Dollars & Sense

How Much Value Can a Financial Advisor Add?

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I manage most of my finances, but I regularly get help from a Certified Financial Planner from Vanguard. I figure that it can only help to get an expert second opinion.

If you are one of those do-it-yourselfers who doesn't use a financial advisor, have you ever wondered if you should? If you did use one, how much value could they add, if any, to what you are already doing?

I recently stumbled upon a Vanguard paper for financial advisors from 2016 entitled "Putting a Value on Your Value - Quantifying Vanguard Advisor's Alpha." Remember, this paper is written for financial advisors, and it is talking about their "alpha."

What's Alpha?

Investopedia defines alpha as:
"Alpha is used in finance as a measure of performance. Alpha, often considered the active return on an investment, gauges the performance of an investment against a market index or benchmark which is considered to represent the market's movement as a whole. The excess return of an investment relative to the return of a benchmark index is the investment's alpha."

To me, a financial advisor's alpha would be the excess return they can add to your portfolio when you hire them versus if you just managed your investment portfolio yourself.

So What's Their Alpha?

In the paper, Vanguard estimates that advisors following their recommendations can add about 3 percent of net value. Three percent of additional return compounded over your investing lifetime could add significant value to your portfolio.

If I invested $18,500 per year (the maximum I can put in my government retirement account) for 30 years and earned 4% annually, I'd have about $1,037,000. If I earned 3 percent more (7 percent), I'd have about $1,747,000, a difference of $710,000. This is a simple example, but it can show you how small percentages can add up over time.

How Do They Add This Value?

The paper points out a number of ways they add value, including:

- Providing wealth management with financial planning, discipline, and guidance.
- Providing sound advice during market highs and lows, helping investors avoid poor investor behavior like chasing market performance and buying high or overreacting and selling low.
- By following the sound investment principles espoused by Vanguard (which many advisors and do-it-yourselfers don't follow).

The sound Vanguard investment principles mentioned in that last bullet are the provision of:

- A suitable asset allocation using broadly diversified mutual or exchange-traded funds.
- Cost-effective implementation with a focus on low expense ratios.
- Assistance with rebalancing.
- Behavioral coaching.
- Optimized asset location.
- A proper spending/withdrawal strategy.
- A focus on total-return instead of income investing.

The Caveats

There are a few caveats to the value an advisor can add. Most investors assume that an advisor will add value by trying to beat the market return, but that is so difficult that almost no one can succeed. They generate too many extra investment and trading costs trying to do it.

In addition, in the paper they talk about how an advisor who deviates from a standard portfolio (which is diversified, low-cost, and market-cap weighted) runs a higher risk of losing their clients due to significantly inferior investment returns.

The value added by an advisor is not consistent. The value they add is intermittent, most often during market highs or lows, also described as "lumpy" in the paper.

The value they add is not easily quantified, which presents a real problem for advisors when trying to demonstrate their worth.

The Bottom Line

Vanguard feels that advisors following their methodology can add about 3% of alpha (or excess investment return) per year, concentrated during period of market highs and lows that tend to cause poor investment behavior. Some of the value provided by advisors is not quantifiable, though, such as the piece-of-mind provided by knowing you obtained expert help.

As I said in the beginning, I'm largely a do-it-myselfer, but appreciate the periodic second opinion that my Vanguard advisors provide.

If you'd like to contact me, please e-mail me at jschofer@gmail.com or check out the two blogs I write for, MCCareer.org and MilitaryMillions.com.

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