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

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The value proposition of advice is changing. The nature of what investors expect from advisers is changing, which is why the tools available to advisers are evolving as well. 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 took the Adviser's Alpha framework further by attempting to quantify the benefits that advisers can add relative to others who are not using such strategies. Each of these can be used individually or in combination, depending on the strategy.

'Putting a value on your value' is as subjective and unique as each individual investor. For some, the value of working with an adviser is peace of mind. For others, we found that working with an adviser can add around 3% in net returns when following the Vanguard Adviser's Alpha framework for wealth management.

We do not believe this potential 3% improvement can be expected annually; rather, it is likely to be very irregular. Like any approximation, the actual amount of value added may vary significantly, depending on client circumstance. Some of the best opportunities to add value occur during periods of market stress or euphoria when clients are tempted to abandon their well-thought-out investment plans.

Our aim is to motivate advisers to adopt and embrace these best practices and to provide a reasonable framework for describing and differentiating their value proposition. Furthermore, with the compensation structure for advisers evolving from a commission- and transaction-based system to a fee-based asset management framework, assets – and asset retention – are paramount.

Our Advised Investor Insights™ research[1] confirmed our long-held belief that improving asset gathering and retention depends largely on a focus on relationship management – particularly, the level of trust that a client has in the adviser – rather than portfolio management. However, a focus on relationship management takes time and commitment. This requires advisers to streamline some aspects of their practice and reallocate the time saved to the clients who increasingly demand and value it. Ultimately, clients determine the value of advice and, as our research reveals, they clearly value and reward an adviser they highly trust with referrals and loyalty.

Following the Adviser's Alpha framework can provide you with additional time to spend communicating with your clients and can increase client retention by avoiding significant deviations from the broad-market performance – not only good for your clients, but also good for your practice.

1 For more information, see the Vanguard research paper *From Portfolios to People: The Evolution of Advisor's Alpha*, (Bennyhoff et al., 2018).

Figure 1: Vanguard quantifies the value-add of best practices in wealth management across various regions

Vanguard's Adviser's Alpha strategy modules	Module Number	Value-add relative to 'average' client experience (in bps of return)			
		US	AUS	UK	CAN
Suitable asset allocation using broadly diversified funds/ETFs	I*	> 0	> 0	> 0*	> 0
Cost-effective implementation (expense ratios)	II	34	70	44	42
Rebalancing	III	26	37	48	86
Behavioural coaching	IV	150	150	150	150
Tax allowances and asset location	V	0 -75	> 0*	0 - 32	0 - 42
Withdrawal order for client spending	VI	0 -110	–	0 - 153	0 - 46
Total-return versus income investing	VII*	> 0	> 0	> 0	> 0
Potential value added		About 3%			

Notes: *Return value-add for Modules I and VII was significant but too variable by individual investor to quantify. Also for 'Potential value added', we did not sum the values because there can be interactions between the strategies. Bps = basis points.

Source: Vanguard.

A high level summary of the results of our quantification exercise across various geographies is detailed in **Figure 1**[2]. Despite differences in the respective environments from market to market, there are some distinct commonalities in all the regions we have assessed thus far. These represent significant opportunities for advisers to add value.

The framework focuses on the most common tools for adding value, encompassing both investment-oriented and relationship-oriented strategies and services. The tools and strategies discussed are by no means an exhaustive list, rather those that would be available to most advisers and clients across geographies. For example, estate and charitable planning may be some areas where advisers can apply more specialised skills and provide a differentiated degree of value. Furthermore, the applicability – and resulting value added – of the strategies assessed will vary by client circumstance (time horizon, risk tolerance, financial goals, portfolio composition and tax bracket, to name a few) and adviser implementation.

Module I: Asset allocation

Asset allocation refers to the percentage of a portfolio invested in various asset classes such as stocks, bonds and cash investments, according to the investor's financial situation, risk tolerance and time horizon. It is the most important determinant of the return variability and long-term performance of a broadly diversified portfolio that engages in limited market-timing[3].

Asset allocation and diversification are two of the most powerful tools advisers can use to help their clients achieve their financial goals and manage investment risk. 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. But, as well as providing a solid foundation for sensible investment decisions, the investment policy statement sows the seed for future behavioural coaching opportunities[4]. 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.

Since the bear market in the early 2000s, many investors have embraced more complicated portfolios, with more asset and sub-asset classes, than in the past. But complexity is not necessarily sophisticated, it's just complex. 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[5].

Simple is a strength, not a weakness, and can be used to promote better client understanding of asset allocation and of how returns are derived. When incorporating index funds or ETFs as the portfolio's core, simplicity and transparency are enhanced, as the risk of portfolio tilts (a source of substantial return uncertainty) is minimised. These features can be used to anchor expectations and help keep clients invested when headlines and emotions tempt them to abandon the investment plan.

2 A more detailed discussion of the underlying modules can be found in *Putting a Value on Your Value: Quantifying Advisor's Alpha* (Kinniry et al., 2019).

3 Davis et al., 2007.

4 Please see the Vanguard research paper *The Vanguard Adviser's Alpha Guide to Proactive Behavioural Coaching* (Bennyhoff, 2018) for more information on behavioural coaching.

5 Based on 2019 NACUBO-Commonfund study of Endowments (2020).

Module II: Cost-effective implementation

Cost-effective implementation is a critical component of every adviser's tool kit and is based on simple arithmetic: gross return minus costs (expense ratios, trading or frictional costs and taxes) equals net return. Every euro paid for management fees, trading costs and taxes is one less in potential return for clients. 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.

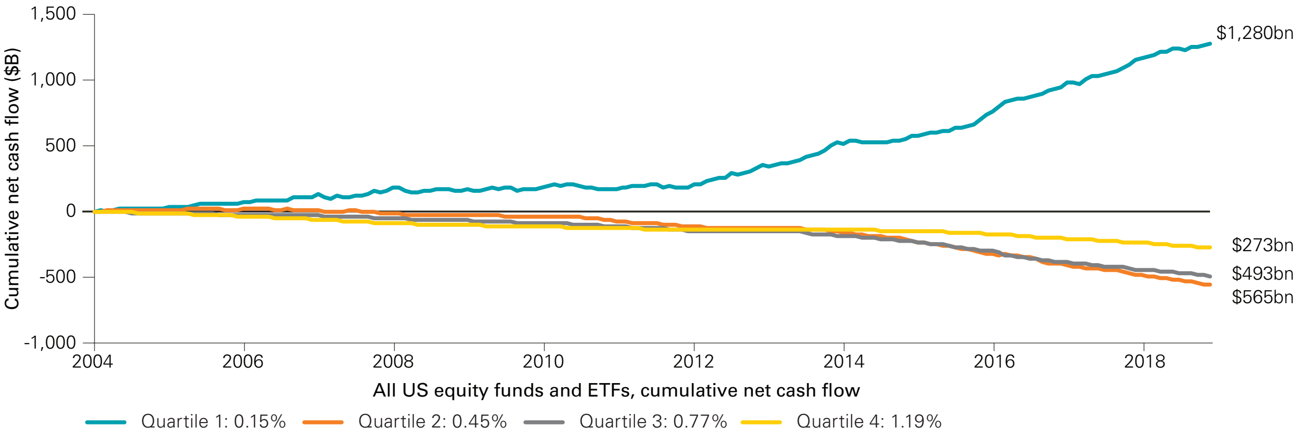
If low costs are associated with better investment performance, then costs should play a role in an adviser's investment selection process. *This fact has been repeatedly illustrated in industry research showing that low-cost funds tend to outperform higher-cost alternatives*[6].

Vanguard's previous research in the US, which examines the link between net expense ratios and net cash inflows, shows a preference for lower-cost products has been a longer-term trend[7]. This is shown over the past 15 years through 2019 in **Figure 2**. Expanding on this, we found that a European investor could save from 41 basis points (bps) to 60 bps annually by moving to low-cost funds, as shown in **Figure 3**.

By measuring the asset-weighted expense ratio of the entire mutual fund and ETF industry across various investment categories, we found that, depending on asset allocation, the average investor pays between 57 bps annually for an all-bond portfolio and 79 bps annually for an all-equity portfolio, while the average investor in the lowest quartile of funds can expect annually to pay between 16 bps (all-bond portfolio) and 20 bps (all-equity portfolio). This includes only the total expense ratio or ongoing charges figure (TER or OCF) and, by some measures, is conservative when taking into account total investment costs.

Furthermore, this value-add has nothing to do with market performance. When you pay less, you keep more, regardless of whether the markets are up or down. In fact, in a low-return environment, costs are even more important because the lower the returns, the higher the proportion that is assumed by fund expenses. In a fee-based practice, this is one of those areas that's a 'win-win' for both clients and their advisers. Not only should clients get higher returns, but this higher return for the client will translate to higher AUM growth rates for advisers.

Figure 2. US investors and advisers are choosing low-cost equity funds



Notes: Expense ratio quartiles were calculated annually. Shown for each quartile are the 2019 asset-weighted average expense ratios, determined by multiplying the annual expense ratios by the year-end assets under management and dividing by the aggregate assets in each quartile.

Source: Vanguard calculations, using data from Morningstar.

Figure 3. 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)	0.79	0.75	0.70	0.68	0.66	0.62	0.57
Lowest quartile AWER (Q1)	0.20	0.19	0.18	0.18	0.18	0.17	0.16
Cost-effective implementation (AWER vs. Q1)	0.60	0.56	0.52	0.50	0.48	0.45	0.41

Notes: Fund universe includes funds available for sale in the euro area 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 area equity – flex-cap, large-cap, mid-cap, small-cap; global – flex-cap, large-cap blend, large-cap growth, large-cap value, small-cap; US equity – flex-cap, large-cap blend, large-cap growth, large-cap value, mid-cap, small-cap; emerging markets equity – global emerging markets, BRIC, EMEA, emerging Europe, global emerging markets small/mid-cap, global frontier markets; Europe bond – EUR diversified; US bond – USD diversified; global bond – global un-hedged bond; UK bonds – UK diversified, UK government.

Source: Vanguard calculations, based on data from Morningstar as of 31 December, 2019.

6 For example, see the Vanguard research paper *The case for low-cost index-fund investing* (Rowley et al., 2018).

7 See the Vanguard research paper *Investors Are 'Voting With Their Feet' on Costs* (Bennyhoff and Walker, 2016).

Module III: Rebalancing

Given the importance of selecting an asset allocation, it's also vital to maintain that allocation. As investments produce different returns over time, the portfolio is likely to drift from its original target allocation, acquiring new risk-and-return characteristics that may be inconsistent with your client's original preferences.

An investor wishing to maximise returns, with no concern for the inherent risks, should allocate their portfolio 100% to equities to capitalise on the equity risk premium. Investments that are not rebalanced, but drift with the markets, have experienced higher volatility. In a balanced portfolio this equity risk premium tends to result in equities becoming over-weighted relative to a lower risk–return asset class such as bonds.

Although failing to rebalance may help the long-term returns of portfolios as the relative weight of equities rises, the true benefit of rebalancing is in controlling risk. ***Vanguard believes that the goal of rebalancing is to minimise risk, not maximise return.*** A portfolio overweighted to equities is more vulnerable to equity-market corrections, putting it at risk of larger losses compared with the target portfolio.

Helping investors to stay committed to their asset allocation strategy and remain invested in the markets increases the probability of meeting their goals. But the task of rebalancing is often an emotional challenge. An adviser can provide the discipline to rebalance when it is needed most, which is often when it involves a very uncomfortable leap of faith.

Module IV: Behavioural coaching

Because investing evokes emotion, advisers need to help their clients maintain a long-term perspective and a disciplined approach. Most investors are aware of these time-tested principles, but the hard part of investing is sticking to them in the best and worst of times. Abandoning a well-planned investment strategy can be costly, and research has shown that some of the most significant challenges are behavioural. Emotional detachment is one of the most overlooked benefits advisers can provide.

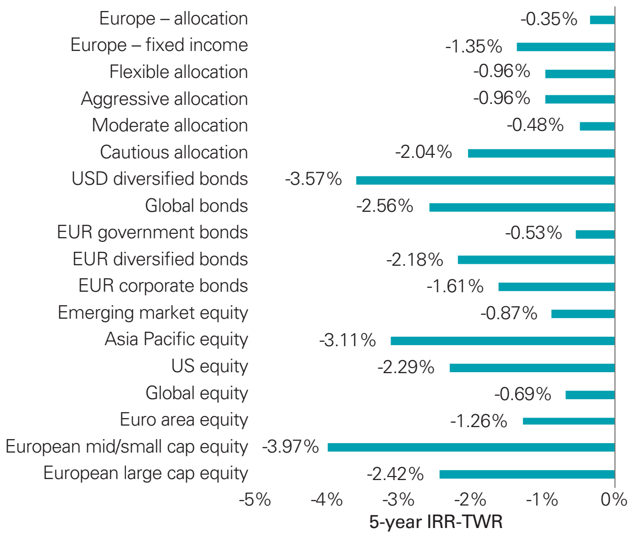
When clients are tempted to abandon the markets because performance has been poor or to chase the next "hot" investment, you need to remind them of the plan you created before emotions were involved. This is where the trust they have in you is key: strong relationships need to be established before the bull- and bear-market periods that challenge their confidence. Advisers can act as emotional circuit breakers by circumventing clients' tendencies to chase returns or run for cover in emotionally charged markets.

Studies have concluded that behavioural coaching can add up to approximately 200 bps per year. For example, we investigated how individual investors exchanging money between funds or into other funds affected their average returns. By comparing 58,168 self-directed investor's personal returns for the five years ended 2012 versus hypothetical results using two Vanguard created 'personal rate of return benchmarks' based on single fund alternatives, we found that the average fund investor who made at least one change to their portfolio sacrificed 104 to 150 bps due to poor portfolio adjustments (Weber, 2013).

A common method of analysing mutual fund investor behaviour is to compare investor returns (internal rates of return, IRRs) with the fund's reported total returns (time-weighted returns, TWRs) over time. The IRR differs from the TWR due to cash flows in and out of the fund; absent any cash flows, the TWR and IRR should be the same. All managed funds should expect a return drag versus their benchmark over longer periods as money continually enters a rising market. However, larger differences can be a sign of performance chasing[8].

As shown in **Figure 4**, investors and the funds they invest in commonly receive much different returns. Observing IRR-TWR gaps for more fund types, markets, and rolling time frames (**Figure 5**) offers a more consistent perspective. Most of the observations, as well as the median, tend to be negative. This suggests a great opportunity for advisers to help their clients and add value by helping them to close the gap.

Figure 4. European investor returns versus fund returns: five years ending 31 December 2017

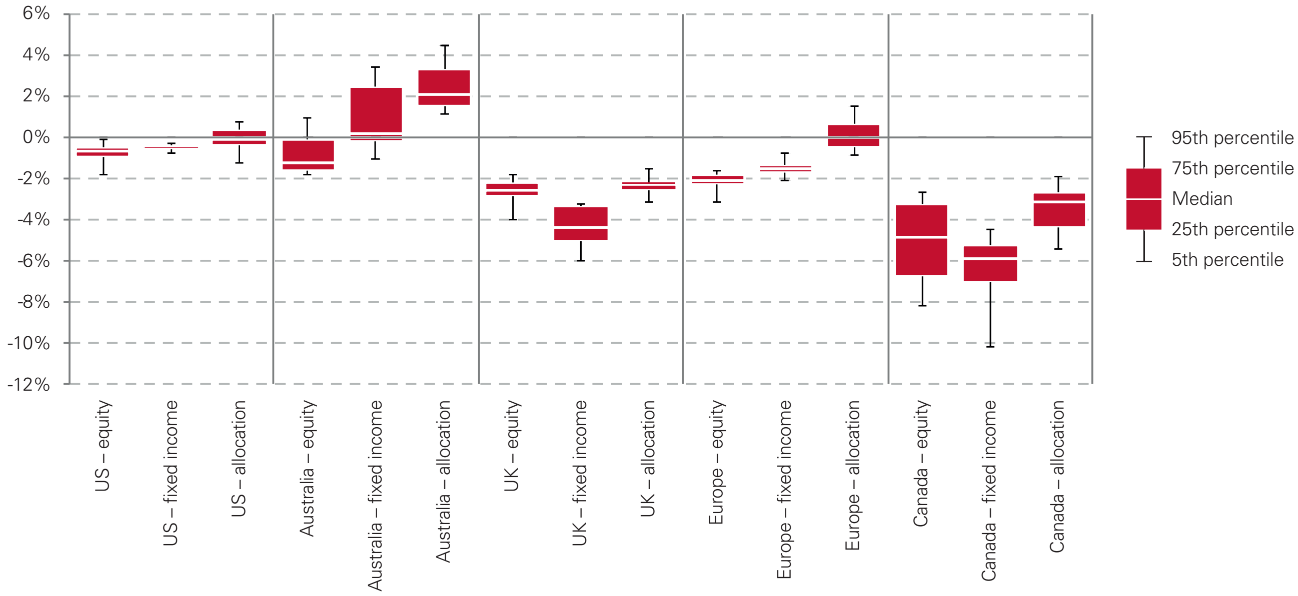


Notes: The time-weighted returns (TWRs) in this figure represent the average fund return in each category. Investor returns assume that the growth of a fund's total net assets for a given period is driven by market returns and investor cash flow. An internal rate-of-return (IRR) function is used, which calculates the constant growth rate that links the beginning total net assets and periodic cash flows to the ending total net assets. Discrepancies in the return 'difference' are due to rounding.

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

8 Kinniry and Zilbering, 2012.

Figure 5. Global distribution of investor returns versus fund returns: Rolling returns for various regions



Notes: The time-weighted returns (TWRs) in this figure represent the average fund return for each category. Investor returns assume that the growth of a fund's total net assets for a given period is driven by market returns and investor cash flow. An internal rate-of-return (IRR) function is used, which calculates the constant growth rate that links the beginning total net assets and periodic cash flows to the ending total net assets. Discrepancies in the return 'difference' are due to rounding. Not every funds or ETF is included for each category given limitations in available data. Data represents quarterly observations of rolling 10-year IRR-TWR differentials for funds and ETFs available for sale in the US, Australia, and Canada, and 5-year rolling observations for UK and Europe, due to data limitations for those regions. Data availability starts in 1993 for US, 2003 for Australia, 2008 for UK and Europe, and 2002 for Canada.

Source: Vanguard calculations, based on data from Morningstar, Inc. Data as of 31 December 2017.

Module V: Tax-efficient investing

Asset location, the allocation of assets between taxable and tax-advantaged accounts, can add value each year that can compound through time. While previous Vanguard research on asset location has focused on US investors[9], we believe that a good asset location strategy can add significant value to investors globally.

The value-add will vary by each jurisdiction as the available tax treatments, wrappers and account types differ. The amount of value added will also depend on the investor's asset allocation and the breakdown of assets between taxable and tax-advantaged accounts. If an investor has all of his or her assets in one account type (that is, all taxable or all tax-advantaged), the value of the asset location would be 0 bps.

From a tax perspective, we found in the US that optimal portfolio construction can minimise the impact of taxes by holding tax-efficient broad-market equity investments in taxable accounts and by holding broad-market bonds within tax-advantaged accounts. This arrangement takes maximum advantage of the different tax treatment between the two asset classes. Similar to cost-effective implementation, these incremental differences can have a powerful compounding effect over the long run.

Module VI: Withdrawal order for client spending

With the retiree population on the rise, an increasing number of clients are facing important decisions about how to spend from their portfolios. Complicating matters is the fact that many clients hold multiple account types, including taxed, tax-deferred and tax-free accounts. The primary determinant of whether one should spend from taxable assets or tax-advantaged assets is taxes. Absent taxes, the order of which account to draw from would yield identical results (assuming accounts earned the same rates of return).

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. Vanguard research in the US and UK[10] has shown that this process alone can represent a significant proportion of the advice value proposition. Taking the UK as an example, our research suggests advisers can minimise the impact of taxes on their clients' portfolios by, as a general rule, spending from taxable accounts first.

Besides the order in which clients should withdraw from their portfolios, further considerations can provide advisers with another opportunity to increase their clients' after-tax returns. For example, UK investors in a defined contribution (DC) pension plan must also select the appropriate method by which to 'crystallise' capital.[11]

9 Jaconetti, 2007.

10 For more information on our research based on the US and UK retirement landscapes, please see the research papers *From Assets to Income: A Goals-Based Approach to Retirement Spending, 2016 and Withdrawal Order: Making the Most of Retirement Assets* (Harbron et al. 2019).

11 Crystallisation method refers to the way by which an investor decides to access the investment in their pension pot. A pension is 'crystallised' once you start taking pension benefits. See the research paper *Withdrawal Order: Making the Most of Retirement Assets* (Harbron et al. 2019) for more information.

There may be further factors that advisers can help their clients to navigate. Examples include whether the investor is likely to be changing tax bands, if there are special tax treatments for investors that have spouses or civil partners and the likelihood of breaching any set allowances, such as the UK's Lifetime Allowance. Advisers can also help to determine whether the client has non-retirement goals that should dictate the subsequent withdrawal order. Many of these considerations and exceptions would require sophisticated cash flow analysis to take full advantage of the planning benefits, providing yet another opportunity for financial advisers to add value.

Module VII: Total return vs income investing

With yields on balanced and fixed income portfolios at historically low levels and expected to remain low relative to past standards, the value of advice has never been more critical for retirees. Historically, retirees holding a diversified portfolio of equity and fixed income investments could easily have lived off the income generated by their portfolios. Unfortunately, that is no longer the case.

Investors who wish to spend only the income generated by their portfolio, referred to here as the "income-only" approach, have three choices if their current cash flows fall short. They can spend less, they can reallocate to higher-yielding investments, or they can spend from the total return on their portfolio, which includes not only the income or yield but also the capital appreciation.

As your clients' adviser, you can help them make the right choice for their situation. Be aware that, for many investors, moving away from a broadly diversified portfolio could actually put their portfolio's principal value at higher risk than spending from it. **Figure 6** outlines several common techniques for increasing a portfolio's yield, along with their impacts.

Some may feel that the income strategies described above will reward them with a more certain return and therefore less risk. But in reality, this is increasing the portfolio's risk. It will become too concentrated in certain sectors, with less tax-efficiency and a higher chance of failing to provide for long-term financial goals.

Vanguard believes in a total-return approach, which considers both income and capital appreciation. It has the following potential advantages over an income-only method:

- **Less risk.** It allows better diversification, instead of concentrating on certain securities, market segments, or industry sectors to increase yield.
- **Better tax-efficiency.** It offers more tax-efficient asset locations (for clients who have both taxable and tax-advantaged accounts). An income approach focuses on access to income, resulting in the need to keep tax-inefficient assets in taxable accounts.
- **A potentially longer lifespan for the portfolio.**

Designing a tax-efficient, total-return strategy when an investor requires specific cash flows to meet their spending needs involves substantial analysis, experience, and transactions. To do this well is not easy, and could well represent the entire value proposition of an advisory relationship.

Figure 6. Income-only strategies and potential portfolio impact

Strategy	Impact on a portfolio
1. Overweighting of longer-term bonds (extending the duration)	Increases exposure to changes in interest rates
2. Overweighting of high-yield bonds and/or underweighting of government bonds	Increases credit risk and raises overall volatility
3. Increasing exposure to dividend-centric equity	Decreases diversification of equity portfolio by overweighting certain sectors and/or increases overall volatility and risk of loss if it reduces the bond portfolio

Note: Impact is measured as the difference between the income-only strategy and a market-cap-weighted portfolio at the sub-asset-class level.
Source: Vanguard.

Conclusion

Where should you begin? We believe you should focus on those areas over which you have control, at least to some extent, such as:

- Helping your clients select the asset allocation that is most appropriate to meeting their goals and objectives, given their time horizon and risk tolerance.
- Implementing the asset allocation using low-cost investments and, to the extent possible, using asset-location guidelines.
- Limiting the deviations from the market portfolio, which will benefit your clients and your practice.
- Concentrating on behavioural coaching and spending time communicating with your clients.

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