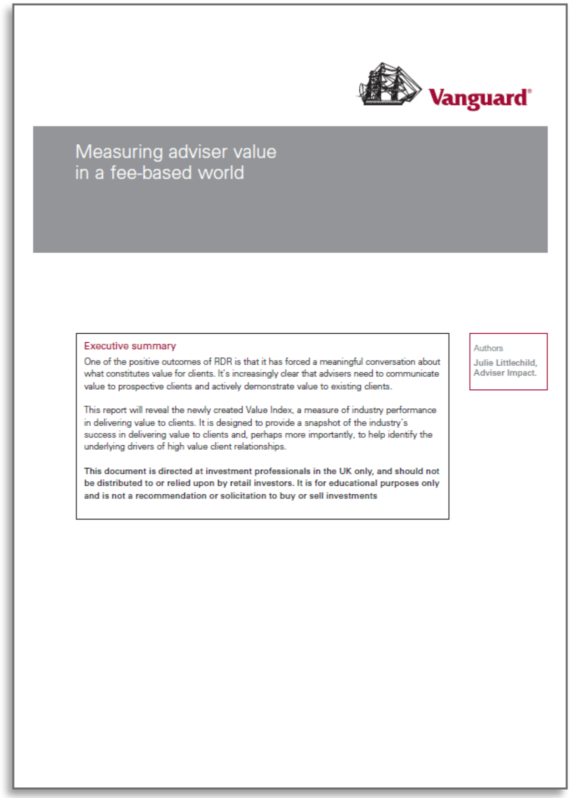
αdviser αlpha

Putting a value on your value

A question of value

Clients who think that their adviser adds significant value are:

1. More confident they will reach their goals
2. More loyal
3. More profitable
4. More likely to provide referrals


Vanguard

Measuring adviser value
in a fee-based world

Executive summary

One of the positive outcomes of RDR is that it has forced a meaningful conversation about what constitutes value for clients. It's increasingly clear that advisers need to communicate value to prospective clients and actively demonstrate value to existing clients.

This report will reveal the newly created Value Index, a measure of industry performance in delivering value to clients. It is designed to provide a snapshot of the industry's success in delivering value to clients and, perhaps more importantly, to help identify the underlying drivers of high value client relationships.

This document is directed at investment professionals in the UK only, and should not be distributed to or relied upon by retail investors. It is for educational purposes only and is not a recommendation or solicitation to buy or sell investments

Authors

Julie Littlechild, Adviser Impact.

And that matters in a
'fee for service' business

What's the problem?

88% of consumers say they need help to achieve their goals

Only 30% of clients say they ONLY pay for investment performance

Source: 'The Economics of Loyalty' Adviser Impact, 2011.

Relationship attributes resonate strongest with clients

We identified six service dimensions that drive adviser value:

1. Helps me to focus on the long term
2. Provides guidance
3. Strong personal relationship
4. Statements are clear and easy to understand
5. Good investment knowledge
6. Helps select investments

Advice and relationship-based attributes dominate

This is how to increase the value your clients perceive

Employing the services of an adviser represents a financial and relationship commitment

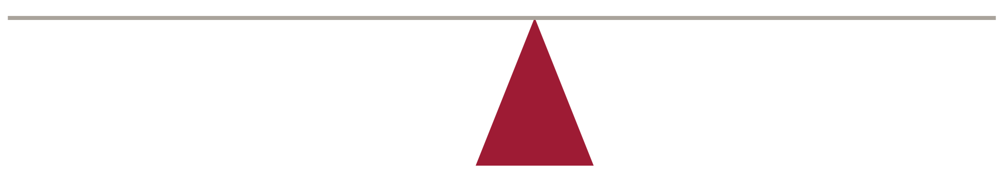
Which one is your client buying into?

Investment focus

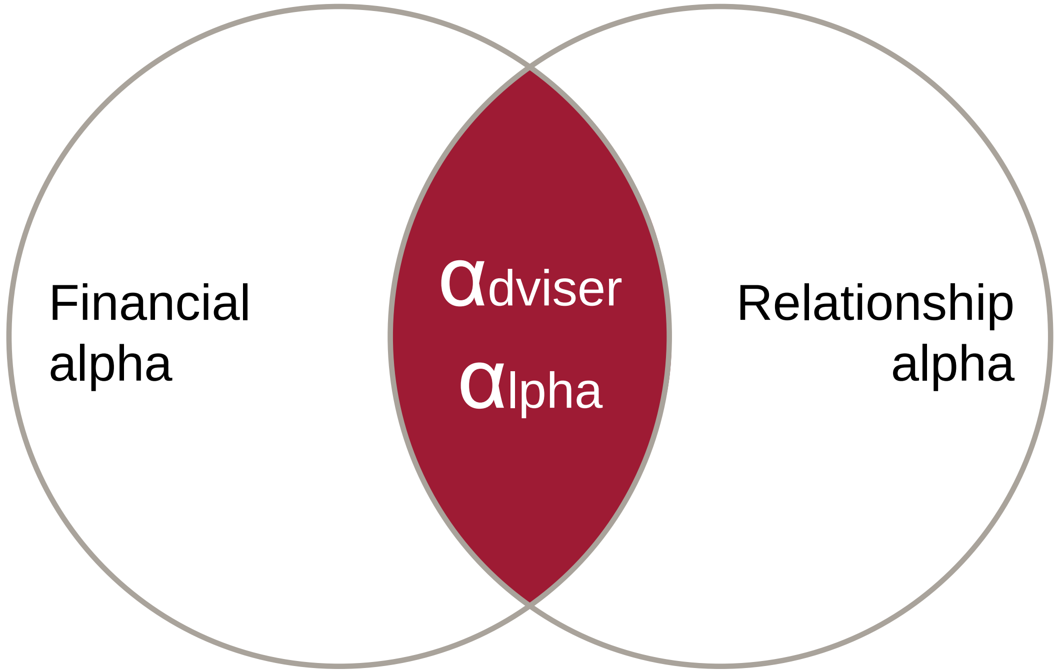
Growth
Income
Risk

Relationship focus

Guidance
Trust
Reliability
Reassurance



Adviser alpha is the blend of two value sets



Advice is difficult to value in advance

- Value may depend on time, willingness and ability?
- Difficult to see…but valuable nonetheless

Adviser Alpha is worth something… but what?

Investors become over-reliant on investment performance measures

Client Discovery	Financial planning	Portfolio construction	Investment management	Asset location	Review

- Advisers search for the least abstract basis to value themselves
- Investment performance seems the most quantifiable metric
- ‘Better returns’
  - But better than what?
  - Benchmark – is it relavant?
  - Client’s need?

Danger that advice is focused on *desired* return…not *required* return?

Adviser Alpha is worth something... but how much?

Wouldn’t it be great to annualise the value of advice?

Financial alpha is hard to predict

- Past performance is no guide to future performance

Relationship alpha even more so

- Relationship alpha doesn’t appear on the client’s statement
- Relationship alpha is often at its highest during distress or euphoria

So can advice be valued?

Advisers are worth…

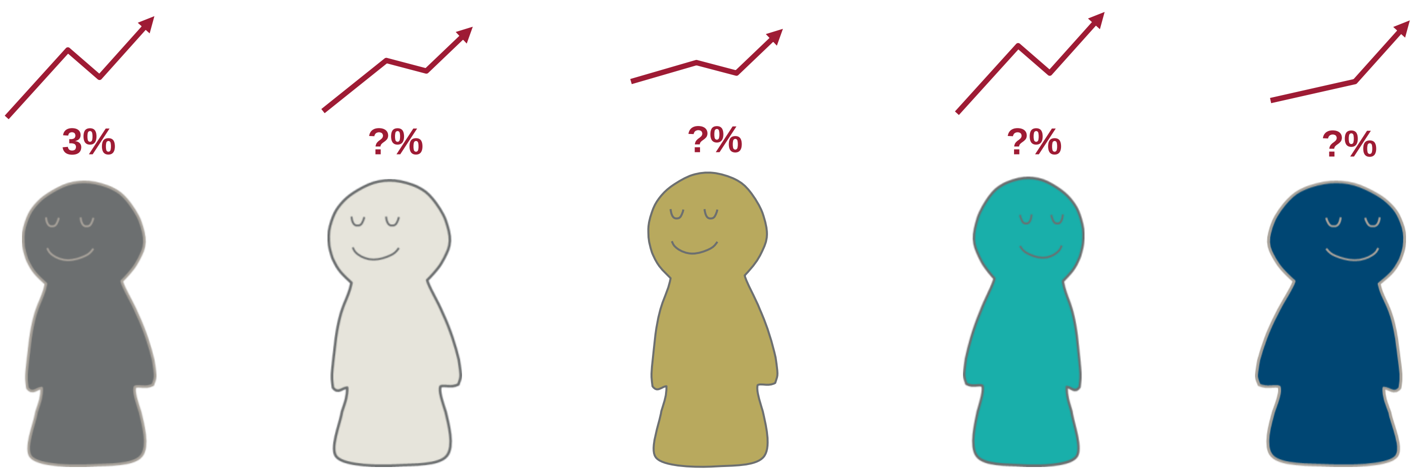
About 3% p.a.

Source: Vanguard Asset Management 'Putting a value on your value', November 2014.

Caveats

<u>About</u> 3% net per annum, however;

- Each client is different
- ‘About’… actual value based on each client’s unique circumstances
- NOT Annual… value is likely to be intermittent
- Difficult to value the emotional benefits



Adviser Alpha is embedded in four principles… we call them the Four Investment Principles

Goals

Create clear, appropriate investment goals.

Balance

Develop a suitable asset allocation using broadly diversified funds.

Cost

Minimise cost.

Discipline

Maintain perspective and long-term discipline.

Adviser Alpha value components

Vanguard's Adviser's Alpha strategy modules	Module number			Value-add relative to "average" client experience (in basis points of return)
Suitable asset allocation using broadly diversified funds/ETFs	I	→	Achieving required return at acceptable risk	> 0 bps
Rebalancing	II	→	Ensuring risk is compensated	0 - 43 bps
Cost-effective implementation (expense ratios)	III	→	Capturing more of the investment return	66-92 bps
Behavioural coaching	IV	→	Avoiding common investment mistakes	150 bps
Tax allowances and asset location	V	→	Paying less tax	0-23 bps
Spending strategy (withdrawal order)	VI	→	Spending savings wisely	0-48 bps
Total-return versus income investing	VII	→	Creating income thoughtfully	> 0 bps
Potential value added				"About 3%"

Source: Vanguard Asset Management 'Putting a value on your value', November 2014.

1. Achieving required return at an acceptable level of risk Asset allocation alpha

- The value of asset allocation is…
  > 0 bps
- Asset allocation underpins investing success and acts as a beacon
- The ‘right’ asset allocation is unique to each client…
- Asset allocation is to target the ‘required return’ at an acceptable risk…

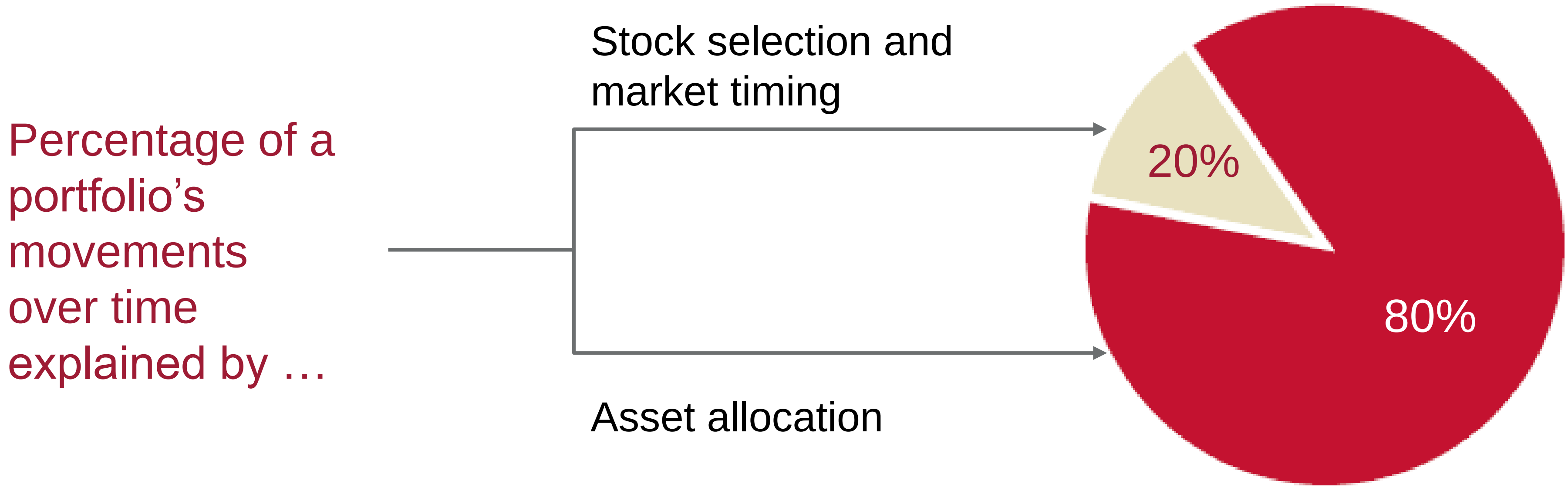
Adviser Alpha Value

>0 bps

But the value to each investor is idiosyncratic

Balance: the importance of asset allocation

Investment outcomes are largely determined by the long-term mixture of assets in a portfolio

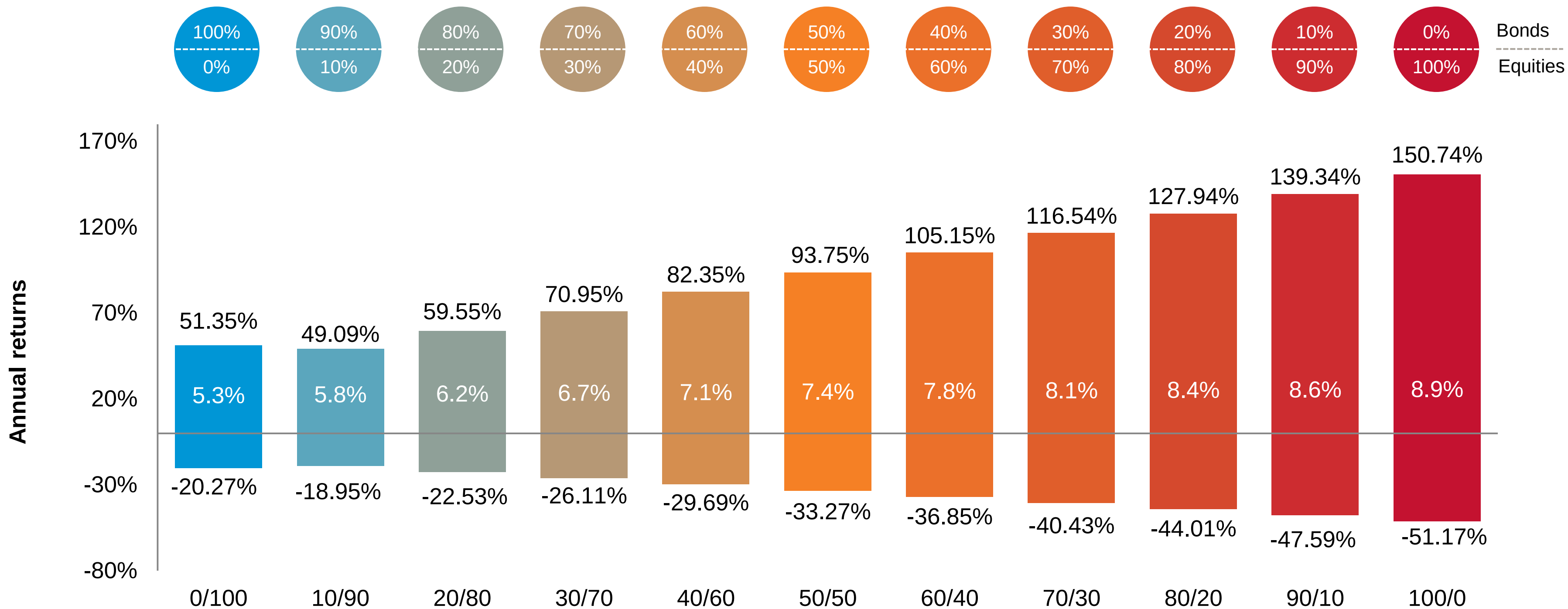


Source: Vanguard calculations using data from Morningstar.

Note: Calculations are based on monthly returns for 294 UK balanced funds from January 1962 through December 2011. For details of the methodology, see the Vanguard research paper *The Global Case for Strategic Asset Allocation* (Wallick et al., 2012).

The mixture of assets defines the spectrum of returns and risk

Best, worst and average returns for various equity / bond allocations, 1900-2013



Past performance is not a reliable indicator of future results.
Source: Vanguard, based on Barclays UK Equity Gilt study, Thomson Reuters, FTSE, MSCI, Citigroup and Barclays.
Notes: Reflects the maximum and minimum calendar year returns, along with the average annualised return, from 1900-2013, for various stock and bond allocations, rebalanced annually. From 1900 through 1984, stocks are represented by the Barclays Equity Gilt Study from 1900 to 1964, Thomson Reuter Datastream UK Market Index Jan.1965 – Dec.1969; MSCI UK Jan.1970 - Dec.1985; Thereafter, stocks are represented by MSCI All Country World Index. Bonds are UK as represented by Barclays Equity Gilt Study 1900-1976 ;FTSE UK Government Index Jan.1977-Dec 1984, Citigroup World Global Bond Index from 1985 through 1989, Barclays Global Aggregate Index thereafter. Returns are in sterling, with income reinvested, through 2013.

But predicting markets is a losing strategy

Key index returns (%), ranked by performance

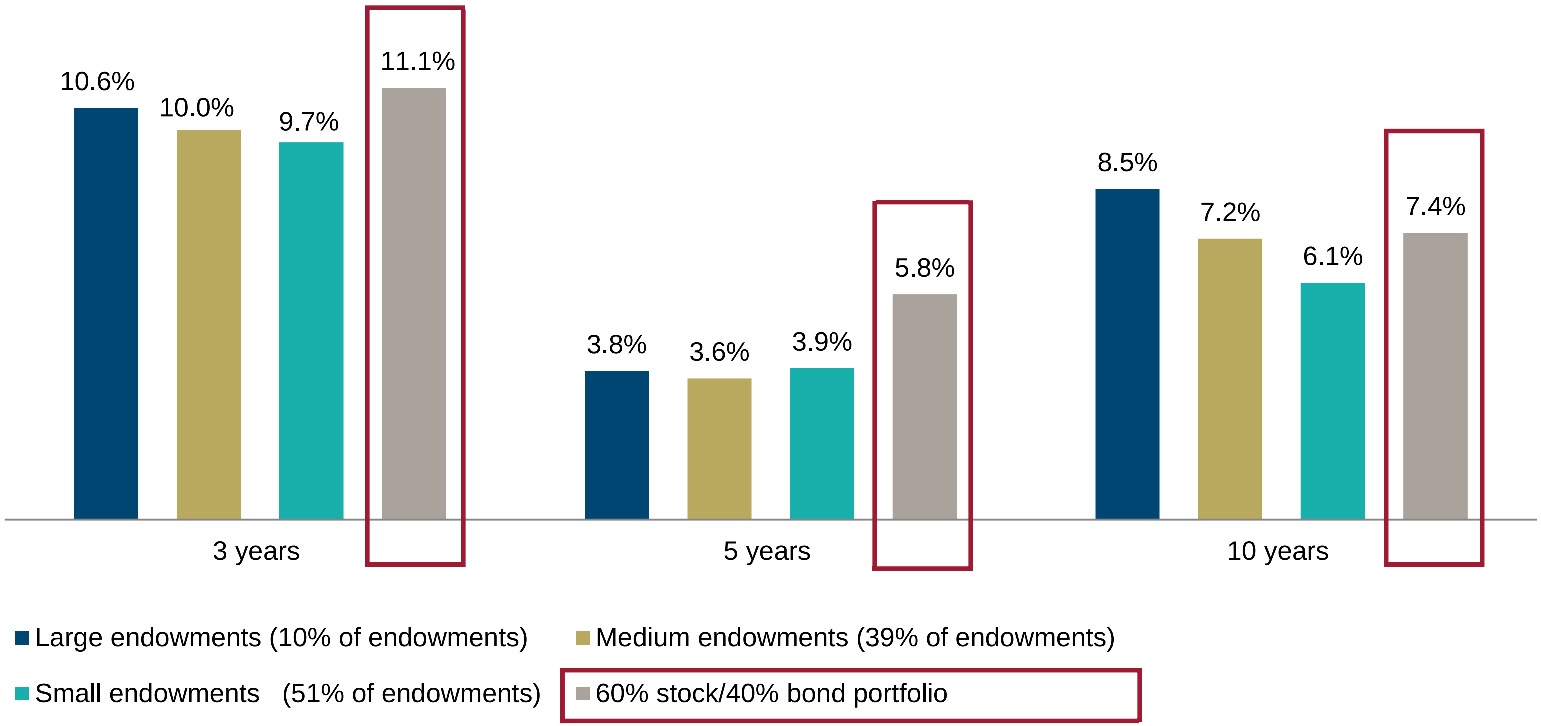
2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
9.9%	8.3%	10.7%	38.5%	19.3%	51.1%	20.1%	37.4%	13.0%	62.5%	23.6%	20.3%	17.8%	28.3%	19.6%
8.9%	7.5%	9.4%	29.7%	13.8%	36.8%	16.8%	15.7%	7.6%	30.1%	21.3%	16.7%	15.5%	25.2%	18.8%
5.9%	5.2%	8.7%	25.3%	12.8%	24.9%	16.8%	10.8%	3.6%	21.2%	19.1%	6.5%	12.8%	21.0%	14.6%
1.7%	3.2%	8.0%	20.9%	11.5%	24.1%	7.2%	8.3%	-10.0%	20.1%	16.7%	5.8%	12.3%	20.8%	12.5%
0.6%	-1.1%	-15.1%	20.9%	8.5%	22.0%	3.3%	6.6%	-13.2%	14.8%	14.5%	1.2%	12.0%	13.6%	11.3%
-0.5%	-10.8%	-17.3%	16.4%	8.3%	20.2%	2.8%	5.8%	-13.3%	14.7%	8.9%	-3.5%	11.2%	1.6%	7.9%
-4.3%	-13.3%	-22.7%	7.1%	8.0%	9.1%	1.7%	5.6%	-19.4%	13.6%	8.7%	-6.6%	10.7%	0.6%	7.9%
-5.9%	-13.8%	-26.6%	6.9%	6.7%	8.5%	0.8%	5.3%	-24.0%	6.3%	7.5%	-12.6%	5.9%	0.0%	2.8%
-20.0%	-20.0%	-27.0%	5.5%	6.6%	7.9%	0.5%	5.2%	-29.9%	5.3%	5.8%	-14.7%	2.9%	-4.2%	1.2%
-27.2%	-22.9%	-29.5%	2.1%	4.1%	5.8%	-0.2%	0.4%	-34.8%	-1.2%	4.8%	-18.4%	0.6%	-5.3%	0.2%

- Global equities
- North American equities (US/Canada
- Emerging market equities
- Developed Asia equities
- European ex UK equities
- UK equities
- UK government bonds (gilts)
- UK index-linked gilts
- UK investment grade corporate bonds
- Hedged global bonds

Past performance is not a reliable indicator of future results.
Source: Vanguard calculations, using data from Barclays Capital and Thompson Reuters Datastream. UK equity is defined as the FTSE All Share Index, Europe ex-UK equity as the FTSE All World Europe ex-UK Index, developed Asia equity as the FTSE All World Developed Asia Pacific Index, North America equity as the FTSE World North America Index, emerging market equity as the FTSE Emerging Index, global equity as the FTSE All World Index, UK government bonds as Barclays Sterling Gilt Index, UK index-linked gilts as Barclays Global Inflation-Linked UK Index, hedged global bonds as Barclays Global Aggregate Index (hedged in GBP), UK investment grade corporate bonds as Barclays Sterling Corporate Index. Returns are denominated in GBP and include reinvested dividends and interest.

Simplicity can be your friend

NACUBO-Commonfund (2014) study on the performance of endowment portfolios



Past performance is not a reliable indicator of future returns.
Sources: Vanguard and NACUBO-Common fund Study of Endowments, 2014.
Notes: Data are as of June 30 for each year. Data through 30 June 2013. 60% stock/40% bond portfolio: Domestic equity (42%) is Dow Jones Wilshire 5000 Index through April 22, 2005, and MSCI US Broad Market Index thereafter. Non-U.S. equity (18%) is MSCI All Country World Index ex USA. Bonds (40%) are Barclays U.S. Aggregate Bond Index.

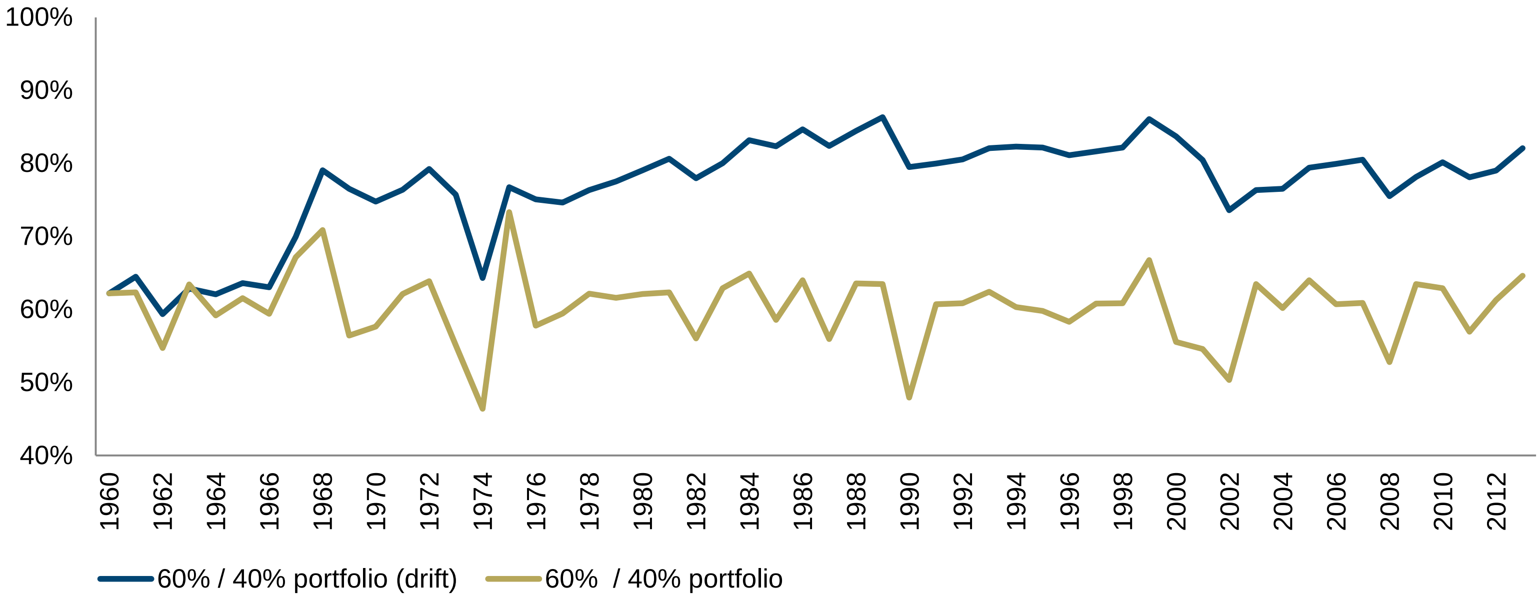
2. Ensuring risk is compensated
Rebalancing Alpha

Adviser Alpha Value

0-43 bps

The value of rebalancing is 0-43 bps

Based upon a 60 / 40 equity / bond portfolio, allowed to drift, compared to 60 / 40 portfolio re-balanced with similar risk



Source: Vanguard, based on Barclays UK Equity Gilt study, Thomson Reuters, FTSE, MSCI, Citigroup and Barclays.
Notes: From 1960 through 1984, equities are represented by the Barclays Equity Gilt Study from 1900 to 1964, Thomson Reuters Datastream UK Market Index Jan.1965 - Dec.1969; MSCI UK Jan.1970 - Dec.1985; thereafter, equities are represented by MSCI All Country World Index. Bonds are represented by Barclays Equity Gilt Study 1960-1976; FTSE UK Government Index Jan.1977-Dec 1984, Citigroup World Global Bond Index from 1985 through 1989, Barclays Global Aggregate Index thereafter. Returns are in sterling, with income reinvested, to 31 December 2013.

Rebalancing can improve risk-adjusted returns

	60% / 40% portfolio	60% / 40% portfolio (drift)	70% / 30% portfolio
Average annual return	10.35%	10.08%	10.51%
Average annual standard deviation	19.70%	21.97%	21.67%
Average equity	60.40%	76.97%	70.26%

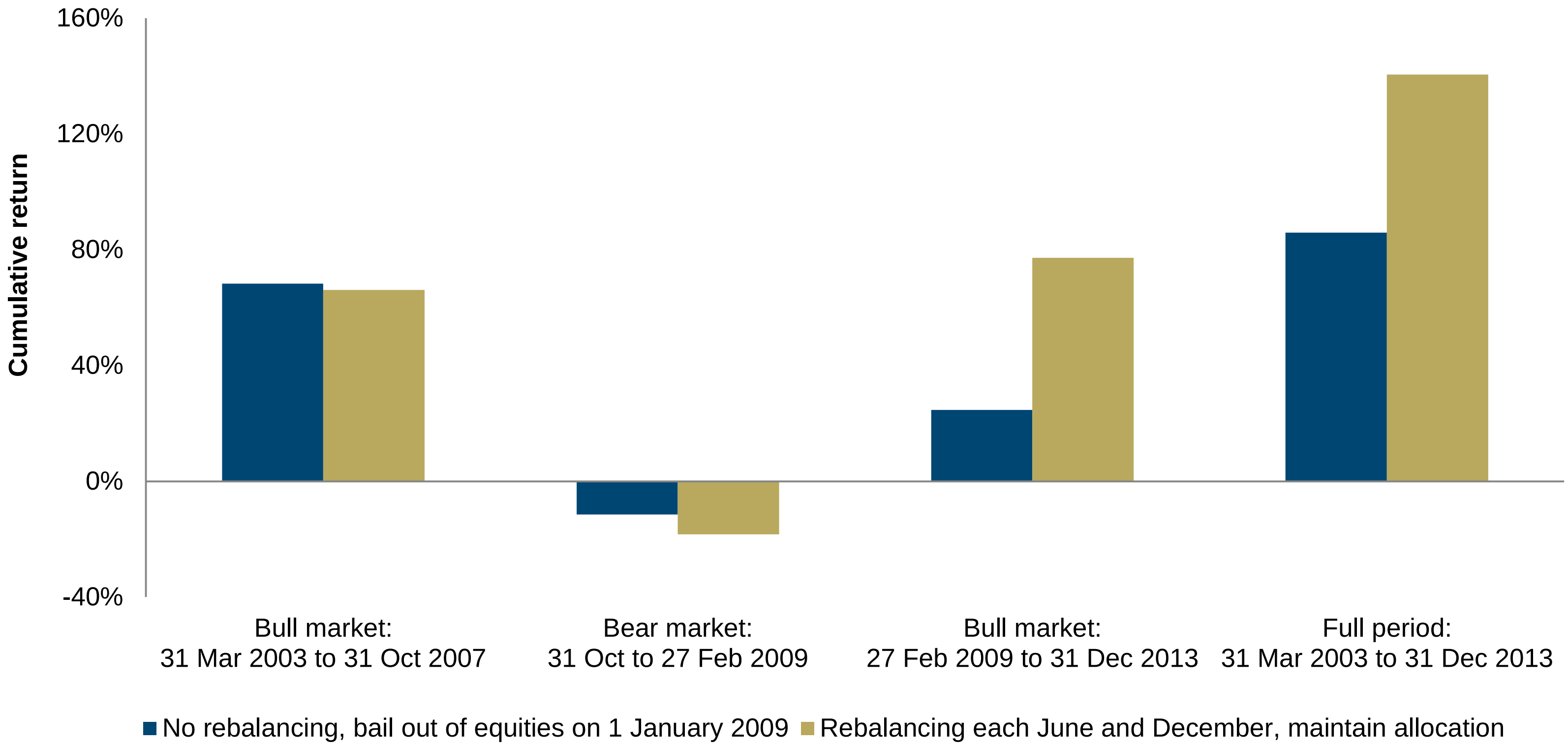
Advisers role

- Rebalancing is not free…needs judicious implementation…costs and taxes…perhaps why Fund of Funds have become popular?

Rebalancing is a vital investment discipline

Discipline: reacting to market volatility can jeopardise return

What if the 'drifting' investor fled from stocks after the 2008 plunge?



Past performance is not a reliable indicator of future results.
Source: Vanguard, based on data from MSCI and Barclays.
Notes: The initial allocation for both portfolios is 60% global equity and 40% global bonds. The rebalanced portfolio is returned to this allocation at the end of each June and December. Global equity is defined as the MSCI All Country World Investable Market Index, unhedged in sterling. Global fixed income is defined as the Barclays Global Aggregate, hedged to GBP. Returns are in GBP with income reinvested.

3. Capturing more of the investment return
Cost effective implementation Alpha

Adviser Alpha Value

66-92 bps

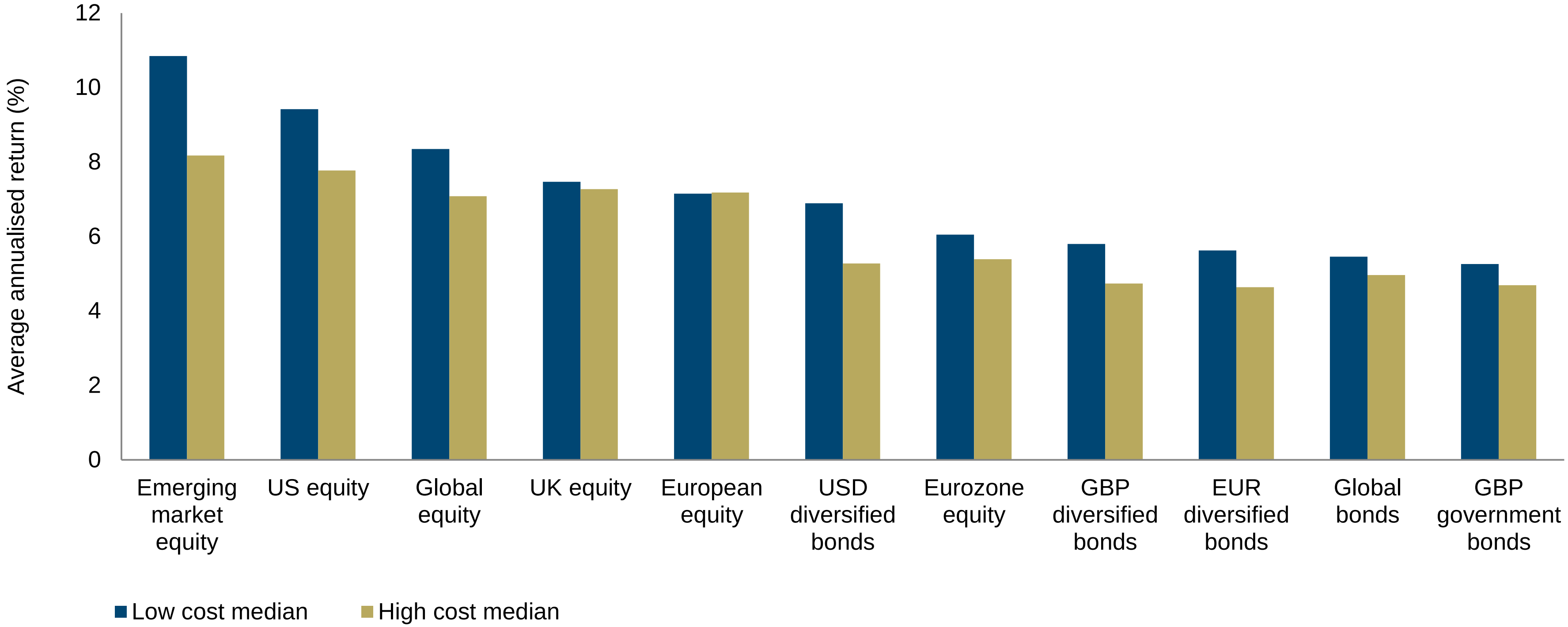
Cost effective implementation – 66 to 92 bps

Equity/bond mix:	100%/0%	80%/20%	60%/40%	50%/50%	40%/60%	20%/80%	0%/100%
Asset-weighted expense ratio (AWER)	1.08	1.07	1.05	1.05	1.04	1.02	1.01
Quartile 1 AWER (Q1)	0.42	0.35	0.29	0.26	0.22	0.16	0.09
Cost-effective implementation (AWER vs. Q1)	**0.66**	**0.71**	**0.76**	**0.79**	**0.82**	**0.87**	**0.92**

Sources: Vanguard calculations, based on data from Morningstar, Inc., as at 31 December 2013.
Notes: 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; Euro zone equity – flex-cap, large-cap, mid-cap, small-cap; Global – 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 un-hedged bond; UK bonds – UK diversified, UK government.

Costs: still the best indicator of likely outperformance?

Average annual returns over the ten years to 31 December 2014



Past performance is not a reliable indicator of future results.
Source: Vanguard Group, Inc. calculations using Morningstar data.
Notes: All mutual funds in each Morningstar category were ranked by their expense ratios as of 31 December 2014. They were then divided into four equal groups, from the lowest-cost to the highest-cost funds. The chart shows the ten-year annualised returns for the median funds in the lowest cost and highest cost quartiles. Returns are in sterling terms with income reinvested, net of expenses, excluding loads and taxes. Both actively managed and indexed funds are included. For funds with both income and accumulation share classes, we use only accumulation share classes to avoid double counting.

Costs matter - a lot

Costs matter

Costs, like interest, compound over time

Impact on investment returns not always obvious

Table shows the impact of ongoing charges figure (OCF) over time

This hypothetical example assumes neutral growth so that the long-term effect of costs is readily apparent

AMC (%)	Percentage of portfolio retained after costs							
	Years							
	1	3	5	10	15	20	25	30
0.10	99.90	99.70	99.50	99.00	98.51	98.02	97.53	97.04
0.15	99.85	99.55	99.25	98.51	97.77	97.04	96.32	95.60
0.20	99.80	99.40	99.00	98.02	97.04	96.08	95.12	94.17
0.30	99.70	99.10	98.51	97.04	95.59	94.17	92.76	91.38
0.35	99.65	98.95	98.26	96.55	94.88	93.23	91.61	90.02
0.40	99.60	98.80	98.02	96.07	94.17	92.30	90.47	88.67
0.45	99.55	98.66	97.77	95.59	93.46	91.37	89.34	87.34
0.50	99.50	98.51	97.52					
0.55	99.45	98.36	97.28					
0.60	99.40	98.21	97.04					
0.70	99.30	97.91	96.55					
0.80	99.20	97.62	96.06					
0.90	99.10	97.32	95.58					
1.00	99.00	97.03	95.10	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
1.10	98.90	96.74	94.62	89.53	84.71	80.15	75.84	71.76
1.20	98.80	96.44	94.14	88.63	83.44	78.55	73.95	69.62
1.30	98.70	96.15	93.67	87.73	82.18	76.97	72.10	67.53
1.40	98.60	95.86	93.19	86.85	80.94	75.43	70.29	65.51
1.50	98.50	95.57	92.72	85.97	79.72	73.91	68.53	63.55
1.60	98.40	95.28	92.25	85.10	78.51	72.43	66.82	61.64
1.70	98.30	94.99	91.78	84.24	77.32	70.97	65.14	59.79
1.80	98.20	94.70	91.32	83.39	76.15	69.54	63.50	57.99
1.90	98.10	94.41	90.85	82.54	75.00	68.14	61.90	[illegible]
2.00	98.00	94.12	90.39	81.71	73.86	66.76	60.35	54.55
2.10	97.90	93.83	89.93	80.88	72.73	65.41	58.83	[illegible]
2.20	97.80	93.54	89.47	80.06	71.63	64.09	57.34	51.31
	97.70	93.26	89.02	79.24	70.54	62.79	55.89	49.76
	97.60	92.97	88.56	78.43	69.46	61.52	54.48	48.25
	97.50	92.69	88.11	77.63	68.40	60.27	53.10	46.79
	97.40	92.40	87.66	76.84	67.36	59.04	51.76	45.37
	97.30	92.12	87.21	76.06	66.33	57.84	50.45	43.99
2.80	97.20	91.83	86.76	75.28	65.31	56.67	49.17	42.66
2.90	97.10	91.55	86.32	74.51	64.31	55.51	47.92	41.36
3.00	97.00	91.27	85.87	73.74	63.33	54.38	46.70	40.10

A low-cost 0.20% fund retains over 95% after 25 years

A high-cost 2.00% fund has lost almost 40%.

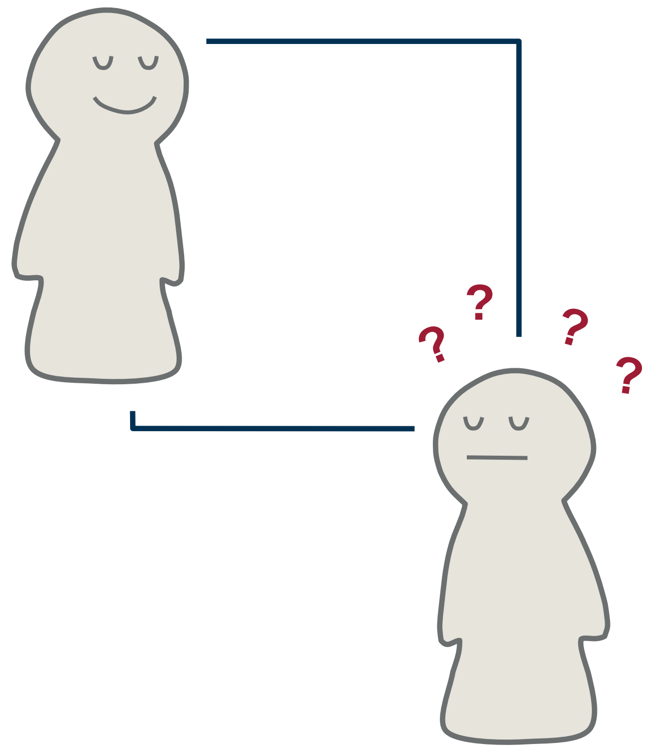
Source: Vanguard Asset Management, Limited.

4. Avoiding common invesment mistakes
Behavioural coaching Alpha

Adviser Alpha Value

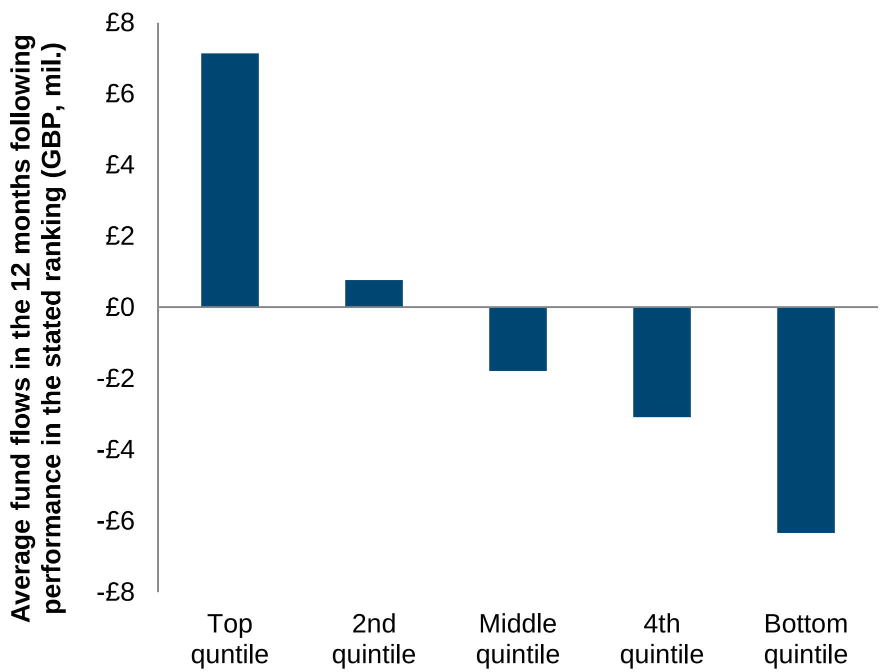
150 bps

- The value of behavioural coaching is around 150 bps
- Abandoning a planned investment strategy is costly
- Key derailers are market timing and performance chasing
- A single client intervention can more than offset a year’s fee
- The adviser is an important emotional circuit breaker

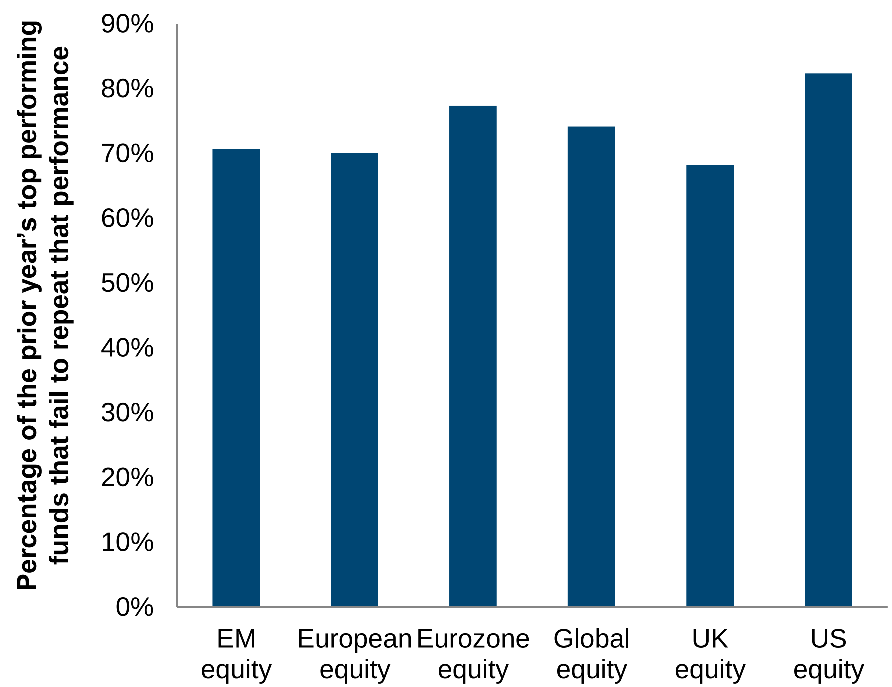


The danger of lacking a plan
Investors tend to chase the previous year's top performers

Investors tend to chase the previous year's top performing funds



Even as prior year performance has no bearing on future returns

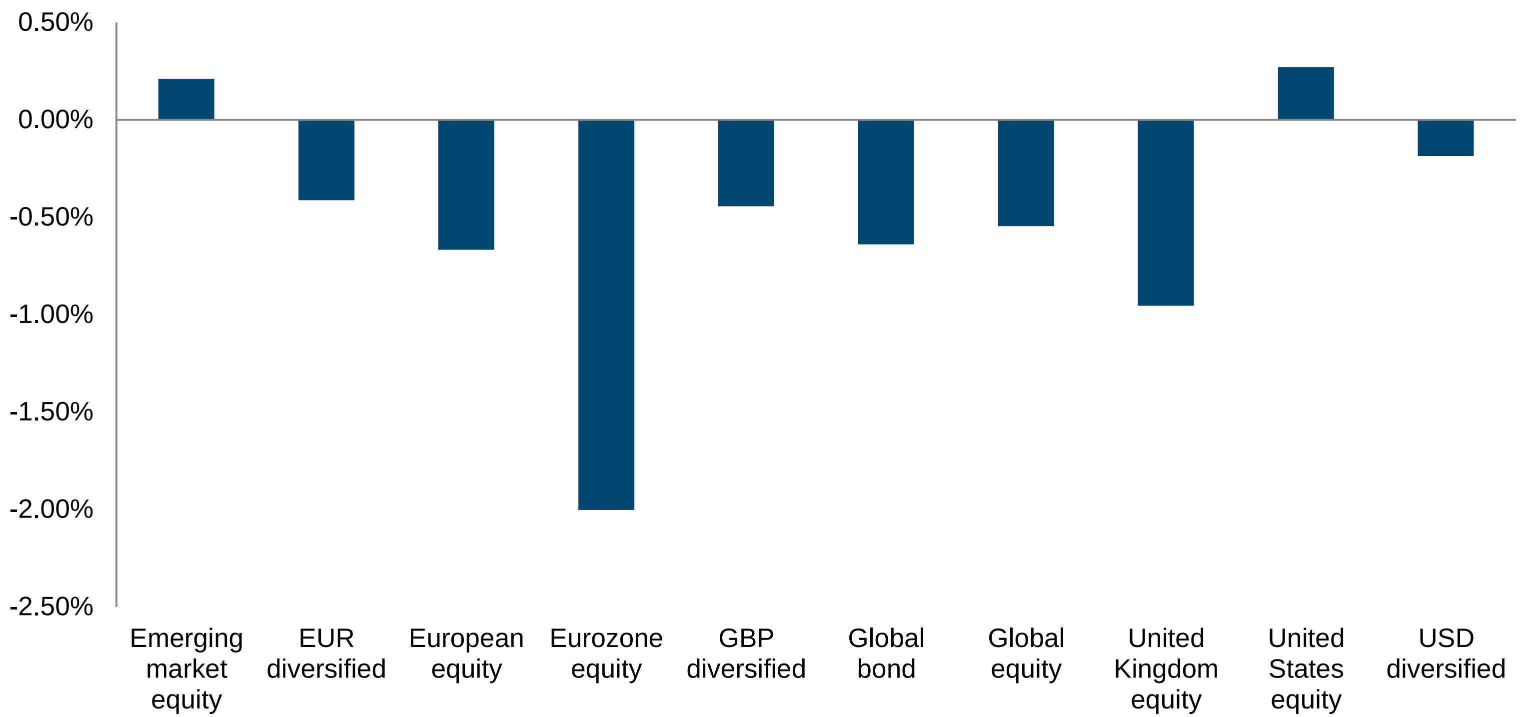


Past performance is not a reliable indicator of future results.

Source: Vanguard based on data from Morningstar. Notes: Charts examine all equity funds available for sale in the UK, as defined in Westaway et al (2014). Funds are ranked according to trailing 12-month total returns, for each rolling 12-month time period, beginning on 1 January 2004. LHS displays the average flows in the subsequent 12-month period into the funds, according to their performance ranking within their regional style in the prior 12-month period. RHS displays the percentage of funds from the previous top 12-month performance ranking that fail to maintain this ranking in the subsequent 12 months. Fund returns are in GBP, net of fees, gross of tax, with income reinvested.

Investor returns vs. fund returns

Investor returns versus fund returns: Ten years ending 31 December 2013



Source: Vanguard calculations, based on data from Morningstar, Inc.
Notes: Figure displays the difference between the investor and fund returns, as defined by the asset-weighted average in each category. Investor returns are calculated as the internal rate of return that sets the beginning and ending fund assets equal, given the interim cash flows. Market returns are the asset-weighted average fund return. Both are derived from aggregate flows data for funds domiciled in the UK, with asset classes defined as in Westaway et al (2014). Returns are in GBP, net of fees, with income reinvested.

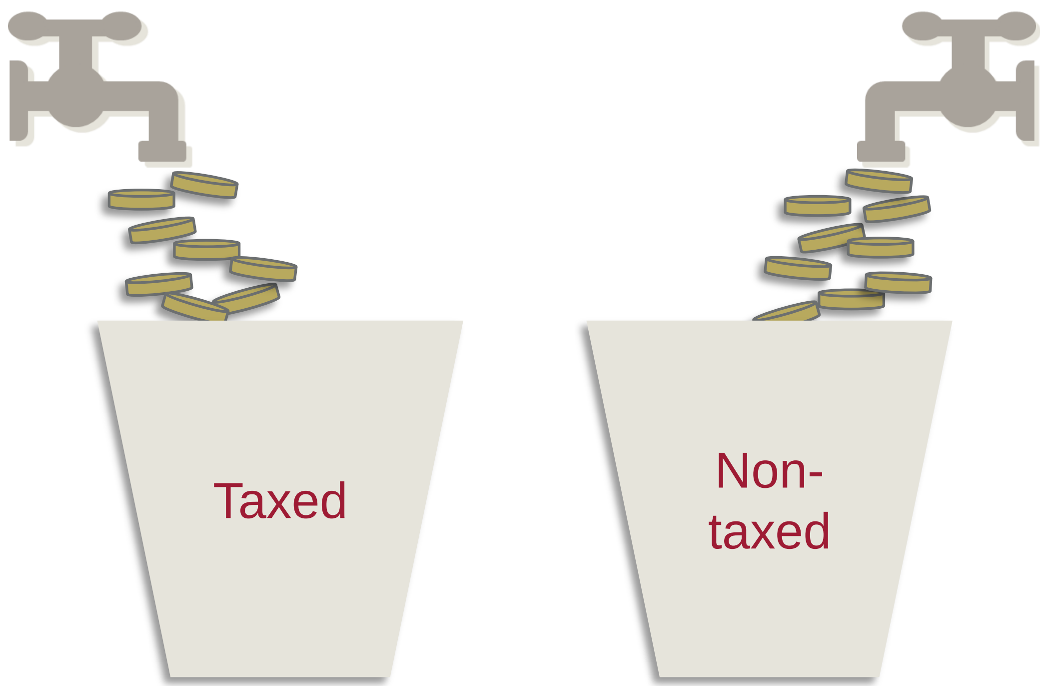
5. Paying less tax
Asset location Alpha

Adviser Alpha Value

0 to 23 bps

Asset location is worth 0-23 bps in the first year… compounded

- Average Investors
- Optimising tax allowances
- Housing income vs. gains?



6. Spending savings wisely
Spending strategies Alpha

Adviser Alpha Value

0 to 48 bps

- Spending strategies are worth 0-48 bps
- Bewildering discretion and choice…especially post budget
- Spending from taxable assets or tax advantaged assets?
- What about Intergenerational wealth transfer?

7. Creating income thoughtfully
Total return vs. income investing Alpha

Adviser Alpha Value

> 0 bps

Traditional 'income' investors only have three choices in a lower yield environment;

- Spend less
- Reallocate to higher yielding holdings
- Spend from total income

But beware;

Chasing yield on bonds

Longer duration = greater sensitivity to rates = volatility

Shifting to dividend centric stocks

Stocks are not bonds

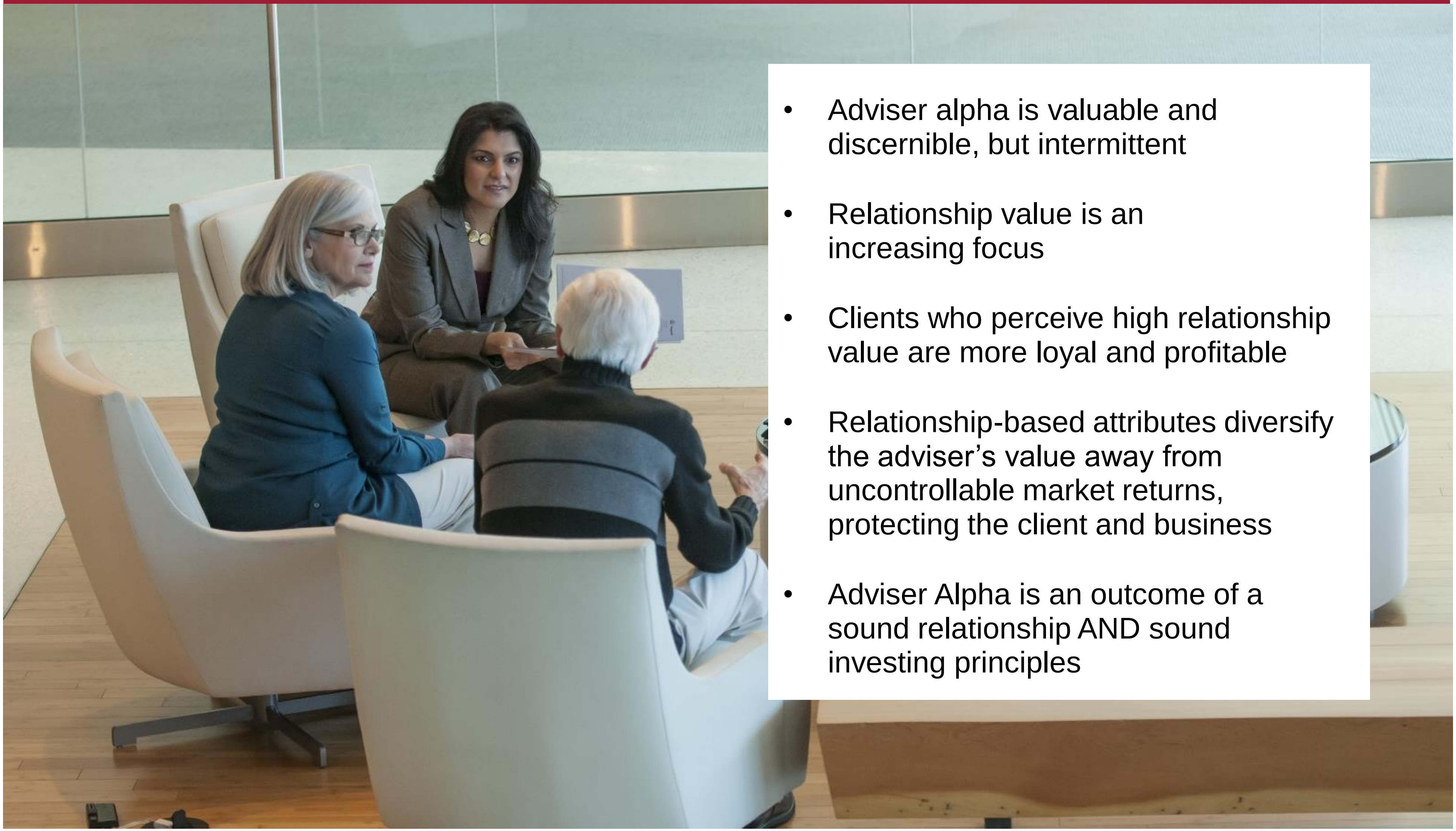
Moving from broad market to dividend focus may alter risk profile

Achieving income from a balanced, disciplined portfolio

Adviser Alpha value components

1. Achieving required return at acceptable risk ✓
2. Ensuring risk is compensated ✓
3. Capturing more of the investment return ✓
4. Avoiding common investment mistakes ✓
5. Paying less tax ✓
6. Spending savings wisely ✓
7. Creating income thoughtfully ✓

Summary



- Adviser alpha is valuable and discernible, but intermittent
- Relationship value is an increasing focus
- Clients who perceive high relationship value are more loyal and profitable
- Relationship-based attributes diversify the adviser's value away from uncontrollable market returns, protecting the client and business
- Adviser Alpha is an outcome of a sound relationship AND sound investing principles

Thanks for listening

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