Morningstar Investment Management Adviser Roadshow

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James Louw

Head of Advice & Investment Solutions
Morningstar Investment Management

Adviser Gamma: Maximising the Value of your Advice

Agenda

- **Introduction to the Value of Advice: “Adviser Gamma”**
- Rethinking advisers as behavioural coaches
- Applying behavioural finance in your practice
- Wrap Up

Foundation of Academic Research and Real World Application

1979 | 1982 | 1984 | 2001 | 2004 | 2006 | 2007 | 2008 | 2010 | 2011 | 2012 | 2014 | 2015 | 2016

270+

Research papers

10

Graham & Dodd Awards for Excellence

All to benefit the adviser and their clients

Legend:

- Graham & Dodd Award
- U.S. Patent
- Montgomery-Warschauer Award
- Academic Thought Leadership Award
- Harry M. Markowitz Award

"Alpha, Beta and … More Gamma"

Spotlight: The Future of Investing

Reprinted from Morningstar magazine
June/July 2017

Alpha, Beta, and … More Gamma

How advisors add value through a robust portfolio-planning process.

David Blanchett and Paul D. Kaplan

In 2012, we introduced a metric we called *gamma* to quantify the value of more intelligent financial planning decisions—in particular, the benefits of working with an advisor.[1] Since this original paper was released, the body of research focused on quantifying the value to investors of working with a financial advisor has grown. We think movement toward fiduciary best practices and the need to demonstrate that certain financial decisions (such as rolling over a 401(k) into an IRA) are in an investor's best interests make this type of research especially timely.

Our new research looks at the decisions around building an investment portfolio and estimates the gamma an advisor might provide in this process. We find that an advisor's reasonably priced robust investment framework can add the equivalent of 2.5% of annual outperformance for an average investor, further evidence that working with an advisor can improve not only investors' experience but their ability to reach their financial goals. We believe robotechnology can address several aspects of the gamma framework and has the potential to boost advisor gamma rather than detract from it.

Building More-Efficient Portfolios

While our first paper on gamma focused on more general financial planning decisions, the scope of this new paper is narrower and explores the value of building more-efficient portfolios. In this new research, we estimate the benefit of portfolio gamma using a comprehensive framework based on seven questions an investor should consider during the portfolio construction process:

1. Why invest at all?
2. Which type of account is best for my situation?
3. What is the appropriate risk level?
4. Which asset classes should be included?
5. How does the risk of the goal affect how I invest?
6. What investments are right to help me reach my goal?
7. When should my investments be revisited or rebalanced?

These considerations result in a process that is far more comprehensive than simply selecting a few mutual funds. It requires the portfolio to be consistent with the goals and risk objectives of the investor, diversified, efficient (high-quality, low-cost), and, if applicable, tax-aware.

A key concept here is goals. Investing needs to start with the end in mind, and investors and advisors who haven't done so already should adopt a goals-based approach to financial planning. Goals aren't just for planning; they can have a significant impact on every decision in the investment process. While it's certainly possible investors could tackle these decisions on their own, our understanding is that many are not up to, or interested in, the challenge.

To quantify the benefits of these decisions, we performed a variety of empirical tests. Unlike our original gamma research, where we used a retirement income metric[2] to contrast the potential value of different services, here we focus on the potential "alpha" benefit of the respective service. That is, we quantify the increase in expected annual return (or equivalent) associated with each decision. This makes it easier to compare the expected benefits of financial advice with its costs, which are typically expressed as annual percentages of assets under management.[3]

We measure the expected value of financial decisions based on three levels of benefit: low, average, and high. We do this to reflect the fact that sophistication differs significantly across investors, as does the complexity of their needs. The benefits of financial advice vary significantly across these three levels. For example, an investor seeking to fund a single goal (retirement) with a single account (a 401(k) plan) who would otherwise invest in an efficient prepackaged multiasset solution (a target-date fund) is likely to realize significantly less value from working with an advisor than an investor with a variety of goals with multiple accounts who would otherwise build portfolios without the help of an advisor.

Overall, we estimate that the "average" investor is likely to benefit significantly from working with an advisor, even if the services are entirely related to building and monitoring the portfolio, so long as the advisor provides comprehensive, high-quality portfolio services for a reasonable fee. Providing other financial planning services, such as savings guidance, pension optimization, insurance planning, and withdrawal planning, will likely result in even more value for the client. While the gamma from this sort of planning advice is very important from an outcomes perspective, it is not considered here.

An Assessment of Portfolio Efficiency

Building a gamma-efficient portfolio is more than

1 The original working paper, "Alpha, Beta, and Now … Gamma," was released in October 2012 and was published in the Fall 2013 issue of the *Journal of Retirement*.
2 To be more precise, in our previous research we estimated certainty-equivalent income using a nested utility function. This higher certainty-equivalent income, resulting from the more efficient strategies, was then converted into an alpha-equivalent value using a separate model.
3 Viewed differently, the financial advisor fee is negative alpha (i.e., the cost). In this research, we explore the potential value associated with the decisions a financial advisor can help an investor make (i.e., the benefit), the net of which would be the value of the advice.

Source: Morningstar

AUTHORS

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Director of Research, Morningstar Canada

"Alpha, Beta and … More Gamma"

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Source: Morningstar

Approach to maximise the potential of Adviser Gamma

To **invest successfully** over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information.

What's needed is a **sound intellectual framework** for making decisions, and the ability to **keep emotions from corroding that framework.**

Warren Buffett

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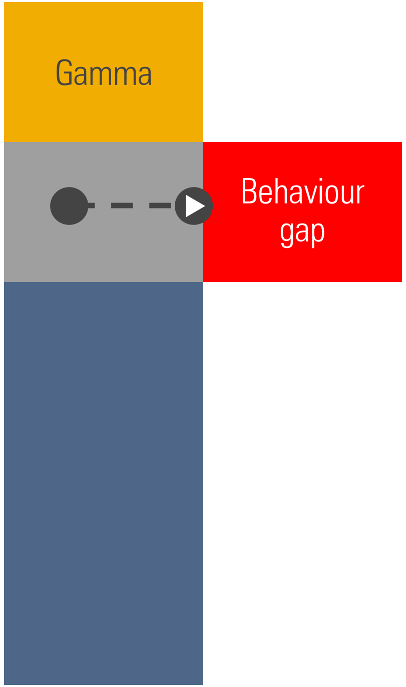
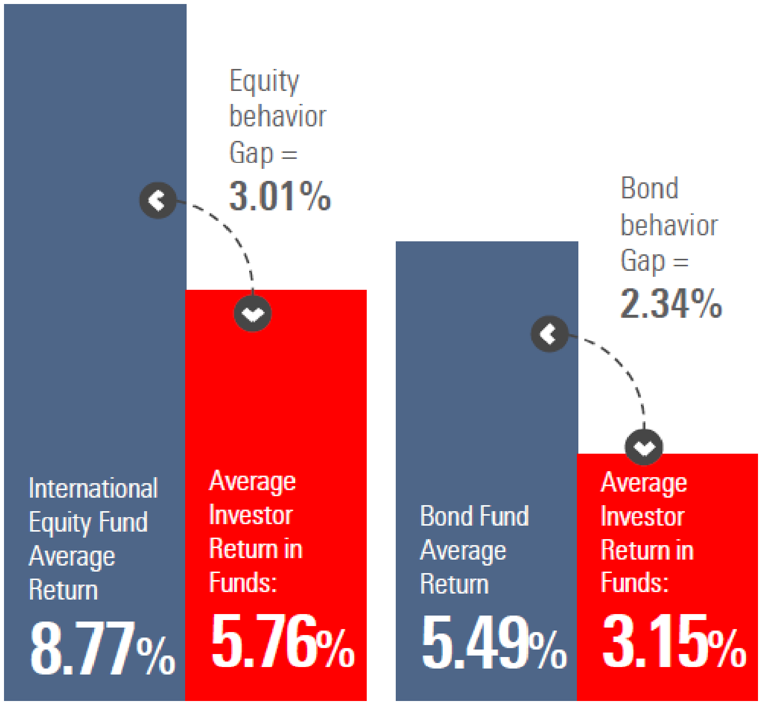


Behaviour Gap – Preventing permanent loss of capital



Source: Morningstar, Inc. Comparison of average 10-Year Total Returns and Asset-Weighted 10-Year Investor Returns, in article "Mind the Gap 2013" by Russell Kinnel, 2-27-14

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- **Rethinking advisers as behavioural coaches**
- Applying behavioural finance in your practice
- Wrap Up

The pillars of investing knew intuitively about psychology…

"The investor's chief problem—
and even his worst enemy—
is likely to be himself."

Benjamin Graham (1894-1976)

We all suffer from behavioural biases

Confirmation

We all suffer from behavioural biases

Confirmation

Hindsight

We all suffer from behavioural biases

Confirmation

Hindsight

Herd mentality

We all suffer from behavioural biases

Confirmation

Hindsight

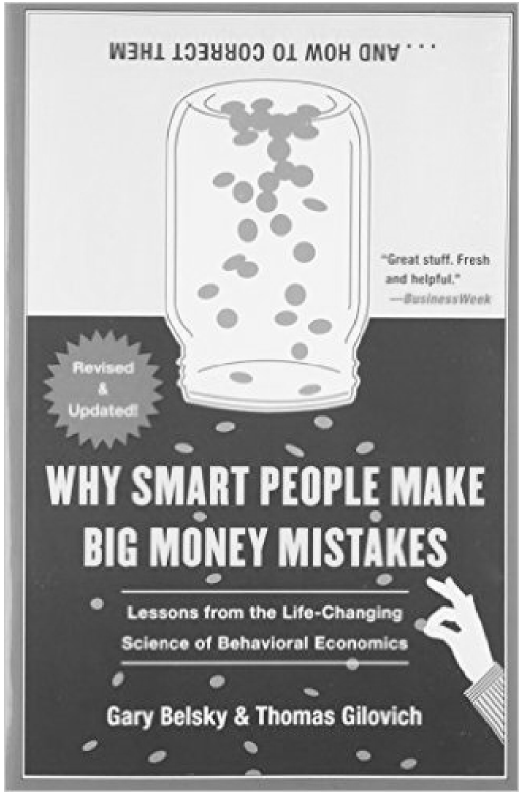
Herd mentality

...and there are many more.

MORNINGSTAR

And you can make money off of them!

A simple promise to investors

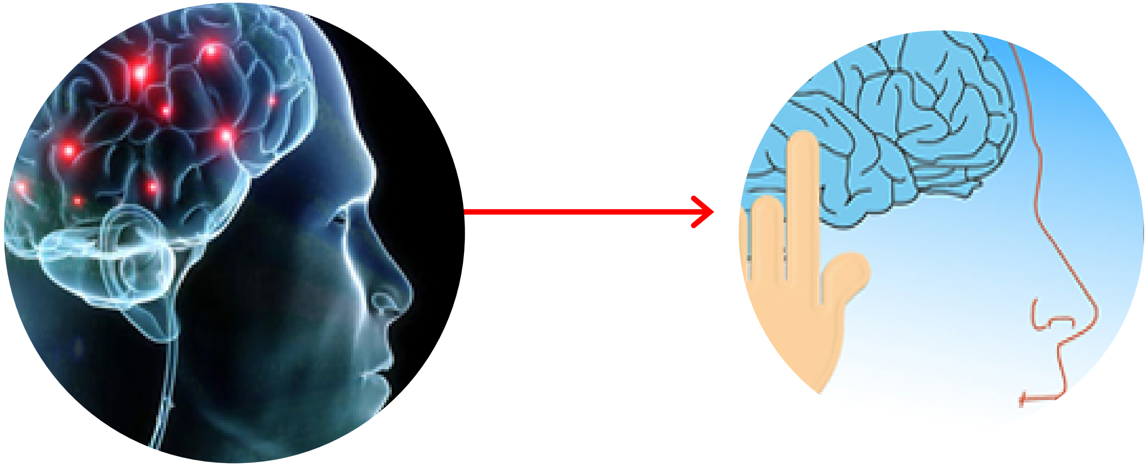


A direct connection to market-level events

See Shiller (2003); Belsky and Gilovich (2010)

Now we can help people overcome them

Now we can help people overcome them



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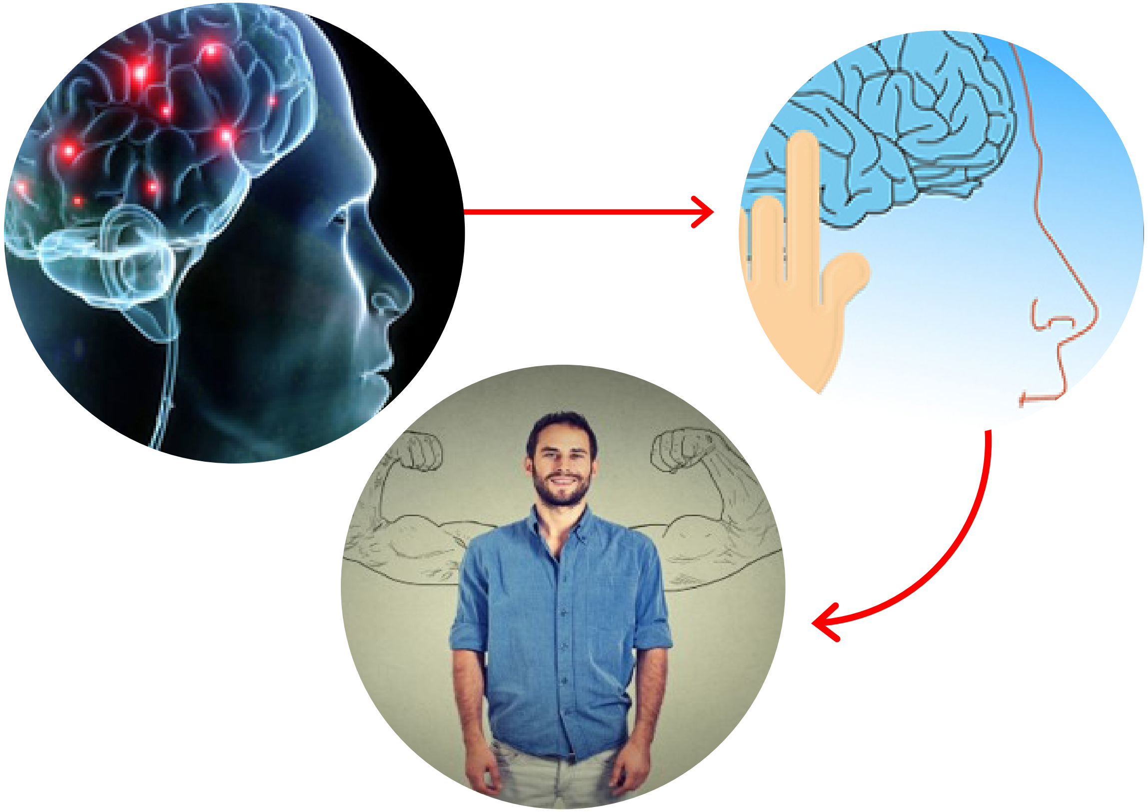

Financial advisers as behavioural coaches

Financial trainer

Financial teacher

Financial counselor

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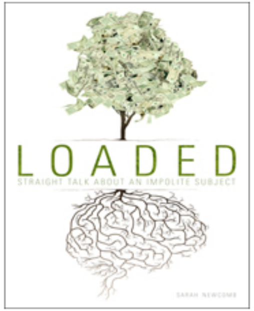
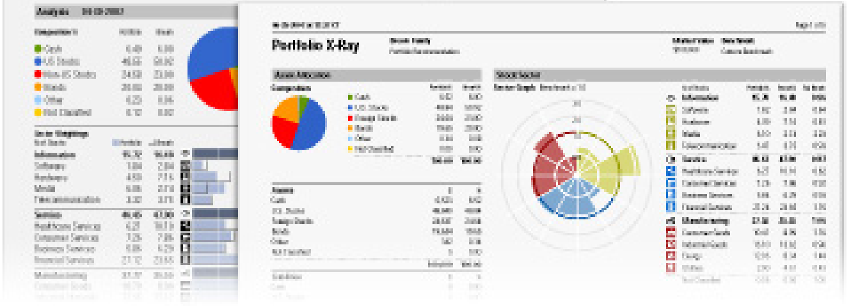
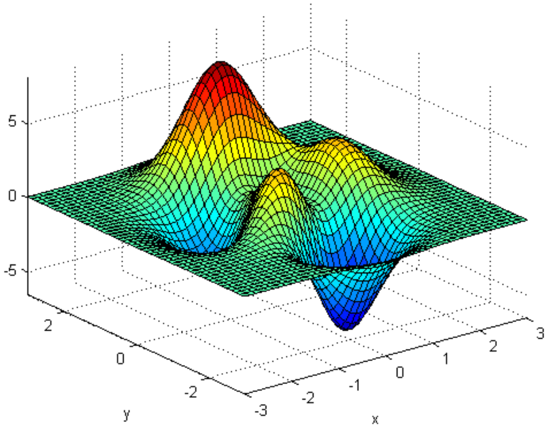
About Morningstar's Behavioural Science Team

Academic research and thought leadership



Investment communication optimisation





Product optimisation

Sarah Newcomb's Book: "Loaded: Straight Talk About How To Get Ahead Without Leaving Your Values Behind"

Morningstar's Behavioural Science Advisory Board

Hal Hershfield (UCLA)

John Lynch (U. Colorado)

Katherine Milkman (Wharton)

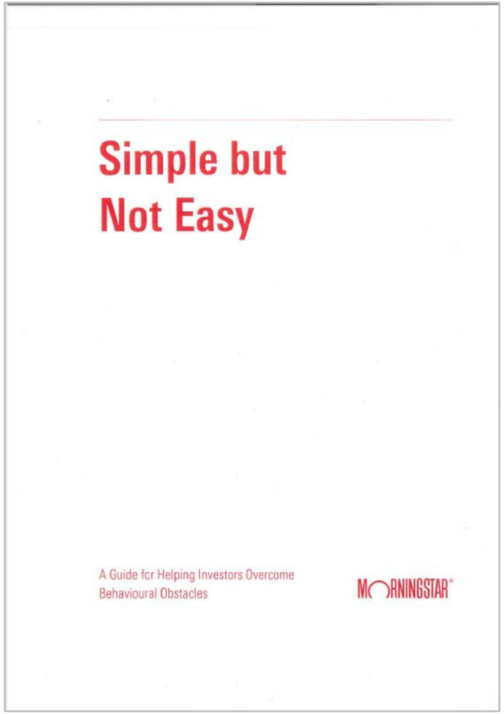
Terrance Odean (UC Berkeley)

Abigail Sussman (Chicago Booth)

Jon Zinman (Dartmouth)

See our guide to applying behavioural science

Morningstar's guide to helping your clients overcome behavioural obstacles



https://morningstarinvestments.com.au/2017-national-adviser-roadshow/simple-but-not-easy/

Play to your strengths as a behavioural coach

Modern Adviser Program

Enhancing your unique and differentiated client value proposition, maximising your potential adviser "gamma"

Advisers must now act as behavioral coaches to adapt to the new financial landscape and to better help their clients achieve their goals.

Key objectives:

- Learn how to recognise behaviours brought on by cognitive biases
- Begin applying simple behavioral techniques to mitigate these biases in your practice

There is a psychological aspect to investing. Often, it's the psychological barriers your clients face that do the most damage to their finances.

Key objectives:

- Understand what it means for a client to be financially healthy, which doesn't always come from their pocketbook
- Learn practical applications you can use to help coach clients toward healthier financial attitudes and behaviors

As a behavioral coach, there are ways you can mold a client's environment to better help them succeed, overcoming behaviour that can reduce their wealth.

Key objectives:

- Identify the obstacles that are preventing a client from acting
- Learn how to implement behavioral techniques throughout your practice to help a client over psychological and environmental roadblocks

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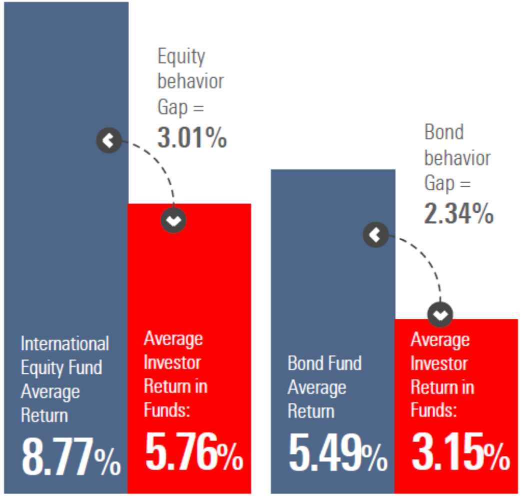
Demonstrate your differentiated value proposition



Assisting advisers to demonstrate tangible and intangible value for the fees they charge their clients

Source: Morningstar, Inc. Comparison of average 10-Year Total Returns and Asset-Weighted 10-Year Investor Returns, in article "Mind the Gap 2013" by Russell Kinnel, 2-27-14

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