CPFA's Quarterly Letter

Comprehensive Personal Financial Advisors, LLC **Third Quarter 2014**

Contact Info:
CPFA LLC
5299 DTC Blvd., Suite 320
Greenwood Village, CO 80111
303-770-0154

Firms like CPFA fully disclose their fees, so our clients know what they are paying for our services. However, the value of our services is often harder to measure. You may be familiar with the saying, "You can't measure a mistake that you are no longer making."

Vanguard recently published a study addressing the value of a financial advisor. This study identifies a series of best practices that can help guide an investor and prevent them from making bad behavioral decisions. CPFA has been applying these best practices since day one.

As your comprehensive professional advisor, we not only help close the gap of investment underperformance due to behavioral mistakes, but strive to create value through the wide array of coordinated services we provide. We hope that you will see how CPFA is involved in every aspect of the "Advisor Alpha" study prepared by Vanguard.

Quarterly Commentary

Third Quarter 2014

What is the Value of an Advisor?

Vanguard recently published a white paper titled "Advisor Alpha". "Alpha" is a term used to describe returns generated in excess of a market average. The premise of Vanguard's white paper was to attempt to measure the added value of ***high quality*** advisors over the average investor's performance. Vanguard did not take a theoretical approach in this study, but instead used data that was "real-world and quantitative in nature" to show that advisors who adhere to certain "best practices" had the potential to add significant value to their client's performance (about 3% per year).

We are pleased that Vanguard, a firm that caters to do-it-yourself investors, would undertake such a study. And we are also not the least bit surprised to see that the "best practices" that they identified are concepts that we have been practicing since day one at CPFA.

In past newsletters, we've mentioned that each year since 1994, Dalbar (a financial research firm in Boston) has compared average investment fund performance to average investor performance. Over a 30 year period, the US stock funds in which they have invested returned about 10% annually, while the investors in these funds have earned ***only*** 3.7% annually. To be fair, other studies conclude that individual investors significantly underperform the average fund, but not by as wide a margin as the Dalbar study suggests.

This outcome begs the question of what is the reason for this underperformance. While not paying attention to expense ratios plays a role, the primary reason for investor underperformance is poor investor behavior. Said plainly, individual investors have a bad habit of buying high and selling low, a pitfall of chasing performance.

To go one layer deeper, the reason individual investors have a bad habit of buying high and selling low is that their investment decisions are too often driven by their emotions. Once a person moves into retirement, the income stream from employment stops, and a retiree is now dependent on their lifelong savings to provide the funds for their lifestyle. And yet, they often feel helpless against the seemingly unknowable and senseless short term movements of the market. It's hard to not respond emotionally to the ups and downs of the investment markets.

This is where the calm hand of a financial advisor can be invaluable. One of the primary roles of a financial advisor is to temper the emotion of an investor and provide a well-reasoned, long term perspective on the portfolio. It is emotionally counter intuitive to recognize that a market is most risky when it's trading at its peak price, and it is least risky when it's trading at its lows.

But let's get back to the details of the Vanguard study. Figure 1 below details these "best practices" identified by Vanguard, and we hope that you recognize all of them.

Figure 1

Vanguard's Advisor's Alpha Best Practices	Value-add relative to "average " client experience (in basis points of return)
Suitable Asset Allocation using broadly diversified funds/ETFs	> 0 bps
Cost-effective implementation (expense ratios)	45 bps
Rebalancing	35bps
Behavioral Coaching	150 bps
Asset Location	0 to 75 bps
Spending strategy (withdrawal order)	0 to 70 bps
Total-return versus income investing	> 0 bps
Potential Value Added	**About 3%**

Suitable Asset Allocation: How a portfolio is allocated across the major asset classes is the most important element of risk adjusted portfolio performance. It is important to note that Vanguard could not quantify a specific value to this best practice. That does not mean that advisors can't add value here; but that since an investor's allocation is based on their unique circumstances, the value added could vary widely.

At CPFA, we have taken a cautious stance (to which we remain committed) with respect to the asset allocation of our clients. We have been concerned for quite some time about the valuation in the equity markets. As the price increases faster than corporate fundamentals, so does the risk of a meaningful correction. We believe that positioning the portfolios to mitigate the effects of a 2008-2009 type correction will add significant value in the long run.

Cost-effective Implementation (expense ratios): The expense ratio is the charge levied by the fund manager. Generally speaking, actively managed funds charge significantly more than passively managed index funds. But there is another layer to this story, and that is the difference between "retail" and "institutional" share classes. Individual investors rarely have access to institutional class share pricing, while clients of an advisor frequently do. The big take away is that expenses matter, and an advisor operating in a fiduciary capacity (like CPFA does) has an obligation to seek the lowest fees possible for the selected strategy. Figure 2 below shows Vanguard's research into this concept supporting their claim of potential, significant added value.

Figure 2

Stocks/Bonds	100%/0%	80%/20%	60%/40%	50%/50%	40%/60%	20%/80%	0%/100%
Asset-weighted expense ratio	0.61%	0.58%	0.55%	0.54%	0.53%	0.50%	0.47%
"Lowest of the low"	0.15	0.14	0.14	0.14	0.13	0.13	0.12
Cost-effective implementation (expense ratio bps)	0.46	0.44	0.42	0.41	0.39	0.37	0.35

Note: "Lowest of the low" category is the funds whose expense ratios ranked in approximately the lowest 7% of funds in our universe by fund count.
Sources: Vanguard calculations, based on data from Morningstar, Inc., as of December 30, 2013.

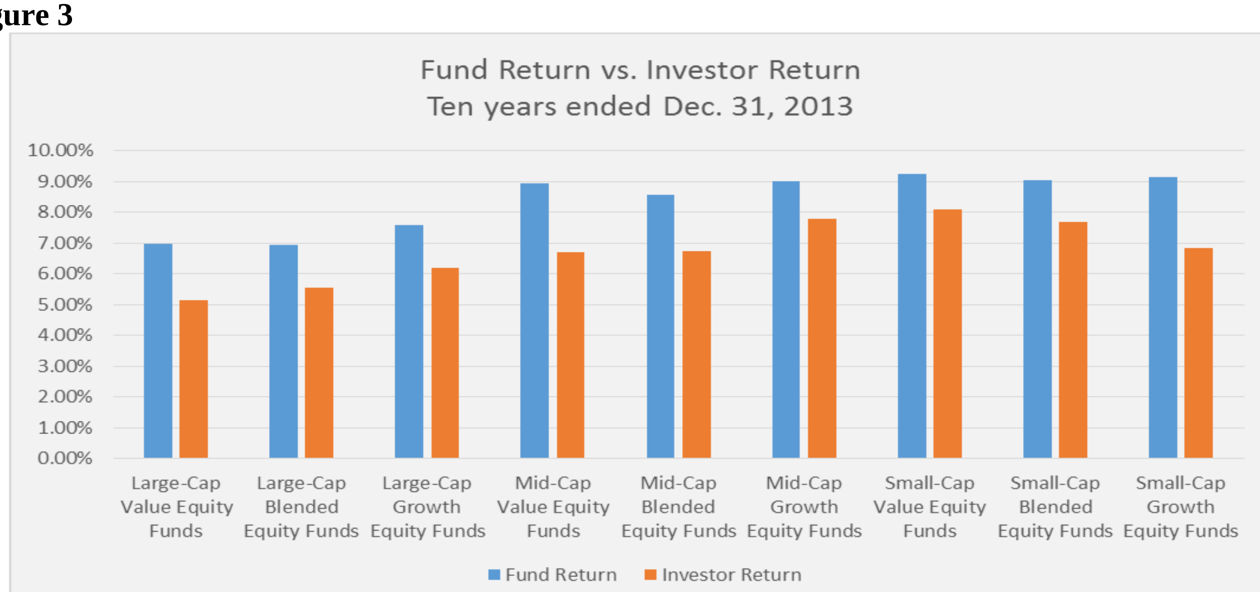
Be advised that it is not our goal to only invest in the funds with the lowest costs. Rather, we have the objective of investing in the funds that are the most cost-effective ***for the selected strategy***. You may note that the expense ratios from some of the funds in which you are invested are higher than what is shown as the "lowest of the low" in Figure 2. In many instances, this is because we are pursuing strategies whose expenses will not fall into this lowest category.

Rebalancing: Since investments have varying returns, your asset allocation will change based on relative returns. The better performing asset classes will become relatively larger, and the poorer performing asset classes will become smaller. If left unchecked, these imbalances can cause an investor's asset allocation to deviate to an unacceptable level. Rebalancing to the target allocation would require selling the best performers and buying the worst performers. (That's right, buy low and sell high!) Vanguard's research showed that a traditional 60% equity/40% bond portfolio that was not rebalanced between 1960 and 2013 experienced an allocation "drift" so large that the risk of the portfolio was nearly identical to that of an aggressive 80% equity/20% bond portfolio. At the same time, the return of this now much riskier portfolio was barely more than that of the regularly rebalanced 60%/40% portfolio. The effect of not rebalancing the portfolio regularly was that investors took on much more risk for only a tiny amount of incremental return. Yikes!

We regularly review your actual asset allocation relative to your target allocation, and rebalance accodingly. Rebalancing is both a risk mitigation and return enhancing best practice.

Behavioral Coaching: While Vanguard and Dalbar may not agree on the magnitude of the difference between fund returns and investor returns, they would agree that individual investors do not achieve the same level of returns as the funds in which they invest. Figure 3 shows the results from Vanguard's research on the difference between fund return and investor return.

Figure 3



Once again, the largest contributor to these differences is investor behavior. An example of how we help our clients avoid these same behavioral pitfalls is evident in the markets right now. As equities soared last year and (until recently) have continued to perform well this year, the temptation is to increase exposure to stocks. Buying at peak valuations (chasing performance) is exactly the type of behavior that leads to the data shown in Figure 3. We have resisted increasing our allocation to equities in an attempt to avoid buying at unsustainably high values. We are advising our clients to be patient and wait for a more attractive price point before increasing their allocation to equities.

Asset Location: Income taxes are one of the biggest drags on investment performance. Some investments generate most of their returns in the form of income like interest and short term gains, and are thus tax inefficient. Other investments like stocks generate the bulk of their return from price appreciation, and the tax on the return can be delayed until the investment is sold. Asset location refers to the analysis of knowing where to hold investements based on their tax efficiency. Generally, inefficient investments should be held in tax advantaged accounts like retirement accounts, and tax efficient investments should be held in tax inefficicient accounts such as personal and trust accounts.

We consider the tax character of investments and try to place them strategically among accounts to maximize tax efficiency. The tax impact of asset location has become even more important by the recent increases in tax rates (expiration of Bush-era provisions and new taxes under the Affordable Care Act). The value add resulting from investment location will compound over time. As CPAs and wealth managers, we are well positioned to help maximize the potential of income tax efficiency through optimizing asset location.

Spending Strategy (withdrawal order): Once an investor is retired and living off their investments, one has to decide where the cash flow will come from—retirement accounts or non-retirement accounts. Laying aside the issue of Required Minimum Distributions for the moment, it is important to look at the long term tax implications of the withdrawal strategy. Conversions to Roth IRAs, accelerating regular IRA distributions, and using appreciated securities for charitable contributions can significantly lower the overall tax burden over time. Again, since we are CPAs and income tax advisors, we are constantly reviewing these strategies in attempt to make your withdrawal strategy as efficient as it can be.

Total-return Investing: Interest rates are at historical lows. Given these lows, it is extremely difficult for many retirees to "live off the income and not touch the principal." This mindset can also be very tax inefficient as interest income is subject to the taxpayer's marginal income tax rate. We have always focused on maximizing after-tax total return. This is not to say that we never hold fixed income in investors portfolios. We do hold fixed income because of the positive effect it has on overall portfolio volatility and short term liquidity needs. Similar to asset allocaiton, Vanguard determined that the implementation of this best practice will be personal to each investor's situation, and that the value added is not quantifiable. Nonetheless, we are convinced that there is real value to be added here.

Conclusion: There is a saying that we would think is appropriate to sum up the purpose of this article: "You can't measure a mistake that you are no longer making."

CPFA has been in business for almost 20 years, and we are well aware of and are actively engaged in implementing all of the best practices identified in the Vanguard paper on "Advisor Alpha." While we don't know the actual quantitative impact of these value-adding practices (and we can't prove 3% additional return each year as a result of these practices), we are confident that we have been adding significant and consistent value to our clients' financial position. Depending on your unique circumstances, we believe that the value our advice adds to your financial position far outweighs our cost.

We are not just your investment manager. Our services are broad and comprehensive. While services such as tax compliance, estate planning, insurance and risk management, withdrawal strategies, etc. may not directly affect the return of your investment portfolio, they can have a major impact on your overall financial position. As our name implies, we are you comprehensive personal financial advisor, and are passionate about improving our client's financial lives.