# Insurance Institute of Leicester Adviser's Alpha

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Business Development Manager

**This document is directed at professional investors and should not be distributed to, or relied upon by retail investors.**
The value of investments, and the income from them, may fall or rise and investors may get back less than they invested.

Vanguard

# Adviser Alpha value components

| Vanguard's Adviser's Alpha strategy modules | Module number |
|---|---|
| Suitable asset allocation using broadly diversified funds/ETFs | I |
| Rebalancing | II |
| Cost-effective implementation (expense ratios) | III |
| Behavioral coaching | IV |
| Tax allowances and asset location | V |
| Spending strategy (withdrawal order) | VI |
| Total-return versus income investing | VII |
| Potential value added | |

Source: Vanguard Asset Management ‘Putting a value on your value’, November 2014.

# Adviser Alpha value components

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| Suitable asset allocation using broadly diversified funds/ETFs | I | → | Achieving required return at acceptable risk |
| Rebalancing | II | → | Ensuring risk is compensated |
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| Behavioural coaching | IV | → | Avoiding common investment mistakes |
| Tax allowances and asset location | V | → | Paying less tax |
| Spending strategy (withdrawal order) | VI | → | Spending savings wisely |
| Total-return versus income investing | VII | → | Creating income thoughtfully |

Potential value added

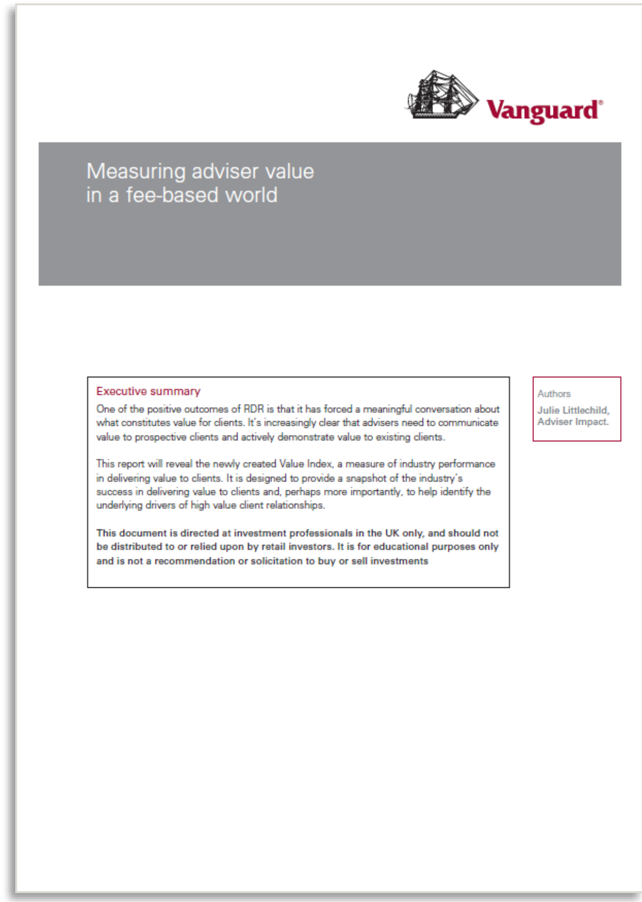
Source: Vanguard Asset Management 'Putting a value on your value', November 2014.

# A question of value

Clients who think that their adviser adds significant value are:

1. More confident they will reach their goals
2. More loyal
3. More profitable
4. More likely to provide referrals

But why does that matter?



Vanguard

Measuring adviser value
in a fee-based world

Executive summary

One of the positive outcomes of RDR is that it has forced a meaningful conversation about what constitutes value for clients. It's increasingly clear that advisers need to communicate value to prospective clients and actively demonstrate value to existing clients.

This report will reveal the newly created Value Index, a measure of industry performance in delivering value to clients. It is designed to provide a snapshot of the industry's success in delivering value to clients and, perhaps more importantly, to help identify the underlying drivers of high value client relationships.

**This document is directed at investment professionals in the UK only, and should not be distributed to or relied upon by retail investors. It is for educational purposes only and is not a recommendation or solicitation to buy or sell investments**

Authors

Julie Littlechild, Adviser Impact.

## What matters to clients

We identified six service dimensions that drive adviser value:

1. Helps me to focus on the long term
2. Provides guidance
3. Strong personal relationship
4. Statements are clear and easy to understand
5. Good investment knowledge
6. Helps select investments

Advice and relationship-based attributes dominate

This is how to increase the value your clients perceive

## Valuable?

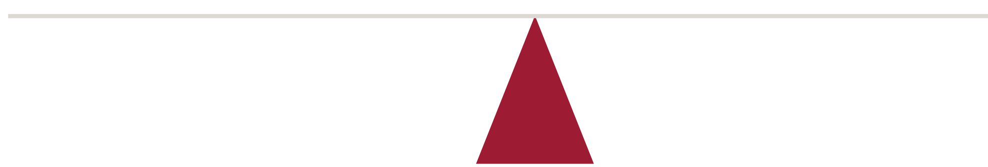
- Employing the services of an adviser represents a financial and relationship commitment
- Which one is your client buying into?

**Investment focus**

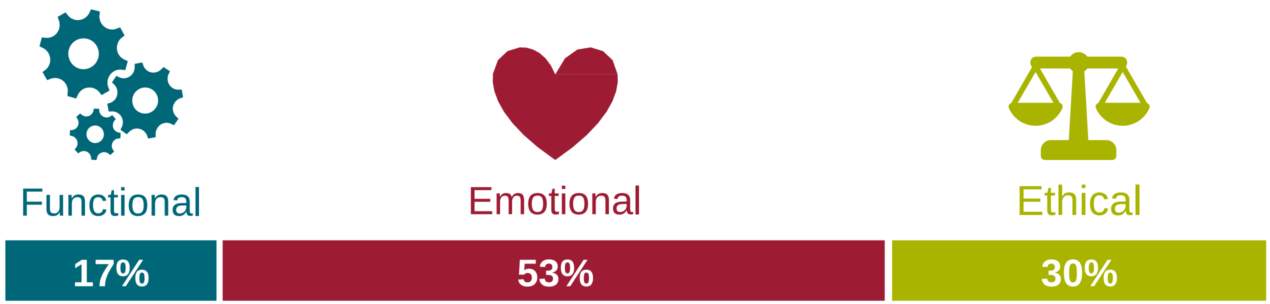
Growth
Income
Risk

**Relationship focus**

Guidance
Trust
Reliability
Reassurance



# Trust is complicated




Source: Vanguard and Chadwick Martin Bailey.

@Vanguard_UKAdv #VanguardEvents

## Making the emotional connection

Have empathy

Speak with respect

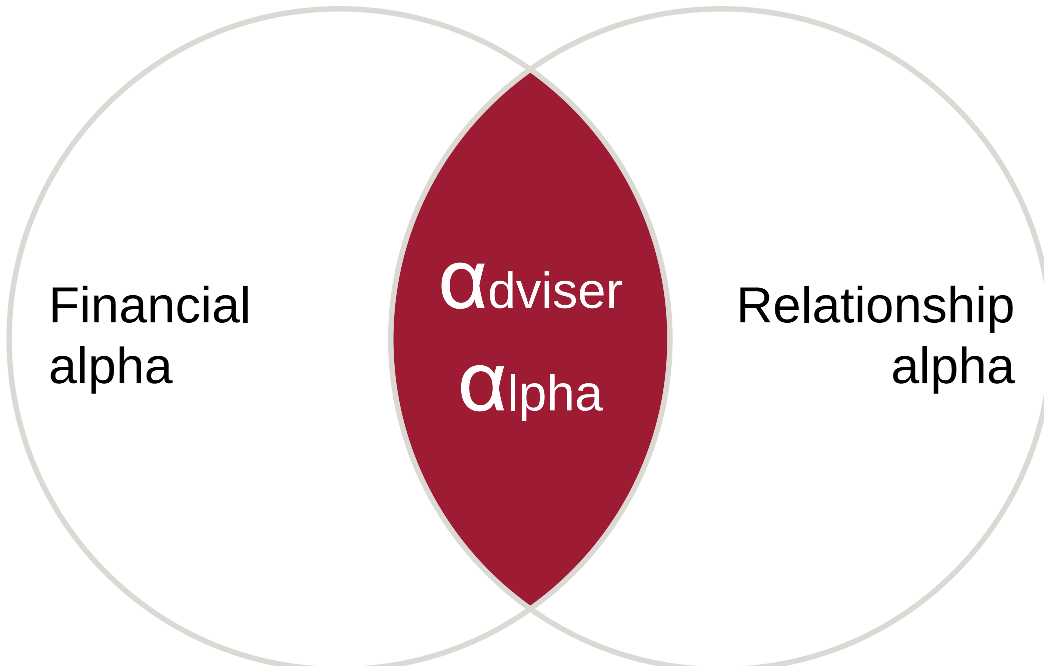
Understand the client's goals

Make the client feel valued

Make time

@Vanguard_UKAdv #VanguardEvents

# The opportunity for advisers



# Advice is a ‘negative-carry’ service

- Time, willingness and ability?
- Difficult to see…but valuable nonetheless

Adviser Alpha is worth something… but what?

# So what happens?

| | | | | | |
|---|---|---|---|---|---|
| Client Discovery | Financial planning | Portfolio construction | Investment management | Asset location | Review |

- Advisers search for the least abstract basis to value themselves
- Investment performance seems the most quantifiable metric
- ‘Better returns’
  - But better than what?
  - Benchmark?
  - Client’s need?

Is advice focused on *desired* return…or *required* return?

# Adviser Alpha is worth something... but what?

## Wouldn’t it be great to annualise the value of advice?

Financial alpha is hard to predict

- Past performance is no guide to future performance

Relationship alpha even more so

- Relationship alpha doesn’t appear on the client’s statement
- Relationship alpha is often at its highest during distress or euphoria

**We only measure the path we take, not the alternatives**

## Advisers are worth…

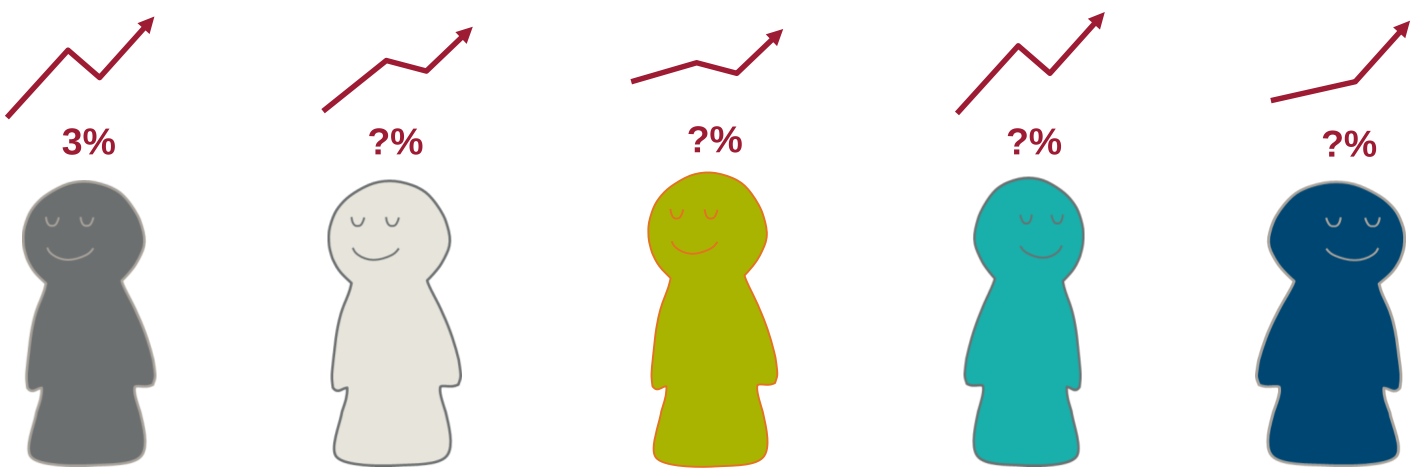
# About 3%

Source: Vanguard Asset Management 'Putting a value on your value', November 2014.

## Caveats

About 3% net per annum, however;

- Each client is different
- ‘About’… actual value based on each client’s unique circumstances
- NOT Annual… value is likely to be intermittent
- Difficult to value the emotional benefits



# Adviser Alpha value components

| Vanguard's Adviser's Alpha strategy modules | Module number | | Value-add relative to "average" client experience (in basis points of return) |
|---|---|---|---|
| Suitable asset allocation using broadly diversified funds/ETFs | I | Achieving required return at acceptable risk | > 0 bps |
| Rebalancing | II | Ensuring risk is compensated | 0 - 43 bps |
| Cost-effective implementation (expense ratios) | III | Capturing more of the investment return | 66-92 bps |
| Behavioural coaching | IV | Avoiding common investment mistakes | 150 bps |
| Tax allowances and asset location | V | Paying less tax | 0-23 bps |
| Spending strategy (withdrawal order) | VI | Spending savings wisely | 0-48 bps |
| Total-return versus income investing | VII | Creating income thoughtfully | > 0 bps |
| Potential value added | | | "About 3%" |

Source: Vanguard Asset Management 'Putting a value on your value', November 2014.

## 1. Asset allocation Alpha

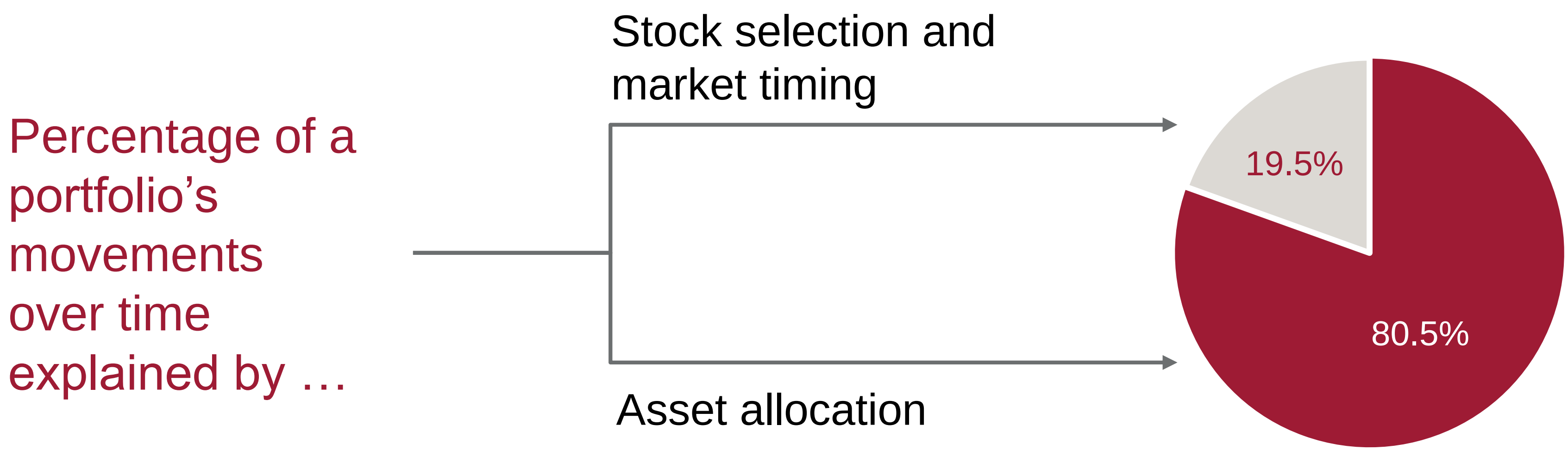
- The value of asset allocation is…
  > 0 bps
- Asset allocation underpins investing success and acts as a beacon
- The ‘right’ asset allocation is unique to each client…
- Asset allocation is to target the ‘required return’ at an acceptable risk…

Adviser Alpha Value

>0 bps

# Balance: The importance of asset allocation

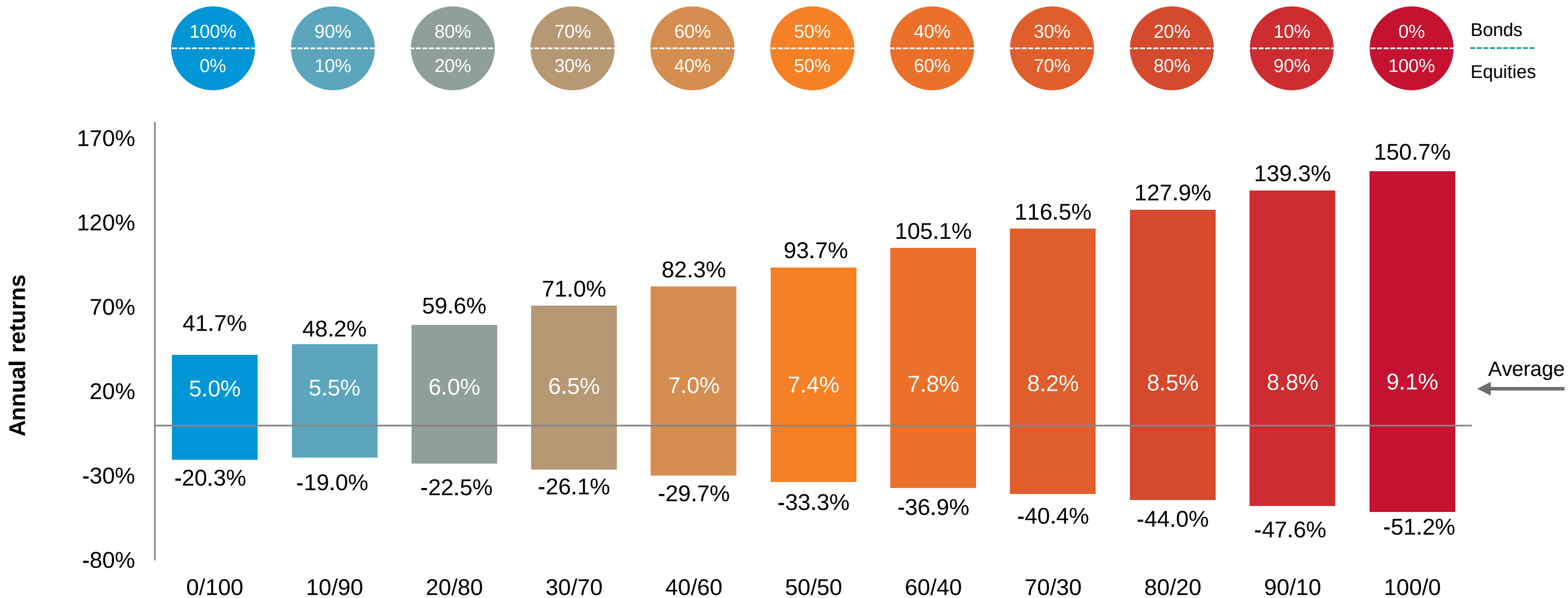
Investment outcomes are largely determined by the long-term mixture of assets in a portfolio




Source: Vanguard calculations using data from Morningstar.
Note: Calculations are based on monthly returns for 743 UK balanced funds from January 1990 through September 2015. For details on the methodology, see the Vanguard research paper The global case for strategic asset allocation and an examination of home bias (Scott et al., 2016).

# The mixture of assets defines the spectrum of returns

## Best, worst and average returns for various equity / bond allocations, 1900-2015




Source: Vanguard. Notes: Equities are represented by: Barclays Equity Gilt Study from 1900 to 1964; Thomson Reuters Datastream UK Market Index from January 1965 to December 1969; MSCI UK Index from January 1970 to December 1985; the FTSE All Share Index from January 1986 to present. Bonds are represented by: Barclays Equity Gilt Study from 1900 to 1976; FTSE UK Government Index from January 1977 to February 2000; Barclays Sterling Aggregate Index from March 2000 to present. Returns are in GBP with income reinvested.

# Balance: Market segments display seemingly random patterns of performance and return variability

## Key index returns (%), ranked by performance

| 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 10.7% | 38.5% | 19.3% | 51.1% | 20.1% | 37.4% | 13.0% | 62.5% | 23.6% | 20.3% | 17.8% | 28.3% | 19.6% | 8.8% | 35.4% |
| 9.4% | 29.7% | 13.8% | 36.8% | 16.8% | 15.7% | 7.6% | 30.1% | 21.3% | 16.7% | 15.5% | 25.2% | 18.8% | 5.5% | 34.1% |
| 8.7% | 25.3% | 12.8% | 24.9% | 16.8% | 10.8% | 3.6% | 21.2% | 19.1% | 6.5% | 12.8% | 21.0% | 14.6% | 5.4% | 29.6% |
| 8.0% | 20.9% | 11.5% | 24.1% | 7.2% | 8.3% | -10.0% | 20.1% | 16.7% | 5.8% | 12.3% | 20.8% | 12.5% | 4.0% | 25.5% |
| -15.1% | 20.9% | 8.5% | 22.0% | 3.3% | 6.6% | -13.2% | 14.8% | 14.5% | 1.2% | 12.0% | 13.6% | 11.3% | 1.4% | 25.4% |
| -17.3% | 16.4% | 8.3% | 20.2% | 2.8% | 5.8% | -13.3% | 14.7% | 8.9% | -3.5% | 11.2% | 1.6% | 7.9% | 1.0% | 21.2% |
| -22.7% | 7.1% | 8.0% | 9.1% | 1.7% | 5.6% | -19.4% | 13.6% | 8.7% | -6.6% | 10.7% | 0.6% | 7.9% | 0.7% | 16.8% |
| -26.6% | 6.9% | 6.7% | 8.5% | 0.8% | 5.3% | -24.0% | 6.3% | 7.5% | -12.6% | 5.9% | 0.0% | 2.8% | 0.5% | 12.3% |
| -27.0% | 5.5% | 6.6% | 7.9% | 0.5% | 5.2% | -29.9% | 5.3% | 5.8% | -14.7% | 2.9% | -4.2% | 1.2% | -1.1% | 10.7% |
| -29.5% | 2.1% | 4.1% | 5.8% | -0.2% | 0.4% | -34.8% | -1.2% | 4.8% | -18.4% | 0.6% | -5.3% | -1.4% | -10.3% | 3.7% |

- Global equities
- North American equities (US/Canada
- Emerging market equities
- Developed Asia equities
- European ex UK equities
- UK equities
- UK government bonds (gilts)
- UK index-linked gilts
- UK investment grade corporate bonds
- Hedged global bonds

**Past performance is not a reliable indicator of future results.**
Source: Vanguard calculations, using data from Barclays Capital and Thompson Reuters Datastream. UK equity is defined as the FTSE All Share Index, World Europe ex-UK equity as the FTSE All World Europe ex-UK Index, developed Asia equity as the FTSE All World Developed Asia Pacific Index, North America equity as the FTSE World North America Index, emerging market equity as the FTSE Emerging Index, global equity as the FTSE All World Index, UK government bonds as Barclays Sterling Gilt Index, UK index-linked gilts as Barclays Global Inflation-Linked UK Index, hedged global bonds as Barclays Global Aggregate Index (hedged in GBP), UK investment grade corporate bonds as Barclays Sterling Corporate Index. Returns are denominated in GBP and include reinvested dividends and interest.

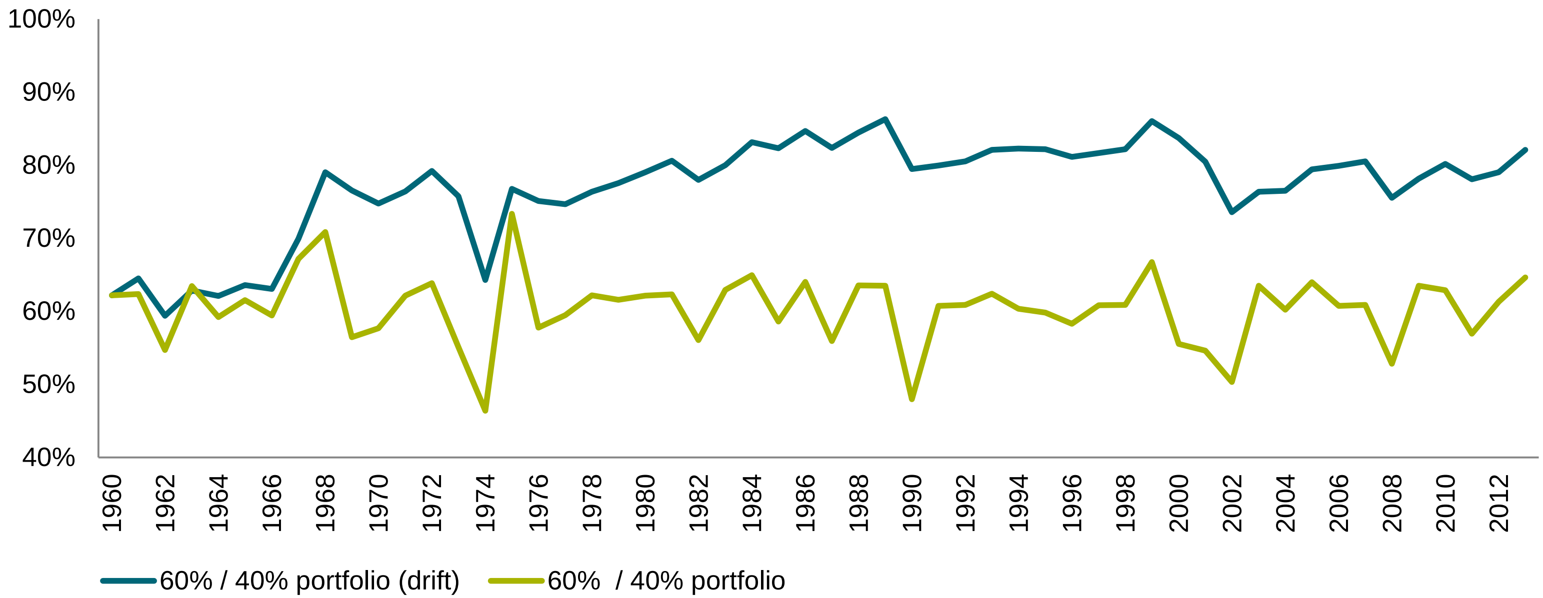
## 2. Rebalancing Alpha

Adviser Alpha Value

0-43 bps

The value of rebalancing is 0-43 bps

Based upon a 60 / 40 equity / bond portfolio, allowed to drift, compared to 60 / 40 portfolio re-balanced with similar risk




Source: Vanguard, based on Barclays UK Equity Gilt study, Thomson Reuters, FTSE, MSCI, Citigroup and Barclays.
Notes: From 1960 through 1984, equities are represented by the Barclays Equity Gilt Study from 1900 to 1964, Thomson Reuters Datastream UK Market Index Jan.1965 - Dec.1969; MSCI UK Jan.1970 - Dec.1985; thereafter, equities are represented by MSCI All Country World Index. Bonds are represented by Barclays Equity Gilt Study 1960-1976; FTSE UK Government Index Jan.1977-Dec 1984, Citigroup World Global Bond Index from 1985 through 1989, Barclays Global Aggregate Index thereafter. Returns are in sterling, with income reinvested, to 31 December 2013.

# Ensure risk is compensated

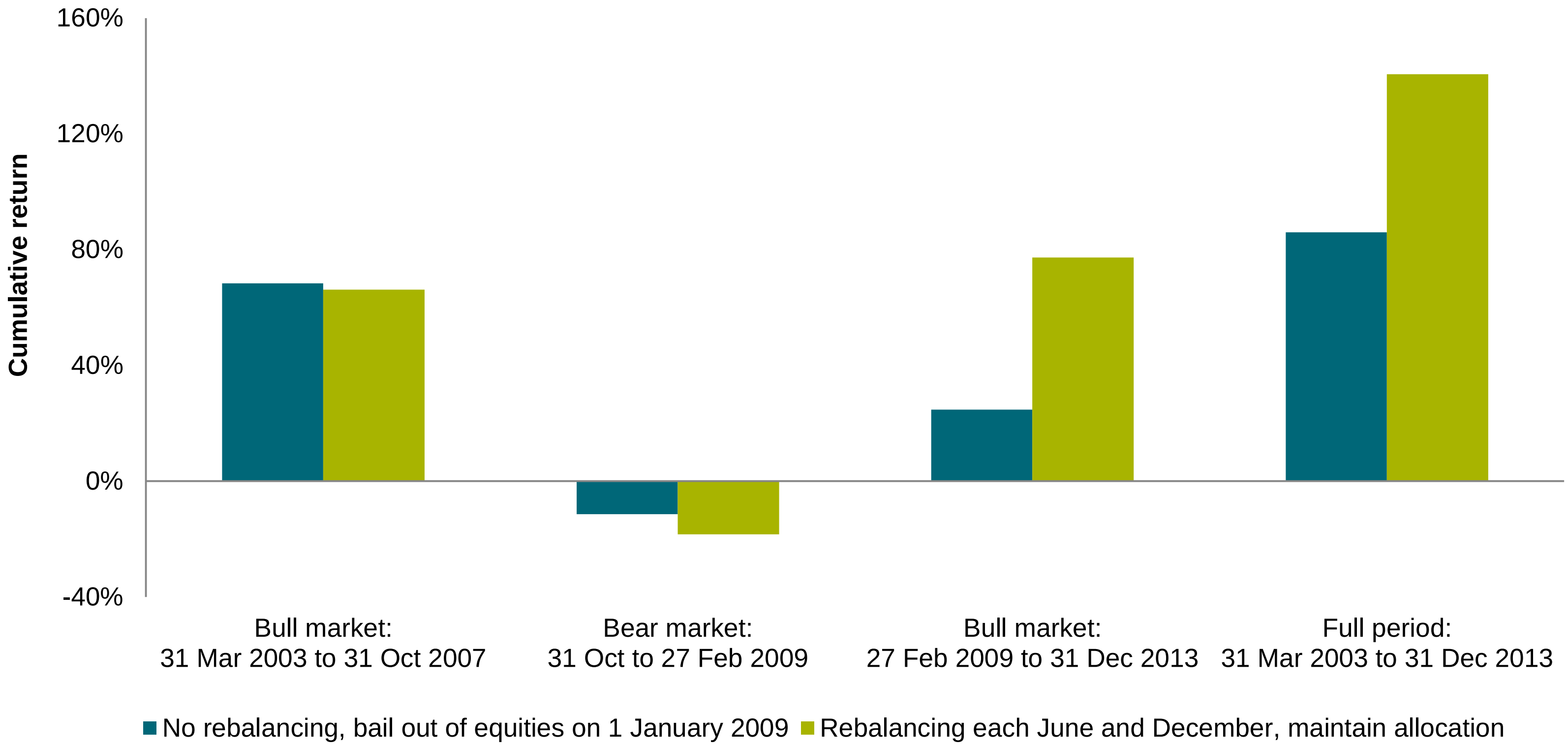
| | 60% / 40% portfolio | 60% / 40% portfolio (drift) | 70% / 30% portfolio |
|---|---|---|---|
| Average annual return | 10.35% | 10.08% | 10.51% |
| Average annual standard deviation | 19.70% | 21.97% | 21.67% |
| Average equity | 60.40% | 76.97% | 70.26% |

## Advisers role

- Rebalancing is a hard discipline to maintain in times of fear and greed…
- Rebalancing is not free…needs judicious implementation…costs and taxes…perhaps why Fund of Funds have become popular?

# Discipline: reacting to market volatility can jeopardise return

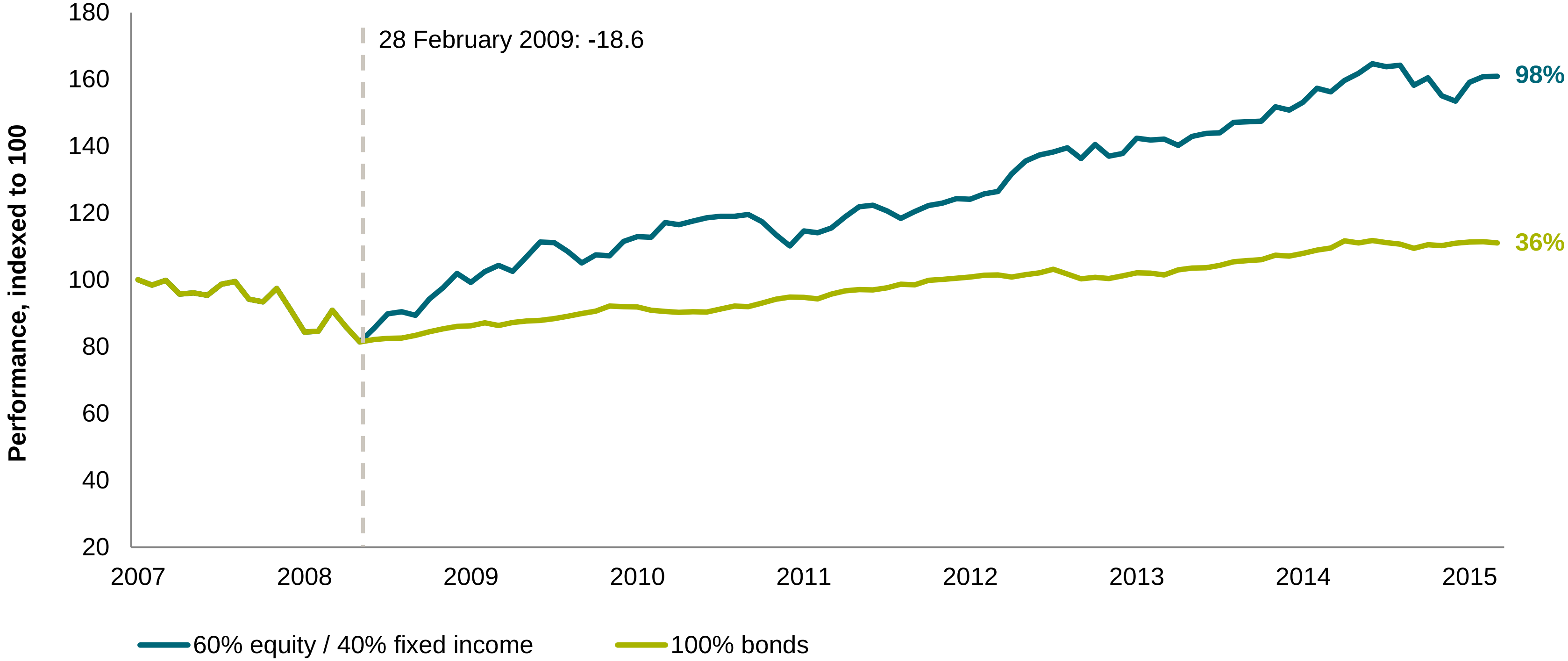
## What if the 'drifting' investor fled from stocks after the 2008 plunge?




**Past performance is not a reliable indicator of future results.**
Source: Vanguard, based on data from MSCI and Barclays.
Notes: The initial allocation for both portfolios is 60% global equity and 40% global bonds. The rebalanced portfolio is returned to this allocation at the end of each June and December. Global equity is defined as the MSCI All Country World Investable Market Index, unhedged in sterling. Global fixed income is defined as the Barclays Global Aggregate, hedged to GBP. Returns are in GBP with income reinvested.

# Discipline: reacting to market volatility can jeopardise return

What if the ‘drifting’ investor fled from stocks after the 2008 plunge and invested in 100% bonds?

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Source: Vanguard, based on data from MSCI and Barclays.
Notes: The initial allocation for both portfolios is 60% global equity and 40% global bonds. The rebalanced portfolio is returned to this allocation at the end of each June and December. Global equity is defined as the MSCI All Country World Investable Market Index, unhedged in sterling. Global fixed income is defined as the Barclays Global Aggregate, hedged to GBP. Returns are in GBP with income reinvested.

# 3.Cost effective implementation Alpha

Cost effective implementation – 66 to 92 bps

Adviser Alpha Value

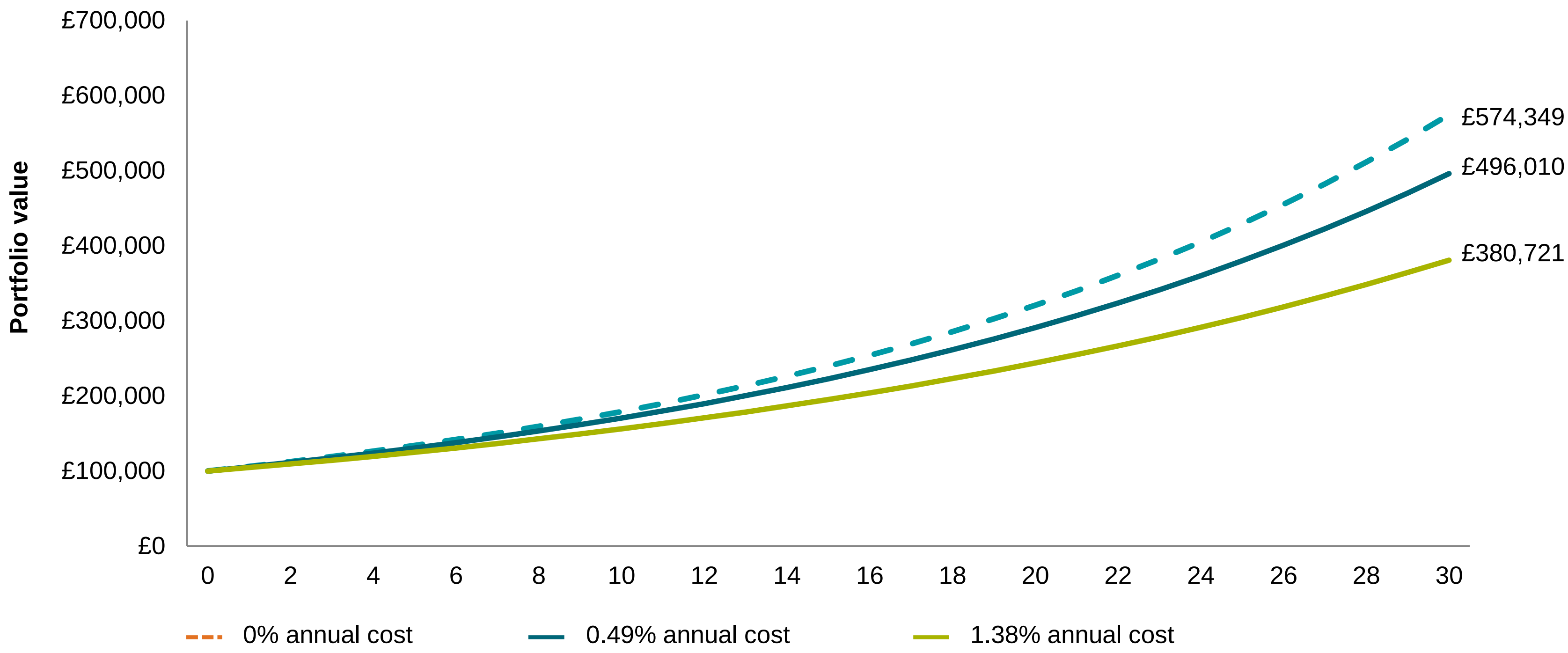
66-92 bps

| **Equity/bond mix:** | **100%/0%** | **80%/20%** | **60%/40%** | **50%/50%** | **40%/60%** | **20%/80%** | **0%/100%** |
|---|---|---|---|---|---|---|---|
| Asset-weighted expense ratio (AWER) | 1.08 | 1.07 | 1.05 | 1.05 | 1.04 | 1.02 | 1.01 |
| Quartile 1 AWER (Q1) | 0.42 | 0.35 | 0.29 | 0.26 | 0.22 | 0.16 | 0.09 |
| **Cost-effective implementation (AWER vs. Q1)** | **0.66** | **0.71** | **0.76** | **0.79** | **0.82** | **0.87** | **0.92** |

Sources: Vanguard calculations, based on data from Morningstar, Inc., as at 31 December 2013.
Notes: Fund universe includes funds available for sale in the UK, 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 zone equity – flex-cap, large-cap, mid-cap, small-cap; Global – flex-cap, large-cap blend, large-cap growth, large-cap value, mid-cap, small-cap; US equity – flex-cap, large-cap blend, large-cap growth, large-cap value, mid-cap, small-cap; Emerging markets equity – emerging markets; Europe bond – EUR diversified; US bond – USD diversified; Global bond – global un-hedged bond; UK bonds – UK diversified, UK government.

# Costs: The long-term impact

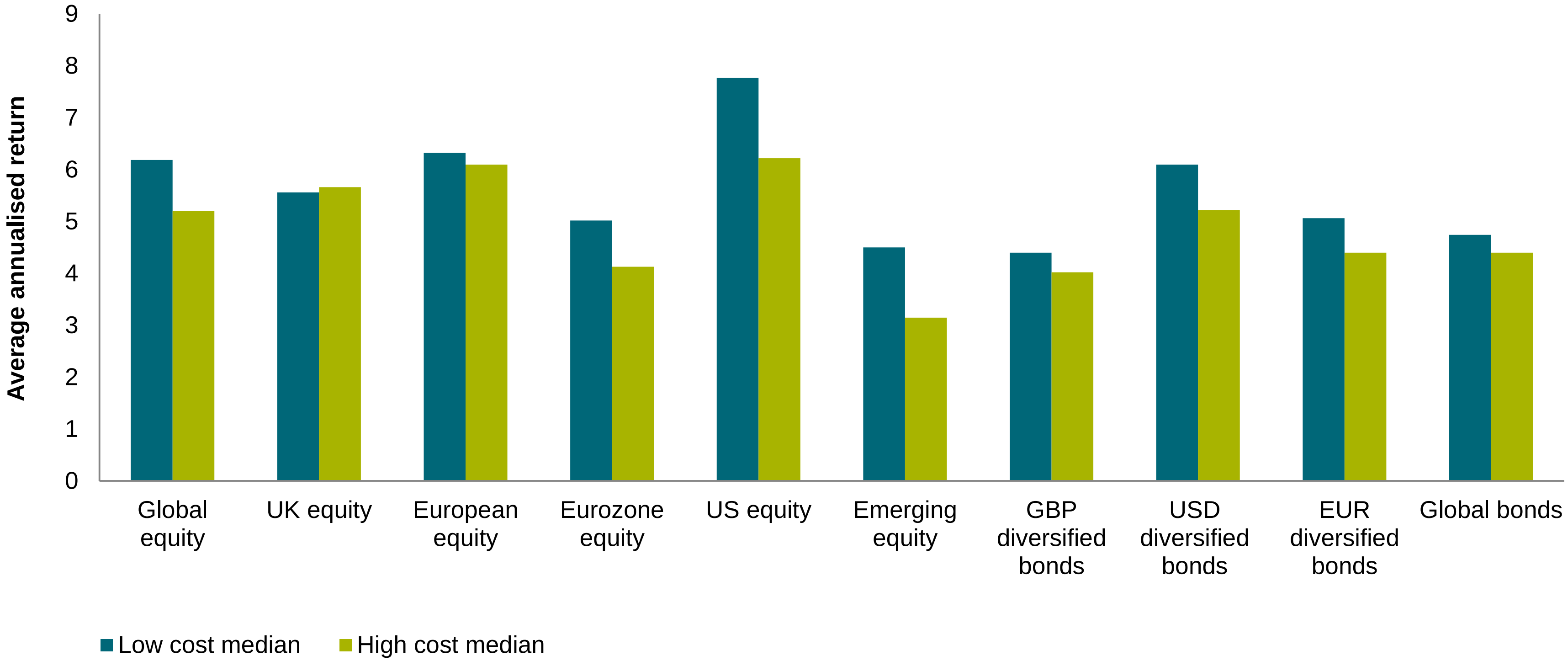
Assuming a starting balance of £100,000 and a yearly return of 6%, which is reinvested




Source: Vanguard Group, Inc,
Note: The portfolio balances shown are hypothetical and do not reflect any particular investment. The final account balances do not reflect any taxes or penalties that might be due upon distribution. These expense figures represent the average asset-weighted total expense ratios for index and active UK equity funds as at 31 December 2015.

# Costs: Lower costs can support higher returns

Average annual returns over the ten years to 31 December 2015




**Past performance is not a reliable indicator of future results.**
Source: Vanguard Group, Inc. calculations using Morningstar data.
Notes: All mutual funds in each Morningstar category were ranked by their expense ratios as of 31 December 2015. They were then divided into four equal groups, from the lowest-cost to the highest-cost funds. The chart shows the ten-year annualised returns for the median funds in the lowest cost and highest cost quartiles. Returns are in sterling terms with income reinvested, net of expenses, excluding loads and taxes. Both actively managed and indexed funds are included. For funds with both income and accumulation share classes, we use only accumulation share classes to avoid double counting.

# Costs matter - a lot

## Costs matter

- Costs, like interest, compound over time
- Impact on investment returns not always obvious
- Table shows the impact of ongoing charges figure (OCF) over time
- This hypothetical example assumes neutral growth so that the long-term effect of costs is readily apparent

| AMC (%) | Percentage of portfolio retained after costs | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Years | | | | | | | |
| | 1 | 3 | 5 | 10 | 15 | 20 | 25 | 30 |
| 0.10 | 99.90 | 99.70 | 99.50 | 99.00 | 98.51 | 98.02 | 97.53 | 97.04 |
| 0.15 | 99.85 | 99.55 | 99.25 | 98.51 | 97.77 | 97.04 | 96.32 | 95.60 |
| 0.20 | 99.80 | 99.40 | 99.00 | 98.02 | 97.04 | 96.08 | 95.12 | 94.17 |
| 0.30 | 99.70 | 99.10 | 98.51 | 97.04 | 95.59 | 94.17 | 92.76 | 91.38 |
| 0.35 | 99.65 | 98.95 | 98.26 | 96.55 | 94.88 | 93.23 | 91.61 | 90.02 |
| 0.40 | 99.60 | 98.80 | 98.02 | 96.07 | 94.17 | 92.30 | 90.47 | 88.67 |
| 0.45 | 99.55 | 98.66 | 97.77 | 95.59 | 93.46 | 91.37 | 89.34 | 87.34 |
| 0.50 | 99.50 | 98.51 | 97.52 | | | | | |
| 0.55 | 99.45 | 98.36 | 97.28 | | | | | |
| 0.60 | 99.40 | 98.21 | 97.04 | | | | | |
| 0.70 | 99.30 | 97.91 | 96.55 | | | | | |
| 0.80 | 99.20 | 97.62 | 96.06 | | | | | |
| 0.90 | 99.10 | 97.32 | 95.58 | | | | | |
| 1.00 | 99.00 | 97.03 | 95.10 | | | | | |
| 1.10 | 98.90 | 96.74 | 94.62 | 89.53 | 84.71 | 80.15 | 75.84 | 71.76 |
| 1.20 | 98.80 | 96.44 | 94.14 | 88.63 | 83.44 | 78.55 | 73.95 | 69.62 |
| 1.30 | 98.70 | 96.15 | 93.67 | 87.73 | 82.18 | 76.97 | 72.10 | 67.53 |
| 1.40 | 98.60 | 95.86 | 93.19 | 86.85 | 80.94 | 75.43 | 70.29 | 65.51 |
| 1.50 | 98.50 | 95.57 | 92.72 | 85.97 | 79.72 | 73.91 | 68.53 | 63.55 |
| 1.60 | 98.40 | 95.28 | 92.25 | 85.10 | 78.51 | 72.43 | 66.82 | 61.64 |
| 1.70 | 98.30 | 94.99 | 91.78 | 84.24 | 77.32 | 70.97 | 65.14 | 59.79 |
| 1.80 | 98.20 | 94.70 | 91.32 | 83.39 | 76.15 | 69.54 | 63.50 | 57.99 |
| 1.90 | 98.10 | 94.41 | 90.85 | 82.54 | 75.00 | 68.14 | 61.90 | 56.24 |
| 2.00 | 98.00 | 94.12 | 90.39 | 81.71 | 73.86 | 66.76 | 60.35 | 54.55 |
| 2.10 | 97.90 | 93.83 | 89.93 | 80.88 | 72.73 | 65.41 | 58.83 | [illegible] |
| 2.20 | 97.80 | 93.54 | 89.47 | 80.06 | 71.63 | 64.09 | 57.34 | 51.31 |
| | 97.70 | 93.26 | 89.02 | 79.24 | 70.54 | 62.79 | 55.89 | 49.76 |
| | 97.60 | 92.97 | 88.56 | 78.43 | 69.46 | 61.52 | 54.48 | 48.25 |
| | 97.50 | 92.69 | 88.11 | 77.63 | 68.40 | 60.27 | 53.10 | 46.79 |
| | 97.40 | 92.40 | 87.66 | 76.84 | 67.36 | 59.04 | 51.76 | 45.37 |
| | 97.30 | 92.12 | 87.21 | 76.06 | 66.33 | 57.84 | 50.45 | 43.99 |
| 2.80 | 97.20 | 91.83 | 86.76 | 75.28 | 65.31 | 56.67 | 49.17 | 42.66 |
| 2.90 | 97.10 | 91.55 | 86.32 | 74.51 | 64.31 | 55.51 | 47.92 | 41.36 |
| 3.00 | 97.00 | 91.27 | 85.87 | 73.74 | 63.33 | 54.38 | 46.70 | 40.10 |

A low-cost 0.20% fund retains over 95% after 25 years

A high-cost 2.00% fund has lost almost 40%.

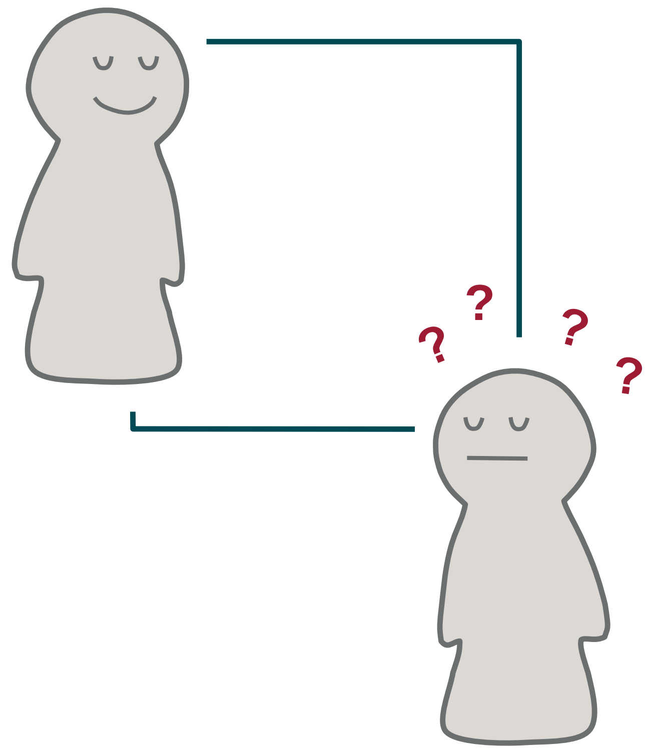
Source: Vanguard Asset Management, Limited.

## 4. Behavioural coaching Alpha

- The value of behavioural coaching is around 150 bps
- Abandoning a planned investment strategy is costly
- Key derailers are market timing and performance chasing
- A single client intervention can more than offset a year's fee
- The adviser is an important emotional circuit breaker

Adviser Alpha Value

150 bps



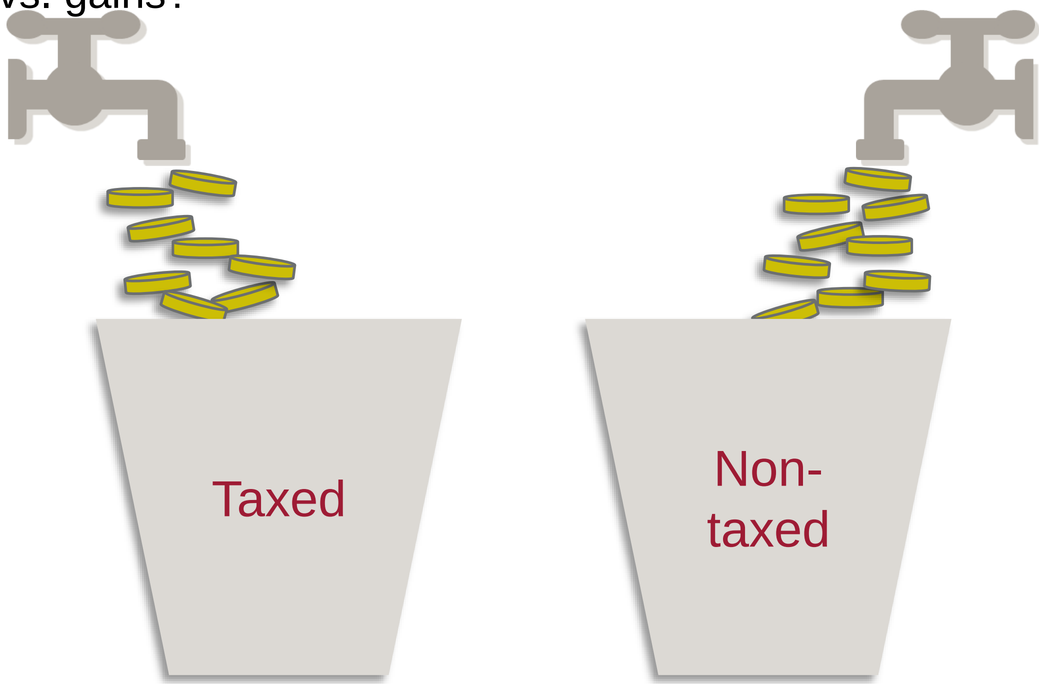
## 5. Asset location Alpha

Adviser Alpha Value

0 to 23 bps

Asset location is worth 0-23 bps in the first year… compounded

- Average Investors
- Optimising tax allowances
- Housing income vs. gains?



## 6. Spending strategies Alpha

- Spending strategies are worth 0-48 bps
- Bewildering discretion and choice…especially post budget
- Spending from taxable assets or tax advantaged assets?
- What about Intergenerational wealth transfer?

Adviser Alpha Value

0 to 48 bps

## 7. Total return vs. income investing Alpha

Adviser Alpha Value

> 0 bps

Traditional income only approach only has three choices in a lower yield environment;

- Spend less
- Reallocate to higher yielding holdings
- Spend from total return

But beware;

Chasing yield on bonds

Longer duration = greater sensitivity to rates = volatility

Shifting to dividend centric stocks

Stocks are not bonds

Moving from broad market to dividend focus may alter risk profile

**Don't let the income 'tail' wag the risk 'dog'… let asset allocation be your beacon**

# Adviser Alpha value components

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|---|---|
| Suitable asset allocation using broadly diversified funds/ETFs | I |
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| Tax allowances and asset location | V |
| Spending strategy (withdrawal order) | VI |
| Total-return versus income investing | VII |
| Potential value added | |

Source: Vanguard Asset Management ‘Putting a value on your value’, November 2014.

“The adviser’s job is to help their clients avoid making costly mistakes”

John C Bogle

# Important information

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