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Portfolio Management

THE BENEFITS OF A GOOD FINANCIAL ADVISOR: SIX SIMPLE CONSIDERATIONS

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Most financial advisors emphasize their ability to provide excellent customer service and coaching to their clients. Indeed, for many people who are unfamiliar with investing and don't have the time to track their finances having a professional who can handle all the paperwork, hold them accountable for saving enough, and prevent them from making simple mistakes under adverse market conditions can be very valuable.

Others, however, are more comfortable with handling the nuts and bolts of investing themselves and are more focused simply on getting a good return. Some are convinced that by holding a few index funds they can do as well, if not better, than any financial professional.

These people view a financial advisor skeptically, knowing that their fees will be a certain drag on performance with an uncertain prospect for superior returns. But setting aside the personal planning and operational services a financial advisor provides, there are several reasons to consider one from a pure portfolio management perspective as well.

Broader Market Exposure

Some intelligent observers, including many in academia, say that you should simply buy a stock index fund and hold onto it forever. "You can't beat the market" they say, so just buy the whole thing. To be sure, this is a better strategy than leaving cash in the bank on the one hand, or day-trading individual stocks on the other—two of the most common mistakes financial amateurs make. But depending on what your idea of what "the market" means, this could leave you

with a portfolio that underperforms for a long time. The S&P 500, the most commonly used benchmark of stocks for US investors, has had an overall negative total return for the first decade of the new millennium. Emerging market equities and bonds, meanwhile, posted double-digit annual returns.

Would you have known to include these in your portfolio? What about small-cap stocks? Real estate? Commodities? These are all part of the market, and can play an important part of a portfolio, but how much you will want to allocate to each is a question without a one-size-fits-all answer. A good advisor will consider both market conditions as well as your personal circumstances in arriving at a solution that works for you, and update it over time as both evolve.

Precise Rebalancing

A well documented phenomenon in finance is that if you buy and hold securities, the riskier assets will tend to increase their share over time, making the overall portfolio riskier. Of course, this is the opposite of what an investor generally wants, as risk tolerance generally declines with age and one approaches retirement. By regularly rebalancing the portfolio to target allocations you can significantly reduce portfolio risk while potentially enhancing returns. Research suggests that the benefits of rebalancing are optimized when the portfolio is checked biweekly and traded on when allocations drift 20% or more from their targets[1]. A good financial advisor will have the time and tools necessary to undertake this monitoring process in a rigorous and precise manner. Will you?

Harvesting Factor Premiums

While most academics consider the market to be more or less “efficient”—that is, it’s impossible to earn more money than average except by taking more risk—there is a large body of evidence showing that there are certain investment strategies, or factor premiums as they are called in the literature, that have earned superior returns compared to an index strategy over a wide span of time in multiple markets[2]. The value effect, short-term momentum, illiquidity, and carry trades are just a few examples of investment attributes that have delivered market-beating returns over decades. While no advisor can or will promise you investments that make handsome profits in all markets, a good one will tilt your portfolio towards these strategies—of which the average investor is typically ignorant—in order improve the odds that you will have a winning portfolio.

[1] Daryanani, 2008

[2] Clifford S. Asness, 2013

Better Fund Access and Trading Terms

Some of the best investment funds, including many that have done the best job of exploiting the factor premiums discussed above, are not available to retail investors, or require a huge initial investment of $1 million or more. As an institutional investor, an advisor can gain you access to a much wider investment universe, and often with lower associated expenses, a fact which pays for part of the management fee itself. Financial advisors are also able to make “block trades,” including multiple clients in on a single trade, spreading the often-ignored costs of market impact and bid-ask spread across accounts, reducing expense for all.

Tax Efficiency

Most investors know to load up on their tax-preferred accounts such as a traditional IRA. But the trade-off between maximizing returns and minimizing taxes is more complicated than most realize. Domestic vs. international stocks, plain vanilla vs. inflation protected vs. municipal bonds, commodity and other derivative strategies: these investments all have different tax treatment and may be better placed in certain account types and not others[3]. How do you know whether it’s best to sell a highly appreciated and overvalued investment to reinvest the profits and realize the capital gain or to hold onto it and delay the tax bill? A good financial advisor has the analytical toolkit available to make the best decision for you. Furthermore, fees paid to a financial advisor count as a tax deduction for most individuals.

Risk Optimization

Volatility and bear markets are an inevitable part of investing, and pulling money out at a market bottom, whether out of panic or necessity, can have a devastating effect on the portfolio’s ability to serve the investor’s long term goals. Beyond diversification and rebalancing, a good financial advisor will be adept in the use of statistical techniques such as mean-variance optimization, which involves analyzing how the securities in a portfolio are correlated with each other and then structuring the portfolio such that at any given time the gains in some investments are offsetting the losses in others. Research shows that portfolios of stocks optimized in this fashion have over the long run delivered roughly the same returns as an index like the S&P 500 without nearly as much of the downside risk associated with index investing[4].

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An excellent advisor will go a step further and consider your personal characteristics such as the industry and line of work you're in, where you live and whether your rent or own, etc. and factor that into the model, constructing a portfolio that's least likely to decline when you need it most, such as in the event you need to move or face a job layoff.

[3] Sue Stevens, 2006

[4] Roger Clarke, 2006

Works Cited:

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