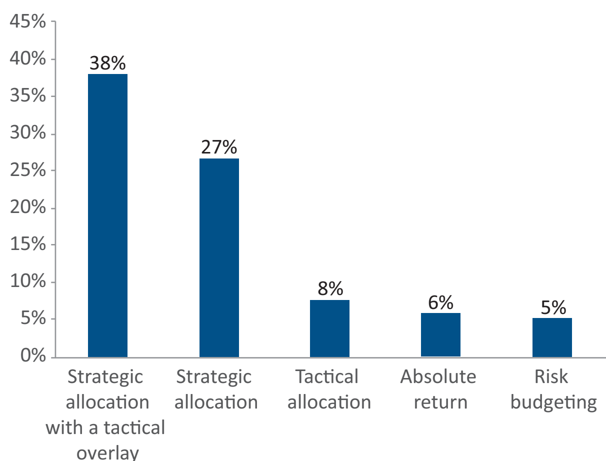
Portfolio Construction Process	Main Influence	All Advisors
Create custom portfolio for each client	Practice	23%
Start with models developed by practice and alter as necessary	Practice	20%
Use models developed by practice	Practice	19%
Start with models suggested by B/D or custodian and alter as necessary	B/D or custodian	19%
Use models suggested by B/D or custodian	B/D or custodian	6%
Start with third-party provider models and alter as necessary	Third party	7%
Use third-party provider models	Third party	6%
Total practice influence		**62%**
Total B/D or custodian influence		**25%**
Total third-party influence		**13%**

Sources: Cerulli Associates, in partnership with the Investments & Wealth Institute (formerly IMCA) and The Financial Planning Association® (FPA®)

with the added active management of tactical overlays creates an efficient way to better ensure consistency of client experiences while also adding value situationally. **Advisors are most likely to report using a strategic allocation with a tactical overlay portfolio construction approach (38%), while a much smaller portion uses other approaches such as tactical allocation (8%).**

TOP PORTFOLIO CONSTRUCTION STRATEGIES, 2018

KEY POINT: Two-thirds of advisors use strategic allocations when building portfolios.



Sources: Cerulli Associates, in partnership with the Investments & Wealth Institute (formerly IMCA) and The Financial Planning Association® (FPA®)

A Mosaic of Models and Information

Advisors are not limited to using only one set of models—they may place the greatest weight on those developed by the practice or firm, for example, but also accept the recommendations of trusted asset managers such as BlackRock and J.P. Morgan. A number of advisors report that they find explanatory information from asset managers helpful even if they do not entirely depend on these firms' models. One advisor suggests that, **"When large asset managers fine-tune models, we are very interested about why they are making that particular shift."** During the 2016 election, for example, BlackRock was prepared with a model reallocation scenario in the event of a Trump victory and was quickly able to both implement changes and communicate the reasoning to tens of thousands of advisors immediately after. It's helpful for advisors to have contextual information behind the shifts so that they can gain comfort with the reasoning and, when necessary, explain the shifts to clients.

WHAT INFORMATION SOURCES DO ADVISORS RELY UPON?

- Asset manager research and publications (*e.g.*, J.P. Morgan Guide to the Markets)
- Newspapers and magazines: *Wall Street Journal*, *The Economist*, *Financial Times*
- Trade publications and websites (*e.g.*, WealthManagement.com, AdvisorPerspectives.com, Asset TV)
- Twitter

Cerulli finds that despite the growing importance of models, advisors use a mosaic approach to develop their strategic asset allocations to the extent that they use a wide variety of information from different sources (model recommendations, but also industry sources and publications) to make decisions. Indeed, despite the growing reliance on models, the portfolio construction process remains unique to each advisor—they are likely to begin with different baseline allocations and their perceptions of markets will be shaped by the various resources that they rely upon.

Asset Allocation Is More Active Than It Appears

When Cerulli discusses tactical positioning with advisors, a recurring theme is advisors' unwillingness to shift away from their strategic asset allocations in search of alpha—risk management is front and center for the advisors and they are uninterested in making shifts that take them away from their carefully designed strategic positioning. When advisors do make tactical changes, the shifts (*e.g.*, underweighting or overweighting) are reported to be relatively small —one advisor references shifting portfolios from international to U.S. by 1% last year, noting that even this is rare. Cerulli doesn't consider this an exception —and believes this is attributable to a fear of making an incorrect move and losing clients or even exposing themselves to liability, especially in an uncertain regulatory and internal compliance environment. This trend is also evident in the increased use of multifactor products. Cerulli believes that growing advisor use of multifactor ETFs is indicative of advisors' interest in gaining exposure in line with their strategic asset allocations while making small factor tilts as recommended by asset managers that they know and whose research they trust—in effect offloading responsibility.

Within the strategic asset allocation component, however, Cerulli finds that several discrepancies exist with how advisors add or subtract risk—in turn amounting to active management.

- Advisors may tilt their portfolios toward specific factors to customize the portfolio or enhance performance, but they likely don't perceive this as adding risk. Cerulli notes that greater returns cannot be achieved without greater risk—even if the risk is that of missing out on a gain and not that of a greater loss (*e.g.*, low-volatility strategies).
- Similarly, while some advisors use factors to express views, others may choose to add or subtract sector exposure to achieve the same objective. The energy sector can be perceived as cyclical while healthcare is countercyclical and defensive, for example. The decision of using sectors to express views is an active one even if the products themselves are passive.
- While some advisors may view international investments as a necessity to providing a well-balanced portfolio or diversifying, others view international investing as risk-on behavior. Politics may play into the decision as well—one advisor mentions that many of his clients are averse to holding non-U.S. equities because of their perception of foreigners.

KEY INSIGHT

12%

While a small percentage of advisors (12%) will rely on models developed outside their practice entirely, the risk focus of the remaining advisors suggests that they should be aware of the active nature of their portfolio construction process, and seek to use investment tools that allow them to best express their views in the most capital-efficient manner.

Source: Cerulli Associates, 2018

ETF Use Largely Remains Passive

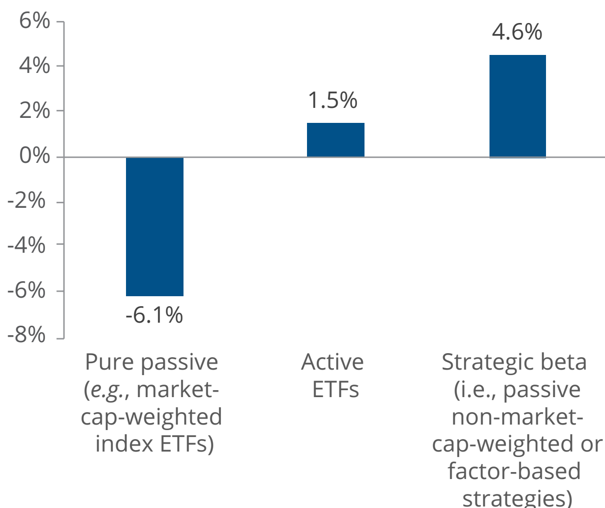
In conversations with Cerulli, advisors consistently state that they seek to lower the underlying expenses to the end-client as much as possible when building portfolios. Following the financial crisis, the swirl of attention that surrounded the industry focused heavily on the fees that investors pay. This has evolved from the now-defunct Department of Labor (DOL) Conflict of Interest Rule into the SEC's Regulation Best Interest (Reg BI). While Reg BI began facing challenges in fall 2019, the message to advisors since the recovery has been a consistent one: advisors need to be prepared to defend their investment decisions, especially when there's a less expensive option available.

> *"When I choose investments, fund expenses are really important, those expenses are a big return impact and people are already paying me so I need to limit the rest as much as possible.*
>
> **Advisor Perspective**

Even though mutual funds are still the most commonly used investment products, ETFs have steadily been increasing their share of client portfolios. In 2018, advisors allocated approximately 14% of their portfolio holdings to ETFs and expect to increase these allocations by almost one-third through 2020. The trend is also reflected in relative flows—in the first half of 2019, ETFs gathered 50% more in inflows than their mutual fund counterparts. The shift to ETFs has been accelerated by active managers' struggles in recent years as the increasingly broad-based nature of the recovery has made it harder to beat passive offerings. As one advisor frames it, **"The evidence says that it's hard to beat the index and it costs a lot to do so."**

ADVISOR-REPORTED ALLOCATION TO ETFS BY PRODUCT TYPE, 2018 VS. 2020E

KEY POINT: **Advisors plan to gradually use more active and strategic beta ETFs.**



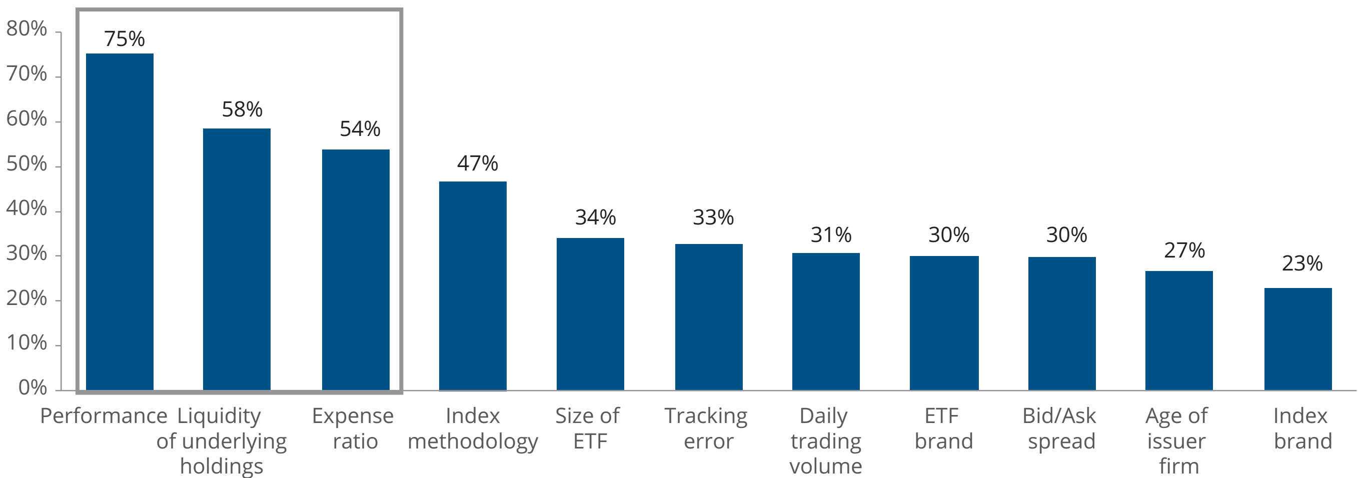
Sources: Cerulli Associates, in partnership with the Investments & Wealth Institute (formerly IMCA), and the Financial Planning Association® (FPA®)

At the highest level, advisors share that they are more likely to use active strategies and mutual funds in retirement accounts while preferring to use ETFs for nonqualified assets to take advantage of their tax efficiency. They are also more likely to take the active route for fixed-income solutions and asset classes seen as less efficient (*e.g.*, emerging markets, domestic small-cap equity). Fee-only advisors are far more likely to use ETFs than commission-based ones. Despite increased use of passive strategies, advisors are still using active and factor-based strategies as long as they feel they are priced appropriately.

Advisors' willingness to combine active and passive solutions has helped drive the development of new ETF offerings in recent years, when asset managers have sought to use the product to arm advisors with new tools. In 2018, fund companies launched 239 ETFs—and as the passive landscape has become largely saturated, 56% of the new products were either active or factor-based strategies. The SEC's approval of non-transparent active ETFs will only broaden the types of offerings being launched, even if the rate of new offerings coming to market slows. Still, Cerulli notes that most advisors who use ETFs use them for passive options and while use of non-passive ETFs is growing, adoption has been slow.

IMPORTANCE OF ETF ATTRIBUTES, 2018

KEY POINT: **Advisors focus on liquidity and cost.**



Source: Cerulli Associates

Advisors Over-rely on Brands as Proxies for Quality

When asked about the factors that influence the selection of ETFs, advisors report placing the heaviest emphasis on performance, liquidity, and cost. These factors have unquestionably contributed to the dominance of a select group of players in the ETF market. In 2018, the three-largest ETF sponsors represented 82% of all ETF assets. This marketshare figure jumps to 90% when expanded to the top five. The largest sponsors have reaped the benefits of first-mover advantage by rapidly attracting assets in what was historically a passive space. Their resulting scale has granted them incredible pricing power. Just 30% of advisors report finding brand a very important consideration—but the previously mentioned advantages have firmly entrenched these fund families in the minds of both advisors and investors.

Some of these new products have offered relatively strong performance since inception; however, the fact that these results have been generated during what has now become the longest recorded U.S. bull market leaves uncertainty as to how they perform both in periods of volatility and for when the market experiences a true bear market. Questions of scale and liquidity become inextricably linked to these concerns. When discussing their hesitance to explore newer ETF offerings, advisors frequently return to memories of headline-grabbing swings generated by VIX ETFs in early 2018 and the performance of exchange-traded notes (ETNs) during the financial crisis. This is in spite of the fact that newer offerings represent a range of exposures and risk profiles that are not reflective of prior products.

While being able to point to lengthy track records is valuable, advisors risk missing out on key contributions that newer tools provide. It is critical to implement risk management strategies before they are needed, not after. As one advisor states, **"Putting on your seatbelt after the accident doesn't do you any good."** These issues in timing, however, play out frequently across product types and sectors. Numerous studies have shown that clients and advisors alike can make the error of hiring managers right at the peak of performance—just as strategies begin to lag—and, conversely, firing them just as they are coming back into favor.

KEY INSIGHT

Cerulli believes that advisors use brands as a proxy for liquidity and cost characteristics that they define as most important. In turn, **this reliance can result in use of products that are not optimized** to these advisors' specific needs.

Though many advisors express interest in learning more about new investment solutions, they are also frank about lacking the time to dedicate toward researching and understanding them. In 2018, advisors reported dedicating just 11% of their time to investment research, due diligence, and monitoring. The balance of their time was allocated to crucial client-facing activities (55%) and administrative responsibilities, including actual trading and rebalancing. This can make it particularly challenging for practices that don't have specific personnel dedicated to investment management to sift through the wealth of options now available. Taking the time to learn how different strategic beta and active ETF offerings within portfolios can allow advisors and clients to reap the benefits of the strategies in the periods when they are truly capable of adding value.

> *"In an era of low forecasted returns, the idea of capital efficiency comes into play. From a bang for the buck perspective, there's value in giving investors more thoughtful exposure to return streams that they want.*
>
> — **Strategist Perspective**

Conclusion

Through interviews with advisors, Cerulli finds a divergence between their goals and how they implement investment decisions. Advisors are extremely risk-focused at this stage of the market cycle, and their portfolio construction process largely relies on the implementation of a strategic asset allocation—often by outsourcing the most impactful decisions to home-office gatekeeping functions and asset managers they trust most. However, selecting and implementing a strategic asset allocation still consists of active decisions.

Opportunity exists for advisors to enhance their portfolio construction approach and toolset:

- Advisors have increasingly gravitated toward products from the largest ETF sponsors, but offerings from other providers may allow them to express specific views in a more targeted manner and build portfolios that better meet client objectives.
- The current market environment has made advisors exceptionally risk focused, a sentiment that is unlikely to fade, however being risk aware should not prevent advisors from building portfolios that can perform well in different market environments.
- Advisors should assess the full array of tools available to them, including factor-based and outcome-oriented strategies, as well as products with embedded capital efficiency to identify how to best achieve the optimal outcome for their clients.

Cerulli believes that advisors should exercise increased awareness of the active decisions involved in the portfolio construction process. With those insights, they can consider more tailored investment products for the purposes of best expressing their investment views. In selecting products, advisors should evaluate additional solutions—beyond the most common passive and strategic beta ETFs—for the purposes of accessing the unique exposures they seek, and at times be willing to go against the grain to differentiate their process and add value to client portfolios.

Glossary

Term	Definition
Alpha	Outperformance of an investment product versus an appropriate benchmark.
Bid/Ask Spread	The difference between the prices at which a security is being offered for sale (ask price) and for purchase (bid price). More liquid products will have tighter bid-ask spreads.
Liquidity	The ability to buy or sell a security without impacting its price—often measured via shares traded (volumes) and bid-ask spreads.
Volatility	The standard deviation of investment returns over a specified time period—one measure of risk for a financial product. Investors may find a higher-volatility product (whose price changes significantly) more difficult to stay invested in, but lower-volatility products may harm the investor's ability to meet long-term objectives.
Tracking Error	Divergence of the performance of an investment product and the underlying benchmark to which it is meant to provide exposure or track.

Investing involves risk including possible loss of principal.

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