Are planners worth the fees they charge?

Wade Pfau | American College | 13 March 2013

Could financial advisers who offer comprehensive services be doing a better job? Two recent studies shed a positive light on the potential of the financial planning profession to do right by clients.

Both studies aim to quantify whether advisers add value by helping clients achieve better financial outcomes, which is defined as the potential to spend more in retirement. Both studies attempt to quantify the value of planners in terms of their ability to increase lifetime consumption, rather than trying to measure investment performance through single-period alpha measures.

Comprehensive planners vs salespeople

Regrettably, the advisory profession has been portrayed in a negative light in prior academic studies. Perhaps most famously in planner circles, a March 2012 study, The Market for Financial Advice: An Audit Study, from the National Bureau of Economic Research (NBER), concluded that financial advisers reinforce behavioral biases and misconceptions in ways that serve the advisers' interests. But such studies have tended to investigate brokers who could be better characterised as salespeople rather than financial advisers.

In a blog post, Michael Kitces of the Pinnacle Advisory Group, explained that the painful flaw of the NBER study is that it focuses on how salespeople provide advice to earn more commission income rather than to help customers. By the NBER authors'' own admission, their categorisation of advisers included only salespeople working at banks and investment firms. Such "advisers" are subject only to a suitability sales standard for their investment recommendations. They may have little training and no responsibility to provide advice that meets the higher standard of fiduciary care.

The NBER study did not consider advisers who subject to SEC oversight and have a fiduciary duty

to their clients under the [US] Investment Advisers Act of 1940. It also did not consider whether the advisers in the study were trained to provide financial advice. The study concluded that financial advisers did not provide good advice, without attempting to provide any measure or control over the quality of the financial adviser and without making any effort to include trained advisers in the study.

"The NBER research study could have been an opportunity to demonstrate the difference between a true adviser - one who has responsibility to give quality advice, is regulated as such, and has the training to do so - and a salesperson," Kitces concluded, "by controlling for the training, education, experience, and regulatory standards across all the advisers and 'advisers' (salespeople) studied."

Now, let's look at the two recent studies.

Planning for retirement

A recent study, Planning for Retirement, by Terrance Martin and Michael Finke at Texas Tech University, is a valiant effort to investigate the differences in outcomes for clients working with comprehensive advisers and clients working with brokers. Their conclusion is that comprehensive planners help clients achieve improved financial outcomes.

Martin and Finke were constrained by the limitations of the survey questions asked, but they were able to look at wealth accumulations in retirement savings accounts and increases in wealth between 2004 and 2008. They measured the value of financial advice in terms of the accumulated savings for retirement in qualified and tax-advantaged retirement accounts using a household survey that has followed the same individuals since 1979.

They classified individuals in the survey into one of four categories. Those who said they used an adviser and had calculated their retirement needs were classified as working with a comprehensive financial planner. Those who worked with an adviser but had not calculated their retirement needs were classified as working with brokers. Those who did not work with an adviser but who had completed a retirement needs assessment were classified as do-it-yourself investors. Finally, the majority of people (66%) in the sample neither worked with an adviser nor had a retirement plan.

The authors addressed several research questions. Does using an adviser help to increase savings for retirement? Is there a difference between comprehensive advisers (who help to assess retirement needs) and brokers? Finally, is the do-it-yourself approach just as effective in increasing savings for those not working with an adviser?

After controlling for a variety of factors, such as income and education levels, the authors found that those working with comprehensive planners saved substantially more for retirement than anyone else across the distribution of wealth outcomes. Those with a DIY retirement plan also saved more than those without any plan. The study confirmed that those working with advisers who did not have a retirement plan were not saving any more than those without an adviser or plan.

We have to be careful about reading too much into the results of the study. For instance, those who seek out comprehensive planners may be more organised and forward-looking on their own, such that their improved outcomes could be explained by their own behavior and not by the planners. Planners may also seek out clients who have greater wealth, which could explain why those with comprehensive planners have saved more for retirement. But this problem was partly corrected by also considering how those with comprehensive planners enjoyed greater wealth increases between 2004 and 2008.

We also have to be cautious about how the study divides comprehensive planners from brokers. The division is based on a question about whether someone works with an adviser and whether someone has made a plan for their retirement. Those with self-directed retirement plans who work with brokers are classified as working with comprehensive planners within the study's framework. Nevertheless, until better data can be obtained, this study demonstrates the importance of distinguishing between adviser types.

Alpha, beta, and now... gamma

A second study, Alpha, Beta, and Now... Gamma, took a different tact. Rather than attempting to measure the influence of actual financial advisers, David Blanchett and Paul Kaplan of Morningstar aimed to quantify the potential value provided by making better financial decisions relative to more naive rules of thumb. Their study defined a new investment measure – gamma (which follows alpha and beta in the Greek alphabet) – as the value of improved decision making.

The study quantified how making better financial decisions affected the potential of increasing retirement income on a utility-adjusted basis.

Financial planners could use the results of this study to help explain to clients the quantitative value of their services. The study quantified the potential impact of making improved decisions along five dimensions, which I will describe in descending order of their importance.

First, using a dynamic withdrawal strategy provided 8.5% more utility-adjusted income for a retiree than simply spending an inflation-adjusted withdrawal amount (4% of retirement-date assets until financial assets are depleted).

Next, incorporating tax efficiency into retirement withdrawal decisions through asset location and withdrawal sequencing increased income by 8.2%.

The third factor is total wealth asset allocation, which increased income by 6.1%.

Next, adding single-premium immediate annuities (SPIAs) to retirement portfolios provided 3.8% more income.

[illegible]% more income.

Finally, by making asset-allocation decisions after incorporating future spending needs, retirees obtained 2.2% more income.

By making these improved financial decisions, retirement income can be increased dramatically. On a utility-adjusted basis, more sophisticated planning [i.e. incorporating the above five techniques which could be the case for an investor working with a planner - Ed] allowed for an increase in retirement income of 29% over the naive case [i.e. not incorporating the above five techniques which would be the case for the investor on his/her own - Ed].

The authors also asked how much all this is worth in terms of traditional alpha measures of portfolio performance. In other words, how much would portfolio returns need to be increased to support 29% more spending? Their answer was that, over a 30-year period, the naive investor would need to earn 1.82% more per year (the median value in a Monte Carlo simulation) to increase income by this amount. This is the "gamma-equivalent alpha."

An investment adviser charging 1% of assets under management fee would be splitting the gains roughly in half in this example, if the clients alternative was to behave naively. The value provided by planners could be even greater if they help clients make better decisions on when to claim Social Security and if the clients also tend to commit correctable behavioral mistakes such as buying high and selling low.

The bottom line

Comprehensive planners help their clients achieve better outcomes in a variety of ways, including budgeting and saving for the future, making better investment decisions, thinking about tax efficiency and considering total-portfolio and lifetime perspectives. Both of these new studies help to quantify this. These studies serve as a wake-up call to other researchers that studying the investment outcomes of broker-guided portfolios is not a sufficient way to quantify the value provided by the financial planning profession. Hopefully, we will see more studies along these lines in the coming years.

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