Model portfolios

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Financial advisers now see model portfolios as a cost effective, consistent and coherent investment proposition to offer clients. Matthew Craig reports

A model portfolio can be described as a ready made investment portfolio with an asset allocation designed to match the investment needs and risk profiles of its investors.

Normally, advisers using a model portfolio approach will have access to a range of model portfolios, each with a different risk and reward profile to suit differing needs among clients. The portfolios are regularly monitored and rebalanced and by using a standardised approach for each different portfolio, investment switches can be easily made for an entire portfolio.

A number of advantages are claimed for using model portfolios. From the adviser point of view, a model portfolio approach can be used to demonstrate that an adviser firm has a consistent investment process for all of its clients. Part of the investment process, such as the heavy lifting of portfolio construction, can be outsourced to investment experts, while the advisers concentrate on building and maintaining client relationships. Model portfolios should also be cost effective, as this approach is more efficient than running myriad individual portfolios.

Some adviser firms that are already using model portfolios believe that the Retail Distribution Review (RDR) and the Treating Customers Fairly (TCF) initiative will boost the use of model portfolios. This is because they fit in within the themes of offering an independent, professional service at prices agreed with the client and ensuring that all clients are treated fairly.

The increasing use of wrap platforms is also seen as facilitating the use of model portfolios, as these platforms frequently offer risk profiling tools and access to model portfolios.

First things first

In order to look at a model portfolio approach in more detail, each stage of the process in setting up and running a model portfolio should be considered.

From the client perspective, the first stage in using a model portfolio is when the adviser and client decide how to invest the client's assets. Here, a number of methods may be used to determine in which of a range of model portfolios a client should invest. Risk profiling and psychometric questionnaires can help determine attitudes to risk and are often used to place clients on a risk spectrum.

At the same time, most advisers will discuss with clients what their financial objectives are and will ensure that these fit with the selected model portfolio. It is also sensible to give clients the opportunity to see what their risk profile looks like and ask whether they agree with it before ploughing ahead.

Once the client's risk profile is decided, this needs to be matched to the appropriate model portfolio. It may be the case if clients are graded in, say, four categories according to their risk profile, that there is an appropriate model portfolio for each category. Or at this stage an adviser may decide that a bespoke approach would be better suited to the client's needs if they fall outside the risk parameters for the model portfolios used.

For many advisers, once the risk profile of the client is known, it will be a case of selecting the appropriate model portfolio from a range available from an investment firm, such as a discretionary fund manager.

Alternatively, some adviser firms may wish to construct their own model portfolios and then use these for their clients. This has the advantage of keeping the investment process under the adviser firm's control.

In the former situation, where the model portfolio construction is outsourced, the adviser should conduct the necessary due diligence to satisfy themselves that the model portfolios are constructed and managed properly. <u>If an adviser firm decides to build and run its own model portfolios, it needs to ensure that it has the necessary investment expertise in-house.</u>

Expected returns

In order to construct a model portfolio, an investment firm will look at the expected returns and expected volatility of a wide range of asset classes. Developed and emerging market equities, property funds, hedge funds, infrastructure, commodities, fixed income including emerging market bonds and high yield bonds and cash are among those likely to be in the frame.

The level of correlation between different asset classes will also be analysed. At the two extremes of correlation, a correlation of +1 shows that two assets are positively correlated, or that they move together in the same direction, and a correlation of -1 shows negative correlation, or that two assets move in opposite directions.

Neither is ideal for constructing a diversified portfolio, as positive correlation doubles up returns or losses, while negative correlation means gains in one asset are negated by losses in another. So the investment experts designing a portfolio will aim for low correlation between different assets.

shows the strategic, or long term, asset allocations used by Seven Investment Management in its model portfolios. It can be seen that the level of equity investment varies from 19% for its moderately cautious fund to 75% for its adventurous fund, with 41% for the balanced fund.

The expected return and standard deviation of the different model portfolios also varies, from an expected return of 5.3% with a standard deviation of 8.3% for the moderately cautious fund through to an expected return of 9.7% for the adventurous fund with a standard deviation of 19.2% for the adventurous fund.

As well as taking a long term view, the investment process for a model portfolio may also take account of short term views. These views can be expressed through tactical asset allocation moves, when asset classes are over- or under-weighted within the overall risk tolerance levels set by the strategic asset allocation. For example, Seven IM's asset allocated passive (AAP) model portfolio fund had an equity allocation of 46.4% in equities in December 2009, compared to its target allocation of 41%, reflecting the opportunities in equities at that time.

One way to make tactical asset allocation moves for a model portfolio is through an investment committee. The committee is likely to be chaired by the investment expert at an adviser firm, or the chief invest-ment officer at a fund manager, with other members representing a range of invest-ment views and backgrounds. Usually the committee will meet on a quarterly basis, either to decide on rebalancing, or to offer a tactical steer on the respective asset classes.

Another vital stage in constructing a model portfolio is selecting the underlying investments to populate the asset classes. Here, model portfolios outsourced to investment firms such as Old Broad Street Research (OBSR), typically use a mixture of qualitative and quantitative research to select fund managers. Quantative methods can be used to screen a large universe of fund managers looking for those who meet certain performance criteria, while quali-tative methods can look at a fund manager's investment team, process and skill.

Model portfolios usually invest in actively managed funds, in order to benefit from manager outperformance, and passively managed funds, which can offer cheaper exposure to asset classes. In practice, both active and passive investments are likely to be used, as passively managed funds may be seen as a more cost effective way of gaining exposure to asset classes where active managers struggle to outperform, such as North American equities.

Advised or discretionary

It is also likely that we will see more model portfolios based entirely on passive funds, such as Seven IM's asset allocated passive fund, which invests via exchange traded funds. This type of fund has a lower total expense ratio than a fund investing in actively managed funds and, over time, this may deliver benefits to investors.

It is important to distinguish between model portfolios offered on an advised basis and those run on a discretionary basis. Adviser firms acting on an advised basis will need to go back to their clients following a quarterly investment review and discuss the proposed portfolio rebalancing, in order to obtain the client's approval before making changes to their portfolio.

Where a model portfolio is run on a discretionary basis, the discretionary manager running the model portfolio on the client's behalf can make any investment changes. And if a model portfolio is available as an investment fund, asset allocation decisions can be made on an ongoing basis.

The increased use of wrap platforms is helping drive the use of model portfolios and Novia estimated that 10% of model portfolios set up by advisers are through discretionary fund managers. Platforms can also offer tools to allow advisers to compare clients' existing portfolios to a model portfolio, which may show that clients are taking too much risk for instance.

For advisers, the use of model portfolios could be seen as a way of future proofing their systems and processes. Martin Blake, managing director of Blake Independent Financial Planning, said that his firm started to use model portfolios partly as a result of seeing the direction in which the FSA was heading with the RDR. "We wanted to have the same system throughout a large firm in order to give clients and advisers a consistent structure and consistency of performance," Blake commented. He added that using model portfolios meant advisers spent less time on investment research and more time facing clients or taking exams.

"It is a piece of the jigsaw that fits into the proposition that we offer to our clients. This type of approach and process really does tick the boxes for the RDR from our perspective", Blake added.

There are a number of reasons why advisers could consider using model portfolios. It should also be clear that there are a number of ways to implement a model portfolio approach, such as through a discretionary fund manager or inhouse at an adviser firm.

Constructed properly, model portfolios should add clarity and consistency to an adviser's investment offering, matching clients to the right portfolio for them, with strategic and tactical asset allocation and exposure to a wide range of assets as part of the service.

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