IMCA RESEARCH QUARTERLY

EXECUTIVE SUMMARY

Quarter I, 2008: Portfolio Construction

Editor's note: This is the executive summary of the inaugural issue of a new publication produced exclusively for members of Investment Management Consultants Association. This report was produced in collaboration with Cerulli and Associates.

Methodology: In February 2008 IMCA distributed an electronic survey to all U.S. members. The respondents included 496 broker–dealer representatives, 84 registered independent advisors, and 99 institutional consultants who completed the survey instrument using Cerulli Associates online survey engine. Wholesaler representatives and other professionals who do not currently work with clients were encouraged to NOT complete the survey, making the response rate for participation 12 percent.

Portfolio construction has presented a wide variety of challenges to financial advisors in recent years. Many financial advisors began in the industry selling individual stocks to their clients, and many still view asset management as core to their value proposition. Three key issues stand out as portfolio construction becomes more challenging for many advisors. First, advisors are presented with a wider variety of products than ever before. Products such as exchange-traded funds (ETFs) and hedge funds have exploded into the market and drawn significant publicity. However, this vast array of products must be evaluated to see if it makes sense for clients and, if so, packaged in a way that creates a more-efficient portfolio for the client. Finally, advisors are forced to decide what role they will play in the portfolio construction process. Many industry observers increasingly advocate outsourcing some or all of the portfolio construction process. Although most advisors prudently seek help to assemble client portfolios, advisors view client investing as the core of their relationship and ultimately take responsibility for the final decision.

First, let's look at the variety of products available to financial advisors. In 2007, there were more than 17,000 mutual funds available in the marketplace. This does not even begin to account for the inventory of separate accounts, ETFs, hedge funds, or other limited partnerships available to advisors and their clients. More than three-quarters of IMCA members reported that the array of products available to them contributed to making portfolio construction more challenging. These matters are compounded by the significant press given to products like ETFs and hedge funds. The publicity granted to these products has created, at the very least, investor curiosity around what they have to offer. Regardless, despite steep growth rates in these products, mutual funds continue to dominate the retail landscape. Nevertheless, advisors must be prepared to address client questions regarding the validity and structure of these products. One traditional mutual fund manager recently acquired a family of hedge funds and reported taking multiple calls on their sales desk regarding hedge funds, but saw little sales activity. As a result, the manager attributed this activity to advisor curiosity that likely was attributable to client questions.

Despite this increasing menu of options, we see classic, simpler methods as the most popular among IMCA members. Style boxes rank as the most-used portfolio construction method. Likewise, looking at individual-component asset classes and their historical correlation are the most-popular methods for determining individual portfolio risk. There have been major shifts in recent years, however, in how institutions construct portfolios. For example, some of the largest endowments have made major shifts into private equity and hedge funds, and these nascent trends reveal themselves in the survey results. Core–satellite portfolio construction, on the rise with institutional investors, ranks as the third most-popular portfolio construction method. Likewise, risk budgeting, although it ranks relatively low, still is reported to be always used by more than one-third of IMCA members.

Finally, advisor outsourcing of portfolio construction has been one of the most-controversial topics in the industry. Advisors are reluctant to give up control of asset manager packaging and selection as they consider it an essential part of their value proposition.

Figure 1
Channel in Which IMCA Members Work, 2008

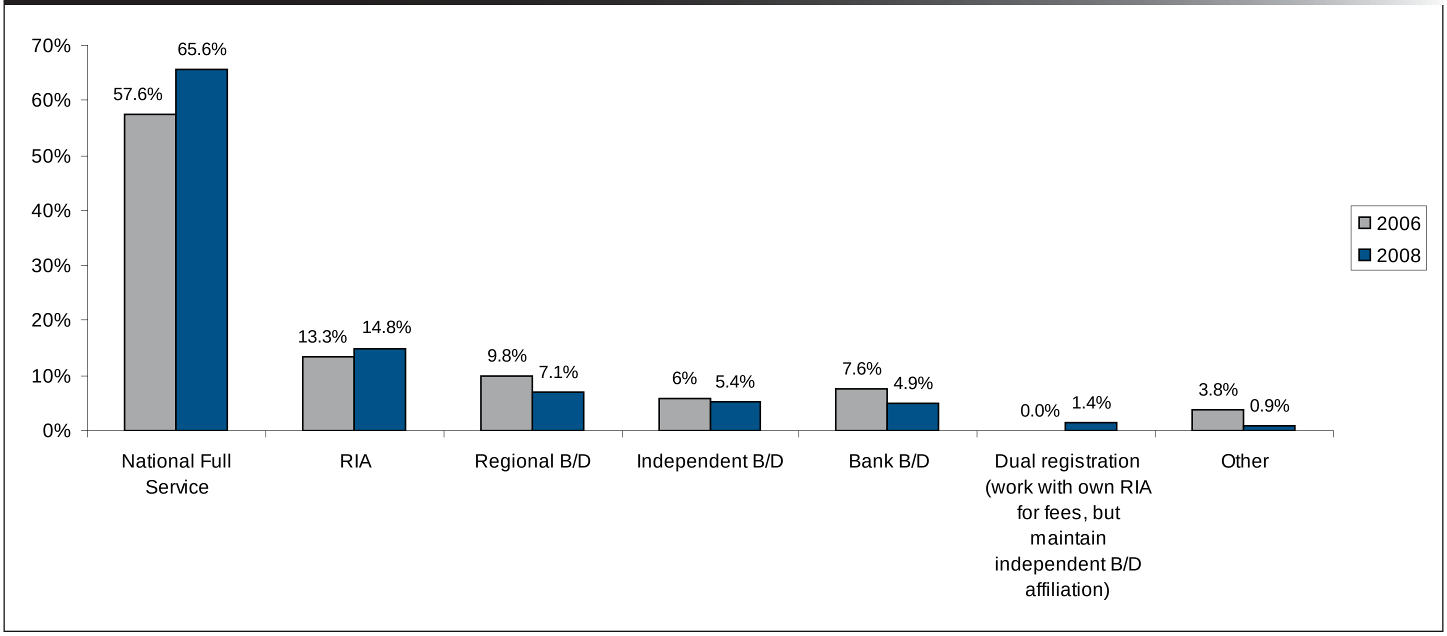
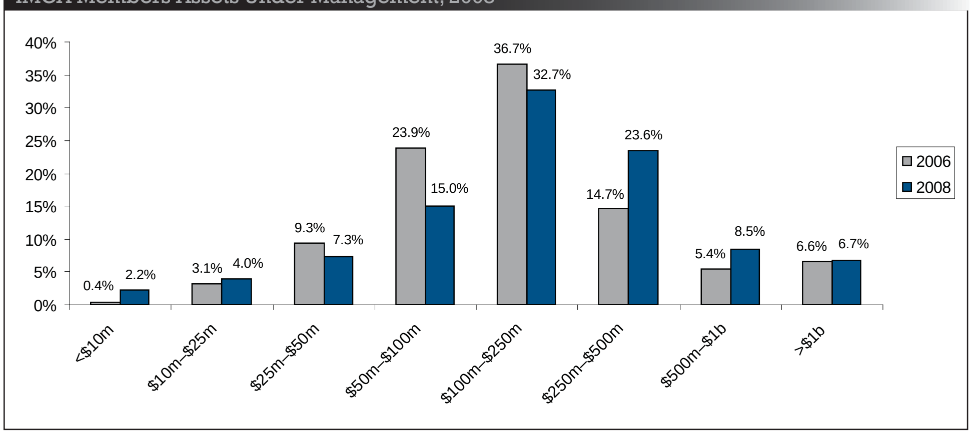


Figure 2
IMCA Members Assets Under Management, 2008



More than half of IMCA advisors report never outsourcing the portfolio construction decision, and another 20 percent report that they rarely do so. Likewise, far and away the most popular method for determining asset allocation is the advisor's own research.

However, advisors are not acting alone when it comes to constructing client portfolios. A number of IMCA advisors report at least sometimes using either academic research or third-party software packages in order to determine client asset allocation. IMCA members detailed a number of factors that could ease the challenges associated with portfolio construction. The common thread running through these were training and on-demand support. Home-office support ranked first and access to research specialists ranked fourth, as advisors sought resources they could tap into in order to address questions they might have regarding specific situations. Training ranked third and designations or education ranked fifth, as advisors felt additional information could better inform their decisions.

When reviewing the market forces making portfolio construction more challenging for advisors, Cerulli Associates sees no signs of these trends abating. The volume of product and the complexity of assembling it will not slow down anytime soon. However, this creates opportunities for advisors, broker–dealers, and asset managers. Advisors must understand and be able to talk intelligently with their clients about the sea of options available to them. They also must be able to demonstrate how these do (or do not) improve their portfolios. Likewise, broker–dealers and asset managers must assist advisors in understanding how these new products fit together and how they best fit in a client portfolio.
