Should You Outsource Your Portfolio Strategy?

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Yes, according to a small but growing number of advisors using ETF managed portfolios.

Asset allocation is widely considered the leading factor for portfolio design and management. A number of studies find that 90% or more of an investment strategy's performance volatility is directly related to selecting asset classes and choosing weight—even if the game plan targets individual stocks and bonds. Why, then, are a rising number of financial advisors farming out this critical aspect of money management to fund companies and boutique shops? Shouldn't the primary driver of investment results be kept in-house?

Not necessarily, according to a rising tide of advisors. The reasoning boils down to enhancing efficiency by giving you more time to focus on areas of the business where the potential for value-added service is higher. Managing money directly, by contrast, is better left to investment firms that specialize in the niche, or so the converts to outsourcing believe.

Outsourcing isn't new. The use of mutual funds, which have been around for more than a century, is one way that advisors have been transferring day-to-day investment oversight to outsiders. The popularity of ETFs has extended and expanded the trend. The rising use of complete portfolio solutions using ETFs represents the next phase of transferring key portfolio decisions.

It's one thing to use mutual funds and exchange-traded products instead of picking individual securities. But more advisors are opting to also give ETF specialists the ability to select funds, structure the asset allocation, and choose rebalancing dates. The trend represents the last step in moving the investment management to fund companies and other firms that specialize in managing ETF-based portfolios for advisors.

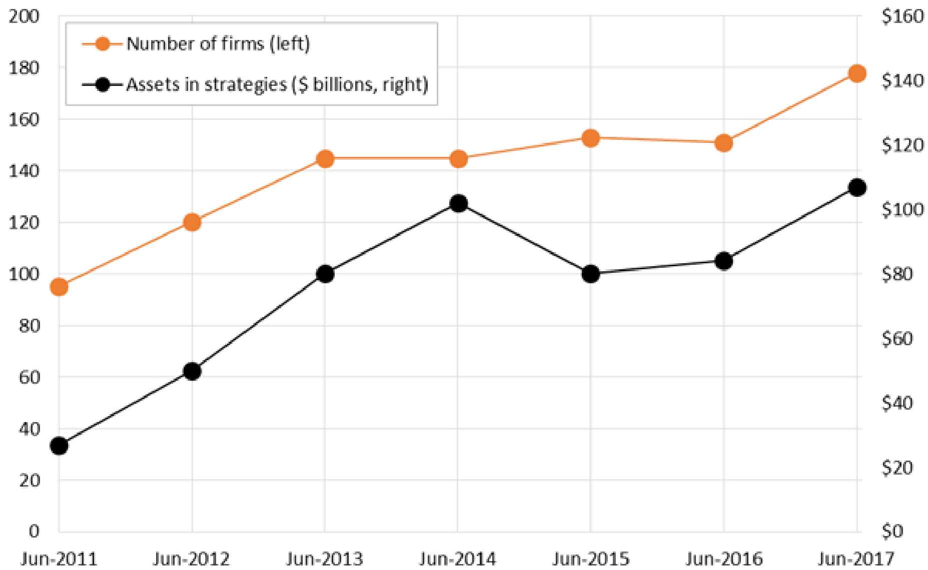
A growth industry

At the end of 2017's second quarter, Morningstar was tracking more than 1,000 managed ETF portfolios—defined as investment strategies with at least 50% of assets in ETFs. These products—a type of fund of funds—are linked to more than $100 billion in assets. That's a small fraction of assets in ETFs overall, which totaled $1.8 trillion as of September 2017, according to the Investment Company Institute.

This niche is tiny in the grand scheme of managed assets, but it's expanding rapidly. The number of ETF managed portfolios in Morningstar's database at 2017's midpoint jumped 18% and assets increased 27% versus the year-earlier figure. The business is "growing at a solid clip," says Ben Johnson, director of global ETF research at Morningstar.

There's also a solid upside trend in the data since 2011, according to Morningstar. The number of firms plying these waters has nearly doubled over the last six years and assets linked to the strategies have surged by roughly 300%.

Managed ETF Portfolios: Managers and Assets



Source: Morningstar

The industry is actually larger than the Morningstar numbers suggest because reps at the big Wall Street wirehouses (Merrill Lynch, Morgan Stanley, and others) also use managed ETF portfolios for clients—portfolios that aren't tracked in the Morningstar database.

2 basic choices

There are two main types of ETF managed portfolios. One is offered by ETF providers, including the largest companies in the field—Vanguard, Blackrock, and State Street. The asset allocation programs run by these firms use their respective ETFs and there's generally no charge beyond the expense ratios of the underlying funds. The strategies in this corner tend to be strategic-oriented with periodic rebalancing schedules. The basic goal is offering broad diversified portfolios for a range of risk tolerances. Piggybacking on the recommended portfolios is free because the fund companies generate revenue through sales of the underlying ETFs.

Alternatively, various ETF specialists run managed portfolios using a variety of products, for a fee, usually ranging from 30 to 50 basis points over and above the expense ratios of the ETFs. These are more expensive choices, but the menu runs the gamut, including various tactical asset allocation strategies. For a recent list of strategies available (excluding programs run by wirehouses), see Morningstar's second-quarter update.

Most providers of ETF-managed portfolios have been reporting brisk demand for the products in recent years. Vanguard, for instance, tells Horsesmouth that the division's assets under management have surged this year, rising to $11.3 billion, a near doubling from $6.8 billion at the end of 2016. That's still a tiny slice of the company's $4.7 trillion under management overall, but the ETF-managed portfolios space is expanding rapidly.

"We started doing this in 2010 for one client on one platform," says Evan Wolf, who heads up Vanguard's Financial Advisor Services division. Today, Vanguard offers a range of turnkey ETF model portfolios that provide one-stop shopping for tapping into managed asset allocation services. Looking ahead, he expects the division's expansion will roll on. "We expect growth to continue at a rapid rate."

The medium of choice for tapping into these portfolios is a fund platform offered by TD Ameritrade, Envestnet, Pershing, and several other financial-services intermediaries. Thanks to evolving technology, buying and selling of strategies is now done in a single transaction—the equivalent of buying one ETF.

The combination of professional offerings at low or even no cost, along with a "one-click" ability to move money in and out of these portfolios, has created a tailwind for the niche in recent years.

John McCombe of Richard Bernstein Advisors (RBA) is upbeat on the future, for his firm and the industry generally. He says that his company is currently running six ETF managed portfolios for advisors with portfolios representing $3.2 billion in assets at October's close—a year-to-date rise of 120%.

What's the allure?

Several catalysts are convincing more advisors to outsource some or all of their investment management tasks, says Morningstar's Johnson. "The overarching trend is to make a practice more efficient and focus attention where advisors can add the most value for clients." More wealth managers are recognizing that growing their business has nothing to do with overseeing asset allocation and picking funds. "They're happy to push it onto someone else."

As the breadth and depth of individual ETFs has expanded over the years, so too have the asset-allocation possibilities. Advisors may have had a compelling reason to build and manage ETF-based portfolios from scratch in the past. But the menu of ETF-based solutions has exploded over the last five years. As a result, advisors are more likely to find strategies run by outside firms that match their clients' needs.

"There are ETF strategies across the board in every niche," says Dan Sondhelm of Sondhelm Advisors, an asset-management consultancy. "It's a growth industry," in part because "advisors are focused more on accumulating assets and outsourcing money management to managers using ETFs."

Jared Wickes, managing partner at Kennedy Wealth Group, says "I've tried to straddle the line between asset manager and money gathering." But the firm decided to take a step back from money management and use ETF-based portfolios managed by third parties, including Provident Capital Management, a boutique shop in Carmel, Ind. that runs several quantitative-driven strategies.

Provident's Drew Wieder says that "more and more advisors realize that their strong point is asset gathering." He adds that even if an advisor has the talent for overseeing portfolios directly, the operational challenges of risk monitoring and building the trading infrastructure to manage money can be problematic, particularly for smaller firms. freeing up a significant amount of time and resources for other tasks.

Advisors are coming to recognize that their time is better spent on the business side and tending to clients, says Roger Scheffel, chief investment officer at WST Capital Management, which runs several managed ETF programs. "It's hard to be an expert in everything." Meantime, more folks are deciding "that the way to grow the business is to give up the part-time job as an asset manager."

The increasing complexity of some ETFs, along with the sheer number of choices—more than 2,000 in the U.S.—is another factor that's raising the appetite for managed portfolios. As fund companies roll out evermore sophisticated fund strategies—many marketed under the so-called smart beta label—the necessary research hurdle rises to understand what's going on under the hood. Not surprisingly, the enthusiasm for diving into the details tends to fade as the analytical workload increases. Leaving the details to an ETF specialist, in turn, has greater appeal.

Adding to the allure of ETF portfolio solutions is the Department of Labor's (DoL) Conflict of Interest Rule, which redefined the fiduciary standard for financial advisors. Although full implementation has been delayed, there's a growing awareness in the advisory industry that the regulatory tide is moving in favor of a fiduciary-based business model. In turn, the DoL ruling strengthens the case for using passively managed ETFs, which offer low fees and high transparency—features that align with the fiduciary standards.

Another feature that advisors find attractive in ETF managed portfolios: the ability to access professional grade risk management services at a low or even zero cost over the underlying funds.

RBA's McCombe reports that switching to these products "checks a lot of boxes" for satisfying the DoL rules while providing clients with professional-grade portfolio strategies. It's only natural, he says, that the general move toward a fee-based advisory model in recent years is convincing investment advisors—in wirehouses and those aligned with independent broker/dealers—to adopt ETF-based strategies.

Caveats

Keep in mind that an ETF managed portfolio is a product, and usually an actively managed one. As such, all the standard provisos apply when wading into this corner of investing.

The fee for tapping into a managed ETF portfolio varies, with an industry average of roughly 30 basis points, says RBA's McCombe. But in some cases the fee is zero. Vanguard, for instance, doesn't charge beyond the underlying expense ratio for its funds. For companies that don't have their own ETFs, however, there's a price tag to consider. Paying more for a strategy may be worthwhile, but at some point the odds may work against you if the fee is lofty.

In addition, don't overlook the fact that when you select a managed ETF portfolio for a client you're essentially choosing an actively managed product. That's a reminder that you should understand how the strategy operates. Getting up to speed may be as easy as reviewing the literature for a product if it follows a simple rebalancing strategy. For more complex strategies, however, it may be prudent to review the track record and talk with the management firm.

For all the allure of managed ETF portfolios, the use of these products still leaves you with a fiduciary responsibility of responsibly selecting one or more investment strategies that align with a client's risk tolerance and investment objective. Some aspects of financial advisory can't be transferred.

If you're thinking of making the transition, prepare for some bumps along the way in your relationship with clients. A cynic might argue that you're imprudently transferring the management of client assets to an outside advisor. Be prepared to respond to that criticism in a thoughtful manner, perhaps by emphasizing that you're still overseeing the portfolios by selecting strategies and asset allocation plans.

The rationale for such a switch, you might add, is that the potential for generating superior risk-adjusted performance is enhanced for clients. The fact that your day-to-day money management tasks will be easier only sweetens the deal.

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