MULBERRY BOW

THE BOW BLOG

Adviser Alpha (Part 2)

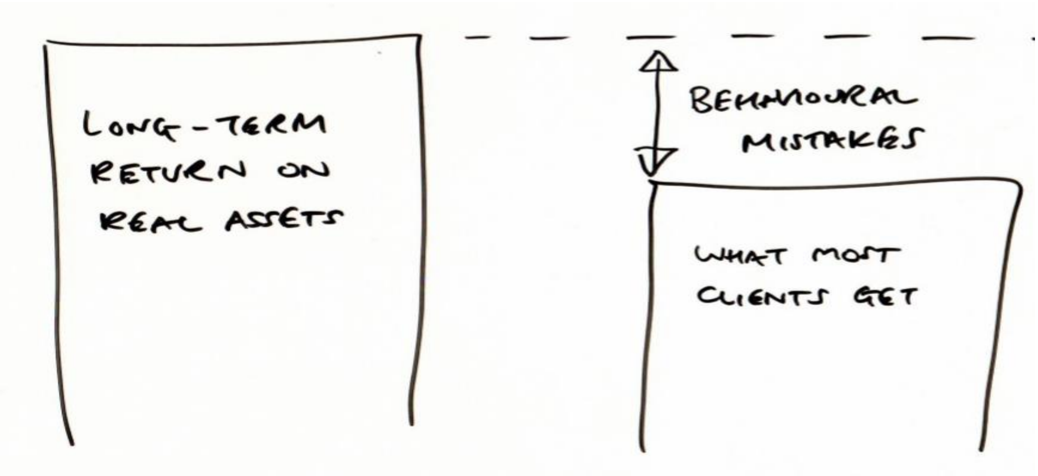
May 2017

In last month's Bow Blog I shared with you the first three elements of Planning adding value, that Vanguard noted in their recent white paper. This month I'd like to touch on the final four and I welcome your thoughts and feedback.

Element 4: Behavioural Coaching

Most clients recognise the importance of consistently sticking to the Plan in turbulent markets, but many still end up taking the wrong course of action and too often we hear even seasoned 'commentators' saying *'This time it's different'*. Behavioural pitfalls such as trying to time the markets or 'chase' sectors are among the biggest issues and why coaching is probably the most important area where Planners create alpha for clients. Revisiting the original plan that was created with a client's goals at the centre comes into its own, helping to put emotions to one side when markets get tough. Extreme market conditions are thankfully fairly rare over the long-term but, when they do happen, measuring **Alpha** could be in percentage points rather than basis points and could repay advice fees several times over. Moreover, once the dust has settled, the experience will have helped to build further trust between the client and the Planner.

So, how much **Adviser's Alpha** can be added in this way? Academic studies conclude that coaching can add between 1% and 2% p.a. Other studies, of the returns generated by same fund for advised investors versus direct similarly showed how much value investors can destroy by trying to time the market and while figures vary by market, the difference came out between 1% and 2% p.a. so Vanguard estimates the value add from behavioural coaching at c.1.5%.



Element 5: Tax Allowances

Like minimising costs, the benefits of investing tax-efficiently compound over time. Simply 'nagging' clients to take up all allowances consistently adds value. Optimal portfolio construction from a tax perspective might involve holding more of the allocation to equities in unwrapped (taxable) 'general investment accounts', with higher income investments (e.g. corporate bonds) held in tax-efficient vehicles such as ISAs or pensions. Wealthy clients may also use a company to enjoy dividends without ongoing tax, compounding income return over time and then passing the company to children. Taking advantage of basic tax-efficient options can mean, according to Vanguard's research, c.0.23% p.a. of additional value without necessarily altering the risk profile adopted, but it could be much higher for wealthier clients.

Element 6: Spending Strategy

We hear "*We're all living longer*" a lot these days and many investors want to make sure they have sufficient income to enjoy their retirement and not worry about issues such as medical costs. With taxable and non-taxable investments and recent 'pension freedoms', Planners can add significant alpha by ensuring 'lifestyle expenditure' is secure, sufficient liquidity is retained for unforeseen circumstances and the Estate Plan is commensurate with the client's own needs.

How much **Alpha** might be added by such discussions and the cash flow modelling that good Planners now use to give meaningful context to them? Consider a higher-rate taxpayer with a portfolio that is simply invested 60% equities/40% in bonds across pensions, ISAs and 'unwrapped'. If this client wishes to withdraw 4% p.a. the way he or she does so will have a big impact on the rate of tax they pay. By spending from the taxable account first, an increasing proportion of the remaining portfolio will be tax sheltered (not to mention IHT in the case of the pension). Thanks to its favourable tax treatment, all things being equal it will grow faster, net, than the starting portfolio. Vanguard calculate that a higher-rate taxpayer with a £1m portfolio could achieve a **0.48% p.a.** advantage over a 30-year period by spending in this way.

Element 7: Total Return Versus Income Investing

Traditionally, investors holding a diversified portfolio of equities and bonds could generate a pretty healthy income from their investments. Not anymore. With yields on cash and government bonds at historic lows, Planners can create significant alpha 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; reallocate their portfolios towards higher-yielding investments or adopt a 'total return' approach. Financial Planners can help their clients make the right choices in this regard. In doing so the dangers of boosting income by 'over-allocating' to areas such as high-yield bonds or piling into high risk options like *peer to peer* lending can also be avoided.

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

Conclusion

The seven elements discussed in this and last month's blog show the real value a Planner can add for their clients, if they are doing their job properly. Independent planners have no products to sell, but they are 'selling' added value, as well as *peace of mind.* Thank you for taking the time to read my thoughts on the Vanguard white paper. Take care!

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Source: Vanguard