



Model Portfolios: A Guide for Portfolio Construction

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Introduction

What Are Model Portfolios?

Model portfolios are pre-constructed collections of investments—such as stocks, bonds, mutual funds, or ETFs—designed to achieve specific investment objectives and risk profiles. Typically created and managed by professional investment managers or financial advisors, these portfolios serve as blueprints for asset allocation and diversification. They are not individualized investment accounts, but rather illustrative or standardized frameworks that can be replicated or adapted for multiple investors.

Model portfolios are widely used in the financial industry to streamline investment management, provide consistency, and simplify the investment process for both advisors and investors. They are often categorized by risk tolerance (e.g., conservative, balanced, aggressive), investment goals (e.g., growth, income), or time horizon.

Risk Categories, Portfolio Mixes, and Expected Returns

The table below presents common risk categories with their corresponding portfolio allocations and expected annual returns, based on a hypothetical return of 8% for stocks and a 4% return for bonds. Expected returns are calculated as the weighted average of the returns for stocks and bonds within each portfolio as well as potential risk, defined as hypothetical performance if the stock market dropped 25% and the bond market remained unchanged.

Category	Potential Risk/Return	Portfolio Stock/Bond Mix	Potential Return %	Potential Risk %
Aggressive	Highest	80/20	7.2	-20
Growth	High	70/30	6.8	-18

Balanced	Middle	60/40	6.4	-15
Moderate	Lower	50/50	6.0	-13
Income Focused	Lowest	40/60	5.6	-10

Key assumptions and explanation:

Expected returns are derived by multiplying the percentage allocation to stocks by the assumed 8% stock return and adding the product of the bond allocation and the assumed 4% bond return. For example, the Aggressive portfolio's expected return is calculated as $(0.8 \times 8\%) + (0.2 \times 4\%) = 7.2\%$. This approach assumes no fees, taxes, or other costs and that bond returns remain constant and is for illustrative purposes only.

Each risk category reflects a different balance between growth potential and risk exposure. The Aggressive portfolio carries the highest expected return and risk due to its large stock allocation. The Income Focused portfolio, with the greatest bond allocation, offers the lowest expected return but prioritizes capital preservation and income stability. This framework provides a clear understanding of how varying stock and bond allocations influence the expected returns across different investor risk profiles. Declines reflect losses from the stock portfolio of the portfolio, assuming bond values remain stable, which may not be the case. The illustration does not reflect actual results but is meant to provide a simplified framework for understanding how different risk profiles might react to market stress. Investors should assess their own personal risk tolerance and consult a professional or additional resources when building a portfolio.

Translating Risk Tolerances into Life Stages

Often, five different risk tolerances are shown for the different strategies that make up a suite of Model Portfolios. Each risk tolerance can be translated into practical use by thinking of five different stages of life. For example:

Early Career Growth Portfolio – Aggressive Mix (80% equities/20% fixed income)

Description:

Designed for investors in their 20s and early 30s beginning their wealth-building journey. This portfolio emphasizes aggressive growth and long-term capital appreciation.

Rationale:

With a long investment horizon and high risk tolerance, early-career investors can take advantage of higher equity exposure, maximizing potential returns through market cycles.

Family Builder Portfolio – Growth Mix (70% equities/30% fixed income)

Description:

For investors in their 30s and 40s, balancing career growth, family needs, and increasing financial responsibilities.

Rationale:

This stage requires a blend of growth and stability, with a modest increase in fixed income to manage risk while maintaining strong equity exposure for long-term goals.

Peak Earning Years Portfolio – Balanced Mix (60% equities/40% fixed income)**Description:**

Targeted at investors in their late 40s to mid-50s, often at their peak earning potential and focused on accelerating savings while managing risk.

Rationale:

A balanced approach that reduces overall equity exposure in favor of increased fixed income, supporting both growth and capital preservation as retirement approaches.

Pre-Retirement Portfolio – Moderate Mix (50% equities/50% fixed income)**Description:**

For investors in their late 50s to early 60s, preparing for retirement and prioritizing capital preservation and income.

Rationale:

This portfolio further increases fixed income exposure, reducing volatility and helping to protect accumulated wealth as the transition to retirement nears.

Retiree Income & Preservation Portfolio – Income Focused Mix (40% equities/60% fixed income)**Description:**

Designed for retirees (typically 65+), this portfolio prioritizes income generation and capital preservation, with limited equity exposure for inflation protection.

Rationale:

A high allocation to fixed income supports stable income and reduces

market risk, while a modest equity allocation helps guard against inflation and longevity risk.

Trade-Offs of the Life Stage Approach

While this approach to choosing the correct portfolio offers the benefit of simplicity, determining the ideal asset allocation is not always that easy. What if you are an early career growth investor, but have a low tolerance for risk? What if you are a retiree, but have a significantly large portfolio and are more interested in leaving assets to your heirs? Generalizations can give you a rough idea of which portfolio to choose, but the best asset allocation for you is the one offers a potential return that achieves your goals for building or sustaining your wealth, that satisfies your need for income, that fits your investment time horizon, and, most importantly is suitable for your risk tolerance. If you are struggling to answer that question yourself, you may need to employ the services of a trusted financial advisor.

How Are Model Portfolios Used in the Industry?

For Advisors and Firms:

- **Efficiency and Scale:** Advisors use model portfolios to manage many client accounts efficiently, freeing up time to focus on client relationships and holistic financial planning rather than constructing individual portfolios from scratch.
- **Consistency:** Firms can ensure a consistent investment approach across their client base, aligning with firm-wide investment philosophies and compliance standards.
- **Customization:** While many model portfolios are standardized, they can be modified or customized to better fit specific client needs by adjusting asset allocations or substituting certain funds.
- **Technology Integration:** Platforms and managed account solutions like separately managed accounts, or SMAs, make it easy for advisors to implement, monitor, and rebalance model portfolios using automation and data feeds.

For Individual Investors:

- **Accessibility:** Many investment platforms, robo-advisors, and 401(k) providers offer model portfolios directly to individuals, allowing investors to select a portfolio that matches their risk tolerance and goals without requiring deep investment expertise.
- **Professional Management:** Investors benefit from professional research, ongoing monitoring, and periodic rebalancing, often at a lower cost than bespoke advisory services.

Pros and Cons of Model Portfolios

Pros	Cons
Diversification: Broad exposure to multiple asset classes, reducing risk	Limited Personalization: May not fully reflect unique circumstances or preferences
Professional Management: Built and monitored by experts	Loss of Control: Investors have less say over specific holdings or strategy changes
Simplicity: Easy to implement and manage portfolio	One-Size-Fits-Most: Risk levels and allocations are predefined, which may not suit everyone
Cost Efficiency: Lower transaction costs if portfolio turnover is minimized	Potentially high annual fees, which can significantly reduce benefits. Higher transaction costs if turnover is high
Can be tax efficient if held in a retirement account or low turnover strategy	Often doesn't take current holding into account, can result in large tax bills if current holdings have to be liquidated

How Individual Investors Can Use Model Portfolios

1. As a Starting Point:

Model portfolios can be particularly valuable for investors who lack the expertise or time to build a diversified portfolio from scratch. By selecting a model portfolio that matches their risk tolerance and investment goals, individuals can access a professionally designed investment strategy with minimal effort.

2. For Hands-Off Investing:

Those who prefer a passive approach can use model portfolios to automate their investing process. Many platforms offer automatic

rebalancing to maintain the intended asset allocation, ensuring the portfolio stays aligned with the investor's objectives over time.

3. For Customization:

Some platforms allow investors to start with a model portfolio and then make adjustments—such as swapping out certain funds or tweaking allocations—to better fit their personal preferences or tax situations.

5. In Retirement Plans:

401(k) providers and robo-advisors often use model portfolios to simplify investment choices for plan participants, offering options that range from conservative to aggressive based on the participant's age, time horizon, and risk appetite.

6. For Goal-Oriented Investing:

Model portfolios can be selected based on specific objectives, such as income generation, capital preservation, or aggressive growth, making them suitable for a variety of financial goals—from retirement to saving for a major purchase.

In-Depth Considerations

- **Customization vs. Standardization:** While model portfolios offer efficiency and simplicity, they may not address every investor's unique needs. Some platforms and advisors offer "custom model portfolios," which start with a standard model and adjust it for individual circumstances (e.g., tax considerations, existing holdings, or personal values), but this is less common.
- **Risk Management:** Model portfolios are typically built with diversification and risk management in mind, but investors should still ensure the chosen model matches their own risk tolerance and financial situation.
- **Fees and Costs:** It's important to understand the fee structure. Some model portfolios are included in platform fees, while others may have additional charges for management or access.
- **Performance:** No model portfolio can guarantee returns. Past performance is not indicative of future results, and even professionally managed portfolios can underperform during certain market conditions.

Summary

Model portfolios are widely used in the investment industry to provide efficient, diversified, and professionally managed investment strategies that can be easily implemented by both advisors and individual investors. They offer significant advantages in terms of simplicity, cost, and access to expertise, but may not be suitable for those seeking highly personalized investment solutions or full control over their portfolio. Individual investors can use model portfolios as a turnkey solution, a starting point for customization, or a benchmark for their own strategies, always keeping in mind the importance of matching the portfolio to their personal goals and risk tolerance.

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