Adding value through sound financial planning decisions

By Paul Kaplan and Christian Charest | 02-19-2013

Christian Charest: The Greek alphabet is already well represented in the field of wealth management. A lot of investors are already familiar with the concept of Beta, which is a measure of the systematic or market-related risk incurred by a portfolio and with Alpha, which is the value that can be added through picking the right investments. Morningstar researchers have taken it a step further. I'm here with Dr. Paul Kaplan, Morningstar Canada's director of research, who with a colleague, David Blanchett, from our Chicago head office recently introduced a new concept called Gamma.

Now Paul, why don't you start by explaining what this measure is?

Paul Kaplan: Sure. So, let's start off with, the name, Alpha, Beta, Gamma. As you mentioned the Greek alphabet and we already use Beta, which means systematic risk and we spend a lot of time controlling that through asset allocation, finding the right mix of stocks and bonds and other asset classes to suit the risk tolerance of the investor.

Then there is Alpha, which is the idea that there are superior managers out there who can outperform the asset class that they play in. So, an active equity manager is expected to produce Alpha over an appropriately chosen equity benchmark.

Now, both of those things are concepts that the investor and the advisor ultimately can't control, because – let's start with Beta. For example, the advisor and the investor can come up with a perfectly suitable asset allocation that's just right for the investor, but then the market crashes and the equity portion goes down by a large amount. You can't control that.

Alpha is even more difficult, because in alpha we have to actually go out and find superior managers, which is a fairly difficult exercise to do. We spend a lot of effort doing that here at Morningstar, but nonetheless, no guarantee that a manager that we believe to be superior will necessarily, consistently outperform their benchmark.

So, the question is, what is it that we can control? What is it that we can actually do that will lead to better long-term outcomes? And that's what we use the third letter of the Greek alphabet for, Gamma. So, basically those things that through financial planning – we can actually pretty much count for a better outcome, than had we not done with good financial planning.

Charest: Now, you and David Blanchett, who is head of retirement research for our Morningstar Investment Management Division, wrote a paper on this a few months ago, and in this paper you outlined five factors that can be sources of Gamma. Why don't you tell us what those are?

Kaplan: Yes. First of all, I'll start off by saying that it doesn't mean there are only five. It just means there are five we focused on in this paper. The first one is what we call *total wealth asset allocation,* and that basically means taking into account your human capital and other factors, so moving your asset allocation over time to consider the whole portfolio.

The second one we call *dynamic withdrawal strategy,* and that means instead of fixing the amount you are going to spend every year, let that vary year by year depending upon conditions of the market and other factors.

The third one is *annuity allocation.* The idea here is to guarantee yourself some additional income year-in, year-out, by using fix pay out annuities.

The fourth one is *asset location and withdrawal sourcing* and here the idea is to take full advantage of your tax deferred savings vehicle such as RRSPs to really get the most out of them by investing in them when you're – before you retired and then when you retired withdrawing them later rather than sooner.

And *liability-relative optimization* and here the concept is that when you retire you are going to face a liability. That is the money you need to spend to fund your retirement; that is going to vary with inflation and therefore when you are doing your asset mix, you want to pick those asset classes that are more inflation sensitive.

Charest: How much value can investors hope to add by making the right decisions in these areas?

Kaplan: Yes, and this is largely what the paper is about, which is to try to put some sort of quantification on this to help the discussion between advisors and investors. And the numbers we came up with within our model is that as far as in terms of income, we came up with a number that we would say is the equivalent to adding 20% to 30% of annual retirement income.

Now I say the equivalent because I don't mean literally you are going to add 20% to 30%, but I mean in terms of how you economically feel about the additions you can get, it's sort of like getting that additional 20% to 30%. And then we looked at it in another way because there is so much focus on Alpha in the industry. We asked the question, to get that additional 20% to 30% in retirement income, how much Alpha would you have to get through active management? That's like 150 to 200 basis point range, which even for excellent managers is still a very tall order.

Charest: Thank you very much, Paul. And more information on this study we just discussed, please click on the link right below the video player and please note that Paul's colleague, David Blanchett will be speaking on this topic at the Morningstar Investment Conference in Toronto on June 5.