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Perspective from
Franklin Templeton Industry Advisory Services

FUTURE OF ASSET MANAGEMENT

Optimizing portfolio returns with new investing models

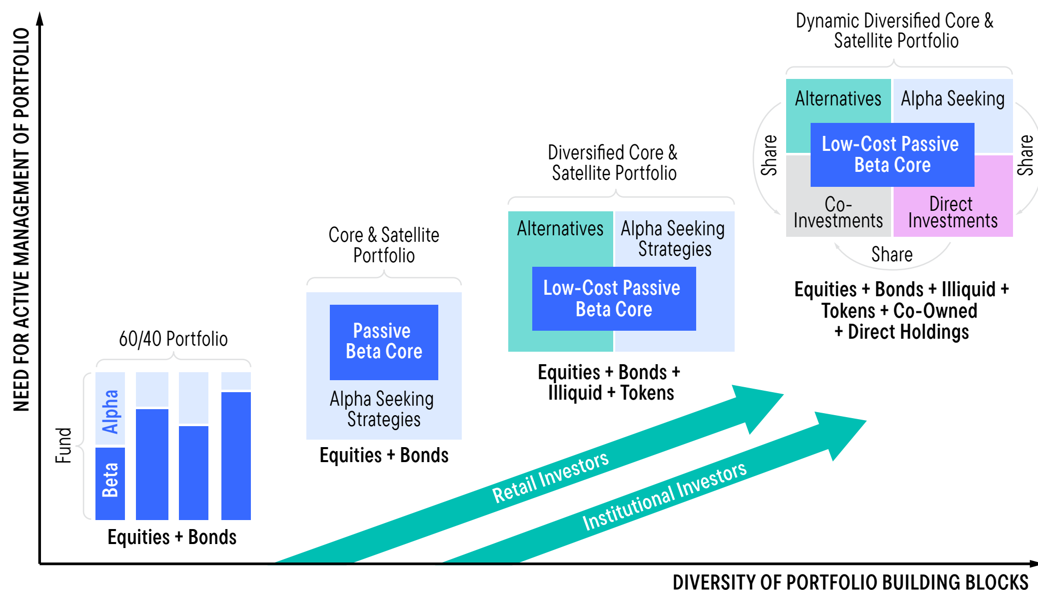
November 2024

This is the fourth article in the Future of Investing series, drawing insights from our annual industry-wide survey.[1] *Please refer to* [The Future of Investing: 2024/25 Edition—Overview](#) *for a summary of the key findings as well as all other preceding articles.*

Since the emergence of "Modern Portfolio Theory" and the "Capital Asset Pricing Model" in the late 1960s, institutional investors have taken a quantitatively driven approach to portfolio construction, looking to create portfolio diversification and obtain better risk-adjusted returns by balancing their asset-class exposures. This journey has seen several important advancements in thinking about how to optimally achieve desired results and has provided a roadmap for those servicing retail investors, as illustrated in the following exhibit.

Originally, institutions determined a target global asset allocation that distributed capital across actively managed equity and bond exposures. The target asset allocation would serve as the benchmark (using index benchmarks for returns) to determine overall portfolio outperformance. The emergence of Fama and French's factor model in the 1990s created a more detailed perspective on the contributors to performance. This eventually led to the groupings of funds in style-box-aligned equity and bond funds (or managed accounts). The ability to build portfolios using these exposure categories represented a bottom-up approach. The selected portfolio managers were expected to deliver both beta—market returns within their style—and alpha—outperformance relative to that constrained benchmark.

Exhibit 1: Evolution of Portfolio Construction



Source: Franklin Templeton Industry Advisory Services. For illustrative purposes only.

Over time, asset managers took a variety of approaches to the style-box benchmarks, with some choosing to systematically replicate only the market returns of the style box, i.e., excluding alpha, resulting in lower cost to the client. As competition drove down fees, this became a very economic basis on which to build a portfolio.

Because institutions were able to obtain market exposure (beta) cheaply and easily, their attention and fee budget was freed up to consider a wide variety of ways and investments to generate alpha in the portfolio. The first major shift in approach broke apart the linkage that supported the bottom-up approach to risk allocation.

Institutions began to look at the market top-down, determining their expectations for potential market returns in different areas, taking into account a broad set of factors and then building a diversified core of passive exposures to capture these return streams. This set of passive fund holdings became the "policy benchmark" against which performance of investment teams would be judged. The remaining risk capital in the portfolio was allocated opportunistically to managers in pursuit of alpha from various sources. Collectively, these additional alpha-seeking allocations were viewed as satellite exposures built around the portfolio's diversified, passive core.

> **"We adopted a portable alpha structure in 2019. To implement this, we create synthetic alpha from derivatives and hedge funds. Our return for portable alpha has been 10% with a volatility of 3%, giving us a Sharpe ratio of greater than 2."**
>
> Corporate Pension

The second major shift in portfolio construction featured the move to include more alternative fund managers as part of the satellite holdings responsible for generating alpha. These managers used longer-lockup fund vehicles to capture an illiquidity premium. Many of the strategies were capacity-constrained, allowing the manager to charge both a high management fee and a performance fee. This approach to portfolio construction created pressure to reduce fees being paid for the portfolio's core exposures, which in turn has driven the industry toward greater use of exchange-traded funds (ETFs) as a low-cost alternative to passive mutual funds or UCITS. Additionally, in the United States, the ETF's status as a tax-advantaged exposure vehicle relative to mutual funds has driven adoption among individual investors.

“You can see the ETF-ization of everything unfolding in front of us. There are some very serious active players in this space. The active game is evolving. If you are serious about active management, you have to have the capabilities in-house to create active ETFs.”

Asset Manager,
>US$1 trillion

Since 2008, the cumulative annualized growth rate of the ETF market globally has been an impressive 19.8%.[2] At the end of 2023, there were more than 9,000 ETF offerings and assets under management (AUM) were estimated at US$11.1 trillion,[3] representing nearly 10% of global AUM.[4] In comparison, in 2008, ETFs accounted for less than 1% of global AUM[5] and were only US$716 billion in 2008.[6]

However, simply focusing on the amount of assets held in ETFs undervalues their importance. While ETFs provide a way to obtain specific portfolio exposures and reduce the costs of the beta-seeking core of the portfolio, they are also important trading tools. Originally used as a transition management vehicle for institutions not wanting to take a performance holiday when they swapped out portfolio managers, ETFs have since become important tools for the alpha-seeking portions of the portfolio as well. This supports key investment activities such as lending, hedging, financing and tilting portfolios. More recently, ETFs are increasingly being used as a chassis that enables the streamlined transport of portfolios of securities or assets.

More ETFs are now being actively managed and are providing lower-cost, and in some cases, more tax-efficient ways of obtaining direct access to pools of individual securities. Active ETFs can offer significant benefits over mutual fund or UCITS vehicles. In those structures, the fund owns the securities, and the investor can only own shares in the fund. Putting the same securities held in a mutual fund or UCITS into an ETF wrapper creates a variety of new opportunities to enhance the management of the portfolio.

“I think tokenization becomes the enabler for blockchain to modernize the ETF. The digitization of ETFs is almost a new product because you can put other things in there. Once we can tokenize ETFs the constituents don’t have to be stocks or bonds, you can put ‘you name it’ in there.”

Asset Manager,
>US$1 trillion

By taking advantage of ETF “create” or “redeem in-kind” options, a portfolio manager can facilitate the efficient purchase or sale of large blocks of securities. This might allow them to generate additional basis points of execution alpha by avoiding the slippage and market impact that results from buying or selling each security individually. The ability to access the ETF primary market also enables new models like direct indexing and fixed income portfolio trading that seek to either add or remove securities from the in-kind basket. This process of converting to a basket of constituent assets essentially enables an investor to quickly and easily convert aggregate fund-level exposure into individual asset-level exposure. By doing this, ETFs increase the mobility of assets, and this ability to more easily move assets into, out of and across portfolios—either individually or collectively—enables managers and investors to choose the scale and level at which they manipulate their exposures. This reduction of friction when moving groups of assets enables more active, targeted and efficient portfolio management. Thus, the concept of asset mobility, or portability, goes well beyond liquidity, the latter simply referring to the ability to buy or sell the asset.

This concept also extends beyond traditional investments, with ETFs also providing exposure to commodities and other types of non-standard assets.[7] Wrapping these assets in an exchange-traded structure makes these assets portable, enabling their inclusion alongside traditional securities holdings in portfolios, and their processing via firms’ existing order and portfolio management, risk, accounting and reporting systems. ETFs and exchange-traded products (ETPs) are already being used to provide exposures as diverse as oil, gold, livestock and both spot bitcoin and Ethereum. In the same way that shipping containers revolutionized the efficiency of the transport of goods, combining standardization with the ability to easily move many different types of goods together, so ETFs’ ability to collectively and easily move different holdings is quietly revolutionizing the efficiency of portfolio and risk management.

“All the resources have moved towards asset allocation and private assets and areas where there is more dispersion of returns which needs to be navigated.”

Asset Manager,
<US$500 billion

“Most people don’t understand the underlying credit associated with a private market investment. This asset class is a ticking time bomb because of credit exposures. Tokenization creates greater transparency by offering more price points with risk priced in.”

Asset Manager,
>US$1 trillion

“Portfolio construction is evolving with more custom indexes, ETFs and the shift to privates versus alts, which make its more complex to manage as there are more moving parts.”

Wealth Manager,
<US$500 billion

This is also opening up more sophisticated portfolio construction options for retail investors, while leading institutions’ pursuit of ever more efficient portfolio construction has seen an increased emphasis being placed on the portability of private, not just public, assets.

Finding ways to create liquidity around private fund limited partner (LP) shares is one form of such portability. More investors are looking to exit their private fund holdings via the secondaries market. Secondaries market transaction volumes grew in 2023 to US$114 billion from US$103 billion in 2022, at a time when there was a challenging fundraising environment.[8]

Tokenizing their LP shares is another liquidity strategy being explored. In 2022, Apollo launched a digitally native investment vehicle to demonstrate how blockchain technology could support on-chain fund subscriptions and redemptions for private funds as well as operations and administration. In 2023, the firm partnered with J.P. Morgan as part of the Monetary Authority of Singapore’s Project Guardian initiative to demonstrate how tokenized private and public funds could be commingled and managed in the same portfolio across multiple blockchains.[9]

Another form of portability in private assets operates at the deal level. Many institutions have begun to invest in an alternative manager’s fund to get access to and share in the deal flow. They are co-investing alongside the manager in order to create options regarding how to handle the duration of their investment and the liquidity impact it has on their broader set of holdings. This co-investing approach thus makes each “deal” more portable, increasing its utility by allowing it to be both placed into the fund structure and shared across a growing set of clients.

A reverse version of co-investing is also beginning to emerge. A growing set of institutions are making direct investments in both private assets and public securities. As these programs advance, many institutions are choosing to become a source of deal flow, contributing portions of their directly held assets back to the funds of their affiliated managers. This is another pathway to creating liquidity in the portfolio.

While the portability enabled by the rising use of ETF in-kind facilities and extended use of private funds and privately held assets are net positives for the construction and management of the portfolio, such activities are adding complexity to asset managers’ operations. Asset managers need to support a far broader set of intermediaries and partners, plug into a growing number of clearing, settlement and processing venues and systems, support a more varied set of processes, post collateral against more types of activities, and manage a more extensive array of data. As noted earlier in Applying the technology being explored in payments to modernize financial markets infrastructure, the adoption and integration of new technology and tokenizing and moving assets onto the same rails as payments would help with these and a number of other problems, but the journey toward this destination is unlikely to be straight or swift. We examine the likely pathway to this future, and the role of ETFs in it, in our next article.

For more information or to request a presentation on the 2024/25 Future of Investing findings, please contact your Franklin Templeton representative or reach us directly at *industryadvisoryservices@franklintempleton.com.*

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Endnotes

1. On an annual basis, Franklin Templeton's Industry Advisory Services team conducts off-the-record, unscripted interviews of leaders across the financial services industry. This year, we were fortunate enough to hear from 85 leading thinkers controlling over US$50.1 trillion of assets under management across the financial services industry about their views on the future of investing between March and September of 2024. Input came from a broad cross-section of the industry—asset owners, private banks, wealth managers, consultants, investment managers, crypto firms, academics, industry leaders and fintech firms. Conversations took place formally as part of free-ranging, qualitative, off-the-record, survey interviews, and informally during one-on-one sessions where the implications and plans for each organization are discussed and explored. Each of these inputs added to an emerging picture of an industry that is changing rapidly and across multiple dimensions. Interviews were conducted globally with about two-thirds of discussions held with leaders of firms based in the United States, and the other third spread between Europe and Asia.
2. Source: "Why ETF Growth Is Booming." State Street Global Advisors. July 25, 2024.
3. Ibid.
4. Source: Franklin Templeton Industry Advisory Services analysis based on "AI and the Next Wave of Transformation." Boston Consulting Group. May 2024.
5. Source: Franklin Templeton Industry Advisory Services analysis based on "Global Wealth 2011: Shaping a New Tomorrow: How to Capitalize on the Momentum of Change." Boston Consulting Group. May 2011.
6. Source: "Assets of global ETFs 2022." Statista. Accessed September 19, 2024.
7. ETFs referred to in this section are not "traditional" 40 Act ETFs that have certain consumer protections.
8. Source: Lovells, Hogan. "Secondary Portfolio Sales - A Guide to Pension Funds Selling Fund Interests." JDSupra. January 31, 2024.
9. Source: "Onyx and Apollo explore tokenization in investments across blockchains." The Paypers. November 16, 2023.

Curated glossary of relevant terms

Blockchain

A blockchain is a digital record or ledger of transactions, duplicated and distributed across an entire network of computer systems. Blockchains represent complete records of all transactions ever performed within that system. Every node in the blockchain network has a real-time, simultaneously updating copy of this ledger. Every node sees new blocks of transactions being appended to the existing chain of verified blocks and could re-create the entire sequential history of transactions on that chain stretching back to the very first (genesis) trade on the ledger. Blockchain is sometimes described as "distributed ledger technology" or DLT.

Spot ETF

A spot ETF is an exchange-traded product that tracks the current market price of an underlying asset, such as a commodity, cryptocurrency or index. Instead of holding the asset directly, investors buy shares of the ETF, which represents a portion of the asset held by the fund. This allows investors to gain exposure to the asset's price movements without needing to purchase, store or manage the asset themselves. Spot ETFs are traded on traditional stock exchanges during regular market hours, providing a regulated and convenient way to invest in various assets with benefits, such as enhanced security and ease of access. However, they may come with higher fees, potential tracking errors, and are limited by traditional market trading hours—unlike the 24/7 cryptocurrency markets. A Spot Bitcoin ETF tracks Bitcoin's market price and a spot Ethereum ETF tracks Ethereum's market price. **These products are not an investment company registered under the Investment Company Act of 1940 (1940 Act), and therefore are not subject to the same regulatory requirements as mutual funds or ETFs registered under the 1940 Act.**

Tokens

Tokens are used to facilitate payments, initiate services, bestow ownership, authorize voting, convey rights and transfer assets. Specialized tokens are used for each of these functions. Broadly, these specialized tokens can be broken down into two categories: cryptocurrency tokens and app-issued tokens.

Tokenization

Tokenization is the process of converting, through symbolic representation or encoded rule sets and attestations, something of value into a digital token that can be transacted on a blockchain. These tokens can represent tangible assets like gold, real estate and art, or intangible assets like voting rights, ownership rights or content licensing.

UCITS

Undertakings for Collective Investment in Transferable Securities (UCITS) is a regulatory framework by the European Commission for managing and selling mutual funds across the EU. Similar to US mutual funds, UCITS are registered and regulated in EU member states, with guidance from the European Commission to ensure their safety and availability for EU citizens.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal.

Companies in the **technology sector** have historically been volatile due to the rapid pace of product change and development within the sector. **Artificial Intelligence** is subject to various risks, including, potentially rapid product obsolescence, theft, loss or destruction of cryptographic keys, the possibility that digital asset technologies may never be fully implemented, cybersecurity risk, conflicting intellectual property claims, and inconsistent and changing regulations.

Blockchain and cryptocurrency investments are subject to various risks, including inability to develop digital asset applications or to capitalize on those applications, theft, loss or destruction of cryptographic keys, the possibility that digital asset technologies may never be fully implemented, cybersecurity risk, conflicting intellectual property claims, and inconsistent and changing regulations. Speculative trading in bitcoins and other forms of cryptocurrencies, many of which have exhibited extreme price volatility, carries significant risk; an investor can lose the entire amount of their investment. Blockchain technology is a new and relatively untested technology and may never be implemented to a scale that provides identifiable benefits. If a cryptocurrency is deemed a security, it may be deemed to violate federal securities laws. There may be a limited or no secondary market for cryptocurrencies.

Digital assets are subject to risks relating to immature and rapidly developing technology, security vulnerabilities of this technology (such as theft, loss, or destruction of cryptographic keys), conflicting intellectual property claims, credit risk of digital asset exchanges, regulatory uncertainty, high volatility in their value/price, unclear acceptance by users and global marketplaces, and manipulation or fraud. Portfolio managers, service providers to the portfolios and other market participants increasingly depend on complex information technology and communications systems to conduct business functions. These systems are subject to a number of different threats or risks that could adversely affect the portfolio and their investors, despite the efforts of the portfolio managers and service providers to adopt technologies, processes and practices intended to mitigate these risks and protect the security of their computer systems, software, networks and other technology assets, as well as the confidentiality, integrity and availability of information belonging to the portfolios and their investors.

ETFs trade like stocks, fluctuate in market value and may trade above or below the ETF's net asset value. Brokerage commissions and ETF expenses will reduce returns. ETF shares may be bought or sold throughout the day at their market price on the exchange on which they are listed. However, there can be no guarantee that an active trading market for ETF shares will be developed or maintained or that their listing will continue or remain unchanged. While the shares of ETFs are tradable on secondary markets, they may not readily trade in all market conditions and may trade at significant discounts in periods of market stress.

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