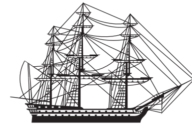

Quantifying Vanguard's Adviser's Alpha: Putting a value on your value

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The value proposition of advice is changing. With the compensation structure for advisers evolving in many countries from a commission- and transaction-based system to a fee-based asset management framework, advisers and wealth managers are under pressure to demonstrate their true value to clients.

In creating the Vanguard Adviser's Alpha™ concept in 2001, we outlined how advisers could add value, or alpha, through relationship-oriented services such as providing cogent wealth management via financial planning, discipline and guidance, rather than by trying to outperform the market.

Since then, our work in support of the concept has continued. We have attempted to quantify the benefits that advisers can add relative to the results that their clients would have achieved without advice. This is what we call Adviser's Alpha. There are seven elements underpinning Adviser's Alpha – each of which can be used individually or in combination, depending on the circumstances of individual clients.

We believe that the Vanguard Adviser's Alpha framework can add around 3% in net returns for your clients. This is an estimate based on research studies we conducted in the US, Australia and the UK. However, not only may the framework help improve client returns, it will also allow you to differentiate your skills and practice.

But before we start, a caveat: although we have estimated an annual figure, 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.

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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) UK	US	Australia
Suitable asset allocation using broadly diversified funds/ETFs	I	> 0 bps	> 0 bps	> 0 bps
Rebalancing	II	0–43 bps	35 bps	42 bps
Cost-effective implementation (expense ratios)	III	66–92 bps	45 bps	75 bps
Behavioural coaching	IV	150 bps	150 bps	150 bps
Tax allowances and asset location	V	0–23 bps	0-75 bps	–
Spending strategy (withdrawal order)	VI	0–48 bps	0-70 bps	–
Tax efficient accumulation and distribution	V and VI	–	–	> 0 bps
Total-return versus income investing	VII	> 0 bps	> 0 bps	> 0 bps
Potential value added		**About 3%**	**About 3%**	**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.[2] We found that for UK investors a very similar level of volatility could be achieved through a regularly rebalanced portfolio made up of 70% equities and 30% bonds.

Furthermore, the 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.[3]

Using US data, this figure was 0.35% per annum. A rebalanced 80% equities, 20% bonds portfolio provided similar risk as measured by standard deviation as a 60% equities, 40% bonds portfolio that was not rebalanced (14.19% versus 14.15%) but with a higher average annualised return (9.71% versus 9.36%).[4]

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 euro, dollar or pound paid in charges is a euro, dollar or 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.[5]

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. The results are in Figure 2. 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 in the UK (see Figure 2). A similar analysis of US data found that advisers could save their clients on average 0.45% annually, while for Australian data we found the figure to be up to 0.75% annually.

2 Equities are represented by the Barclays Equity Gilt Study from 1960 to 1964, the Thomson Reuters Datastream UK Market Index from Jan.1965 – Dec.1969; the MSCI UK from Jan.1970 – Dec.1985; thereafter, equities are represented by the MSCI All Country World Index. Bonds are represented by the Barclays Equity Gilt Study from 1960 – 1976; the FTSE UK Government Index from Jan.1977 – Dec 1984, the Citigroup World Global Bond Index from 1985 to 1989, the Barclays Global Aggregate Index thereafter. Returns are in sterling, with income reinvested, to 31 December 2013.
Source: Vanguard, based on Barclays UK Equity Gilt study, Thomson Reuters Datastream, FTSE, MSCI, Citigroup and Barclays.

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

4 Stocks are represented by Standard & Poor's 500 Index from 1960 through 1974, Wilshire 5000 Index from 1975 through April 22, 2005, and MSCI US Broad Market Index thereafter. Bonds are represented by S&P High Grade Corporate Index from 1960 through 1968; Citigroup High Grade Index from 1969 through 1972; Barclays U.S. Long Credit AA Bond Index from 1973 through 1975; and Barclays U.S. Aggregate Bond Index thereafter.
Source: Vanguard calculations, based on data from Thompson Reuters Datastream.

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

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.

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.

Element 5: Tax allowances

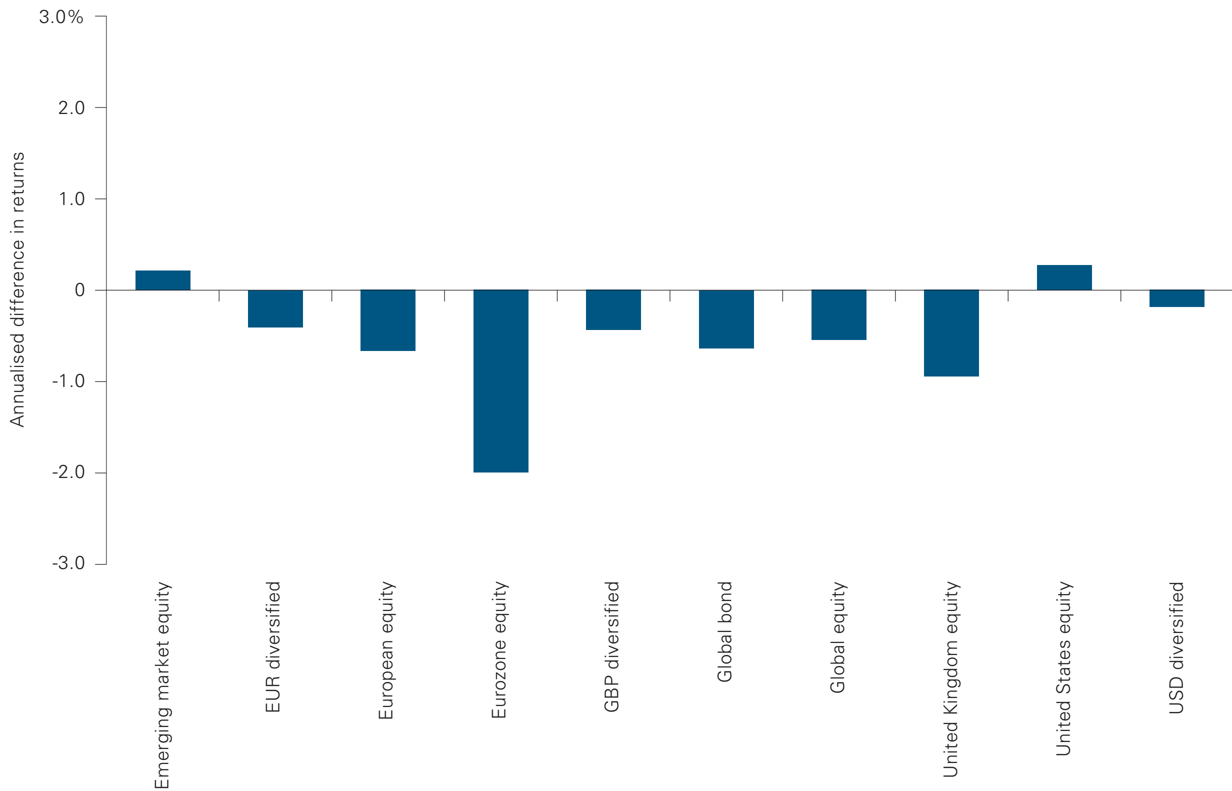
The allocation of assets between taxable and tax-advantaged accounts – sometimes referred to as asset location – is another important tool you can use that can add value each year. What's more, just like minimising costs, the benefits of investing tax-efficiently will compound over time. Optimal portfolio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

This arrangement takes maximum advantage of the different tax treatments of different asset classes. Our research suggests that structuring a portfolio in this way can create up to 0.23% of Adviser's Alpha in the first year without increasing risk, for a higher-rate UK taxpayer within the capital gains tax allowance of £11,000. In the US, the figure is between 0 and 75 bps depending on the investor's asset allocation and the breakdown of assets between taxable and tax-advantaged accounts.

The potential value-add for asset location is likely to vary significantly depending on where an investor is located given the different tax regimes of different countries.

In our Australian study, we found we could not separate elements 5 and 6, tax allowances and spending strategy. However, we did find that the combination of the two, namely tax-efficient accumulation and distribution, made a significant

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



Notes: Past performance is not a reliable indicator of future results. The performance data does not take account of the commissions and costs incurred in the issue and redemption of shares. 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.

contribution to adviser's alpha. Although the value is deemed significant, it is too unique to each investor to quantify, based on each investor's varying risk tolerance, financial goals, portfolio composition, different types of retirement savings accounts and tax bracket.

Element 6: Spending strategy

The number of retirees is rising rapidly and many investors have both taxable and non-taxable investments. 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 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 UK 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.

The gain for US clients could be up to 70 bps, according to our research. US advisers can minimise the impact of taxes on their clients' portfolios by spending in the following order: Required minimum distributions, if applicable, followed by cash flows on assets held in taxable accounts, taxable assets, and finally tax-advantaged assets.

We believe that advisers who implement informed withdrawal-order strategies can minimise the total taxes paid over the course of their clients' retirement, thereby increasing their clients' wealth and the longevity of their portfolios. This process alone could represent the entire value proposition for the fee-based adviser.

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 for the foreseeable future, 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.

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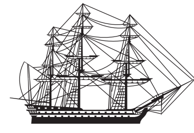

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