Evaluating Financial Planning Strategies And Quantifying Their Economic Impact

Executive Summary

- If the purpose of financial planning is to help people improve their financial well-being, with strategies that enhance financial outcomes, it should be possible to measure the economic benefit of typical financial planning strategies.

- Accurately assessing the economic impact of a financial planning recommendation is crucial beyond just validating that the advisor is worth the cost. It's also fundamental to determining what constitutes a "good" financial planning strategy to implement in the first place, versus one that should be avoided because it doesn't actually improve the situation.

- The means by which a strategy's outcomes are measured can have a significant impact on whether it is deemed worthwhile – or not – in the first place. As a result, proper consideration of *how* outcomes should be measured is actually crucial. For instance, a retirement strategy that is "best" at maximizing wealth or income could be "worst" when measured based on the probability of success, and might be good or bad when evaluated based on a utility function (depending on the client's relative aversion to spending cuts versus a desire for greater wealth).

- When comparing two financial planning strategies to each other, it's feasible to compare the outcomes and decide which is best. Trying to assess the value of financial planning advice in the abstract, though, is much harder because of the "compared to what" problem – it's not always clear exactly how any particular client would have behaved in the absence of

the advice (since that future never actually happened), which makes it impossible to measure whether or how the advice actually changed the outcome.

- Notwithstanding the "compared to what" problem, several research studies have tried to assess the economic impact of financial advice. Morningstar dubs the value of advice as "Gamma" and estimates it to be 1.59%/year for retirees. Vanguard calls it "Advisor's Alpha" and pegs the value at upwards of 3%/year. Envestnet labels it "Capital Sigma" and also estimates advisors can add as much as 3%/year of value.

- The existing studies on the impact of financial advice combine multiple solutions, which in reality may have varying impacts for any client situation in particular. Some are pure value-adds like tax alpha (e.g., tax loss harvesting and asset location), while others are behavioral and may vary by client, and some are related to investment selection where the value will depend on what the client really did (or did not) own already.

- Most research on the value of financial advice has focused primarily on how advisors add value around a portfolio. Ultimately, though, financial advice can impact a wide range of areas, from income and estate tax planning, to insurance planning (where the expected value is typically negative in absolute terms, but an improvement in risk reduction), and more. In some cases, the "value" of financial planning is in the eye of the beholder – based on how the client values his/her own time relative to paying for the advisor.

- In a world where ultimately, most financial planning strategies "could" be implemented by a consumer themselves – given sufficient education, time, and an inclination to get it done – arguably the greatest value a financial planner provides is the behavioral coaching and support to ensure the recommendations are actually implemented. Unfortunately, the financial impact of this is virtually impossible to measure, given the uncertainty of how a prospective client *might have* behaved in the future without an advisor. Nonetheless, it is essential to recognize that the economic impact of financial planning is not merely the strategy itself, but its implementation, too!

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Introduction

For any financial planner who charges for their advisory services, quantifying the value (or value-add) of good financial planning advice is crucial in order justify the cost. At the most basic level, no service business is viable – financial planning or otherwise – if the value of what's delivered fails to exceed its cost.

Yet ultimately, the exercise of trying to determine the economic impact of financial planning strategies is more than just a self-serving exercise about the value of a financial planner. The ability to appropriately measure the economic consequences of a recommended strategy is crucial to assessing whether the supporting tactics are even appropriate to implement in the first place. After all, advice that has a negative value isn't just "not worth its cost" – it's a recommendation that perhaps shouldn't be given *at all*. Viewed another way, demonstrating the value of a financial planning strategy is as much about validating the appropriateness of the strategy itself, as the value of the advisor who recommended it.

In this issue of *The Kitces Report*, we explore the issues to consider when trying to evaluate the benefits and economic impact of various financial planning strategies, from the importance of deciding *how* to measure the outcomes in the first place, to the challenging "compared to what" problem that makes it difficult to objectively assess the value of advice, and how for many financial planning strategies the economic impact is actually *negative*… but reduces risk enough that it's probably good advice anyway!

Quantifying The Economic Benefits Of (Good) Financial Advice?

In recent years, a growing base of research and white paper studies have begun to quantify the economic impact of popular financial planning strategies, particularly those related to portfolios (which can be measured in percentages or basis points relative to the value of the assets themselves). Such research is important again not only because it validates the value of the advisor providing those services, but also because it affirms those services have positive economic impact and are worth trying to deliver or implement in the first place.

For instance, a 2013 study by David Blanchett and Paul Kaplan of Morningstar entitled "*Alpha, Beta, and Now… Gamma*" found that the benefits of financial advice for retirees improve their outcomes by the equivalent of a 1.59%/year increase in returns. Notably, these advisor-driven outcome improvements were *not* merely about delivering higher absolute investment returns or generating portfolio alpha, though; instead, the advice pertained to areas like "tax alpha" through asset location and tax-savvy retirement liquidations (from a mixture of brokerage and retirement accounts), designing a 'more appropriate' holistic asset allocation that accounts for *all* of a household's assets (including the asset value of Social Security and pensions), effective use of annuities and dynamic withdrawal strategies, and selecting investments in a manner that maximizes the stability and sustainability of inflation-adjusted retirement cash flows (as opposed to just picking investments that have the highest expected returns). Given that these value-adds were all outside of the portfolio itself, the authors dubbed the advisor's contribution as "Gamma" to distinguish it from more traditional investment/portfolio metrics like alpha and beta.

A similar 2014 study from Vanguard researchers Francis Kinniry, Colleen Jaconetti, Michael DiJoseph, and Yan Zilbering entitled "*Putting a value on your value: Quantifying Vanguard Advisor's Alpha*" went a step further, estimating the economic benefits of a financial advisor's advice to be as much as 3%/year. This included value-adds in areas from cost-effective investment selection and rebalancing, to asset location, behavioral coaching (to avoid poorly-timed portfolio changes), and the (tax-sensitive) withdrawal order of liquidation strategies. Again, the authors excluded any direct portfolio-related return enhancements like superior asset allocation or improved diversification, which ostensibly could just add further "portfolio" alpha on top of the "advisor alpha" (but aren't necessary to justify the advisor's cost).

More recently, the Envestnet Quantitative Research Group also tackled the topic, in a white paper entitled "*Capital Sigma: The Advisor Advantage*" and similar to Vanguard suggested that financial advisors add value in a wide range of areas, from general financial planning strategies, to systematic rebalancing, and portfolio tax management through tax loss harvesting, as well as more effective asset allocation diversification and choosing lower cost investments. The researchers estimated these various advisor contributions cumulatively add up to as much as 3%/year of enhanced returns, which they dubbed "Capital Sigma" (the Greek symbol for summing up the parts).

The bottom line is that whether it is called Gamma, Advisor Alpha, or Capital Sigma, the research (as summarized in Figure 1) suggests significant potential value-add from a financial planner. In fact, arguably the *total* value of an advisor could be even greater than what any of the particular studies found, given that each cites and quantifies some unique value-adds that the others don't (e.g., Capital Sigma estimates the value-add of an advisor at >3%/year *without* including asset location and tax-efficient withdrawal strategies cited in the Vanguard and Morningstar studies).

Figure 1. Popular Studies Estimating The Economic Benefits Of (Portfolio-Related) Financial Advice

	MORNINGSTAR GAMMA	VANGUARD ADVISOR ALPHA	ENVESTNET CAPITAL SIGMA
Financial Planning Advice/ Dynamic Withdrawal Strategies	70bps		50bps
Asset Class Selection/ Allocation & Product Selection	67bps		28bps
(Lower Cost) Investment Selection		45bps	82bps
Systematic Rebalancing		35bps	44bps
Tax-Efficient Withdrawal Ordering	23bps	Up to 70bps	
Asset Location	23bps	Up to 75 bps	
Behavioral Coaching		150bps	
Tax Loss Harvesting			100bps
Total Advisor Value	**1.59%/year**	**>3%/year**	**>3%/year**

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However, the notable caveat to this research is that the means by which an advisor's "value" is measured varies in significant ways from one study to the next. Vanguard assesses the prospective increases in absolute wealth (compounded over time), while Envestnet largely looks at *risk-adjusted* return improvements, and Morningstar evaluates whether the advisor's strategies improve the economic *utility* of the outcome (and equate it to what return enhancement would have been necessary to generate similar improvements in utility). More generally, the studies do not always even use the same framework to test and evaluate the advisor strategies, and how they're being compared… which as it turns out, is crucial to properly understanding which advisor strategies really do or do not add value for any particular client situation!

The Importance Of Accurately Measuring Economic Impact

While it might seem like an issue that is only relevant after the fact to measure an outcome, the reality is that establishing a proper methodology to evaluate the impact of a financial planning strategy is actually crucial in advance. After all, if you can't determine ahead of time what the financial outcomes and economic impacts of various strategies are going to

be, you can't determine what an effective recommendation would be in the first place!

Yet in turn, the statement "you should determine in advance what the financial outcomes are likely to be, to evaluate which strategy is best" is actually a far greater challenge than it first appears, because of the trade-offs that any financial decision entails in the real world given most people's limited resources. Saving more means spending less. Investing more aggressively can produce more upside potential but also more downside volatility. Spending more in retirement means leaving less to heirs.

In some cases, the trade-offs are so complex, and the outcomes so nuanced, that even determining *what* to measure to assess the economic consequences of a decision can be remarkably challenging.

Determining *How* To Measure What Is "Best"

Imagine for a moment that a 65-year-old couple is trying to decide how much to spend for a 30-year retirement from their $1,000,000 portfolio, and how that portfolio should be invested. The seemingly simple trade-off choices might include:

A) Spend an inflation-adjusting $30,000/year from the portfolio, by putting 90% of it into an immediate annuity and keeping the other 10% in cash reserves

B) Spend an inflation-adjusting $45,000/year from the portfolio, and invest it 50/50 in stocks and bonds

C) Spend an inflation-adjusting $60,000/year from the portfolio, and invest it 100% in stocks

While many advisors might intuitively lean towards one strategy or another as likely to be the "best", it turns out that accurately assessing which is really the best depends heavily on how the outcome is measured in the first place.

Measuring The Outcome: Projected Wealth

The first way these three strategies might be assessed – and what appears to have been the most common methodology for the first several decades of financial planning – is to project how wealth would accumulate and compound over the 30-year retirement time horizon.

For instance, Figure 2 (below) graphs the remaining wealth in the portfolio across each of the three strategies, assuming inflation averages 3%, and that long-term 30-year investment returns are 3% for cash, 5% for (intermediate) bonds, and 10% for stocks. (The immediate annuity is assumed to have a principal refund feature if death occurs before the payments
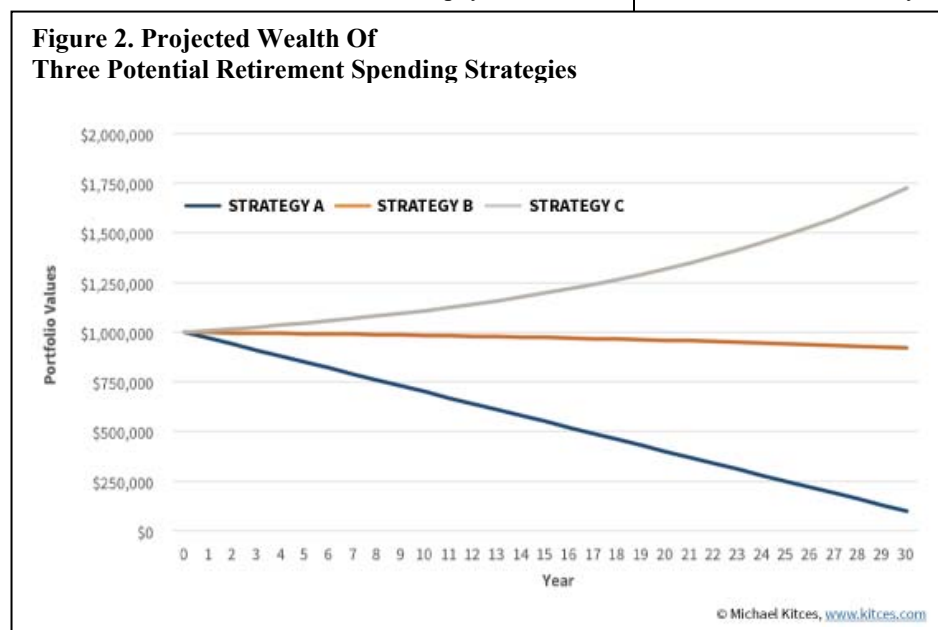
have been recovered, which winds down over time as the payments are made.)

As the chart illustrates, on the basis of this analytical approach – which strategy accumulates the most wealth in the long run – strategy C is the best. Ironically, this is true even though in general, long-term wealth would actually be maximized by spending the *least* (and allowing the most to compound for future growth). Yet in this case, the long-term compounding return of stocks is *so* dominant, it creates the most long-term wealth, *even though* that growth is also slowed by what are also the largest ongoing withdrawals.

Measuring The Outcome: Cumulative Spending

Notwithstanding the fact that strategy C actually turned out to create the most wealth – despite taking the largest withdrawals – in practice, retirees who ultimately want to enjoy retirement should probably not measure outcomes based on final wealth alone. Otherwise, for any two strategies that have similar returns, the "better" one will always be the one with the least spending, which at the logical extreme would mean the "most successful" retirement strategy is the one where the clients never spend a dime of their retirement funds!

An alternative approach would be to look at the cumulative amount of dollars actually spent, which more accurately represents the retiree's opportunity to actually *enjoy* the retirement portfolio. In this context, the "best" strategy will not be the one that leaves the most money in the portfolio at the end, but the one that allows the most money to be consumed while the retiree is alive.

In this case, evaluating outcomes based on cumulative spending once again supports strategy C as the "best". As shown in Figure 3 (top of next page), strategy C produces by far the largest amount of cumulative retirement income spending, in addition to the fact that it also produces the greatest wealth accumulation over time (as shown earlier), thanks again to the long-term compounding return of equities.

Figure 2. Projected Wealth Of Three Potential Retirement Spending Strategies

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Of course, the caveat to this methodology is that it doesn't just show projected wealth and cumulative spending, per se. It shows the projected levels of wealth and spending *if average returns are earned*. Moreover, it's based on having returns average out to their long-term target *with no volatility along the way*.

Yet a zero-volatility projection is not reflective of the real world. Thus, when those dynamics *are* considered – i.e., the "best" strategy is evaluated with a different measuring stick – suddenly the optimal approach changes.

Measuring The Outcome: Probability Of Success

Over the past 15 years, as computing power has continued to grow exponentially, it's no longer necessary to project the financial outcome of a strategy by just measuring the economic impact based on *average* returns. Instead, we can now measure economic outcomes by modeling thousands of possible scenarios, each with randomized returns (based on the probability that they will occur), and instead quantify how often the results are "successful" (i.e., have money left at the end) or are not (i.e., run out of money before the end of the time horizon).

When using this different methodology to quantify the outcomes, though, the relative benefits of each strategy begin to look very different as well. For instance, Figure 4 (right) shows the financial outcomes of these strategies, *and*

Figure 3. Projected Cumulative Spending Of Three Potential Retirement Spending Strategies

the range of *possible* outcomes based on a 95% confidence interval (long-term returns that are plus-or-minus two standard deviations).

When measured earlier based on (median) final wealth and cumulative spending dollars, the "best" scenario was the all-stock strategy C and the worst was the immediate-annuity-based strategy A (with the latter coming in last in terms of *both* spending *and* wealth accumulation). Yet now when we observe the *range* of results, Strategy C has the best average but also includes the worst failures, while Strategy A has an extremely narrow range of outcomes that are "mostly" well below

Figure 4. Probabilities Of Success And Range Of Outcomes (+/- 2 SDs) For Three Retirement Spending Strategies

PROBABILITIES OF SUCCESS:
STRATEGY A: 100%
STRATEGY B: 95%
STRATEGY C: 75%

FINAL WEALTH +/- 2 SD: —— STRATEGY A —— STRATEGY B —— STRATEGY C

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the average of Strategy A… but *none* of them are failures!

In other words, based upon probabilities of success instead, annuity-based strategy A is now the "best" (with no projected failures, presuming the annuity company is secure in the first place), and strategy C is the worst (the lowest probability of success and highest frequency of depletions/failures). The entire sequence of which strategies are "best" changes completely when using a different measuring stick, as the "best" for accumulating wealth and spending on average is the all-stock portfolio but the "best" for avoiding any risk of depletion is to spend less and annuitize assets to secure that spending goal!

Measuring The Outcome:
Magnitudes Of Failure And Adjustment

The charts in the prior section – based on probabilities of success – showed that strategy A was "best" and superior to both strategy B and strategy C.

However, a more nuanced look reveals that the "superiority" of strategy A over strategy B was not by a large margin. For instance, if strategy B "only" spent $40,000/year adjusting for inflation instead of $45,000/year, the approach would have been successful with a 99+% probability of success. And to be fair, that is about the same as strategy A, which has a 100% probability of success when looking the risk of market volatility, but is really only 99% (or perhaps 99.9%) when considering the small-but-not-zero default risk of the insurance company as well).

Of course, if strategy B were adjusted to spend "only" $40,000/year and have a 99% probability of success similar to strategy A, now the only difference between the two is the spending level: which is 33% higher, for life, with strategy B over strategy A, as shown in Figure 5 (right)!

Viewed another way, the key distinction here is that while the original strategy B had a 95% probability of success and a 5% probability of failure, the

magnitude of that failure wasn't actually very severe, and it wouldn't take much of an adjustment to stay on track (cutting from $45,000/year to $40,000/year of spending is sufficient). And even with poor returns, there is only a 5% chance the portfolio runs out of money *at all*, and those scenarios don't run out until almost 28 years into retirement. Which means realistically spending would likely only need to be adjusted later – if at all – to stay on track for those final years if returns had been especially poor along the way.

Furthermore, for a 65-year-old couple, there's a roughly 70% chance that both of them will have passed away by then anyway. Which means there's a barely 30% probability that this 5%-failure risk is even relevant (i.e., the "joint probability" of *both* running out of money in their 90s *and* still being alive in their 90s is less than 2%). And again, if there's *still* a fear that the bad returns are occurring or may occur soon, a "mere" 10% cut in spending is more than sufficient to ensure the plan stays on track, because the "failure" isn't actually a very dramatic shortfall in the first place. Notably, even if the spending cut does have to occur, strategy B *still* produces more retirement spending cash flow than strategy A!

On the other hand, strategy C still turns out to be vastly inferior under the "magnitude of failure" approach, as the "bad" outcome can be *very* bad (flat broke by the 23rd year), and the size of the adjustment necessary to get/stay on track would be far more than "just" a 10% spending reduction.

In other words, when weighing the magnitudes of failure (and the small or large adjustments to stay on

Figure 5. Cumulative Spending Of Adjusted Systematic Withdrawal Strategy Vs Annuity

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track) against the higher spending levels, strategy A turns out to be inferior to strategy B, but strategy C is still worse than all of them!

Measuring The Outcome: Utility Functions And Risk Aversion

Notably, the conclusions of the prior section – which determined that strategy B was superior to strategy A because the likelihood of even needing a spending adjustment was "small", and the magnitude of the adjustment required to get back on track was also "minor" – still presumes that the retirees are comfortable with those "small" and "minor" risks. In reality, not *all* retirees will be comfortable facing such trade-offs, even if the requisite spending adjustments in strategy B are likely "minor" and of remote likelihood.

Conversely, the magnitude of potential adjustments for strategy C – which could fall seven years short on a 30-year retirement goal and possibly need 20%-30% spending cuts to get back on track – were already deemed untenable, despite the materially higher initial spending amount. Yet again, in reality at least *some* retirees might be willing to risk such trade-offs, and are willing to face the possibility of a "big" spending cut in order to enjoy a "big" spending increase up front.

In theory, these scenarios could be weighed against each other by trying to quantify how much "happiness" the retiree derives from greater spending, and weight it against the "unhappiness" of having a spending cut and how risk-averse the retiree is to the possibility such a cut would have to occur.
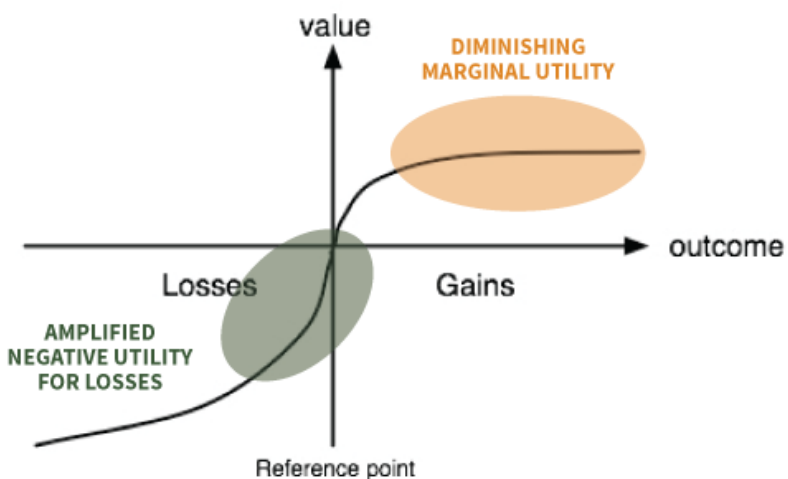
And in point of fact, this is exactly what a "utility function" is meant to measure. A concept derived from economics, the purpose of a utility function is specifically to assign a measuring unit – "utils" – to potential outcomes. More positive outcomes (e.g., higher spending levels) have higher utils. Adverse outcomes (e.g., spending cuts necessitated by the depletion or near-depletion of assets) have negative utils. On this basis, we can

then compare and contrast widely-differing strategies that have a complex range of outcomes by adding up the positive and negative "utils" over time to determine which creates the most satisfying net or cumulative outcome.

Another key advantage of using a utility function is that it becomes possible to give *different* weights to positive versus negative outcomes – specifically, to assign greater negative weight to negative outcomes than positive weight to positive outcomes. In theory, this shouldn't matter, because a "rational" human being should be equanimous in the face of gains or losses. In point of fact, though, the recognition that as human beings we have greater aversion to losses (more "negative utils") than the enjoyment we gain from favorable results (relatively fewer "positive utils") is the "Prospect Theory" first discovered by Daniel Kahneman and Amos Tversky, for which Kahneman won the Nobel Prize.

If investors were indifferent to relative gains and losses, the utility function graphed in Figure 6 (below) should be a straight diagonal line that goes from the bottom left to the top right. Instead, though, it is not. To the upper right, the line begins to flatten, revealing that we have a "diminishing marginal utility" for additional wealth. In practical terms, increasing your wealth by $1,000,000 if your prior net worth was $0 is a big deal (from poverty to being a millionaire!); increasing your net worth by $1M if you already had $99M is not such a big deal (it's not as exciting for net worth to rise from $99M to $100M). Notably, *both* are a $1M increase in wealth, but we weight the latter one less favorably because its value is diminished by the prior millions already accumulated. On the other hand, as the Prospect Theory

Figure 6. Kahneman and Tversky's Prospect Theory Utility Function

graphic shows, when we *lose* money, we show a more "consistent" level of distress with both initial and extended losses (though the initial losses still appear to sting a little bit more).

Given that behaviorally, we do *not* weight gains in the same manner as offsetting losses (and vice versa), this makes it even *more* important to give each its appropriate weighting in the first place.

In the context of our three strategies, this means that

the relative order of which is "best" or "worst" will depend heavily on how the retiree weights the positive utils of having more spending and wealth, versus the negative utils of being forced to cut spending in order to avoid running out of wealth altogether.

For the *highly* risk-adverse retiree, who assigns an outsized negative weight (e.g., 5:1 or even 10:1) to spending cuts over spending gains, the "best" strategy is the all-annuity strategy A, which (if you believe in the security of the annuity company at least) has the

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Revealing Preferences And The Challenge Of Measuring An Individual's Utility Function

While from the theoretical perspective, a utility function is a robust way to quantify the benefits and trade-offs of one strategy versus another, it suffers from one key challenge: there's no clear way to measure how any particular person will weigh those trade-offs in the first place.

In other words, if we're trying to compare the relative benefit of spending more money up front versus the risk of a spending cut later – so that we can calculate the utils of each and determine the optimal strategy – how do we figure out, for any particular client, the numbers of positive utils to assign to the greater spending, and the negative utils to assign to the spending cut? After all, if we can't figure out what the proper weightings are, there's no way to assess which strategy is better or worse!

Historically, economists have tried to evaluate the parameters of a person's utility function by giving them (hypothetical) choices between various trade-offs, and asking them to select which is preferable. Actual dollar amounts tied to each trade-off then make it possible to mathematically quantify and associate a number of utils with each outcome and choice. The idea is that an investor's utility function can be determined by their "revealed preferences" as they select amongst a series of trade-offs.

For example, an investor might be given a choice about whether he/she prefers a certain gain of $3,000, or a gamble with an 80% chance of $4,000 but a 20% chance of $0. A highly-risk-tolerant investor would take the second choice, which on average has an expected value of 80% x $4,000 = $3,200, while the highly risk averse investor would take the "sure thing" bet of $3,000. The gamble (or similar ones) could then be repeated, where the "sure thing" is an amount higher or lower than $3,000, to further hone in on where the investor is willing to trade off the "sure thing" for the more uncertain scenario with upside and downside potential, to "reveal the preference" of the investor.

Notably, though, the caveat is that it may still be a challenge to convert the mathematical quantification of these somewhat abstract exercises into the even-more-complex trade-offs that investors (or retirees) would face in the real world. In addition, indirectly the rise of "behavioral economics" – including Kahneman and Tversky's original research – has shown that this approach can be problematic precisely because people's revealed preferences are not always rational nor internally consistent. For instance, if we have a choice between a gamble for upside or a sure thing, we tend to take the sure thing. When faced with the reverse (but mathematically equivalent) decision between a sure *loss* or a gamble to recover it, we suddenly prefer the gamble. As a result, measuring someone's utility function and revealed preferences becomes especially complex, because of the inconsistent and not-always-rational ways we evaluate the trade-offs in the first place (i.e., the way the trade-off is asked can shape the outcome for otherwise-mathematically-equivalent scenarios).

Nonetheless, a growing body of research has found that, at least when faced with investment decisions to the upside, we are fairly consistent in choosing the sure thing over the gamble, unless we're especially well rewarded for risking the gamble. This consistency makes it possible to select a generic utility function that does a "reasonably" good job of modeling investment trade-off decisions, and can be easily adapted for those who are more or less risk averse (who would use a similar utility function, but with a line that has a different slope or curvature, based on how risk averse the individual is). In this framework, obtaining some estimate of a person's overall risk aversion (e.g., a measure of risk tolerance) can provide some associated estimate of his/her utility function, making it possible to compare strategies based on their utility.

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smallest danger of any spending cuts, nor does it face any market volatility either (and thus no negative utils from bear markets along the way). For this retiree, anything that decreases wealth – temporarily with market volatility or permanently and necessitating spending cuts – will be inferior, and end out with a negative utility result.

On the other hand, for the retiree who is far more sanguine about potential losses (or simply feels more flexible to accommodate them with spending adjustments) and places a greater weighting on upside potential and enjoying more money today, strategy C could actually still be the optimal result. While as noted earlier, this strategy has a "whopping" 25% probability of failure (or at least, a 25% probability of necessitating a spending adjustment), and could require a 25%+ spending cut to get back on track, for the retiree with flexible spending who doesn't mind the downside risk if it means a better-than-50% chance of just getting to spend more, this may be an appealing trade-off. For this retiree, strategy A once again goes from being best to worst, and strategy C is superior.

And for the retiree in the middle – who perhaps is "rather" negative about spending cuts but is willing/able to tolerate them as long as they're "likely to be rare" and infrequent – strategy B turns out to be the "best" strategy after all, because it has the most appealing balance. For this retiree's utility function, strategy A doesn't bring enough upside happiness, strategy C exposes the retiree to too much downside unhappiness, and the ideal Goldilocks outcome (not too much risk, nor too little upside) is strategy B.

The ultimate point: in order to determine which strategy is "best", given both the potential for upside wealth, and downside spending cuts, and the trade-offs entailed in pursuing greater upside at the risk of more downside, it's necessary to "score"

both the upside *and* the downside to objectively find the best balance between the two. And how those upside and downside outcomes are weighted will in turn depend on the retiree, and his/her preferences for managing downside risk and enjoying upside return in the first place (i.e., his/her personal utility function).

Determining The "Best" Strategy Depends On How It's Measured

As the examples in the preceding sections have shown, determining which option is the "best" financial planning strategy can be heavily reliant on the measuring stick used to quantify the outcomes in the first place. In our choice between three strategies – annuitizing most of a portfolio for guaranteed income, taking 'moderate' distributions from a moderate growth portfolio, or taking large distributions from an aggressive portfolio – each strategy's outcomes were variously best, second, or worst, depending on how the outcome was measured. A summary of the results is shown in Figure 7 (below).

This means that careful thought about *how* a strategy will be evaluated is actually an essential aspect of the process in crafting financial planning recommendations. The issue is akin to what any scientist analyzing any problem has to consider: the research methodology used to analyze an issue can impact the conclusion about it, so it's crucial to vet not just the results but the methodology itself. Otherwise, a flawed design to a

Figure 7. Summary Of Which Strategies Are Best, Second, And Worst, Based On Means Of Measuring Outcomes

OUTCOME MEASURED	STRATEGY A	STRATEGY B	STRATEGY C
Final Wealth	WORST	SECOND	BEST
Cumulative Spending	WORST	SECOND	BEST
Probability of Success	BEST	SECOND	WORST
Magnitude of Failure/ Adjustment	SECOND	BEST	WORST
Utility - Highly Risk Aversion	BEST	SECOND	WORST
Utility - Moderately Risk Aversion	SECOND	BEST	WORST
Utility - Low Risk Aversion (Risk Tolerant)	WORST	SECOND	BEST

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research study can yield a flawed conclusion about its results.

For instance, imagine a medical study analyzing a weight-loss drug in the hopes that reducing obesity will cut down on deaths from diabetes and high blood pressure. The research focuses on whether the drug leads to weight reduction, and finds that it does, concluding it's a good drug. However, in reality side effects of the drug itself *include* diabetes and high blood pressure. As a result, the drug does "cure" obesity but actually increases the risk of the same bad health outcomes that losing weight was meant to help minimize. In this context, if you measure "impact on weight loss" the drug is a success, but when measured by "impact on overall health" it's actually a failure.

When it comes to financial planning, though, the situation is complicated by the fact most clients have multiple and complex goals and preferences. A Roth IRA may be a superior retirement savings vehicle over "just" keeping money in an annually taxable brokerage account, but if the client might leave his job to start a business in five years (and not necessarily use the funds for retirement) the "best" recommendation (Roth vs brokerage account) becomes less clear. Similarly, a more aggressive portfolio with a higher growth rate can help a client retire much earlier, but can also cause a client to be forced to retire much later if returns are especially poor, a risky trade-off that not all prospective retirees may be want to pursue. And as we saw earlier, the relative appeal of an aggressive portfolio over a guaranteed annuity for retirement income depends a lot on the retiree's desire for spending upside versus his/her tolerance for or aversion to the risk of future spending cuts instead.

Of course, this is why the process of financial planning begins with the process of establishing goals and determining client preferences in the first place. Because it's not possible to determine the "best" strategies (or decide how to measure them) until it's clear what the goal is to be pursued and measured to begin with. It's only once the goal is set that it becomes possible to optimize the strategy to achieve it.

Accordingly, then, it's almost impossible to establish financial planning strategies that are "objectively" dominant and superior in all situations. At best, some products or solutions might be better than others *for a particular goal,* or subject to particular constraints and

client preferences. For instance, an emergency savings fund invested in a money market that yields 1% is clearly better than one that only yields 0.1%, and for the "core" indexing portion of a retirement account an S&P 500 index with an expense ratio of 0.1% is better than one with an expense ratio of 1%. Nevertheless, whether the high-yield money market or the low-cost index fund are "best" in the first place depends on the goals to be pursued (accumulating for retirement versus saving for an emergency fund).

Nonetheless, there are financial planning strategies and recommendations that are so common – or rather, are improvements to common goals (e.g., retirement) – that we can begin to assess the overall value of financial advice by looking at the favorable economic impact these common strategies can produce.

The "Compared To What" Problem

An additional complication to be considered when trying to vet the quality of financial planning strategies or recommendations is that to evaluate the benefit, it is necessary to do a comparison – strategy A isn't "best" in the abstract, but only compared to some alternative.

When trying to compare whether known strategy A is superior to known strategy B, the approach is relatively straightforward. We can quantify the economic impact and outcomes of strategy A and strategy B, determine which is superior (based on whatever form of measurement we choose to make that assessment), and conclude which is best.

When it comes to abstractly measuring the value and benefit of financial advice, however, the problem is more complex. The issue is that while we can quantify the financial outcome of the recommended strategy, it's not so clear how to quantify what would have happened in the *absence* of the financial planner's recommendation. In other words, when we ask the question "did the financial planner's advice improve the outcome" we can only answer it by measuring how the advice improved the situation compared to what would have happened without the advice. Except we don't actually *know* (for certain) what would have happened without the advice or advisor! At best, we can only estimate what the "Do-It-Yourself" outcome might have been (as shown in Figure 8, top of next page).

Figure 8. Measuring Advisor Value-Add Over A Do-It-Yourself Baseline

decline won't be as harmful to the portfolio anyway. Even worse, what if *this* client is *not* well diversified and holds a concentrated portfolio of company stock, but this stock really *is* the next Apple or Microsoft or Google or Facebook, and diversifying out of it will turn out, after the fact, to have dramatically *reduced* long-term wealth!?
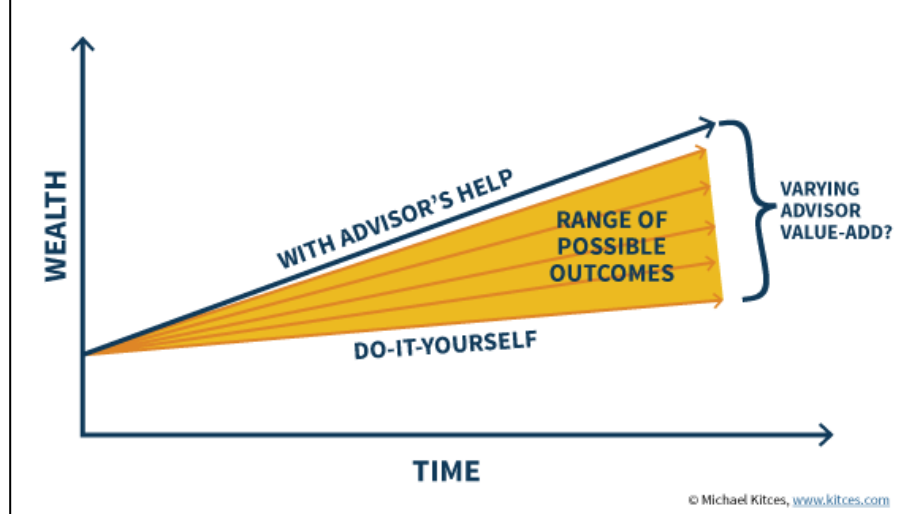
The fundamental issue is that when we try to assess the economic value of financial advice (or having a financial planner), we are stuck comparing the world that is to the world that "might have been", without any way to know what might be in advance, nor even to know what might have been after the fact, either. Maybe the client who was prone to selling out in bear markets in the past had learned his lesson and would have been able to stay the course next time on his own anyway. On the other hand, maybe the client who kept the concentrated portfolio of company stock that was "the next big one" wouldn't have actually managed to hold onto it for the long run anyway, and instead would have taken gains too early. When comparing the history that actually occurred to the one that might have been (but wasn't), we just don't know. Which means, as shown in Figure 9 (below), the actual "Do-It-Yourself" outcome could have been quite close to what the advisor would have recommended anyway, or very far off, and there's little way to tell (and therefore to understand how the advisor impacted the outcome).

For instance, consider the classic example of "financial planners add value by helping clients to close the 'behavior gap'". The behavior gap is the purported difference between the returns that *investors* earn with their portfolios, versus the return that the market provided. The difference between the two impliedly being the underperformance that investors bring upon themselves with "bad" investing behavior. To the extent the advisor can help the client minimize bad investment decisions and avoid under-performance, the advisor adds value – even if that "value" doesn't involve any alpha or *excess* market returns, but simply bringing the client up *to* the market return from an underperforming alternative.

The problem with assessing the advisor's value in closing the behavior gap is that we don't really know, for any particular client, what that behavior gap would have been in the future. The future hasn't happened, future market returns haven't occurred, and future client behavior (or market-timing misbehavior) hasn't actually manifested yet. Perhaps *this* client is actually already very good at staying the course and not selling out the portfolio during times of market volatility. Maybe *this* client won't even *have* a bear market occur before it's time to retire anyway. Alternatively, perhaps *this* client has already designed a well-diversified portfolio, such that a severe market

Figure 9. Measuring Advisor Value-Add Over An Uncertain Range Of Possible Do-It-Yourself Outcomes

And of course, for a study whose goal is to "show value", there's a significant danger that the researchers deliberately pick a baseline scenario designed to show the best possible results and the most advisor value – even if it's debatable whether that's reflective of a real-world prospective client!

Evaluating Studies That Evaluate The Benefits Of Financial Advice

Comparing To Counterfactuals

As discussed earlier, in recent years there have been a number of studies aiming to measure the (economic) benefits of working with a financial advisor. Yet all of them suffer, to varying degrees, from the "compared to what" problem discussed here – where it's difficult to measure the economic impact of financial advice because there's no clarity about what, exactly, to compare to. This doesn't necessarily mean their conclusions are "wrong", just that it's difficult to validate whether the purported benefits would hold for any client in particular.

For instance, in the Vanguard Advisor's Alpha research, the authors attempted to quantify how many additional basis points a financial advisor can add to portfolio returns by better controlling investment costs. The starting point was to determine a baseline against which results would be measured; for the Vanguard paper, the decision was to use broad market metrics in the aggregate. Thus, for instance, Vanguard observed that for a 60/40 portfolio of stocks and bonds, the "average" investor pays an expense ratio of about 0.55% (based on the asset-weighted average expense ratio of the entire mutual fund and ETF industry) but by using the "lowest of the low" cost ETFs available, the investor could establish the same portfolio with an expense ratio of only 0.14%. Thus, through the advisor's assistance in selecting low(er) cost funds, the advisor is bringing about 0.55% - 0.14% = 41 bps of value to the table. (This analysis was *before* counting the advisor's own fee.)

The caveat to this outcome, though, is that the "value creation" of the advisor is based on the 0.55% expense ratio of a hypothetical portfolio that the client may or may not actually be holding! In fact, the Envestnet Capital Sigma research assumed that the average investor would be holding an actively managed mutual fund, while the advisor would recommend a low-cost ETF, and found an average expense ratio savings from the advisor of 82bps! Yet the advisor in the Envestnet study producing 82bps of value is recommending the same low-cost ETFs as the advisor in the Vanguard study producing only 41bps of value. The difference was the baseline investment they *assumed* the client *would have* held in the absence of the advisor.

Furthermore, the reality is that some prospective clients may already be holding low-cost ETFs to varying degrees, for which this savings/advisor-benefit becomes moot altogether. On the other hand, some investors might be holding funds that are far more expensive, where the advisor could save the client enough to cover his/her *entire* fee on that basis alone. Ultimately, though, the problem remains that measuring the difference between an average cost and the lowest cost (or the average active mutual fund to the average passive ETF) may work on average – by definition – but not necessarily for any particular client. (And notably, as more investors buy low-cost ETFs and the dollar-weighted average expense ratio declines, the presumed advisor benefit from this strategy would also decline!)

In another example of this "compared to what" problem in the research on advisor value, the Vanguard paper also tries to evaluate the potential benefit of an advisor closing the "behavior gap". To measure the impact of the behavior gap in the first place, the Vanguard study evaluated the performance of 58,168 self-directed IRA investors from 2008-2012, and compared it to the performance of a target-date fund over the same time period. The presumption is that the steady investment implementation and regular rebalancing of the target-date fund represents what the advisor "might have done" over that time period, as compared to what the IRA investors *actually* did. As the Vanguard results show, overall the "average" investor trailed the target date fund by 19bps (much of which may have simply been the difference in expense ratios between the investors' other investments and the low-cost target date fund), but investors who made an exchange from one fund to another during the time period (and thus are presumed to have been engaged in some active investment decisions) underperformed by an average of 150 bps. Thus, the conclusion is that for investors prone to the "behavior gap", they could have gained another 150 bps of annual performance

with the help of an advisor to stay the course and not make those generally-poorly-timed exchanges.

In this scenario, the "actual" is what Vanguard investors really *did* hold, and the theoretical is what the advisor "might have" held (if the advisor mimicked the allocation of a target-date fund) – supported by the *assumption* that any client who would have made a "bad" investment timing decision on their own will be successfully persuaded by the advisor not to (which may or may not turn out to be the case). In addition, while the Vanguard study notes that the average investor *who made investment exchanges* mistimed them for an average underperformance of 150bps, many investors did *not* make such changes. In fact, the Vanguard results suggest that only a minority of the accounts they analyzed had made such switches. Thus, the "average investor" actually underperformed by far *less* than 150bps (because most simply held their investments throughout), and investors who *were* able to hold their investments would not have experienced any "advisor value add" at all. Or viewed another way, the value of the advisor "closing the behavior gap" of bad market timing looks a lot better when the analysis is constrained to only those who engaged in market timing in the first place, but that means it's a value the advisor at best can only provide to that particular subset of clients.

Evaluating The Benefit Of Risk Management and Risk-Adjusted Benefits

Another important caveat to the studies about the value that advisors can potentially add is that not all of the potential benefits of an advisor are about enhanced returns and increased wealth. In fact, some of the greatest value that an advisor provides may actually be likely to *reduce* future wealth, albeit for the "benefit" of reducing risk even more.

For instance, as discussed in the Volume 2, 2015 issue of *The Kitces Report*, the reality is that rebalancing – particularly between stocks and bonds – is generally a return-*reducing* strategy. After all, without any rebalancing, the fact that the long-term return of stocks is higher than the long-term return on bonds means an investor's total allocation to stocks will naturally creep higher over time (simply due to the stocks compounding the bonds). And given an expectation that stocks have higher returns, that's actually a *good* thing for long-term wealth, as it leads to accumulating more stocks with better returns!

Systematically rebalancing from the higher-returning stocks back into the lower-returning bonds will simply reduce long-term returns for the overall portfolio!

However, rebalancing is still appealing, because the process may reduce long-term returns by a little, but it can reduce long-term *risk* by a lot. Thus, for instance, the Vanguard Advisor Alpha study found that from 1960 to 2013, systematically rebalancing a 60/40 stock/bond portfolio *reduces* the average annual growth rate of the portfolio by about 0.24% (from 9.36% to 9.12%)... but at the same time, the *risk* of the portfolio (as measured by standard deviation) is reduced by a whopping 20% (from 14.15% to 11.41%). Which means on a risk-adjusted basis, this is an extremely appealing trade-off, with a very small reduction in return producing a much larger reduction in risk. In fact, Vanguard finds that the investor willing to tolerate the volatility of a 60/40 *unrebalanced* portfolio could also own an 80/20 *rebalanced* portfolio and come out with the same level of risk. Except the 80/20 portfolio has a *higher* return (by about 35bps). Which means, in essence, that annual rebalancing may reduce absolute returns by 0.24%/year, but it *increases risk-adjusted returns* by 0.35%/year. Similarly (albeit with a slightly different methodology), the Envestnet study finds that annual rebalancing increases *risk-adjusted* (but not absolute) returns by about 0.44%/year of alpha over just rebalancing every three years.

Of course, enhancements to risk-adjusted returns aren't just a benefit of systematic rebalancing. It's also a benefit of diversification itself – which, again, generally isn't about enhancing *absolute* returns but risk-adjusted returns. After all, for the investor who *really* just wants to maximize returns, the "optimal" portfolio is rather straightforward: just put 100% into the investment with the highest expected return, and hold on for the likely-to-be-very-bumpy ride.

The caveat, of course, is that in practice not all investors have the tolerance to hold on for such a ride, and for those in retirement a too-volatile ride can expose the portfolio to sequence-of-return risk (where ongoing withdrawals deplete the portfolio so much during a period of bad returns that even if better returns show up later and average out in the long run, the unfavorable sequence causes the retiree to run out of money). Accordingly, it can be appealing to hold a more diversified portfolio, even if it gives up some long-term return (by owning other lower-returning investments) if it makes the overall portfolio less volatile. An added benefit of diversification, as illustrated with Markowitz's Modern Portfolio Theory, is that in situations where the lower-returning investments have

low (or negative) correlations, the reduction in risk may be far more than the reduction in return – which means *risk-adjusted* returns for the portfolio are enhanced by adding an allocation to those events (even as the portfolio's absolute level of expected returns declines).

Even in this scenario, though, the problem remains that determining the risk-adjusted return enhancements of a "more diversified" portfolio requires an assessment of what (less diversified) portfolio the investor would have owned, and what (more diversified) portfolio the advisor recommends instead. For instance, Envestnet estimates that the value of an advisor's asset allocation and diversification guidance is 28bps of risk-adjusted return, based on the assumption that the "naïve" investor simply owns a 56/44 stock/bond portfolio (based on the world market cap of stocks and bonds), with the equities allocated into the Russell 3000 index and the fixed income invested into the Barclays U.S. Aggregate Bond index. By contrast, the advisor is assumed to invest into a more diversified portfolio (along the same 56/44 stock/bond split), including sub-equity asset classes like REITs and international stocks (both developed and emerging), and sub-bond asset classes like high-yield, TIPS, emerging market fixed income, and bank loans. The end result over the past 18 years – that extra 28bps of alpha. Assuming, of course, that the investor really would have held nothing but 56% in the Russell 3000 and 44% in the Barclays Agg. It also assumes that the advisor really would have used all of those other asset classes. And that the additional asset classes that received allocations in the Envestnet study generate as much alpha in the future as they did for the past few decades!

Alternatively, the Morningstar Gamma study took an entirely different approach to evaluating the benefit of an advisor's diversification and investment allocation strategies. In the Morningstar study, the "measuring stick" for success was not about higher returns, nor risk-adjusted returns, but improvements in *utility* using a utility function as discussed earlier. In particular, the Morningstar study measures based on a utility function where losses and spending cuts to the downside are weighted more (in a negative manner) than gains to the upside are (in a positive manner). Furthermore, the Morningstar study's utility function assumes that gains experience diminishing marginal utility over time. Based on this framework, the researchers then look at the strategies that produced higher utility (e.g., from better matching asset allocation to future spending needs), and calculated

how much greater returns *would have had to be to produce a similar increase in utility*. In other words, technically Morningstar didn't show that advisors add return (or risk-adjusted return); the research showed that advisors improve utility by an amount *equivalent to* the additional utility you *could* get from higher returns.

Of course, even with a utility measure, a comparison is still necessary – utility can't be improved with the advisor's strategies until we make an assumption about the utility the investor would have achieved with his/her own approach in the absence of the advisor. In this case, the Morningstar authors assume the retiree would have owned what an "average" retiree owns (based on the average equity exposure for investors aged 65 to 95 with at least $10,000 in financial assets in the 2010 Survey of Consumer Finances), which means the retiree is assumed to have "only" a 20% allocation to equities, with the other 80% in fixed income. The study further assumes this "naïve" investor would have had the equity allocation 100% in U.S. Large-Cap stocks, with the fixed income split 80% to US bonds and 20% to cash. By contrast, the advisor's asset allocation is assumed to have 45% in equities (with an allocation that includes Large Cap, Small Cap, International Developed, and Emerging Markets) and 55% in fixed income (includes cash, US bonds, TIPS, and some international bonds).

On this basis, the Morningstar study finds that this "more diversified" portfolio improves gamma by the equivalent of a 0.57% better return. Yet the result really only holds if we assume that the retiree was really going to invest in a US-only portfolio with "just" 20% in equities in the first place!

The Tax Alpha Of Advisor Tax Strategies

Another commonly cited area of value-add for advisors is the opportunity to engage in proactive tax strategies that generate tax savings, particularly in a portfolio (where the larger the portfolio, the larger the potential for tax benefits).

For advisors managing portfolios, "tax alpha" generally comes in two primary forms: asset location (optimizing in which types of accounts the various investments will be held, such as putting annually taxable ordinary income investments inside of tax-deferred accounts); and tax-loss harvesting (capturing portfolio losses to offset taxable gains generated by other investments or triggered via rebalancing to minimize current tax obligations).

The significance of tax alpha is not only that it presents an opportunity for the advisor to add value, but that unlike traditional *investment* alpha – which ultimately is a zero-sum game – leveraging "tax alpha" is simply about implementing portfolios in a manner that takes advantage of and maximizes the available tax rules. Which means it's a "pure" value-add that could be done for *every* investor (and is not zero-sum).

Asset Location

As noted earlier, investors who hold a diversified portfolio of stocks and bonds (and sub-asset classes within those categories, and alternative investments) often have a choice about *where* to hold – or "locate" – those assets amongst taxable brokerage accounts, tax-deferred retirement accounts (e.g., IRA and 401(k) accounts), and tax-free Roth style accounts. Additionally, a growing base of research suggests that effective asset location – for instance, maximizing the tax-free Roth with the highest-returning investments overall, or sheltering annually-taxable-as-ordinary-income investments inside of tax-deferred accounts-can generate more long-term wealth over a less effective strategy.

For instance, the Morningstar paper suggests that asset location (combined with tax-efficient withdrawals) can provide a 3.2% enhancement in utility, equivalent to about a 0.23% enhancement in long-term wealth accumulation. The Vanguard research suggests that asset location benefits are about 0.30% with an 'optimal' allocation of indexed equities in taxable accounts versus bonds in a tax-deferred account (versus having investment locations reversed), or as much as 0.75%/year compared to the "worst possible" investor who puts active high-turnover equity strategies in the taxable account (which triggers the most severe adverse tax drag). These results are also generally consistent with research by Daryanani and Cordaro, who in 2005 wrote "*Asset Location: A Generic Framework for Maximizing After-Tax Wealth*" and estimated asset location benefits up to 20bps.

Notably, though, as the Vanguard results highlight, the "value" of asset location is still prone to the "compared to what" problem, where asset location benefits are on the order of 20bps – 30bps versus a "naïve" neutral strategy, but much higher if compared to a "deliberately inferior" (or maximally *inefficient*) portfolio.

Of course, the value of asset location is also limited by the fact that it is only a benefit for investors who *have* multiple types of accounts across which allocations can be made in the first place; for the investor who already has most/all assets concentrated in one type of account or another (e.g., all brokerage accounts, or all IRAs), there is no benefit to asset location, because all investments will end out in the same type of account no matter what (since that's where the only available dollars are!).
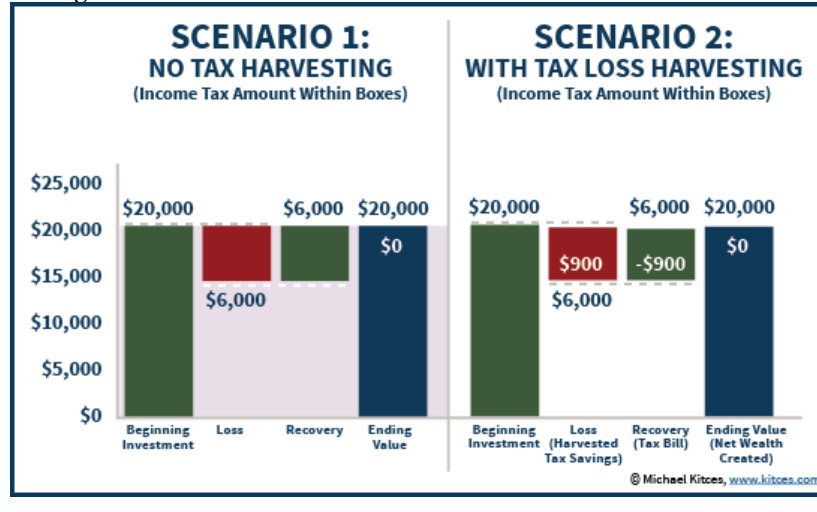
Tax Loss Harvesting

Tax loss harvesting is the strategy of selling an investment that has experienced a loss in order to capture a loss for tax purposes (to be offset against capital gains to generate tax savings), without permanently changing the underlying investment/portfolio. (Obviously investors can sell an investment at a loss, change to a new investment, and enjoy the tax benefits of claiming the loss, but that's simply the consequence of any normal sale of an investment with a loss. The point of tax loss *harvesting* is to "just" harvest the loss, without necessarily changing investments any more than is necessary to claim the loss itself.)

The caveat to tax loss harvesting is that, to limit potential abuses, Congress actually *requires* at least a *temporary* change in investments to claim the loss. Under the so-called "wash sale" rules, a tax loss can only be claimed if the investor does *not* replace the investment with a "substantially identical" investment within 30 days before or after the sale. In essence, this forces the investor to take at least 30 days of "risk" holding another investment – during which the new investment may potentially under-perform the original – in order to claim the loss.

In addition, it's important to recognize that with tax loss harvesting, there is a secondary effect to selling an investment (to claim the tax loss) and buying it back again – the investor's cost basis is stepped *down* from the original basis (eligible for the loss) to the current value of the investment (the price at which it was bought back again). Thus, in practice a harvested loss triggers a future gain for an equivalent offsetting amount, which means tax loss harvesting is really just the value of tax *deferral* from the time the loss is originally claimed until the "recovery" loss is triggered in the future.

For instance, imagine an investor who bought a stock for $20,000, and its value has now declined to $14,000. The investor can harvest the loss and claim the $6,000 tax loss, but doing so means the investment (after harvesting the loss) will have a cost basis of only $14,000. If in the future the investment appreciates and recovers back to its original $20,000 value, the investor will face a future *gain* of $6,000. The end result is that for an investment that started at $20,000 and ended at $20,000, the investor had a $6,000 loss and a $6,000 gain. Which is exactly the same as if the investor had just held the $20,000 purchase for the full round trip ride to finish with $20,000 (and a net gain of $0), as shown in Figure 10 (right).

Notwithstanding these offsetting losses and future gains, the opportunity to defer taxes (saving on taxes with the loss now, and not owing the taxes on the gain until the future) still has economic value, equivalent to the growth that can be earned in the meantime. The Envestnet study estimates that tax loss harvesting may be worth as much as 60bps over a buy-and-hold portfolio (although it's not clear that their analysis includes adjusting for the future gains created by initially harvesting losses and driving cost basis lower), and as much as 100bps over an especially tax-*inefficient* portfolio (that routinely triggers gains). An analysis by Kitces (2014) found that the value of tax loss harvesting may be closer to 20bps (at 15% capital gains tax rates) to 30bps (at 23.8% capital gains tax rates, including the 3.8% Medicare surtax) once the tax deferral and future capital gains implications are accounted for. Notably, transaction costs to implement tax loss harvesting (as well as the risk of tracking error during the wash sale period) could partially mitigate this value further.

Nonetheless, the fundamental point remains that tax loss harvesting represents – similar to asset location – another form of "tax alpha" that is available to any/all investors proactive enough to take advantage of the opportunity themselves, or with an advisor doing so on their behalf! Though, again, to the extent that investors do so themselves, either on their own or with the assistance of available technology tools, the "value-add" of the advisor is diminished accordingly!

Figure 10. How Tax Loss Harvesting Produces No *Net* Tax Savings

What Is The Value Of Good Financial Planning?

While the benefits of financial advice on a portfolio – from investment selection and better diversification to tax alpha opportunities – are hard enough to calculate due to the "compared to what" problem, the economic benefits of financial planning are even harder to analyze. The reasons are ultimately three-fold.

First and foremost, there still remains little agreement on what exactly is and is not covered by "comprehensive financial planning" in the first place, which leads to an inconsistent formulation of what *should* be measured for value. For instance, some advisors give guidance on property and casualty insurance policies (i.e., automobile and homeowners coverage) while others do not, so how can an estimate of value be formulated? The same is true for income tax advice (which is done to varying degrees from one advisor to the next), or budgeting and cash flow advice, etc.

The second challenge to measuring the value of non-portfolio financial planning advice is yet another version of the "compared to what" problem – i.e., what would the individual have done in the absence of the advisor? Does the presence of an advisor have more impact for someone who lacks proper insurance, than someone who already has it (where the advisor can't make the recommendation to buy coverage that's already been purchased?)? Is an advisor less valuable for someone who already has control of their spending,

than someone who lacks a household budget? If the "average" consumer already claims most of their tax deductions, the "average" advisor relationship might not have a lot of impact… yet for the subset of households who are grossly failing to claim their deductions, and arguably are in the most need of an advisor, the potential financial benefit is many times greater. Yet that means the value of advice is not a generic "value of advice" but "the value of advice *for a particular client with particular problems or failings* that need to be remedied."

The third challenge in measuring the value of non-portfolio financial planning advice is determining the appropriate *terms* of measurement. As noted earlier, when evaluating the benefits of a financial planning strategy in general, the "value" will vary depending on the measuring stick used. But at least when the advice pertains to a portfolio, there is a natural way to calculate the benefits – relative *to* the value of the portfolio.

For other financial planning strategies, however, it's less clear how the value should be framed. For instance, the tax savings of contributing the maximum $5,500 (in 2015) to an IRA could be a material improvement in net worth for someone with very little in current savings, but worth less than 0.01% to a multi-millionaire whose net worth dwarfs a 'mere' $5,500 contribution (as the IRA limit has the same maximum contribution cap for both!). Similarly, strategies like saving on insurance premiums, from life insurance to automobile and homeowner's coverage, may have a consistent absolute value – perhaps a few hundred or a couple thousand dollars a year? – but that *relative* value could be 10%, 1%, or 0.01%, depending on overall income and net worth.

Other strategies have even more significant scaling problems. The value of "estate planning" for a mass affluent household might be a few thousand dollars of probate expense savings by recommending a revocable living trust, but could be $10s of

millions of dollars implementing a series of rolling two-year GRAT strategies for a $100-millionaire. And of course, for some risk management strategies – e.g., buying insurance coverage – the expected value of the strategy is actually *negative* (as insurance premiums are a "known and certain" loss, albeit a small one) – but may be appealing for risk management purposes *despite* being an expected financial loss.

Nonetheless, once again there is clearly *some* economic benefit to be measured for financial planning strategies, even if the relative benefits of particular recommendations will vary from one household to the next based on both their overall financial situation to begin with, and the extent to which their finances are already in good order (or not).

The Benefits Of Good Income Tax Planning

While financial planners are generally not in the business of tax preparation, there are tax planning implications for many strategies that a financial planner might recommend. Not to mention the outright tax planning strategies a good advisor can suggest.

For some tax strategies, the "benefits" are simply limited to whatever the tax code itself permits as a benefit. For instance, the tax benefits of claiming the American Opportunity Tax Credit for college are limited to the $2,500 credit. The value of tax-free growth in a Roth IRA is limited to the $5,500 (in 2015) annual contribution limit and the growth that can accrue thereon. The $250 schoolteacher expense deduction is capped at the value of a $250 deduction. Although in some cases the size of the deduction is larger, such as with the Income in Respect of a Decedent (IRD) deduction for estate taxes that were paid on an inherited IRA (which can amount to a tax deduction of hundreds of thousands of dollars for a multi-million-dollar IRA!).

On the other hand, some tax strategies aren't even outright tax savings at all,

but just tax *deferral* instead. Most commonly, this includes contribution to pre-tax accounts (e.g., IRAs or 401(k)s), which are often characterized as "tax savings" but in truth just defer the taxes to the future (when the accounts are liquidated). The value is thus not the outright tax savings, but the *growth* on the taxes that were deferred. (Notably, tax loss harvesting falls into the same category!) Again, the value to these strategies is often limited by how much the tax code permits to be tax-deferred in the first place (e.g., contribution limits on retirement accounts).

Fortunately, some tax strategies "scale" more effectively to the overall income and wealth of the client. For instance, systematic partial Roth conversions to fill up available lower tax brackets is limited "only" by the total amount of pre-tax dollars held in retirement accounts in the first place. The larger the IRA, the more the tax savings. Moreover, the higher the tax bracket, the more it matters.

Of course, the reality for strategies like Roth conversions is that a pre-tax IRA is really only a tax *deferral* vehicle in the first place, and a Roth conversion is just an acceleration (hopefully at a more favorable tax rate) of a tax liability that would have eventually been due no matter what. Thus, it's important to recognize that the tax savings of an IRA, or the benefits of a well-timed Roth conversion, aren't just the outright tax savings or future tax-free growth, but the *difference* in tax rates between when the IRA deduction is claimed and what the income (as an IRA withdrawal or Roth conversion) is ultimately recognized.

In essence, these strategies benefit from "tax rate arbitrage" – the opportunity to create tax deductions in higher-income years, and recognize that income later when rates are lower, benefitting from the tax rate differential. If a $250,000 IRA can be systematically partially converted at a 15% tax rate over time, instead of spent at a 25% tax rate in the future, the actual economic benefit is the 10% difference in tax rates x $250,000 = $25,000 of true tax savings.

In fact, given today's progressive tax system – where higher income levels are subject to higher tax rates – the tax bracket arbitrage opportunity to shift income from high-tax-rate years to lower-tax-rate years, and generate tax savings for the difference, is often the biggest income tax planning opportunity available. Strategic retirement liquidation strategies that are sensitive to the withdrawal source – for instance, planning around the liquidation of taxable and tax-deferred accounts in a manner that leverages the

benefits of tax bracket arbitrage – is another related opportunity.

The Benefits Of Good Estate Planning

When it comes to estate planning, the potential economic benefits can either be much larger than income tax planning, or much smaller, often depending on the size of the estate in the first place.

For those estates "above the line" of $5.45M (in 2016, or $10.9M for a married couple with portability) which are potentially subject to Federal estate taxes (and possibly state estate taxes as well), the estate tax savings can be significant. After all, while income tax planning saves taxes only on the *income* produced by assets (and earnings), the estate tax is applied to the *entire asset value*, which means effective estate planning strategies can have a dramatically larger tax savings. The 39.6% income tax on a $10,000,000 asset producing a 3% return is "just" $118,800, but an estate planning strategy to shift that $10,000,000 out of an already taxable estate (e.g., because it's the appreciation that shifted with a rolling GRAT or the growth of a business sold to an IDGT) at a top 40% Federal estate tax rate is a whopping $4,000,000 tax savings! If there's an up-to-16% state estate tax involved, that's another $1,600,000 of tax savings on top!

On the other hand, for those whose estates are below the relevant Federal (and state) estate tax thresholds (and/or live in a state without estate taxes altogether), estate planning is no longer an exercise in *estate tax* planning (although there may still be some opportunities to plan for step-up in basis from an income tax perspective). Still, though, the process of probating and estate administration after death can have a non-trivial financial impact as well. Many states permit a statutory probate fee as high as 2%-4% of the value of the estate, and some provide for another 2%-4% fee available to be paid to a personal representative/executor of the estate as well. By contrast, the use of a revocable living trust generally avoids the probate fees, and can stipulate lower (or no) fees to be paid to a personal representative. Given a "hard dollar" cost of a few thousand dollars to establish a revocable living trust in the first place, this effectively means that any estate worth at least about $250,000 can potentially save on estate administration costs by going through the process of setting up (and funding) revocable living trusts. The greater the assets of the estate, the more the potential savings.

Of course, arguably some of the biggest benefits of "good" estate planning are not financial in the first place. Estate planning is about the orderly disposition of assets after death, ideally utilized in a manner that helps to propagate the family's values and the financial success of future generations. In some cases, the best estate planning may even "limit" assets to future generations, to shield against their potential creditors or their own fiscal irresponsibility. In other words, it's hard to put a price on the value of simply ensuring that an inheritor doesn't just blow his/her inheritance wastefully in the first place, even though that may be the greatest estate planning value of all!

The Benefits Of
Good Retirement Planning

In the world of retirement planning, most of the economic benefits of a financial advisor are simply the application *of* various investment and tax strategies discussed earlier, applied in the retirement context. After all, retirement portfolio strategies like tax loss harvesting, asset location, and tax-sensitive and tax-efficient liquidation strategies are ultimately still "just" income tax planning strategies that happen to be applied to a "retirement" portfolio. Similarly, the benefits of good diversification, managing investment costs, etc., are relevant to any portfolio… including one for retirement.

Nonetheless, some additional financial strategies emerge solely in retirement. One of the most substantive is the decision of when to begin claiming Social Security benefits, where optimal claiming strategies can bring in additional dollars (e.g., over $60,000 for a well-timed restricted application claim, while it is still available), or result in outright superior wealth accumulation (e.g., by spending down fixed income assets first while delaying Social Security for the long run with its much-higher internal rate of return). Other tax planning strategies in retirement have a unique angle simply because of the interplay between income for tax purposes and other retirement benefits – for instance, the phase-in of the taxability of Social Security, or the Medicare Part B and Part D premium surcharge for higher income individuals.

For many prospective retirees, though, the biggest benefit is not about maximizing the investment and tax strategies *in* retirement, but simply figuring out *whether* the person *can* retire, and/or what can be safely spent *during* retirement, and how to fit household expenses to that available budget (e.g., by moving/downsizing, adjusting spending habits, etc.).

In other words, the opportunity for value creation is not about producing more dollars, but setting someone's mind at ease about whether the accumulated assets and retirement spending plan laid out before them is sustainable, how to execute that plan, and if it's not viable, what needs to be done to improve the situation.

Notably, in this regard it means sometimes the "best" thing a financial planner can do to provide value is help someone accept that they may need to spend *less* than desired. While this may not necessarily be appealing to most – there are few who *like* to be told that they cannot spend what they wish – helping someone understand the risk and unsustainability of a current spending path can be a crucial value-add to prevent an even more adverse outcome in the future. Technically, this may still be a "wealth enhancement" in the long run – or at least, a wealth stabilizer – to spend a little less now to ensure that the retiree won't have to spend *a lot* less later. But the fundamental point is that not everything about good planning is necessarily about creating more wealth. Often it's about trying to help someone strategize about the best way to *enjoy* the (limited) wealth they do have!

The Benefits Of
Good Insurance Guidance

While most financial planning strategies help to enhance wealth, good insurance planning is fundamentally different: it is normally expected to *decrease* wealth on average.

After all, the simple mathematical reality of insurance itself is that from the insurance company's perspective, total premiums collected (plus growth thereon, less insurance company expenses and profits) *should* exceed total claims paid. If the insurance company pays out *more* than it takes in, that means it's an insurance company soon to go bankrupt. Yet the fact that the insurance company expects to pay out less on average than it takes in means from the consumer's perspective, insurance premiums will cost *more* than the average claim is likely to be. It's *expected* to be a financially losing proposition for the consumer (on average).

This isn't necessarily a bad strategy, though, because the advantage of insurance is turning an uncertain and potentially large (and possibly unmanageable) expense into a certain but small and manageable one. For instance, if there's a 0.1% probability that my $300,000 house will burn down, but I can insure the house for $350/year, it's a "good trade-off" for most. Technically, the mathematical expectation of loss on average is only 0.1% x $300,000 = $300 per year and paying $350/year

increases the *average* loss. The difference is that for an insurance company, it can average out one house burning down against 999 that don't; for the consumer, having a house burn down without homeowner's insurance is a $300,000 loss most can't afford. So paying a *known* $350/year is superior to an "average" loss of $300/year that *could* be as high as a destructive $300,000 in any particular (albeit unlikely) year.

Viewed another way, this is simply the recognition that good insurance planning is good risk management, turning potentially destructive and highly uncertain large expenses into certain expenses that are small and manageable. "On average" wealth will be decreased, but the (financial) danger of a catastrophe can be eliminated.

Nonetheless, what this means from the perspective of the "economic benefits" of financial planning is that while obtaining proper insurance coverage may reduce the risk of disasters, it is not expected to increase wealth. Certainly, for the one person who buys homeowner's insurance and actually *has* a homeowner's claim, the coverage had a nearly 1,000,000% "return". But that's not an expected return (as if every buyer got that, the insurance company would quickly go broke!); that's a disaster averted.

Stated more simply, good insurance guidance is truly all about risk management to avoid financial disasters, not enhancing (average) financial outcomes.

The True (Unmeasurable) Benefit Of Financial Planning: Behavior Change

Ultimately, perhaps the greatest financial impact of good financial planning is not directly financial at all, but behavioral: the fact that a financial planner may help ensure that everything *gets done* in the first place, that wouldn't have been done without help.

Of course, the caveat to this "benefit" is that virtually all of the actions necessary to implement a good financial plan are relatively straightforward, and things that an individual *could* do for themselves. At worst, it might take some time and self-education to be certain it's done right, but most of financial planning is not "rocket science" – the tactics and implementation steps *are* able to be done directly by most consumers.

Nonetheless, the clear reality is that not everyone actually does it all for themselves. Some don't have

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Delegation And The (Financial) Value Of Time
While most of the benefits of financial planning can be measured in terms of the wealth enhancement or risk reduction of financial assets, arguably one of the greatest benefits of financial planning is simply the fact that it frees up the time of the client to do something else.

For those clients who are in high-income professions or business owners, the trade-off of hiring a financial planner may be appealing simply because it allows the client to pay a "lower" cost to free up more of their time for generating even greater income. For instance, a doctor who earns $500/hour would be ahead financially by paying a financial planner $200/hour to do some of the financial work, *even if* the doctor "could have" done it personally instead.

In essence, for every hour the doctor *doesn't* manage his/her own financial affairs while earning $500/hour, and pays someone "only" $200/hour to do it instead, the household's wealth is enhanced by $300/hour. In essence, this implies that anytime the client actually generates more income with their time than the advisor they're hiring, it's financially beneficial to delegate as much as feasible. More generally, this means that *the value of delegating to a financial planner is relative to the person doing the delegating* (and what *their* time is "worth").

For other clients, their personal earnings may not necessarily be high enough to justify this trade-off in financial terms, but it may still be appealing as a personal trade-off. After all, a growing base of research on happiness and well-being finds that one of the *best* ways someone can spend money to increase their happiness is using it to free up time. Or stated more simply, you *could* spend your entire Saturday reading up on investments and trying to rebalance your portfolio, or you could just spend $200 for an advisor to review the portfolio for an hour, and then enjoy the rest of the day with your family. At that point, the $200 isn't a "financial enhancement" for financial planning, but it may be a good expenditure to increase your overall happiness!

the time to do so, given other demands of work and life. Some just don't want to take the time or have the inclination and motivation to get it done. Others suffer from behavioral biases that keep them from recognizing the problems to be addressed, or taking the steps necessary to resolve it (e.g., failing to spot that a concentrated position in employer stock is a risk, not updating estate planning documents due to a discomfort in facing the issues of death and mortality, or just

procrastinating to the point that insurance coverage is never actually bought). In other words, a behavioral benefit of working with a financial planner is the potential to "de-bias" the client away from behavioral finance mistakes, and in some cases a task that is delegated is simply more likely to be done than one the client "could" do themselves but realistically will just procrastinate about instead.

Unfortunately, it's *especially* challenging to measure the economic impact of "getting behavioral assistance", due to the "compared to what" problem – in the end, there's no way to *know* exactly how much an actual financial planning client might have done on their own (or not) in the absence of the planner. At best, we can see what has or hasn't been done already,

and project that behavior into the future (which may or may not have been how it was really going to turn out!). Similarly, there's no way to measure whether someone who *doesn't* hire a financial planner *really* would have done more with the planner's assistance (as not every planner is successful at getting every client to implement every recommendation!). And of course, even if "some" or "many" or "most" people don't do all their financial planning themselves, the *next* person may have been fully capable of doing it themselves.

In practice, the "behavior change" benefit of financial advising may be most akin to those who seek out personal trainers for their physical fitness as well – it's a service that most would benefit from, but everyone makes their own personal judgment about whether the cost is worthwhile relative to the incremental improvement in their behavior over just trying to motivate themselves to get it done.

Bringing It All Together

Across all the different dimensions of financial planning, financial advisors have an opportunity to craft solutions that impact clients in a myriad of ways, as shown in Figure 11 (left). Some strategies are about the outright enhancement of financial wealth and gain. Others are technically a reduction in expected wealth, but with an even greater reduction in risk (e.g., portfolio diversification, or buying insurance). Still other strategies express themselves primarily in improving a client's overall mental state of happiness and well-being (from crafting a viable retirement spending strategy, to ensuring that heirs will not fight over assets after death). And in many cases, the primary value the advisor provides is helping clients actually *implement* the change that they hypothetically *could have* done themselves, but in practice had not and probably weren't going to.

Figure 11. Potential Economic Impacts Of Financial Planning Strategies

FINANCIAL PLANNING STRATEGY	POTENTIAL ECONOMIC IMPACT
INCOME TAX BENEFITS	
- Claiming tax deductions, credits, & tax-free investing opportunities. Deductions, credits, ROTH IRAs and 529 plans, etc.	$1,000s or $10,000s
- Tax deferral - Retirement contributions, TLH.	$10,000s or $100,000s
- Tax bracket arbitrage - Roth conversions, tax sensitive liquidations.	0%-30% of total wealth
INVESTMENT PLANNING BENEFITS	
- Picking Lower-Cost Investments	0.45%-0.82%
- Tax Loss Harvesting	0.20%-0.60%
- Asset Location	Up to 0.75%
- Investment Selection for Alpha?	>0%
- Rebalancing	0.35%-0.44%
- Diversification	Risk reduction
- Behavior Gap	Up to 1.50%?
ESTATE TAX BENEFITS	
- Federal estate tax savings (for those >$5M?)	Millions
- State estate tax savings	$100,000s or Millions
- Probate and settlement cost savings	$1,000s or $10,000s
- Ensuring assets go where they should and when	Priceless!
RETIREMENT PLANNING BENEFITS	
- Retirement portfolio tax strategies and withdrawal sourcing	0.50%-0.70%
- Maximizing Social Security benefits	$10,000
- Retirement-sensitive tax planning strategies (e.g., Medicare Part B and Part D premium surcharges)	$1,000s to $100,000s
- Setting spending policies and budgeting	Making retirement work!
- Determining when you can stop working!	Priceless!
INSURANCE PLANNING BENEFITS	
- Optimizing Insurance Coverage	$100s or $1,000s
- Eliminate Financial Catastrophes	Priceless!
DELEGATION BENEFITS	
- Enhance Value of Your Time	$1,000s or $10,000s
- Spend Money to Free Up Time	Emotional Well-Being!
- Ensure Things Actually Get Done!	Priceless!
BEHAVIORAL BENEFITS	
- Debiasing	Unquantifiable?
- Financial coach for implementation	Priceless!

EASIER TO MEASURE ⬆ HARDER TO MEASURE ⬇

TYPES OF IMPACT
■ Financial Gain   ■ Risk Reduction   ■ Well-Being Enhancement   ■ Behavioral Change

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Nonetheless, the fact that there is no way to know what the future might have been makes it remarkably difficult to effectively assess the economic impact of many financial planning strategies. Those planning recommendations are purely quantitative – e.g., many tax-related strategies – can be more reasonably assessed, both because the outcomes are easier to measure, and there is often a clearer baseline against which it can be measured. Others that are primarily behavioral – e.g., improving savings habits and helping someone to reduce their spending – are far more difficult to measure, likely to vary significantly in value from one client to the next, and arguably aren't even "improvements" in many cases but simply trade-offs (for instance, saving more today *does* also mean spending less on things you enjoy today!).

Still, a proper assessment of the value of a strategy, including fully accounting for its costs, tax impacts (now and in the future), and with a good "measuring stick" for assessing the outcome, is vital to determine what strategies are even worthwhile to engage in to begin with. Otherwise, the advisor risks making recommendations that aren't actually even an improvement in the first place.

Of course, for those who go even deeper into various niches and specializations, the true value of financial planning *for that particular clientele* may encompass a wide range of benefits not discussed here. Advising younger clients could include career advice that has a significant financial impact in the long run. Consulting with executives about stock options and restricted stock has unique value creation opportunities of its own. And working with doctors selling their medical practice and maximizing *its* value may be the single greatest opportunity for wealth enhancement for those clients… but it is only for advisors working with doctors in the first place.

Still, hopefully the list of prospective strategies that advisors can provide to add value, and an understanding of their economic benefits, is crucial both in deciding what strategies to implement and which may be most valuable for clients. Hopefully this discussion provides a helpful framework for making such assessments in the future!

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