INVESTMENT NEWSLETTER

> *Advisor Alpha is a belief that you, as the investment advisor, add value (measured by additional overall invest returns) to a client's portfolio.*

IN SEARCH OF ADVISOR ALPHA

FEBRUARY 2019
OBS Financial

If you do an internet search on the topic of "Advisor Alpha," you will discover that Vanguard owns this space. The firm has been researching, measuring, and writing on this topic since 2001. So, what is Advisor Alpha? What is this subject that has so engrossed one of the biggest investment firms in the industry?

Bottom line, it is a belief that you, as the investment advisor, add value (measured by additional overall invest returns) to a client's portfolio. It is the worth you bring to the client over and above what he or she could do on their own.

Vanguard's research teams believe the enhanced value for a client in an implemented Advisor Alpha model is about a 3% increased annual return. Of course, this differs from client to client depending the makeup of the portfolio, client goals, and time horizon. There are times when your value is greater and some years it may be less; but overall, on average, Vanguard believes this amount is a measure of the value you can deliver to your clients.

Historically, advisors have verbalized their value by stating that, through the use of a sharp eye and keen investment sense, they provide guidance that delivers greater portfolio returns when measured against the market or a predetermined index. However, it has been shown that this is a dicey approach because consistently beating the market is a challenging goal to deliver. Markets are cyclical and uncertain. You have come to realize the majority of the economic factors going into a portfolio's return is completely out of an advisor's control. The impact of trade wars, Federal Reserve rate increases, Washington partisanship, and global events are difficult to calculate or predict over time. Add to that unforeseen corporate scandals as well as the effect wildfires, hurricanes, and nor'easters have on unsettling individual sectors of the market, and you can see the inherent challenge.

FirstCapital Bank of Texas
You above all.

Some advisors may discuss financial planning services as a value-add package even if it was hard to quantify. It was a way to sway the client's belief in their advisor during those years when the portfolio underperformed its benchmark.

What does the Advisor Alpha framework look like?

INVESTMENT MANAGEMENT	**FINANCIAL PLANNING**
BEHAVIORAL FINANCE	**SERVICE MODEL**

Vanguard Advisor's Alpha®
Vanguard Research July 2018

It is the combination of all of the above activities working congruently to solve a client's long-term financial goals.

INVESTMENT MANAGEMENT

- Manager selection
- Investment policy statement
- Controlling expenses
- Rebalancing
- Tax-efficient investing for non-qualified accounts
- Asset allocation

Notice I did not add selecting the actual securities as part of the Investment Management services. For the majority of advisors, I believe the time you would spend researching, monitoring, and adjusting a selection of risk-adjusted model portfolios is better spent deepening the relationship with the client and improving your understanding of their individual and family financial goals and objectives.

FINANCIAL PLANNING

- Estate planning
- Education planning
- Cash flow planning
- Retirement income planning
- Health insurance/Medicare/long-term care insurance
- Risk management

Within the retirement income planning process, you provide significant value as you assist with the Social

Security retirement elections, using annuitization to enhance the probability of success of a retirement income plan, liquidation order, and minimizing the sequence of returns risk.

BEHAVIORAL FINANCE

I am confident that over the years, you have likely come to realize that humans are not naturally wired for success when investing. Managing your clients' emotions can deliver significant value in Advisor Alpha.

Think back to the heart of the global economic meltdown. In 2008, how many of your clients called you at the bottom of the cycle with a desire to sell out of his or her portfolio and escape to cash, CDs, or fixed annuities? Those clients you successfully encouraged to stay invested have profited from the longest bull market in U.S. history.

Those calming conversations kept your clients from allowing market fluctuations to derail their intended investment plan. Your experience, knowledge, and skills minimize the effect of an investor's tendency for performance chasing and the "fear vs. greed emotional rollercoaster".

SERVICE MODEL

- Investment and financial plan reviews
- Service standards
- Client communication program
- Staffing
- Client-only educational workshops
- Client appreciation events

As the financial services industry evolves from a commission-based approach to a fee-based strategy, the Advisor Alpha business model will become an important framework to consider for your business.

Also, think of it as a structure that gives you an opportunity to differentiate yourself from other financial advisors in your area – not all advisors are created equal. Experience, business acumen, staff resources, and commitment to an Advisor Alpha model varies from advisor to advisor.

If you are currently providing only asset allocation, manager selection, and reporting as your business model, it may seem like these changes are too wide-ranging to implement simultaneously. If that is the case, take Vanguard's advice by initially concentrating on the following items when looking to add Advisor Alpha:

1. Asset allocation
2. Implementing with lower cost investment products
3. Limiting deviations from the initial asset allocation
4. Concentrating on behavior finance and client communication

The Vanguard researchers also advocate that advisors begin a new relationship with a financial plan and a written investment policy statement; these activities will set the framework for an Advisor Alpha engagement going forward. This approach is also encouraged, if not required, for those of you who are Certified Financial Planner® professionals.

The advantages to building a business model using the Vanguard Advisor Alpha® guidelines include:

Greater client retention

If you are building a business using a fee-based revenue model then retaining clients is a worthwhile activity.

Clients win

The added alpha gained by the clients can add up to a significant amount over a 15- or 20-year period.

Advisor differentiation

Not all advisors possess the will or ability to deliver on such a high-level of client interaction and support.

Client advocates

Delivering on an Advisor Alpha experience will create clients who bring you all of their assets and deliver 10 to 15 qualified client referrals annually.

Some may question the "about 3%" conclusion by Vanguard's team. A recent study by Russell Investments called Why Advisors Have Never Been More Valuable determined that for 2017, the Advisor Alpha was measured at 4.08%. Regardless of your thoughts on the quantifiable value, it is hard to argue against the substance you bring to a comprehensive client relationship.

Resources:

Putting a value on your value: Quantifying Vanguard's Advisor Alpha®. Vanguard Research, September 2016. Francis M. Kinniry Jr., CFA, Colleen M. Jaconetti, CPA, CFP ®, Michael A. DiJoseph, CFA, Yan Zilbering, and Donald G. Bennyhoff, CFA

The evolution of Vanguard's Advisor Alpha®: From portfolios to people. Vanguard Research, January 2018. Donald G. Bennyhoff, CFA; Francis M. Kinniry Jr., CFA; and Michael A. DiJoseph, CFA

Vanguard's Advisor Alpha®. Vanguard Research, July 2018. Donald G. Bennyhoff, CFA; Francis M. Kinniry Jr., CFA

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DÉJÀ VU ALL OVER AGAIN

FEBRUARY 2019
Dimensional Fund Advisors

Investment fads are nothing new. When selecting strategies for their portfolios, investors are often tempted to seek out the latest and greatest investment opportunities.

Over the years, these approaches have sought to capitalize on developments such as the perceived relative strength of particular geographic regions, technological changes in the economy, or the popularity of different natural resources. But long-term investors should be aware that letting short-term trends influence their investment approach may be counterproductive. As Nobel laureate Eugene Fama said, "There's one robust new idea in finance that has investment implications maybe every 10 or 15 years, but there's a marketing idea every week."

WHAT'S HOT BECOMES WHAT'S NOT

Looking back at some investment fads over recent decades can illustrate how often trendy investment themes come and go. In the early 1990s, attention turned to the rising "Asian Tigers" of Hong Kong, Singapore, South Korea, and Taiwan. A decade later, much was written about the emergence of the "BRIC" countries of Brazil, Russia, India, and China and their new place in global markets. Similarly, funds targeting hot industries or trends have come into and fallen out of vogue. In the 1950s, the "Nifty Fifty" were all the rage. In the 1960s, "go-go" stocks and funds piqued investor interest. Later in the 20th century, growing belief in the emergence of a "new economy" led to the creation of funds poised to make the most of the rising importance of information technology and telecommunication services. During the 2000s, 130/30 funds, which used leverage to sell short certain stocks while going long others, became increasingly popular. In the wake of the 2008 financial crisis, "Black Swan" funds, "tail-risk-hedging" strategies, and "liquid alternatives" abounded. As investors reached for yield in a low interest-rate environment in the following years, other funds sprang up that claimed to offer increased income generation, and new strategies like unconstrained bond funds proliferated. More recently, strategies focused on peer-to-peer lending, cryptocurrencies, and even cannabis cultivation and private space exploration have become more fashionable. In this environment, so-called "FAANG" stocks and concentrated exchange-traded funds with catchy ticker symbols have also garnered attention among investors.

THE FUND GRAVEYARD

Unsurprisingly, however, numerous funds across the investment landscape were launched over the years only to subsequently close and fade from investor memory. While economic, demographic, technological, and environmental trends shape the world we live in, public markets aggregate a vast amount of dispersed information and drive it into security prices. Any individual trying to outguess the market by constantly trading in and out of what's hot is competing against the extraordinary collective wisdom of millions of buyers and sellers around the world.

With the benefit of hindsight, it is easy to point out the fortune one could have amassed by making the right call on a specific industry, region, or individual security over a specific period. While these anecdotes can be entertaining, there is a wealth of compelling evidence that highlights the futility of attempting to identify mispricing in advance and profit from it.

It is important to remember that many investing fads, and indeed, most mutual funds, do not stand the test of time. A large proportion of funds fail to survive over the longer term. Of the 1,622 fixed income mutual funds in existence at the beginning of 2004, only 55% still existed at the end of 2018. Similarly, among equity mutual funds, only 51% of the 2,786 funds available to US-based investors at the beginning of 2004 endured.

WHAT AM I REALLY GETTING?

When confronted with choices about whether to add additional types of assets or strategies to a portfolio, it may be helpful to ask the following questions:

1. What is this strategy claiming to provide that is not already in my portfolio?
2. If it is not in my portfolio, can I reasonably expect that including it or focusing on it will increase expected returns, reduce expected volatility, or help me achieve my investment goal?
3. Am I comfortable with the range of potential outcomes?

If investors are left with doubts after asking any of these questions, it may be wise to use caution before proceeding. Within equities, for example, a market portfolio offers the benefit of exposure to thousands of companies doing business around the world and broad diversification across industries, sectors, and countries. While there can be good reasons to deviate from a market portfolio, investors should understand the potential benefits and risks of doing so.

In addition, there is no shortage of things investors can do to help contribute to a better investment experience. Working closely with a financial advisor can help individual investors create a plan that fits their needs and risk tolerance. Pursuing a globally diversified approach; managing expenses, turnover, and taxes; and staying disciplined through market volatility can help improve investors' chances of achieving their long-term financial goals.

CONCLUSION

Fashionable investment approaches will come and go, but investors should remember that a long-term, disciplined investment approach based on robust research and implementation may be the most reliable path to success in the global capital markets.

Source: Dimensional Fund Advisors LP.

Past performance is no guarantee of future results. This information is provided for educational purposes only and should not be considered investment advice or a solicitation to buy or sell securities. There is no guarantee an investing strategy will be successful. Diversification does not eliminate the risk of market loss.

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Eugene Fama is a member of the Board of Directors of the general partner of, and provides consulting services to, Dimensional Fund Advisors LP.

allocation to equities, at 70%, than the LDI/equities portfolio. When compared to T-bills, intermediate bonds have a longer duration which is closer to that of the liability, thereby reducing some of the volatility from interest rates and allowing a higher equity allocation.

Exhibit 7 reports the results of the three portfolios formed in Exhibit 6. We verify that the average income volatility is now the same across all portfolios—$0.45 standard deviation in income that can be afforded at retirement. The LDI/equities portfolio results in the highest income growth with a 2.6% annualized return, outperforming the intermediate bonds/equities portfolio by 48 basis points (bps) per year. In addition, the LDI/equities portfolio also has the largest returns in wealth units—78 bps per year more than the intermediate bonds/equities portfolio and 4.27% per year more than the T-bills/equities portfolio. This is largely attributable to the higher equity allocation. The standard deviation of the wealth level at retirement was higher for the LDI/equities portfolio than for the intermediate bonds/equities and T-bills/equities portfolios. However, for an income goal this may not be a primary concern.

CONCLUSION

If one of the primary goals of retirement savings is to provide for consumption in retirement, the investment approach should be aligned with the investment goals. This means that it is important to manage the risks that are relevant to the goal. In the case of retirement income, two primary risks are inflation and interest rate risk, both of which can be addressed with an LDI approach to risk management. Not having the right risk management in place leads to unnecessary uncertainty about how much income one can afford. Additionally, investors may sacrifice returns unnecessarily. As investors shift away from growth assets, they tradeoff some expected return to gain risk reduction. So, it's imperative that the investments reduce the risks that matter to make this a good tradeoff. We show that a blended LDI and equity solution may be able to achieve a better balance of growth vs. risk reduction—that is, a higher income return per unit of income volatility.

1. In the US as of the most recent Actuarial Life Table made available by the Social Security Administration.
2. 25 years of cash flows assumes an additional five-year buffer to address longevity risk.
3. We assume nominal cash flows throughout the analysis and hence apply nominal US Treasury yields. This allows us to extend the analysis back to the 1960s. Real US Treasury yields are only available from the 2000s on. The implications of the analysis, however, would apply to a real cash flow framework as well.
4. Duration measures the sensitivity of an asset or liability to changes in yields. Duration-matching is a common approach for managing an LDI strategy.
5. Income return measures the change in retirement income estimate leading up to retirement (i.e. if 10 years from retirement, the retirement income estimate was $1 and at retirement the retirement income estimate was $1.10, this would be a 10-year income return of 10%). Income volatility measures the dispersion of income returns (i.e. the variation in ending retirement income estimates from the same starting estimate throughout simulations). Refer to the next section with more detail about income returns and volatility.
6. US intermediate bonds are represented using the returns of the Bloomberg Barclays US Aggregate Intermediate Bond Index for 1976–2016 and the average return of long-term US government bonds (33.3%), long-term US corporate bonds (33.3%), and US one-month T-bills (33.3%), rebalanced monthly prior to 1976 due to the inception date of the Bloomberg index. US one-month T-bills, long-term US government bonds, and long-term US corporate bonds returns are sourced from Morningstar with underlying data provided by Ibbotson Associates via Morningstar Direct. Long-Term US government and corporate bonds include bonds with an average maturity of 20 years.
7. The simulated LDI portfolio is designed to mitigate against interest rate risk. It is constructed using 1-, 7-, and 25-year constant maturity rates from the US nominal yield curve to match the duration of the retirement income liability of $1 per year over an assumed 25 years in retirement. The simulated LDI portfolio will re-weight assumed allocations to the 1-, 7-, and 25-year constant maturity bond yields based on changes in duration between the three yield curves and the retirement income liability each month. Simulated returns are calculated monthly based on changes in the yield curve. Yield curve data sourced from Federal Reserve Bank of St. Louis. The simulated portfolio is hypothetical and cannot be invested into directly. Performance does not reflect fees and expenses associated with an actual portfolio.

   **Please see additional important disclosures at the end regarding the data for T-bills, intermediate bonds, and the simulated LDI portfolio.*
8. Average of the monthly duration of the Bloomberg Barclays U.S. Aggregate Intermediate Bond Index from January 1989–December 2016.
9. The interquartile range is the difference between the 75th and 25th percentile outcomes at retirement across the 45 simulations.
10. The equity allocation used in the simulations is the Fama/French US Marketwide Index.
11. This analysis is completed using the same methodology as the previous trials, looking at 45 individual 10-year investment periods from 1971–2016. We target a 0.45 standard deviation in income terms (income volatility) and solve for how much equity allocation we have to add to each risk management asset in order to reach this point.
12. Income units show the impact of portfolio performance on income estimates. Wealth units show the impact on the account balance. See below for further descriptions.
13. Growth in income units represents the growth in the retirement income estimate for each strategy from $1, 10 years prior to retirement, to a final estimate at retirement date. Growth in wealth units represents the growth of wealth of $1 invested in each strategy over the 10-year period.
14. Standard deviation 10-year outcomes in income units measures the standard deviation between the income estimates at retirement for the 45 simulations.