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Investment strategy insights

The anatomy of advice: How do advisors add value?

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- Using a unique data set based on Canadian investors and financial advisors, researchers have found that investors working with financial advisors have wealth gains equal to 5–10% annually when compared to investors not working with financial advisors.
- These gains are present even after controlling for over 50 economic and demographic factors.
- Financial advisors appear to add value in a wide variety of ways. They encourage savings, help improve after-tax returns, and make it easier for their clients to successfully take on a greater allocation to equities.
- Additionally, financial advisors can add value through portfolio management, retirement planning, and taking a total wealth approach with their clients.

What is the value of financial advice? To ask the question even more directly: What is the value of a financial advisor? Recent research helps clarify how advisors add value for their clients. The results are positive, but perhaps surprising.

There are two main approaches for quantifying the value of an advisor.

One option is to look at the theoretical ways advisors can add value for their clients. Asset allocation, stock selection, portfolio management, manager selection, retirement planning, tax planning, and behavioral coaching are all possible ways – among many others – through which financial advisors can add value. We'll refer to this approach as the *theoretical approach*, because these are plausible but not guaranteed sources of value.

Another approach is to look at households that work with a financial advisor and compare them to households that don't work with a financial advisor. We'll call this the *empirical approach*. This approach – which shows us the realized value investors have actually received from working with advisors – allows us to measure the real-life impact of financial advisors. However, the empirical approach doesn't always clearly show exactly what advice led to improved outcomes.

By putting these two approaches together, we can start to answer three important questions about financial advice: *Do* financial advisors add value for their clients? *How much* value do they add for their clients? *How* do they add value for their clients?

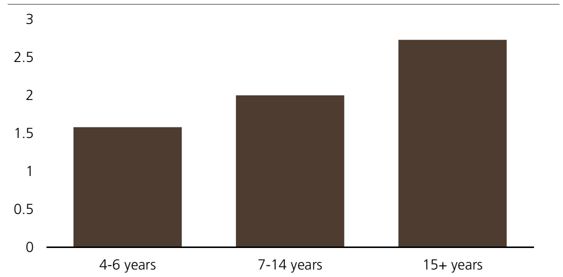
Research on the realized value of financial advice

Two data sets from Canada have enabled academic researchers to dig deep on the issue of advisor value. The first is a longitudinal study of Canadian investors that has been running since 1999. The second study is based on 10 years of transaction-level data for Canadian investors provided to the researchers by three large financial advisory firms. These data-sets track investor performance, include a wide range of characteristics about the investor and his or her household, and indicate whether or not the investor has an advisor. If the investor is working with an advisor, the data-sets enable the researcher to look at the advisor's personal portfolio and performance and compare it to the client's portfolio and performance.

Unfortunately, we don't have the necessary data-sets to effectively compare advised and non-advised households in other countries, including the United States. Although there certainly could be differences in many regions, the role of an advisor is broadly the same in Canada and other countries: to provide investment advice and financial planning advice. We feel comfortable that general conclusions from Canadian households apply globally.

Fig. 1: Households that work with advisors accumulate wealth more quickly than those that don't work with advisors

Relative wealth multiple, advised versus non-advised households (x axis)



Source: Claude Montmarquette and Nathalie Viennot-Briot, "Econometric Models on the Value of Advice of a Financial Advisor" (2012), UBS

Do advisors add value?

The empirical data is very clear that financial advisors add value for their clients. After controlling for a wide variety of demographic and economic variables, Montmarquette & Viennot-Briot (2012) find that advised households have, on average, 1.58x the wealth of non-advised households after working with an advisor for 4–6 years, 2x after 7–14 years, and 2.73x more wealth after 15 years or more. Those multiples are equivalent to percentage wealth increases of 7–12% annually over 4–6 years and 5–10% annually over 7–14 years (see Fig. 1).

The data from the Montmarquette & Viennot-Briot study was based on investor survey data, and therefore can be considered to be net of fees and realized taxes.

How do advisors add value?

The Montmarquette, *et al* study also explores the mechanisms through which financial advisors improve household net worth. For instance, advised households hold a larger share of their assets in equities than non-advised households, indicating that advisors helps families: 1) become more comfortable with the prospect of higher short-term volatility (characteristic of equity-heavy portfolios); and 2) overcome the behavioral obstacles to successful equity investment. Our research at UBS estimates that increasing the equity portion of a portfolio by just 10 percentage points, relative to fixed income, can lead to an increased average return of about 0.5% annually.

The researchers also find that working with a financial advisor improves savings behavior by nearly 100%. Saving more, and investing a greater share of those savings in equities, is responsible for a substantial component of the improvement in lifetime wealth accumulation.

Finally, advised households in Canada are more likely to use tax-efficient accounts than non-advised households. The Department of Finance Canada estimates that use of tax-efficient vehicles improves performance for those investors by about 1.5% per year.[1]

Even so, the Montmarquette, *et al* study is limiting because it cannot tell us exactly how advisors are creating value for the households they work with. In order to move beyond increased equity exposure, improved savings behavior, and improved tax-efficiency, we need to explore some of the theoretical areas advisors add value to fill in the gaps.

The “dark matter” of financial advice

Most astronomers believe that "dark matter" exists in the universe. They can't directly observe it, but they can quantify its mass and measure its gravitational pull. They can see it in the data even if they can't see it with their eyes.

The value of financial advice, to some extent, is similar. At this time, the empirically derived sources of financial advisor value mentioned above cannot fully explain the outcome gap between advised and non-advised households. There's a component of dark matter in the value of financial advice: We can quantify that it exists, but we cannot yet fully explain it based on the data-sets available. Instead, we need to look at some theoretical explanations for advisor value to build a hypothesis as to how advisors improve outcomes.

There are five main sources we will pull from for this section: Vanguard's "Advisor Alpha" publication; Morningstar's "No Portfolio is an Island," "Alpha, Beta, and now Gamma," and "The Value of a Gamma Efficient Portfolio" publications; and our own research on this topic in various publications at UBS.

Categories of sustainable value

There are various ways to categorize value-generating actions. For simplification, we've grouped sources of value into the following categories:

1. **Goal-oriented allocation:** Optimizing asset allocation based on goals and objectives

   Many investment portfolios are designed to maximize risk-adjusted returns, where risk is measured by the volatility of the portfolio over the short term. Unfortunately, these portfolios rarely match the investor's specific set of goals. By alternatively selecting a portfolio that is designed around the investor's goals and objectives, Morningstar found that advisors can add up to 0.5% in excess performance, relative to the investor's goals, per year.

2. **Total wealth approach:** Optimizing to the entire balance sheet including real estate, pension-like assets, and liabilities.

   By accounting for their other balance-sheet assets when designing portfolios, like real estate and pensions, investors can allocate their liquid assets in a way that improves overall outcomes. Morningstar estimates the overall benefit averages about 0.3% per year.

3. **Life-cycle customization:** Shifting the target portfolio based on life-cycle considerations

   Portfolio allocations should not be static. There is no particular reason to think that an investor with a 60/40 stock–bond split at the age of 55 should have the same allocation at the age of 65, 75, or 95 (or 45, for that matter). By customizing the portfolio based on where the investor is in their life-cycle, we find that advisors can add, on average, 1% in additional performance per year over the investor's lifecycle (Crook et al, 2018).

4. **Asset location:** Allocating the right investments (stocks, bonds, etc) into the right accounts (taxable, tax-deferred, tax-exempt) to maximize after-tax return

   Vanguard and Morningstar have both found that allocating particular types of assets to the optimal account-types based on taxation can add up to 0.5% or 0.75% per year in after-tax performance. Specific examples include utilizing tax-advantaged fixed income (e.g. municipal bonds) in taxable accounts or holding active equity managers, who on average have created a 1.5% annual tax drag for their investors over the last 25 years, in tax-advantaged accounts.

5. **Behavioral coaching:** Advisor-based discipline and guidance during periods of market stress

   Investors systematically underperform due to behavioral biases, like chasing high-performing stocks or asset classes and capitulating during volatile or bear markets. Deep academic literature exists on this topic, and Vanguard estimates annual underperformance of about 1.5%.

6. **Withdrawal sequencing:** Managing withdrawals from various account types correctly

   Investors taking distributions from their portfolios need to do so in a tax-effective way. General guidelines regarding withdrawals based on account type can be effective as a starting point, but every family's specific situation requires custom guidance. Vanguard and Morningstar estimate the value-add is up to 1% per year.

7. **Portfolio management:** Ongoing tax-loss harvesting and rebalancing

   Portfolios need maintenance. When securities or asset classes decline in value, investors have the opportunity to harvest those losses and use them at a later time to offset gains from the portfolio. Portfolios also need to be rebalanced following bull and bear market cycles. We estimate these actions can add up to 0.4–1.5% per year in excess after tax performance. Morningstar has estimated a slightly larger range: 0.1–1.6% annually.

8. **Implementation:** Cost- and tax-efficient implementation

> Selecting the optimal implementation for an asset class can have a significant impact on after-fee, after-tax performance. Investors can use active or passive managers. They can also implement through a wide variety of vehicles, such as exchange-traded funds (ETFs), mutual funds, separately managed accounts, limited partnerships, and other structures, all with unique fee and tax characteristics. The difference between optimal and sub-optimal implementation, on a net-of-fee and net-of-tax basis, can be more than 1% per year.

It's likely that all advisors offer some combination of the above value propositions for each of their clients as the relevance of each will likely depend on the household in question. Estimated values for each category can be found in Fig. 2.

Fig. 2: Estimates of advice-based value

	Vanguard	Morningstar	UBS
Goal-oriented allocation	>0%	0.05-0.5%	
Total wealth approach		0.3%	
Life-cycle customization			1%
Asset location	0-0.75%	0.1-0.5%	
Behavioral coaching	1.50%		1%
Withdrawal sequencing	0-1.10%	0.70%	
Portfolio management	0.35%	0.1-1.6%	0.4-1.5%
Implementation	0.40%	0-1.5%	1%

Source: Morningstar, Vanguard, UBS

These estimates help complete the overall picture of a financial advisor's value. In addition to the three sources of advisor value found in the Canadian studies, financial advisors can also add value through the wide range of additional activities listed above. Once those additional categories are included, it becomes easier to quantify how investors working with advisors increase their wealth by 5–10% annually in excess of investors not working with advisors.

Some readers might notice two items missing from the above list: manager and security selection, and tactical positioning (i.e. market timing). The Canadian data-sets do not offer any indication that the average financial advisor is able to outperform based on either of these tactics (Foerster et al, 2017). Although this finding might be surprising, it shouldn't be.

First, keep in mind that security selection and tactical positioning are zero-sum. If one investor outperforms, another has to underperform. If financial advisors, on average, were able to outperform systematically, it would require that some other group of investors systematically underperformed. Much like the widespread evidence on mutual fund underperformance, there's no evidence that financial advisors are systematically able to extract value from another group of investors that would result in sustainable benchmark-based outperformance.

Second, the research we are referencing only speak to averages. Some financial advisors can and do add performance through security selection, manager selection, or tactical asset allocation. Even so, unlike the activities discussed earlier, those activities are not sustainable sources of value for all advisors.

How can advisors further enhance their value-add?

In addition to clarifying some of the areas in which financial advisors add value for their clients, the empirical research also indicates some areas where the average advisor could improve outcomes even further: customization, implementation, and over-trading.

Customization

Although most financial advisors customize the advice they give their clients, it doesn't appear as though advisors customize that advice enough, on average, based on the investor's characteristics and risk tolerance (Foerster et al, 2017). In fact, the best predictor of an investor's portfolio is his or her advisor's personal portfolio. In other words, many advisors recommend portfolios to their clients that look a lot like their own portfolios.

In some ways, this finding is good – advisors proverbially "eat their own cooking" and there's no evidence that advisors steer clients into products they wouldn't own themselves. On the other hand, customization can lead to superior outcomes relative to the household's specific goals and objectives. In general, it appears as though this is an area many advisors could focus on to improve overall value. One explanation for the lack of customization is that most performance reporting is done relative to benchmarks that reflect the investor's strategic asset allocation – which means advisors don't "get credit" for customizing the portfolio in the first place.

Implementation
There is evidence that advisors, on average, exhibit some of the same return-chasing behavior all investors must be careful to avoid (Linnainmaa et al, 2016). The easiest way to observe return-chasing behavior is in mutual-fund selection. Whether due to client pressure or their own investment philosophies, many advisors (and institutional investment committees, for that matter) will only utilize managers that have shown superior performance over some trailing period, often three or five years. Similarly, some advisors will also sell a manager after a sustained period of underperformance. Because investment strategies are generally mean-reverting, buying (or selling) managers based on the last 3–5 years of performance tends to be a poor way to select implementation. Forming a manager selection process that limits return-chasing behavior is one step toward improving value in implementation.

Additionally, advisors can improve net returns by allocating larger portions of assets to low-fee, tax-efficient ETF strategies (Linnainmaa et al, 2016). Between 1993 and 2017, the average mutual fund trailed its index by 3% per year after fees and taxes (Arnott *et al*, 2018). The average ETF underperformed its index by half that amount (1.5%). One simple takeaway from that data is to mainly use active management, when the fee is justified by the strategy, in tax-efficient accounts and to use more tax-efficient ETFs in taxable accounts. Importantly, both passive index-tracking strategies and "smart beta" strategies are available through ETFs, and both show similar tax-efficiency.

Conclusion

Using unique data-sets based on Canadian investors and financial advisors, researchers have found that investors working with financial advisors have wealth gains equal to 5–10% annually when compared to investors not working with financial advisors. These gains are present even after controlling for over 50 economic and demographic factors.

Financial advisors appear to add the most value through actions associates with behavioral coaching and financial planning. . They encourage savings, help improve after-tax returns, and make it easier for their clients to successfully take on a greater allocation to equities. Additionally, financial advisors can add value through portfolio management along with retirement, tax, and estate planning

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Appendix

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