


# Financial Planning

INVESTED IN ADVISORS / JANUARY 2018

A portrait of Matt Cooper, a middle-aged man with a beard and mustache, smiling. He is wearing a white dress shirt and a red tie with a small floral pattern. The background is a solid light blue.

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Matt Cooper  
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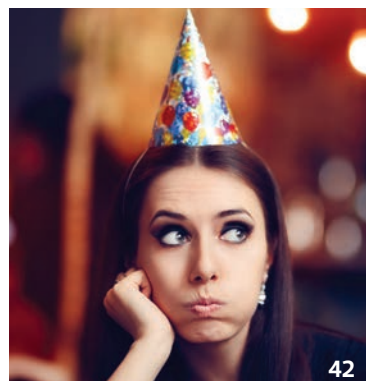
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## TAKING NOTICE



## Bitcoin Mania Grows Despite Doubts

The price of bitcoin touched a record last year — and it's not only clients taking notice. Even as bankers and others warn about the potential for money laundering, some financial firms see opportunity. For example, Cantor Fitzgerald plans to offer bitcoin swaps. And some advisors (many of them wary) have been fielding client calls about investing. Learn more about bitcoin's wild ride: <http://bit.ly/2jTubZD>



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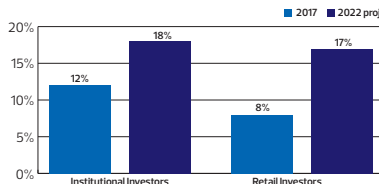
## Strategic Beta Is Attracting Inflows

Smart, strategic, factor-based — whatever you call them, these ETFs are winning over institutional and retail investors alike. But that hasn't silenced critics. Nonetheless, the global strategic beta ETP market has skyrocketed in recent years, and 2017 was no different. By early December, assets grew 18% to \$818 billion, according to Morningstar. What's driving the trend? Go to <http://bit.ly/2BAwF6C>

### GUIDE TO GROWTH

**Factor allocations are expected to continue growing.**

Percent invested in strategic beta



Source: Invesco, 2017.

## EVENTS

### JANUARY

**29-31**

**FSI OneVoice**

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<http://bit.ly/2zvofgV>

**31- Feb. 3**

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### FEBRUARY

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**Technology Tools for Today Advisor Conference**

Fort Lauderdale, Florida

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### APRIL

**23-26**

**FPA Retreat**

Litchfield Park, Arizona

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## EDITOR'S VIEW

### RIA Land Grab

Deals have heated up, but can this rapid pace continue?

**THERE'S BEEN A FLURRY OF RIA ACQUISITIONS OVER THE PAST YEAR,** and the trend shows little sign of slowing. Between 10 to 20 qualified buyers are lined up for every seller currently, according to industry estimates. And RIAs are willing partners. So what's behind the M&A frenzy?

From the seller's perspective, consider the rapid shifts in the technology and regulatory landscape, Matt Straut, head of Oppenheimer Funds' RIA group, told me at Schwab's Impact conference in November.

"Twenty years ago, when I first started to work with RIAs, a large one was \$100 million. It was a three- to four-person firm. It had an administrative assistant and a CRM and a phone. And that's really all it needed," Straut said. But now firms of all sizes require new tech tools to manage the increased complexity around tax optimization, rebalancing, asset selection and fees, he noted.

Those tools are expensive, Straut said. They must be purchased, maintained and leveraged. Then there are new regulations, which can be costly to implement. A deep-pocketed buyer can be an antidote.

"If I'm at a smaller firm with fixed costs at X that are going to 2X, and I don't have increased revenues to offset that, I've got a decision to make," Straut said. "Do I bring someone in at yet more costs, or do I merge?"

As for buyers, they're attracted like "bees to nectar" to RIAs' recurring revenue, Charles Paikert writes in this month's main feature, "Buying Spree." Deal volume in 2017 was on track to set a new record exceeding 150 transactions, according to the most recent data.

Going into 2018, "demand to buy is clearly still very strong," Paikert tells me. Even if the stock market has a sustained dip from 2017's record highs, overall volume may decline, but "good, big firms will remain in high demand and will command high prices," Paikert says.

A recession or prolonged market correction could throw sand in the gears, Paikert says. "But buyers think it may work to their advantage because sellers will be more desperate to get what they can while they can," he adds.

Still, cheap credit has underpinned the boom, Paikert cautions. A spike in interest rates could dampen enthusiasm. In the meantime, however, RIAs must slow down and do extra due diligence when working with suitors.

"Sellers usually are involved with just one sale — their own — while buyers usually make many transactions and are much more experienced in M&A," Paikert cautions. "So sellers often leave money on the table because they don't realize their true value to buyers." —*Chelsea Emery*



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# BENCHMARK

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## RETIREMENT ADVISOR CONFIDENCE INDEX

# Swept Up by Stock Gains

Risk tolerance strengthens as advisors report that clients are hoping to build on gains in their investment portfolios.

### CLIENTS ARE BECOMING MORE CONFIDENT

as they are apparently being swept up by stock market gains and are looking past frothy valuations, international tensions and the unstable political climate, advisors say.

The improvement in investor sentiment is helping to sustain favorable conditions in the industry, according to the latest Retirement Advisor Confidence Index – *Financial Planning's* monthly barometer of business conditions for wealth managers.

The component measuring client risk tolerance increased 2.8 points to 56.6 – one of the biggest moves across the factors covered by the index. Readings above 50 indicate improving conditions, while readings below 50 indicate deterioration.

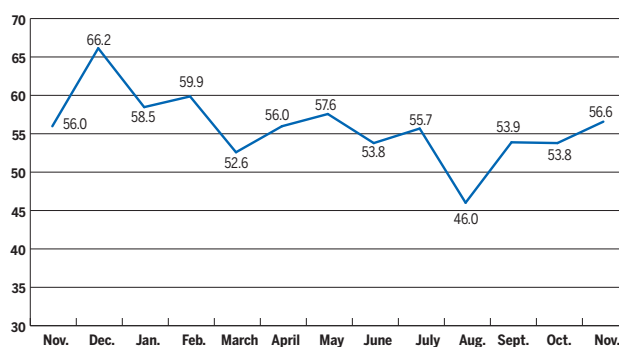
Advisors say equity gains dulled clients' fear of a correction, regardless of expensive multiples. "Clients are making money in stocks and have a higher risk appetite," one planner says.

Investor sentiment was also buoyed by lawmakers' efforts to deliver a huge tax cut to corporations, advisors say. "Potential tax cuts are raising everyone's market outlook," one says.

To be sure, some advisors say they are trying to push back against overexuberance among clients and are working to review and rebalance portfolios frequently. "We try to temper expectations and keep them within their risk tolerance limits," one says.

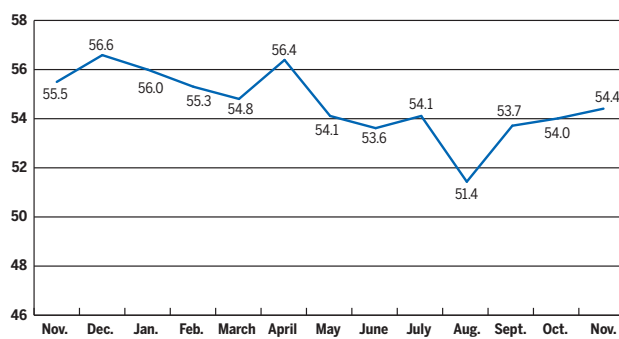
With the boost from the risk perception component, the composite RACI rose 0.4 points to 54.4. The

### CLIENT RISK TOLERANCE



Source: SourceMedia Research

### RETIREMENT ADVISOR CONFIDENCE INDEX



Source: SourceMedia Research

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composite also tracks asset allocation, investment product selection and sales, client tax liability, new retirement plan enrollees and planning fees.

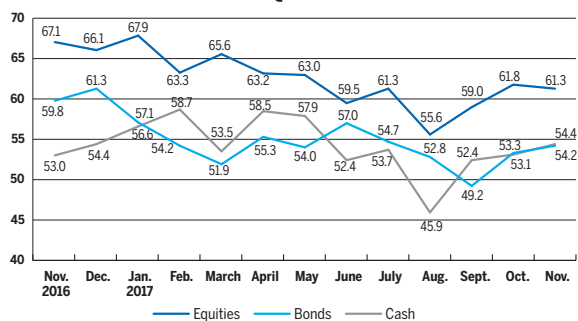
With stock prices soaring, clients have added to positions in equities, bonds and cash. The index component measuring allocations to stocks dipped 0.5 but remained well within expansion territory at 61.3. The index component measuring

cash allocations was up 1.3 to 54.4, and the component measuring allocations to bonds rose 0.9 to 54.2.

Advisors continue to vent their objections to the fiduciary rule, but the index component tracking fees charged for retirement services surged 4.2 points to 58.6. As one advisor says, "Higher markets meant higher assets under management fees." — *Harry Terris*

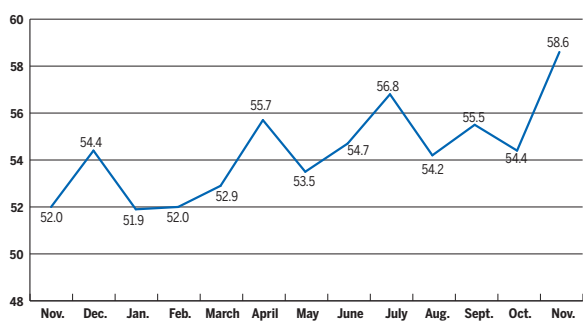
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## ASSETS ALLOCATED TO EQUITIES, BONDS AND CASH



Source: SourceMedia Research

## FEES FOR RETIREMENT SERVICES

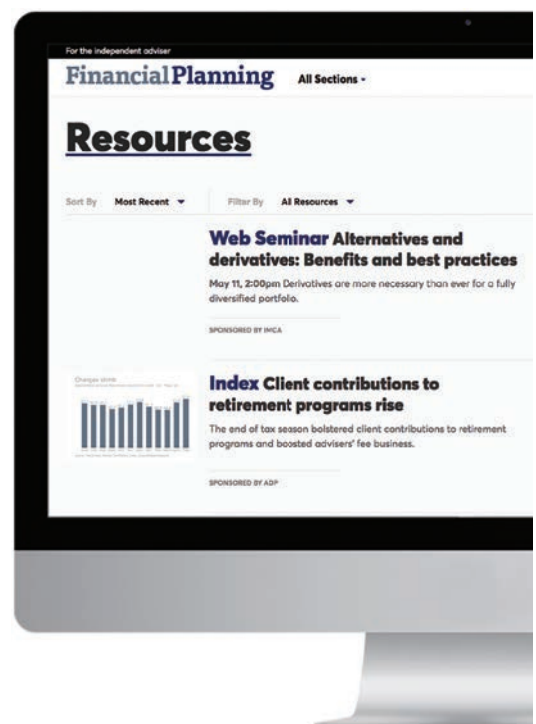


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INDUSTRY INSIGHT  
**VERES**

## The Advisor's Retirement Blues

Winding down a long and successful career often comes with angst. Follow these steps to make the process a little bit easier, Bob Veres says.

**AS A NEW YEAR BEGINS, LET'S TAKE THE OPPORTUNITY** to assess one of the more painful traumas advisors face in their careers — retirement.

It's probably safe to say that when most successful advisors started growing their businesses, they had no idea

they were creating something that would be so demanding of their time and energy.

But as they grew accustomed to the long hours and never-ending mind share, they probably didn't realize quite how messy things would become as they came closer

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to the end of this long process.

The thought of scaling back and giving up day-to-day responsibilities feels to them as if they're cutting out a part of their lives, taking their status and self-image with it.

On top of that is the same kind of angst a parent feels when the nest is about to become empty; your baby is no longer yours, and the potentially life-altering decisions are no longer coming from your reserves of wisdom and experience.

A whole generation of founders is learning to face co-dependency angst in their diminishing relationship with their firms. The issues that I'm hearing the most about, some of which are outlined here, are not so easily resolved:

- After having pushed so hard for two or more decades, I feel like I'm cheating when I'm not going full force and actually want to enjoy life a little more.
- What kind of role will I have? Will I be a big-picture thinker, or a mentor, or will

I continue in an advisory role and let client attrition gradually diminish my working hours?

- What should I be paid as I transfer ownership and responsibility? Nothing? My current salary even though I'm working less? Profit distributions only?
- What will I say to clients as I ease out the door? Will they regard it as success that a partner is retiring, or a betrayal because they, themselves, are still working?
- How do we handle unequal desire to work among the senior partners?

Of course, every firm and every founder will come up with unique answers to these questions. But it might help to have a framework for thinking them through.

#### **GIVE UP NITTY-GRITTY TASKS**

Start by transitioning your role from a doer and daily grinder to something else. I believe founders can become more valuable as they exchange the nitty-gritty labor aspect of the

**Founders can become more valuable as they exchange the nitty-gritty labor aspect of the job for bigger-picture guidance on the direction of the firm.**

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job for big-picture guidance on the longer-term direction of the firm, and look toward mentoring the talent they've acquired over the years.

Think to yourself: Does the firm benefit more when you work with a valuable client, or when you spend that time helping a half-dozen younger advisors become partners and rainmakers who can attract and tend to a hundred new clients each?

I also believe that unequal responsibilities at the top can be handled just as you currently handle the rest of the organizational chart. Founders and partners tend to think of themselves as equals in every way. But as they start to take on different kinds of workloads, it makes more sense to separate their equity from their diverging roles.

What does that mean in practice? Each partner should receive a partnership distribution in proportion to his or her ownership. These profit distributions do not – and should not – imply that any work on the part of the owner must be done.

After all, if we all own shares of Apple, we then feel entitled to a share of the company's earnings. But do we also feel obligated to show up to work in the company offices?

## **PAYING A WINDING-DOWN PARTNER**

Now let's turn to the other element of compensation. In terms of salary, each staff member is paid according to the value they provide, right? Why shouldn't that general formula also apply to the founding generation as they take on new roles?

The partner who checks into the office once or twice a week on the way to the golf course would receive a proportionately lower salary than the partner who is working with younger advisors and working in a hands-on capacity 40 hours a week.

The salaries can be determined in some fair and objective way, and this is also a great way to reduce the guilt factor for those founders who are cautiously testing out a new work-life balance while their partners are still engaged.

Finally, my recommendation is not to

skulk out the back door as you slowly shift client responsibilities.

Instead, include clients in a glorious celebration of retirement. Planners who live a long, prosperous life and enjoy great outcomes from their own planning should naturally enjoy more credibility than those who are mired in drudgery, who never seem to achieve for themselves the same great life they are hoping to facilitate for their clients.

If the firm is retiring its principals to a great next phase of life, how much more can we believe it knows how to achieve that for the rest of us?

I suspect that these retirement celebrations, or even the disclosure that your years of planning and discipline have led to an optimal work-life balance, can actually become a marketing benefit and new source of client referrals.

## **WHAT ABOUT THE ANGST?**

What's the solution to the feeling that you're no longer Mr. or Ms. Successful Firm Owner, or that the firm you've lovingly nurtured will be guided into an uncertain future by people whom you first met only five or 10 years ago?

Over the years, I've learned that the most difficult, complicated obstacles in life are those we manufacture for ourselves.

The procedural challenges to a successful retirement are much more easily resolved than the guilt that so often accompanies the letting go of status and responsibility.

Knowing that navigating the transition to retirement has been a challenge for your clients is no consolation when you arrive face-to-face with it yourself.

For the mental part, you're on your own – but not without resources. Tell yourself what you've told your clients: The new life has to be planned for just as the old life was, and you have to develop different sources of joy and satisfaction.

Advisors can cure the co-dependency they've developed with their firms by using the same skills they use on their best days with their best clients.

**FP**

**The procedural challenges to a successful retirement are more easily resolved than the guilt or separation anxiety that often accompanies letting go of status and responsibility.**

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**Bob Veres**, a *Financial Planning* columnist in San Diego, is publisher of Inside Information, an information service for financial advisers. Visit [financial-planning.com](http://financial-planning.com) to post comments on his columns or email them to [bob@bobveres.com](mailto:bob@bobveres.com). Follow him on Twitter at @BobVeres.



## ELITE ADVISOR **BOWEN**

# Strength in Numbers

Don't try to be a jack-of-all-trades. Instead, view advising as a team sport and build a powerhouse lineup of pros, John J. Bowen Jr. says.

**ADVISING IS A TEAM SPORT, NOT A SOLO** act. With financial planning becoming more complex, it's tempting for independent advisors to want to single-handedly offer clients a full range of services and products. But trying to do it yourself is a recipe for subpar advice and dissatisfied clients.

Instead, the key to success lies in building a network of highly specialized experts to address the needs of your affluent clients.

### CORE FOUR MEMBERS

Elite financial advisors typically build expert teams composed of these four members:

**1. A private client lawyer:** This professional will address your clients' estate planning, wealth protection and legal needs — three critical areas of concern. This lawyer might work on succession planning and business planning issues, as well as questions around probate and guardianships. Seek out this professional first, because he or she will probably know the other experts you'll want to add later. High-end boutique firms are great places to start your hunt. In every case, your client hires the lawyer directly and you will receive no portion of his or her fees.

**2. A life insurance specialist:** These professionals tend to work closely with a private

client lawyer on insurance solutions. Look for a true independent here who doesn't receive incentives from a company. For insurance products, expect a 50-50 split of commissions (which are typically 90% to 120% of the first year's premium).

**3. An accountant:** While a private client lawyer may well provide a big-picture perspective on tax planning, an accountant typically has much more detailed day-to-day knowledge of income taxes. He or she should be able to make specific recommendations to mitigate these taxes.

**4. Yourself (of course!):** As the wealth manager, your job is to be the general manager of your team of franchised professionals and achieve your

goal of helping clients address their most pressing advanced needs. As the G.M., you are responsible for building and managing the team, providing your pros with a clear and thorough understanding of each client's needs, and facilitating meetings that result in recommendations and action steps for those clients.

It is not your job to be a technical expert in noninvestment areas. You will grow over time to better understand the technical issues and the range of potential recommendations. You'll also learn enough to be able

**As a wealth manager, it is not your job to be a technical expert in non-investment areas.**

### Video

Form a team of four experts who can handle any client situation.  
<http://bit.ly/2i71h84>



to recognize when there may be an opportunity to pursue. But you will always continue to rely on your professional network to positively identify those opportunities.

## HOW TO SCOUT THE RIGHT PROS

Finding highly qualified experts to join your team is not as difficult as it might seem. Start by considering the financial firms where you

didates on these key criteria:

**1. Level of expertise:** Look for the top experts who serve your target market. Don't bring on board a second-rate attorney who can't generate the best recommendations for your clients' financial challenges. But also don't aim too high. If your typical affluent client has \$3 million in net worth, avoid bringing on an attorney who specializes in clients with \$50 million and above. There would simply not be enough opportunities to make the relationship work.

**2. Ability to collaborate:** Your team must be able to play well together in the sandbox. A lawyer and a life insurance specialist must be able to work together, for example, because insurance products will often support the lawyer's planning strategies.

**3. Client relationship management skills:** You need to be comfortable in putting your team in front of your valued clients. This means you need people who will graciously accept it should the client choose not to pursue that recommendation, even after doing a great deal of work.

**4. A noncompetitive outlook:** Members of your network cannot compete with you, period. Your life insurance specialist, say, cannot manage money in any way,

**The DIY approach simply doesn't work anymore — and I'm not sure it ever really did.**

## CONSIDER THESE ADDITIONS TO THE CORE

There are many professionals that you may need to call on occasionally or even just once. Some of the most common one-off experts include:

- A personal lines insurance specialist — a property-casualty agent who works at the very high end of the market.
- A credit expert to evaluate a client's current loan situation.
- A derivatives specialist to deal with concentrated stock positions.
- An actuary to address certain complex life insurance issues.
- A valuation specialist to appraise business interests, real estate or collectibles.

Best bet: Look to your core team members to tap into these specialists on an as-needed basis. Chances are, they work with many of these ancillary experts already, and can bring them on board when the time comes.

already obtain services or products. Some life insurance companies, for example, offer wealth transfer and charitable giving services. Referrals from other advisors are another effective route, as are referrals from your top clients. As part of your discovery process, you should already know who your clients' other professional advisors are.

Consider asking wealthier clients for introductions to their other advisors. Also, don't overlook experts you meet at industry seminars and conferences, or those you read about in trade publications.

As you start your search, size up your can-

shape or form. Competition negates the benefits of working as a unified team.

## A GREAT TEAM

The DIY approach simply doesn't work anymore — and I'm not sure it ever really did. Building a great team of outside experts will only make you a better advisor in the eyes of your clients.

You'll also differentiate yourself from the competition in the eyes of ideal prospective clients. The end result: a stronger practice that's capable of competing with any other wealth management firm.

**FP**

**John J. Bowen Jr.**, a *Financial Planning* columnist, is founder and CEO of CEG Worldwide, a global coaching, training, research and consulting firm for advisors in San Martin, California. Follow him on Twitter at @CEGAdvisorCoach.



## HUMAN CAPITAL **CRUZ**

# Charting Your Career Course

Here are a set of directions to follow to keep your professional goals on the right track, Kelli Cruz says.

**IN 2016, A 28-YEAR-OLD NEW JERSEY** tourist was traveling in Iceland and misspelled the address of his hotel in his GPS. He drove nearly six hours before realizing something was wrong. Many people were fascinated with this story and it quickly became an internet sensation.

How could someone drive around for so long without realizing the error? As hard as it is to imagine, we've all heard stories about people getting lost following directions.

Your planning career can follow the same misguided path if you aren't intentional about how you pursue the course. We all follow a GPS system of sorts throughout our career – a set of directions that take us from point A to point B. Like the driver in Iceland, it's easy to get lost. To prevent wrong turns in your career, I have carefully prepared the following directions to help you navigate your path.

### **SET CLEAR CAREER GOALS**

Take some time to think about what you want out of your career, and then be clear about these goals with your manager. Use your goals as a guidepost for engaging your manager and others about where you are headed and how they can help.

Three typical trajectories that define career paths at an advisory firm are: the advisory track; the operations or administrative track; and, for firms that have an in-house investment function, there can be an invest-

ment track. Of course, not every advisory firm is structured the same way, so there can be some variations across firms.

The advisory track consists of the support, service and lead advisor roles that lead ultimately to the partner level. The operations/administration tracks include administrative assistant, client service administrator, operations manager, chief operations officer/chief compliance officer also leading to the partner role.

Our career goals should not only be defined by the different positions you pursue along the way, but also by a plan for progress, development, education and growth. Make sure you have the expertise and knowledge to handle the challenging financial situations and questions that you will encounter over your career.

Some credentials to consider include: certified financial planner; chartered financial analyst or certified investment management analyst; retirement management analyst, established by the Retirement Income Industry Association; retirement income certified professional, offered through the American College; and certified retirement counselor, established by the International Foundation for Retirement Education.

### **STRENGTHS AND WEAKNESSES**

As you think about your career, take a step back to assess your strengths and weak-

**Take some time to think about what you want out of your career, and then be clear about these goals with your manager.**

nesses. The following core competencies are needed to be a strong advisor:

- **Organization:** plans, prioritizes, schedules and budgets in an efficient manner.
- **Analytical skills:** structures and processes qualitative and quantitative data to draw insightful conclusions.
- **Intelligence:** learns quickly and demonstrates an ability to understand and absorb new information.
- **Attention to detail:** does not let important details slip through the cracks.
- **Persistence:** demonstrates a willingness to go the distance to get something done.
- **Communication:** speaks and writes clearly without being overly verbose.
- **Listening skills:** lets others speak and seek to understand their viewpoints.
- **Flexibility and adaptability:** adjusts quickly to changing priorities.

If you aren't clear where your strengths and weaknesses lie, I recommend using an online assessment tool such as the StrengthFinders from Gallup and the CliftonStrengths assessment. Additionally, you may want to ask some trusted sources what you are good at (and not so good at). This is the easiest and, often times, the most difficult assessment to utilize.

It's never easy to hear of our weaknesses from those we trust. However, we're much more likely to take advice from those we admire and put it into practice. Remember to concentrate on what you're best at. Don't spend an inordinate amount of time trying to turn your weaknesses into your strengths.

Finally, once you have some additional insight into your strengths and weaknesses, be sure to practice self-awareness. Be clear about your values and live them, and be aware of your impact on others and learn how to manage your emotions and thoughts. The latter can be the greatest contribution or downfall to your career success.

## QUANTITATIVE TERMS

Try to discuss your accomplishments in more quantitative terms than qualitative. Incorporating more quantitative speak into your vernacular will quickly define your suc-

cesses for others without a lot of hyperbole. Think about it as if you're selling an asset to a client. They want to hear the nuts and bolts. What numbers, examples, achievements and results did you produce this year?

## GET INTO THE CONVERSATION

Read, read and read some more. Include industry publications, websites and blogs. Share the articles you like and make comments to spark a conversation. This can apply to social media, as well as in-person formats such as industry meetings.

Position yourself as an expert in the industry or on a specific topic, and you will become a valuable resource within your firm and professional community.

## RAISE YOUR HAND

When a new project comes up and it aligns with your goals, raise your hand and volunteer to handle it. Let your manager know that you want to learn some new skills or gain a deeper experience on a knowledgeable topic. Be clear on what you can offer to the project and get involved.

## FIND A MENTOR

Hire a coach, or find an experienced person to give you counsel, preferably someone who is outside your firm. This can be the same person whom you asked about your strengths and weaknesses – a trusted mentor to guide you to the wisest decisions.

Admittedly, all of these recommendations will take extra time and effort beyond your normal job, but this is what is required to take ownership of your career.

Start with a few hours a month reading and researching the industry and connecting with new people. Spend time building and maintaining your work files, documenting key accomplishments and maintaining and building your social media profiles.

Managing your career requires quality networking, knowing your unique value proposition and being influential. If you are able to incorporate some or all of the directions I provide, you will most likely find your career GPS on point.

**FP**

**Once you have some additional insight into your strengths and weaknesses, be sure to practice self-awareness.**





## NEW GENERATION GRANT

# The True Measures of Success

To help clients achieve happiness, hitting tangible financial goals is only part of the story, Dave Grant says.

**THERE'S ONE CRUCIAL QUESTION I ASK** clients before I start working with them. It often doesn't take them very long to answer, but it can determine if I accept these people as clients or not:

"What would make our relationship successful 12 months from now?"

This question can elicit a range of answers. Some of them are realistic, while others are not.

But this conversation is a great way to determine if our goals and methods are compatible, and it helps us start off a relationship on the right foot.

But then the situation gets more complicated. When I get further into the planning process — after the prospects have become actual clients — and ask them, "What would have to happen to make your life successful?" the answers are usually very tangible.

They might be something like, "Retire at 65, spend more time with my family, travel twice a year ..."

### A GAP IN THE LIST

In these lists, it is rare that inspirational goals come up.

This is unfortunate because often such ideals could actually provide the foundation for reaching their tangible goals.

It would be reasonable for clients to be listing such intangibles as maintaining good physical health, exploring faith, loving a spouse on a deeper level, and so on.

In short, identifying important intangible goals should be a vital part of the planning process as well.

Why is it so hard to verbalize intangible measures of success? Why do we anchor our happiness on results and not enjoy the process of getting there?

Finding the answers is just as hard for advisors as it is for clients.

### UNEXPECTED SUCCESS

This topic hit home recently for me. In 2016, my solo RIA nearly collapsed and I undertook a rebranding.

This project forced me to be more realistic about my goals.

I reverse-engineered an income target that would be ideal for my family. I understood that it might take me a couple of years to achieve success with all the changes I was in the process of making, and I was prepared for sacrifice and discouragement.

And yet that was not the way it worked out at all. Things took a serendipitous turn and I was able to reach my new income, objective within nine months. My gross income actually ended up doubling in that period of time.

But here's where matters became somewhat troubling. What should have been a celebratory time professionally and personally didn't feel that way.

I started to feel anxious about whether I could replicate this income, as almost 50%

**Despite good times, I began to realize that my definition of success had been misguided. I had focused on the result (my income) and not on the process (growing a business).**

had come from freelance writing and one-time financial planning fees.

I thought that even though I didn't need the income, I had to keep my funnel of prospective clients full in order to maintain the firm's momentum.

Even as my workload became lighter, I struggled with feelings of guilt about not constantly working on my business and I found it difficult to enjoy my downtime.

Just like some of my clients, I began to realize that my definition of success had been misguided.

I had focused on the result (my income) and not on the process (growing a business). Once I reached my income goal, I had come to the end of my journey and now I had no direction. I was unable to savor my good results. Clearly, my focus should have been less binary.

## MISSING CONTENTMENT

Why wasn't I happy with my apparent success? Sure, my professional life had been a severe challenge before when I was running a failing company.

But now, having turned things around, shouldn't contentment be easier to find? My growing roster of clients were happy, my bank balances were growing, and my business stress was fading away.

In choosing to anchor my success on a singular milestone, I had created an inevitable problem.

Once I reached that one goal, I would have to adjust it or create new ones. Would life become a frustrating, never-ending process of chasing increasingly difficult milestones and never being happy? I realized I was not enjoying this process.

I started to reflect on my clients, their financial plans and their overall lives.

How many were just like me – striving to achieve a certain investment balance because that would be the signal of the best time to retire, versus enjoying the process of life and work, right now?

What did they need to change? And, did I have the confidence to ask them and to

actually be able to help them explore their answers? If I was having these struggles, surely others were as well.

## WHAT DOES SUCCESS LOOK LIKE?

For advisors, as well as for our clients, the focus should be the process and not solely the results.

We should zero in on improving our own lives and the impact we have on others. Reaching those objectives should make our lives, and the lives of those around us, easier and more enjoyable.

If all this results in having more income, excellent. If it means we don't make as much money, but there is contentment, then we've also won.

For our clients, we may need to reframe our conversations. Instead of asking them "What does your successful financial plan look like?" maybe we should ask them "What would you like to improve in your life? What impact would you like to make and for whom? What would you like to experience? What needs to happen in your day so that when you lay your head down to sleep, you do so with a smile?"

Some advisors may do this already. However, for me, asking these questions will be a drastic change.

Discovery will look a lot different and will probably result in a search for a lot of intangible and qualitative information on which to build financial plans.

Even the plans themselves might look different. I expect planning software will be able to tell only half the story of someone's hopes for their future. It's hard to quantify someone's desire to, say, spend time immersed in a new language each year, mentor disabled children and cherish their spouse each day.

If I can refocus my definition of success on continual improvement and the positive impact on people's lives, tangible milestones will become only part of the story. Earning money and prudently saving will become less of a focus, and the journey of life will become more fulfilling.

FP

**We may need to reframe our conversations and search for intangible and qualitative information on which to build financial plans.**

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**Dave Grant**, a *Financial Planning* columnist, is founder of the planning firm Retirement Matters in Cary, Illinois. He is also the founder of NAPFA Genesis, a networking group for young fee-only planners. Follow him on Twitter at @davegrant82.

## Conflicts on the FINRA Board

A group of attorneys raises concerns about extensive industry ties among FINRA's public board members.

BY ANN MARSH

**A REPORT BY A GROUP OF SECURITIES ARBITRATION** attorneys calls into question FINRA's ability to protect investors, given alleged conflicts of interests on its board.

The report was issued in November by the Public Investors Arbitration Bar Association, whose members represent investors in legal disputes with FINRA member firms.

The group raises concerns about five of FINRA's 13 public governors and one recently departed governor who now sits on the Federal Reserve's Board of Governors.

FINRA's board is composed of 24 members. Among them, 10 have open industry ties consistent with the nonprofit's public-private status as a self-regulator of the financial industry.

Another 13 seats are designated to public members, intended to represent investors. The remaining seat is for FINRA's CEO.

PIABA alleges, however, that, of the 13 public members, five are tied too directly to financial services firms to represent investors' interests. Among their concerns, PIABA notes that FINRA board Chairman William Heyman also serves as an executive for the Travelers Cos.

Other public governors, including Eileen Murray, Shelly Lazarus, Carol Anthony (John) Davidson and Joshua Levine, either work at financial services firms or sit on the boards of financial companies.

The authors of the report, PIABA President Andrew Stoltmann and Benjamin Edwards, a law professor at the University of Nevada, Las Vegas, and a PIABA board member, call on FINRA to replace those five board members with investor or whistleblower advocates, or former whistleblowers.

In response to the allegations, FINRA spokeswoman Michelle Ong said the organization has a "robust appointment process" in place to determine its board.

FINRA is currently in the process of reviewing PIABA's views on the issue, as well as other letters that were submitted after FINRA issued a request for comments in March, Ong says.



"Each governor, regardless of his or her affiliation or classification, is responsible for serving in an unbiased and objective manner, and voting on matters for the good of the investors, industry and marketplace," Ong wrote in an email. "Board members need to have an understanding of the issues facing FINRA, and an ability to apply their knowledge and expertise to those issues."

### PUBLIC DIRECTORS, INDUSTRY PEDIGREE

The PIABA report found the following about FINRA's public board members:

- Heyman, the board's chairman, is also the chief investment officer of the Travelers Cos., one of the largest insurance companies in the nation.
- Murray is co-CEO of the world's largest hedge fund, Bridgewater Associates.
- Lazarus is a director with private equity and financial services firm Blackstone.
- Davidson sits on the board of FINRA member and global asset management firm Legg Mason.
- Levine founded the single-family office Kita Capital Management.

In addition, Randal Quarles, recently appointed to the board of the Federal Reserve System, was a FINRA public board member until last summer.

While at FINRA, he also served as a director for the U.S. Chamber of Commerce, which filed a lawsuit last year to prevent the Department of Labor from implementing the fiduciary rule. Quarles could not be reached for comment. FINRA did not make the five public board members in question available for an interview.

#### **‘HOW CAN WE TRUST YOU?’**

“It’s just a disgrace,” says corporate and non-profit governance expert Nell Minow. “These conflicts of interest are a monstrous issue. It destroys any credibility that the organization has at all.”

Minow, who is vice chairwoman of ValueEdge Advisors in Portland, Maine, was not involved in PIABA’s report.

“This is exactly the reason that we don’t like to see industries regulate themselves,” she says. “Normally it takes a government agency at least a generation to become completely captive to industry. But in a self-regulatory system, it takes five minutes.”

During confirmation hearings on Capitol Hill in July, a senator pressed Quarles about how he could be effective as a regulator, given his industry ties.

“The Chamber of Commerce has repeatedly sued regulatory agencies to overturn investor protections on behalf of its Wall Street members,” Sen. Catherine Cortez Masto (D-Nevada) said to Quarles. “If confirmed to a position at the Fed, how can we trust you to balance the public interest against the interests of Wall Street, given the obvious conflicts in your current role?”

In response, Quarles said he would do what he’d done at FINRA. “In the same way that in representing the public on the FINRA board I have done that, without any influence from or even discussion with the Chamber of Commerce,” he said.

Stoltmann, one of the PIABA report’s co-authors, says that kind of hat-switching fails to serve American investors. “Non-conflicted board members provide the crucial check against Wall Street domination at a self-regulatory organization,” he says.

#### **PRAISE FOR FINRA CEO**

Stoltmann’s co-author Edwards says FINRA CEO Robert Cook deserves praise for releasing more detail about FINRA’s governors.

Prior to Cook joining FINRA in 2016, Edwards said the regulator released scant, if any, details about its public governors.

Public governor Levine, for example, had been described for years simply as “retired,” with no mention of involvement in the sin-

**“Normally it takes a government agency at least a generation to become completely captive to industry. But in a self-regulatory system, it takes five minutes.”—Nell Minow, ValueEdge Advisors**



BLOOMBERG NEWS

July hearings on Capitol Hill touched on the issue of FINRA conflicts of interest.



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gle-family office. "This is very important, to be able to look at the people serving on the board and observe whether or not there are conflicts," Edwards says.

### **'OVERBOARDING' RISK**

The report also cites another potentially critical fiduciary risk relevant to most of the board members: Overboarding refers to directors holding so many positions on different boards that, in the event of a crisis such as an economic downturn, they are unable to fulfill all their obligations.

Overboarding is an issue that has been of increasing concern to investors in recent years. Institutional Shareholder Services recommends that investors vote against overboarded directors, such as Heyman, the FINRA chairman, the report says.

The report found the issue is a problem with four of the governors in question:

- Heyman holds six governance and advisory roles at the same time, including his role as FINRA's chairman. In addition to managing Travelers' \$70 billion portfolio as CIO, Heyman is also a director at Bank Leumi USA and sits on the advisory board of Atlas Merchant Capital, among other duties for prominent organizations including Princeton University.
- Lazarus serves on 10 boards, the most of any of the governors cited in the study. It found she maintains board commitments or affiliations with entities including Merck, General Electric, the World Wildlife Fund and Lincoln Center for the Performing Arts, among others.
- Levine serves on or is affiliated with six entities, including Fresh Direct, Fantex Holdings and Classroom Inc.
- Davidson serves on at least five boards, including Pentair, DaVita and the University of Rochester.

"An overboarded public governor on FINRA's Board of Governors cannot devote substantial time and attention to mitigating systemic risks or to ensuring that FINRA's management vigorously protects public investors," Stoltmann and Edwards write in

the report.

The report also claims FINRA broke its own bylaws with respect to Heyman. While FINRA only allows public governors to serve two consecutive three-year terms, the report says, Heyman has served on FINRA's board for 14 years.

### **BORZI ON BOARD**

PIABA's report proposes five individuals as alternatives for the jobs, including Phyllis Borzi, the former Labor Department official credited with the shepherding the fiduciary rule into law; securities lawyer Jill Gross, who ran an investor rights clinic at Pace University for 16 years; Jordan Thomas, a former SEC official who now represents whistleblowers in his legal practice; and two others.

The revelations about FINRA's governors are not surprising, says Minow, especially in light of instances when, for example, critics said the regulator appeared to follow the lead of one of its largest members, JPMorgan, in becoming an instrument of retaliation against firm whistleblower Johnny Burris.

JPMorgan retaliated against Burris in firing him, according to a Department of Labor finding. After Burris continued to talk publicly about fiduciary breaches to which the bank later admitted, FINRA then launched a new investigation into Burris over a mere \$624 client loss that had already been refunded.

At the time FINRA investigated Burris, JPMorgan's former general counsel, Stephen Cutler, had just joined FINRA's board as an industry member. FINRA did not make Cutler, who still sits on the board, available for an interview to answer questions about the investigation.

"That's only to be expected from a group that in reality is so far from its stated rhetoric and purpose," says Minow of FINRA's handling of the Burris case, noting the investigation may have scared other whistleblowers into silence. "This is not the fox guarding the henhouse," she says of FINRA's governance issues. "This is the fox eating all the hens."

**FP**

**"Non-conflicted board members provide the crucial check against Wall Street domination at a self-regulatory organization."  
—Andrew Stoltmann, PIABA president**

## Aiming at ‘Egregious Conduct’

The SEC is drilling down on investor protections, while warning firms on cybersecurity and AML compliance.

BY KENNETH CORBIN

### AS THE SEC CHARTS A NEW COURSE UNDER CHAIRMAN

Jay Clayton and his top lieutenants, enforcement actions against advisors serving Main Street investors could be on the rise, officials warn.

In September the SEC launched a task force focused on abuses against individual investors, and now enforcement officials are training their sights on a broad range of issues in play for advisors working with retail clients.

Clayton — along with the recently installed co-chairs of the SEC’s Enforcement Division, Stephanie Avakian and Steve Peikin — has led the agency’s new approach.

“What Chairman Clayton and Steph and Steve have spoken about in terms of priorities for enforcement are subject matters that impact and matter to Main Street investors,” Lara Shalov Mehraban, associate regional director for enforcement in the SEC’s New York office, said at a recent conference hosted by the Practising Law Institute in New York that was also broadcast online.

“So what does that mean? At a high level, it means that we in enforcement are focused on retail investor fraud, investment professional misconduct, financial fraud ... and insider trading,” she said.

### FERRETING OUT ‘EGREGIOUS CONDUCT’

The Retail Strategy Task Force will cast a wide net, but its core focus will be on ferreting out “egregious conduct by registered entities and individuals,” Mehraban said.

In the RIA world, that translates into increased scrutiny into the appropriateness of the investments advisors are recommending to their clients.

Specifically, the SEC is increasingly concerned with conflicts of interest and high-cost mutual fund share classes. “Some examples of problems we’re continuing to see are investment professionals steering customers to mutual fund class shares with higher fees, when lower-fee share classes of the same fund are available,” Mehraban said.

Mehraban also cited concerns about wrap fees, micro-cap



SEC Chairman Jay Clayton has pushed enforcement efforts that focus on retail investor fraud, investment professional misconduct, financial fraud and insider trading.

stocks and alternative investments as areas of focus for the retail investor task force.

In creating the panel, the SEC drew on enforcement staff throughout the country, as well as officials from the SEC’s Office of Compliance Inspections and Examinations and Office of Market Intelligence.

The new group “will look at the many ways that retail investors intersect with the securities market, and will look for widespread misconduct,” Mehraban said.

### DEDICATING RESOURCES

“By dedicating additional resources and expertise to developing strategies to address misconduct that victimizes retail investors, we’ll be in a better position to protect our most vulnerable market participants,” she added.

The retail investor task force isn’t the only recent structural addition to the commission. Aligned with that group is a separate unit that is dedicated to managing cybersecurity issues, a related field Mehraban says is coming into sharper

focus at the commission.

"When Steve Peikin first came on board this summer, he said that, in his view, cyber-related threats and misconduct are among the greatest risks facing investors and the securities industry," Mehraban said.

### SEVERAL CYBER THREATS

Those threats could take the form of bad actors trying to gain access to material non-public information, using social media in an attempt to sway markets or hacking into brokerage accounts to manipulate trading.

Or, for advisors covered under the SEC's Regulation S-P privacy rules, it could mean a failure to reasonably safeguard clients' personal information.

Mehraban stressed that the cyber initia-

dering programs, which could become a major issue for advisors.

As of late November, the Treasury Department's Financial Crimes Enforcement Network was drafting a rule that would require advisors to develop formal AML programs.

A FinCEN spokesman confirmed the agency is committed to advancing the rule, but declined to speculate on timing.

"It's still under development and still moving forward," Stephen Hudak wrote in an email. Should that rule become the law of the land, the SEC would have responsibility for overseeing advisors' AML programs.

### KEEPING OUT THE BAD ACTORS

The agency's recent reviews of how other firms have been working to keep bad actors out of the financial system have found significant compliance failures.

"First, adopting AML policies is not enough," Mehraban said. "Having adopted AML policies, firms need to implement them. An AML policy that says all the right things yet sits on the bookshelf is not particularly useful."

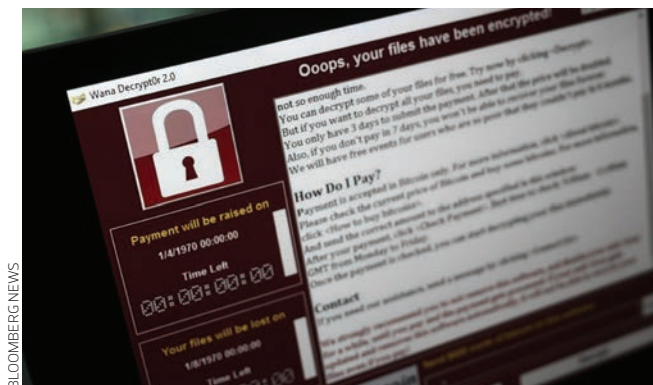
Several recent cases that the SEC has brought against brokers and other registrants for AML issues

have centered on firms' failures to adequately implement policies already on the books, she said.

Those cases included failing to identify and respond to red flags, not filing suspicious-activity reports or filing those reports with insufficient information to spot potential abuses of the financial system.

Mehraban argued that an AML program can be a window into a firm's broader compliance posture. To get it right, she said, firms must establish compliance as a core function, as both a matter of culture and in terms of how the firm runs on an operational level.

**"We in enforcement are focused on retail investor fraud, investment professional misconduct, financial fraud, cyber and insider trading."**  
— Lara Shalov Mehraban, SEC



Cybersecurity issues are a major source of risk facing investors, and a key focus of the SEC.

tive and the retail task force are working toward a common purpose, and are intended as complementary efforts.

"For each of the priorities, you can see the connection to the protection of the Main Street investor, and I think you can also see the importance of compliance personnel and strong compliance programs," she said.

Indeed, in many of the cases in which the SEC has brought an enforcement action, "a strong compliance program would have prevented the issue from even occurring in the first place," she said.

Mehraban said she sees additional compliance failures in firms' anti-money laun-

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Kenneth Corbin is a *Financial Planning* contributing writer in Boston and Washington. Follow him on Twitter at @kecorb.

# M&A FRENZY

## MORE DEALS, MORE COMPETITION

Dealmaking is setting records, private equity capital is pouring in and RIA buyers are scrambling to keep up. Is the pace sustainable?

BY CHARLES PAIKERT

**T**he red-hot M&A market for RIAs shows no sign of slowing down. Yet.

Deals are being transacted at a record pace, capital is pouring in and strategic buyers, led by well-financed RIAs, are frantically plotting to consummate more acquisitions in 2018.

There are approximately 10 to 20 qualified buyers for every seller, according to industry estimates. Through the third quarter of 2017, the most recent data available, deal volume for the year was on track to set a record with over 150 transactions, reports research and investment banking firm Echelon Partners. The record is 138 transactions in 2016.

Deals have also gotten bigger: The average size of an RIA transaction the past three years has topped \$1 billion in AUM, according to Schwab Advisor Services.

Like nectar attracting bees, the highly desirable assets, recurring revenue, talent and clients of advisory firms have a magnetic appeal to deep-pocketed suitors seeking to turbocharge growth.

Indeed, top-tier private equity firms are investing heavily in the independent advisory space, with an especially keen interest in consolidators. Last year, KKR and Stone Point Capital acquired a majority stake in Focus Financial Partners, and Thomas H. Lee Partners made a \$100 million investment in HighTower Advisors. Genstar Capital continues to fund an aggressive growth push by Mercer Advisors.

Scrambling to keep pace, independent RIAs committed to leveraging M&A for growth are tapping their own sources of capital – and are poised to go on buying sprees this year.

“We have the ability to grow organically around 10% to 15% a year,” says Neal Simon, chief executive of Bronfman Rothschild, a \$5 billion advisory firm backed by capital from the two billionaire families that provide its name, along with other private investors. “But we want to grow faster than that, and M&A is a way to accelerate that process.”

Advisor scarcity is also spurring the M&A frenzy, according to Brent Brodeski, CEO of Savant Capital Management, a \$5 billion-plus RIA based in Rockford, Illinois.

“Acquisitions allow me to partner with top advi-



# TION, MORE EXPENSIVE



Matt Cooper, Beacon Pointe president, says his firm is targeting RIAs with AUM of \$200 million to \$550 million.

sor talent and hire more qualified people, because now I have greater resources,” Brodeski says. “For the same amount of time and energy that it takes to open a new office, I come out ahead if I buy one.”

Savant is one of a number of billion-dollar-plus RIAs that have recapitalized with an eye to expanding their footprint this year. In 2016, Savant’s M&A war chest was fattened by a \$50 million infusion from an array

Wealth Advisors will also have ample resources as it pursues advisory firms in 2018.

The sale of an asset management firm owned by the RIA’s parent company, Mariner Holdings, is expected to add around \$1 billion to Mariner’s coffers. After sitting on the sidelines for nearly three years, Mariner plans to make seven to 10 acquisitions this year, according to CEO Marty Bicknell, targeting firms across the country with

and plan to be very active in the M&A market,” Carson says.

Beacon Pointe Advisors in Newport Beach, California, is also strongly committed to increasing growth through acquisitions. But unlike many of its competitors, it relies entirely on equity, not cash, when making deals.

### BEATING THE COMPETITION

“The fact that we don’t want to cash people out makes us more attractive than our competition,” says Matt Cooper, Beacon Pointe president. “We’re not offering a short-term financial transaction. We’re offering equity to smaller firms who want to contribute to a growing enterprise for the long term.”

The firm, which has acquired four companies since 2015 with a cumulative AUM of around \$865 million, is targeting RIAs with \$200 million to \$550 million in AUM, and hopes to do three or four deals in 2018, Cooper says. He and the other RIA acquirers hope to capitalize on being part of the advisory fraternity.

“The operators speak the same language, and there’s a higher degree of comfort,” says the investment banker and consultant David DeVoe, managing director of DeVoe & Co. “The cultural fit is more likely to work, and there’s often more clarity on how things will unfold after two RIAs complete a deal.”

Indeed, Bronfman Rothschild’s Simon believes advisors considering a sale will be swayed by the “real operational synergies” a fellow RIA can offer. “Unlike an aggregator — which is a collection of silos — or a private equity deal, firms who merge with us will be part of one investment team, one brand, one back office,” he says. “We offer cash and equity and have more deals on the table today than we’ve ever had.”

But successfully wooing a like-minded RIA in this market is hardly a slam dunk.

“Advisory firms often face capital

**“A MARKET PULLBACK WOULD HAVE A PROFOUND EFFECT. ... ADVISORS HAVE TO PUT EVERYTHING ELSE ASIDE. M&A FALLS TO THE WAYSIDE.” — DAVID DEVOE, DEVOE & CO.**

of private investors including an asset manager, a merchant bank and three large single-family offices.

After a buying hiatus last year, Savant expects to complete two to three smaller deals in Wisconsin, Washington, D.C., and Illinois through mid-2018, says Brodeski, followed by an acquisition in the \$750 million to \$1.5 billion range to establish a beachhead in a new market.

In Leawood, Kansas, Mariner

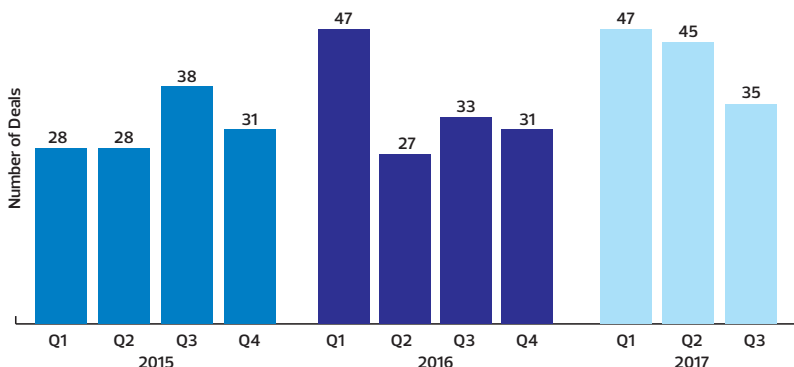
between \$250 million and \$1 billion in assets.

The high-profile executive Ron Carson avoided dealmaking last year after a switch of vendors to Cetera Financial Group from LPL Financial.

But new funding from Carson Group’s largest shareholder, the private equity firm Long Ridge Equity Partners, signals a buying spree this year. “We will have plenty of financial resources to be an aggressive buyer

### M&A Activity on Track for Another Record Year

Buying in 2017 has been fueled by private equity capital.



Sources: Company reports, SEC, Echelon Partners

constraints, offer lower pricing and tend to have more seller financing, using promissory notes for risk mitigation," says Liz Nesvold, managing partner of Silver Lane Advisors, a New York investment bank specializing in the RIA M&A market.

"They don't have the revenue distribution that a bank does, for example, or the stability," she adds. "And while equity is a great form of consideration, the only buyer for that stock is the acquiring firm itself."

RIA buyers are also confronting an increasingly crowded market of well-funded buyers hunting for similar sellers. The roll-up firm United Capital received a cash infusion from an Australian life insurance company that will boost its already relentless M&A efforts.

Captrust Financial Advisors, which specializes in retirement planning services for institutions, was one of 2017's most active buyers, with seven deals totaling over \$1 billion in assets. The firm plans to double its national footprint to 35 metro markets in 10 years, says CEO Fielding Miller.

Also pursuing an aggressive M&A strategy is Wealth Partners Capital Group, a newly formed RIA aggregator founded last year by the executive

team that ran the highly successful wealth management division of Affiliated Managers Group.

Wealth Partners is targeting small and midsize RIAs across the country via three regional firms in which it has already invested.

Banks are also in the mix as buyers with deep pockets. Although their share of M&A deals has dipped to single digits in recent years, banks have accounted for approximately 13% of RIA acquirers through the third quarter of 2017, according to Echelon Partners.

### ROOM TO RUN?

Can the hot M&A pace — and the resulting seller's market — continue? For starters, buyers and sellers are keeping a wary eye on the stock market.

"The bull market has run well beyond a typical cycle," DeVoe says. "A market pullback would have a profound effect. Clients will be calling, and advisors have to put everything else aside. M&A falls to the wayside."

In addition, assets, earnings and revenue would all drop during a correction, making advisory firms worth less. A spike in interest rates would be another red flag for the market, industry observers say.

Cheap credit has helped fuel the M&A boom, allowing buyers to leverage their capital, pay higher prices and still get a handsome return on the seller's EBITDA. "If the market turns, leverage remains a fixed requirement," Nesvold says. "That can make a big difference."

Or, as Brodeski puts it: "Leverage is like adding octane to your gas. A little bit can boost your fuel, but too much can blow your engine."

As demand for sellers rises, they are also getting choosier, notes Matthew Matrisian, senior vice president of strategic initiatives for AssetMark, an industry service provider.

"If an acquirer has a system in place, it's simple to integrate the seller's asset base, and the economics are beneficial to the buyer because they can take the revenue stream and drop it into their EBITDA with little overhead," Matrisian explains. "It makes sellers very attractive right now."

A potential headwind for buyers "is the fact that sellers are getting much smarter about what they want to accomplish," he says. "They have leverage now and have more ability to dictate terms when picking a buyer."

Nonetheless, RIA buyers remain remarkably optimistic.

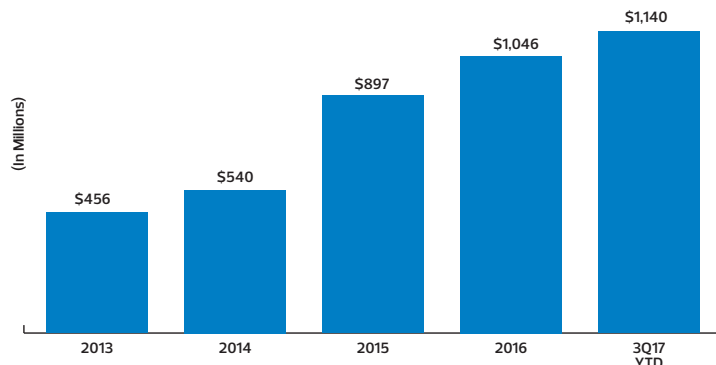
"Even if there's an economic event, I think it will only have a very short-term impact on the market," Mariner's Bicknell says. "The supply of sellers will still be there. Those who haven't solved the succession issue will be looking for partners for growth. And those doing financial deals today will lose their appetite. That leaves buyers like us in a good place."

Cooper, Beacon Pointe's president, agrees. "The forces driving this market, including changing demographics and the rising cost of compliance, regulation, technology are so strong," he says, "that I'm not concerned it will slow down anytime soon."

**FP**

## Average AUM per M&A Deal

Billion dollar transactions are the new normal.



Sources: Company reports, SEC, Echelon Partners

# How to Make an RIA Attractive to Buyers

There are savvy ways to position a firm for a future sale beyond focusing on revenue or AUM, experts at Schwab Impact told advisors.

By Charles Paikert

**T**wo advisory firms can have nearly identical revenue and assets under management. Yet if one firm structures its business in specific strategic ways, it can command more than twice the valuation of a lifestyle-oriented practice – even if the other firm is larger.

“Characteristics drive value, not size,” said John Furey, principal of Advisor Growth Strategies, at the annual Schwab Impact conference in November.

Furey, who spoke to advisors about how RIAs are valued, together with Todd Thomson, chairman of Dynasty Financial Partners, stressed the importance of advisory principals running their business as if they were trying to sell it.

Firms that focus on areas they can control, such as investment practices, client relations and technology, can potentially achieve a multiple of nine to 11 times free cash flow, Furey and Thomson maintained.

## WHY NET MARGIN MATTERS

Net margin and earnings growth are two of the most important characteristics that potential buyers will evaluate, the men said.

Even if firms have similar earnings, a larger net margin can have “a significant impact on valuation,” Thomson said. “It’s a multiplier effect.” Earnings expansion is also critical, he pointed out.

“Buyers want free cash flow to be sustainable,” he said. “They are going to ask sellers, ‘How are you growing, exactly?’ ”

## THE LIFESTYLE FIRMS

Lifestyle practices tend to have clients tied directly to the firm’s principal, Thomson said, while professionalized firms institutionalize client relations.

The former will result in a discounted valuation, according to Thomson. “If more clients are directly tied to the principal, the buyer is only going to pay the owner when the clients actually transition over,” he said. “Institutionalized firms don’t have to worry about that.”

Lifestyle firms also have to worry about having too many older clients

than firms that spend more time and money on customized investment solutions, Thomson asserted.

“Buyers want less risk,” Furey said, “and a scalable model is considered more sustainable.”

## WHAT BUYERS LOOK FOR

Valuations are highly dependent on what buyers are looking for. Furey and Thomson noted that buyers can often be characterized as financial, strategic or peer-to-peer.

Financial buyers, for example, are looking for growth and are unlikely to buy a practice from a principal who is retiring. Strategic acquirers may be more interested in larger firms, while an RIA who is a peer-to-peer buyer may be less concerned about an

“BUYERS WANT FREE CASH FLOW TO BE SUSTAINABLE. THEY ARE GOING TO ASK SELLERS, ‘HOW ARE YOU GROWING, EXACTLY?’ ”  
— TODD THOMSON, CHAIRMAN, DYNASTY FINANCIAL PARTNERS

and advisors. “Buyers want younger clients and advisors,” Furey said. “If they’re older, it’s considered a declining asset and buyers pay a lot less.”

## ASSET MANAGEMENT MODELS

Firms that institutionalize asset management with standardized investment models that are scalable tend to be more highly valued

owner retiring if the seller is a local firm that is a good cultural fit.

Furey warned sellers that they should not to read too much into news stories about firms selling for a high price or multiple.

“The main impediment to the sale of RIAs,” Thomson added, “is unrealistic expectations on the part of the seller.”

**FP**

Charles Paikert is a senior editor of *Financial Planning*. Follow him on Twitter at @paikert.





# How Fee Details Can Make or Break a Takeover

If an acquiring advisory firm doesn't adequately consider the nuts and bolts of a seller's fee structure and billing processes, headaches are guaranteed.

BY MICHAEL KITCES

It seems straightforward enough: One advisory firm wants to merge with another – or acquire it outright. They agree on a valuation, and the post-transaction integration process begins. If only it were so simple. A potentially massive yet overlooked blocking point for the two firms is aligning their advisory fee schedules and billing processes.

If one charges substantially more or less than the other, or uses a different business model (as when an AUM firm acquires a retainer-fee firm), the feasibility of integrating their billing processes can be a major blocking point for a merger or acquisition.

## DUE DILIGENCE

Consequently, it is crucial to do detailed due diligence on fee schedules before a merger or purchase occurs. In particular, advisors should be evaluating any differences in the level of fees charged to clients, the timing of those fees and the methods for calculating fees.

Of course, fee schedules do not need to be identical for firms to successfully navigate these waters, but approaching a merger with a clear-eyed understanding of the potential risks is crucial.

In situations where the buyer charges higher fees than

the firm being acquired, most firms eventually pass along those new higher fee schedules to the clients of the acquired firm. In fact, when firms have successfully created a compelling value proposition that allows them to charge above-average advisory fees – and justify them – it can even lead to a willingness to pay a premium in the purchase price.

## ADJUSTING FEES

For instance, imagine a firm that charges 1.1% on the first \$1 million of assets and is seeking to buy a firm that charges a flat 1% AUM fee.

Valuation experts measure the value of the firm being acquired based on its revenue. If the target firm charges 1%, the valuation is based on that fee. But if an acquirer charges 1.1% and expects acquired clients to transition to the higher fee, it can afford to pay a little bit more for the firm because of the potential to recoup the cost down the line in higher fee revenue.

Some firms will keep the original fee schedule in place for a year or two, just to give clients some stability in the transition and ensure they stick around.

Fees are adjusted once the new owners have an opportunity to build a real relationship with the newly acquired clients and demonstrate real value to them that justifies the

higher fees.

But when the acquirer charges lower fees than the firm being acquired, it gets messier. In such a situation, acquirers have to bring the acquired firm's fee schedule down to their own fee schedule. This means that the buyer will be cutting its newly acquired revenue stream.

Fortunately, this sometimes works out fine because, in general, larger advisory firms tend to acquire smaller firms, and if the larger is significantly more efficient than the smaller, it may more than make up the loss of revenue with cost savings.

For example, suppose a firm being acquired is part of a partnership with \$120 million under management that generates about \$1.5 million in revenue, and has a 20% profit margin – creating \$300,000 in profits. Meanwhile, the acquiring firm is able to cut \$100,000 or \$200,000 in staffing cost by merging the new firm into the existing infrastructure. Even if the acquiring firm has a lower fee schedule, it can afford to give up some revenue and still maintain profits.

Still, the key point here is that fee schedules are overlooked at everyone's peril.

Ironically, because so many advisors charge approximately the same fee, around 1% on a \$1 million client, advisory fee schedules in practice tend to line up pretty well.

Still, it's not just about whether both firms charge the same 1% on \$1 million.

Rather, it's the structure of the advisory fees all the way up and down the line; if the firm doesn't align for \$500,000, \$1 million and \$5 million clients, then a misalignment of fee schedules can create challenges to raise or lower fees on newly acquired clients.

### ADVANCE BILLING VS. ARREARS

The second area that advisors need to watch out for is the billing process.

The really big issue here is whether the firm bills in advance or in arrears. In other words, when a client starts, is the first quarterly billing for the prior partial quarter that they were with you, or is their first billing in advance for the upcoming quarter (which determines whether, if they decide to terminate the next quarter, you refund them a pro rata portion of their fees)?

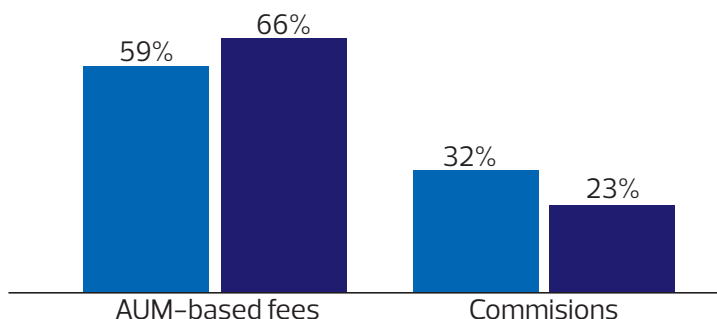
Some firms prefer to bill in arrears, believing that no client should be billed until the firm has started doing work on their behalf. Others firms prefer to bill in advance, thereby avoiding any accounts receivable or the need to collect from terminating clients as they leave, and simply providing a pro rata refund for a terminating client instead.

On an ongoing basis, most firms don't even think about this. They simply bill clients quarterly, whether it's in arrears or in advance. After the first billing, no one really cares about the timing of billing unless they want to terminate – in which case a firm

**When an acquirer faces a decrease in revenue because of lower fees, it sometimes can offset part of the decline through cost savings from increased efficiency.**

### Commission Phaseout

Most advisors expect to collect AUM fees next year, but fewer than a quarter say they will get commissions.



Source: Cerulli Associates, The Cerulli Edge—U.S. Edition, October 2017

that bills in advance must determine if it will prorate back a portion of the last fee, while a firm that bills in arrears must collect its final partial-quarter fee.

In a merger or an acquisition, however,

three more months into Q1.

Unfortunately, the situation is not much better in the opposite direction. If the acquiring firm bills in advance and the firm being acquired bills in arrears, then the only way

**It takes skill to persuade clients to stick around when you're immediately going to double-bill them.**



these little differences can have outsized impact. If a firm bills in arrears and acquires a firm that bills in advance, then the acquiring firm immediately takes on the liability of refunding any clients who terminate in the quarter right after they've been billed. Unless these new clients are immediately converted to arrears billing, then the acquiring firm maintains this potential liability in the future. Yet if the acquirer wants to convert the clients, this gets even messier.

Imagine that a firm billing in arrears acquires a firm that bills in advance. We're in negotiations now, the deal closes in October, and shortly after Q4 billing has happened at the end of September. So the clients of the firm just purchased have already paid for Q4. This means that if the buyer wants to bill them in arrears, the next billing isn't going to happen for five months – at the end of Q1.

If the acquirer bought the firm in October, it would not see any revenue at the end of the fourth quarter. And if it doesn't bill in advance, it cannot bill for Q1 at the end of the year either. Instead, the acquirer has to wait

the acquiring firm can true up clients is to double-bill them. Continuing the earlier example, if the acquired firm is purchased in October and bills in arrears while the acquirer bills in advance, then at the end of Q4, on Dec. 31, the acquirer is going to bill Q4 in arrears because the clients haven't paid for that yet, and then must bill Q1 in advance because that's what the acquirer does on an ongoing basis. And so new clients will be hit with two bills to get them on track the first time the acquirer does billing.

Now, it is worth noting that clients are not being cheated, as it is not a literal double-charge. Rather, they are paying the fourth-quarter fees because services were rendered in the fourth quarter, and they are being billed in advance for the first quarter because that is what the acquirer does with all clients. If they don't like this and terminate, the acquirer would still issue a partial refund.

But the bottom line is that the acquirer has to be prepared to communicate to clients that to transition them from an arrears into an advance billing cycle, an initial double-

billing must occur. At the least, it takes real skill to persuade newly acquired clients to stay when the first thing an acquiring firm is going to do is double-bill them – right when they're getting to know their new advisor.

Firms also need to align on the calculation of AUM fees. Do you calculate based on end of quarter balance, or the average daily balance throughout the quarter? On average, these balance out, but not always.

If clients are net savers, end of quarter balances tend to be higher than average daily balances because clients keep contributing – such that the end of quarter tends to be the higher of the two.

But if the firm mostly works with retirees, the inverse is typically true. Average daily balances tend to be higher than end-of-quarter balances, because at the end of the quarter, all the withdrawals have occurred.

And, of course, there's also a risk of big gaps caused by sharp market movements in the closing weeks of a quarter – making an end-of-quarter balance look very different than an average daily balance.

### RETAINER VS. AUM

Even thornier challenges crop up when one advisory firm has an AUM-based fee schedule and the other uses a retainer model. Industry research shows that the majority of advisory firms are still AUM-centric. And in fact, the larger the advisory firm, the more affluent their clients, and the more likely they are to charge AUM fees. This means that generally, acquisitive firms are AUM firms.

But when an AUM acquires a retainer firm, there's usually a plan to convert the retainer clients over to an AUM fee structure. This can be difficult, because the firms that use retainer fees – particularly for affluent clients – tend to aggressively sell against AUM fees to convince their clients that the retainer model is superior. In the process, they poison the well for most acquirers.

This is one of the major drawbacks to pivoting from AUM to retainer fees.

It isn't necessarily an issue for those who

are doing retainer fees for younger clients who don't have assets, because no AUM buyer is going to acquire a practice filled with clients who don't have assets – or if they do, they're going to acquire because they want to actually do the retainer model the way the retainer model is being executed, or they help clients grow into the AUM model later.

### THE RISK

But if a firm works with affluent clients who have assets and simply charges retainer fees, this makes finding prospective buyers a lot more difficult. AUM buyers want to convert but are afraid of the risk, and there aren't very many non-AUM buyers. The net result: advisors adopting retainer fee for affluent clients risk drastically reducing the appeal of the firm for most prospective buyers.

In fact, even other retainer firms often have trouble acquiring those that do complexity-based retainer fees, because different firms characterize "complexity" differently. Consequently, even two firms doing annual retainer fees for affluent clients might charge very differently for some of those clients, which makes life messy for the acquirer.

Indirectly, this is actually one reason the AUM model work so well. By its nature, it is a very systematized billing model. At worst, a firm may have to change a few rates or break points on its AUM fee schedule, but there's a standard fee structure for all clients. And that's often not the case with retainer firms.

The key point: making the billing process much harder to reconcile for an acquiring firm may narrow the number of interested buyers, particularly for firms that move away from AUM fees toward the emerging range of nontraditional fee structure. This is obviously unwelcome news for anyone hoping to sell one day.

At a minimum, though, be certain to deeply and deliberately research fee and billing structures so that everyone – whether the acquirer, the seller or the client – emerges feeling that they won.

**FP**

**Thorny challenges crop up when one advisory firm has an AUM-based fee schedule and the other uses a retainer model.**

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**Michael Kitces**, CFP, a *Financial Planning* contributing writer, is a partner and director of wealth management at Pinnacle Advisory Group in Columbia, Maryland; co-founder of the XY Planning Network; and publisher of the planning blog Nerd's Eye View. Follow him on Twitter at @MichaelKitces.



## Shunning Offshore Investing

Long before the Paradise Papers, many advisors were wary of foreign tax shelters. “Your risk of being audited goes up,” Ron Carson says.

BY ANN MARSH

**UNTIL A DECADE AGO, ONE OF THE INDUSTRY’S MOST** influential planners, Ron Carson, held about 20% of his assets in a trust based in Canada.

The idea was to shield those funds from creditors, but after maintaining it for about 10 years, Carson shuttered it. Two IRS audits convinced him the offshore strategy was attracting heightened scrutiny. “Your risk of being audited goes up” with offshore assets, Carson says.

If the new global revelations from the Paradise Papers about offshore tax evaders have made one thing clear to the investing world, it’s that holding assets offshore no longer provides a guaranteed shelter from public scrutiny, among other risks. And many advisors now eschew them entirely.

“We used to get all kinds of requests for that stuff,” Carson says. Now, by contrast, “we don’t deal with them at all.”

The Paradise Papers involve a leak of 13.4 million documents that have revealed the tax-sheltered holdings of more than 120 politicians and world leaders, ranging from the Queen Elizabeth II to the Trump administration officials Wilbur Ross and Gary Cohn. In early November, journalists led by the International Consortium of Investigative Journalists published a number of investigations there were based on the documents.

### RISKS TO FIRMS

None of the planners reached for this story say their clients have been impacted. Moreover, it’s rare these days for clients or prospects to ask about offshore investing, many said.

Advisors tend to stay away from these strategies not only because of the risk to their clients, but also because of the risks to their own practices. The recent indictment of President Trump’s former campaign manager Paul Manafort provides another good illustration as to why, says Megan Gorman, a CPA and managing partner of Chequers Financial Management in San Francisco.

Part of Robert Mueller’s ongoing investigation into Russian interference in the presidential election, the indictment



Ron Carson, founder and CEO of Carson Wealth Management, has stopped investing assets in a foreign trust and says client requests to place assets offshore have declined.

claims Manafort “represented falsely” that he did not have authority over foreign bank accounts.

Some of the evidence for this assertion came from Manafort’s emails with his CPA and, Gorman says, other advisors to the political consultant have been drawn into the federal investigation. The case shows why planners need to ask what role they are willing to play if a client falls under regulatory or legal scrutiny for their offshore holdings, Gorman says. “You really have to think about, ‘What if it goes to hell in a handbasket?’ ” she adds. “Are you going to be helping the client or will they be on their own?”

In working with new clients in her own practice, Gorman says, she explains her approach of being both transparent and fully compliant with tax and other authorities, which tends to foreclose on moving assets offshore.

Seth Streeter, CEO of Mission Wealth Management in Santa Barbara, California, says he takes the same approach with U.S. investors. But, helping international investors with offshore investments does not necessarily come with the

same risks, he says.

While U.S. investors have been under heightened reporting requirements from the IRS for offshore holdings for nearly a decade, the same restrictions for foreign investors don't apply, Streeter says. "Any time a domestic-based client has come to us and said, 'I am interested in offshore strategies,' we have steered them away," he says.

But ever since foreign prospects began to express interest in retaining Mission Wealth to help them invest in the more stable U.S. financial markets while legally placing those assets in other jurisdictions, Streeter has been investigating how to do so.

Recently, he says, a prospect from Panama wanted the firm to manage \$18 million for him, but Mission has held off on taking the money. For now, Streeter is working with him on a consulting basis and talking to various offshore investment managers about devising a workable strategy. "I'm kind of using this Panamanian client as a beta," he says, to see "if we can get him an offshore solution to address his investment need."

## A NEED TO CONCEAL

Some international investors have an understandable — if unfortunate — need to conceal their ownership of the assets by placing them offshore. "There are some people who live in countries where the government knowing things about your families' wealth can be really problematic," says Rachel Harris, chairwoman of the law firm Loeb & Loeb's international trust and estate planning practice, who advises high-net-worth families from around the world.

"So, if heaven forbid, [a client's holdings] were just posted on the internet, that could lead to your getting kidnapped. That's a reality for some people. It's very scary."

The Paradise Papers isn't the first international development to raise these kinds of concerns. The journalism consortium revealed secretive offshore holdings of many world leaders in its worldwide Panama Papers investigation two years ago.

About a decade ago, several roughly con-

current events began putting new pressure on the secret holdings of offshore investors.

The Obama administration's far-reaching Foreign Account Tax Compliance Act, enacted in 2010, began requiring banks in other countries to report on the holdings of many U.S. citizens, at the risk of facing penalties of up to 30% on the banks' transactions in the United States.

Two years earlier, the whistleblower Bradley Birkenfeld, then with the Swiss bank UBS, revealed how his employer was helping U.S. investors hide assets offshore. The next year, UBS agreed to pay a \$780 million fine to the U.S. government, dealing a historic blow to perhaps the world's best-known tax haven, Switzerland.

Also in 2008, in an attempt to track down its own tax scofflaws, German authorities bought stolen client data from an employee of a bank in another tax haven, the small European country of Liechtenstein.

This confluence of events "sparked, in my mind, the beginning of the end, the radical change of this offshore investment world," says Andrew Fisher, founder of Worldview Wealth Advisors in Lake Oswego, Oregon, and author of "The Cross-Border Family Wealth Guide."

Although he doesn't put clients into offshore investments, Fisher says he sometimes helps extricate them from ill-advised ones that others have sold to them.

The Paradise Papers revelations stand to put more pressure on all investors with assets to hide, according to Fisher.

That said, offshore investing is not likely to go away quickly, he predicts. "It's going to happen slowly because it's so embedded," he says, adding that stashing money offshore has been a foundational strategy for the wealthiest of the wealthy for at least 100 years and probably longer.

The new momentum against hiding assets offshore, Fisher says, has "sparked a wave that is not going to stop, which is this move toward more international information sharing and a crackdown on offshore tax havens."

FP

**Clearly, there is a "move toward more international information sharing and a crackdown on offshore tax havens," says Andrew Fisher, founder of Worldview Wealth Advisors.**

## Future of HSAs Is ‘Very Bright’

Health savings accounts present advisors with a great opportunity to help clients deal with health care costs during retirement.

BY CHARLES PAIKERT

**2018 MAY BE THE YEAR OF HEALTH SAVINGS** accounts for advisors. Managing HSA accounts is “the direction the industry is moving,” says Peter Stahl, principal of Bedrock Business Results, speaking at a presentation at Schwab’s annual Impact conference. Now that medical expenses are a top retirement concern, HSAs are thrust into the spotlight, he adds.

“Health care costs are now the biggest issue for people,” Stahl says. “The national average for medical expenses once someone reaches age 65 and is on Medicare is \$6,772. HSAs really present advisors with a great opportunity to help clients deal with this problem.”

A number of planners are eyeing the opportunity to manage the investments in a client’s HSA account, while researching which companies to work with and how much to charge.

Advisors should also consider working with companies that offer HSA accounts to employees, Stahl says. That opportunity, he adds, “may be the rocket booster in 2018.”

### BRIGHT FUTURE, TAX FREE

The tax-advantaged accounts allow users to save for health care costs their insurance doesn’t cover. Money is deposited tax-free, grows tax-free and can be withdrawn without paying taxes as long as the money is spent on health and medical expenses. However, HSAs can be

used only by people who have qualifying high-deductible health insurance.

HSA accounts now have over \$42 billion in assets, Stahl says, a 23% increase from a year ago. Nearly \$7 billion in HSA accounts are invested, a 44% jump from a year earlier.

The trajectory is likely to continue on a fast-track growth path, according to Stahl.

“The future is very bright for HSAs,” he says, noting that deductions and contributions are expected to increase and that the mandate for HSAs was set to be expanded in the Republican health care bill that narrowly failed to pass in the Senate earlier in 2017.

### KEEP CLIENTS INFORMED

Advisors should urge clients to contribute the maximum amount to their HSAs and utilize the catch-up provision that allows individuals over 55 to contribute an extra \$1,000 a year, Stahl recommends.

A tax-free 401(k) plan with an employer match should be funded first, Stahl suggests, but as soon as the match is met, clients should begin to fund their HSA.

Advisors may also want to suggest apps, such as HSA Coach, that can help clients track their medical expenses.

### What an HSA Account Should Include

Morningstar’s recommendations for an ideal health savings account.

| Allocation                 | Recommendation |
|----------------------------|----------------|
| Target-Date Series         | At least one   |
| Target-Risk Series         | -              |
| Other Allocation           | -              |
| <b>Equity</b>              |                |
| U.S. Large-Cap             | At least one   |
| U.S. Mid-Cap               | -              |
| U.S. Small-Cap             | -              |
| International Developed    | -              |
| World Stock                | -              |
| Emerging Markets           | Optional       |
| Specialty Equity           | Optional       |
| <b>Fixed Income</b>        |                |
| Cash Equivalent/Short-Term | At least one   |
| Core                       | -              |
| Specialty Equity           | Optional       |
| <b>Alternatives/Other</b>  | Optional       |

Source: Morningstar

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Charles Paikert is a senior editor of *Financial Planning*. Follow him on Twitter at @paikert.

## Keeping Up Your Guard

The NSA, Equifax and the SEC were all breached. Advisors of all sizes are fair game, too. Follow these measures to protect your clients' data.

BY WES STILLMAN

**IF THE NSA, EQUIFAX AND THE SEC ARE ALL WITHIN** cyberhackers' crosshairs, it's safe to assume that financial advisors are fair game for a potential breach, too.

Even firms that believe they're too small to matter should think again. If a cyberattack happens at a firm's outsourced CRM partner, portfolio management vendor or custodian, and clients' personal information is compromised, where is the client going to turn first to demand an explanation?

Advisors need to act swiftly when there's a cybersecurity breach. Doing nothing is simply not an option.

Planners can use recent headlines to reiterate their own cybersecurity policies and procedures. If news on cyberattacks prompts the firm to make internal operational or IT adjustments, explain this to clients.

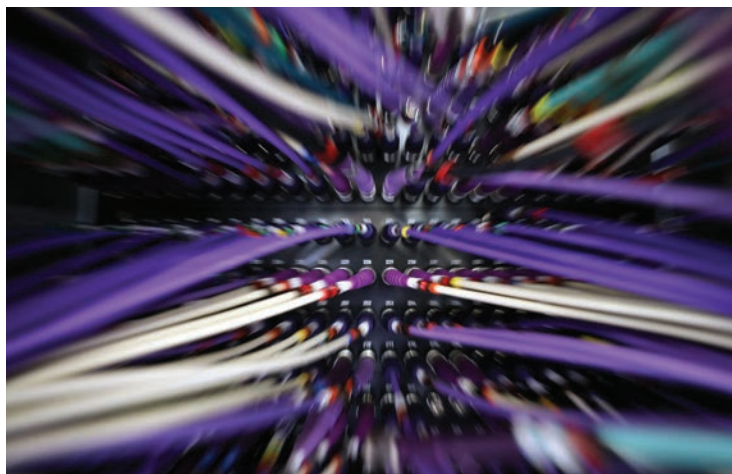
For example, advisors can remind clients what to expect in firm emails. This could mean reviewing the type of information that is – and is not – shared via email. Just as advisors might be targets of a breach, they might also be impersonated for a phishing attack on their clients. Advisors should spell out the steps clients should take if they receive a suspicious email or phone call.

### STAY ON TOP OF THIRD-PARTY SECURITY

While RIA custodians do a significant amount of risk assessment of their technology providers, advisors should not lean solely on custodians as a safeguard. This is especially true for vendors that fall outside of a custodian's tech offering and as a result, may not be vetted to the same rigorous standards.

Conducting ongoing due diligence on third parties is critical. Advisors should periodically ask their vendors the following questions: Is my data stored in the U.S.? How are you encrypting data in motion, at rest and in use? What information do you pass along and is it on a need-to-know basis?

Additionally, RIAs should demand daily communication from their vendors on cybersecurity enforcement. For



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example, advisors should be reviewing access logs, back-up reports, change logs and system reports, as well as results of vulnerability testing and assessments.

RIAs are entrusted to manage hard-earned assets to achieve financial goals, and to protect against downside risk, and today that includes managing risk of fraud or cybertheft. This dialogue can be part of the progression of the client-advisor relationship, and can be a differentiator for the firm.

While communicating with clients about the firm's cybersecurity protocols, RIAs can also educate clients on how to act online to keep their information safe. Throughout these discussions, advisors can convey confidence and make suggestions without getting overly technical.

Do not wait until a breach occurs to communicate with your clients. Instead, offer cybersecurity updates as a part of the normal workflow of doing business. A word of caution here: take care not to overcommunicate on cybersecurity, either. Proactive client updates should happen throughout the year, but no more than quarterly.

**FP**

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Wes Stillman is founder and chief executive officer of Overland Park, Kansas-based RightSize Solutions.



## Going Through the Roof

Most Americans would prefer to age in place, but sometimes the costs of home care make it impractical. Here's how to help.

BY DONALD JAY KORN

**FOR CLIENTS WHO NEED LONG-TERM ATTENTION,** the home-sweet-home solution unfortunately may be a money pit.

Nearly eight in 10 older Americans (77%) would prefer to receive care in their homes, according to a recent poll by The Associated Press and the National Opinion Research Center. That's no surprise. How many seniors would opt instead for a nursing home or space over their son-in-law's garage?

Preferences may not lead to practicality, though. "It's hard to age in place, for seniors who live alone, especially if family doesn't live close by or in the case of advancing dementia," says Jennifer Cray, partner at Investor's Capital Management in Menlo Park, California. "It's less expensive in the beginning when the care needs are still light. But over time, it can get more expensive than living full time at a facility."

### THE CHALLENGE

For advisors, the challenge is to make home care more affordable. How expensive can it be to bring in caregivers?

The national median cost for homemakers' services is about \$4,000 a month, or \$48,000 a year, with a similar median for home health aides, according to the Genworth 2017 Cost of Care Survey.

Those costs assume the care totals 44 hours a week, or about six hours a day. More hours would boost the bills, as would living in a high-priced area. In some surprising places like Iowa and Kentucky, the annual costs for even a 44-hour week can top \$100,000 a year.

### THEN DISASTER STRUCK

People preferring to stay in familiar surroundings may be clients or their parents, and may be either single or married. "Usually, one spouse — often the husband — needs care, which is provided by the other spouse," says Judy Ludwig, vice president of financial planning services at Braver Wealth Management in Newton, Massachusetts. "Some outside support will help to care for the ill individual who would



prefer to stay at home."

Traditional marital roles may also be reversed. Debbie Gallant of Gallant Financial Planning in Rockville, Maryland, tells of clients in which the wife was 75 years old and the husband was 85. They needed to downsize out of their five-bedroom, three-level house, so they moved into a two-bedroom apartment, instead.

Then disaster struck.

The wife was in a head-on collision, and then spent 10 weeks in an ICU and in rehab before she was discharged to the care of her husband.

"Due to her injuries, they were able to activate her long-term care policy from Day One, as it covered home care," Gallant says. The policy, purchased 14 years earlier with a 5% inflation adjustment and no elimination period for home care, had grown to pay \$350 a day. Those benefits, along with the proceeds of the home sale, her IRA, her teacher's pension and Social Security covered their costs. Altogether, they were paying \$3,700 per week for care plus their normal living expenses at their apartment.

According to Gallant, the extra outlays for staying in their

apartment included 24-hour caregivers, a geriatric social worker who visited twice a month and someone to organize their medications each week. The couple also needed to modify their new apartment by installing grab bars in the bathroom and widening doorways, and they bought a walker, a portable wheelchair, a hospital bed, a seat for the shower, a portable toilet and medical alert necklaces.

In many cases, Ludwig notes, food expenses also usually increase as caregivers also need to be fed. And Carmen Wong, partner and senior wealth advisor at Confluence Wealth Management in Portland, Oregon, reminds clients not to overlook transportation costs, especially if the most desired medical specialists are not located within close driving distances.

Eventually, Gallant says, both spouses mentioned above saw their health decline so much that they had to move into an assisted living home. Ironically, even at \$8,000 to \$10,000 a month, the facility was less expensive than hiring caregivers to come to the apartment.

## HIGHER CEILINGS

Therein lays the dilemma. Clients will probably prefer to stay home if they need long-term care, but the costs can be overwhelming. How can advisors approach this topic?

Step 1 entails recognizing the costs of home care and adjusting financial plans accordingly. "I've been surprised at how expensive long-term care can be," Cray says. Sources such as the Genworth Cost of Care survey cite median costs by area, but that's just the median. In reality, costs can be vastly higher, even for the basics, she says.

Cray reports that her firm is changing its modeling for the potential costs of long-term care. "We'll probably add about 20% to the already high numbers we've been using," she says. "Finding that extra money won't be easy."

"We may suggest saving more and holding more cash. When someone needs care and is living in a house, they'll need to keep it in good repair. The cash needs can be enormous," she adds.

Planning also can include buying LTC insurance with home-care coverage. "I tell my clients that the 14 years of premiums that this couple paid for their LTC insurance were recovered in about six months of benefits," Gallant says.

## 'POOL OF MONEY'

Tax savings can help too, at least under current law. For the aforementioned couple, the long-term care reimbursements from their LTC insurance policy were not taxable. In addition, unreimbursed long-term care costs were deductible above 7.5% of their adjusted gross income. (Proposed tax legislation would eliminate this deduction, which now kicks in above 10% of AGI.)

"Long-term care insurance is something we might use, but costs are high," says Cray. "We'll be looking at annuities with LTC riders as an alternative."

"Conceptually, I like the idea of a pool of money that can be used for different purposes. However, with insurance products it's vital to look closely at the details," she says.

Wong adds that life insurance cash value also can be used to help cover LTC costs. "Another case we are working on involves clients who have not purchased long-term care insurance," she says. "We are exploring strategies to allocate a part of the retirement account to a designated pool of assets earmarked for long-term care, which may eventually morph into an annuitized income stream to fund part of the monthly needs."

## MONEY FROM HOME

Long-term care insurance can help cover home care costs, along with other income sources and drawing down savings.

"Sometimes the children pitch in to help financially," says Ludwig.

Still, there may be a gap — one that might be partially filled with home equity. "In many parts of California, for example, home equity is by far the largest asset that many people have," Cray says. A reverse mortgage might provide a lifelong source of untaxed cash flow, but come up short.

"The amount of equity that can be made liquid with a reverse mortgage is limited and

**Clients will probably prefer to stay home if they need long-term care, but the costs can be overwhelming.**

would only cover a few years of high-cost care," Cray says.

"It's not a solution for everyone who wants to stay in their home." For the aforementioned couple, Gallant recalls, "a reverse mortgage could not possibly have provided the income stream that they needed to pay for their care once they required more than just a few hours a day."

Online, advisors can find many reverse mortgage calculators to give clients an idea of what they can expect.

At [reversemortgage.org](http://reversemortgage.org), for instance, the calculator indicates that a free-and-clear house in Peoria, Illinois valued at \$500,000, could qualify for a federal Home Equity Conversion Mortgage (HECM) with cash advances around \$1,250 a month to a

For individuals, up to \$250,000 of gain from the sale can be tax-exempt, and for married couples filing joint tax returns, the cutoff increases to \$500,000. Recently widowed clients may also qualify for the larger exemption, provided they sell their home within two years of their spouse's death.

#### 'A FORTUNATE PROBLEM'

Another tactic, mentioned by Ludwig, is for the children to purchase the home from a parent or parents needing care, which can provide needed cash.

The parents can then rent the home from the children or the children can gift the value of the rent to the parents, Ludwig says. The annual gift tax exclusion – the limit for gifts without tax consequences – will be \$15,000

**Advisors can become part of the solution by apprising clients of the possible costs involved and starting early with a financial plan.**

## Long-Term Care Costs Rise

Over the 12 months ended September 2017, expenses for these services climbed:

- Home health aide services, up 6.2% to \$21.50/hour
- Homemaker services, up 4.8% to \$21/hour
- Adult day health care services, up 3% to \$70/day
- Assisted living facilities, up 3.4% to \$123/day or \$3,750/month
- Semi-private room nursing home care, up 4.4% to \$235/day or \$7,148/month
- Private room nursing home care, up 5.5% to \$267/day or \$8,121/month

Source: Genworth 2017 Cost of Care Survey

couple, both age 72. In 2017, the HECM limit is \$636,150 of home value, putting a cap on loans backed by more expensive properties.

Ludwig asserts that reverse mortgages can work but they are tricky, and they come with fees. "I strongly recommend that a professional review any documents that the couple has to sign before they turn over their house to a lender," she says.

#### ON THE SELL SIDE

Selling the house could free up even more home equity, but how can such a sale be reconciled with a desire to stay home for long-term care?

One tactic is to sell and move into a smaller and presumably less expensive place, as Gallant's clients did.

per recipient in 2018, an increase from \$14,000 in 2017.

Tax-wise, it would be better to keep the home and get the basis step-up, Cray says, so at the owner's death, the heirs could avoid income tax on a subsequent sale. If money is needed immediately, a sale might be necessary, but the \$250,000 or \$500,000 capital gains exclusion may not cover the full gain on some homes.

As Cray observes, "that's a fortunate problem to have."

Not all problems arising from long-term home care are so fortunate. Advisors can become part of the solution by apprising clients of the possible costs involved, and starting early with a financial plan designed to help clients stay put as long as possible. **FP**

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Donald Jay Korn is a contributing writer for *Financial Planning* in New York. He also writes regularly for *On Wall Street*.

## Broaching a Touchy Subject

Should an advisor do nothing if a client is abusing illicit substances, or seize the opportunity to discuss it?

BY CAROLYN McCLANAHAN

**WITH ONE OUT OF 10 PEOPLE CONSUMING ILLICIT** drugs, it is highly likely some of your clients are at least occasionally smoking up, popping pills or getting high one way or another. Even rare drug use has potential for legal, medical and financial complications. Should advisors ask their clients about drug consumption? And what – if anything – should an advisor do if they find out a client is abusing marijuana, cocaine or opioids?

### WE CAN'T LIVE OUR CLIENTS' LIVES

Just like we can't command clients to not waste money, it's also not our place to tell them not to use drugs. In my practice, I don't ask specifically about illicit drug use, especially early in the relationship. Most people don't use drugs and even fewer have serious problems with drug use where they might need an intervention. I don't want to go there unless I see a need to address the situation.

What do I do when I identify an issue? There are a number of ways drug use may come up, and when it does, I grab the opportunity to discuss it.

I've had a couple of clients share that while they are visiting Amsterdam or Colorado, they plan to enjoy some legal marijuana. Since legal recreational marijuana use often has little risk, I don't worry.

But if they work for an employer who may test for drug use, I humorously remind them to not let their employer find out. Although recreational marijuana is now legal in eight states and the District of Columbia, it is still illegal on a federal level and employers can hold a failed drug test against workers or job applicants.

Clients most likely will not bring up the fact they are using illegal drugs. In our practice, we ask about health issues early on, but we do not specifically ask about drug use. Instead, chronic substance abuse is revealed through an event such as a hospitalization or arrest, through a discovery process of realizing something isn't right with a client, or through a family member sharing their concern.



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If a client is hospitalized for abuse, I immediately reach out to offer help. Advisors can help clients with the plan to get treatment, address cash flow needs, and remind the family to keep up with the costs for future tax deductions. I've had this happen two times with clients, and the main concern is how they will pay for treatment not covered by insurance. We helped them devise ways to come up with cash to pay for the help they needed.

### NONJUDGMENTAL QUESTIONS

If I recognize something isn't right with a client, and I'm concerned about drug use, I ask. Authenticity, concern and willingness to have hard conversations create better relationships. Approach the concern with open-ended, non-judgmental questions. My clients know I have a sense of humor, and a phrase I often use is, "Everyone has their poop. Is there something going on that I should know about?"

The book "Fierce Conversations" by Susan Scott is a great resource for advisors who want to improve their ability to have hard conversations about tough subjects with clients. I purposefully reread this book every few years to reinforce



my communication skills.

### DON'T BREACH CONFIDENTIALITY

I do not go to family members or trusted contacts directly about my concern. Although we have letters in place to contact trusted people in the event of concerns around incapacity, most drug use is not an issue of incapacity. I owe it to clients to be direct and get their input about my concerns, plus it is a breach of confidentiality if I talk to other family members.

If I find out a client is using drugs illegally,

### Marijuana Usage and Experimentation in the U.S.

|                   | Have tried marijuana<br>% Yes | Smoke marijuana<br>% Yes |
|-------------------|-------------------------------|--------------------------|
| <b>Gender</b>     |                               |                          |
| Men               | 48                            | 13                       |
| Women             | 35                            | 7                        |
| <b>Age</b>        |                               |                          |
| 18–29             | 38                            | 18                       |
| 30–49             | 51                            | 10                       |
| 50–64             | 49                            | 8                        |
| 65+               | 23                            | 3                        |
| <b>Income</b>     |                               |                          |
| <\$30,000         | 42                            | 13                       |
| \$30,000–\$74,999 | 42                            | 10                       |
| \$75,000+         | 44                            | 9                        |

Based on aggregated data from July 10–14, 2013; July 8–12, 2015; July 13–17, 2016; and July 5–9, 2017

Source: Gallup

which would include marijuana in states where use isn't legal, I share my concerns about the legal and employment complications that may occur.

### OFFER LEGAL RESOURCES

Legal issues may occur if a client gets arrested for trying to obtain drugs. I've never had a client arrested, but I have a network of attorneys I can reach out to on behalf of clients if this happens. The cash flow needed

for their defense may be significant, so we would plan ahead for how to get the cash needed in the most tax efficient way.

### RECOMMEND 12-STEP PROGRAMS

Addiction is the main medical issue of concern. This often leads the client down the path of health issues and financial ruin. Ideally, an advisor will help the client and their family get help early in the process.

Helping clients find appropriate treatment facilities, referring family to 12-step programs and support groups like Al-Anon and Nar-Anon, and planning for the finances around their new reality are services that clients and their family will value highly.

There is no legal obligation to provide this type of service to clients with addiction issues. But as robo advisors continue to commoditize the typical work of financial planners, helping clients solve problems in their greatest time of need will go a long way toward cementing the relationship. Additionally, helping a client stay physically and mentally healthy will reduce the chance they run out of money and will no longer be good clients.

People with drug problems are often paralyzed by fear, so we do as much as possible to

get them where they need to be. When it is all over, the client and their family are grateful for your help and you've ideally kept a good client for life.

Drug use and other lifestyle issues may not be a field where advisors are comfortable, but knowing how to deal with these issues in advance will prepare you for the day when it happens. Not only may you save a great client relationship, you may also help save your client's life.

**FP**

**Helping a client stay physically and mentally healthy will reduce the chance they run out of money and will no longer be good clients.**

**Carolyn McClanahan**, a CFP and M.D., is a *Financial Planning* contributing writer and director of financial planning at Life Planning Partners in Jacksonville, Florida. Follow her on Twitter at @CarolynMcC.

## Why No Party for the Roth?

Future tax savings from a Roth IRA often easily offset the immediate tax liability. But, even after 20 years, clients aren't celebrating this product.

BY ED SLOTT

**WHEN THE ROTH IRA MARKED ITS 20TH BIRTHDAY** on New Year's Day, the event didn't trigger nearly as much celebration as it merited.

Over two decades, this product has truly become a key retirement account. Roth accounts have grown to hold more than \$660 billion in assets, according to the Investment Company Institute. And yet, as popular as they are, they are still greatly underused. Investments held in Roths totaled only about 8% of the \$7.9 trillion that was held in IRAs overall at the end of 2016, according to the ICI.

This huge disparity exists in large part because big-dollar rollovers from employer-sponsored qualified retirement plans, which can involve millions of dollars, are made overwhelmingly into traditional IRAs, not Roths.

Roth IRAs, instead, remain funded predominantly by smaller contributions, which currently cannot exceed \$5,500 annually for most investors and \$6,500 for those who are age 50 and older.

### CLIENTS COULD BENEFIT, BUT DON'T

In 2015, 85% of newly opened traditional IRAs were funded solely by rollovers, versus only 15% for new Roth IRAs, according to the ICI. During the nine years from 2007 through 2015, only 6.9% of Roth investors at the end of 2015 had made rollovers into their Roth IRAs.

These facts suggest that many clients who could benefit from doing a Roth conversion are failing to do so. Why? The likely answer is they are deterred by the immediate tax liability that results when you convert pretax savings in a qualified plan to post-tax savings in a Roth IRA.

Yet for many of these clients, the future tax savings from a Roth – perpetual tax-free distributions in retirement – plus greater planning flexibility under Roth rules would more than offset the immediate tax liability. Planners who can advise clients on conversions can provide great benefits to both those clients and their own practices.

In many ways, the Roth IRA was created as a mirror image



to traditional IRAs. To begin, contributions to traditional IRAs are generally deductible and distributions from them are taxable at ordinary rates, whereas with Roths, it's the reverse: Contributions are nondeductible, but distributions in retirement are tax-free.

Consider a simple case, in which an IRA owner remains in the same tax bracket throughout her life. In this scenario, a traditional IRA and a Roth will lead to the same after-tax result. But in reality, most people will not stay in the same tax brackets as they age. People tend to be in lower tax brackets early in their careers, and in higher ones later. In this situation, the Roth IRA can produce large tax savings.

Roth IRAs also differ from traditional IRAs in their treatment of long-term capital gains. When such gains are distributed from traditional IRAs, they are taxed at ordinary tax rates, not the long-term capital gain rate, which is lower. This makes traditional IRAs inferior to taxable accounts. But Roth IRAs provide higher after-tax returns than taxable accounts on long-term gains.

These advantages have caused Roth IRAs to be most popular with young investors. Among Roth IRA owners in 2015,

31% were under age 40 and only 25% were 60 or over, the ICI reports. For traditional IRAs, only 16% of owners were under age 40 and 40% were 60 or over.

Another huge advantage for Roth IRAs is that there are no annual required minimum distributions during the owner's lifetime. By contrast, owners of traditional IRAs must begin taking RMDs after age 70½, depleting and paying tax on their IRA balances.

Young clients may find it hard to envision the value of freedom from RMDs – but its actual value is clearly seen in the actions of IRA owners age 70 and older. Among this group, only 5.7% of Roth owners took distributions during 2015, compared with 80.8% of traditional IRA owners.

This stark difference suggests that at least some owners of traditional IRAs would have preferred to keep their money invested to accumulate greater tax-free returns, rather than take the distributions.

#### MORE ADVANTAGES OF ROTH IRAS

There are an array of other possible benefits from using a Roth IRA instead of a traditional one. Here are a few:

**No age limit:** Whereas clients are prohib-

ited from contributing to a traditional IRA once they turn age 70½, Roth IRAs have no age limits. That said, Roths are subject to income limits, unlike traditional IRAs.

**Roths can complement 401(k)s:** Participating in an employer's qualified retirement plan has no effect on a person's ability to contribute to a Roth IRA. It also has no effect on being able to contribute to a traditional IRA, but participation in an employer plan may limit the ability to deduct that traditional IRA contribution, depending on income limits.

**No penalty on withdrawals:** Contributions to a Roth IRA can be withdrawn at any time for any reason, tax-free and penalty free. Withdrawals from a traditional IRA are subject to income tax and generally subject to a 10% early withdrawal penalty if taken before age 59½.

**Roths raise revenue for Uncle Sam:** Another surprising benefit of the Roth IRA results from the fact that it is a tax revenue raiser on a current basis, in contrast to traditional IRAs and 401(k)s, which reduce current tax revenue through the deduction for contributions to them.

This may make the Roth IRA the most politically secure of the tax programs benefiting savers. One recent tax proposal considered by Congress sought to increase revenue by reducing maximum deductible contributions to 401(k)s and pushing savers toward Roths.

Despite all these benefits, the numbers and amounts of conversions into Roth IRAs have remained far behind the comparable figures for rollovers into traditional IRAs.

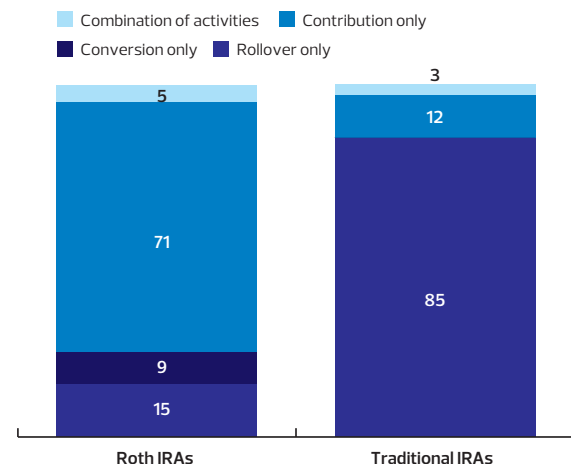
Paradoxically, it seems investors prefer Roth IRAs over traditional IRAs as an annual savings device, while they remain extremely reluctant to convert distributions from company plans into Roth IRAs.

When pretax funds are held in a traditional IRA, 401(k) or

**One huge advantage for Roth IRAs is that there are no annual required minimum distributions.**

### A Split: How Roth IRAs and Traditional IRAs Are Opened

Percentage of ways new IRAs are established



Sources: IRA Investor Database; Investment Company Institute. 2015 data

other qualified employer plan and are converted to a Roth IRA, their value becomes subject to income tax at ordinary rates.

Some clients are so averse to paying taxes that the thought of a current tax hit can stop them from doing Roth IRA conversions — and instead cause them to roll over employer plan funds into a traditional tax-deferred IRA — even when the long-term benefits of a Roth conversion would far outweigh the immediate liability.

## HOW ADVISORS PROVIDE VALUE

Advisors can provide real value for clients by examining whether the long-run benefits of a Roth conversion will exceed the current cost and, if so, explain that fact to them. To do this, they should consider the following options:

- Plan to convert to a Roth in a low-income year, perhaps after leaving a job or when between jobs or when a client will have business losses or income-reducing deductions. This cuts the tax on the conversion.

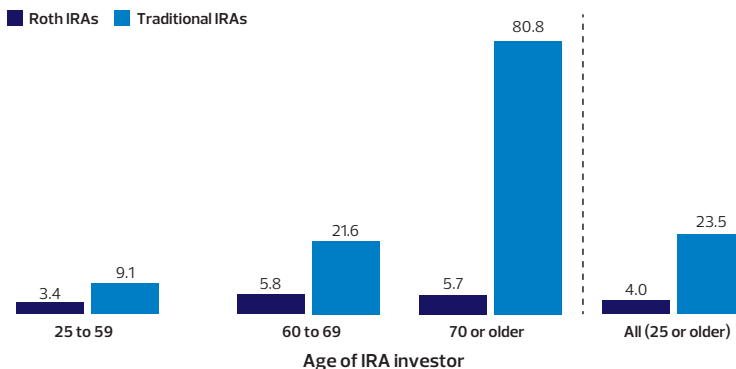
- Help clients to see the value of tax-free income over their entire lifetime and more. Because Roth IRAs aren't depleted by RMDs, one can use a Roth IRA to accumulate tax-free investment income for one's entire life, and then leave the Roth IRA to children or grandchildren, so they get tax-free income over their lives, too. For most beneficiaries, the Roth IRA will also be free of federal estate tax, given the high current exemption.

- Avoid stealth taxes and save costs every year going forward by having tax-free, instead of taxable, income. Higher taxable income reduces deductions and increases expenses throughout your return.

As an example, taxes on Social Security benefits and Medicare premiums and the 3.8% tax on investment income may all rise, while income-indexed deductions such as for medical expenses, student loan interest, and real estate losses are reduced. Count the annual tax savings from having less taxable

## Withdrawal Activity

Roth IRA investors rarely take withdrawals, even though there is no penalty for doing so. Traditional IRA investors are forced to take required minimum distributions.



Sources: IRA Investor Database; Investment Company Institute

income every year in the future against the one-time tax cost of the Roth conversion.

- Not all clients will benefit from a Roth conversion. Clients who will need to consume their retirement savings in the near future, or who can't pay the tax on a conversion with nonretirement funds, are poor candidates. Clients who are reasonably sure they will be in a lower tax bracket in retirement may also be better off not doing the Roth conversion.

## TAX INSURANCE

But current tax rates are not guaranteed forever, and Roth IRA conversions can provide tax insurance against possible higher rates, not to mention avoiding RMDs from traditional IRAs if the funds are not converted.

Additionally, Roth conversions can provide tax-risk diversification, so that at least a portion of a client's retirement funds can be shielded from future taxes.

With \$7 trillion now in traditional IRAs and trillions more in employer retirement plans, certainly there are many clients who could gain from doing Roth conversions.

Finding these clients and teaching them may provide great long-term benefits for both them and you.

**One key service an advisor can provide is to plan to make a conversion to a Roth in a low-income year.**

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**Ed Slott**, a CPA in Rockville Centre, New York, is a *Financial Planning* contributing writer and an IRA distribution expert, professional speaker and author of several books on IRAs. Follow him on Twitter at @theslottreport.



# PORTFOLIO

ALSO IN PORTFOLIO: P. 48: Say Hello to FAIL | P. 50: Annuity Firms Shift Their Pitch

## New Look for a Classic Portfolio

The conventional wisdom is that a 60/40 mix is highly effective. But there could be a better partner for large-cap U.S. stocks than U.S. bonds.

BY CRAIG L. ISRAELSEN

### LET'S TALK ABOUT THE VENERABLE 60/40 PORTFOLIO.

This is the conventional way to provide moderate-risk long-term growth in a retirement portfolio. The classic mix is 60% large-cap U.S. stocks and 40% U.S. bonds.

At the moment, I won't mess with the 60% stock portion, but how about the 40% component? If you were building a 60/40 model from scratch, you might wonder if that 40% piece has to be U.S. bonds. Or is there another asset class that would work even better?

The chart "Potential Large-Cap Partners" shows the return and risk metrics for large-cap U.S. stocks and for 11 other major asset classes that could be partners for large-cap U.S. stocks in a 60/40 portfolio. Included among the 11 are U.S. aggregate bonds, the typical 40% partner for large-cap U.S. stocks. In this analysis, the performance of large-cap U.S. stocks is represented by the S&P 500.

The 11 major asset classes are listed in order of their 15-year correlation with large-cap U.S. stocks – from lowest to highest. The first potential partner is U.S. TIPS, with a 15-year correlation with large-cap stocks of 0.02; 15-year average annualized return of 5.3% from 2002-2016; a 15-year standard deviation of annual returns of 6.69%; and a 2017 YTD return of 1.94% through Oct. 31, 2017.

Recall that in most cases the desired correlation coefficient is zero (or close to it), indicating a completely random correlation. So, a coefficient of 0.02 is a very low correlation.

The asset class with the next lowest correlation with large-cap U.S. stocks over the past 15 years was U.S. cash at minus 0.04. Cash produced a 15-year return of 1.25% with very little volatility (the standard deviation was 1.64%). Next were non-U.S. bonds with a 15-year correlation of 0.06, then

U.S. bonds with a 15-year correlation of minus 0.09, and finally commodities with a 15-year correlation of 0.32 and a 15-year return of 4.85%.

Unlike the fixed-income asset classes (TIPS, cash, bonds, and non-U.S. bonds), commodities had a very large standard deviation of return at 21.68%. But the 2017 YTD return of commodities was only 1.19% as of Oct. 31.

The remaining six asset classes in the chart all have much higher correlations with large-cap U.S. stocks. All but one of the higher-correlation asset classes outperformed large-cap U.S. stocks in 2002-2016.

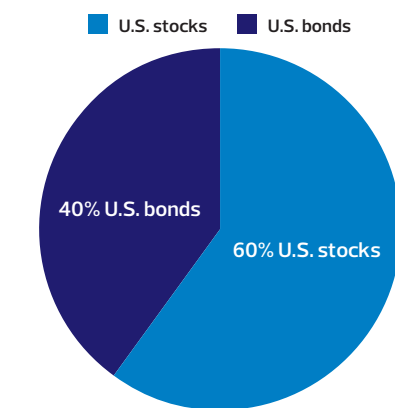
The exception was developed non-U.S. stocks (MSCI EAFE index). However, it is worth noting that as of Oct. 31, 2017, the year-to-date performance of the EAFE Index was 21.78% – well ahead of the 16.9% return of the S&P 500. The 2017 YTD performance of emerging market stocks, however, was the clear winner at 32.64%.

The correlation of non-U.S. developed stocks and large-cap U.S. stocks over the past 15 years was 0.86 – only slightly lower than the 0.91 correlation between large-cap U.S. stocks and mid-cap U.S. stocks.

This suggests that non-U.S. stocks – particularly in developed non-U.S. economies – are no longer a reliable diversifier for U.S. investors. In the 1970s and 1980s, developed non-U.S. stocks had much lower correlation with U.S. equity markets and, as such, were a useful diversifier for U.S. investors. However, the economic intertwining of the globe has synchronized markets to a high degree over the past 10 to 15 years.

Now, on to the real issue: Which of these 11 asset classes was the best partner when teamed with large-cap stocks over the last 15 years? The answer depends on your goal: Do you

**Standard 60/40 Portfolio**



# PORTFOLIO

want lower volatility or enhanced performance? A summary of the 15-year risk and return measurements for various 60/40 portfolio combinations is provided in the table "60/40 Combos."

If your goal was to reduce volatility below that of the S&P 500, the five low-correlation asset classes (U.S. TIPS, cash, non-U.S. bonds, U.S. bonds and commodities) achieved that.

For example, a portfolio that consisted of 60% large-cap U.S. stocks and 40% TIPS had a 15-year standard deviation of return of 10.92%, compared with 18.16% for large-cap U.S. stocks by themselves. Yet, the 15-year return dropped by only 4 basis points – from 6.69% to 6.65%.

Note in the previous table that the

15-year return of TIPS alone was 5.3%, so you might think that adding TIPS as the 40% component would have degraded performance by far more than 4 bps. The key is in the 0.02 correlation of TIPS to large-cap U.S. stocks. TIPS and large-cap U.S. stocks do not march to the same drummer – and that's a good thing.

## LOW CORRELATION

Thus, the performance of a teammate of large-cap stocks can have a lower return than large-cap U.S. stock, but if it also has a low correlation to U.S. stocks, the net result can be a 60/40 portfolio that has nearly same return as large-cap stocks by themselves – but with far less volatility.

If your objective was to maximize return, the high correlation ingredients accomplished that goal – with the exception of developed non-U.S. stocks. In fact, let's examine the impact of blending developed non-U.S. stocks with large-cap U.S. stocks in a 60/40 portfolio. You will notice that developed non-U.S. stocks (specifically the MSCI EAFE Index) had a 15-year return by themselves of 5.28% – almost identical to the 15-year return of TIPS.

However, developed non-U.S. stocks had a high correlation of 0.86 with large-cap U.S. stocks. Thus, unlike TIPS, combining the MSCI EAFE Index with the S&P 500 resulted in a 15-year return of 6.23% – or 42 basis points below the return of a

## Potential Large-Cap Partners

15-year performance and volatility of major asset classes (2002–2016)

| Asset Class  | Representative Index   | 15-Year Correlation with Large Cap U.S. Stock (2002–2016) | 15-Year Average Annualized Return (2002–2016) | 15-Year Standard Deviation of Return (2002–2016) | 2017 Year-to-date performance (through Oct. 31) |
|--|--|---|---|--|---|
| Large-Cap U.S. Stock   | S&P 500  | 1.00  | 6.69  | 18.16  | 16.90   |
| <b>Asset Classes with Low Correlation to Large-Cap U.S. Stock</b>    |  |   |   |  |   |
| U.S. TIPS  | Barclays U.S. Treasury U.S. TIPS Index   | 0.02  | 5.30  | 6.69   | 1.94  |
| U.S. Cash  | U.S. T-Bill 90 Day   | -0.04   | 1.25  | 1.64   | 0.68  |
| Non-U.S. Bonds   | Barclays Global Treasury Index   | 0.06  | 4.78  | 7.33   | 5.56  |
| U.S. Bonds   | Barclays U.S. Aggregate Bond Index   | -0.09   | 4.58  | 2.99   | 3.20  |
| Commodities  | Deutsche Bank Liquid Commodity Optimum Yield Diversified Commodity Index Excess Return | 0.32  | 4.85  | 21.68  | 1.19  |
| <b>Asset Classes with Higher Correlation to Large-Cap U.S. Stock</b> |  |   |   |  |   |
| Global Real Estate   | S&P Global REIT Index  | 0.63  | 10.10   | 22.24  | 4.14  |
| Natural Resources  | S&P North American Natural Resources Index   | 0.66  | 7.64  | 25.07  | -5.71   |
| Emerging Stock   | MSCI Emerging Market Index   | 0.76  | 9.85  | 32.64  | 32.64   |
| Small-Cap U.S. Stock   | S&P Small Cap 600 Index  | 0.83  | 10.17   | 19.66  | 9.96  |
| Developed Non-U.S. Stock   | MSCI EAFE Index  | 0.86  | 5.28  | 21.12  | 21.78   |
| Mid-Cap U.S. Stock   | S&P Midcap 400 Index   | 0.91  | 9.73  | 19.73  | 11.88   |

Source: Data from Steele Systems Mutual Fund Expert, calculations by author

60% U.S. large stock/40% TIPS portfolio.

Here is a key take-away: In building portfolios, we need to know if a fund we are considering will be a good teammate to the other funds in the portfolio, rather than its stand-alone performance.

Understandably, correlation in the past is not a perfect predictor of correlation in the future, but it is a logical starting point to evaluate when you are building multiasset portfolios.

Note that the Barclays U.S. Treasury U.S. TIPS Index and the MSCI EAFE Index had nearly identical returns in 2002-2016. But, the TIPS index was a better fit for large-cap U.S. stocks due to its lower correlation with the S&P 500. Blending low-correlation funds isn't a guarantee that performance will improve, but it almost always results in a reduction of volatility. And that alone makes it worth doing.

As a final note, as shown in the last row of the chart, if all 12 asset classes (large-cap U.S. stocks through mid-cap U.S. stocks) were blended together in equal portions of 8.33% and rebalanced annually, the 15-year standard deviation of return was 13.22% (27% lower than the S&P 500 by itself), the 15-year return was 7.6% (91 bps higher than the S&P 500 by itself), and the performance in 2008 was minus 25.5% (31% better than the 37% loss experienced by the S&P 500).

Moreover, the 12-asset portfolio (which

## 60/40 Combos

Risk and return measurements of various 60/40 portfolios over the past 15 years (2002-2016)

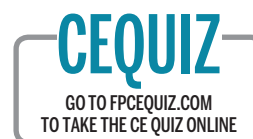
| Large-Cap U.S. Stock vs. 60/40 Combinations vs. 12-asset model | 15-Year Standard Deviation (2002-2016) | 15-Year Annualized Return (2002-2016) | Performance in 2008 | 2017 YTD Performance (through Oct. 31) |
|--|--|---------------------------------------|---------------------|--|
| 100% Large-Cap U.S. Stock                                      | 18.16                                  | 6.69                                  | -37.00              | 16.90                                  |
| 60% Large-Cap U.S. Stock 40% TIPS                              | 10.92                                  | 6.65                                  | -23.14              | 10.71                                  |
| 60% Large-Cap U.S. Stock 40% Cash                              | 10.81                                  | 4.97                                  | -21.64              | 10.16                                  |
| 60% Large-Cap U.S. Stock 40% Non-U.S. Bonds                    | 10.14                                  | 6.56                                  | -18.11              | 12.27                                  |
| 60% Large-Cap U.S. Stock 40% U.S. Bonds                        | 10.43                                  | 6.36                                  | -20.10              | 11.26                                  |
| 60% Large-Cap U.S. Stock 40% Commodities                       | 15.85                                  | 6.60                                  | -34.95              | 10.43                                  |
| 60% Large-Cap U.S. Stock 40% Global Real Estate                | 18.40                                  | 8.31                                  | -40.22              | 11.65                                  |
| 60% Large-Cap U.S. Stock 40% Natural Resources                 | 19.34                                  | 7.40                                  | -39.22              | 7.48                                   |
| 60% Large-Cap U.S. Stock 40% Emerging Stock                    | 22.02                                  | 8.51                                  | -43.47              | 23.03                                  |
| 60% Large-Cap U.S. Stock 40% Small U.S. Stock                  | 18.46                                  | 8.13                                  | -34.63              | 14.17                                  |
| 60% Large-Cap U.S. Stock 40% Developed Non-U.S. Stock          | 18.80                                  | 6.23                                  | -39.55              | 18.86                                  |
| 60% Large-Cap U.S. Stock 40% Mid-Cap U.S. Stock                | 18.60                                  | 7.94                                  | -36.69              | 14.89                                  |
| All 12 asset classes, 8.33% to each, rebalanced annually       | 13.22                                  | 7.60                                  | -25.49              | 8.40                                   |

Source: Data from Steele Systems Mutual Fund Expert, calculations by author

is a 65% growth/35% fixed-income model rather than 60/40) outperformed the traditional 60/40 model by 124 bps in 2002-2016, albeit with somewhat higher volatility (13.22% standard deviation versus 10.43% standard deviation).

Now, as for my core question, is there a better partner for U.S. large-cap stocks in a 60/40 portfolio? Depending on your objectives, there are several that you might find better. But, beyond that, consider more than two asset classes.

FP



**Craig L. Israelsen**, Ph.D., a *Financial Planning* contributing writer in Springville, Utah, is an executive in residence in the personal financial planning program at the Woodbury School of Business at Utah Valley University. He is also the developer of the 7Twelve portfolio.

## Say Hello to FAIL, My New ETF

The standard process for launching these funds is flawed. Here's a modest proposal about a better way to do it.

BY ALLAN S. ROTH

**I'D LIKE TO DEVELOP A NEW INVESTMENT FUND** that has two main selling points: a superior strategy and a particularly memorable ticker symbol.

I'll call it the FAIL ETF.

Now, to be clear, I haven't yet developed the specific methodology for this fund just yet. But I am in the process of reinventing how new investment funds are introduced.

### THE CURRENT PROCESS

First, some review. Here's how new ETFs are typically launched.

**Step 1:** Crunch investment results and compare thousands of factors that may be driving performance. In a world of big data, this data-mining process is easy and can take mere seconds.

**Step 2:** Use the output to identify factors that have worked sometime in the past.

**Step 3:** Develop a compelling storyline around these factors to create excitement around your fund's brilliant new methodology. Although the fund doesn't exist yet, it can paint a hypothetical scenario, showing people how much more money they would have earned if only they had bought into the fund being launched.

**Step 4:** Launch the fund for real, market the brilliant strategy globally and reap the financial rewards.

In 2016 alone, ETF providers introduced 247 new products, including both exchange-traded funds and exchange-traded notes, according to SeekingAlpha. Unfortunately,

2016 was also a record year for ETF closings, with 128 ETFs and ETNs going defunct.

What happened?

### A PROBLEM WITH THE SYSTEM

I suspect that every one of those funds went through the same process of back-tested research, and each created a compelling storyline as to why it would beat the boring strategies, such as old fashioned cap-weighted index funds.

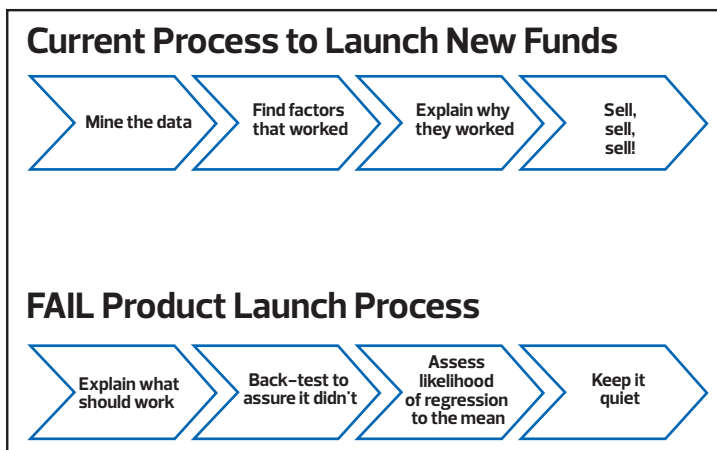
So why do so many new funds quickly close down, then?

It all starts with the data. For each 512 random factors reviewed, roughly one will have a 99.9% probability of correlation (either positive or negative).

Correlation is not causation, however, and strong past performance doesn't usually persist. We know that over time outcomes will tend to even out — a phenomenon known in statistics as regression to the mean.

ETF prices have been driven higher in the short run as investors pour cash into these hot new products. But when regression to the mean occurs and the outperformance turns into underperformance, investors will flee and cause the strategy to do even worse. The end result? Many of these funds are bound for the ETF graveyard.

According to Ben Johnson, director of global ETF research for Morningstar, a majority of strategic-beta ETFs have failed to deliver over the past one to three years. Strategic beta funds use methodologies other than market-cap weighting.





Smart beta can go “horribly wrong,” warned Rob Arnott, CEO of Research Affiliates, in a paper in early 2016.

Arnott and his colleagues wrote that we have a “factor zoo,” where many funds are being launched purely based on past performance and stand little chance to outperform in the future.

At one point, some quants found that butter production in Bangladesh had the highest correlation with U.S. stocks. I feel confident that a fund based on this strategy would have been huge had anyone been able to develop a storyline as to why it should work going forward.

Needless to say, the current process

sion to the mean and future outperformance.

**Step 4:** If it looks good, I’ll launch the fund and keep it as quiet as I can. No doubt, the FAIL symbol will minimize inflows to the ETF, so there will be no worries about hot money raining on my parade.

#### A SERIOUS MESSAGE

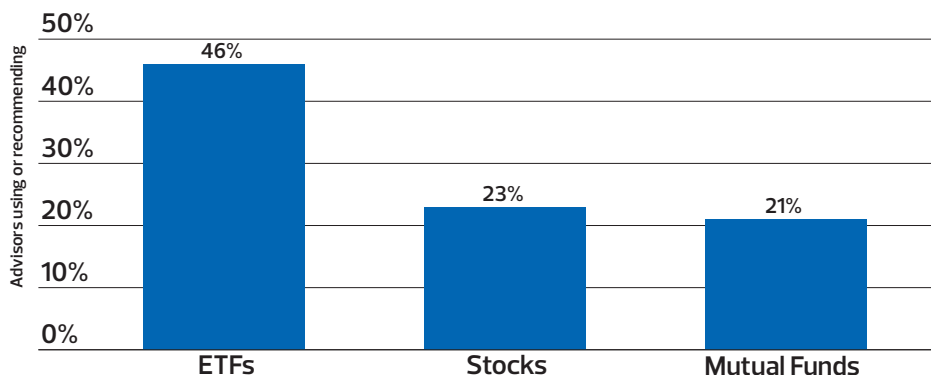
FAIL is obviously a fictitious fund that I won’t actually launch. Still, I have a serious message. The current flawed process is yet another way we all chase performance.

As silly as it sounds, FAIL would be a much better ETF than the abundance of ETFs being launched based on past performance and phony storylines.

**At one point, some quants found that butter production in Bangladesh had the highest correlation with U.S. stocks.**

## ETFs Dominate Advisor Plans

Nearly half say they plan to recommend them more frequently over the next 12 months.



Sources: Journal of Financial Planning, FPA Research and Practice Institute

behind new fund launches is badly flawed.

### THERE'S A BETTER WAY

For my new FAIL ETF, the process would be far superior to the above. Here's how it would work.

**Step 1:** Rather than reach for an explanation to falsely explain why random outperformance occurred, I'll start by theorizing why a strategy should have outperformed.

**Step 2:** Next, I'll back-test to assure the strategy failed to outperform in the past.

**Step 3:** I'll assess the likelihood of regres-

Forget back-tested logical storylines and compelling sales pitches. Instead, consider how illogical the current process is for launching new funds and shaping investment strategies. Factors that work include some old standbys: fees, tax efficiency, diversification and rebalancing. Though not as exciting as those hot new ETFs, they have a far greater likelihood of actually working.

Someday, if you see me getting out of my private jet, it's probably not because I launched FAIL — but rather because I devised my own investment strategy. **FP**

**Allan S. Roth**, a *Financial Planning* contributing writer, is founder of the planning firm Wealth Logic in Colorado Springs, Colorado. He also writes for *The Wall Street Journal* and *AARP the Magazine* and has taught investing at three universities. Follow him on Twitter at @Dull\_Investing.

## Annuity Firms Shift Their Pitch

Wholesalers have taken a new approach for planners leery of sales calls, regulation and litigation.

BY TOBIAS SALINGER

**THE FIDUCIARY RULE AND THE WANE OF TRADITIONAL** wholesaling have prompted annuity issuers to change their pitch to financial planners, along with their product shelves. The firms are betting the new approach will appeal to advisors wary of sales calls, regulation and litigation.

Jackson National Life Insurance has instructed agents to strive for deep conversations around investment strategy, technology and planning, rather than just “pushing their own product and bashing the competition,” says Jackson Chief Distribution Officer Greg Cicotte.

Similarly, Voya Financial hopes technology and tailored services help it shift away from a past in which “we were really kind of product pushers,” says Chad Tope, Voya’s president of annuities and individual life distribution.

Voya launched a data analytics pilot studying advisors’ sales, preferences and interests, with the tool slated for all external wholesalers in the annuities unit in 2018.

Jackson, which the LIMRA Secure Retirement Institute says is the No. 1 seller of annuities by revenue, recently introduced a new fee-only variable product with optional guaranteed living and death benefits.

Wholesalers know advisors have become skeptical of their usual approach. More than 80% of wholesalers chose “not receptive to traditional wholesaling” as a challenge of distributing to RIAs, the second most popular answer after time limitations, according to a survey by Cerulli Associates.

For their part, advisors from RIAs told the research firm they find only nine of 33 weekly contacts from wholesalers meaningful, on average.

Cold calls and sales pitches usually turn advisors off, says NAPFA Chairman Scott Beaudin of South Burlington, Ver-

mont-based Pathway Financial Advisors.

Annuity sales have fallen this year to a 16-year low, but LIMRA in October revised expected sales upward for 2018 due to the Trump administration’s delay of the fiduciary rule. The rule and accompanying uncertainty regarding its implementation have upended sales, with broker-dealers bulking up their compliance oversight and commissions from the products receiving enhanced scrutiny.

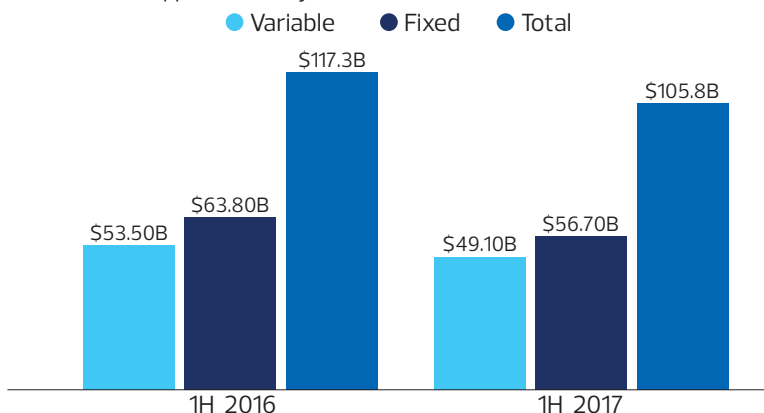
Fee-only advisors’ abstention from commissions does not spare them from sales pitches for highly technical products of questionable value to their clients. However, wholesalers can provide helpful education to advisors, and the fee-only variable products carry appeal, Beaudin says.

“The cost structure has come down so much, particularly with the removal of surrender fees and lower ongoing fees. Advisors have to get rid of the old thinking that annuities are all bad. That’s changing,” he says.

Voya works primarily through the independent broker-

### Annuity Sales Slipping

Revenue has dropped 10% this year



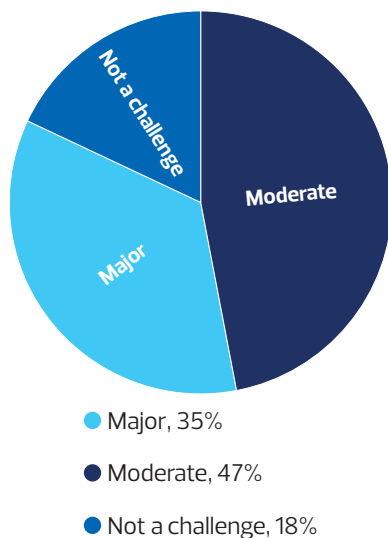
Source: LIMRA Secure Retirement Institute

dealer space for its distribution, according to Tope. The firm counts about 400 IBDs as clients, including major firms like LPL Financial, Cetera Financial Group and Cambridge Investment Research, Tope says.

Ascend, Voya's upcoming structured product, provides four levels of buffer protection from 5% to 30%, four index investment options and three durations from one to six years. The firm will offer tech tools to advisors to help them match their clients

## RIAs Not Receptive to Traditional Approach

Cerulli asked wholesalers whether it's a challenge and more than 80% agreed it's a major or moderate one.



Source: Cerulli Associates

with the best options for them.

Data analytics will allow Voya to assign what the firm calls a "propensity score" to advisors, based on their sales track record, clicks on Voya's website and their orders of research materials, according to Tope.

"I think the role of the advisor is challenging right now, to say the least. They've got a lot of things coming at them in understanding the products that they have to sell, making sure that they're following the regula-

tions, and then, of course, this best interest of the customer statement," Tope says.

Cicotte, of Jackson, agrees that the fiduciary rule has altered annuity companies' shelves, with more advisory products in particular hitting the market. Jackson's first fee-only variable annuity came out in September 2016, and its third such product, Perspective Advisory II, opened this September.

The product, which has a core contract charge of 45 basis points plus more for the living and death benefits, features no surrender period and low-cost institutional subaccounts with no 12b-1 fees.

"From a cost structure standpoint, we feel that it's going to be very attractive to traditional fee-based advisors," Cicotte says, noting that Jackson's commission-based variable annuities held little sway with the group.

## KEEP IN MIND

LPL advisor Sarah Carlson of Spokane, Washington-based Fulcrum Financial Group has been offering fee-only variable annuities for four or five years. Carlson cautions that advisors and their clients should keep the extra internal fees of the products in mind, but their benefits have proven helpful for older clients who haven't saved enough, she says.

"For those people, the annuities have performed very well because they would otherwise not have been able to take that risk in their portfolio without the guarantees," Carlson says.

"You really have to be motivated to help people because it's so difficult to get issued. It's because those products are so complex," she says. "The insurance companies are constantly coming out with new products, and it's difficult to service."

The complexity among the various kinds of annuities and the required due diligence make advisors worry about litigation, Carlson adds. From January to November 2017, 202 new FINRA arbitration filings have involved annuities, the fifth most commonly cited type of security in client claims, according to the regulator.

**Fee-only advisors' abstention from commissions does not spare them from sales pitches for highly technical products of questionable value to their clients.**

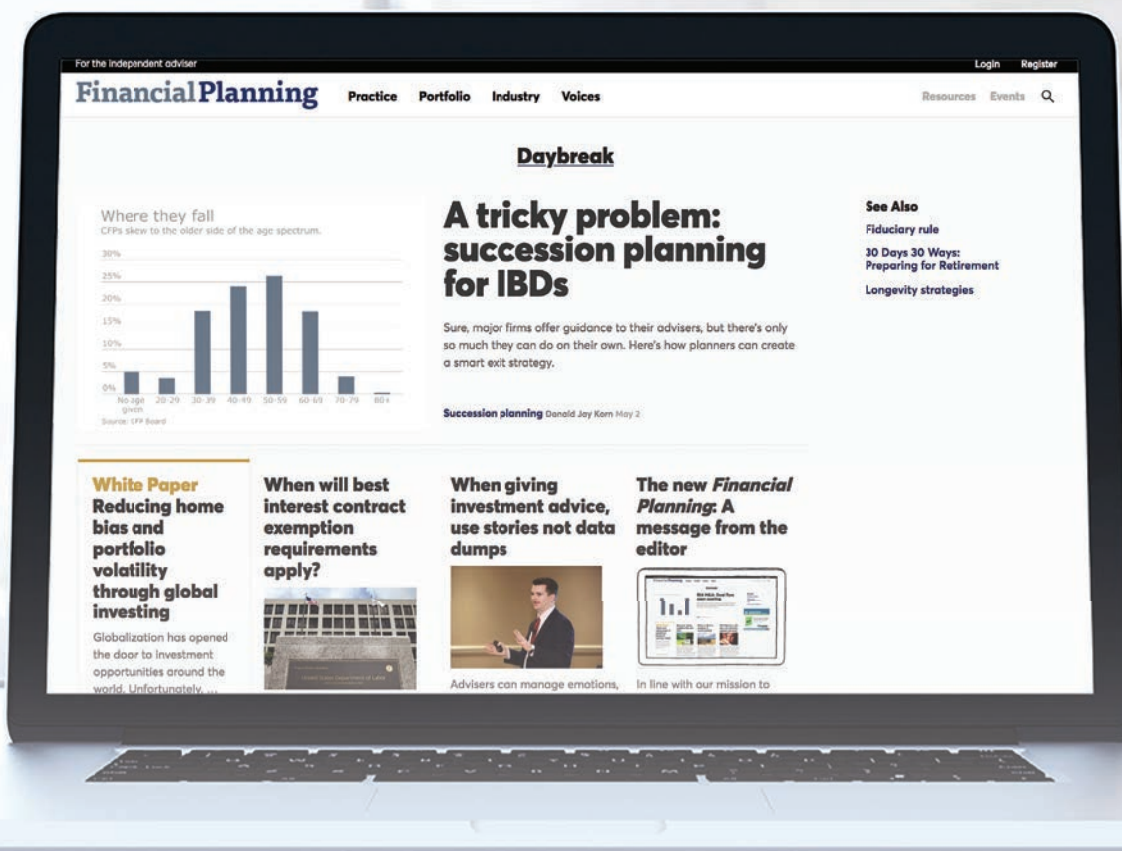
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**Tobias Salinger** is an associate editor of *Financial Planning*, *On Wall Street* and *Bank Investment Consultant*. Follow him on Twitter at @TobySalFP.

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# CE QUIZ

## JANUARY 2018

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### FROM: GOING THROUGH THE ROOF

1. What is the approximate national annual median cost for homemaker services (cooking, cleaning, running errands, etc.) according to a 2017 Genworth survey?

1. \$25,000
2. \$48,000
3. \$35,000
4. \$55,000

2. What is the annual gift tax exclusion for 2018?

1. \$14,000
2. \$15,000
3. \$14,500
4. \$16,000

### FROM: WHY NO PARTY FOR THE ROTH?

3. At the end of 2016, investments held in Roth IRAs totaled approximately this percentage of the \$7.9 trillion held in IRAs overall?

1. 10%
2. 15%
3. 8%
4. 25%

4. During the nine years from 2007 through 2015, what percentage of Roth investors made rollovers into their Roths?

1. 8.5%
2. 7.7%
3. 10.2%
4. 6.9%

### FROM: NEW LOOK FOR A CLASSIC PORTFOLIO

5. Of U.S. bonds, U.S. TIPS, non-U.S. bonds and commodities, which has the lowest correlation to large-cap U.S. stocks from 2002 to 2016?

1. U.S. TIPS
2. Commodities
3. Non-U.S. bonds
4. U.S. bonds

6. During the same period, which of these asset classes had the highest correlation to large-cap U.S. stocks?

1. Global real estate
2. Small-cap U.S. stocks
3. Mid-cap U.S. stocks
4. Developed non-U.S. stocks

### FROM: ANNUITY FIRMS SHIFT THEIR PITCH

7. What was the difference in total annuity sales from the first half of 2016 to the first half of 2017?

1. Sales decreased by \$5.2 billion
2. Sales decreased by \$10.2 billion
3. Sales decreased by \$11.5 billion
4. Sales decreased by \$9.2 billion

### FROM: FUTURE FOR HSAs IS 'VERY BRIGHT'

8. After age 55, how much extra, annually, can a client contribute to an HSA?

1. \$500
2. \$1,000
3. \$1,500
4. \$800

### FROM: WITH LTC HYBRID SALES HUMMING, WHY THERE'S STILL ROOM TO GROW (Online only)

9. How many seniors aged 65 and over will need long-term care services, according to the Department of Health and Human Services?

1. 45%
2. 60%
3. 52%
4. 25%

### FROM: WHAT'S THE OPTIMAL RETIREMENT STRATEGY? (Online only)

10. If a safe portfolio approach includes a lifetime immediate annuity covering all essential expenses of retirement, which retirement planning shape would this fall under?

1. Curve
2. Rectangle
3. Triangle
4. Circle

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# SELFIE

## The Slow Road To a Hot Career

For nine years, I did administrative work at a planning office and gradually learned the essentials of the profession.

BY DAVID J. LUTZ JR.



**IN THE FALL OF 1997, I WAS 26 YEARS OLD AND UNSURE** of what I wanted to do in life. I had already earned a B.S. in mathematics, student-taught eighth-grade math, partly owned a three-employee deejay business and was working as an assistant manager at a gas station.

I then read in the local newspaper about a free retirement seminar sponsored by a planning firm. I decided to attend. The scene may have looked quite funny: a room full of 50- and 60-year-olds and me. The planner talked about the benefits of investing and the stock market. For over two hours, I was glued to his every word.

When I left that meeting, my first thought was not about investing. Rather, it was about whether being a financial advisor was what I was called to do.

Reviewing my qualifications, I honestly felt as if all the pieces of my experience were coming together: I was strong in math, I had practiced customer service at the gas station, I had learned how to run my own company as a deejay, I had teaching skills and I was good at managing my own money.

### FROM THE GROUND UP

After the seminar, I enrolled in college for the second time to get my B.S. in business administration. Once I got out, I was hired as an administrative assistant at a planning office. I was very eager to learn the ins and outs of the industry from the ground up.

For the next nine years, I did administrative work, sat in on meetings, went to educational seminars and passed my Pennsylvania insurance exam and the Series 7, 63 and 66 exams. As I acquired my licenses, I started to work in the evenings and on weekends with friends, family mem-

bers and some of the smaller clients who my boss was not actively working with. We split anything I brought in 50/50.

The best part was that I was earning a regular salary for doing administrative work for his clients. With a regular paycheck (and commissions on the side), I could afford to meet people and not be a pushy salesman. I was respectful and sincere and let the individual have a say. I think most people appreciated that, and my book of business quickly grew to the point where I couldn't do both the administrative work for my boss and all the work for my clients.

Some years later, I passed the CFP exam, bought out my boss's 50% share and went out on my own. I now serve over 225 individual clients and small businesses, and write a quarterly newsletter, "Save with Dave," in which I share my life experiences and wisdom on money.

### A MORE EFFECTIVE APPROACH

I've always felt this model of bringing people into the business is much more effective than the old way of pressuring new recruits to quickly pass their tests and sell.

In an industry where there is going to be a severe advisor shortage in a few years, I hope others can follow my approach. In a few years, when I begin to look for my successor, I plan on looking for someone with similar work skills and bringing them along in a similar fashion.

Did my path into the business take longer than most? I'm sure it did. But, in an industry where we try to get people to focus on the long term, my life's journey is a perfect complement to that philosophy. In the end, I forged my own path into the business. I couldn't be happier with my life, my career and my future.

**FP**

David J. Lutz Jr. is a CFP with Celtic Financial Services in McMurray, Pennsylvania. He provides financial planning services to individuals and small business owners.

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