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Building blocks, solution funds and model portfolios: What are they and how do they work?

If you enjoy reading about investments, it's likely that at some point you would have come across terms such as: building block funds, solution funds and model portfolios. While these may sound complicated at first, they are actually pretty easy to understand. In this article, we'll take a closer look at each of these concepts and provide some insight into how they work.

Understanding asset classes
To begin, it's important to have a basic understanding of the three main types of asset classes that make up a typical diversified portfolio.

Cash: Cash usually refers to investments consisting of various types of short-dated debt instruments (usually issued by banks) ranging from a few days to up to one year. They can have fixed or floating interest rates and are low risk, highly liquid and usually offer better returns than the average call (or bank) deposit. Investors often use cash as an alternative to keeping money in the bank.

Bonds: Bonds are longer-dated debt instruments with maturities ranging from one year upwards. Bonds are issued by companies, banks or governments as a means of raising money, with the agreement that they will repay the loan in full plus interest. There are many factors that can influence the value of a bond as it trades in the market (such as inflation), but for now the important part is knowing that they are regarded as higher-returning investments compared to cash, but with more risk due to their longer maturity and the chances of not being repaid.

Equities: Equities refer to investments in the ownership of a company. These companies operate in a range of different sectors, from Property, to Resources to Industrials. Equity funds, meanwhile, like (the Prudential Equity Fund), hold shares across a range of companies. Equity fund investments are directly linked to the prices of the shares they hold, which usually go up or down multiple times in the course of a day in line with equity market trading. As a result, they are regarded as high risk in the short- to medium term, but have outperformed all other asset classes over the long term.

It's important to note that each asset class can be subdivided even further, based on country, currency, sector, company… the list goes on! The reason why this is important to know is because all asset classes (and the subcategories of each) perform differently in different market conditions. This is the main reason why some investors choose to hold one over the other, or to hold a combination of each… but more about this below.

Choosing the right structure

Now that you have a good overview of the main asset classes, it's time to look at how building block funds, solution funds, and model portfolios work.

Building block funds

These are funds that hold primarily one type of asset class. For example, this can be a money market fund, a bond fund or an equity fund. Several of these funds can be used to create a holistic portfolio of assets with the appropriate level of risk and potential returns to meet your investment goals. Each can be managed by a different asset manager. However, using this approach to build an overall portfolio requires sound knowledge of the various funds and fund managers, and how they can work best together. With this option, it is best to have the advice of an experienced financial adviser to create an appropriate portfolio for you, and then track the performance of each fund and manager over time.

Solution funds

These are investments where one fund holds a combination of different asset classes together, also called a “multi-asset” fund. The benefit of using solution funds is that the fund manager makes the decisions on which asset classes to invest in, and how much of each to hold, based on the mandate of the fund and their assessment of where the most value can be found. These are great all-round investments for most market conditions. Based on your investment objective and risk profile, you can choose a solution fund that is most appropriate for you – such as a fund with more equities and less bonds and cash (which would be higher risk), or one with less equities and more bonds and cash (lower risk).. For example the Prudential Balanced Fund has a higher weighting to equities, while the Prudential Enhanced Income Fund has a higher weighting to bonds and cash assets.

Model portfolios

These investments are similar to solution funds; however they consist of a combination of different building block funds (and sometimes solution funds) managed by different fund managers wrapped together into a single portfolio. Model portfolios are established by financial professionals, and are usually used as bespoke solutions for their larger clients, due to the amount of time and research needed to get the appropriate blend of underlying investments.

For most investors, the best approach is to simply invest in a solution fund, where you get the convenience of dealing with one single fund. You also benefit from having your asset allocation decisions made for you and actively managed by your chosen fund manager, without having to do all the research yourself. To find out more about which solution funds Prudential has to offer, visit the Our Fundssection of our website.

For more information please feel free to contact our Client Services Team on 0860 105 775 or email us at query@prudential.co.za