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LONG LIVE YOUR MONEY

Value Proposition

Twelve Value-Added Services Performed by Investment Advisors

Abstract

It is difficult to estimate the value that can be obtained from a competent investment advisor. This paper reviews 12 value-added services performed by competent investment advisors. Nine of these services are difficult to quantify, and three are reasonably quantifiable. We conclude that these quantifiable services may add as much as 3.22% to long-term investor returns.

Raymond Kerzérho, MBA, CFA
Director of Research
PWL CAPITAL INC.

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Raymond Kerzérho, *Director of Research*, PWL Capital Inc., *"Value Proposition: Twelve Value-Added Services Performed by Investment Advisors"*

For more information about this or other publications from PWL Capital, contact:

PWL Capital – Montreal, 3400 de Maisonneuve O., Suite 1501, Montreal, Quebec H3Z 3B8

Tel 514 875-7566 • 1-800 875-7566 **Fax** 514 875-9611

info@pwlcapital.com

Introduction

It is difficult to estimate the value that can be obtained from a competent investment advisor. However, for some investors, the remuneration of their financial advisor is a significant expense. Thus, it is important to understand the services performed and their value. This paper will discuss the services offered by investment professionals.

This paper reviews 12 value-added services performed by advisors. Nine of these services are difficult to quantify, and three are reasonably quantifiable. For readers who do not have an advisor, this paper is intended as a guide about what to look for in an advisor and how to decide whether or not you need one. For those who do have an advisor, this paper will help you gauge whether you're paying a fair price for what you're getting and whether your advisor performs all the services you need.

Section 1: Investment Advice for Your Life and Challenges

The Challenge of Valuating Advice

While financial advice comes at a cost, its actual value is difficult to calculate. Here's why:

1. **Investors' needs vary widely** depending on the complexity of each person's financial life. Since those needs differ so much, no single number can nail down what advice is worth in general.
2. **The services offered are very diverse** from one advisor to another. Some advisors offer the most basic services and others the most sophisticated. In this context, comparisons are difficult to make.
3. **Some services are hard to value.** Left to their own devices, most investors will not write a formal long-term investment strategy, execute regular maintenance or systematically review their portfolio's performance. Because of this lack of process, portfolio decisions are often based on "gut feelings" rather than financial knowledge, and this can lead to serious capital losses. A competent investment advisor will implement a process to help you achieve your financial goals; yet, it is difficult to determine the value of that process.

Costs and Benefits of Advice: A Balancing Act

In our view, a well-managed balanced portfolio will likely return 3% to 4% net of inflation (1% to 2% for bonds, and 5% to 6% for stocks) over long periods, ***before costs.*** Thus, if costs are not controlled, the expected return of your portfolio will shrink rapidly. On the other hand, going without professional advice can lead to costly mistakes that will also diminish returns. Just like a business, running your investment program soundly involves incurring some costs. The challenge is to find the right balance between costs and the value of the services provided.

Who Needs an Investment Advisor?

A lot of individuals manage their financial affairs (including investments) themselves and do it well. However, there are situations where an advisor's services are welcome. Here are a few:

1. You don't have the expertise or interest in the workings of the financial markets.
2. Your assets are significant, so you're not comfortable managing them without professional help.
3. You tend to abandon your investment strategy in times of market stress.
4. You own several properties or businesses.
5. You have a complicated financial life in general.
6. You're a busy person and have little time or patience to manage your finances.

What Type of Professional Is Right for You?

In our view, there are three levels of service, from the simplest to the most sophisticated.

1. **Non-Discretionary Advisors**

   This type of financial advisor makes investment recommendations but is not allowed to execute any individual transaction in your name without your consent. The classic non-discretionary advisor is the commission-based stockbroker or mutual fund salesperson.

2. **Discretionary Portfolio Management**

   In this case, you defer investment decisions to your advisor, who is legally bound to comply with your investment policy. The content of such an investment policy is discussed in Section 2.

3. **Integrated Wealth Management**

   In this type of practice, the management of investments is often discretionary, but the portfolio manager in charge of your investments also teams up with non-investment financial experts, such as a financial planner, a tax accountant and/or a trust and estate planner.

What Is a Competent Advisor?

Look for a person with the ***character*** and the ***expertise*** to provide ***solutions*** that are best suited to your needs. Character ensures the person will put your interests above his or her own and has the work ethic, transparency and accountability to deliver the best possible independent advice. Expertise ensures your advisor has the knowledge required to help you achieve your goals. Here three pointers:

1. **Conflicts of Interest**

   Advisors who are remunerated on the basis of management fees and who do not accept commissions or trailer fees for selling products are less prone to conflicts of interest. If the advisor works at a firm that offers in-house products or keeps an inventory of securities, there's a greater risk that decisions will be made in the interest of the advisor or the advisor's employer, rather than yours. Make sure the interests of your advisor's firm align well with yours. Avoid salespeople passing themselves off as advisors.

2. **Credentials**

   In order to identify the right advisor for you, consideration should be given to professional certifications or credentials. This article[1] from Morningstar should help you understand the most relevant and useful certifications in Canada. Some require long, hard work to receive, and some also require continuous education to maintain in force. While even the best certifications are no guarantee of quality, they provide a strong signal about your advisor's dedication, work ethic and expertise.

3. **Reputation**

   Of course, you should check on the reputation of any advisor and their firm. If you know other people who have worked with an advisor, take advantage of their experience. Also, some advisors will agree to provide references to their potential clients: feel free to ask for them.

[1] Bebee, G., *Decoding Advisor Tiles*, Morningstar.ca, 2015.

Section 2: Nine Services with Hard-to-Quantify Benefits

1. **Assessing Your Ability and Willingness to Take on Risk**

   Risk tolerance questionnaires, which recommend a stock/bond mix based on a scoring system, are widely available on the Web. However, an investment professional will typically interview clients to better understand their personality before recommending an asset mix.

2. **Evaluating Your Personal, Business and Family Situation**

   The portfolio management process must be centered on you and your needs. **There is no way to get an appropriate portfolio on an ongoing basis without a good knowledge of you, your family situation and your business.** Marriage, divorce, births, changes in your health, and business purchases or sales are all examples of personal changes that will influence what portfolio is right for you.

3. **Preparing an Investment Policy Statement (IPS)**

   Once your investor profile (risk tolerance, and your personal, business and family situation) has been established, the next step is to put your investment strategy in writing. **This Investment Policy Statement will guide portfolio decision-making, especially during times of high market stress.** Equally important, it binds your portfolio manager to the strategy, so you won't have to worry about a change in direction happening without your consent.

   An IPS typically includes the following elements:

   a) Return objective and risk constraints
   b) Time horizon
   c) Asset mix
   d) Liquidity requirements
   e) Tax and legal considerations
   f) Special constraints or requirements (for example, avoiding tobacco companies).

4. **Designing Your Portfolio**

   Investing is all about being compensated for taking investment risk, without endangering your wealth. In other words, although you must take risks to make returns, it's important to construct a portfolio that will spare you from losing a significant portion of your wealth permanently. **This portfolio design incorporates diversification at four different levels:**

   a) Asset class: Stocks and bonds
   b) Geography: Canada, U.S. and international markets
   c) Sector: Financial services, consumer products, technology, etc.
   d) Security: The portfolio must hold as many individual securities as possible.

   Securities bearing certain characteristics tend to produce higher returns than others. In addition to diversification, **your portfolio strategy will augment expected returns** by emphasizing these securities. Here are a few examples:

   a) Corporate bonds often outperform government bonds
   b) Small company stocks tend to outperform those of large companies
   c) Value stocks tend to outperform growth stocks.

5. **Reviewing Your Portfolio Performance Annually**

This may come as a surprise, but a lot of investors don't track their portfolio returns regularly. Returns can be calculated in many ways. Therefore, the first step in this service is to determine the appropriate method of calculation. The second step, obviously, is to actually do the calculation. And finally, the investor must compare this return to a benchmark in order to determine whether the return is satisfactory. The traditional benchmark is a composite index that reflects the portfolio's asset mix. This makes it possible to look at whether your portfolio is tracking the market. To illustrate, if the asset mix is 50% Canadian stocks / 50% Canadian Bonds, then the benchmark would be made up of 50% S&P/TSX Composite Index / 50% FTSE TMX Bond Index. Another way to benchmark your return is by measuring whether you're closing in on your financial objective. For example, if your goal is to have $850,000 in assets by 2022, and in 2014, you have moved from $550,000 to $625,000, you probably had a good year.

6. **Integrating Portfolio Management with Financial and Tax Planning**

No advisor, no matter how skilled, can control the short-term returns of your portfolio, which depend entirely on what the markets decide to do. But under any market conditions, financial planning helps you set financial goals that are more meaningful to your well-being than tracking the market's rate of return. **Integrating financial planning and portfolio management together helps set the right objectives for you and better evaluate portfolio performance.** In addition, when tax planning and portfolio management are done under the same roof, it is common to uncover additional tax credits and other savings.

7. **Harvesting Tax Losses**

Throughout an investor's life, capital gains are occasionally realized in taxable accounts. After market corrections, securities can often be sold at a loss to allow the investor to reclaim the accumulated capital gain taxes paid in the previous three fiscal years or to use them against future taxable capital gains. **A competent investment advisor will instinctively review your portfolio after market downturns, and realize losses if this will allow you to recoup some money from the government.** Afterward, the advisor will replace the security sold with another one (tax laws don't allow you to repurchase the same security immediately) that provides you with similar (and often identical) market exposure.

8. **Locating Assets**

Asset location involves finding the most tax-efficient type of account (RRSP, TFSA, taxable account…) for each holding in a portfolio. The various types of investment return are taxed differently. Interest income from bonds and dividends from foreign stocks are taxed at the full ordinary income tax rate. But dividends from Canadian corporations and capital gains receive a preferential tax treatment in the form of the Canadian dividend tax credit and the (currently 50%) inclusion rate on capital gains. Furthermore, foreign withholding taxes can be mitigated through asset location.

9. **Providing and Executing a Withdrawal Strategy for Retirees**

Retirees are frequently concerned about securing a sustainable financial future. **A sound withdrawal strategy will help them get the most out of their portfolio without outliving their money.**[2] And it will minimize the investor's tax bill by carefully withdrawing the right amounts from the various taxable and registered accounts.

[2] For more information on portfolio withdrawal strategies, we suggest: Westmacott, G., Daley, S., The Design and Depletion of Retirement Portfolios, PWL Capital, 2015.

Section 3: Services with Quantifiable Benefits

10. Behavioural Coaching

It is common among investment advisors to believe that individual investors, when left to their own devices, will lack the discipline required to design and execute an effective portfolio strategy. But is this borne out by evidence? The answer appears to be yes. Research supports the claim that investors tend to struggle with their investments. They especially engage in market-timing activities that are detrimental to portfolio returns.

The method now commonly used to document this struggle involves comparing mutual fund ***investment returns*** (the returns achieved by the funds) with their corresponding ***investor returns*** (the returns achieved by the funds' investors). Investment returns are measured with the ***time-weighted rate of return***, while investor returns are measured by the ***dollar-weighted rate of return.***[3]

Using this methodology, two different studies[4,5] concluded that investors tend to underperform the funds they invest in by 1.50% and 1.56%, respectively, because of poor market timing. **Assuming that an advisor simply eliminates market timing, this would create 1.50% in behavioural coaching benefits for the client.**

11. Rebalancing Your Portfolio

Over time, market fluctuations cause investment portfolios to drift away from their target asset allocation (for example 60% stocks / 40% bonds). Rebalancing is the process of restoring the different asset classes in a portfolio to their target weights.

In a recent study,[6] PWL compared the return and volatility (which measures risk) of a Canadian portfolio under a non-rebalancing scenario and ten naive rebalancing strategies, over the 1980-2014 period. All rebalanced portfolios produced higher returns and lower volatilities than did the non-rebalanced one. Computing the results for the 1980-1991, 1992-2003 and 2004-2014 sub-periods arrived at the same conclusion. Finally, the same ten rebalancing strategies were tested with a U.S., a U.K. and a Japanese portfolio. We found that 29 of the 30 naively rebalanced portfolios outperformed their non-rebalanced counterpart. **We estimate that rebalancing adds 0.41% to risk-adjusted returns net of transaction and tax costs.**

12. Selecting Investments

The underperformance of actively managed mutual funds is very well documented. A recent study from the Vanguard Group[4] measured the average investor excess cost, through the difference between 1) the average investment cost (management fees, administrative fees and sales taxes) for mutual funds and ETFs available for sale in Canada, and 2) the lowest-cost quartile of funds. **The authors concluded that just by selecting low-cost passive funds, an advisor can save clients up to 1.31%.** In our view, this estimate is conservative, considering that other data from Standard and Poor's document a much higher underperformance of active mutual funds.[7]

[3] For more information about the time-weighted and money-weighted rates of return, we suggest: Bender, J., Bortolotti, D., Understanding Your Portfolio's Rate of Return, PWL Capital, 2015.

[4] Rich, R., Jaconetti, C., Kinniry, F., Bennyhoff, D., Zilbering, Y., Putting a Value on Your Value: Quantifying Vanguard Advisor's Alpha in Canada, The Vanguard Group, 2015.

[5] Friesen, G., Sapp, T., Mutual Fund Flows and Investor Returns: An Empirical Examination of Fund Investor Timing Ability, CBA Faculty Publications, 2007.

[6] Kerzérho, R., A Rebalancing Act: Estimating the Value Added Through Portfolio Rebalancing, PWL Capital, 2015.

[7] The SPIVA Canada Scorecard documents an average underperformance of active mutual funds versus their benchmark index of 2.46% for the 2010-2014 period, and 2.50% for the 2005-2009 period.

Conclusion

We have looked at 12 different services that are available from investment advisors. Not all of them are offered by every advisor, nor are they all relevant to every investor. Furthermore, this list is probably incomplete. Most of the "non-quantifiable benefit" services regard portfolio process and governance, and the maximization of after-tax returns. **The "quantifiable benefit" services can boost investor returns by up to 3.22%.** Each investor's situation is different, so this number does not apply uniformly to everyone. However, it highlights that while the services of a competent investment advisor do cost money, not hiring an advisor can also be quite expensive.

Recap: Investment Advisor Services

Services with Hard-to-Quantify Benefits

1	Assessing your ability and willingness to take on risk
2	Assessing your personal, business and family situation
3	Preparing an Investment Policy Statement
4	Designing your portfolio
5	Reviewing your portfolio performance annually
6	Integrating portfolio management with financial and tax planning
7	Harvesting tax losses
8	Locating assets
9	Providing and executing a withdrawal strategy for retirees

Services with Quantifiable Benefits

		Estimated Benefit
10	Providing behavioural coaching	1.50%
11	Rebalancing your portfolio	0.41%
12	Selecting investments	1.31%
	Sum of quantifiable benefits	***3.22%***

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Raymond Kerzérho, MBA, CFA
Director of Research
PWL CAPITAL INC.

raymondk@pwlcapital.com
https://www.pwlcapital.com/Kerzerho-blog

PWL

LONG LIVE YOUR MONEY

PWL Montreal
3400 de Maisonneuve O.
Suite 1501
Montreal, Quebec
H3Z 3B8

T 514.875.7566
1-800.875.7566

F 514.875.9611
info@pwlcapital.com

www.pwlcapital.com/Montreal

PWL Ottawa
265 Carling Avenue
Suite 401
Ottawa, Ontario
K1S 2E1

T 613.237.5544
1-800.230.5544

F 613.237.5949
ottawa@pwlcapital.com

www.pwlcapital.com/Ottawa

PWL Toronto
3 Church Street
Suite 601
Toronto, Ontario
M5E 1M2

T 416.203.0067
1-866.242.0203

F 416.203.0544
toronto@pwlcapital.com

www.pwlcapital.com/Toronto

PWL Waterloo
20 Erb St. W,
Suite 506
Waterloo, Ontario
N2L 1T2

T 519.880.0888
1.877.517.0888

F 519.880.9997
waterloo@pwlcapital.com

www.pwlcapital.com/Waterloo

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