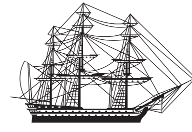

Vanguard

Adviser's Alpha: Putting a value on your value

Adviser brief

March 2015

The Retail Distribution Review has changed the adviser value proposition. Clients have greater clarity on the fees they are paying and, unsurprisingly, they want to know that they are receiving good value for money.

This has prompted many advisers to ask how they might put a number on the value they add for their clients. In a bid to provide an answer to this question, we've launched our "Adviser's Alpha" programme for UK advisers. It's a programme that has been running very successfully in the US for many years; it's helped many US advisers and we're excited to be launching it in the UK.

The programme starts by defining Adviser's Alpha as the difference between the return that investors might achieve with an adviser and the return that they might have achieved on their own. It then sets out seven key areas where advisers add value before estimating values for each area, arriving at a total Adviser's Alpha figure of around 3% per annum.

The programme will continue by providing tools and training to help advisers maximise their own alpha, so that you can be confident in describing and demonstrating the value that you add for your clients. Moreover, these tools represent best practices that can influence the success of your own practice as well as your clients' success in achieving their goals.

But before we start, a caveat: although we have estimated an annual figure for Adviser's Alpha, we would point out that delivery of Adviser's Alpha is likely to be "lumpy". For example, although some elements of Adviser's Alpha are annual and will be delivered smoothly, other significant parts – such as behavioural coaching – will come sporadically, chiefly at times of market stress or euphoria.

This underlines the importance of trust and regular communication with your clients; for it is these two vital ingredients that will ensure your clients hear you when they need you most.

For more detailed analysis, please see our white paper "Putting a value on your value: Quantifying Vanguard Adviser's Alpha in the UK"

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Figure 1. Vanguard quantifies the value-add of best practices in wealth management

Vanguard's Adviser's Alpha strategy modules	Module number	Value-add relative to "average" client experience (in basis points of return)
Suitable asset allocation using broadly diversified funds/ETFs	I	> 0 bps
Rebalancing	II	0–43 bps
Cost-effective implementation (expense ratios)	III	66–92 bps
Behavioural coaching	IV	150 bps
Tax allowances and asset location	V	0–23 bps
Spending strategy (withdrawal order)	VI	0–48 bps
Total-return versus income investing	VII	> 0 bps
Potential value added		About 3%

Notes: Return value-add for Modules I and VII was deemed significant but too variable by individual investor to quantify. See Appendix 1 for detailed descriptions of each module. Also for "Potential value-added," we did not sum the values because there can be interactions between the strategies.

Source: Vanguard

Element 1: Suitable asset allocation

It is widely accepted that strategic asset allocation – i.e. the setting of long-term allocations between equities, bonds, cash and other asset classes, and the subsequent adherence to these weightings – is the most important driver of long-term performance and volatility.

Setting the correct asset allocation is therefore a fundamentally important foundation of investment success and Adviser's Alpha. In order to set the right asset allocation, you need to have detailed conversations with your clients about their goals, as well as their financial situation, risk tolerance, contribution and spending levels, and time horizon.

Writing an investment policy statement helps to crystallise these questions, as well as highlighting any other factors, such as ethical considerations, which might affect how to implement a strategy. But, as well as providing a solid foundation for sensible investment decisions, the investment policy statement sows the seed for future behavioural coaching opportunities.

Perhaps, following a period of strong performance, your clients will be tempted to increase risk in their portfolios. Alternatively, in times of heightened uncertainty they may wish to retreat into lower-risk assets. Having a clearly set out investment policy will allow you to defend against these common behavioural pitfalls and encourage your clients to stick with their original plan.

Back to basics

Over the last 15 years, changes in regulation and an unusual market backdrop have caused some investors to increase the complexity of their portfolios. This, together with the long-term tendency for investors to build portfolios based on "fund collecting" rather than rational choices based on their goals, creates opportunities for advisers to add real value by taking things back to basics.

Building a portfolio from broadly based index funds and ETFs allows you to deliver the key benefits of asset allocation and diversification at low cost. Importantly, it also separates your value proposition from the vagaries of complex products and active manager performance.

Simple in this sense should not be confused with unsophisticated. In fact, our research from the US suggests that a simple 60% equity, 40% bond portfolio made up of index funds has delivered performance on a par with many highly sophisticated and complex endowment portfolios[1].

Simple is a strength

So, simple can be a strength in a client portfolio, allowing you to focus the discussion not on the intricacies of the latest complex investment product or star manager but rather on the enduring benefits of asset allocation, diversification and discipline.

1 Based on US data. Source Vanguard and 2013 NACUBO-Commonfund Study of Endowments (2014).

Element 2: Rebalancing

Having taken the time to set the appropriate asset allocation, the next area where you can add alpha is by regularly rebalancing to that weighting. Because different assets perform differently, the initial weighting will drift over time. Typically, because equities outperform bonds over the long term, the equity weighting would be likely to increase at the expense of bonds. And because equities are riskier than bonds, the result is a portfolio that is more risky than you had originally discussed.

Regularly rebalancing can help to correct portfolio drift as well as providing a chance for you to reiterate the importance of discipline. For many investors rebalancing in this way seems counter-intuitive: after all, it means taking money out of what is performing well and allocating it to assets that are not performing so well. Left to their own devices, most investors will not do this, making rebalancing a key area where advisers can add value.

It's important to stress that rebalancing is designed to control risk, not maximise returns. If the goal were to maximise returns over the long term, it would be logical to keep the portfolio invested 100% in risky assets – an approach that most investors would find unpalatable.

So, regular rebalancing, perhaps timed to follow your annual review to check that your client's goals haven't changed, will help you to add alpha. To quantify how much, we looked at the performance and volatility of a portfolio of 60% equities, 40% bonds that was allowed to drift. We found that a very similar level of volatility could be achieved through a regularly rebalanced portfolio made up of 70% equities and 30% bonds.

However, this latter portfolio delivered a return that was 0.43% per annum higher than the drifting 60/40 portfolio. So the value of rebalancing can be assessed at 0.43% per annum[2].

Element 3: Cost-effective implementation

Cost-effective implementation is a critical component of every adviser's toolkit and it's based on simple arithmetic: gross return minus costs = net return. Every pound paid in charges is a pound off your clients' potential returns – and that's true in up markets and down. Moreover, just like returns, costs compound over time. So, choosing a cost-effective fund on day one could really reap rewards over the long-term.

This fact has been repeatedly illustrated in industry research showing that low-cost funds outperform higher-cost alternatives[3].

To try to put a figure on the alpha that you can add by implementing your clients' asset allocation through low-cost funds, we assessed the universe of mutual funds available to UK investors. We found that the asset-weighted average ongoing charges figure (OCF) was 1.01% for an all-bond portfolio and 1.08% for an all-equity portfolio. Meanwhile, in the lowest quartile of funds by OCF, the asset-weighted average for bond funds was 0.09% and the average for equities was 0.42%.

The precise savings available will vary according to asset mix, with greater economies generated in portfolios with heavier weightings in bonds. However, our calculations suggest that advisers can create between 0.66% and 0.92% of value each year just by implementing client portfolios cost-effectively (see Figure 2).

Figure 2. Asset-weighted expense ratios versus low-cost investing

Equity/bond mix:	100%/0%	80%/20%	60%/40%	50%/50%	40%/60%	20%/80%	0%/100%
Asset-weighted expense ratio (AWER)	1.08	1.07	1.05	1.05	1.04	1.02	1.01
Quartile 1 AWER (Q1)	0.42	0.35	0.29	0.26	0.22	0.16	0.09
Cost-effective implementation (AWER vs. Q1)	0.66	0.71	0.76	0.79	0.82	0.87	0.92

Notes: Fund universe includes funds available for sale in the UK from the following Morningstar categories: UK equity – flex cap, large-cap blend, large-cap growth, large-cap value, mid-cap, small-cap; Europe equity – Europe OE: flex-cap, large-cap blend, large-cap growth, large-cap value, mid-cap, small-cap; Euro zone equity – flex-cap, large-cap, mid-cap, small-cap; Global – flex-cap, large-cap blend, large-cap growth, large-cap value, mid-cap, small-cap; US equity – flex-cap, large-cap blend, large-cap growth, large-cap value, mid-cap, small-cap; Emerging markets equity – emerging markets; Europe bond – EUR diversified; US bond – USD diversified; Global bond – global un-hedged bond; UK bonds – UK diversified, UK government.

Sources: Vanguard calculations, based on data from Morningstar, Inc., as of December 31, 2013.

2 Of course, a 60% equity, 40% bond allocation is not representative of all investors. However, it is representative of many investors' allocations .

3 See, for example, "*The Case for Index Fund Investing for UK investors", Westaway et al, 2014*

Element 4: Behavioural coaching

Most investors understand the importance of remaining disciplined at times of heightened uncertainty. However, very few succeed in staying calm in turbulent markets. Indeed, many end up taking exactly the wrong course of action.

Behavioural pitfalls such as trying to time the markets or chase performance are among the biggest derailers. That's why behavioural coaching is probably the most important area where you can create alpha for your clients.

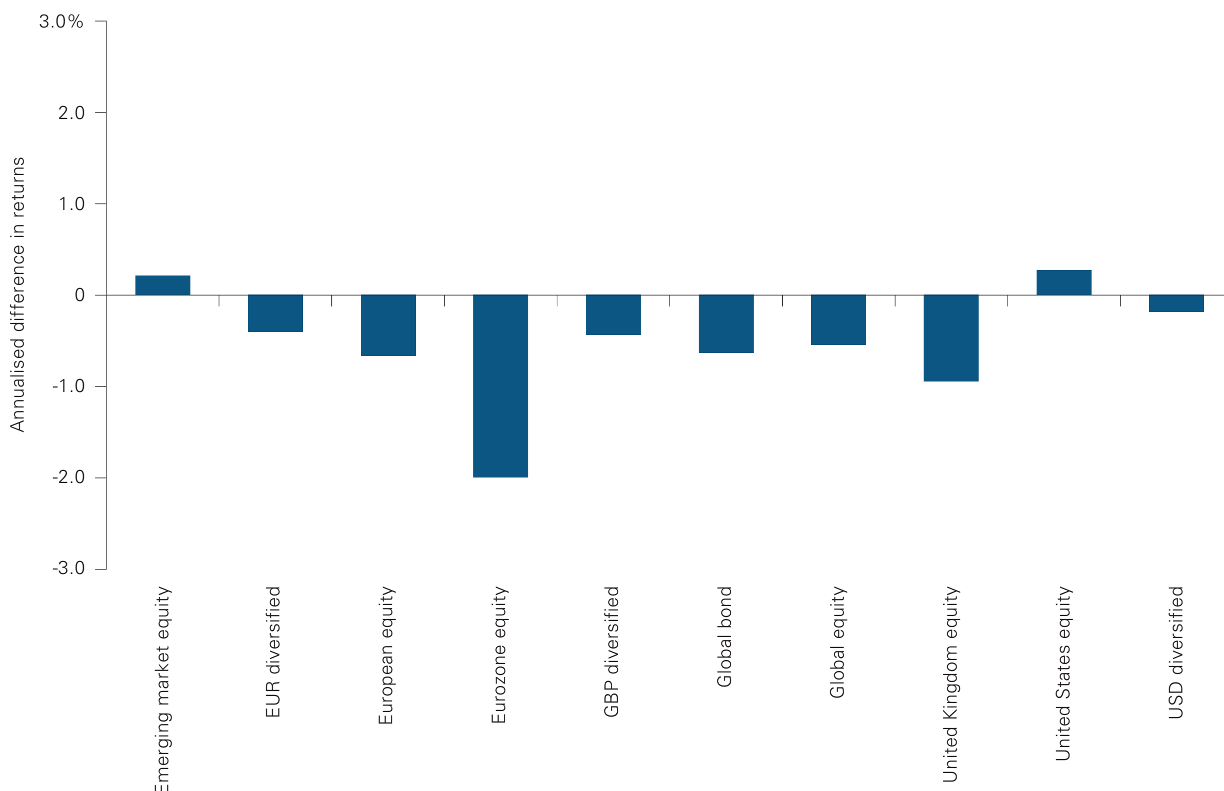
Go back to the plan

This is where the original plan that you created with your clients comes into its own. Reminding clients of the plan will help them to put emotions to one side when markets get tough. These market conditions are thankfully fairly rare over the long term but, when they do happen, you could be measuring your Adviser's Alpha in percentage points rather than basis points.

In fact, by helping your clients to avoid destroying wealth through common behavioural pitfalls you could easily repay your fees several times over. Moreover, once the dust has settled, the experience will have helped to build further trust in the client-adviser relationship.

So, how much Adviser's Alpha can you add in this way? Many academic studies have concluded that behavioural coaching can add between 100 to 200 basis points per year. Another way of estimating a value for Adviser's Alpha from behavioural coaching is to compare the returns generated by a fund with the returns experienced by the average investor in the same fund. This should show how much value investors destroy on average by trying to time the market. This figure varies by market, with some categories around 1% per annum and others approaching 2%, as shown in Figure 3. Therefore, we estimate the value add from behavioural coaching at 150bps.

Figure 3. Investor returns versus fund returns: Ten years ending 31 December 2013



Notes: Figure displays the difference between the investor and fund returns, as defined by the asset-weighted average in each category. Investor returns are calculated as the internal rate of return that sets the beginning and ending fund assets equal, given the interim cash flows. Market returns are the asset-weighted average fund return. Both are derived from aggregate flows data for funds domiciled in the UK, with asset classes defined as in Westaway et al (2014). Returns are in GBP, net of fees, with income reinvested.

Sources: Vanguard calculations, based on data from Morningstar, Inc.

Element 5: Tax allowances

The allocation of assets between taxable and tax-advantaged accounts – sometimes referred to as asset location – is another important tool you can use that can add value each year. What's more, just like minimising costs, the benefits of investing tax-efficiently will compound over time. Optimal portfolio construction from a tax perspective might involve holding tax-efficient broad-market equity investments in taxable accounts, while broad-market bonds are held in tax-advantaged accounts such as ISAs and pensions.

This arrangement takes maximum advantage of the different tax treatments of the two asset classes. Our research suggests that structuring a portfolio in this way can create 0.23% of Adviser's Alpha in the first year without increasing risk, for a higher-rate taxpayer within the capital gains tax allowance of £11,000.

Element 6: Spending strategy

The number of retirees is rising rapidly; many investors have both taxable and non-taxable investments and recent budget changes have increased the financial options open to the recently retired. In this environment, advisers can add significant alpha by ensuring that post-retirement spending is undertaken as tax-efficiently as possible.

How much alpha? Let's look at a hypothetical example. Consider a higher-rate taxpayer with a portfolio that is invested 60% in equities and 40% in bonds and split evenly between taxable and non-taxable investments. If this client wishes to withdraw 4% of the portfolio each year, the order in which he or she makes those withdrawals will have a big impact on the rate of tax they pay. This, in turn, will affect the long-term returns that the portfolio will generate.

Spend from taxable accounts first

For example, if our hypothetical client draws down the taxable portfolio first, an increasing proportion of the remaining portfolio will be tax-sheltered. Thanks to its favourable tax treatment, this remaining portfolio will subsequently grow faster than the starting portfolio, half of which was being taxed.

We have calculated that a higher-rate taxpayer with a £1m portfolio could achieve a 0.48% advantage in the internal rate of return over a 30-year retirement period by spending in this way, compared with another client who spends from both the taxable and tax-sheltered parts of the portfolio at the same rate.

Of course, without taxes, or without the wish to withdraw, the scope to add alpha in this area disappears. But, for clients who do have some tax liability and who wish to make withdrawals, sound advice can make a real difference. For example, a client with a £250,000 portfolio who is within the capital gains allowance and only has 20% of the portfolio in taxable accounts could still generate savings of 0.29% per annum by spending in a tax-efficient way.

Element 7: Total return versus income investing

Historically, investors holding a diversified portfolio of equities and bonds could quite easily generate a healthy income from their investments. Not any more. With yields on low-risk government bonds at historic lows and likely to stay that way throughout the rest of 2014 and 2015, you can create significant alpha for your clients by offering advice on how to address the income conundrum.

There are three basic options for clients whose portfolio income falls short of their spending plans: they can spend less; they can reallocate their portfolios towards higher-yielding investments; or they can spend from the total return of their portfolio, which includes capital appreciation as well as income.

You can help your clients to make the right choices in this regard. Bear in mind that, for many investors, moving away from a broadly diversified portfolio may place their investments at greater capital risk than actually spending from capital.

For example, four common approaches to boost portfolio income are to:

1. Increase weightings to longer-duration bonds;
2. Invest in higher-yielding, credit-sensitive bonds;
3. Allocate some of the bond weighting to income-generating equities; or
4. Allocate some of the broad equity weighting to higher dividend yielding equities.

Each of these approaches carries its own potential dangers. Longer-duration bonds, for instance, are typically more susceptible to capital losses when interest rates rise. Meanwhile, higher-yielding bonds carry greater credit risk than government bonds and can exhibit high levels of price volatility in times of market stress, greatly reducing the diversification benefits of holding fixed income alongside equities.

The third option, moving some of the bond portfolio to high-yielding equities, can substantially alter the risk profile of the portfolio, potentially exposing your clients' investments to much higher levels of capital risk than those set out in the original plan. Finally, moving some of the broad equity exposure into higher dividend yielding equities will skew the equity allocation towards certain income-generating sectors, reducing diversification and potentially increasing risk.

Think total return

Rather than pursuing any of these four paths, Vanguard favours a total-return approach, i.e. one that focuses on both income and capital appreciation. Such an approach has the advantages of maintaining the originally agreed-upon asset allocation; allowing greater flexibility from an asset location and tax efficiency perspective and controlling risk by ensuring maximum diversification.

The amount of value that you can add by employing a tax-efficient total-return strategy for your clients will vary according to the size and breakdown of their portfolios and their spending needs. However, it is likely to be significant for many clients.

Conclusion – what to do?

We have set out the seven areas in which you can add significant value, or Adviser's Alpha, for your clients. We have also sought to place a value on the alpha that you can add, and found that it's likely to be in the region of 3% per annum, albeit not delivered at a constant annual rate. In summary, to maximise the value you add for your clients, it makes sense to focus on the things you can control:

- Help your clients to select an asset allocation that is suitable for their goals and attitudes
- Implement the asset allocation using low-cost investments, making use of tax-efficient asset location guidelines
- Limit deviations from the market portfolio
- Concentrate on behavioural coaching and building trust with your clients

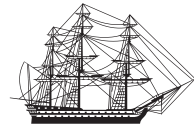
Following these guidelines should give your clients, and your advice practice, the best chance of long-term success.

For further guidance

1. Read the full white paper: Putting a value on your value: *Quantifying Vanguard Adviser's Alpha in the UK*
2. Call our Adviser Support team on 0800 917 5508 to register for our ongoing Adviser's Alpha programme

References

Westaway, Peter, Todd Schlanger, Charles J. Thomas and Christopher B. Philips, 2014. *The case for index fund investing for UK investors*. London, England: Vanguard Asset Management.



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