paracle

PERSPECTIVES

The Value-add of an Advisor

A few good research articles have been published recently to address the common question, "How does an advisor add value for the fees that I pay?" For our clients, we expect that you already have an understanding for what is valuable to you in our relationship together. (Or at least we hope that you do!) Nevertheless, since our work to integrate financial planning and investment management is multi-faceted, we think it is worth taking time to summarize the recent research as well as add our own thoughts regarding the value of our approach and how we strive to benefit our clients.

DIFFICULT TO QUANTIFY, BUT POSSIBLY THE GREATEST VALUE

Some areas where we add value for our clients are the most difficult to quantify. It is a situation of the sort described in the poem, "The Road Not Taken," by Robert Frost. Two roads diverged in the woods: To manage your finances and investments yourself or to engage professional help. You may never know what the results would have been if you had continued on your own, but hopefully you are pleased with the path you have chosen to hire us to walk with you.

Time savings

Quite likely you chose to hire Paracle in the first place because you wanted to do something with your time that you enjoy more than managing money. How valuable our service is to you in this regard depends on how you value your own time and how much you enjoy studying financial planning and investing. Rather than make any effort to quantify this, we will simply say that if you were to set out on your own to manage all aspects of your finances and investments with the same care and diligence that Paracle applies, it would take many hours of your time.

The Value of Collective Resources

We have built a solid platform of people and technology for serving clients, and as a result, we have access to tools and resources that would be impossible for the average individual to replicate on their own without incurring great cost. (This is true due to economies of scale that we are able to achieve in managing $500,000,000+ of assets versus any individual going it alone.)

Financial Planning Opportunities

Tangible benefits are achieved when we identify specific financial planning opportunities that save you money. This may include the opportunity to convert Traditional IRA assets into a Roth IRA at low cost in a year where your income is lower than usual. It may include the tax benefits of setting up a self-employed 401K plan or optimizing use of corporate benefits. It may include determining that you no longer need life insurance and can stop paying for it or helping you obtain lower cost mortgage financing. Such planning opportunities by their nature occur intermittently and vary client-by-client depending on their unique circumstances. So, while we always endeavor to add value by identifying these opportunities, it can be difficult to quantify our value.

Resource and Sounding Board

We often solidify our relationships with clients when they go through challenging times or major life events. A death, a divorce, a remarriage, a child in personal or financial trouble, an aging parent who needs assistance. These life events can lay a heavy burden on our clients, and we are often able to help serve as a sounding board or make referrals to third party professionals whose specialized expertise is an invaluable resource.

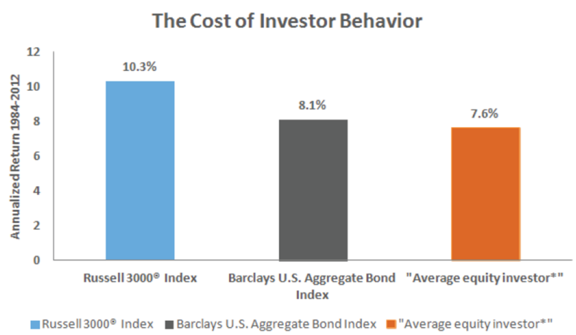
Investment Asset Allocation

An often-quoted study by Gary Brinson became the foundation for a conclusion that asset allocation explains 90% of the variability of an investment portfolio's results. If this is the case, which we believe that it is, then the single most important investment decision is to select an appropriate asset allocation that strikes a reasonable balance between cash flow needs, long-term return requirements, and your personal tolerance for risk and appetite for return. Getting this top-level asset allocation decision correct is the best way to make sure that you do not need to sell your investments at an inopportune time, that your portfolio will outpace inflation over the long run, and that you don't lose too much sleep at night along the way. The value of this cannot be perfectly quantified, but it is priceless. For this reason, the starting point for the implementation of any client's investment portfolio is gaining input regarding their unique financial planning circumstances and personal objectives and very carefully structuring a portfolio that works well for you. Your investment portfolio follows your plan, and this leads to investment success.

POSSIBLE TO QUANTIFY, WITH TANGIBLE VALUE

It is easier to quantify the value-add in some specific areas of investment management, and we will focus the remainder of this summary on these areas where we expect to achieve tangible benefits.

Saving from Behavioral Mistakes: Estimated at 1.50%



A recent study by the Russell Investment Group concluded that the average equity investor achieved returns of 7.60% while the Russell 3000 US stock index returned 10.30%[1]. This tells us that the average investor in equities achieved returns that were 2.70% less than simply investing in an index and forgetting about it for the next 25+ years.

Suggesting that investors cost themselves a full 2.70% is likely overstating the damage though, since most people don't invest 100% in equities. If we assume a 60% equity allocation and a 40% bond allocation, and if we assume no investor underperformance in the fixed income arena (which almost certainly is not correct, but we don't have data on this), then we could conclude that the average investor performed 1.60% lower than a similarly-weighted index.

Vanguard performed a similar study that focused specifically on the challenging five-year time period from 1/1/2008 – 12/31/2012. Vanguard wanted to understand how its own target-date funds fared against investors who traded in their IRA accounts. The study determined that investors who placed trades in their accounts trailed the target date funds by 1.50%. In other words, Vanguard's study agreed with Russell's conclusion that investors had a high tendency to hurt themselves rather than to add value through their portfolio adjustments.

Why do investors have such a strong tendency to hurt themselves by trading versus just leaving things to ride with the market's ebbs and flows? Emotion. Investors trust their gut and their imperfect expectations for the future far more than they should, and they often conclude that taking action is better than sitting tight and sticking with an earlier decision. No matter the specific psychological processes involved, the obvious conclusion is that investors have a very strong tendency to trade at exactly the wrong times. They are tempted to get out of equity markets when stocks fall and they race to buy them when markets are up strongly.

Working with an advisor as a trusted counselor can help create accountability and discipline during those times that an investor is likely to make decisions based upon emotions alone.

Rebalancing at Opportune Times: .50% - 1.00%

A "buy-and-hold" investment philosophy entails buying a well-structured portfolio and never trading it. At Paracle we use the term "buy-and-rebalance." We recognize that the market is somewhat whimsical in the short-term with regard to rewarding one asset category versus another, and, as a result, some of the strategies that we put to work will do better than others at any given point in time. As a result, adjustments must be made to keep the portfolio in the intended strategic balance.

"Be fearful when others are greedy and greedy when others are fearful." Warren Buffett

Rebalancing at its simplest definition is an effort to take advantage of the market's random short-term movements and to capture the time-tested benefit of buying low and selling high. Maintaining strategic asset category weights and rebalancing to them consistently causes an investor to naturally buy asset categories that have declined in value recently and to sell ones that have risen. Most important, rebalancing completely removes emotion from the trading equation (and remember, it is emotion that causes the average investor to trail the market by 1.50%). Rebalancing often entails doing the opposite of what others are doing, going against the crowd.

Many studies have reviewed the topic of rebalancing, usually reaching conclusions that rebalancing adds value in the range of .50% - 1.00%. Russell's recent study determined that properly executed rebalancing can be expected to add .93% of additional return over time[2].

Rebalancing Comparison, July 1996 through September 2011

	Buy and Hold	Annual Rebalancing	Quarterly Rebalancing	Monthly Rebalancing
Annualized Return	5.92%	6.85%	6.50%	6.43%
Annualized Standard Deviation	10.35%	10.06%	10.10%	10.23%

Saving Costs on Investment Products: .50%

Vanguard's study validated our own conclusion that saving costs is one of the most practical ways that an advisor can add value. Vanguard determined that the quantifiable benefit for saving costs by using low cost products is .45% on average. Our own research based on Morningstar data suggested that the benefits may be even greater, closer to .55%. Whichever figure you use, the cost savings we are able to achieve by using low cost institutional products that the average do-it-yourself investor does not have access to can cover a portion of the fee that our clients pay.

Tax-Sensitivity and Determining Optimal Asset Location: Up to .75%

Another way that a good advisor can add practical value is to think carefully about which specific investment strategies should be held in taxable non-retirement accounts versus tax-deferred or tax-free retirement accounts. Simply taking time to stop and think about taxes, both current and future, provides real benefits. Vanguard's research concluded that the benefit of being careful in this regard can be as high as .75%. When we engage new clients, this is one of the most common things that we see overlooked.

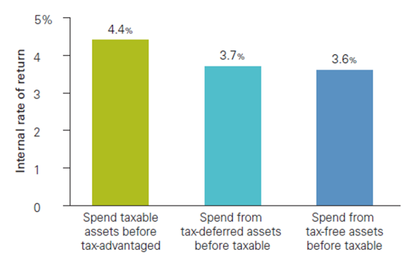
Tax Loss Harvesting: Up to 1.2%

Another opportunity to add value is the ability to sell investments that have declined in value, allowing clients to take a tax loss. The benefit of taking that loss is it can then be used to offset other tax gains within their portfolio. It is important to note that we are not talking about cashing in and walking away (i.e. selling at the wrong time), but instead when we harvest losses, we reinvest the proceeds in a similar way so that the eventual upside is the same as before. We are simply taking a practical tax benefit that can add up to 1.2%[3].

Developing a Withdrawal Strategy: Up to .70%

Once a client is retired and living on their portfolio assets rather than on earned income, they must decide where to pull assets from to meet their monthly cash flow needs. Many

Figure VI-1a. Average internal rate of return of different withdrawal-order strategies



Important note: These hypothetical data do not represent the returns on any particular investment. Each internal rate of return (IRR) is calculated by running the same 10,000 VCMM simulations through three separate models, each designed to replicate the stated withdrawal order strategy listed.

Source: Vanguard.

individuals simply don't know how to approach this and make poor decisions as a result. For instance, they might take a larger IRA distribution than they are required to take. Vanguard determined that an advisor can add up to .70% of value by thoughtfully designing a withdrawal plan[4]. We think that this may be slightly overstating the benefit, since Vanguard's analysis assumes that an individual would make bad decisions all the time. The exact benefit will vary considerably based on an individual's circumstances and thought processes.

CONCLUSION

If we add up the maximum potential benefit in all areas that can be quantified, the total expected value-add is over 5.0%! Well, not so fast. The various areas can overlap and are not mutually exclusive from one another. However, the collective benefits remain significant. Russell and Vanguard each concluded that the aggregate benefits add up to about 3%.

We believe that the very practical value-adds cover the cost of our investment management fee. For instance, product cost savings and strategic rebalancing can add up to 1.00% - 1.50%. One doesn't need to quantify the exact benefits afforded by ideal asset location, tax loss harvesting, ideal withdrawal strategies, behavioral coaching, etc. in order to conclude that there is benefit in working with a good advisor.

Remember too that this doesn't include the intangible benefits of achieving time savings, having solid financial planning in place, establishing a well-thought-out asset allocation, and achieving the clarity and peace of mind that naturally come when one has confidence that these things are in order.

Sources

1. Jung, Brad, 2014. *The Value of an advisor: worth more than 1%.* Tacoma, WA.: Russell Investments. http://blog.helpingadvisors.com/2013/06/25/the-value-of-an-advisor-worth-more-than-1/

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3. Bouchey, Paul and Hemambara Vadlamudi, 2012. *Simulating Loss Harvesting Opportunities Under Different Tax Environments.* Seattle, WA.: Parametric

4. Kinniry, Francis M., 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.

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