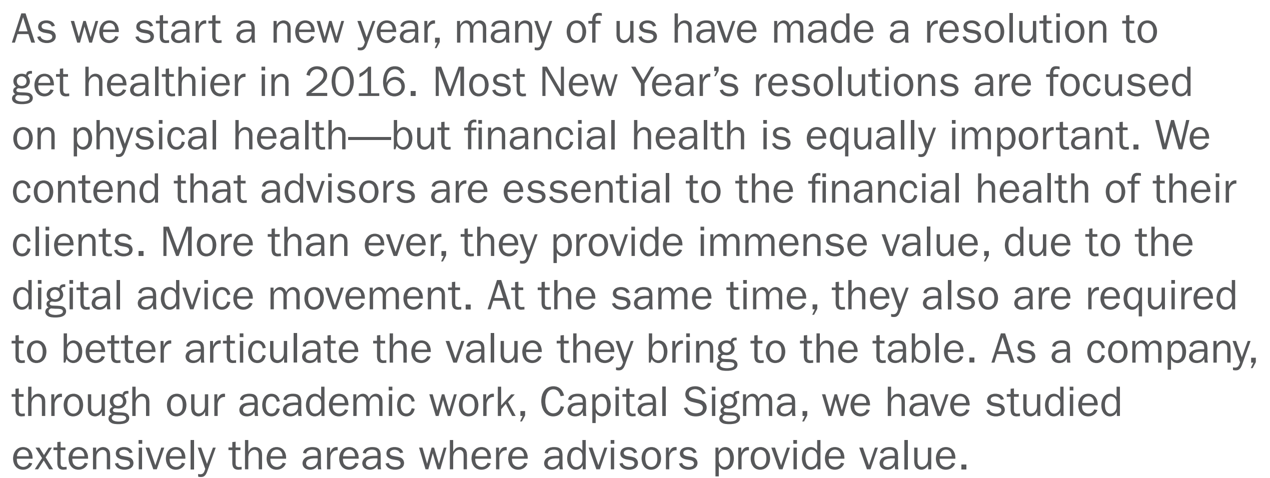
ENVESTAT

INTERSECTION

January 2016



As we start a new year, many of us have made a resolution to get healthier in 2016. Most New Year's resolutions are focused on physical health—but financial health is equally important. We contend that advisors are essential to the financial health of their clients. More than ever, they provide immense value, due to the digital advice movement. At the same time, they also are required to better articulate the value they bring to the table. As a company, through our academic work, Capital Sigma, we have studied extensively the areas where advisors provide value.

During this quarter, we took a deeper dive into some of them to answer the following questions:

1. How can an advisor quantify the importance of coaching clients to remove emotion from the investment process?
2. What impact does being out of the market have on performance over a full market cycle?
3. How, and by how much, can an advisor generate tax alpha? (a hot topic in today's investment vernacular)
4. Does rebalancing really add client value?

Put me In Coach

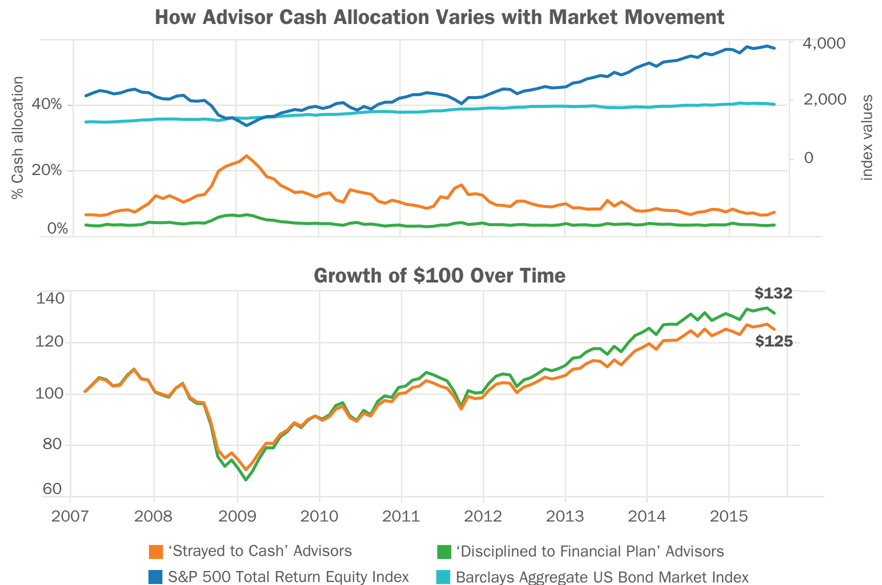
There's continued debate in the industry about the commoditization of investment management, which is causing firms to move towards financial planning as the foundation of their value propositions. Unlike the relative ease in quantifying asset allocation and investment vehicle selection, advisors can struggle to quantify the benefits of a sound financial planning process. We assert that planning also includes "coaching," which is the process by which an advisor guides a client to make the right choices by removing biases or other emotions in the wealth management decision-making process. The value of planning and coaching thus can be quantified as keeping investors in the market through an entire investment cycle, including those times of extreme volatility.

We reviewed an entire market cycle from January 2007 – June 2015, and compared those advisors who kept their clients invested, versus those who strayed to a heavily weighted cash allocation, to see if staying in the market produced value. The advisors who kept their clients invested beat those whose clients moved to cash by 700 basis points in total, or 64 basis points annually during the time period reviewed.

Keeping clients calm during market turmoil can be extremely challenging, but it's a valuable role of the advisor, and one that drives extensive value to the client.

Graph 1:
In Good Times and Bad, Coaching Your Clients to Stay Invested Adds Value

The advisors who kept their clients invested beat those whose clients moved to cash by 700 basis points in total, or 64 basis points annually, during the time period reviewed.



Advisors who were active both during Jan 2007 and June 2015 have been considered for the analysis.
'Strayed to cash' advisors have more than 15% cash allocation in at least 3 months during the analysis period.

A Missing Pillar of Value

Our Capital Sigma research demonstrated that end clients could benefit by as much as 1% per year from active tax management. Given this potential, it would seem that advisors would look for ways to scale tax management capabilities. What we found, however, is that fewer than one in four of the advisors on the Envestnet platform use automated tax overlay services. When we work with advisors, we generally hear two primary reasons for not using automatic tax overlay services: 1) it's not necessary, because I can rebalance on my own, or 2) it's too expensive, and my client will object to the cost.

Although we understand, we don't agree with either justification. You will see later in this report that a high percentage of the advisors on our platform do not systematically rebalance at all, so it's difficult to see how they can provide tax management value by rebalancing on their own.

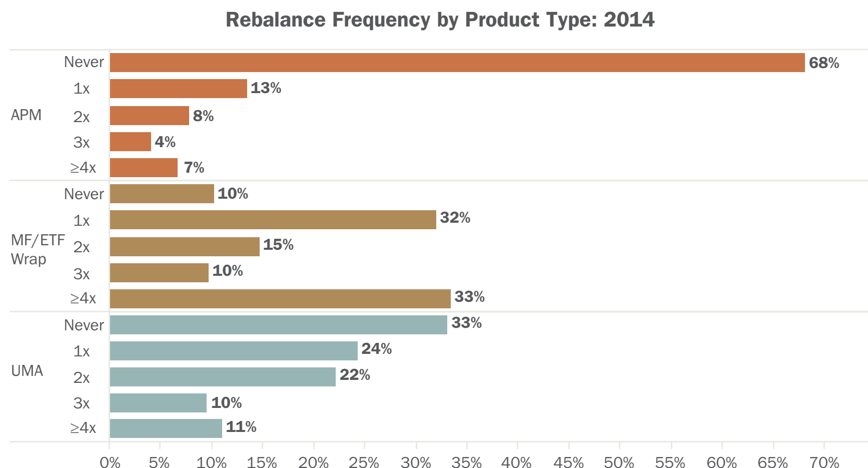
The cost item is indeed reasonable, if the advisor cannot quantify the value above the cost to the client. Absent this ability to find value, the added cost is nonsense. However, the day is coming when clients will demand that this value be articulated, and an advisor will be able to demonstrate tax alpha well in excess of the added cost.

The Curious Case of Rebalancing

Robo advisors are in the headlines, and when you get down to the basics, they are doing three things: setting an asset allocation; selecting low cost (and often mostly passive) investments; and systematically rebalancing. In our Capital Sigma work, we stated that effective rebalancing can generate 44 basis points in annual value to the client. The concept of rebalancing is something about which clients, as recently as just three years ago, knew little. The digital movement has made this topic front and center, and one which more end-clients will both understand and come to expect. When we reviewed the accounts on the Envestnet platform, we were surprised to find that 68% of the advisor-managed accounts in 2014 were not rebalanced. It would not be uncommon for accounts not to be rebalanced in a flat market year, but the S&P 500 Index was up almost 12% in 2014. The lack of rebalancing not only can leave value on the table for the client, but it also can be a red flag and draw regulatory concerns in the event of an audit.

Graph 2:
The Curious Case of Rebalancing in Advisor Managed Accounts

The lack of rebalancing not only can leave value on the table for the client, but it also can be a red flag and draw regulatory concerns in the event of an audit.



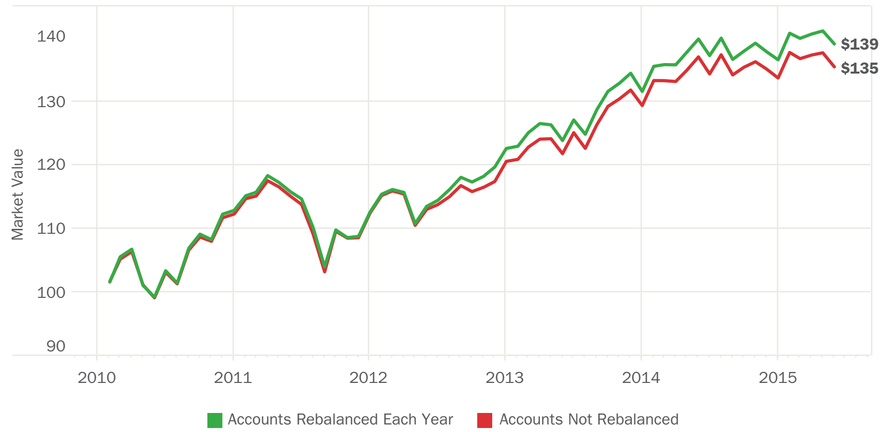
Only APM, MF/ETF Wrap and UMA accounts managed through ENV platform are included in the analysis

In our last Envestat, we reviewed actual platform performance data from 2010-2015 to see whether our 44 basis points of value from performance (which we calculated in Capital Sigma) really materialized. The actual results were even slightly higher: regardless of product, accounts that were rebalanced over this time period, versus those that were not, outperformed by 53 basis points annually.

Graph 3:
Rebalancing Really Pays Off

Regardless of product, accounts that were rebalanced between 2010-2015, versus those that were not, outperformed by 53 basis points annually.

The Benefits of Rebalancing: Growth of $100 Over Time



Accounts that were active during Jan 2010 and June 2015 have been included in the analysis.

Next Quarter

We maintain that there is a definite Return on Advice for clients benefiting from an advisory relationship. We will continue to analyze the pillars of value in the next quarter.

About Envestnet

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