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A model for the future: How model portfolios may increase satisfaction and generate net new assets

Model portfolios versus advisor-built portfolios? Which one wins?

Done correctly, model portfolios—sometimes called model strategies—are comprised of a variety of underlying mutual funds to provide exposure to stocks, bonds, and alternative investments. Built for investors at any life stage, these portfolios provide broad diversification, dynamic portfolio management, and can be aimed at a specific investor need, like growth, wealth preservation through tax efficiency, or retirement income.

But before flipping the switch on models, we need to answer the question: do they work as well as portfolios built by advisors? And which are better for investors, for home offices, and for the advisors themselves?

Let's start with investors

A 2017 Envestnet study showed that in any given year, some advisor-managed portfolios outperform and some underperform against model portfolios. But at what cost? The same study showed that the average advisor-managed portfolios have double the volatility of model portfolios, as measured by their respective standard deviations of 3.2% and 1.6%. Simply put, a bumpier ride.

At Russell Investments, we intentionally focus on a multi-asset approach for the sake of consistency—designed to smooth out that ride. We believe a smoother ride gives investors the highest likelihood of reaching their financial goals, because it may help keep them invested. As students of behavioral finance, we believe that by reducing downward volatility, investors are more likely to stay in the market and to avoid those costly *sell-low* mistakes, when a big downward dip makes the temptation of cashing out too hard to resist. Reducing the size of the dips reduces the size of the sell-low temptation.

I believe one key driver of lower volatility is successfully deciding when to include newer asset classes or products. Does a busy advisor really have time to do serious evaluation of all the *silver bullets* constantly being introduced? You can probably make a list as easily as I can: Emerging market equities in the 1990's, infrastructure in 2010's, currencies, microcap stocks, and leveraged ETFs. Instead, a skilled model provider with professional oversight has the breadth and depth to research these innovations, introduce them when the risk/reward analysis is complete and protect investors and advisors from the shiny objects that can cause harm. I recommend that you look for a provider with a robust manager research function. And ask the provider how many in-person meetings they hold with managers every year.

How about advisors?

Reducing volatility also aids in what we might call *noise reduction*. The variability of returns creates noise in an advisor's practice. Because when an investor's portfolio takes an unexpected dip, the office phone is more likely to ring. The conversation focuses on that downward volatility, fear of the future, and those *what are you going to do about it* questions. Meanwhile, the advisor is trying to move the conversation back toward objectives, toward relationships, holistic financial advice, and referrals.

Model strategies that smooth out the ride may help take the noise level down a few clicks and allow advisors to focus conversations on what matters most—client outcomes and relationships.

Models may also reduce the tension between the time it takes to act as a true fiduciary and the time it takes to successfully grow the value of a practice. Advisor-managed portfolios take time to build and even more time to manage. Risk preferences change. Market conditions change. Regs change. Do advisors really have time to maintain their custom-built portfolios to a level of quality that meets the fiduciary standard? And if they do take that time—to build from scratch, then constantly monitor and rebalance—how much time do they have to focus on their most valuable clients? How much time do they have to offer holistic financial advice? Models can help to free up time. And because they are dynamically managed, advisors may be able to worry less about advice quality.

How models may help home offices

Home offices—the national brands that many advisors work under—can benefit from a model approach as well. Here are the first two benefits that come to my mind:

1. **Client satisfaction.** I believe that if we reduce downward volatility, we increase the overall satisfaction level for end clients, because those investors are more likely to stay on track. And the higher the satisfaction, the deeper the relationships, and the more consistent the flows.
2. **Advisor satisfaction.** When home offices provide the option of model strategies, advisors have increased choice and greater flexibility on how they deliver value to their clients. This can help lead to greater satisfaction with their home office.
3. **Risk mitigation.** Models may help to ensure that the quality of advice investors are receiving is at the highest possible levels at all times. This matters, because if advice quality wavers, firms open themselves to litigation, to losing clients and, in the long run, potentially even more regulatory pressure.
4. **Net new advisory assets.** The powerful combination of client satisfaction, advisor satisfaction, and risk mitigation is intended to lead to a growth of advisory assets. I believe this can be a powerful value creator for the firm.

What does this mean for advisor value?

As our 2017 Value of an Advisor study shows, Russell Investments is a recognized advocate for advisor value. But, according to that study, the single largest value advisors provide is by helping investors avoid behavioral mistakes. That level of behavioral guidance requires a focus on the right things. Using models frees advisors from the risky practice of building and monitoring custom portfolios and gives them time to focus.

Does this feel counter-intuitive? Don't be surprised. In our decades of practice management, we've heard many advisors say that their primary value comes from building portfolios. Our data disagrees. Building portfolios from scratch takes time away from the primary value advisors provide: filling the vital role of behavioral finance coach and guiding clients with a holistic view of their financial lives. Models can help put the focus on that primary value back on top.

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