

Measuring the Value of a Financial Advisor

Good financial advisors are like good athletic coaches. Sometimes, their value is easy to appreciate and at other times, despite its presence, it can be harder to discern. Imagine a coach and athlete working together for an event. The coach devises a great training regime, provides motivation and feedback, and the athlete follows through and achieves a personal best. Compare that with a different scenario where the athlete is already out in front but being challenged by a strong competitor. The coach has instilled the discipline needed to keep the athlete alert and working to seal the victory. Analogously, there are times when an advisor sees a great opportunity, draws up a plan, works with the client to execute, and the client's wealth increases. There are also times when vigilant advisors notice a risk, prepare a contingency plan, and save clients from financial ruin or emotional trauma.

Good financial advisors and coaches also demonstrate value over long periods of time, in perhaps less obvious ways. The best coaches motivate their players to keep practicing and remain focused; in a similar way, the best advisors motivate their clients to stick with their financial plans. Coaches and advisors set goals and come up with plans, long before they are executed. They work with their players or clients to improve their skills, keep them accountable, provide motivation and encouragement, and provide data and analysis to improve decision-making.

But our analogy runs thin when we consider the tangible consequences of having a good coach or a good advisor. The value of a good coach is relatively obvious: more wins! The value of a good advisor is more nuanced. In this paper, we first provide evidence that financial advisors improve their clients' financial and emotional well-being, that they guard them from potential risks, and that they increase both cash flow and investment returns. We then return in detail to the myriad ways advisors provide these benefits.

What value do advisors provide?

When thinking about hiring an advisor, clients often think about increasing investment returns. Who can blame them? Until recently, financial advisors really *did* focus primarily on ways to increase after-tax returns through investing and using tax deferral strategies. Moreover, the title *financial* advisor naturally connotes someone who focuses on money. And, new technologies called *robo-advisors* are really just *robo-investors*.

While financial advisors *do* tend to increase investment returns, we believe they provide much more value in other ways. For example, financial advisors provide considerable assistance in reducing clients' exposure to a variety of potentially ruinous financial risks.

Increased Well-Being

In this section, we summarize the different values advisors provide, beginning with increased well-being, a finding Mitch Anthony describes as a “return on life” (Kitces, 2015).

Working with a comprehensive financial advisor appears to improve both clients’ financial as well as emotional well-being. A 2013 study of 15,000 people by the Financial Planning Standards Council (the national accrediting body of CFPs in Canada) found that people who worked with an advisor were almost twice as likely (81% vs. 44%) to feel on track with their finances, on track to retire, prepared to deal with unexpected financial emergencies, prepared for their loved ones to be looked after in the event of their death, confident they can take an annual vacation, and confident that they have enough money to live the life they want. Additionally, those with an advisor felt they had 62% more emotional well-being, were 45% more contented, and were 79% better able to meet their life objectives. These effects speak to the depth and scope of the value of working with a financial advisor.

In 2012, a study of military personnel found similar financial and emotional benefits to working with an advisor. People who worked with a financial advisor were more financially responsible, more secure in their month-to-month finances, and more confident that they can retire comfortably. They also were almost half as likely to have trouble falling or staying asleep, experience general stress, have unexpected weight gain, or feel irritable (First Command Financial Services, 2012).

It is important to distinguish between working with a comprehensive advisor held to a fiduciary standard and one who is merely a salesperson for a brokerage. The aforementioned Financial Planning Standards Council (2013) study demonstrated that the benefits of working with an advisor were largely isolated to people working with a fiduciary. Likewise, a 2010 RAND study found that working with the advisors provided by your company’s 401k provider did not appreciably affect financial well-being (Hung & Yoong, 2010). Indeed, they reported that mandating every employee meet with these advisors would be “ultimately ineffective.”

These studies represent a growing body of academic and applied research that demonstrate how working with a financial advisor can improve quality of life. This is particularly true, we suspect, when advisors help clients mitigate the consequences of tragic life events.

Improved Risk Management

When advising clients on investments, clients are often concerned with minor differences in the rate of return and, consequently, minor improvements to quality of life. In contrast, certain tragic life events can result in *fundamentally different life outcomes*. For example, how much is it worth to know you won’t be bankrupted by catastrophic medical bills, that your loved ones are taken care of if you pass away, or that your life won’t be turned upside down if you’re sick and can’t work?

Many of us have had major loss events in life. Good risk management can greatly reduce the financial impact of these events. The Principal of our firm knows firsthand that he is sitting in his

chair today due in large part to the financial planning his late mother instituted during her life. Through her forethought, she enabled him to come to the US and paved the way to his business. And, sadly, we also know of a family that did not plan ahead: a 45 year old woman who passed away suddenly and unexpectedly, leaving her two children and husband without a mother or the second income necessary to live in their Bay Area home.

The magnitude of these events on quality of life is difficult to ponder, let alone quantify. The few studies on the topic demonstrate the positive effect of adequate insurance coverage. One 20-year study found that severe chronic disability decreased earnings by about 70% - a loss virtually erased after-taxes by disability insurance (Meyer & Mok, 2014). Another series of studies linked a lack of health insurance to over 40,000 deaths a year in the United States alone (before the Affordable Care Act made insurance mandatory; Bernstein, Chollet, & Peterson, 2010).

In applying a risk management process, clients experience benefits prior to and following loss events. Prior to a loss, a thorough risk management approach helps reduce clients' anxiety while preparing for potential losses in the most economical way. Following a loss, it helps to minimize household disruption, stabilizes the standard of living, and minimizes social consequences.

Increased Cash Flow

Financial advisors can provide their clients direct monetary value as well as increased quality of life by helping them to manage liabilities and reduce expenses (Moskowitz, 2016).

Clients' single greatest expense may be housing. As mortgage rates remain historically low, many clients should consider refinancing. Reducing rates by 0.75% over 30 years, for example, can save \$300/month on a \$700,000 mortgage. According to Fazzi (2003), one advisor helped his client refinance from a 30 year to a 15 year fixed term on a \$300,000 mortgage, lowering the client's rates by 3.75%, and reducing total payments by \$328,000.

Another major liability our younger clients face are student loans. Federal student loan rates hover around 6.5% while private rates can surpass 10%. Refinancing companies, in contrast, offer rates as low as 2.1% (Wasik, 2016)! Despite this opportunity for significant savings, many clients are not aware that student loans can be refinanced or are hesitant to undergo the process themselves.

Student loans also present opportunities for loan forgiveness. Unfortunately, clients may not know whether to seek forgiveness (say, by working for a non-profit) or a higher salary. Financial advisors can analyze expected earnings, interest payments, and tax consequences to design a repayment plan, saving clients significant interest payments, and protecting them from years of stress.

For clients struggling with debt, advisors can help with budgeting and overspending (Danielson, 2015), create repayment plans, and analyze relatively obscure products (e.g., balance transfer cards) and niche promotions (e.g., 0% APR offers). In extreme cases, we can help clients negotiate

with creditors to decrease the amount owed and bring feelings of empowerment and stress reduction.

People who are not in debt can still benefit from the perks of responsible credit card usage. NerdWallet lists over 1,700 credit cards - far too many for most people to research or understand. Advisors can match clients' spending behavior to the best card to maximize rewards. Playing "the game" (LaPonsie, 2015), can net additional consumer protections, free flights, cheaper food, and thousands in cash.

Besides managing liabilities, financial advisors can increase cash flow by reducing expenses. People with more money tend to be happier (Dakin & Wampler, 2008), but not all money is spent on purchases that lead to increased quality of life. The price difference between a brand new and a slightly used luxury car may be tens of thousands of dollars - yet their differential effect on happiness is likely minimal. Likewise, fixed expenses for cable TV, phones, restaurants, and so on dramatically increase cost of living but only marginal increase quality of life (Diener, Lucas, & Scollon, 2006). This lesson is particularly important for retirees on fixed income with little cushion for mismanagement (Falk, 2010).

Advisors provide value by helping identify truly vital vs. wasteful spending. We helped one client, for example, decide to move from an expensive apartment with a roommate to an affordable one where she lived alone. Besides no longer suffering through a negative roommate relationship, she saved \$350/month and paid off a large credit card balance.

Medical costs must be managed within a complex web of out-of-pocket expenses as well as both public and private insurance: few clients may be willing to consider the myriad options around premiums, deductibles, health savings accounts, flexible spending plans, tax bracket management, and so on. Improperly navigating these options can leave clients underinsured and unable to meet their medical needs (Kramer, 2014). Medical expense management, therefore, presents advisors with the power to potentially save their clients' lives!

Increased Investment Returns

In addition to improved risk management, cash flow, and sense of well-being, financial advisors can help increase investment returns by about 1.5 to 3% according to separate studies by Morningstar (Blanchet & Kaplan, 2013) and Vanguard (Kinnery, Jaconetti, Di Joseph, & Zilbering, 2014).

It is important to note, however, what is meant by increased returns. We must consider *market return* (the geometric return on a well-diversified index over a period) vs. *investor return* (the geometric return of the typical investor over the same period). When we compare advisors to the market return, they don't look particularly helpful. For example, after fees are considered, only about 10% of active investment managers beat an S&P 500 index fund (Dyck, Lins, & Pomorski, 2013).

Over the long run, we doubt that advisors could consistently beat the performance of an appropriately allocated passive investment approach after taking fees into account. Additionally, many of the reasons why good investment advisors sometimes beat the market can - and have been - duplicated by computer algorithms.

But market return is not a good benchmark: the typical casual investor very *rarely* perform as well as the market return. According to a 30 year study of market and investor returns, the average investor's returns were only a *third* of the market return (Dalbar, 2015). Why are investors getting such bad returns? According to Vanguard (Kinnery et al., 2014), the biggest reasons are psychological: people suffer from a host of judgment and decision-making biases which make it very difficult for us to do the "right thing" when it comes to investing.

When we use investor returns as the benchmark, we see the real value of a financial advisor - that 1.5 to 3% effect we mentioned above. In the next section, we discuss *how* advisors provide increased investment returns. As you may have guessed from the previous paragraph, some of the most important reasons concern human psychology and behavior.

How do advisors provide these values?

In the previous section, we provided evidence for how financial advisors can increase their clients' well-being, lower their risk exposure, and increase their investment returns. In this section, we explain *how*. In our view, advisors provide value as behavioral coaches, partners, and technical experts.

Advisors as Behavioral Coaches

Despite the growing popularity of robo-advisors and index funds, the typical investor still falls well short of typical benchmarks (Dalbar, 2015). Kinnery et al. (2014) pins much of the blame on a host of errors in judgment and decision-making. For example, some people buy the hot stock after its value has already peaked. Or, they panic and sell their portfolio at a loss. Or, they hold on to cash for too long, missing market recoveries like the one witnessed from 2010 to 2014. And, unfortunately, even people who know about these biases fall victim to their influence (Willis, 2011)!

Fortunately, advisors can and do help their clients avoid these errors. By providing a rational, data-driven perspective and structure, advisors increase their clients' returns by about 1.5% - in addition to gains from technical expertise (Pfau, 2015)!

Given its importance to investment returns and other aspects of financial well-being, Bob Seawright (2016) made different forms of behavioral coaching 3 of the 4 pillars of his "hierarchy of the value a financial advisor provides." In his view, the most important value advisors provide is encouraging increased and consistent savings, followed by encouraging consistent investment as well as managing expectations and behaviors. He anticipates that these values will become increasingly important as robo-advisors and index funds grow and attract new clients.

Advisors as Partners

Managing finances is difficult - it's why companies have CFOs and legions of accountants. Clients can partner up with financial advisors to decrease the burden of managing their finances and, in turn, increase their financial and emotional well-being. Mitch Anthony identified six ways financial advisors, acting as partners, increase their clients' "return on life" (Kitces, 2015):

- **Partnership:** advisors are uniquely positioned as partners, working collaboratively to articulate and achieve clients' goals, prepare for clients' futures, and improve clients' quality of life.
- **Organization:** advisors work to bring all the pieces of clients' financial lives together under a coherent structure. This framework helps us to find gaps in investments, retirement plans, or insurance coverages that may have otherwise gone unrecognized.
- **Accountability:** advisors help to set, prioritize, and follow through with goals.
- **Objectivity:** Unlike salespeople, a fiduciary-oriented advisor is dedicated to using rational, unbiased, data-driven approaches to inform recommendations and work in clients' best interests.
- **Proactivity:** advisors are vigilant for risks to clients' well-being and opportunities for improved quality of life. In this way, advisors help clients proactively prepare for both the best of times and the worst of times.
- **Education:** The financial landscape is arguably more complex now than ever. According to Dr. Lauren Willis, these complexities, coupled with human biases and judgment errors, "mean that effective financial education would need to be extensive, intensive, frequent, mandatory, and provided at the point of decision-making, in a one-on-one setting, with content personalized for each consumer." (Willis, 2011, p. 431). Fortunately, this type of personal education and training is precisely what good financial advisors provide their clients.

Advisors as Technical Experts

According to Kinnery et al., 2014, financial advisors primarily increase their clients' returns through behavioral coaching. In addition, this research identified other, more technical aspects of financial advising that also increase return.

- **Selecting the most appropriate investments:** advisors specify asset allocation depending on clients' risk tolerance, goal timeline, need for income or growth, and so on.
- **Maximizing tax-advantaged strategies:** in addition to 401ks, advisors can reduce tax burdens by utilizing IRAs, municipal bonds, life insurance, trusts, and other tax advantaged accounts.
- **Avoiding high brokerage fees and commissions:** advisors are mindful of transaction expenses and help clients avoid paying high expense ratios and commissions by selecting less expensive funds and leveraging relationships with various product providers.

- **Rebalancing for the market:** advisors utilize a top-down approach to maintain an ideal asset allocation despite changing markets.
- **Rebalancing for life:** advisors maintain a "glide path" approach to shift to more conservative assets over time, helping to lock in gains and lower risk.

Case Study

Sam and Melinda Saver are married with two children and are business partners in a real estate investment partnership. Their oldest child, Alex, is 17 and a child from Sam's previous marriage. Max, 4, is about to enter preschool. They are interested in maximizing their ability to plan for retirement and make the best decisions about their business finances. But for now, the most pressing issue is that Alex is applying to college in the fall and the Savers are anxious about their ability to fund her education.

Sam and Melinda decide to work with Pat, a fiduciary-oriented Certified Financial Planner, to help accomplish their education funding goal. Pat is committed to providing her clients with a real "return on life", above and beyond increased investment performance. Her first step is to help her clients define their goals and create specific criteria for success. She quickly realizes that the Savers have not thought concretely about where Alex will go to school - let alone how much it will cost or their funding options.

Pat educates Sam and Melinda on the various options for Alex's education and ways to both increase funding (e.g., scholarships, work study, subsidized student loans) and decrease costs (living at home, attending a junior college first, delaying enrollment for a year). She coaches them on how to discuss these options with Alex and refers them to an academic advisor.

By the next meeting, the Savers have a better sense of Alex's educational opportunities and costs. When they see Pat again, they expand the engagement to include Max's education as well. They work with her to estimate Max's future educational costs, create a budget and savings plan, and set up appropriate 529 plans for Max and Alex.

Throughout their engagement, Pat continues to monitor and update Sam and Melinda's plan, take advantage of new opportunities, and continuously ensures plan is integrated with their other financial goals. When possible, she tries to increase the return on investment of the 529 plans - but recognizes her primary goal is to ensure the safety and stability of these accounts.

The couple feels much more confident and secure in their ability to fund their children's education. As their financial situation evolves, they return to Pat for assistance with home insurance, a potential liability lawsuit, and deciding whether to purchase a deferred annuity. They are thankful they have Pat to provide clarity on their financial decisions. With all the help Pat gave them with their education, risk management, and fixed income questions, they never even considered whether she was maximizing their 529 plan investment returns!

Summary

The traditional metric for measuring the value of a financial advisor is return on investment. Yet this metric is incomplete and defines value too narrowly. The greatest value financial advisors provide is increased "return on life" found in a greater sense of stability and well-being. This return is predominantly accomplished by 1) prudently managing and reducing clients' exposure to financial disaster and other risks and 2) being a coach and partner who helps to articulate, monitor, motivate and achieve goals while providing accountability, objectivity, and education.

As the case study suggests, focusing on "return on life" provides much greater increases to quality of life than a few extra dollars. Moreover, the human touch provided by a financial advisor cannot be replicated by a computer (at least, not yet!).

We are confident that financial advisors deliver value far above-and-beyond their fees, and that most of this value can be found in qualitative improvements to clients' quality of life.

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