# Wealth Management Alpha™

The decision to hire a professional, whether for something simple like painting a house or something more complex like a legal issue, requires consumers to consider two main factors: cost and value. The former is generally straightforward and usually determined by price. The latter can be far more difficult to assess and involves both quantitative and qualitative measures. What is the value of letting someone else navigate tall ladders and tight spaces in order to get the house painted? The cost is known, but the value is largely subjective.

For those considering the services of a financial advisor, these same two factors become important decision points. The cost is clear, but how is the value of an advisor quantified? Will the value received ultimately justify the fees paid? Will the advisor's investment performance exceed that which could be achieved without an advisor? These are important questions, and the answers have not always been clear.

This paper will attempt to explore and identify the objective, quantifiable value that an advisory relationship can provide. Through our own research and other third-party studies, our ability to articulate a clearer sense for this "alpha" has improved. Once we have covered the items which are more readily quantified, we will explore the significant value inherent in the many other planning disciplines we include as part of a comprehensive wealth management relationship.

## WEALTH MANAGEMENT

The term "wealth management" has become ubiquitous in the advisory world. Many financial advisors assert that they provide wealth management, but very few advisors have the in-house expertise and experience to do it well. At Brighton Jones, we have integrated the principles of comprehensive wealth management since our founding nearly 15 years ago, but for many, the term remains misunderstood. This article will attempt to better define the components, benefits, and long-term value of true wealth management.

Before continuing, let us define a couple of terms.

## ALPHA

The term 'alpha' has come to mean many things. In addition to serving as the first letter of the Greek alphabet, it is a term used in chemistry, physics, biology, and sociology. As it relates to investments, alpha refers to the excess return beyond what the market would otherwise provide. If the S&P 500 returns 10%, and Mutual Fund XYZ returns 11%, this 1% excess return is sometimes referred to as "alpha."

Beyond this more traditional use of the world alpha, we would like to introduce another use for them. We believe that the practice of comprehensive wealth management, of which investment management is an important component, adds a significant amount of quantitative and qualitative alpha to the long-term success of our clients' life plans.

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## WEALTH MANAGEMENT ALPHA DEFINED

Wealth Management Alpha™ is the long-term economic benefit Brighton Jones delivers for clients, both quantitative and qualitative, as a direct result of integrated wealth management.

## QUANTITATIVE BENEFITS

There are numerous qualitative benefits to working with a comprehensive wealth manager (which will be discussed later), but equally important are the measurable, quantifiable benefits. Vanguard has spent considerable time researching what they describe as "Advisor's Alpha," and their work is cited below:

| Vanguard's Advisor Alpha Component[1] | Value-add relative to "average" client |
|---|---|
| Asset Allocation/Broad Diversification | >0.00% |
| Reduced Internal Expense Ratio | 0.45% |
| Rebalancing | 0.35% |
| Behavioral Coaching | 1.50% |
| Asset Location | 0.00-0.75% |
| Spending Strategy | 0.00-0.70% |
| Total Return vs Income Investing | >0.00% |
| Total Potential Value-Added | About 3%[1] |

As illustrated by the table, Vanguard's research would suggest that the potential annualized value-add, on average, of working with an advisor like Brighton Jones is around 3%. As with anything that involves very case-specific data, this number will vary for each individual client, and the value-add will ebb and flow year-by-year based on circumstances, but over time, Vanguard's research suggests that this value-add is persistent and meaningful.

If cost and value are the two primary factors involved in hiring a professional, the framework noted above provides potential (and existing) advisory clients with a clearer sense for the value inherent in a Brighton Jones advisory relationship. But what do these terms mean, and how do we get from Advisor's Alpha, which Vanguard has quantified, to Wealth Management Alpha?

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[1] Francis M. Kinniry Jr., CFA, Colleen M. Jaconetti, CPA, CFP®, Michael A. DiJoseph, CFA, and Yan Zilbering. *Putting a value on your value: Quantifying Vanguard Advisor's Alpha.* Vanguard Research March 2014

[2] Potential value-added is not a simple sum as there can be interactions between strategies.

## UNDERSTANDING THE BENEFITS – QUANTITATIVE AND QUALITATIVE

Although a thorough description of the methods used to calculate the aforementioned value-add is beyond the scope of this paper, it is important for the reader to understand the context behind each component and the many additional sources of value that Wealth Management Alpha provides for Brighton Jones advisory clients.

- **Asset Allocation and Broad Diversification:** Academic research has repeatedly shown that effective diversification is as close to a "free lunch" that one can find in the world of investing. By owning asset classes that are not highly correlated over the long-term, portfolio risk can be reduced significantly without giving up material expected return.

- **Reduced Internal Expenses:** Our relationships with institutional money managers give our clients access to institutional share classes that are not always accessible to retail investors. These share classes provide substantially lower internal expenses relative to category averages.

- **Rebalancing:** A disciplined, systematic approach to rebalancing the portfolio ensures a more consistent level of risk over time. Through regular rebalancing, we're able to unemotionally pare down positions that have over-performed and add money to positions that have under-performed, a de facto form of selling high and buying low.

- **Behavioral Coaching:** An intelligent approach to investing cannot be successful if we don't maintain discipline to the strategy over time. Brighton Jones serves as a barrier of sorts between the investor's emotion and their long-term investment strategy. Multiple and repeated studies have consistently demonstrated that individual investors' returns substantially lag the returns freely offered by the market, with the primary source of this underperformance attributable to emotion-based decisions at inopportune times (e.g. giving up on stocks during the height of the credit crisis). Brighton Jones coaches clients through these difficult times, and the end result is better returns.

- **Asset Location:** Brighton Jones portfolios employ a variety of asset classes, and some are more tax efficient than others. For clients with a mix of after-tax and tax-deferred assets, we employ strategic asset location to ensure that the less tax efficient asset classes are held in tax-deferred accounts (where they are shielded from current taxation). This exercise can significantly improve the after tax rate of return generated by the portfolio

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- **Spending Strategy and Withdrawal Order:** When funds are needed from a client's portfolio, where should they come from and in what order? In the absence of professional guidance, many might make sub-optimal decisions with respect to what asset classes are best suited for cash needs and what mix of accounts (after-tax vs. tax-deferred) should supply these cash needs. Brighton Jones provides a clear framework for these decisions, resulting in a more optimal portfolio spending strategy.

- **Total Return vs. Income Investing:** Individual investors often embrace the misguided view that one should only spend the "income" generated by a portfolio. In a low-yielding environment, this approach can be particularly detrimental to portfolio construction and volatility. When yields are low, individuals might over-weight long-term bonds, high-yield bonds, and stocks with above-average dividends. Although doing so might increase portfolio income, it has the unintended consequence of increasing interest rate risk, credit risk and sector overexposure. By embracing a total return approach, these risks are mitigated and clients understand that cash flow can be generated from multiple sources, including capital gains.

- **Proactive Tax Planning:** Virtually every financial transaction involves some consideration for taxation. Whether it's optimizing the value of charitable gifts, harvesting tax losses to offset future capital gains, investing in municipal vs. corporate bonds, or locating tax-inefficient asset classes in qualified accounts, the practice of wealth management seeks to optimize net after-tax returns.

- **Risk Capacity Analysis:** Before we can determine the strategic asset allocation for a client, we first must have a comprehensive understanding of the client's *capacity* for taking risk (which might be different than the client's *tolerance* for taking risk). We assess this by running a Cash Needs Analysis that aims to quantify the liquidity requirements from the portfolio over the next 10-15 years. Only after determining the client's short to intermediate-term cash needs can we design a customized asset allocation that is tailored specifically to the client's risk capacity and risk tolerance.

- **Vocational Freedom Planning:** It's one thing to know how much wealth one has, but to understand the ability for that pool of wealth to provide for one's lifestyle indefinitely (and in many cases provide for the next generation) is entirely another thing. As wealth managers, we understand the dynamic that exists between cash flow planning, vocational freedom planning, wealth transfer objectives, and the overall structure of the portfolio.

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- **Estate Planning:** With in-house expertise on a broad range of estate planning tools and techniques, and extensive independent estate planner relationships, clients have access to advice on structuring their estate plan to reduce administrative costs, pass wealth efficiently, and most importantly, minimize estate taxes. Estate planning within the context of wealth management is oftentimes a significant source of Wealth Management Alpha, with many planning techniques resulting in hundreds of thousands to millions of dollars of savings for select clients.

- **Risk Management:** There are many potentially catastrophic financial risks that could occur at any moment, from property risk and liability risk to disability and premature death risk. Part of effective wealth management involves understanding these risks, deciding which can be self-insured, and deciding which should be transferred to insurance providers. Our in-house expertise paired with outside providers gives clients access to the tools they need to make informed decisions about insurance.

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- **Strategic Philanthropy:** For those who desire a philanthropic component to their overall life plan, Brighton Jones can help design and implement charitable giving plans that become effective either while living or at death (or both). Donor-advised funds, private foundations, charitable remainder trusts and charitable lead trusts are some of the many tools at our disposal to help fulfill clients' philanthropic intentions.

- **Coordination of Outside Experts:** An important component of Wealth Management Alpha is effective coordination of both in-house and outside experts. Clients may have outside counsel assisting with mortgage refinancing, property and casualty insurance, or the execution of estate planning documents, among many others. Brighton Jones serves as the coordinator and primary point of contact to ensure that all outside advice is integrated and coordinated with the client's broader financial goals and life plan.

- **Wealth Management Scorecard:** We have built an in-house, proprietary tool called the Brighton Jones Wealth Management Scorecard (WMS). The WMS is designed to track all aspects of our comprehensive wealth management process, and provides a qualitative score regarding each component of our clients' overall plan.

- **Execution:** Because we understand and advise on the many components of our clients' financial lives, we recognize the importance of not only establishing a plan, but executing that plan. An estate plan that is drafted but never implemented accomplishes very little. A charitable giving strategy that is proposed but never realized will not advance the worthy causes it endeavors to support. Effective execution is critical, and execution is a powerful and significant component of the value that Wealth Management Alpha can bring to a client relationship.

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## CONCLUSION

The power of Wealth Management Alpha is real, both quantitatively and qualitatively. By working with Brighton Jones' objective, independent team of experts, clients should receive incremental economic value that compounds over time and creates measurable long-term alpha. But perhaps just as importantly, clients gain tremendous peace of mind knowing that their advisor has the expertise to serve as their advocate in all important areas of comprehensive financial planning.

Brighton Jones has been providing this level of integrated advice for nearly 15 years, and with a team of JDs, CPAs, CFPs and CFAs, we have the in-house expertise to create meaningful, measurable Wealth Management Alpha™ for our many valued clients.