Clearwater
WEALTH MANAGEMENT LLP
CHARTERED FINANCIAL PLANNERS

How Much is a Relationship with Clearwater Really Worth?

"You wouldn't buy a cheap parachute, would you?"

Kenneth Aubrey Ponting

(my late father)

"If you think it's expensive to hire a professional to do the job, wait until you hire an amateur."

'Red' Adair
(famous oil well firefighter)

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1. Introduction

The question of whether one receives value for money from a service can be somewhat subjective, some may perceive more value from a particular service than another for example, and not every component of a comprehensive service will be relevant to every client. In addition, paying an adviser 0.5 per cent of the value of a portfolio could work out more expensive than paying 1 per cent, if the latter provides a super all round service and the former does very little.

We must also remember the distinction between price and value! A client recently reminded me of the John Ruskin quote about pricing: "It's unwise to pay too much, but it's worse to pay too little. When you pay too much, you lose a little money – that's all. When you pay too little, you sometimes lose everything because the thing you bought was incapable of doing the thing it was bought to do."

I also recall my late Father's view on value, his favourite saying on the subject was "You wouldn't buy a cheap parachute, would you?" To paraphrase 'when something is important, sometimes the best is better than the cheapest'.

What makes one car with four doors and wheels worth £300,000 and another £30,000? Although we might all have an answer, that answer likely differs from person to person. The value a Financial Planner provides is similarly difficult to define consistently. For some investors without the time, willingness, or ability to confidently handle their financial matters, working with an adviser may be a matter of peace of mind: They may simply prefer to spend their time doing something—anything—else.

While virtually impossible to quantify, in this context, the value of a Financial Planner is very real to clients, and this aspect of the value proposition should not be overlooked because of an inability to objectively quantify it. By virtue of the fact that the overwhelming majority of investment fund assets are advised, investors have already indicated that they strongly value professional advice.

In this document I have tried to articulate where I believe the Clearwater service is likely to add value for most of our clients and, using external research from Vanguard, actually put an approximate annual percentage figure to the value of these services.

The key areas where Clearwater adds value are as follows:

- The construction of a Lifelong Cashflow Model & associated life coaching
- Suitable asset allocation using broadly diversified portfolios
- Cost effective implementation
- Rebalancing
- Behavioural coaching around investments
- Choosing the correct tax wrapper
- Spending strategy (withdrawal order)
- Total-return vs income investing

I will provide a little commentary on each of these areas below and in the Executive Summary I have shared with you the results of some research by Vanguard on just how much tangible value can be derived from the discipline of working with a Financial Planner.

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2. Executive Summary

The Vanguard research attributes the following possible annual value to each of the components of the service provided by Clearwater Wealth Management LLP:

	Component	Value
1.	The construction of a Lifelong Cashflow Model	> 0.00%
2.	Suitable asset allocation using broadly diversified portfolios	> 0.00%
3.	Cost effective implementation	0.40%
4.	Rebalancing	0.35%
5.	Behavioural coaching	1.50%
6.	Choosing the correct tax wrapper	0 to 0.75%
7.	Spending strategy (withdrawal order)	0 to 1.10%
8.	Total-return vs income investing	> 0.00%
	Total Potential Value Added	**About 3% per annum in net returns**

Another study conducted by Brad Jung at Russell Investments in the US concluded this net value to be closer to 3.75%. Jung said

"So, the more typical 1% advisory fee can be considered a bargain for investors."

It is also important to note that we do not believe this potential 3% or so improvement can be expected every year; rather, it is likely to be 'lumpy' – potentially lots more than 3% in one year but then much less in another.

As previously stated, it is impossible to add a percentage figure to the value of some aspects of what we do for clients but they do have significant value nonetheless:

Peace of mind
Tax planning
Succession planning
Examining what-ifs
Access to ongoing advice
Hand-holding
Collaboration with other professional advisers
Looking after the bereaved

3. The construction of a Lifelong Cashflow Model

If we want to encourage our clients to live their lives to the full and not waste even one moment, we can't rely on chance. They have to have a Plan!

I have often said to our new clients, that they are probably already in possession of the pieces of the jigsaw which is going to define their financial future, what is usually missing is the picture on the box! This is where a Lifelong Cashflow Model is invaluable, it provides the framework to enable clients to see how each of the pieces of the jigsaw fit together and how they combine to provide a clear picture of one's financial future.

It is usually very difficult for a good financial planner to offer useful advice on just one piece of the jigsaw, without knowing where it sits, relative to the other pieces; the Cashflow Model provides this context.

ALL of our clients who have engaged with this process have found it invaluable in helping them make hugely important decisions about their financial future:

Can they afford to retire?
Should they make gifts to their children and, if so, when?
Is that holiday of a lifetime within reach?
Will they need to downsize their home in future?
What if they need care in later life?
How much tax will their children pay when they die and can this be reduced?
What would happen in the event of a catastrophe such as long-term illness?
Who would manage their affairs if their wife/husband/partner died?

or, just as importantly as the above

Could they just be enjoying a better life?

In addition to the many millions we have saved our clients in Inheritance Tax, Capital Gains Tax and Income Tax, with the help of carefully constructed Cashflow Models we have encouraged many clients to retire early, make substantial gifts to their children or charities, go on amazing holidays (and fly Business Class when they do) and we have even helped a client pay for their daughter's IVF – they are now proud grandparents and you can't you really put a price on that, can you!?

Some aspects of the value we add are more easily quantifiable and these are covered below.

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4. Suitable asset allocation

The value of careful asset allocation is deemed significant but too unique to each investor to quantify, based on each investor's varying time horizon, risk tolerance and financial goals.

It is widely accepted that a portfolio's asset allocation—the percentage of a portfolio invested in various asset classes such as stocks, bonds, and cash investments, according to the investor's financial situation, risk tolerance, and time horizon—is the most important determinant of the return variability and long-term performance of a broadly diversified portfolio that engages in limited market-timing (Davis, Kinniry,and Sheay, 2007).

Starting our client relationships with a well-thought-out plan not only ensures that clients will be in the best position possible to meet their long-term financial goals but can also form the basis for future behavioural coaching conversations.

Whether the markets have been performing well or poorly, we can help our clients cut through the noise they hear on a regular basis, noise that often suggests to them that if they're not making changes to their investments, they're doing something wrong.

The problem is, almost none of what investors are hearing pertains to their specific objectives: Market performance and headlines change far more often than do clients' objectives. Thus, not reacting to the ever-present noise and sticking to the plan can add tremendous value over the course of our relationship.

The process sounds simple, but adhering to an investment plan, given the wide cyclicality in the market and its segments, has proven to be very difficult for investors; Clearwater provides that discipline.

We use a sophisticated Risk Profiling tool to establish our clients' appetite for risk and also to enable us to understand their capacity for loss. The results of the risk-profiling form the basis for discussion around which asset allocation might be most appropriate for them. Just because a client has an appetite for risk does not necessarily mean that they should take it; why risk failing to meet one's objectives if (when) a downturn occurs, when these goals can be met with a lower risk portfolio?

We use a series of risk rated portfolios constructed by Evidence Based Investments (EBI) to enable us to provide our clients with appropriate exposure to higher or lower risk assets. Each of the EBI portfolios has exposure to approximately 20,000 individual securities, spread across many asset classes around the globe, providing us with significant diversification.

More information on EBI is available on request.

5. Cost-Effective Implementation

The Vanguard research suggests that we can expect to save our clients approx. 0.4% per annum by using low-cost institutional investment funds. This value-add is the difference between the average investor experience, measured by the asset-weighted expense ratio of the entire Fund Industry, and the lowest-cost funds within the universe. This value could be greater if a client's existing holdings are in higher cost funds than the asset-weighted averages, when they engage us.

The benefits of cost-effective implementation can be summarised in the following simple equation:

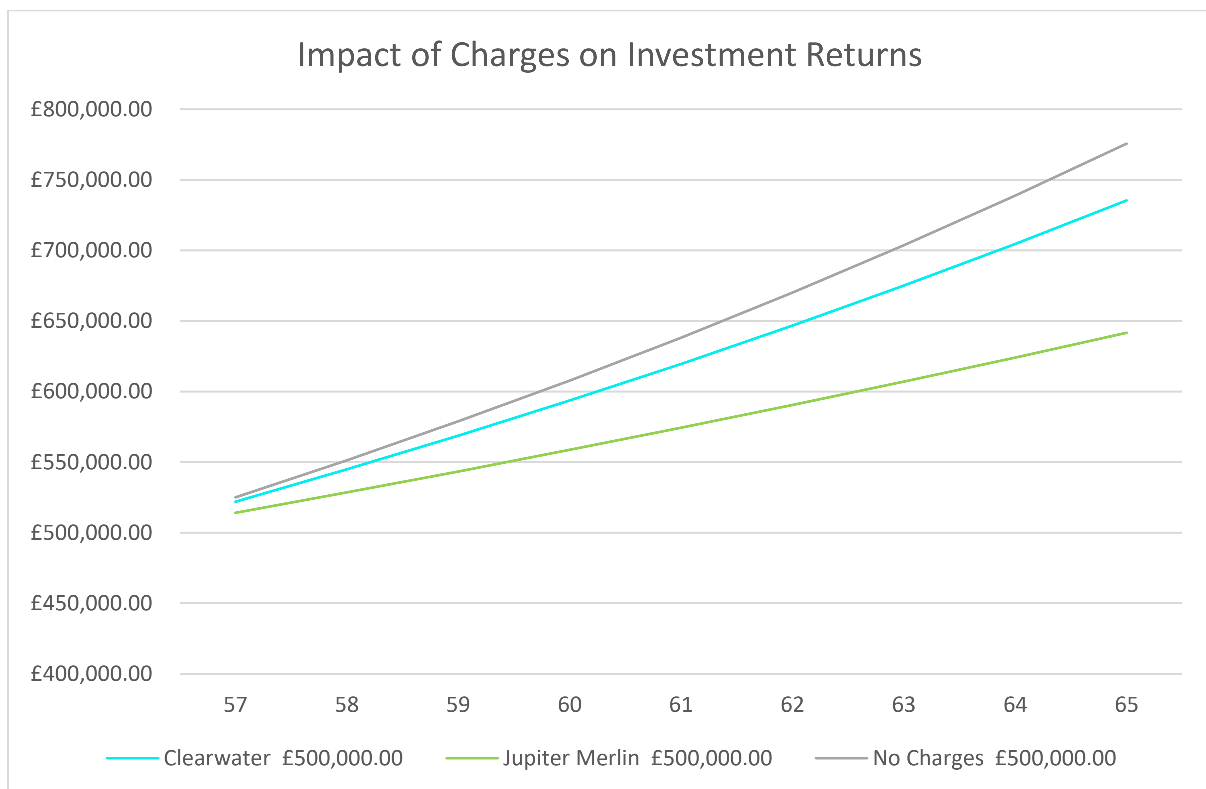
Gross return minus costs (expense ratios, trading or frictional costs, and taxes) equals net return.

Every pound paid for management fees, trading costs, and taxes is a pound less of potential return for clients. And, for fee-based advisors like Clearwater, this equates to lower growth for our assets under management, the base from which our fee revenues are calculated. As a result, cost-effective implementation is a "win-win" for clients and Clearwater alike.

Research has repeatedly shown that low costs are associated with better investment performance, and this is why costs play a significant role in our investment selection process.

I have provided an example below of just how important paying attention to costs can be:

The following illustration compares the difference in costs between the Jupiter Merlin Balanced Portfolio, a popular fund available on most direct investment websites, with a similarly asset weighted portfolio available via Clearwater.



The example assumes a man of 56 retiring at 65 with a single investment of £500,000 and a 5% per annum investment return. The figure shown below is equivalent annual percentage drag on the value of the investment each year and does not include any allowance for Adviser Charges.

Jupiter Merlin Balanced Portfolio	2.19%
Clearwater Portfolio EBIP 60	0.62%
Annual Difference	1.57%

This difference may not sound particularly large but, over a long period of time, it can have a significant impact on the value of one's investment.

The chart above shows the impact of these costs over the period, when compared to an investment with no charges at all (which is of course, purely hypothetical as no such investment exists).

It's important to note, too, that this value-add has nothing to do with market performance. When you pay less, you keep more, regardless of whether the markets are up or down. In fact, in a low-return environment, costs are even more important because the lower the returns, the higher the proportion that is consumed by fund expenses.

6. Rebalancing

The Vanguard research suggests that we can expect to save our clients up to 0.35% per annum when risk-adjusting a 60% stock/40% bond portfolio that is rebalanced annually versus the same portfolio that is not rebalanced (and thus drifts). Research by Dimensional Fund Advisors concluded that there is no optimal frequency for rebalancing but that rebalancing to control risk is nonetheless important.

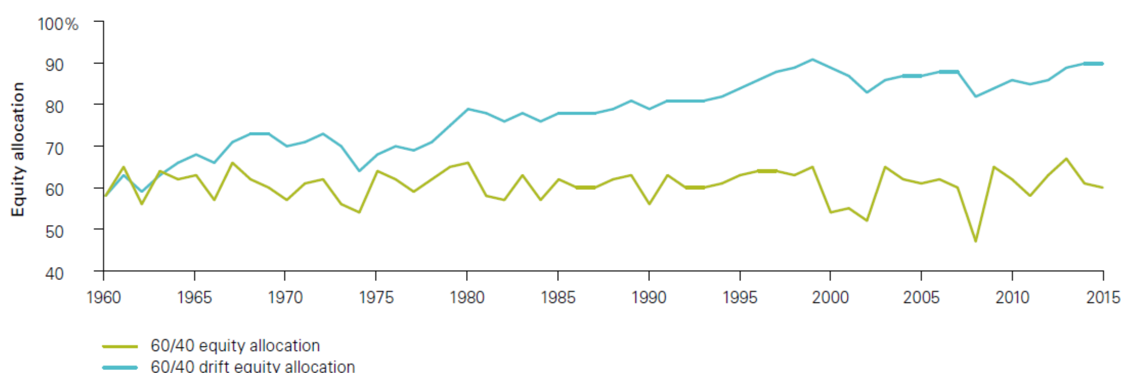
Given the importance of selecting an asset allocation, it's also vital to maintain that allocation through time.

As a portfolio's investments produce different returns over time, the portfolio likely drifts from its target allocation, acquiring new risk-and-return characteristics that may be inconsistent with our client's original preferences.

Note that the goal of a rebalancing strategy is to minimise risk, rather than maximise return.

An investor wishing to maximise returns, with no concern for the inherent risks, should allocate his or her portfolio to 100% equity to best capitalize on the equity risk premium. The bottom line is that an investment strategy that does not rebalance, but drifts with the markets, has experienced higher volatility. An investor should expect a risk premium for any investment or strategy that has higher volatility.

Equity allocation of 60% equity/40% bond portfolio, rebalanced and non-rebalanced, 1960 through 2015.



Notes: Stocks are represented by the Standard & Poor's 500 Index from 1960 to 1974; the Wilshire 5000 Index from 1975 to April 22, 2005; the MSCI US Broad Market Index from April 23, 2005, through June 2, 2013; and the CRSP US Total Market Index thereafter. Bonds are represented by the S&P High Grade Corporate Index from 1960 through 1968; the Citigroup High Grade Index from 1969 through 1972; the Barclays U.S. Long Credit AA Bond Index from 1973 through 1975; the Barclays U.S. Aggregate Bond Index from 1976 through 2009; and the Barclays U.S. Aggregate Float Adjusted Index thereafter.

Sources: Vanguard calculations, based on data from FactSet.

During this period (1960–2015), a 60% stock/40% bond portfolio that was rebalanced annually provided a marginally lower return (8.97% versus 9.24%) with significantly lower risk (11.27% versus 13.95%) than a 60% stock/40% bond portfolio that was not rebalanced.

In a portfolio that is more evenly balanced between stocks and bonds, this equity risk premium tends to result in stocks becoming over-weighted relative to a lower risk–return asset class such as bonds; thus, the need to rebalance.

Although failing to rebalance may help the expected long-term returns of portfolios (due to the higher weighting of equities than the original allocation), the true benefit of rebalancing is realised in the form of controlling risk. If the portfolio is not rebalanced, the likely result is a portfolio that is over-weighted to equities and therefore more vulnerable to equity-market corrections, putting a client's portfolio at risk of larger losses compared with the 60% stock/40% bond target portfolio. See above.

Helping our clients to stay committed to their asset allocation strategy and remain invested in the markets increases the probability of their meeting their goals, but the task of rebalancing is often an emotional challenge. Whether in bull or bear markets, reallocating assets from the better-performing asset classes to the worse-performing ones feels counterintuitive to the "average" investor. As advisers we can provide the discipline to rebalance when rebalancing is needed most, which is often when the thought of rebalancing is a very uncomfortable leap of faith.

7. Behavioural Coaching

The Vanguard study of actual client behaviour, found that investors who deviated from their initial retirement fund investment, trailed the target-date fund benchmark by 1.50 % per annum. This suggests that the discipline and guidance that we, as advisers, might provide through behavioural coaching could be the largest potential value-add of the tools available to us. In addition, Vanguard research and other academic studies have concluded that behavioural coaching can add 1% to 2% in net return.

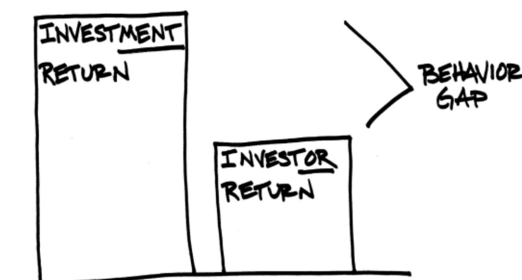
Because investing evokes emotion, we need to help our clients maintain a long-term perspective and a disciplined approach—*the amount of potential value we can add here is large.* Most investors are aware of these time-tested principles, but the hard part of investing is sticking to them in the best and worst of times—that is where we, as a behavioural coach to our clients, can make a significant difference.

Abandoning a planned investment strategy can be costly, and research has shown that some of the most significant drivers of poor behaviour are the allure of market-timing and the temptation to chase performance.

Persuading investors not to abandon the markets when performance has been poor or dissuading them from chasing the next “hot” investment is where they need to be reminded of the plan we created (the agreed asset allocation) before emotions were involved. This is where the faith and trust that clients have in us is key: Strong relationships need to be established before the bull- and bear-market periods that challenge clients’ confidence in the plan detailed for them.

Thankfully, as stated earlier, these potentially disruptive markets tend to occur only sporadically but there is no doubt that they do occur from time to time and when they do, it can be very unsettling.

We at Clearwater can act as emotional circuit breakers by circumventing clients’ tendencies to chase returns or run for cover in emotionally charged markets. In the process, we may save our clients from significant wealth destruction and therefore add significant value, although this is not always easily quantifiable. A single client intervention, such as we’ve just described, could more than offset years of advisory fees.



8. Choosing the Correct Tax Wrapper

Research suggests this can add somewhere up to 0.75% per annum, depending on the investor's asset allocation and "bucket" size (the breakdown of assets between taxable and tax-advantaged wrappers, such as ISAs). The majority of the benefits occur when the taxable and tax-advantaged wrappers are roughly equal in size, the target allocation is in a balanced portfolio, and the investor is in a high marginal tax bracket. However, if an investor has all of his or her assets in one account type (that is, all taxable or all tax-advantaged), the added value of asset location is of course 0%.

The correct allocation of assets between taxable and tax-advantaged wrappers, is one tool we can use to add value each year, with an expectation that the benefits will compound through time.

In addition to Income and Capital Gains Tax saving, we are often able to protect a client's investments from Inheritance Tax (IHT). The use of Alternative Investment Market strategies can lead to substantial reductions in IHT after just 2 years for example and not the usual 7, which is the case for large gifts.

9. Withdrawal Order for Client Spending

Vanguard research suggests that getting this right can save clients, up to 1.10% per annum.

If a client has the following:

- Cash holdings - low volatility, low return
- Investments (ISAs, GIAs etc.) - higher volatility, higher return
- Pensions - as with Investments but with tax considerations

It makes sense to spend Cash Holdings first, because the return lost is low, there are usually no tax considerations and there is no volatility – this means investments might be falling but there are no negative consequences from spending cash at this time.

Once Cash Holdings are exhausted (or more reasonably have reduced to a level where they form just a contingency fund), then it can be sensible to begin making withdrawals from investments. Whilst clients are spending their cash, we can be discussing with them when might be a good time to sell some investments to top this cash up.

This would not be immediately after a stock market crash, for obvious reasons, but it might well be after a sustained period of market rises.

Pensions come last! This often surprises many people, particularly when one reflects on why they might have invested money into a pension in the first place – to provide them with income in retirement! Pensions however, sit outside of one's estate for IHT purposes and this means that such a fund is potentially worth 40% more in the hands of one's beneficiaries. Pension withdrawals (above the 25% tax free lump sum) are also exposed to income tax and care needs to be taken to ensure that no more tax is paid than necessary, by ensuring a client does not stray into a higher tax bracket, for example.

We were recently able to help a client save £17,000 per year in Income Tax (and potentially save the family a significant amount of IHT) by simply altering their withdrawal strategy.

A saving considerably in excess of our Adviser Fees!

10. Total-Return vs Income Investing

This is an area where it is believed that the benefits are significant but the value is deemed too unique to each investor to quantify reliably.

With yields on balanced and fixed income portfolios at historically low levels, and the anticipation that yields will remain low for the foreseeable future, the value of advice has never been more critical for retirees. Historically, retirees holding a diversified portfolio of equity and fixed income investments could have easily lived off the income generated by their portfolios. Unfortunately, that is no longer the case. Investors who wish to spend only the income generated by their portfolio, referred to here as the “income-only” approach, have three choices if their current cash flows fall short of their spending needs:

They can spend less, they can reallocate their portfolios to higher-yielding investments, or they can spend from the total return on their portfolio, which includes not only the income or yield but also the capital appreciation. As advisers, we can help our clients make the right choice for their situation.

It is important to note that for many investors, moving away from a broadly diversified portfolio could actually put their portfolio’s principal value at higher risk than actually spending from it.

11. Conclusion

I hope I have established that Clearwater Wealth Management LLP are likely to provide significant value to our clients through a long-term relationship, however, we do accept that not all clients will benefit to the same extent (some may benefit less but some much more) because of their unique circumstances.

Even during periods where we have not recommended any material changes to our clients' arrangements, much of the added value discussed in this document is, of course, still being provided, albeit behind the scenes.

12. Case Study

Paul came to our first meeting with the usual cardboard file overflowing with documents relating to pensions past and present. He explained that he had reached a point in his life where it was absolutely essential to make sure his affairs were in order. He had a very stressful (although well paid) job, and he wanted to know whether he could afford to either partially or fully retire and spend some more quality time with his family.

As the discussion continued, Paul explained that he had undergone a heart transplant in October 1985 and was “thumbing his nose” at medical science by still being alive. He told me that a significant number of heart transplant patients don’t survive a year, and of those that do, a greater number don’t survive more than five years, owing to the toxicity of the cocktail of drugs needed to prevent rejection – and yet here he was, 17 years later, still going strong.

Paul said that despite having fathered two daughters with his wife Jenny since the operation, he had spent the first couple of years doing little more than trying to ensure that sufficient funds would be available on his death for his wife and children. Effecting additional life assurance he found to be impossible - hence all available cash went into pensions and other forms of saving.

It was only some years after the operation that Jenny managed to persuade Paul that he should be enjoying the extra time he had been given, and not focusing all his energies on worrying about her and the girls. He got the message, and not so long ago bought a brand-new Porsche Boxster for some ‘wind in the hair’ motoring.

Having gathered all of the relevant data, Paul and Jenny came to our Financial Planning Meeting where we looked at the possibilities of Paul stopping work completely, or at least reducing his workload to two or three days per week. By producing lifelong cash flow forecasts, based on assumptions that we all agreed were reasonable, we were able to help Paul and Jenny make the fully informed decision for Paul to semi-retire.

Although the lifelong cash flow forecast suggested that they would run out of readily realisable assets by Paul’s 87th birthday, Jenny pointed out that Paul was unlikely to live that long, and that spending time together was far more important than worrying about money in 30 years’ time. It was refreshing not to have to “walk on eggshells” around the subject of Paul’s fragile health. Both Paul and Jenny had lived with his medical condition for many years and were able to discuss it calmly and rationally.

When we looked at the scenario of Paul’s death, it became clear that he had done a wonderful job of ensuring that his family would be well provided for – and I am sure that having this confirmed to him gave Paul great peace of mind.

Essentially, by laying out Paul and Jenny’s financial future in front of them we had given Paul ‘permission’ to reduce his workload safe in the knowledge that his family would not be adversely affected. It was being put in a position to be able to make this decision that Paul and Jenny found most valuable. From a personal perspective, it felt exceptionally good to know that we were answering fully the questions that Paul had posed and doing the job he had asked of us.

To supplement Paul's income, it was agreed to pool all of his various pension entitlements into a Self-Invested Personal Pension (SIPP), and use Phased Income Drawdown to provide the required shortfall in income, in as tax efficient a manner as possible. Not unnaturally, the availability of lump sum death benefits was a significant driver in the choice of retirement options.

Interestingly, the allowance that would have been given for Paul's serious medical condition by impaired life annuity providers was fairly meagre. When I spoke to an underwriter about this he said that as far as they were concerned, anyone who had defied the medical profession for this long could 'go on forever' – they didn't have sufficient data on heart transplant patients who had lived this long for them to be able to offer a better enhancement.

I also effected an introduction to a high-quality firm of local solicitors (B P Collins of Gerrards Cross) in order to have tax planning Wills drafted and Enduring Powers of Attorney put into place. This gave Paul and Jenny a further opportunity to consider what they wanted to happen on Paul's death.

The SIPP was established in the May, shortly before Paul fell very ill. The hospital had changed the cocktail of drugs he needed and this didn't agree with him at all.

Eventually he suffered kidney failure and for a while it was very much 'touch and go'. However, he pulled through, and we arranged for his first income instalment to be paid on his 57th birthday.

Just over a month later, Jenny called with the sad news that Paul had died the previous afternoon. Despite the fact that we had known about Paul's serious medical condition right from the first day of our relationship, the news still came as a shock. The day was one of quiet reflection in our office. We all really liked Paul: he was a gentleman, kind and courteous, and a nice man to do business with – in short, a perfect client.

Shortly after his death I attended the probate meeting at B P Collins Solicitors with Jenny and her brother and, as far as possible, we held her hand through most of the financial issues that accompany bereavement. The solicitors were very helpful and the grant of probate was obtained quickly. Most of Paul's life and pension policies had been written subject to Trust and as a consequence payment of the benefits due, were not delayed.

On several occasions throughout this difficult period for her Jenny said that she didn't know how she would have coped if we had not been on hand to help. Our ability to provide this assistance was greatly enhanced by the fact that we knew absolutely everything about Paul's finances. This further underlined the importance to us of providing a comprehensive service and not just concentrating on one or two aspects of a client's affairs.

We are now in the process of helping Jenny put together an investment strategy that will ensure she has the income she needs for the rest of her life. This will include making funds available to see her daughters through university.

I relay this story to you as an example of a client who needed properly structured Financial Planning advice to help ensure that he and his family would be financially secure for the rest of their lives. The provision of this type of advice was only possible through a comprehensive Financial Plan, incorporating lifelong cash flows.

Paul and Jenny did not need a commission-based salesman - they needed a properly qualified Financial Planner who could empower them to make fundamental, life-altering decisions.

In conclusion, Paul was a charming man who valued the service that we were able to provide to him and his family, and if he were able to look in on us now, I hope he would be pleased with how we are continuing to help Jenny and their children. It is also very gratifying to know that we helped Paul achieve his primary objective - the financial security of his family.

As a touching postscript to this story, Jenny popped into our offices recently and presented me with Paul's watch. She said that as they have no male heirs Paul would have liked me to have it. To say I was lost for words is an understatement, but one thing is for sure - I have never felt so proud to be a member of my profession.