Research | Analytics | Consulting

WHITE PAPER

EDUCATING U.S. ADVISORS TO PRACTICE WHAT THEY PREACH: INCREASING ADOPTION OF RISK-MANAGED STRATEGIES

U.S. advisors may not always be protecting their clients sufficiently from downside risk. It may be that advisors don't understand liquid alternative products or how certain strategies fit in asset allocation. Either way, advisors need to learn alternative ways to manage downside risk for their clients. Asset managers should seize this as an opportunity.

Market Conditions – Why Is There Risk?

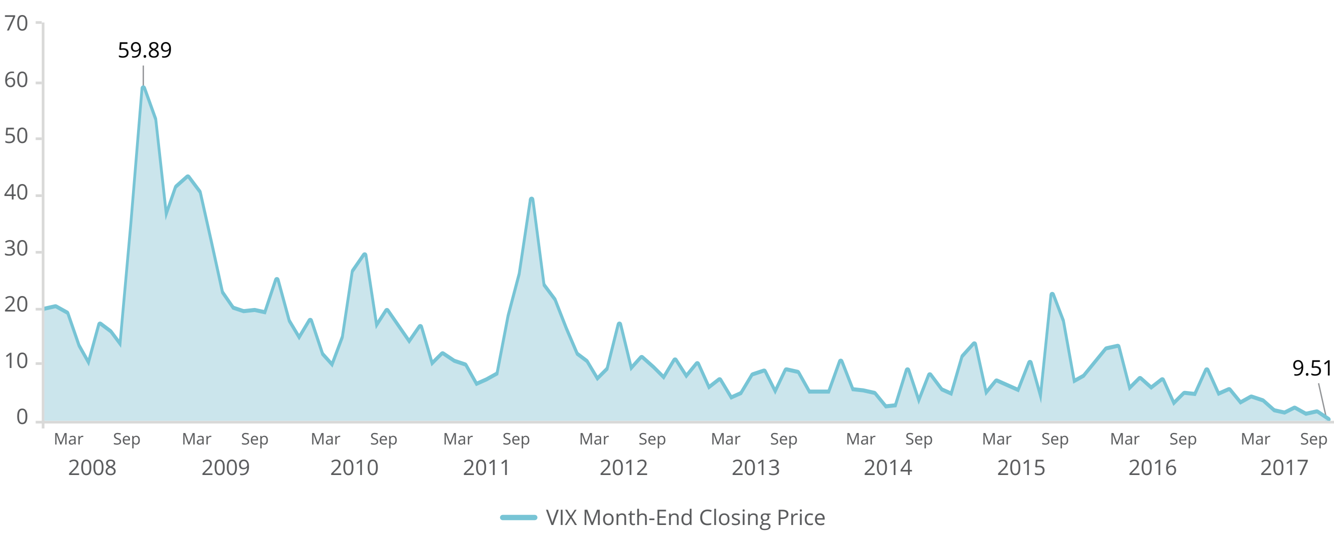
It has been nearly a decade since investors experienced the cataclysmic turmoil brought on by the global financial crisis. Fast forward to 2017, and most the wounds have healed. Since those tumultuous days, the markets have not only rebounded, they have thrived. Investors have recouped their losses, and some have made significant headway advancing their investment returns. Overall, there is general sense of confidence in financial markets, but the past has prompted a "forgive but not forget" mentality from investors, and concerns about managing their investment portfolios through next potential market downturn continue to weigh on their minds.

Despite markets such as the Dow Jones Industrial Average and the S&P 500 closing at unprecedented highs of 22,873 and 2,555, respectively, in October, and the Volatility Index (VIX) buoying near all-time lows over the long term, there have been indications that warrant some consideration for investors to position themselves for a potential risk-off environment should markets retreat from these all-time highs. The following list collectively shows there are some headwinds that continue to outplay market headlines.

1. Geopolitical risks are increasing. Most recently, these risks have been evident in mounting U.S. tensions with North Korea, decertification of the Iran nuclear deal, and nationalism in Europe—including the U.K. leaving the European Union and Catalan independence.
2. The value of the stock market is nearly 150% higher than the nation's GDP, a level last seen around the dot-com bust in 2000, according to the World Bank.
3. Stock pricing continues to outpace earnings growth—valuation metrics such as price to earnings ratios (P/E) are still rising causing valuations to stretch.

Exhibit 1: VIX Month-End Closing Value, January 2008–September 2017

As of month-end September 2017, the VIX was at its lowest level since the onset of the financial crisis in 2008.



Source: Federal Reserve

4. Real GDP growth rates, a leading economic indicator, are down from the 2015 high of 3.3%.
5. The Federal Reserve has hiked short-term rates twice this year. The current Federal funds rate is 1.25% and further rate hikes are expected, which would ultimately increase borrowing costs and slow down the economy.

What Advisors Believe Is Different Than What They Do

Breaking Down Advisors' Book of Business

A review of financial advisors' investment objective affirms there is a heightened focus on downside risk protection in client portfolios. Given that the U.S. has enjoyed a nearly 10-year economic boom, it's reasonable to think that advisors' recent gains—and the need to protect them—weigh heavily on their minds. More than half (52%) of advisors claim they are very focused on downside risk protection over the next 12 months.

The amount of portfolio risk an advisor assumes is largely dependent on their clients' willingness to accept risk, which could be higher or lower than the calculated ability to bear risk based on client age and the amount of investable assets. As a result, no two client portfolios look alike. Client age is one factor advisors must consider when determining risk tolerances of client portfolios. Baby Boomers nearing retirement are less likely to be able to absorb and recover from a significant portfolio loss during a market downturn than Millennials who are just beginning to save for retirement. Despite the difference in age, clients with the longest time horizons tend to be less reluctant to take on equity risk even though they are farther from reaching their accumulation goals because they do not have as much wealth accumulated as clients who have been saving for a longer period of time. Investors who fall into lower wealth tiers cannot afford to bear more risk because they are typically more focused on preserving what little wealth they have accumulated. On the other hand, advisors may have clients who have accumulated significant wealth, but may not have a high tolerance for risk—whatever their reasons may be.

Exhibit 2: Risk Tolerance Thresholds by Core Client Market and Age Range, 2017

Advisors' client risk tolerance varies based on their age and amount of investable assets

	All Advisors by Core Market			
Client Age Range	**<$100K**	**$100K to <$500K**	**$500K to <$2m**	**≥$2m**
Under age 40	20%	12%	9%	10%
Ages 40 to 49	16%	18%	16%	17%
Ages 50 to 59	24%	26%	26%	25%
Ages 60 to 69	23%	25%	28%	27%
Ages 70 to 79	11%	13%	15%	15%
Ages 80 and older	5%	5%	6%	6%

	All Advisors by Core Market			
Client Age Range	**<$100K**	**$100K to <$500K**	**$500K to <$2m**	**≥$2m**
Under age 40	Medium	High	High	High
Ages 40 to 49	Low	Medium	High	High
Ages 50 to 59	Low	Medium	Medium	High
Ages 60 to 69	Low	Low	Medium	High
Ages 70 to 79	Low	Low	Medium	High
Ages 80 and older	Low	Low	Medium	High

Green High Risk Tolerance — Yellow Medium Risk Tolerance — Red Low Risk Tolerance

Source: Cerulli Associates

Investor Perceptions of Passive

Assessment of a client's risk tolerance is a chief premise for how an advisor constructs a given portfolio. From the investor perspective, many understand the basic premise of passive investments, but may not recognize the risks associated with the bargain prices passive offers. According to a recent study conducted by Natixis Global Asset Management, two-thirds of investors recognize that passive strategies offer market returns, and 58% know that they are supposed to deliver these returns at a lower fee. Yet, investors may be blinded by the bargain passive investments offer, forgetting about potential risks associated with investing in passive strategies. Nearly two-thirds (62%) have the misconception that passive investments are less risky and 63% believe index funds can help minimize losses. Further confirming this is a recent study by Edward Jones showing that 64% of Americans are concerned about market volatility over the next 12 months, yet 55% of respondents have no plans to adjust their portfolios even if the market declines by more than 10%.

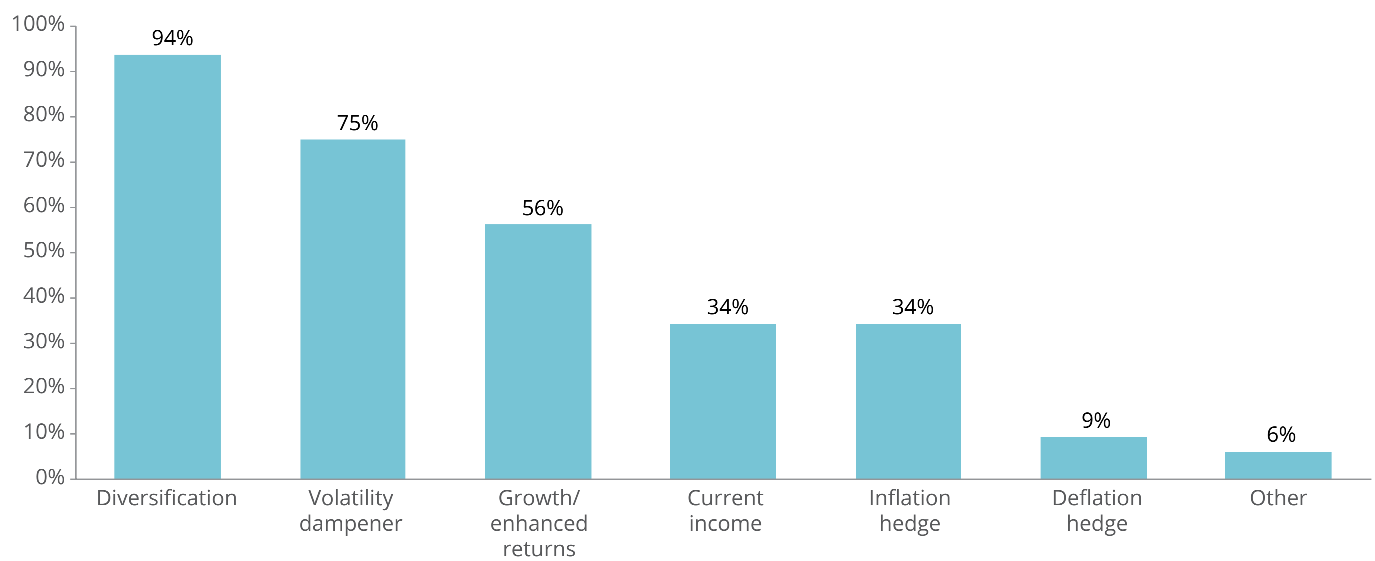
Practice What They Preach

Fortunately, most advisors know how to differentiate the opportunities and risk of passive investments. According to Cerulli data, while 81% of advisors recognize that passive investments help to minimize overall portfolio fees, 74% of advisors believe that in volatile markets, active managers can offer downside risk protection through their ability to tactically trade.

Advisors' sentiments about passive strategies indicate they are aware of the shortcomings, but their plans to increase use of passively managed funds and exchange-traded funds (ETFs) over the next two years implies they may not be practicing what they preach. In layperson's terms, advisors feel there is little need for protection in a market that keeps going skyward, yet when asked, they share the viewpoint that they are most concerned about managing risk in client portfolios. Over the past two years, actively managed mutual funds suffered outflows of $XXX billion while index funds and ETFs gathered $X.XX billion. Furthermore, advisor-reported portfolio allocations tell Cerulli 29% of their portfolios are currently allocated to passive strategies, but the percentage is expected to increase to 33% over the next two years. Perhaps advisors believe that their current approach to managing downside risk is sufficient? Maybe advisors think the most effective way to manage downside risk is to pour money into bonds, as evidenced by the substantial flows going into fixed-income ETFs this year.

Exhibit 3: Primary Objective of Liquid Alternative Investment Strategy, 2017

The primary objective of liquid alternatives, according to three-quarters of asset managers surveyed by Cerulli, is to serve as a volatility dampener.



Source: Source: Cerulli Associates

Implications for Product Development and Positioning

Based on the assumption that most advisors understand the importance of downside risk protection but that they may not be implementing the strategies that help them best achieve their objective, there is potential opportunity for asset managers with the right products. Successfully taking advantage of this opportunity will depend on the product(s) offered, as well as the firm's positioning and distribution efforts.

Exhibit 4: Advisor Interest in Strategic Beta Strategies, 2017

Financial advisors are most likely to consider using risk-weighted strategic beta.

Factor	Considering Using	Previously Used	Not Using
Risk weighted	17.2%	6.1%	44.7%
Earnings weighted	17.2%	13.5%	52.3%
Multi-factor	17.1%	7.5%	33.0%
Fundamentally weighted	15.6%	3.7%	43.6%
Momentum	13.6%	7.4%	43.2%
Risk parity	13.6%	3.7%	66.1%
Low volatility	13.5%	0.0%	37.2%
Minimum variance	13.5%	7.4%	59.4%
Equal weighted	13.4%	3.7%	41.3%
Quality	9.8%	0.0%	42.9%
Dividend weighted	9.7%	0.0%	41.4%
Value	6.0%	0.0%	23.6%
Growth	6.0%	2.2%	21.7%

Source: Source: Cerulli Associates

Product Offering Downside Risk Protection

Asset managers have developed, and continue to develop, product that aims to provide return while also seeking to mitigate risk or reduce volatility. Most notably, this includes the slew of liquid alternative products launched in the wake of the financial crisis. The primary objective of liquid alternatives, according to three-quarters of asset managers surveyed by Cerulli, is to serve as a volatility dampener. Furthermore, 77% identify the need to optimize risk-adjusted performance of portfolios as a significant driver of interest in alternatives. However, as assets and flows would indicate, turning interest into action has not necessarily come to fruition. Cerulli's sizing of liquid alternative mutual funds reveals that assets have plateaued since 2013 ($345.7 billion), now standing at $343.7 billion as of 1Q 2017. As of late, liquid alternative mutual funds collectively suffered net negative flows, bleeding $12.3 billion in 2015 and $16.2 billion in 2016.

In another go-around, asset managers pursued the development of risk parity funds to help financial advisors limit tail risk. These products use tactical allocation to allocate risks evenly across asset classes, with the goal of better risk-adjusted returns. Entrants into this space include Columbia and AQR, among others. While adoption has been limited, Columbia's Adaptive Risk Allocation Fund has garnered flows of more than $800 million so far during 2017, and boasts $2.4 billion in assets.

One of the limitations of liquid alternative funds and risk parity products that are currently available is their cost. For example, Cerulli finds that the median management fee for all liquid alternative mutual funds hovers at 1.04% for institutional share classes. Having previously mentioned advisors' proclivity to use low-cost passive investments, asset managers have sought out lower-cost ways to provide downside risk protection. One such method has been through strategic beta ETFs—particularly those tracking risk-weighted indices. Cerulli data shows that advisor adoption remains relatively low, but the factor type is among the most commonly cited by advisors when it comes to potential future use. Asset managers offering these products include VictoryShares and J.P. Morgan, each managing S1.9 billion in risk-weighted ETF assets.

Need to Ramp Up Product Positioning and Distribution Efforts

While supply is evident, it appears to not be enough, as adoption of product with an objective of risk-adjusted return has been slow. Cerulli believes that managers need to adopt lessons learned from the liquid alternatives boom in the post-financial-crisis period to help increase adoption. The cautionary tale that managers need to heed is that the product launches were not accompanied by sufficient support from asset managers. While product information and educational material were provided, efforts need to be more extensive. Arming advisors with the competency to articulately inform their clients they will need to potentially trade upside participation for downside risk protection requires more than baseline knowledge (e.g., index constructions, correlation analysis).

Baseline product information and education on concepts will continue to be essential, but Cerulli believes more emphasis will be needed when it comes to how products should be implemented. At the advisor level, portfolio construction consultants will need to play a bigger role in educating advisors how the products fit within their clients' investment strategies. Services would range from general thought leadership pieces all the way up to customized instruction for investment advisors or advisor teams.

Additionally, more flows are moving through model portfolios, especially those developed and maintained by home offices. Because of the magnitude of potential flows that could stem from landing a product within in a model, this should be an area of focus for any manager. Downside risk is certainly on the minds of the home-office teams tasked with building models—with one executive going as far as to say they will sometimes avoid riskier asset classes that they view as undervalued. Accordingly, key accounts teams, paired with product/portfolio specialists, will be essential to winning sleeves in these models.

The bottom line is that advisors may not always do what they say they are doing to protect their clients from downside risk. This could be due to the complexity of risk-managed strategies or because advisors do not fully understand how certain strategies fit within a broader asset allocation, compounded by the challenge of explaining these strategies to clients. However, there has to be some self-awareness on the part of advisors to learn alternative ways to manage downside risk for their clients. Therefore, asset managers should seize this as an opportunity because, in a perfect world, it would come full circle as a teachable moment both for advisors and their clients. ◆