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BREAK POINT

Few advisers realize they're liable for data breaches. For **David Edwards** of Heron Financial Group, that means getting tough on vendors.

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Heron Financial Group
President David Edwards says
his firm won't do business
with vendors who cannot
meet high client data security
standards.

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RAMPING UP SCRUTINY



8 Ways FINRA Will Tighten the Screws

The future of the fiduciary rule may be uncertain, but that doesn't mean firms and advisers can expect the regulatory tide to recede anytime soon. Additionally, this isn't the only regulatory change to which the industry needs to pay attention. In its annual letter, FINRA identified a number of areas where it will be ramping up scrutiny, from product suitability to cybersecurity. Type this link in your browser to click through important changes for advisers and firms: <http://bit.ly/2iMLytt>



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Sound Off: A Marketing Niche

In a response to an article about Social Security savvy, *Financial Planning* contributor **Michael Kitces** tweeted:



"It's a good topic for advisers to market themselves around."

What do you think? Weigh in by commenting at <http://bit.ly/2jcKQsW>



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APRIL

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EDITOR'S VIEW

Hidden Digital Threat

Who's responsible for a digital problem caused by a third-party program? Not the vendor.

THE STERN WORDS OF A FORMER FBI AGENT PLANTED THE IDEA FOR this month's issue on cybersecurity. At last year's FSI OneVoice conference, Clyde Langley, a former agent who's now vice president of Schwab's fraud prevention and investigations unit, told a room of worried executives that hackers were probably lurking in their firm's systems.

"Criminals are sitting in compromised accounts, watching traffic and seeing what you and your clients are talking about," Langley said.

That thought has stayed with me ever since. But when I spoke with *Financial Planning* Managing Editor Suleman Din about probing this topic more deeply, he opened my eyes to an even more insidious – and lesser-known – digital threat.

Well-intentioned advisers have been integrating as many new tech tools into their practice as they can, Din told me. But few realize that these programs, primarily built by third-party vendors, could come with glitches and bugs that allow client and firm data to be accessed by thieves, or just mistakenly disseminated by users.

Who's responsible for the resulting data leaks? Advisers. Not vendors.

"It's a regulatory and legal issue with real consequences for advisers, who should bear the blame and fallout even if the firm didn't cause the data breach through any action of their own," Din says.

"Advisers have to take an invested, proactive approach to learning about the tech that they are using and the partners they choose," Din adds. Stay on top of security inquiries, he warns, but expect a runaround. He says he was surprised by how "vendors can thwart diligence inquiries from advisers and still get business."

Donald Jay Korn, who wrote a companion piece on cybersecurity, tells me his research revealed ways to stop thieves from using information from already-breached systems.

"Require a live phone call instead of an email, for instance," he says. "Use code words or phrases with each client, and mandatory delay times to verify a cash request," Korn adds, citing his source, Sanjiv Bawa, founder of Chi Networks.

Those are words that should stick with you, similar to the FBI agent's warning that stuck with me. —*Chelsea Emery*





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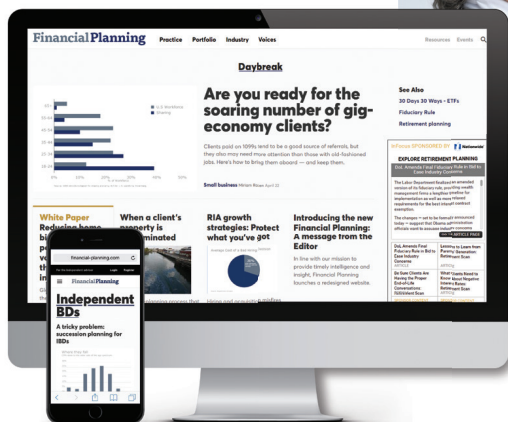
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RETIREMENT ADVISER CONFIDENCE INDEX

Trump Era Boosts Client Confidence

Still, some worries are emerging, particularly around rising interest rates and health care costs, advisers say.

CLIENTS' RISK TOLERANCE ROSE, BOOSTED BY THE election of President Trump, advisers said in providing input for this month's Retirement Adviser Confidence Index – *Financial Planning's* monthly barometer of business conditions for wealth managers.

"We're calling it the Trump bump!" one adviser wrote.

The index overall gained a modest 1.1 points to 56.6, helped by growing optimism. But the client risk tolerance measure rose 10.2 points to 66.2, putting the metric comfortably into positive territory. It rose almost 20 points the previous month. Advisers still credit the U.S. election with the rise in confidence and risk appetites.

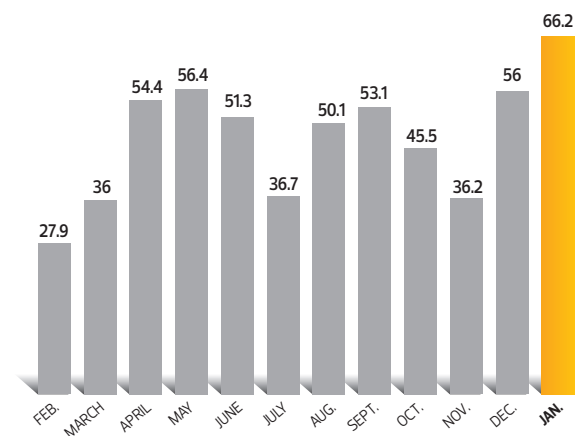
Still, some advisers are trying to keep client exuberance at bay. "Clients' risk tolerance appears to have increased, as is typical when unwarranted euphoria captivates the market without any fundamental changes in the underlying securities," one adviser said.

As clients became more eager to invest, advisers noted a boost in retirement saving. The index tracking contributions to retirement plans rose 4.4 points. Advisers also raised their fees, reporting a 2.4-point index bump in what they charged.

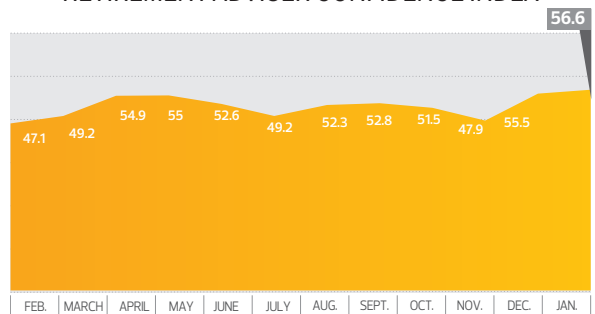
"We acquired more assets under management. That, coupled with moving money from cash to equities, caused the fees to be higher," one adviser said.

Despite the optimism, some advisers reported their clients were nervous about the new administration. Others noted it was affecting clients' investment decisions. Many advisers reported moving away from global assets. As one adviser wrote: "Since Trump's victory, more and

PERCEIVED RISK-TOLERANCE LEVEL



RETIREMENT ADVISER CONFIDENCE INDEX



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more clients are pro-U.S. [They have] uncertainty about international [assets].”

The Retirement Adviser Confidence Index is composed of 10 factors – including asset allocations, investment product recommendations, economic and risk factors, taxes and planning fees – to track trends in wealth management. RACI readings below 50 indicate deteriorating business conditions, while readings over 50 indicate improvements.

This month’s index also features *Financial Planning’s* Retirement Readiness Assessment, which asks advisers to track their clients’ preparedness. The analysis tracks a number of factors, including retirement status, income replacement ability, dependence on Social Security and vulnerability to economic shifts.

Health care costs continue to be a top concern for advisers, particularly concerning ultrawealthy clients. Advisers reported that 50% of their ultrahigh-net-worth clients’ retirement readiness could be compromised by a jump in care costs.

Some respondents expressed concern for their clients’ current outlays. “Clients are struggling with health care expenses,” the adviser wrote. “Many employers are requiring more employee contribution.” Another adviser said concerns were also generational: “Health care costs for those under 65 [are] a major concern.”

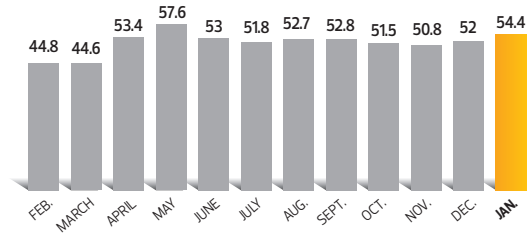
After the Fed’s decision to hike interest rates, advisers are anxious to see how the bump will affect their clients’ ability to save – particularly those in the mass-affluent category.

However, some clients may not be aware of those worries. One adviser wrote: “Interest rates continue to be worrisome. This worry is felt more by my fellow advisers than it is our clients.”

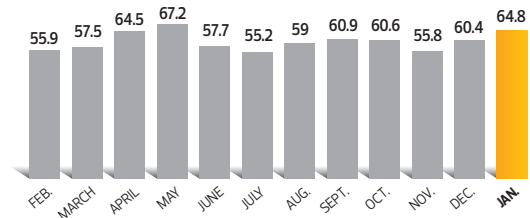
Respondents said fewer than half of ultrahigh-net-worth clients would be somewhat to extremely vulnerable in the event that interest rates rise significantly. More than half of high-net-worth clients would be affected.

—Maddy Perkins **FP**

FEEES CHARGED FOR RETIREMENT SERVICES

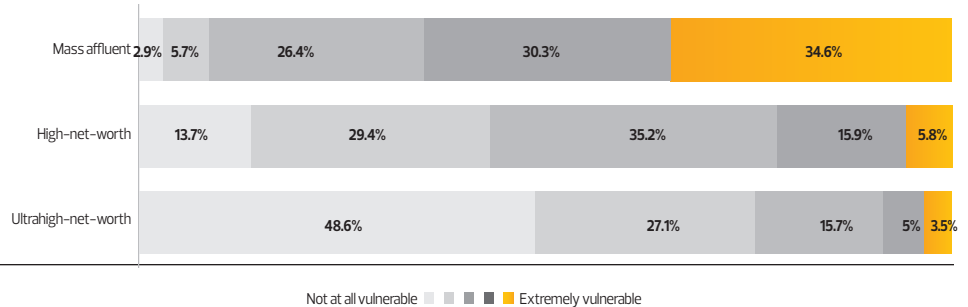


CONTRIBUTIONS RECEIVED FOR RETIREMENT PLANS

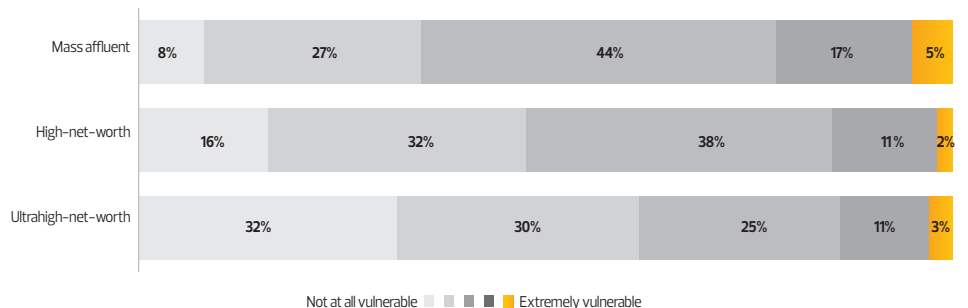


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VULNERABILITY TO SIGNIFICANT INCREASE IN HEALTH CARE COSTS



VULNERABILITY TO SIGNIFICANT INCREASE IN INTEREST RATES



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GLOBAL ASSET ALLOCATION TRACKER

Back in the U.S.A.

Clients are becoming more bullish on domestic equities, planners say.

ADVISERS BOOSTED ALLOCATIONS to U.S. equities and pulled back on bonds in the face of rising interest rates and uncertainties around future economic and trade policy.

The latest Global Asset Allocation Tracker shows allocations to domestic equities reached a record high since the survey started in June 2013. The tracker, which polled 330 advisers, also showed a slight increase in allocations to global equities.

Allocations to bonds remained in negative territory, largely due to anticipated changes in interest rates, according to advisers. Global Asset Allocation Tracker

readings below 50 indicate decreases.

Clients have been on an emotional roller coaster, says one adviser. "In November, a few clients were spooked by possible market downside scenarios, so there was no additional buying of equities, especially early November. However, by December, they were buying back into the rally," the adviser says.

Another adviser finds clients have become more bullish on U.S. markets in light of President-elect Donald Trump's perceived pro-business, pro-tax-cuts political agenda.

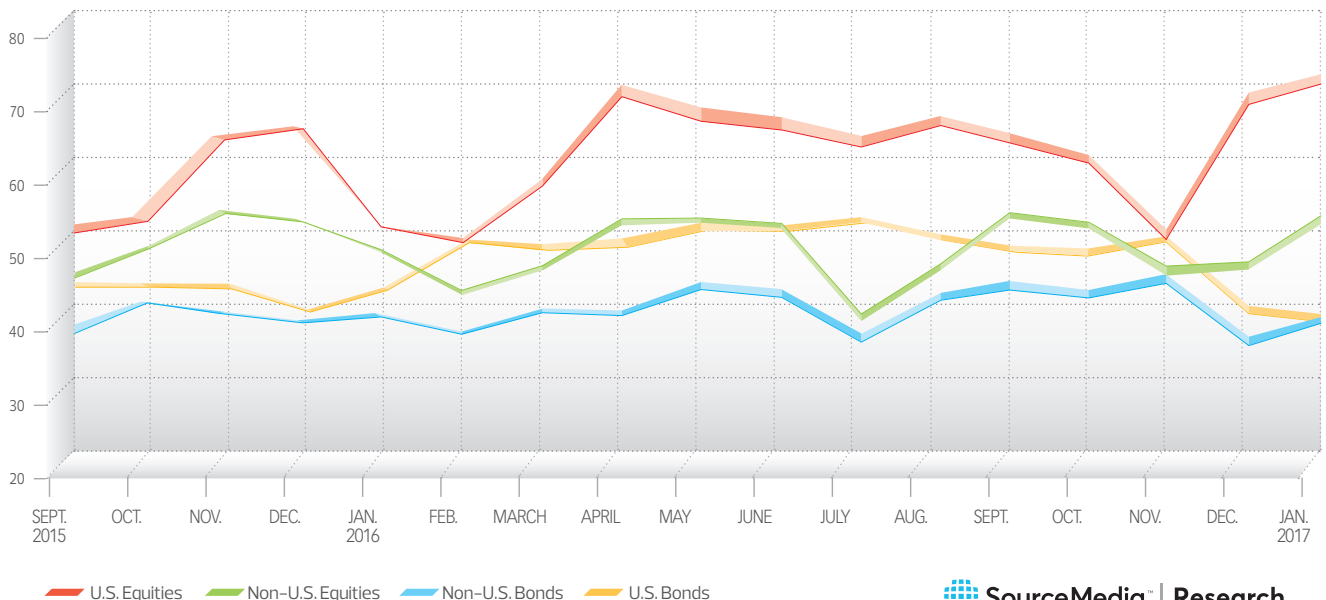
A planner, explaining the move to U.S. stocks and away from global equi-

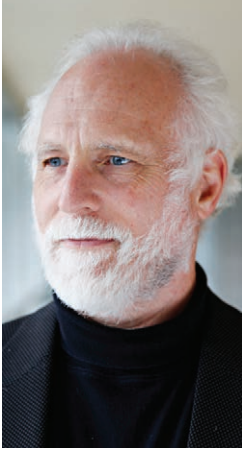
ties, says the Trump administration "seems positive for U.S. stocks at the expense of other countries."

Indeed, several wealth managers also report they are pulling back on global equities, particularly emerging markets, in anticipation of major shifts in international trade under the new Trump administration.

Yet one adviser took a contrarian position with an eye to current stock prices, saying, "We feel markets are starting to become overvalued." The adviser adds: "We have increased our cash positions in an anticipation of a market sell-off." —*Andrew Welsch* **FP**

GLOBAL ASSET ALLOCATION TRACKER





INDUSTRY INSIGHT **VERES**

Don't Get Left Behind

Change is coming to the advisory world at warp speed. But there's a comprehensive solution that will prepare your firm to succeed, Bob Veres says.

LAST MONTH'S SURVEY OF RIAs IN *Financial Planning* revealed that more than a third of the largest advisory firms are experiencing a decline in assets and revenues. Why? I believe that the planning profession has reached an inflection point. The rate of change is now rising faster than the ability of aging baby boomer founders to adapt.

We've all seen this in individual cases. Think of that well-known planner who was considered a leader in the profession 10 or 15 years ago and now is invisible and irrelevant. It happens whenever people think they've reached their professional destination – that glorious time when they finally don't have to change how they operate. It used to be that the profession leaves them behind gradually. Now it happens much more quickly.

What is behind this trend? What changes must we respond to today? I would argue that they fall into three categories.

1. TECHNOLOGICAL CHANGE

You probably think I'm talking about robos here, but in fact they are a symptom of a much larger transition. Financial planning, CRM and client account management software are all incorporating alerts into their feature sets, telling you whether there's enough cash in a client's accounts to cover an upcoming required minimum distribution, whether asset allocation positions have moved more than 10% (or whatever toler-

ance you set) or whether last week's market decline has moved a client's retirement projection out of the safe zone.

Meanwhile, online advice platforms are becoming increasingly proficient at automating the rebalancing and tax-loss harvesting chores that most advisers are still doing manually. To me, their most interesting innovation is the Automated Customer Account Transfer Service, where they use account aggregation engines to pull in client portfolio data and then allow clients to transfer the money to your management online. Once this becomes ubiquitous, client accounts will become a lot more fluid – meaning that advisers will be able to change custodians, and tens of thousands of brokers will move into the adviser space and bring their clients with them.

Software is encroaching on a variety of things that you're accustomed to doing by hand. That's a good thing, not something to be feared. It means that if you can get your technology act together, you'll be able to spend more time in front of clients.

2. CLIENT CHANGES

Most of you know that millennials are the clients of the future, but how many advisory firms are going after them aggressively? If they don't meet your account minimums, they don't qualify to become part of your client base – and people early in their working careers have rarely saved up millions.

Software is encroaching on a variety of things that you're accustomed to doing by hand. That's a good thing, not something to be feared.

This lockout of the unwealthy happened so gradually that it's hard to remember back to the day when the founding members of the planning profession started their businesses by taking on their unwealthy peers as clients. One of the great untold stories of the profession is that those lucky initial clients who followed their planner's advice became wealthy – so wealthy, in fact, that planning firms all over the country gradually raised their minimums to conform to the increasing wealth of these initial clients. Now it's time to open your doors again.

Before you do, there's one other thing to understand about millennials: the ones that I've talked to are skeptical about any professional's ability to beat the market. This means that the traditional value proposition of an experienced planner no longer impresses your potential clients. Planners will have to shift their value proposition from asset management to financial planning and providing their experience and wisdom. That's healthy for the profession but potentially painful for many advisers.

3. REVENUE MODELS

I've written before that there is a movement from commissions to fees, which is accelerating because of the impact of the Department of Labor's rule. In the fee-compensated community, we're slowly experiencing a similar shift from charging based on assets under management to retainer fees.

Why? First, and most important, because millennial clients prefer paying that way. Second, and nearly as important, retainers are the only way you can charge people who haven't yet accumulated assets but have sufficient cash flow to pay you to help them become wealthy. Finally, and most controversially, retainers come with fewer conflicts of interest than the AUM model.

Some readers will want to argue. But I've talked with hundreds of advisers who switched from commissions to fees, and they all, in one way or another, told me that it was like a lightbulb going off, how they

suddenly realized how much more free they felt to give advice in their clients' best interests. When I talk with advisers who have shifted from an AUM to a retainer model, I hear them saying exactly the same thing.

COMPREHENSIVE SOLUTION

So how, exactly, can you adapt to these overlapping drivers of rapid change in our profession? Believe it or not, there is a comprehensive solution that covers all bases.

Let's start with a caveat. If you're a successful founder of a planning firm, you should not be the person who maps out how you're going to respond to new technology, new clients and a new revenue model.

Instead, give the millennial planners in your office a new project. Tell them to come up with a service model that can help their peers become financially successful – just as you did with people your own age back in the day. Let them develop a way to charge these people, via retainers or a monthly fee deducted from credit cards, and turn them loose to bring in the clients of the future.

The new service model will involve leveraging not only the online advice platforms, but also all the new intelligent features being built into professional software. This will lower the human costs of working with unwealthy clients to a point where they become profitable to the firm. At the same time, you'll impress millennial prospects with your technological sophistication.

These changes, taken together, will open your firm to the 95% of the people in your area who don't meet your minimums but could profit from your advice.

Yes, this is a whole heap of change for you to endure at a time when you're going to have to learn a new tax regime and adapt to shifts in the regulatory environment.

The good news is that you aren't going to have to map out this comprehensive solution. Let that be the responsibility of your successors. You're giving them the green light to build the firm that they would want to inherit 10 or 20 years down the road. **FP**

There's one thing to understand about millennials: They are skeptical about any professional's ability to beat the market.

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



ELITE ADVISER **BOWEN**

5 Ways to Move Upmarket

Here are the moves advisers can make to serve larger, wealthier and more-profitable clients, John J. Bowen Jr. says.

THERE'S ONE QUESTION I GET MORE often than any other from advisers these days. They may phrase it multiple ways, but it essentially boils down to this: How do I move upmarket and serve larger, wealthier and more-profitable clients?

For starters, it's important to understand that moving upmarket doesn't always have to mean catering only to the very wealthiest few or adopting a family office business model.

What I recommend is positioning your practice so you increase your average client size by 20% or more within the next 18 months – all while serving your clients extremely well. This is realistic for most advisers and will enable them to stand out from their peers.

Here is a five-step process that we teach our advanced coaching clients.

1. ASSESS THE CHALLENGES

Start by making sure you are fully aware of the landscape you're working in. I would argue that extremely skillful advisers have never been more needed than they are today, due to developments that include:

- Societal changes. If the last election doesn't tell you there are societywide changes afoot, you're not listening. There's likely a lot of change coming, and a lot of noise as well. Your ability to provide clarity to clients will be valued more than ever.
- Regulatory changes. Will there be more

regulations going forward, or far fewer? President Trump campaigned pledging to reform the regulatory landscape, including the potential for a full repeal of the Department of Labor fiduciary rule. However, there has been very little clarity on how this will play out.

- Robo advisers. Automated services are helping more investors recognize that investments are becoming commoditized. Investors are increasingly convinced that, if you simply offer investment management, they don't need to pay you very much. Even worse, increasing numbers of investors are discovering they don't need you anymore.

- Mobility. All of us can do business and conduct transactions and get advice from just about anywhere now. The expectation is that you should be able to do it as well.

- Virtualization. When my partners and I talk with investors about introducing them to advisers, we often hear that they're happy to work with someone virtually. Many even prefer that approach.

- Aging and longevity. The likelihood of living to 100 is increasing. That presents enormous challenges for clients trying to ensure their wealth lasts, and also offers enormous opportunities for advisers offering creative solutions.

2. SELECT YOUR IDEAL CLIENT

Obviously, the way to move upmarket is to attract more wealthy investors and families.

It's important to understand that moving upmarket doesn't have to mean catering only to the very wealthiest few or adopting a family office business model.

Of the approximately 125 million households in the U.S., 4.5 million can be considered affluent (over \$1 million in investable assets), according to my firm's research, in conjunction with WealthEngine.

Within that group are many niches. However, when we drill down, we see that one group represents a disproportionate share: business owners. Affluent households headed by entrepreneurs total 1.6 million, making it the largest subset.

- One-third of U.S. households with investable assets of between \$1 million and \$5 million own businesses.

- Three-quarters of households in the \$5 million to \$25 million range own businesses.

- Among the truly wealthy – those with \$25 million or more – nine out of 10 are business owners.

My advice: Focus on attracting and serving successful business owners. They have complex needs beyond simply investing that you can position yourself to address.

3. CHOOSE A MODEL

There are four distinct business models in our industry, all of which work to varying degrees, depending on your personal and professional goals. Here's what they entail:

- Investment adviser: No financial planning. Totally focused on money management.

- Financial adviser: Limited proactive planning plus money management.

- Wealth manager: Combined investment and advanced planning that deals with noninvestment concerns of the affluent: estate planning, wealth protection, tax mitigation and charitable impact.

- Elite wealth manager: Bring targeted wealth management strategies to wealthy business owners and the very affluent.

Again, there's no wrong business model. But to put yourself in the line of money and move upmarket, the elite wealth manager model is going to work best.

4. POSITION YOURSELF AS AN EXPERT

Most advisers have hidden talents –that is, their talents are hidden from the people,

families and businesses that could benefit most from them. Chances are you know how good you are and how much you can make a difference, but too few other people know it.

Thought-leadership efforts can position you as a true expert among the client base you want to serve. Some ideas:

- Produce white papers, articles and ebooks that detail the specific financial challenges business owners face, and offer a process or methodology for solving them.

- Produce webinars on specific advanced financial strategies to help business owners (succession planning, buy-sell agreements, various types of insurance, and so on).

- Give in-person presentations to business owners and groups that serve them.

5. EXECUTE

Of course, positioning yourself as an expert in solving a group's financial issues won't get you far unless you can actually provide the solutions and services they truly need. In the business-owner niche, we find that a vast majority of successful entrepreneurs want to grow their wealth even more.

As an adviser, you can help them address an area that often gets short shrift – their personal wealth outside their business assets – using a broad range of strategies. Among the high-impact approaches I've seen work with business owners are:

- Private placement life insurance to reduce current taxes in an investment portfolio.

- Nonqualified retirement plans to invest significant amounts of money that grows tax-deferred.

- Captive insurance companies to protect wealth from being taken.

The desire to move upmarket is strong among all adviser groups – from newbies to highly experienced veterans looking to step confidently onto the highest rungs of success. Taking these types of focused, deliberate steps can put you in a position for strong and sustainable growth for years to come – and give you access to the type of clients you need to outrun the competition. **FP**

I recommend positioning your practice so you increase your average client size by 20% or more within the next 18 months.

John J. Bowen Jr., a *Financial Planning* columnist, is founder and CEO of CEG Worldwide, a global coaching, training, research and consulting firm for advisers in San Martin, California.



IN PRACTICE **FOSS**

Heading Off Hackers

After watching a client get victimized, I conducted a security audit. Here's how to defend your clients' information, says Kimberly Foss.

ADVISERS STORE LARGE AMOUNTS of sensitive personal and financial information, and clients deserve to know it's kept safe.

I assure clients that we store their sensitive data in a responsible and effective way, with numerous backups. I stress that we follow best practices, storing only the information that is necessary for our business and never intermingling personal and work documents.

However, I do not share the full details of our cybersecurity program with clients because that would pose a risk to our business. They understand that decision.

WITNESS TO AN ATTACK

An outside cyberattack on a client two years ago prompted me to get a jump on beefing up my firm's security. I happened to be visiting this client's office when he logged on to his computer only to discover he was a victim of the CryptoLocker virus, a program that targets computers running Microsoft Windows. Once in place, the virus encrypts the individual's data and demands payment to release a key which would un-encrypt it. The panic that my client went through was awful to witness.

Although the cyberattack had nothing to do with my business, I felt I had to help him recover his data. Together, we contacted several different companies that were experts in the CryptoLocker

virus. Their assessment was bleak. Because his data backup had failed, he would have to deal with the extortionists. In the end, he paid what they asked in bitcoin and his data was unlocked in two stages.

This painful experience prompted me to hire a security auditor to test my technology for weaknesses.

I selected a company called Viollis Group International, a consulting, investigation and crisis management firm specializing in security solutions for the affluent community and major corporations. After what had happened to my client, I wanted a full audit of my firm to find out where my walls were thin.

MORE ON PROTECTING YOUR FIRM AND CLIENTS FROM CYBER THREATS

P. 30

This meant turning to outside professionals for my audit rather than my internal IT people. After all, you wouldn't permit your accounting firm to audit itself. Viollis Group analyzed my business servers to verify that data had not already been compromised.

Also, it offered services that many advisers should avail themselves of, such as comprehensive vulnerability assessments and penetration to ensure they have not been breached and to identify any future weaknesses.

I happened to be visiting a client's office when he realized he was a victim of the CryptoLocker virus.

AN INFORMATION SECURITY PLAN

In addition to conducting these audits, Viollis Group drafted the written information security program that now guides our cybersecurity efforts.

Here are some details I don't mind sharing.

While the firm's chief executive, Paul Viollis, says "secured wireless" is an oxymoron, we did install advanced software to do all we could to secure communication from our office and homes and while traveling.

We encrypt client email by using Vaporstream for highly sensitive information to and from our clients. Vaporstream is an application that encrypts electronic communication in transit.

Therefore, emails cannot be copied, printed or forwarded, and can be read only by the intended recipient. Once read, messages are vaporized and no longer exist. We regularly test the effectiveness of cybersecurity controls, including encryption, and have developed incident response and recovery plans to deal with any unauthorized access.

We emphasize to our staff that email attachments from unknown or untrusted sources should never be opened and that links to websites should not be accessed. The same is true for known or trusted sources when the attachment and/or referral links are unexpected.

We train employees periodically with respect to cybersecurity and continually review company policies and procedures for protecting sensitive data on personal and corporate devices.

One employee, who reports directly to me, is tasked with oversight of privacy and information security.

We use two-factor authentication. Essentially, it's a simple feature that asks for more than your password.

For example, to log onto your Google account, you need to type in your password, wait for Google to send you a text message with a code, and then type that in

before you could access your account on a new PC or mobile device.

PROTECTING YOUR DATA

Cybercrime is a constant and growing threat, and we recognize that a financial firm may be a more attractive target than a grocery store. Accordingly, we operate with the National Institute of Standards and Technology's five-step cybersecurity framework: identify, protect, detect, respond and recover.

As cybersecurity becomes more of a focus of compliance exams, it is important to adhere to a comprehensive and disciplined program. Also, to ensure all the necessary resources are available when needed, cybersecurity remains a line item in our annual operating budget, right alongside computer hardware costs.

TOOLS YOU CAN USE

Looking at the bigger picture, protecting your data will become easier when cybersecurity becomes more instinctive. To that end, education that begins well before its time to secure a workplace is essential.

For example, the importance of using passwords should be something we teach our children, just as we instruct them not to talk to strangers and to lock the door when they leave the house. I'm considering offering a cybersecurity seminar for clients and their children to review threats and best practices to keep them safe.

Finally, protecting your data requires taking the time to stay up to date. Providers of cloud software offer a range of interesting and current white papers. Downloads are free and you can get a quick sense of the major issues and learn how some of their products work.

Additionally, FINRA has created a Checklist for a Small Firm's Cybersecurity Program to assist small firms in establishing their cybersecurity programs. And the SEC also provides cybersecurity guidance on its website.

FP

Cybersecurity remains a line item in our annual operating budget, right alongside computer hardware costs.

Kimberly Foss, CFP, CPWA, is a *Financial Planning* columnist and the founder and president of Empyryon Wealth Management in Roseville, California, and New York. Follow her on Twitter at @KimberlyFossCFP.



PRACTICE CONSULTANT **KAUTT**

Focus on Staff Goals

When you help your employees grow and thrive, your firm is sure to follow, Glenn G. Kautt says.

PART OF OUR JOB IS TO HELP CLIENTS overcome their reluctance to make financial decisions by reducing complexity and uncertainty. This allows them to feel confident they will achieve their desired outcome just by doing everything laid out in their financial plan.

The same is true when it comes to the talent at our firms: When we are able to help each staff member overcome their own doubts and reach their professional and personal goals, our business succeeds.

The first part of this success formula – helping clients – is taught in every CFP program. However, there isn't a complete course on how to help our staff members reach their own goals. And if you can't succeed at both parts of the formula, your business growth may stall, and your firm may stagnate.

What are successful firms doing to assure they're overcoming uncertainty and complexity for their own staff members, and developing effective to-do lists that will help their people grow?

A MULTIFACETED RESOLUTION

Many small businesses struggle to create a coherent plan or framework for developing their staff. To overcome this deficit, my firm, Savant Capital Management, focuses on the personal goals of our staff members, as well as professional development and performance.

Our multifaceted plan for each employee challenges them to describe in detail their

one-, three- and five-year life goals, both personal and professional.

To draw from one example of melding the personal and professional, a CFP working on our planning team is mentored by a senior professional who was hired from a law firm, where he was a partner and their estate planning expert. The mentee set a goal to attend law school.

His personal and professional goals aligned with the company values and goals, so he's now at law school while still working for the firm.

OBJECTIVE MEASUREMENT

Advisory firms may have performance-measurement systems, but most have no human-capital-development programs.

At Savant, advisers discuss objectives in the following areas: client experience and care; business development; community involvement; networking and centers of influence involvement; personal development; professional development and job-specific competencies.

Personal development metrics include reading both professional and non-industry-specific books, attending conferences and industry meetings for peer-to-peer networking and other individually developed objectives.

Job-specific competencies are for those who grow by managing others. Objectives and metrics include creativity, persistence, problem solving, work planning, attitude,

When we are able to help each staff member overcome their own doubts and reach their professional and personal goals, our business succeeds.

self-organization and, where it is appropriate, managerial effectiveness and persuasiveness. Our firm objectives include sharing intellectual capital or best practices through presentations, adviser communication meetings and committee assignments.

Community involvement includes working with a local philanthropic organization, with a focus on the position worked and the number of hours volunteered each year.

One of our employees, a mother who works full time at home, is active with our volunteering program and was tasked with calling organizations to verify that Savant employees were appearing for their volunteer duties.

At first, the work seemed “mundane,” she wrote in a report. But now, she continued, “I can easily say that most employees dedicate WAY more than the 25 minimum hours required for the grant. As I look at the list of grants and the number of hours that we ded-

icate to organizations and missions we are passionate about, it makes me very proud to be an employee here, knowing we truly are building ideal futures in many ways – even outside of financial planning and investing.”

It’s worth noting that, at most firms in our industry, salary is generally not the daily motivator. Rather, it’s the emotional satisfaction of having done a good job by helping someone else, whether it’s a client or colleague or member of the community.

How should this work in your firm? You can start by developing a framework that looks at topical areas, and modify them to reflect the strategic direction and needs of your firm.

Don’t ignore personal development areas. If you get stuck, engage an HR professional to help complete your planning guide. Everyone in your firm will be glad you made this effort, and the positive results should make it well worth the time spent. **FP**

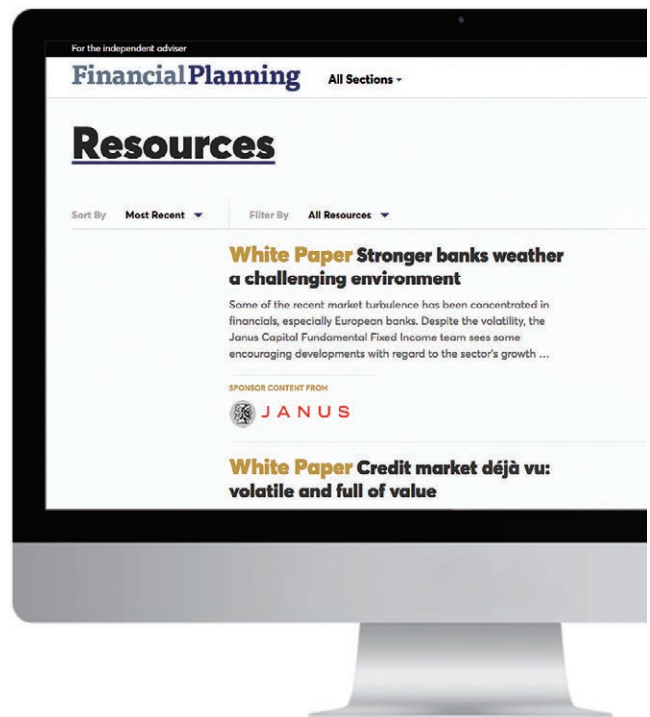
Our firm objectives include sharing intellectual capital or best practices through presentations, adviser communication meetings and committee assignments.

Glenn G. Kautt, CFP, EA, is a *Financial Planning* columnist, is a principal at Rockford, Illinois–based Savant Capital Management.

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**Financial
Planning**

Cetera and the ‘Client Experience’

The financial advice model “is primed and ready for change,” says Cetera CEO Robert Moore. One initiative: adding facial-recognition technology.

BY ANN MARSH

A RECONSTITUTED CETERA FINANCIAL GROUP, having emerged from years of turmoil, wants to set the tone among independent broker-dealers for a new generation of client-centric financial service.

“We think conditions are present for a firm to take a leadership position when it comes to the client experience,” CEO Robert Moore told *Financial Planning* in a joint interview in December with President Adam Antoniades. The model for financial advice “is primed and ready for change. ... We don’t view that as a threat to the industry. We view that as an exciting thing and a seismic shift.”

Moore, once considered a likely successor to Mark Casady as CEO of the country’s largest IBD, LPL Financial, made the remark the same week that Casady announced that he would retire after 14 years with LPL.

Casady’s departure follows a multiyear stretch during which LPL Financial has contended with lackluster stock performance, regulatory issues and ongoing technology problems.

The entire IBD sector has been struggling for years with compressed margins, increased compliance and technology costs, as well as consumer calls for greater transparency around the commission-based services that have historically formed the core of its business model.

Cetera has nearly 9,000 advisers, compared with some 14,000 at LPL.

Moore, who left LPL in March 2015, took over the top spot at Cetera last Sept. 12, replacing Larry Roth, whose

departure was positioned as a break from the recent years of exceptional turbulence at the firm.

A WILD RIDE

Cetera’s roller-coaster ride began in early 2014, when the private equity firm Lightyear Capital sold it to RCS Capital, a firm headed by nontraded REIT kingpin Nicholas Schorsch, for \$1.5 billion.

In all, Schorsch snapped up 10 BDs in a buying spree that left much of the industry breathless. Schorsch paid top dollar to cobble together a new company out of disparate pieces.

A subsequent accounting scandal at another Schorsch-owned firm affected public perceptions of his leadership at RCS Capital.

By the spring of 2016, RCS’ stock had collapsed and was delisted. The company cut its ties to Schorsch through a prepackaged bankruptcy, which restructured the firm.

Cetera has since shed two smaller BDs that Schorsch bought: VSR Financial Services and Investors Capital. In September, it said it would offload a third, the Legacy Group, early this year.

ACQUISITIONS UNLIKELY

Moore notes that Cetera would continue to grow, but probably not through acquisitions. It will instead focus on organic growth and attracting new affiliated advisers.

“Cetera is a team that has come through quite a lot and has demonstrated its resiliency,” Moore says, citing the firm’s new board, fresh injections of investor capital and a new leadership team.



“Cetera is a team that has come through quite a lot and has demonstrated its resiliency,” CEO Robert Moore says.

"We've certainly tested the strength of our relationship with our advisers through adverse times," Antoniades adds.

CAPITALIZE ON NEW TECHNOLOGIES

Moore suggested that Cetera is newly well-positioned to navigate one of the most substantial changes to face the financial services industry, with the adoption of the Department of Labor's fiduciary rule, which – barring derailment by the Trump administration – is scheduled to begin its phase-in in the spring.

The IBD is also primed to capitalize on new technologies, ranging from robo advice tools to leading edge software to increase advisers' EQ.

Early this year, some Cetera advisers will begin using facial-recognition software tools capable of reading the emotions on clients' faces as they contemplate various planning scenarios and questions. Moore predicts this tool will be "transformative. ... It really moves the needle in terms of the kind of dialogue that you can engage in with a client."

Like its facial-recognition software, Cetera's robo solution will be offered as part of an array of options for clients.

"It's important that it be integrated," Moore says. "I don't see it as a separate and distinct offering" from other services available to clients.

Cetera does not envision any robo service putting an adviser out of work.

"When a client calls up and says, 'My father just passed away'" and there's a large estate to transfer, he says, "that is not something you sort of plug into Siri."

FACTORING IN CHANGES

While Cetera looks forward to leveraging complex technological advances, it sees an unexpected upside to one of the other challenges facing the entire industry – the tightening regulatory environment, Moore says.

The changes are likely to drive cost savings for Cetera, which has also successfully navigated the loss of many lucrative prod-

ucts, such as nontraded REITs, frequently sold by its advisers, he adds.

"The market has already had a pretty significant correction in terms of alternative investments and higher commissionable products," Moore says "and we have absorbed that already."

Antoniades noted, however, that nontraded REITs – a class of investments that some other IBDs eschew as too expensive and without sufficient counterbalancing upside – are still being sold by Cetera advisers via T shares.

T shares, which were introduced specifically in response to new regulation of nontraded REITs, spread out the same level of commissions, often more than 10%, over time instead of charging them all upfront, which has been the norm for years.

When asked why Cetera elected to retain such high commissions in its retirement accounts at the same time that some larger players like JPMorgan Chase and Merrill Lynch were discontinuing their use, Moore said that commissions still have a place.

"There are situations where a commission-based activity is in a client's best interest," he observes.

He points out that Cetera does not have other lines of business such as banking services to offer. "All that says is that we are different," Moore says.

MISSED OPPORTUNITY

One industry consultant believes retaining commissions in retirement accounts was the wrong response to the fiduciary rule.

"Cetera missed the opportunity to make a stand," says Tim Welsh of Nexus Strategy.

But the IBD still has a chance to capitalize on this period of restructuring, Welsh notes, as the recent rough years continue to fade in the rear-view mirror, he says.

"Despite the overwhelming bad news facing IBDs in general," Welsh says, "they have a brief moment in time to prove their self-worth in resurrection mode. But if it doesn't translate into short-term results, they will be in a world of hurt."

FP

Early this year, some Cetera advisers will begin using facial-recognition software tools capable of reading the emotions on clients' faces as they contemplate various planning scenarios.

Rolling With the Changes

The industry is going through a time of rapid transformation and advisers must adapt, TD Ameritrade Institutional President Tom Nally says.

BY CHARLES PAIKERT

HAVING TROUBLE KEEPING UP WITH THE DIZZYING twists and turns of the financial advisory marketplace?

Get used to it. Advisers who don't adapt to a rapidly transforming industry will be left behind, warns Tom Nally, president of TD Ameritrade Institutional.

"You've got to be able to embrace change to survive," Nally says.

Technology, regulations, demographics, client expectations, pricing, competition and business models are all evolving, Nally pointed out in a wide-ranging interview with *Financial Planning*.

"There's a huge shift going on," he says, "that advisers have been slow to embrace."

HOW TO DRIVE NET NEW ASSETS

Planners "have to adapt to a new America" that is more diverse than what they've been used to, Nally notes. And an "enormous demographic shift" is resulting in a clientele that will have very different needs and demands.

As a result, advisers will have to articulate their value range more effectively and do a better job of differentiating themselves, Nally says.

"Consumers want life coaches, but advisers are still billing on assets under management," he points out. To drive net new assets, advisers must consider providing "white-glove service" and "create a client experience that is worth sharing," Nally says.

"Advisers have to make sure they are engaging clients where they want to be engaged," he stresses.

The commoditization of basic asset allocation and portfolio management by robo advisers is forcing planners to "elevate the value of other services," Nally says. "It's not about generating alpha any more. Clients are looking for partners."

Getting clients to pay more than the 25 to 40 basis point pricing floor set by robos represents "an existential threat" to



Tom Nally, president of TD Ameritrade Institutional, on a visit to the company's new Southlake, Texas, office.

advisers, Nally argues. The industry hasn't adjusted to new pricing realities, he adds.

New pricing models, including possibly billing on a client's net worth, have to accompany emphasis and awareness of value-added services such as financial life management, comprehensive planning and specialized planning options, Nally says.

ENCOURAGING TRENDS

There's also good news for advisers grappling with how to adapt to the future. No matter what happens in Washington and with the Department of Labor's fiduciary rule, the concept of an adviser as a fiduciary is a "secular trend" that's not about to be reversed, Nally maintains.

"You can't put that genie back in the bottle, and it's a huge opportunity for RIAs," he says.

In addition, Nally notes that the RIA market is the fastest-growing in financial services.

"RIAs have a nice tailwind," he says. "The secular trends are all moving to the independent advisory channel." **FP**

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

Steve Lockshin's New Venture

AdvicePeriod presents a new RIA platform model, which offers star power and IBD qualities. But there are a lot of different models out there.

BY CHARLES PAIKERT

HERE'S A TEMPTING PITCH TO ADVISERS: A 70/30 payout and 100% ownership of clients. That's the premise of a brand new platform, backed by a growth-minded RIA and one of the advisory business' biggest names.

The latest offering in a fiercely competitive marketplace comes from AdvicePeriod, a two-year-old advisory firm specializing in high- and ultrahigh-net-worth clients co-founded by Steve Lockshin, which has been quietly expanding for the past several months, adding partners and opening new offices around the country.

AdvicePeriod has just added its 10th partner, luring Todd Butler from Wescap Group, an RIA in Glendale, California. In December, Silicon Valley-based Katherine Simmonds, formerly with Stanford Investment Group, opted to join AdvicePeriod instead of going to Aspiriant, which is set to close its purchase of Stanford Investment.

The Los Angeles-based firm hopes to add one to two advisers a month, says Larry Miles, an AdvicePeriod principal and co-founder, along with Lockshin and Jonathan Straub. "We believe we can be one of the largest independent RIAs with this model," Miles says.

HERE'S THE PITCH

Advisers who want in must become W-2 employees; they earn 70% of the revenue they generate to run their business and pay themselves and staff. The remaining 30% goes to AdvicePeriod, which provides the new partner with operational resources, technology and compliance, administrative and back-office support.

Partners work under a unified AdvicePeriod brand with marketing support but own their own book. "There is no nonsolicit agreement," Miles says. "Partners own 100% of the value they create. If they want to leave, they can take clients with them, no questions asked."

When pitching to clients, financial planning and lifestyle goals are emphasized, not investment performance. Over 90% of the firm's fees are generated by a flat annual fee



Steve Lockshin, Larry Miles and Jonathan Straub at AdvicePeriod's Los Angeles office.

based on the complexity of the clients' needs, and not the standard percentage of assets under management, according to Lockshin.

"Commoditization of the investment side of the business is not ubiquitous – yet," Lockshin says. "But there is going to be a sea change in how consumers value their relationship with advisers. We think this approach helps advisers to cross the chasm from what they've been selling in the past to the kind of offering they need to present to clients now."

THE 'BIG UNKNOWN'

Matt Sonnen, a consultant who works with advisers looking to transition to an independent RIA, says he's impressed with what he's seen – with a caveat.

"Leading with financial planning and personal goals jumped out at me," says Sonnen, CEO of PFI Advisors and a former Focus Financial and Luminous Capital executive who specialized in setting up newly independent RIAs. "And saying that they 'believe in charging commodity prices for commodity services' really nails it in the age of the robo adviser. I was also impressed with their clear value

proposition and transparent compensation structure.

"The big unknown is management's capacity for deals," he continues. "Will they be able to execute on their plan and can they integrate many advisers at one time?"

Jeff Spears, who offers advisers à la carte operational platform support via his San Francisco-based firm, Sanctuary Wealth Services, gives AdvicePeriod above-average odds of success, with some question marks.

"We've seen what people want – a tool kit to run the business and compliance and

lon Wealth Management and Convergent Wealth Advisors, replies: "AdvicePeriod is a firm built for advisers, by advisers. Many IBDs and other platforms were started to resell financial products to advisers. That's a vendor relationship. There's nothing wrong with it, but we partner with our advisers and run the business together. And we do not lock up our partners and make it hard for them to leave."

AdvicePeriod isn't shy about touting one of its biggest assets: Steve Lockshin. Even the competition acknowledges his star

Once ranked *Barron's* No. 1 adviser, Lockshin is available to help partners close deals with high-end prospects.

Steve Lockshin: At a glance

Convergent Wealth Advisors. Founded 1994. Sold to City National Bank in 2007.

Fortigent (formerly Lydian Advisor Services). Co-founded 1996. Sold to LPL Financial in 2012.

Betterment Institutional. Co-founder, 2014.

AdvicePeriod. Co-founded 2014.

Barron's top independent adviser, 2011; ranked second in 2012.

operations services – and AdvicePeriod has a credible hook," Spears says. "Their appeal to breakaways will be limited because those advisers aren't being compensated for their book of business. And, down the road, advisers who have joined them and have gotten their bearings may start questioning the cost of what they're paying for and the revenue they're giving up."

LIKE AN IBD?

When asked to examine the AdvicePeriod offering, other executives characterized it as an independent broker-dealer model for fiduciary advisers instead of registered reps.

"It's the same basic support structure with a very high payout," says one senior executive who did not want to be identified.

Pushing back on the IBD comparison, Miles, who has worked at BNY Mel-

power: "Lockshin is the linchpin of that company," Spears says.

THE DIGITAL REVOLUTION

Lockshin co-founded Lydian Advisor Services in 1996, which became Fortigent, the investment management platform for HNW advisers that was sold to LPL Financial in 2012. A few years earlier, he founded Convergent Wealth Advisors and was CEO for 17 years and chairman for nearly three before the firm was sold to City National Bank in 2007. During that time, he was ranked as *Barron's* top independent adviser nationally in 2011, placing second the following year.

Lockshin was quick to embrace the digital revolution. He was an early investor in Betterment, a co-founder of Betterment Institutional (now Betterment for Advisors)

and an investor in the financial planning software firm Advizr and the digital aggregation firm Quovo since 2015.

To be sure, Lockshin doesn't hit a home run every time. He co-founded Advizent, an ill-fated consortium of advisers that was meant to influence – and profit from – marketing to consumers about wealth management, and he was non-executive chairman of Convergent when it was tarnished by a scandal involving a questionable private fund set up by CEO Dave Zeir, who committed suicide in 2014.

But there's no question that Lockshin is a draw.

The company makes it clear he is available to help partners close deals with high-end prospects, a benefit that appealed to Butler. "Steve's name brought me in the door," he says. "Everyone, including me, took notice when he was named *Barron's* No. 1 adviser. It's been a dream of mine to work with him."

HIGH-PROFILE COMPETITORS

Lockshin's appeal – and his considerable sales skills – notwithstanding, AdvicePeriod faces plenty of competition from a number of companies whose leaders have similar high profiles. These include Dynasty Financial Partners' Shirl Penney and Hightower Advisors' Elliot Weissbluth among platform providers and United Capital's Joe Duran and Focus Financial Partners' Rudy Adolf among RIA aggregators.

Similarly, the top executives of aggressively acquisitive – and rapidly expanding – RIA firms like Mariner Wealth Advisors (Marty Bicknell); Aspiriant (Rob Francais) and Savant (Brent Brodeski) are also bold-face names in the advisory world.

Lockshin thinks Carson Institutional Alliance, run by Ron Carson, another brand name in the industry, may have the business model closest to AdvicePeriod's.

But, he says, "[Our companies] have yet to run into each other," Lockshin says. "There's plenty of room for both of us out there."

Industry observers point out that the

appeal of the different platform models is that different approaches are often geared to different stages of advisers' careers as well as how they want to do business.

Breakaway brokers who want to maximize the value of their book are prone to pick a provider like Dynasty, Hightower or Sanctuary, while older advisers who want to monetize the value of their business tend to sell to buyers like United Capital or one of the RIAs with growing national footprints.

THE SWEET SPOT

The sweet spot for AdvicePeriod, which is self-funded out of profits and by its principals, is probably advisers like Simmonds who have a sizable book of business and crave autonomy but don't want to hang out their own shingle.

After examining Aspiriant's equity-ownership model, Simmonds decided the firm's buy-in procedure, financial commitment and ownership structure wasn't for her, and instead chose AdvicePeriod's more straightforward payout deal.

"I wanted to focus on organic growth and own my clients, but get the help that I need," Simmonds says. "And the legal agreement was very clean."

MORE TO COME?

Pershing Advisor Solutions CEO Mark Tibergien thinks the appeal of an AdvicePeriod-type of platform model will be widespread.

"In my opinion there will be a number of firms in the RIA business who accomplish what many broker-dealers have done – build a brand around a client experience, a market positioning and a process that is compelling for both advisers interested in coming into the profession and clients who feel more comfortable working with a known company," Tibergien says.

"The retail businesses of Schwab, Fidelity and TD Ameritrade have a head start in building national brands to serve consumers," he adds, "but there is opportunity for innovators with enough savvy and enough capital to compete well."

FP

AdvicePeriod is seen as an ideal landing spot for advisers who have a sizable book of business and crave autonomy but don't want to hang out their own shingle.

Ex-RIA Loses \$13M Arbitration

A former adviser's counterclaims for \$51 million in damages were also rejected.

BY ANDREW WELSCH

A BROKER-DEALER'S \$13 MILLION ARBITRATION win against an ex-RIA owner is a stark example of how complex business relationships can turn adversarial – sometimes leading to years of legal wrangling by firms and burned clients as well as bankruptcy.

The length of the arbitration dispute makes it even more distinctive: The case lasted for 142 hearing sessions stretching from 2013 to 2016.

"I don't see too many cases that stretch on for 70 days," says James Eccleston, a Chicago-based attorney who was not involved in this arbitration dispute.

This was the most recent bout in an ongoing series of legal battles stemming from a troubled investment strategy and the contentious relationship between former business partners C.L. King & Associates and William Nicklin, owner of NSB Advisors.

This particular round was important because there's a lot at stake for the participants; in a previous case a client won a \$10 million arbitration award against C.L. King. But in addition recouping losses through arbitration wins, the disputes also show how business partnerships can fall apart for unexpected reasons, even those between veteran advisers and established firms.

In the latest case, C.L. King sought damages for breach of contract against Nicklin regarding his personal brokerage account at the firm, according to arbitration documents. The suit does not apply to accounts he managed on behalf of his clients.

'EXTREMELY SOPHISTICATED, YET RISKY'

Nicklin is a veteran adviser, having begun his career at Alex. Brown in 1967, according to FINRA BrokerCheck.

He started NSB Advisors in Fishkill, New York, in 2009. Nicklin then entered into an agreement with C.L. King to provide technical resources to NSB and custody and brokerage services to its clients, according to court documents he filed when the RIA declared bankruptcy



MICHAEL CHU

in 2015.

Nicklin allegedly pursued an aggressive strategy in his personal account that relied heavily on the use of margin calls, C.L. King said in arbitration.

"Essentially, Mr. Nicklin's investment strategy was to maintain core holdings of long equity positions with a hedge provided by the spread of index option positions. Mr. Nicklin's strategy, through the use of margining the long positions and leveraging the short positions, was an extremely sophisticated, yet risky strategy," the firm told arbitrators.

Nicklin allegedly pursued a similar strategy in his clients' accounts, according to the firm and people familiar with the ongoing dispute between the parties.

Nicklin said in arbitration documents that C.L. King knew that he and many NSB clients "followed the same investment strategies and purchased the same securities after May 2009 when NSB's services agreement with C.L. King was entered into, since it was the NSB customers' broker."

According to court documents, NSB Advisors had

more than 700 client accounts and managed over \$1.2 billion in assets in 2012.

Albany, New York-based C.L. King says NSB Advisors managed accounts at the firm that held large debit balances and concentrations in stocks of two companies. C.L. King says it was concerned about risk factors and asked NSB Advisors to adjust its debit balances.

In January 2012, the C.L. King's CFO emailed Nicklin that his concentrated debit positions exceeded 25% of the firm's net capital.

He also told Nicklin he had to decrease his large margin positions to take pressure off of C.L. King's funding lines, the firm told arbitrators.

C.L. King further says that Nicklin failed to take care of margin calls against his personal account, despite repeated calls and emails from the firm.

His account's value plummeted from about \$55 million in December 2011 to \$15 million in April 2012, according to C.L. King, which liquidated it on May 15, 2012. The firm says it was forced to cover a shortfall of \$13 million.

The firm says that customer agreement forms and other documents clearly stipulated that the firm had the right to liquidate assets to cover margin calls and that clients are responsible for covering any shortfalls that occur.

UNCLEAN HANDS?

Steven Shore, an attorney at Gafner & Shore who represented Nicklin in arbitration, declined to comment on the case.

Nicklin denied C.L. King's allegations, according to arbitration documents.

He alleged that C.L. King's claims were barred in part because of the firm's actions against NSB Advisors' client accounts, which "prevented Nicklin, a manager of NSB, from being able to sell long positions in the Nicklin Account," according to arbitration documents.

"C.L. King knew, or should have known, that Nicklin, as a manager of NSB, could

not trade ahead of NSB's clients to get a better sale price, and that if Nicklin sold any of his long positions, his sales would influence the market by depressing the stocks and making it more difficult for his customers to sell their securities," Nicklin said in arbitration documents.

Among other allegations, Nicklin says that C.L. King inconsistently enforced margin and maintenance requirements against NSB clients' accounts. He also says that C.L. King sold the securities in his personal account at a 20% discount to Candace King, CEO of the firm, according to arbitration documents.

Richard Roth, a New York-based attorney who represented C.L. King, says that the securities had to be sold in order to meet a New York Stock Exchange call, and that the discount was the best and only offer on the table.

Nicklin asked the arbitration panel to deny the firm's claims and grant him \$51 million in monetary damages.

The panel rejected his claims and ruled in C.L. King's favor. Of the \$177,600 of hearing fees, the panel assigned all but \$600 to Nicklin. The arbitrators did not explain their ruling, as is customary.

"That sends a message," Roth says. "The panel issued the right decision."

But while this case is over, other clients are pursuing damages against the firms, according to attorneys familiar with the cases.

Ross Intelisano, a New York-based attorney at Rich, Intelisano & Katz, says his firm is representing a client in one such case, but declined to discuss it in detail. His firm previously represented the estate of John Montfort, an ex-NSB client who won a \$10 million arbitration award against C.L. King.

Of Nicklin's loss, Intelisano says that "it's very hard for an investment adviser who had unclean hands and caused much of the problem to win an already difficult customer debit case. It's hard to separate the two."

Among other allegations, Nicklin says that C.L. King inconsistently enforced margin and maintenance requirements against NSB clients' accounts.

FP

BY SULEMAN DIN

Every four years, Heron Financial Group completely tears down and rebuilds its technology platform. One big focus: A review of how every vendor handles clients' private data, says David Edwards, head of the New York-based advisory firm. Not all contracts are renewed. "We've told vendors, We can't work with you anymore because we're not confident our data is secure," Edwards says. "They don't like it, but there it is. We're fiduciaries. That means protecting your client against every threat."

From all sides, independent advisers are told that, to stay current, they must integrate the latest technology tools into their practice. They hear regular warnings, too, about cybertheft schemes and protecting their businesses against malicious electronic attacks.

Few advisers, however, are cautioned about the risk they face when plugging in those same tools. An exposure of client data can trigger tough regulatory action and costly lawsuits, not to mention reputational harm, even if the firm wasn't the source of the error.

It's not just hackers or a rogue employee RIAs have to be vigilant about. In its annual report on data breaches, Verizon deemed unintentional breaches so common that it created a category for them: miscellaneous errors. Verizon counted over 11,300 incidents last year, with almost 200 confirmed breaches. In a majority of cases, a client discovers personal data has been made public before the firm does. The financial sector suffered over 1,300 data breach incidents last year, Verizon says.

To ensure client data safety, Edwards says advisers must scrutinize contracts signed with vendors, conduct regular follow-ups, have a cybersecurity policy in place and even purchase cybersecurity insurance.

BREAK

A portrait of David Edwards, a middle-aged man with dark hair, wearing a dark suit jacket, a white dress shirt, and a red tie with a blue and white paisley pattern. He is looking slightly to the right of the camera with a serious expression. The background is dark and out of focus.

Few advisers realize they are liable for data breaches, even if it's not their firms' fault. For **David Edwards** of Heron Financial Group, that means getting tough on tech vendors early and often.

POINT

"Everything needed for identity theft is neatly packaged within your own computer systems," Edwards says. "That's why we go through that process of up-arming everything we do."

WHO'S REALLY RESPONSIBLE?

The modern RIA uses an array of tools – CRMs, form generators, portfolio management and risk-analysis applications, to name just a few – that access client data. These tools give advisers deeper insights about clients, as well as the means to run their practices more efficiently.

Though the developers of these tools are private companies competing for the same advisers, they have collaborated on building programming integrations, creating joints and fittings that are all part of a virtual data pipeline extending from an RIA's computer and servers to those utilized by tech vendors, and ultimately to custodians and brokerages.

The data flow goes both ways. Custodians and brokerages generate trade

as the fiduciary, is responsible for safeguarding it.

Take, for example, the case of R.T. Jones Capital Equities Management of St. Louis, which, according to the SEC, suffered a data breach in July 2013 when a third-party-hosted web server it was using was hacked.

PAYING THE PRICE

Thousands of client records were exposed in the incident, which was traced back to a China-based attacker. Though the SEC noted that no client was harmed financially, the firm settled with the SEC for \$75,000 in 2015 for not having a cybersecurity policy in place.

That case makes it clear that advisers, not technology providers, will be held responsible by securities regulators for a breach, says Bryan Baas, managing director of risk oversight at TD Ameritrade Institutional.

"It comes down to, 'Who is the regulator regulating?'" Baas asks. "They only go after who they have

vendors is to include clauses stating that they are not liable for any data breaches that may occur.

"Every party tries to obfuscate their responsibility," Kvitka says. "Everyone tries to waive all liability from the beginning of time to the end of time. It's just a matter of if that holds up in court."

The challenges presented by securing client data as its uses and volume increases should keep advisers up at night, compliance pros say.

"The liability is so amorphous," says Chad Christensen, chief compliance officer of Semper Augustus Investments Group in Highlands Ranch, Colorado. "What do you do about it? What can you control? People sit and worry about China when, probability wise, it's going to be something relatively simple that will become a problem. You'd better be in control of what you can control."

Expect more litigation between RIAs and vendors.

Advisory firms will begin pushing back on bearing the responsibility and costs in the event of a breach they did not cause directly, says Lisa Marsden, president of the Miami-based compliance consulting firm Coulter Strategic Services.

According to the cybersecurity firm SecurityScorecard, 16% of firms using cloud server providers received a failing grade in terms of updating their defenses regularly against attacks. "You have a certain level of responsibility to keep your clients' information safe," Marsden says. "But there are different sources of sensitive client data – from the custodian, from the portfolio management software – so definitely the ownership can be shared."

NARROW THE LIABILITY GAP

Though the idea of bearing responsibility for safeguarding client data

"YOU'RE THE FIDUCIARY. YOU'RE SUPPOSED TO PROTECT YOUR CLIENTS' INFORMATION."

– BRYAN BAAS, MANAGING DIRECTOR OF RISK OVERSIGHT AT TD AMERITRADE INSTITUTIONAL

and transaction data for RIAs that they download. It's a system that has developed and expanded over time organically, and it works.

But there's a slow-burning industry debate over data ownership and the role it should play should that piping spring a leak, and client-sensitive information (account numbers and balances, Social Security numbers, birthdays) becomes exposed.

Most tech providers, custodians and brokerages state in documents and business agreements that an RIA is the owner of their clients' data and,

authority over.

"Legally, you could argue the vendor screwed up, and that it's not your fault. But the regulator has no authority over the vendor. You're the fiduciary. You're supposed to protect your clients' information."

'AMORPHOUS' LIABILITY

Advisers will find little protection in their agreements with their tech providers, notes Cary Kvitka, a securities attorney with the Lawrenceville, New Jersey-based firm Stark & Stark.

Standard industry practice among

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a fund is derived from a weighted average of the performance figures associated with its three-, five- and ten-year (if applicable) Morningstar Rating metrics.

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AB Intermediate Diversified Municipal Portfolio was rated 5 stars among 172, 147 and 94 funds in the category for the three-, five- and 10-year periods, respectively.

AB High Income Municipal Portfolio was rated 4 stars against 142 and 119 funds in the category, for the three- and five-year periods respectively.

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AB Income Fund was rated 5 stars against 869, 759 and 541 funds in the category for the three-, five- and 10-year periods, respectively.

AB Discovery Value Fund was rated 4 stars against 337, 301 and 207 funds in the category for the three-, five- and 10-year periods, respectively.

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while a vendor handles it might seem onerous, there are a number of steps that can minimize risk to clients and narrow the liability gap, too.

The first step is effective information, says Michael Delgass, CEO of New York-based Sontag Advisory.

"It doesn't mean you have to learn how to code security software, but you have to know more about the tools that you are using, where to go for help and how to stay informed where things are changing," Delgass says.

"For example, more people are going to work remotely. So it's increasingly important to understand where they are pulling down data from, where that data is being stored and the measures you have to protect that data. As you allow people to do more things with technology, you have to know the threats to those areas, too," he adds.

Advisers should take inventory of all client data they share and identify who has access to it internally and externally, Marsden suggests.

That can help determine vulnerability and risk among parties, as well as pave the way for more-detailed inquiries into whom your vendors share that data with, how they transmit it and where they store it.

That effort takes time. "You can't just pick it up on a weekend, as many advisers tend to do," Marsden says. "You should have a process."

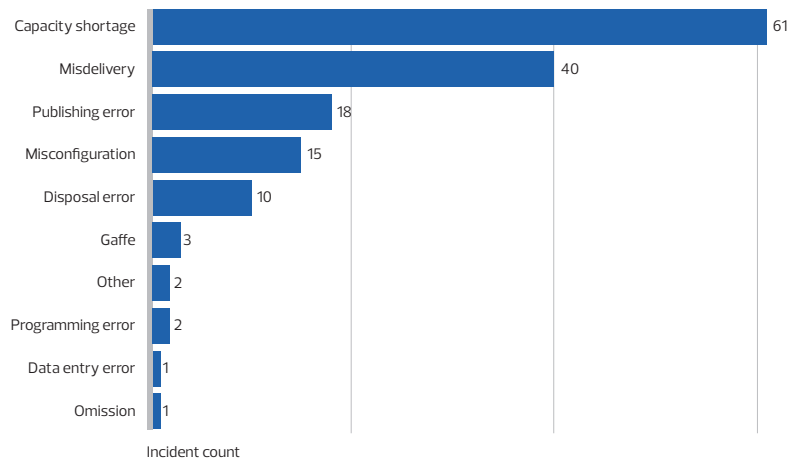
NEGOTIATE, NEGOTIATE

Knowledge and structure will help firms to know their vendors better and to ask smarter questions about how client data will be handled, Delgass adds.

That's crucial in the due diligence process, not only in vetting a vendor, but also in being able to scrutinize vendor contracts with data security in mind.

Any contract, for instance, should

Top 10 Miscellaneous Errors



Source: Verizon 2016 Data Breach Investigations Report

spell out who has the responsibility to notify affected clients in the event of a breach, Marsden says.

At his firm, Delgass says, vendors are pushed to explain in detail their data-handling procedures, including how they acquire files, what confidentiality agreements their employees sign and how they control clients' information when they access it.

And they push back against the standard liability clauses.

"Any contract is an opportunity for negotiation," Delgass says. "We read the clauses, and we changed them. Those are a starting point, not an ending point, if you're doing things right."

Marsden agrees, noting that she counsels her clients to seek added protections in their agreements with vendors, whenever possible.

"Nobody can guarantee anything 100%, and every party is going to be different," she says. "But you should push back to get an agreement that you will at least get help if a situation occurs, especially if the circumstance comes under them."

There are technical barriers that advisers can place around clients'

data, such as encryption, protected servers with redundancies to store information and more-secure platforms for communicating with clients, says Edwards of Heron Financial, who sits on the advisory board of eMoney Advisor.

TOUGHER MEASURES

Having tougher measures means that advisers may have to allow for an adjustment period on the part of clients, he adds.

His firm adopted encryption for all outbound email, but had to stop because most clients could not open the correspondence.

And then there is paperwork: Every RIA should now have a cybersecurity policy, and it should have insurance against liability claims, Stark & Stark's Kvitka says.

In September, the SEC proposed rules requiring advisory firms to have cybersecurity programs. The SEC and FINRA have increased examinations of firms' digital controls, with a greater focus on cybersecurity.

Crucial in defending against a breach claim is being able to demon-

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strate that an RIA firm made the best effort possible to reasonably determine the safety of its clients' data, Kvitka says.

"A focus will come on what did you do before you let a vendor access your data," he says. "Advisers need to have as much information as possible, as specific as possible, to say they were confident that clients' data was secure. The more you know, the more

always a lack of effort on an adviser's part. Often, the vendor dodges some data security questions, either by offering formulaic responses or begging off specific requests, citing proprietary concerns.

"One thing I wish I could see more from vendors is to be more understanding and willing to dedicate time to the adviser due diligence process," notes Michelle Thetford, vice presi-

Junxure and the wealth management firm Private Ocean.

And vendors who are integrated with the biggest custodians and brokerages have already gone through rigorous testing of their data controls, he adds.

Vendors do acknowledge the challenges facing RIAs as the responsible stewards of clients' data, says Eric Clarke, CEO of Orion Advisor Services, which develops software and adviser platforms.

Attempting to develop best practices on how to handle data, Orion and other providers are working on a proposal for a private network to communicate clients' data more securely, Clarke says. Another proposal would reduce the amount of personal information transmitted between vendors and custodians.

EQUAL RESPONSIBILITY

As an adviser and technology provider, Friedman sees equal responsibility in making sure clients' data is kept safe.

"Rather than get into a debate about who owns the data, I believe everyone who touches it has an ownership stake in it," he says.

It's a point that Heron's Edwards is willing to concede.

Just five years ago, his six-employee firm had no budget for cybersecurity. But in the past year alone, he has spent \$60,000 on cybersecurity measures.

Advisers, Edwards says, have to commit to staying on trend with best practices in technology, and they also have to commit dollars.

"You cannot hide from this," he says. "The upside to not spending on data and cybersecurity is that you'll save money. But the downside is that, if there's a breach, you'll be gone in an instant."

FP

"THE MORE YOU KNOW, THE MORE YOU CAN DOCUMENT, THE SAFER YOU ARE."

— CARY KVIKKA, SECURITIES ATTORNEY AT STARK & STARK

you can document, the safer you are."

One source Kvitka studied for insights into developing a cybersecurity policy: the health care industry's stringent standards for handling confidential patient information under the HIPAA law.

The need for information shouldn't stop once a partnership has been agreed upon, warns Dan Skiles, president of the San Diego-based custodian Shareholders Service Group, and an FPA board member.

Skiles says the FPA recently quizzed members on how they work with vendors and found that many did not keep up their initial checks.

'ONE AND DONE'

"After they go through the due diligence and the agreement, they have very little work done on the follow-up, as it relates to making sure the data is safe, and checking in on a regular basis to make sure there have been no breaches," he says. "Not even annual checkups with their vendors for their own documentation to show their clients; it's sort of one and done."

This lapse in discussions isn't

dent of client strategic solutions at Schwab Advisor Services.

"It's very common, especially among larger vendors, to not be very flexible with due diligence questions," she adds. "Advisers are ready to spend the time, but what they get is a canned, one-page answer. Vendors don't want to engage in a dialogue. They need to understand advisers are being held to a much higher standard. They can't use a vendor if they aren't confident in them."

TD Ameritrade's Baas acknowledges the difficulty that small RIA firms may encounter when dealing with vendors in their efforts to get more assurances about data.

He suggests those firms consider TD's approach to integrating with vendors. "We give them our requirements for transmission of data," he says. "If the vendor says, 'I can't do that,' we will not do business with them."

The process need not be adversarial, however.

Advisers need to understand that tech vendors are deluged with due diligence requests, says Greg Friedman, president of the CRM provider

Cybersecurity and Your Practice

Guarding client and firm data can help protect a firm from regulatory penalties.

BY DONALD JAY KORN

YAHOO MAY NOT BE A FINANCIAL SERVICES FIRM, but investment professionals everywhere no doubt took notice late last year when it belatedly disclosed the biggest known data breach in internet history – over 1 billion accounts.

When hearing about such breaches, advisers should do the math and realize just how vulnerable they and their clients are.

“Advisers possess a repository of client names, account numbers and other data that make them high-value targets for hackers,” says Sanjiv Bawa, founder and CEO of Chi Networks, a Chicago-based IT company. “In many cases, financial advisers have documents stored on their computers that have this information.”

Eric Kies, the chief compliance officer at the Planning Center, in Moline, Illinois, says he has been surprised to learn “how sophisticated and/or persistent the cyber criminals can be, and how sophisticated the cybercrime black market has become.”

Rich Feight, founder of IAM Financial in Grand Rapids, Michigan, echoes this alarm. “I can tell from our firm’s website, my blog and my email that there has been a huge

increase in brute force attacks,” he says. “Reports from our website provider indicate 30 or 40 a month, often of foreign origin,” from cyberthieves seeking clients’ information.

As an example, Bawa recalls a news account of a hacker who broke into a client’s computer and obtained all the data needed to impersonate the client. “In a deceptive email,” Bawa says, “the hacker tricked the client’s financial adviser into wiring \$58,000 to the hacker.”

Such incidents can damage a firm’s reputation, as well as its relationships with clients, and possibly lead to expensive litigation. Moreover, the financial damage may be considerable. “The authoritative IBM/Ponemon study found that the financial sector ranks third in the per capita data breach cost,” Bawa says, behind health care and education.

REGULATORS’ REQUIREMENTS

Cybersecurity risks are increased by the peril of running afoul of federal and state regulators. Bawa points to remarks last year by then-SEC chairwoman Mary Jo White, who told Reuters that cybersecurity is “the biggest risk facing the financial system.”

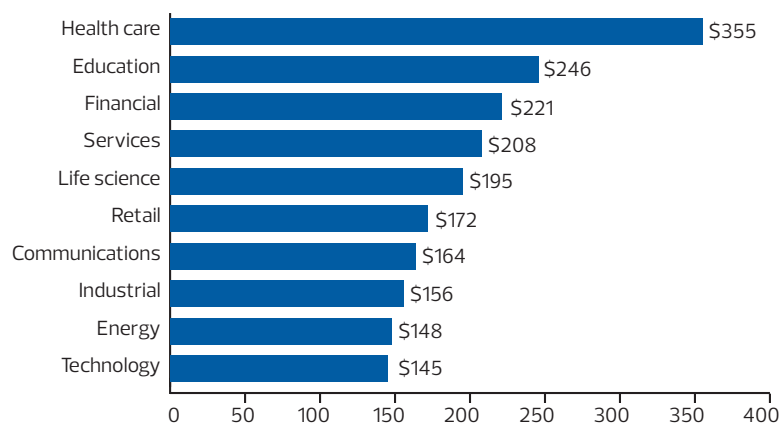
White revealed that SEC examiners were doing sweeps of broker-dealers and advisers to assess their defenses against a cyberattack. In all likelihood, planners should expect during regulatory visits a review of their cybersecurity policies and procedures.

Indeed, the SEC website prominently puts a spotlight on cybersecurity. Among the listed regulations is Regulation S-P, which requires registered broker-dealers, investment companies and investment advisers to “adopt written policies and procedures that address administrative, technical and physical safeguards for the protection of customer records and information.”

Failures to safeguard client data can be costly. “In one case,” Bawa says, “an investment advisory firm agreed to settle charges by the SEC that it failed to establish required cybersecurity policies in

Cost of Data Breaches

Per capita impact of cyber incidents, globally



Sources: IBM, research conducted by Ponemon Institute, 2016

advance of a security breach that compromised customer data.”

The firm was fined \$75,000 by the SEC, which said the firm violated the “safeguards rule” by failing to adopt any written policies and procedures to ensure the security and confidentiality of personally identifiable information of about 100,000 individuals,

“I CAN TELL FROM OUR FIRM’S WEBSITE, MY BLOG AND MY EMAIL THAT THERE HAS BEEN A HUGE INCREASE IN BRUTE FORCE ATTACKS.”

— RICH FEIGHT, IAM FINANCIAL

including thousands of clients.

Among other rules and regulations to protect client information, Bawa points to the principles and effective practices mentioned in FINRA’s 2015 Report on Cybersecurity Practices.

For example, the report states that “a sound governance framework with strong leadership is essential. Numerous firms made the point that board- and senior-level engagement on cybersecurity issues is critical to the success of firms’ cybersecurity programs.”

According to Bawa, the principles in this FINRA report are not legally binding, but are intended to create a “culture of compliance” grounded in “explicit and implicit norms, practices and expected behaviors that influence how firm executives, supervisors and employees make and implement decisions in the course of conducting a firm’s business.”

HELP WANTED

Advisers may have the capability of handling cybersecurity in-house, or they may need to go outside for the necessary expertise.

“At its founding,” Kies says of the Planning Center, “our firm hired an IT consulting firm to help manage our technology and servers. That firm,

along with news in industry publications, helps us stay up to date with our technology, business continuity and cybersecurity plans.”

Other advisers report recent efforts to bolster their barriers. “After evaluating several options that other advisers have found successful, we have chosen a cybersecurity solution that

meets several of our needs,” says Melissa Sotudeh, a wealth adviser and chief compliance officer at Halpern Financial in Rockville, Maryland. “Those needs include security, compliance recording and ease of use for our team. Most financial advisers face similar cybersecurity challenges, so asking others in our network was a good starting point. From there, our due diligence process helped us to select a vendor.”

For any outside vendor, Halpern Financial requires documentation of the security processes, including testing and certification or attestation.

“We also have a checklist to ensure that any vendor we use has physical and cybersecurity protections up to our standards,” she says, “which include a formal risk-assessment program, third-party audits, documented information security procedures, encrypted file transmission and storage. We even ensure that the organization does background checks on its employees.”

Sotudeh’s firm ended up with a vendor she describes as “an all-in-one cloud workspace providing compliance-required document storage capability as well

as cybersecurity protections and IT support.”

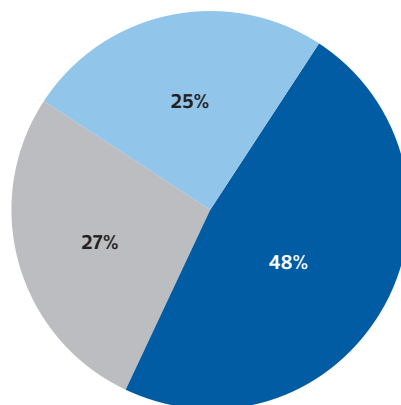
Elyse Foster, founding principal of Harbor Financial Group in Boulder, Colorado, reports that her firm did not hire a specific cybersecurity expert after a previous consultant retired. “However,” she adds, “when hiring our current IT consultant, experience and awareness of cybersecurity was one of the main focuses when making our decision. It was imperative to hire a consultant who has experience in the financial industry and who is aware of the growing issues facing our business.”

The new consultant, who heads an independent IT company, is on a retainer for server maintenance, according to Foster.

“He watches the system for intruder alerts, possible breaches and system success at blocking the malware or other threats,” she says. “In addition, he provides other assistance, such as the instillation of our

Cause of Data Breaches, Globally

More than a quarter of incidents are caused by IT and business process failures



- Malicious or criminal attack
- Human error
- System glitch

Sources: IBM, research by Ponemon Institute, 2016

new malware software, on an as-needed basis.

Besides hiring this IT consultant, Foster's firm has assigned a team member to be its internal expert on cybersecurity. "She is tuned into various news feeds and regular updates on this subject," Foster says. "Then, as everyone on our staff sees articles or additional information that we think might be pertinent, we channel it through her. This team member, in turn, has professional contacts to run the information by and verify that we are covered, or help her look for other updates to keep our client and company information secure."

FOLLOWING THROUGH

With or without a designated in-house cybersecurity specialist, an outside professional can help with continuous precaution.

The engagement with Halpern Financial's consultant, for example, includes a program of educating employees about data security, with updates about new threats. "We have ongoing cybersecurity training

throughout the year," Sotudeh says. "When the workspace was implemented, all of our employees were trained to use it securely. Procedures were established to ensure the most secure usage."

Kies says his firm has an extensive array of new procedures implemented to improve cybersecurity. On the list

"WHEN WE TOOK OUT A CYBER POLICY IN 2015, WE DISCOVERED THAT SOME POLICIES DON'T COVER RANSOMWARE."

— ELYSE FOSTER, HARBOR FINANCIAL GROUP

are better firewalls; more-advanced anti-virus, anti-malware, anti-spam email filtering and archiving; a more sophisticated backup system for its servers; better password management features; and password vault implementation. "Our IT firm also provides end-user training on common mistakes," he says.

At Harbor Financial, the result of hiring an outside expert has been a two-step process to strengthen cybersecurity. First, the firm created a list of

procedures that were already in place. "They included having strong firewall protection, robust anti-viral software and spam filters," Foster says. "We use encryption software when emailing sensitive client information, and use tokens when logging onto Schwab."

The second step, new safeguards, includes more-extensive wire pro-

cedures and ongoing education for employees, who are reminded about taking care when opening files in suspicious emails.

"In addition," Foster says, "we have protocols for any work done remotely, we continue to move to more cloud-based software and we maintain cybersecurity insurance coverage." As yet another precaution, Harbor Financial has separated its phone and internet services.

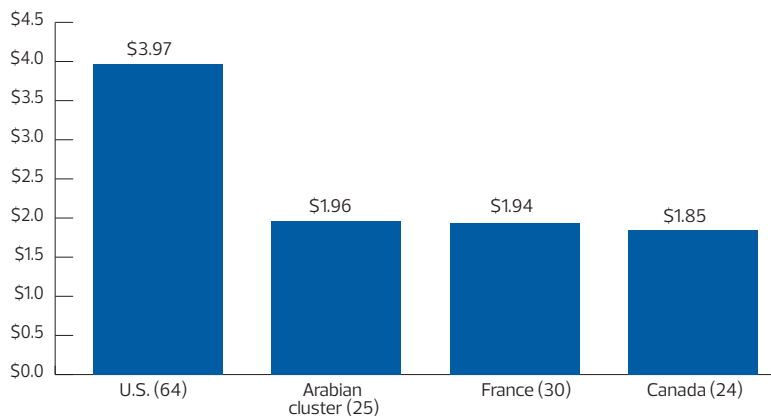
"We have learned that the threats to our company are very real and need to be covered by insurance," Foster says. "However, we were surprised that these items are not covered in a standard business policy. When we took out a cyber policy in 2015, we discovered that some policies don't cover ransomware. In the event of a breach, some policies might not cover our business loss of cash, for example, even though they might cover losses in client accounts. It is hard to keep up with the risk coverage when the risk itself is rapidly changing."

Unfortunately, those changes don't seem to be slowing, so advisers may find themselves needing astute advice themselves in order to avoid cyber catastrophe.

FP

Lost Business Costs

U.S. firms paid the highest price for losing customers after a data breach



Source: IBM, research conducted by Ponemon Institute, 2016

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

Learning From Her Past

Adviser Zaneilia Harris seeks out clients who resemble a former version of herself — young and single African-American women.

BY KATHY KRISTOF

THE FIRST FINANCIAL DECISION ZANEILIA

Harris made in life turned out to be a costly mistake. When her grandmother, who raised her, asked whether they should pursue Harris' estranged father for child support, Harris petulantly replied, "No."

If he didn't want to be part of her life, she thought they should have no contact — financial or otherwise.

"It was an emotional choice — not one that I would have made now," she says.

Looking back, it was not surprising that Harris made a bad financial choice. After all, she was 8 years old at the time.

What was surprising was that Harris' guardian left the decision to a third-grader — and abided by it — even though their family struggled with money throughout all of her young life.

More than three decades later, after working as an accountant, a consultant and a stockbroker, Harris went back to school to get financial planning credentials so she could help people like the grandmother who raised her make smarter choices about money.

"What is driving me is having watched my grandmother suffer," she says. "My grandmother was always stressed out about money — always. It was a horrible way to live."

AN ATYPICAL STRUCTURE

Harris, who is now 45, set up shop in Upper Marlboro, Maryland, a small town with one of the wealthiest predominantly African-American populations in the country.

Although her average client has between \$100,000 and \$500,000 in liquid assets, she

says they are not accustomed to handing over their money for management or paying upfront fees for financial advice. This prompted her to structure her practice in an atypical way.

"I have to be original," she says. "If I wanted to work with people who looked like me, I couldn't build my practice the way that other people were doing it."

Consequently, Harris cobbled together a half-dozen different payment models.

Clients can choose to compensate her by the hour, via retainer, by assets under management or through commissions she earns by selling life, health, disability and long-term care insurance.

In addition, Harris sponsors events, such as finance and fashion shows at Talbots and an upcoming four-day spa retreat in Northern California's wine country.

Though neither the fashion shows nor the retreat would make sense if she wanted to bill at her normal \$250 hourly rate, Harris hosts the events as a client service.

She says the professional women who come to her for advice need financial education and the best way to get it to them is in a fun, friendly and supportive environment.

"I try to think outside the box to reach women like me," she says. "If I were on the other side of the table, how would I be able to learn what I need to know?"

EDUCATION IS KEY

Education is a key part of her practice, because Harris seeks out clients who resemble an earlier version of herself — young and single African-American women who are striving to

PRACTICE PROFILE



Zaneilia Harris

President,
Harris &
Harris Wealth
Management
Group

Upper Marlboro,
Maryland

Credentials: CFP

Experience:

Accountant,
consultant
and securities
saleswoman before
starting her firm in
2009

AUM: \$4 million

How I see it: "I have to be original. If I wanted to work with people who look like me, I couldn't build my practice the way that other people were doing it."

make wise choices in an environment where seeking advice about money is uncommon.

More than half of her current clients are single minority women, she says. Many of them grew up in families with limited financial role models, like her own.

"I am just getting comfortable with talking about the family history that molded me," Harris says. "For so long, I was ashamed. But as you share different pieces of your life, you realize that your background isn't unique."

Indeed, Harris says she has begun to realize that her upbringing resonates with members of her community.

The only child of a single mom, Harris was raised by her grandmother in a rural town in Southern Virginia.

Her grandmother, a seamstress, worked full time, leaving Harris and her cousin, who was two years younger, to fend for themselves after school.

During the summer, a neighbor "babysat" by having the youngsters pick tobacco at a nearby field.

Harris, then only 8 or 9 years old, says she remembers never being able to completely rid her hands of the tobacco oil, with the bitter taste tainting everything that she ate over the summer.

The tobacco picking ended when an aunt reminded their neighbor about child labor laws, but Harris says she has been working in one way or another ever since.

FINDING HER PURPOSE

After high school, Harris studied accounting at St. Paul's College and got a job working for the Department of Defense in an internal auditing division.

She later joined the Big Four accounting firm PricewaterhouseCoopers and had a successful consulting career. But even as she took on increasingly responsible and lucrative positions, she was dissatisfied.

Friends at home and work had been nudging her toward financial planning, so she decided to try her hand at selling invest-

ments. She got a job as a broker at Edward Jones, later moving to PNC and then to Merrill Lynch.

She hung out her own shingle in 2009, and, with the economic and psychological support of her husband, she went back to school to complete the coursework necessary to pass the CFP Board exam.

Her practice has a range of offerings, from full-service financial planning to investment management.

Hourly clients can hire her to handle simpler questions about big financial transactions, such as buying homes and cars, or how to handle an inheritance.

UNUSUAL REQUIREMENT

When it comes to investment management, her one unique requirement is that each of her clients acquires at least a few individual stocks.

She doesn't have a recommended investment list that she's touting. Instead, Harris insists that clients think about the places they shop, the things they buy, and the products and services they consume every day. She then urges clients to pick a few companies that Harris will research fully on their behalf.

Owning individual stocks is a key to understanding how the entire investment universe works, she explains.

When she asks clients why they shop at a particular store, drive a particular car or use a particular service, they usually respond with lots of fundamental reasons, from quality to convenience, she says.

Explaining how those same factors work to the advantage (or disadvantage) of shareholders helps build her clients' confidence and makes them better investors.

"When I worked for [other firms], our clients invested, but they didn't understand what they were buying," Harris says. "No one ever took the time to explain it. I think I have an obligation to my clients to educate. I want to be available to do that."

FP

"I am just getting comfortable with talking about the family history that molded me. For so long, I was ashamed. But as you share different pieces of your life, you realize that your background isn't unique."

Kathy Kristof, a *Financial Planning* contributing writer in Los Angeles, also contributes to *Kiplinger's* and CBS MoneyWatch. Follow her on Twitter at @kathykristof.

A Tax Nightmare

There are limits to how much clients can contribute to IRAs in any year. Exceeding these thresholds can result in costly penalties.

BY ED SLOTT

WE'RE QUICKLY APPROACHING THE TIME OF YEAR when most contributions are made to IRAs and Roth IRAs. It's also the time when tax preparers see how much clients have contributed to their IRAs.

But there are limits to how much can be contributed to an IRA, and exceeding them can result in costly penalties. Advisers should monitor their clients' contributions to make sure they are legal, and help them avoid expensive consequences.

Such was the unfortunate fate for two taxpayers in an court ruling handed down last year.

In 2007, Michael and Christina Wu sold their Illinois home and each deposited \$200,000 of the profits into their respective traditional IRAs. The problem with this move may seem obvious to advisers, but not to all average taxpayers.

This created tax problems for the Wus, because in 2007, each of them was allowed to contribute a maximum of \$4,000 to an IRA.

A PENALTY HIT

Each \$200,000 IRA contribution created an excess contribution for 2007, which was not removed by the deadline, which was Oct. 15, 2008. The Wus faced the 6% excess contribution penalty, along with penalties for filing Form 5329 late, and interest plus penalties on the late payment.

The Wus realized their mistake in early 2010, informed the IRS and corrected the problem by withdrawing the excess contributions from their IRAs. They paid the penalties for 2007 through 2009.

Although they conceded liability for the first two years, the Wus sought a refund for tax year 2009, arguing that they had avoided the 6% excess contribution penalty by removing it before the April 2010 filing deadline for their 2009 tax return.

The IRS disagreed with the Wus, and the case was brought to court (*Wu v. United States*). The district court sided with IRS, and the Wus appealed.

WHAT IS AN EXCESS CONTRIBUTION?

As the name implies, excess IRA contributions are those that exceed the limit that a taxpayer can contribute to an IRA for the year.

Examples include IRA contributions that exceed the maximum annual dollar limit (for example, \$5,500 for someone under age 50 for 2017), as well as rolling over an amount that isn't eligible (for example, a required minimum distribution or a rollover after the 60-day clock has expired).

Whenever clients roll over funds that aren't eligible, the ineligible amount is automatically treated as an annual IRA contribution. In the Wus' case, they rolled over money they received when they sold their house.

Excess contributions will be subject to the 6% penalty each year until they are fixed. The only way to fix the mistake and avoid the penalty is to withdraw the excess, plus or minus the earnings (what the IRS calls the

net income attributable) by Oct. 15 of the year after the year for which the contribution was made.

So if your client makes an excess IRA contribution for 2016 in April 2017, he or she has until Oct. 16, 2017, (Oct. 15, 2017, is a Sunday) to fix it and avoid the penalty. If the excess is not fixed by the deadline, the penalty applies each year that the amount is in the account, as of Dec. 31, until it is fixed.

The penalty is paid by filing IRS Form 5329, which can be filed with your client's tax return or as a stand-alone return. Unlike most other tax forms, Form 5329 has its own signature line, like the Form 1040. For that reason, Form 5329 is

Form 5329 Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts OMB No. 1545-0045
2016
Attachment Sequence No. 20
Your social security number

Department of the Treasury Internal Revenue Service
Information about Form 5329 and its separate instructions is at www.irs.gov/form5329
Name of individual subject to additional tax. If married filing jointly, see instructions.

Home address (number and street), or P.O. box if that is not delivered to your home Apt. no.
City, town or post office, state, and ZIP code. If you have a foreign address, also complete the appropriate section below.
Foreign country name Foreign province/state/country Foreign postal code

Part I Additional Tax on Early Distributions. Complete this part if you took a taxable distribution before you reached age 59½ from a qualified retirement plan (including an IRA or modified endowment contract) unless you are reporting this tax directly on Form 1040 or Form 1040NR (see above). You may also have to complete this part to indicate that you qualify for an exception to the additional tax on early distributions or for certain Roth IRA distributions (see instructions).

1	Early distributions included in income. For Roth IRA distributions, see instructions	1
2	Early distributions included on line 1 that are not subject to the additional tax (see instructions). Enter the appropriate exception number from the instructions	2
3	Amount subject to additional tax. Subtract line 2 from line 1	3
4	Additional tax. Enter 10% (or 15% of line 3, include this amount on Form 1040, line 5b, or Form 1040NR, line 5f). Caution: If any part of the amount on line 3 was a distribution from a SIMPLE IRA, you may have to include 25% of that amount on line 4 instead of 10% (see instructions)	4

Part II Additional Tax on Certain Distributions From Education Accounts and ABLE Accounts. Complete this part if you included an amount in income on Form 1040 or Form 1040NR, line 21, from a Coverdell education savings account (ESA), a qualified tuition program (QTP), or an ABLE account.

5	Distributions included in income from a Coverdell ESA, a QTP, or an ABLE account	5
6	Distributions included on line 5 that are not subject to the additional tax (see instructions)	6
7	Amount subject to additional tax. Subtract line 6 from line 5	7
8	Additional tax. Enter 10% (or 15% of line 7). Include this amount on Form 1040, line 5b, or Form 1040NR, line 5f	8

Part III Additional Tax on Excess Contributions to Traditional IRAs. Complete this part if you contributed more to your traditional IRAs for 2016 than is allowable or you had an amount on line 17 of your 2016 Form 5329.

9	Enter your excess contributions from line 18 of your 2016 Form 5329 (see instructions). If zero, go to line 10	9
10	If your traditional IRA contributions for 2016 are less than your maximum allowable contribution, see instructions. Otherwise, enter 0	10
11	2016 traditional IRA distributions included in income (see instructions)	11
12	2016 distributions of prior year excess contributions (see instructions)	12
13	Add lines 10, 11, and 12	13
14	Prior year excess contributions. Subtract line 13 from line 9. If zero or less, enter 0	14

considered a separate tax return. If it is not filed, the statute of limitations does not start to run, and the IRS can go back indefinitely to assess the penalty on the excess contribution, as well as penalties for failure to file.

POST-DEADLINE FIXES

One way to fix an excess contribution after the deadline is to withdraw it. Otherwise, the penalty continues each year. To do so, you must alert the IRA custodian that this is a withdrawal of excess IRA contributions, so that they issue the 1099-R with the correct coding for tax return filing.

Interestingly, the Tax Code does not require the net income attributable to be withdrawn. This seems illogical, because these excess earnings or investment gains are tax-deferred inside the IRA (but they don't belong there because they're attributed to IRA money that should not have been contributed in the first place).

Excess traditional IRA contributions withdrawn after the deadline are generally fully taxable. If the IRA owner has after-tax funds, the pro-rata tax rule would apply. Excess Roth IRA contributions withdrawn after the deadline are not taxable.

Another way to fix an excess IRA contribution after the deadline is to leave it there and carry it forward to use up as an annual IRA contribution. However, this method doesn't work well for large excesses, such as the Wus' contributions, because the most you can use up in a given year is limited to the IRA contribution limit that year, and the 6% penalty still applies on the excess amounts that remain in the IRA.

To get back to the Wus, the appeals court agreed with the district court and the IRS, and held that the Wus owed the penalty on the excess IRA contribution for 2009.

The court rejected the Wus' argument that excess contributions, for whatever year they are contributed to an IRA, are exempt from the penalty in a later taxable year if a distribution is made before a tax return is due for that year.

According to the court, the Wus made

their excess contributions in 2007, so for that tax year, they could have avoided incurring the penalty on excess contributions by withdrawing the excess before the return-filing deadline for that taxable year.

But for any later year, the Wus could avoid the annual tax only by taking the distribution before the taxable year ended. To avoid the penalty for 2009, the Wus would have to remove the excess contributions by Dec. 31, 2009. But they didn't do that, so they owed the penalty.

A TRICKY BUSINESS

Advice on excess IRA contributions is a tricky business. Advisers should carefully monitor client accounts to ensure that excess contributions don't happen in the first place. Educating clients on the basics of IRA contribution rules may help.

For example, there are income limits for Roth IRA contributions, but not for Roth conversions. If clients' incomes exceed these limits and they contribute to a Roth IRA, that is an excess contribution, and it must be removed by the deadline to avoid the penalty.

Traditional IRAs have no income limits for contributions, but there are age limits. You cannot contribute to a traditional IRA for the year you turn age 70½ or later. Sometimes, clients are not aware of this and keep contributing beyond age 70½. These are excess contributions, because they are not legal. Roth IRA contributions have no such age limits.

To make IRA or Roth IRA contributions, the client must also have compensation, such as wages or self-employment income. Pension income is not compensation. If a client does not have compensation and makes an IRA contribution, that is an excess contribution, and it must be removed.

As the Wus learned, excess IRA contributions can result in a tax nightmare.

For advisers faced with these situations, proper action must be taken to fix the error as soon as possible, because an excess contribution is not a problem that will go away on its own. **FP**

If your client makes an excess IRA contribution for 2016 in April 2017, he or she has until Oct. 16, 2017, to fix it and avoid the penalty.

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

Life Insurance SOS

Policy owners who take out loans may need a rescue — but not all life preservers are created equal.

BY MICHAEL KITCES

AS SOME CLIENTS MAY HAVE REALIZED, LOANS against cash-value life insurance policies can be made at relatively favorable interest rates. However, those clients run the risk of a substantial tax liability if the loan compounds out of control. This can happen whether the loan was a proactive “bank on yourself” borrowing strategy, or just a loan that accidentally was allowed to accrue too far over time.

For advisers with clients who come in with existing life insurance policies carrying substantial loans, it’s important to understand the ins and outs of the process to rescue the policy before an adverse tax consequence results.

THE WARNING SIGNS

A life insurance policy loan is ultimately nothing more than a personal loan from a life insurance company, for which the policy’s cash value serves as collateral.

The policy owner can never be on the hook for a loan that’s greater than the available cash value, but if the policy must be liquidated to pay off the loan, the owner may still receive a Form 1099-R for the underlying gains (even if there’s no cash value remaining to pay the taxes).

Take this hypothetical example of a woman who has paid \$125,000 of premiums into a universal life policy. The policy has a current cash value of \$200,000.

Many years ago, she borrowed \$100,000 against the policy, and after more than a decade of compounding loan interest, the balance has reached the \$200,000 cash value.

Consequently, the policy lapses, and the insurance company keeps the \$200,000 cash value proceeds to pay off the loan.

However, because the policy was worth \$200,000 at liquidation, and the cost basis was only \$125,000, our subject will receive a Form 1099-R for \$75,000, and has to pay taxes on the gain — even though she doesn’t receive any cash upon liquidation.

In such cases, it may make some sense to try rescuing the life insurance policy, either to avoid the adverse tax conse-



ADOBE STOCK

quences or simply to retain the value of the death benefit itself.

There are various rescue strategies, all of which share a common starting point: a thorough evaluation of the current policy. Key information that must be gathered includes (among other factors) the policy type, ownership structure, beneficiaries, the original underwriting classification and getting an in-force ledger.

Once this background has been gathered, it’s feasible to start evaluating potential strategies.

RESTRUCTURING

The first approach is to restructure the policy in an effort to help it survive longer.

One restructuring possibility is to change the dividend option. For any permanent policies that are paying a dividend, there are several paths available for how dividends will be used. The most common — and often default — option is to purchase paid-up additions, which, as the name implies, are small amounts of additional coverage that are fully paid up when purchased. The good news about PUAs is that

they're quite favorably priced for additional insurance, in part because they include no acquisition costs. The bad news is that, if there's a compounding loan, buying more insurance while the main policy founders is not a sound strategy.

Fortunately, the dividend option can be changed and redirected to pay the loan interest (or principal, or both) with just a simple request to the insurance company. If the dividends are large enough, they may eventually extinguish the loan, allowing the policy to sustain. And after that point, the dividends can be directed toward purchasing PUAs again.

DEATH BENEFIT REDUCTION

The next option to improve the sustainability of a policy is to restructure the cash value or death benefit.

If it's a universal life policy, the death benefit can be reduced. In the case of a whole life policy, this is accomplished through a partial surrender (either of the base policy, or its PUAs), which may trigger some taxation. Either way, less death benefit means less ongoing cost of insurance charges, which can improve the sustainability of the policy.

The obvious downside to reducing the death benefit is that it literally reduces the death benefit. But for those just trying to ensure the policy remains in force, a reduction may be more appealing than a total lapse.

Another option for a universal life policy is to take a withdrawal from the cash value itself, and use the funds to pay down the loan balance. Provided the policy is not a modified endowment contract, or subject to a "force-out" for overfunding under IRC Section 7702B, withdrawals from a universal life policy are treated as a basis-first return of principal, and are not taxable until all basis has been recovered. This provides a means to take a tax-free withdrawal from the policy, and use it to immediately repay a portion of the loan.

Notably, depleting the cash value with a withdrawal may mean the policy will ultimately need another contribution — for example, more premium payments — to sustain in the long run. Nonetheless, if the cash value is spiraling toward lapse anyway,

a withdrawal to repay the loan will at least help extend the life of the policy.

MORE CASH

Beyond restructuring the policy to improve its longevity, the next option is simply to put more money in.

To the extent the loan balance is reduced by an infusion of outside dollars, the rate of compounding will slow, while the likelihood of the policy lasting until it matures will increase. If the loan can simply be repaid altogether, then the entire issue is resolved.

This strategy is especially appealing if the policy owner carries a substantial amount of money in a bank account or a large bond allocation, as it makes little sense to have dollars in a money market or bond paying 1% to 3% while a life insurance policy loan simultaneously accrues at 4% to 6% or more.

If there isn't enough money available to fully repay the loan, the next way to rescue the policy is to at least pay the annual loan interest, which prevents the loan from compounding further.

Of course, this presumes that the policy owner is otherwise making the necessary premium payments in the first place.

In fact, the failure to pay life insurance premiums is often what triggers problematic loan situations in the first place, either because it's a whole life policy that forces premiums to be paid via the automatic premium loan provision, or because it's a universal life policy that has insufficient cash value to keep up with all costs and charges while the loan accrues.

To the extent that premiums aren't being paid, reinstating them can help slow a bad loan situation from getting even worse.

THE 1035 EXCHANGE

If restructuring the policy with a loan isn't enough, and the policy owner is unwilling or unable to put additional cash into the policy to support it, the next option is policy replacement, where the original policy is exchanged for a loan to a new policy that may be more sustainable.

Among life insurance agents, replacing a policy with a loan for another one is usually

The good news about PUAs is that they're quite favorably priced for additional insurance, in part because they include no acquisition costs.

the primary approach to executing a life insurance loan rescue – in part because the agent often stands to earn a substantial commission.

That an agent would be compensated for executing a good policy replacement isn't necessarily a bad thing. Unfortunately, though, the commission incentive may cause the insurance agent to lead with this approach, rather than looking at the aforementioned options of restructuring or adding more cash first.

In some cases, however, a replacement may be the only option. An improvement in the insured's health sometimes even makes it appealing to do this. In other cases, there's no change in health, but it's still possible to replace with a more favorable policy simply because the original one wasn't shopped around aggressively in the first place.

Additionally, today's life insurance policies may offer more-favorable loan provisions than policies of the past did. For instance, many policies provide that the loan interest rate be simply the current crediting rate, plus a spread of 0.5% to 1% – which, combined with a low 3% crediting rate, means the loan interest rate might be as low as 4%. By contrast, loan interest rates of 6% or even 8% proliferated on policies issued in the 1980s and '90s.

The new replacement policy could con-

sequently be far more sustainable than the original, simply because the loan interest rate will compound more slowly.

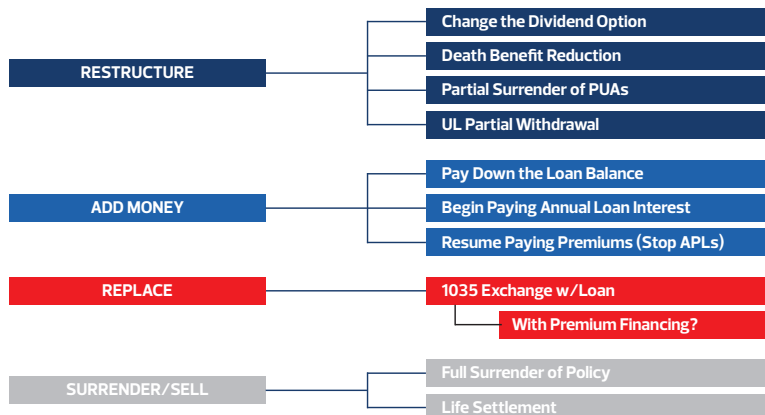
An important caveat of doing a 1035 tax-free exchange to rescue the old life insurance policy: It's essential that the new policy still take on an identical loan. In other words, the exchange should still be for the gross cash value of the life insurance policy, with a loan attached. If a policy with a loan is exchanged for a policy without a loan, the policy holder is treated as having received a partial liquidation of the policy, which triggers income tax consequences.

For instance, consider a man who has a \$750,000 universal life policy with a \$200,000 cash value and a \$150,000 outstanding loan balance – and thus a net surrender value of \$50,000.

If he does a 1035 like-kind exchange from his current life insurance policy to a new, smaller policy for just the \$50,000 of net cash value, he's treated as having exchanged \$50,000 of cash value plus receiving another \$150,000 of cash to boot, which was used to repay the loan. Furthermore, that \$150,000 is taxable as a partial surrender of the policy. To avoid this so-called boot treatment, it's essential that our individual's new policy be a \$200,000 cash value with a \$150,000 outstanding loan balance, precisely match-

An important caveat of doing a 1035 tax-free exchange to rescue an old life insurance policy: It's essential that a new policy take on an identical loan.

Life Insurance Loan Rescue Strategies



Source: Michael Kitces

ing the original.

Fortunately, it's possible to get a replacement policy with a loan, but such transactions are not standard. Instead, it is necessary to request a version of the life insurance policy that can accept an incoming loan – which, at many companies, is dubbed a “life insurance loan rescue policy” because it's put to this exact use. Genworth, Zurich, Voya and Lincoln all offer life insurance loan rescue policies.

If a replacement policy loan rescue is being contemplated, though, it's crucial to still thoroughly vet the replacement policy itself – most notably, how the life insurance cash value will be invested, and whether it is being illustrated at an appropriate rate or not.

For instance, determining the appropriate rate for an indexed universal life policy is highly controversial in today's environment, and forecasting a higher-than-realistic growth rate could make the exchange look appealing, but ultimately cause the replacement policy to get into trouble in the future. This re-creates the exact problem the replacement policy intended to avoid.

The same caution goes for replacement policy loan rescues that refinance using a premium financing strategy. This practice can potentially lower the loan interest rate, but again might create unforeseen problems if interest rates rise but the life insurance policy's crediting rate doesn't keep up.

SURRENDERING A POLICY

The last option for a policy that can't be effectively rescued is to just let it go.

The most straightforward way to do this is simply to contact the insurance company and request a surrender. To the extent there is any positive cash value remaining, the proceeds will be sent to the policy owner.

As with any policy that has a substantial loan, the taxable gain will still be based on the gross cash value before repayment of the loan, which means it's possible that most if not all of the cash-value proceeds will be consumed by the tax liability. Still, getting at

least some cash value out of the policy – to help cover the tax gain – is better than getting no cash value out of it at all by allowing a problematic loan to compound until the cash value really is zero.

For policy holders in their 60s or older, another alternative is a life settlement transaction, which involves the sale of a life insurance policy to a third-party buyer/investor. In such cases, the buyer may pay more than just the remaining net cash value surrender after repaying the loan, leaving the former policy owner with more cash in his/her pocket. This transaction is still taxable, but a life settlement for an amount greater than the cash value nonetheless gives more dollars to help pay the taxes. And once the buyer takes over the policy, he/she is responsible for sustaining the loan as well.

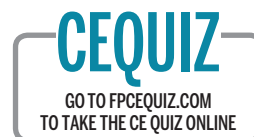
For those who just don't want the cash flow obligation of maintaining the policy given a substantial loan, and are at least in their 60s with some health conditions, getting full value from a third-party buyer in a life settlement transaction is generally a better way to salvage what's left of the policy's remaining value, rather than simply surrendering it to the insurance company for its cash surrender value.

MONITORING IS KEY

Because most life insurance policies have several moving parts – from crediting and loan interest rates, to dividends on participating policies – it's still necessary to have a proactive monitoring process. Otherwise, there's a risk that a rescued policy could take a downward turn, which, if not caught and corrected quickly, could just necessitate yet another rescue down the road.

Still, a life insurance policy with a loan – even a substantial one that was neglected and allowed to compound for years – often can be saved, at least partially. Taking steps to engage in a rescue can at least potentially ensure that a depleting cash value doesn't turn into a forced policy lapse – and a big tax liability.

Determining the appropriate rate for an indexed universal life policy is highly controversial in today's environment.



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

When a Safety Net Disappears

Occasionally — remember 2008? — diversification seems to fail, but such cases are so rare that the underlying principle should not be discarded.

BY CRAIG L. ISRAELSEN

ONE OF THE MAJOR AIMS OF ASSET ALLOCATION IS TO construct a portfolio with ingredients that don't all behave in exactly the same way. This low-correlation medley offers protection against the possibility that all assets will head south at the same time.

But, of course, that downside protection can be a double-edged sword; the portfolio's ingredients are also unlikely to all do well at the same time. While some of your funds will be winners, others will be relative losers.

That's the deal with a diversified portfolio; over the long haul, it works out well, but we have to be patient in the short run.

A common sentiment heard during the 2008 financial crisis was, "All correlations have gone to 1." While not exactly true, it was the case that correlations among a large number of asset classes increased in relation to large-cap United States stocks (as measured by the S&P 500) during the latter part of 2008.

We now have sufficient historical perspective to look back and examine where we were then and where we are now in terms of correlations among major asset classes.

In this analysis, the asset class against which all of the correlations will be calculated is large-cap U.S. stocks. The other 11 major asset classes that will be included in this analysis are shown in the table on this page.

As a reminder of the basics, the maximum correlation between two things

is either +1 or -1.

A correlation of +1 indicates that the two parts move up and down at the same time. A correlation of -1 indicates that the two parts behave very differently — when one moves up, the other always moves down.

Finally, a correlation of zero or closer to zero indicates that the behavior between the two portfolio ingredients is random — and that is the goal.

A DESIRABLE RANGE

We're generally happy when the correlation between the ingredients in a portfolio are in the range of -0.4 to +0.5. There will clearly be exceptions to that, such as the correlation between large-cap U.S. stocks and mid-cap U.S. stocks (which tends to be quite a bit higher than +0.5).

Studying correlation makes the most sense when we do it in the context of a diversified portfolio. This analysis uses the 12-asset model shown on page 49. The correla-

Asset Class	Representative Index
U.S. Large-Cap Stocks	S&P 500 Total Returns (Benchmark asset class against which correlation will be calculated)
U.S. Mid-Cap Stocks	S&P MidCap 400 TR
U.S. Small-Cap Stocks	S&P SmallCap 600 TR USD
Non-U.S. Developed Stocks	MSCI EAFE Net Returns USD
Emerging Markets Stocks	MSCI EM Gross Returns USD
Real Estate	DJ US Select REIT TR USD
Natural Resources	S&P North American Natural Resources TR
Commodities (Broad Basket)	Deutsche Bank Liquid Commodity Optimum Yield Diversified Commodity Index Excess Return
U.S. Bonds	Barclays US Aggregate Bond TR USD
TIPS	Barclays U.S. Treasury US TIPS TR USD
Non-U.S. Bonds	Barclays Global Treasury TR USD
Cash	US Treasury Bill 90 Day TR

tions were calculated over rolling 12-month periods starting on Jan. 1, 1998, and going through Nov. 30, 2016.

CALCULATING CORRELATIONS

The first 12-month correlation of large-cap U.S. stocks and mid-cap U.S. stocks was calculated from January 1998 through December 1998, and it was 0.96.

The correlation between large-cap U.S. stocks and small-cap U.S. stocks was calculated over those same 12 months, and it measured 0.97.

As shown in the chart “Portfolio-Level Correlations” on page 50, the average correlation between large-cap U.S. stocks and the other 11 asset classes during the first 12-month period was 0.39. Over the next 12-month period (February 1998 through January 1999), the average correlation in the portfolio was 0.39.

This same calculation was done for all the subsequent 12-month rolling periods through November 2016 (for a total of 216). The average portfolio-level correlation for this 12-asset model was 0.41 over the total 18-plus-year period.

But in the fall of 2008, it’s clear to see that the average correlation between large-cap U.S. stocks and the other 11 asset classes spiked much higher (see the circle within the graph).

In October 2008, every asset class in

this 12-asset model had significant negative monthly returns except for cash.

WEARING A SEAT BELT

This serves as a reminder of why we wear seat belts, and why we have cash in a broadly diversified portfolio.

October 2008 was indeed the time of a seismic event as measured by the correlation among the ingredients in this 12-asset portfolio.

Consider this: The rolling 12-month portfolio-level correlation was 0.39 as of September 2008. Then, one month later, the average correlation of the 11 assets classes to large-cap stocks jumped to 0.62.

Aggregate correlation within the 12-asset portfolio continued to increase over the next several months, and hit a high point of 0.7 in June and July of 2009. Since that time, correlation within the 12-asset model has declined.

In September 2015, correlation was down to 0.17. As of November 2016, the average correlation of the 11 asset classes to large-cap U.S. stocks was 0.48.

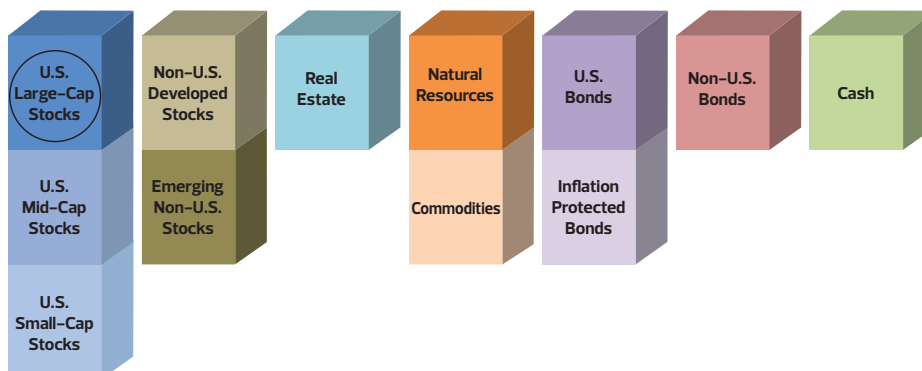
DEEPER VIEW

Let’s now examine the rolling correlations of each individual asset class with large-cap U.S. stocks for the two years before and after October 2008 (see the chart “Upward Pull” on page 51). It’s visually clear that cor-

October 2008 was indeed the time of a seismic event as measured by the correlation among the ingredients in this 12-asset portfolio.

12-Asset Class Model Portfolio

Each asset class is weighted equally at 8.33%



relations between large-cap U.S. stocks and the 11 other major asset classes were generally lower before October 2008 and higher afterward – except for cash.

Cash, by virtue of its consistently positive nominal returns, tends to have low correlation with large-cap U.S. stocks. Fixed-income asset classes also tend to have reliably low correlation with large-cap U.S. stocks. In October 2006, the rolling 12-month correlation between large-cap U.S. stocks and U.S. bonds was 0.21. Correlation was 0.09 with U.S. TIPS, -0.21 with non-U.S. bonds and -0.12 with cash.

By October 2008, the 12-month correlation had become 0.46 for large-cap U.S. stocks when paired with U.S. bonds, 0.46 with TIPS, -0.09 with non-U.S. bonds and 0.22 with cash.

By October 2010, the 12-month correlation of large-cap U.S. stocks with U.S. bonds was -0.38, and it was -0.06 with TIPS, 0.23 with non-U.S. bonds and -0.17 with cash.

We observed some upward fluctuation in the correlation between large-cap U.S. stocks and U.S. bonds and U.S. TIPS, but in general these fixed-income ingredients maintained their low correlation with U.S. large-cap stocks during this particular four-

year period.

By contrast, the correlation between large-cap U.S. stocks and the other equity ingredients started fairly high and went higher. Indeed, in October 2006, the 12-month correlation between large-cap U.S. stocks and mid-cap U.S. stocks was 0.84, and it was 0.78 with small-cap U.S. stock, 0.63 with non-U.S. stocks and 0.77 with emerging stocks.

In October 2008, the 12-month correlations had jumped to 0.98 with mid-cap stocks, 0.96 with small-cap U.S. stocks, 0.92 with non-U.S. stocks and 0.85 with emerging stocks. As of October 2010, the 12-month correlation between large-cap U.S. stocks and mid-cap U.S. stocks remained high at 0.96, and it was 0.91 with small-cap U.S. stocks, 0.9 with non-U.S. stocks and 0.92 with emerging stocks.

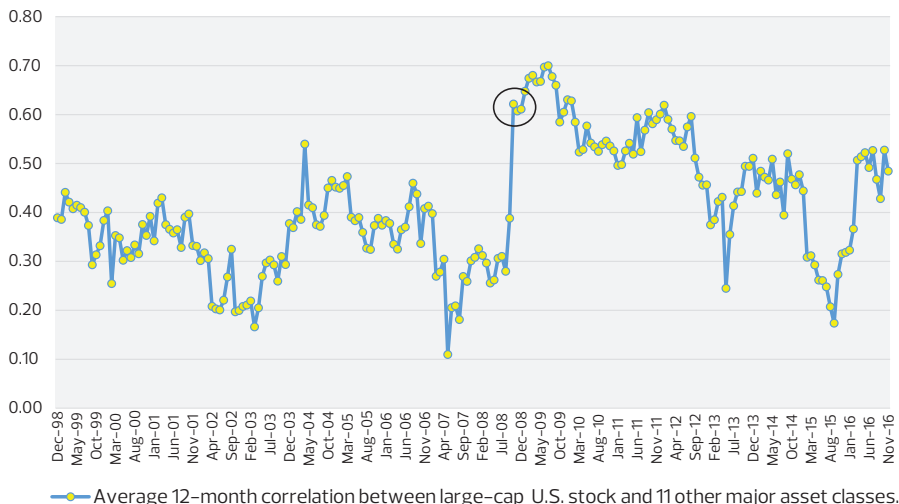
THE DIVERSIFIERS

Among the diversifier asset classes, the 12-month correlations with large-cap U.S. stocks as of October 2006 were relatively low: 0.57 for real estate, 0.34 for natural resources and -0.03 for commodities. By October 2008, those correlations had risen to 0.84 for real estate, 0.72 for natu-

The 2008 financial crisis serves as a reminder of why we wear seat belts, and why we have cash in a broadly diversified portfolio.

Portfolio-Level Correlation

Average 12-month correlation of 11 major asset classes with large-cap U.S. stocks



Source: Steele Mutual Fund Expert software, calculations by author

ral resources and 0.53 for commodities. At the end of October 2010, they were even higher: 0.87 for real estate, 0.95 for natural resources and 0.87 for commodities.

As of November 2016 (not shown in "Upward Pull"), 12-month correlations between large-cap U.S. stocks and the other U.S. equity asset classes were still high (0.96 with mid-cap stock and 0.92 with small-cap stocks).

Encouragingly, the correlations between large-cap U.S. stocks and non-U.S. equity had declined somewhat (0.79 between large-cap U.S. stocks and non-U.S. stocks, and 0.68 between large-cap U.S. stocks and emerging stocks).

The diversifiers are doing their job better now (0.67 correlation between large-cap U.S. stocks and real estate, 0.64 with natural resources and 0.23 with commodities).

Finally, as of November 2016, U.S. bonds

had a 12-month correlation with large-cap U.S. stocks of -0.07, and 0.1 for TIPS, 0.1 for non-U.S. bonds and 0.32 for cash.

While it's important to consider the correlation of each ingredient with every other portfolio ingredient, we can also get an overall sense of the aggregate portfolio correlation by simply calculating the correlation of each portfolio ingredient with large-cap U.S. stocks.

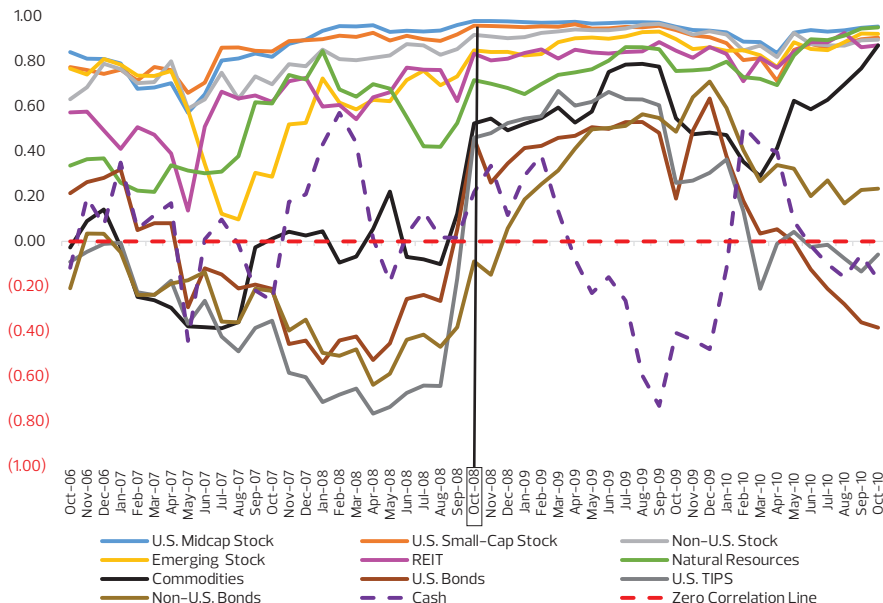
Did correlations all go to 1 in the fall of 2008? No, not if measuring correlation over rolling 12-month periods at the portfolio level.

Just as performance tends to regress to its mean, portfolio-level correlation tends to do the same. One key message from this analysis is that although portfolio-level correlation increased in 2008 and 2009, that is not a reason to abandon the core investing tenet of diversification. **FP**

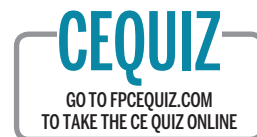
There may be short-term seismic events, but over time portfolio-level correlation tends to regress to the mean.

Upward Pull

Rolling 12-month correlation of major asset classes to large U.S. stocks two years before and after October 2008



Source: Steele Mutual Fund Expert Software, calculations by author



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

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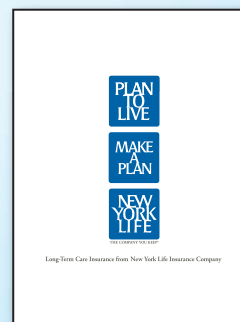
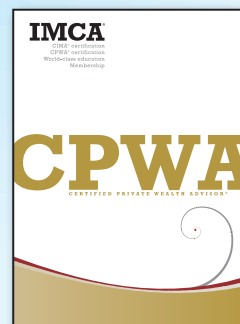
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FROM: WHEN A SAFETY NET DISAPPEARS

1. When referring to the correlation between two assets in a portfolio, which number indicates that, when one asset moves up, the other always moves down?

1. 0
2. -1
3. 1
4. 0.5

2. By how much did the average correlation between the S&P 500 and a portfolio of 11 other asset classes (U.S. mid-cap stocks, U.S. small-cap stocks, foreign developed stocks, emerging market stocks, real estate, natural resources stocks, commodities, U.S. bonds, TIPS, foreign bonds and cash) jump from September to October 2008?

1. 0.50
2. 0.62
3. 0.23
4. 0.39

FROM: A TAX NIGHTMARE

3. Which of these would constitute an excess IRA contribution from a client under age 50?

1. \$5,000
2. \$4,500
3. \$5,200
4. \$5,500

4. If a client made an excess IRA contribution in April 2017 for 2016, by which date must they withdraw the extra funds in order to avoid a penalty?

1. Dec. 31, 2017
2. Oct. 16, 2017
3. May 15, 2017
4. Sept. 30, 2017

5. A client can no longer legally contribute to a traditional IRA after what age?

1. 70
2. 75
3. 71
4. 70½

FROM: LIFE INSURANCE SOS

6. When using a 1035 tax-free exchange to rescue a life insurance policy, the new policy must take on a loan that is equal to what?

1. The net surrender value of the policy.
2. Plus or minus \$50,000 of the original loan.
3. The exact amount of the original loan.
4. Plus or minus \$25,000 of the original loan.

FROM: CYBERSECURITY AND YOUR PRACTICE

7. What is the global cost, per capita, of data breaches in the financial industry?

1. \$221
2. \$148
3. \$156
4. \$208

FROM: COUNTERING SLOW DIVIDEND GROWTH (online only)

8. What was the S&P 500's dividend payout ratio as of mid-December, according to S&P Dow Jones Indices?

1. 44.4%
2. 51.4%
3. 40.5%
4. 55.5%

FROM: A BETTER BASELINE FOR RETIREMENT PLANNING (online only)

9. By what percentage does real spending decline each year in the first decade of retirement, according to a Morningstar study?

1. 2%
2. 1%
3. 3%
4. It remains the same

10. How much does real spending decline annually in the second decade of retirement, according to Morningstar?

1. 3%
2. 0.5%
3. 2%
4. It actually rises by 1%

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SELFIE

A Big Payback From Giving

When advisers are deeply involved in clients' charitable plans, both families and firms may find real gratification.

BY SHARON ALLEN



THROUGHOUT MY YEARS AS AN ADVISER, ONE DISTINCT thread running through family stories has been the practice of generosity. I've found that the way a family approaches charitable giving showcases its financial, personal and intellectual wealth and can truly define the family life story. This single aspect of a client's planning can provide for connection and growth unlike any other.

Working with clients across generations on an intentional charitable plan involves having deep conversations about what money truly means to them and how to use it effectively. These discussions also forge new relationships with clients, and connect them with centers of influence and strategic partners. Finally, they enable clients to execute planning strategies that will endure for lifetimes.

FAMILY MONEY CONVERSATIONS

Recently, a client worried that the family's younger generation didn't understand their privilege and responsibility. This client wanted to find a way to talk about a commitment to their local community that would outlive them.

Through conversations with the client's children, we heard what was important to them, what they hoped to give back and what they planned for the future.

The most memorable family money conversations I have been a part of have also involved finding opportunities for volunteerism. I firmly believe that spending time helping those who are less fortunate creates a sense of gratitude that doesn't come from anywhere else.

From a planning perspective, there are many different ways to help clients with charitable giving or a multigenerational generosity plan. Some helpful strategies are lever-

aging our strategic relationships with development officers at colleges and nonprofit organizations, utilizing donor-advised funds and creating family foundations.

In one case, our client made a lifetime donation to an endowment created by the development officer of a large educational institution. The donation allowed the client to finance their specific interests. As part of that gift, the client is actively participating in the lives of the students – something that might not have happened without a strategic conversation with the development officer.

DONOR-ADVISED FUNDS

We have another subset of clients who are generous and want a current tax deduction, but need more time to put a deliberate charitable giving plan in place. Donor-advised funds have been an incredible resource that fit that undecided category. Many national funds, like the Fidelity Charitable and Vanguard Charitable, provide simplicity and anonymity, which we've found can be important for clients who have large estates. For clients who have a heart for the local community but aren't sure about the charity, we have forged relationships in community foundations as well.

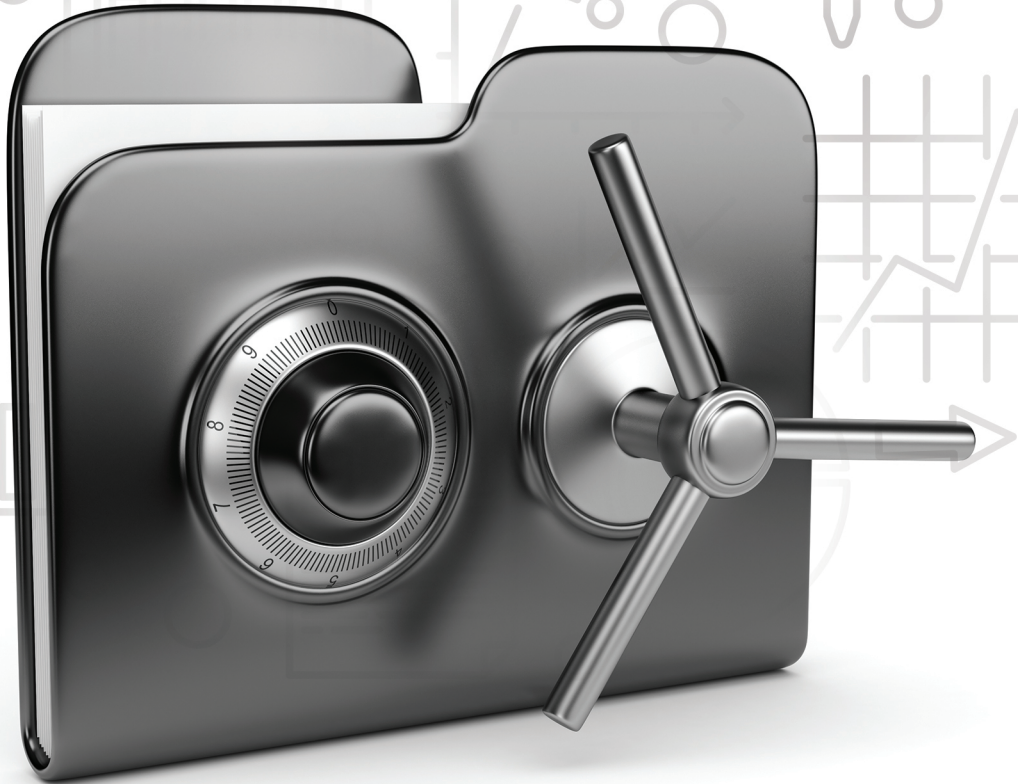
Finally, for clients who wanted to be more hands on in directing donations, we have used private family foundations. What is beneficial about this option is how tailored and personal it makes a charitable plan. Multiple generations get a chance to be involved in making the decisions, and it becomes a valuable moment for a family to connect.

Solidifying relationships with generations of clients' families through philanthropic conversations is a vital aspect of our practice, one I hope all professionals will embrace. **FP**

Sharon Allen, CFP, CTFA, is co-founder and president of Sterling Wealth Management, a fee-only wealth management firm in Champaign, Illinois.

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