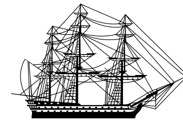


Vanguard®

Advisor’s alpha: Canada

Vanguard research | May 2012

Executive summary. How do sophisticated advisors construct portfolios? Typically, they use some form of wealth management process to determine the most suitable portfolio for their clients’ particular goals. Some focus on traditional investments; others split traditional asset classes into sub-asset classes; still others add alternative investments. Regardless of the mix, these processes share a common objective—to obtain the highest return for a given level of expected risk. Index funds are often employed in allocations, but probably more often an advisor selects actively managed investments in an attempt to enhance performance, thereby validating the advisor’s fees.

Outperforming the broad market has historically been very difficult, both in absolute terms and in tax- and risk-adjusted frameworks. Where adding value is the goal, advisors may be better served by changing their performance benchmark from the market’s return to the returns that investors might achieve on their own, without professional guidance. A financial advisor has a greater probability of adding value, or *alpha*, through relationship-oriented services, such as providing cogent wealth management and financial planning strategies, discipline and guidance, rather than by attempting to outperform the market.

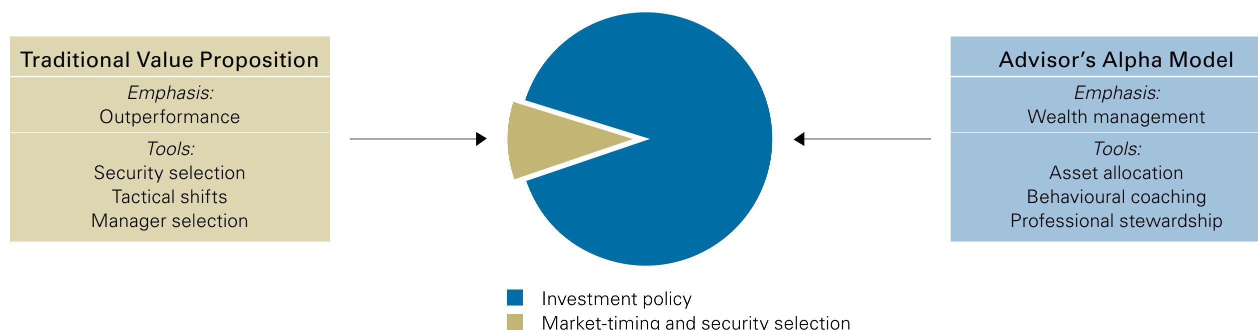
Author

Donald G. Bennyhoff, CFA

Francis M. Kinniry, Jr., CFA

This paper is based on an earlier Vanguard work, *Advisor’s Alpha*, which was intended for a U.S. audience. Vanguard has been at the forefront of supporting advisor’s efforts to define their value proposition, particularly those advisors utilizing fee- or asset-based fee business models.

Figure 1. Evolution of the value proposition for advice



Source: Vanguard.

Introduction

Investment performance can be deconstructed into the portions of return attributable to the market (that is, beta), to market-timing, and to security selection (**Figure 1**). The latter two are specific to active management. By definition, if a portfolio is to perform differently from a market benchmark (before expenses), the portfolio must look different from that benchmark. Historically, many investment advisors have sought to add value through the two active portions of return—market-timing and security selection—without regard to the mounting data suggesting that these efforts will help neither their clients nor themselves in the long run. Over longer time horizons, active management often fails to outperform market benchmarks.[1]

In the past, the passive portion of investment performance—the beta return—was viewed by many as leading only to "average" returns and requiring no investment skill. Today, ironically, the capturing of beta has become a cornerstone for leading financial advisors, who routinely incorporate index funds or exchange-traded funds (ETFs) in their recommended portfolios. This transition has been facilitated by at least two factors. First, the "democratization of indexing" via ETFs brought a plethora of index-oriented investment opportunities to anyone with a brokerage account. Second, advisors have begun to move towards a fee-based, holistic investment-guidance model. We believe that it is these disciplined advisors who are best positioned to add value to their client relationships as they take on the role of behavioural investment coaches and professional stewards, helping clients who often lack the time, willingness, or ability to plan and manage their wealth.

Over time, compensation in the Canadian investment industry has been shifting from commission-based, transaction-oriented sales toward fee-based asset management. The benefits of this shift for clients and advisors alike suggest that the trend will likely continue. From the client's perspective, asset-based fees largely remove concern about potential conflicts of interest in the advisor's recommendations. From the advisor's perspective, asset-based compensation can promote stronger client relationships and more reliable income streams. The advisor can spend more time with clients, knowing that compensation does not depend on whether or not a transaction occurs.

This transition, however, has not been devoid of obstacles.

1 Philips, Christopher B., 2011. *The case for indexing: Canada*. Valley Forge, Pa.: The Vanguard Group.

Figure 2. Asset-weighted average management expense ratios of Canadian active and index mutual funds as of 31 December 2011

	Actively managed funds	Index funds	Difference
Canadian equity funds	2.35	0.86	1.48
Canadian bond funds	1.42	0.76	0.66

Source: Vanguard calculations using asset-weighted management expense ratios compiled from prospectuses by Morningstar, Inc. Data as of 31 December 2011.

Cost comparisons are for illustrative purposes only and are not meant to be all-inclusive. MER is calculated as the total fees and expenses charged over the previous 12-month period. MER is expressed as an annual percentage of fund assets. It is composed of the base management fee plus certain operating expenses, such as administrative costs, plus applicable taxes. Transaction costs associated with the issue, exchange, sale, and redemption of funds are not included. Trading, portfolio rebalancing, optional costs, and income taxes payable by any unit-holder, are also not included. Different components contribute to the respective MER calculations for actively managed funds and index funds. MERs may not reflect management fee waivers or operating expense absorptions. There may be significant differences between the investments that are not discussed here including different objectives and risk factors.

What is 'advisor's alpha'?

For some clients, paying fees regardless of whether transactions occur or not may seem like "money for nothing." This is viewing the advisor's value proposition through only one portion of the cost-benefit lens. The benefit and wisdom of not allowing near-term market actions to result in the abandonment of a well-thought-out investment strategy can be underappreciated in the moment. Much of the time, changing nothing in a client's portfolio is the proper response to the ever-changing market news that often promotes action and results in interesting, if not useful, headlines.

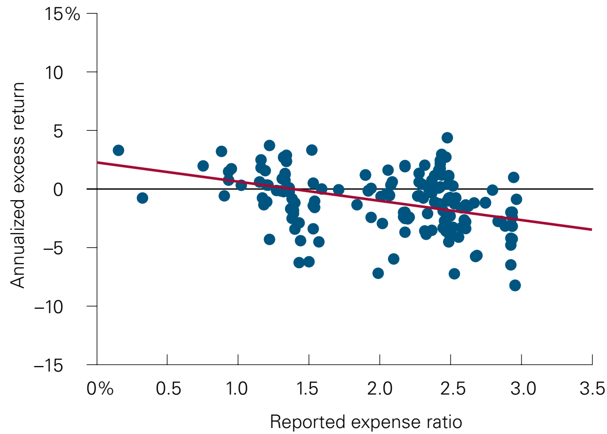
The confusion can grow if the advisor has based his or her value proposition on an ability to deliver better returns for the client, as many do. But better returns relative to what? For many advisors and clients, the answer would be "better than the market," but a more pragmatic answer for both parties might be "better than investors would likely do if they didn't work with a professional advisor." In this framework, an advisor's alpha (i.e., added value) is more aptly demonstrated by his or her ability to effectively act as a wealth manager, financial planner, and behavioural investing coach—providing discipline and reason to clients who are often undisciplined and emotional—than by efforts to beat the market.

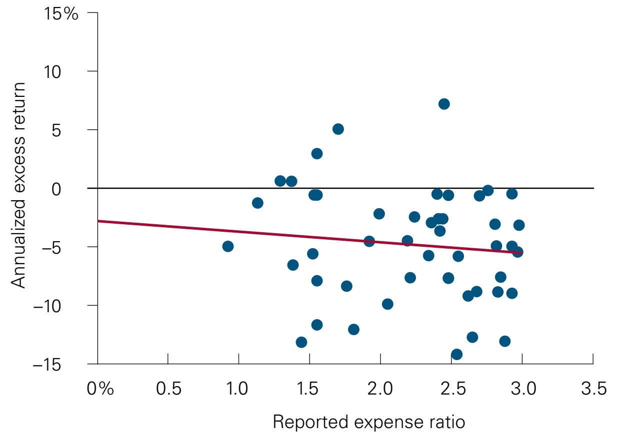
Outperforming the market is difficult

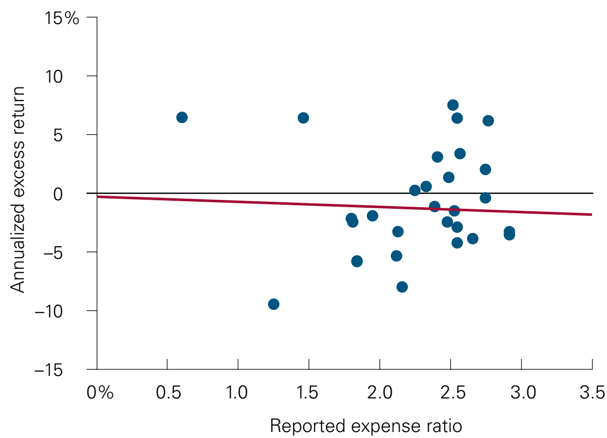
While it is possible for active managers to outperform (particularly in the short run), underperformance tends to be more probable after all fees and trading costs are considered. *Consistent* outperformance is rare. This isn't necessarily due to a lack of management skill; rather, it is a consequence of the burden of higher costs (**Figure 2**). Time is an important consideration in this relative performance comparison, as advisors try to coach investors away from the distraction of short-term market actions, whether positive or negative. As the downwardly sloping trend lines in **Figure 3** illustrate, over longer time frames the added expense of active management often proves too much to overcome.

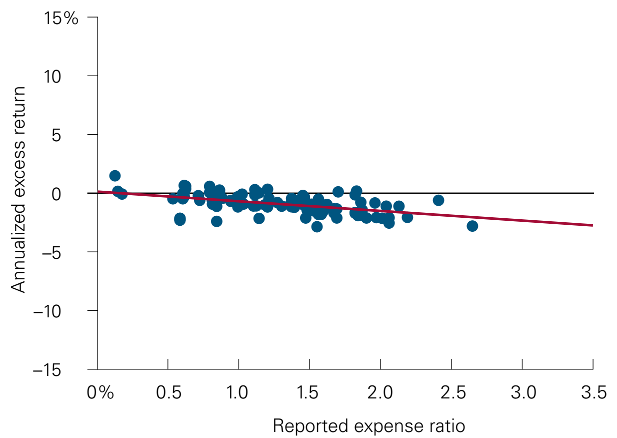
A value proposition based on outperforming the market places an advisor at a meaningful disadvantage and—using history as a guide—is hard to fulfill consistently over time. Not only does success depend on factors outside the advisor's control, such as the returns from individual securities or professionally managed funds, but the strategy also can promote a horse-race mentality among clients, leading them to depart if the promised outperformance does not materialize. Fortunately, the advisor's alpha model emphasizes more reliable benefits of a professional relationship.

Figure 3. Inverse relationship between Canadian mutual fund expenses and excess returns: 10 years ended 31 December 2011









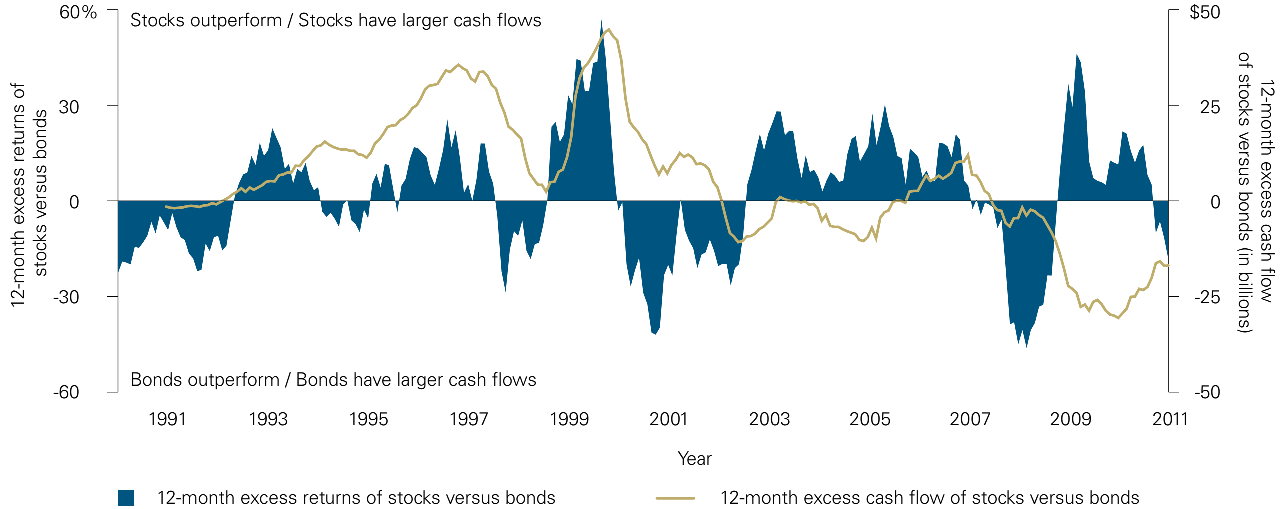
Notes: Each plotted point represents a fund within the specific size, style, and asset group. Each fund is plotted to represent the relationship of its expense ratio (x-axis) versus its ten year annualized excess return relative to the benchmark (y-axis). The straight line represents the linear regression, or the best-fit trend line—that is, the general relationship of expenses to returns within each asset group. The scales are standardized to show the slopes' relationship to each other, with expenses ranging from 0% to 3% and returns ranging from -15% to 15%. Some funds' expense ratios and returns go beyond the scales and are not shown.

Equity benchmarks are represented by the following indexes: Large: MSCI Canada Large Cap Index; Mid: MSCI Canada Mid Cap Index; Small: MSCI Canada Small Cap Index; Bonds: Citi Canadian GBI 5-7 Year Bond Index.

Sources: Vanguard calculations using data from Morningstar, MSCI, and Citigroup.

Figure 4. Fund cash inflows compared with rolling 12-month excess returns for the Canadian stock and bond markets, 1990–2011

Percentage of active funds underperforming *style benchmark*



Date label as of 31 December for each year.
Stock returns use the S&P/TSX Composite Index. Bonds consist of the Citigroup World Government Bond Canada All Maturities Index.
Sources: Vanguard Investment Strategy Group, S&P, Citigroup, and Investor Economics Insight.

Professional stewardship: Central to the advisor's alpha model

Rather than investment capabilities, the Vanguard Advisor's Alpha™ model relies on the experience and stewardship that the advisor can provide in the relationship. Left alone, investors often make choices that impair their returns and jeopardize their ability to fund their long-term objectives. Many are influenced by capital market performance; this is often evident in market cash flows mirroring what appears to be an emotional response—fear or greed—rather than a rational one. Investors also can be moved to act by fund advertisements that tout recent outperformance, as if the investor could somehow inherit those historical returns, despite disclaimers stating that past performance "is no guarantee of future results." A study of Canadian mutual fund cash flows shows that, after protracted periods of relative outperformance in one area of the market, sizeable cash flows tend to follow (see **Figure 4**).

This performance-chasing behaviour is often detrimental to returns. Research into investors' returns in Canadian mutual funds[2] suggests that investors often trail the performance of the funds they invest in, sometimes by a considerable amount—results that tend to parallel the experience of mutual fund investors in the United States.[3] The returns that investors receive may be very different from those of the funds they invest in, since cash flows tend to be attracted by, rather than precede, higher returns. The advisor's alpha target, then, might be to improve upon this return shortfall by means that don't depend on market outperformance: asset allocation, rebalancing, tax-efficient investment strategies, cash flow management, and, when appropriate, coaching clients to change nothing at all.

While return-chasing behaviour is often associated with individual investors, evidence suggests that institutions are guilty of it as well. Goyal and Wahal (2008) looked at the hiring and firing decisions of a

2 Sinha, Rajeeva and Jog, Vijay, "Returns and Fund Flows in Canadian Mutual Funds'" in Greg N. Gregoriou (ed.) *Performance of Mutual Funds: An International Perspective*, 2007.

3 Philips, Christopher B., 2011. *The case for indexing.* Valley Forge, Pa. The Vanguard Group.

Figure 5. Institutional investment management hire/fire decisions, 1996–2003

Amount of excess return

	Years before manager change			Years after manager change		
	3	2	1	1	2	3
Difference	9.52	9.12	4.57	–0.49	–0.88	–1.03

Source: Table 10 in The Selection and Termination of Investment Management Firms by Plan Sponsors Amit Goyal, Sunil Wahal (Journal of Finance Volume 63, Issue 4, printed August 2008.)

Data: 8,775 hiring decisions by 3,417 U.S. plan sponsors delegating $627 billion in assets. 869 firing decisions by 482 plan sponsors withdrawing $105 billion in assets. Analysis covers the period 1996 through 2003.

group of U.S. plan sponsors from 1996 through 2003. They found that the hired firms outperformed the fired firms in the periods immediately preceding the decision to change, but underperformed the fired firms for one, two, and three years thereafter (**Figure 5**).[4] Advisors, as behavioural coaches, can act as emotional circuit-breakers in bull or bear markets by circumventing their clients' tendencies to chase returns or run for cover in emotionally charged markets.

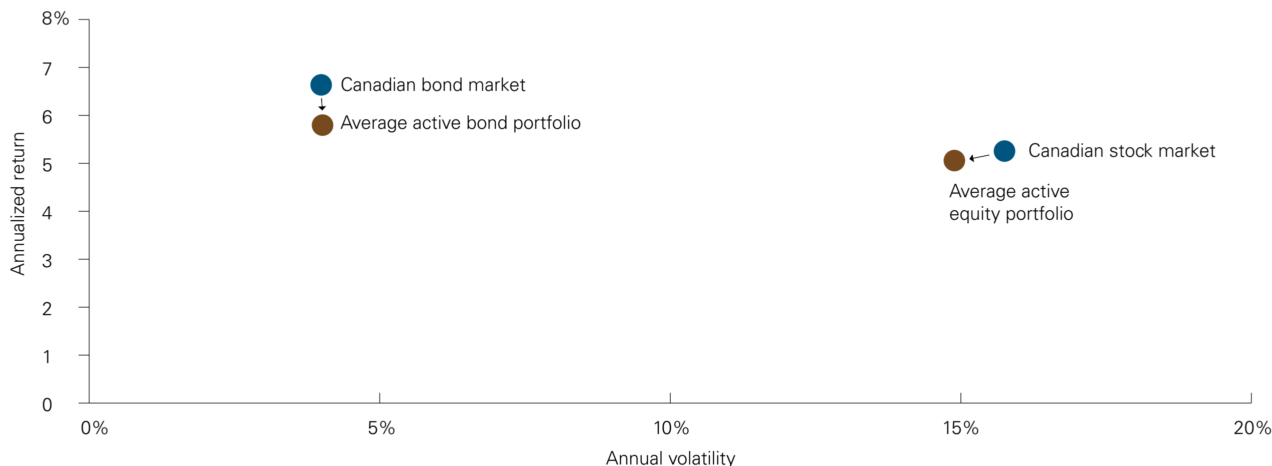
Adding value through portfolio construction

Many advisors use a "top-down" approach that starts with analyzing the client's goals and constraints and then focuses on finding the most suitable asset allocation strategy. This process is extremely important, yet too many investors neglect it on their own, overlooking its contribution to their long-term investment success. As a result, providing a well-considered investment strategy and asset allocation is an important way in which advisors add value. And the knowledge that the asset allocation was arrived at after careful consideration, rather than as a happenstance of the investment equivalent of butterfly collecting, can serve as an important emotional anchor during those all too-frequent uprisings of panic or greed in the markets.

However, many investors (and certainly some advisors) approach investing from the "bottom up," focusing foremost on security or fund selection, with emphasis on investments that have caught their eye because of recent outperformance. Cash flow patterns such as those we've just illustrated in Figure 4 tend to be the result, often with the greatest differential in net cash flows occurring at or near the peak in relative outperformance. After a lengthy stock market boom that peaked in 2000, one might have looked for cash coming into bond rather than stock funds as a result of portfolio rebalancing. However, such an expectation would presume that a large majority of investors and advisors both employed asset allocation strategies and possessed the discipline to execute rebalancing as planned—paring the holdings of their outperformers and committing more capital to the underperformers. The data do not seem to validate this presumption.

4 See also the Vanguard research paper LaBarge, Karin Peterson, 2010. *What matters most? An analysis of investment committee hire/fire decisions.* Valley Forge, Pa.: The Vanguard Group.

Figure 6. Average returns and volatility of Canadian actively managed funds versus their markets



Notes: **This hypothetical illustration does not represent the return on any particular investment.** The Canadian equity portfolio was constructed by dividing the stock allocation into large-cap (75%), mid-cap (15%) and small-cap (10%), approximating the historical weights for the Canadian stock market (since 2001). The Canadian stock market is represented by the S&P/TSX Composite Index. The fixed income portfolio was constructed by dividing the Canadian bond market into short-term (25%), intermediate-term (45%) and long-term (30%) sectors. The Canadian bond market was represented by the Citigroup World Government Bond Index. All returns are in Canadian dollars.

Sources: Vanguard calculations, using fund data provided by Morningstar, Inc. Data include liquidated and merged funds and cover the period 1 January 2001, through 31 December 2011.

The asset allocation process may be separated into two parts: determination and implementation. Within the overall framework of each client's goals and circumstances, determination of the allocation is often based on the historical risk and reward relationships between asset classes. Although no forward-looking investment process is perfect, particularly one based on historical data, it is reasonable to think that some historical risk/reward relationships are likely to persist in the future. Future investors are as likely to demand compensation for bearing risk as investors in the past and, as a result, it is logical to expect assets with more return uncertainty (such as stocks or lower-quality bonds) to outperform lower-risk assets over the long run.

Once an asset allocation has been determined, advisors can help their clients understand the important considerations regarding its implementation. For example, the next question might be, "Do I want to use actively managed funds or index funds (or ETFs) to implement this portion of the allocation?" To help clients evaluate the index side of the scale, an advisor can point out that—in addition to the higher expense ratios commonly charged for actively managed funds (recall Figure 1) —active funds tend to be less diversified than index funds in their respective categories. The combination of higher expenses and less diversification has often contributed to lower returns for actively managed funds than for their index competitors, creating an unpalatable combination with potentially more risk,[5] (**Figure 6**).

5 For the gross returns of an actively managed fund to differ from that of a style-matched benchmark, its portfolio must differ in some way in its composition. Often actively managed funds are not as well diversified as the benchmark, a factor that adds idiosyncratic risk. In addition, while an actively managed fund may significantly outperform its stated benchmark, it may too significantly underperform the benchmark, a possibility commonly referred to as "active manager risk." It is not uncommon for an index fund to fully replicate the composition and volatility of its benchmark.

Addition by subtraction: Emphasis on tax-efficient strategies

Taxes are another important consideration for many clients and tax management is another important way advisors can demonstrate the value they add. Actively managed equity strategies or funds tend to be tax-inefficient, potentially diminishing or erasing any gains from outperformance if they are held in taxable accounts. If an advisor has great faith in the active manager's abilities, then techniques such as asset location—sheltering tax-inefficient investments or strategies in tax-advantaged accounts—may help preserve the expected rewards for bearing active-manager risk. Helping clients not only with their asset allocation but also with their asset location can be a meaningful part of advisor's alpha, adding clear value by helping to improve the client's after-tax returns.

Further, clients who are in retirement often can benefit from tax-conscious guidance about spending from their portfolios. On their own, investors often spend first from their tax-advantaged accounts, and to some degree this is understandable since those accounts were explicitly set up for this purpose. However, it is generally more advantageous to spend from taxable accounts first, allowing the tax-advantaged accounts to grow as much as possible.

Determining the appropriate drawdown strategy often includes making some assumptions about future tax rates as well as estimating the client's future income levels. Meeting with the client to work through these assumptions can provide an excellent opportunity to discuss possible future scenarios, demonstrate that the guidance is personalized, and promote the client's confidence in the strategy and the advisor. A well-thought-out drawdown strategy can improve the likelihood that the client's assets will be able to support his or her financial goals through retirement and beyond, which is a significant, if hard to quantify, added value.[6]

Conclusion

The compensation structure for advisors is evolving from a commission and transaction-based system to a fee-based, wealth management framework. In our view, this is a mutually beneficial transition for clients and advisors alike. However, the traditional value proposition for many advisors has been based on their investment acumen and their prospects of delivering better returns than the markets. No matter how skilled the advisor, the path to better investment results may not lie with the ability to pick investments or strategies. Historically, active management has failed to deliver on its promise of outperformance over longer investment horizons.

Instead, advisors should consider a new value proposition based on alternative skills and expertise: acting as a wealth manager and behavioural investing coach, providing discipline and experience to investors who need it. On their own, investors often lack both understanding and discipline, allowing themselves to be swayed by headlines and advertisements surrounding the "investment du jour"—and thus often achieving wealth destruction rather than creation. In the advisor's alpha framework we've described, the advisor becomes an even more important factor in the client-advisor relationship, because the greatest obstacle to clients' long-term investment success is likely *themselves*.

6 For more information on the topic, see Jaconetti, Colleen M., and Maria A. Bruno, 2008. *Spending From a Portfolio: Implications of Withdrawal Order for Taxable Investors*. Valley Forge, Pa.: The Vanguard Group.

References

Goyal, Amit, and Sunil Wahal, 2008. "The Selection and Termination of Investment Management Firms by Plan Sponsors." *Journal of Finance*, 2008.

Jaconetti, Colleen M., and Maria A. Bruno, 2008. *Spending From a Portfolio: Implications of Withdrawal Order for Taxable Investors*. Valley Forge, Pa.: The Vanguard Group.

LaBarge, Karin Peterson, 2010. *What matters most? An analysis of investment committee hire/fire decisions*. Valley Forge, Pa.: The Vanguard Group.

Philips, Christopher B., 2011. *The case for indexing: Canada*. Valley Forge, Pa.: The Vanguard Group.

Sinha, Rajeeva and Jog,Vijay, "Returns and Fund Flows in Canadian Mutual Funds'" in Greg N. Gregoriou (ed.) *Performance of Mutual Funds: An International Perspective*, 2007.

Vanguard®

To Canadian resident investors: This report is intended for Financial Advisors Only and is not for public distribution. This report does not necessarily represent the views of Vanguard Investments Canada Inc. This report does not represent any product or service by Vanguard Investments Canada Inc. Vanguard Investments Canada Inc. accepts responsibility for the contents subject to the terms and conditions stated herein. The first date of use by Vanguard Investments Canada Inc. is June 6, 2012.

Commissions, management fees and expenses all may be associated with the Vanguard ETFs. This offering is only made by prospectus. Copies are available from Vanguard Investments Canada Inc. at www.vanguardcanada.ca. Investment objectives, risks, fees, expenses, and other important information are contained in the prospectus; read it before investing. ETFs are not guaranteed, their values change frequently, and past performance may not be repeated.

This report was originally published by The Vanguard Group, Inc. on May 30, 2012. The opinions expressed in this material are those of the individual strategists as of the original date of publication. This report may not be updated, supplemented or revised whether as a result of new information, changing circumstances, future events or otherwise.

The information contained in this report has been compiled by from proprietary and non-proprietary sources believed to be reliable, but no representation or warranty, express or implied, is made by The Vanguard Group, Inc., its subsidiaries or affiliates, or any other person (collectively "The Vanguard Group") as to its accuracy, completeness or correctness. The Vanguard Group takes no responsibility for any errors and omissions contained herein and accepts no liability whatsoever for any loss arising from any use of, or reliance on, this report.

This report is not intended to be relied upon as investment or tax advice, and is not a recommendation, offer or solicitation to buy or sell any ETFs or to adopt any investment or portfolio strategy. The views expressed in this report should also not be construed as investment advice or research and do not take into account the particular investment objectives, needs, restrictions and circumstances of your clients or prospective investors.

Any security, fund, index, portfolio or market sector mentioned is this report was done so for illustrative purposes only. The case studies and examples in this report are designed for illustrative purposes only.

The information contained in this publication does not constitute an offer or solicitation and may not be treated as an offer or solicitation in any jurisdiction where such an offer or solicitation is against the law, or to anyone to whom it is unlawful to make such an offer or solicitation, or if the person making the offer or solicitation is not qualified to do so.

Notes on risk: All investments, including those that seek to track indexes, are subject to risk, including the possible loss of principal. Diversification does not ensure a profit or protect against a loss in a declining market. While Vanguard ETFs are designed to be as diversified as the original indexes they seek to track and can provide greater diversification than an individual investor may achieve independently, any given ETF may not be a diversified investment. Investing in ETFs involves risk, including the risk of error in tracking the underlying index. ETFs are subject to risks similar to those of stocks. Investments that concentrate on a relatively narrow market sector face the risk of higher share-price volatility. Prices of mid- and small-cap stocks often fluctuate more than those of large-company stocks. Stocks of companies in emerging markets are generally more risky than stocks of companies in developed countries. Investments in exchange-traded bond funds are subject to interest rate, credit, and inflation risk. Foreign investing involves additional risks including currency fluctuations and political uncertainty.

The information from Morningstar contained herein: (1) is copyright of Morningstar Research Inc. and all rights are reserved; (2) is proprietary to Morningstar and/or its content providers; (3) may not be copied or distributed; and (4) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results.

© 2012 Vanguard Investments Canada Inc.
All rights reserved.

ISGAAC 052012