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How precise is your professionally-managed model?

Are your models missing something?

Building model strategies—investment portfolios that target and solve for specific client objectives—is hard work. We'd know. At Russell Investments, we've been doing just that for over 25 years. Along the way, we've learned the importance and performance-driving potential of strategic asset allocation. That long-term asset allocation is intended to be about big levers and thoughtful moves, and rightly so. But, we believe model portfolios also need speed and precision. They need the ability to make precise tweaks to the overall portfolio that reflect ever-changing capital markets. Doing so may allow models to capitalize on valuations and volatility while potentially better positioning investors to stay invested and focused on long-term goals.

Precision matters

For many model providers, the instruments for adjusting model strategies are often blunt and untimely, which can potentially lead to clumsy execution, as many models tend to be simple collections of mutual funds or ETFs which trade on a pre-determined schedule. Typically, model builders make annual changes to portfolios by simply swapping out one ETF or mutual fund for another. But simply combining funds can often create unintentional gaps and overlaps, not to mention generate transaction costs for investors.

What about more precise tilts to portfolios, like adding exposure to a factor, like momentum, when investor sentiment is high? What about underweighting an interest-rate-sensitive industry to account for the expectations for higher rates? Or temporarily dialing down exposure to a currency around an uncertain political election?

Without specialized capabilities, executing specific, nuanced positioning changes within a model becomes difficult, if not impossible. That's why we believe the best model providers focus intently on developing strategies and capabilities that can help make precise, tactical changes in real time. We call this **dynamic portfolio management**. And we think advisors should demand it from their model-providing partners.

Here's an analogy: Remember the old 1960's board game, *Operation*, where one shaky move ended your turn with the jolting sound of a buzzer? Now imagine playing Operation with oven mitts on. The resulting lack of fine motor skills would leave your red-nosed patient in a perilous position. So why do it? Models work the same way. Why choose imprecise, slow-moving model portfolios, when best-practice model providers offer speed and precision? Why not take off the oven mitts?

Beyond strategic asset allocation

We believe the best models use the strategic and the tactical. But again, we believe the tactical is only meaningful with precise, dynamic portfolio management. And for us, dynamic means managing right at the moment when opportunities or risks are present and actionable, not once per year.

When it comes to building models, precision can be added by focusing on the following best practices.

1. **Incorporation of near-term market views.**
    - Most strategic asset allocations are changed on an annual schedule. But markets move more frequently, so model positioning should have the flexibility to adjust.
2. **Use of an open-architecture investment process.**
    - An open-architecture investment process allows model builders to source expertise from multiple firms, which means clients can benefit from specialist opportunities that come and go over a market cycle.
3. **Efficient trading to ensure precise portfolio positioning.**
    - Does your provider have daily transparency into each position in the model? If they do, and can combine this with an in-house trading capability, this can allow portfolio managers to dial-in more exact portfolio positions.

Now what?

When it comes to models, what's an advisor to do? My strong opinion is that savvy advisors should select a model manager, not build their models from scratch. Why? As I discussed in a previous blog post, models can help free advisors from the burden of building portfolios from scratch. Custom portfolio construction takes time away from the primary value advisors provide: filling the vital role of behavioral finance coach, handling complex and challenging wealth management opportunities, while continually guiding clients with a holistic view of their financial lives.

When choosing model strategies for your investors, be sure you're doing more than just outsourcing the core stuff—the strategic asset allocation. The models you choose should offer much more. They should offer truly dynamic tactical adjustments and a level of precision that works to gather in more upside opportunities and minimize uncompensated risks.

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