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2016 Value of a financial advisor update: More than 3.75%

Is anyone else tired of hearing that robo-advisors are the panacea for all investors? Because I sure am! Admittedly, an automated risk tolerance questionnaire with an investment solution tied to it is a valuable service for some investors.

But, other investors need more - especially if they are seeking guidance on coordinating the accumulation, distribution and transfer of their wealth. For them, a bona fide, human advisor is invaluable when navigating the technical and emotional facets of investing. These investors may well agree that ***the value of an advisor is worth more than 1%… again.***

We have estimated the value of an advisor for three consecutive years and each time the value of an advisor has easily surpassed the typical 1% fee many advisors charge the advisory accounts they manage. Let's see how an advisor's value is stacking up for 2016.

The value of an advisor in 2016

For this year's edition of the study, I have added a new variable (T) to the equation to account for the value of the tax-aware planning/investing many advisors deliver to their clients. So, this year's formula looks like this:

Value of an advisor: A + B + C + P + T > Your fee

A = Annual rebalancing of investment portfolios B = Behavioral mistakes individual investors typically make C = Cost of basic investment-only management P = Planning costs or the costs of providing a financial plan, updates and your services T = Tax-aware planning/investing Your fee = Annual advisory fee you charge clients

(Note: Our estimates are based on a $500,000 advisory portfolio.)

A = Annual rebalancing of investment portfolios

Many individual investors underestimate the value of a disciplined rebalancing policy. But that's a mistake, as research by my colleague, Natalie Miller, shows in the table below. Advisors who apply a disciplined annual rebalancing policy have the potential to add up to 0.20% to a portfolio's return while reducing the portfolio's risk by up to 1.6%. That's like offering clients more opportunity for return and less volatility in portfolios. Not too shabby!

Hypothetical rebalancing comparison: Jan. 1988 – Dec. 2015

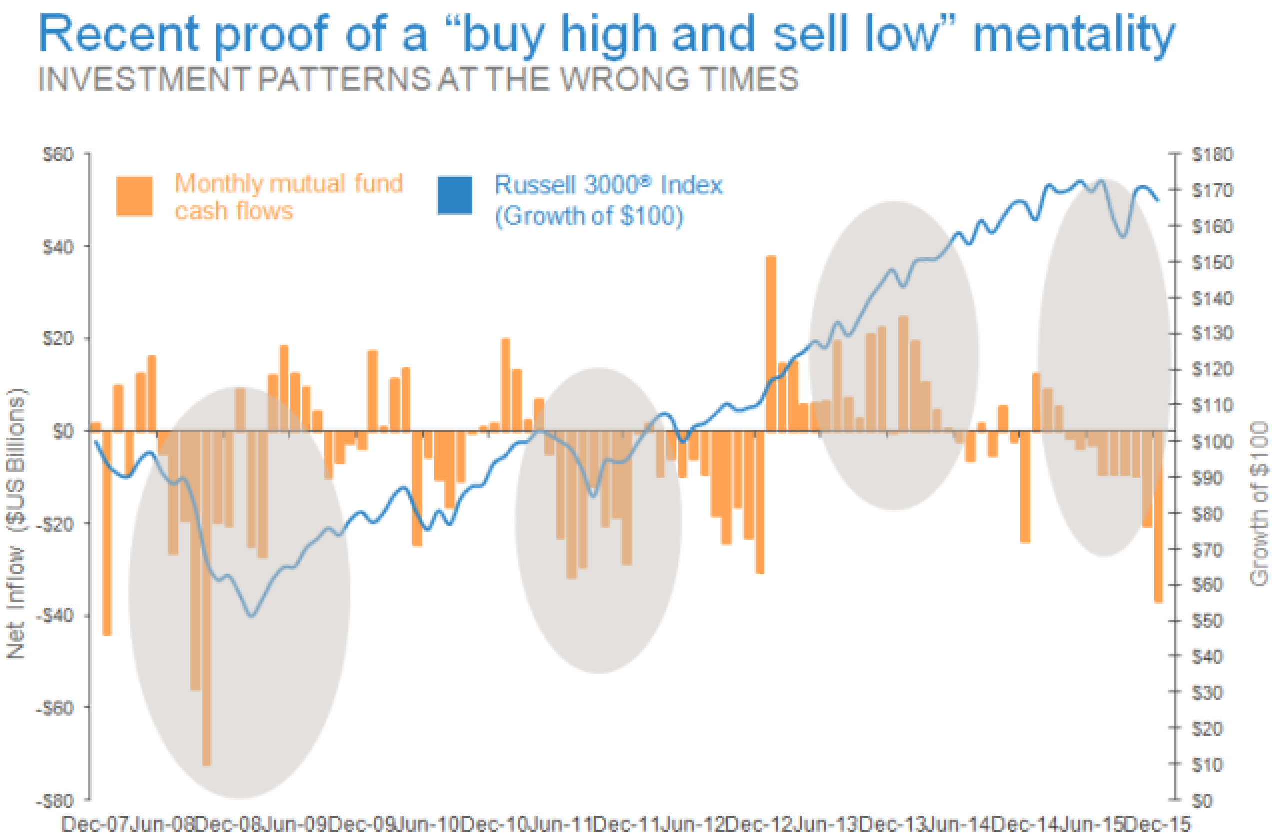
	Buy and hold	Annual	Quarterly	Monthly
Annualized return	8.6%	8.8%	8.7%	8.6%
Annualized standard deviation	10.4%	8.8%	9.0%	9.0%

For illustrative purposes only. Not meant to represent any actual investment. Methodology available in notes at the end of this blog post.

Value of A (annual rebalancing of investment portfolios) = 0.20% in additional potential annual return with a potential reduction in portfolio risk of up to 1.6%

B = Behavioral mistakes individual investors typically make

Although advisors don't typically include "behavior coach" in their job description, it's most likely the single largest contributor to the total value they bring their clients. Left to their own devices, investors will typically find a way to perfectly "buy high" and "sell low," as the chart below illustrates.



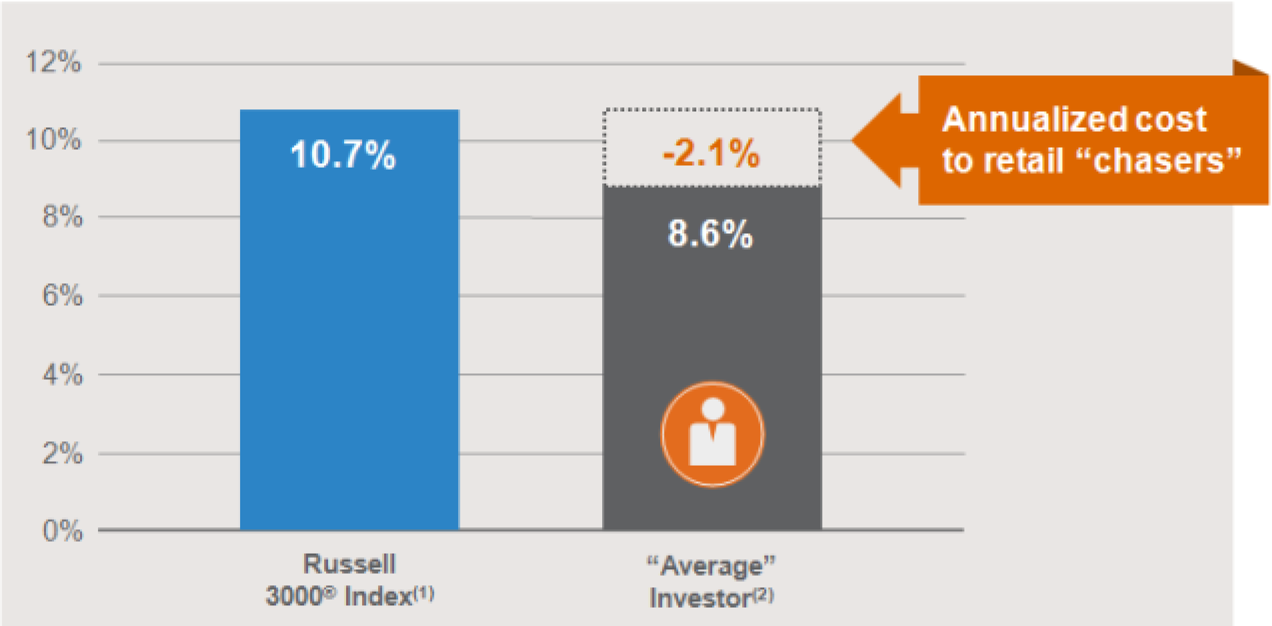
Data shown is historical and not an indicator of future results. Source: Industry flows into equities. www.ici.org/research/stats.Russell 3000® Index: www.https://russellinvestments.com/indexes ("value with dividends"). Data as of December 31, 2015. Index performance is not indicative of the performance of any specific investment. Indexes are not managed and may not be invested in directly.

From 2009 to 2013 investors withdrew more money from U.S. stock mutual funds than they put in (see the orange bars). Could that be great market timing? Not at all. During that time the stock market (the blue line, represented by the Russell 300 Index) steadily climbed. To the tune of 16.1%.[1]

What impact might this have on the "average" equity investor's portfolio? The chart below tells all.

The high cost of investor behavior

1984-2015



(1) BNY Mellon Analytical Services, Russell 3000® Index annualized return from January 1, 1984 to December 31, 2015. (2) Russell Investment Group & Investment Company Institute (ICI). Return was calculated by deriving the internal rate of return (IRR) based on ICI monthly fund flow data which was compared to the rate of return if invested in the Russell 3000® Index and held without alteration from January 1, 1984 to December 31, 2015. This seeks to illustrate how regularly increasing or decreasing equity exposure based on the current market trends can sacrifice even market like returns. Indexes and/or benchmarks are unmanaged and cannot be invested in directly. Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.

Left to their own devices, the average stock fund investors' inclination to chase past performance cost them over 2% annually in the 31-year period from 1984-2015. In that sense, an advisor's ability to keep their client stick to their long-term financial plan, and thereby skirt irrational, emotional decisions, is worth *2.1%.*

The value of B (behavioral mistakes individual investors typically make) = 2.1%

C = Cost of basic investment-only management (aka, robo-advisors)

What should an advisor charge if they deliver investment-only management and no financial plan, no ongoing service, no guidance, nothing except for an annual statement, online access and a phone number to call in case of questions?

Robo-advisors have set that price at approximately 0.25%.[2]

Value of C (cost of basic investment-only management) = 0.25%

P = Planning costs and ancillary services

As part of a fee-based relationship, advisors can add value by building and regularly updating a custom financial plan for each client and conducting regular portfolio reviews. Many also offer ancillary services, such as investment education, assistance with annual tax return preparation, Social Security and retirement income planning, as well as one-off custom requests from clients—all of which could cost thousands of dollars if purchased à la carte.

How much does the financial planning component cost nowadays? According to a recent Financial Planning Association's (FPA) study,[3] there is a shift among advisors: Compared to prior years, many advisors are now charging more for creating a financial plan and less for the ongoing management of the investor's financial portfolio. The cost of developing and building that initial financial plan is coming in at around $2,600 on average, and includes the cost of the advisor spending up to 13 hours interviewing the investor as a basis for the plan. Planners now typically charge an hourly rate of approximately $200 per hour for ongoing monitoring and updating the plan.

By providing a financial plan with ongoing goal and risk tolerance monitoring, the value of both the initial plan and ongoing adjustment are worth approximately of 0.50% on a $500,000 account. (In our example here, we assume that creating and maintaining the financial plan are part of the annual advisory fee.)

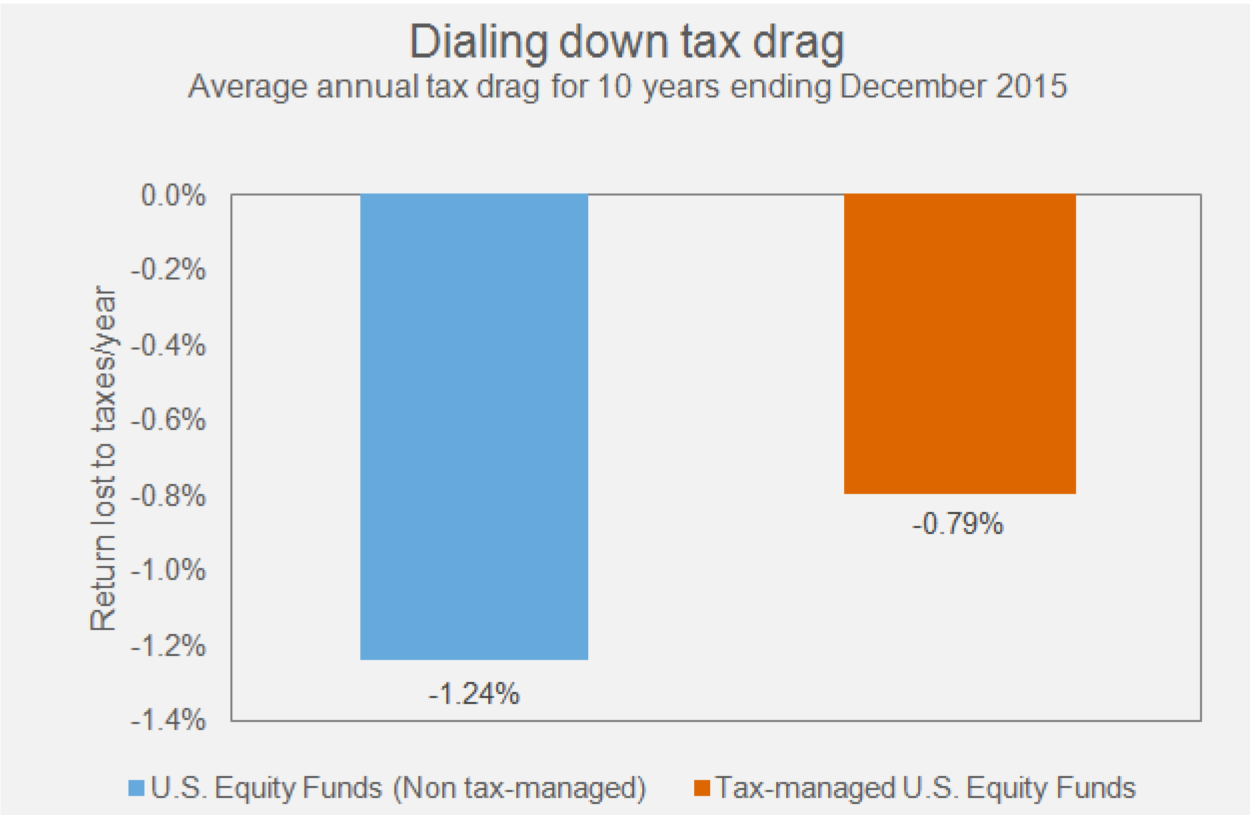
What is the value of typical ancillary services an advisor and their staff offer? Advisors and their staff consistently underestimate the value of the ancillary services - time saving and peace of mind during tax season, in preparation for retirement, custom requests and questions - they may provide their clients. These additional services can quickly consume 20, 50, or 100 hours each year. I estimate that value at 0.25% (assuming these are part of the annual advisory fee).

Value of P (planning costs and ancillary services) = 0.75% (0.50% for annual planning and 0.25% for other services outlined above)

T = Tax-aware planning/investing

For many of the investors who own a portion of the nearly $6 trillion in taxable (non-qualified) assets invested in open-end mutual funds,[4] 2015's after-tax investment returns may have clarified the impact that taxes can have on the overall return of an investment portfolio. Although the U.S. stock market[5] had flat returns for the year, thousands of funds had sizable capital gain distributions in 2015, further reducing the after-tax return investors earned. How frustrating is that?

2015 wasn't an anomaly. As the chart below, developed by my colleague Frank Pape—who has written extensively about the tax impact on portfolio returns—shows, the average annual tax drag for the 10-years ending Dec. 2015 is not a negligible sum.



Tax-Managed: funds identified by Morningstar to be tax-managed. Universe averages: Created table of all U.S. equity mutual funds and ETF'sas reported by Morningstar. Calculated arithmetic average for pre-tax, post-tax return for all shares classes as listed by Morningstar. Morningstar Categories included: U.S. ETF Large Blend, U.S. ETF Large Growth, U.S. ETF Large Value, U.S. ETF Mid-Cap Blend, U.S. ETF Mid-Cap Growth, U.S. ETF Mid-Cap Value, U.S. ETF Small Blend, U.S. ETF Small Growth, U.S. ETF Small Value, U.S. OE Large Blend, U.S. OE Large Growth, U.S. OE Large Value, U.S. OE Mid-Cap Blend, U.S. OE Mid-Cap Growth, U.S. OE Mid-Cap Value, U.S. OE Small Blend, U.S. OE Small Growth, U.S. OE Small Value.*

To clarify, tax-aware advisors can add value for their clients by:

- Helping build and implement a personalized, comprehensive tax-sensitive investment approach
- Implementing the plan by using a variety of appropriate products

So, what is the value of a tax-aware advisor over a 10-year period? It's at least the difference between:

- Average tax drag of non tax-managed U.S. equity mutual funds = 1.24%
- Average tax drag of tax-managed U.S. Tax-Managed Mutual Funds = 0.79%

Value of a tax-aware advisor is: 0.45% at minimum

T= 0.45% value of tax aware planning/investing

The bottom line

What is your true value as an advisor in 2016? Are you worth more than 1%, 2%, 3%? If you are delivering all of the services and value beyond the cost of investment-only advice then… A + B + C + P + T > Your fee

The value of your services individually may be:

Annual rebalancing 0.20% Investor behavior 2.10% Basic investment cost 0.25% Additional services/planning 0.75% Tax aware planning/investing 0.45% **2016 Value of an advisor 3.75%**

(For illustrative purposes only).

0.20% + 2.1% + 0.25% + 0.75% + 0.45% = 3.75% > Your fee

There you go…for our 2016 study the value of an advisor is: 3.75%. Be proud, as you are definitely worth more than the typical 1% fee you charge for advisory services.

"The stock market is filled with individuals who know the price of everything, but the value of nothing." - Phillip Fisher

As financial advisors, I challenge each of you to make 2016 the year in which we all work even harder to add and improve upon the value we deliver to clients and help them achieve their goals with greater certainty. When you truly deliver the value and service clients expect (value exceeds the price), investors who have received investment-only advice by an R2D2-type of robo-advisor will most likely become a natural referral source for your practice. Create value!

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[1] Russell 3000 Index from 12/31/2009 - 12/31/2013.[2] Based on the average fee charged for investment-only management by the top 10 robo advice offerings for a client portfolio of $500,000.

[3] FPA Research & Practice Institute, "Financial Planning in 2015: Today's Demands, Tomorrow's Challenges."

[4] Source: 2015 Investment Company Factbook, p. 212.

[5] Represented by the Russell 3000® Index.

*Methodology for Universe Construction: From Morningstar, extract U.S. equity and fixed income mutual fund and ETF's for reported period. Averages calculated on a given category. For example, average after-tax return for the large cap category reflects a simple arithmetic average of the returns for all funds that were assigned to the large cap category as of the end date run. For funds with multiple share classes, each share class is counted as a separate "fund" for the purpose of creating category averages. Morningstar category averages include every type of share class available in Morningstar's database. Large Cap/Small Cap/Municipal Bond determination based upon Morningstar Category. If fund is indicated by Morningstar as passive or an ETF, the fund is considered to be passively managed. Otherwise, the fund is considered to be actively managed. Tax Drag: Pre-tax return Less After-Tax Return (pre-liquidation) The Morningstar categories are as reported by Morningstar and have not been modified.

The Investment Company Institute is the national trade association of U.S. investment companies, which includes mutual funds, closed-end funds, exchange-traded funds and unit investment trusts.

The Russell 3000® Index measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market.

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