
EVALUATING ETF MODEL PORTFOLIOS: THE DUES & DON'TS

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This article is relevant to financial professionals interested in model portfolios. WisdomTree ETF model portfolios are available only to financial professionals, through various portfolio platforms.

I previously wrote “Debunking the Myths of a Model Portfolio Approach,” [exposing the difficulties of third-party due diligence as a myth](#).

Let’s prove it by diving deeper into best practices for ETF model portfolio due diligence.

Ask the right questions

Starting at the firm level, here are a few questions advisors should ask when evaluating model portfolio providers:

- How long has the firm been in the ETF business, and does it have a reputable history in model portfolios?
- Has the firm been able to attract top talent?
- Is the firm operationally equipped to manage model portfolios?

The goal is to be assured the model portfolio provider has robust operations and the support in place to manage model portfolios, as well as core competencies in providing asset allocation advice.

Investment Committee

Next up is the investment committee. The key is understanding not just *who* makes the decisions, but also *how*, and specifically *what*, type of decisions are being made. Starting with the “who” and the “how”:

- Who makes up the committee (background, years of industry experience, years at firm, etc.)?
- How long has the committee been in existence and managing model portfolios?

- How are decisions made (group consensus, voting structure, breakout of voting and non-voting members, etc.)?

The depth, breadth and experience of an investment committee is important. It's also crucial to understand this committee in the broader context of the asset allocation framework. This includes the "what" of decisions being made:

- How often does the committee meet, and is it consistent?
- How clear and robust is the investment process, and has the asset allocation framework changed over the years?
- Quantitative vs. qualitative input—how much subjectivity is involved in the fund selection and asset allocation decisions?

Increasing usage of quantitative modeling and data analytics has refined investment processes. It's important to understand how the people and the processes come together and the consistency of that framework.

Model Portfolio Objectives

When evaluating the actual model portfolios, advisors should understand each model's objective:

- What's the model portfolio's benchmark and the tracking error or [style drift](#) relative to that benchmark?
- How often is the model portfolio [rebalanced](#) or reconstituted, and has this been consistent over time?
- Can the investment committee deviate from the equity/fixed income target asset mix of the benchmark?

Don't automatically group all ETF model portfolios together just because they have the risk tolerance "moderate" in their names. The risk and return profiles of moderate model portfolios can materially differ if they lack similar objectives, asset mixes and turnover constraints.

Consider the Investment Universe

- Is the ETF universe open-architecture¹ or confined to the asset manager's proprietary products?
- Which types of asset classes are considered (equities, bonds, commodities, currencies, etc.)?
- Within an asset class, what geographies, [market capitalizations](#) and [factors](#) are considered (domestic vs. international equity exposure, large-cap vs. small-cap, etc.)?

Similarly constructed model portfolios can have large variations in returns and [volatility](#) if their investment universes differ greatly from one another. When evaluating model portfolio performance, ask:

- How long is the live track record and is it third-party verified?
- Does the performance justify the underlying fees of the ETFs or any strategist fees charged?
- Are there any explanatory variables (factors) that can explain the long-term performance relative to its benchmark?

The questions listed above aren't meant to be an exhaustive list but should provide a good starting point.

Many of these questions can be answered on an asset manager's website provided you have the appropriate log-in credentials.

We also highly recommend consulting with the asset manager directly—not only to gain confidence in the firm—but also to understand the level of the support that advisors can expect.

- How much access do advisors have to the investment committee?
- How does the asset manager communicate model portfolio rebalances and their investment committee's views on the market?
- Who is the dedicated point of contact at the firm ?

Communication and transparency are vital in the due diligence process. WisdomTree designed the experience for advisors using our model portfolios with those two things in mind. We also encourage financial professionals to compare other model portfolios with ours by visiting our [Digital Portfolio Developer](#) tool page or contacting a WisdomTree representative.

¹Unrestricted architecture means that a model portfolio may include ETFs other than WisdomTree ETFs. However, the model portfolios are expected to include a substantial portion of WisdomTree ETFs

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DEFINITIONS

Style Drift: The divergence of a fund from its investment style or objective. Style drift can result from capital appreciation. It can also occur from a change in the fund's management.

Rebalance: An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.

Market Capitalization: Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Factor: Attributes that based on its fundamentals or share price behavior, are associated with higher return.