Vanguard

Vanguard research

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The value of personalised advice

- Communicating the true value of financial advice to existing and potential clients is not easy.
- Calculations of value are often anchored in investment performance and fail to recognise the value of financial planning interventions outside of portfolio construction.
- Vanguard has expanded its research on quantifying the value of advice to include four key sources of advice value – financial, portfolio, emotional and time savings.
- Understanding how these sources of value apply to different clients – and therefore understanding the value of personalised advice – can help advisers to retain and attract more clients.

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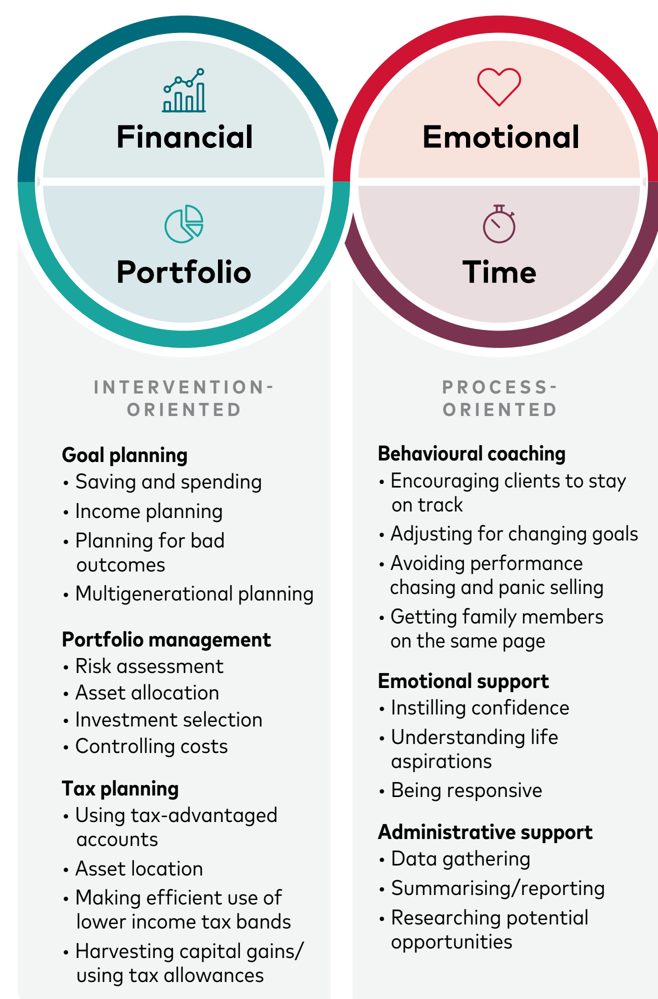
Introduction

This research briefing summarises the key findings in the paper, *The Value Of Personalized Advice*[1], which explores Vanguard's methodology for valuing advice for individual clients. The study expands on Vanguard's 20+ years of thought leadership in advice research which includes Adviser's Alpha®, now widely recognised by the investment industry as a key tool for defining and measuring the financial and emotional value that advisers provide to their clients.

For financial advice providers, quantifying the value of the advice they provide is of utmost importance. By demonstrating their value to clients, they can retain and attract new business. At the same time, clients can gain a better understanding of how their advisers provide value over and above their fees.

FIGURE 1.
Sources of advice value



Source: Vanguard.

1 *The Value Of Personalized Advice*, Vanguard, August 2022.

A new model of advice value

Vanguard's original value of advice model concentrated on quantifying the value of advice to investors on an aggregate basis, but it didn't expand on how these values may vary from client to client.

Our latest study builds on our original three-pillar framework (financial, portfolio and emotional value) with the addition of a fourth dimension—time savings. This new pillar includes performing tasks that an investor may not have the time, willingness or ability to perform on their own.

Financial value
Investment returns are important only in helping clients achieve their goals. Advisers engage in a range of strategies to help clients address their financial challenges.

Emotional value
Instilling confidence, and helping their clients achieve financial well-being and peace of mind.

Portfolio value
Building a well-diversified portfolio that generates better after-tax risk-adjusted returns net of all fees, suitably matched to the client's risk profile.

Time value
Performing tasks that individual investors might otherwise not have the time, willingness or ability to perform on their own.

Advisers can use the new framework to maximise their value with individual clients by matching the advice interventions in each of the four pillars that are likely to provide them with the most value in the most efficient manner. In many ways, the adviser's most valuable task is choosing which advice opportunities to implement with each client.

Advice as an ongoing process

While financial value and portfolio value are most often delivered through **specific interventions** that advisers recommend to investors, emotional value and time value are most often delivered through an **ongoing process.** This involves the adviser regularly engaging with their clients and monitoring their portfolios—and, in doing so, earning their clients' trust—one of the primary drivers of successful long-term advisory relationships.

Ongoing value activities include:

- Following up with clients to ensure they are saving as much as they need to.
- Showing clients how their plans give them flexibility to spend and enjoy life.
- Educating clients in times of economic euphoria and turmoil.
- Recognising opportunities to take advantage of tax-efficient strategies.
- Encouraging clients to stay invested and avoid unnecessary cash holdings.

The importance of personalisation

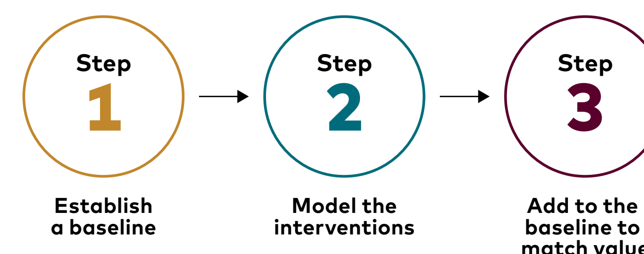
Engaging with an advice provider is more than a financial decision; it is also an emotional commitment. Investors who do not feel their adviser understands their needs are unlikely to be confident in the adviser's ability to deliver results.

Understanding the investor's aspirations and crafting a tailored and personal financial plan is key to delivering value. In fact, we believe the more personal an advice plan is, the more value it can deliver, at least before fees are considered. Products, digital advice services and human advisers can all provide advice value through personalisation[2].

A new process for measuring the value of advice

To assist advisers in using our new framework, Vanguard has developed a three-step process for measuring the value of a set of advice interventions for an individual client relative to their existing 'baseline' investment strategy. The process can also be used to discover higher-value advice opportunities that can assist clients in their decision-making[3].

FIGURE 2.
To measure value, compare the advised alternative to a baseline



Source: Vanguard.

1. **Establish a baseline model:** What will an investor do absent the advice interventions that we want to measure?
2. **Model the interventions:** Once a baseline is established, we can change the modelled outcomes by adding the advice interventions we want to value. How does the range of potential outcomes improve when we undertake the suggested interventions?
3. **Add to the baseline model to match value:** Return to the original baseline model and determine how much additional wealth or extra annual return the investor would need to achieve across a distribution of outcomes, using their current approach, that is equivalent to the advised alternative.

2 See Vanguard's research paper, "*Quantifying the investor's view on the value of human and robo-advice*" for a discussion of how advised investors perceive the relative strengths and weaknesses of digital versus human advisers.

3 Further details will be provided in the forthcoming full version of this paper, which will be available in 2024.

The Vanguard Financial Advice Model

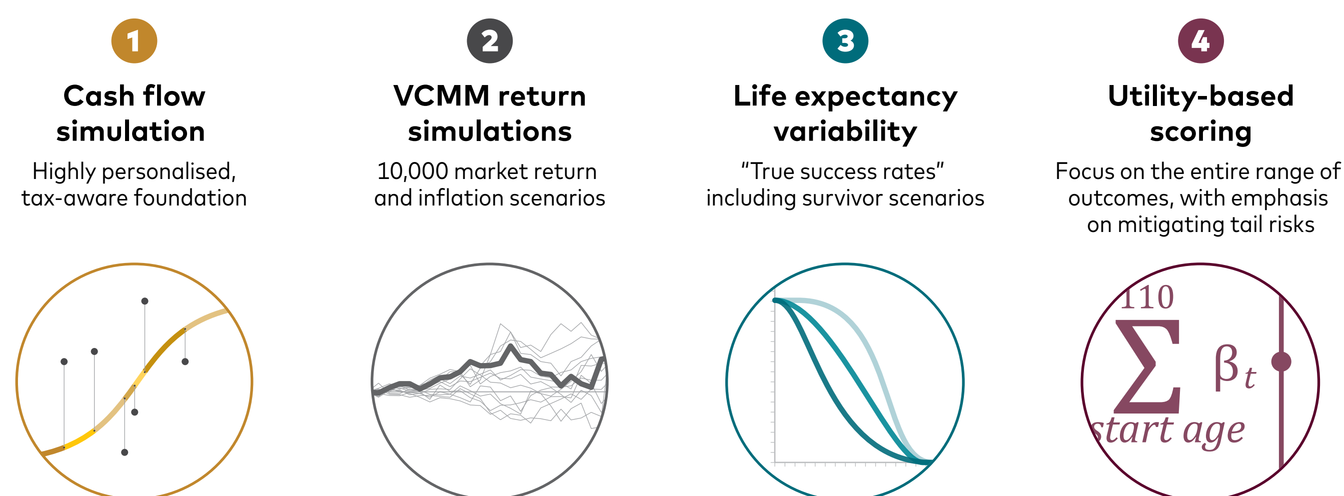
The Vanguard Financial Advice Model (VFAM) was developed in conjunction with our new framework to facilitate calculations of value provided by advice for individual clients relative to their current investment and financial planning strategies.

To calculate the value of a specific set of advice interventions, VFAM draws on the unique needs and goals of the individual client, taking into account the tax and regulatory landscapes of the client's home market. The model's results are expressed as an annualised return value provided to the individual investor, in basis points (a basis point is one-hundredth of a percentage point), as well as in a "windfall equivalent" – the amount that would need to be added to a taxable account held by the individual today.

Currently, VFAM is configured to calculate the value of advice for US-based investors based on the US financial and tax landscapes. UK and European versions of VFAM are under development. Further details of the VFAM model will be discussed in our forthcoming full version of this research paper.

FIGURE 3.

Elements of the Vanguard Financial Advice Model



Source: Vanguard.

Benefits of our measurement approach

We think the values provided by VFAM improve on traditional metrics in several ways:

Personalisation

Most prior discussions of value have focused on valuing advice interventions in a general way. Our approach concentrates on assessing value at the individual investor level, explicitly accounting for differences in client tax brackets and other attributes. This helps advisers measure the value of a specific set of advice interventions and can also help them discover and prioritise higher-value interventions for each investor.

Multi-strategy effects

Each potential advice intervention can provide value in isolation, but by measuring a set of interventions together, we can see how their total value is not simply the sum of its parts. Sometimes multiple interventions can overlap in value, while others can work together to produce superior outcomes.

Distributional outcomes

Although many advice discussions use Monte Carlo simulations to illustrate the range of potential investment outcomes, our method explicitly values each of those possible outcomes and weighs them appropriately. Our method also explicitly accounts for variability of life expectancy outcomes, while most advice conventions simply project to a given age.

Utility-based scoring

VFAM employs utility scoring, rather than portfolio success rates, to compare different strategies and evaluate which one provides the most value based on an individual client's needs. We explore the benefits of utility-based scoring as a measurement of value in the following section.

A more meaningful measure of success

Utility scoring vs portfolio success rate as a measure of value

Traditional financial planning uses a "portfolio success rate" to measure results and "score" a client's portfolio preparedness, as well as the quality of the financial planning strategy or decision. With VFAM, we use a utility framework to score the lifetime spending and bequest distributions of a client's baseline and advised scenarios.

While a portfolio success rate is useful for conveying a portfolio's longevity at a specific age, it has clear shortcomings. For example, consider a client who is 65 years old and has a cashflow horizon age of 100. If their portfolio is only expected to last until age 95 it is considered insufficient at meeting the client's needs. Yet, there's an 80% chance that the client will not live past the age of 95; in which case the portfolio actually has a success rate of more than 80%.

Using a fixed horizon age often layers one conservative assumption on top of another. This approach often leads to the pursuit of a high success rate to account for market risk, while using a long horizon age to protect against longevity risk. The compounding effect of both conservative assumptions makes the probability-of-success metric especially conservative: The only way to fail, assuming a high success rate, is to live an unusually long life and have unusually bad investment returns throughout.

Taking life expectancy into account gives clients with lower life expectancy the freedom to spend more; while allowing clients with higher life expectancy to consider strategies that mitigate longevity risk.

To address all these considerations, VFAM employs utility scoring, rather than portfolio success rates, to compare different strategies and evaluate which one is the best.

What is utility scoring?

In essence, utility is not strictly a measure of wealth, but the life satisfaction or usefulness that wealth can provide. When we consider utility scoring, greater wealth does not necessarily lead to greater outcomes for investors.

A utility function allows VFAM to rank different strategies from best to worst. It captures the trade-offs between current and future spending, and between spending and inheritance. The 'best' utility strategy is one that fares better than other strategies across all market scenarios and accounts for uncertain mortality risk.

Penalising extreme negative outcomes

The utility score does not simply recommend the best average outcome—it also penalises strategies that risk extremely negative outcomes. For example, consider the following two options:

<table>
<tr><th colspan="2">Option 1</th><th colspan="2">Option 2</th></tr>
<tr><td>50% chance</td><td>£0</td><td rowspan="2">100% chance</td><td rowspan="2">£1,000,000</td></tr>
<tr><td>50% chance</td><td>£3,000,000</td></tr>
<tr><td colspan="2">Option 1 has the higher average outcome, a 50% chance of £0 and 50% chance of £3 million, for an average of £1.5 million.</td><td colspan="2">However, a utility scoring approach would favour Option 2, as it guarantees £1 million.</td></tr>
</table>

As we can see in this example, it is better to have a 100% chance of something, than a 50% chance of nothing, even if the potential upside (a 50% chance of £3 million) is far greater.

More isn't always better

With each additional unit of wealth, the increase in additional utility becomes smaller. This design is also intended to reflect investors' inherent risk aversion by penalising catastrophic scenarios (such as being left with zero in 'Option 1' above). Investors care more about losing £1 than they care about gaining £1.

VFAM is not intended to make recommendations to maximise wealth or spending or minimise tax. Instead, the model considers downside risk and chooses options that result in utility maximisation across a wide range of potential outcomes.

Applying the new framework

The advice activities that are most valuable will vary greatly from person to person depending on one's individual circumstances, life stage and market conditions. To show the flexibility of our measurement approach, our research uses case studies of hypothetical clients at different life stages and with different levels of financial experience.

On page 7, we provide an example of a case study based on the the US financial and tax environments. While the values of the outputs may differ in the UK and Europe, the principles apply across these regions and demonstrate how different personalised advice interventions can provide significant value to individual clients.

Conclusion

Financial advisers provide a great deal of value in a myriad of ways; the value of helping investors reach their goals is far higher than many people imagine. By making that value tangible, advisers can improve client outcomes, attract new clients and retain existing ones.

The key to providing value in any situation is to first understand the goals and plans of each client, then identify the right set of advice interventions to match their needs. Measuring this value is a key task to help advisers discover the most valuable advice recommendations and to communicate to clients the ongoing value of following through.

As life progresses and aspirations and market conditions change, advisers need to depend on their process so they can understand clients' changing needs and continue to find opportunities to provide value.

Case study example:
Tristan

Key attributes	Tristan's age	25
	Tax status	Single
	Retirement age	65
	Current annual salary	$120,000
	Asset mix	80% individual stocks, 20% cash
	Taxable investments	$80,000
	Tax-advantaged accounts	$0

Tristan is a young, high-income professional earning $120,000 a year. He has vague financial goals but likes buying shares in companies based on recommendations from friends, family and social media. Recently, Tristan saw the value of his portfolio drop by over 50% in just a few weeks, so he decided it might be worth the 1% annual fee to enlist the help of a professional financial adviser.

Advice interventions

Tristan's adviser focuses on getting Tristan into a formal, disciplined savings and investment plan. They start by ensuring Tristan moves away from a strategy of haphazardly saving into taxable accounts. They achieve this by formalising and automating his savings, while increasing the amount saved from $10,000 to $11,000 per year to take full advantage of Tristan's tax-efficient annual allowances[4].

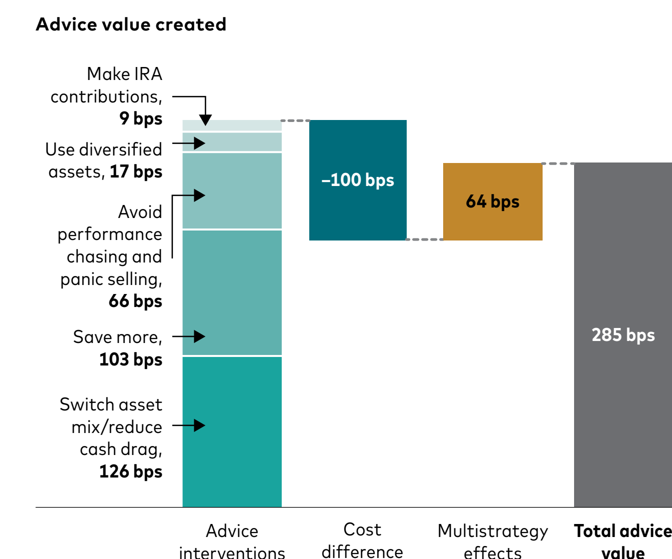
Then the adviser moves on to Tristan's portfolio, getting his cash off the sidelines and moving him from a haphazard mix of individual securities to a globally diversified asset allocation using mutual funds and ETFs (realising some tax losses in the process). Tristan's adviser knows they will need to be attentive to Tristan going forward, as without behavioral reinforcement he is likely to drift from his plan and react to market swings. With ongoing support, he can avoid these potential pitfalls.

Specific advice interventions

- Helping Tristan establish a formal, disciplined savings and investment plan.
- Moving him away from haphazard savings in taxable accounts.
- Increasing Tristan's annual savings from $10,000 to $11,000 per year.
- Using tax-advantaged accounts.
- Switching Tristan out of individual securities into a globally-diversified portfolio.
- Realising some tax losses that can be used later on to provide a benefit.

The advice suggested by Tristan's adviser, if implemented faithfully, can provide an expected value equivalent to an additional return of 2.85% annually, even after accounting for the adviser's 1% annual fee. In cash terms, this equates to a substantial cash equivalent windfall of about $489,000[5].

FIGURE 4.
Tristan can get 285 basis points of annual advice value



4 The tax-efficient allowances are based on the US tax landscape and are for illustrative purposes only. In this example, the value of advice includes Tristan's adviser helping him open an Individual Retirement Account (IRA), a US-based tax-advantaged wrapper account.

5 "Cash equivalent windfall" is the cash amount that would need to be added to a taxable account today to provide the same long-term equivalent value as the proposed advice interventions.

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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 U.S. 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.

Important risk information

The value of investments, and the income from them, may fall or rise and investors may get back less than they invested.

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