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

Research brief

March 2015

Vanguard created the concept that advisers could add more value through relationship-oriented services than investment selection in the United States back in 2001. Since then Vanguard has undertaken extensive research to evolve this framework to reflect the changing nature of the advice industry, client needs and available investment tools.

In this research brief, Vanguard takes the 'Adviser's Alpha' framework one step further, and quantifies the potential value this strategy can add to clients' net returns from an Australian perspective.

While the research estimates that 'implementing the Adviser's Alpha framework can add about 3% to clients' net returns, it also offers significant benefits for your advisory practice.

What is the Adviser's Alpha framework?

Vanguard's Adviser's Alpha framework is a six module framework of best practice wealth management strategies. It helps you identify your potential value add for clients and can also influence the success of your advisory practice.

While many Australian advisers can add value in a variety of ways such as, for instance, through insurances and estate planning, these six selected modules represent the approaches that would commonly apply across most investors and their situations.

The framework is particularly relevant now, as the industry shifts towards a fee-for-service approach and away from transaction-based practices where advisers are paid to transact regardless of the benefit to clients.

What is Adviser's Alpha?

Advisers can demonstrate their value through their ability to effectively act as a wealth manager, financial planner and behavioural investment coach – providing discipline and reason to clients who are often susceptible to behavioural biases such as emotions.

Advisers using the Vanguard Adviser's Alpha framework offer a very different value proposition to traditional performance-based models, which rely on market benchmarks to determine their value add.

Alpha in this context is based on projections of a portfolio that is managed using best practice wealth management strategies against a portfolio that does not use these value-add practices.

Adviser's Alpha is different to market alpha

Alpha is traditionally defined as the risk-adjusted return above the index attributed to market-timing and security selection. Historical performance data shows that many active managers fail to consistently outperform their benchmarks. This makes it difficult for advisers who link their value to market outperformance to be successful.

If the dramatic increase in the use of exchange traded funds (ETFs) is anything to go by, many investors seem to be questioning the value of market-beating return strategies. These investors are making a conscious choice to choose investments that are structured to match, rather than outperform, a benchmark. These same strategies are considerably lower in cost – increasing the odds of investment success when combined with a cohesive and well-crafted financial plan.

Using passive strategies doesn't mean that investors aren't seeking better performance, they are just measuring it in a different way. While index funds aren't expected to outperform the performance benchmark, they can be expected to outperform the return of the average managed fund investor in similar funds due to their lower costs and the observed tendency for actively-managed funds to underperform lower-cost, passive funds and ETFs.

Vanguard's Adviser's Alpha framework

Paying a fee for advice and guidance to a professional who uses the tools and tactics described in the Adviser's Alpha framework can add meaningful value compared to the average investor experience, currently advised or not.

Table 1 provides a brief summary of each of the six modules comprising Vanguard's Adviser Alpha framework and their potential value add when compared to the 'average' client experience.

While this is not an exhaustive list of all the ways advisers can use to add value, it focuses on the most common investment and relationship-oriented strategies and services. Some of these may not be appropriate for every client's circumstances, so we have broken down the potential value add for each component.

The value added may vary through time and may not occur every year. It is likely to be more lumpy than that and its extent will vary based on each client's unique circumstances and the way the assets are managed.

Table 1: Vanguard's Adviser Alpha framework

Module	How it works	Potential value add*
1. Asset allocation	While asset allocation is the primary determinant of long-term return variability, it is difficult to quantify its value-add due to the differences in individual investor time horizons, risk tolerances and goals. Nonetheless, asset allocation and diversification are two of the most powerful tools advisers can use to help their clients achieve their financial goals. They should form part of the investment policy statement you establish with your clients at the outset, providing a roadmap for you and your clients to follow through market cycles.	>0
2. Cost effective implementation	Every dollar saved on management fees, trading costs and taxes contributes to your clients' net returns. Vanguard analysed the asset-weighted indirect cost ratios of the Morningstar universe of managed funds and ETF industry to demonstrate the value of using low-cost funds. ETFs are among the lowest cost funds in the industry.	75
3. Rebalancing	Allowing a portfolio's asset allocation to drift can change the risk and return characteristics of the portfolio. While a non-rebalanced portfolio could provide better returns it is likely to have much higher risk given the equity risk premium. Annual rebalancing helps to control risk.	42
4. Behavioural coaching	This is possibly the largest potential value-add tool. Helping clients maintain a long-term perspective through different market cycles and discouraging market-timing and performance chasing behaviours can save clients from potential wealth destruction. Analysis of actual investor returns against managed fund returns shows these behaviours account for a significant erosion of returns across different equity segments and multisector funds. Vanguard's Adviser's Alpha framework is built on having a significant allocation to the core portfolio and smaller satellite allocations appropriate to each investor and practice.	180
5. Tax efficient accumulation and distribution	In Australia, superannuation is one of the most tax effective ways of accumulating savings for most clients. Using asset-location strategies that take advantage of tax inefficient funds in superannuation accounts and more efficient funds in taxable accounts can add value. Given their lower turnover levels, index funds are more tax-efficient than active funds. From an asset class perspective, Australian shares offer the lowest effective tax rate. Once in the retirement phase, withdrawal location strategies become the focus. Advisers can help investors set realistic and flexible annual spending amounts and use implementation strategies that minimise total taxes.	>0
6. Total return versus income investing	With yields on fixed income portfolios at historically low levels, the value of advice is even more critical for retirees. If cash flows fall short of spending needs there are three choices 1. Spend less; 2. Reallocate their portfolio to higher yielding investments or 3. Spend from the total return on their portfolio (including income and capital appreciation component). Many investors are under the misconception that an income only approach strategy will provide a higher certainty of income and less risk. Relying on an 'income-only' approach where clients use the interest from bonds and dividends on equities to meet their income needs can reduce diversification; increase interest rate and credit risks; and increase volatility. Vanguard believes in maintaining a broadly diversified portfolio and following a total-return approach, which considers both components of total return: income plus capital appreciation.	>0
		Total value added: About 3%

* basis points of return.

Notes: Value-add is measured relative to the "average" client. Value-add for Modules 1, 5 and 6 was deemed significant but too unique for each investor to quantify. Also, for "Potential value added," we did not sum the values because there can be interactions between the strategies.

Source: Vanguard Australia.

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