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Behavioral Alpha

An Advisor's Greatest Value

Dr. Daniel Crosby
Chief Behavioral Officer

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A Discussion of the Value Financial Advisors Bring to the Wealth Management Process

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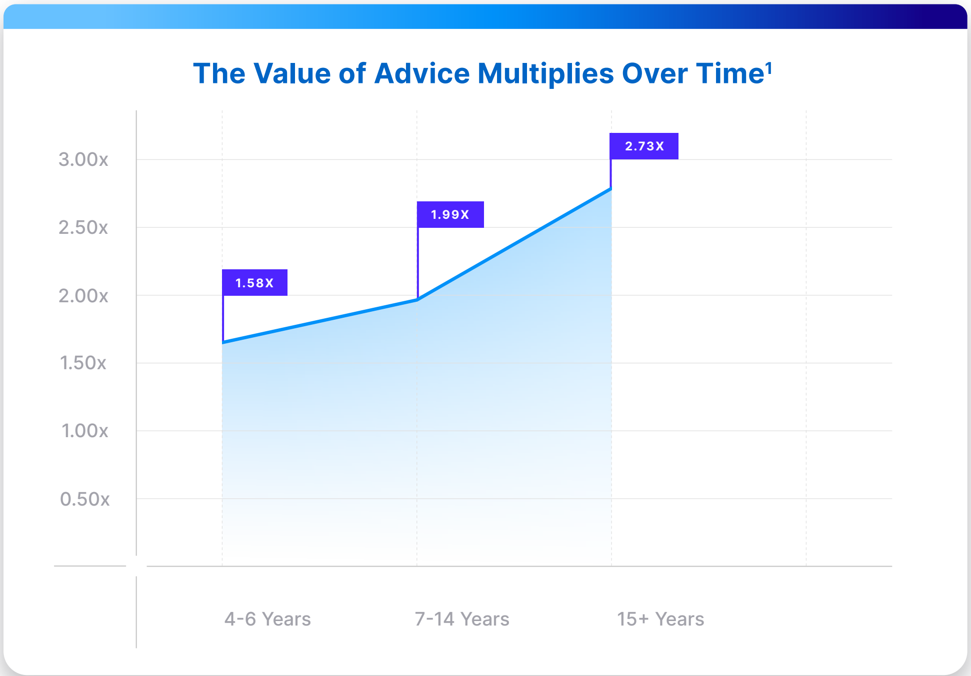
Learn how advisors can enhance an investor's life by helping improve their decision-making process, and how working with an advisor may increase an investor's sense of confidence and security.

Research has found investors who purchase financial advice are more than one and one half times more likely to stick with their long-term investment plan than those who did not. Because of this commitment to a game plan, the wealth discrepancies between families who receive advice and those who do not grows over time.

The chart below shows how those who receive four to six years of advice, the multiple attributable to advice is 1.58. Those receiving seven to 14 years of advice nearly double (1.99x) their no-advice peers, and those receiving 15 or more years of advice clocked in at an overwhelming 2.73x multiple. Good financial advice pays in the short run, but the multiplication of those gains over an investing lifetime is truly staggering.

This paper will examine the ways in which working with a financial advisor makes sense. It will also explore the financial advisory activities that add the most value. Finally, it will discuss areas in which the advisor-investor relationship can be enhanced.



LET'S DIVE IN

Financial Advice Pays

In an era of seven-dollar trades and fee compression, some have been quick to dismiss the traditional advisory relationship as a relic of a bygone era.

Years ago, brokers and advisors were the guardians of financial data, the keeper of the stock quote. Today, investors need only an iPhone and a free online brokerage account to do what just 30 years ago was the exclusive purview of Wall Street. It is worth asking in such an age, "Is my advisor really earning their fee?" An appeal to the research shows the answer is a resounding "yes," albeit not for the reasons you might suppose.

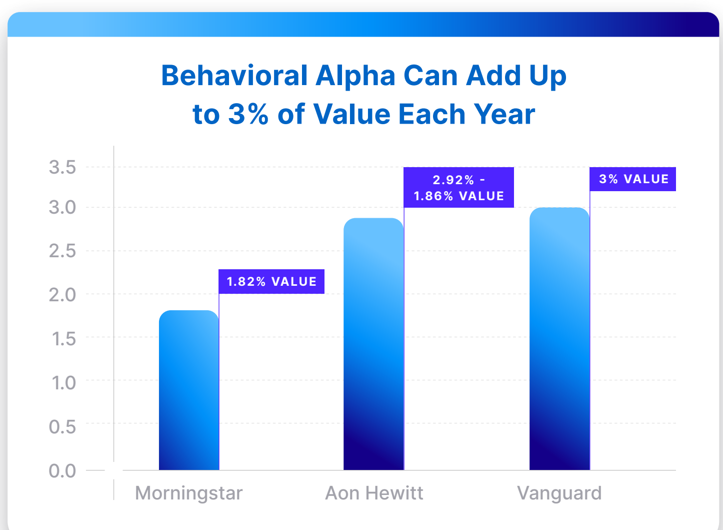
In a seminal paper titled "Advisor's Alpha," the famously fee-sensitive folks at Vanguard estimate the value added by working with a competent financial advisor is roughly 3% per year. The paper is quick to point out the 3% delta will not be achieved in a smooth, linear fashion. Rather, the benefits of working with an advisor will be "lumpy" and most concentrated during times of profound fear and greed. This uneven distribution of advisor value presages a second truth we will discuss more fully in the next section; the highest and best use of a financial advisor is as a behavioral coach rather than an asset manager.

Further evidence of advisor efficacy is added by Morningstar in their whitepaper, "Alpha, Beta, and Now...Gamma." "Gamma" is Morningstar's shorthand for "the extra income an investor can earn by making better financial decisions" and they cast improving decision-making as the primary benefit of working with a financial advisor. In their attempt at quantifying Gamma, Morningstar arrived at a figure of 1.82% per year outperformance for those receiving advice aimed at improving their financial choices. Again, it would seem advisors are more than earning their fee and that improving decision-making is the primary means by which they improve clients' lives.

Research conducted by Aon Hewitt and managed accounts provider Financial Engines, also supports the idea that help pays big dividends. Their initial research was conducted from 2006 to 2008 and compared those receiving "help" in the form of online advice, guidance through target date funds or managed accounts to those who "did it themselves." Their finding during this time was that those who received help outperformed those who did not by 1.86% per annum, net of fees.

Seeking to examine the impact of help during times of volatility, they subsequently performed a similar analysis of "help vs. no-help" groups that included the uncertain days of 2009 and 2010. They found the impact of decision-making assistance was heightened during times of volatility and the outperformance of the group receiving assistance grew to 2.92% annually, net of fees. The research suggests the benefits of advice are disproportionately experienced during times when rational decision-making becomes most difficult.

We have now established that financial guidance tends to pay off somewhere in the ballpark of 2% to 3% a year. Although those numbers may seem small at first blush, anyone familiar with the marvel of compounding understands the enormous power of such outperformance. If financial advice really does work, the effect of following good advice over time should be substantial and indeed, research suggests that very thing.



Financial Advice Improves Quality of Life

Hopefully at this point, there is little doubt in your mind the cumulative effects of receiving sound investment counsel are financially impressive. But as we look beyond dollars and cents, it is worth considering whether there are quality of life benefits to be enjoyed by working with a financial professional.

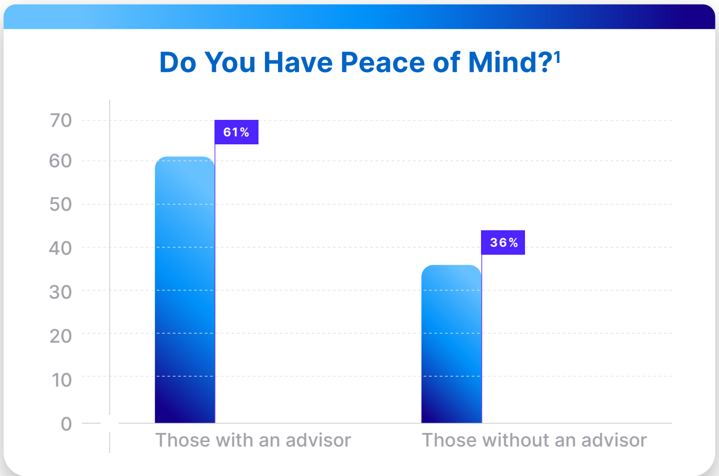
KEY TAKEAWAY

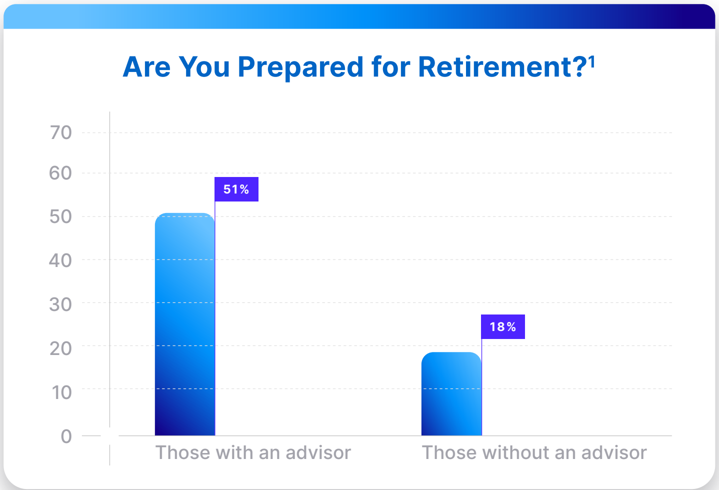
Receiving good advice pays a dividend that builds both wealth and confidence.

After all, many people perfectly capable of mowing a lawn, cleaning a home or painting a room will outsource those jobs. While you may have lawn mowing skill equal to that of the person you hire, you may still enjoy peace of mind and increased time with loved ones as a result of your delegation. The research suggests in addition to the financial rewards that may accrue to those working with an advisor, it also provides increases in confidence and security that are no less valuable.

The Canadian "Value of Advice Report" found those paying for financial advice reported a greater sense of confidence, more certainty about their ability to retire comfortably and having higher levels of funds for an emergency. A separate study performed by the Financial Planning Standards Council found 61% of those paying for financial advice answered affirmatively to "I have peace of mind" compared to only 36% of their "no plan" peers. The majority (54%) of those with a plan felt prepared in the event of an emergency versus only 22% of those without a plan. Finally, 51% of respondents with a plan felt prepared for retirement against a frightening 18% of those not receiving advice.

Receiving good financial advice pays a dividend that builds both wealth and confidence. The research is unequivocal that a competent financial guide can both help you achieve the returns necessary to arrive at your financial destination while simultaneously improving the quality of your journey.





Where Do Financial Advisors Add Value?

Often, simple solutions are ignored because of their simplicity. Investors tend to ignore the greatest value provided by a financial advisor by looking beyond the mark to more glamorous pursuits like asset management.

The tendency to seek complexity and ignore simplicity has been alive and well for years in investment circles. For far too long, financial advisors have led with proprietary product pitches or the assertion they can outperform the market through superior investment acumen. This appeal to complexity has rung true to an investing public overwhelmed by the vagaries of financial markets, but is beginning to crumble in the face of popular research that highlights the difficulties in generating investment "alpha."

Once again, we will appeal to the research to try and determine the sources of outperformance for those receiving professional financial advice. Vanguard's "Advisor's Alpha" study quantifies the value added (in basis points, or bps) by many of the common activities performed by an advisor, and the results may surprise you. They include:

- Rebalancing: 35 bps
- Asset allocation: 0 to 75 bps
- Behavioral coaching: 150 bps

What will surprise most investors seeking an appropriate financial guide is that hand-holding provides more added value than any of the activities more directly associated with the management of money. Based on the above assumption of 3% per year average added value, fully half of that owes to behavioral coaching, or preventing clients from making foolish decisions during times of fear or greed!

Morningstar's "Gamma" study is also illustrative of the true value added by an advisor and the things investors should seek out when choosing a professional. The study lists the sources of added values as follows:

- Asset allocation
- Withdrawal strategy
- Tax efficiency
- Product allocation
- Goals-based advice

While some sources of gamma can easily be self-taught (e.g., asset allocation) others remain uniquely powerful in the hands of an outside advisor. Just as anyone can look up a sensible workout regimen, it is not difficult to find instructions on investing in a broadly diversified mix of asset classes. But if knowledge were sufficient to induce appropriate behavior, America would not be the most obese developed country in the world and be staring down the barrel of a looming retirement crisis. While appropriate knowledge is an important starting point, a personal coach that ensures adherence to a plan is demonstrably even more important.

KEY TAKEAWAY

An advisor is adding more value when they manage emotions than when they manage your money.

The Bottom Line

So, do financial advisors add value? The research strongly supports that they do, both in terms of improving means and quality of life. But they only add value when we know what to look for when selecting the appropriate wealth management partner.

Our natural tendencies will be toward excess complexity and flash, seeking out those who lead with bold claims of esoteric knowledge. But what might add much greater richness is a partner who balances deep knowledge with deep rapport. Someone we will listen to when we are scared and who will save us from ourselves. A simple solution to a complex problem.

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EMAIL
info@orion.com

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SOURCES

1 Source: Crosby, D. (2018). The Behavioral Investor.

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