PERIODICALS

Wealth Management™

THE MAGAZINE OF
WealthManagement.com

January/February 2019

Is your investment management firm gumming up the works?

(*See inside cover.*)

DO HEDGED BOND ETFS WORK? p. 24

CONGRESS AND TAXES IN 2019 p. 40

LPL ON THE REBOUND p. 44

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Cover illustration: Tim Gabor

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In the Year, 2044…

I don't really like the term "visionaries," but there are a fair number of folks who qualify for that descriptor when it comes to the business of retail financial advice and investment management. You'll find a few of them in this issue, speculating on what financial advice will mean and what financial advisors will do in the year 2044, a quarter century from now.

Artificial intelligence, machine learning and voice-recognition are mentioned more than a few times, so by consensus alone I think we can trust that a reliable, if still fuzzy, map is being laid out by the folks charting the future course for the space—and for the most part, it is a very optimistic vision.

Financial services can seem like a slow-moving industry, but consider it was only 25 years ago— around 1994—that the brokerage house of K. Aufhauser & Company (remember them? neither do we) unveiled WealthWeb, arguably the first online trading platform on what was then called the "World Wide Web." Online trading took off fast—within a few years dozens of brokerage platforms were available to retail investors. K. Aufhauser itself was acquired in 1995 by Ameritrade, now TD Ameritrade.

Before that, brokers taking orders over the phone, like Bud Fox in the movie Wall Street, were the norm. Arguably, it was the online discount brokerages that fueled the growth of independent financial advisors not beholden to Wall Street brokerages; half the assets at Schwab—to name just one of the major custodians in the space—come from registered investment advisors.

The role of regulators in shaping the business did not get as much attention in the future speculations here, and I think that makes perfect sense. Consider the big divide in our industry between FINRA-registered brokers and SEC-registered investment advisors: These are labels based on securities regulations passed a little less than a century ago, yet they still drive much of the commentary.

That narrative—that commission-based business is the handiwork of the devil while fee-based advice rains down from heaven like pure justice—is an increasingly outdated paradigm.

At the recent Financial Services Institute OneVoice conference for independent broker/dealers, the consensus was that the Securities and Exchange Commission would succeed in getting Regulation BI passed before the end of 2019—Chairman Jay Clayton knows that a change back to a Democratic administration would likely derail the effort, just as the change to the Trump administration was instrumental in derailing the Department of Labor's fiduciary rule for ERISA accounts.

We still don't know what the disclosure part of Reg BI will look like, or how effective it will be in protecting consumers from bad actors.

But consider that even without the rule, in the 25 years since the advent of online trading, most investors today are in far better portfolios, paying far more appropriate fees for trades and advice, and generally far more knowledgeable about what they are buying and why, than they were when they were being cold-called by the likes of Bud Fox with a hot tip. Technology moves a lot faster than regulations, and that's largely why the future visions outlined in this issue look so bright.

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Wells Fargo Details Plan to Serve Independent RIAs

THE INDEPENDENT FINANCIAL ADVICE CHANNEL HAS GROWN CONSIDERABLY OVER THE LAST DECADE AND "IF YOU BELIEVE THAT IS A TREND, AND NOT A FAD, WHY WOULD WE NOT BE DOING THIS?" AN EXECUTIVE SAID. BY MICHAEL THRASHER

Photo: Justin Sullivan /Getty Images

David Kowach, the president of Wells Fargo Advisors, stirred the wealth management industry in December when he said at a conference in Las Vegas that the company planned to launch a new service for independent advisory firms.

But the proclamation was not a knee-jerk reaction to the business unit's shrinking number of employee brokers, or out of character for its multichannel wealth management strategy, said John Peluso, head of First Clearing, the Wells Fargo & Company subsidiary that will now provide custody services to fee-only RIAs. For the first time since Kowach's announcement, the company shared details about the new business channel on Tuesday.

More advisors and clients are choosing the independent advice channel and their interest doesn't show signs of waning; it's the fastest-growing channel in wealth management and Wells Fargo Advisors sees opportunity in it, according to Peluso.

"If you look at the last one, three, five and 10 years in the [independent] space…If you believe that [growth] is a trend and not a fad, why would we not be doing this?" Peluso said.

First Clearing and TradePMR, the introducing broker/dealer that will also provide middle-office support to independent RIAs that choose the new custodial service, have discussed partnering to serve independent RIAs on and off for eight years, Peluso told *WealthManagement.com*.

Wells Fargo's move to serve more independent RIAs was "long overdue," according to Carolyn Armitage, managing director at Echelon Partners, a Los Angeles-based investment bank and consulting firm focused on wealth and investment managers. The custody business has more favorable margins than wealth management and providing a landing place for brokers interested in starting their own RIA at least keeps their assets with Wells Fargo. The bank reported in its fourth quarter earnings that Wells Fargo Advisors lost 4 percent, or roughly 550, financial advisors in 2018, bringing its year-end total to just under 14,000.

"If Wells Fargo can keep the custody [assets] and keep those fees, they've still won," Armitage said. "I could see the other big banks following suit, too." Although, the other so-called wirehouse brokerages haven't been so welcoming to the idea as Wells Fargo. Andy Sieg, the head of Merrill Lynch Wealth

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Home Team Advantage

Lightyear Capital, a private equity firm with stakes in several financial services firms, such as Advisor Group and Wealth Enhancement Group, has settled with the Securities and Exchange Commission over allegations related to its expense allocation and fee-sharing practices. Without admitting or denying the findings, the firm has agreed to pay a $400,000 fine.

The firm manages four flagship private equity funds, as well as three Employee Funds, which invest alongside those funds. According to the SEC, the firm allocated certain expenses, including broken deal, legal, consulting, insurance and other expenses, to the Flagship Funds, while the firm didn't allocate a proportional share to the Employee Funds. The firm should have disclosed the conflict to investors, the SEC claims. As a result, shareholders in the Flagship Funds paid $167,000 more in expenses from 2000 to 2016.

The SEC also found that co-investors were not expensed properly, and, again, Lightyear failed to disclose that to the Flagship Funds investors. That resulted in investors paying an additional $221,000 more in expenses over the 16-year period.

In addition, the firm had arrangements in place where it received fees for providing advi-

Wells Fargo Details Plan to Serve Independent RIAs

Management, recently told *WealthManagement.com* that his firm "has no intention of moving in that direction."

Peluso rejected the notion the new service was simply a net to catch assets that might otherwise escape Wells Fargo entirely. "Our goal is to grow the company, not just move people around internally," he said, although he acknowledged that there will undoubtedly be Wells Fargo advisors who want to start their own RIA.

But there won't likely be a glut of Wells Fargo advisors departing the wealth manager's employee channel for the latest service offering, Peluso said. Not every broker wants to go independent, let alone start their own RIA. Nor are they capable of doing so. The RIAs must also be fee-only and have at least $100 million in assets.

"I think it's going to be a huge success," said Robb Baldwin, CEO of TradePMR, which created a team specifically to help advisors establish and transition to their new RIA. Advisors in the program will have access to TradePMR's advisor technology (Fusion) and to the Wells Fargo Advisors' SmartStation desktop technology, contact management systems and innovations such as the Envision planning process. However, Baldwin said RIAs will still be able to choose different third-party software and build their own technology stack if they want.

Longtime Wells Fargo advisor Carl Schultz was the first to start his own RIA using the new channel, Forefront Wealth Management, in January and Peluso said he's in conversations with others to make the transition as well. ■

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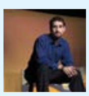

Michael Kitces @MichaelKitces

One of the striking new trends really visible at #T32019 - return of Advisor #FinTech founders back for their second/new ventures. Oleg Tishkevich, Edmond Walters, even heard Jim Starcev of Etelligent is here! It's a sign of depth in our space that we're on 2nd Gen companies.

Nina O'Neal @noneal510

I just found out I'm supposed to make HOMEMADE play dough for the pre-k class. Please tell me this is a cruel joke

I have 16 meetings this week and a sick kid. WHY CAN'T I JUST BUY IT?!

#aintnobodygottimeforthat #workingmomprobs #thejuggleisreal

Jeffrey Gundlach @TruthGundlach

The most recessionary signal at present is consumer future expectations relative to current conditions. It's one of the worst readings ever.

Jason Lahita @TruthGundlach

On the way to #T32019, just got sprayed in the face twice by pressurized tiny creamer tubs. Fool me once. . . but on the flip side of that coin, plane is half-empty. Or is it half-full? Either way, so excited to kickoff conference season at the industry's premier #fintech show!

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sory services to its portfolio companies; those fees were supposed to offset management fees paid by the Flagship Funds, according to its disclosures. But, between 2010 and 2015, $1 million of those fees went to co-investors, increasing the management fees paid by the Flagship Funds.

Supervision Failure

New Jersey-based broker/dealer Summit Equities was ordered to pay a $100,000 fine for the firm's failure to supervise agents who mishandled personal information of clients, according to a complaint by the Massachusetts Secretary of the Commonwealth William F. Galvin.

Galvin's securities division found that Summit Equities allowed its agents to enter clients' personal information into a third-party CRM system, which went against the firm's own privacy and security policies.

When reps left the firm, the b/d had no access or control over the personal information, while those reps had the access and could share it. The firm also had no measures in place to erase clients' information from reps' devices using the third-party CRM.

"The security of personal information is a very serious issue for me and my office," Galvin said. "It is more important than ever that companies gathering personal information keep that information as secure as possible."

Advisors in the Wild

Thousands of estate planning professionals descended on Orlando to attend the Heckerling Institute on Estate Planning in January. Here are some highlights from *Trusts & Estates* magazine's distinguished authors awards dinner, held at the event.

Sandra Glazier basks in the adulation after her big win.

Three generations of Shenkmans were in attendance to witness father Marty (middle) and son Jonathan (far left) both take home awards.

T&E Editor-in-Chief Susan Lipp (far left) and editorial advisory board Co-Chair Al W. King (far right) flank award winners Amy Castoro (left) and Kathleen Loehr (right).

Restaurant Latitude & Longitude proudly hosted this year's ceremony.

Photos: Cornelius O'Donohue

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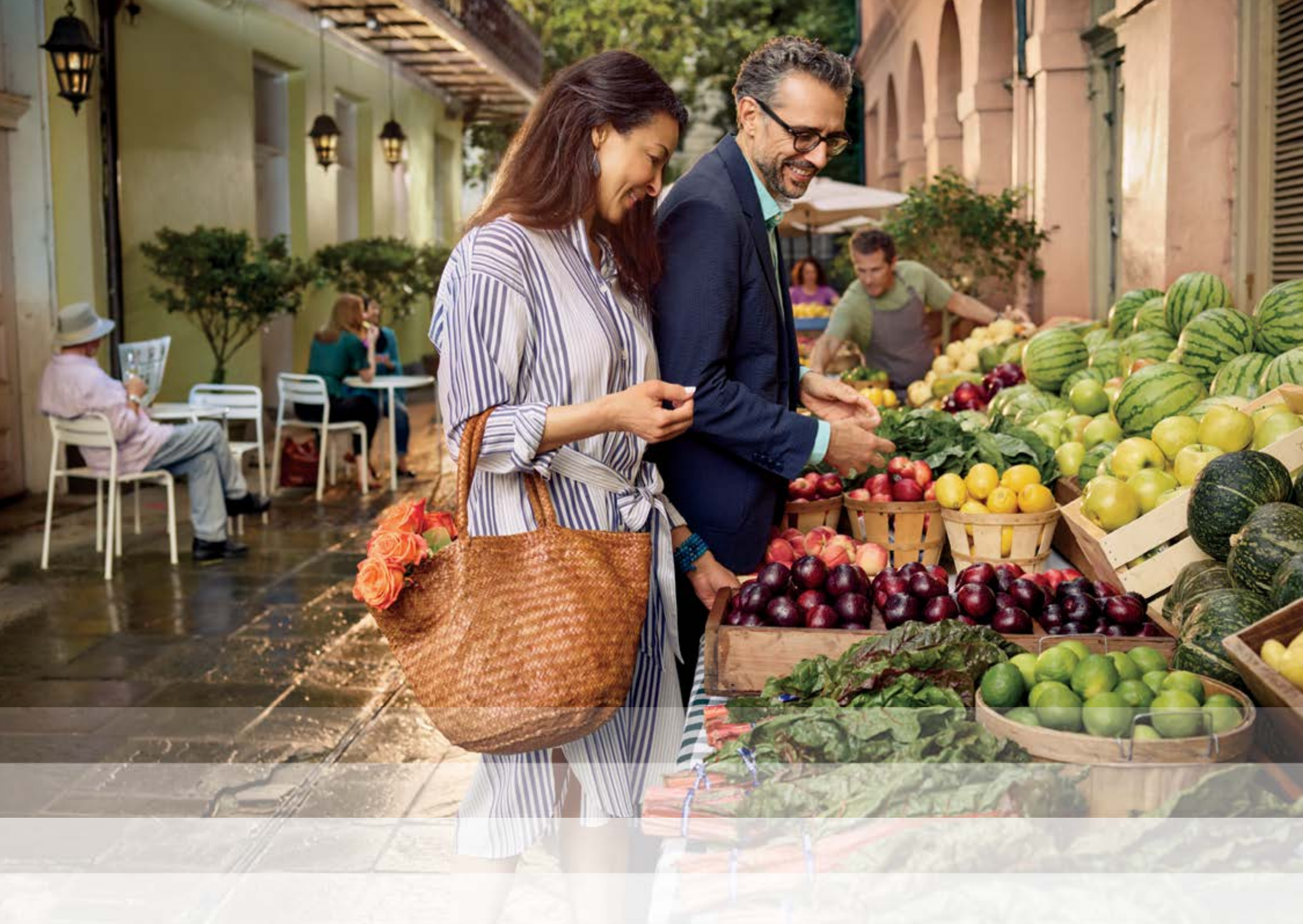

Why a Decline in Fines Doesn't Mean Relaxed Enforcement

DESPITE NUMBERS TO THE CONTRARY, REGULATORS ARE LIKELY TO DOUBLE DOWN ON COMPLIANCE IN THE NEAR FUTURE. BY DAVID WAGNER

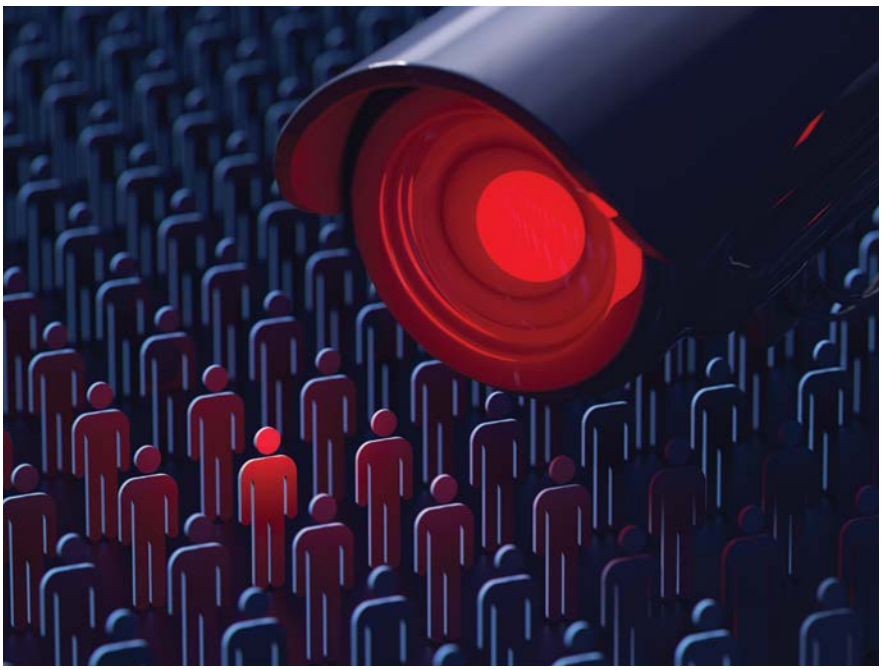

Illustration: Wit Olszewski/Shutterstock

Fines from the two of the country's leading financial regulatory bodies are down big time. FINRA sanctions dropped from $173.8 million last year to just $64.9 million in 2018, and there were fewer fines overall. This trend was also true of the Securities and Exchange Commission, suggesting that regulators are taking a newly relaxed approach to the rules. Look behind the numbers, however, and the reality is just the opposite.

The enforcement chief and top staff members at both agencies left this year, limiting the agencies' ability to pursue wrongdoing. The focus of enforcement is also shifting to retail crimes, which produce lower fees.

FINRA CEO Robert Cook was quick to rebut the numbers in recent remarks. "Our commitment to enforcement has in no way changed," he stated, explaining that enforcement had actually increased in the second half of 2018. Despite what the numbers indicate, they're clearly an anomaly and not evidence of a new approach to enforcement.

The decline in fines is attention-grabbing, but the statements from FINRA are the real takeaway: Regulators are not taking their focus off enforcement or making a conscious attempt to fine lightly. In fact, they're likely to double down on compliance in the near future.

Regulation at the Brink of Transformation

Traditionally, regulation has been a manual process reliant on human input. That is beginning to change now that technology has become so adept at data collection and analysis. The advent of artificial intelligence vastly expands both the depth and breadth of what regulators can investigate.

The combination of AI and machine learning allows investigators to root out noncompliance with far greater speed, scale and precision. Once regulators have these tools in their arsenal it's only logical that penalties and fines will swing upward.

Technology will not transform regulation overnight, but it won't take ages either. Predictions show we will have a computer that matches the power of the human brain by 2020. And by 2050, we will have processing power on par

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These breakthroughs will transform what regulators are capable of finding—and fining. So while it might be tempting to look at the reduction in fees and write off noncompliance as a manageable cost, that would be shortsighted. Instead, firms need to make compliance management a top priority.

Staying on the Right Side of Regulators

Enforcement is evolving, and the way firms approach compliance should evolve as well. Otherwise, it will be difficult to manage the ever-rising cost of fines, penalties and damaged reputations. Follow these strategies to stay compliant no matter what tomorrow's regulatory landscape might look like:

- **Get great with data.** In order to avoid noncompliance, companies need to have all their data in one place and be able to manage it carefully. Regulators will expect firms to turn over precise pieces of data on request. Integrating data from all your communication channels onto a platform with unified search makes it easy to comply. Plus, it allows firms to effectively govern their own data and periodically review it for regulatory issues. Regulators are quickly getting great at combing through huge data sets. Firms need to get great at keeping that data in order.
- **Revise supervisory procedures.** Whenever regulations are updated, those changes need to be reflected in the written supervisory procedures of every affected client group. If they're not, it's possible to make the same mistakes multiple times and invite a massive penalty. It's recommended to review these documents quarterly—even if regulations don't change—just to monitor for any potential issues. When regulations do change, using a supervising manager makes it much more efficient to update procedures across client groups without mistakes or oversights.
- **Join a peer group.** No firm is perfect at compliance. It's such a complex challenge that any single firm can be overwhelmed by the effort, especially when regulations change or expand. Joining a regional FINRA group or another association of peers helps firms work though compliance issues cooperatively. They can discuss common problems, develop shared solutions, and devise a set of universal best practices. The collective wisdom of the crowd is a huge asset for the many firms that struggle to manage compliance individually.
- **Partner with a consultant.** Firms need to be honest about the limits of their own capabilities. They may excel at wealth management but be overmatched when it comes to compliance. When this is the case, a consultant is a great resource. They offer the expertise that firms lack in-house. Plus, they understand the latest updates and granular details of applicable regulations.
- **Embrace new tech.** The same tools that regulators are using to enforce compliance can be used to preserve it. Data-driven tools make it easy to manage information on a large scale. And when the vendor understands financial regulations, these tools also help with compliance management. They automate the most time- and labor-intensive processes while eliminating costly mistakes. As enforcement becomes more high-tech, compliance should keep pace.

Compliance and complacency are not a good mix. Instead of watching what regulators did last year, prepare for where they're headed next year and beyond. ■

David Wagner is the president and CEO of Zix, an email security firm. He previously held leadership roles at Entrust for 20 years.

The combination of AI and machine learning allows investigators to root out noncompliance with far greater speed, scale and precision.

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The Real Message Behind the Movement of $1 Billion Teams

FOUR HARBINGERS OF CHANGE THAT ARE REDEFINING THE LANDSCAPE FOR ADVISORS AT ALL LEVELS. BY MINDY DIAMOND

Advisor movement among the top producers in the industry—those from traditional brokerage firms and banks who are managing $1 billion or more in client assets—is on the rise. Twenty five of these uber-teams moved in 2018. What can the rest of the industry learn from this wave of movement?

First, it's noteworthy that so many large teams moved at all: Historically speaking, those in the "Billion Dollar Plus Club" were the least likely to move. For those teams that did move, it was typically from one brokerage firm to another, as these folks strongly believed that the wirehouses were the only place to serve wealthy clients. And it didn't hurt that the recruiting deals were quite lucrative as well.

Today, it's a very different story. Just six of these 25 teams moved to another big brokerage. The rest opted for independent models or boutique firms, like J.P. Morgan Securities or First Republic Wealth Management.

There's little doubt that we're in the midst of another evolution of the landscape, and it's trends like this that serve as harbingers for what may lie ahead for the industry at large. Consider these four points:

The reverse effect: Brokerage firms are tightening the handcuffs that keep advisors captive, but may be achieving the opposite result. Advisors value freedom, flexibility and control more than anything and will do what they need to grow their businesses and serve their clients with autonomy.

Business mindset: In the last decade or so, top advisors have placed a greater focus on thinking of themselves as businesses. That's why so many are exploring the registered investment advisory space, which offers them the opportunity to build equity, self-brand, maximize enterprise value and gain greater freedom to run their businesses as they see fit.

The best deals: Firms like J.P. Morgan Securities and First Republic Wealth Management are winning the race for top talent. They've picked up the mantle from the wirehouses by offering high watermark transition deals, and their names are very attractive to the industry's best.

A leveled playing field: With wirehouse deals down from their peak, the playing field has been leveled for regional firms. Not to mention, less transition money offered by the wirehouses makes independence that much more attractive.

The Net Effects of Change

Departing from the broker protocol, shoring up non-solicitation agreements, deferring compensation and mandating garden leave are strategies implemented by big firms to stave off attrition. Yet, as firms tighten their grip, advisors are feeling the pain.

When an advisor's ability to serve clients becomes restricted—and the opportunity to realize the full potential of their business is diminished—they seek other avenues. And the changes we're seeing at the banks and brokerages are fueling their exploration.

It's important to take notice of the movement and momentum of these big teams, as they typically serve as proxies for the industry. The rest of the advisory world looks at them as the "first wave," the biggest and bravest paving the way for the rest of the population.

The momentum behind big team moves is one we expect to continue and along with it, a surge of advisors at all levels who are seeking alternatives to have greater freedom and flexibility. Stay tuned. ■

Mindy Diamond
is president of Diamond Consultants of Morristown, N.J., a nationally recognized boutique search and consulting firm in the financial services industry.

Illustration: jokerpro/Shutterstock

Small IBDs—Is It Time to Become an OSJ?

IN THE CURRENT ENVIRONMENT, THIS COULD BE THE RIGHT MOVE FOR B/D EXECUTIVES SEEKING TO RESTORE GROWTH, STRENGTHEN ADVISOR PRODUCTIVITY AND DEAL MORE EFFICIENTLY WITH REGULATORY AND OPERATING RESPONSIBILITIES. BY JIM NAGENGAST

Illustration: solarseven/iStock/Getty Images

For small to mid-size broker/dealers, the economic calculus that led them to establish their own firms has shifted drastically over the past several years; the environment only continues to get more challenging.

Investor and advisor expectations for technology platforms continue to grow as advisor productivity becomes increasingly crucial. At the same time, regulatory burdens, the threat of litigation and the cutthroat war for advisor talent are putting increasing pressure on b/d margins.

Fortunately, the industry has evolved to provide many of these besieged firms a better option: They can shed their b/d operations and refocus their efforts as an office of supervisory jurisdiction (OSJ) or branch office under another independent advisory and brokerage (IAB) firm. At the same time, they keep their teams, brands and cultures intact.

This alternative potentially offers the best of all worlds, freeing IAB executives from many compliance and regulatory responsibilities, while preserving the valuable relationships they have built with their teams and advisors. For many, it enables them to return to what they originally loved about the business—helping advisors make a positive difference for clients.

This transition, however, can entail significant changes for clients, advisors and the IAB team itself. Here are the key questions executives should ask themselves to determine if this path is right for them:

1. What is the state of our technology platform—and, if we're behind, what will it take to catch up? Most IAB executives know that keeping pace with changing technology is no longer optional. Developments in portfolio management, performance reporting and CRM software have increased advisor productivity for most

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of the larger competitors in the space. For smaller firms that lack the budget to keep up, underinvestment in technology can quickly lead to a downward spiral, creating obstacles for advisors trying to win new clients while b/d cash flow continues to dwindle. (Even firms that have deployed some of these systems can find themselves struggling if they lack the resources to properly integrate them into a cohesive platform.)

For IABs in this position, becoming an OSJ or branch office may be a better option than executing a full turnaround plan. Doing so can give their advisors immediate access to the productivity tools mentioned above, while providing the home office with cutting-edge compliance and supervision systems.

For firms that successfully implement this transition, the technology benefits and resulting gains in advisor productivity, recruiting, retention and cash flow can be substantial. In our experience, the shift can be such a game changer that some advisors who had been thinking about retirement instead decide to extend their careers by another five or even 10 years.

2. For owners: What is my current risk tolerance? From a financial planning standpoint, having a significant portion of an owner's net worth tied up in a regional IAB has never been a riskier proposition. With margins so thin, these firms are never more than one large arbitration filing away from going out of business. And in the current litigious climate, such a filing could result from a single well-meaning but misguided advisor recommendation, to say nothing of outright misconduct.

Joining forces with a larger IAB as a branch office can enable owners to share these risks across a better-capitalized firm, while also reducing expenses by locking in more robust and affordable insurance coverage for errors and omissions and cybersecurity, among other benefits. Perhaps, most important, it can curtail risk by providing access to stronger back-office and supervision capabilities that can more effectively handle the business' regulatory and operational requirements.

Many IAB owners are currently entering their retirement or preretirement years. For these entrepreneurs, there may be no time like the present to strengthen their financial planning positions by shifting business models and reducing risk.

3. What are the constraints on our recruiting efforts? Recruiting advisors is the bread-and-butter business of IAB firms. Unfortunately, the current recruiting environment has become intensely competitive, requiring two resources that are in short supply for many smaller firms: capital and time.

Incentive packages for in-demand advisors can be significant in today's market, not only to encourage advisors to move their books but also to provide the white-glove transition assistance needed to bring clients to a new firm with minimal attrition. Helping advisors through the transition also requires an enormous amount of time, which, for smaller IAB executives, is often consumed by regulatory and operational duties.

Here again, a larger firm with greater resources may be an invaluable partner for smaller IAB owners, freeing up their time and supplementing it with robust recruiting resources and capabilities of its own.

The decision to transition away from operating as an IAB to an OSJ or branch-office model can be difficult and may involve some soul-searching for entrepreneurs who have poured years into their businesses. In the current environment, however, it can also be exactly the right move for IAB executives seeking to restore growth, strengthen advisor productivity, deal more efficiently with regulatory and operating responsibilities, and bring back the excitement and joy that inspired them to start their firms in the first place. ■

Jim Nagengast is CEO and president of Securities America, a wholly owned subsidiary of Ladenburg Thalmann Financial Services.

The shift can be such a game changer that some advisors who had been thinking about retirement instead decide to extend their careers by another five or even 10 years.

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How to Achieve a Five-Hour "High-Impact" Day

BY IDENTIFYING WASTED TIME IN YOUR DAY AND FOCUSING ON $1,000/HOUR ACTIVITIES, YOU CAN CUT DOWN YOUR WORKDAY AND GROW YOUR BUSINESS AT THE SAME TIME.

BY MATT OECHSLI

Years ago, I asked an advisor I was coaching: "If you did everything you needed to do on a daily basis, what impact would it have on your income?" His response? It would double.

I then asked him to outline his perfect day, and he listed six activities, which I call "fixed daily activities." I asked him how long it would take him to complete his six activities, and he said he could have them all done by noon.

This advisor could double his income by doing what he already knew how to do and work only a half day? Yes, but it had to be a productive half day. I followed his progress for a few months, and he was true to his word—doing his six activities in a half day. Whether or not he doubled his business, I never audited the results, but my guess is that he was successful.

Many of today's offices are unwittingly designed to sabotage productivity. Sure, you can attempt to close your door and time block, but with interruptions coming from all directions (assistants, advisors, management, wholesalers, clients, emails, family, friends, etc.), the odds are against you.

If you want to shorten your workday to a highly productive five hours, you're going to have to become extremely organized, develop a laserlike focus that enables you to prioritize and execute and evaluate the new routine you're developing.

The following steps will get you started:

Step 1: Assess Your Current Day

- Create a detailed outline of your current day.
- Identify wasted time. What was it that pulled you off track? Don't judge or defend your actions—the idea is to become aware of your time wasters.
- Identify activities you're involved with that could be delegated. The objective is to focus on $1,000/hour activities, those high-priority activities.
- Identify the high-priority activities you were engaged with. How much time of your day did they require, and could they have been handled more efficiently?

You must commit to eliminating time wasters and determining to whom you will delegate and/or outsource those areas of responsibility that have been gobbling up blocks of your precious time.

Step 2: Prioritize

- Create a priority "to-do" list ($1,000/hour activities) for each upcoming day.
- Identify to whom, how and when you will delegate non-$1,000/hour activities.

Step 3: Execute, Evaluate, Repeat

- Execute Step 2 for two weeks.
- Make necessary adjustments.
- Conduct a second evaluation for two weeks.
- Evaluate and make any necessary adjustments.

Most likely, there will be a handful of adjustments to make, and then it's another two weeks of execution and evaluation. At this stage, you will be very close, if not spot-on, to your highly productive five-hour workday.

Tune out the naysayers. You're going to have a lot of less-focused, time-wasting advisors who are going to be very envious of your productive five-hour day. They'll likely try to get you to backslide into your old unproductive habits. Consider yourself forewarned.

Whether or not you double your income isn't the point—it's all about being focused on your goal, improving your daily productivity and working less. ■

Matt Oechsli
is author of *Building a Successful 21st Century Financial Practice: Attracting, Servicing & Retaining Affluent Clients*. Visit *www.oechsli.com*.

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THAT WORKS AS HARD
AS YOU DO.
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Lorraine Wolfe, founder of Aware Creative Solutions

Photo: Sara Huggard

My Life as a Client

Lots of Errors, Not Enough Caring

LEARNING FROM THE CLIENTS' EXPERIENCE OF AN ADVISORY RELATIONSHIP GONE BAD.

BY ANNE FIELD

We talked to Lorraine Wolfe, a 36-year-old founder of Aware Creative Solutions, a digital marketing firm in Phillips, Wis. Here's what she had to say.

My brother and I had a trust account, set up in the 1990s, that was under custodial management at a bank. We didn't choose where the money was invested. I never spoke to them, and they never reached out. Then, about four years before the trust was set to terminate—when I turned 35—they started making an effort to discuss what was going on in the account. There were three or four individual names on my statement; one would call me once a year. That was pretty much it.

When the trust terminated, we could decide to leave our investments there or move them elsewhere. My brother was always interested in self-managing, but I felt I didn't know much about it and needed a professional. So, I decided I'd give these guys a chance and wait a year.

The money was in stocks, mutual and exchange traded funds and cash. They were supposed to reach out to me and provide advice about where to invest the cash, but I didn't hear from them for about six months. Then, an investment advisor called and said something like, "I finally remembered to contact you, and I have a recommendation for a floating rate bond." I wanted to learn more about it, so we went back and forth for probably two months. I asked her why she was recommending this bond, because it didn't seem to be performing all that well. I wanted her to help me understand why this was good for my portfolio. She ended up getting frustrated and stopped responding to my emails.

I realized I wasn't getting the attention I needed to stay in this relationship. Plus, they constantly made small errors. For example, they would call a number where I'd lived 20 years ago, never bothering to update it. Then, when we were talking about the floating rate bond, the advisor sent me a prospectus. Even though I was new to reading prospectuses, it didn't look right. When I questioned her about it, she said, "Oh, I sent you the wrong one." At one point my spouse and I were considering investing in real estate property; they called him by my brother's name. And with emails, I usually got a response in two days; sometimes a week and a half. So I thought, "they're really not listening to me."

When I calculated all the fees, they ended up being about 1.25 percent, while the account was mostly just sitting there. At the end of the day, I can let my account just sit there, too—and save those fees.

When I told them I wanted to move, they connected me with an investment advisor under the same company umbrella. At the same time I spoke to someone at another large firm I had worked with back in 2006. Both were likable and came up with proposals for selling off what I owned and diversifying into other investments. I connected more with the first advisor, but he was really excited about options overlay strategies. I responded that it would just add another layer of complexity. The second advisor was excited about separately managed accounts, even when I told him the rest of the world was into ETFs. It felt like I was floundering in bad relationships. I needed a break.

I went on the Internet and did some research to see if I'd be able to invest on my own. I found a brokerage firm where I could do just that, so I transferred my account. Though I'm still in the transition period, I already find the new firm to be much more detail-oriented. They seem to care more, even though I don't pay them.

If I feel like I'm screwing up, I can always find a new advisor. ■

Photo: Scott Rothstein/Shutterstock

Do Rate-Hedged Bond ETFs Work?

IF INTEREST RATES RISE SHARPLY, YES. BUT THERE ARE SIGNIFICANT TRADE-OFFS.

BY BRAD ZIGLER

The problem with fixed income investments isn't the income. Not directly, anyway. It's the value of that income in relation to prevailing market rates. The laws of bond physics dictate that the resale price of a 3 percent coupon is likely to be diminished if yields rise to 4 percent. This manifestation of interest rate risk is especially worrisome for holders of bond ETFs. For traditional bond ETFs, that is.

Over the past few years, a slew of rate-hedged bond ETFs have launched with an eye toward mitigating the deleterious effects of rising yields. The hedge is accomplished by shorting Treasury futures or entering into swap agreements that offset the overall duration of the bond portfolio. Swaps entitle the ETF to floating payments tied to prevailing interest rates in return for a series of fixed disbursements. If rates rise, the increasing cash sums received by the ETF help to offset declines in the value of the underlying bond portfolio.

Duration combines the timing of interest payments and the return of principal into a gauge of a bond or bond fund's relative value. Expressed in years, duration is most commonly known to investors as an estimate of an instrument's sensitivity to interest rate fluctuations. A 1 percentage-point shift in rates will, generally, push a bond portfolio's value in the opposite direction by a like amount, multiplied by the security's duration. You'd, therefore, expect the value of a bond ETF with a five-year duration to slump by 5 percent in response

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to a 1 percentage-point hike in rates. Interest rate-hedged ETFs are designed to have a duration approximating zero.

Mind you, duration hedging doesn't wipe away the entirety of a bond ETF's risk. Neutralizing interest rate risk merely isolates the portfolio's credit risk—the danger of default. With that, ETF holders become exquisitely sensitive to changes in economic conditions that affect default rates. This makes rate-hedged ETFs a good bet when investor sentiment about economic growth and corporate earnings is positive. When credit conditions worsen, however, the hedge is a drag. At the very least, a portfolio hedge should dampen the volatility found in a traditional bond ETF. That, in turn, ought to produce a performance advantage.

Hedging doesn't come without cost. That cost is reflected in dividend yields. A rate-hedged ETF's payouts will typically be smaller than that of a comparable unhedged portfolio but may be still higher than those of floating rate ETFs of similar quality or funds populated with notes of shorter maturities.

So, how do rate-hedged ETFs stack up against conventional bond products? To answer that question, we sorted the universe for pairs of directly comparable investment-grade portfolios. In each pair, one fund is hedged, the other unhedged. We then set them up against the **iShares Core U.S. Aggregate Bond ETF** (NYSE Arca: AGG), a long-established tracker of investment-grade corporate bonds, Treasurys, agencies, CMBS and ABS. Three hedged/unhedged pairs immediately hove into view.

At the long end of the yield curve are iShares portfolios keyed to the ICE BoAML 10+ Year U.S. Corporate Index. The unhedged **iShares Long-Term Corporate Bond ETF** (NYSE Arca: IGLB) lays a foundation for the **iShares Interest Rate Hedged Long-Term Corporate Bond ETF** (NYSE Arca: IGBH), an actively managed portfolio that uses Treasury note swaps—primarily of three tenors—to hedge away rate risk across the right side of the term structure. For this, IGBH charges an extra 10 basis points in annual holding expenses versus IGLB. That's a portfolio management upcharge. There's another cost reflected in dividend yields. Presently, IGBH's yield is nearly a full percentage point less than IGLB's.

And what do you get for these additional costs? IGBH pulls down an average annual return 219 basis points higher than the underlying IGLB portfolio. With significantly less volatility, to boot. One consequence of interest rate hedging during the

Chart 1 - **Growth of $10,000 in Longer-Term Investment-Grade Corporate Bond ETFs**

(October 2015 – October 2018)

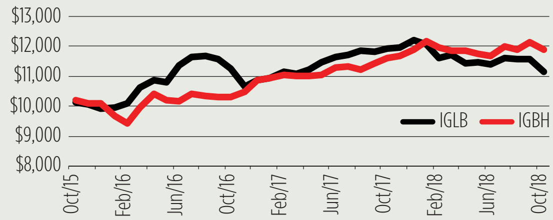

Table 1 - **Longer-Term Investment-Grade Corporate Bond ETF Performance**

(October 2015 – October 2018)

	Average Annual Return (%)	Annualized Volatility (%)	Maximum Drawdown (%)	Duration (Yrs)	Dividend Yield (%)	Expense Ratio (%)
IGLB	5.75	7.58	-8.85	12.95	4.7	0.06
IGBH	3.56	7.02	-7.55	-0.27	3.71	0.16
AGG	**0.96**	**2.77**	**-3.52**	**3.55**	**2.91**	**0.05**

Chart 2 - **Growth of $10,000 in Medium-Term Investment Grade Corporate Bond ETFs**

(October 2015 – October 2018)

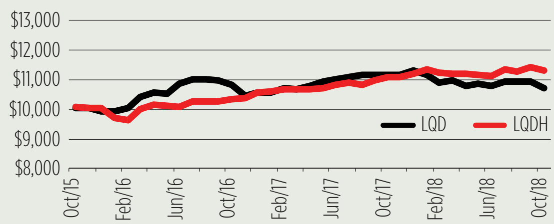

Table 2 - **Medium-Term Investment Grade Corporate Bond ETF Performance**

(October 2015 – October 2018)

	Average Annual Return (%)	Annualized Volatility (%)	Maximum Drawdown (%)	Duration (Yrs)	Dividend Yield (%)	Expense Ratio (%)
LQD	2.34	4.66	-5.2	8.23	3.74	0.15
LQDH	4.01	4.15	-4.41	-0.29	3.05	0.24
AGG	**0.96**	**2.77**	**-3.52**	**3.55**	**2.91**	**0.05**

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> **Hedged bond portfolios are, ideally, designed to capitalize on relatively quick and steep interest rate hikes.**

recent equities bull market, however, is noteworthy—heightened correlation. IGLB owns a 0.39 correlation coefficient to the domestic stock market; it's 0.64 for IGBH.

In the middle of the term structure are a pair of iShares portfolios based on the Markit iBoxx USD Liquid Investment Grade Index. The **iShares iBoxx $ Investment Grade Corporate Bond ETF** (NYSE Arca: LQD) draws only notes with maturities three or more years out. That's not to say that the fund's average weighted maturity is short. In actuality, it's nearly 13 years. LQD correlates to the broad stock market with a 0.36 coefficient.

With LQD as its base, the **iShares Interest Rate Hedged Corporate Bond ETF** (NYSE Arca: LQDH) also relies on swaps to lay off risk. As with the iBoxx pair of ETFs, hedging goosed up returns, tamped down volatility and chewed into dividend yields. LQDH's correlation to the stock market, at 0.63, is also conspicuously higher than LQD's.

Last, we looked at the hedged analogue of our AGG benchmark. The **WisdomTree Barclays Interest Rate Hedged U.S. Aggregate Bond Fund** (NYSE Arca: AGZD) uses Treasury futures instead of swaps to insulate its bond portfolio from interest rate risk. Another distinction: AGZD doesn't hold an ETF at its core. Instead, the fund replicates the Bloomberg Barclays U.S. Aggregate Bond Index by taking long positions in the benchmark's investment-grade constituents. Maturities are on par with those of the LQD/LQDH pair, and the hedging effect is also similar. AGG earns a -0.02 correlation to the stock market. The Treasury futures overlay ratchets the coefficient up to 0.58 for the AGZD fund.

The Good and the Not-So-Good

So, what's the upshot of our survey? Put simply, hedging works. Whether swaps or futures are employed by portfolio runners, zeroing out duration produces a double benefit: It boosts gross returns and reduces volatility in a rising rate environment. The cost for this is at once obvious and subtle. We've clearly seen the impact hedging has in reducing dividend yields and increasing ongoing holding expense. We've also noted that hedging with Treasury instruments mitigates the risk that abounds as rates ratchet higher, but it won't diminish credit risk. If economic prospects worsen, default risk will rise, though less so in the investment-grade sector compared with lower-quality issues.

This brings us to a more global risk. Adopting a hedged approach to the bond market carries with it an explicit assumption that Treasury yields will rise. It's fairly apparent that the multidecade bull market in bonds is coming to an end, but there's no guarantee that rates will rise over any discrete period of time in the short or intermediate term. Considering the costs enumerated above, flat rates can be just as deleterious to a hedged position as falling rates. One has only to look at the Japanese bond market to find a paragon of an obstinately stagnant rate environment.

Above all, investors should heed Page One of the hedging rulebook: So long as rate protection is in place, an investor forgoes the windfall profits obtainable in an unhedged position. Holders of unhedged bond funds can enjoy capital gains if interest rates fall. Those gains are forfeited in a hedged portfolio.

Keeping this in mind, hedged bond portfolios are ideally designed to capitalize upon relatively quick and steep interest rate hikes. The question for investors to measure now is how confident they are in such a future. ■

Chart 3 - **Growth of $10,000 in Medium-Term Broad Market Bond ETFs** (October 2015 – October 2018)

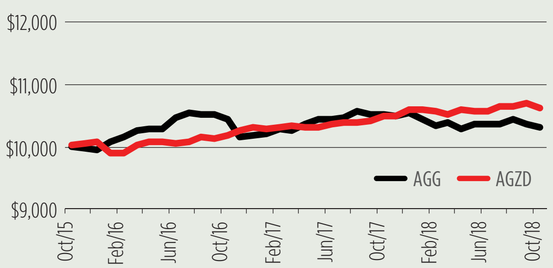

Table 3 - **Medium-Term Broad Market Bond ETF Performance** (October 2015 – October 2018)

	Average Annual Return (%)	Annualized Volatility (%)	Maximum Drawdown (%)	Duration (Yrs)	Dividend Yield (%)	Expense Ratio (%)
AGG	0.96	2.77	-3.52	3.55	2.91	0.05
AGZD	1.96	1.75	-1.75	0.35	2.6	0.23

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Active ETFs: "An ETF Innovation That Makes Sense"

THE BENEFITS OF AN ETF WRAPPER CAN APPLY AS MUCH TO ACTIVELY MANAGED STRATEGIES AS THEY DO TO THEIR PASSIVE COUNTERPARTS.

BY DAN WEIL

Photo: Ruben Ramos/iStock/Getty Images

Actively managed exchange traded funds still represent a small part of the ETF space, but it's a niche that is growing. It is, according to ETF watchers, one of the few innovations in the market that makes sense, unlike some other frivolous products designed to benefit issuers more than investors.

Actively managed U.S. ETFs received a net inflow of $23 billion last year through October, exceeding the full-year total for 2017 by 48 percent, according to Morningstar Direct. There are 285 actively managed ETFs with total assets of $67.3 billion. That still amounts to only 1.9 percent of the $3.5 trillion ETF market.

What's the appeal? If there is an active strategy that a manager or investor believes in, putting it in an ETF wrapper carries distinct benefits for investors, including lower fees, no investment minimums, higher liquidity and the tax efficiency inherent in the structure of an ETF.

"If you have a manager you believe in, it's hard to find a 'con' in an ETF wrapper," says Dave Nadig, managing director of *ETF.com*, an ETF research firm owned by Cboe Global Markets.

To be sure, financial advisors must keep their clients cognizant that actively managed ETFs are a different animal from passive ETFs. They can produce poor returns as easily as positive, and as with actively managed mutual funds, it's not easy to pick winners based on past performance.

"Investors should be aware that these are active strategies," says Ben Johnson, director of global ETF research for Morningstar. "Just because you deliver it in a new package doesn't mean you provide antigravity boots. Some do well; some less well."

In addition, on the bond side, an active manager generally can't make up for the fact that bond prices fell across the board this past year.

In fact, the average return of all actively managed ETFs registered negative 1.63 percent over the 12 months through November 20, compared with positive 6.36 percent for the S&P 500 Index.

But perhaps the biggest benefit of actively managed ETFs is pricing. "Average retail investors get fees comparable to institutional share prices for the ETFs' sibling mutual funds," Johnson says.

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> **"Just because you deliver it in a new package doesn't mean you provide antigravity boots. Some do well; some less well."**

While it's simple to determine your costs for an actively traded ETF, older mutual funds have multiple share classes with all sorts of different fees, Nadig notes.

Actively traded ETFs have lower fees than actively traded mutual funds, because ETFs don't have to worry about record keeping for individual shareholders, 12b-1 marketing fees or hiring transfer agencies. The average annual expense ratio for actively managed ETFs is 0.7 percent, compared with 1.12 percent for actively managed mutual funds, according to Morningstar.

That won't seem like such a bargain to some investors who are used to paying expenses of 3 to 5 basis points for passive, broad stock market ETFs, says Todd Rosenbluth, director of ETF and mutual fund research at CFRA, a research firm. The average expense ratio for passive ETFs is 0.53 percent, according to Morningstar.

"Investors are increasingly cost-focused," he says. "In the equity space, active management has failed to consistently deliver outperformance, so investors are more hesitant than perhaps they should be to take a look at some of these products."

But, Rosenbluth and others note, the ETF wrapper does provide investors with liquidity, transparency and tax efficiency. Availability is a benefit too, Johnson says. You can purchase as little as a single share, with no worries about the minimum investment requirements of mutual funds. "The fact that they trade like stocks on an exchange makes these strategies more accessible than those packaged in a traditional mutual fund," he says.

Most of the money flowing into actively managed ETFs has gone to a few top funds, with the 10 largest accounting for more than half of total assets, according to Morningstar.

The four biggest funds as of November 20 were ultrashort-term bond funds: **PIMCO Enhanced Short Maturity Active ETF (MINT)**, **iShares Short Maturity Bond ETF (NEAR)**, **JPMorgan Ultra-Short Income ETF (JPST)** and **First Trust Preferred Securities and Income ETF (FPE)**. Morningstar gives the Pimco fund its top gold rating.

Fixed income funds are garnering the bulk of the assets in the actively managed ETF universe. Issuers have been less interested in equities because they don't want to constantly reveal their holdings. "They are worried about giving away their secret sauce and about front running," Johnson says. "Some are probably flattering themselves."

Ark ETFs are ones that have succeeded on the equity side. "There's a lot there to love," says ETF.com's Nadig. The **Ark Innovation ETF (ARKK)**, which holds companies the managers consider to be innovative, sported a three-year annualized return of 27.92 percent as of November 21 and held $1.25 billion of assets, according to Morningstar. "Ark is gathering assets because it's outperforming," Rosenbluth says.

The success of Ark and Davis ETFs' actively managed offerings shows that "if you have the goods, investors will give you money," Nadig says.

But Johnson maintains that fund managers are unlikely to commit deeply to actively managed equity ETFs until the Securities and Exchange Commission (SEC) permits nontransparent funds. And so far the SEC has batted back almost all requests for them by issuers.

On the fixed income side, issuers aren't as concerned about transparency because bond funds have far less turnover, and many of the players in the bond market, such as insurance companies, aren't looking for outsize returns, Johnson says. "There are far fewer opportunities for front running," he says.

Meanwhile, investors have gravitated to actively managed bond funds amid rising interest rates and volatility in the stock market. The strong popularity of ultrashort-term bond funds stems from the fact that these funds generally hold up better than longer-term funds in a period of rising interest rates. Investors in active strategies benefit from having a human manager who can adjust to changes in interest rates, Rosenbluth says. ■

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Swedroe: "Most ETFs Are Garbage"

THE DIRECTOR OF RESEARCH FOR BUCKINGHAM WEALTH BEMOANS THE FACTOR "ZOO" THAT THE ETF MARKET HAS BECOME.

BY DAN WEIL

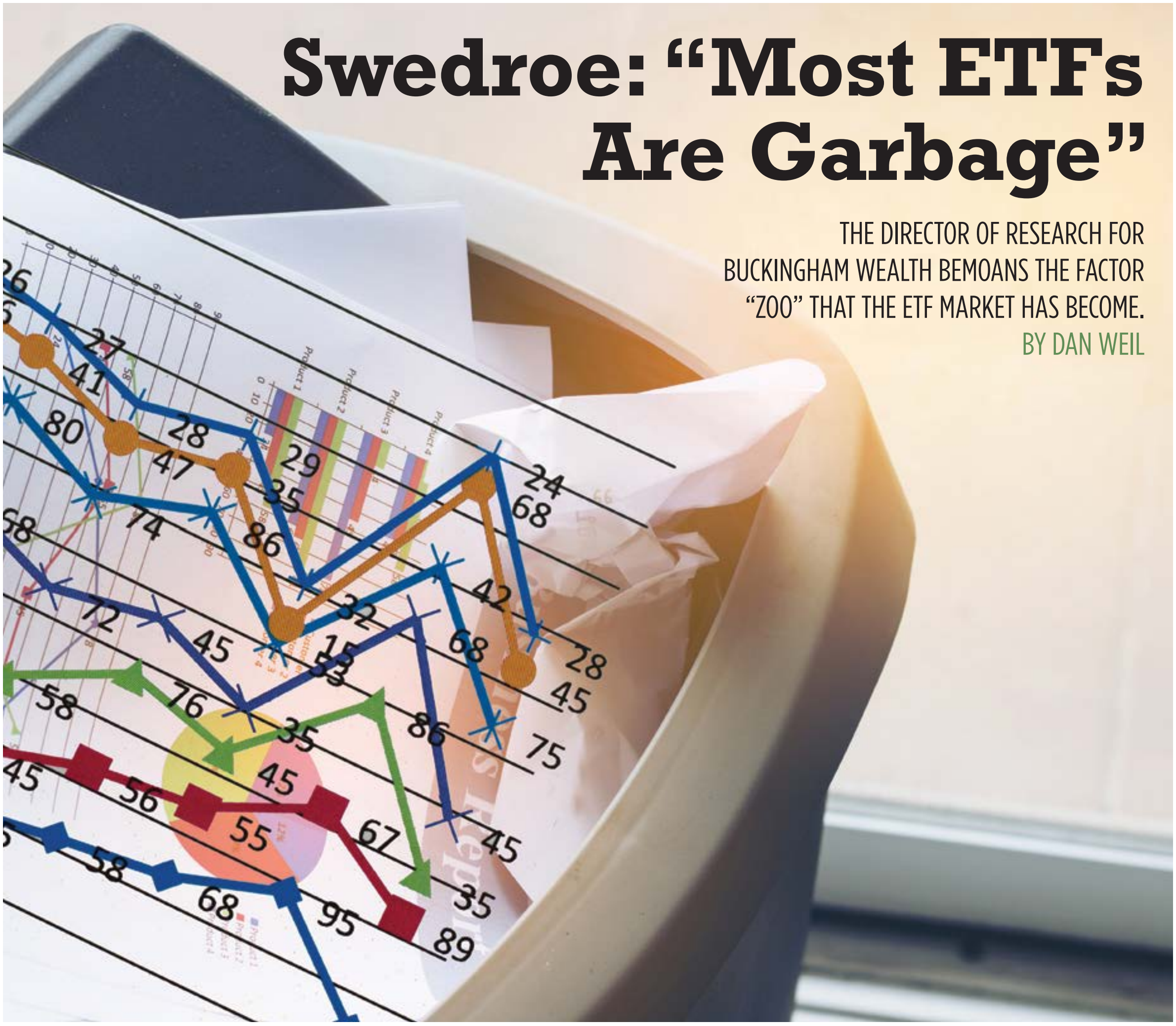

Illustration: Happy cake Happy cafe/Shutterstock

Larry Swedroe, director of research for Buckingham Strategic Wealth, doesn't pull any punches when it comes to his views on exchange traded funds (ETFs).

"Ninety-nine percent of ETFs out there are garbage—marketing hype," he tells *WealthManagement.com*. "They are products meant to be sold, not bought."

If anyone can make that case, it's Swedroe. In addition to a long and storied career in the investment business, he's the author of multiple books about the subject. His latest, *Your Complete Guide to a Successful and Secure Retirement*, is out this month.

He gave *WealthManagement* a full rundown of his opinions on ETFs.

***WealthManagement*:** Do you think that broad-based, low-fee ETFs are the best for investors?

Larry Swedroe: I want to be highly concentrated in the factors that I want, but broadly diversified. Large-cap stocks move mostly on a systemic basis, so I'd want funds with 100 to 200 stocks. Small-cap is a lot more idiosyncratic, so I'd want 500 to 600 stocks there. I don't want idiosyncratic stock risk; I want idiosyncratic factor risk.

What you really want is a barbell strategy. One end is owning all of the market in the cheapest way. Then you want the concentration that gives you the most exposure to the factors that you want. The more you load up on factors, the more diversity you give up. You have to balance it.

WM: What do you see as the benefits of ETFs?

LS: The big benefit is the tax advantage. As a one-time investment, there's a benefit to the low cost of trading. Expenses tend to be lower. The fact that you can trade intraday is touted as a positive, but it's really a negative, because it

"Bitcoin is just the fear of missing out on an investment. There are proposals for bitcoin ETFs, despite the fact it has declined about 80 percent over the last year."

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can tempt you into trading when you're better off not trading.

WM: What are the other negatives?

LS: There are many things to be careful of. All these smart beta funds are something to be wary of. The term "smart beta" is close to an oxymoron. The beta is just exposure to a factor that has unique risk. There's nothing smart about it, per se. Smart beta is mostly marketing.

WM: Are you concerned about stock concentration in the hands of ETFs?

LS: No, I think that's a phony argument. Fund families like Vanguard are becoming very active in good corporate governance issues. Twenty five years ago, retail investors had about 1 percent of their assets in passive. Now it's about 15 percent.

While the trend is big among institutions too, individuals are moving maybe 1 percent of their assets from active to passive per year. Meanwhile, the percentage of trading from institutions has gone up to 95 percent. These arguments are phony. We're nowhere near where this can be a problem.

WM: What do you think about niche ETFs?

LS: Ninety-nine percent of ETFs out there are garbage—marketing hype. They are products meant to be sold, not bought. There's a factor zoo: about 600 funds.

There are five traits a fund should have:

Evidence of a premise that's persistent over a long period is key, and it must be pervasive across asset classes, industries, etc. It also has to be robust for definitions, such as different measurements of value. You want to get confidence this will persist in the future. There has to be an explanation for why the opportunity exists. Finally, It has to survive implementation costs, turnover and trading.

That's not there for things like robotics and water. There's no evidence that you might find those things mispriced. The evidence gets worse for active managers. People don't understand the difference between information and relevant information.

If there's a water shortage, say, I'm not the only one who knows it. It's already built into the price. The market is sufficiently efficient that playing that game makes no sense, unless you know more than others. And the odds of that are pretty low. Stay away from sector ETFs and most of smart beta.

WM: What do you think about actively managed ETFs?

LS: That's a loser's game as much as mutual funds. I don't like playing a game where the odds are 90 percent against me. The possibility of winning the active manager game is like the lottery and Las Vegas casinos. It's OK for entertainment, but you shouldn't take your IRA account.

WM: As for future ETF trends, which ones do you think will be positive and which negative?

LS: Wall Street is great at creating demand. I think bitcoin should never be considered an investment because there is unlimited supply. It's pure speculation. Individuals have a history of manias—dot.com, biotech, bowling alleys in the 1960s, tulip bulbs, etc. Bitcoin is just the fear of missing out on an investment. There are proposals for bitcoin ETFs, despite the fact it has declined about 80 percent over the last year.

Wall Street will keep creating it and then create marketing demand. There are a zoo of ETFs today. Maybe a handful or two are worth considering. The rest are hype. Most investors allow hype and hope to triumph over wisdom and experience.

That doesn't mean some good ones won't be introduced as we learn what factors drive returns. If we learn something new, I would expect that to be introduced. Quality and profitability were only introduced in the literature starting in 2012-13. ■

Larry Swedroe is scheduled to speak at the Inside ETFs conference running from Feb. 10-13.

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Falling Angels and the Threat to Bond ETFs

HALF OF THE DEBT IN INVESTMENT GRADE CORPORATE BOND FUNDS TEETERS JUST ABOVE JUNK. IF THE ECONOMY SLOWS AND DOWNGRADES FORCE PASSIVE FIXED INCOME MANAGERS TO SELL, WILL ETF INVESTORS FEEL THE PINCH? BY DIANA BRITTON

The fixed income market is starting to look a little bleaker. U.S. corporate debt is at a record high as many corporations took advantage of low interest rates to fund a record number of mergers and acquisitions last year. But analysts say we're near the end of the credit cycle, and credit quality is diminishing.

In fact, half of the Bloomberg Barclays investment-grade bond index comprises BBB-rated bonds, one step away from junk; that's nearly double the level of the 1990s. The **iShares iBoxx $ Investment Grade Corporate Bond ETF (LQD)**, based on the Markit iBoxx USD Liquid Investment Grade Index, with 48 percent of its bond portfolio at a BBB rating, saw one-year outflows of nearly $7 billion, according to Morningstar data ending November 2018.

As the economy and markets slow, some analysts say we could see a wave of so-called "fallen angels," bonds originally issued at investment grade but downgraded to junk. (To be sure, there are a few ETFs that exist to catch the angels on their way down.)

The concern among some is that the ETF managers of widely held, investment grade corporate debt funds will be forced to sell the junk bonds, and the price of the funds will fall.

According to Moody's, the number of potential fallen angels, Baa3-rated companies with either a negative outlook or that are on review for downgrade, increased to 47 at the end of the third quarter last year, compared with 42 in the second quarter. (Baa3 is the lowest investment grade rating on the Moody's scale.) In addition, the debt of potential fallen angels in the U.S. rose to $102 billion in the third quarter, the highest it's been since Moody's first started collecting that data in 2014.

"The border between investment grade and high yield has been recognized in the marketplace

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ETF watchers say the fear of fallen angels among corporate bond ETFs is misplaced.

as a weak spot for passive managers, because they're really obliged to sell something that's had a downgrade," says Elisabeth Kashner, vice president and director of ETF research at FactSet. "In any market when you've got a whole bunch of forced sellers, what's going to happen to the price?"

Five of the biggest ETFs that could be affected by a downgrade of BBB-rated bonds, according to *ETFTrends.com*, include LQD, the **Vanguard Short-Term Corporate Bond ETF (VCSH)**, the **Vanguard Intermediate-Term Corporate Bond ETF (VCIT)**, the **iShares Short-Term Corporate Bond ETF (IGSB)** and **iShares Intermediate-Term Corporate Bond ETF (IGIB)**.

An Overblown Fear

But ETF watchers say the fear of fallen angels among corporate bond ETFs is misplaced. Asset managers have been through periods of heightened downgrades before, with fairly minimal impact on most investors.

Despite the perception of an indexed bond fund being rules-based and relatively static, taking bonds in and out of a portfolio is par for the course for many managers who have leeway to deal with downgrades without the forced sale of bonds at a depressed price.

"If you are a fixed income portfolio manager, just on a routine, run-rate basis, you expect adjustments to the index, which you are obliged to track; you expect those adjustments pretty much on a monthly basis," Kashner says.

"There is a narrative out there that, if a downgrade happens, the index manager must sell that bond on the very last day of the month, robotically without consideration for execution … because the last day of the month is rebalancing," says Steve Laipply, head of U.S. iShares fixed income strategy at BlackRock. "That is not, strictly speaking, true."

Asset managers don't have to wait until the end of the month to rebalance, Laipply says. "Part of the role of the portfolio manager is to understand market conditions and to make a decision on what would be the most optimal time to sell."

"Particularly within fixed income, investing is never passive," says Matthew Bartolini, head of SPDR Americas Research at State Street Global Advisors. "An index manager will make relative value active decisions. But those active decisions are not to seek alpha. Rather, it is to minimize beta degradation due to high trading costs."

SPDR may look to trade a bond on a day of the month when that issue is more liquid, as the price can change when trading is thinner, Bartolini says.

"If there's a significant amount of downgrades, we're going to be using those really flexible techniques that we have as index managers, such as optimization or sampling, to make sure that the portfolios will have the necessary data exposure to track their indexes and mitigate any sort of high transaction costs."

Bond Funds Are Different

"It's easy for investors to think, 'These are passive; these are indexed; they've got to just do whatever happens to the index,'" says Todd Rosenbluth, director of ETF and mutual fund research at CFRA. "It's not as clear as that."

While equity ETF managers will fully replicate an index, bond managers buy just a sample of the market to replicate the underlying risk factors of the index, such as the duration exposure, credit spreads, and sector and industry exposures. That gives the manager leeway to build samples that will have the least amount of downgrades, says Josh Barrickman, head of fixed income indexing Americas at Vanguard.

"We do have a team of senior analysts that will opine on different credits, give us some sort of their take on the direction of a lot of different credits, and we can factor that into how we build the samples in our portfolios."

VCIT, for example, has about 1,900 securities, while the index, the Bloomberg Barclays U.S. 5-10 Year Corporate Bond Index, has close to 2,000 securities in it. A number of the securities in the index but not the ETF

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are either illiquid or too expensive to transact in.

If an analyst expects a bond to be downgraded in the next three to six months, good managers may start to build in an underweight to that name ahead of a downgrade or simply won't add to that name.

"We are going to use our technique that we've honed over the last 30 years as index managers to precisely deliver that beta exposure to clients they've hired us for," SPDR's Bartolini says. "If that means holding less bonds in the index because those smaller bonds may not be additive to the portfolio but they'll be destructive from a cost perspective, the cost to purchase those outweighs the beta afforded by them."

ETFs Have Weathered Downgrades Before

There is historical precedent for this pace of downgrades. In 2002, 17.7 percent of BBB bonds were downgraded; it was 13.6 percent in 2009, according to a Moody's study. Managers also experienced a heightened volume of fallen angels in 2015 when energy prices collapsed. (There were just 14 actual fallen angels in the first three quarters of 2018, Moody's says, similar to the 12 for the full-year 2017 and much lower than the 63 in 2016. Moody's attributes that high volume in 2016 to weakness in commodity-linked industries and the downgrade of Brazil.)

"[In 2015 and 2016], I think the performance of the investment grade ETF actually was fairly good," said Francis Rodilosso, head of fixed income ETF portfolio management at Van Eck, which runs the **Fallen Angel High Yield Bond ETF (ANGL)**. "I think they continued to track their indexes fairly well, and there were some pretty large issuers in those spaces that moved down to high yield."

Rodilosso says the recent volumes of fallen angels are not significantly higher than in the past. He says the BBB universe is currently over $800 billion, and about one-eighth of that, a little over $100 billion, is on negative watch by the ratings agencies.

But there is potential for higher downgrade volume in the next 12 months, and it can be a technical buying opportunity, he says. Historically, bonds in the ICE BofAML US Fallen Angel High Yield Index—which buys original investment grade bonds that have fallen to junk status—see an 8 percent price decline in the six months prior to index entry and almost a full recovery in the six months after. "But the dispersion of actual results around that average is quite high."

"From a day-to-day risk management perspective, there's virtually no difference in terms of the actual cumulative probability of default between a bond that's at the bottom of investment grade and that's at the top of junk," says Dave Nadig, managing director of research firm *ETF.com*. "This is where discussions about active management often end up, which is if you were an active manager who was managing a fund that otherwise had a mandate for investment grade corporate bond exposure, chances are you have the flexibility in your mandate to still hang on to something that may have just gotten downgraded."

Many corporate bond mutual funds have a buffer of about 10 to 15 percent that can be below investment grade, he says. It's reasonable to say these active managers can take advantage of some of these structural issues. Yet recently, active managers of bond funds haven't outperformed. During the one-year period ending June 30, the majority of active bond managers investing in long-term government and long-term investment grade bonds underperformed their benchmarks, according to the U.S. SPIVA Scorecard.

Nadig believes the BBB problem is overblown, and the impact of increased downgrades on bond ETFs to be minimal.

"The bond market is pretty good at pricing risk," he says. "As things get downgraded, they get a little bit oversold. They get a little cheaper. Their yields come up. Now all of a sudden they're attractive high-yield bonds that don't really have any additional risk, so people buy them up. It tends to self-regulate pretty well." ■

The recent volumes of fallen angels are not significantly higher than in the past.

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An Ivy League Education Is No Longer Worth the Cost

DON'T JUST BLINDLY DRINK THE KOOL-AID.

BY LYNN O'SHAUGHNESSY

Photo: Shutterstock

Does attending an elite university really make a difference in a graduate's lifetime earnings power?

This is an important issue to address, since the very people who would swear it's true are more likely to be financially well-off. In other words, your clients and the grown children of your clients with kids of their own are more inclined to accept the superiority of elite universities as fact.

These affluent parents also are more likely to have the means to spend $300,000 or more when underwriting a single bachelor's degree from an ultra-expensive rankings darling, like Stanford or Princeton. And the financial pain will be even greater for parents sending more than one kid off to college.

Making the decision to sink a hefty six figures into an undergraduate experience can turn a positive retirement scenario for parents into an iffy one and leave financial professionals with fewer assets to manage.

The financial damage would be even worse for affluent parents who have not saved enough for college and resort to borrowing to pay the tab for a trophy-school degree. This goes on a lot. According to recently released statistics from the Survey of Consumer Finances for 2016, 24 percent of all college debt was held by households in the top quintile of income. These families make at least $144,720 annually.

Ironically, while many high-income parents believe that attending a school like Harvard, Duke,

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Northwestern or Johns Hopkins is essential if their children are to ultimately earn the best salaries, the research doesn't bear it out.

Two landmark studies, which for years have appeared airtight, indicated that wealthy students don't boost their earnings power by attending these institutions. A new study, which offered a slightly different take on this issue, also concluded that there isn't a salary boost for smart, high-income students who attend the most-coveted schools versus less-selective institutions.

Let's take a look at the research findings.

The first study, which was released in 2002, examined salaries of graduates who attended Ivy League schools in the late 1970s versus those who were accepted by Ivies but went to other less-selective universities. When Alan Krueger, a noted Princeton economist, and Stacy Dale, a senior researcher at Mathematica Policy Research, looked at the graduates' initial earnings, the differences in income earned between the two cohorts was "generally indistinguishable from zero."

The pair of researchers released a follow-up study in 2011 that documented the same earnings phenomenon from the original study subjects as they progressed in their careers. They also expanded their scope by looking at salaries earned by graduates of Ivy League institutions and comparing them with those earned by individuals who got rejected from the Ivies but who possessed the same stellar academic profiles. When they examined the salary history of both groups of graduates, who all started college in 1989, there was no difference in salaries.

The conclusion of this much-lauded research was that the wealthy teenagers who apply to these prestigious universities will do well in their careers—regardless of where they are admitted—because they are bright, talented, ambitious and have rich parents. For these affluent students, an elite education just isn't necessary.

The research suggests that a better predictor of earnings was the average SAT scores of the most selective school a teenager applied to and not the typical scores at the institution the student attended.

Both studies, however, did document a significant boost in income among graduates who came from minority and low-income households. These graduates are less likely to have parents who can help their children financially and professionally.

Despite the benefits that elite schools can bestow on less-fortunate students, these institutions remain primarily in the business of educating wealthy children. They enroll more students from the top 1 percent of the income scale than the bottom 60 percent.

Finally, the most recent study, which comes from researchers at Virginia Tech, Tulane and the University of Virginia, backed up much of what the older research illustrated. For high-income, white male graduates, the study that was published in the *National Bureau of Economic Research* found no relationship between college selectivity and future salaries.

At least on the surface, there seemed to be a significant difference in wages for women who attended elite schools. The women's earnings increased 14 percent. The researchers, however, explained that this boost was almost entirely achieved not by higher per-hour wages but by the women staying in the workforce longer. These women delayed marriage and childbirth longer than women who attended less-selective schools.

If you have clients who have drunk the Kool-Aid peddled by *U.S. News & World Report's* rankings and believe an elite education is essential, talk to them and share this research. Doing so could help parents who are tempted to spend way too much for their children's college years, and also help your bottom line. ■

Wealthy students don't boost their earnings power by attending these universities.

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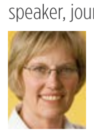
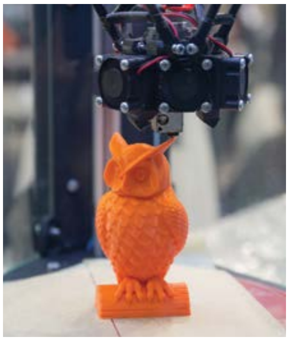


The Fourth Industrial Revolution Is Here

FAMILY BUSINESSES NEED TO ADAPT OR GO UNDER. BY MITZI PERDUE



For family businesses, the Fourth Industrial Revolution, a concept introduced by Professor Klaus Schwab, founder and executive chairman of the World Economic Forum, can mean undreamed of success and profitability. That's if they're agile enough to take advantage of technologies, such as big data, artificial intelligence (AI), 3-D printing and thousands of other innovations.

We all know what happens to those that aren't agile enough. Think Kodak, Toys "R" Us, Radio Shack or Sears.

What do your clients need to do to be in the category that thrives?

Don't Be Caught Unawares

The technologies involved will mean change on a scale unlike anything we've ever experienced. For a glimpse into the scale of change, consider the changes the Fourth Industrial Revolution has already caused.

To take an example from the industry I grew up in, look at travel. It still amazes me that the largest hotel company (Airbnb) doesn't own a single hotel. Or, that the largest global taxi operator, Uber, doesn't own a single taxi.

Now, imagine the scale of changes that will happen when we go beyond the information revolution to what's just beginning now: physical products can be produced, copied and transmitted instantaneously without impacting their quality.

According to family business theoretician Abhijit Bhattacharya, a visiting scholar at Salisbury University in Maryland, "Developments in manufacturing, developments in material sciences, machine learning and high-speed internet now allow an entrepreneur to get a product manufactured without having to set up a manufacturing operation."

An entrepreneur can create the digital design for a product and then send it to the other side of the world in mere seconds. There, the actual physical products can be created on a 3-D printer.

As a researcher in family businesses, whether in Asia, Europe or the United States, Bhattacharya worries that most family businesses are unprepared for the tsunami of change that's approaching.

Innovative Companies

Cargill, the $110 billion grain and beef company, has developed facial recognition software for individual animals, so farmers can now track productivity as never before. To develop this highly desirable software, Cargill employees combined coding ability with knowledge of markets, cutting-edge higher math and a deep understanding of the needs of farmers.

Google is getting into the automotive business with its efforts to create self-driving cars.You might expect the experts on cars to be General Motors or Toyota, but Google is leveraging its AI and computing expertise to get into a market that could, in theory, be worth billions.

Steps Your Clients Can Take

1. Be constantly on the alert for signals that the business model of the firm needs change or could benefit from change.
2. Overcome the HiPPO (highest paid person's opinion) syndrome. Make sure arguments are won by the person with the best idea, not necessarily by the person at the top with the greatest salary and seniority. Personally, I love it that at Perdue, we tap into the innovative spirit of even the youngest associates.
3. Create an environment for everyone to speak their minds and contribute ideas without everyone's adapting to what they think the boss wants to hear. My late husband, Frank Perdue, was aware of this issue and used to ensure that at the start of meetings, no one but himself knew his views.
4. Google's example of inviting people at all levels to spend 20 percent of their time "thinking of new stuff" may not be appropriate for you. However, it still might be beneficial to your business to encourage employees to invest time on creativity and innovation.

The Fourth Industrial Revolution is here, and it's going to mean change for you and every one of your clients. Are you helping them prepare?

Mitzi Perdue is a speaker, author and businesswoman. She is the widow of Frank Perdue and daughter of Ernest Henderson, co-founder of the Sheraton hotel chain.

Illustration: DmyTo/iStock/Getty Images

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Stop the Reinvestment Insanity

IT MIGHT BE BETTER TO TAKE THE CASH FROM MUTUAL FUND DISTRIBUTIONS.

BY KEVIN MCKINLEY

During the past few months, clients who hold mutual funds in non-tax-sheltered accounts likely received distributions from those funds in the form of interest, dividends or capital gains.

Often, those payouts are immediately and automatically reinvested in the purchase of more shares of the same fund. But, by doing so it could cost your clients money and create big headaches for them and you, now and in the future.

Here is why you and your clients should reconsider whether they should reinvest those mutual fund distributions at all.

A Taxing Situation

There are several scenarios in which reinvesting mutual fund distributions can create tax problems for clients if the funds are not held in tax-sheltered accounts.

The first scenario might come in the next few weeks, when clients who had payouts reinvested during 2018 get 1099-DIV statements from the Internal Revenue Service, stating that those distributions are taxable.

Don't be surprised when some of your otherwise knowledgeable clients think that since those distributions were reinvested, they don't owe taxes on the payouts "because we didn't take the money."

A more covertly negative situation can happen when a client sells fund shares to realize a loss but, in the meantime, has automatically reinvested distributions in the fund within a time frame that violates the IRS "wash sale" rule. If the client buys shares, whether via reinvestment or an outright purchase, in the fund within a window that begins 30 days before and ends 30 days after the date of the loss sale, the client's deductible loss is reduced by the amount of the purchases made within the window.

From Nuisance to Nightmare

Woe be unto the client who has owned a mutual fund in a non-tax account for many years (or worse yet, decades) and has dutifully reinvested the distributions over that long period of time. Eventually, when the client may need to sell those shares, whether to cover spending needs or

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to re-allocate the asset mix by reducing the exposure to that fund, a sale of some or all of the shares means the client has to report the sales proceeds and cost basis on the ensuing income tax returns.

Unless the client is selling shares that were purchased in the last few years, this situation can trigger an aggravating series of phone calls to the fund company and send the client digging through boxes in the basement in search of old statements to try to come up with the actual purchase dates and prices. If the client can't find the correct cost basis information, the IRS may deem that the cost basis is zero, and the entire sales proceeds could be taxable.

What could be even worse is when the client sells just a portion of the mutual fund position and has to choose from several cost basis reporting procedures, and then remember which strategy was used (and perhaps which shares were and weren't sold) until the entire position is liquidated.

Buying at the "Top"?

Whether the account is tax sheltered or not, another danger of reinvesting mutual fund distributions is that the client may end up investing more money when prices are high and less when prices are low.

According to the 2018 Investment Company Fact Book, mutual funds paid out $512 billion in dividends and capital gains during the stock market peak year of 2000. That figure fell dramatically to $130 billion in 2002, when stock indexes reached cyclical lows. In the heady year of 2007, mutual funds distributed $690 billion in dividends and capital gains, but in 2009, during the wake of the financial crisis and precipitous asset price declines, the figure dropped over 70 percent, down to $202 billion. Causation certainly doesn't equal correlation, but these figures show that mutual funds usually distribute more in dividends, and especially capital gains, after good years, rather than bad years.

Allocation Imbalance

Even if you and the client are comfortable with more money going back into a fund near a cyclical peak, reinvesting a particular fund's distributions right back into the same fund may overweight its portion of the portfolio. As mentioned earlier, selling some of a fund's shares to realign the allocation can trigger a load of tax and bookkeeping hassles. But if the fund's distributions are already being taken by the client in cash, it's much easier to redeploy the money in the optimal investment or send it out for spending.

When Reinvesting Might Be Right

Despite the potential hassles of reinvested distributions, there are still a few instances in which you and your clients may want to start or continue the practice.

First, tax-sheltered vehicles, like IRAs and Roth IRAs, require no tax reporting while the investments are within the accounts, so the reinvestments will not create any tax issues now or in the future.

Second, if you're using "A" share class mutual funds that allow the client to reinvest distributions with no new sales charge, it's likely in the client's best interest to do so.

Avoiding Future Problems

There are several steps you can take going forward to minimize the pain you and your clients experience from reinvesting mutual fund distributions. Start by reviewing the clients' current holdings in taxable accounts, and when appropriate and after discussing it with the clients, remove the automatic investment of dividends and capital gains in their current accounts.

Make sure any new purchases of mutual funds in non-tax sheltered accounts have the same "cash" designation for distributions. Finally, consider a campaign to make sure every mutual fund held in a client's non-tax account has the correct cost basis and purchase date information in your system. Getting the numbers right will not only help you analyze if and when to sell the shares for maximum tax efficiency, but also will help you and your client avoid scrambling for that data at the end of the year or on April 15. ■

If the client can't find the correct cost basis information, the IRS may deem that the cost basis is zero, and the entire sales proceeds could be taxable.

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Kevin McKinley is principal/owner of McKinley Money LLC, an independent registered investment advisor. He is also the author of *Make Your Kid a Millionaire* (Simon & Schuster).

Congress and Taxes in 2019

TWO BIG PRIORITIES ARE DOMINATING THE AGENDA.

BY SANDRA G. SWIRSKI, SARA BARBA

Photo: Pool/Getty Images

As lawmakers continue negotiating a deal to reopen parts of the government where funding expired in December, tax wonks in Washington are looking ahead to what we might expect on Democrats' tax agenda early this year. From our perspective, there are two big priorities dominating the agenda: revisiting the 2017 Tax Cuts and Jobs Act and nosing around President Trump's tax returns.

Tax Bill Reconsidered

As already outlined by Ways and Means Committee Chairman Richard Neal (D-Mass.), priority No. 1 for House Democratic tax writers and their new position in the majority is to revisit—and reimagine—parts of the 2017 tax bill they don't like.

As you may recall, Democrats weren't part of the tax reform process last year (the why depends on who you ask). So now that their brand of politics and policy is powering the House of Representatives, it's their turn to make a mark. But the landscape is very different from what it was almost a decade ago when they were in power. This different landscape will make for more-challenging governing, particularly on tax issues.

Tax Burden Distribution

As they revisit the 2017 tax bill, one fundamental issue Democrats will want to address is who should be paying more taxes and who should be paying less. The distribution of the tax burden will be front and center next year. The new majority is talking about what amounts to a Robin Hood approach to redistributing that burden. In practice, this likely means increasing taxes on upper-income earners while lowering taxes on those toward the bottom. But consider that almost half of Americans don't pay federal income taxes

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(again, the why depends on who you ask), so what would that distribution look like? From higher-income earners (and corporations because they don't vote) to less-higher-income earners?

SALT Deductions

Another fine line Democrats will have to walk is on a much-maligned new law that puts a $10,000 cap on state and local tax (SALT) deductions. The new majority in the House will have to tread gently on this one. That's because more than half of the benefit of repealing that cap—and going back to the good old days—would go to millionaires and billionaires, and a full 93 percent of the benefit would go to households earning more than $200,000, according to the Urban-Brookings Tax Policy Center. Not exactly giving to the poor. Or even to most people's definition of the middle-class. How do they square this priority with their Robin Hood approach?

And then there's the cost. Without a tax increase on somebody, repealing the SALT cap would add more than $600 billion to the deficit over the next 10 years, according to the Tax Policy Center. Who's that somebody?

Our best guess is probably corporations. They don't vote, and they made out fairly well in the 2017 tax bill, so that makes them a solid target. But really this debate is just that. Unless Democrats can get 60 votes in the Senate to prevent a filibuster by Republicans, this is just talk.

Or Is It?

Those glitches in the tax bill won't fix themselves. Perhaps there's a deal to be made in which House Democrats get some relief from the SALT cap for their coastal constituents and Senate Republicans get those glitches taken care of. Stay tuned.

The Elephant in the Room

Then there's the other No. 1 priority: getting access to President Trump's tax returns. A lot of Democrats ran on this in the 2018 election, and even before the election was called in their favor, House Democratic leadership began their research into how to legally obtain Trump's tax returns. Speaker Nancy Pelosi (D-Calif.) told the San Francisco Chronicle editorial board that it's "one of the first things we'd do—that's the easiest thing in the world. That's nothing."

She's right, the process appears to be easy. Under the so-called committee access provision of 1924, the chairman of a tax-writing committee—in this case, Chairman Neal—sends a letter to Treasury Secretary Steven Mnuchin requesting the president's tax returns. Secretary Mnuchin can then order the Internal Revenue Service to send Trump's tax returns over to Congress. At that point, all 30+ members of the Ways and Means Committee can review the returns. And although the returns can't be made public, leaks happen, and then all or parts will be out there for all of us to see. But, another plausible scenario is Trump intervenes and fights the request with his lawyers. Your guess is as good as ours.

Here's something else to think about. Just because Democrats can doesn't mean they should. Demanding Trump's tax returns could be a risky bet with big political stakes and possibly no clear winner. If they don't find anything, Trump would surely rile up his base with an "if they can get my returns, they can get yours" message. If they do find something, it's not likely to be "clear as day." Tax return nuances never are. And the Democrats could be left with a political loss in the lead-up to the 2020 presidential election.

Even though Pelosi only recently officially took her spot as leader of the Democrats, she and President Trump have long been at odds. A contentious meeting in December among Trump, Pelosi and Senate Minority Leader Chuck Schumer (D-N.Y.) showed both Trump and Pelosi are ready to fight. The smart money is on counting neither of them out. Stay tuned. ■

Sandra Swirski is an attorney with almost three decades of public policy experience and founder of Urban Swirski & Associates.

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Even though Nancy Pelosi only recently officially took her spot as leader of the Democrats, she and President Trump have long been at odds.

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The Rise of Discordant Retirement

FEW MARRIED COUPLES RETIRE AT THE SAME TIME; THE DISCORDANT PATTERN HAS MAJOR IMPLICATIONS FOR THE WAY THAT ADVISORS WORK WITH MARRIED CLIENTS. BY MARK MILLER

Photo: Chris Jackson/Getty Images

What happens when married couples experience "discordant retirement?" It sounds like a marital spat, but it really just describes a phenomenon retirement researchers have been digging into lately: the fact that few married couples retire at the same time.

A recent study based on data from the University of Michigan Health and Retirement survey found that the pathways people take to retirement are complex, frequently involving phased-retirement, bridge jobs and periods of non-employment and returns to work. Decisions often are impacted by eligibility for pensions, on-the-job stress, physical limitations and caregiving responsibilities.

Often, there is a so-called discordant phase, when one spouse works longer than the other. Katherine Carman, a senior economist at Rand Corporation and lead author of the study, found that these discordant patterns were apparent for a majority of couples: She studied 2,600 couples and found 1,400 unique retirement pathways.

"We tend to think that people retire at the same time, but when we take a longer approach and look at multiple years, we see much more diversity," she says.

Younger households studied were more likely to experience fully or partially discordant retirements. The phenomenon also was more common in couples with larger age differences.

In one sense, Carman's findings are not surprising, considering how retirement has evolved and been redefined in recent decades. But the results do have implications for the way that advisors work with married clients.

It's standard practice to create retirement plans with projected individual retirement dates. But advisors should look for opportunities to discuss discordant retirement with clients, says Kathleen Burns Kingsbury, an expert on wealth and psychology and author of *How to Give Financial Advice to Couples: Essential Skills for Balancing High-Net-Worth Clients' Needs*.

"What is most important is to discuss the expectations and visions for retirement—both as partners who plan to retire at different times and also if and when they plan to be retired together," she says. "For example, if one partner plans to retire at 60 and wants to spend the next five years working in a

Click for more RETIREMENT PLANNING SHARE this article part-time position with less stress and the other partner plans on retiring at 65, then the discussion should be about financially planning for this loss of income for five years and then full retirement for both."

But the math actually is the easier part of the equation, she adds. "What is more challenging is creating a space where the partners are free to explore what they each want for this next phase of life and, at the same time, discuss how having different visions for retirement can work. I encourage planners to look for shared values the couple is honoring. For example, a value might be meaningful work."

"Let's say partner one is already working for a nonprofit, is mission driven and plans to continue in their career longer than partner two. Partner two works in a corporate leadership position but wants to retire earlier to pursue their interest in giving back to a cause important to them. Staggering the retirement of the partners works, because it allows both of them to honor their shared value of meaningful work."

Helping couples communicate openly about this can be especially valuable.

A recent survey by Fidelity Investments found that 43 percent of married couples disagreed about the age when they will retire, and 54 percent don't know how much they will need to save for retirement (including 46 percent of people who already are retired or getting close).

This is a big opportunity for an advisor to demonstrate their value to clients, Kingsbury says, and to take a more holistic approach to the guidance they provide. "Ask them curious open-ended questions to find out how each partner views retirement and then facilitate a conversation about how these visions complement each other and may also cause conflict."

This service to clients could go well beyond one-on-one meetings, she believes. "A creative planner could offer workshops, online courses for a fee to existing and potential clients," she says. "The advisor also can bring in consultants with expertise in coaching clients on retirement and work as a team."

Discordant retirement also presents plenty of opportunity from a dollars-and-cents standpoint. Continued income from one spouse helps insulate couples from post-retirement financial shocks, such as an emergency health problem or a large home repair. Steady income also could enable the retired spouse to pursue a passion.

In some situations, staggered retirement enables both spouses to stay on employer-subsidized health insurance, reducing premium and out-of-pocket costs. That can be especially meaningful if one spouse is no longer working but has not yet reached the age of Medicare eligibility (65) and might otherwise face high (unsubsidized) premiums on the Affordable Care Act insurance exchanges.

It also opens the door to the triple threat of better retirement outcomes: more years of saving, fewer years of drawdowns and delayed Social Security filing.

The delayed filing credit—an 8 percent annual guaranteed rate of return—remains the best deal on the planet. Starting benefits at 62—the earliest possible claiming age—will reduce your client's benefit by 25 percent for life. By waiting until after the full retirement age to start benefits, a claimant gets the delayed retirement credit, which works out to 8 percent for each 12-month period of delay.

The challenge is meeting living expenses while waiting to claim. That can be done through drawdown of savings; research by Meyer and Reichenstein has shown that this strategy results in improved portfolio and overall retirement outcomes. But, living on continued income as one spouse keeps working is even better.

The partner with the higher expected Social Security benefit should claim based only on the expected lifetime of their spouse. If one spouse lives well past the point at which the higher earner turns 80, most couples' cumulative lifetime benefits will be highest if the higher earner delays benefits until age 70, Meyer and Reichenstein have found.

And higher income could go a long way toward avoiding discord in retirement. ■

"A creative planner could offer workshops, online courses for a fee to existing and potential clients. The advisor also can bring in consultants with expertise in coaching clients on retirement and work as a team."

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Mark Miller is a journalist and author who writes about trends in retirement and aging. He is a columnist for *Reuters* and also contributes to Morningstar and the *AARP* magazine.

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LPL on the Rebound

FOR THE FIRST TIME IN A LONG WHILE, ADVISORS ARE SINGING THE PRAISES OF THE NATION'S LARGEST INDEPENDENT BROKER/DEALER.

BY SAMUEL STEINBERGER

Nearly a year ago, LPL Financial CEO Dan Arnold took a deep breath, picked up the phone and made one of the toughest calls of his tenure leading the independent broker/dealer. The firm's acquisition of National Planning Holdings was not going smoothly. Speaking to home office leaders, he explained that advisors from NPH were unimpressed with the culture of LPL. The reputation of the country's largest IBD, already strained among some advisors, was taking a hit. Its service to advisors, approach to innovation and leadership style needed a change.

What a difference a year can make.

An earlier transition from BranchNet to ClientWorks that received low marks gave way recently to a well-received integration with Riskalyze. That, in turn, was followed by a $28 million cash acquisition of AdvisoryWorld, with the new tech being used as the centerpiece of the firm's advisor workstation. LPL is budgeting $135 million for technology improvements in 2019, after setting aside $120 million in 2018.

Even more promising is the enthusiasm LPL advisors are showing for the firm's technology, replacing the frustration advisors have had with the corporate attitude, service culture and pace of innovation at the company. As LPL advisors (and their clients) saw consumer tech getting better around them, as well as improvements in the technology of other financial advisory platforms, they were left wondering when their own tools would be upgraded.

It seems that wait is over. "There's been a considerable upgrade in LPL's technology in the last 12 months," said Robert Russo, founder and CEO of Independent Advisor Alliance, an office of supervisory jurisdiction based in Charlotte, N.C., that has about 170 advisors on LPL's hybrid RIA platform. "Their whole core has changed in terms of how they're doing technology."

Previously the firm had placed more weight on developing its technology in-house, Russo said. But lately he's found the firm taking a more holistic approach, opening its programming to outside partners and ensuring its existing technology works as intended with third parties. The purchase of AdvisoryWorld, in particular, sent a strong message that the firm was taking tech seriously, he added.

Many advisors credit Scott Seese, LPL's chief information officer, as the force behind the firm's technology turnaround. Brought on by Arnold as "an innovator and digital disruptor" less than two years ago, he logged over 150,000 miles visiting advisors in 2018 to watch and listen as they used the firm's technology.

For some advisors, that alone was a welcome change. "LPL actually listens to the advisors in the field more," said Stacy Bush, president and founder of Bush Wealth Management, LLC in Valdosta, Ga. He's been an LPL advisor for 14 years. "LPL went through several technology people back to back to back for several years and now that we've got someone of Scott's expertise, no question, I've seen a positive difference."

Seese's approach centers more around Silicon Valley concepts like "outside-in" thinking, where technologists look to the world outside of their industry for new ideas and solutions, and iterating development in stages, rather than mapping out long-term projects.

At least one of Seese's ideas, a "connect-the-dots" approach to understanding client and advisor needs, is not new. It's the same customer-centric approach he employed as an executive at eBay, where he led a team of approximately 3,000, and more recently at American Express, where he was responsible for bringing on new customers and growing global revenue.

It starts, he said, with getting a clear picture of what a customer needs, then connecting those

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needs with what in-house experts, outside thinkers and even new startups are developing. "All of a sudden, if you connect the dots around you and you connect with the people around you, anything is possible," Seese said. "I think the framework and approach plays no matter what the industry is. If you get it right for your customer, then you're just getting it right."

At eBay, Seese was focused on the workflows of listing and selling products. The approach was successful—revenue at the e-commerce company expanded from $6 billion to $18 billion during his four-year tenure. He's taken the same workflow-centric technique to LPL, where he's focused on giving advisors more time to grow their businesses just by providing a better user experience for the advisor. LPL technology should not function like a basic service, he said. It should be seen as a "strategic asset" that is constantly evolving.

What he calls "ClientWorks 1.0" was a utility. The second iteration of the tool is a "competitive platform" with new capabilities, thus the Riskalyze integration and purchase of AdvisoryWorld, and the third will be "industry leading," with more integrations and a powerful enough foundation to support the machine learning and artificial intelligence technologies Seese sees on the horizon. The company is currently on the verge of moving into that last iteration, he said.

Seese's vision is an extension of the entrepreneurial attitude that Arnold brought to the company's C-suite when he was named CEO, according to Burt White, chief investment officer and managing director of investor and investment solutions, LPL's corporate strategy team. White has been at the firm since 2007, a perspective that's allowed him to see "ground zero" of the innovation-driven turnaround.

LPL's new entrepreneurialism is enticing the best tech providers with the promise of getting their tools onto the platform. It's no secret that LPL's vast network of more than 16,000 advisors is a mouthwatering prospect for outside tech firms. But having access to those companies is an advantage that some financial services companies don't leverage. Many will develop tools in-house even when there are better outside solutions available.

White knows the firm's advantage, however, and is playing to it. "We are privileged in the fact that we have this broad, diversified, talented network of advisors," he said. "It is a beacon." The holistic approach the firm is aiming for balances building in-house solutions with looking at acquisition and integrations.

Similar to Charles Schwab's new approach to innovation, LPL is looking to Silicon Valley. The iterative approach at LPL incorporates 30-day bursts of development, which builds more flexibility into new innovation and allows designers to reevaluate tools more frequently.

When it comes to acquisitions, LPL is interested in bringing on more than just new tools; it wants the people who built those tools. "Talent that we've acquired from AdvisoryWorld is already beginning to work on what we call our ClientWorks connected ecosystem," said White, describing the workflows built into the ClientWorks workstation.

Then there are integrations, which need to be intentional, said White. "A lot of folks are thinking about integrating just to integrate," he said. Instead, the approach should be to solve real problems. LPL advisors have already benefited from integrations with wealthtech providers like Riskalyze, Redtail and eMoney. Advisors should expect to see three to five more integrations in 2019.

While 2018 was a year of improvement, there's still room for perfection and the culture change should help, said advisors. Led by Arnold, LPL has been working to make sure heavy lifting, like operations or oversight, is done at the corporate level, not by the advisor, said Russo.

"We're not batting a thousand, but it's not below the Mendoza line either," added Bush. "Anytime you have a firm the size of LPL, you're going to have some give and take." Advisors know it will be a slow change, but they're looking forward to the outcome. ■

"We're not batting a thousand, but it's not below the Mendoza line either. Anytime you have a firm the size of LPL, you're going to have some give and take."

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The Digitally Supported, High-Touch Concierge

OPTIMIZATION BECOMES TRANSFORMATION IN THE WEALTH MANAGEMENT INDUSTRY. BY DARRIN COURTNEY

Twenty-five years from now, the financial services industry will still be alive and well, but it won't look like it does today. Much like the film, music, travel and retail industries have transformed, so too must wealth management. Financial advisors will still be in demand, but the skills required, role they play and tools they use will change dramatically.

Technology will not displace the advisor but instead will empower them to deliver, at scale, the concierge-like services currently available to only the wealthiest of clients. Perhaps they'll be employed by (or clear and custody with) a traditional wealth firm, or perhaps they'll be tied to a telecom, social media, retail, fintech or other platform provider that has decided to throw their hat into the financial services ring.

Digital Optimization.

In the near future, wealth managers must catch up to and surpass the digital capabilities of other industries. Digital optimization is not groundbreaking. Sending an email instead of writing a letter is a form of digital optimization. As consumers, we text our

Illustration: cherezoff/iStock/Getty Images

plumbers, screen share with our cable providers and open our hotel room doors with our smartphones, but some of us are still checking our mailbox for paper statements from our advisor. Wealth firms need to accelerate optimization so that advisors can provide the integrated, automated and digital experience that clients in all wealth bands have come to expect. Future clients will still want white glove service, but they'll also want to interact with a virtual agent, at 2 a.m. on a Sunday, while sitting in their driverless car.

Digital Transformation.

This is the area where most firms will struggle. Digital transformation means looking for new business opportunities, new revenue streams, new partner models and taking an entirely new approach to where your offering fits in a broader digital world. Rather than being the reactive center of your client's financial life, your firm becomes a proactive and empathic part of an interconnected digital world. By sharing your data into a broader ecosystem and receiving data back from multiple financial and nonfinancial sources, your firm will be able to proactively reach out to clients, anticipating their needs and offering solutions that are customized and tailored to solve issues they hadn't even realized had arisen.

Data and Platforms.

In the coming years, the digital ecosystem will consist of multiple platform providers. Wealth firms will either control a digital platform, partner with other providers, or feed data to and from them. In order to take advantage of emerging digital platforms and technologies, including robotic process automation, artificial intelligence, internet of things, advanced analytics, virtual reality and whatever is coming down the road, firms must have a strong approach to data. As LOB leaders echo information technology and take an agile approach to how they run their firms, they will also take a microservices approach, monetizing data and sharing it in a broader digital world to create entirely new offerings.

As physical and digital worlds combine, firms will need to win the battle to be at the center of their clients' personal ecosystems. One doesn't need to look 25 years down the road to see how urgent this need has become. At a hypothetical kitchen table somewhere, a potential client who just inherited $20 million looks at their digital assistant in the corner and says aloud, "Hey (Google, Alexa, Siri, insert another name here), find me a financial advisor." Did your firm name just get suggested? If not, you've got far fewer than 25 years to figure out why. ■

Darrin Courtney is a vice president and analyst at Gartner, specializing in wealth management.

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Where Fintech Will Be in 25 Years

THE RACE IS ON TO SEE WHICH PROVIDERS CAN CREATE A PLATFORM OF ENGAGEMENT THAT IMPROVES CLIENT EXPERIENCE AND DRIVES TOP-LINE GROWTH.

BY LORI HARDWICK AND MIKE ZEBROWSKI

Client experience will be a primary measure of advisor value. Exposure to social networks and digitally enhanced and intuitive retail experiences has already begun to transform clients' expectations. This trend will continue. The same level of digital experience clients enjoy in other aspects of life will erode their tolerance for outdated fintech and taint their overall experience.

Technology will help advisors build trust. Clients trust technology when the applications they interact with are well-designed, intuitive, transparent and accurate. When technology fails, clients lose faith that their advisor has what it takes.

The "I Want What I Want When I Want It" mentality will intensify. Overwhelmed by the volume of information thrust upon them, consumers ignore it until they need it, at which time they expect immediate solutions. Mobile access, the speed of delivery, personalization and a bundled client experience will all be in high demand. Ultimately, the walls now dividing online versus in-person interactions will crumble and new communication paths will emerge.

Advisors will no longer be plagued with as many non-value-added tasks. Advisors of the future will be able to personalize, customize and simplify the digital experience easily. Today's siloed partners will evolve into interconnected app stacks across the ecosystem of partners, and they will improve navigation and reduce inefficiencies, redundancies and inconsistencies, increasing advisor efficiency and productivity.

Data-driven innovations and offerings. Technology platforms will provide a framework for user data to drive innovations. This will be possible with an open-architecture system that creates a network effect by allowing data to flow between interrelated APIs. The network effect will facilitate what Oliver Wyman recently described as "flywheel momentum." Flywheel momentum is created by collecting and combining data in ways that enable increasingly value-added services for customers. Artificial intelligence will rapidly gain speed as more behaviors and data are gathered and mapped. AI will evolve from being predictive to having the ability to execute on behalf of the consumer.

Gamification will help identify needs and design solutions. A digital experience that includes elements of gamification will engage with clients and encourage the sharing of information.

Advisors will wield greater influence and value. Open application programming interfaces and the ability to create a unified experience will allow advisors to merge all aspects of the client's financial life. The likely result will be inclusive of other wellness measures, like physical and psychological. This will allow for a more-streamlined intersection of data and the opportunity for a constructive and meaningful AI overlay.

Clients will use their voices. Consumers conduct all sorts of daily activities by shouting commands into digital home devices. They will soon expect to bellow a directive to move money between their brokerage accounts, too. Not only will voice commands revolutionize clients' engagement, but they will change how advisors work, as well. Advisors will continue the trend of untethering from a fixed workstation.

The benchmark of "we." Tomorrow's clients will have grown up in the age of "how many likes did I get," which may create a demand for real-time reporting and comparison against a "rank" relative to peers. Social benchmarking may join "performance against goals" and "performance against indices" as a meaningful data point.

Race to the future. We believe the fintech of the 2050s will address these digitally influenced client expectations and deliver an integrated, open framework that leverages client engagement to drive deeper insights and better results. The race is on to see which providers can create a platform of engagement that improves client experience and drives top-line growth. ■

Lori Hardwick and Mike Zebrowski are co-founders of Advisor Innovation Labs.

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When Androids Dream of Electric Piggy Banks

IN 2044, UBIQUITOUS ONLINE WEALTH MANAGEMENT WILL BE THE NORM. BY MARGARET J. HARTIGAN

Think about the most recent purchase you made. Was it an impulse buy, perhaps a candy bar at the checkout counter or that cat toy you kept seeing in online ads? Maybe it was a new dishwasher, which you'd carefully researched and saved toward. What does this purchase say about your appetite for investing?

Tantalizing as it is, this data's value today is largely anecdotal when it comes to predicting a person's investment behavior. But in the future, when the next generation of artificial intelligence-powered digital assistants can take our spending habits and array them against a lifetime of other personal data points, plus those of your friends, this spending track record could hold the key to assembling an investment portfolio. Think "know your client" on steroids. The more data about you to analyze, the more personalized a recommendation can be continuously tailored to your age, education level, net worth and so on.

This is just one example of how wealth management will look different—more automated and connected—in the future. No longer tagged with the "robo" or "digital advice" monikers, wealth management will be a seamless and ubiquitous component of people's lives online.

Illustration: Madrolly/iStock/Getty Images

Several emerging trends will drive this ubiquity. Digital personal assistants such as Siri and Alexa, still in their infancy now, will be smarter and more integrated into all aspects of daily life. Future generations will have a cradle-to-grave relationship with their assistants, which will be tasked with managing everything from a person's education and well-being to employment and money.

Always "on," digital assistants will never be more than a tap, glance or nerve twitch away. Even when they're not talking with us, our digital assistants will be talking with each other and with the businesses we use: scheduling social appointments, paying bills, etc. Seeing a clearer picture of your financial health will be instant. And through analyzing the myriad data they amass on us and our families, our assistants will know the right timing and approach to use when alerting us to financial pitfalls or opportunities alike.

A convergence of big data and cashless technologies, such as blockchain and mobile wallet, could also open new areas for personal revenue and wealth management. As guided by our digital assistants, we might each become a mini venture capitalist investment shop: pursuing microinvestment opportunities created by lending money to friends across town, or funding individual entrepreneurs in emerging economies around the world. Each opportunity will be sourced by our digital assistants.

In an interconnected and cashless society, the de facto expectation for wealth management advice will be online. As we've already seen with the rise of automated advice platforms, or so-called "robo advisors," the cost of this online experience will continue falling, opening the world of wealth management to more people. Uptake rates will accelerate and drive a feedback loop of further adoption and financial literacy. The trend will also create new revenue possibilities for leveraging data—similar to how the rapid adoption of wearable tech continues to fuel increased demand for digital health management.

If this talk of ubiquitous, online wealth management leaves you wondering about the fate of human advisors, have no fear. Better financial wellness benefits everyone.

The role of human financial advisors will become more specialized. As advisors gain more information about clients, they can shed the busy work of account management—much like the development of automated design tools has enabled architects to create better and more interesting buildings. ■

Margaret J. Hartigan is the founder and CEO of Marstone, Inc., an enterprise-ready online wealth management platform.

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Artificial Intelligence: The Next Frontier in Planning

ADVISORS WILL HAVE TO EMBRACE TECHNOLOGY AND ADAPT TO ITS POTENTIAL, FILLING IN THE GAPS THAT STILL REQUIRE HUMANS. BY STEVE LOCKSHIN

The world has seen more technological advances during the past 25 years than the preceding 100. There's no reason to think this trend will slow down. Unfortunately, the wealth advisory industry has not maintained the same pace of improvement.

Financial advice can generally be divided into two components: math-based advice and emotion-based advice. Looking forward a quarter century, we can expect significant changes that advisors should prepare for now.

Math

People who hire advisors desire to achieve a few simple goals:

- They wish to maintain or better their style of living;
- They want to pay the least amount of taxes they can legally pay; and
- They want to determine where their assets go and when they go, rather than have the government decide for them.

Everything on this list can be solved by math when given the proper inputs. Today's financial planning software can easily optimize these outcomes. Tomorrow's software will do much more as a result of having access to more data. Moreover, the role that most advisors play—the interpreter of all of this data—will be supplanted by easily accessible and consumable artificial intelligence that is always on and always monitoring an authorized set of financial data. Inputs will include spending, savings, your health, where you shop and what you shop for, all while calculating your life expectancy and so much more. AI will be the equivalent of financial planning software that is always on, always connected, never emotional and continuously making judgments based on your data against billions of other people's petabytes of data—and then constantly adjusting recommendations as appropriate.

Emotion

In addition to serving as interpreter, many advisors fill the function of emotional counselor, particularly when it relates to their clients' finances. This role ranges from being the advisor onto whom a consumer has elected to offload their personal financial decision-making responsibility, to being someone who can console investors when markets are volatile.

Tomorrow's technology will also outperform humans in this regard. Each person's wearable (or equivalent) device will monitor their heart rate, blood pressure, sweat, body heat and more, knowing what and when each person is reading or watching. All of this data will be interconnected. So, rather than having a quarterly review with a human advisor, your digital advisor will know what information—and in what form—is needed at the exact right time to deliver advice to quell concerns or guide you into making the right decisions.

The computer you talk to will not sound like Alexa or Siri but rather just like the type of human you are most likely to trust. If you don't believe it's possible, then you've not heard about Google's Duplex or seen the 2013 movie "Her." The technology to interface in natural language and voice exists today—imagine what it will be like in 25 years.

Chatbots (or their future derivative) will outperform a human every time. Consider the computer program that recently cheated to improve its output or that AlphaZero, a chess-playing algorithm, learned to play without any human programming beyond the basic rules and then handily beat every opponent—human or computer. Computers can ingest far more data than humans can, and they never sleep. Deep-learning AI learns at a far more rapid pace than humans.

So, what are we human advisors to do? Embrace technology and adapt to its potential, filling in the gaps that still require humans. While AI will learn and adapt, it will not (yet) create. ■

Steve Lockshin is a founder and principal of AdvicePeriod and former chairman of Convergent Wealth Advisors.

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Wealth Management 2044

A DAY IN THE LIFE OF THE ADVISORS OF THE FUTURE. BY ED OBUCHOSWKI

The year is 2044. America has successfully sent men and women to Mars and brought them safely home. Global warming has been halted via the introduction of dozens of new technologies and capabilities. The average life span has increased to just under 120 years. The robots have arrived, taking care of certain tasks like cooking, cleaning and, most important, post-laundry sock pairing. Looking back just a short 20 or 25 years, the world, in some regards, is a better place. But it has also changed so dramatically that there is no going back.

Samantha, an independent financial advisor, has built a successful business with more than $1 billion in assets under management and one employee. She has just turned 30 and works out of her house in Austin. Michael, one of her larger clients, has an appointment with her at 8 a.m. He is based in Phoenix, and they plan to have breakfast together to discuss the wonderful news that he is about to become a first-time father. After her morning routine, she goes to the kitchen table, and Michael sits down at his. At 8 on the dot, the two are instantaneously connected not by phone or videoconferencing, but instead through a technology known as augmented reality. Through this technology, Samantha and Michael are sitting at the same virtual breakfast table. They both decided to have the same breakfast, an egg white omelet, which has been prepared for them by their kitchen robot, Alice. The augmented reality technology virtually connects the two rooms and creates a 3-D illusion that the two are sitting together 24 inches apart. The technology advanced from 4k and then 8k TVs in the early 2020s, then progressed to virtual reality via wearables and on to holograms in 2030.

Illustration: nmedia/Sutterstock

As the breakfast meeting evolves, Samantha is empowered with a vast array of cloud-based artificial intelligence technology that can process Michael's words, gestures, emotions and tonality in real time. Powered by incredible computing power, these quantum computers are able to analyze thousands of data points and reference them against brontobytes worth of information to provide Samantha with succinct themes and recommendations. This information is fed directly from the cloud to Samantha, where she is able to mentally consume the data without reading or listening. As the meal progresses, the conversation turns to taxes, and the predictive technology has already arranged for a CPA to join them. In seconds, Kathryn, the CPA, joins their breakfast for a last-minute cup of coffee and a bit of sage tax advice.

Despite the 300 clients that she supports, Samantha's days are typically rather light, which allows her to spend most of her time with her top clients. This is due to the automation and AI revolution that has taken place over the previous 20 years. In 2044, accounts are opened, closed, transferred and maintained fully digitally via voice and gestures.

In our future world, smartphones have evolved into virtual personal assistants that are also cloud-based and always connected via an implant or wearable. When any of her 300 clients has a question, the assistant handles nearly any concern or inquiry via AI-based bots that can harness the collective intelligence of millions of interactions and seemingly endless amounts of data. Samantha's employee and assistant, Stella, monitors these inquiries throughout the day with the help of automated systems that look for trends and themes, so she can ensure her client base is well taken care of. Necessary meetings are automatically scheduled if the system's predictive engine detects any anomalies with any interaction or client life event.

As Samantha's day comes to a close, she jumps in her electric car for a dinner date with her husband. On her drive to the restaurant, she runs into a little bit of traffic. She wonders, "Will cars ever be able to fly?" ■

Ed Obuchowski is the chief technology officer of Advisor Group, a network of independent broker/dealers.

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Back to the Future

VISUALIZING THE FUTURE OF THE FINANCIAL ADVISORY BUSINESS BY UNDERSTANDING THE PAST. BY CHAD PARKS

Whenever we try to predict what will happen in the future, it's helpful to look at the past. I've worked in the financial services field for more than 20 years. During that time, technological advances have revolutionized not only this industry but also society in general. Just consider the iPhone, which has existed for only about a decade and yet has fundamentally changed our lives. So many different products that once needed to be bought separately now fit into your pocket thanks to smartphone technology.

From a financial services standpoint, automated advice platforms, or so-called "robo advisors," and extensive low-cost investment options have made long-term planning more accessible to a wider range of people than ever before, while simultaneously roiling the industry. So when we think about how financial services could be different 25 years from now, technology is bound to be a key player. Here are a few developments that I believe could define the future:

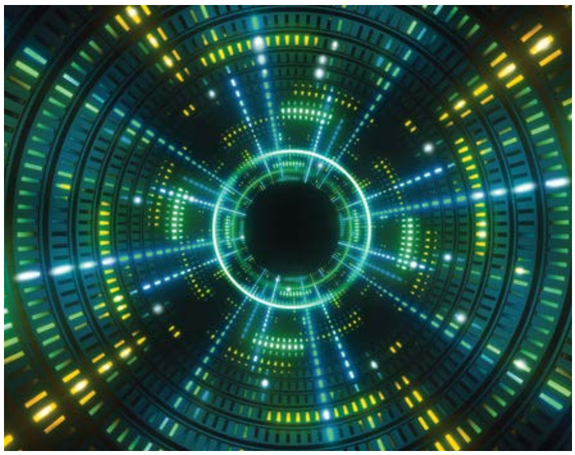

Illustration: wacomka/iStock/Getty Images

Humans will be almost entirely eliminated from financial advisory roles. In the next 25 years, artificial intelligence will all but remove the human element from financial advice. Algorithms will become progressively more insightful and accurate, constantly accounting for new information while eliminating the potential of human error.

Even today, if your role as an advisor is essentially portfolio allocation, this service is being threatened by robo advisors. You need to instead position yourself as a retirement readiness expert. Ask clients about their fears, hopes and dreams so you can help create positive change from an emotional standpoint. There will always be a place for human connection; after all, clients are human beings. But it remains to be seen how that connection will be compartmentalized in the future. It almost certainly won't be in the role of a traditional financial advisor.

The current financial services business model will become obsolete. When I entered the field in the mid-1990s, commission-based payment models dominated. This clearly wasn't in the best interest of clients, as financial advisors made money only by trading assets. In the late 1990s, the industry started transitioning toward an asset-based fee system. This was better but still flawed because even a 1 percent fee can cost a client significant wealth over 30-plus years due to compounding interest.

As a result, I believe asset-based fees will be largely eliminated over the next 25 years. My company already avoids this model, instead charging a set monthly fee to manage 401(k) plans. If the asset-based model fades away, firms that rely on it will either disappear or be forced to adapt. Although my company has been successful with a set monthly fee, that model too could eventually become obsolete.

Just look at the most successful companies in America over the past decade, such as Facebook. They've grown exponentially by providing free services to users. As technology evolves, clients will increasingly expect their financial services to be free as well, or close to it.

How will firms generate revenue in the future if the model isn't based on commission, assets or a set monthly fee? Facebook makes money by providing targeted advertising through the mining of metadata. Financial services could head in that direction too, and free services like Mint and Yodlee demonstrate the future model may already be here.

The future of financial services has a lot of exciting things in store, especially for retail investors. It's imperative that we as professionals work in tandem to determine how to implement these technological advances and present them to consumers in a way that ultimately supports their financial lives. ■

Chad Parks is the founder and CEO of Ubiquity Retirement + Savings, headquartered in San Francisco.

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Virtualized Scenarios and Automated Research

MACHINES WILL OFFLOAD SOME ADVISOR WORK WHILE ALSO ENHANCING THE CLIENT EXPERIENCE. BY WILL TROUT

Imagine a world defined not by physical and digital channels but where the real and the virtual are one. A place where artificial intelligence is not understood as artificial or even particularly intelligent, but as part of the fabric of the client advisor dialogue.

That world is almost here. By 2025, use cases for AI in wealth management will extend beyond security selection and compliance to managing advisor capacity in terms of workload and client engagement. Today, advisors are using AI-driven tools to manage and create client-facing marketing and education content. Tomorrow, the ubiquity of technology like the internet of things will herald nearly unforeseeable use cases.

From NLG to NLP and Beyond

Deployment of AI in wealth management is already a phenomenon. Natural language generation tools offered by firms like Narrative Science and Automated Insights are creating portfolio commentary and investment research for global firms, such as Vanguard and Credit Suisse. Wealth managers have also started to embrace chatbot and other

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natural language–processing solutions developed for the more transaction-focused banking and insurance businesses. IPsoft's virtual communications agent, Amelia, can gauge client contentment by voice timbre and tone and shift the conversation to a human advisor as needed. How much longer before bots and other intelligent agents are helping to automate advisor meeting preparation?

The Future Is Virtual

Given ongoing digitization and the trend to investor self-service, virtual reality technology may present intriguing opportunities. The size and affluence of the baby boomer generation means that, by 2025, the general investor population will look a lot grayer than today. VR offers a potential salve to a population that will live longer and become increasingly isolated and infirm. Here access will be delivered not through headsets and goggles but through Internet-based alternate realities that allow users to experience possible scenarios in a visceral way online. Think Second Life, the early 2000s platform that is undergoing a rebirth or next generation alternatives like Sinespace. The changing shape of advice, in addition to demographics, foretells greater interest in such visualization. Over the past decade, the focus of digitization has shifted from portfolio manufacturing and maintenance to more holistic advice ranging from wellness to wealth transfer.

Democratization of Advice

As formerly complex services are digitized, access is diffused to all levels of wealth, spurring even more adoption. Vendors like Advizr have tapped into the wave by introducing cloud-based technology supporting delivery of "financial planning lite" tools to advisors. Because the need for portfolio management is not going away, planning tools are incorporating investment functionality within their advisor portals. Enabling a more dynamic relationship between the portfolio management and the planning processes is also an objective of investment-centric hybrid delivery models like Vanguard's Personal Advisor Services automated advice platform.

Next Step Forward

By 2025, there will be as many flavors of advice delivery as ice cream. Enabling advisor choice and access to new tools is the proliferation of the application programming interface. And the shift to cloud computing and advances in processing power and analytics promise to accelerate the shifts taking place within the wealth management business too, specifically in terms of the way human and machine interact. ■

Will Trout is head of wealth and asset management at research and advisory firm Celent.

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The Puzzler

BY JOHN KADOR

How Smart Are You About Regulation Best Interest?

The comment period for the SEC proposed Regulation Best Interest just ended. How much do you know about what Regulation Best Interest, if fully implemented, would require of advisors? Of broker/dealers? Don't be caught flat-footed when change comes. This 12-item quiz will test your understanding of the regulatory playing field and determine how prepared you are for the coming regulations. Give yourself one point for every correct answer. If you score nine points or higher, count yourself suitably prepared for Regulation Best Interest.

1. Regulation Best Interest would ban broker/dealers from using the term "advisor" in their name or title.

A. True
B. False

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2. In the 400-plus pages of the proposed rules, the SEC defines "best interest" as:

A. Advisors must act as a fiduciary with respect to retirement accounts.
B. Advisors must act as fiduciary with respect to all investment decisions.
C. Advisors must have "product neutrality" before making investment recommendations.
D. No definition is offered.

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3. Regulation Best Interest requires broker/dealers and advisors to eliminate "conflicts of interest."

A. True
B. False

4. Regulation Best Interest requires that advisors must have a "reasonable basis" that an investment recommendation is in the best interest of the client.

A. True
B. False

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5. Regulation Best Interest applies only to retail customers, defined as a person who uses the recommendation primarily for personal, family or household purposes.

A. True
B. False

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6. Regulation Best Interest changes the definition of "recommendation."

A. True
B. False

7. Regulation Best Interest combines elements of the current suitability standard (e.g., suitable at time of transaction) with a few fiduciary-like elements (e.g., disclosure).

A. True
B. False

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8. Regulation Best Interest harmonizes the RIA and b/d standards with respect to the standards of care applicable to advisors and brokers, respectively.

A. True
B. False

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9. Regulation Best Interest requires product neutrality.

A. True
B. False

10. Regulation Best Interest requires advisors to provide a new short-form disclosure document, called a customer or client relationship summary (Form CRS), that reveals "the scope and terms of the relationship."

A. True
B. False

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11. Regulation Best Interest expands the definition of "traditional suitability" by requiring broker/dealers to consider not just individual recommendations but also a series of recommended transactions.

A. True
B. False

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12. Regulation Best Interest imposes new "reasonable diligence, care, skill and prudence" standards, requiring advisors to understand the product they're recommending to clients.

A. True
B. False

ANSWERS: 1. A, 2. D, 3. B, 4. A, 5. A, 6. B, 7. A, 8. B, 9. B, 10. A, 11. A, 12. A.

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