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# A Framework for Evaluating Model Portfolios

An overview of model portfolios and the factors investors should consider when evaluating them.

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## Summary

In March 2019, we began assigning forward-looking Morningstar Analyst Ratings to target-risk series of separate accounts that are representative of model portfolios. Model portfolios are a growing area of focus for asset managers as they seek to offer financial advisors more holistic investment solutions instead of pushing individual products. Advisors can benefit from outsourcing the investment process by having more time to focus on other areas of their practice, like financial planning. As of the end of April, we have assigned analyst ratings to five target-risk series of separate accounts and plan to continue expanding our coverage universe.

To evaluate model portfolios, we used a framework that's similar to how we evaluate asset-allocation strategies packaged in other vehicles, such as mutual funds or separate accounts. This article provides a high-level overview of the model portfolio landscape and outlines the framework we used to evaluate these portfolios.

## Key Takeaways

- Third-party model portfolios have garnered significant assets from financial advisors, and the growth is expected to continue.
- Financial advisors are increasingly outsourcing investment management to model portfolios as they focus more on financial planning.
- Morningstar now offers forward-looking analyst ratings on separate account composites that are representative of model portfolios. We will continue to add coverage of model portfolios going forward.
- Model portfolios have some key advantages over using comparable asset-allocation mutual funds, such as the ability to customize the underlying funds and have greater control over the tax implications.
- There are some disadvantages as well. The managers of the model portfolios might not have as many tools to express their investment views in the model portfolios.

**Morningstar Analyst Ratings of Model Portfolios**

Pillars ( Positive  Neutral  Negative )

| Target Date Series Name | Morningstar Analyst Rating | People | Process | Parent | Performance |
|---|---|---|---|---|---|
| American Funds Growth and Income | Silver | Positive | Neutral | Positive | Positive |
| BlackRock Target Allocation ETF | Silver | Positive | Positive | Positive | Neutral |
| Fidelity Target Allocation | Bronze | Positive | Neutral | Positive | Neutral |
| Invesco Cornerstone Total Beta | Neutral | Neutral | Neutral | Neutral | Neutral |
| Oppenheimer Target-Risk Series (ETF/MF) | Neutral | Neutral | Neutral | Neutral | Neutral |

# Overview

Financial advisors use model portfolios to outsource all or part of a client's asset allocation and underlying fund selection. Investment managers typically offer these portfolios as target-risk or outcome-based options. In our discussions with asset managers and industry experts, the use of third-party model portfolios by advisors is significant and projected to continue to grow.

Outsourcing the investment process gives advisors access to professional money managers who have the means and ability to construct diversified portfolios using more in-depth research and risk management tools than advisors might have at their disposal. Advisors can then focus on other financial planning matters, such as relationship management, estate planning, and tax strategy. It also allows advisors to service smaller client accounts in a more efficient manner without sacrificing portfolio quality.

Model portfolios, unlike mutual funds, are not directly investable (although some, like American Funds' Growth and Income model portfolios, have matching mutual funds). Instead, model portfolios offer a blueprint for asset allocation and fund selection. They tend to be designed with ease of use and simplicity as a main goal. Most firms stick to the core asset classes and keep the number of recommended underlying holdings between five and 10. When advisors choose a model portfolio, they receive these recommendations along with monthly or quarterly updates. Most model portfolio providers also offer short-term, tactical asset-allocation recommendations as a way to enhance returns. The implementation can be automated at some brokerage firms.

**Advantages and Trade-Offs of Model Portfolios Over Comparable Mutual Funds**

Advisors can follow the model portfolio's blueprint or modify it. For instance, an advisor can swap out underlying funds or choose to delay or ignore recommended trades and rebalances. If used properly, this flexibility gives model portfolios potential advantages over comparable multi-asset mutual funds.
The control over the underlying holdings also gives advisors the ability to add value through tax-loss harvesting at the individual account level. Advisors using models can realize losses by replacing a fund where the client has a negative return with a similar fund. The realized losses can then offset gains realized from rebalancing or capital gains distributions, thereby lowering the overall tax liability for clients. This can have a meaningful impact on a portfolio's after-tax returns. Most multi-asset mutual funds are agnostic when it comes to taxes, unless tax management is a specific stated goal.

One of the trade-offs for the simplicity that model portfolios provide is that the asset managers have fewer tools at their disposal to implement their views. BlackRock, for example, offers a target-risk series of their popular multi-asset income fund BlackRock Multi-Asset Income BAICX. In the mutual fund, management can sell call options to boost the fund's income. The mutual fund also includes derivatives, which are used to manage risks like duration and currency exposures. Trading options and other derivatives requires an extra level of trading and risk management expertise, so it's not surprising those trades are left out of the model portfolios. The hybrid active/passive version of the models does allocate to active funds that make use of derivatives, but it's not equivalent to the mutual fund. The exclusion of the more complex tools may not have a big impact on performance over the long term, but these factors are worth considering when choosing models that replicate more-complex strategies.

**Something for Everyone**

Model portfolios don't have the same regulatory hurdles or costs to launch as mutual funds. This has led to some asset-management firms and larger RIAs taking a "something for everyone" approach to launching new models. For instance, an asset manager might offer a target-risk series that comes in flavors of active, passive, hybrid active/passive, strategic beta, or ESG-focused. Vanguard offers three nearly identical target-risk model portfolio series, the key difference being which index provider (S&P, Russell, or CRSP) the passive equity funds track. Some firms also offer a choice of portfolios that use only their proprietary funds or those that use funds from multiple firms.

Target-risk model portfolio series also come in more granular forms than what's typically offered in mutual fund format. It's common to see only three risk levels in mutual fund target-risk series; most stick to conservative, moderate, and growth options. In models, the low barriers to launching new strategies means firms can offer many more versions. BlackRock's Target Allocation ETF model portfolio series, for example, ranges from a 100% fixed-income portfolio to a 100% equity portfolio, with nine portfolios in between at 10 percentage points of equity intervals.

The proliferation of model portfolios offers advisors far more choices than they have in mutual funds. With such a wide selection, however, advisors should bring a healthy dose of skepticism when selecting a model portfolio. To help advisors sort through the myriad of choices, Morningstar now offers forward-looking analyst ratings for these strategies. They are intended to supplement advisors' own due-diligence work on model portfolios and provide a forward-looking perspective.

**Morningstar Analyst Ratings for Model Portfolios**

The Morningstar Analyst Ratings for model portfolios were assigned to separate accounts that reflect investment performance of the model portfolios as they were implemented by the asset manager. The separate accounts represent live track records of real money. As there is actual money invested in the separate accounts (typically seed money invested by the asset management firm), the accounting of the separate account's performance generally follows the Global Investment Performance Standards. Model portfolios report hypothetical performance, and the accounting is not necessarily held to the same standards.

To determine an analyst rating, Morningstar Manager Research analysts evaluate each target-risk series separate account by examining four key pillars: Process, People, Parent, and Performance. Although price is not a stand-alone pillar in Morningstar's separate account rating methodology, it does play a role in analysts' determination of the quality of underlying investments.

### Process

An evaluation of the asset manager's process for asset allocation, underlying fund selection, and tactical tilts (if applicable), to determine whether the managers have the skills, tools, and strategy in place to add value and manage risk.

### People

Our assessment of both the quality of the team driving the asset-allocation decisions and the underlying funds recommended by the model portfolio provider.

### Parent

An evaluation of the parent firm's culture, how well it can attract and retain investment professionals, and its alignment with shareholders. Strong cultures have the willingness and ability to sustain centers of investing excellence through investment-talent retention and thoughtful succession planning. They also have a sensible product lineup and a proven track record on product development and lineup management.

### Performance

Performance factors into our analysis but plays a smaller role than other pillars given its backward-looking nature. To determine a series' Performance Pillar rating, we compare each portfolio's results against peers in its representative Morningstar Category that we view as reasonable alternatives, its category benchmark, and its custom benchmark.

## Applying The Framework

**American Funds Growth and Income Model** target-risk series earns a Morningstar Analyst Rating of Silver. It replicates American Funds' target-risk mutual funds (BLPAX, GAIOX, and INPAX), which also earn the same ratings. This series stands out for its excellent actively managed equity funds. Nine out of the 10 used in the series earn Gold or Silver ratings. The bond funds are less impressive: Two are rated Bronze, and one is rated Neutral. Advisors should expect this series to have low turnover at the portfolio level, so ongoing maintenance should be light.

**BlackRock Target Allocation ETF** target-risk series also earns a Silver rating. It's managed by a dedicated team within BlackRock's target-date group. It's also able to leverage the firm's exceptional risk management group. The team has its own active research agenda for improving its portfolio construction and tactical-allocation process. The tactical tilts can shift the asset allocation by up to 5%. Allocations are reviewed at least quarterly, but the team can implement trades more frequently depending on market conditions. Management expects turnover to be in the 50% range annually. The portfolios are built using low-cost iShares ETFs, ensuring the overall cost of using the model is kept in check.

**Fidelity Target Allocation** target-risk series earns a Bronze rating. Its most attractive features are its strong underlying investments, particularly its actively managed fixed-income funds like Gold-rated Fidelity Advisor Total Bond FBKWX, and its focus on low costs. Each portfolio's fees are capped at 40 basis points, about 30 basis points cheaper than the median fee for an institutionally distributed target-risk mutual fund. The process is designed to add value through underlying fund selection and relies on short-term momentum of excess returns. The fund selection model has some merit, because there's evidence that momentum exists in asset class returns. Still, the emphasis on a single factor means the fund selection model will periodically struggle, as momentum tends to do poorly during sharp market reversals. Turnover is capped at 50% annually.

**Invesco Cornerstone Total Beta** and **Oppenheimer Target-Risk Series (ETF/MF)** are both rated Neutral. The Invesco series combines strategic-beta-focused multi-asset portfolios with extremely low-cost market-cap-weighted index exposures. The team managing both the strategic-beta and model portfolio series has been in place only since 2015, and it's not clear the combination has a long-term edge over either as a stand-alone. On the plus side, the overall costs are less than 20 basis points across the series. The Oppenheimer target-risk series uses both active and passive funds from the firm, and the asset-allocation process is reasonable if not distinctive. However, the set of opportunities to gain the underlying exposure is restricted to Oppenheimer's lineup. While the firm has a solid franchise in international equities, it fails to excel everywhere.

**About Morningstar Manager Research**

Morningstar Manager Research provides independent, fundamental analysis on managed investment strategies. Analyst views are expressed in the form of Morningstar Analyst Ratings, which are derived through research of five key pillars—Process, Performance, Parent, People, and Price. A global research team issues detailed Analyst Reports on strategies that span vehicle, asset class, and geography. Analyst Ratings are subjective in nature and should not be used as the sole basis for investment decisions. An Analyst Rating is an opinion, not a statement of fact, and is not intended to be nor is a guarantee of future performance.

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