AUGUST 2019

Special Report: High Net Worth

Financial Planning

INVESTED IN ADVISORS | AUGUST 2019

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Financial Planning

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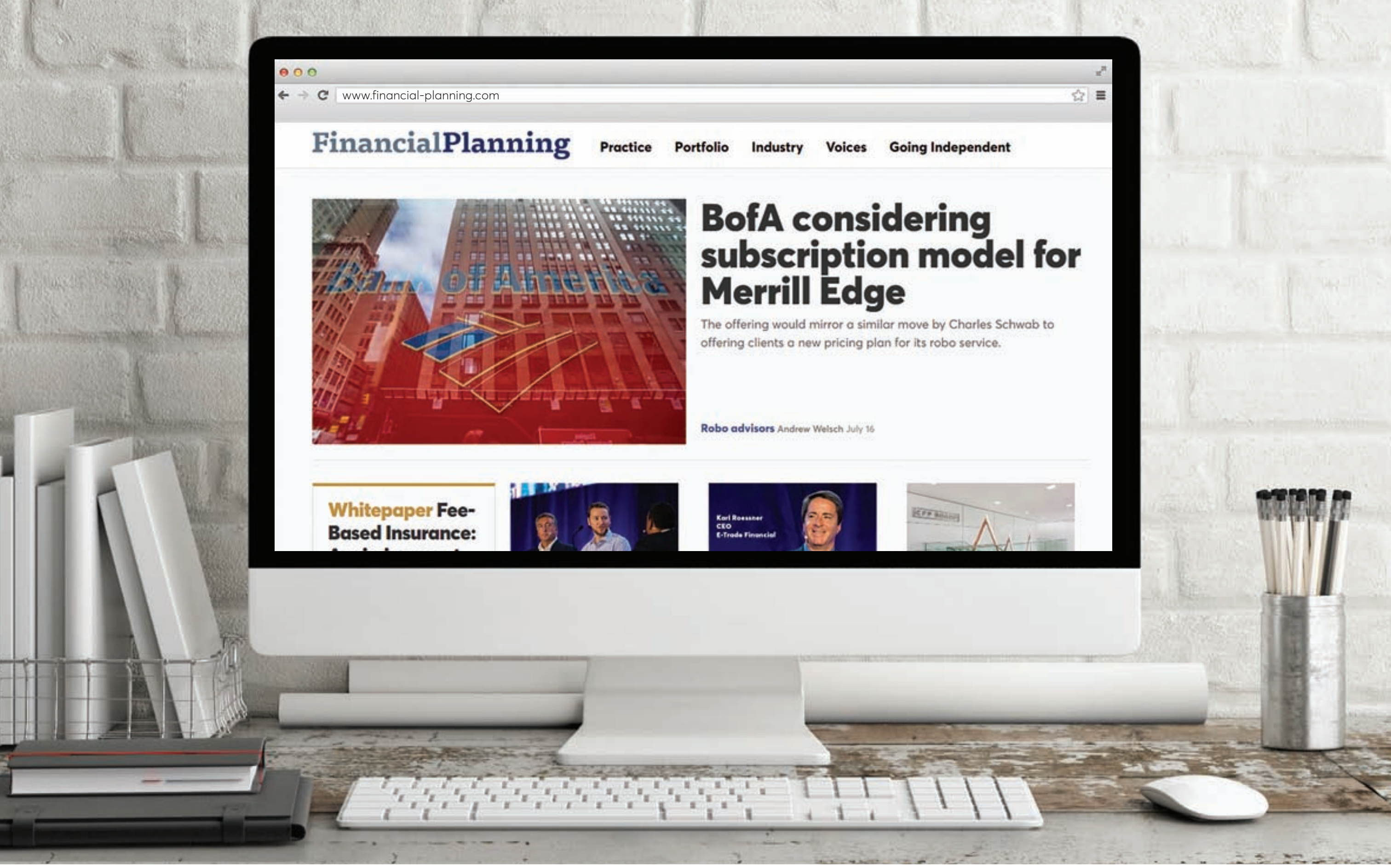
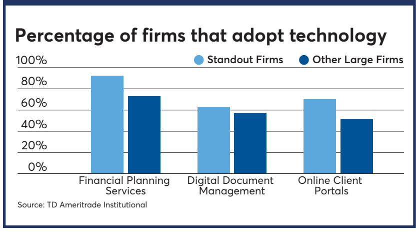


ENFORCEMENT

Impersonation and FINRA Arbitration

The recording was meant to be a gotcha moment for AXA Advisors in a $13 million arbitration fight. It turned into a gotcha for two former clients when arbitrators learned it was a fraud. Read more: https://bit.ly/2xbP1dS

GUIDE TO GROWTH



Secrets of Standout RIAs

The biggest advisory firms in the industry — those with over $1 billion in assets — did not reach their size overnight. How did they do it? With acquisitions, new tech and new employees. See how they pulled it off here: https://bit.ly/2J3jhgA

EVENTS

Sept. 8-11
XYPNLive
St. Louis
https://bit.ly/2JVTj1A

Sept. 9-11
FSI Forum
Washington
https://bit.ly/2JdZ87M

Oct. 1–4
NAPFA Fall Conference
Chicago
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Oct. 16-18
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Editor's View

Predictions for AUM Fee Model, Digitization and More

Pershing's new CEO revisits 2017 forecasts and offers new ones.

When I first met Jim Crowley two years ago, the now-CEO of BNY Mellon | Pershing made some predictions for the future. The biggest issues at that time were the Department of Labor's fiduciary rule and the advent of robo advice.

"Firms have to redefine themselves," Crowley said then on the sidelines of the FSI OneVoice conference in San Francisco. "You're going to see stories emerging throughout 2017 about how firms, large and small and medium, are going to be making some bold changes in their operating models and in their product choice to drive efficacy, create scale and a better investor experience."

Fast forward to 2019: We are sequestered in a quiet room in Phoenix's massive convention center, taking a break from Pershing's bustling Insite conference. I read Crowley that comment from January 2017. Was he right? He laughs and says he was.

"I see a continuation of all those things for the next few years," he tells me. But, he adds, he has been surprised by a few upheavals — and the trends he sees now have the potential to upend wealth management even more.

"I did not anticipate how quickly some things were going to happen," Crowley says. "For instance, the pace at which the passive, beta asset management process took shape. I don't think anyone anticipated the flow away from active as quickly as it actually happened. And now we're seeing the emergence of much more price competition in the ETF and mutual fund world." Still, Crowley adds, "Mutual funds are not going away."

Looking ahead, what bold changes must firms undertake for future success?

"Will the advisor-client relationship be based on AUM, or will it transition into something else based upon the depth of the relationship that investors are looking for?" Crowley ponders. "It probably won't continue to be an AUM basis-point model."

Robos dominated conversation in 2017. They still do, kind of. "I would not describe the trend as robos," he says. "I would describe it as digitization of the business. The robos created and redefined investors' experiences. They now expect convenience, simplicity, speed, access. That raised the bar for how we — the financial services industry — need to adapt. And we must. It's not optional."

And when we meet in 2021, what will we talk about?

Crowley looks chagrined. "If we're sitting here in Phoenix, we'll probably be talking about the weather," he tells me, referring to the 110-degree temperature outside the convention center.

"I think we'll still be talking about technology and trends. Will we continue to have a multitude of third-party partnerships, or will the trend go back toward enterprise technology platforms? Will the trend be toward individual portfolio management or will it go back to more model-based portfolio management?"

Crowley answers his own question: "Our crystal ball is this: We think we will be more enterprise-driven from a technology perspective. And there will be more centralized portfolio management ... with flexibility built in with the appropriate surveillance tools."

Will Crowley be right? Check back with me in 2021.
— Chelsea Emery

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Retirement Advisor Confidence Index

A Rebound in Activity

"Better market, more aggressive," one planner says. Still, others say their clients are putting more money into cash as they foresee a possible market correction.

By Kenneth Corbin

Despite concerns about a looming market downturn, clients have been buoyed by strong returns, shifting more money into equities and putting away more for retirement, according to the latest Retirement Advisor Confidence Index — *Financial Planning's* monthly barometer of business conditions for wealth managers.

"Clients are getting nervous about the economy but see stocks increasing," one advisor says, noting that investors have been moving more assets into equities in response.

"Better market, more aggressive," says another advisor.

Thus, the RACI component that tracks spending on equity-based securities increased 4.4 points in the most recent month, posting a mark of 58.5, up 5.8 points from the corresponding month last year. RACI scores that are higher than 50 show an increase, while scores below that mark indicate a decline.

While it bounced back from an earlier decline, the equity score was the second-lowest mark in that category this year, suggesting some jitters about a potentially worsening global economy and ongoing trade tension.

Some advisors report that their clients are beginning to feel the stock market is overpriced and seem to be responding accordingly.

One advisor explains that clients are "feeling the market is expensive so [they] moved assets to cash."

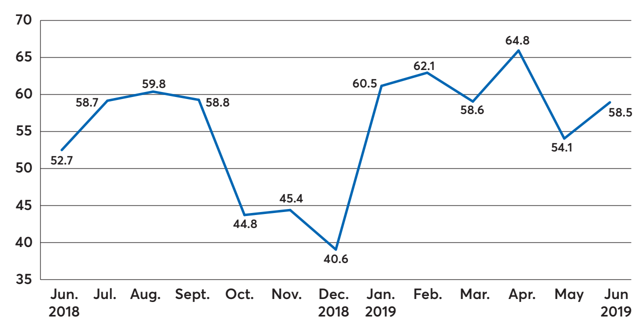
"The market value of securities, in general, has many clients nervous enough to take a little money off the table," another advisor says.

Cash allocations jumped 2.7 points from the previous month, notching a score of 50, up 6.5 points from the year-ago period. In general, cash allocations were down from the earlier months of this year, but well ahead of where they stood in the second half of last year, when they hovered in the 40s and reached a nadir of 33.8 at the end of 2018.

In total, the RACI composite index was 52.5, rebounding 2.4 points from the previous month but still down from its scores in the mid-50s earlier this year.

Many clients seemed to regain their tolerance for risk in the retirement space despite worries about an overheating

CLIENTS ASSETS USED TO PURCHASE EQUITIES



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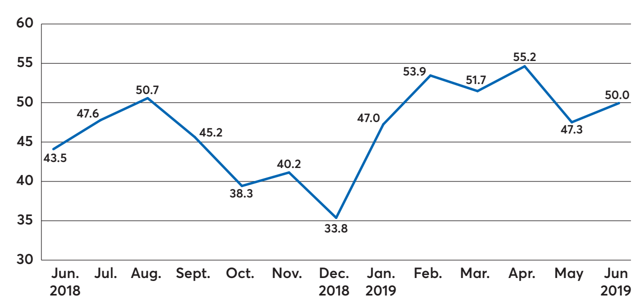
CLIENT ASSETS ALLOCATED TO CASH



Source: SourceMedia Research

The Retirement Advisor Confidence Index, published in partnership with ADP®, is created by the editors of Financial Planning *and is based on a monthly survey of about 300 advisors. Visit financial-planning.com for more results.*

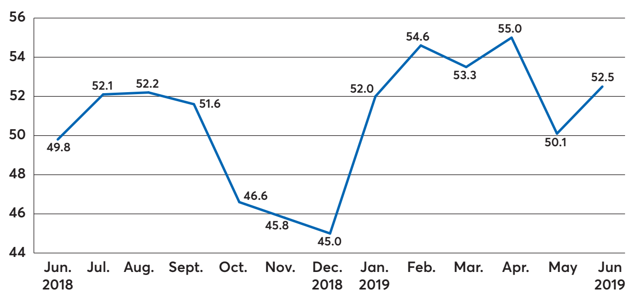
market and ongoing global uncertainty.

The component of the RACI index measuring risk tolerance checked in at 51 in the most recent month, up nine points from the previous month and 8.8 points from the year-ago period.

Risk tolerance hit a high of 60.8 earlier this year, but the most recent score of 51 still ranks ahead of where the index was in the second half of 2018, just once rising above 50 and eventually plummeting to 25.8.

However, some clients see an opportunity in a prospective market dive. "As the stock market hit record highs, clients are expecting a correction," according to one advisor. "More than ever, if the market goes down 20%, they then want to increase their equity allocation." **FP**

RETIREMENT ADVISOR CONFIDENCE INDEX



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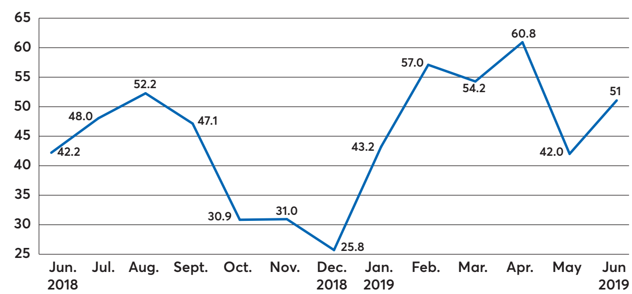
RISK TOLERANCE



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

Cruz

A New Career Progression

The advisory industry has reached a point where it needs to move beyond an ad hoc approach to professional development.

By Kelli Cruz

Keeping talented young recruits in place means creating the right balance of learning with realistic expectations for the timing of career advancement.

We've reached the point in the financial advisory industry's evolution where we need to move beyond the kind of ad hoc career development that has previously defined the advisory career track.

In the past, advisory jobs advanced and progressed as the firm grew without systematic management or guidance. Historically, it has taken 10 to 15 years for a junior advisor to progress to senior level position.

A Shorter Time Frame

Now, the industry is more mature and diverse and in need of a more disciplined and purposeful career management process. I am seeing a change in the timing of career progression for the advisory track. What once was a decade-or-longer process is now a five-to seven-year progression.

Moreover, the millennials, who have grown up in a faster-paced, social-media-driven world, have taken over the job market, and they are simply not wired to wait as long as previous generations of advisors did to excel in their careers.

According to the report Manpower Millennial Careers: 2020 Vision, while millennials do place a high priority on the security of full-time employment, they also want flexibility, new challenges and advancement. According to that study, millennials want new opportunities with their current employer — 63% intend to stay with them for the next few years or longer.

However, when asked what the "right" amount of time is to stay in a single role before being promoted, about two-thirds said less than two years and a quarter said less than 12 months — confirming their impatient appetite for new challenges.

This means that the challenge for today's firms is creating the right balance of learning with realistic expectations for the timing of career advancement.

I believe the answer lies in setting the right expectations for your employees from the beginning, starting with the recruiting process.

Another key is ensuring that once that talent is hired, there are sufficient options for learning experiences that keep employees engaged and committed to the firm's long-term success.

Millennial advisors are eager to ascend the career ladder, and college has often prepared them to do so.

Aside from millennial impatience, why are we seeing this shortened timeline? In part, the answer involves the emergence and success of academic personal financial planning programs, and the improved preparation they give to young advisors entering the job market.

According to *Financial Planning's* 2018 annual survey of colleges and universities that offer CFP Board-registered degree programs, there are some 102 such programs in the United States.

They have been extremely successful in attracting and educating talent for the advisory industry.

Students not only gain knowledge from the excellent curricula provided by these institutions, they add to their education through internship programs. Some undergraduates start in their sophomore year and gain practical work experience until graduation.

Yonhee Gordon, principal and COO at JMG Financial Group in Chicago, has seen the advisory career track timing shortened. She attributes this acceleration to several factors, one of which is the firm's strategy of hiring graduates from PFP programs into an entry-level role of financial planning associate. These already experienced recruits hit the ground running from the start of their tenure with the firm.

Learn from the Golden State Warriors. Draft and develop top young talent and use select recruiting to round out the team.

Another integral part of JMG Financial Group's recruiting efforts is to create awareness of a career path in the industry by inviting local students to their office to spend a day with employees of the firm and learn about the industry as a whole. The firm is also very committed to investing in technology, which can free up time to focus on the higher-value activities that create a more challenging and engaging employee experience.

"Making JMG Financial Group a top place to work is fundamental to our ability to provide consistency and drive results," Gordon says. "Since our founding in 1984, we've worked to attract and retain a talented team that is deeply committed to our clients. Creating bench strength and depth in the advisory ranks is key."

Creating bench strength is an important principle for any firm that has growth as a key strategic initiative. And in order to grow, you need talent. We can learn a lot from professional sports organizations in this regard.

Take, for example, my favorite basketball team, the Golden State Warriors. Its run of five consecutive years in the NBA finals was largely built by developing young talent over time. Three of the starting five players were drafted by the Warriors, and it wasn't until the organization was into its championship run that it recruited the MVP Kevin Durant.

Although the Warriors did go on to win two championships after Durant joined the team, his recent departure shows us that no amount of money will keep a team member onboard if they are unhappy and not a cultural fit.

The Warriors' winning culture comes from select recruitment and relentless training, augmented with the occasional experienced recruit to round out the bench.

Training and Development

Another part of building a strong bench is the training and development process. I recommend developing and implementing a well-defined career path that outlines a plan for progress, development and growth over an employee's career — one that covers the progression of capabilities, skills and experience.

Many of the calls that my consulting firm has received in the last 12 months are from firms with a need to create a career path for key employees. In some cases, firm leaders feel the need to create a separate career track for every role in the firm.

One client firm, for instance, wanted to create a separate career path for a dedicated data management or technical role even though there were no plans to add technical jobs.

Undoubtedly, it is easier for larger firms to offer defined paths of career progression. However, at smaller firms job roles are typically blended so employees get the opportunity to learn the functions of the firm quickly. Additionally, because roles are not specialized, everyone must pitch in and do whatever it takes to service clients.

I encourage client firms to think of career progression as an apprenticeship program within the financial services industry.

I encourage my clients to think of career progression as a traditional apprenticeship program within the financial services industry. I call the first phase of the path the "financial planning and investment management apprenticeship." This encompasses the roles of operations and client administration, support advisor and the introduction to servicing clients.

Phase 2 is the "relationship management apprenticeship," which then progresses to include "business development and leadership apprenticeships." Along the way employees are learning different skills and gaining experience that can lead to running the firm with other partners.

I believe that clarifying and explaining the apprenticeship pathways will meet the desires of today's new talent.

It's time for firms to reimagine their talent management practices, and to remember that career progression doesn't always have to mean promotion. Climbing the proverbial career ladder isn't as up or down as it used to be; sometimes you also have to move left and right. **FP**

Kelli Cruz *is a* Financial Planning *columnist and the founder of Cruz Consulting Group in San Francisco. Follow her on Twitter at @KelliCruzSF.*

Which Ranking Matters?

In contrast to measurements used by some lists, it's revenue — not AUM or team size — that's the true measure of an RIA.

By Brent Brodeski

Top advisor lists usually rank RIAs by assets under management and occasionally by the number of employees, but these metrics can be quite misleading.

Many firms that are high on the AUM list are really multifamily offices that work with ultra-affluent clients who have somewhere between $25 million and $100 million in investable assets. While a few billionaire clients can move an RIA high up the list, it does not mean these firms make money or have high-quality scalable businesses.

Checking Out the Pitch Books

Since my firm, Savant Capital Management, has made a number of acquisitions, I often get to look at pitch books that investment bankers prepare when they sell multifamily offices with high AUM.

What I have learned is that, while they may have lots of assets under management, the highly competitive nature of the ultra-affluent marketplace means these firms, on average, charge low basis points.

Their UHNW clients also demand lots of customization. As such, firms advising the megawealthy need to hire many expensive professionals. This makes it difficult to scale a business and maintain healthy margins.

The beauty of revenue is that it's easy to measure. And if you don't have enough revenue, you just need to add clients, or raise your fees.

What about having lots of employees? Well, that can be a good or bad thing. The number of employees you have needs to be evaluated relative to total revenues, not AUM.

Measuring Employee Numbers

For example, Savant has over 170 employees managing a bit over $6 billion in AUM, which seems like a lot of people. But, when you consider that we advise nearly 5,000 clients, and have an average fee (inclusive non-AUM fees) that approaches 1%, we are actually reasonably staffed.

Of course, we would be grossly overstaffed if our average client had $50 million in investable assets paying 20 to 30 basis points versus an average client with $1.3 million who pays closer to 1% in fees.

What really matters is top line revenue, revenue growth and bottom line EBITDA.

So, how should you think about size?

What really matters is top line revenue, revenue growth and bottom line EBITDA. Over time, your business is worth a higher multiple if you can demonstrate consistent best-in-class revenue growth and a healthy EBITDA.

The beauty of revenue is that it's easy to measure. And if you don't have enough revenue, you just need to add clients or raise your fees to improve this measure of size.

Of course, all revenue is not created equal. Recurring revenue — that is, basis points on AUM — represents higher quality revenue than commissions, fixed or hourly fees.

15% Revenue Growth

Then there is revenue growth. I've long been a proponent of investing for 15% annual revenue growth. This assures you can grow

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Well-run RIAs tend to have EBITDA percentages between 25% and 35%.

EBITDA, which is a measure of cash flow, is more complicated.

To calculate EBITDA you first add state and federal income tax, depreciation and amortization back to your earnings. It's worth noting that EBITDA is not nearly as simple to measure and optimize. Most advisors' financial statements are a mess.

Too often, advisors use their business checkbook as a personal checkbook. And RIAs too often use their business to pay for Cubs season tickets, for their spouse's Porsche or to fund boondoggles.

What's more, most advisors also don't pay themselves a market wage. Sometimes they overpay themselves, which results in subpar profit margins. In other cases they underpay themselves so they can be proud of high (but misleading) profit margins.

Normalizing EBITDA

To be a good financial manager you first need to normalize EBITDA.

This means adding back expenses that are really personal in nature, and adjusting your wage to a market rate — in other words, what you would have to pay someone else to do your job.

Once normalized, you then calculate what percentage your EBITDA is of your total revenue.

If normalized EBITDA is $300,000 and your revenue is $1 million, your EBITDA percentage is 30%.

Once you calculate a normalized EBITDA percentage, it will give you a more realistic picture of your business' financial health.

Once you calculate a normalized EBITDA percentage, it will give you a more realistic picture of your business' financial health.

While there is no exact magic correct number, from my experience evaluating prospective RIA acquisitions, an optimally run RIA will typically have an EBITDA percentage between 25% and 35%.

I call this the EBITDA sweet spot. For example, an EBITDA percentage of 25% may be a good number if you are investing significantly back into the business. While 35% of revenues may be a stretch for some small firms, it is certainly attainable for some larger well-run firms.

And multibillion-dollar RIAs who are able to scale their business can even reach 40%.

RIAs too often use their business to pay for Cubs season tickets, for their spouse's Porsche or to fund boondoggles.

What should you do if your EBITDA percentage is below 25%?

The best strategy may be to build your revenue base by bringing on more clients without adding new fixed costs. You may also be overstaffed or might be overpaying your staff.

For another perspective on boosting revenue, see "More Clients, Less Profit," page 32.

No Bragging Rights

But don't start patting yourself on the back if your EBITDA percentage is over 35%.

In this case, there is a good chance you are understaffed, are paying your team below market wages or have very limited capacity to grow.

While you can certainly brag about having a high EBITDA percentage, the value of your business is probably lower than you realize.

Prospective buyers will not want to pay a high multiple for your firm if your growth opportunity is limited.

Unfortunately, having robust revenue growth, and managing your business so you are in the EBITDA sweet spot, does not give you bragging rights in the top RIA lists, which don't consider actual revenues or know your EBITDA.

When you can brag about having an EBITDA over 35%, the value of your business is probably lower than you realize.

But, unlike rankings based only on AUM and your total staff, revenue, healthy revenue growth and a solid EBITDA percentage creates real wealth — both from ongoing cash flow and by building enterprise value.

I will take that over AUM bragging rights any day. FP

***Brent Brodeski** is a* Financial Planning *columnist and CEO of Savant Capital Management in Rockford, Illinois.*

When Being a Fiduciary Can Cost You

Advisors must be willing to take a financial hit for their clients.

By Dave Grant

If you're a true fiduciary, it should be tough at times. You'll sometimes need to make decisions that are best for your client but rough on your wallet.

Take, for example, the situation of clients of mine. At the depths of a down market, this couple in their mid-70s put their life savings into indexed annuities and for the next 10 years watched the market run up while their annuity returns lagged.

Unhappy with this situation, they sought me out for a second opinion. As we talked about their goals, they explained that they did not need the funds for living expenses and wanted to leave most of their assets to their heirs.

In addition, however, my clients did want access to their money in case of unforeseen expenses. As a result, we unwound the annuities and invested the proceeds in a conservative portfolio.

But my clients weren't used to market movements. They loved increases to their account balances but were unhappy when the market went down.

In our time together, none of the market movements have been out of the ordinary. Still, they panicked.

One phone call in particular had me questioning their whole approach.

"Dave, I can't do this anymore," my client said. "Our money is disappearing, and we won't have any left for our kids. We HAVE to do something."

I listened to the couple air their frustrations, knowing there wasn't much any of us could have done to prevent them.

My clients brought up getting more conservative in their investments and even putting everything in cash. I reassured them that this movement in their portfolio was normal.

We had all the typical discussions — that markets will go up and down, and long-term investing requires patience — but when emotions take over, those realities don't penetrate.

I could see the conversation wasn't helping. When we finished, I took another look at the portfolio. As I examined their holistic portfolio across three accounts, I realized I had neglected to take into consideration where they had come from in transitioning to where they were now.

"Our money is disappearing, and we won't have any left for our kids. We HAVE to do something."

One of the current accounts was more aggressive than another and my clients were fixated on how far this account had fallen from its original balance.

By contrast, their annuities had moved in roughly the same direction even though the balances were different. I sought to see if this difference was the underlying issue.

I asked my clients if they would like their accounts to all have the same portfolio design. It would no longer be at a holistic allocation — each account would be the same and move in lock step with each other.

I explained that the accounts could still lose value, but this approach — where no account would be more aggressive than another — seemed to allay their fears. Until, that is, their account balances dropped a couple more percentage points in ensuing weeks.

We then had a more in-depth discussion about how their money was ultimately going to be used. Their priorities hadn't changed: They still wanted a legacy for their children, but also needed their assets to be liquid so they could use funds if needed.

An insurance broker had a reasonable solution, but it meant payments for him. I looked at him with a raised eyebrow.

I asked them again if they were comfortable losing money in the short term. Upon reflection and seeing what had happened to their accounts recently, they both said, "No."

This is where being a fiduciary gets tougher. I put a drastic allocation change on the table. I told them if they wanted a portfolio that's liquid, keeps up with inflation and has minimal risk of losing money, they should be 100% in TIPS. It would limit the downside risk but severely limit their upside to grow their investments.

This approach concerned everyone. My clients knew they were acting emotionally. I thought the approach might make my clients more comfortable with their investments, but I also knew that my compensation would now have zero room to grow.

While my clients were taking some time to think the potential change through, I shared the situation with a longtime friend and colleague who is an insurance broker.

He suggested that since the assets were split between taxable and retirement accounts and legacy was the main goal, buying life insurance policies with the taxable portion might be a good option. I looked at him with a raised eyebrow: After all, he would get paid if I referred him business.

But his suggestion made sense. My clients would still have investable assets in IRAs to meet living expenses and they could transfer the risk of providing for their children onto an insurance company.

BLOOMBERG NEWS

It's challenging for planners when retiree clients favor short-term stability over long-term potential.

It was also a move that would lose me money. I was now entering the hardest level of being a fiduciary.

With some rough insurance proposals, I presented the idea to them. Why not split their assets down the middle; ensure the legacy portion and still keep money liquid?

They saw the benefit in this approach, but they didn't want to get back into bed with an insurance company. They had faith in the market over the long term and knew that while they kept all the risk, they also stood to gain all the reward.

I was in a situation where I stood to lose from a client's action. But that's what I signed up for. Clients' interests come first.

I also explained to them how I had a conflict of interest here. If they took the money and put it in insurance policies, I would lose money. By abiding by a fiduciary oath, I was now in a situation where I stood to lose from a client's action. But that's what I signed up for. Clients' interests will always come first.

Insurance registered advisors might say it doesn't have to be that way. But I don't want my clients questioning, "Why is he suggesting an insurance policy if he's going to get paid on that as well? Does he stand to gain more with the policy he's suggested versus what we have now?" I'd rather have them understand that I will continually offer suggestions in their best interest even if I lose money doing so.

In the end, the clients decided to stay with their portfolio.

While I would have supported them in whatever decision they made, playing the fiduciary game really tested me. But I'd it do again for every client that I work with. **FP**

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

ALSO IN RIA IQ: NO LET UP FOR TORRID M&A MARKET, P. 22

As part of a rules package approved in June, the SEC revised its interpretation of an RIA's fiduciary duty.

BLOOMBERG NEWS

SEC 'Guts' RIA Industry With a 2-Letter Word

The regulator's rule change sparks outrage among fiduciary advocates and some advisors.

By Ann Marsh

A single word change has upended wealth management.

By substituting an "or" for an "and" in a footnote in June, the SEC watered down the meaning of investment advisors' fiduciary duty to clients. The change prompted sharp criticism from multiple quarters, including the commission's own investor advocate, and left some industry insiders bewildered.

"It guts the RIA industry," says Brian Hamburger, founder of MarketCounsel, a regulatory compliance consulting firm. "RIAs are not fiduciaries anymore."

As part of the Regulation Best Interest rules package, the SEC revised its interpretation of an RIA's fiduciary duty. Previously, advisors had to seek to avoid conflicts of interest and make a full disclosure of all material conflicts of interest. The SEC changed the "and" to an "or."

SEC Investor Advocate's Reaction

That alteration "weakens the existing fiduciary standard by suggesting that liability for nearly all conflicts can be avoided through disclosure," Rick Fleming, the SEC's investor advocate, said in a statement critiquing the rule-making package.

"I do not believe this is what an investor would reasonably expect from a fiduciary, nor does it align with the ways that real-world investment advisors tend to view (and describe) their fiduciary obligation," he added.

The broader implications could be far-reaching. If, over time, the fiduciary downgrade erodes the quality of service provided by the RIA industry, as numerous experts predict, it could depress the value of all RIAs.

Client assets for RIAs, including hybrids, grew at a compound annual rate of 8.6% from 2007 to 2017 compared with 4.1% for broker-dealers, including independent broker-dealers and insurance advisors, according to Cerulli Associates, a market research firm in Boston.

The change suggests "liability for nearly all conflicts can be avoided through disclosure."

Many industry insiders assert that this fast growth has stemmed from the high legal standard that the commission has required of RIAs. But the SEC's revision could undermine independent advisors' advantage in the marketplace.

The commission has rendered the definition of fiduciary "meaningless," according to Barbara Roper, the director of investor protection at the Consumer Federation of America.

In his own statement, the one commissioner who dissented from the majority in the vote, Robert Jackson, writes that "the commission today concludes that investment advisors are not true fiduciaries."

Chairman Jay Clayton, who along with two other commissioners voted for the change, asserts otherwise, describing the new guidance as "reaffirming — and in some instances clarifying — the fiduciary duty investment advisers owe to their clients."

By virtue of this vote, "the commission today concludes that investment advisors are not true fiduciaries."

"This rule-making package," Clayton says in the SEC's announcement, "will bring the legal requirements and mandated disclosures for broker-dealers and investment advisers in line with reasonable investor expectations, while simultaneously preserving retail investors' access to a range of products and services at a reasonable cost."

Indeed, the overall rules package, which included Regulation Best Interest and Form CRS, placed a heavy emphasis on disclosure.

The inescapable problem with disclosure, long demonstrated in academic studies, is that it does not protect investors from advisors bent on harming them, experts say.

"We all know consumers read glossy sales literature and not disclosure documents that are dozens and hundreds of pages long with dense language written by lawyers," says Ric Edelman, co-founder of Edelman Financial Engines, one of the largest RIAs in the country with about $200 billion in assets under management.

"Clients accept the verbal assertions of their advisor rather than reading prospectuses," he adds. "It is therefore essential that the advisors be required to behave as fiduciaries, rather than disclose away behaviors that are not in the best interests of their clients."

Edelman calls the commission's revision Orwellian. "This is doublespeak and this is very worrisome that the government has overtly created a confusing landscape that will only serve to harm investors," he says.

In response, the SEC provided this statement: "Our rules and interpretations are designed to enhance the quality and transparency of retail investors' relationships with investment advisors and broker-dealers, and preserve access (in terms of choice and cost) to a variety of types of advice relationships and investment products. ... Our fiduciary interpretation in no way weakens the existing fiduciary duty; rather, it reflects how the commission and its staff have applied and enforced the law in this area."

The commission did not elaborate when asked how a change that makes the mitigation of conflicts of interest voluntary preserves or strengthens RIAs' fiduciary duty.

Markets for Lemons

By opening the door for RIAs to legally introduce conflicts of interest into their practices, the whole RIA space runs the risk of falling prey to the Market for Lemons economic phenomenon, says Benjamin Edwards, associate professor at the law school at the University of Nevada, Las Vegas.

"Market for Lemons" is a foundational paper by George Akerlof, who later won the Nobel Prize, that demonstrates how, in a market for used cars, when consumers have no way to determine the quality of the vehicles, they discount the price for all vehicles, to account for the risk of buying a lemon.

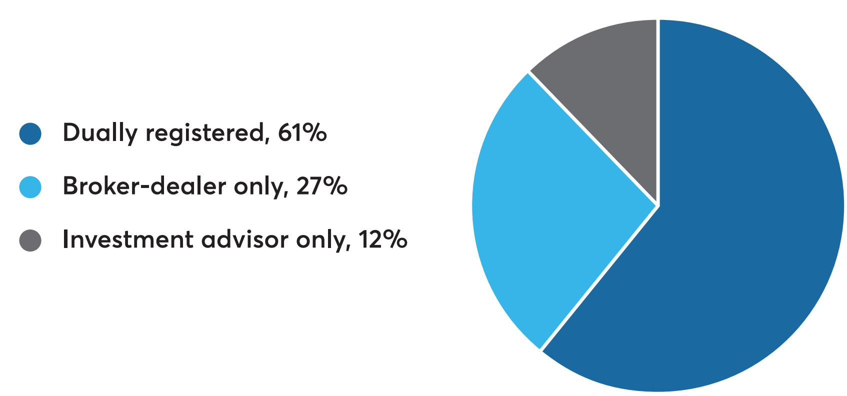
The SEC tends to fetishize disclosure, ... [but] nothing like that can operate in the financial advisor space."

"As this happens, it drives down the quality of the goods in that marketplace to the point where all you have left is lemons," Edwards says. "If people can't distinguish between good advice and bad advice, you will gradually see bad advice take over the market."

The SEC's position springs from a fundamental misunderstanding of the limits of disclosure's effectiveness, he says. "The SEC tends to fetishize disclosure because it's so important for public companies, [but] nothing like that can operate in the financial advisor space — it's a misplaced disclosure fetish," Edwards explains.

When it comes to public company regulation — a core responsibility of the commission — large, well-funded industry players such as mutual fund companies, hedge funds and research giants like Morningstar minutely dissect

Where Advisors are Registered by Firm Type



Source: SEC

disclosures to derive valuable insights. Many investors will then buy products and services, often guided by insights gleaned from those disclosures, according to Edwards.

But wealth management is a different beast. Disclosures that are given to clients are unlikely to face the level of scrutiny and expertise that is conducted by research firms and mutual fund companies.

When the commission leaves the analysis to retail investors — who, even if they had the time to read through volumes of disclosures, lack the background to understand them — the value of any transparency evaporates, Edwards maintains.

When the FPA Took on the SEC

The SEC has been blinkered before about the impacts of its rule-making, says Dave Yeske, co-founder of Yeske Buie, an RIA in San Francisco.

That's why the FPA sued the SEC in 2004, after the commission proposed an exception to the Investment Advisers Act for brokers. For a number of years, the exception allowed brokerages to receive fees for offering financial advice on retirement accounts despite the fact that they were not fiduciaries, says Yeske, who was chairman of FPA's national board at the time.

The SEC move was well-intended, he thinks, surmising that commissioners thought it would reduce brokers' tendency to churn client accounts for higher commissions.

But they overlooked different ways the exception enabled brokers to self-deal in those accounts, according to Yeske, such as selling clients in-house products for high commissions. A federal appeals court overturned the SEC's exemption for brokers in 2007.

Edwards says he expects to see legal challenges to the SEC's new regulation, in much the same way that the brokerage industry killed the Department of Labor's fiduciary rule by challenging it in court.

"The government has overtly created a confusing landscape that will only serve to harm investors."

The SEC has already faced a bevy of criticism. AARP lambasted the commission, saying the rule-making "weakens the interpretation of the Investment Advisers Act, undercutting decades of accepted practice."

Yeske wonders, "Who the hell ever thought we'd ever see the Investment Advisers Act under such assault?" **FP**

__Ann Marsh__ is a senior editor and the West Coast bureau chief of Financial Planning. *Follow her on Twitter at @Ann_Marsh.*

No Let Up for Torrid RIA M&A Market

Advisory firms are generating "phenomenal" internal rates of return for PE buyers, prompting aggresssive volume.

By Charles Paikert

The wealth management M&A market is on a white-hot streak and is poised to blast through the 200-deal barrier to hit an all-time high by year's end, according to Echelon Partners RIA M&A Deal Report.

Already, deal volume is more than halfway to a new annual high: Echelon documented a record 52 transactions in the second quarter ended June 30, following 49 deals in the first quarter. Last year, when the existing record was established, there were a total of 181 M&A deals.

Fidelity Clearing & Custody Solutions, which has a narrower set of reporting criteria for RIAs, is also reporting a record volume of deals and transacted assets under management for the first half of 2019.

A 'Hidden Market'

And there's even more to the market frenzy than meets the eye, says Carolyn Armitage, Echelon's managing director.

A "hidden market" of smaller deals, which are not publicly noted, more than doubles the number of M&A transactions recorded by firms like Echelon, Fidelity and DeVoe & Co., according to Armitage.

One reason the M&A market is still sizzling: "It's perceived to be easier to grow inorganically." Armitage says.

"If you can acquire $500 million in client assets at once versus winning each client individually — and if there's a good cultural and investment philosophy fit — that's a tremendous win," she adds.

And private equity capital continues to pour into the independent financial advisory space.

Compared with other options in financial services, wealth management offers private equity firms “the best return for their money,” Armitage says. “Their internal rate of return for these deals is phenomenal, much better than historical norms.”

"If you can acquire $500 million in client assets at once versus winning each client individually, … that’s a tremendous win.”

Strategic buyers and one-off RIA-to-RIA acquisitions dominated the mergers and acquisitions market, accounting for nearly 75% of all transactions, according to Echelon.

At midyear, the strategic buyers with the most RIA acquisitions were Focus Financial Partners (16), Mariner Wealth Advisors (6), Captrust Financial Advisors (5) and Mercer Advisors (4).

The biggest RIA deal of the second quarter, however, was transacted by a Wall Street giant: Goldman Sachs purchased United Capital for $750 million, at a multiple estimated to be around 18 times EBITDA.

Small Ball

The average deal size for the first half of 2019 actually decreased to just over $1 billion in AUM, compared with an average AUM per transaction of $1.27 billion in 2018.

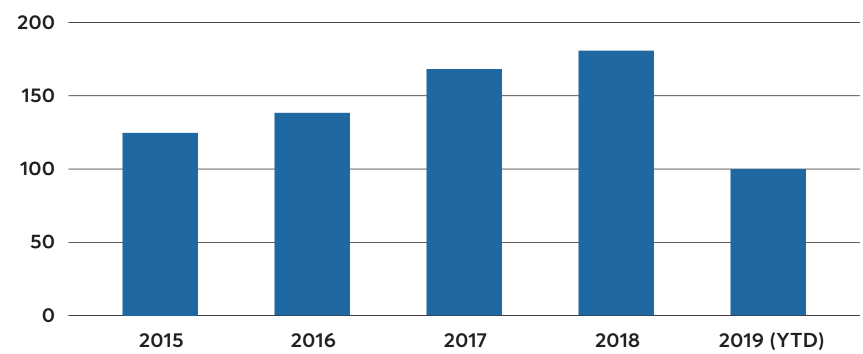
As a matter of fact, “the declining average AUM supports a key trend of 2019: record deal volume is being driven by smaller firms,” according to the Echelon Deal Report.

Firms that have less than $1 billion in AUM know they need growth and scale to increase their operating efficiency and value.

What’s more, the more deals that smaller firms transact, the more experience they gain, Armitage points out. “There is an increase in buyer preparedness,” she says. “The process is not as haphazard as it used to be and the market is more efficient.”

Another major trend is the large number of breakaways from wirehouses, independent broker-dealers and large RIAs. Breakaways more than doubled in the second quarter to 192 from 94 in the first quarter.

RIA M&A Deal Volume



Source: Echelon RIA M&A Deal Report

A Staggering Exodus

Another headline this year was the staggering exodus of approximately $17 billion in client assets from First Republic’s Private Bank after the team from Luminous, which joined the bank seven years ago, parted company to form two new RIAs.

Compared with other financial services, wealth management offers private equity firms “the best return for their money.”

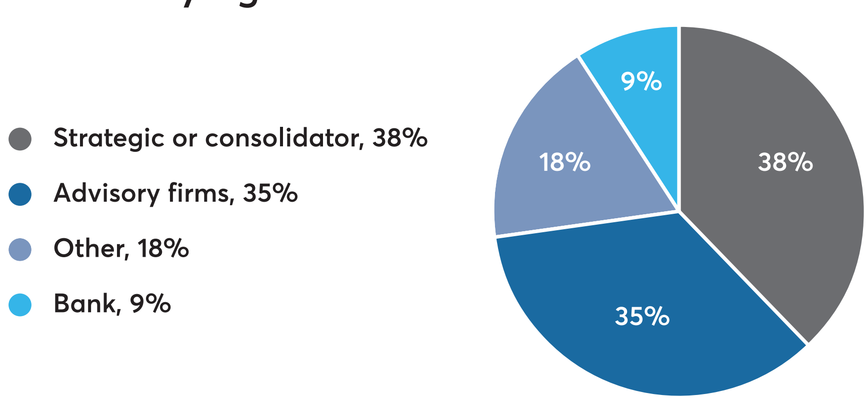
But a combination of factors drove many dozens of smaller teams to split from their mother ships: aging advisors, a desire for liquidity, a maturing business cycle and attempts by some wirehouses to foist onerous retention packages on their brokers.

The increasing number of firms that can help brokers transition to independence and provide financing has also spurred breakaway volume, according to Echelon.

“The break-even point for breakaways is getting shorter and shorter,” Armitage says. **FP**

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

Who’s Buying



Source: Echelon Partners RIA M&A Deal Report

GROW

KEEP

GAIN

How a Pizza Night for Advisors Brought in HNW Clients

Successful firms reveal how they appeal to wealthy prospects — and elite advisors.

By Ann Marsh

At first, nobody at Cresset Capital Management was particularly eager to play a game using "fuzzy balls" from a nearby crafts store to prospect for high-net-worth clients. But, at the insistence of the firm's leaders, the client services team at Chicago-based Cresset hit the phones for three solid hours.

One fuzzy ball went into a jar for every call completed, three for each conversation held and five for every meeting scheduled. "Not to make a pun, but it was a ball and we had pizza and beer afterward," says Cresset partner Doug Regan.

The game netted two new clients. The bottom line? "Make time to prospect," Regan says.

There's no single formula deployed by the best planning firms to attract wealthy clients, as the fuzzy ball game demonstrates. Some firms highlight unique services. Others specialize in recruiting advisors who already are working with a large roster of HNW clients.

Other firms have marquee-name founders who are locally or even nationally known as rainmakers, able to get the ear of the most challenging prospects by virtue of their reputations. No matter the approach, a little out-of-the-box thinking helps, too. It's also important to keep in mind that advisors will have more success talking about their clients' needs rather than about themselves, says Larry Miles, a principal at AdvicePeriod in Los Angeles. "The best advisors should stop trying to sell that they are better than everyone else," he says.

When talking with prospects, AdvicePeriod advisors also play down asset management services, Miles says. That's because industrywide commoditization makes it harder for planners to add value in that area. "If they can find it on Google, they're not going to pay for it," he says.

Thirty to 40 years ago, clients needed assistance to find an asset allocation or investment selection, but not anymore. These days, most firms are using similar, if not the same, investment managers.

"That's not really moving the needle for clients," Miles adds.

Instead, AdvicePeriod focuses on philanthropy and estate planning. "When we are talking to our clients about financial and estate planning, we are talking about things that are incredibly valuable to them," Miles says. "It's about their families, their children, about how they want to be remembered."

Beyond the Algorithm

The key, he says, is to provide services like these that no one has found a way to deliver via an algorithm

In fact, a 2018 study by Bank of America, "Insights on Wealth and Worth," did find that more clients are discussing these needs with advisors. The survey shows that 48% of clients have shown interest in estate planning solutions and 15% are currently seeking guidance in strategic philanthropy.

Advisors can deliver real value in this area because estate planning attorneys are, at best, reactive rather than proactive, Miles maintains. After setting up a grantor retained annuity trust, for example, many attorneys aren't likely to pay attention to how the assets inside of it have performed, nor deliver follow-up advice for clients.

"We've grown precisely because of the missed opportunities" like these, Miles says. The firm, with about $3.5 billion in AUM, has grown its HNW clientele to 800 from 377 in the past four months.

'Partnership' Culture

By contrast, Summit Trail Advisors in New York aims at attracting advisors with strong HNW books of business.

The Dynasty Financial Partners firm, with $5.5 billion in AUM — 90% of which is attributed to wealthy clients — prides itself on a so-called partnership culture in which all firm advisors have equity. This approach builds loyalty, says Jack Petersen, Summit Trail's managing partner.

In addition, the firm does not erect obvious barriers to leaving.

"We don't have non-solicitation [or] non-compete" agreements, Petersen says. "We don't believe in them. If you cannot help an advisor build their business … you're not going to likely retain them."

Summit's primary engine of growth, however, is its referral network, fueled by its existing client base. It also acquires practices, drums up interest through the media and works to build its brand recognition among prospects. The firm manages 15 advisors in New York City, Boston, Chicago, San Francisco and Seattle.

More Than Fun and Games

At Cresset, advisors don't just rely on games to attract prospects.

The firm's structure also helps, Regan says, given that it was founded by private equity entrepreneurs Eric Becker and Avy Stein.

Frustrated by opacity, lack of transparency, conflicts of interest and difficulty contacting their previous advisors, Becker and Stein launched Cresset, which started managing money in 2017.

"Most clients, when they get upset, fire the firm and they go somewhere else," Regan says. "Private equity clients fire the firm and start their own."

Cresset now has about $5 billion in AUM, according to the firm. Thanks to their backgrounds, the founders were able to introduce the firm to a pool of private equity investor prospects.

"We rely heavily on our own internal network," Regan says.

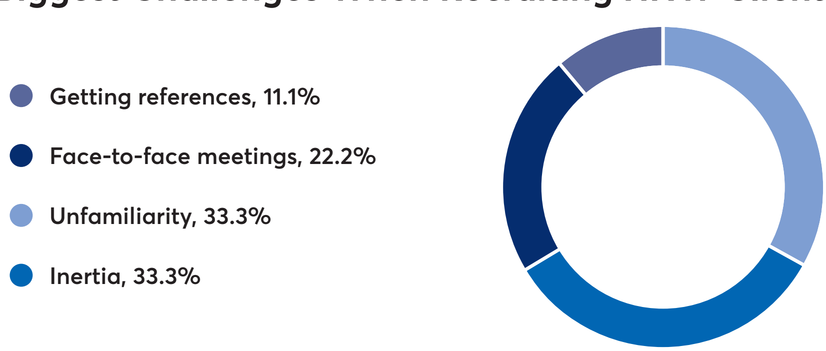
Once it has brought clients in the door, Cresset leverages their interests in unusual ways.

For example, one client who is passionate about cars opened his garages to Cresset's existing clients and prospects for a gathering.

The firm is talking to another client, who has a presidential autograph collection, about a similar event.

"It creates an opportunity for us to have dialogues outside of commercial transactions," Regan says, so planning is about "more than money." —*Additional reporting by Paola Peralta* **FP**

Biggest Challenges When Recruiting HNW Clients



Source: Survey of 178 respondents in *Financial Planning* webinar "Growing your HNW Business: Best Practices," February 2019.

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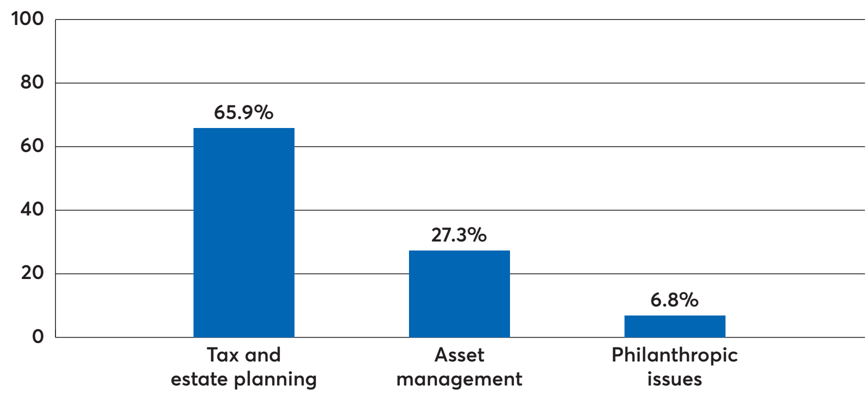
Paola Peralta *is a reporter with* Financial Planning. *Follow her on Twitter at @paperaltanews.*

Services Attracting HNW Clients



Source: SourceMedia webinar, "Growing Your HNW Business," February 2019

New Tax Strategies

From CRTs to opportunity zones, the tax law overhaul has created planning opportunities for advisors.

By Jessica Mathews

In mid-April, Leslie Geller, wealth strategist at Capital Group, received about 15 calls from friends who hadn't understood what occurred with their tax filings following the recent tax law changes. Why did they owe money? Should they get new accountants?

While the modifications have caused clients angst, there's a bright side for advisors, Geller says.

"The good news is these changes have brought about a lot of planning opportunities," Geller said in a presentation at the Investment & Wealth Institute's annual conference in Las Vegas. While clients' individual circumstances may vary, Geller, a former estate planning attorney, says advisors should have these strategies on their radar for HNW clientele:

Qualified Small Business Stock

For tech entrepreneurs looking to exit a venture, or for second- or third-generation clients who received an inheritance, QSBS opportunities could now be more lucrative.

Clients can receive exemptions on up to 100% of capital gains from these investments, versus 50% before the tax law changes.

The exemptions are capped at either $10 million, or up to 10 times the basis of the shares sold.

For example, an individual who purchased $2 million in shares could exclude gains of over $20 million, according to Geller.

"It's a little aggressive, but definitely something to explore," she says.

Through incorporating IRC Section 351, Geller says there may be the potential to exclude as much as $500 million in gains.

Opportunity Zones

An opportunity zone investment could be explored for Gen X clients with a highly appreciated asset who want to diversify. Created under the new tax law, opportunity zones are a vehicle where clients can invest in economically distressed communities within all 50 states in the U.S.

Now advisors can recommend clients sell a highly appreciated asset and roll over that gain into an opportunity zone investment, which could potentially defer gains until the end of 2026, according to Geller.

"Not only can you defer that gain, but if you hold that gain for long enough, seven years or more, you get a 15% step up in basis," Geller says, adding: "If you have held it for 10 years, when you sell that investment, you do not have to recognize any further gain. That's a really, really big deal."

Still, Geller warns advisors to be careful, as opportunity zones are new. "It's definitely an alternative investment," she says.

Advisors can recommend clients sell a highly appreciated asset and roll over that gain into an opportunity zone investment.

Guidance has been scarce on details about opportunity zone investing. A second set of clarifications elucidates that the investments are not limited to real estate and that clients can roll over investments from one opportunity zone to another without an inclusion event.

"Do your diligence, but I think this is a really interesting area to watch right now," Geller says.

Charitable Remainder Trust

A potential opportunity for Gen X clients with a highly appreciated asset is to transfer it to a CRT. If the client is aggressive and wants to maximize the benefit of the appreciated asset, this may be something to consider.

The advisor could sell the highly appreciated asset within the trust and will not have to recognize the gain until it is taken out of the trust. "This doesn't exclude gain. It defers it," Geller says.

She adds CRTs are a flexible option. Advisors can control the amount and timing of distributions.

Spousal Lifetime Access Trust

A SLAT could be used for clients looking for estate planning options who may be hesitant to give up control of the assets.

"This is a great way for them to give away the assets but still retain a safety net," Geller says.

By placing an asset in a SLAT, the appreciation and value of the asset is removed from the grantor's estate, but the grantor has indirect access through their spouse's discretionary interest.

Geller warns advisors to consider potential outcomes. "You want to make sure the trust has provisions for what happens if the marriage ends," she says.

In addition, if advisors make a SLAT for each spouse, they should make similar provisions so one spouse is not more advantaged than the other. Another aspect to note: The validity of the trust will not be recognized if two spousal SLATs do not have substantial differentiations between them. Specifically in California, SLATs could be one way for clients to protect assets from an estate tax that has been proposed.

Pick Up and Move

Another opportunity for older clients is moving to a different state or city with better tax opportunities. While proposing a client move may at first cause a laugh or two, the numbers may speak for themselves, according to Geller.

"A lot of baby boomers are in the stage of life where [moving is] actually a possibility," she says, adding: "The one caveat is you really have to move."

Geller says it is critical to make sure clients move absolutely everything, from pets to cars, and change all forms in order to avoid liability.

"There have been cases decided on where your [veterinarian] is located," she says. FP

***Jessica Mathews** is an associate editor of* Financial Planning. *Follow her on Twitter at @jessicakmathews.*

Advisor Mark Hogan rented out a movie theater for clients to view "Star Wars."

Attracting Clients' Kids

When it comes to building these relationships, it's best to start early.

By Jessica Mathews and Graison Dangor

Advisors who aren't building relationships with their clients' children are taking a huge risk — losing a big chunk of their business.

The industry is approaching a $30 trillion wealth transfer, and financial planners need to make sure they are ready for it.

By engaging the rest of the family, advisors can take steps to guarantee that their HNW assets won't be moved elsewhere when a client passes away.

From family vacation funds to stock-picking games, here are some tips on how to start getting to know your HNW clients' children now, before it's too late.

Don't Act Superior

"I don't know if I would have listened to a financial planner at 22," says Charles Weeks, founder of Barrister Wealth Management, who is now 40.

Weeks offers his clients' children a basic financial plan at milestones such as graduating from college.

But getting young adult children to plan their finances can be a hard sell, and about half are simply not interested, he says.

"Don't act superior to them because [they're] younger," he says. Explain and make things concrete by showing actual dollar amounts.

"Bringing yourself to their level and acting as if they're your equal will get you a much better response," he says.

Ask for an Introduction

Tell clients how a conversation with their children can help them.

"I discuss how I can add value during life's milestones such as college, first job, marriage and having children of their own — and half of my clients have accepted my offer to meet with their kids," says Sandra McPeak, a managing director of investments at Wells Fargo Advisors.

Try creating a family vacation fund that kids can help grow through investing.

McPeak also shares her Family Letter with clients.

"It is a succinct list of everything my kids would need to know about our assets and related topics if we die suddenly and they need to step into our shoes," she says, saying it helps clients visualize how to start a conversation with their kids and make their own list.

Make a Family Vacation Fund

Try creating a fund that kids can help grow through investing, suggests Frazer Rice, senior wealth strategist at Calamos Wealth Management.

Even young children can participate. If the assets grow, children get to discuss what they want to add to their vacation. If they lose money, the kids will have to discuss how to scale back their plans. The advisor can then step in with more-detailed lessons on financial literacy.

It's a low-stakes way to give children a sense of risk and reward and help them understand the consequences of their decisions, Rice says. Learning this earlier on can help children avoid making bad decisions later. "They've touched the stove," Rice says.

Host Engaging Events

Advisor Mark Hogan of Snowden Lane Partners rented out a local movie theater in San Antonio the night before a "Star Wars" debut.

Clients brought children and grandchildren to watch the movie five hours before the midnight premiere. "Their grandchildren think they are very cool to get them into the movie before everyone else sees it," Hogan said in an email. "For our clients without family in town, they tend to bring a friend or neighbor, so we also meet some new potential clients in a very non-threatening environment."

Play a Game

Following a company with a client's kids can help them better understand finance, says Scott Pedvis, a managing director of investments at Wells Fargo Advisors. "I ask them to think of a product or service they really enjoy … We identify the parent company and make a game of following the stock of that corporation," he said.

Pedvis provides the children with research on the company and then they discuss the company's earnings and annual reports.

"The best way to engage is through something the children find interesting," Pedvis says.

Instill Good Habits

"Wealth does not automatically create deep personal finance knowledge," says Carol Fabbri, managing partner of Fair Advisors.

That's why she runs money workshops for her clients' adult children.

Not only is it "a lifelong skill," she says, but it also helps protect them from being swindled.

Following a company with a client's kids can help them better understand finance.

Even for adults, though, finance can be boring. To get them on board, she encourages parents to plan something fun as a family, like a nice dinner, to celebrate the end of her class.

Fabbri also tells clients to encourage their children to save, "[whether the] habit is putting away a dollar when you're six or putting away $1,000 when you're 25."

Parents can match allowance money saved or, for a grown son or daughter, match money saved for the down payment on a home.

Be Tech Friendly

Adopting tech-forward solutions is a step in the right direction, as clients' kids tend to be more digitally native than they are, says Dan Steichen, founder of Personal Wealth Partners, an RIA at LPL Financial.

"We use the tech to ease and facilitate the basics of opening accounts and provide robo investment options," he says.

However, don't underestimate the impact of a personal relationship, Steichen warns. The need for that crosses generations. Hiring younger advisors to work with the next generation of clients can also help.

"The younger advisors participate in the family meetings we occasionally hold for our clients, which helps … to ease the transition of the younger clients to the younger advisors," Steichen says. **FP**

__Jessica Mathews__ is an associate editor of Financial Planning. *Follow her on Twitter at @jessicakmathews. __Graison Dangor__ is a former associate editor of* Financial Planning.

ALSO IN PRACTICE: THE 'FINANCIAL AFTERSHOCKS' OF CANCER, P. 36 | ADVISOR AS TRAVEL EXPORT, P. 38

It may see seem counterintuitive, but a full waiting room is probably not a good sign for an advisory practice.

ADOBE STOCK

More Clients, Less Profit?

Adding accounts will increase the top line, but it may undermine growth, free time and even happiness.

By Michael Kitces

The traditional growth path for any business is fairly straightforward: Craft a product or service that you can deliver profitably, and then deliver it to more people.

When an advisor is starting out and has a lot of time but not a lot of clients, adding more clients can quickly ramp up the advisor's income.

But, only to a point.

When Profit Declines

The individual capacity of an advisor is typically no more than 100 clients in an ongoing relationship. Once that capacity is reached, the advisor must add staff, including another advisor, which makes the next 100 clients not nearly as profitable to the advisor as the first 100.

This illustrates a difficult but essential truth — A business grows either by adding more clients, or by earning more revenue from each existing client.

There is not necessarily a right or wrong path, but advisors who are seeking growth should approach the idea with their eyes wide open.

When starting out, it's natural to have excess capacity. That's another way of saying that we're ready, willing and able to serve clients whom we haven't even won yet.

For the advisor, this usually means having negative income for a period, given that there are at least some overhead costs to run the business, from compliance to website development to licensing core platform technologies.

Of course, as clients do begin to show up, the revenue of the firm rises, cash flow breaks even and then turns positive.

The individual capacity of an advisor is typically no more than 100 clients in an ongoing relationship.

That's because most overhead expenses at a startup firm are fixed and already sunk, so that every marginal new dollar of revenue at the top line drops directly to the bottom.

Therefore, the most direct path for the typical advisor to generate more income is straightforward: Get more clients.

And this approach works quite well; it's not uncommon for solo advisory firms to take home nearly 70 cents for each dollar of revenue, and the most profitable solo advisory firms take home as much as 85% of the revenue brought in.

In real dollar terms, an

advisor with 70 clients generating $200,000 per year of revenue might take home nearly $140,000 of it, while an advisor who grows to 100 clients and $300,000 per year of revenue would typically keep anywhere from $210,000 to $250,000 in profits.

Notably though, from the perspective of take-home income, the bigger driver of net income to the advisor is not actually the firm's profit margin, but the total number of clients that the firm serves and the revenue they generate for the firm.

This formula works only up to a point, though. When advisors reach their existing maximum capacity to service their client relationships, expansion-based growth is effectively no longer sustainable.

Counting Work Hours

After all, if the advisor is going to meet with clients at least twice a year, plus field another four hours' worth of emails and phone calls per client that lead to ad hoc research projects and analysis to answer planning questions, plus four hours of miscellaneous service time for trading, rebalancing and other investment management duties, it adds up to 14 hours per client.

And at 100 clients, such tasks would consume 1,400 of the available 2,000 working hours in a year.

At that point, it takes most of the other 30% of the advisor's time just to handle the rest of the administrative and management tasks of the firm, compliance duties and professional development — not to mention the time required to prospect and market to get new clients.

Research suggests that our brains are limited in the total number of relationships we can handle effectively.

Recent research shows that advisors on average spend only 60% of their time on direct client-facing and investment management tasks throughout the year.

Limited Brain Power

Research also suggests that our brains themselves are limited in the total number of relationships we can handle effectively.

Known as Dunbar's Number, the data notes that physiologically, the human brain may not be able to handle more than 150 total relationships with other human beings.

Given that a chunk of those available relationship slots will typically be claimed by friends and family, most advisors may not have more than 100 slots left to give.

In other words, even if the advisor had more time to service more clients, it's not clear that they would be able to keep track of who's who — even with the support of good advisor CRM — undermining their ability to maintain effective relationships.

The key point is that at some moment, every growth-minded advisor hits their personal capacity, and this point appears to be in the neighborhood of 100 clients in ongoing planning relationships.

The Second 100

The virtue of the solo advisor model is the fact that overhead costs are so low, and generally fixed.

But even the high-margin solo advisory firm isn't truly running those aforementioned 85% profit margins, because a large portion of the advisor's compensation is actually for the work in the business, not just the profits of the business.

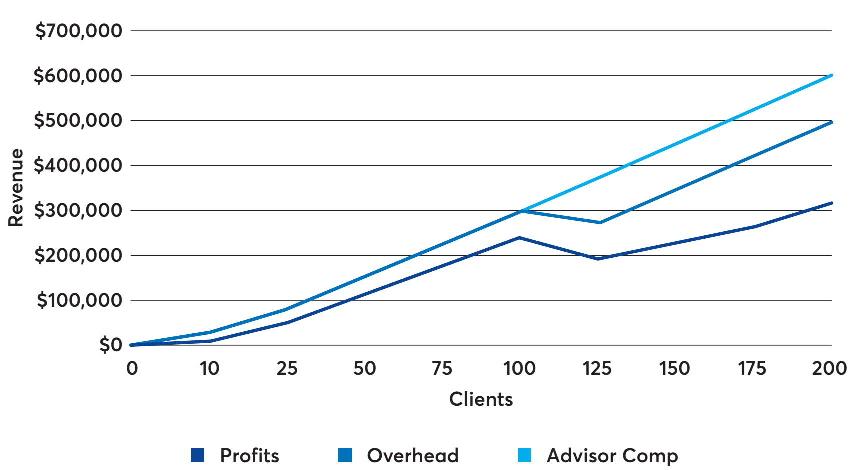
Historically, this is embodied by the 40/35/25 rule of advisory firms. Under this rule, 40% of a firm's revenue goes to the direct costs of servicing clients, including providing the advisors to deliver planning services and the investment team to manage the portfolio, where applicable.

Meanwhile, another 35% of revenue goes to overhead costs, from rent and technology expenses to compliance and administrative staff costs.

That leaves 25% of revenues as a net profit margin for the advisory firm business owner.

Solo advisory firms may find it feasible to run with as little as 15% to 25% overhead, leaving the formula more akin to 40/15/45 or perhaps

How Profits Flatten When Costs Rise



Source: Michael Kitces

40/25/35, and a combined take-home pay as high as 75% to 85% between the first 40% for the advisor's work in the business doing planning and investments, plus the remaining 35% to 45% of bottom-line profits.

This means that after the first 100 clients, the only way to add the next 100 is to hire another associate or even a lead advisor to service those clients. And that's when the economics of growth begin to change for the owner-advisor.

The next advisor who joins — and who very likely is not an owner in the firm — will simply want to be paid what they're worth off the top, as a direct cost of the business.

This means that about 30% to 40% of the next 100 clients' worth of revenue doesn't accrue to the firm's owner, but rather is paid to the next advisor who services them.

Adding Overhead

Bringing on another advisor adds overhead in other ways too. Growing from 100 to 200 clients often requires more administrative infrastructure.

There may now be a full-time client service manager, plus an administrative assistant to support the two advisors, and potentially someone to handle the trading and to support the investment research or paraplanning analyses.

These developments in turn may require new office space, additional technology licenses and more compliance support.

> **The transition from 100 to 200 tends to undermine economies of scale and requires substantial reinvestment into the business.**

At that point it may no longer be feasible to run the firm with only 15% overhead. Now those costs rise to 25% to 30% as the firm's formal infrastructure — at industry-standard overhead expense ratios — starts to take shape.

The end result is that not only does the advisory firm owner just participate in the bottom-line profits of the next 100 clients, but those clients — saying nothing of the advisor and support staff required to service them — typically increase the overhead costs of the firm as well.

That ultimately means the advisor participates in even less of the revenue for the next 100 clients.

For example, a solo advisor might have originally had $300,000 of revenue — for example, $3,000 in revenue per client time for 100 clients — and enjoyed an 80% profit margin as well as $240,000 of take-home revenue. However, while the addition of the next 100 clients may bring the firm to $600,000 of revenue, the next advisor would need to be paid at least $100,000 to service that new group.

The firm's overhead costs may rise to 30% times $600,000 = $180,000, as two more full-time staff members would be needed to support the breadth of 200 clients — such that the firm owner's net profits rise just $80,000, from $240,000 to $320,000,.

The end point of the above example is that the advisor has added far more in complexity to the advisor-owner's life, as the firm may well shift from just the advisor and assistant or paraplanner to a team of five, including two advisors and three support staff.

That in turn requires an increase in the time allocated by the advisor to the management of the firm. And even after doubling the firm's revenue — a 100% increase in clients and the fees they pay — the advisor gets an increase of only 33% in compensation.

Missing Economies of Scale

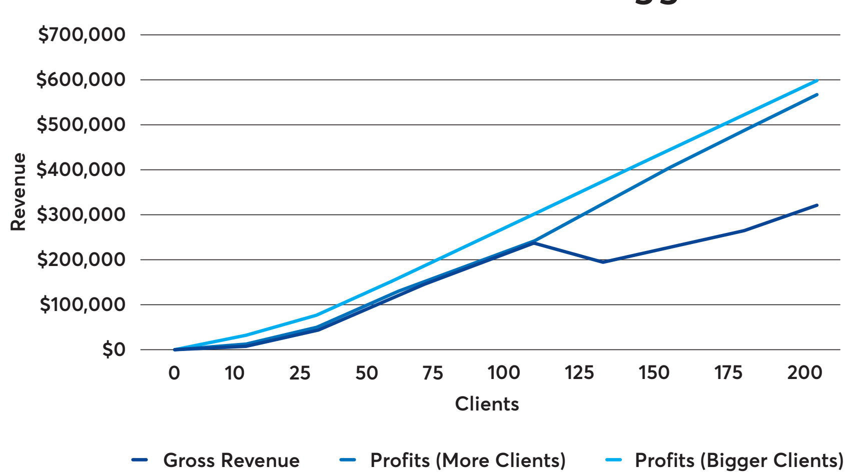
In other words, growing past an advisor's individual capacity is the opposite of growing to gain economies of scale, at least in the near term.

Instead, the transition from 100 clients to 200 clients tends to undermine economies of scale. Such growth requires a substantial level of reinvestment into the business and infrastructure building, to the point that the advisor's income may initially go backward, and only as the second advisor approaches capacity will it finally turn positive once again.

By then the advisor is still up only 33% in profits, despite doubling revenue and more than doubling staff headcount and complexity.

Ultimately, though, that's the whole

Profit Growth: More Clients vs. Bigger Clients



Source: Michael Kitces

point of the shift from getting paid for the clients that the advisor takes on to getting profits by adding more clients to the business.

Traveling the path to 100 clients compensates the advisor for both the clients themselves and the profits of the firm, while the next 100 clients compensate the advisor only with the profits of the business — at a cost of investing in infrastructure and complexity along the way.

Going Big

Even if economies of scale cannot be realized, there is still the possibility of growing profits on a larger revenue base from the same number of clients — that is, getting more for less.

Indeed, for those who want to increase the financial rewards of doing advising, the trick may be growing revenue, not by earning more clients, but by landing bigger clients who slowly but steadily replace the ones that the firm already has.

The central driver for income growth for most advisory firms is not just growing total revenue and profits by adding more clients, but specifically by increasing revenue through an increase in revenue per client.

This raises the amount of revenue the founding advisor can generate, given a maximum capacity of 100 clients or less, without adding overhead or other staffing costs.

After all, an advisor who moves upmarket and tries to focus on fewer but more affluent clients — and ends out with just 50 great clients paying $12,000 a year — will generate double the revenue of someone serving 100 clients at $3,000 a year.

But rather than seeing only a 33% increase in take-home pay for the advisor (from $240,000 to $320,000) by doubling the firm's revenue, working with fewer and more affluent clients causes the advisor's take-home pay to potentially double.

And it may go even higher than that, given the fact that additional revenue drops right to the bottom line. What's more, scaling down from 100 to 50 clients may even reduce the advisor's overhead costs, further improving the firm's profit margins.

This probably explains why it's already so often the case that advisory firms tend to move upmarket as they grow, seeking out and working with more affluent clients and establishing or increasing their asset minimums.

Again, increasing revenue per client is a more efficient way to grow an advisor's income than increasing total clients and revenue.

To increase financial rewards, the trick may be landing bigger clients who slowly replace the ones the firm already has.

This path doesn't require hiring more staff and, more importantly for many advisors, doesn't require adding more management complexity to the business, given that many advisors started their firms in order to serve clients, not to manage a growing team of people.

Moving Upmarket

For advisors who are approaching capacity and must decide what to do next, a decision to move upmarket coincides with the advisor's own growing level of credibility and community connections that make it feasible to generate more affluent business opportunities or referrals.

The key point is simply to know what you want to build, and why.

Just adding more clients won't necessarily generate much more income for the founding advisor, but will potentially generate a lot more work and complexity for the firm.

That's a fine challenge to work through for those who envision being an entrepreneur, growing and scaling far beyond themselves.

But it is also important to recognize and be prepared for the challenges of this path.

Otherwise, the advisor risks becoming an accidental — and accidentally very unhappy — firm owner, simply trying to grow the business and ending out managing a substantial number of staff members and complexity instead of doing more of the client work they enjoyed in the first place.

The Key to Growth

For most advisors who simply may want to grow a little and have some potential for additional income and upside — albeit without the complexity of hiring and adding staff — continuing to grow the total number of clients is perhaps counterintuitively not the best path forward.

The bottom line is that the next 100 clients are simply never as profitable for an advisory firm owner and founder as the first 100.

Instead, the most straightforward path to growth is not adding another 100 clients, but increasing the revenue earned per client.

And while that may mean replacing many of the clients that the advisor is serving today, there's fortunately always another advisor for whom those people would be most welcome in their client roster. **FP**

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LouAnne and Travis Hicks took on $75,000 in debt related to the cancer treatment of their eldest daughter, Lilli (second from right). Also pictured: son Collin and daughter Amelia.

TRAVIS HICKS

Fighting the 'Financial Aftershocks' of Cancer

Pro bono advisors help clients manage substantial debt.

By Graison Dangor

Twelve days before Christmas in 2014, sixth grader Lilli Hicks was diagnosed with acute myeloid leukemia, setting into motion a rush of tests, treatments and prescriptions that would consume her family's life for the next several years.

Nearly five years later, Lilli is heading into her junior year of high school cancer-free. But while the family's eldest daughter has recovered physically, the Hickses are fighting a protracted battle to restore their financial health. Treating cancer and the unexpected costs that come with it — from parking at the hospital to removing asbestos-laden flooring in their home — put the family about $75,000 in debt, says Lilli's father, Travis Hicks.

For three years, the family hit the maximum out-of-pocket spending cap in its insurance policy, he says. "We maxed out all of our credit cards."

The debt could have been worse without family and friends, who held fundraisers and donated money. Aid also came from the nonprofit Family Reach, which helps patients navigate the finances of cancer care from its bases in Boston and Parsippany, New Jersey. Part of that mission includes setting clients up with advisors through the Foundation for Financial Planning. Hicks worked with planner Steve Csenge of Csenge Advisory Group in Clearwater, Florida.

For three years the family hit the maximum out-of-pocket spending cap in its insurance policy, Hicks says. "We maxed out all of our credit cards."

Since teaming up with Family Reach in 2017 to start the Pro Bono for Cancer campaign, the foundation has provided free financial planning to more than 270 families from 38 states through a network of 135 volunteer planners.

$10,000 in Medical Bills

Monica Dwyer is a CFP with Harvest Financial Advisors in West Chester, Ohio, and a member of the Financial Planning Association, which helps recruit volunteers for the effort. In the last year Dwyer has worked with three families in the pro bono campaign.

Her first clients, a couple in their early 20s, faced $10,000 in medical bills after their son was born with brain cancer. They had no insurance. Before long their car was repossessed and, forced to leave their apartment, they moved in with his parents.

Dwyer had expected some of her pro bono clients to be irresponsible with money, and part of her job would be to help them.

"That's not what I found at all," she said. "They couldn't have cut corners anywhere," she says.

Instead, Dwyer coached the young mother on calling the hospital to ask for debt forgiveness. It worked. The hospital forgave the entire balance.

Others have been less fortunate. After 15 years of living with cancer, Dwyer's most recent pro bono client finds it hard to access many nonprofit services for cancer patients, such as the Patient Advocate Foundation and Imerman Angels. The woman can only muster energy for a few moments of housework or budgeting each day.

The client's lack of strength makes it nearly impossible for Dwyer to set up a financial plan so the advisor helps in other ways. She shared some slow-cooker recipes, sent information about the intricacies of a possible bankruptcy filing and worked with the woman and her son to put together a budget.

"It forces me to think about things differently than I normally would," she says of her clients' challenges. "I don't know what else to do except meet them where they're at."

The work has been rewarding for Dwyer. "What was really eye-opening for me was how pervasive cancer can be ... and how it touches every aspect of their lives."

"We help people that are very privileged all the time," she adds. "This is a really good way to help people who would never have access" to financial planning.

'To Me, That's Being a Fiduciary'

For clients fighting cancer, the stream of expenses can seem endless, says Yusuf Abugideiri, a partner with Yeske Buie, which has offices in San Francisco and Vienna, Virginia.

Over the last year, Abugideiri and an assistant have worked with three families to develop a financial plan, meeting with each by phone four or five times. Each discussion takes him and his assistant three to four hours of prep work.

Dwyer had expected some of her pro bono clients to be irresponsible with money. "That's not what I found at all," she says.

"It's not insignificant," says Abugideiri, who is based in the firm's Virginia office, but "it's some of the most fulfilling and rewarding work that we do."

It's work that gives Abugideiri perspective on his own challenges. When he was matched with his second client a week before Thanksgiving, the task seemed impossible to fit in his packed end-of-year schedule.

The client was the father of a 13 year-old boy with cancer. At the time, Abugideiri was also a new father. His son had not yet turned 1.

"I'm just sitting here trying to imagine being this boy's father," he says."If it was me, I would need someone to help me and I would hope that someone could. To me, that's being a fiduciary. Putting yourself in the client's shoes and [giving] what that person needs."

Scaling Up, Looking Forward

By the end of 2020, the foundation predicts it will have worked with 500 families fighting what CEO Jon Dauphiné calls "the financial toxicity of cancer."

"It can affect not only people's finances," he says, "but also their health outcomes ... the financial aftershocks can be lifelong and devastating."

Dauphiné says he believes the program, which relies on virtual meetings, can scale up the number of families it serves. The foundation is also seeking donations from influential planning firms and advisors, he says.

Meanwhile, the Hicks family just celebrated the three-year checkup on Lilli's bone marrow transplant, which showed she is doing well. On the financial side, Travis and his wife LouAnne Hicks recently paid off their first credit card of the five they maxed out and are down to a total balance of $65,000.

Despite their progress, the cost of cancer care is still a burden. Each yearly checkup costs $4,000 to $5,000 out of pocket for a roughly three-hour visit.

Often, Hicks says, cancer survivors celebrate their recovery by ringing a ceremonial bell. The financial obligations that remain do not allow the same sense of closure.

"There's not really a ringing of the bell for your debts," he says. "The costs of cancer don't go away with treatment." **FP**

Learn More About Pro Bono Advising

For more about financial advisors' initiatives, visit financial-planning.com/tag/pro-bono

For more about volunteering or how nonprofits can receive grant funding, visit FoundationforFinancialPlanning.org

***Graison Dangor** is a former associate editor of* Financial Planning.

My Planner, My Travel Agent

As robos take over investment management tasks, advisors need to reimagine the kinds of services they offer. Enter the "experience concierge."

By Chelsea Emery

Could the next trend in mass affluent financial planning be … travel planning? The idea is not so far-fetched. These days, families with $10 million — or less — are demanding the kinds of services once reserved for clients with $100 million or more, according to Gabe Garcia, head of relationship management for BNYMellon|Pershing's Advisor Solutions group.

"The traditional building blocks of a successful practice may need to be torn down," said Garcia, who spoke on a panel at the firm's Insite conference. "How does your business evolve and adjust?"

When a client asked Scott Klososky, the founding partner of digital strategy firm TriCorps Technologies, to help arrange a special family trip, Klososky made it happen. He then created and filled a position dedicated to client experiences. He recommends advisors make similar concessions to client demands.

The idea of hiring an "experience concierge," as Garcia calls it, may seem like a stretch. However, societal changes are rattling the foundation of wealth management.

Having someone on staff who knows the details of a family's wealth and priorities is a "selling point for new clients," Klososky said.

"We know how much they can afford, we know whether they will fly on a private plane versus first class. Wealth managers will need to figure out how to provide services that are different from just managing money," he added.

Robos are taking over many investment recommendation duties. Indeed, they run through risk scenarios better and faster than humans, Garcia and Klososky agreed.

Machine intelligence easily and inexpensively performs back office tasks, investment monitoring — even client communication. And boomers, who hold 56% of the country's investable assets, compared with younger investors' 20%, increasingly tell Pershing advisors they want to invest in experiences rather than waiting for their children to inherit their wealth.

Societal changes are rattling the foundation of wealth management, and advisors need to catch up.

Concierge-type services will also help attract and keep younger clients without millions to invest, Garcia said. "You have 82 million millennials who are earning income. They have equally complex needs as boomers but don't have the assets," he said.

Advisors who have shifted away from offering just financial advice have benefited, according to Garcia and Klososky.

"Today, we are seeing more experience-led, experience-driven services; more technological collaboration," said Garcia. "And we are seeing better outcomes." **FP**

BLOOMBERG NEWS

Advisors can help clients gain experiences, such as exotic trips.

Chelsea Emery is editor-in-chief of Financial Planning. *Follow her on Twitter at @Chelsea_Emery.*

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WASTED HOURS ON OUTDATED TECH, P. 42

SourceMedia's digital wealth management conference In|Vest has become one of the industry's largest events of the year.

BENJAMIN NORMAN

Subscription Pricing Fever

Smaller RIAs want to follow Schwab's lead. Will the model boost diversity and attract younger clients?

By Charles Paikert

Grassroots industry momentum is building for subscription pricing.

Charles Schwab introduced a subscription pricing model in April that has gained traction with clients, bringing in $1 billion in new client assets in the last three months.

Bank of America appears to be next up. "Clients are simply getting used to paying to subscriptions," Teron Douglas, head of digital capabilities at Merrill Edge, said at SourceMedia's In|Vest conference in New York. "It's a logical next step. It's just a question of getting the pricing right."

Executives of two smaller firms also endorsed the subscription pricing model at In|Vest. "Charging on a percentage of assets under management works well for clients who have assets, but that's about 1% to 2% of Americans," said Alan Moore, co-founder of XY Planning Network. "Subscription pricing is a great way to add younger clients who are beginning to build wealth and are used to that payment model."

Anders Jones, CEO of Facet Wealth, agreed: "Charging on AUM makes no sense. If a client gets a $100,000 raise, why should the advisor get an extra 1% of that? Subscription pricing is more transparent and shows the client the value they are paying for."

Subscription pricing also has the potential to boost an RIA's valuation, Moore said.

Many RIAs have clients who in distribution mode. "That means the value of their firms is diminishing," he said. "If subscription pricing brings in younger clients, assets will grow faster and increase the value of the firm."

The subscription model can bring much-needed diversification to an RIA's client base and advisor mix, Moore contended.

"Charging on assets is charging on accumulated wealth and too many minorities haven't had that opportunity," he said. "But subscription pricing is based more on income and will attract more nonwhite clients, which will, in turn, attract more minorities to the profession."

Both Moore and Jones concede, however, that AUM remains the dominant pricing model for advisors and is unlikely to be usurped anytime soon.

Underscoring that conclusion was the show of hands when Moore asked advisors in the room how many were currently using subscription pricing — and only a few responded affirmatively.

"There's more pressure on advisors to justify their fees when they use a subscription model, and value is more top of mind for the client," Moore said. "And billing efficiency and technology for subscription pricing haven't yet caught up to advisors' needs."

What's more, regulators in several states, including Nevada, Washington and Illinois, have been asking firms about subscription pricing. "They don't understand the model yet and are looking for more documentation," Moore explained. **FP**

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

Schwab Attracts a Younger Crowd

Also, more than one-third of the $1 billion new assets on the digital advice platform are from new clients.

By Jessica Mathews

Schwab's robo advisor — which has added $1 billion in new client assets in the last three months — is attracting younger clients with bigger accounts, Bernie Clark, head of Schwab's RIA channel, told attendees at the Source-Media In|Vest conference.

About 37% of clients on the digital advice platform are new to Schwab, Clark said, refuting a comment made by Barry Ritholtz earlier that morning that suggested the company was simply moving money from "left pocket to right pocket."

"Please make no mistake about it — $1 billion is real money," Clark said.

A "high percentage" of Schwab's new robo clients are millennials, according to Clark. The average account size is also larger now — about $300,000 to $400,000. He did not specify what the average account size was before the March launch of Schwab's new pricing model.

"We think the digital offering, the self-help digital offering, with these added plans as well as portfolios, is a way in the future for many mass affluent [clients] — and others who want to actually self-direct themselves," Clark said.

This digital offering may not always be a subscription-based model, Clark said, although he noted that Schwab as been satisfied with the early results of the program.

Across the industry, "[subscription pricing] is the way of the now. Will it be the way of the future? We'll see," said Clark. He notes that J.P. Morgan Chase CEO Jamie Dimon has described the bank as "a collection of subscription services."

The averge account size on Schwab's robo advisor has grown to about $300,000 to $400,000, and many of the new users are millennials, according to Bernie Clark, head of the firm's RIA channel.

"You wouldn't have heard that even just a short couple of years ago," Clark said. Even with about $3.5 trillion in client assets, Schwab has less than 10% of the overall U.S. wealth market, Clark said.

"We're all just scratching the surface, and new ways of doing business are going to be so critically important in the future," he said.

RIAs are becoming more receptive to the benefits of digital advice, however. "Advisors are coming to the game, but really they've been looking at it as a next gen tool," Clark said.

Ideally, the appeal of digital offerings will expand beyond young investors: "Great technologies attract clients of all ages," he said.

Clark warned that there will continue to be pressure on various pricing models.

"One of the challenges in the industry is so much of the industry bases [its] pricing on assets, and so much of the value comes outside of the assets," Clark said, adding later, "I think that's a reconciliation that we'll see coming in the future."

As for the potential $2 billion purchase of USAA's wealth and brokerage units?

"We certainly won't comment on rumors in the marketplace, but thanks for asking," Clark said. **FP**

***Jessica Mathews** is an associate editor of* Financial Planning. *Follow her on Twitter at @jessicakmathews.*

Don't Waste Hours on Outdated Tech

Instead of thinking about clients, too many advisors are struggling with behind-the-times systems, says Hamesh Chawla of Edelman Financial Engines.

By Sean Allocca

What are the biggest tech problems advisors face?

There's a lot of duplication of data entry. Advisors have manual forms that are given to the client and then the client comes back to the planner and the planner then enters in the data. Technology can provide more automation. So then, how do we connect their systems so that data becomes seamless?

How big of a problem is legacy technology?

[The question is:] where can we give the capability to the clients to enter the data using our systems or uploading the documents in an automated manner? We can then take the information from those documents and feed it into different systems. So it's more on the back-office operations. It's incredible to look at the amount of hours outdated technology has taken from the lives of advisors when they could have been thinking about the client. Instead, now they're frustrated because they have to fax off a document to a client.

How can firms stay ahead of technology?

Here's an example: When I wake up, I'm already on my mobile device. [Let's] say I know my portfolio has changed and I want to go and see the state of my accounts through my app. Those portals need to be able to provide the trading information when and how clients are asking for it. It has to provide multichannel access and more meaningful insights. That's how you .start to stay ahead of the game.

"Build out a data lake," says Hamesh Chawla, chief technology officer of Edelman Financial Engines.

What's next in terms of harnessing data?

Traditionally, the industry looked at data as an afterthought. Data was used for reporting analytics, like a published report about how many converts or how many prospects have been through the system. Where we want to be heading is: how do we use the data to make decisions in real time?

What is the hottest tech trend you see today?

If you look at the trends of the industry and how we have evolved in the last few years, there have been a number of interesting trends. We want to go cloud, we want to go security-first, we want to go mobile. If you look at the sectors like finance, or even outside of financial services like education, for example, there are still a lot of instances where technology can provide new advantages.

What's on the horizon?

We want to build out a data lake, which is essentially a pool of data that's able to ingest the structured and unstructured data. The data could come from mobile or from other devices, too. Then, we are trying to figure out how you start to manage that data to make models and give recommendations — what we call the next layer of a customer journey. **FP**

***Sean Allocca** is an associate editor of* Financial Planning. *Follow him on Twitter at @sjallocca.*

ALSO IN CLIENT: BEWARE A WIDOW'S PENALTY, P. 45 |
FACING A LATE 60-DAY ROLLOVER CRISIS, P. 46

A bad fit: My firm learned a client was investing on the side, including a nice sum dedicated to bitcoin.

BLOOMBERG NEWS

Preventing Client Breakups

Making sure that what clients hear matches what we say involves trial and error, but it has yielded useful results.

By Carolyn McClanahan

Client breakups are a fact of life. There will always be some clients who just don't mesh and end up parting ways with a firm. But through trial and error — which continues to this day — our firm has succeeded in minimizing such partings. Here's how:

First impressions are key. When a potential new client calls, our office manager, Krissy, coaxes out their initial story to determine if they fit our typical client profile. She can get even the most reluctant caller to share enough information to determine the next step.

Our headline service is comprehensive financial planning, of which investment management is only a part. We charge a quarterly flat fee for our service, based on an account's complexity.

If someone is looking only for investment management, hourly services or a one-time engagement, Krissy will provide a warm referral to another advisor who will be a better fit.

If the caller seems like a good fit, Krissy sends outs an email summarizing the conversation, along with a copy of our client engagement standards and a document outlining our investment philosophy and process. The instruction to the prospect is to review these documents and if the information resonates, to make an appointment. This reduces the number of nonfruitful meetings with potential clients.

Face-to-face meetings also set a vital tone. In our introductory meeting, we assess clients' goals, learn about their lives, answer questions and take stock of why they want to hire a financial advisor. They bring in basic financial documents like tax returns and financial statements, but we talk very little about their assets or financial questions.

The tax return is the window to the financial soul, and I never set a fee without seeing the tax return and a list of assets first.

Many prospective clients were referred by current clients, while others read about our comprehensive planning process in the press. Most have experienced an event that warrants hiring an advisor. Others realized their "planner" was charging a lot of money and providing just investment management, not real financial planning.

In this first meeting, we review our engagement standards. Based on the discussion and a review of their basic documents, we discuss our scope of services and set our fee.

If they did not bring in any basic documents, we give them a ballpark figure of our fees based on the conversation. I learned a long time ago that all clients think they are uncomplicated. The tax return is the window to the financial soul, and I never set a fee without seeing the tax return and a list of assets first.

In the early years of our intake process, we provided a synopsis of our passive investment management philosophy on our website and discussed the big picture philosophy of how we managed investments in our initial meeting — a crucial step since our client engagement standards state that clients must agree with our investment philosophy.

But what we realized over time was that some clients dearly wanted our help and would therefore agree to everything without totally understanding what they were agreeing to — especially our investment process.

With that in mind, we created an investment education piece that spelled out our investment philosophy and the nuts and bolts of how we manage investments. For example, in addition to using only passive funds, we will not provide advice on individual stocks, private placements, or anything else that we do not already utilize in our portfolio. If someone comes to us with these types of investments, our goal is to get them out of these investments as soon as possible in a tax-efficient manner.

This is the educational piece that now goes out to clients before we have an initial meeting.

The number of potential clients who showed up with an investment philosophy that differed from our style was significantly reduced.

Red Flags

Despite our best efforts, in the past few years we've had a small number of clients slip through. These are clients who agreed to everything, then pushed back on how their investments were being managed.

One client was the family member of a different client. From the beginning, we were concerned he would not be a good fit based on his questions and steered him in another direction. He came back again and promised that his old style would not interfere with our strategy. He showered us with praise over our planning, but over time his investment questions continued to escalate and he never seemed satisfied with our answers. Eventually, we kindly told him to find another advisor.

We realized some clients dearly wanted our help and would therefore agree to everything without clearly understanding what they were agreeing to — especially our investment process.

Another long-standing client never pushed back on our investment process but would occasionally ask questions about alternatives, bitcoin and active management. These questions concerned us, as it was a flag that he didn't wholeheartedly drink the passive investment Kool-Aid.

Eventually, he shared that he was investing on the side, including a nice sum dedicated to bitcoin, and was talking to friends about private placements. Why, he asked, "don't you help me shop for the best people doing private investments," the same way we helped him shop for the best insurance using multiple providers? This, of course, was at the height of the bitcoin boom and all of his friends were doing well. He wanted in on the party.

I had to spell out that shopping for insurance was very different from shopping for the best investors. Maybe we did not do a good job from the beginning explaining what we do or he agreed with our process, but never shared that he felt someone out there could be smart enough to beat the market. Highly educated people seem to be more prone to this fallacy.

Reviewing the histories of both those clients and a few others, we realized they had all asked red-flag questions in our initial meetings. For a number of reasons, we chose to ignore the red flags and paid for that mistake.

Now we have a new process. In the initial meeting, we ask more pointed questions about potential clients' investment philosophy and their thoughts on reading our investment education piece. If it seems they totally embrace how we manage investments, we'll sign them up. If not, we schedule a second meeting with Tim, our investment manager, before they can become a client.

In that meeting, Tim questions them extensively on their thoughts about investments and covers in depth the logistics of our investment philosophy and process.

If the prospects present any pushback or any red flags in this meeting, we will not take them as clients.

Taking on new clients is a wonderful adventure that consumes time and energy. If the relationship doesn't work out, the only benefit is an education in how to do better the next time. Let's hope I can spend my future educational time on more fruitful endeavors! **FP**

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

ADOBE STOCK

Help Clients Avoid the Widow's Penalty Tax Trap

Prepare for hikes that can occur after a spouse's death.

By Donald Jay Korn

When it comes to finding the ideal client, advisors might want to look for seniors on a date night.

Based on Fed data, the website Don't Quit Your Day Job estimates the median nonresidential net worth for people ages 60 to 64 is more than $105,000. For those age 80 and older, it's over $120,000. No age bracket under 55 comes close to that figure.

Indeed, people who have built wealth over six or more decades can be prime clients. That is particularly true for senior married couples. These families often want an ongoing relationship with an advisor. They'll need help planning their saving and spending in retirement and navigating the financial fallout after the first spouse dies. Advisors can then demonstrate their value by helping them trim what's known as the widow's penalty tax on the surviving spouse.

There's also the potential for long-term engagements with the couple's children.

Detailed planning should begin as early as possible. Laird Green, an advisor with Abacus Planning Group in Columbia, South Carolina, worked with a couple who wanted the working spouse to retire within three to five years. "We reviewed their cash flow plan, including a savings plan until retirement," Green says.

Green says clients "find urgency" around their future cash flow as they near and enter retirement.

In this couple's case, following a savings plan for the next few years is essential for them to achieve their desired retirement lifestyle.

Is the goal to reach a suitable investment amount for implementation of the much-touted 4% rule for portfolio drawdown?

People who have built wealth over six or more decades can be prime clients, particularly senior married couples.

"The 4% rule provides a good back-of-the-envelope number," says Green, but her firm goes further. She enters an array of data — such as estimated portfolio values and potential inheritances — into Money Tree's Total Planning program to see if positive outcomes result.

Green also runs 10,000 Monte Carlo simulations. She feels comfortable if the successful results for a client are around 75% or higher.

If they aren't, she might

recommend moves to raise cash, such as selling a second home.

Clients — especially those who have a lot of equity in their primary home — should consider opening a reverse mortgage line of credit early in retirement, suggests Bob Lepson, vice president of wealth management at Adviser Investments, based in Newton, Massachusetts.

Due to reverse mortgage technicalities, the credit line increases over time and it does not need to be tapped unless needed.

"Startup costs must be considered," Lepson says, "but this vehicle is worth exploring for folks who are concerned about their liquidity in retirement."

Having this line of credit can help "sidestep" the sequence of returns risk, Lepson adds, referring to the danger of a steep market drop that may occur near the onset of retirement.

Borrowing could provide an alternative source of retirement spending money after market declines, and create more opportunity for the portfolio to recover.

If both members of the couple are listed as borrowers on a reverse mortgage, after the death of one spouse, the survivor can remain in the house with the same loan terms. Withdrawals are not taxed.

Who Has the Money

Age	Median Net Worth (No Home)
18-24	$4,012
25-29	$4,397
30-34	$15,980
35-39	$17,247
40-44	$36,393
45-49	$50,463
50-54	$50,154
55-59	$69,339
60-64	$105,876
65-69	$94,665
70-74	$77,473
75-79	$69,552
80+	$121,563

Source: Don't Quit Your Day Job. Estimates based on Fed data.

From Joint to Single Filer

After a spouse's death, the survivor will eventually go from a joint return to being a single filer. The widow or widower's tax bracket will probably rise, resulting in a larger tax bill.

This bracket creep occurs because the survivor's taxable income may be almost as much as it was on a joint return. (The drop in taxable income from the loss of one Social Security check may be substantially offset by a smaller standard deduction.)

"I have clients who would go from a 24% tax bracket, filing jointly, to a 32% bracket for the survivor," says Bob Morrison, founder of Downing Street Wealth Management in Greenwood Village, Colorado.

A series of partial IRA conversions should be done over several years, taking care to keep the amounts within low tax brackets.

The result will be thousands of dollars a year in extra tax payments. As a single filer, the surviving spouse could also owe more tax on Social Security benefits, or face more exposure to the 3.8% surtax on net investment income.

So what actions can couples take? For one, it's important to address the widow's penalty while both members of the couple are alive.

"After age 59 1/2, but before they begin taking Social Security benefits, they probably can convert part of their traditional IRAs to Roth IRAs at a lower tax rate," says Judy Ludwig, vice president of planning and taxation at Adviser Investments.

The 10% early distribution penalty won't apply then, and the conversion would be taxed at the lower joint filing rate. Moreover, Roth IRA conversions reduce taxable RMDs from traditional IRAs after age 70 1/2.

Today's tax rates for married couples filing jointly are relatively low, no higher than 24% on taxable income (after deductions) up to $321,450. That same income would put a single filer in the 35% bracket.

Series of Conversions

A series of partial conversions should be done over a period of years, taking care to keep the amounts within low tax brackets.

"For the money moved to the Roth IRA, there are no RMDs for the owner or the surviving spouse," Ludwig says. "Therefore, the account can continue to grow or be used with no tax consequences."

Drawing down a reverse mortgage line of credit or taking life insurance policy loans could be other sources of cash flow that won't trigger highly taxed income.

Many clients in or near retirement want to ensure their financial legacy, says Green. Careful and sophisticated planning can provide more income for the surviving spouse, a larger inheritance for the next generation and more opportunities for planners. **FP**

***Donald Jay Korn** is a contributing writer for* Financial Planning *in New York.*

A Late 60-Day Rollover Nightmare

After an advisory firm's booking error, a client barely avoided being taxed on $500,000, and dodged more than $200,000 in taxes and penalties.

By Ed Slott

A late IRA rollover spiraled into a five-year ordeal, with an investor barely escaping being taxed on over $500,000. That's the mess that landed Nancy Burack in Tax Court.

It's a nightmare that could have easily been avoided. What's more, this incident serves as a cautionary tale for advisors regarding the need for vigilance in monitoring all rollovers of retirement funds — 60-day rollovers in particular, as they are subject to more stringent tax rules than the preferred method of direct transfers. Advisors should also be aware of the various relief provisions available to avoid the time and expense of a full-blown Tax Court case like this one.

On June 25, 2014, Burack received a distribution in the amount of $524,981 from an IRA held with Capital Guardian, with Pershing serving as custodian. Burack used the distribution to purchase a new home while awaiting the closing of the sale of her former home. She intended to redeposit the sale proceeds back into her IRA as a 60-day rollover.

On Aug. 21, Burack received a check in the amount of $524,981, drawn from the closing. Burack was told by someone at Capital Guardian that she could carry out the rollover by overnighting the check to Capital Guardian, which she did on Aug. 21.

Even a rollover made within 60 days can have serious tax consequences if the once-per-year rule is violated.

Capital Guardian received the check on Aug. 22 — 58 days after the June 25 distribution to Burack. However, Capital Guardian did not record the deposit of the check into Burack's IRA account at Pershing until Aug. 26 — 62 days after the distribution. (The Tax Court said it "is not entirely clear" what happened between the receipt of the check by Capital Guardian and the deposit of the check at Pershing.)

The IRS determined Burack's redeposit of funds was not made within the 60-day rollover period and therefore assessed her $524,980 of additional taxable income for 2014.

Burack appealed to the court, making two arguments. First, that the late rollover should be excused, as it was due to a bookkeeping error, citing the seminal Wood v. Commissioner, 93 T.C. 114 (1989), where a custodian made an error recording the rollover. Second, that she was entitled to a hardship waiver, citing IRS Rev. Proc. 2003-16.

The court accepted both arguments and found her rollover to be valid. Burack's rollover was saved, plus the IRS tax bill of $214,333 and additional penalties of $42,867 were removed.

Dangers of 60-Day Rollovers

This case offers a number of indispensable IRA lessons for advisors.

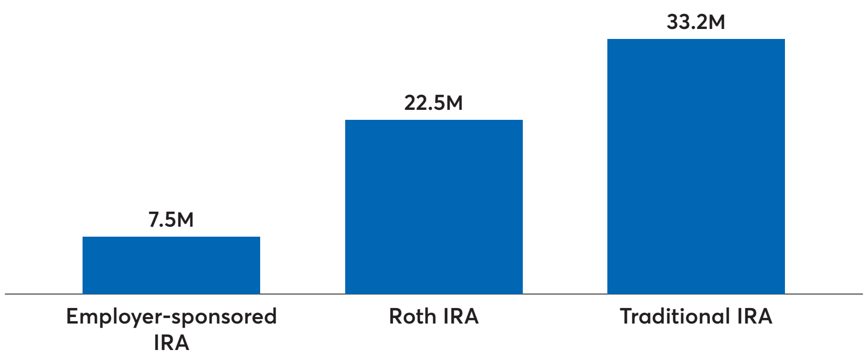
First and foremost, as tempting as it is for a client to use an IRA distribution as a short-term loan with the intention of paying it back within 60 days, a lot can go wrong to cause that deadline to be missed.

Although it is now easier than ever to obtain relief for a late rollover, there are still circumstances in which a taxpayer will be forced to spend a lot of money and time trying to persuade the IRS or Tax Court to waive the 60-day rule.

Additionally, the taxpayer will not always be successful in court, and the consequences of a failed rollover can be quite devastating.

Had the IRS prevailed in Burack, the rollover amount would have been considered a taxable distribution, adding over $500,000 of taxable

42.6 Million U.S. Households have IRAs



Source: Investment Company Institute annual mutual fund shareholder tracking survey and U.S. Census Bureau, 2018 income to Burack's 2014 tax bill. In addition, the IRS was assessing an accuracy-related penalty of $42,867.

Furthermore, if Burack were under the age of 59 1/2, an additional 10% early distribution penalty would have applied. Finally, if considered late, the rollover could have been deemed an excess contribution in the receiving IRA, and subject to a 6% annual penalty unless timely withdrawn.

An indirect, but crucial, lesson to be gleaned from this case is that even a rollover made within 60 days won't relieve clients from potentially serious tax consequences if they violate the IRA once-per-year rule, which limits certain 60-day rollovers to one in every 12-month period.

Note that this period does not comprise a calendar year; it starts on the date when funds are distributed — not when they are rolled over. And while there may be a relief when the 60-day deadline is missed, the IRS has no authority to provide relief when the once-per-year rule is violated — it is a fatal error that cannot be fixed.

Another danger area an advisor should be on the lookout for is if a company plan participant takes a distribution and does not elect a direct transfer, the plan must withhold 20% of the distribution for federal income taxes and may be required to withhold for state taxes as well.

This holds even if the participant does a valid 60-day rollover. (Note that 20% mandatory withholding does not apply to IRA distributions.)

Therefore, instead of a 60-day rollover, clients should be strongly advised to do a direct transfer whenever possible, in which the IRA custodian or plan trustee of the outgoing funds directly transfers the funds to the receiving IRA custodian.

The funds are never made available to the IRA owner or plan participant. (Direct transfers are often called "direct rollovers" when the distribution is paid from a company plan.)

Instead of a 60-day rollover, clients should be strongly advised to do a direct transfer whenever possible.

As Burack easily satisfied the conditions for the automatic hardship waiver, it is unclear why this matter could not have been resolved at the IRS level. Going to Tax Court no doubt forced her to spend substantial amounts in legal fees, and dragged out her case for over five years.

And it still may not be over, as the IRS could possibly decide to appeal the Tax Court decision.

Avenues of Relief

To help clients avoid similar messes — and even potentially salvage a lifetime of retirement savings put into jeopardy by a late rollover — advisors need to know that avenues of relief outside the courtroom may be available when the 60-day deadline is missed.

There are three such recourses: an automatic hardship waiver, a private letter ruling and self-certification.

The automatic hardship waiver is a seldom-used but easy and completely free way that you can help clients to immediately salvage a late rollover.

Note that there is a strict deadline for this fix, so advisors should act quickly if this option is on the table. Under Rev. Proc. 2003-16, an automatic waiver is granted when the following two conditions are met:

(1) The funds are deposited into an eligible retirement plan within one year from the date the distribution was received.

(2) The rollover would have been valid if the financial institution had deposited the funds as instructed.

A PLR is a written statement issued to a taxpayer in which the IRS applies tax laws to a particular set of facts represented by the taxpayer.

In Rev. Proc. 2003-16, the IRS allowed taxpayers to apply for a waiver of the 60-day rule by requesting a PLR, and hundreds of taxpayers have taken advantage of that opportunity.

But PLR requests are expensive — the IRS user fee is $10,000, and professional fees can add thousands of dollars more.

They are also slow — a ruling can take as long as nine months. Even then, there is no guarantee of success. For example, the IRS will typically not issue a PLR for a late rollover if the taxpayer uses the IRS funds as a "60-day loan." This may explain why Burack did not request a PLR.

A client who misses the 60-day rollover deadline can now obtain relief through self-certification under Rev. Proc. 2016-47 — a cheaper and faster alternative to a PLR.

An individual can use self-certification only if the late rollover was for one or more of the 11 reasons specified in the Revenue Procedure.

The most important lesson:: Using a direct transfer instead of a 60-day rollover means the client doesn't have to worry about complying with all the IRS rules, or about fixing the rollover if those rules aren't complied with.

If clients feel they must use the 60-day rollover, they need to be extra careful to make sure that the funds are eligible to be rolled back over and that the rollover is completed well before the 60-day deadline. **FP**

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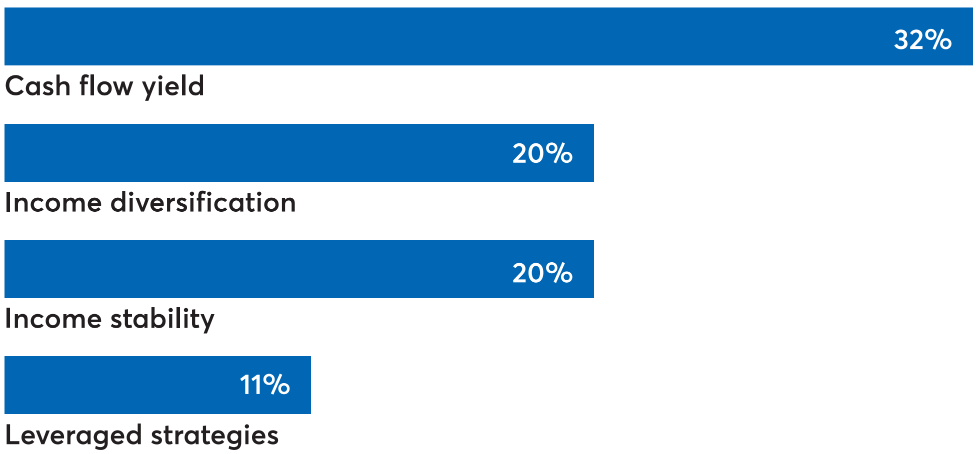
Why Advisors Like Closed-End Funds



Source: Advisors Use of CEFs, 2017, Dubick and Associates. 326 statistically representative financial advisors surveyed.

Explaining Closed-End Funds to Clients

Even advisors may have a lot to learn about CEFs.

By Charles Paikert

Given the wide range of complex financial options, clients need all the help they can get. That means advisors may need to brush up on some asset classes that aren't in the spotlight, so they can help clients grasp how they work.

For example, closed-end funds aren't a top-of-mind portfolio selection for many clients — although the funds hold about $275 billion in assets.

Help Clients Diversify

But these funds can help clients achieve diversification, and they come with a reliable and attractive income stream as well as the potential for appreciation.

There are misconceptions about some of the more distinctive features of these investment vehicles, however.

The use of leverage in investments is commonly misunderstood, says Devin Ekberg, chief learning officer of the Investments & Wealth Institute.

Introducing Leverage

"Closed-end funds can introduce leverage in ways that mutual funds and others can't," Ekberg says.

"For many people, the thought of funds using leverage triggers memories of banks in 2008 and the financial crisis. But that's not the right way to view it," he adds.

Levels of leverage used by CEFs "are much lower than what people might expect — usually not more than 30%," Ekberg points out.

The average leverage ratio for bond funds stood at 28% last year, according to data from the Investment Company Institute.

For equity funds, the leverage ratio was 22%.

Unlike open-end mutual funds, closed-end funds can use leverage to widen investment exposure and potentially boost returns, borrowing at rates pegged to LIBOR or the fed funds rate for taxable funds, and the SIFMA index for tax-exempt municipal funds.

Because CEFs don't continuously issue or redeem shares, they can remain fully invested, don't have to hold large amounts of cash and have more freedom to use leverage, potentially resulting in higher returns.

Extra Risk

"The extra risk closed-end funds are taking with leverage can certainly benefit investors on the upside, but of course they can be penalized on the downside if things don't work out," says Josh Duitz, senior vice president of global equities at Aberdeen Standard Investments. Consequently, advisors should make sure that clients fully understand the risks, Duitz says.

Closed-end funds' use of leverage can be relatively safe "if the underlying assets are of high quality and have volatility of around 3% to 4%, commensurate with stable assets such as high-quality bonds," says Nathan Sonnenberg, CEO and founder of Wealth Management Consultants in Tysons Corner, Virginia.

Funds investing in short-term, high-quality fixed-income such as municipal bonds or investment-grade corporate bonds can usually take credit risk out, Sonnenberg says.

But he warns that the high amounts of leverage used in funds that are investing in master limited partnerships or real assets "can be a toxic, dangerous combination."

Pricing Mechanism

Closed-end funds have a unique pricing mechanism that may hinder some advisors from making use of them in portfolios, while prompting others to take a risky approach.

Unlike mutual funds, CEFs don't issue new shares after their initial public offering.

A good closed-end fund can mimic investing strategies used in limited partnerships and hedge funds.

When shares trade, their price is based on the net asset value of the portfolio. But demand may be greater — or less — than the actual value of the underlying securities.

When the purchase price is valued above the NAV, it trades at a premium; when it's valued at less, it trades at a discount.

"Because of the fluctuations of premiums and discounts, advisors think that closed-end funds are about market timing, but they're not," says Ekberg. "For most advisors' clients, the priority should be distribution of income."

Simply trading at a discount is not a reason for advisors to pick CEFs for their clients' portfolios, says Ben Webb, the director of manager selection at Balentine, an Atlanta-based wealth management firm.

"Buying a CEF at a discount adds one more risk to the investment," Webb says. "It may sound good, but there is not always a clear reason why a discounted price will close [to the value of the assets in the fund]."

Income Benefits

Once a closed-end fund is purchased, advisors should help clients monitor distribution of income.

Because CEF managers aren't subject to the redemption pressure faced by mutual fund managers, they are not forced to buy or sell when they don't want to, Duitz points out.

As a result, advisors can help clients "plan how much income they will be receiving over a period of time."

What's more, the ability to distribute returns more equally throughout the year makes income more predictable and can help clients manage their taxes more efficiently, Ekberg says.

But income is not guaranteed for the life of the fund, according to Duitz. "There is a market risk that comes with the underlying investments in the fund," he says.

For clients who can't afford access to a hedge fund, a closed-end fund may be an option, says Ben Webb, director of manager selection, Balentine.

The biggest risk investors face is a closed-end fund that is not managed well.

"If the value of an underlying asset goes down in the market, the fund's dividend can be cut. A CEF is not an income stream for perpetuity," he adds.

Advisors should also keep in mind that closed-end funds' ability to purchase illiquid assets is another important reason they can generate higher yields.

'A Tool on the Liquidity Spectrum'

Indeed, a good closed-end fund can mimic investing strategies used in limited partnerships and hedge funds.

"For clients who want access to an MLP or a hedge fund but can't afford it, a closed-end fund may be an option," says Webb. "It can be a tool on the liquidity spectrum for advisors."

But the freedom to invest in illiquid assets comes with caveats.

"The biggest risk investors face is a closed-end fund that is not managed well, where managers are overpaying for assets and not handling risk well," Ekberg says.

"Advisors should evaluate a fund's track record, its underlying holdings and the composition of its income distribution," he adds. **FP**

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

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This article was originally published as part of a special editorial series on closed-end funds sponsored by Nuveen.

Building a portfolio is a lot like building a basketball team. Each player brings a different attribute.

ADOBE STOCK

The Diversification Game

A basketball analogy can help clients understand the benefits of investing across multiple asset classes.

By Craig L. Israelsen

Say you have a client who calls you, concerned, because her portfolio is not, at the moment, doing as well as the headline S&P 500 numbers she is seeing on the news.

It's up to you to illustrate how a diversified portfolio won't simply mimic the S&P 500, but can perform better over time, and with less volatility.

With your help, clients should come to understand why portfolios should branch out across multiple asset classes that ideally have low correlation with each other.

You can explain it like this: Building a portfolio is like putting together a basketball team. Each player brings a different skill or attribute to the team. It's the differences between the players — not the similarities — that help form the best lineup.

Thus, if a portfolio only includes the 500 large-cap U.S. stocks that comprise the S&P 500, isn't that kind of like building a basketball team by only having point guards, or only power forwards?

Those are not diversified basketball teams. Similarly, investing in the S&P 500 does not make for a diversified portfolio.

Now to provide a demonstration, which you can share with your clients.

In "Diversify Your Diversification," the starting point is a portfolio that only includes large-cap U.S. equities.

Over the past 20 years, the average annualized return was 5.62%, well below the historical norm of roughly 10%. But that was the reality from Jan. 1, 1999, to Dec. 31, 2018.

During this period, the S&P 500 produced positive annual returns 75% of the time. The index had a standard deviation of annual returns of 17.48%. Its worst calendar-year return was 37% in 2008, at the height of the financial crisis.

Over the past 20 years, the average annualized return of the S&P 500 was well below the historical norm.

Let's start building our portfolio team by adding some other ingredients to large-cap U.S. equities.

The result is an equally weighted four-asset portfolio that includes cash (90-day Treasury bills), U.S. bonds (Barclays Aggregate Bond Index) and small-cap U.S. stock (Russell 2000).

Each asset class is given a 25% allocation and rebalanced annually. With this portfolio, the 20-year return does decline slightly to 5.34%, but the portfolio volatility (as measured by standard deviation of return) plummets to 8.68%.

This means volatility was cut in half. Positive annual returns occurred 80% of the time, and the worst one-year loss was only 16.04%, compared to 37% if only invested in large-cap U.S. stock. Overall, this is an endorsement for adding more ingredients to a portfolio.

But we need not stop there. We will now add some diversifiers to our portfolio team. The first is non-U.S. stock (MSCI EAFE Index).

Each asset class now has

a 20% allocation and is rebalanced every year.

As shown in the table, 20-year performance declined slightly to 5.14% and standard deviation ticked up from 8.68% to 10.94%.

The percentage of positive annual returns fell to 65%, and the worst one-year loss increased to 21.51%. Foreign equities have been a party pooper asset class over this time.

If we added REITs (Dow Jones US Select REIT Index) as the diversifier asset class instead of foreign equities, the results were much better.

The 20-year average annualized return for the five-asset portfolio jumped to 6.43%, or 81 bps higher than the S&P 500 by itself.

Even better, the added return was achieved with 44% lower volatility.

Adding commodities (represented here by the S&P Goldman Sachs Commodity Index) as the 5th asset diversifier hurt performance (4.89% 20-year return) but actually lowered the standard deviation of return more than when we added foreign stock.

What happens if we equally weight all seven asset classes? The 20-year performance is 5.67%, or 5 bps higher than the S&P 500 alone.

This is rather amazing, inasmuch as the seven-asset portfolio had an overall asset allocation of 71% to equities and diversifiers, and 29% to fixed income. Yet it outperformed 100% equity.

Plus, it achieved that slight outperformance while reducing volatility by 33%. Positive annual returns were achieved 75% of the time, and the worst calendar-year loss was 27.6%. The past 20 years paint a very supportive picture for broad portfolio diversification. How about over the past

Diversify Your Diversification

Equally Weighted Portfolios Equal allocation to each asset class with annual rebalancing, 20-year period from 1999 to 2018	20-Year Annualized Return (%)	20-Year Standard Deviation of Annual Returns (%)	Percentage of Years With a Positive Return	Worst Calendar-Year Return
100% U.S. Large-Cap Stock	5.62	17.48	75%	-37%
Now Build a 4-Asset Portfolio **25% allocation to each asset with annual rebalancing**				
U.S. Cash, U.S. Bonds U.S. Large-Cap Stock, U.S. Small-Cap Stock	5.34	8.68	80%	-16.04
Now Add a Diversifier **20% allocation to each asset with annual rebalancing**				
U.S. Cash, U.S. Bonds U.S. Large-Cap Stock, U.S. Small-Cap Stock **Add Non-U.S. Stock**	5.14	10.94	65%	-21.51
U.S. Cash, U.S. Bonds U.S. Large-Cap Stock, U.S. Small-Cap Stock **Add REITs**	6.43	9.82	80%	-20.67
U.S. Cash, U.S. Bonds U.S. Large-Cap Stock, U.S. Small-Cap Stock **Add Commodities**	4.89	10.09	75%	-22.13
Now Blend All 7 Assets Together **14.28% allocation to each asset with annual rebalancing**				
U.S. Cash, U.S. Bonds U.S. Large-Cap Stock, U.S. Small-Cap Stock Add Non-U.S. Stock, REITs and Commodities	5.67	11.65	75%	-27.6

Source: Steele Mutual Fund Expert; calculations by author

49 years (from 1970-2018)?

Since 1970, the S&P 500 produced a 49-year average annualized return of 10.21%, had a standard deviation of 16.98% and generated positive annual returns 80% of the time.

The equally weighted four-asset portfolio consisting of cash, U.S. bonds, large-cap U.S. stock and small-cap U.S. stock had a 49-year return of 8.75% and a standard deviation of 9.63%. It produced positive annual returns 86% of the time.

If we add foreign stock as the 5th asset class, the return is 8.90%, the standard deviation 10.93%, and positive annual returns were generated 78% of the time.

Real estate produced a 49-year portfolio return of 9.45%, a standard deviation of 10.42% and 84% positive annual returns.

Commodities as the 5th asset class generated a portfolio return of 8.86% and a standard deviation of 9.04%, and positive returns 88% of the time.

Interestingly, commodities — while not enhancing performance — did the best job of lowering volatility and producing positive annual returns. This is due to the low correlation between commodities and the other assets..

Finally, if we combined all seven asset classes into an equally weighted portfolio (14.28% allocation to each asset), the 49-year return was 9.48%, the standard deviation was 10.23% and there were positive returns 86% of the time. The performance of the seven-asset portfolio was slightly lower than the S&P 500 (by 73 bps), but volatility was reduced by nearly 40%. Additionally, the multi-asset portfolio produced positive annual returns more often (86% to 80%).

The key takeaway: Clients should understand that diversification across multiple asset classes is just as important as diversification within each asset class. Here's to enjoying the upcoming basketball season. **FP**

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Is It Europe's Time to Shine?

If clients' portfolios need international diversity with a focus on dividends, these three funds may be worth consideration.

By Joseph Lisanti

The MSCI Europe Index rose a hefty 14.46% in the first six months of 2019, but performance in the second half of last year was dismal.

As a result, over the 12 months that ended in June, the index gained a measly 0.13%.

But after a decade of U.S. stock outperformance, it might just be Europe's big moment.

Markets are expecting a rate cut from the European Central Bank, which could help boost the region's stocks. Equity valuations are modest and yields are attractive.

It should be noted, however, that some potential clouds are on the horizon, including the U.K.'s headlong rush into a no-deal Brexit in October.

If you believe your clients' portfolios need a bit of European dividend seasoning, here are three ETFs that focus on the region.

Markets are expecting a rate cut from the European Central Bank, which could help boost the region's stocks.

Note: We have eliminated currency-hedged funds as well as those that concentrate on a particular capitalization size or yield level.

Each of the following takes a broad view of European stocks.

O'Shares FTSE Europe Quality Dividend ETF

(OEUR, expense ratio: 0.48%) holds stocks of more than 150 dividend-paying European companies. The fund, which was launched in August 2015, owns equities that meet certain capitalization, liquidity, quality, volatility and yield criteria established by index provider FTSE Russell.

Weighting is factor based. At the end of June (the fund's most recent report of country and sector positions), OEUR's heaviest country bets were in the United Kingdom (29.26%), Switzerland (20.14%) and France (15.91%).

Health care was the largest sector

weighting at 20.43%, followed by consumer goods at 13.63% and energy at 13.62%.

Through July 5, the ETF's year-to-date return was 13.57%.

OEUR's one-year and three-year annualized returns were 3.36% and 5.13%, respectively.

Morningstar sees the ETF's forward dividend at 4.41%.

ProShares MSCI Europe Dividend Growers ETF

(EUDV, 0.55%) owns stocks of companies in the MSCI Europe Index that have increased their dividends for at least 10 consecutive years.

Potential clouds are on the horizon, including the U.K.'s headlong rush into a no-deal Brexit in October.

The ETF, which came public in September 2015, currently holds 34 stocks that are weighted equally.

As of July 5, the fund's largest country positions were in the U.K. (38.58%), Switzerland (12.12%) and France (11.85%).

The biggest sector holdings were in health care (21.23%), consumer staples (20.05%) and industrials (15.10%). Year to date, the ETF has returned 12.62%, with -1.40% for the 12 months ended July 5.

Over three years, the portfolio delivered 5.15% annually.

EUDY's forward yield is 3.34%, according to Morningstar.

WisdomTree Europe Quality Dividend Growth ETF

(EUDG, 0.58%), launched in May 2014, currently holds 215 dividend-paying European stocks.

Despite its title, the fund, based on a proprietary WisdomTree index, does not actually require its holdings to exhibit dividend growth.

The "growth" in the fund's name refers to the expected long-term earnings growth.

The index judges quality by looking at return on assets and return on equity over a three year period.

Stocks are weighted by annual cash dividends paid.

As of July 5, EDUG's largest country positions were in the U.K. (25.57%), France (16.46%) and Switzerland (14.04%). The weightiest sectors in the fund were consumer staples (19.86%), industrials (19.32%) and consumer discretionary (19.06%).

Through July 5, EUDG's return for 2019 was 18.10%.

For the 12 months through that date, it delivered 3.31%.

Annualized three- and five-year returns were 9.42% and 2.37%, respectively. Morningstar projects the ETF's forward dividend yield at 3.67%.

Final Caveats

It should be noted that none of these funds have very long records and all suffered during last year's downturn in European stocks.

Historically, dividend growth wasn't a high priority for European companies.

Also, EUDV's small number of holdings may dampen enthusiasm for the fund.

Historically, dividend growth wasn't a high priority for European companies.

In contrast, ProShares' domestic stock dividend-growth ETFs hold between 52 and 60 issues. **FP**

3 ETFs for European Dividends

	Ticker	Expense ratio	3-year return	3-year Sharpe ratio	5-year return	5-year Sharpe ratio
O'Shares FTSE Europe Quality Dividend	OEUR	0.48%	5.13%	0.34	NA	NA
ProShares MSCI Europe Dividend Growers	EUDV	0.55%	5.15%	0.33	NA	NA
WisdomTree Europe Quality Dividend Growth	EUDG	0.58%	9.42%	0.63	2.37%	0.19

Annualized total returns as of July 5; Sharpe ratios as of June 30
Source: Morningstar

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AUGUST 2019

CE Quiz

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From: Help Clients Avoid the 'Widow's Penalty' Tax Trap

1. What is the median net worth (not including a home) of U.S. residents ages 40 to 44, according to Fed data?
1. $105,876
2. $36,393
3. $50,154
4. $77,473

2. As a single tax filer, a surviving spouse may face the surtax on net investment income, at what percentage?
1. 2.5%
2. 4.2%
3. 3.8%
4. 1.5%

From: The Diversification Game

3. Which of these portfolios had the best average annualized return from 1999 to 2018?
1. U.S. cash, U.S. bonds, U.S. large-cap stocks, U.S. small-caps stocks, REITS
2. U.S. cash, U.S. bonds, U.S. large-cap stocks, U.S. small-cap stocks, commodities
3. U.S. cash, U.S. bonds, U.S. large-cap stocks, U.S. small-cap stocks, foreign stocks
4. 100% large-cap stocks

4. Which of these portfolios, in the same time period, had the lowest percentage of years with a positive return?
1. U.S. cash, U.S. bonds, U.S. large-cap stocks, U.S. small-cap stocks, REITS
2. U.S. cash, U.S. bonds, U.S. large-cap stocks, U.S. small-cap stocks, commodities
3. U.S. cash, U.S. bonds, U.S. large-cap stocks, U.S. small-cap stocks, foreign stocks
4. 100% large-cap stocks

5. Which had the most favorable standard deviation?
1. U.S. cash, U.S. bonds, U.S. large-cap stocks, U.S. small-cap stocks
2. U.S. cash, U.S. bonds, U.S. large-cap stocks, U.S. small-cap stocks, commodities
3. U.S. cash, U.S. bonds, U.S. large-cap stocks, U.S. small-cap stocks, foreign stocks
4. U.S. cash, U.S. bonds, U.S. large-cap stocks, U.S. small-cap stocks, foreign stocks, REITS, commodities

From: Explaining Closed-End Funds to Clients

6. What was the average leverage ratio for bond funds in 2018, according to the Investment Company Institute?
1. 35%
2. 15%
3. 28%
4. 25%

From: Bond Funds Drift Into Risky Debt, Adding to Angst Over Liquidity (online only)

7. Bond funds that take on more risk have returned what percentage in the past five years, according to Morningstar?
1. 2.22%
2. 3.14%
3. 2.86%
4. 1.80%

From: SEC 'Guts' RIA Industry With a 2-Letter Word

8. Which of the below is true, under a June 2019 SEC revision of the Regulation Best Interest rules package?
1. Advisors have to seek to avoid conflicts of interest and make a full disclosure of all material conflicts of interest
2. Advisors have to seek to avoid conflicts of interest or make a full disclosure of all material conflicts of interest
3. Advisors no longer have to make a full disclosure of all material conflicts of interest under any circumstances
4. None of the above

From: The Dangers of IRA-Owned Real Estate (online only)

9. Typically, when a prohibited IRA transaction occurs, such as using direct IRA-owned real estate for personal use, what is the penalty for the IRA owner?
1. The IRA is deemed fully distributed as of Jan. 1 of the year when the prohibited transaction first occurred
2. The IRA is deemed fully distributed as of April 15 of the year when the prohibited transaction first occurred
3. The IRA is deemed fully distributed as of Jan. 1 of the year after the prohibited transaction first occurred
4. The IRA is deemed partially distributed as of Jan. 1 of the year when the prohibited transaction first occurred

From: Worst Passive Fund Returns Over 5 Years (online only)

10. Which of these passive funds had the worst one-year return (as of June 2019), according to Morningstar data?
1. Invesco DB Commodity Tracking (DBC)
2. iShares Global Energy ETF (IXC)
3. Energy Select Sector SPDR ETF (XLE)
4. Vanguard Energy ETF (VDE)

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Financial Planning

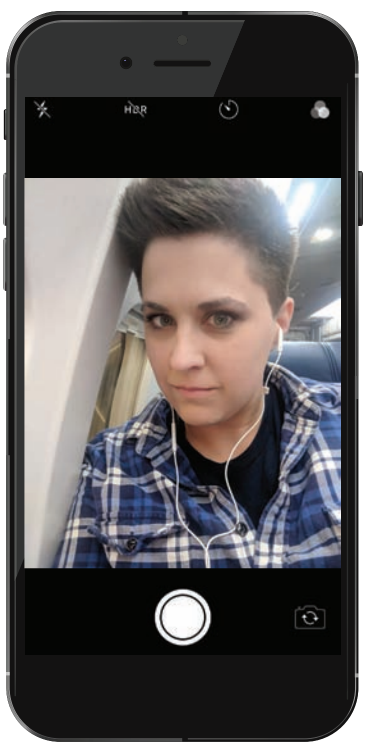
Finding A Place

This was the message I heard loud and clear: "You can't be a planner because you are a masculine-presenting lesbian."

By Cait Howerton

Growing up in rural Arkansas, I felt like an outlier. I was inquisitive, politically moderate and — though no one knew it then — a member of the LGBTQ+ community.

Coming out was a difficult process. Tokenism was part of my daily experience. Stress and shame wove themselves into the fabric of my identity when I faced comments about my hairstyle and clothes, was told not to introduce my girlfriend or to repent and change my ways. I felt self-conscious, anxious and depressed. I doubted my identity and my self-worth.



After finishing my MBA, I was driven by my knack for personal finance. I wanted to use my abilities and education to help people like me. Research revealed significant lack of representation of female, black, Latinx, Asian and LGBTQ+ planners. I struggled to find role models in the industry who looked like me. I delayed my pursuit out of fear of rejection: I worried I couldn't attract enough clients for a sustainable wealth management and holistic life planning practice.

Despite my doubts, I was drawn to financial counseling and coaching. I became an accredited financial counselor, which taught me foundational groundwork and the value of leading clients with curiosity.

Years later and feeling brave, I applied for a job with a fee-only RIA in Florida. After the interview, the firm owner affirmed my qualifications but said he wasn't sure I would resonate with his clients. The message I heard was loud and clear, "you can't be a financial planner because you are a masculine-presenting lesbian."

I almost said, "to heck with financial planning" — but dusted off the residual rejection and tried again months later, landing a position as a financial coach with an Atlanta-based start-up fintech company called SmartPath.

This job has been a game changer, in part because of SmartPath's commitment to diversity and inclusion. In addition to growing as a professional, the acceptance I've found here has encouraged me to open up about my LGBTQ+ identity and desire for greater industry diversity.

Emboldened by my new job, I gained two amazing mentors: Laura LaTourette, a successful lesbian financial planner and CFP from North Georgia, and Elizabeth Jetton, a CFP who heads the Action Learning group.

Elizabeth recommended I apply for the FPA Diversity Scholarship. I was honored to be selected. I attended the 2019 FPA Retreat, where each person was gracious and genuinely interested in my perspective as the Diversity Scholar. Having an encouraging platform was unbelievably impactful.

We have to continue to seek out marginalized people and give them seats at the table.

It is crucial for underrepresented voices to receive space and attention. The past year has been filled with opportunity and effective mentorship for me. I'm finally starting to find my place.

We have to continue to seek out marginalized people and give them seats at the table. The impact of diversity initiatives and outreach in the industry can't be overstated. People often leave behind spaces that make us feel rejected or isolated. But thanks to these efforts, I'm planning on sticking around for a while. **FP**

__Cait Howerton__ is a financial coach at SmartPath in Atlanta and the 2019 FPA Diversity Scholar. Follow her on Twitter at @CaitHowerton.
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