

ETF Model Portfolios

The Due Diligence Factor



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METHODOLOGY

Between November 2016 and March 2017, Greenwich Associates conducted a study examining the ETF model portfolio space. Interviews were held with 90 key industry stakeholders including ETF strategists, investment consultants, national and regional broker-dealers, robo advisors, and turnkey asset management programs (TAMP). Questions explored the dynamics driving growth in the segment and what methods of evaluation both advisors and investors currently leverage when selecting model portfolio strategies and providers.

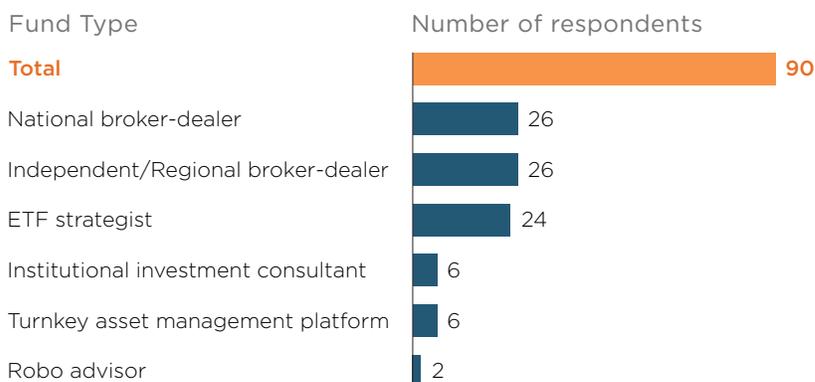


Managing Director Andrew McCollum advises on the investment management market globally.



Associate consultant Christopher Dunn advises the Firm's investment management clients globally.

ORGANIZATIONS INTERVIEWED BY TYPE



Source: Greenwich Associates 2017 ETF Model Portfolio Study

This study was sponsored by:

**STATE STREET
GLOBAL ADVISORS.**

*Source: Morningstar ETF Managed Portfolios Landscape Report, Q4 2017

Introduction

As the number of exchange-traded funds (ETF) model portfolios grows, broker-dealers, fund platforms and other distributors of these vehicles face an increasingly complex task in selecting the right portfolios and providers. To gain a better understanding of what the investment community is looking for from their ETF model portfolios and providers, Greenwich Associates conducted a study of 90 users of these vehicles, including more than 50 national and independent and regional broker-dealers and 24 ETF strategists, as well as representatives from the ranks of investment consultants, turnkey asset management platforms and robo advisors. The results of this study are incorporated into a comprehensive framework for users of ETF model portfolios to follow when conducting due diligence on the expanding array of these products.

By the end of 2017, investors poured at least \$123 billion into ETF model portfolios, according to Morningstar.* Assets under management in ETF model portfolios covered in the Morningstar universe increased 46% in 2017. The rapid proliferation of portfolios and the entrance of new providers into the space is a clear sign that ETF model portfolios will remain on a growth trajectory. The number of options available to investors has expanded rapidly, as the ETF strategists that pioneered these vehicles have been joined by many large asset managers and ETF providers. Investment in ETF model portfolios could increase even more dramatically should long-discussed fiduciary standards be implemented—changing the economics of the brokerage industry.

Finding and selecting the right ETF model portfolios in an increasingly crowded market is very challenging. Assessing traditional due diligence metrics of investment process, performance and price to weed out underperformers and identify top prospects is not enough. To find the provider best positioned to fill the role of a long-term partner, investors need to conduct more thorough evaluations. A comprehensive due diligence process should incorporate a range of qualitative, value-added factors that enable buyers of ETF model portfolios to truly differentiate one provider from another and select the best partner to help achieve their goals. To aid in the evaluation process, please refer to our *ETF Model Portfolio Due Diligence Checklist* on the following page.

By the end of 2017,
investors poured
at least



*Source: Morningstar ETF Managed Portfolios Landscape Report, Q4 2017

ETF MODEL PORTFOLIOS DUE DILIGENCE CHECKLIST

Evaluating an ETF model portfolio involves a thorough assessment of the eight principal elements listed below. Use this checklist to shape a comprehensive due diligence process that truly differentiates one provider from another, helping you select the best partner to assist you in achieving your goals.

 PROCESS	<ul style="list-style-type: none"><input type="checkbox"/> Is the investment process clear, understandable, and repeatable?<input type="checkbox"/> Do the product characteristics meet your specific needs?<input type="checkbox"/> Does the provider execute as outlined in the process?
 PERFORMANCE	<ul style="list-style-type: none"><input type="checkbox"/> Does the performance track record satisfy your expectations?<input type="checkbox"/> Does the product deliver the desired exposures?<input type="checkbox"/> Does the provider employ best-in-class performance evaluation standards?
 PRICE	<ul style="list-style-type: none"><input type="checkbox"/> How are management fees broken out vis-à-vis the fees related to the underlying securities?<input type="checkbox"/> What is the full value-for-fee, taking into account value-add services?<input type="checkbox"/> How are costs minimized with respect to tax efficiency and security turnover?
 RESOURCES	<ul style="list-style-type: none"><input type="checkbox"/> Does your provider allocate dedicated resources to manager and ETF research?<input type="checkbox"/> How does the supporting infrastructure (compliance, legal, risk, etc.) factor into the process?<input type="checkbox"/> Has the provider thoughtfully structured resources to more effectively meet client needs?
 REPUTATION	<ul style="list-style-type: none"><input type="checkbox"/> Is the firm regarded as a stable producer of quality product?<input type="checkbox"/> What is the provider's background in the ETF space?<input type="checkbox"/> Is the provider seen as a forward-thinking thought leader?
 TALENT	<ul style="list-style-type: none"><input type="checkbox"/> How experienced is the portfolio management team?<input type="checkbox"/> What kind of access to key professionals do clients have?<input type="checkbox"/> Is there clear division of labor and subject area expertise?
 COMMUNICATION	<ul style="list-style-type: none"><input type="checkbox"/> Are product messages consistent across touch points?<input type="checkbox"/> Is reporting timely, effective, and thorough?<input type="checkbox"/> Does the provider actively engage in client education?
 TRANSPARENCY	<ul style="list-style-type: none"><input type="checkbox"/> Does the provider explain the process by which benchmarks are selected?<input type="checkbox"/> How does the provider approach revenue sharing agreements with third parties?<input type="checkbox"/> Are you confident in the accuracy of provided performance and attribution documentation?

Begin with the Basics

The evaluation process for an ETF model portfolio should start with fundamentals that underlie due diligence for all institutional investment products: investment philosophy and process, performance and price. A comprehensive assessment of these principal elements will eliminate subpar competitors and shorten the list of candidates. This smaller group of providers can then be compared to identify the firm and the product that best meets the user's needs.

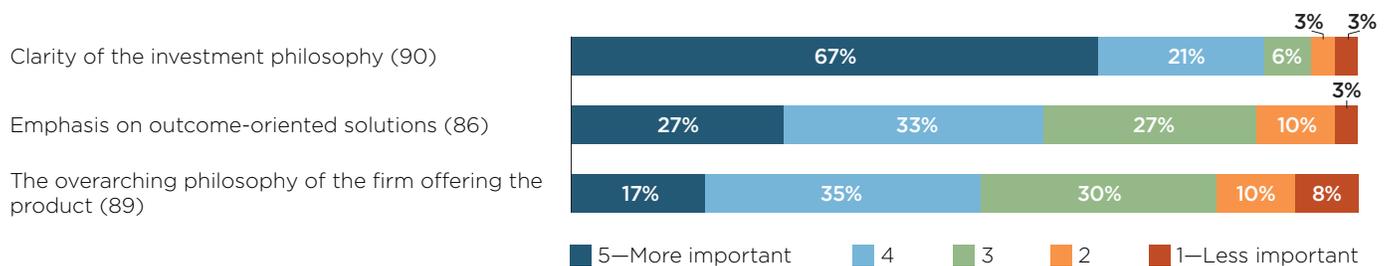


Investment Philosophy and Process

Any projections about a provider's ability to deliver strong results on a consistent basis start with an assessment of the firm's investment philosophy and the structure, execution and overall quality of the investment process.

When it comes to an ETF model portfolio, clarity of investment philosophy and process should be the first requirement. Look for a provider who simply and clearly articulates both philosophy and process in a way that makes immediate and intuitive sense.

IMPORTANCE OF INVESTMENT PHILOSOPHY TO DECISION-MAKING PROCESS

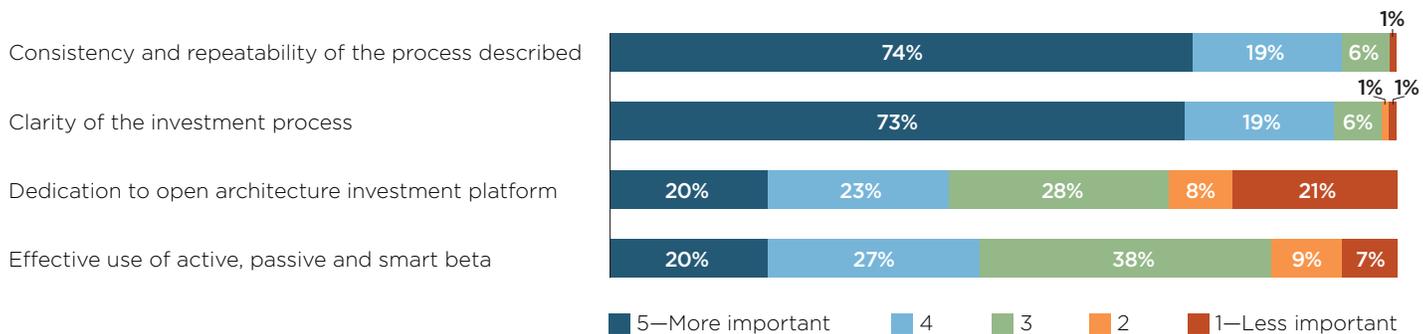


Note: May not total 100% due to rounding. Respondent counts in parentheses.
Source: Greenwich Associates 2017 ETF Model Portfolio Study

Although buyers tend to focus (appropriately) on investment philosophy at the product level, they should not overlook a provider's overarching firm-wide philosophy. An organization's *raison d'être* is often more difficult to nail down than the philosophy behind a product. But a philosophic orientation can play a huge role in determining whether the firm will be a good fit as an ETF model portfolio partner. Buyers should seek out providers with client-oriented philosophies focused on delivering outcome-oriented solutions, as opposed to those with a more product-centric philosophy.

When evaluating investment process, investors should seek consistency and repeatability above all else. “Predictability to the mandate is really, really important,” says the Chief Solutions Officer who specializes in overlay portfolio management for a U.S. asset management platform. “From our perspective, it’s consistency in a way that meets our stated objective...”

IMPORTANCE OF INVESTMENT PROCESS TO DECISION-MAKING PROCESS



Note: May not total 100% due to rounding. Based on 90 respondents.
Source: Greenwich Associates 2017 ETF Model Portfolio Study

The review of investment process should include a close look at how and how well providers design their ETF model portfolios. Even the best day-to-day execution cannot overcome the fatal flaw of poor strategy. “We see a lot of faulty strategic design at the fund level,” says one ETF strategist. “It’s not going to work because they have a program that can’t be executed properly. It’s just doomed to fail due to the nature of how they put it together.”

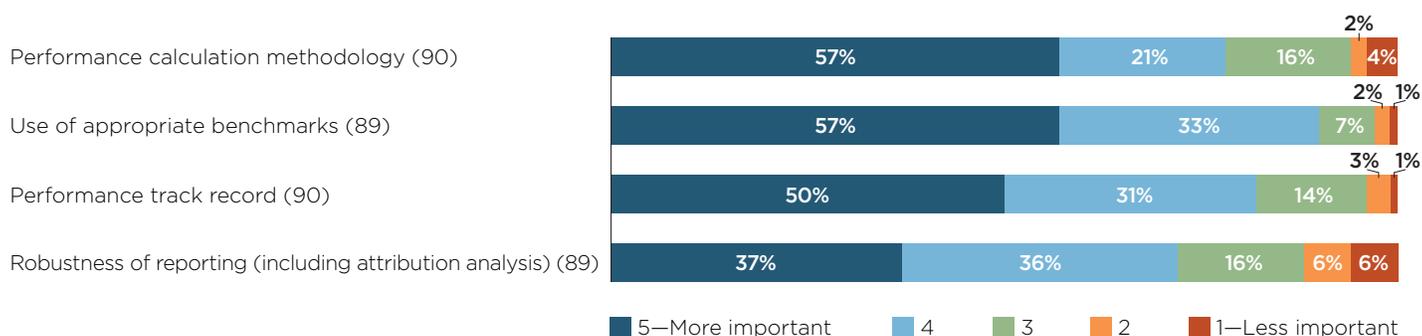
Finally, the openness of a provider’s investment process and platform plays a key role in determining the composition of the portfolios offered to clients. One critical question to ask: Does the provider employ an open architecture platform, leveraging best-in-class third-party products in portfolio construction? If not, determine why the provider eschews this feature—ask the firm to explain in detail why a model portfolio comprised solely of the proprietary funds available on its closed platforms represents superior value to investors.



Performance

About 80% of study participants say performance track record plays a big role in their decision-making processes. However, assessing the historic performance of ETF model portfolios and providers is not necessarily a straightforward task. For that reason, buyers should pay as much attention to how performance is calculated as to reported performance itself.

IMPORTANCE OF PERFORMANCE TO DECISION-MAKING PROCESS



Note: May not total 100% due to rounding. Respondent counts in parentheses.
Source: Greenwich Associates 2017 ETF Model Portfolio Study

The standard performance measures for ETF model portfolios are performance relative to a benchmark and tracking error. While assessing the performance of many underlying ETFs in isolation is straightforward, calculating performance for the portfolio components in aggregate can be more complicated. (For more detail, see the section on Transparency following later in the paper.) However, most users and providers employ some type of blended benchmark, combining a number of relevant performance evaluation measures to analyze investment outcomes.

“There has to be an umbrella evaluation,” says one ETF strategist. “There needs to be a portfolio-level benchmark that provides measurement of tactical asset allocation decisions and performance of individual holdings.” A representative of a national broker-dealer agrees, saying that his firm looks at the totality of the portfolio. “A lot of the time managers are switching in and out, and in my opinion, that would be a fool’s game to look at it any other way.”

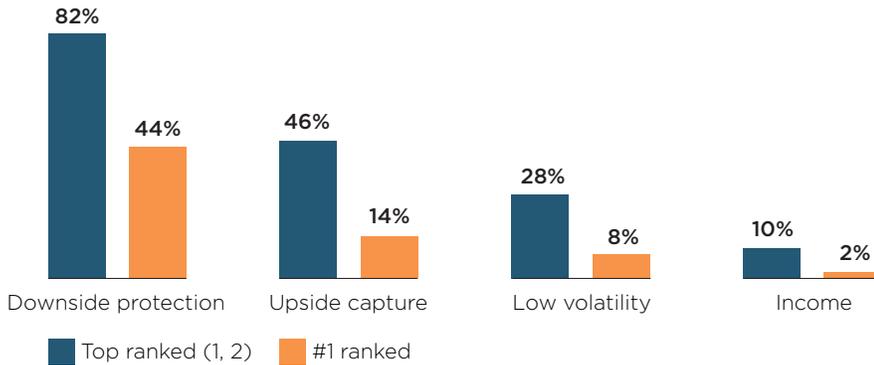
A close examination of the blended benchmarks employed by the provider in reporting overall portfolio performance must be an important part of buyer due diligence.

As a next step, buyers should go beyond relative benchmark comparisons and assess how well providers have done in achieving specific goals. “...We’re looking at capture and performance beyond the benchmark and at the overall assets,” says one ETF strategist. “Benchmarks are just an indicator; it’s how they consistently repeat those returns and how the portfolio is built that are equally important to us.”

In particular, buyers of ETF model portfolios should analyze providers’ track records in delivering downside protection, upside capture and liquidity—the three functions beyond simple returns rated most important by study participants.

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TOP WAYS TO EVALUATE THE SUCCESS OF AN ETF MODEL PORTFOLIO



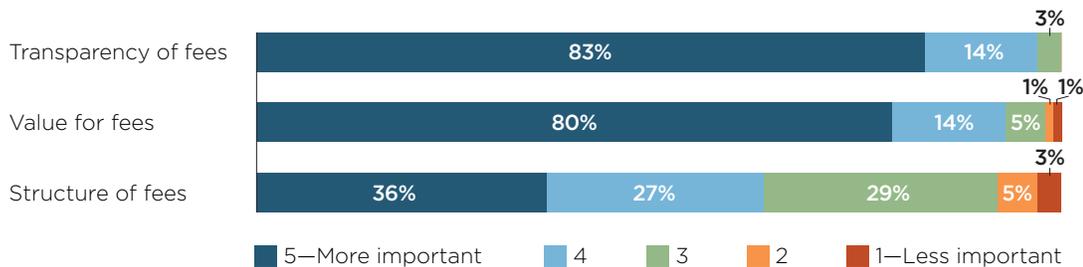
Note: Based on 87 respondents.
Source: Greenwich Associates 2017 ETF Model Portfolio Study



Study participants name price as the top factor they consider when assessing competing ETF model portfolio providers. Although top-line price comparisons are important in assessing competing providers, ETF model portfolio buyers should look beyond overall pricing to components that influence total costs.

Many institutions are already parsing these factors, with participants in the study placing a high priority on fee transparency and the value received for fees paid. Buyers should also pay close attention to fee structure, the complexity of which can sometimes obscure actual costs for ETF model portfolio buyers. Moreover, users should look at the fees relative to the strategy being provided, as the product's overall perspective can influence fees charged.

IMPORTANCE OF PRICING AND FEES TO DECISION-MAKING PROCESS



Note: May not total 100% due to rounding. Based on 89 respondents.
Source: Greenwich Associates 2017 ETF Model Portfolio Study

Take a Deeper Dive

Given the complexity involved in assembling and maintaining an ETF model portfolio, it's clear that potential buyers should be adopting a more comprehensive and sophisticated due diligence process that goes beyond the basic categories of philosophy, process, performance, and price. There are several considerations unique to ETF model portfolios that potential buyers should incorporate into their due diligence frameworks:



Resources

When asked to name the area in which current or past providers of ETF model portfolios most often fall short, study participants point to a simple lack of resources that limit the providers' ability to deliver on promises.

Investors should carefully evaluate the robustness of provider infrastructure. Does the firm have sufficient staff, resources and capabilities in the areas of risk management, legal and compliance? Does the firm have a client-centered structure and designated resources to coordinate all these functions, delivering a high-quality service and a seamless solution to the buyer? These questions are especially relevant when conducting due diligence on boutique firms with relatively small staffing and budgets.

These concerns are clearly important to investors. Approximately 80% of study participants rank investment-supporting infrastructure, including risk management, legal and compliance, as important criteria in provider selection. Three-quarters cite the amount of resources providers dedicate to manager/ETF selection as an important factor in their decision-making.

“We see chronic pitfalls more in the operational area of these firms,” says the representative of a U.S. asset management platform. “We have found that the sales and marketing teams are really powerful. But what they stink at is the actual execution—sometimes delivering the wrong information. Once you get below the marketing level, you see that they don't invest as much in the operational structure as they do in the marketing and sales infrastructure. And that is widespread—up and down the board, everywhere you look, with a couple of exceptions.”

80% of study participants



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Study participants had a lot to say about the lack of resources among ETF model portfolio providers:

- One of the areas that is underinvested in is their compliance function. I would also say that their sales and support functions are usually less robust...but you largely see these things in smaller firms.
~ Regional broker-dealer
- Especially for small and emerging managers, they tend to be short resources across the board. You'll have the same person who's doing compliance also doing admin work and also doing some marketing. We definitely don't like to see that and tend to shy away from those firms.
~ National broker-dealer
- Most [providers] seem to be focused on just selling the product and not necessarily a broad-based solution. This fits real well, but how does it work with everything else? I would like more of a "we're a team" approach. It's more of a relationship than it is a product to us.
~ Regional broker-dealer



Experience and Reputation

A vice president for a U.S. ETF strategist puts it best: "You know that old saying, 'Nobody ever got fired for buying IBM'? There is something to it, dealing with these larger well-known companies."

With so many providers entering the market for ETF model portfolios, there is wide variation among competitors in terms of their experience, expertise and commitment to these products. Although investors should by no means write off younger firms or small, boutique providers, the due diligence process should require these providers to make a clear demonstration of their depth of knowledge and capabilities.

The reality is that the largest providers often have capabilities out of the reach of smaller competitors. These advantages can include global footprints that provide access to products and research from international markets, and expansive in-house ETF businesses. Of course, bigger is not always better. The due diligence process on large providers should answer the question of whether the firms have the reputation of being able to harness diverse capabilities into effective strategy and service delivery.

Among study participants, 80% consider a provider's experience in the ETF model portfolio business as an important factor when selecting a partner, and half try to evaluate the overall expertise of the provider. To that end, about 50% of study participants assess the firm's reputation as a thought leader in the space as part of their ultimate decision in choosing a partner.



80% consider a provider's experience in the ETF model portfolio business as an important factor when selecting a partner

“We respect brand,” says one study participant. “The size of the company and the reputation of the company as a fair-minded provider and that they’re not fly-by-night.” Another study participant talks about the value of a “clean” reputation: “It makes research go better and our due diligence go better. I don’t want to have to overcome some of the challenging questions that I get a lot nowadays. Keeping it clean and compliant. Integrity—have a high degree of integrity.”



Talent

Buyers of ETF model portfolios should look for providers with clear divisions of labor across functions. Dedicated staff to investments, manager and ETF selection, risk management, legal and compliance functions demonstrates that a provider has the resources, expertise and commitment required to execute their strategies and support clients on a day-to-day basis.

As a study participant from a national broker-dealer puts it, “‘Key man risk’ is not confined to small managers, but it’s definitely in small managers. We like to see dedicated people in various functional areas.”

It is also important to confirm that, as a buyer, you will have access to multiple touch points across the organization to help deal with issues that arise in each of these essential functions. That said, buyers express a clear preference for a single point of contact who can act as a quarterback and coordinate the activities of professionals and functions across the firm. Relationship manager (RM) performance will go a long way in defining the quality of service the investor receives and the overall client experience. As such, RM quality should be a key consideration in due diligence.

As in any investment business, the tenure of professionals is a marker of both organizational stability and experience/expertise. In fact, 63% of study participants say they regularly consider the tenure of professionals as an important factor in their due diligence.



Communications

Given the increasing array of available ETF products and the significant amount of time required to review them, buyers of ETF model portfolios would like to rely on the expertise of their providers. However, that expertise will be of no benefit if providers fail to communicate with their clients consistently and effectively.

“Providers that deliver a consistent message to the marketplace and have enough resources to work with advisors on a more personal level are going to deliver a stronger service to that organization,” says the CIO of a turnkey asset management platform.

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~CIO of a turnkey asset management platform

Buyers should seek out providers with a proven track record in the area of client communications. They should review past examples of firm communications to assess consistency, comprehensiveness, responsiveness, and proactivity. Providers should be continuously sharing investment ideas and alerting investors about any changes to the portfolio or underlying products, providing relevant updates about the firm itself and supplying market research and thought leadership that informs clients' monitoring of the portfolio. Investors should expect a steady flow of communications from the firm's various strategy teams.

Of course, all those communications features are secondary to basic reporting, which should be a minimum criterion for consideration. In the case of ETF model portfolios, which are often comprised of many underlying ETFs that provide different exposures and serve different functions, buyers should pay particular attention to performance attribution.

Transparency

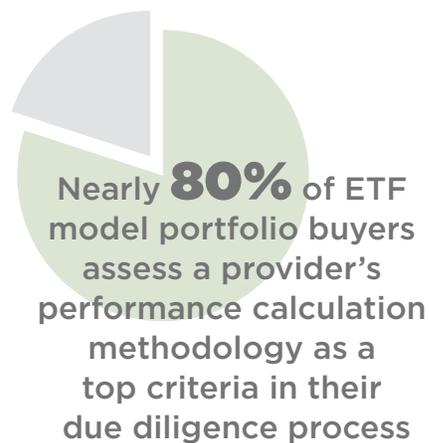
With a growing universe of ETFs and increasing numbers of ETF model portfolios, provider transparency must be a paramount concern for buyers. Buyers should pay special attention to transparency in two key areas:

1. Performance Assessment and Reporting

Calculating the performance of an ETF model portfolio is a complicated task. Nearly 80% of ETF model portfolio buyers assess a provider's performance calculation methodology as a top criteria in their due diligence process. As a best practice, buyers should have in place a standardized process for reviewing and assessing performance reports from all potential providers.

Participants in the study use a variety of approaches, including contracting with a third-party expert, requiring GIPS compliance or employing an in-house application to review performance calculations and reports. "We use a number of different data sources such as FactSet, Bloomberg and Morningstar," says one national broker-dealer. "We use a compilation of those along with proprietary approaches from a data-mining standpoint to cross-check and verify the information that we see."

For most users, benchmarks act as the foundation for performance evaluation in ETF model portfolios. Participants in the study see benchmarks as critical to the process, but imperfect. "Most of the time you can't find the right benchmarks," says a representative of a robo-advisory firm. "They tend to be overly simplistic and they have a lot of weaknesses. They're a necessary part of this business. But a lot of times, there isn't a good fit for what you're looking for. We're doing customization. I'm looking for more transparency from the provider."



During due diligence, buyers should determine not only which benchmarks are used on the portfolio, but also why these benchmarks are used instead of other options. One study participant explained his firm's approach: "We'd actually do an analysis of the benchmark and then form a view of the various instruments relative to the benchmark, and then form a view as to which of the benchmarks is best constructed that we'd most like to follow."

2. Conflicts of Interest

In this era of heightened regulatory and compliance standards, financial service firms must avoid any potential conflicts of interest at all costs. This can be difficult in complicated portfolios with many underlying products and managers. "The industry is moving on a path of wringing conflict out of investment management in any [way] they can, and we tend to be pretty serious about conflicts and complying with regulations as such," says a regional broker-dealer.

Buyers of ETF model portfolios should seek out providers with clearly defined functions and reporting lines, both of which can stave off potential conflicts of interest within model portfolio teams.

Buyers should also be wary of revenue-sharing agreements. During due diligence, investors should push providers to disclose any such arrangements. The majority of study participants say revenue-sharing agreements raise red flags. About a third of the respondents consider these arrangements "deal-breakers," and another third say the existence of revenue-sharing arrangements would trigger additional scrutiny.

As a best practice, buyers should identify any revenue-sharing agreements among their buyers during due diligence and either avoid firms that have them or put in place some process to monitor the issue on an ongoing basis.

ACTIVE, PASSIVE AND SMART BETA: TO MIX, OR NOT TO MIX?

One central question in both building and assessing the performance of ETF model portfolios is whether and how to mix active, passive and smart beta strategies within individual portfolios.

Forty-six percent of participants in the Greenwich Associates 2017 ETF Model Portfolio Study say they will not mix these strategies in one portfolio. At the other extreme, 36% of participants view the combination of these approaches favorably, as a sophisticated way to create value.

Study participants gave conflicting opinions on the topic:

“I tend to use a mix because it aligns with my thinking—you can use all the tools available. But it depends on the asset class because it may not make sense to do a combination in, say, large caps. We’d simply use a passive strategy.”

-National broker-dealer

“Passive and smart beta together is fine, but there’s a risk when you’re putting together portfolios with active and more rules-based strategies. It’s hard to combine them because you don’t know at any given time what the active portfolio is doing. So if you’re trying to combine with the other strategies, it’s hard to do that in a robust way.”

-Robo advisor

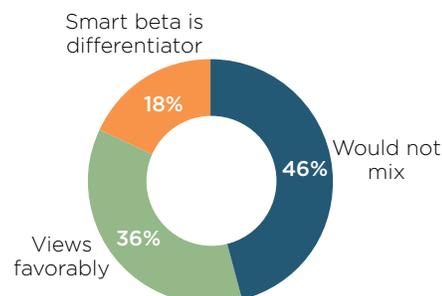
“We’re typically looking for passive management, so a blend of the three is less than ideal. We’ll create the blend on our own.”

-Regional broker-dealer

“It depends on the client goal. It’s a complicated question. I’m not necessarily a big proponent of smart beta or active strategies unless they fulfill a particular need that I have.”

-ETF strategist

TOP MESSAGES



Note: May not total 100% due to rounding.
Based on 83 respondents.
Source: Greenwich Associates 2017 ETF Model Portfolio Study

Conclusion

Broker-dealers, fund platforms and other users of ETF model portfolios require a due diligence framework that takes into account the unique characteristics and complexity of these strategies. An effective due diligence process must cover a host of factors, ranging from the composition and construction of the portfolio to its actual and relative performance.

However, users of ETF model portfolios are not just buying a portfolio—they are selecting a partner who will support the portfolio and the relationship over a long-term horizon. As a result, potential buyers must also analyze important value-added factors, including providers' level of expertise and commitment to the products, resource levels, talent, and communication practices. Finally, users must have in place a process for identifying and dealing with revenue-sharing agreements and conflicts of interest that arise within these portfolios and among providers.

Accounting for all these specialized factors requires significant experience with ETF model portfolios and providers. For this reason, buyers of these products should rely on established best practices when implementing due diligence procedures for ETF model portfolios.

This study was sponsored by State Street Global Advisors.

DEFINITIONS

Downside protection: The use of an option or other hedging instrument designed to limit or reduce losses in the case of a decline in the value of an underlying security. Downside protection often involves the purchase of an option to hedge a long position. Other methods of downside protection include using stop losses or purchasing assets that are negatively correlated to the asset being hedged. An example of downside protection would be the purchase of a put option for a particular stock. If an investor already owns shares and the price of that stock falls, the value of the option will increase and thus limit the total loss exposure.

Upside capture ratio: Upside capture ratios for funds are traditionally calculated by taking the fund's monthly return during months when the benchmark had a positive return and dividing it by the benchmark return during that same month.

Liquidity: The ability to quickly buy or sell an investment in the market without impacting its price. Trading volume is a primary determinant of liquidity.

IMPORTANT RISK INFORMATION

Investing involves risk including the risk of loss of principal.

ETFs trade like stocks, fluctuate in market value and may trade at prices above or below the ETFs' net asset value. Brokerage commissions and ETF expenses will reduce returns.

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