INTEGRATING WISDOMTREE MODELS INTO A "CORE/SATELLITE" FRAMEWORK

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This article is relevant to financial professionals who are considering offering Model Portfolios to their clients. If you are an individual investor interested in WisdomTree ETF Model Portfolios, please inquire with your financial professional. Not all financial professionals have access to these Model Portfolios.

Satellite in my eyes
Like a diamond in the sky
How I wonder
Satellite strung from the moon
And the world your balloon…

("Satellite" by the Dave Matthews Band, 1994)

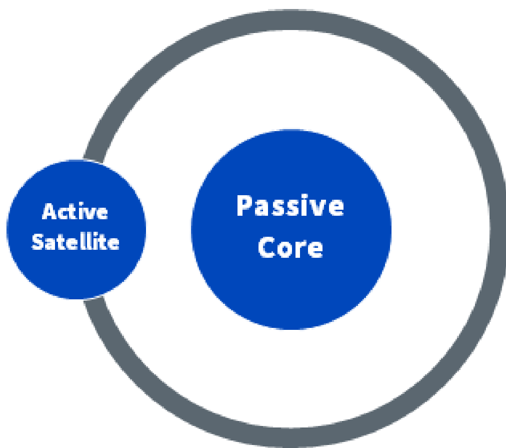
Defining Core/Satellite

Most advisors are familiar with the concept of "core/satellite" portfolio construction (sometimes referred to as "core and explore"), but let's define terms, so we are working from a similar framework.

The idea is to build a relatively inexpensive and passive "core" portfolio, typically using ETFs, in an attempt to build a desired market exposure (or "beta") portfolio in a cost- and tax-efficient manner. Then surround that core portfolio with actively managed "satellite" managers in an attempt to add net-of-fee outperformance (or "alpha") to the overall portfolio. Historically, those active managers have come by way of mutual funds or, for larger clients, separately managed accounts (SMAs).

To understand the notion of adding "alpha," we also need to remind ourselves of the concept of "active risk." Simplistically, active risk can be thought of as "bets" (over-weights, under-weights, factor tilts, etc.) an active manager takes away from the underlying benchmark in an attempt to generate outperformance versus that benchmark.[1]

So, the goal of a core/satellite portfolio is to deliver cost- and tax-efficient outperformance relative to a defined benchmark (e.g., the S&P 500 Index or the MSCI ACWI Index for an equity portfolio).



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Building a Better Mousetrap

The satellite component of the portfolio was constructed using actively managed mutual funds and/or SMAs. But the structural shortcomings of mutual funds are well-known—they are typically more expensive than comparable ETFs, have certain potential tax disadvantages, cannot be traded intra-day and so forth.

But what if you could build the satellite portfolio with structurally advantaged ETFs? Enter the WisdomTree Outcome-Focused Model Portfolios.

We built these models with "satellite" very firmly in mind. While they can be—and are—used as stand-alone models, they were built specifically to complement already existing portfolios to help achieve specific investment mandates.

Our Outcome-Focused models include:

- **Global Dividend**, an all-equity portfolio seeking capital appreciation and high current income.
- **Global Multi-Asset Income**, exactly as it sounds, this portfolio includes stocks, bonds and other assets in an attempt to maximize current income while managing risk.
- **Multifactor**, an all-equity portfolio that seeks to improve the risk factor diversification of an overall portfolio while pursuing the generation of a positive total return. This model is available in U.S., EAFE and EM versions.
- **Volatility Management**, a portfolio allocated to nontraditional or "alternative investment" strategies, including equity long/short, managed futures, diversified arbitrage, short-biased and options-based. The investment objective of including this portfolio is to help improve the overall diversification of the portfolio by including lower-correlated strategies and thereby seeking to deliver more consistent performance over full market cycles.
- **Disruptive Growth**, precisely as it sounds, this portfolio's objective is maximum long-term capital appreciation, and it seeks to take advantage of evolving or disruptive trends in the workplace, platforms, cloud computing, financial technology, cybersecurity, biotech and genomics, video games and esports, and sustainable investing.

All these portfolios are ETF-only, except for the Volatility Management portfolio, which contains one mutual fund (diversified arbitrage). They are all "open architecture" and contain both WisdomTree and third-party strategies. We charge no strategist fee on the models—our revenue capture is only the expense ratios of any WisdomTree strategy we include in each model.

If you know WisdomTree, you know we are not a passive beta shop, even though we are an ETF shop. ALL our products have one or more "factor tilts" embedded in them—dividends, value, size, quality, earnings and so forth.

In other words, all our strategies take "active risk" relative to an underlying passive beta index—risks that we believe, both academically and empirically, have the potential to deliver "alpha" over full market cycles in comparison to passive beta.

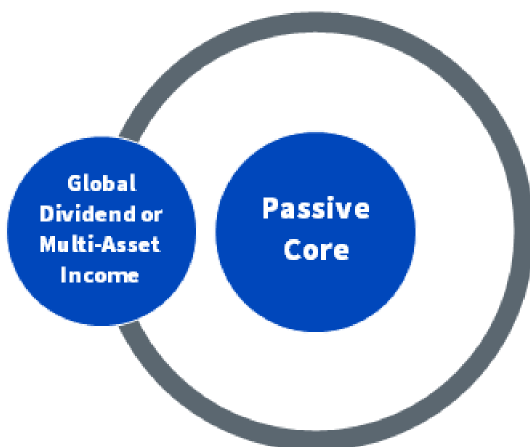
Think about an actively managed mutual fund (the typical component of a "satellite" portfolio). What is it? It is a portfolio manager (or team) taking on active risk in an attempt to deliver net-of-fee alpha, right?

Well, that is exactly what WisdomTree does. The difference is that our active risk "bets" are rules-based and quantitative in nature. We are one of the few asset managers that "self- indexes"—we define a quantitative and rules-based filter or screen for a given product, develop an index around those defined screens and then wrap an ETF around that index.

So, in many respects, despite being an ETF shop, most of our products are more accurately compared to actively managed mutual funds than passive beta products. We typically will be more expensive than the passive beta product but much less expensive than the more comparable mutual funds while taking on similar active risk.

So, let's visualize some potential "core/satellite" portfolios using WisdomTree Outcome-Focused models versus actively managed mutual funds.

1. Goal of the satellite is to optimize risk-adjusted income:



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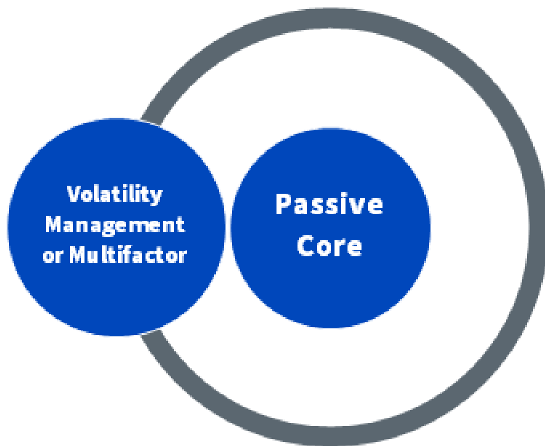
2. Goal of the satellite is to increase the overall diversification of the portfolio:



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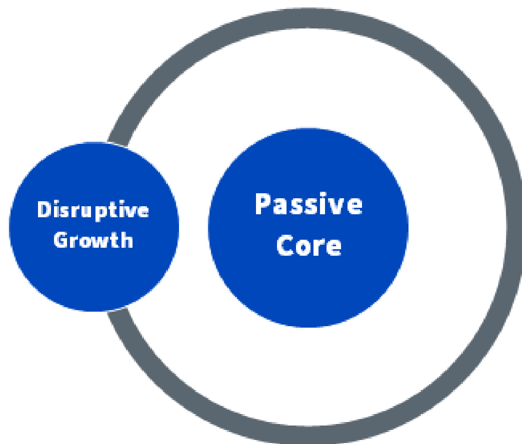
3. Goal of the satellite has potential for high growth and its objective is maximum long-term:



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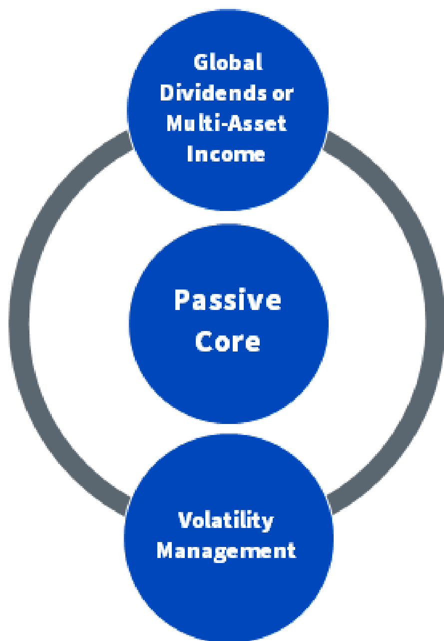
4. Goal of the satellite is maximize long-term capital appreciation and overall portfolio diversification:



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Conclusion

The beauty of "core/satellite" portfolio construction is that the possibilities are almost endless—you can construct the satellite portfolio with myriad investment objectives and populate it accordingly.

We built our suite of Outcome-Focused model portfolios with this flexibility in mind. They are designed and managed to address a number of potential investment objectives and can be mixed and matched to meet multiple objectives. A primary purpose in doing so is to make "core/satellite" portfolio construction easy using what we believe is a more cost- and tax-effective approach—a "better mousetrap."

You can learn more about our Outcome-Focused models (allocations, line-item tickers, performance, yields, fees, etc.) on our Model Adoption Center.

[1] The seminal paper on active risk is "How Active is Your Fund Manager" by Martijn Cremers and Antii Petajisto, first published as a working paper in 2006. It can easily be found by searching on the title and authors.

Important Risks Related to this Article

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Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline.

Derivative investments can be volatile; these investments may be less liquid than other securities, and more sensitive to the effects of varied economic conditions

Due to the investment strategy of certain funds included in a model portfolio, such funds may make higher capital gain distributions than other funds. Actively managed ETFs, unlike typical ETFs, do not attempt to track or replicate an index. Thus, the ability of these ETFs to achieve their objectives will depend on the effectiveness of the portfolio manager.

Please see the prospectus of each fund included in a model portfolio for discussion of risks of investing in the fund.

Diversification does not eliminate the risk of experiencing investment losses.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

View the online version of this article here.

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You cannot invest directly in an index.

DEFINITIONS

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Alpha : Can be discussed as both risk-adjusted excess return relative to a specific benchmark, or absolute excess return relative to a benchmark. It is sometimes more generally referred to as excess returns in general.

Separate account : An investment portfolio owned by an investor and managed by a professional investment firm—typically registered investment advisors (RIA). Also known as separately managed accounts (SMAs),

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

MSCI ACWI Index : A free-float adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets.

Stock : A stock (also known as equity) is a security that represents the ownership of a fraction of a corporation. This entitles the owner of the stock to a proportion of the corporation's assets and profits equal to how much stock they own. Units of stock are called "shares."

Bond : A fixed-income instrument that represents a loan made by an investor to a borrower (typically corporate or governmental).

EAFE : Refers to the geographical area that is made up of Europe, Australasia and the Far East.

Emerging market : Characterized by greater market access and less potential for operational risks when compared to frontier markets, which leads to a larger base of potentially eligible investors.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Long/short : An investing strategy that takes long positions in stocks that are expected to appreciate and short positions in stocks that are expected to decline.

Managed futures : An alternative investment strategy in which futures contracts are used as part of the investment strategy.

Arbitrage : The simultaneous purchase and sale of the same asset in different markets in order to profit from tiny differences in the asset's listed price.

Dividend : A portion of corporate profits paid out to shareholders.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Size : Characterized by smaller companies rather than larger companies by market capitalization. This term is also related to the Size Factor, which associates smaller market-cap stocks with excess returns vs the market over time.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over tim.