Vanguard | Advisory Research Centre

ADVISER'S ALPHA® PERSPECTIVES | JUNE 2025

Quantifying Adviser's Alpha® in the UK: Putting a value on your value

Introduction

- In 2001, Vanguard introduced the Adviser's Alpha concept in the US, highlighting how advisers could generate more substantial and predictable value, or alpha, through financial planning, behavioural coaching and relationship-oriented services.
- At that time, the primary value proposition for advisers was to try to outperform the market, with indexing and low-cost investing comprising less than 10% of advisory portfolios.
- In 2014, *Quantifying Advisor's Alpha* was published in the US, which found that advisers that follow wealth management best practices could add up to, or even exceed, 3% in net returns[1] for their clients while also providing them with a tangible way to differentiate their skills and practices.
- In 2020, *Quantifying Adviser's Alpha in the UK*: was published in the UK, which took into account the UK tax and regulatory landscape and paved the way for a more localised approach to Adviser's Alpha research in new markets.
- Over the past 25 years, Vanguard and the investment advisory community have maintained a strong partnership, with advisers widely adopting the Adviser's Alpha framework. This collaboration has led to a significant transformation in how advisory portfolios are managed, with advisers moving to more transparent, positive-sum activities — resulting in material improvements to clients' investment outcomes.
- While financial markets will continue to experience both bull and bear cycles, we believe there will always be a secular bull market for fee-based investment advice from advisers that embrace the value creation activities within the Adviser's Alpha framework.

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1 Like any approximation, the actual amount of value added may vary significantly, depending on a client's circumstances.

This year marks the 25th anniversary of Vanguard Adviser's Alpha – making it an opportune time to reflect on its impact on the advisory industry and its role in improving client outcomes. The widespread adoption of the Adviser's Alpha approach, coupled with the industry trends we will discuss, has led to a heightened focus on positive-sum activities and relationship-oriented services – resulting in better outcomes for clients and advisory practices alike.

2001: Vanguard introduces the concept of Adviser's Alpha in the US

When Vanguard Adviser's Alpha was introduced in the US in 2001, it revolutionised the traditional value proposition of financial advice with a focus on planning, tax optimisation, wealth management and behavioural coaching **(Figure 1)** — rather than by outperforming a policy portfolio, which was the dominant adviser value proposition at the time.

Figure 1: The Adviser's Alpha concept

Source: Vanguard Advisory Research Centre.

Adviser's Alpha brought to light that a value proposition based primarily on outperforming the market puts an adviser at a meaningful disadvantage and, if history offers any guidance, 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 can also lead to a focus on short-term performance, leading clients to "drop out" if the promised outperformance does not materialise. Instead, Adviser's Alpha emphasises the more consistent and reliable benefits of a professional advisory relationship. Advisers can add meaningful value by helping their clients with asset allocation, investment selection, rebalancing, tax-efficient strategies, cash flow management, family and legacy planning and coaching during periods of market volatility — each of which are well within an adviser's control.

At this time, the compensation structure for advisers was evolving from a commission- and transaction-based system to a fee-based asset management framework. This aligned with the principles of Adviser's Alpha, reflecting a move towards aligning adviser and client interests and emphasising long-term financial objectives over short-term transactions.

Finally, Adviser's Alpha highlighted that beyond providing clients with a more stable and disciplined investment experience, following the framework could enhance advisory practices by building trust and client retention through demonstrable and consistent value creation, thereby putting clients in the best position to meet their long-term financial goals.

2014: *Putting a value on your value: Quantifying Vanguard Advisor's Alpha®*

As the advisory industry continued to gravitate towards fee-based advice, there was a great temptation to define an adviser's value-add as an annualised number. In this way, advisers could justify the fees they deducted by quantifying the 'annual value-add' they provided to clients. The critical question, therefore, was: how much value does Vanguard believe advisers can add by following the Adviser's Alpha framework? This, in turn, led to our seminal research paper, *Putting a value on your value: Quantifying Vanguard Advisor's Alpha®*, which found that **advisers can potentially add up to, or even exceed, 3% in net returns by using the Vanguard Adviser's Alpha framework**.

Figure 2 provides a summary of what we believe are the most valuable wealth management activities that advisers can provide[2]. We look at each of these practices in greater detail in the modules section beginning on page M-1.

Figure 2. The value-add of best practices in wealth management

Vanguard Adviser's Alpha strategy	Module	Value-add relative to "average" client experience (in basis points of return)
Suitable asset allocation using broadly diversified funds/ETFs	1	> 0*
Investment selection	2	0 to 100
Rebalancing	3	12
Behavioural coaching	4	Up to 200 or more
Asset location	5	0 to 45
Tax-efficient retirement strategy	6	Up to 112 or more
Total return versus income investing	7	> 0*
Range of potential value added		**Up to, or exceeding, 3% in net returns**

* Value is deemed significant but too unique to each investor to quantify.

Notes: We believe implementing the Adviser's Alpha framework can add about 3% in net returns for your clients and allow you to differentiate your skills and practice. The actual amount of value added may vary significantly, depending on a client's circumstances. "3% in net returns" means three percentage points of additional net return over an unspecificed period.

Source: Vanguard Advisory Research Centre.

> "Vanguard's *Adviser's Alpha* white paper was the most seminal thing ever written about the ways in which financial advisers can add value to a client away from the fussing over asset management. I don't know a single serious person in our industry that hasn't read it, shared it and internalised it."
>
> Josh Brown, CEO, Ritholtz Wealth Management & CNBC commentator

2 The quantification of value compares the projected results of a portfolio that is managed using well-known and accepted best practices for wealth management with those that are not. Obviously, results will vary significantly.

Because clients only get to keep, spend or bequest net returns, the focus of wealth management should always be on maximising net returns. While some of the strategies herein can be expected to yield an annual benefit — such as reducing expected investment costs or taxes — the most significant opportunities present themselves not consistently but intermittently, often during periods of market duress or euphoria. These opportunities can pique investors' fear or greed, tempting them to abandon well-thought-out investment plans. In such circumstances, the adviser may have the opportunity to add tens of percentage points of value-add, rather than mere basis points (bps)[3], potentially offsetting years of advisory fees.

Similarly, we cannot hope to define here every avenue for adding value; instead, our analysis focuses on the most common advisory activities for adding value, particularly those that are widely applicable and measurable. For example, creating a will, engaging in estate planning, facilitating the transfer of wealth between generations and supporting appropriate and tailored protection planning are just a few of the activities (among hundreds more) where advisers can add tremendous value in the right circumstances – but are not as universally applicable and/or may be more difficult to broadly quantify. In addition, for some investors without the time, willingness or ability to confidently manage their financial matters, working with an adviser is likely to be the best, if not the only, option. They may simply prefer to spend their time doing something else. In this context, the value of an adviser is virtually impossible to quantify. Nonetheless, the overwhelming majority of fund assets are advised, indicating that investors strongly value professional investment advice.

Paying a fee to a professional adviser who follows the Vanguard Adviser's Alpha framework can add value in comparison to the average investor experience, currently advised or not. Many advisers are already applying these best practices and adding value; others have the opportunity to move closer to these outcomes for their clients. As a result, we present the potential total value-add as a range. Note that individual client circumstances can result in outcomes closer to the lower end, or exceed the upper end, of the range.

Finally, we are in no way suggesting that every adviser, charging any fee, can add value. Instead, advisers can add value if they follow the techniques and activities that have been shown to have a high probability of adding positive value and avoiding the activities that have negative value.

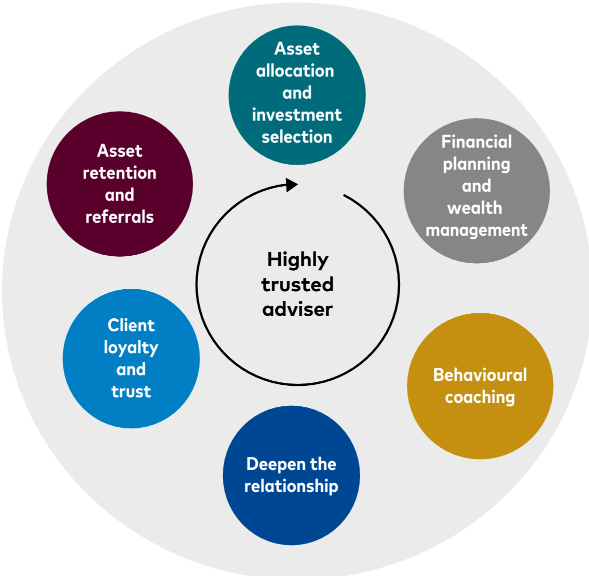
Our aim is to motivate advisers to adopt and embrace these best practices and to provide them with a framework for describing and differentiating their value propositions.

Ultimately, clients decide the value of advice, and, as our research has shown, they clearly value and reward an adviser they highly trust. But establishing trust takes time and a concerted effort, and time is a limited resource. However, advisers have a number of tools and strategies to better use the time they have: they can use technology-enabled efficiencies to streamline client onboarding, portfolio construction and ongoing management. They can form advisory teams to capitalise on the diverse skills and increased capacity to serve clients well as a group and can use every contact with clients as an opportunity to make them feel valued, respected and cared for. Advisers must judge for themselves the best use of their limited time, but the benefits from allocating more of their time to client relationships may be unsurpassed by other efforts.

As illustrated by our Adviser's Alpha flywheel (**Figure 3**), the value of an adviser has evolved into a collective of different activities – benefitting both clients and advisers that have adopted the Adviser's Alpha framework.

Figure 3: Vanguard Adviser's Alpha flywheel

Collective activity increases the probability of improving client and practice outcomes



Source: Vanguard Advisory Research Centre.

Vanguard Adviser's Alpha: Good for advisory clients and advisory practices

The Vanguard Adviser's Alpha framework is not only good for advisory clients — it also provides benefits for advisory practices. With the compensation structure for advisers evolving from a commission- and transaction-based system to a fee-based asset management framework, assets – asset retention, and referrals – are paramount. Following our framework enhances the advisory practice by building trust and client retention through demonstrable, consistent value addition creation while also providing a means for advisers to differentiate their value and practices.

3 One basis point equals 1/100 of a percentage point.

2025: Celebrating Vanguard Adviser's Alpha

As we mark the 25th anniversary of the Vanguard Adviser's Alpha framework and the fifth anniversary of our UK version, now is an opportune time to reflect on the evolving value proposition of financial advisers compared with 25 years ago, when the financial advisory landscape was characterised by high fees and a more transactional approach to client relationships.

Fast forward to today and the picture has changed dramatically. The focus has shifted away from low-probability, negative-expected-return activities like chasing hot funds and cost-agnostic attempts to outperform, towards higher-probability, positive-expected-return activities like those outlined in the Adviser's Alpha framework.

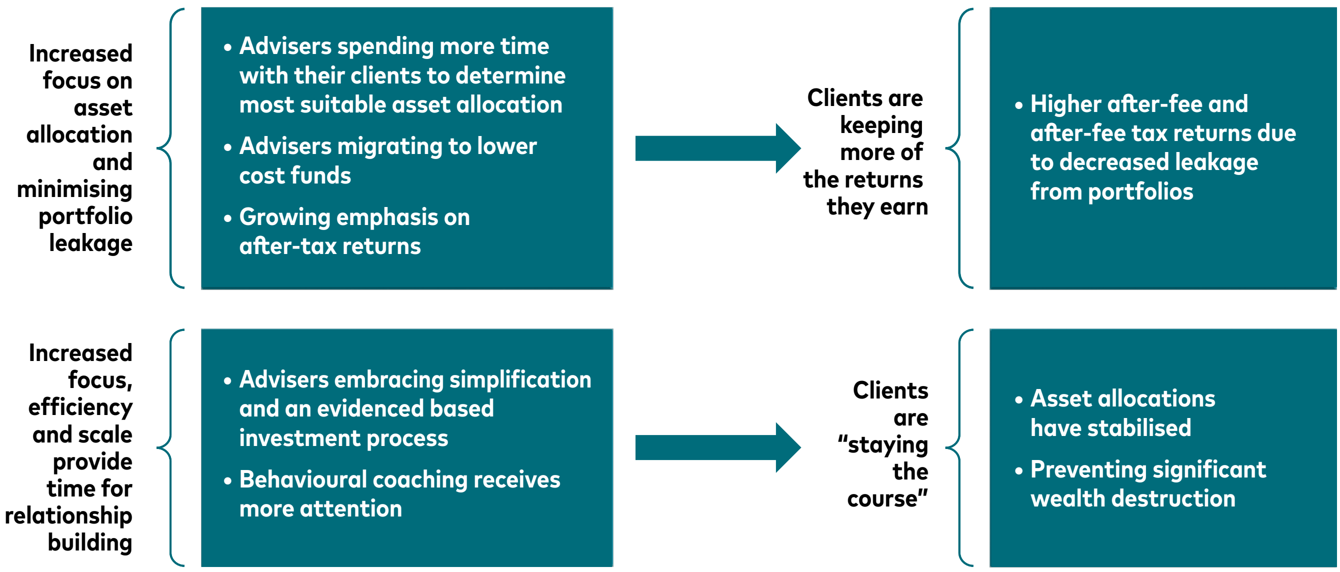
This transition represents a fundamental change in the advisory industry's approach to wealth management, prioritising evidence-based strategies that are within the adviser's sphere of influence.

As a result, the industry has experienced:

1. Materially lower expense ratios.
2. The stabilisation of asset allocations due to proactive behavioural coaching – in other words, less performance-chasing behaviour as well as a higher commitment to rebalancing.
3. The rise of index and market-cap-weighted investing.
4. An increased focus on after-tax wealth and financial planning.

By adopting Adviser's Alpha best practices, advisers have been able to provide more consistent and reliable value to their clients, and clients are keeping more of the returns that they earn (**Figure 4**).

Figure 4: Advisers are delivering more... and investors are keeping more



Source: Vanguard Advisory Research Centre.

As advisers have evolved their individual value propositions, they have simultaneously transformed the value proposition of the entire advisory industry – benefitting clients, advisers and the industry overall.

In turn, advisers' assets under management (AUM) have increased as well as client satisfaction, retention and referrals. A true win-win for clients and advisers.

While so many positive developments have occurred since Adviser's Alpha was first introduced, these three stand out:

I. Minimising return leakage

In recent years, there has been a heightened emphasis on minimising return leakage. Return leakage usually refers to reducing preventable fund losses due to various factors, with three particularly noteworthy ones over the last 25 years:

1. Shift in adviser fund selection criteria.
2. Shift in focus from maximising pre-tax returns to maximising after-tax returns.
3. Advisers becoming proactive behavioural coaches.

1. Shift in adviser fund selection criteria

The financial advisory landscape used to be characterised by higher fees and a more transactional approach to client relationships. Yet over the past two decades, advisers have increasingly prioritised fund selection criteria such as low costs and highly-talented teams, rather than relying on past performance alone, which often overlooks the impact of costs.

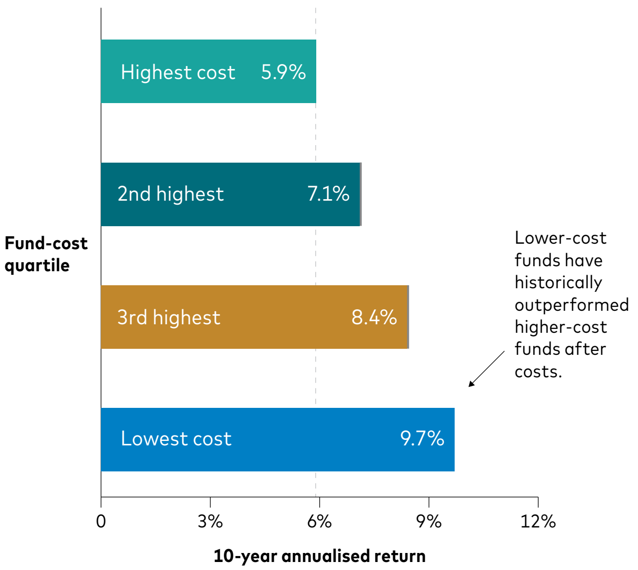
The transformation has been nothing short of staggering. Investors and advisers have radically changed their fund selection process, from chasing trailing returns to an evidence-based method using lower-cost funds with talented teams – resulting in lower average expense ratios for both equity and fixed income funds.

Since 2001, UK equity fund expense ratios have fallen to 0.39% and UK fixed income fund expense ratios have fallen to 0.27%[4].

This shift towards lower-cost funds has not only reduced the cost of investing but has also delivered better net outcomes for investors. **Figure 5** shows that, over the last ten years, the funds in the lowest-cost quartile have outperformed higher-cost funds, delivering higher net returns to investors while meaningfully reducing the costs of investing.

Figure 5: Lower-cost funds can support higher returns to investors

Average annualised returns of equity funds, 2014-2024



Notes: We considered all active equity funds available in Morningstar Direct that survived the period of 31 December 2014 to 31 December 2024, regardless of where they were available for sale. In total, there were 7,669 funds. Each fund is represented by its oldest share class. Average annualised returns are calculated in GBP and net of expenses, excluding loads and taxes. We relied on prospectus expense ratios when they were reported; otherwise, we approximated the expense ratio using the annual expense net ratio, which is based on the actual fee charged. By cost quartile, the average expense ratios are: 0.55% (lowest-cost quartile), 1.10% (second-lowest-cost quartile), 1.61% (second-highest-cost quartile) and 2.36% (highest-cost quartile).

Source: Vanguard calculations, using data from Morningstar, Inc.

4 Source: Vanguard Advisory Research Centre, using data from Morningstar, Inc.

2. Shift in focus from maximising pre-tax returns to maximising after-tax returns

Over the last 25 years, advisers have increasingly focused on reducing tax drag via prudent financial planning techniques such as tax-efficient fund selection, asset location, tax-efficient rebalancing and tax-efficient, to name a few.

In 2001, tax-optimised investment strategies were most often reserved for the ultra-high-net-worth advisory segment due to the time and complexity involved. However, as tax-optimised software has become more accessible and user-friendly, these services are now more widely available. This democratisation has improved after-tax outcomes for advised clients and simultaneously bolstered the value proposition of advisory practices and their offerings. (For more detailed information on each of these, see the **Adviser's Alpha Quantification Modules starting on page M-1.**)

By managing every decision and action with tax implications in mind, advisers can help their clients keep more of the returns they earn without increasing risk.

3. Advisers becoming proactive behavioural coaches

One way to gauge the impact of advisers making strides in proactive behavioural coaching is to analyse how they select funds. Another way to gauge advisers effectively operating as behavioural coaches is to examine the overall asset allocation for fund industry assets through time. In the past, asset allocations were trend-following; thus implying allocators may not have been as prudent in rebalancing or were chasing performance. However, in the last 7-10 years, asset allocations have remained remarkably stable — despite the fact this period was characterised by very strong equity returns with two equity bear markets sandwiched in between. Our research reveals that fund allocators, including financial advisers acting on behalf of their clients, remained disciplined and rebalanced their portfolios, which is a meaningful shift from prior decades.

As a result, investors have had much lower asset allocation drift, resulting in lower net return leakage compared to most of history, and leading to improved outcomes for both investors and advisers. This behaviour is notably different from previous bear market recoveries and aligns with our Adviser's Alpha research.

Potential catalysts for stabilisation of aggregate industry asset allocations

We hypothesise several potential catalysts for these positive developments: 1) the movement towards a top-down versus bottom-up investing process; 2) the rapid diffusion of ETFs and a more institutional client base that may use them; 3) the adoption of the Adviser's Alpha framework by the advisory community; and 4) the penetration of investment solutions and allocators that rebalance. While the jury is still out on whether these trends are cyclical or secular, our hypothesis – that advisers have successfully helped their clients tune out the noise and stay the course – has held strong.

By steadfastly providing education, guidance and emotional support, especially during periods of market volatility, advisers have likely prevented significant wealth destruction for their clients, potentially offsetting a lifetime of fees in the process.

Behavioural coaching: Setting clear expectations

Proactive behavioural coaching focuses on educating clients up front — as it is extremely difficult to educate and coach in the midst of a raging bull or bear market since emotions are naturally running high.

To this end, advisers have increasingly helped their clients understand the rationale behind their asset allocation, the potential outcomes and the inherent risks. By setting realistic expectations, advisers have helped clients be in a better position to "tune out the noise" and reach their investment goals.

This type of coaching is particularly important when materially deviating from a market-cap-weighted portfolio. Our Adviser's Alpha research has shown that consistently beating a market-cap-weighted portfolio is a formidable challenge. While it's not impossible, achieving returns that beat the market consistently over the long term without taking on excessive risk is exceptionally difficult.

Investing is rife with ironies such as the paradox of skill and the fact that most engaged in the pursuit of outperforming the markets end up underperforming them. The acknowledgment and understanding of this critical insight has led many advisers to adopt Vanguard Adviser's Alpha as the framework for their advisory practices.

Consequently, many advisers are moving further into goals-based financial planning, where they have a much higher probability of adding value for their clients as opposed to trying to predict the future of the financial markets. By educating clients on how market capitalisations are formed and explaining the potential impact of deviations from a market-cap-weighted portfolio, advisers have empowered their clients to make informed decisions and remain committed to their financial plans. This shared understanding has shaped the strategies employed, enhanced the adviser's value proposition and deepened client relationships by more closely aligning client and adviser expectations.

Advisers acting as "emotional circuit breakers" for their clients can prevent significant wealth destruction

Behavioural coaching also focuses on real-time support and guidance, particularly during periods of market volatility. In times of stress, clients often look to their financial advisers as guardians of their financial and emotional well-being. Our Adviser's Alpha research has shown that periods of uncertainty and capital losses are the "moments that matter" and "Adviser's Alpha weather". During these critical times, advisers have acted as "emotional circuit breakers" for their clients (see Vanguard's 3B mental model on page 9), saving them hundreds of thousands or even millions of pounds, potentially offsetting years or even a lifetime of fees, as seen in **Figure 6.**

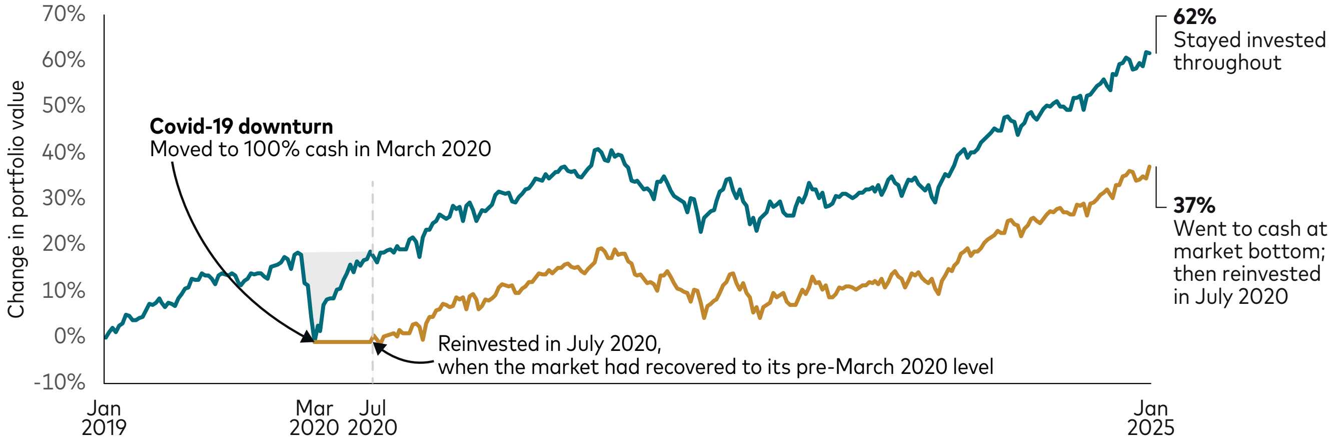
The chart demonstrates how a diversified investor has fared relatively well by sticking with a balanced portfolio even through severe market downturns. While it's understandable to want to alleviate immediate emotional pain and anxiety by moving out of declining assets, deviating from one's long-term asset allocation after market falls has proven detrimental to a portfolio's long-term growth. This common reaction underscores the challenge of staying the course.

Figure 6 tracks a 60% stock/40% bond portfolio's performance from 1 January 2019 to 31 December 2024, covering the period of the Covid-19 crisis.

Here's what it shows:

- **Stayed invested:** An investor who stayed with their 60/40 allocation throughout would have earned a 62% return.
- **Moved to cash:** An investor who moved to 100% cash in March 2020 at the market bottom and re-entered in July 2020 after the market had recovered would have earned a 37% return.

Figure 6: Reacting to market turbulence can jeopardise returns



Past performance is not a reliable indicator of future results.

Notes: The chart compares two UK investors with starting portfolios comprised of 60% shares and 40% bonds. Shares are represented by the FTSE Global All Cap Index, in GBP. Bonds are represented by the Bloomberg Global Aggregate Bond Index (GBP Hedged). Cash is represented by the Sterling Overnight Index Average (SONIA) rate. Returns do not take into account inflation.

Source: Vanguard calculations, using data from Morningstar, for the period 1 January 2019 to 1 January 2025.

While this is an extreme example, in our decades of analysing risk appetite and investor cash flows, we have seen that the moments that matter— like in times of market distress and contagion — often coincide with investors de-risking from higher-risk assets into lower-risk assets.

Throughout most of history, equity allocations have peaked at market highs and bottomed at market lows, which has led to tangible wealth destruction. However, the steadying of industry asset allocations during recent bull and bear market episodes underscores the positive influence of the collaboration between Adviser's Alpha and the advisory community in enhancing client outcomes.

By integrating these principles, advisers have fostered stronger client relationships, reduced stress and enhanced long-term investment success.

Vanguard's 3B mental model

To better manage client stress during periods of uncertainty, advisers have adopted our 3B mental model to help educate clients to tune out the noise and stay the course.

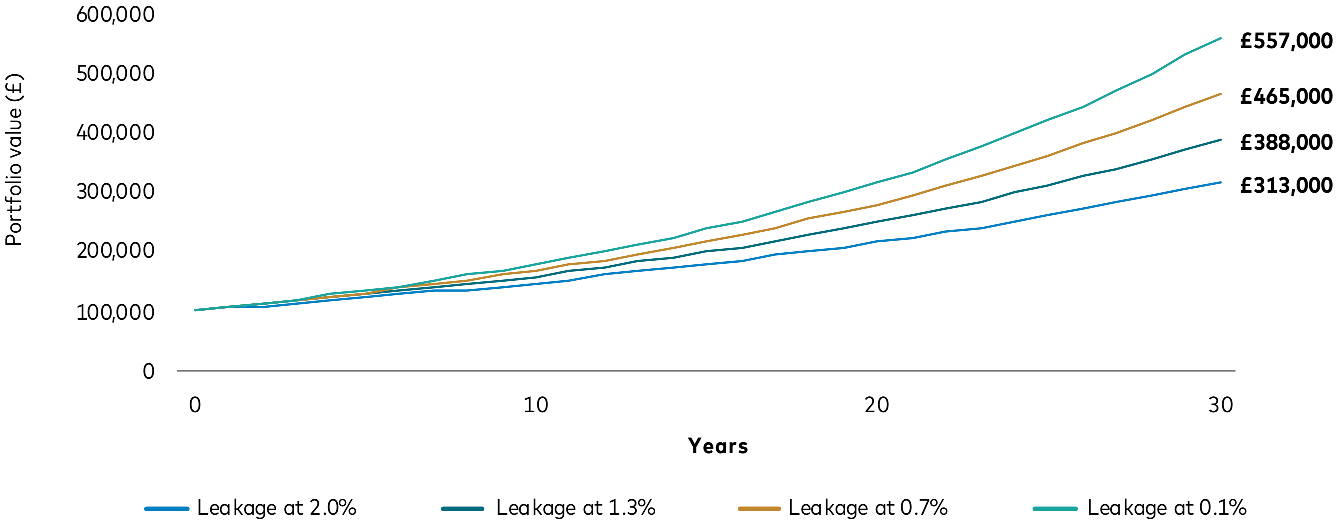
The three B's are:
Business model: The incentive-based revenue model used by most in the financial media, is primarily centred on grabbing your attention, promoting noise, fueling drama and encouraging trading; their incentives are most often not aligned with the best interests of investors reaching their long-term goals. Carefully curating sources of information, news feeds, readings, attention and time is critical for reducing anxiety and stress as well as achieving long-term investment success.
Biology: Anxiety, fear and pain shrink time horizons, shifting focus to short-term survival. Understanding this can help advisers and clients pause and evaluate decisions for long-term benefits
Behaviour: Being acutely aware of the first two Bs, and their influence on the third B (behaviour), is often the primary difference between investors reaching or failing to reach their goals. This is where advisers act as emotional circuit breakers for their clients and coach them through the volatility of markets, loss aversion, etc. — thus, putting their clients in the best position to meet their long-term financial goals.

Impact of reducing return leakage

Figure 7 presents a hypothetical comparison of four investment leakage scenarios: 0.1%, 0.7%, 1.3%, and 2.0%. The chart shows the ending balances for each scenario over a 30-year period, starting with a £100,000 initial balance and a 6% annual return. With minimal leakage of 0.1%, the investment grows to £557,000, as almost all returns are reinvested. In contrast, high leakage of 2.0% results in a significantly lower ending balance of £313,000, as a substantial portion of returns is lost to fees, taxes or other costs.

Notably, the impact of leakage magnifies over time. After ten years, the difference in ending balances between 0.1% and 2.0% leakage is only £30,000. However, this gap widens to a striking £240,000 over 30 years, highlighting the long-term importance and compounding implications of minimising investment leakage. These return leakages are highly controllable by advisers who follow the Vanguard Adviser's Alpha framework.

Figure 7: Hypothetical impact of reduced return leakage on client wealth and adviser book



Notes: The portfolio balances shown are hypothetical and do not reflect any particular investment. In this example, a starting balance of £100,000 returns 6% annually, with returns reinvested, and investment costs are taken at the end of the year. The rate of return is not guaranteed. The final account balances do not reflect any taxes or penalties that might be due upon distribution. Costs are one factor that can impact returns. There may be differences between products that must be considered prior to investing.

Source: Vanguard Advisory Research Centre.

II. Recognition that asset allocation is most effectively learned through time via deep client relationships

The IQ and EQ of asset allocation

Understanding and implementing a client's "best fit" asset allocation is arguably one of the most critical aspects of managing client portfolios – but this exercise is not as easy as it may seem. This is because truly grasping a client's goals, objectives and risk tolerance is a journey that unfolds over time and through various market cycles, as the client-adviser relationship deepens. This journey extends beyond merely selecting asset mixes and investments. It involves understanding the risks and returns of asset classes, investments and portfolio construction, as well as understanding a client's emotional responses, temperament and reactions to market events, such as the fear of missing out (FOMO) and apprehension surrounding potential market declines and corrections. As such, it requires both intellectual and emotional intelligence (IQ and EQ). It involves knowing your clients, coaching them, managing their expectations and continuously adapting their investment strategies based on deep insights gained through your ongoing relationship with them.

This process, when done correctly, is one of the most valuable services an adviser can provide, because even small differences in asset allocation can have a big impact on a client's ability to: 1) meet their financial goals; and 2) stick with – and rebalance to – the allocation in both the best and worst of markets.

Small differences in asset allocation when compounded have a meaningful impact on investment outcomes

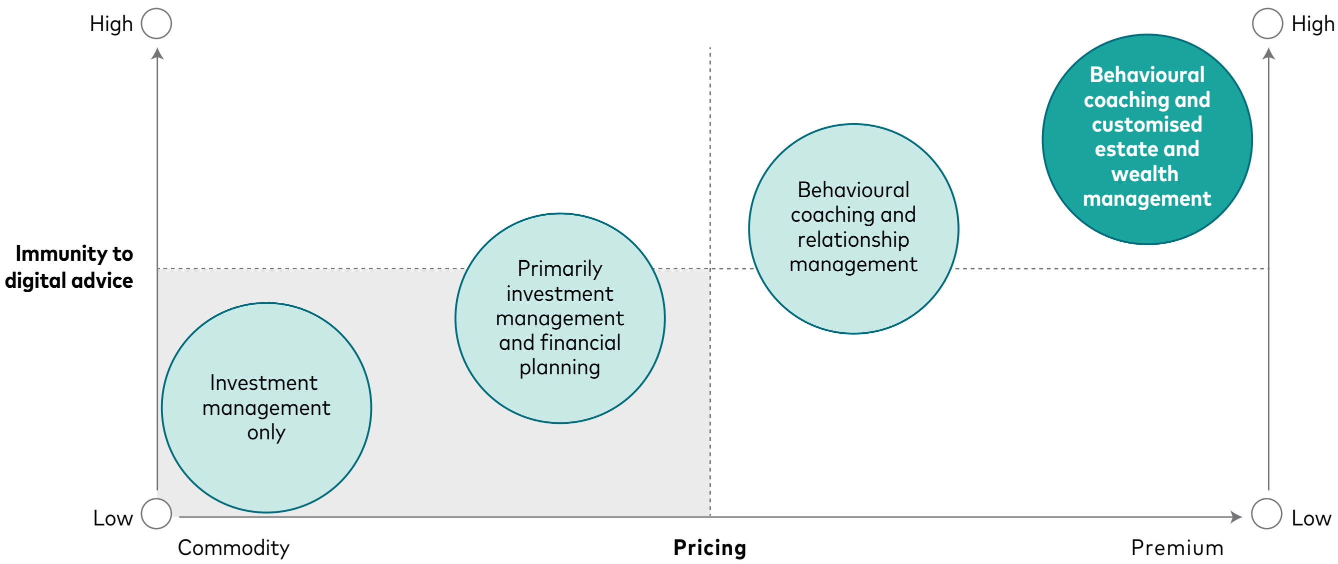
Small differences in asset allocation can have a significant impact on client outcomes — especially over longer time horizons. For example, if a client is invested in a 40% stock and 60% bond portfolio or a 50% stock and 50% bond portfolio when their "best fit" allocation is 60% stocks and 40% bonds, they will likely forgo significant compounding benefits. The magnitude of this impact is closely tied to the investment time horizon. Such a discrepancy could significantly affect a client's ability to achieve their financial goals, potentially requiring them to extend their working years or reduce retirement spending. It might even dictate whether they need to downsize or relocate during retirement. The ramifications for a client's future are vast, and the importance of getting this right is immeasurable.

Conversely, if this client's "best fit" allocation was actually 30% stocks and 70% bonds, the additional risk could result in the client abandoning their asset allocation during market turmoil which could result in significant wealth destruction.

III. Increased focus on deepening client relationships and moving up the value stack of advisory activities — both time intensive endeavours — resulting in advisers further embracing technology and scaling their practices

Over the last 25 years, advisers have increasingly focused on deepening client relationships and moving up the value stack of advisory activities. However, each of these endeavours is very time intensive, and time is an adviser's most valuable – and scarce – resource. By leveraging advanced technologies, software and artificial intelligence (AI) for many tasks, as well as outsourcing where appropriate, advisers have been able to free up time to deepen relationships with their clients and to engage in more personalised, higher-value-added activities as illustrated in the Adviser's Alpha Value Stack (**Figure 8**).

Figure 8: Vanguard Adviser's Alpha value stack



Source: Vanguard Advisory Research Centre.

Conclusion

The rapid and widescale adoption of the Adviser's Alpha framework, as well as the industry trends that we have discussed, have been good for client outcomes, advisers and the advisory industry. Clients are keeping more of the returns they earn, they are better able to stay the course and they are more likely to achieve their goals. Advisers are benefitting from deeper client relationships and higher levels of client satisfaction, retention and referrals. The advisory industry is more respected, offering a tangible and positive value proposition based on high-probability, positive client outcome activities that add meaningfully more value when applied relative to the fees charged. This is in stark contrast to the past, where low-probability activities often led to diminished client wealth.

As the advisory industry continues to professionalise and demonstrate value relative to their fees, public perception improves, opening up further growth opportunities. By focusing on evidence-based strategies that enhance client outcomes and moving away from activities that have proven detrimental, the advisory services business opportunity has never been stronger. And even though the penetration of the Adviser's Alpha framework as a template for the enduring value proposition of fee-based advice has been material, it is still in the very early innings of transformation.

While the advisory industry has made notable strides in areas like asset allocation, investment selection, rebalancing and behavioural coaching, there is still opportunity for advisers to add tremendous value to their advised client portfolios through financial planning, tax management and estate planning. New technologies and innovations have – and will continue to – streamline the time it takes to deliver value in these areas, unlocking new possibilities.

Moving forward, we expect ongoing technological progress and the increasing democratisation of advisory services to further reduce friction costs, making a wider range of financial planning and tax and estate planning services accessible to a larger audience. This transformation will empower more clients and advisers to leverage advanced wealth management strategies that were once exclusive to the ultra-wealthy.

As these services become increasingly accessible, we remain bullish on the potential for the adviser community and our Adviser's Alpha research to further improve client outcomes.

As a result, clients are better positioned to meet their goals and the adviser's value proposition is not only stronger but also less susceptible to automation.

Vanguard Adviser's Alpha quantification modules

This section provides a high-level summary of wealth-management best-practice tools and their corresponding modules, together with a range of potential values we believe can be added by following these practices.

Modules

The value-add of best practices in wealth management

Vanguard Adviser's Alpha strategy	Module	Value-add relative to "average" client experience (in basis points of return)
Suitable asset allocation using broadly diversified funds/ETFs	1	> 0*
Investment selection	2	0 to 100
Rebalancing	3	12
Behavioural coaching	4	Up to 200 or more
Asset location	5	0 to 45
Tax-efficient retirement strategy	6	Up to 112 or more
Total return versus income investing	7	> 0*
Total potential value added		**Up to, or exceeding, 3% in net returns**

* Value is deemed significant but too unique to each investor to quantify.

Notes: We believe implementing the Vanguard Adviser's Alpha framework can add up to, or exceed, 3% in net returns for your clients and also allow you to differentiate your skills and practice. The actual amount of value added may vary significantly, depending on a client's circumstances and time horizon. "3% in net returns" means three percentage points of additional net return over an unspecified period.

Source: Vanguard Advisory Research Centre.

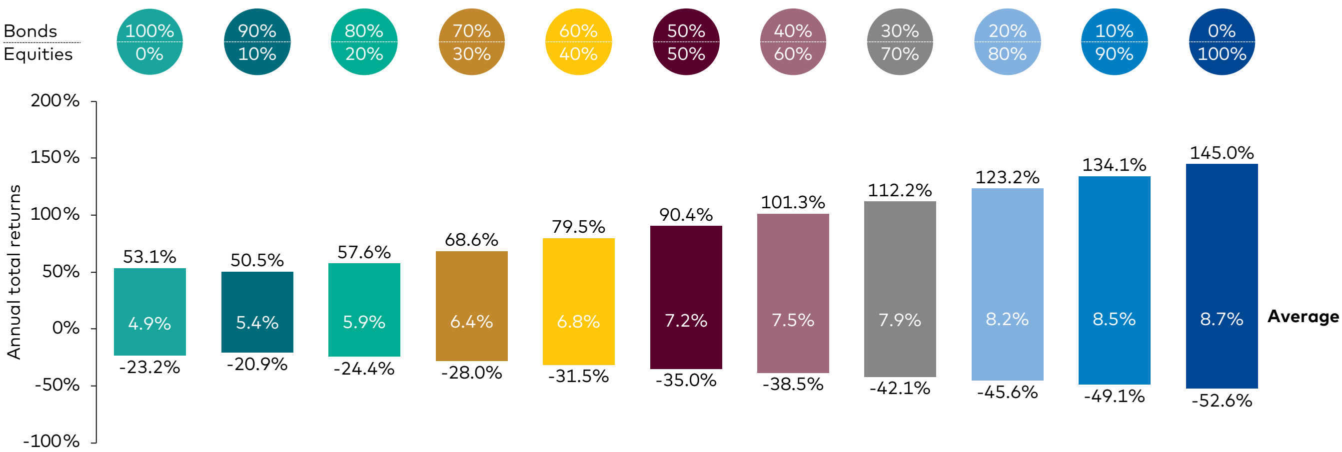
Module 1

Asset allocation

Potential value-add: Value is significant but too unique to quantify, based on each investor's time horizon, risk tolerance and financial goals.

Asset allocation refers to the percentages of a portfolio invested in various asset classes such as stocks, bonds and cash investments, according to the investor's financial situation, risk tolerance and time horizon. It is the most important determinant of return variability and long-term performance of a broadly diversified portfolio that engages in limited market timing.

Figure I-1: The mixture of a portfolio's assets defines the spectrum of returns



Past performance is not a reliable indicator of future results.

Notes: Reflects the maximum and minimum calendar year returns, along with the average annualised return, from 1901-2024, for various stock and bond allocations, rebalanced annually. Equities are represented by the DMS UK Equity Total Return Index from 1901 to 1969; thereafter, equities are represented by the MSCI UK Total Return Index. Bond returns are represented by the DMS UK Bond Total Return Index from 1901 to 1985; the FTSE UK Government Index from Jan 1986 to Dec 2000 and the Bloomberg Sterling Aggregate Index thereafter. Returns are in sterling, with income reinvested to 31 December 2024.

Source: Vanguard.

We believe a sound investment plan begins with an individual's **investment policy statement**. This outlines financial objectives as well as any other pertinent information such as asset allocation, annual contributions, planned expenditures and time horizon. Unfortunately, many ignore this critical effort, in part because it can be very time-consuming, detail-oriented and tedious. But the financial plan is integral to success; it's the blueprint for a client's entire financial house and, when done well, provides a firm foundation on which all else rests.

Starting with a well-thought-out plan can not only ensure that clients will be in the best position possible to meet their long-term financial goals but can also form the basis for future behavioural coaching. Whether the markets have been performing well or poorly, you can help your clients cut through the noise they hear suggesting that if they're not making changes in their investments, they're doing something wrong.

Almost none of what investors hear pertains to their specific objectives: market performance and headlines change far more often. Thus, not reacting to the ever-present noise and sticking to the plan can add tremendous value. The process sounds simple but has proven to be difficult for investors and advisers alike.

Asset allocation and diversification are two of the most powerful tools advisers can use to help their clients achieve their financial goals and manage investment risk. Over the last 25 years, many sophisticated investors have embraced portfolios with more asset classes than in the past. This is often attributed to a trio of significant equity bear markets as well as very low yields on traditional high-grade bonds.

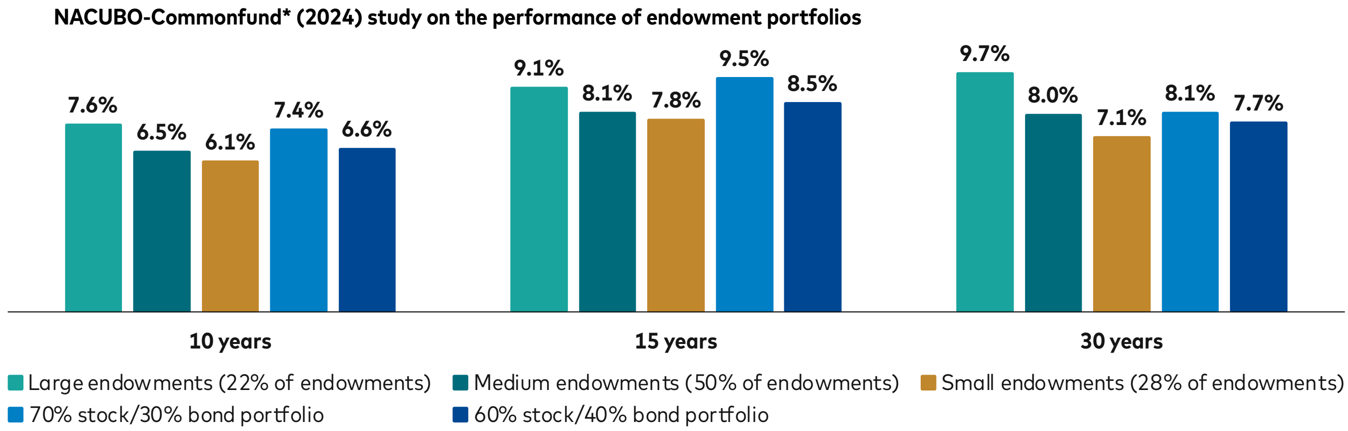
One way to demonstrate that a traditional long-only, highly liquid, investable portfolio can be competitive is to compare traditional stock/bond portfolios to the endowments studied by NACUBO-Commonfund (2024), as shown in **Figure I-2**. The institutions studied have incredibly talented professional staffs as well as unique access, so replicating their performance would likely be a tough task. And yet, a portfolio constructed using traditional asset classes—US and non-US stocks and bonds—held up quite well, outperforming the majority of these endowments. At the same time, the largest endowments have combined heavy doses of active and alternative investments, such as private equity, with unique access, early adoption and professional due diligence in manager selection to improve their investment outcomes.

Although the traditional stock/bond portfolios may not hold as many asset classes as the endowments, it should not be viewed as unsophisticated. More often than not, these asset classes and the investable index funds and ETFs that track them are perfectly suitable. For example, a diversified portfolio using broad-market index funds gives an investor exposure to more than 9,000 individual stocks and more than 16,000 individual bonds—representing more than 99% and 83% of market cap coverage, respectively. Better yet, the tools for implementation, such as funds and ETFs, can be very efficient — broadly diversified, low-cost, tax-efficient, highly liquid and more accessible to the average investor.

Taking advantage of these strengths, assets can be allocated using only a small number of funds. Too simple to charge a fee for, some advisers say, but simple isn't simplistic. A portfolio that provides broad asset class diversification, low costs and return transparency can enable most investors to adopt the investment strategy with confidence and better endure the inevitable ups and downs in the markets.

Simple is a strength, not a weakness, and can be used to promote better understanding of asset allocation and how returns are derived. When incorporating index funds, ETFs and highly talented lower-cost active funds as the core of a portfolio, simplicity and transparency are enhanced, as the risk of portfolio tilts (a source of substantial return uncertainty) is minimised. These features can be used to anchor expectations and help keep clients invested when headlines and emotions tempt them to abandon the investment plan.

Figure I-2: Performance comparison of endowments and traditional stock/bond portfolios



*NACUBO = National Association of College and University Business Officers.

Note: Data are as at 30 June for each year through 30 June 2024. For the 60%/40% and 70%/30% stock/bond portfolios, the equity portion is split 70% US equity and 30% global ex-US equity. US equity is represented by the Dow Jones Wilshire 5000 Index through 22 April 2005; MSCI US Broad Market Index through 2 June 2 2013; and CRSP US Total Market Index thereafter. Global ex-US equity is represented by the MSCI World ex USA Index through December 1987 and MSCI All Country World Index ex USA thereafter. Bonds are represented by the Bloomberg US Aggregate Bond Index. All NACUBO returns are reported net of fees. The volatility of the 60/40 and 70/30 portfolios is materially different from that of the NACUBO institutions' portfolios. NACUBO institutions may have had during the time periods noted above, and may currently have, investment objectives that are not consistent with the 60/40 and 70/30 portfolios.

Large endowments: over $1 billion; medium endowments: $101 million to $1 billion; small endowments: under $100 million.

Average assets: large: $5.2 billion; medium: $350 million; small: $55 million.

Sources: Vanguard Investment Advisory Research Center and NACUBO-Commonfund Study of Endowments, 2024.

Module 2

Investment selection

Potential value-add: 0 to 100 bps annually, by moving to low-cost funds. This is the difference between the average investor experience, measured by the asset-weighted expense ratio of the entire fund industry, and the lowest-cost of these funds. This value would be larger if compared with higher-cost funds.

Investment selection is a critical component of every adviser's tool kit and is based on simple mathematics: Gross return minus costs (expense ratios, trading or frictional costs and taxes) equals net return. As the formula states, it is not always about lowest costs, but gross returns less expenses. As such, we do not rule out active management. Over the long term, index and talent-driven active funds with higher gross returns at lower costs, such as the ones at Vanguard, outperformed the return of the average fund in their benchmark categories.

If low costs are associated with better investment performance (and research has repeatedly shown this to be true), then costs should play a role in an adviser's investment selection process. With the recent expansion of the ETF marketplace, advisers now have many more investments to choose from – and ETF costs tend to be among the lowest in the fund industry.

An adviser could increase their clients' returns by 0-100 bps annually by moving to lower-cost index funds or highly-talented low-cost active funds, as shown in **Figure II-1**. By measuring the asset-weighted expense ratio of the entire fund industry, we found that, depending on asset allocation, the average investor pays between 27 bps annually for an all-bond portfolio and 39 bps annually for an all-stock portfolio, while the average investor in the lowest quartile of the lowest-cost funds can expect to pay between 7 bps (all-bond portfolio) and 14 bps (all-stock portfolio) annually. This includes only the explicit carrying cost and is a conservative estimate when taking into account total investment costs, which often include sales commissions and other fees.

This value-add has nothing to do with market performance. When you pay less, you keep more, regardless of whether the markets are up or down. In fact, in a low-return environment, costs are even more important because the lower the returns, the higher the proportion that is assumed by fund expenses. In comparison to higher-cost funds than the asset-weighted average shown in **Figure II-1**, the increase in value would be even higher than stated here.

Figure II-1: Asset-weighted expense ratios versus low-cost investing

Asset-weighted expense ratios versus "low-cost" investing							
Equity/bond mix (%)	**100/0**	**80/20**	**60/40**	**50/50**	**40/60**	**20/80**	**0/100**
Asset-weighted expense ratio (AWER)	0.36	0.33	0.30	0.29	0.28	0.25	0.23
Lowest quartile AWER (Q1)	0.14	0.13	0.11	0.11	0.10	0.09	0.08
Cost-effective implementation (AWER vs Q1)	**0.22**	**0.20**	**0.19**	**0.18**	**0.18**	**0.16**	**0.15**

Notes: "Lowest quartile" category includes funds whose expense ratios ranked in approximately the lowest 25% of funds in our universe by fund count Fund universe includes funds available for sale in the UK from the following Morningstar categories: UK equity: flex cap, large-cap blend, large-cap growth, large-cap value, mid-cap, small-cap; Europe equity: Europe OE: flex-cap, large-cap blend, large-cap growth, large-cap value, mid-cap, small-cap; Eurozone equity: flex-cap, large-cap, mid-cap, small-cap; Global equity: flex-cap, large-cap blend, large-cap growth, large-cap value, mid-cap, small-cap; US equity: flex-cap, large-cap blend, large-cap growth, large-cap value, mid-cap, small-cap; Emerging markets equity: emerging markets; Europe bond: EUR diversified; US bond: USD diversified; Global bond: global unhedged bond; UK bonds: UK diversified, UK government.

Source: Vanguard calculations, based on data from Morningstar, as at 30 June 2024.

Module 3

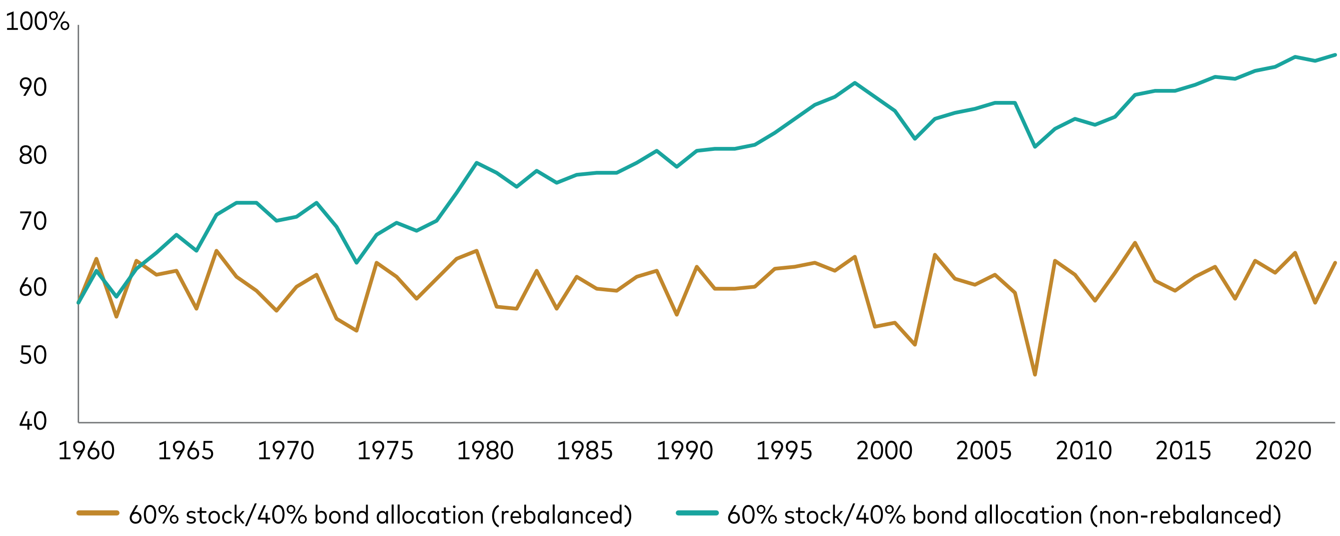
Rebalancing

Potential value-add: Up to 12 bps when risk-adjusting a 60% stock/40% bond portfolio that is rebalanced annually versus the same portfolio that is not rebalanced (and thus drifts).

Given the importance of selecting an asset allocation, it's also vital to maintain that allocation. As investments produce different returns over time, the portfolio likely drifts from its target allocation, acquiring new risk-and-return characteristics that may be inconsistent with your client's original preferences. *Note that the primary goal of a rebalancing strategy is to adhere to the investor's risk tolerance.* Investors wishing to maximise returns, with no concern for the inherent risks, should allocate their portfolios to 100% equity to best capitalise on the equity risk premium. Investments that are not rebalanced but drift with the markets have experienced higher volatility.

In a balanced portfolio, this equity risk premium tends to result in stocks becoming overweighted relative to a lower risk-return asset class such as bonds, as shown in **Figure III-1**. Although failing to rebalance may help long-term returns as the weighting of equities rises, the true benefit of rebalancing is in controlling risk. A portfolio overweighted to equities is more vulnerable to equity market corrections, putting it at risk of larger losses compared with the 60% stock/40% bond target portfolio.

Figure III-1: Equity allocation of 60% stock/40% bond portfolio, rebalanced and non-rebalanced, 1960 through 2023



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

Notes: Stocks are represented by the Standard & Poor's 500 Index from 1960 to 1974; the Wilshire 5000 Index from 1975 to 22 April 2005; the MSCI US Broad Market Index from 23 April 2005 through 2 June 2013; and the CRSP US Total Market Index thereafter. Bonds are represented by the S&P High Grade Corporate Index from 1960 through 1968; the Citigroup High Grade Index from 1969 through 1972; the Bloomberg US Long Credit AA Bond Index from 1973 through 1975; the Bloomberg US Aggregate Bond Index from 1976 through 2009; and the Bloomberg US Aggregate Float Adjusted Index thereafter. Data are until 23 December 2023.

Sources: Vanguard calculations based on data from FactSet.

During this period (1960–2023), a 60% stock/40% bond portfolio that was rebalanced annually provided a lower return (8.90% versus 9.57%) with significantly lower risk (11.38% versus 14.22%) than a 60% stock/40% bond portfolio that was not rebalanced but drifted, as shown in **Figure III-2**.

To assign a return value for rebalancing, we found the portfolio that created a risk parity to compare the rebalancing premium.

Specifically, we searched over the same time period for a rebalanced portfolio that exhibited risk similar to that of the non-rebalanced portfolio. We found that an 80% stock/20% bond portfolio provided similar risk as measured by standard deviation (14.03% versus 14.22%) with a higher average annualised return (9.69% versus 9.57%), as shown in **Figures III-2** and **Figure III-3**.

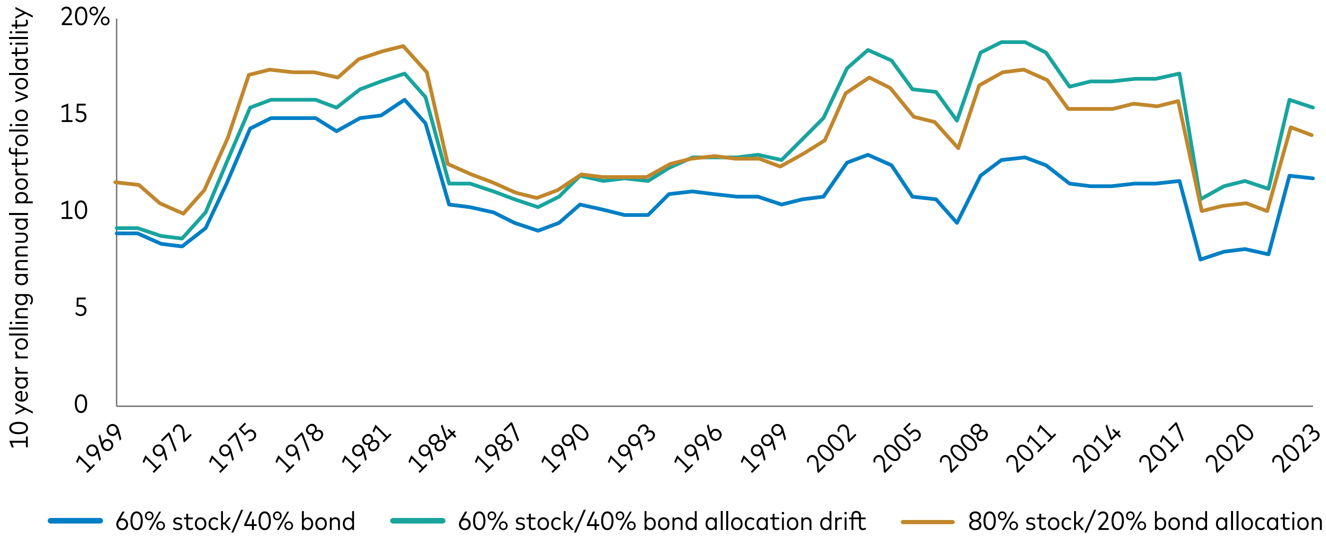
Figure III-2: Portfolio returns and risk, rebalanced and non-rebalanced, 1960 through 2023

	60% stocks/40% bonds, rebalanced	60% stocks/40% bonds (drift)	80% stocks/20% bonds, rebalanced
Average annualised return	8.90%	9.57%	9.69%
Average annual standard deviation	11.38	14.22	14.03
Sharpe ratio	0.39	0.36	0.37

Notes: Stocks are represented by the Standard & Poor's 500 Index from 1960 to 1974; the Wilshire 5000 Index from 1975 to 22 April 2005; the MSCI US Broad Market Index from 23 April 2005 to 2 June 2013; and the CRSP US Total Market Index thereafter. Bonds are represented by the S&P High Grade Corporate Index from 1960 to 1968; the Citigroup High Grade Index from 1969 to 1972; the Bloomberg US Long Credit AA Bond Index from 1973 to 1975; the Bloomberg US Aggregate Bond Index from 1976 to 2009; and the Bloomberg US Aggregate Float Adjusted Index thereafter. The risk-free rate used in the Sharpe ratio calculation is the US cash reserve return, using the Ibbotson US 30-Day Treasury Bill Index from 1960 to 1977, and the FTSE 3-Month US T-Bill Index thereafter. Data are until 31 December 2023. Calculations are in USD.

Sources: Vanguard Investment Advisory Research Center calculations based on data from FactSet.

Figure III-3: Looking backward, the non-rebalanced (drift) portfolio exhibited risk similar to that of a rebalanced 80% stock/20% bond portfolio



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

Notes: Stocks are represented by the Standard & Poor's 500 Index from 1969 to 1974; the Wilshire 5000 Index from 1975 to 22 April 2005; the MSCI US Broad Market Index from 23 April 2005 to 2 June 2013; and the CRSP US Total Market Index thereafter. Bonds are represented by the S&P High Grade Corporate Index from 1960 to 1968; the Citigroup High Grade Index from 1969 to 1972; the Bloomberg US Long Credit AA Bond Index from 1973 to 1975; the Bloomberg US Aggregate Bond Index from 1976 to 2009; and the Bloomberg US Aggregate Float Adjusted Index thereafter. Data are until 31 December 2023.

Sources: Vanguard calculations based on data from FactSet.

Helping investors stay committed to their asset allocation strategy and remain invested increases the probability of meeting their goals. But the task of rebalancing is often an emotional challenge.

Historically, rebalancing opportunities have occurred when there has been a wide dispersion between the returns of different asset classes (such as stocks and bonds). Whether in bull or bear markets, reallocating assets from the better-performing asset classes to the worse-performing ones feels counterintuitive. An adviser can provide the discipline to rebalance when it is needed most, which is often when it involves a very uncomfortable leap of faith.

Keep in mind, too, that rebalancing is not necessarily free. Associated costs can include taxes and transaction costs, as well as time and labour on the part of advisers. These could all potentially reduce a client's return. An adviser can add value by balancing these trade-offs, thus potentially minimising costs. For example, a portfolio can be rebalanced with cash flows by directing dividends, interest payments, realised capital gains and new contributions to the most underweighted asset class. This can keep the client's asset allocation closer to its target and limit costs.

An adviser can furthermore determine whether to rebalance to the target or to an intermediate allocation based on the type of costs. When trading costs are mainly fixed and independent of the size of the trade—the cost of time, for example—rebalancing to the target allocation is optimal because it reduces the need for further transactions. When trading costs are mainly proportional to the size of the trade—as with commissions or taxes—rebalancing to the closest boundary is optimal, minimising the size of the transaction[5].

Advisers who can systematically direct investor cash flows into the most underweighted asset class or rebalance to the most appropriate boundary are likely to reduce rebalancing costs and thereby increase the returns their clients keep.

5 Yan Zilbering, Colleen Jaconetti, and Francis M. Kinniry, Jr. *Best practices for portfolio rebalancing*. Vanguard, 2015.

Module 4

Behavioural coaching

Potential value-add: Vanguard research has concluded that coaching can add 0 to >200 bps in net return. The value-add could be significantly higher in periods of market volatility, in narrow segments of sub-asset classes, and at the individual fund level. Providing discipline and guidance could be the largest potential value-add of the tools available to advisers.

Because investing evokes emotion, advisers need to help their clients maintain a long-term perspective and a disciplined approach. *This can add a large amount of potential value*. Most investors are aware of these time-tested principles; the hard part is sticking to them in the best and worst of times. Having emotions isn't a 'rational' or 'irrational' investor issue; it's a human issue. It's normal for people to be swayed by the opinions voiced by experts — the talking heads or news headlines that often recommend change. Abandoning a well-planned investment strategy can be costly, and research has shown that some of the most significant challenges are behavioural. That is where you, as a behavioural coach, can earn your fees and then some. Providing emotional detachment is one of the most overlooked benefits you can offer.

When clients are tempted to abandon the markets because performance has been poor or to chase the next "hot" investment, you need to remind them of the plan you created before emotions were involved. The trust they have in you is key: strong relationships need to be established before bull- and bear-market periods challenge their confidence. Advisers can act as emotional circuit breakers by circumventing clients' tendencies to chase returns or run for cover in emotionally-charged markets. In the process, they may prevent significant wealth destruction and add percentage points – rather than basis points – of value. A single such intervention could more than offset years of advisory fees.

It is important to point out that such an evaluation is time-period dependent; results can look much different from one year to the next. Take, for example, **Figure 6**, which highlights the Covid-19 crisis and underscores the importance of acting as a behavioural coach during episodic market distress.

Module 5

Asset location

Potential value-add: 0-45 bps*, depending on the investor's asset allocation, tax band and the breakdown of assets between different account types. If an investor has all of his or her assets in one account type, the value of asset location is 0 bps.

Asset location, the allocation of assets between taxable and tax-advantaged accounts, can add meaningful value each year that can compound over time.

In the UK, equity and bond investments (including funds comprised of these assets) that are held in taxable accounts are taxed differently from those held in tax-advantaged accounts, and are also taxed differently from one another. While the capital appreciation for both asset classes is subject to capital gains tax, the yield income from equities (dividends) is taxed at a lower rate than the income from bonds (interest income). Additionally, the different components of investment returns — capital gains, dividends and interest income — have their own annual tax exemption allowances.

From a tax perspective, optimal portfolio construction takes into consideration the disparities in tax treatment of the different components of asset returns and optimises them across an investor's taxable and tax-advantaged accounts to align with their income needs.

Historically, equities have achieved more of their total investment returns from capital appreciation than from dividend income. By contrast, bonds have earned more of their total returns from coupon payments (interest income) than from principal appreciation. There have been exceptions — for example, higher-yielding equities and higher-growth bonds — but over time, the broader asset class trends become increasingly visible.

For tax-advantaged wrappers, there is no tax to pay on returns generated in individual savings accounts (ISAs). Investment gains within a pension are tax-free; however, withdrawals from a pension are subject to income tax when they are beyond the investor's eligible tax-free amount. What this means, in effect, is that all investment growth on either stocks or bonds within a pension will be subject to a blend of 0% tax (the tax-free lump sum) and the corresponding income tax rate when the investor wants to withdraw money from their pension.

For many investors, where they hold both taxable and tax-advantaged accounts, there will be a tax advantage for prioritising the purchase of equities within taxable accounts and bonds within tax-advantaged accounts. This is for a number of reasons:

- An annual capital gains tax allowance on taxable accounts (remember that more of the total returns from equities tend to be from capital appreciation).
- A lower rate of tax on capital gains relative to the tax rates on dividends and interest income for many investors.
- A lower rate of tax on dividends versus interest income.
- A potentially higher tax-free allowance on dividends (relative to the tax-free allowance on interest income).

Accordingly, a relatively modest portion of the total return from equities will be lost to tax when held in a taxable account. By contrast, because bonds will have more of their total return taxed at higher rates, more of their return is lost to tax when held in a taxable account. Depending on the circumstances, the taxes saved can be material – and when compounded over time, can make a significant difference to investor outcomes.

By optimising their asset location, investors can take greater advantage of their annual tax allowances for both their taxable and tax-advantaged accounts and mitigate the impact of the tax drag on their withdrawals – thus allowing them to keep more of their pre-tax total returns.

Our research shows that constructing a portfolio in this manner can add up to 45 bps of return in the first year, without increasing risk (see **Figure V-1**).

We tested several asset location scenarios and compared their pre- and post-tax returns with the reverse of holding assets in the 'wrong' accounts. For an additional rate taxpayer holding a 50% stock/50% bond portfolio, the maximum benefit can be achieved when the assets are split evenly between 50% taxable/50% tax-advantaged accounts.

The largest difference was found in this scenario:

Figure V-1: Asset location can add up to 45 bps of value annually to a portfolio

Account balances	
Pension	£25,000
ISA	£25,000
Taxable	£50,000
Total	**£100,000**
Tax assumptions	
Investor tax status	Additional rate taxpayer with applicable allowances, as at April 2025.
Pension taxation	When the money is realised, we assume the investor is a 20% taxpayer in retirement and receives 25% of their pension withdrawal tax-free.
1-year returns	
Pre-tax returns	5.50%
After-tax returns	
Stocks prioritised in taxable account	5.04%
Bonds prioritised in taxable account	4.58%
Difference	**0.45%**

Notes: For simplicity, calculations are based on a 1-year return timeframe. Results over time would be affected by cashflows as well as the changing relative size of each account due to investment growth.

As per the scenario above, it is common for investors to be in a lower tax bracket when they withdraw their pension than when they were working. Investors with larger pensions should also consider the fact that the amount they can withdraw tax-free is limited. If a pension experiences higher growth that takes its value above the standard individual lump sum allowance and death benefit allowance it will, in effect, face a higher effective tax rate at withdrawal.

Pre-tax and after-tax returns are based on the following assumptions: return on equities: 6.5% total return (2.5% of which is from dividend income); return on bonds: 4.5% total return (4.0% of which is from interest income).

Returns for equities and bonds are based on global market–cap-weighted indices, from the perspective of a GBP investor. Yield and total return figures are rounded to the nearest 0.5%.

Returns are based on 30-year forecasts provided by the Vanguard Capital Markets Model (VCMM), as at 30 September 2024.

Source: Vanguard Advisory Research Centre.

Module 6

Withdrawal order strategy for retirement spending

Potential value-add: 0-112 bps, depending on the investor's income tax bracket. If an investor has all of their assets in one account type, or an investor is not currently spending from the portfolio, the value of the withdrawal order is 0 bps.

With the UK's retiree population on the rise, an increasing number of clients are facing important decisions about how to spend from their portfolios in their retirement years. Complicating matters is the fact that many clients hold multiple account types, including taxable, tax-deferred and tax-free accounts. In addition to this, the shift from defined benefit to defined contribution pension plans, greater pension freedoms and other factors have increased the complexity that many UK investors face when it comes to making retirement spending decisions.

Advisers who implement informed withdrawal order strategies can minimise the total taxes paid by their clients over the course of their retirements, thereby increasing their clients' wealth and the longevity of their portfolios. This process alone could represent the entire advice value proposition.

Many investors will retire with multiple account types, but we focus here on the three most common for UK investors:

- Defined contribution pensions (DCP)
- Individual savings accounts (ISA)
- General investment accounts (GIA)

Additionally, our focus here is on helping investors reach their retirement goal. In doing so, we assume that investors primarily derive benefit from using their retirement assets for spending in retirement, rather than leaving a legacy upon their death.

In practice, many wealthy investors will have plans around their legacy that need to be taken into consideration when planning how they spend their retirement assets. When it comes to legacy planning in particular, the "right" approach is often highly personalised to the individual investor, making general assessments of value challenging.

When thinking about an investor's retirement goal, the primary determinant of how one should spend from different account types will be the taxes – and more specifically, the differences in the tax treatment of investment income by different account types.

A summary of the taxation rules for the three main account types are as follows:

1. Savings held in a DCP are subject to income tax upon withdrawal, with 25% of the amount withdrawn exempt from income tax (up to an annual capped amount – see the Appendix for further details).

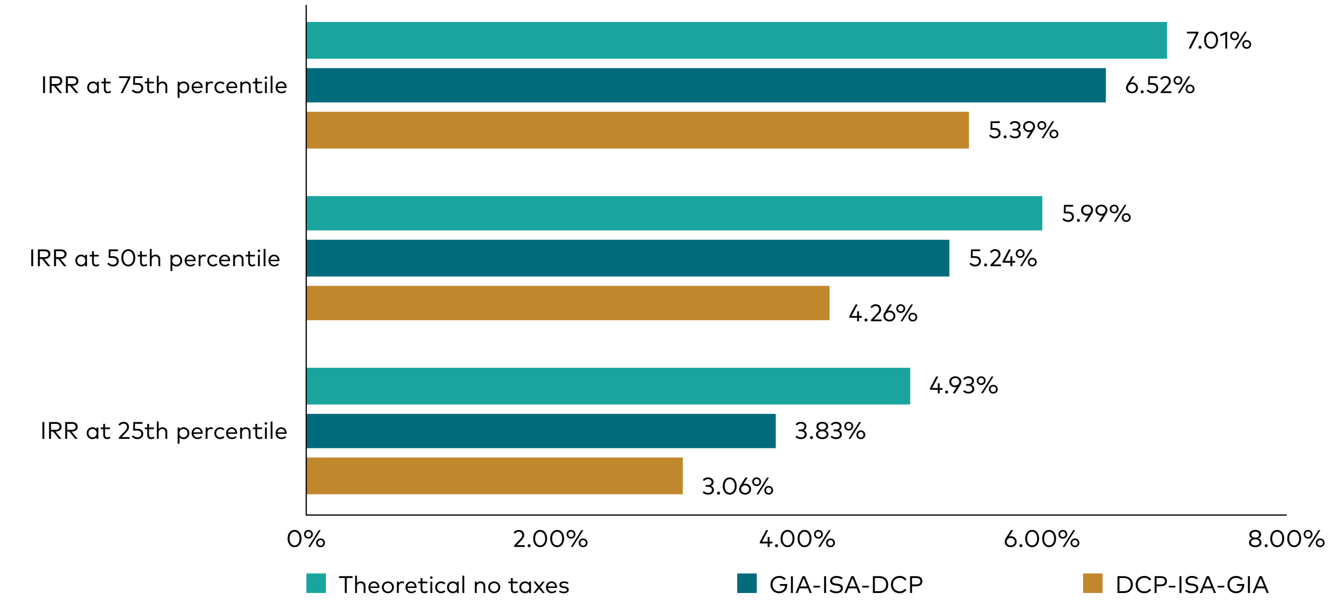
2. Savings held in an ISA are tax-free on withdrawal.

3. Savings held in a GIA are subject to taxation on crystallised capital growth, as well as interest and dividend income that arises from the bond and stock components, respectively.

It is the material differences in taxation between these wrappers that provide opportunities for advisers to plan efficient withdrawal strategies for their clients. When maximised, these efficiencies can result in a significant difference in outcomes between a withdrawal approach implemented tax efficiently and one implemented inefficiently.

To analyse the value of efficient withdrawal strategies, we considered a range of client scenarios. In each scenario, we compared an efficient withdrawal order with an inefficient alternative. Below is an example of an investor scenario where the value of the withdrawal order was found to be towards the higher end of the range, but one which we regard as a realistic client scenario.

Figure VI-1: After-tax internal rate of return (IRR) when comparing (i) a scenario where taxes are set to zero, (ii) the most tax efficient withdrawal order and (iii) the least tax efficient withdrawal order

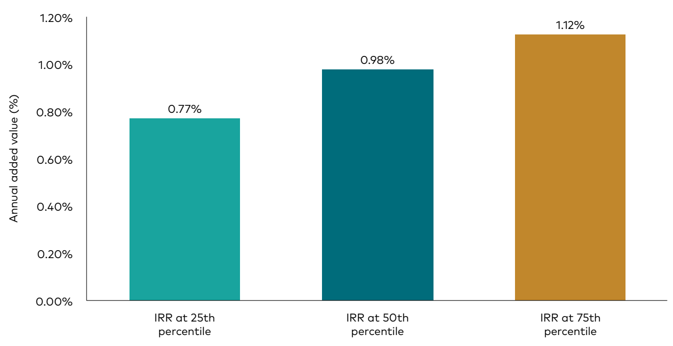


Notes: Calculations based on a portfolio value of £1,200,000, spread equally across three accounts, with £400,000 in each of the GIA, ISA and DCP accounts. (For the GIA, the cost basis of the account is 50% of its value). The portfolio has an asset allocation of 50% stocks/50% bonds. Within each asset class, the geographic allocation is 5% UK/95% global ex-UK. The investor has £100,000 of after-tax spending with £50,000 of income paid to them outside of the portfolio (for example, a combination of rental income and State Pension). The method for withdrawing from the pension is to take a pension commencement lump sum and income at the same time (effectively, an uncrystallised pension lump sum). The analysis is run over a 30-year period with spending, income and tax bands increasing with inflation. These hypothetical data do not represent the returns on any particular investment. They are based on 10,000 VCMM simulations modelling the effect of taxes deducted for a UK investor over time. The IRR represents the internal rate of return of the portfolio after taxes. The percentile represents the ranking of the IRR figure within the 10,000 VCMM paths.

Source: Vanguard Advisory Research Centre.

Of course, our analysis is based on a hypothetical case study scenario and actual results will vary from client to client based on their personal circumstances, asset allocation, investment performance and other factors. But there are some notable observations. First, we can see the "theoretical no taxes" scenario produced returns that are meaningfully ahead of both of the taxable scenarios, demonstrating the material degree of "tax drag" that most investors experience during their retirements. We can also observe a considerable difference in how much tax drag applies when we compare the efficient withdrawal order to the inefficient one. We pull this into further focus in **Figure VI-2**.

Figure VI-2: Difference in "tax drag" between the most tax efficient withdrawal order (GIA-ISA-DCP) versus the least tax efficient withdrawal order (DCP-ISA-GIA)



Notes: The calculations are based on the data shown in Figure VI-1. For each of the three percentiles (25th, 50th and 75th), we calculated the difference in the net after-tax annual returns between the most efficient and the least efficient withdrawal order.

Source: Vanguard Advisory Research Centre.

It is here that we see the tax drag savings from using the most efficient withdrawal order are very meaningful. At the 25th, 50th and 75th percentiles (which we can view as proxies for modest, average and strong returns, respectively), we find the tax drag to be 77 bps, 98 bps and 112 bps, respectively. It is the latter, 112 bps, which we define as our reasonable upper range for the value of an efficient withdrawal order. It is unsurprising, therefore, that at higher levels of return (moving from the 25th percentile to the 75th percentile) the investor can enjoy a higher benefit from implementing their tax planning efficiently.

Our analysis found that depleting the GIA first, then the ISA, and then the DCP provided the best results for the retiree (with the opposite order (DCP-ISA-GA) providing the worst results) across a range of different scenarios. The main driver here is that the GIA is the least tax efficient account — so by advising a client to deplete this account first (rather than later in retirement), the adviser can help dampen: (i) the amount of income tax the client would have to pay on any income generated by the account; and (ii) the continued growth of any potential underlying capital gains tax liability payable by the client in the future.

It's worth noting that in our analysis we assume the investor depletes one account fully before moving on to the next account. In reality, advisers have the chance to provide even higher value to their clients by drawing from multiple accounts simultaneously. For example, an investor could take part of their DCP in the earlier years of retirement to take advantage of any lower-rate tax bands; or, they can defer the sale of their GIA over a greater number of years to better use their capital gains tax allowance. The withdrawal plan can become even more personalised to match an individual client's needs and should adapt to their changing circumstances over time.

Crystallising pension gains

Investors have another opportunity to increase their after-tax returns by selecting the appropriate method for "crystallising" the capital they withdraw from their pension account (DCP). The choice of crystallisation method can be every bit as important to the investor's outcome as the withdrawal order itself.

There are three main options for crystallising the capital in an investor's DCP account*:

1. **Full withdrawal:** The investor withdraws the full balance of their DCP account as one lump sum. 25% of the account balance will normally be free from tax, and the remainder will be taxed as income.

2. **Pension commencement lump sum (PCLS):** The investor crystallises the entire DCP account balance, but only withdraws the 25% tax-free portion initially before moving on to income withdrawal to fund later years of expenditure.

3. **Annual:** The investor withdraws a series of partial lump sums each year in order to meet his or her spending needs. 25% of each year's withdrawal is tax-free and the remainder is taxed as income.

**Note that (i) investors could use a blend of the three withdrawal options; and (ii) an additional option could be to annuitise some or all of the capital in the investor's DCP account.*

In many instances, the full withdrawal approach is likely to lead to a considerably worse outcome for the investor than the other two options. This is because fully withdrawing from the DCP account in one tax year will likely lead to the investor incurring tax at a much higher marginal rate (and therefore a higher effective rate) than drawing over a number of tax years.

The difference between the PCLS and annual withdrawal approach is less pronounced; however, depending on the circumstances, either option could potentially offer an advantage to the investor. When choosing between these two options, advisers will often have other factors to consider, such as taxes that could apply around legacy and the ability to make further pension contributions in the future (where relevant).

Overall, the question of tax efficient withdrawals is a challenging one that few investors will be well-equipped to optimise themselves without expert guidance.
In exploring several case studies, we found that an added value in excess of 1% is certainly achievable. However, with further personalisation and consideration of a client's wider goals, and by leveraging the use of sophisticated cashflow analysis, the value added by the adviser could be even higher.

Module 7

Total return versus income investing

Potential value-add: Value is significant but unique and unquantifiable, based on each investor's desired level of spending and portfolio composition.

For investors approaching and in retirement, the value of advice has never been more critical.

Retired investors who wish to spend only the income generated by their portfolio – referred to here as the "income-only" approach – have three choices if their current cash flows fall short. They can spend less, reallocate to higher-yielding investments or spend from the total return on their portfolio, which includes not only the income or yield but also the capital appreciation.

As your clients' adviser, you can help them make the right choice. For many investors, moving away from broad diversification could put their portfolio's principal value at higher risk than spending from it. **Figure VII-1** outlines several common techniques for increasing a portfolio's yield, along with their impacts.

Figure VII-1: Income-only investment strategies and their potential portfolio impact

Strategy	Impact on portfolio (compared with a market cap-weighted portfolio at the sub-asset class level)
1. Overweighting longer-term bonds (extending duration)	Increases exposure to changes in interest rates
2. Overweighting high-yield bonds and/or underweighting government bonds	Increases credit risk and raises overall volatility
3. Increasing exposure to dividend-centric equities	Decreases diversification of equity portfolio by overweighting certain sectors and/or increases overall volatility and risk of loss if it reduces the bond portfolio

Source: Vanguard Advisory Research Centre.

1. Overweighting longer-term bonds (extending duration)

Extending the duration of the bond portfolio will likely increase the current yield but will also increase its sensitivity to changes in interest rates. Generally speaking, the longer the bond portfolio's duration, the greater the decline in value when interest rates rise (and the greater the gain when rates fall).

2. Overweighting high-yield bonds

Another strategy to increase a bond portfolio's yield is to increase its allocation to higher-yielding bonds exposed to marginal or even significant credit risk[6]. However, credit risk tends to be correlated with equity risk, which tends to be magnified when investors move into riskier bonds at the expense of government bonds. Government bonds are a proven diversifier during periods of equity market duress, when diversification is needed the most.

Vanguard research has shown that replacing broad-market, investment-grade fixed income holdings with high-yield bonds has historically increased the volatility of a balanced portfolio. This is because high-yield bonds are more highly correlated with equity markets and are more volatile than investment-grade bonds. Investors who employ such a strategy are sacrificing diversification benefits in hopes of receiving higher current income.

3. Increasing exposure to dividend-centric equity

An often-advocated approach to increase income is to shift some or all of an investor's fixed income allocation into higher-yielding, dividend-paying stocks. But stocks are not bonds. At the end of the day, they will perform like stocks—they have higher volatility and the potential for greater losses. Moreover, dividend stocks are correlated with stocks in general, whereas bonds typically show little to no correlation with either of these. If you view fixed income as providing not just yield but also diversification, dividend-paying stocks fall well short as a substitute.

6 The term "high-yield bonds" refers to fixed income securities rated as below investment grade by the primary ratings agencies (Ba1 or lower by Moody's Investors Service; BB+ or lower by Standard & Poors).

A second approach is to shift from broad-market equities to dividend- or income-focused equities. However, this may inadvertently change the portfolio's risk profile, because dividend-focused equities tend to display a bias towards value stocks. Although value stocks are generally considered to be a less risky subset of the broader equity market, the risks nevertheless can be substantial. Portfolios focused on dividend-paying stocks tend to be overly concentrated in certain individual stocks and sectors.

Benefits of a total return approach to investing

Some may feel that the income strategies described above will reward them with a more certain return and therefore less risk. But in reality, such strategies will increase a portfolio's risk, with higher concentration in certain sectors, with less tax efficiency and a higher chance of failing to reach an investor's long-term financial goals.

Vanguard believes in a total return approach, which considers both income and capital appreciation. This has the following potential advantages over an income-only method:

- **Less risk.** It allows better diversification, instead of concentrating on certain securities, market segments, or industry sectors to increase yield.
- **Better tax efficiency.** It offers more tax-efficient asset locations (for clients who have both taxable and tax-advantaged accounts). An income approach focuses on access to income, resulting in the need to keep tax-inefficient assets in taxable accounts.
- **A potentially longer lifespan for the portfolio.** Designing tax-efficient total return strategies when investors require specific cash flows to meet their spending needs involves substantial analysis, experience and transactions. To do this well is not easy and could well represent the entire value proposition of an advisory relationship.

Conclusion

Where should you begin? For advisers who are new to the Adviser's Alpha framework, we believe you should focus on the areas where you have the most control, such as:

- Helping your clients select the asset allocation that is most appropriate for meeting their goals and objectives, given their time horizon and risk tolerance.
- Implementing a client's asset allocation using low-cost investments and, to the extent possible, asset-location guidelines.
- Limiting any deviations from the market portfolio, and thus benefitting your clients and your practice.
- Concentrating on behavioural coaching and spending more time communicating with your clients.

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Appendix I. UK tax rates and allowances

Taxpayer status	Taxable income	Income/interest	Dividends	Capital gains
Allowance	£12,570	£12,570*	£500	£3,000
Basic rate	£12,571 to £50,270	20%	8.75%	140%
Higher rate	£50,271 to £125,140	40%	33.75%	24%
Additional rate	Over £125,1400	45%	39.75%	24%

*Personal allowance decreases by £1 for every £2 earned above £100,000 and is £0 over £125,140.

Source: HMRC. Data as at 31 December 2024.

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The Vanguard Capital Markets Model® is a proprietary financial simulation tool developed and maintained by Vanguard's primary investment research and advice teams. The model forecasts distributions of future returns for a wide array of broad asset classes. Those asset classes include US and international equity markets, several maturities of the US Treasury and corporate fixed income markets, international fixed income markets, US money markets, commodities, and certain alternative investment strategies. The theoretical and empirical foundation for the Vanguard Capital Markets Model is that the returns of various asset classes reflect the compensation investors require for bearing different types of systematic risk (beta). At the core of the model are estimates of the dynamic statistical relationship between risk factors and asset returns, obtained from statistical analysis based on available monthly financial and economic data from as early as 1960. Using a system of estimated equations, the model then applies a Monte Carlo simulation method to project the estimated interrelationships among risk factors and asset classes as well as uncertainty and randomness over time. The model generates a large set of simulated outcomes for each asset class over several time horizons. Forecasts are obtained by computing measures of central tendency in these simulations. Results produced by the tool will vary with each use and over time.

The primary value of the VCMM is in its application to analysing potential client portfolios. VCMM asset-class forecasts—comprising distributions of expected returns, volatilities, and correlations—are key to the evaluation of potential downside risks, various risk–return trade-offs, and the diversification benefits of various asset classes. Although central tendencies are generated in any return distribution, Vanguard stresses that focusing on the full range of potential outcomes for the assets considered, such as the data presented in this paper, is the most effective way to use VCMM output.

The VCMM seeks to represent the uncertainty in the forecast by generating a wide range of potential outcomes. It is important to recognise that the VCMM does not impose "normality" on the return distributions, but rather is influenced by the so-called fat tails and skewness in the empirical distribution of modelled asset-class returns. Within the range of outcomes, individual experiences can be quite different, underscoring the varied nature of potential future paths. Indeed, this is a key reason why we approach asset-return outlooks in a distributional framework.

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