



## **Cerulli Survey Results: New Themes in Advisors' Portfolio Strategies**

By Bing Waldert  
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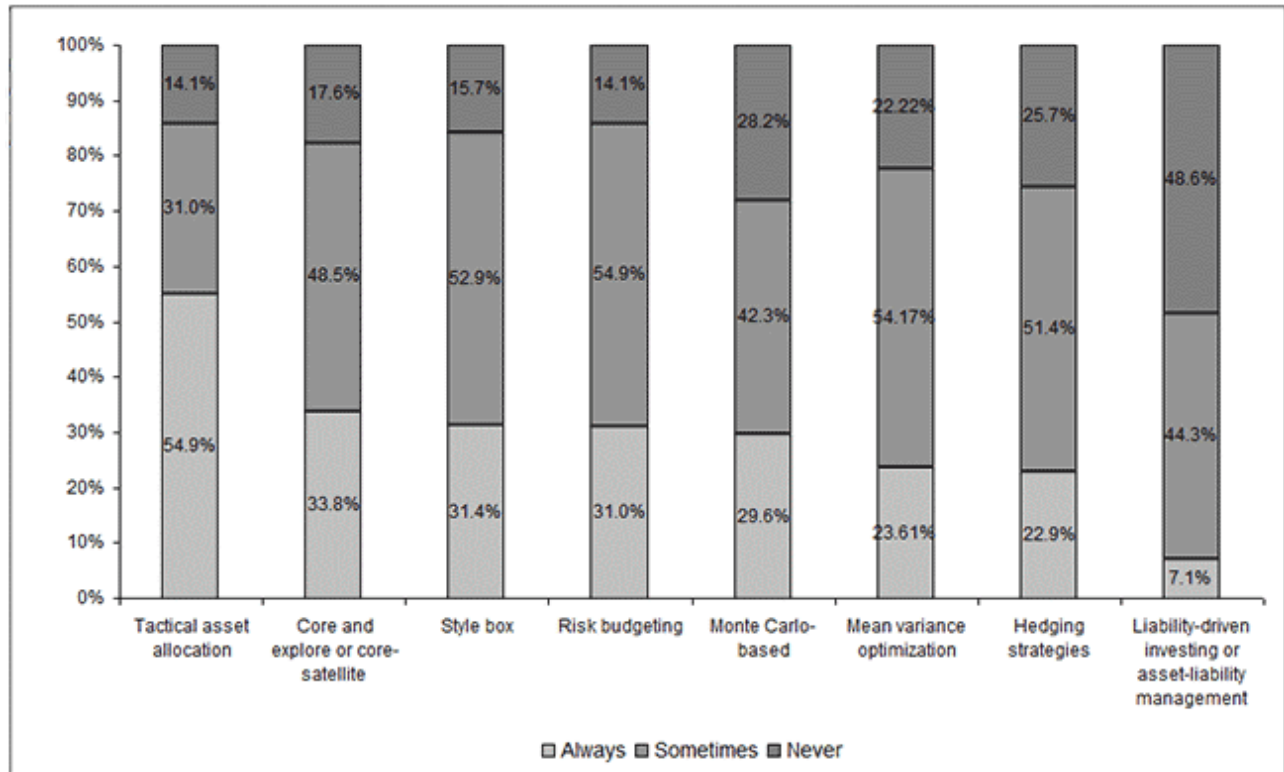
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The aftereffects of the bear market are far reaching – retail advisors and investors and institutions alike are questioning how to best construct portfolios, particularly with a greater eye towards downside protection. The breadth of the market downturn exposed flaws in the application of Modern Portfolio Theory, as nearly every asset class performed poorly and investors suffered accordingly.

Client risk tolerance retracted. Money has flowed into conservative vehicles, such as fixed income and cash. Likewise, investors are less likely to identify themselves as “aggressive” than at any point in recent memory.

Advisors are unlikely to dramatically change how they run client portfolios, but new thinking is emerging as to how those portfolios can be more efficiently constructed to better manage risk. These new ideas, such as tactical asset allocation and use of alternatives, had seen some uptake even before the market crisis, particularly within large institutions, but they are receiving increased attention as solutions for risk-averse clients. This article will examine some of the evolutions, using data from a Cerulli Associates survey of Advisor Perspectives readers conducted in June and July of 2010.

Perhaps no other strategy has seen a greater change in perception than tactical asset allocation. Market timing gave tactical asset allocation a bad name, particularly as some of the industry's largest fund families paid out massive settlements to investors for allowing late trading in their funds. In past years' Cerulli surveys around portfolio construction, using style boxes has consistently ranked as the most popular portfolio construction method for financial advisors. Surprisingly, better than half of Advisor Perspectives readers reported they always used tactical allocation, the most popular option selected.



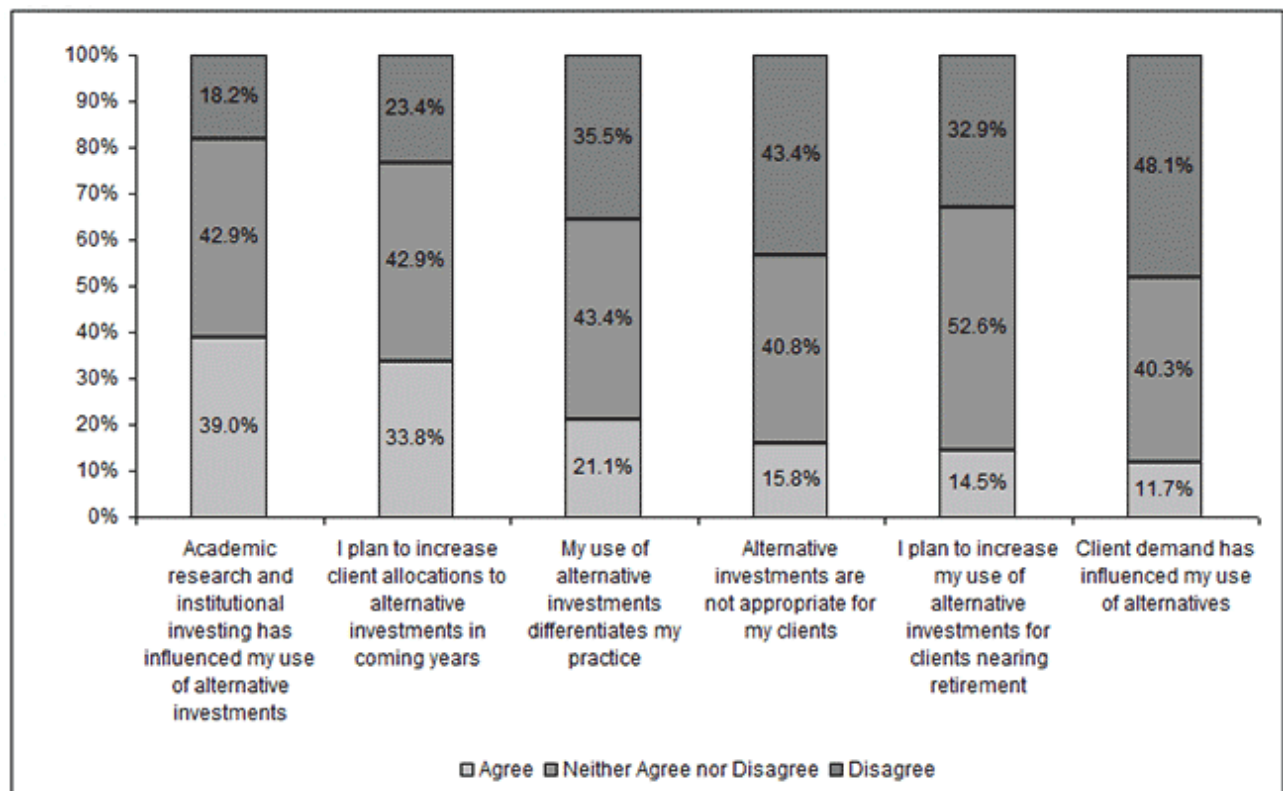
As tactical asset allocation reaches the mainstream, its implementation is undergoing a makeover. Early iterations of this strategy often involved making large moves in and out of the market, possibly using leveraged products to enhance returns. Increasingly, tactical moves are around the margin of a client portfolio, rather than the central strategy. For example, Morgan Stanley Smith Barney is offering its advisors guidance on how to under- and overweight various asset classes and investment disciplines. However, these recommendations may not amount to more than a few percentage points. Likewise, exchange-traded funds (ETFs) are increasingly being used to make tactical moves through exposure to a certain industry, asset class, or even region. Nearly half (43%) of Advisor Perspectives plan to increase their usage of ETFs.

Product	Increase by more than 10%	Increase up to 10%	No change	Decrease by up to 10%	Decrease by more than 10%
Variable annuities	16.2%	9.6%	64.3%	9.9%	0.0%
Exchange-traded funds	15.1%	28.4%	56.5%	0.0%	0.0%
Variable life/VUL/Whole life/Term/LTC	13.8%	14.0%	72.1%	0.0%	0.0%
Hedge funds or funds of hedge funds	13.2%	9.7%	73.8%	0.0%	3.2%
Individual fixed income securities	12.2%	7.5%	65.0%	12.7%	2.5%
Other mutual funds	9.8%	13.0%	77.3%	0.0%	0.0%
Equity mutual funds	7.7%	31.1%	43.3%	17.9%	0.0%
Individual equities	7.2%	12.7%	59.8%	20.2%	0.0%



Money markets, cash, etc.	6.4%	6.4%	61.0%	23.0%	3.1%
Fixed income mutual funds	5.1%	20.3%	51.5%	18.0%	5.1%
Private equity	3.6%	7.1%	82.2%	7.1%	0.0%
Immediate annuities	3.6%	11.1%	85.4%	0.0%	0.0%
Fixed annuities	3.6%	3.7%	85.2%	7.6%	0.0%
Managed futures funds	3.4%	10.4%	86.2%	0.0%	0.0%
Commodities	0.0%	39.2%	57.1%	3.7%	0.0%
REITs	0.0%	19.9%	76.8%	3.4%	0.0%
Separate accounts	0.0%	14.3%	82.2%	3.5%	0.0%
Other limited partnerships	0.0%	11.5%	84.6%	3.9%	0.0%
Structured notes	0.0%	4.1%	95.9%	0.0%	0.0%

Likewise, the second-most used portfolio construction method for Advisor Perspective users is core-and-explore or core-satellite. The separation of alpha and beta has been on the increase in many institutions for the better part of the last decade. As noted above, tactical asset allocation is one method by which advisors are adding alpha to client portfolios. In addition, advisors are increasingly looking to alternative investments as a way to lower risk and increase return in client portfolios. Approximately two-fifths of respondents have had their usage of alternative investments influenced by the institutions and academic research. In addition, nearly a quarter of Advisor Perspectives readers plan to increase their usage of hedge funds and non-traditional mutual funds.

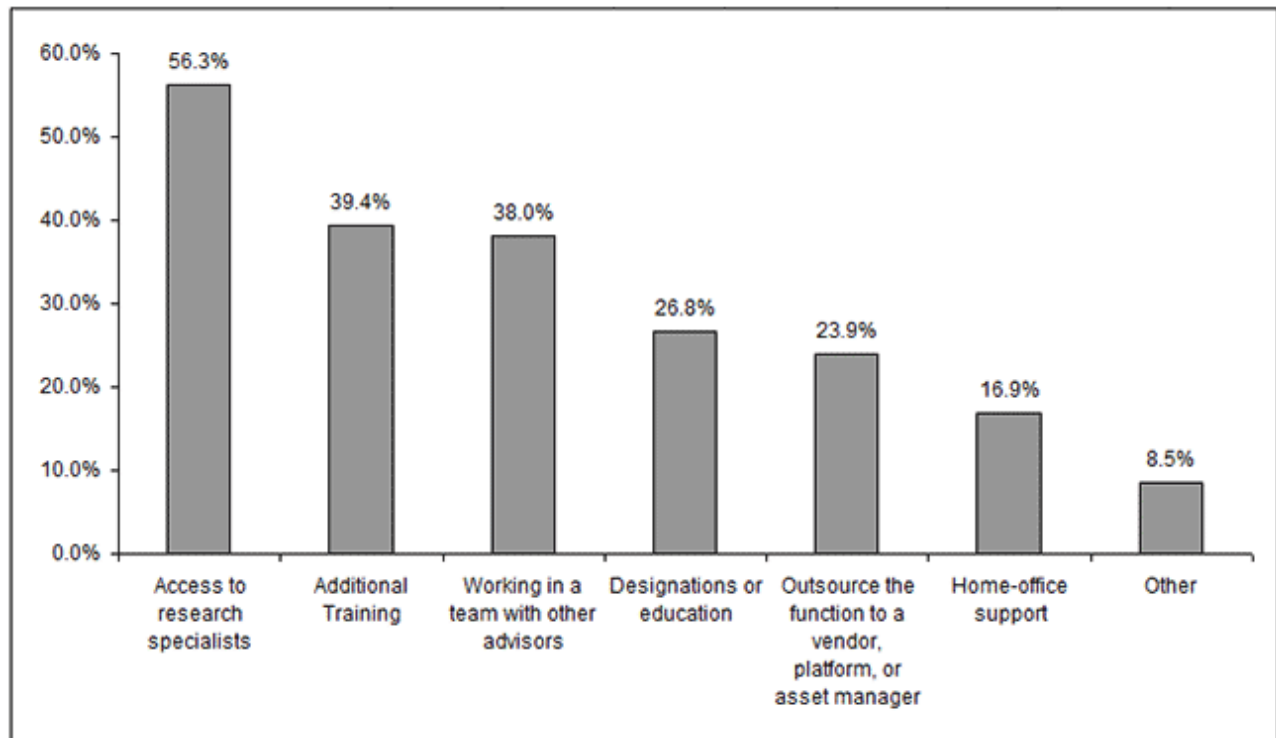




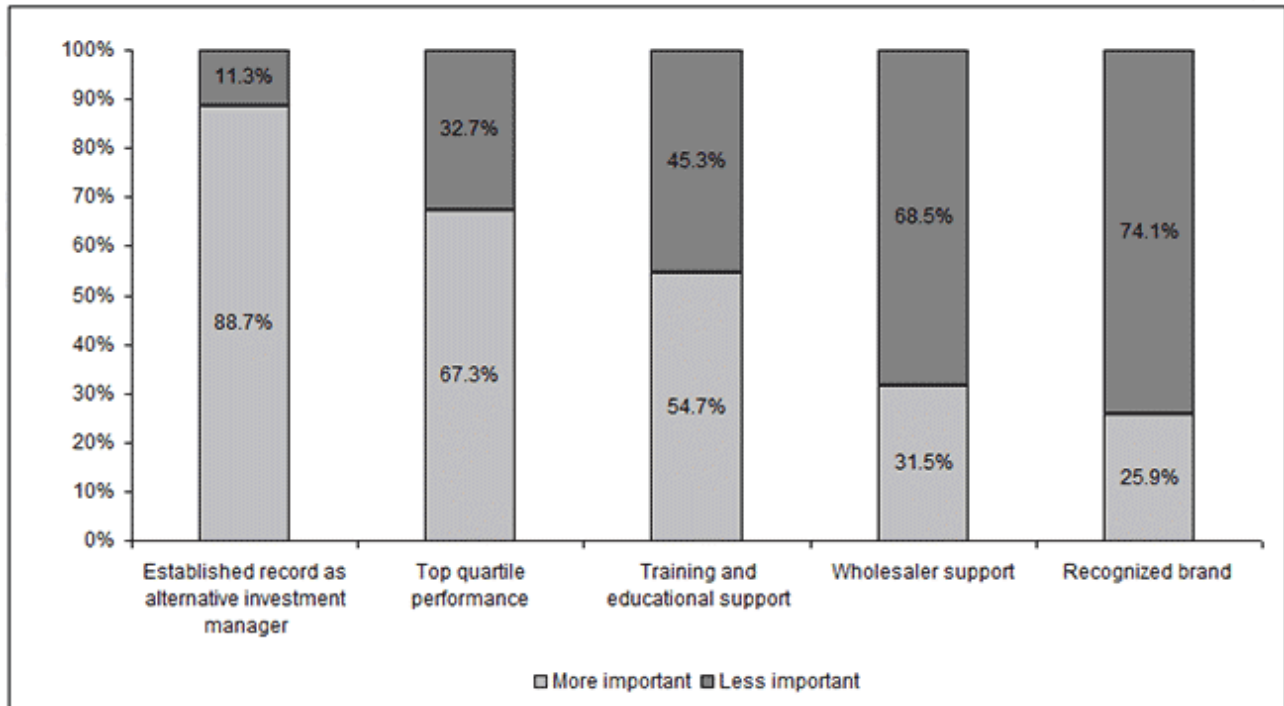
However, investing in alternative investments comes with a unique set of challenges. Certainly, Bernie Madoff was a warning of the perils of incomplete due diligence, but the hurdle for manager review is quite a higher for alternative investments than with traditional long-only managers. Given the complexity of many alternative strategies, due diligence is not just to test the repeatability of a strategy, but also the operational infrastructure of the manager. With increased interest in alternative strategies, many institutional consultants have struggled to find talent who are qualified to review alternative investment managers. Indeed, adequate due diligence is even more challenging for independent advisors seeking to include an alternatives manager in their client portfolio.

For advisors who can successfully apply absolute return strategies and institutional portfolio construction techniques, there are a number of interesting potential client applications. For example, foundations, by rule, must pay out a specified percentage of their value every year. Likewise, endowments pay out a certain amount each year for an educational institution to meet set expenses. Given the predictable spending patterns of these institutions, both have increasingly adopted absolute return strategies in an effort to smooth returns. One can easily see then the application of these strategies for retirement income, where investors need a predictable stream of income to meet their retirement needs.

However, the challenge with change in strategy remains implementation. As portfolio construction techniques grow more complex, advisors need assistance and education in how to apply them to their client base. This challenge can be especially steep as they attempt to build bespoke portfolios for hundreds of clients, each with unique needs. Advisor Perspectives readers named access to research specialists and additional training as the factors that would help make portfolio construction easier. Herein lies an opportunity for product manufacturers, broker/dealers, and other service providers. Pre-crisis, some large wirehouses had research specialists who worked with advisors to design portfolios that included complex investment vehicles. However, these specialists worked only with high-end advisors and their wealthiest clients. As interest in alternative asset classes grow, advisors can benefit from greater use of professionals with similar experience.



Content experts don't necessarily need to be broker/dealer- or custodian-supplied either. As noted above, advisors are also seeking training and education around portfolio construction. Better than half of respondents named training and education as an important factor in choosing an alternatives manager. However, prospective managers should note that training ranks ahead of wholesaler support. If a manager is supplying training, it should not be a thinly veiled product pitch, but rather concrete examples of how a specific asset class or strategy can create better client outcomes.



Investors and advisors are clearly demanding new methods for reducing risk in portfolios. However, implementing those methods comes with added complexity and risk, if done incorrectly. Education will continue to play a major role in adoption of these strategies. Advisors are open to training on the topics, but that must be geared to client solutions and ultimately improving the client experience.

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