Gamma

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Morningstar has published a research report that purports to show that a properly constructed financial plan can generate a meaningful increase in lifetime retirement spending. The value added from a plan is referred to as "gamma" following in the line of Greek letters being used to assess investment returns. The first Greek letter "alpha" is the extra-market return offered by active investment managers, and the second Greek letter "beta" is commonly used to refer to exposure to overall market risk and return.

The value added ("gamma") from a well-devised financial plan is estimated to be 29%. That is, retirement income is expected to increase by 29%. Translated into an annualized benefit, the value of the plan is 182 basis points per year, according to the authors' calculation[1].

The sources of additional value due to financial planning include a) taking into account the effects of human capital in establishing the asset allocation (which generally means a higher equity allocation when young), b) considering the use of life annuities to hedge longevity risk, c) substituting a dynamic portfolio withdrawal strategy, d) tax efficient portfolio allocations, and e) a liabilities driven process.

The Morningstar methodology is to simulate the outcome of a smart strategy and evaluate its performance against a base case consisting of a fixed equity allocation of 20% and a 4% portfolio withdrawal rule in retirement. The authors compare the income generated by their financial planning strategy as compared with that generated by the fixed rule.

Asset Allocation for Dummies

John Bogle, former CEO of Vanguard, has similarly reported[2] on the potential for improved financial performance. His approach is a little different in that he compares actual investment returns earned by retail investors with the market returns that were available to them through passively managed index funds (of which Vanguard is a major provider). Bogle has documented hundreds of basis points of return shortfall due to the combined effects of large fees, transactions costs, excessive trading and poor investment timing.

Bogle's comparison is actual performance of retail investors as compared to index fund performance. It is possible that the Morningstar and Bogle performance gains may be additive. That is, the financial planning strategy may be able to add value on top of passive investment in index funds. If so, there is the potential for many hundred's of basis points combined value added.

Is this reasonable, or has Morningstar, and Bogle as well, simply identified value added as compared to a straw man of their own creation?

Financial experts do not always agree on the best strategies. For example, some advisors promote passive strategies utilizing index funds while others prefer active management. Still, the old saying that the best is the enemy of the good may apply here. Even without identifying the very best solution, it may be that Bogle and MS are correct in their assertion that the strategies deployed by many if not most people today are clearly sub-optimal. In that case, there is a great opportunity to improve financial performance without necessarily resolving all disputes among the experts.

But there are pitfalls. At first glance, added value of 182 basis points per year is surely impressive. But then you have to ask how much of this gain do we need to pay in order to hire the financial planners to implement the strategy? Also, how do we know we have found competent advisors?

In order to realize this opportunity, Mom and Pop have to improve their financial decision making. While probably not feasible for everyone, the best solution is to become sufficiently knowledgeable about these issues that you can create your own plan, or be confident that you can hire the right people to help you do so.

Conclusions

The bottom line is that there appears to be a significant opportunity for individuals to improve their financial performance. But, this opportunity can easily be wiped out by excessive fees or mistakes. You need to find trusted advisors who add value in excess of their fees. But it is very hard to discern this in advance. The best way out of this box is for people to become more financially literate.

[1]David Blanchett and Paul Kaplan, “Alpha, Beta and Now … Gamma”, Morningstar, 2012.

[2]John Bogle, The Little Book of Common Sense Investing, Wiley, 2007.