

Vanguard®

# The evolution of Vanguard Advisor's Alpha<sup>®</sup>: From portfolios to people

Vanguard Research

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- Trends in the investment advice industry—regulation, fees, and technology-enabled competition—likely will continue to shape the contours of the advice industry and mold client satisfaction.
- As Vanguard's Advisor's Alpha research has suggested, for the typical advisor, the path to greater client satisfaction and asset growth should lead to an underappreciated destination—relationship management.
- A focus on relationship management takes time and commitment, and requires advisors to streamline some aspects of financial planning or wealth management and reallocate the time saved to the clients who increasingly demand and value it.
- Ultimately, clients determine the value of advice and, as our Advised Investor Insights™ research reveals, they clearly value and reward an advisor they highly trust with referrals and loyalty.
- To differentiate themselves from their competitors—both robo and human—advisors should embrace the fact that relationship management is not “customer service” but, rather, the crucial element of peerless financial advice.

Forecasting the future of advice is a popular exercise. And, as with most efforts at prediction, while some expectations will prove more accurate than others, the majority will generally fall short of even the most forgiving standards. Such is the challenge of trying to position oneself at the forefront of change.

But challenging or not, the future of advice is too important a topic to sit idly by on, without comment. Vanguard is a large and growing provider of advice services and a longtime advisor to many of our shareholder-owners. The future of advice seems to be unfolding before our eyes and we believe we have useful insights to add.

Several drivers are shaping the future of financial advice: regulation; a focus on fees and compensation charged for products and services; and technology-assisted entrants such as robo advisors in an already competitive marketplace.

While these drivers should affect the *environment* for advice in the future, ultimately, clients determine the *value* of advice. Our proprietary Advised Investor Insights research highlights opportunities for advisors to adapt to and thrive in a changing industry. These observations confirm our long-held belief (Kinniry et al., 2016a) that a focus on relationship management is the most rewarding course for advisors' prosperity—as well as for their investors'. If the drivers we discuss affect the future environment for advice as we expect, firms and their advisors will need to be very sensitive to client preferences if they wish to establish profitable advice models and long-lasting client relationships.

## Current influences—lasting impressions

### Regulatory environment—global, not local, considerations

The beginning of the 21st century has not been a quiet era for the financial markets or the advice industry. Two bear markets of historic magnitudes have shaped the investing and advice landscapes, but it was the second one—commonly referred to as the global financial crisis—that led to increased scrutiny of financial services and advice that our industry is still addressing.

As tempting as it may be to view U.S. regulators' emphasis on transparency and disclosure in our industry as more stringent today, our industry has always been closely regulated. Today's efforts may seem more vigorous because they are more visible now—thanks in large part to today's instant-news culture.

The 2016 U.S. presidential election raised questions about the future path of regulation and the application of fiduciary standards. But the genie is out of the bottle: Investors are more interested than ever in knowing whose interests their advisor is working for, as well as how their advisor is paid for services. Investor interest in this important information is unlikely to wane, regardless of the regulatory outcome. This "great awakening" of investors may be one of the most important and disruptive factors affecting the value proposition for advisors in the future.

In fact, it is not just a U.S. circumstance but a global one. In the wake of the global financial crisis, each of the following governments (and their regulatory changes) has implemented meaningful reforms that are intended to protect the best interests of investors, an effort that is most likely to continue:

-  United States (Department of Labor fiduciary rule)
-  Australia (Future of Financial Advice)
-  United Kingdom (Retail Distribution Review)
-  European Union (Markets in Financial Instruments Directive II)
-  Canada (Client Relationship Models I/II)

### Fees and costs—heightened transparency and awareness

Today's spotlight on investment fees illuminates both the costs of investment products and the fees for investment advice. While groundbreaking changes in advisor compensation have been spurred by regulation—Australia and the United Kingdom, for example, no longer permit fees such as sales loads, trailers, and commissions—the movement away from transaction-based advice in the United States has been both

voluntary and significant. For example, in the United States, commissions accounted for 45% of advisors' compensation in 2013 and have declined significantly to 32% as of 2016, a decline that is projected to continue down to 23% of revenues in 2018 (Cerulli Associates, 2016).

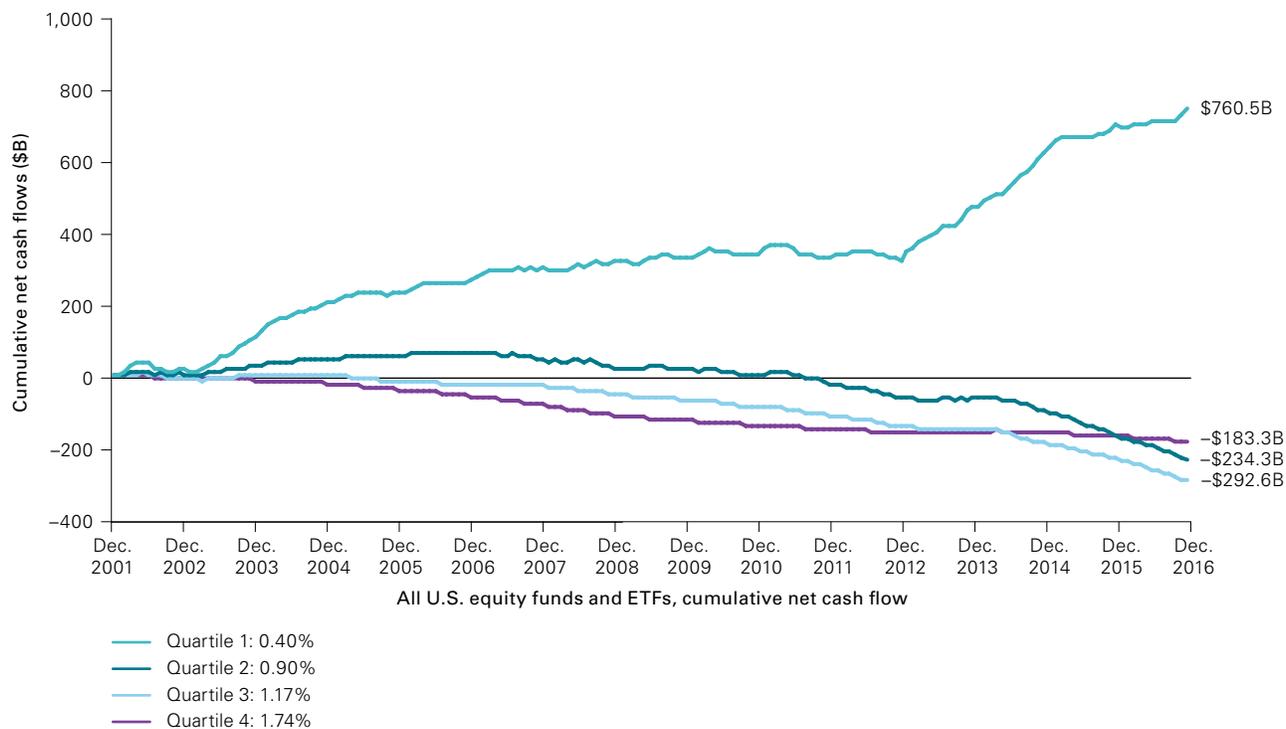
Fees, too, have for some time been a consideration for investors and advisors, and an issue for regulators. For investment products, such as mutual funds and exchange-traded funds, this preference for lower-cost products has been a longer-term trend<sup>1</sup> (Figure 1). It should also be noted that, since the majority of investor assets are intermediated (Spectrem Group,

2016b), cash-flow trends and fee awareness likely reflect advisors' recommendations rather than investors' unaided choices.

### Technology

Technology will certainly be a critical underpinning for success. However, given the speed of change in technology, rather than speculate on what improvements technology will bring to our industry, we feel it is safe to assume that improvements will come and their effects will be profound. Today's average smartphone has more computing power and capability than the best personal computers of only 25 years ago, when a fax machine and a landline phone were the go-to tools for instant messaging and chat.

Figure 1. Investors and advisors are choosing low-cost equity funds



**Notes:** Expense ratio quartiles were calculated annually. Shown for each quartile are the 2016 asset-weighted average expense ratios, determined by multiplying the annual expense ratios by the year-end assets under management and dividing by the aggregate assets in each quartile.

**Sources:** Vanguard calculations, using data from Morningstar, Inc.

<sup>1</sup> While we've chosen to illustrate the cash-flow trends only for U.S. equity funds and ETFs, previous research by Vanguard has shown that similar trends are evident in other asset classes, too, both in the United States and abroad. See *Costs Matter*, a Vanguard research paper published with versions for U.S., Canadian, and U.K. clients.

Figure 2. Advanced skills remain uniquely human

Basic ●○○	Repetitive ●●○	Advanced ●●●
<ul style="list-style-type: none"> <li>Growing</li> <li>Harvesting</li> <li>Digging</li> <li>Moving objects</li> <li>Recording information</li> </ul>	<ul style="list-style-type: none"> <li>Inspecting</li> <li>Monitoring</li> <li>Assembling</li> <li>Getting information</li> <li>Processing information</li> <li>Scheduling</li> </ul>	<ul style="list-style-type: none"> <li>Maintaining relationships</li> <li>Interacting with the public</li> <li>Persuading outcomes</li> <li>Training</li> <li>Developing teams</li> <li>Applying knowledge</li> <li>Strategizing</li> <li>Thinking creatively</li> <li>Solving problems</li> <li>Assisting/caring for others</li> <li>Judging quality</li> <li>Conducting complex physical movements</li> </ul>

Source: Vanguard.

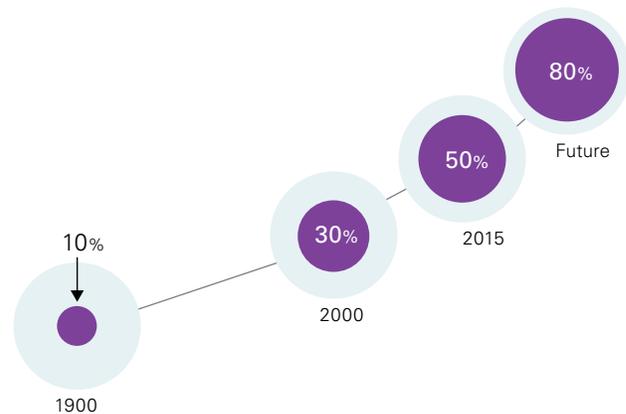
We can, however, glean some insights from the past into how technology affects the nature of industries and jobs. Tasks that are repeatable and scalable and that do not involve uniquely human creativity or critical thinking are most susceptible to automation. And that’s usually a good thing. Think of the factories of the past in which employees often worked long hours doing repetitive and sometimes dangerous tasks. While many of those jobs have been automated away, other jobs have been created to manage, design, and analyze the manufacturing processes.

This technological evolution is gathering momentum and is affecting industries and workers’ efforts differently, according to a Vanguard analysis of Labor Department data. As noted above, basic or repetitive tasks are most vulnerable, while those that rely on the creativity and adaptability of the human mind—arguably the greatest supercomputer yet developed—might be more resilient (Figure 2). In fact, these advanced tasks are more likely to harness and benefit from technology’s advances than be replaced by them.

In 1900, the typical worker spent only 10% of the workday on advanced tasks such as relationship management and problem solving, with the remaining 90% spent on basic or repetitive tasks such as gathering information

(Figure 3). (In 2000, workers still spent just 30% of their time on advanced tasks.) By 2015, as workers harnessed productivity-enhancing technologies, the proportion of the workday spent on advanced tasks rose to 50%. That figure is sure to rise in the decades ahead.

Figure 3. The work of the future will be dominated by advanced tasks



Sources: Vanguard estimates are calculated based on data from McKinsey & Company, the U.S. Bureau of Labor Statistics, and the U.S. Department of Labor O\*Net OnLine.

Financial advice has undergone the same transformation, with technology liberating advisors to devote more time to advanced tasks. While the personal digital assistants of the recent past have been obsolesced by more effective and capable software to aid with client relationship management, the architect of the client relationship—the advisor—remains. And, while there is nothing physically dangerous about, say, manually rebalancing a portfolio, a technological surrogate to help with the task allows an advisor to allocate his or her time elsewhere. Again, that is a good thing.

It is easy to view technology as a threat, but it does not have to be. It also does not mean advisors can ignore it and risk going the way of Blockbuster.<sup>2</sup> Advisors who embrace technology and adapt to the new environment can choose to be Netflix instead. Vanguard, through its Advisor’s Alpha work, has been urging advisors for many years now to redefine their value proposition away from solely managing their clients’ portfolios. That message is even more important today. Take a look at the table below (Figure 4) from Vanguard’s framework for quantifying the value of advice. One could argue that six of the seven common opportunities to add value are now automated in some fashion, with the exception of behavioral coaching.

For many key decisions, people rely on past performance or expert testimonials to aid in decision-making. The past-performance heuristic may serve us well in many aspects of our lives—choosing a restaurant, car, or even a surgeon—but it is a generally unproductive way to choose investments (Kinniry et al., 2016b). Changing this ingrained decision-making process and human behavior is difficult, but can provide a valuable opportunity to both educate the client and potentially improve the investment results for the client’s portfolio. This is one reason we believe that human advisors and behavioral coaching will not be obsolesced by technology.

We are fairly certain that technology will not soon be building deep, trusting relationships, and this insight establishes the foundation for valuable behavioral coaching efforts with clients. We do not know for sure how it will happen or what particular software or company will drive the transition, but technology will reduce the time an advisor spends not just on routine administrative tasks but also on much of what advisors have traditionally defined their value propositions around. Whether it is embracing an existing robo advisor platform, firm-level software, or even a simple spreadsheet, expect technology to become more pervasive. The only thing we know with

**Figure 4. Vanguard quantifies the value-add of best practices in wealth management**

Vanguard Advisor’s Alpha strategy	Moving from the Vanguard Advisor’s Alpha methodology Typical value added for client (basis points)
Suitable asset allocation using broadly diversified funds/ETFs	> 0 bps*
Cost-effective implementation (expense ratios)	40 bps
Rebalancing	35 bps
Behavioral coaching	150 bps
Asset location	0 to 75 bps
Spending strategy (withdrawal order)	0 to 110 bps
Total-return versus income investing	> 0 bps*
<b>Total potential value added</b>	<b>About 3% in net returns</b>

**Notes:** \*Value is deemed significant but too unique to each investor to quantify. We believe implementing the Vanguard Advisor’s Alpha framework can add about 3% in net returns for your clients and allow you to differentiate your skills and practice. The actual amount of value added may vary significantly, depending on clients’ circumstances.

**Source:** Vanguard.

For details on our calculations, see the Vanguard research paper *Putting a Value on Your Value: Quantifying Vanguard Advisor’s Alpha*, which can be found on our website for financial professionals, <https://advisors.vanguard.com>.

<sup>2</sup> Blockbuster was a chain of American-based home movie and video game rental stores that famously failed to adapt to the threat from video streaming on-demand services and was forced to file for bankruptcy in 2010.

absolute confidence is that technology will exist in the not-so-distant future that we cannot even imagine today. Just like smartphones a short decade ago.

### A look ahead: The evolution of the advisory offerings

The drivers we just discussed should lead to advice offerings that are more transparent about both costs and the degree of fiduciary obligation, as well as to a broader range of choices for accessing advice. From fully digital to full service, the future will bring a wide range of advice services to people in a cost-effective manner. We illustrate this breadth of advice choices or service offerings in what we think of as the *efficient frontier for advice services* (Figure 5).

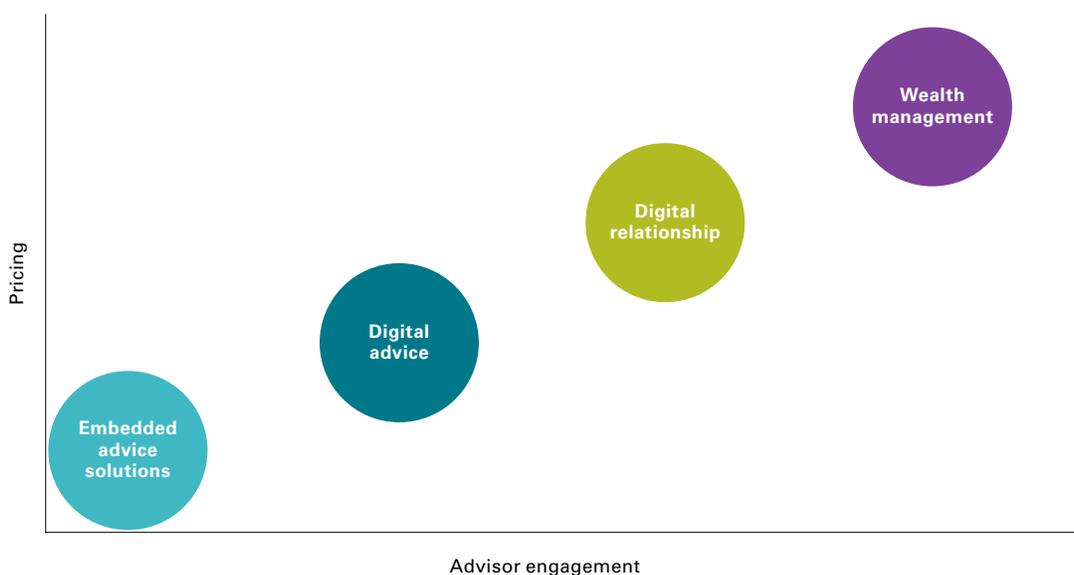
We provide this illustration to help frame the discussion about the breadth of potential advisory offerings; we don't suggest that the offerings are limited to these four models. In fact, in the future, we expect that advisory firms and advisor teams will likely offer a combination of the models along our frontier to accommodate a greater range of client preferences for services and fees. Some, however, may choose to specialize in just one advice model. And, as we discuss later, it is very possible that fees for advice will decline (though margins may be

preserved) while demand for advice increases. This makes it imperative for advisors and advisory firms to consider the opportunities and implications of lower-price, lower-advisor-engagement-oriented services. As long as advice services and pricing are appropriately aligned, opportunities exist across the frontier for firms willing to pursue them.

This frontier for advisory offerings is framed by two critical considerations: the level of engagement by the advisor(s) and the price of the service or product provided. While the pricing component is fairly straightforward, this concept of engagement requires some explanation because of the way we define "advice."

In our view, advice need not be delivered by an advisor, but might be defined as an *embedded advice solution*, an investment philosophy embedded within a product or service. A target-date fund is one example. In this case, a firm or advisor might be involved in the construction, management, or selection of the target-date fund/product, but thereafter may have little or no involvement with the client until the client's preference or circumstance changes. Given the vast efficiencies of this "one-to-many" service offering, the lower relative price should be commensurate with the lower expected engagement, resulting in modest, yet profitable, opportunities.

Figure 5. The efficient frontier for advice services



Source: Vanguard.

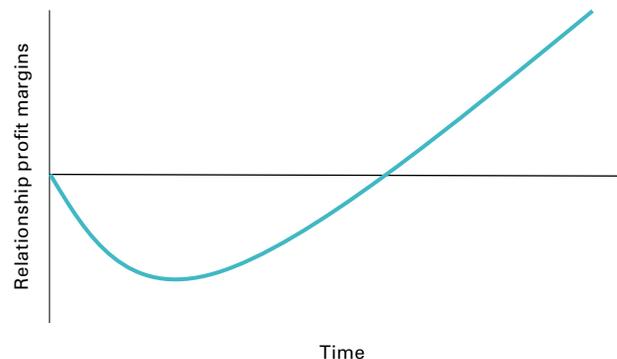
We think of *digital advice* as an offering involving a modest degree of personal (yet not necessarily face-to-face) engagement. “Robo advice” services offered by a variety of companies are an obvious example of this model. Providing a standard array of financial advice—asset allocation, rebalancing, and portfolio construction services—for a very low fee has, in the opinion of some, begun the process of efficiently scaling many of the foundational tools of financial planning. Similar to embedded advice, digital advice offers the opportunity to provide many aspects of financial planning, as well as low (human) engagement, while being priced lower than subsequent offerings.

A *digital relationship* might be thought of as a hybrid advice model, involving active engagement by an advice professional and relying heavily on technology for communications with clients as well as for portfolio management. It also relies on a client’s acceptance of and/or preference for face-to-face communications via electronic meetings or videoconferences, rather than the traditional person-to-person meeting. Again, more dedicated time from an advice professional should justify a higher service fee, but the higher costs and time limitations may make the profit margins on this service model less attractive than they might seem at first glance. Achieving the right price/engagement balance for this service model is imperative for the advisor or firm.

Finally, *wealth management* is most similar to today’s traditional full-service advice model and encompasses not only asset management and basic financial planning but also tax, estate, insurance, and other specialized services. This is an admittedly broad categorization that might include everything from a wirehouse team or financial planning firm to a family office, with diverse fee levels and services provided. Even here, wealth managers should embrace technology to gain the efficiencies needed to provide more time for higher-value, less scalable activities. Given the relative lack of scalability in this high-engagement service model, wealth management generally corresponds to the highest prices.

The goal in all of these models is to cultivate long-term relationships that can help clients meet their goals and help advisors build successful practices. The key difference among the models is the advisor’s level of engagement, and thus the cost to serve.

**Figure 6. The keys to profitability are time and retention**



Source: Vanguard.

In the first years of a client relationship, as illustrated in the J-curve (Figure 6), the high costs of onboarding can make a client unprofitable. If price and engagement are properly calibrated, however, an advisor soon recoups the costs of onboarding and generates attractive profit margins. The longer a client’s tenure, the more profitable the relationship becomes.

### A look ahead: The evolution of the advisory practice

The efficient frontier for advice that we just discussed can help serve as a framework for evaluating some of the challenges of building advisory practices to compete for investor relationships in the future. First, with the wide variety of models that might be offered, should advisors offer all, some, or just one of these structures? Second, how might an advisor think about advice fees and operating efficiencies in the future? And finally, what might be done to help free up the time an advisor needs to deliver a truly personal client experience?

The advice models in Figure 5 tend to appeal to clients in some generalized circumstances. Younger investors just beginning to build wealth tend to favor the offerings toward the very left on our advice frontier, while clients with more assets and more complicated financial circumstances tend to favor the far right. But a fairly large and less easily defined client cohort is finding the middle of the frontier appealing, too. These moderate-engagement models—

which benefit strongly from technological improvements that streamline client onboarding, financial plan creation, portfolio construction, and ongoing portfolio management—should be viewed as an attractive opportunity area.

Traditionally, advisory practices have tended to favor wealth management practice models, preferring the higher fees and greater opportunities for value-added services that are associated with wealthier clients. In many ways this makes sense, as the efficient frontier of advice closely follows the opportunities for advisors to add value as outlined in Figure 4. Building cost-effective portfolios and rebalancing them tends to provide a lower relative value opportunity and might align best with the embedded advice or digital advice models. Higher added-value services, such as customized retirement income strategies and behavioral coaching, will probably be most effective where there is greater advisor engagement (as in the digital relationship or wealth management models) and should be less prone to technology-enabled advice substitution.

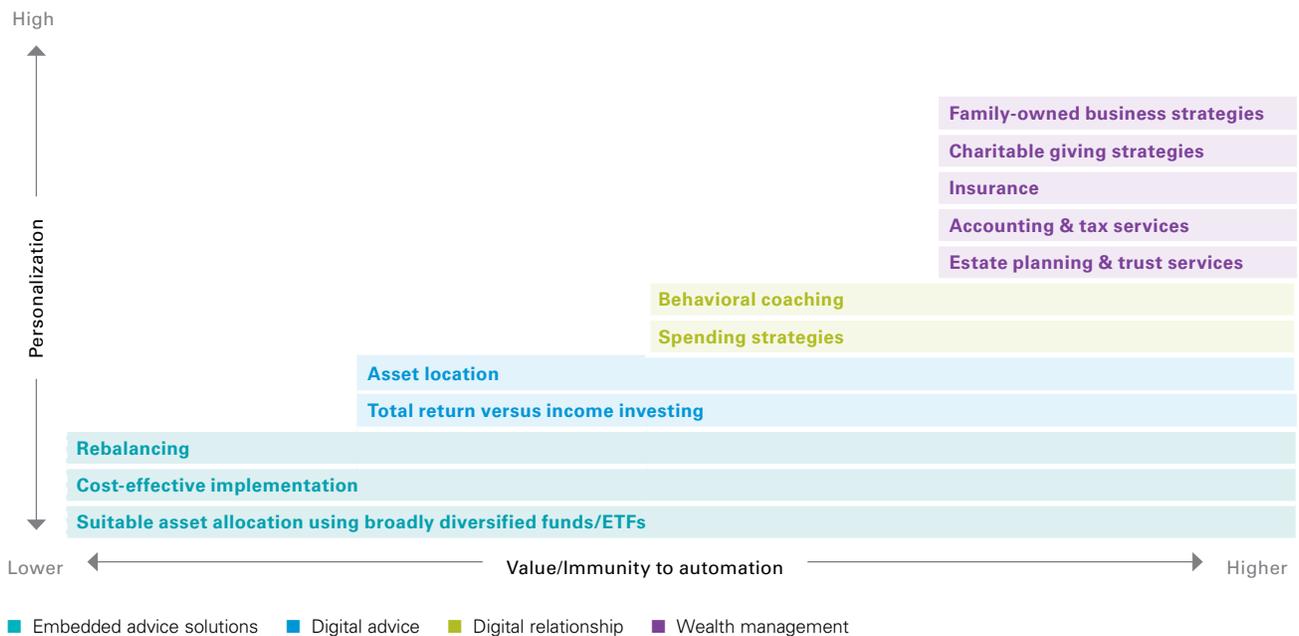
There may also be other opportunities that are unique to the client’s circumstance and tend to correlate positively with wealth. Estate, tax, and charitable planning, as well

as business succession/sale planning, are some of the areas where advisors could apply more specialized skills and provide a differentiated degree of value. Pricing advice services relative to the potential value-added opportunities and advisor engagement should be an important consideration if the future of advice is as competitive as we expect it to be.

Providing a greater variety of advice models enables an advisor to best satisfy the preferences of the investors who are likely to become a firm’s wealth management clients of the future. Otherwise, by the time a client builds enough wealth to make him or her a more ideal wealth management prospect, the client may already have built a relationship with a competitor. Figure 7 looks at these considerations from a different perspective. While technology may create opportunities to deliver advice more broadly and inexpensively, the increased personalization that some wealth management advice requires means the advice is more immune to automation.

While broadening advice models may be more of an option for an advisory firm than for an advisor working for a firm, there may be opportunities for advisors to

Figure 7. Not all advice can be automated



Source: Vanguard.

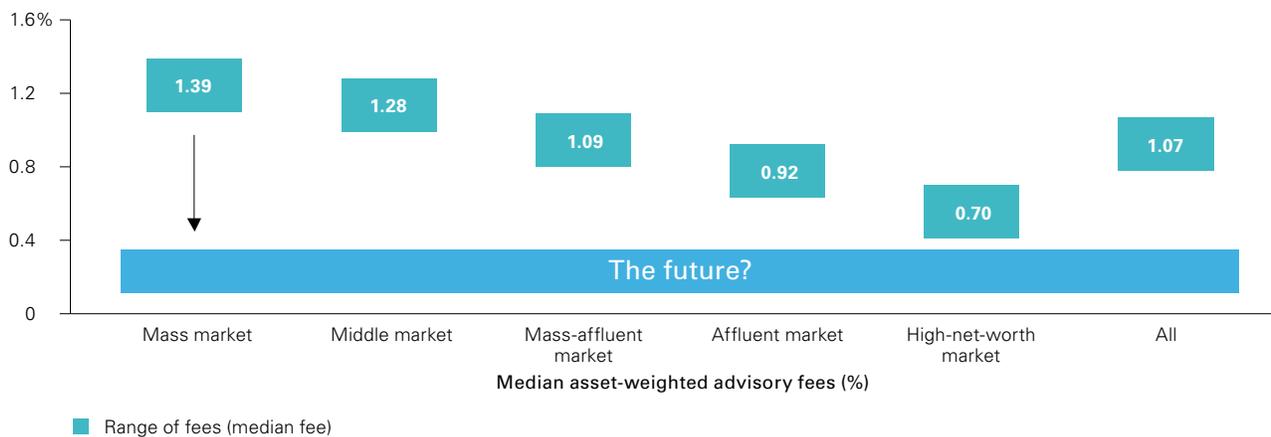
tailor their practice to provide for a greater flexibility in advice. For example, advisory teams are common and the benefits are obvious: They can add diverse skills to facilitate a broader range of advice services, as well as more time to accommodate a larger number of clients. It is one reason that we expect advisory teams to dominate advice in the future. It also provides the opportunity to add more diverse personalities. This is an often overlooked aspect of team-building but one that helps teams achieve a good advisor fit for a client—often, an important step in relationship- and trust-building. And, larger, more diverse teams provide the opportunity for more comprehensive succession planning, benefiting both teams and firms alike.

The rapid expansion of investment products and strategy offerings has contributed to the choice overload that has led many investors to seek help from advisors. However, choosing an advisor can be a challenge unto itself, as the variety of advice offerings and fee differentials makes the value proposition for advice more difficult than ever.

By our estimation, the average annual fee<sup>3</sup> paid to advisors is 1.07% (Figure 8). Does that mean that a firm offering advice for 0.5% is a better value? Not necessarily, as value is very subjective and reflects not only the cost of the service but also the services an investor receives. This is why investors shouldn't focus only on advice choices that charge the least or on choices that offer the most advice and planning services. They should focus on both and balance each of these considerations with their unique circumstance. And it is incumbent upon advisors to clearly communicate their value, which can be considerable over the course of a relationship and yet may not be made explicit by a client's performance statement.

That said, the future is likely to be shaped by a lower advisory fee world. The environment will likely be one of "doing more for less." This is common for a maturing industry. It may be fitting that the industry responsible for providing some of the catalysts for efficiencies and lower advisory fees is the industry that itself is one of the best

Figure 8. Fee compression is a reality



Notes: Advisory fees are reported by account size, rather than core market. For calculation purposes, we matched each core market to the closest account size. Mass market is \$100,000; middle market is \$300,000; mass affluent market is the average of \$750,000 and \$1.5 million; affluent market is the average of \$1.5 million and \$5 million; high-net-worth market is \$10 million.

Sources: Vanguard calculations using data from Cerulli Associates.

3 This is asset-weighted to better reflect the "average fee" paid per dollar for advice.

examples of doing more for less—technology. Today’s personal computers are far more powerful and inexpensive than computers of only a decade or two ago and so, too, are their components. Companies, regardless of their industry, need to adapt and evolve or face extinction. Darwinism is a powerful force in capitalism.

In our view, if advisory fees decline, then both operational efficiencies and scale become more important, as does client retention. While fee compression seems to be the principal concern in our industry, *cost* compression should be the solution. Streamlining operational tasks such as onboarding clients, as well as some portfolio tasks (e.g., rebalancing), frees advisors and their teams to provide other, more highly valued services and client touchpoints utilizing the advanced skills shown in Figure 2.

While technology is the most likely catalyst for change in streamlining these efforts, an effective use of a team’s personnel may be a more appropriate, productive, and immediate solution. For example, the typical advisory team comprises a variety of skills and experience levels. Taking a page from the triage model used in medicine, while one professional may determine that a patient needs surgery, another professional may perform the surgery. And, if the circumstance requires an even more specialized degree of experience and skill, a different surgeon entirely may perform the procedure. In the financial advisory business, this same triage might enable one professional to conduct the client onboarding and initial assessment, another to prepare the financial plan, and a third to help with insurance, estate, or tax planning.

Less experienced advisors are often tasked with helping clients with smaller assets and less complicated needs. These efforts may be more effective and scalable when paired with the digital relationship or digital advice models we discussed earlier. Typically, these clients are early in their investing efforts, have more straightforward needs such as increasing contribution levels or reducing debt, and can benefit from the behavioral coaching that an advisor can provide.

Many firms or investment platforms provide a wide variety of model portfolio solutions, so it is easier than ever to match a portfolio with a client’s objectives in a personal yet efficient manner. The benefits are clear for both clients and advisors: Less wealthy or younger clients who are often underserved gain the investment and behavioral coaching they want, while younger advisors gain experience and add value by building relationships with clients who might otherwise escape the attention of the advisory team.

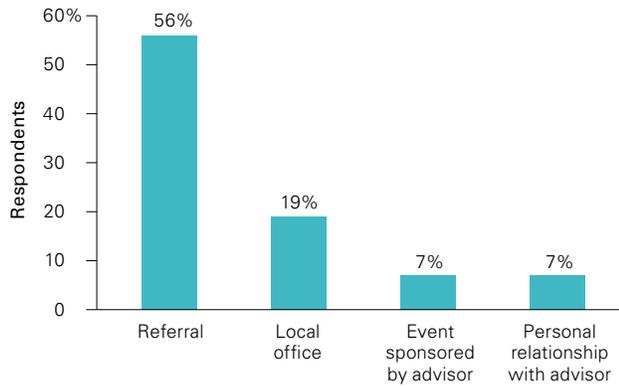
### **A look ahead: The evolution of the advisor**

The investment advice industry has already evolved in many ways, but perhaps none is more significant than the transition from commission-based compensation to an asset-based fee structure. The fact that such a large portion of the industry has voluntarily embraced fee-based compensation is encouraging. As a result of this transition, asset gathering and retention, rather than transactions, should be the focal point for a successful practice, as the advisor’s upfront investment of time in the client relationship takes a longer time to recoup, compared with the commission-based model. And improving asset gathering and retention depends largely on a focus on relationship management—particularly, the level of trust that a client has in the advisor—rather than portfolio management.

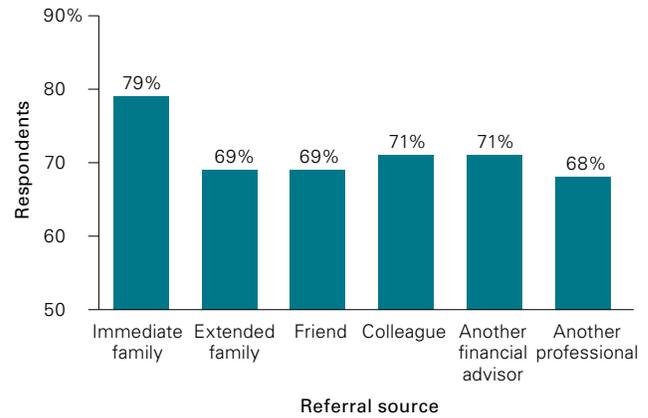
This is in no way meant to denigrate the investment knowledge and experience that an advisor can provide to investors. In fact, it is a recognition of the value of those skills when they’re applied where they can make the greatest difference: client relationships. Advisors can guide their clients to improve their investment outcomes by helping them better understand an all-too-common reality: Investment “failure” results more often from not keeping pace with the returns from asset class beta than not successfully capturing alpha. The paradox of skill and zero-sum game illustrate how difficult it is to successfully deliver excess returns, meaning that a value proposition based on investment outperformance has a reasonably high probability of resulting in disappointed

**Figure 9. Relationship management is business development**

a. How current advisor was found



b. Likelihood of selecting an advisor, based on referral source



Sources: Vanguard and Chadwick Martin Bailey.

clients. By applying their knowledge and experience to relationship-oriented efforts, such as behavioral coaching, advisors improve the probability of satisfying clients.

It is tempting to equate relationship management with customer service. And, while the association is partially correct, it is an incomplete picture of relationship management and the scale of the benefit if done well. *Relationship management is business development.*

Our Advised Investor Insights<sup>4</sup> research can help illustrate this more clearly. Nearly 4,000 individual investors were surveyed, and, when asked how they found their current advisor, the majority said they were referred to the advisor (Figure 9a). This response is not likely to surprise many advisors, as the importance of referrals in building a practice is well-recognized. In fact, increasing the number

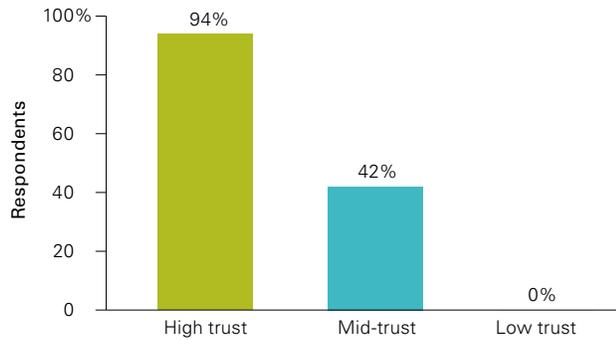
of referrals they receive is a top priority for many advisors. However, the magnitude of difference between finding an advisor through a referral and finding one through other common means (as shown in Figure 9a) is quite significant and worth consideration.

Often, the solution to this issue focuses on improving the sources of referrals (centers of influence). As we can see above, with the possible exception of a referral from an immediate family member, the source of the referral is less important to investors choosing an advisor than the fact that they were referred to the advisor in the first place (Figure 9b). And, while this is not shown in Figure 9b, an average of 78% of respondents in our survey reported that they selected the advisor they had been referred to.

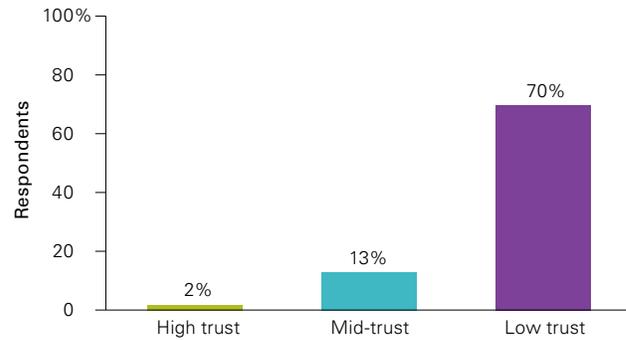
<sup>4</sup> Vanguard’s Advised Investor Insights is an ongoing, proprietary research series that provides actionable insights on investor behavior.

**Figure 10. Trust motivates referrals and drives asset retention**

a. Extremely likely or likely to offer referral



b. Extremely likely or likely to switch advisors



Sources: Vanguard and Chadwick Martin Bailey.

Given the very high conversion rate of referrals into clients, what should advisors focus on to increase their chances of gaining a referral? In a word, trust. Respondents in our research indicated that, when they highly trusted their advisor, they were “extremely likely or likely” to refer them to others (Figure 10a). Now this, too, may not seem like a groundbreaking conclusion, but, again, the magnitude of the differential is most notable: Clients who *highly* trust their advisors are more than twice as likely to refer their advisor as those who have more modest levels of trust in them. To maximize the chance of being referred by clients, and, just as critically, to retain the clients they already have (Figure 10b), advisors need to achieve a very high level of trust and that is likely to require both their time and attention.

So what can advisors do to increase the levels of client trust? Unfortunately, there is no simple answer: Client relationships are complicated and what builds trust with one client may not work as well with others. Our research suggests that higher levels of trust are associated with longer-term client relationships, which makes sense. But what can advisors do to help retain clients long enough to establish high levels of trust?

Perhaps a better understanding of the components of trust can help. “Trust” means different things to different people (Figure 11). An ethical framework (in which clients believe advisors are “acting in my best interests”) or a functional framework (in which clients believe their advisors do “what they say they will do”) are often the

**Figure 11. The components of trust**



Source: Vanguard.

first definitions that come to mind. But the emotional component (peace of mind) is often underappreciated. The impact of the emotional component is clear, based on our Advised Investor Insight data—53% of respondents listed the emotional component as the most important component of trust in their advisory relationship. And certain emotions lead to both higher levels of trust and quicker attainment of it. To drive trust in their relationships, advisors should make sure that clients feel valued, that they are respected, and that their objectives and feelings are understood.

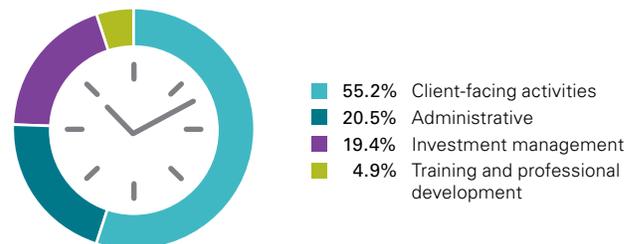
Care should be taken not only with *what* is said but also *how* it is said if advisors want to send the right message to clients. To help convey to clients that they are valued, advisors should make clear that they are extremely conscious of what clients value most. For example, asking, “How are Judy and Jimmy?” says something entirely different about your familiarity with a client’s family than simply asking, “How are the kids?” For many clients, their greatest treasure is their family. Similarly, saying that you speak *with* clients rather than *to* them may send the message that you will work with them as a respected partner, rather than as a novice. Little nuances can make a large impression, and speak volumes.

Generally speaking, trust must be nurtured opportunity by opportunity, and that takes time. For the typical advisor, however, time is in short supply but high demand. The level of an advisor’s expected engagement that we discussed earlier is an important consideration, as it directly affects the time an advisor has available for clients. This, in turn, affects the total number of clients an advisor can take care of effectively.

So how might the average advisor free up more time for clients? The good news is that advisors already seem to spend most of their time engaged with their clients (Figure 12). However, a meaningful amount of time is still spent on efforts that might be handled effectively—possibly *more* effectively—by means other than an advisor’s direct involvement. For example, fully one-fifth of advisors’ time is spent on administrative tasks, defined in a survey by research firm Cerulli Associates as office administration, management, and operations, as well as compliance and other similar tasks. That’s about eight

Figure 12. Time is an asset to be invested

Advisor time allocation by activity



Source: Cerulli Associates, US Advisor Metrics 2016.

hours out of a 40-hour workweek. While it’s unreasonable to expect that advisors can divorce themselves from all administrative tasks, is it unreasonable to expect that a prudent use of time, staffing, and perhaps technology might help the typical advisor recapture half that time? How many client or prospect connections could be made with four additional hours each week?

Similarly, while advisors should not divest themselves of all investment management responsibilities, they may have some good alternatives to building and maintaining client portfolios security by security. Here again, technology may be useful, but a simpler answer may be a change in investment philosophy. Today, many firms and platforms provide managed solutions that warrant consideration, such as ETF model portfolios and separately managed accounts. Managed solutions exist to fit most investment strategies and, as a result, should not be viewed as impersonal, generic portfolios (as they too often are) as long as the advisor matches the managed solution to the client’s circumstances.

Advisors in the Cerulli survey reported that they spend nearly 10% (included in investment management in Figure 12) of their time on research and due diligence. That’s nearly another four hours a week. If advisors combine those time savings with the time saved on administrative tasks, several dozen more value-added client opportunities each month should be possible.

### Cultivating—and preserving—client trust

Our Advised Investor Insights indicate that “being the client’s advocate” and “acting in the client’s best interest” are the most important drivers of trust. Clients most often lose trust in their advisors because they “did not pay enough attention to me or my portfolio.”

These survey responses suggest possible strategies for cultivating—and preserving—client trust.

**Be the client’s ally and advocate:** When evaluating investments, many clients rely on a mental shortcut, or “heuristic,” that works well in other purchase decisions: past performance. In investing, however, past performance is an unreliable guide to the future. Skillful coaching and communication can help clients adopt a more productive approach. Some tactics:

- Reframe the investment objective as meeting long-term goals, not exceeding an arbitrary performance target.
- Educate as an ally. Acknowledge that both you and the client are subject to the same behavioral biases and stimuli that can lead to counter-productive behavior. Explain how research and experience have taught you that a focus on goals, rather than performance, is the basis for a successful plan. (See Kinniry et al., 2016b).

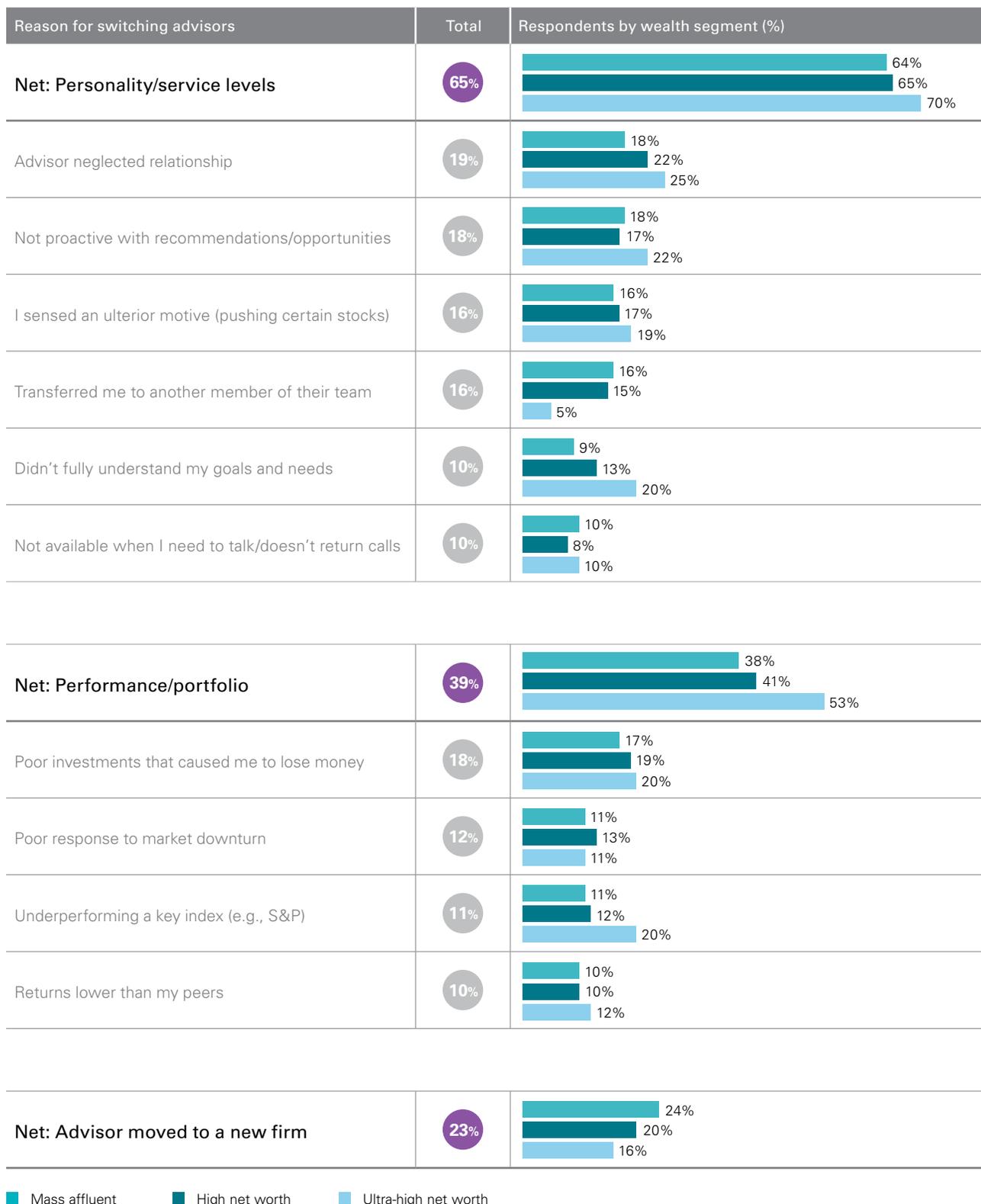
**Act in the client’s best interest:** An understanding of client costs and profitability may suggest novel ways to demonstrate commitment to the client’s interest. Long-tenured clients, for example, are generally the most profitable. If a firm has the flexibility to offer one, a longevity discount can serve as an incentive for clients to remain in the relationship and a demonstration of the alignment between the client’s interests and yours.

Time is a finite resource, an asset to be invested, not spent. This factor should not be considered casually: Clients across various wealth cohorts have indicated that a primary reason they switched advisors was the perceived lack of time and attention they received from their advisor (**Figure 13**, on page 15). Clients are asking for more of their advisors’ time, not less.

As Figure 13 also illustrates, while clients do not ignore performance, it may not be as significant a factor in client retention as many advisors believe. It is understandable that, after investing so much time in themselves as investment professionals, many advisors believe this to be the source of their value-add. However, we believe that advisors’ value propositions should be based foremost on their relationship-management capabilities, which are too often underappreciated (Kinniry et al., 2016a). Much of an advisor’s investment knowledge is based on experience and judgment, a valuable resource for decision-making as well as behavioral coaching. As a result, reallocating time from portfolio construction-related tasks to relationship management seems to be a very prudent investment indeed.

The conclusions from Figure 13 may contrast sharply with the perceptions of advisors, who reported that performance was very often the factor that motivated clients to move to another advisor (Vanguard, 2016). We believe the majority of advisors want to serve the interests of their clients to the best of their ability. However, this disconnect between perception and reality—clients prioritizing relationship management over portfolio management—creates an unprosperous circle: The more time advisors spend on portfolio- or performance-related tasks, the less time they have for client relationships, which suffer as clients feel neglected.

Figure 13. Clients are evaluating their advisor’s performance more than their portfolios’



■ Mass affluent   ■ High net worth   ■ Ultra-high net worth

Sources: Vanguard and Chadwick Martin Bailey.

## Conclusion

Changes to the advice industry in the future are inevitable. The forces spurring these changes—regulations, fees, and technology—should benefit both advisors and their clients, rather than result in an Orwellian dystopia. Regulatory efforts to clearly define an advisor’s level of responsibility for a client’s best interests should increase investor confidence and perhaps encourage many more investors to seek advice. While attention to fee transparency and investment costs may result in fee compression, the efficiencies and benefits of cost compression and time management should allow firms to remain competitive and profitable. The trend toward technologically enabled advice is both friend and foe, bringing an increased opportunity for firms to profitably serve a larger number of clients and deliver Advisor’s Alpha even as it brings to the market potentially more competition for advised clients.

Ultimately, clients decide the value of advice and, as our Advised Investor Insights research reveals, they clearly value and reward an advisor they highly trust. To establish this level of trust takes time and a concerted effort from an advisor, and time is a limited resource. However, advisors have a number of tools and strategies to better use what time they have: They can use technology-enabled efficiencies to streamline client onboarding, portfolio construction, and ongoing management; form advisory teams to capitalize on the diverse skills and increased capacity to serve clients well; and use every contact with clients as an opportunity to make them feel valued, respected, and cared for. Advisors must judge for themselves the best use of their limited time, but the profits from allocating more time to their client relationships may be unsurpassed by other efforts.

As illustrated by our Advisor’s Alpha flywheel (Figure 14), the industry evolution that we’ve described in this paper creates a virtuous circle, benefiting both clients and advisors alike. With this outcome in mind, who could be so pessimistic as to believe that the future for the advice industry is not a bright one?

Figure 14. Vanguard Advisor’s Alpha flywheel



Source: Vanguard.

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