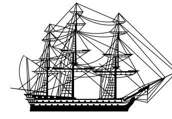


# Vanguard Advisor's Alpha®

Vanguard Research

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- Since the creation of the Vanguard Advisor'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 Advisor's Alpha concept outlines how advisors can add value, or alpha, by providing relationship-oriented services—such as cogent wealth management via financial planning, behavioral 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 can add meaningful value compared to the average investor experience, currently advised or not.
- We believe implementing the Vanguard Advisor's Alpha framework offers the opportunity to add net returns in excess of the standard fees charged for advisory services.

*Acknowledgments:* This paper is the most recent update of Vanguard research first published in 2010 under the same title. For additional information on the Vanguard Advisor's Alpha framework, see *Putting a Value on Your Value: Quantifying Vanguard Advisor's Alpha®* (2016) by Francis M. Kinniry Jr., Colleen M. Jaconetti, Michael A. DiJoseph, Yan Zilbering, and Donald G. Bennyhoff and *The Evolution of Vanguard Advisor's Alpha®: From Portfolios to People* (2018) by Donald G. Bennyhoff, Francis M. Kinniry Jr., and Michael A. DiJoseph.

What is advisor's alpha? The Vanguard Advisor's Alpha concept outlines how advisors can add more consistent value, or alpha, through wealth management in the form, for instance, of financial planning, behavioral coaching, and guidance—rather than outperforming a policy portfolio, which has historically been the primary value proposition for many advisors. For some clients, paying fees to an advisor whether or not transactions occur may seem like "money for nothing" and not much of a value proposition. However, this is viewing the advisor'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 advisor 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 advisors 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 advisor." In this framework, an advisor'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

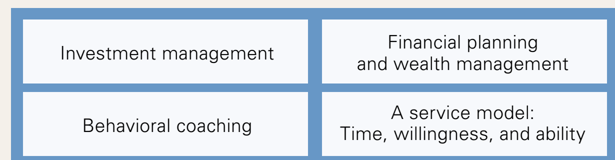
Although Vanguard is best known for its index funds, the company also provides low-cost, actively managed funds in many investment strategies and asset classes. We believe this gives Vanguard a uniquely objective perspective on using active management to enhance relative returns.

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

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

The focus:

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




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

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

- The traditional value proposition for financial advisors 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 advisor, you are the value. The Vanguard Advisor's Alpha framework emphasizes 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-U.S. 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 realized through the fund's trading or through your own redemption of shares. For some investors, a portion of the fund's income may be subject to state and local taxes, as well as to the federal alternative minimum tax. Consider consulting a tax advisor regarding your individual situation.*

*Conclusions of this analysis are based on aggregate data. Performance of individual funds or advisors 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 Rowley, Walker, and Yating Ning, 2018). *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 advisors 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 **Figure A-1** in the appendix, on pages 9–10, over longer time frames the added expense of active management often proves too much to overcome.

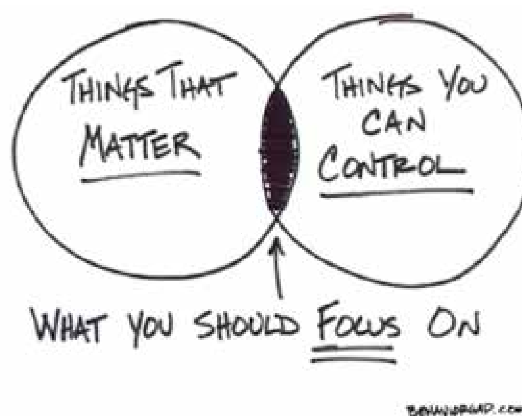
A value proposition based primarily on outperforming the market puts an advisor at a meaningful disadvantage and—using history as a guide—is hard to fulfill consistently over time. Not only does success depend on factors outside the advisor's control, such as the returns from individual securities or 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 materialize. Fortunately, the advisor's alpha model emphasizes more reliable benefits of a professional relationship.

Figure 2. Asset-weighted average expense ratios of active and index mutual funds as of December 31, 2017

| | Investment type | Actively managed funds | Index funds | ETFs |
|---|---|---|---|---|
| U.S. stocks | Large-cap | 0.67% | 0.08% | 0.12% |
| | Mid-cap | 0.82 | 0.12 | 0.20 |
| | Small-cap | 0.88 | 0.12 | 0.16 |
| U.S. sectors | Stock sector | 0.84 | 0.50 | 0.27 |
| | Real estate | 0.80 | 0.12 | 0.17 |
| International stocks | Developed market | 0.78 | 0.12 | 0.21 |
| | Emerging market | 0.98 | 0.18 | 0.31 |
| U.S. bonds | Corporate | 0.47 | 0.07 | 0.07 |
| | Government | 0.39 | 0.05 | 0.12 |

**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 Advisor's Alpha but the essence of how we believe investors and advisors 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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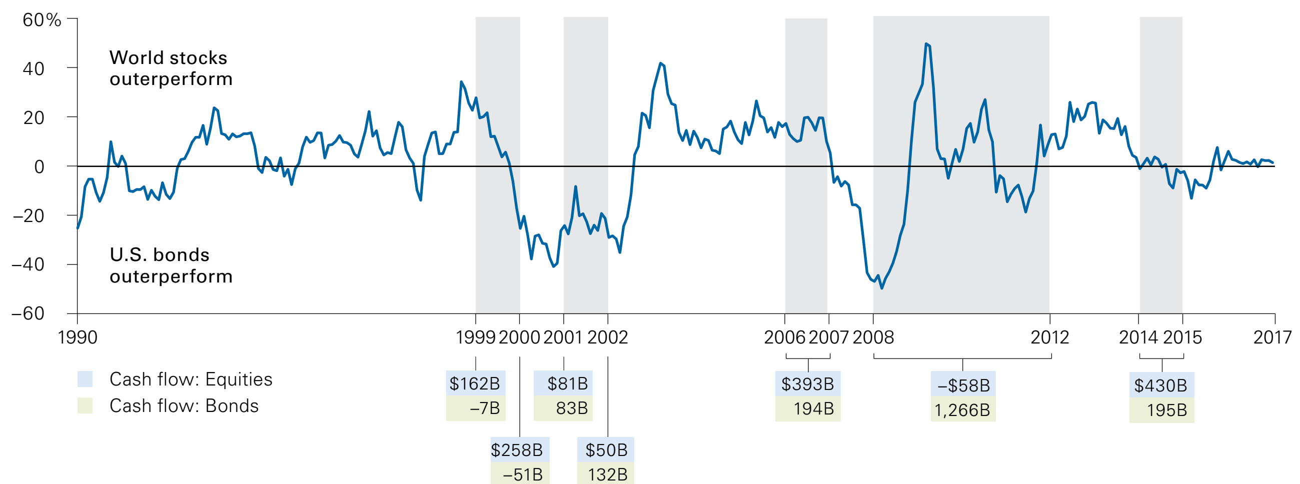
## Professional stewardship: Central to the advisor's alpha model

Rather than placing its major focus on investment capabilities, the advisor's alpha model relies on the experience and stewardship that the advisor can provide in the relationship. Left alone, investors often make choices that impair their returns and jeopardize 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 behavior 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,[1] since cash flows tend to be attracted by, rather than precede, higher returns. On average, for the ten years ended December 31, 2017, fund investors trailed a moderate policy allocation by 0.76 percentage point (76 basis points) per year, according to Morningstar. The advisor'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 behavior is often associated with individual investors, evidence suggests that institutions engage in it 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**). Advisors, as behavioral 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 U.S. bond market compared with net highlighted cash flows: 1990–2017**




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

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

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

## Adding value through portfolio construction

Many advisors use a "top-down" approach that starts with analyzing 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 advisors 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

**Figure 4. Investor returns versus fund returns: Ten years ended December 31, 2017**

| | | Value | Blend | Growth |
|---|---|---|---|---|
| Large-cap | Time-weighted fund category return | 6.84% | 7.98% | 8.69% |
| | Investor return | 5.98 | 7.47 | 7.14 |
| | Difference | –0.86 | –0.51 | –1.55 |
| Mid-cap | Time-weighted fund category return | 7.81 | 7.91 | 8.32 |
| | Investor return | 6.56 | 7.77 | 5.88 |
| | Difference | –1.25 | –0.13 | –2.45 |
| Small-cap | Time-weighted fund category return | 8.01 | 8.33 | 8.47 |
| | Investor return | 7.79 | 7.80 | 7.51 |
| | Difference | –0.22 | –0.53 | –0.96 |

| | Cautious allocation | Moderate allocation |
|---|---|---|
| Time-weighted fund category return | 4.52% | 6.39% |
| Investor return | 4.15 | 5.63 |
| Difference | –0.38 | –0.76 |

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

**Notes:** The time-weighted returns in this figure represent the average fund return in each category. Investor returns assume that the growth of a fund's total net assets for a given period is driven by market returns and investor cash flows. An internal rate-of-return (IRR) function is used, which calculates the 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. For allocation fund categories, we have included fund-of-fund assets and cash flows to best capture investors' true experiences where the fund-of-fund structure is common. Cautious allocation uses Morningstar's U.S. fund allocation categories including 15% to 30% equity and 30% to 50% equity. Moderate allocation uses Morningstar's U.S. fund allocation category including 50% to 70% equity.

**Sources:** Vanguard IRR calculations using data from Morningstar, Inc.

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

| | Before manager change | | | After manager change | | |
|---|---|---|---|---|---|---|
| Years | 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 |

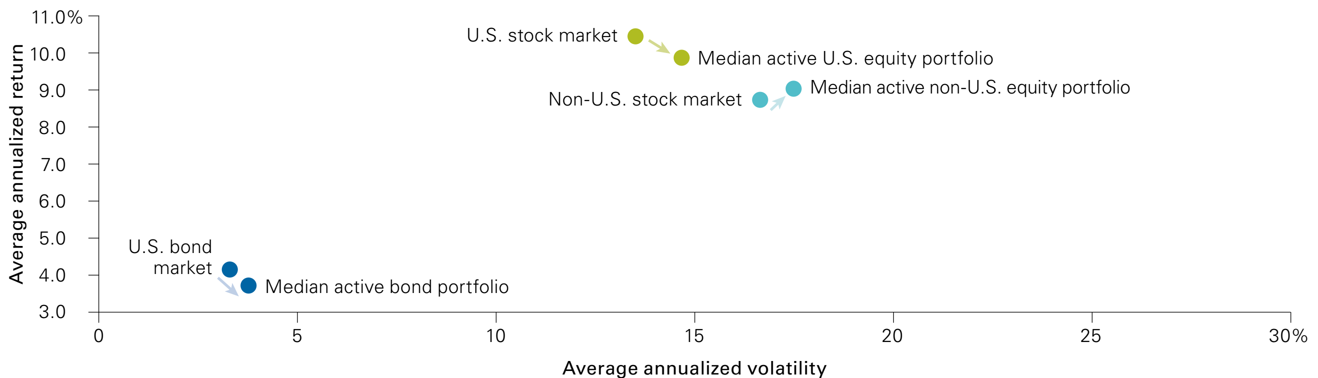
**Source:** Goyal and Wahal (2008), based on 8,775 hiring decisions by 3,417 plan sponsors delegating $627 billion in assets, and 869 firing decisions by 482 plan sponsors withdrawing $105 billion in assets.

expect assets with more return uncertainty (such as stocks or high-yield bonds) to outperform lower-risk assets over the long run.

Once an asset allocation has been determined, advisors 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 advisor 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.[2] 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.[3] 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, 2003–2017**

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




**Notes:** Portfolio weights approximate relative allocations within each market as of December 31, 2017. Median active U.S. bond portfolio comprises two funds allocated to the portfolio as: 68%, median government fund; 32%, median corporate fund. Median active U.S. 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-U.S. equity portfolio comprises two funds allocated to the portfolio as: 80%, median developed-markets fund; 20%, median emerging-markets fund. Returns and volatility cover 15 years ended December 31, 2017.

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.

2 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."

3 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 advisors) 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 3 tend to result, often with the greatest differential in net cash flows occurring at or near the peak in relative outperformance.[4] For example, Figure 3 shows that in 1999 and 2000, cash flows into U.S. 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 advisors 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 advisors 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 advisor 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 munis 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 Bloomberg Barclays U.S. Aggregate Bond Index. Historically, the muni/taxable yield differential has been approximately 111 basis points per year (though amid the recent stresses in the U.S. financial markets, munis have sometimes yielded more than taxable bonds, an unusual occurrence).[5]

An advisor 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 annualized 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 advisor 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 advisor's alpha, adding clear value by helping to improve the client's after-tax returns.

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

5 The average (median) yield differential (muni/taxable spread) for the Bloomberg Barclays U.S. Aggregate Bond Index and the Bloomberg Barclays Municipal Bond Index from January 1980 through December 2017 was 1.11% (i.e., 111 basis points); as of December 31, 2017, the muni/taxable spread for the same indexes was 0.35% (35 basis points).

Further, clients who are retired can often 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 personalized, and promote the client's confidence in the strategy and the advisor. 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.[6]

## Conclusion

The compensation structure for advisors 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 advisors. However, the traditional value proposition for many advisors 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 advisor, 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, advisors should consider a new value proposition based on alternative skills and expertise: They should act as wealth managers and behavioral 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 advisor's alpha framework we've described, the advisor becomes an even more important factor in the client-advisor relationship. Our analysis and conclusions are meant to motivate you as an advisor to adopt and embrace these best practices as a reasonable framework for describing and differentiating your value proposition. The Vanguard Advisor'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 can add meaningful value compared to the average investor experience, currently advised or not. We believe implementing the Vanguard Advisor'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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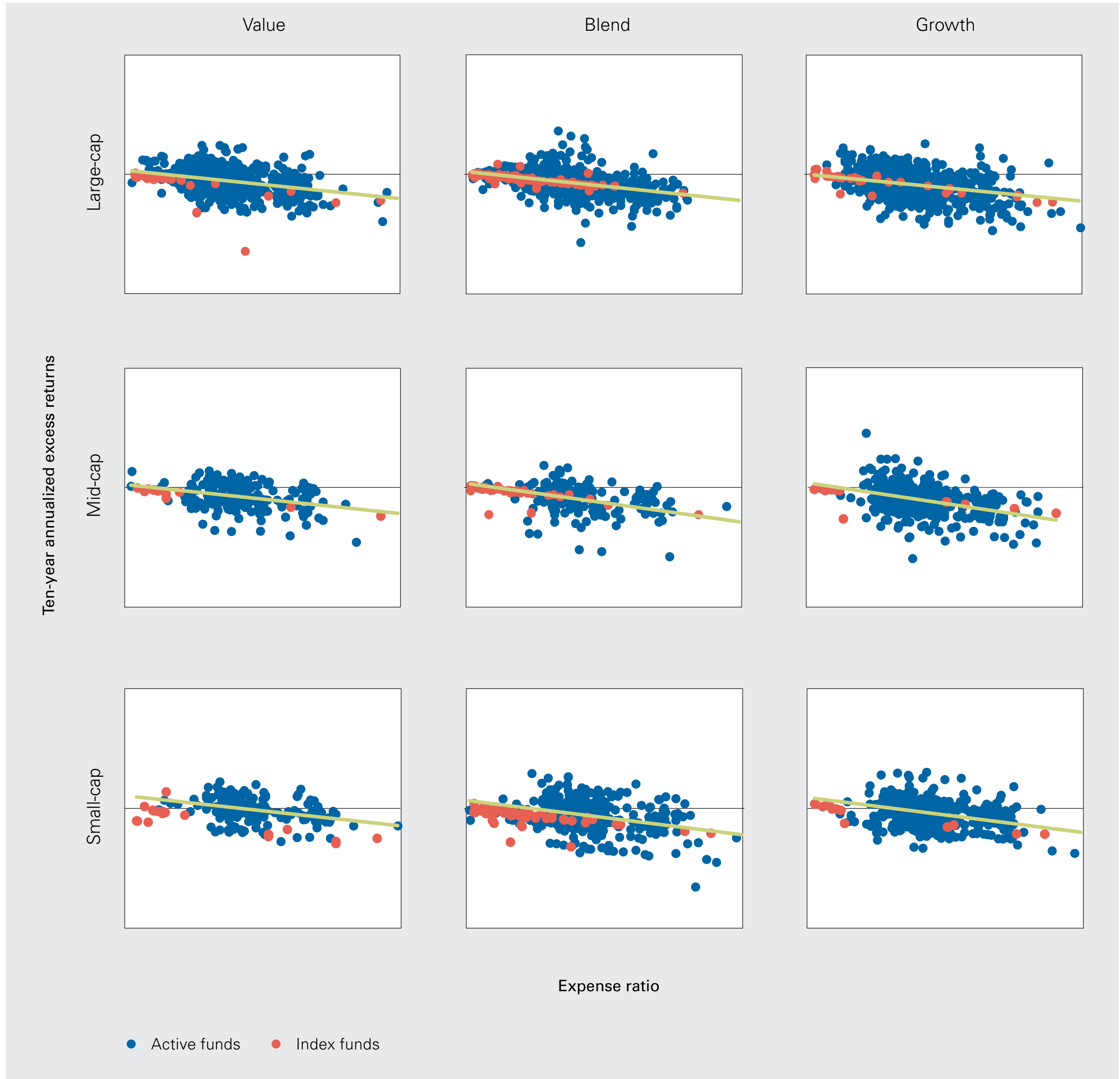
6 For more information on the topic, see Kinniry et al. (2016).

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

Figure A-1. Higher expense ratios were associated with lower excess returns for U.S. funds: As of December 31, 2017

a. U.S. equity funds




*(Continued on page 10)*

Figure A-1 *(Continued).* Higher expense ratios were associated with lower excess returns for U.S. funds: As of December 31, 2017

b. U.S. bond funds

**Notes:** Index funds noted in red. Each plotted point represents a U.S. mutual fund within the specific size, style, and asset group. Each fund is plotted to represent the relationship of its expense ratio (x-axis) versus its ten-year annualized excess return relative to its stated benchmark (y-axis). The straight line represents the linear regression, or the best-fit trend line—that is, the general relationship of expenses to returns within each asset group. The scales are standardized to show the slopes' relationship to each other, with expenses ranging from 0% to 3% and returns ranging from –15% to 15% for equities and from –5% to 5% for fixed income. Some funds' expense ratios and returns go beyond the scales and are not shown.

**Sources:** Vanguard calculations, using data from Morningstar, Inc. All data as of December 31, 2017.

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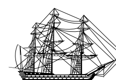

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