Advisors, Investors, and Gamma: 4 Ways to Quantify Your Value

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Two studies, one from Morningstar and another from Vanguard, help advisors show clients—in cold, hard percentage points—how much their expertise and guidance is actually boosting investment returns.

In our current fee-sensitive environment, advisors are forced to communicate (and defend) their value on a daily basis. Yet it is often difficult to quantify our value in general terms, particularly as it applies to a broad swath of clients. Well, Morningstar and Vanguard tried to do just that in recent studies that evaluated "advisor value," and their timing couldn't be better in light of the recent *Wall Street Journal* article (July 26, 2017) also addressing—and questioning—the worth of an advisor. By describing the variety of advisor services, Morningstar and Vanguard were able to address and in some sense quantify the potential value added by an advisor's investment management.

Morningstar's 2017 Study "Alpha, Beta, and...More Gamma" used seven main areas to determine the value of financial advice (see the table below) and measured advisor value in terms of “gamma.” Similarly, Vanguard’s 2016 Study “Quantifying Your Value to Your Clients” (see the following chart below) used “alpha” to measure the advisor value in three main areas: portfolio construction, wealth management, and behavioral coaching. Because the topics discussed in both studies overlapped in many (though not all) areas, we were able to compare Morningstar’s research and Vanguard’s research by relying upon Vanguard’s three main categories.

Here are Morningstar’s seven main questions, used to identify the “benefit of financial advice,” or the total potential additional annual returns gained through the use of an advisor.

Morningstar Advisor Gamma

Investor question	**Benefit of financial advice (%)**		
	Low	**Average**	**High**
1. Why invest at all?	0.05%	0.30%	1.00%
2. Which type of account is best for my situation?	0.10%	0.25%	0.50%
3. What is the appropriate risk level?	0.10%	0.40%	1.00%
4. Which asset classes should be included?	0.00%	0.20%	0.60%
5. How does the risk of the goal affect how I invest?	0.05%	0.20%	0.50%
6. What investments are right to help me reach my goal?	0.00%	0.45%	1.50%
7. Should my investments be revisited or rebalanced?	0.10%	0.65%	1.60%
Total additional annual returns added by advisor	~0.40%	~2.45%	~6.70%

Source: “Alpha, Beta, and…More Gamma,” Morningstar

Vanguard took a slightly different approach, relying upon three main categories to identify the benefit of financial advice mostly as it pertains to portfolio construction and monitoring.

Vanguard Advisor Alpha

Quantifying your advisor's value	Potential value relative to "average" client experience (in percentage of net return)
Portfolio construction	
Suitable asset allocation using broadly diversified mutual funds/ETFs	>0%
Use of low-cost index-based products	0.45%
Asset location between taxable and tax-advantaged accounts	0–0.75%
Total-return versus income investing	>0%
Wealth management	
Regular rebalancing	0.35%
Spending strategy for drawdowns	0–0.70%
Behavioral coaching	
Advisor guidance to help adhere to financial plan	1.5%
Potential value added	**"About 3%"**

Source: Francis M. Kinniry Jr., Colleen M. Jaconetti, Michael A. DiJoseph, and Yan Zilbering, 2014. *Putting a value on your value: Quantifying Vanguard Advisor's Alpha.* Valley Forge, Pa.: The Vanguard Group.
Note: For "Potential value added," we did not sum the values because there can be interactions between the strategies.

Source: "Quantifying Your Value to Your Clients," Vanguard

We discuss below the value that an advisor contributes, relying upon Vanguard's construct.

1. Portfolio construction

There are many factors that go into portfolio construction, from choosing suitable asset allocations to finding the appropriate risk level. The value created by the proper handling of these portfolio issues proves that creating a portfolio is not as simple as just selecting a bunch of ETFs or mutual funds. Indeed, a portfolio should be a reflection of the client's goals, which means that certain aspects, like the risk level and assets, should be reflective of what the client needs.

The key word here is *goals*, because an advisor needs to understand clients' goals in order to help clients achieve them. Thus, there is still a need for active management, just a different sort. Indeed, the "new normal" requires active asset allocation of passively managed assets tied to the client's cash flow needs and other goals.

Both Morningstar and Vanguard see significant value in how financial advice positively impacts portfolio construction and results in net gains for clients. Moreover, their results are comparable on exactly how much portfolio construction positively impacts clients' net gains. Morningstar's study found that when including the right asset classes (0.20% on average), and selecting the right investments (0.45% on average) and the appropriate investment risk level (0.40% on average) tied to the goal (0.20%), financial advice has an average annual benefit of 1.25% on the overall portfolio.

Meanwhile, Vanguard found that portfolio construction resulted in at least 1.20% of net gains when asset allocation, low-cost index-based products, asset location between taxable and tax-advantaged accounts, and total-return versus income investing are considered. Effective diversification and proper asset allocation is especially important in creating a successful portfolio. We all see clients sitting on large amounts of cash or with concentrated positions, among other things, which can be detrimental to their portfolios. This is but one area where advisors can make a difference and earn their fee, even over a robo-advisor. In short, both Morningstar and Vanguard significantly value the total benefit from strategic asset location and selection of appropriate risk levels at about 1.25% gains (and possibly more) to the overall portfolio.

2. Wealth management

Both Morningstar and Vanguard agree that wealth management, which includes selecting the right accounts for each client, regularly rebalancing portfolios, and creating a spending strategy for drawdowns, provides clients with great value. Morningstar's study states that by choosing the best account for each client's situation (average 0.25%) and revisiting each client's investments (0.65% on average), financial advice benefits the entire portfolio by about 0.90% on average. Meanwhile, Vanguard's study states that regular rebalancing and creating a spending strategy for drawdowns can add approximately 1.05% in net returns. **Regardless of the differing numbers, each study states that rebalancing and well-designed spending strategies add significant value to clients' portfolios.**

We also agree that effective wealth management is the key to providing clients with value. For example, asset location, where we sort certain investments into tax-deferred versus taxable accounts, can create significant tax savings. In addition, an advisor should always revisit her clients' investments before they make any major life transitions, such as having a child, marrying, divorcing, or starting a new job, as doing so will make sure the investments remain on track with their goals.

Advisors can also add value by revisiting and rebalancing their clients' investments biannually (if not more often) to make certain that their investments are still consistent with their goals. In addition, advisors can rebalance or adjust risk levels at inflection points in the market, whether highs or lows. At market highs, we may take some risk off the table (or take a withdrawal), and at market lows, we may decide to buy equities. Finally, advisors can create personalized spending strategies for each of their clients (with tax sensitivity in mind) to keep them on track towards their goals. By doing this, we make clients' lives easier and provide them with additional value.

3. Behavioral coaching

According to the Morningstar and Vanguard studies, behavioral coaching comes in many forms, from teaching clients why they should invest to providing clients with guidance to help them adhere to their financial plans. Morningstar's study shows that financial advice in regard to behavioral coaching, specifically why clients should invest, adds an average of 0.30% to clients' portfolio returns. Meanwhile, Vanguard's study shows that the potential value added relative to behavioral coaching, specifically advisor guidance to help clients adhere to their financial plans, is 1.50%.

While these benefits are already high, I believe that the monetary benefit to investment results can (at times) be even higher. Take, for instance, one of my newer clients who had $500,000 of a $1,000,000 portfolio sitting in cash. By putting my client's money into a hedged equity strategy, which had a 10% return in 2016, my client earned $50,000 and gained 5% on the overall portfolio, which is much more value than either Morningstar's study or Vanguard's study suggests.

4. What about financial planning?

While Morningstar and Vanguard did a great job quantifying the value of aspects such as portfolio construction, wealth management and behavioral coaching, one *huge* area that neither counted or quantified in their studies was the value advisors add through providing additional financial planning services. Examples of valuable financial planning services include estate planning, tax planning, retirement planning, Social Security planning, and many more! Through providing these services, we have saved some clients hundreds of thousands of dollars, if not millions (think effective estate planning strategies).

More important, these financial planning services have enabled us to help our clients achieve their goals, whether that be creating a college fund for their grandkids or retiring early, and provided them with invaluable peace of mind. We believe that neither study addressed financial planning services because it would be too difficult to quantify. In essence, the value could be so high that it is impossible to quantify, which is a shame given all of the criticism that advisors have endured as a result of the fees they charge. Hopefully, a study will emerge that addresses this area in the same way that investment management has been addressed.

Some significant value

While it is worth mentioning that investment management is much more involved than just choosing a couple of ETFs or mutual funds, both Morningstar and Vanguard found that as long as advisors provided such services for a reasonable fee, the benefits to the clients would outweigh the costs. In short, advisors provide significant value to their clients through making intelligent financial decisions and presenting sound investment advice, and can provide clients with even more value by offering additional financial planning services.

In conclusion, the Morningstar study suggests that the quantified annualized benefit of financial advice is great, at an average total benefit of 2.45% to clients' portfolios. Similarly, the Vanguard study suggests that the total potential value added by an advisor is 3.00% in additional annual returns. This means that through providing thorough investment planning advice and behavioral coaching, advisors can add significant value that is equivalent to a boost in investment returns of about 2.45%-3.00% annually. And, that is just a starting point for many.

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