Where advisors really add value

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The world is changing and it's changing at an increasingly rapid pace. Companies, industries and societies ignore these changes at their own peril. History is littered with examples of companies who closed their eyes to what was happening around them until it was too late… whether it be Kodak who ignored digital cameras, Barnes and Noble and Blockbusters who did not adapt quickly enough to fend off Amazon and Netflix or more recently the taxi industry which has had its world turned upside down by new competitor who does not own a single car; Uber.

The financial services industry is not immune to these dynamics. In fact, if we consider the combined trends of shifting demographics (particularly the increasing voice of millennials), massive technological innovation, increased regulation and consumerism, all signs are indicating that the industry is ripe for disruption.

Staying relevant in a future world

The answer lies in making sure that you truly add value. This requires deep, honest reflection as it is often a different proposition to where you may think or want to add value, or where your clients perceive you add value. In the new, transparent, automated world, unless you really add sustainable value to consumers, your business model is under threat of extinction.

International research has quantified the potential value of a good advisor's alpha at up to 3% per annum. This is obviously client and time dependent but is significant, both in relation to average advisor fees (0.5% -1% per annum) and total expected returns. We are currently doing research into the South African market to determine the quantum and intend releasing a range of articles dealing with each of these areas.

Good advisors should first make sure that they are adding this value (whether it is true and sustainable) and secondly present their services in such a way that their clients recognise and appreciate this contribution. Such advisors are likely to be able to withstand the rapid change and position themselves and their businesses for a successful future.

Unpacking advisor's 'alpha'

The term 'alpha' is widely used in our industry to describe the goal of active asset managers to outperform their benchmarks. The broad debate goes that if managers cannot outperform their benchmarks consistently over time, it is difficult to justify their fees over a low-cost passive manager.

The term 'alpha' is, however, less frequently used by advisors, but remains an equally important concept. This is the value that advisors add to clients or why their clients are better off than unadvised clients. Our experience is that many advisors are not sufficiently clear around what their alpha proposition is and even when they are, their clients are not fully aware (or do not appreciate) this alpha. A lack of awareness or alignment poses an unnecessary and serious business risk.

International research also confirms that good advisors add material value. This is often achieved not from trying to outperform the market, but through relationship-orientated services such as sensible wealth management via financial planning, discipline and guidance. This value-add can be broken into a number of categories, which include:

Being an effective and trusted behavioural coach

This is probably the most important and often unrecognised value that an advisor can add. Being a truly effective and trusted behavioural coach means making sure investors are able to get over the fear or apathy that prevents them from actually committing to growth (risky) assets and taking sufficient risk where necessary.

Furthermore, once the investor has invested, an effective and trusted behavioural coach must make sure that investors have a clear plan, appropriate asset allocation and crucially, that they stick to their plan. This can be a huge challenge in practice. The three most significant derailers of a good investment plan are the allure of market-timing; the temptation to chase performance; and the risk of abandoning markets after they have been poor.

Because it is in times of extreme volatility when clients are more likely to panic, it is in these times that the value-add that trusted advisors provide can be material. However, this benefit is lumpy and does not come in a straight line.

Having a tax-efficient allocation

Investors are or should be interested in after-tax returns. An advisor who can assess a portfolio holistically, ensure that assets are allocated in the most tax-efficient manner and that investors are maximising the benefit of tax allowances can add significant value. Examples of this are ensuring the income portion of one's portfolio is in exempt retirement portfolios, that investors benefit from tax-free and retirement allowances, making full use of their interest and CGT annual exemptions and regular tax-loss harvesting.

Making use of cost-effective investments

Advisors are able to use their knowledge and experience to ensure that clients receive best value from a range of providers including platforms and asset managers. This may include negotiating on behalf of the client or including a portion of low-cost passive funds where appropriate.

Disciplined rebalancing

Research has shown that regularly rebalancing in a disciplined manner can add value over time. Investors do not do this, and suffer from portfolio drift, because either they are unaware of the risk this drift adds to their portfolios or consider this an inconvenient hassle. Ideally this should be done in a tax-efficient manner (using distributions or exemptions) to minimise CGT implications.

Drawdown strategy

This relates to the period when a client starts drawing down on their accumulated savings as they enter retirement. End outcomes can be optimised if an advisor considers a dynamic withdrawal strategy updated based on market performance and expected investor longevity. Intelligent tax location and withdrawal sequencing – for example withdrawing money from taxable accounts first – can add further value to a client.

These as well as some other slightly more technical topics which include valuing an investor's human capital and financial capital together, developing the optimal blend of annuitisation, and total-return investing are other sources of advisor's alpha which we will discuss over the next few issues of this newsletter. ☐

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