The evolution of blending

Turning ‘active vs passive’ into ‘index, factors and alpha’

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Delivering outcomes as returns become harder to find

Advisors today aim to improve client outcomes while also reducing cost. With likely lower returns and higher volatility ahead, the stakes are high and the decisions are complex. Advisors must wrestle with thousands of funds and tradeoffs between expected returns, cost, tax efficiency and risk. But we believe there is a way to cut through the noise and achieve desired investment outcomes for clients: Build efficient portfolios by blending complementary sources of return.

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Advisors traditionally have built portfolios based on two investment types: index and active (or alpha-seeking) strategies. Some held all alpha-seeking products and began to add index strategies to lower costs. Others have held all index products for broad asset allocation with low fees. Whatever your starting point, we believe investors can benefit from incorporating factor strategies alongside index and alpha-seeking mandates as a means to pursue lower cost exposure and a source of diversified returns.

We believe index, factor and alpha-seeking investments each offer a unique set of benefits that deserve a place in a portfolio. All three help advisors pursue the excess returns their clients need — important in a lower return environment. All three can be deployed with efficiency and precision.

But that's not enough. Simply having access to the proper tools doesn't ensure success. Going forward, pursuing client return goals will likely require an "all hands on deck" approach to portfolio building. Identifying and using all three sources of returns is likely critical to achieving success. In other words, we believe that thoughtfully combining index, factor and alpha-seeking strategies may lead to more diversified portfolios and superior results.

Index strategies	Factor strategies	Alpha-seeking strategies
Seek to provide low-cost, diversified market exposure and can serve as the anchor for core portfolio exposures	Seek to provide incremental returns by targeting historically broad and persistent sources of return such as value, momentum and quality	Seek incremental returns by targeting unique and harder to access insights
No excess returns, unless through successful market timing	Potentially meaningful excess returns	Potentially meaningful excess returns and differentiated from factor returns
Lowest fees	Low to moderate fees	Moderate to high fees

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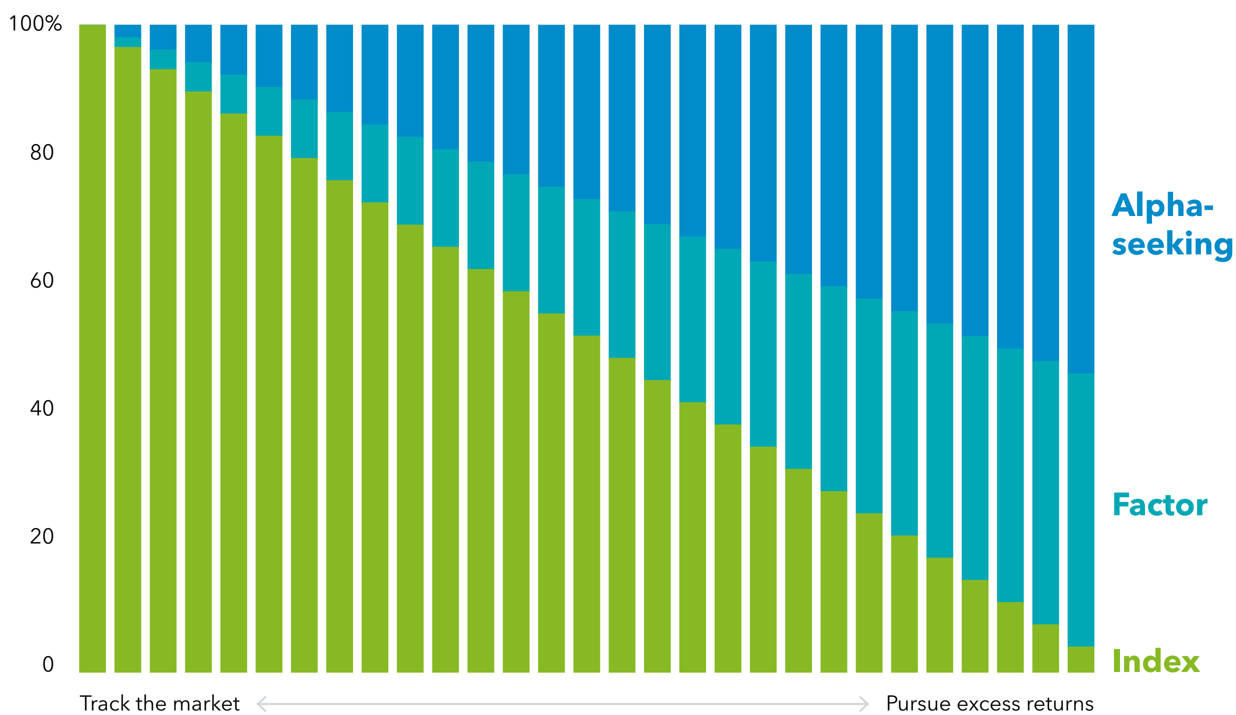
Combining index, factor and alpha-seeking strategies

Indexing. The first decision an advisor must make is the client's asset allocation. Index vehicles offer low-cost exposure to asset classes and serve as the portfolio's base. Consider starting with index strategies at the core of the portfolio.

The next question to ask yourself: How much excess return (or active return) are you looking to generate for your client? The flipside to that question is how much downside can your client endure if your tilts prove incorrect? (See "Setting tolerances" section on page 5.)

With excess return and risk tolerance levels in mind, we can consider an optimal portfolio across index, factor and alpha-seeking vehicles by making basic assumptions about expected return and risk. From there, the portfolio seeks to become a well-diversified combination of these three complementary sources of return, as shown below.

The mix of index, factor, and alpha-seeking strategies is different at varying levels of active risk



Note: The above chart illustrates the mix of indexing, factors and alpha-seeking strategies at different levels of active risk. Different assumptions can create different weightings, so it's important to understand your inputs. This exercise was based upon risk, return and correlation assumptions for index, multi-factor ETF and low-risk active strategies in U.S. equities. We assume an information ratio of 0.35 for factor strategies and 0.5 for alpha strategies. For illustrative purposes only. These do not reflect the characteristics of any particular fund or strategy.

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Setting tolerances

Determining the right size of portfolio tilts requires an advisor to consider a range of potential outcomes, and understand what level of outperformance or underperformance versus a benchmark is possible over time.

How to do this

1. Make strategic asset allocation tilts yourself (e.g., overweight U.S. large cap).
2. Build intentional tilts toward factors. We recommend focusing on rewarded style factors (e.g., overweight momentum, value, quality).
3. Outsource your tilts to a combination of factor or alpha-seeking strategies.
4. Some combination of the three strategies above.

Targeting the proper range

The goal is to keep your tilts sized within a range over time, defined by two questions:

1. Floor: What fee do you typically charge clients? The tilts should be large enough to recognize this – avoid becoming a closet indexer if clients are assuming you are offering a different service.
2. Ceiling: By how much can you afford to trail the benchmark if the portfolio has a bad year? The tilts should remain reasonable enough to be cognizant of this number and the overall risk tolerance.

Managing the proper level through time

Use your core index vehicles (which replicate your benchmark) to moderate the size of the tilts through time.

The higher excess return you're targeting, the more alpha-seeking and factor exposures you'll need to reach your target. The less excess return you need, the higher proportion of index products you can use, reducing fees and other sources of drag on the portfolio.

The actual return and risk expectations for your own set of managers may vary from our assumptions. Further, clients often guide portfolio design with considerations that are not strictly mathematical. These include the client's ability to tolerate a drawdown, income needs, tax considerations and investing values.

Factors. Factor strategies are an efficient source of potential excess return, and generally earn a lower fee than alpha-seeking strategies. Factors are the broad, persistent drivers of return that result from a risk premium, structural impediment or behavioral bias. Macro factors such as economic growth, real rates and inflation describe movements of whole markets. Style factors capture persistent sources of return within asset classes. Style factor include: value, momentum, carry, low volatility, quality and size. When balanced in a portfolio as part of a strategic allocation, factor strategies can potentially improve your portfolio's return and risk profile over time.

Keep in mind that all portfolios have some level of factor exposure already embedded within existing index or alpha-seeking strategies, so you'll want to know how much you own before you implement. You can either layer in these factor exposures at the broad portfolio level through multifactor ETFs, or fine-tune existing exposures with single-factor funds.

Alpha. The returns of an alpha-seeking strategy should be driven by something unique that demonstrates skill – security selection, tactical asset allocation, or timing broad market and factor moves. Since you will likely pay more for these returns, alpha-seeking strategies should deliver something that can't be obtained through index or factor strategies for less cost. It also places a premium on your ability to identify a skillful manager and to own that strategy during the period of its outperformance.

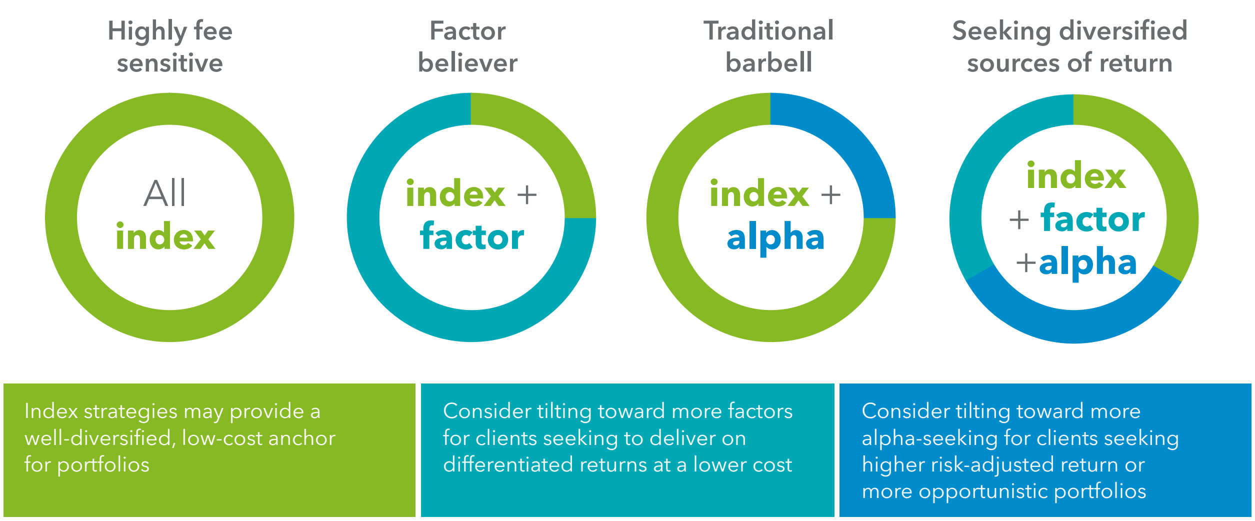
Strategies that deliver alpha are a good complement to index and factor strategies and may result in a higher level of risk-adjusted return for the overall portfolio over time.

Producing alpha is difficult to do, especially for sustained periods of time, and positive excess returns from any source also don't happen every day. However, if you can uncover alpha, it can make a meaningful difference to a portfolio's performance.

You should also consider the potential overlap of alpha-seeking strategies with each other. If two alpha-seeking managers have similar insights, their positions may also be similar. Combining these managers could result in more concentrated exposures and a less diversified portfolio that may earn lower expected returns. Some active strategies may merely duplicate factor returns. Both of these are poor outcomes: You're paying extra fees to get less of the very thing you're paying for.

In practice, it can be a complex exercise to effectively blend indexing, factors and alpha-seeking strategies. Consider working with a partner that has access to the tools and expertise to help. BlackRock can run an x-ray of your portfolio to understand its factor exposures and identify how managers deliver returns, helping you construct an appropriate mix of these three types of return sources. Contact your BlackRock representative for more information.

Illustrative portfolio mixes



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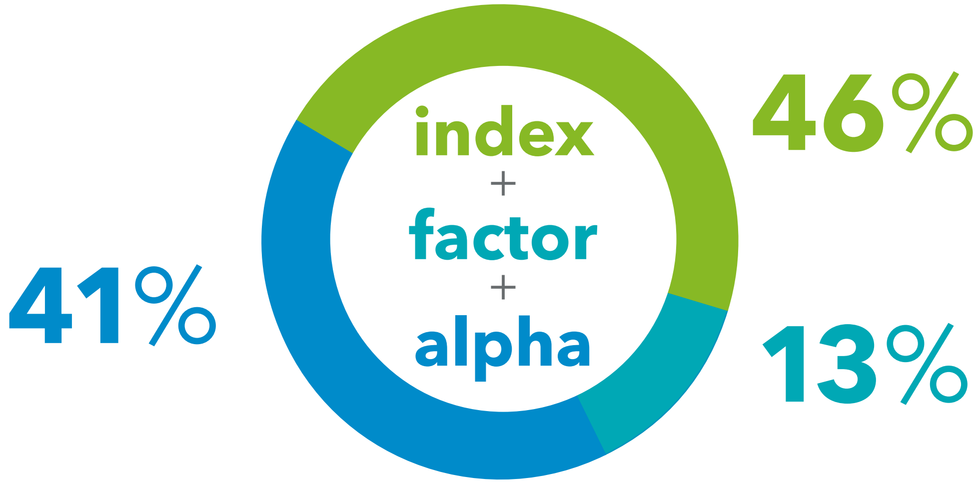
Real-life example: BlackRock Model Portfolios

BlackRock Target Allocation model portfolios use a blend of index, factor and alpha-seeking strategies. Our allocation is typically around 40-50% index, 15-25% factors and 35-45% alpha. With the help of BlackRock's Aladdin® risk analytics, our portfolio strategists calibrate exposures to alpha-seeking mutual funds alongside factors and index ETFs to help deliver an efficient, transparent, low-cost portfolio for advisors to use as a resource in building portfolios for their clients. Core index products are used to manage the overall size of the tilts, while factor and alpha-seeking strategies deliver a diverse set of strategic historical return drivers over time. For more detail, you can subscribe for free[1] to our model portfolios at blackrock.com/models.

BlackRock Target Allocation 70/30



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Conclusion

In a world of lower returns, advisors will likely find it harder to keep their pledge to help clients reach their goals. The ability to create portfolios that seek less drag, more precision, and more persistent excess returns will be a key element separating advisors who make good on that client pledge, and those who fail.

BlackRock's framework is designed to both simplify and go deeper than the traditional approaches. By accounting for costs, sourcing the critical underlying drivers of returns and identifying true alpha, we believe it's a valuable resource for advisors helping their clients navigate a changing world.

Want to know more?

blackrock.com 877-275-1255 (1-877-ASK-1BLK)

1 The BlackRock Model Portfolios are made available at no cost; however, there are expenses associated with the underlying funds within the models. There is no guarantee that the models will be made available.

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