THE DISRUPTIVE EFFECTS OF FREE MODEL PORTFOLIOS

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Free asset allocation models offered on no-cost model marketplaces will erode the market presence of turnkey asset management providers and third-party strategists

CERULLI ASSOCIATES

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Free Models

Asset allocation strategists are becoming increasingly popular with advisors and their firms, with 70% of managed account sponsors indicating they allow advisors to use third-party strategists, and half that number (35% of the total) looking to expand their lineup of strategists.

Yet the landscape for asset allocation strategists is changing dramatically as large asset management firms enter the asset allocation strategist market, offering full asset allocation models with no explicit strategist fee. These firms have broad enough mutual fund and exchange-traded fund lineups to populate all—or nearly all—of the asset classes and sub-asset classes required to create a complete client portfolio.

Asset managers offer these models at no cost, forgoing the strategist fee by allowing the expense ratios of their funds to subsidize revenue lost. These "free" asset allocation models threaten to displace third-party strategists that often charge 10–25 basis points. An executive who works with strategists tells Cerulli, "The third-party strategists ... They are in trouble. From the amount of calls I have received no-cost, they are concerned." Some analysts also argue that no cost asset allocation strategies offered on the emerging strategist platforms will displace large turnkey asset management providers (TAMPs) such as Assetmark and Envestnet.

Summary

Large asset management firms are aggressively promoting free asset allocation models, threatening to disrupt the market position of third-party strategists and turnkey asset management providers (TAMPs).

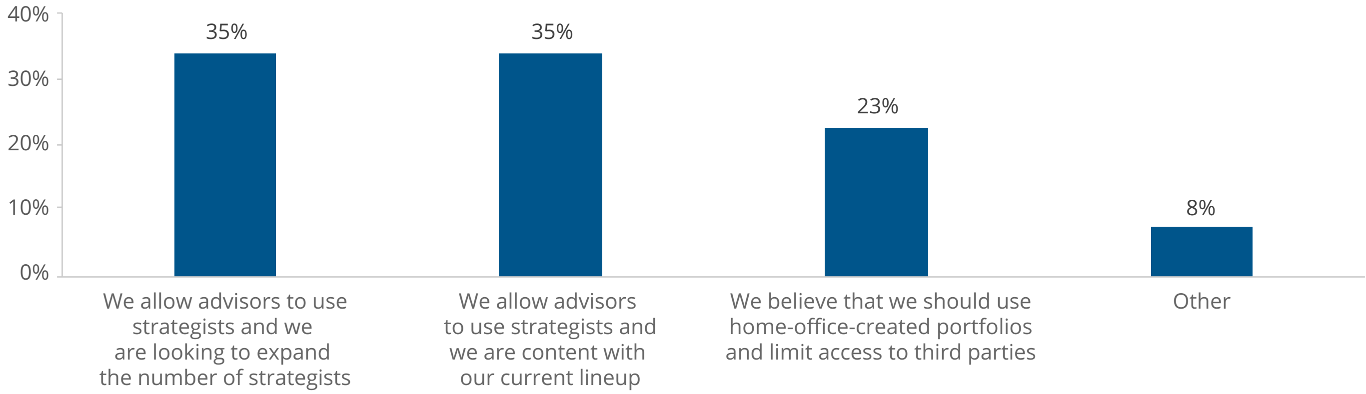
Key Points

- The landscape for asset allocation strategists is changing dramatically as large asset management firms enter the asset allocation strategist market, offering full asset allocation models with no explicit strategist fee. In addition, asset allocation model marketplaces have emerged, offering these free portfolios without charging a platform fee.
- Free asset allocation models offered on no-cost platforms threaten to erode the market presence of third-party strategists and TAMP platforms, although TAMPs may be less affected because they offer a wide variety of other solutions and can package these solutions into an all-inclusive platform.

EXHIBIT 1

Managed Account Sponsors' Opinions of Third-Party Strategists, 2018

More than one-third (35%) of managed account sponsors look to expand their roster of third-party strategists.



Source: Cerulli Associates

Analyst Note: Respondents were asked, "What is your opinion of using third-party strategists to build asset allocation models for your advisors?" Other includes, "We have a strong home-office-created platform and will continue to strongly support it and offer third-party strategies that either offer additional mandates we wish to outsource or add complementary strategies to our own traditional allocation strategies," and "We do not allow our advisors to create or manage models; all of our managed accounts are run by our home office."

Free asset allocation models have been around for quite some time. Firms such as BlackRock, Franklin Templeton, and the Capital Group have distributed model portfolios to advisors on printed handouts for years, spawning the term "paper models" as a name for these portfolios. Recently, a new class of product distribution platforms called model marketplaces has emerged to allow advisors to go beyond manually updating accounts when paper models change. Tech firms such as Orion, Oranj, and Riskalyze, along with Morningstar and TD Ameritrade, have created platforms that allow advisors to assign client accounts to an asset allocation model provided by a firm such as BlackRock, Wilshire, or Vanguard, allowing these accounts to be rebalanced with each model change.

Different from a TAMP

This sounds much like a TAMP, but model marketplaces differ in two important ways. First, unlike a TAMP, in which an advisor cedes discretion to the strategist allowing them to automatically trade a client's account with each reallocation, model marketplaces leave it up to the advisor to decide whether to accept the model's changes for each account. Second, model marketplaces do not charge a fee to the advisor or their client for access to the portfolio models, whereas TAMPs charge a platform fee, and strategists distributed through the TAMP charge a strategist fee.

Model marketplaces have tremendous appeal because so many advisors rely upon models when building client portfolios, but then tweak these models to a client's specific needs. Nearly half (46%) of advisors start their portfolio construction process with an asset allocation model provided by their broker/dealer, practice, or a third party, and then customize the model for each client. Model marketplaces, combined with no-cost asset allocation strategies, allow advisors to satisfy their need to inject themselves into the investment process.

Although advisors hesitate to outsource money management, many understand they need to gain greater efficiency and cannot devote time to a soup-to-nuts effort in crafting client portfolios. Marketplaces hosting "free" asset allocation models provide a compromise solution by allowing advisors to leverage already-created models, while at the same time leaving their own imprint on a client's portfolio. Advisors who are conscious of the total cost of owning a portfolio can do this without loading the account with a strategist or platform fee.

Several industry pundits speculate that asset allocation strategies on model marketplaces will disintermediate TAMPs because marketplaces, which lack platform or strategist fess, are less expensive. Cerulli believes that while these solutions will attract certain advisors,

EXHIBIT 2

Advisor Portfolio Discretion, 2017

Most advisors (46%) create portfolios by starting with an asset allocation model and altering as necessary.

Portfolio Construction Process	Main Influence	All Advisors
Start with models developed by practice and alter as necessary	Practice	23%
Use models developed by practice	Practice	21%
Create custom portfolio for each client	Practice	21%
Start with models suggested by B/D or custodian and alter as necessary	B/D or custodian	18%
Use models suggested by B/D or custodian	B/D or custodian	7%
Start with third-party provider models and alter as necessary	Third party	5%
Use third-party provider models	Third party	5%
Begin with model from practice, B/D, or strategist and then alter as necessary		**46%**
Use model portfolios from practice, B/D, or strategist and do not alter		**33%**
Create bespoke (custom) portfolios		**21%**

Sources: Cerulli Associates, in partnership with the Investments & Wealth Institute (formerly IMCA) and The Financial Planning Association® (FPA®)

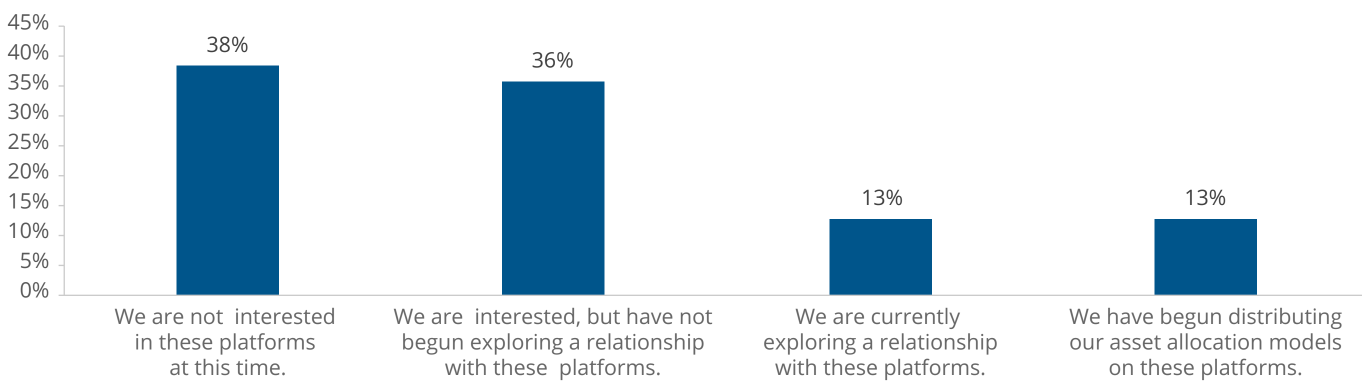
many will continue to value the wide variety of services offered by TAMPs and their ability to package these services in an all-inclusive platform.

Even though model marketplaces will not completely displace TAMPs, asset managers should view these distribution outlets as an important opportunity to cultivate new clients. The majority of asset managers (74%) have not engaged with marketplaces, but they should carefully explore partnerships with these groups. As one sales executive tells Cerulli, "We launched on TDA's Model Market Center [in] October, started marketing in January, and accumulated a significant amount of assets. We used our CRM to identify money that came in and where it's coming from—50% [from] advisors and teams we have never been in front of."

EXHIBIT 3

Asset Managers' Perceptions of Model Marketplaces, 2018

Only a minority (13%) of asset managers are working with model marketplaces.



Source: Cerulli Associates

Analyst Note: Participants were asked, "What is your opinion of the emerging marketplaces for distributing 'no fee' asset allocation model portfolios (e.g., TD Model Market Center, Orion Communities, Oranj MAX)?"

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