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Build the Portfolio of the Future — Today

By Chris Latham

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Within a decade, asset managers say, U.S. investors' portfolios will look very different from the way they do now. Strategies that an older generation of clients considered daring — alternatives, foreign holdings and sustainable investing — will be mainstream for millennials, who 10 years from now will be right in the thick of their asset-accumulation years. But don't take the providers' word for it: Advisors who responded to a recent *FA-IQ* poll overwhelmingly agreed with that forecast.

What can financial advisors do to prepare for the shift? Experts say it's time to start talking to clients about the potential suitability of these formerly unfamiliar options. But first advisors must understand them thoroughly, so they can ensure that clients grasp not only how they work but also why their risk-reward tradeoffs may enhance traditional portfolios.

Foreign securities don't seem terribly exotic to young investors, who tend to have more nationally and ethnically diverse friends and colleagues than their elders did. Still, advisors must take care that clients don't lump developed and developing markets together — or equities and bonds. Indeed, many wealth managers like to stick with certain subsets.

At RMB Capital in Chicago, which manages more than $3.8 billion, partner Sarah Tims favors developed-market equities. "We're finding ourselves on the fifth anniversary of the bull market in U.S. equities and are looking for places where we can find relative value," Tims says. "We're finding more and more of those abroad."

Sarah Tims. RMB Capital

RMB Capital has steadily increased clients' exposure to international stocks to nearly 30% of a portfolio's equities. And in developed foreign markets, the firm is even adding to small- and mid-cap allocations.

Developing markets also can be great investments for clients with the stomach for volatility, according to Tims. However, because their short- and mid-range outlooks are questionable, she thinks the average client won't want a lot of emerging-market exposure until a few years hence.

As for alts, asset managers are increasingly pitching them to retail investors. Skeptics suggest that fund providers have squeezed the lion's share of profits from institutional clients and are looking downmarket for new assets. Whatever the reason, Tims thinks alternatives will make up steadily larger parts of retail portfolios as management fees decrease and more funds offer daily liquidity.

Some advisors are already solidly on the bandwagon, insisting that alternatives belong in a well-diversified portfolio. “Twenty years ago there were no hedging strategies in a client’s portfolio, and now we could allocate 20% to that,” says **Michael Conway**, whose **Conway Wealth Group** manages over $200 million in Parsippany, N.J. “Long-short. Convertible arbitrage. All in an attempt to mitigate risk” while maximizing returns, he says. Conway uses ETFs and mutual funds for those strategies. He also allocates 5% to 7% of a portfolio to energy, metals, real estate and commodities.

But Conway doesn’t think illiquid instruments like hedge funds and private equity are likely to become central to grandma’s portfolio during the next decade. That’s partly because, not being used to them, clients may wonder in six months or a year why a significant chunk of their assets is essentially off-limits to them, even though their advisors explained it. Also, regulations limit them to accredited investors — financially savvy, high-net-worth clients.

Social Impact

Sustainable investment comes with several overlapping labels: impact investing; socially responsible investing, or SRI; environmental, social and governance-based investing, or ESG. Whatever the term, it seeks to incorporate clients’ personal values into their financial planning.

In the near future, there will be nothing fringe about it, according to Thomas Van Dyck, senior vice president at SRI Wealth Management, a San Francisco team in RBC Wealth Management overseeing $1.5 billion for the wealthy, entrepreneurs, celebrities and foundations. Looking at America’s corporate landscape, Van Dyck predicts that companies minimizing waste and improving conditions for workers will beat their competitors and boost profits even in low-margin conditions. Just as much as regulations, Van Dyck sees profitability pushing more businesses to implement sustainable practices.

Environmental factors like climate change, energy usage and pollution are big concerns for younger investors, he says. Furthermore, their tendency to scour the Internet for data makes them inclined to value corporate transparency. According to Van Dyck, 49% of millennials say they want to own at least some socially responsible investments.

“They realize the consequences, that pollution will affect their lives and the lives of their kids,” says Van Dyck. “The best advisors will be introducing these conversations, because right now people are looking for [sustainable investing]. I’ve been thinking it’s about a decade away from mainstream for about 30 years. But I do think it will probably happen within this decade.”