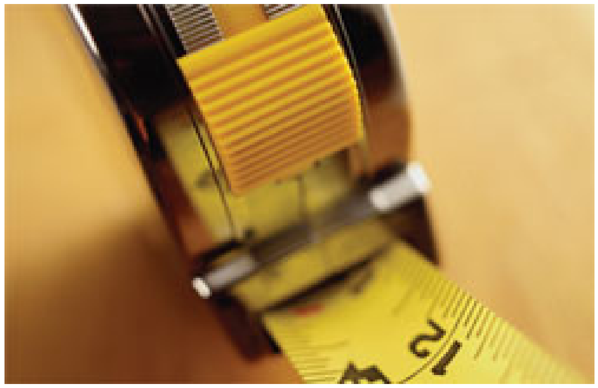
Financial Planning
INVESTED IN ADVISORS



How to Calculate an Advisor's Value

by: Allan S. Roth

How can you quantify smart financial advice? And more important: How do your clients do so? A new Morningstar approach may help advisors put a value on their performance.

In the wake of alpha, focused on picking individual managers, and beta, which looks at how much systematic stock market risk to take, researchers at Morningstar have devised what they're calling gamma to quantify the benefit planners can deliver to clients.

Gamma is defined as the additional value achieved by an individual from making more intelligent planning decisions. According to Morningstar, planners can add the equivalent of a 1.82% annual arithmetic return to clients through five components of gamma. Over time, that can translate to nearly 29% more that clients can spend in retirement.

Morningstar research executives David Blanchett and Paul Kaplan list five components of client service that make up gamma.
(The table below spells out the payoff Morningstar expects from each element of its calculation.) None of these should come as much of a surprise to a good planner:

* Total wealth asset allocation
* Tax efficiency
* Dynamic withdrawal strategies
* Annuity planning
* Liability-relative optimization

If one or two of those terms seem opaque, you're not alone, so below are details on the actions and services planners should be providing to clients in each of the five areas, as well as a few others.

CALCULATING GAMMA

Gamma Component	Income Generated	Equivalent Alpha
Total Wealth Asset Allocation	6.1%	0.38%
Asset Location and Withdrawal Sourcing	8.2%	0.52%
Dynamic Withdrawal Strategy	8.5%	0.54%
Annuity Allocation	3.8%	0.24%
Liability-Relative Optimization	2.2%	0.14%
Total	**28.8%**	**1.82%**

Source: Morningstar

1. TOTAL ASSET ALLOCATION

Determining how much equity risk a client should take is a key service advisors provide to clients. Although advisors often use risk profile questionnaires to do so, these types of surveys have two critical problems.

First, the way people feel about risk is not stable, and varies with market conditions: When the market is up, clients forget the pain of past plunges, such as the meltdown of 2008 and early 2009, and feel they can accept more risk. The dynamic reverses when markets tank. Suddenly, the market has become the Titanic and clients run for the lifeboats of cash.

This behavior may explain why many studies demonstrate that investors' dollar-weighted returns lag fund returns by about 1.5%annually. Investors chase returns like heat-seeking missiles, locking onto the hottest asset class. Don't assume advisors are much better; research shows they chase returns, as well, although many claim they are only carrying out the wishes of their clients.

The second problem with risk profile questionnaires is they don't measure a client's need to take risk. The purpose of a portfolio is to support your clients' desired lifestyle, not to have them die and become the richest people in the graveyard. Thus, for example, if your clients have already won the game and no longer need to take risk, they needn't take it - even if they have a willingness or desire to.

I tell clients that picking an asset allocation is important, but committing to it is even more important. Princeton psychologist Daniel Kahneman won the Nobel Prize in economics for his work in behavioral finance - more specifically, on prospect theory, which asserts that losses hurt much more than gains feel good. You can apply this theory by helping clients pick a portfolio that tilts toward the conservative side of their allocation range.

For example, in working with a client, you may determine that both tolerance and need for risk dictate an allocation of 40% to 50%to equities. But with Kahneman's research in mind, consider recommending 40% rather than the 45% midpoint. Picking the lower range will make the client feel less pain the next time stocks tank - and be more willing to stay committed to rebalancing the portfolio by buying more equities. Doing so can make their dollar-weighted returns exceed fund returns.

2. TAX EFFICIENCY

Here's a reminder to clients: Investing may be simple, but taxes aren't. After the asset allocation has been selected, it's crucial to locate the assets and source withdrawals in a way that minimize taxes.

In general, stocks and low-turnover stock funds are best located in the taxable accounts, while investments taxed at the highest ordinary income rates belong in the tax-advantaged accounts, such as IRAs and 401(k)s. The decision of what to place in Roth accounts is more complex and depends on other factors. You can add value by converting tax-deferred assets into tax-free Roth assets through multiple Roth conversions with possible recharacterizations. This essentially allows clients to buy out the government's share of tax-deferred assets and, if those assets perform poorly, hit the "undo button" and have the government buy back its share at the original, undiscounted price.

Finally, sourcing the withdrawals is key. A rule of thumb is to use taxable assets first, tax-deferred assets second and Roth assets last. But if the client is in a low tax bracket now but will jump two or more tax brackets later, it may well make sense to pay some taxes sooner at a lower rate.

3. DYNAMIC WITHDRAWALS

How much money can your clients spend safely without running out? Should it be chosen using a 10% chance of failure, or a 25%chance?

Morningstar itself has said that, because of low bond yields, the old 4% rule has become a 3% rule. That means for every $100,000 in a portfolio, it considers the new safe spend rate to be $3,000 annually, increasing with inflation.

In reality, picking the safe spend rate is also related to the prior two components - selecting the right asset allocation and achieving tax efficiency. Advisors must minimize both investment expenses and client emotions in order to achieve the highest safe spend rate from a portfolio.

Moreover, these safe spend rates must be somewhat flexible. If stocks lose half their value again, clients may have to accept that, at least temporarily, they might need to reduce spending. If you can help clients figure out in advance where they would cut spending if the markets tumbled, you allow them to more readily implement changes if their investments perform worse than the bad-case scenario.

4. ANNUITY PLANNING

One way to reduce the likelihood that clients will outlive their money is to annuitize part of the portfolio. Typically, this is done by purchasing a single premium immediate annuity that will pay out during the client's lifetime. This isn't income per se, since most of the payment is actually a return of the client's principal. Still, it can make sense in certain situations.

Without a doubt, the best single annuity option for any client - that is, the option that creates the higher monthly cash payment - is to delay Social Security. I often calculate the additional cash payment that clients would receive by delaying Social Security to age 70 from 66; it typically would cost almost 70% more to buy that same cash stream (as an annuity on the open market) than the client would be forgoing in those four years of benefits.

And certain Social Security options, such as file and suspend, allow a client's spouse to collect spousal benefits while the client's own benefit continues to grow.

5. LIABILITY-RELATIVE OPTIMIZING

This technique takes the asset allocation decision one step further by looking at clients' specific liabilities - namely, future cash needs.

At its most basic, it requires advisors to account for the potential for higher inflation or other shifts to real-world purchasing power. But it also maps a client's expected financial needs - a child's college funding, which would be tied to a specific time frame, for instance, or the need to develop real cash flow in retirement - against the assets needed to cover them. In retirement, for instance, traditional modern portfolio theory might come up with a portfolio with little to no TIPS, while a liability-relative strategy might use TIPS as the highest-weighted asset class to minimize exposure from potential inflation.

GETTING OTHER GAMMA

In a presentation at the Morningstar Investment Conference in June, Blanchett, the gamma researcher, noted that there were other sources of gamma. (Asked precisely how many, he quipped that there were at least 119 different areas.)

Among the most important ones:

* Risk management: Advisors can help clients with risk management by assessing their insurance needs and helping clients buy the right coverage at the right price. If the clients can sustain a loss without having it affect their lifestyle, self-insurance is typically the most cost-effective - say, having a higher deductible on a policy, or dropping collision coverage on a 10-year-old car. But for other clients, comparing insurance policies is anything but simple - and it is certainly one way financial planners can bring value to the table.

* Estate planning: Helping clients pass on money in the most efficient way is an essential value that planners add. Should clients gift money to their children now? Should they consider creating a 529 plan for their grandchildren? You can also help a client find the right estate planning attorney, and then work with that attorney to create a portfolio that is most efficient from an estate-tax perspective.

There are other pieces of advice advisors can offer to add gamma for clients: SHould they pay off their morgage or even get a reverse mortgage as a source for cash? Should they take a lump-sum defined benefit payout, or an annuity withor with a survivorship option? Can they truly afford the vacation home they've always wanted?

Blanchett admits that the five areas are all interrelated. For example, the safe withdrawal rate is impacted by the asset allocation and tax efficiency decisions. And gifting money to children may be wise, but could reduce the amount your client has to live on safely.

Blanchett doesn't necessarily suggest that advisors focus on the exact value of the gamma they offer. Yet whatever the figure, and whatever the term, the framework gives advisors a way to discuss the services they provide to clients.

That work can increase the cash that clients have to live on dramatically. Since money is essentially stored energy - allowing clients the freedom to do whatever they want with their lives - creating at least 29% more of this energy for clients is delivering great value.

Allan S. Roth, a Financial Planning contributing writer, is founder of the planning firm Wealth Logic in Colorado Springs, Colo. He also writes the Irrational Investor column for CBS MoneyWatch.com and is an adjunct faculty member at the University of Denver.