



Vanguard®

# Vanguard Adviser's Alpha

Vanguard Research

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- Since the creation of the Vanguard Adviser's Alpha concept in 2001, the value proposition of advice has continued to rapidly change – we believe for the better. And our work in support of the idea has continued.
- The Vanguard Adviser's Alpha concept outlines how advisers may add value, or alpha, by providing relationship-oriented services – such as cogent wealth management via financial planning, behavioural coaching, and guidance – as a primary objective of the value proposition.
- Paying a fee for advice and guidance to a professional who uses the framework described here may add meaningful value compared to the average investor experience, currently advised or not.
- We believe implementing the Vanguard Adviser's Alpha framework offers an opportunity to add net returns in excess of the standard fees charged for advisory services.

What is adviser's alpha? The Vanguard Adviser's Alpha concept outlines how advisers may add more consistent value, or alpha, through wealth management in the form, for instance, of financial planning, behavioural coaching, and guidance – rather than outperforming a policy portfolio, which has historically been the primary value proposition for many advisers. For some clients, paying fees to an adviser whether or not transactions occur may seem like “money for nothing” and not much of a value proposition. However, this is viewing the adviser's value through only one portion of the cost–benefit lens. For instance, the benefit and wisdom of *not allowing* near-term market actions to result in the abandonment of a well-thought-out investment strategy can be underappreciated in the moment.

The confusion can grow if the adviser has based his or her value proposition primarily on an ability to deliver better returns for the client, as many do. But better returns relative to what? For many advisers and clients, the answer would be “better than the market”, but a more pragmatic answer for both parties might be “better than investors would most likely achieve if they didn't work with a professional adviser”. In this framework, an adviser's alpha is more aptly demonstrated by relationship-oriented services as just mentioned – providing discipline and reason to clients who are often undisciplined and emotional – than by efforts to beat the market (see **Figure 1**).

### Outperforming the market is difficult

Although Vanguard is best known for its index funds, the company also provides low-cost, actively managed funds in many investment strategies and asset classes. We believe this gives Vanguard a uniquely objective perspective on using active management to enhance relative returns.

**Figure 1. Vanguard Adviser's Alpha: Adding up the value of advice**

### What is the Vanguard Adviser's Alpha concept?

The focus:

- A service-centric model.
- Adviser's alpha: Reframes the benchmark for the value of advice.

Investment management	Financial planning and wealth management
Behavioural coaching	A service model: Time, willingness, and ability

**We believe the net returns of successfully implementing Vanguard Adviser's Alpha may be greater than the fees charged for advisory services.**

### Why has Vanguard Adviser's Alpha become so popular?

- The traditional value proposition for financial advisers has been primarily focused on outperformance versus a fund's benchmark.
- As such, this value proposition has extremely high hurdles.
  - It requires tremendous alpha after fees and taxes.
  - Expected outperformance has not been achieved by the vast majority of funds.
  - The result: Lower asset-retention rates.

**As a financial adviser, you are the value. The Vanguard Adviser's Alpha framework emphasises the more reliable benefits of a professional relationship.**

Source: Vanguard.

### Notes on risk

*All investments are subject to risk, including possible loss of principal. Investments in bonds are subject to interest rate, credit, and inflation risk. Prices of mid and small-cap stocks often fluctuate more than those of large-company stocks. Investments in stocks issued by non-US companies are subject to risks including country/regional risk and currency risk. These risks are especially high in emerging markets. Although income from a municipal bond fund is exempt from federal tax, you may owe taxes on any capital gains realised through the fund's trading or through your own redemption of shares. Consider consulting a tax adviser regarding your individual situation.*

*Conclusions of this analysis are based on aggregate data. Performance of individual funds or advisers may be better or worse than the averages presented here.*

Although it is possible for active managers to outperform (particularly in the short run), underperformance tends to be more probable after all fees and trading costs are considered (e.g., see Harbron, Roberts, and Rowley, 2016). *Consistent* net outperformance is rare. This isn't necessarily due to a lack of management skill; rather, it is a consequence of the burden of higher costs (Figure 2). Time is an important consideration in this relative performance comparison as advisers try to coach investors away from the distraction of short-term market actions, whether positive or negative. As illustrated by the downwardly sloping trend lines in the appendix (Figure A-1, a. and b.), on pages 9–10, over longer time frames the added expense of active management often proves too much to overcome.

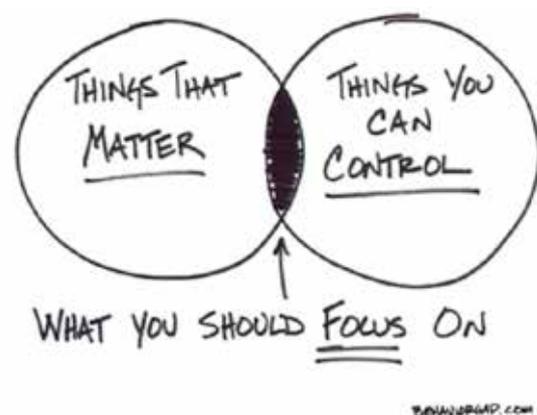
A value proposition based primarily on outperforming the market puts an adviser at a meaningful disadvantage and – using history as a guide – is hard to fulfill consistently over time. Not only does success depend on factors outside the adviser's control, such as the returns from individual securities or professionally managed funds, but the strategy also can promote a horse-race mentality among clients, leading them to "drop out" if the promised outperformance does not materialise. Fortunately, the adviser's alpha model emphasises more reliable benefits of a professional relationship.

**Figure 2. Asset-weighted average expense ratios of active and index mutual funds as at 31 December 2015**

	Investment type	Actively managed funds	Index funds	ETFs
US stocks	Large-cap	0.75%	0.10%	0.14%
	Mid-cap	0.93	0.15	0.25
	Small-cap	0.97	0.17	0.18
US sectors	Stock sector	0.82	0.54	0.29
	Real estate	0.88	0.13	0.19
International stocks	Developed market	0.86	0.17	0.27
	Emerging market	1.08	0.21	0.35
US bonds	Corporate	0.53	0.11	0.11
	Government	0.41	0.33	0.15

Sources: Vanguard calculations, based on data from Morningstar, Inc.

Carl Richards, CFP®, a popular author and media figure in investor education, is known for creating illustrations that bring immediate clarity to complex financial issues. One of his sketches, reproduced at right, encapsulates not only the basic framework of Vanguard Adviser's Alpha but the essence of how we believe investors and advisers should view the entire investing process: Understand what's important; understand what you can control; and focus your time and resources accordingly.



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**Professional stewardship:  
Central to the adviser’s alpha model**

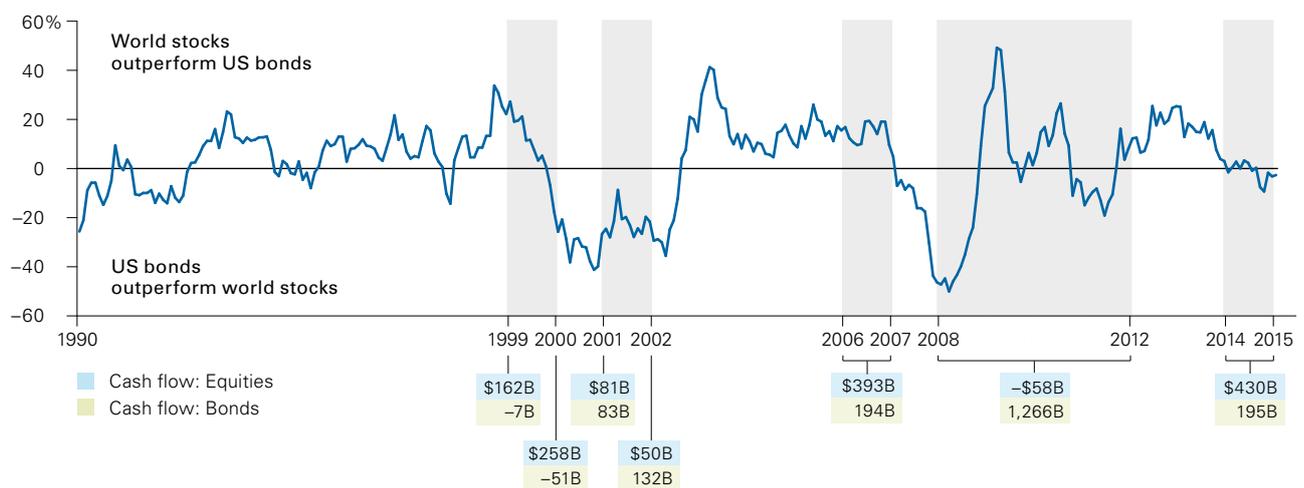
Rather than placing its major focus on investment capabilities, the adviser’s alpha model relies on the experience and stewardship that the adviser can provide in the relationship. Left alone, investors often make choices that impair their returns and jeopardise their ability to fund their long-term objectives. Many are influenced by capital market performance; this is often evident in market cash flows mirroring what appears to be an emotional response – fear or greed – rather than a rational one. Investors also can be moved to act by fund advertisements that tout recent outperformance, as if the investor could somehow inherit those historical returns, despite disclaimers stating that past performance “is not a guarantee of future results”. Historical studies of mutual fund cash flows show that, after protracted periods of relative outperformance in one area of the market, sizable cash flows tend to follow (see Figure 3).

This performance-chasing behaviour is often injurious to returns. As Figure 4 illustrates, the returns that investors receive may be very different from those of the funds they invest in,<sup>1</sup> since cash flows tend to be

attracted by, rather than precede, higher returns. On average, for the ten years ended 31 December 2015, fund investors trailed the funds they invested in by 86–229 basis points per year, according to Morningstar. The adviser’s alpha target, then, might be to improve upon this return shortfall by means that don’t depend on market outperformance: asset allocation, rebalancing, tax-efficient investment strategies, cash flow management, and, when appropriate, coaching clients to change nothing at all.

Although return-chasing behaviour is often associated with individual investors, evidence suggests that institutions do so as well. Goyal and Wahal (2008) looked at the hiring and firing decisions of a group of plan sponsors from 1996 through 2003. They found that the hired firms outperformed the fired firms in the periods immediately preceding the decision to change, but underperformed the fired firms for one, two, and three years thereafter (see Figure 5). Advisers, as behavioural coaches, can act as emotional circuit breakers in bull or bear markets by circumventing their clients’ tendencies to chase returns or run for cover in emotionally charged markets.

**Figure 3. Rolling 12-month excess returns for total world stock market versus US bond market compared with net highlighted cash flows: 1990–2015**



**Notes:** Excess return is difference between returns of broadly diversified world stocks and US bonds. World stocks represented by MSCI All Country World Index; US bonds represented by Barclays U.S. Aggregate Bond Index. Dates shown are as at December 31 for each year.

**Sources:** Vanguard, based on data from MSCI and Barclays.

<sup>1</sup> The time-weighted returns in Figure 4 represent the average fund return in each category.

### Adding value through portfolio construction

Many advisers use a “top-down” approach that starts with analysing the client’s goals and constraints, then focuses on finding the most suitable asset allocation strategy. This process is extremely important, yet too many investors neglect it on their own, overlooking its contribution to their long-term investment success. As a result, providing a well-considered investment strategy and asset allocation is an important way in which advisers add value. And the knowledge that the asset allocation was arrived at after careful consideration, rather than as a happenstance of buying funds with attractive returns (the investment equivalent of butterfly collecting), can serve as an important emotional anchor during those all-too-frequent spikes of panic or greed in the markets.

The asset allocation process may be separated into two parts: determination and implementation. Within the overall framework of each client’s goals and circumstances, the allocation is often determined based on the historical risk–reward relationships between asset classes. Although no forward-looking investment process is perfect, particularly one based on historical data, it is reasonable to think that some historical risk–reward relationships are likely to persist. Future investors are as likely to demand compensation for bearing risk as investors in the past, and as a result, it is logical to expect assets with more return uncertainty (such as stocks or high-yield bonds) to outperform lower-risk assets over the long run.

Figure 4. Investor returns versus fund returns: Ten years ended 31 December 2015

	Value	Blend	Growth
Large-cap	5.59%	6.44%	7.33%
	3.70	5.06	5.69
	-1.89	-1.38	-1.64
Mid-cap	6.59	6.50	7.16
	4.30	4.68	5.53
	-2.29	-1.82	-1.63
Small-cap	6.01	6.27	7.14
	4.45	4.63	5.20
	-1.56	-1.64	-1.94

Conservative allocation	Moderate allocation
4.15%	5.23%
3.29	4.08
-0.86	-1.15

- Time-weighted fund category return
- Morningstar Investor Return
- Difference

Notes: Morningstar Investor Return™ assumes that the growth of a fund’s total net assets for a given period is driven by market returns and investor cash flow. To calculate investor return, a fund’s change in assets for the period is discounted by the return of the fund, to isolate how much of the asset growth was driven by cash flow. A Morningstar proprietary model, similar to an internal rate-of-return calculation, is then used to calculate a constant growth rate that links the beginning total net assets and periodic cash flows to the ending total net assets. Discrepancies in the return “difference” are due to rounding.

Source: Morningstar, Inc.

Figure 5. Relative performance of hired versus fired firms, 1996–2003

Years	Before manager change			After manager change		
	3	2	1	1	2	3
Difference in excess return (in percentage points)	9.52	9.12	4.57	-0.49	-0.88	-1.03

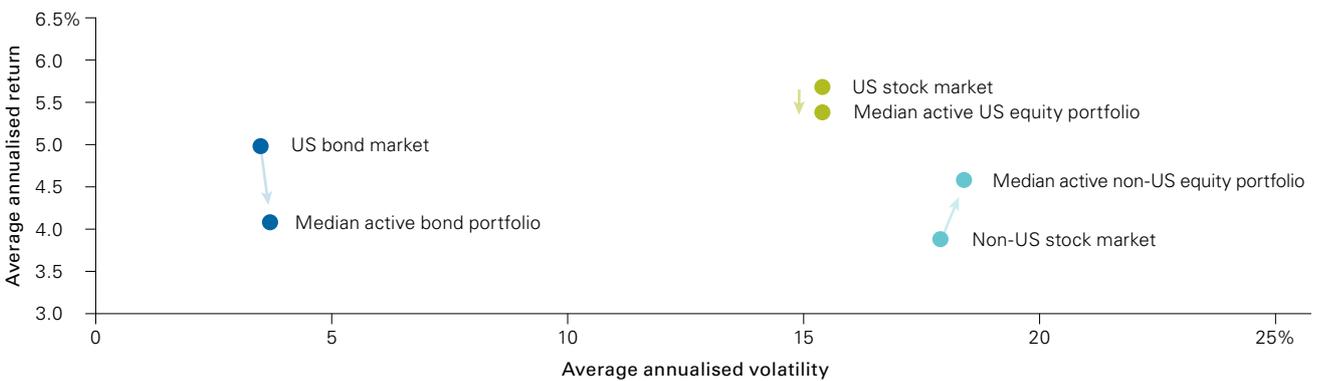
Source: Goyal and Wahal (2008), based on 8,775 hiring decisions by 3,417 plan sponsors delegating \$627 billion in assets, and 869 firing decisions by 482 plan sponsors withdrawing \$105 billion in assets.

Once an asset allocation has been determined, advisers can help their clients understand the important considerations involved in implementing it. For example, a client’s next question might be, “Do I want to use actively managed funds or index funds to implement this portion of the allocation?” To help clients evaluate the index side of the scale, an adviser can point out that – in addition to the higher expense ratios commonly charged for actively managed funds (recall Figure 2) – returns from active funds tend to be more volatile than those of the index benchmarks for their categories.<sup>2</sup> The combination of higher expenses

and higher volatility has often contributed to lower returns for actively managed funds than for their benchmarks, but with more risk – an unpalatable combination (Figure 6). Not uncommonly, an index fund replicates the composition of its benchmark, and provides returns and volatility that consistently approximate those of the benchmark over time.<sup>3</sup> Using history as a guide, index funds often provide higher returns and lower volatilities over time, relative to actively managed funds in the same category.

**Figure 6. Average returns and volatility of actively managed funds versus their markets, 2001–2015**

Portfolios of actively managed funds can increase risk or lower returns, or both.



**Notes:** Portfolio weights approximate relative allocations within each market as at 31 December 2015. Median active US bond portfolio comprises two funds allocated to the portfolio as: 62%, median government fund; 38%, median corporate fund. Median active US equity portfolio comprises three funds allocated to the portfolio as: 70%, median large-cap fund; 20%, median mid-cap fund; 10%, median small-cap fund. Median active non-US equity portfolio comprises two funds allocated to the portfolio as: 83%, median developed-markets fund; 17%, median emerging-markets fund. Returns and volatility cover 15 years ended 31 December 2015.

Past performance is not a guarantee of future results. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

**Sources:** Vanguard calculations, based on data from Morningstar, Inc.

<sup>2</sup> For the gross return of an actively managed fund to differ from that of a style-matched benchmark, its portfolio must differ in some way in its composition. Often actively managed funds are not as well diversified as the benchmark, a factor that adds idiosyncratic risk. In addition, although an actively managed fund may significantly outperform its stated benchmark, it may also significantly underperform it, a possibility commonly referred to as “active-manager risk”.

<sup>3</sup> As a result, using an index benchmark as a proxy for the return and volatility characteristics of an index fund tracking that benchmark is reasonable.

However, many investors (and certainly some advisers) approach investing from the “bottom up”, focusing foremost on security or fund selection, with emphasis on investments that have caught their eye through recent outperformance. Cash-flow patterns such as those illustrated in Figure 4 tend to result, often with the greatest differential in net cash flows occurring at or near the peak in relative outperformance.<sup>4</sup> For example, Figure 3 shows that in 1999 and 2000, cash flows into US equities dwarfed those into bonds. More specifically, in 2000, bond funds saw approximately \$51 billion depart, while stock funds gathered in about \$258 billion. After a five-year stock market boom, one might have looked for cash coming into bond funds as a result of portfolio rebalancing. However, such an expectation would presume that a large majority of investors and advisers both used asset allocation strategies and possessed the discipline to execute rebalancing as planned – paring the holdings of their outperformers and committing more capital to the underperformers. The data do not seem to validate this presumption.

#### **Addition by subtraction: Emphasis on tax-efficient strategies**

Taxes are another major consideration for many clients, and tax management is a further important way in which advisers can demonstrate the value they add. If future returns turn out to be more modest while taxes on those returns are higher than they have been, as some professionals are forecasting, then total costs (management fees, expense ratios, frictional costs, taxes, etc.) will erode an investor’s returns even further. And tax-conscious financial planning and tax-efficient portfolio construction will have proportionately larger benefits.

Actively managed equity strategies or funds tend to be tax-inefficient, potentially diminishing or erasing any gains from outperformance if they are held in taxable accounts. If an adviser has great faith in the active manager’s abilities, then techniques such as asset location – sheltering tax-inefficient funds in tax-advantaged accounts – may help preserve the expected rewards for bearing active-manager risk.

An asset-location strategy can also help clients to understand the trade-offs between municipal bonds and taxable bonds. For higher-tax-bracket clients, tax-exempt municipal bonds are often the default fixed income holdings, as these bonds provide income exempt from federal, and sometimes state and local, income taxes. Because of the tax-free income, as well as the generally higher creditworthiness of municipalities, a municipal bond portfolio is typically expected to have a lower yield than a broadly diversified portfolio of investment-grade bonds, such as the Barclays U.S. Aggregate Bond Index. Historically, the municipal bond/taxable yield differential has been approximately 130 basis points per year (though amid the recent stresses in the US financial markets, municipal bonds have sometimes yielded more than taxable bonds, an unusual occurrence).<sup>5</sup>

An adviser familiar with the asset-location process can help a client understand the interplay of these decisions – index or active funds, taxable or tax-exempt bonds – in implementing the asset allocation. Taxable bonds have historically outperformed municipal bonds by more than 100 basis points a year in annualised returns, but they are tax-inefficient unless they can be sheltered in a tax-advantaged account. Actively managed equity funds offer the opportunity to outperform, but they are also tax-inefficient and are principal candidates for tax-advantaged accounts, too. But if the assets available for tax-advantaged accounts are limited, which investment should be sheltered first? Unless the investor or adviser has tremendous confidence that the active fund manager can consistently outperform after expenses by at least 100 basis points annually (approximating the historical muni/taxable spread), then sheltering the taxable bonds first is likely to yield better after-tax results. Helping clients not only with their asset allocation but also with their asset location can be a meaningful part of adviser’s alpha, adding clear value by helping to improve the client’s after-tax returns.

<sup>4</sup> Although our illustration reflects the relative cash flows and performance for the overall US stock and bond markets, our research has shown that similar patterns exist for US growth and value stock funds, US large-cap and small-cap stock funds, and domestic and international stock funds.

<sup>5</sup> The median yield differential (muni/taxable spread) for the Barclays U.S. Aggregate Bond Index and the Barclays Municipal Bond Index from January 1980 through December 2015 was 1.30% (i.e. 130 basis points); as at 31 December 2015, the muni/taxable spread for the same indices was 0.47% (47 basis points).

Further, clients who are retired may benefit from tax-conscious guidance about spending from their portfolios. On their own, investors often spend first from their tax-advantaged accounts, and to some degree this is understandable since those accounts were explicitly set up for this purpose. However, it is generally more advantageous to spend from taxable accounts first, allowing the tax-advantaged accounts to grow as much as possible.

Determining the appropriate drawdown strategy often includes making some assumptions about future tax rates as well as estimating the client's future income levels. Meeting with the client to work through these assumptions can provide an excellent opportunity to discuss possible scenarios, demonstrate that the guidance is personalised, and promote the client's confidence in the strategy and the adviser. A well-thought-out drawdown strategy can improve the likelihood that the client's assets will be able to support his or her financial goals through retirement and beyond, which is a significant – if hard-to-quantify – added value.<sup>6</sup>

## Conclusion

The compensation structure for advisers is evolving from a commission- and transaction-based system to a fee-based, asset management framework. In our view, this is a mutually beneficial transition for clients and advisers. However, the traditional value proposition for many advisers has been primarily based on their investment acumen and their prospects for delivering better returns than those of the markets. No matter how skilled the adviser, the path to better investment results may not lie with the ability to pick investments or strategies. Historically, active management has failed to deliver on its promise of outperformance over longer investment horizons.

Instead, advisers should consider a new value proposition based on alternative skills and expertise: They should act as wealth managers and behavioural coaches, providing discipline and experience to

investors who need it. On their own, investors often lack both understanding and discipline, allowing themselves to be swayed by headlines and advertisements surrounding the “investment du jour” – thus often achieving wealth destruction rather than creation. In the adviser's alpha framework we've described, the adviser becomes an even more important factor in the client-adviser relationship. Our analysis and conclusions are meant to motivate you as an adviser to adopt and embrace these best practices as a reasonable framework for describing and differentiating your value proposition. The Vanguard Adviser's Alpha framework is not only good for your clients but also good for your practice.

Paying a fee for advice and guidance to a professional who uses the tools and tactics described here may add meaningful value compared to the average investor experience, currently advised or not. We believe implementing the Vanguard Adviser's Alpha framework offers the opportunity to add net returns that are greater than the standard fees charged for advisory services.

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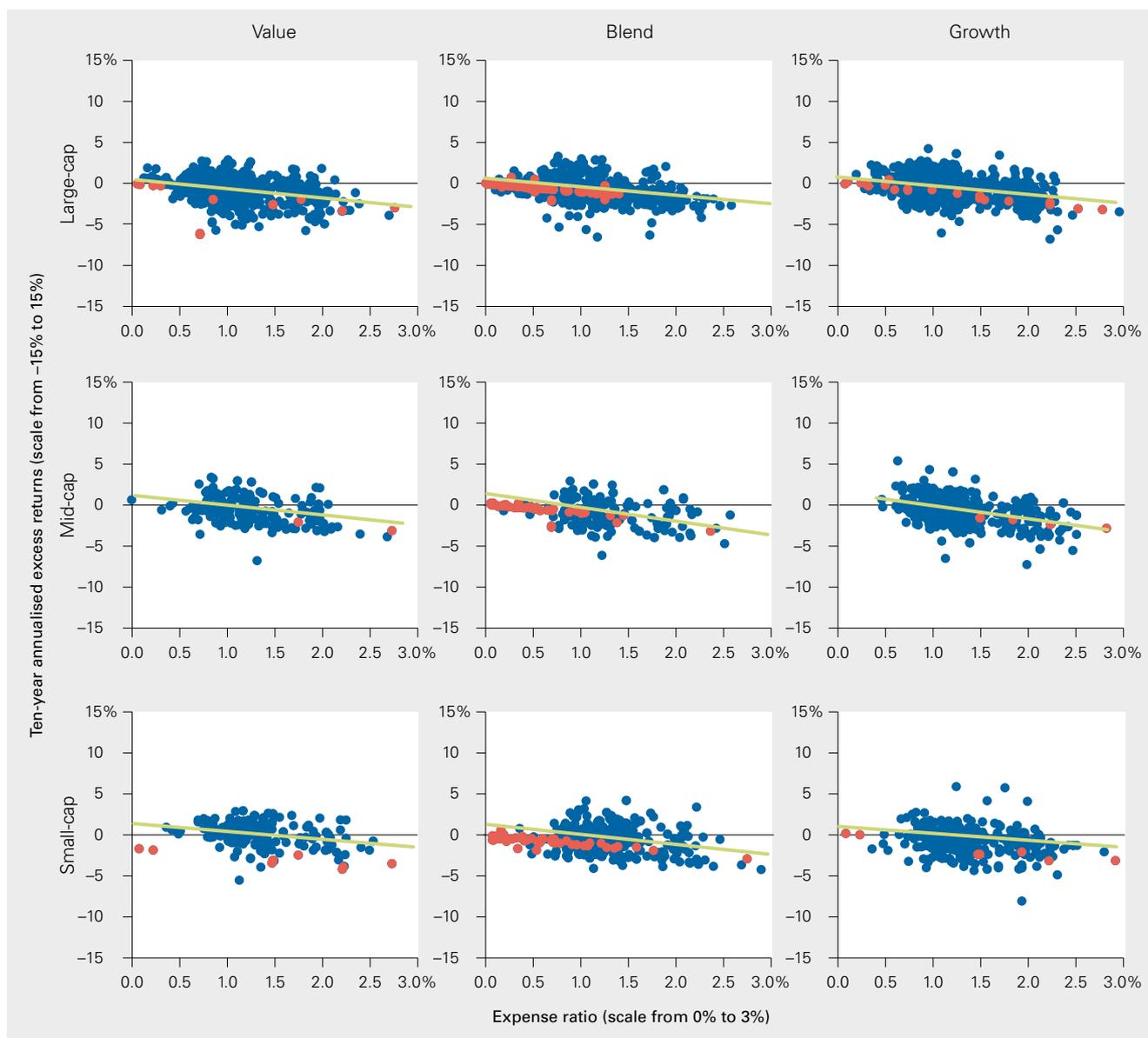
<sup>6</sup> For more information on the topic, see Kinniry et al. (2014).

Appendix. Performance effects over time resulting from expense of active equity and bond fund management

Figure A-1. Inverse relationship between expenses and excess returns: Ten years ended 31 December 2015

a. Equity funds

Each plotted point represents a US equity mutual fund within the specified size, style, and asset group. Each fund is plotted to represent the relationship of its expense ratio (x-axis) versus its ten-year annualised excess return relative to its stated benchmark (y-axis). Straight line represents the linear regression, or the best-fit trend line (the general relationship of expenses to returns within each asset group). Scales are standardised to show the slopes' relationship to each other, with expenses ranging from 0% to 3%; returns for equities range from -15% to 15%. Some funds' expense ratios and returns go beyond the scales and are not shown.

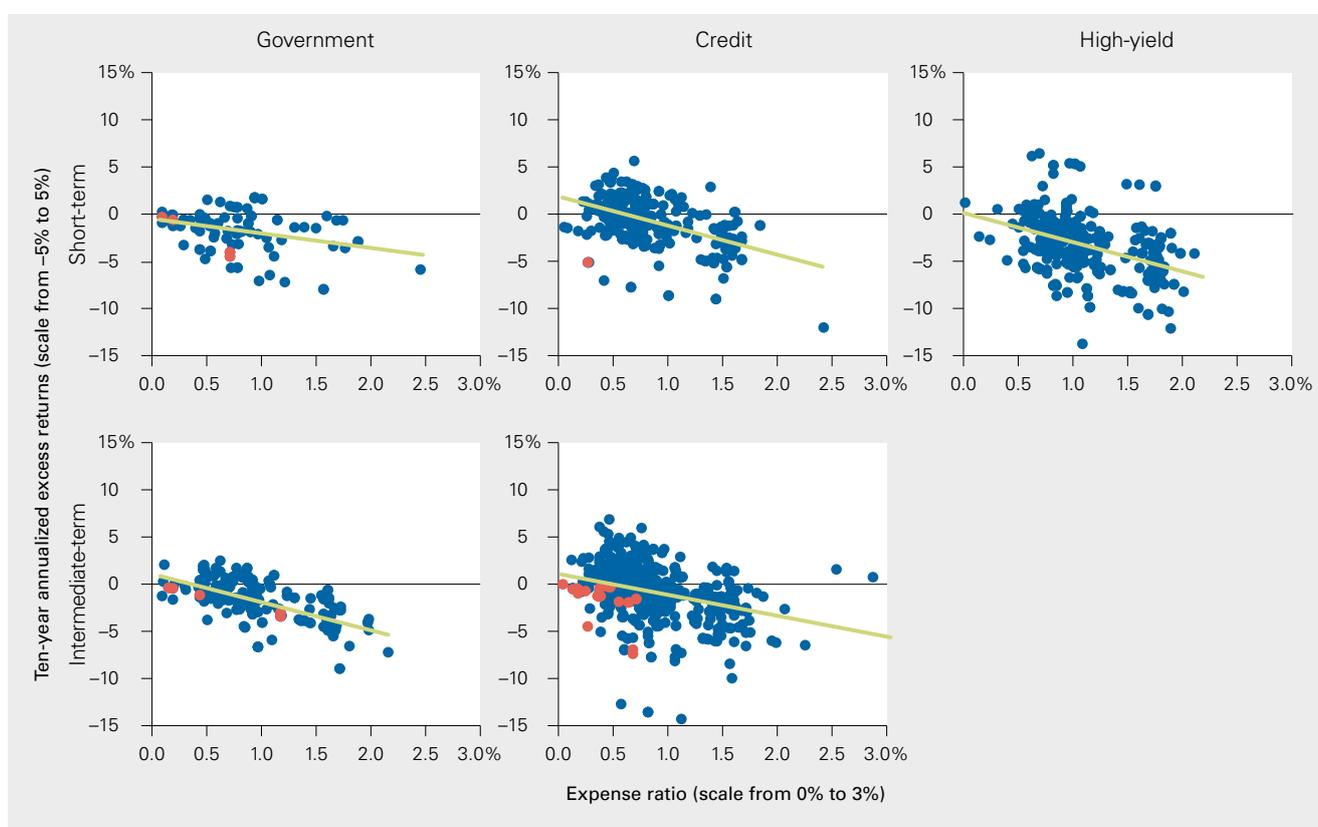


(Continued on page 10)

**Figure A-1 (Continued). Inverse relationship between expenses and excess returns: Ten years ended 31 December 2015**

b. Fixed income funds

Each plotted point represents a US fixed income mutual fund within the specified maturity and asset group. Each fund is plotted to represent the relationship of its expense ratio (x-axis) versus its ten-year annualised excess return relative to its stated benchmark (y-axis). Straight line represents the linear regression, or the best-fit trend line (the general relationship of expenses to returns within each asset group). Scales are standardised to show the slopes' relationship to each other, with expenses ranging from 0% to 3%; returns for fixed income range from -5% to 5%. Some funds' expense ratios and returns go beyond the scales and are not shown.



**Notes:** All data as at 31 December 2015. Index funds are shown by red dots. Some funds' expense ratios and returns go beyond the scales and are not shown. Style benchmarks are represented by the following indices: large-cap core equity – MSCI US Prime Market 750 Index; large-cap value equity – MSCI US Prime Market 750 Value Index; large-cap growth equity – MSCI US Prime Market 750 Growth Index; mid-cap core equity – MSCI US Mid Cap 450 Index; mid-cap value equity – MSCI US Mid Cap 450 Value Index; mid-cap growth equity – MSCI US Mid Cap 450 Growth Index; small-cap core equity – MSCI US Small Cap 1750 Index; small-cap value equity – MSCI US Small Cap Value Index; small-cap growth equity – MSCI US Small Cap Growth Index; short-term bond – Barclays U.S. 1–5 Year Credit Bond Index; short-term US government bond – Barclays U.S. 1–5 Year Treasury Bond Index; intermediate-term bond – Barclays U.S. 5–10 Year Credit Bond Index; intermediate-term US government bond – Barclays U.S. 5–10 Year Treasury Bond Index; high-yield bond – Barclays U.S. Corporate High Yield Bond Index. The results shown, and the data from which the conclusions were drawn, would vary if other time periods were chosen.

Past performance is not a guarantee of future results. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

**Sources:** Vanguard calculations, based on data from MSCI, Barclays, and Morningstar, Inc.





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