MULBERRY BOW

THE BOW BLOG

Adviser Alpha (Part 1)

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The government's "Retail Distribution Review" (31/12/2012) changed the adviser value proposition. Clients have greater clarity on the fees they are paying and, quite rightly, they want value for money.

This has had two knock-on effects: 1) many clients now understand they need good financial planning advice, not just good investment management and 2) both financial planners and investment managers are increasingly being asked to quantify the value they add for their clients. Tax and costs are the only certainties and it's while gross is what you earn ***net is what you get!***

In an effort to address these areas, Vanguard, a global titan of the investment world with approximately $4 trillion (and rising fast) in assets under management and more than 20m investors across 170 countries, recently produced a white paper **Adviser's Alpha** and we thought it would be helpful to spend this blog, and next month's, exploring their findings.

Vanguard®

Adviser's Alpha focuses on financial planning and the difference between the return that investors might achieve with a Financial Planner versus on their own. It sets out **seven key areas** where Planners can add value before estimating the impact for each area, arriving at a total figure of **c.3% p.a.** over the long-term, if the Planner is doing their job properly. We'll explore the first three elements in this blog, returning to the final four in 'Part 2' next month, and help you understand how they arrived at this figure:

Element 1: Suitable Asset Allocation - It is widely acknowledged that strategic asset allocation, the split of equities, bonds, property and 'alternatives' is the most important driver of long-term performance and volatility. Setting the correct asset allocation is fundamental to client's achieving their aims. Clearly, to set the right asset allocation, the Financial Planner needs to have in-depth conversations with the client about goals, their situation, risk tolerance, spending, time horizon and so on. Stating the obvious, clients cannot have that 'conversation' alone.

Writing an investment policy statement helps to crystallise these questions, as well as highlighting any other factors, such as ethical considerations or previous investment experience, which might affect how to implement a strategy. The investment policy statement sows the seeds for future behavioural coaching opportunities.

Keeping it simple is paramount. Simple can be a strength in a client portfolio, moving the focus of discussions from the intricacies of the latest complex investment product or 'star fund manager', to the overall Plan and the enduring benefits of appropriate asset allocation, diversification, tax-efficiency, investor discipline and the Estate Plan.

Element 2: Rebalancing - Having taken the time to set the appropriate allocations, the next area where a Planner can add alpha is regular rebalancing back to those weightings. Because different assets perform differently, the initial weighting will of course drift over time. For many investors rebalancing 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 Financial Planners can add value. In 2008/9 many private investors suffered this impact of not rebalancing, and even chasing the sectors that were the most vulnerable, some have never recovered, selling out into cash where they remain today.

It's important to stress that rebalancing is designed to control risk rather than maximise returns (or the latter is relevant only in a risk-adjusted sense). To quantify how much, Vanguard looked at the performance and volatility of a portfolio of 60% equities/40% bonds that was allowed to drift and found that a comparable level of volatility could be achieved through a regularly rebalanced portfolio made up of 70% equities, with the latter portfolio outperforming by 0.43% p.a.

Element 3: Cost-Effective Implementation - Cost-effective implementation is a critical component of a good Planner's toolkit and it's based on simple arithmetic: gross return minus tax and costs = net return. Every pound paid in charges is a pound off client's potential returns – and that'll be particularly impactful if we're moving into a low inflation/low growth/low return period.

Just like returns, costs compound over time, choosing a cost-effective fund on day one could really reap rewards for clients over the long term. This has been repeatedly illustrated in industry research showing that low-cost funds outperform higher-cost alternatives. Vanguard's calculations suggest that a Planner can create between 0.66% and 0.92% of value each year just by implementing client portfolios cost-effectively, but of course this last element only makes sense for clients who are negative or agnostic about active management – many feel it offers them peace of mind and the opportunity to outperform.

I hope that's been of interest and look forward to sharing with you the rest of the findings in next month's Bow Blog.

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Source: Vanguard