

M&A: WHAT RIA SELLERS NEED TO KNOW P. 26

# Financial Planning

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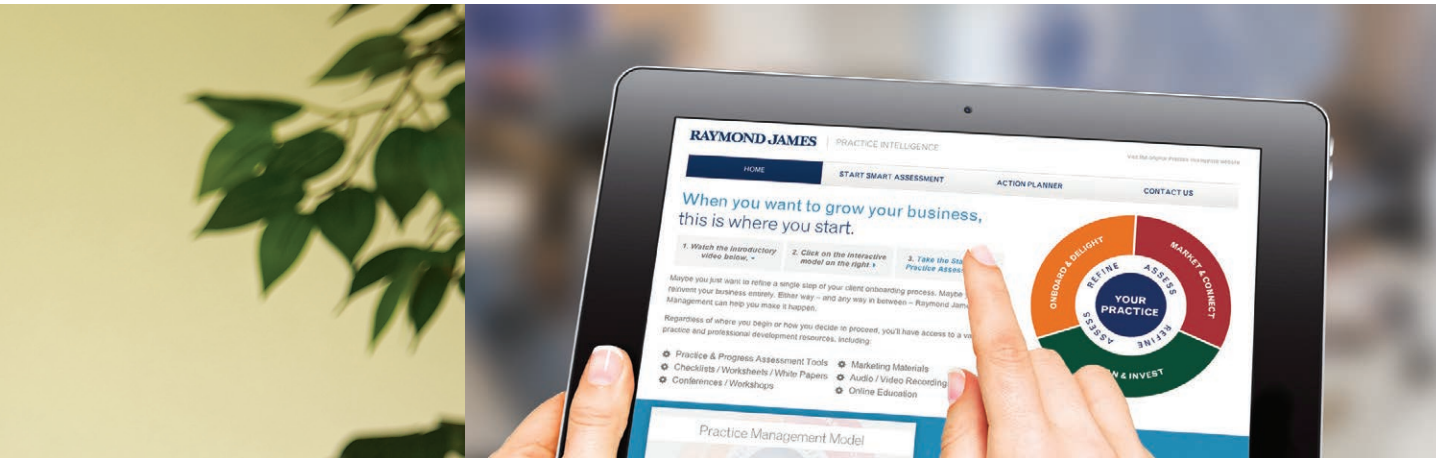
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## FIDUCIARY FORWARD

The future of the rule may be uncertain, but executives such as Advisor Group's Valerie Brown say they've come too far to reverse course





# 45

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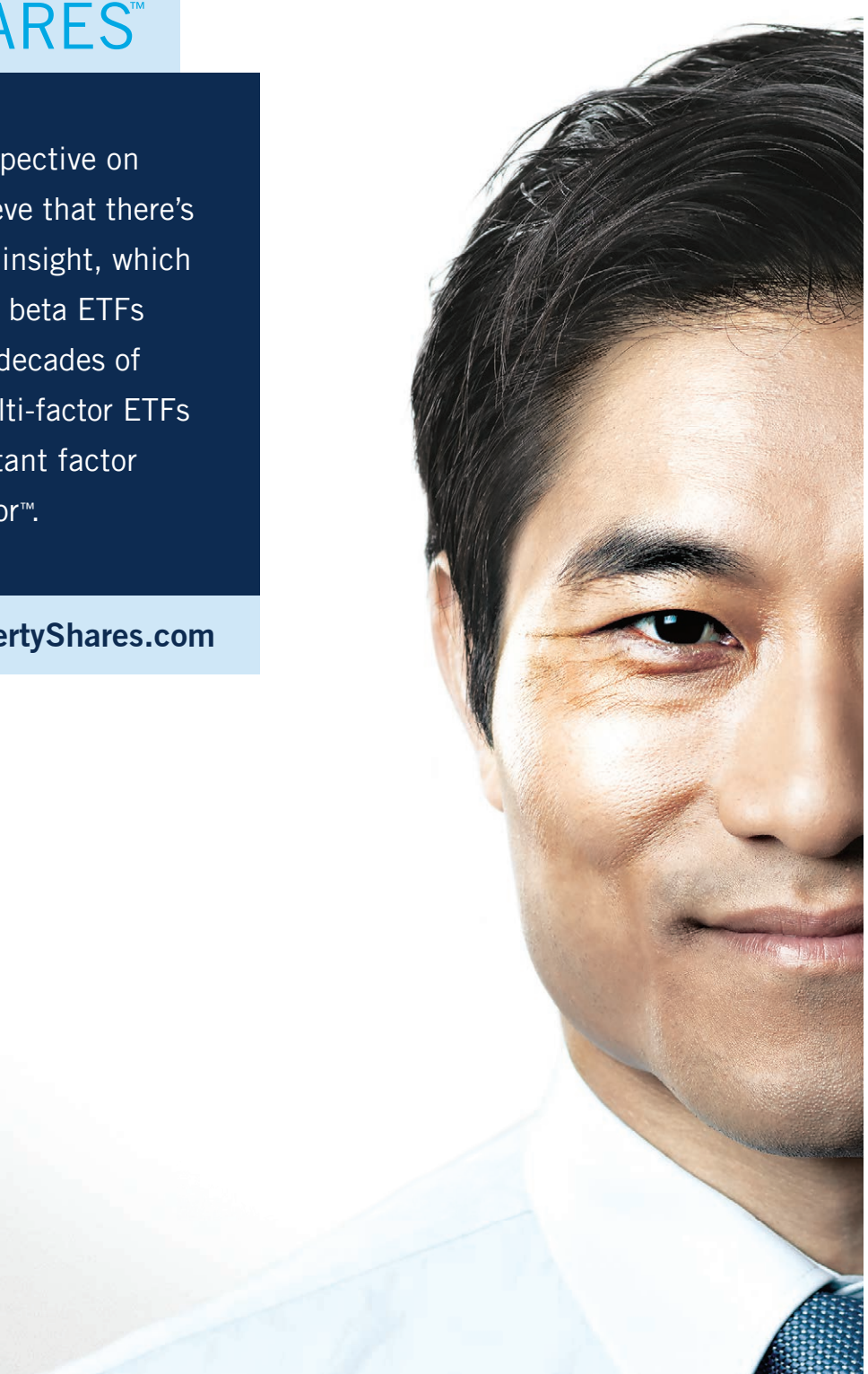
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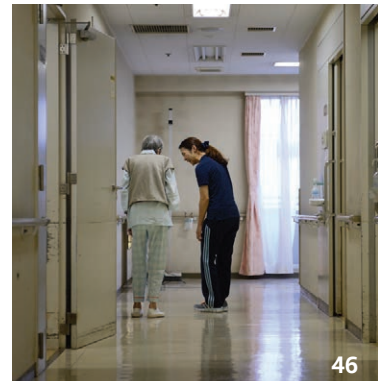
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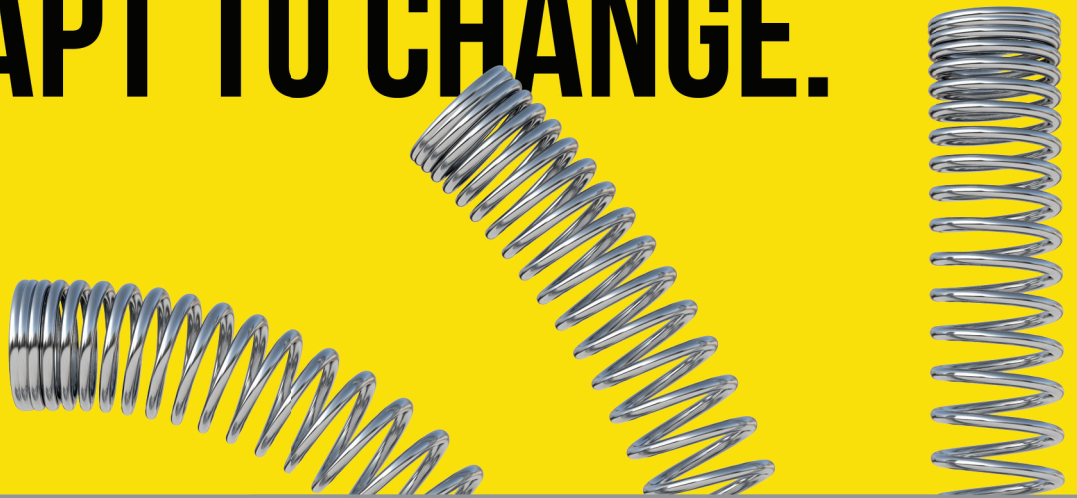
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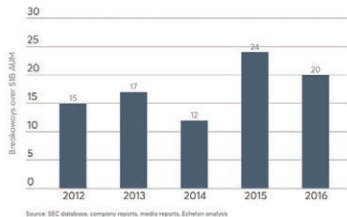
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## ON A HIGH NOTE

Breakaways with over \$1B in AUM fell in 2016  
The number slipped to 20 from 24.



## Breakaway Surge For RIA M&A

2016 was a record-setting year for RIA M&A deals and the pace shows no sign of slowing in 2017, according to research and consulting firm Echelon Partners. What were some of last year's outstanding benchmarks, and what are this year's prospects? Click this link to see metrics of keen interest to buyers and sellers, including billion-dollar deals and where they are taking place: <http://bit.ly/2kn8i40>

## Sound Off: Yeah, Right!

In a response to an article by *Financial Planning* contributor Carolyn McClahanan about fiduciary planners prevailing in spite of President Trump's move to roll back the fiduciary rule, adviser

**Richard Clemens** tweeted:

**"Regardless of Trump, the DoL attempt to regulate a fiduciary standard left much to be desired."**

What do you think? Weigh in with your own comments at: <http://bit.ly/2kmVYkk>



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**FPA Retreat**  
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<http://bit.ly/1SOXINP>

**26-28**  
**Morningstar Investment Conference**  
Chicago  
<http://bit.ly/2iihNVg>

**30-May 3**  
**IMCA Annual Conference**  
San Diego  
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## EDITOR'S VIEW

### Fiduciary Future

The rule's outlook seems uncertain, but a strong undercurrent is carrying the industry along.



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**THE FIDUCIARY RULE HAS BEEN THE BIGGEST CATALYST FOR INDUSTRY** change in years.

An enormous amount of energy, time and money has been expended fighting for and against it. Still more effort has gone into complying with the regulation. Now that the president is moving to undo it, the question naturally arises: Does that make all the planning and work firms did worthless?

Unequivocally, the answer is no.

"This rule has made us better," Michael Partnow, a vice president at Pershing Advisor Solutions, told attendees at the FSI OneVoice conference in January. "It's made for more informed advisers."

Sure, coming into compliance has increased expenses. It's also taken quite a bit of effort. "We've just concluded our 25th meeting," said Wayne Talleur, the president of Madison Avenue Securities, at the FSI conference.



#### 'CAN'T BE UNDONE'

But as Ann Marsh, a *Financial Planning* senior editor, sees it: "The highly public debate around the fiduciary rule can't be undone. The public is more aware of fiduciary service than ever and is only likely to become more so in the future."

Clients increasingly want — demand, even — lower fees and greater transparency, adds Andrew Welsch, the senior editor who wrote our special report on the topic, "Fiduciary Forward."

"The phrase 'conflict of interest' has become part of everyday vocabulary," Welsch tells me. "The business will keep moving toward greater transparency because that's what clients say they want. It's Econ 101, supply and demand."

If the rule is completely overturned, some firms may revise or jettison their plans around the best interest contract exemption, Welsch suggests. "Some firms may also re-examine recruiting deals, which came under fire from the Department of Labor for creating potential conflicts of interest," he adds. But for the most part, executives plan to retain most of their fiduciary preparation "regardless of the fate of this rule," Welsch says.

The same is true for digital advice, *Financial Planning* Managing Editor Suleman Din found when reporting, "Robo Advisers: We Can't Be Stopped." Due to increased transparency and digital information, the era of hiding behind fine print and pushing products is over, he says.

"Firms that continue such practices will soon be passed over by customers — rule or no rule," Din tells me. —*Chelsea Emery*

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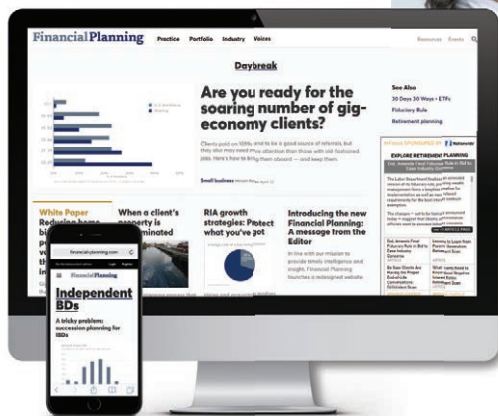
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# BENCHMARK

DATA-BASED INSIGHT FROM *FINANCIAL PLANNING* AND SOURCEMEDIA RESEARCH

## RETIREMENT ADVISER CONFIDENCE INDEX

# Backing Away From Risk

After two months during which clients' risk tolerance rose strongly, now they seem "worried about everything," advisers report.

### CLIENTS' OPTIMISM ABOUT THE ECONOMY SINCE

Election Day has given way to concern about the future amid falling fees for retirement planning, advisers say.

Both demographics and politics prompted greater caution, according to this month's Retirement Adviser Confidence Index – *Financial Planning's* monthly barometer of business conditions for wealth managers. "Clients are worried about everything," one adviser wrote.

The index ticked down 0.6 points to 56 while clients' perceived risk-tolerance level slumped 7.7 points to 58.5. Both indicators remain in positive territory.

Advisers also reported rising employer retirement plan enrollments and a positive business outlook, even as preparation for the fiduciary rule has pushed down fees.

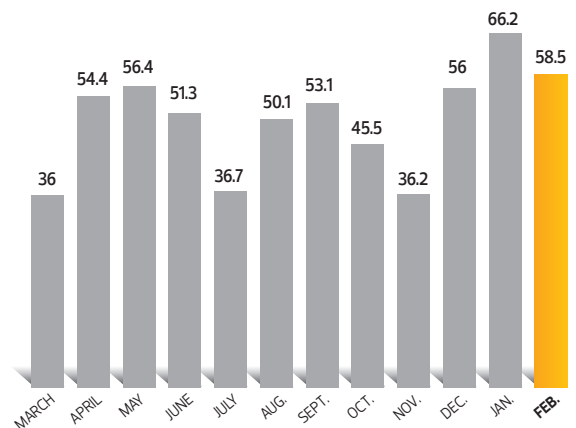
One adviser reported being "cautiously optimistic," but added, "uncertainty feels like it's at an all-time high."

Advisers seem split on whether their clients see economic conditions improving under President Trump. "People are more confident in investing than they were last year," one adviser said. But another wrote, "[Clients] are scared and frozen about investing."

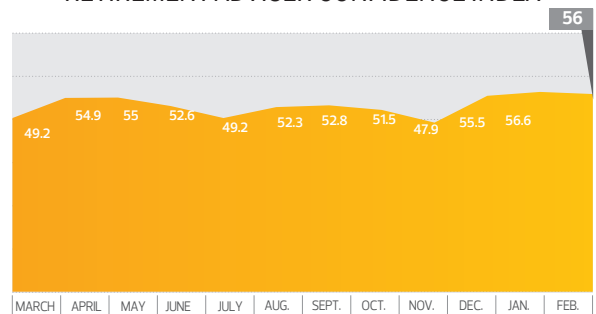
Clients have pulled back on taking risk, advisers said, after 10- and 20-point jumps in risk tolerance the previous two months. Many are wondering whether Trump's policies will lead to the economic growth he promised, advisers said. "Clients are concerned with [the] current political environment, but don't want to be left out of market gains," one planner wrote.

Despite the fears, enrollment in employer-based retirement plans rose. "People want to retire earlier,

PERCEIVED RISK-TOLERANCE LEVEL



RETIREMENT ADVISER CONFIDENCE INDEX



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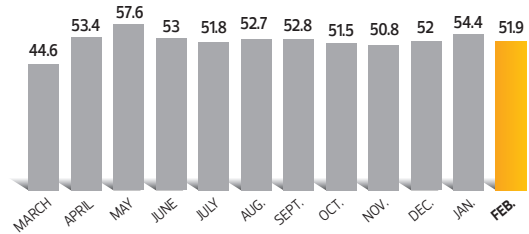
while knowing that they will be living longer in retirement. This means those in the mid- to higher-income areas are more willing to plan and listen,” one adviser wrote, adding that most clients enrolling are 50 or older.

Enrollment grew 1.9 points; however, total cash contributions to retirement plans dropped 2.9 points and total retirement product sales fell 1.2 points.

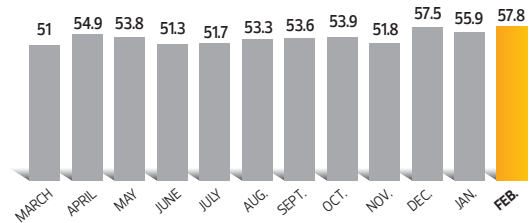
Advisers expressed confidence in their retirement business, despite reporting a 2.5-point decline in fees charged for their services. Planners connected the lower costs to the fiduciary rule. “We are forced to lower fees and provide more service to accounts,” an adviser said. “Every size account is talking fees.”

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. –Tobias Salinger **FP**

### FEES CHARGED FOR RETIREMENT SERVICES



### NEW PARTICIPANTS ENROLLING IN EMPLOYER-SPONSORED RETIREMENT PLANS

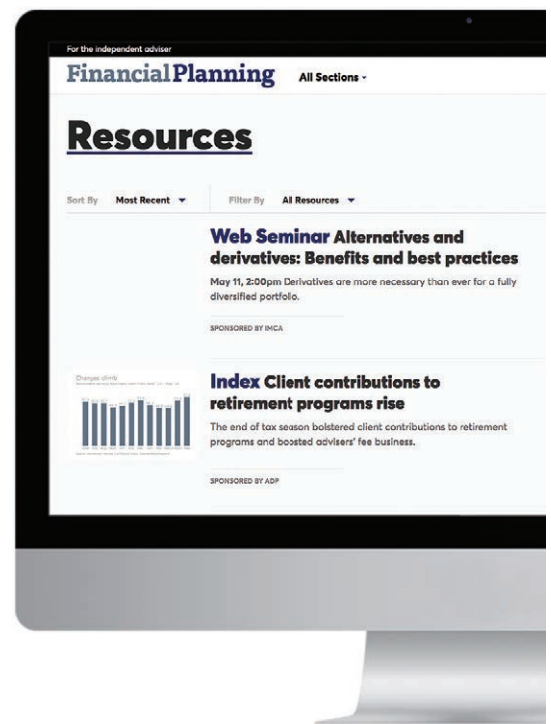


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## GLOBAL ASSET ALLOCATION TRACKER

# The Trump Effect

Advisers report that the new administration is affecting how clients choose to invest.

**ADVISERS HAVE A NEW FACTOR** to contend with when helping clients decide where to allocate funds: Trump.

The president's policies, and tweets, are weighing heavily on client psychology, driving some to raise allocations to U.S. equities and others to hesitate about investing new funds, advisers say.

The latest Global Asset Allocation Tracker shows allocations to domestic equities remained at last month's record high. The survey, which polled 326 advisers, also showed little to no increase in allocations to global equities and bonds.

Some planners report they and their

clients have a positive outlook on U.S. equities due to the perceived pro-business policies of the president and Congress. Several also cited potential tax cuts and the so-called Trump bump in domestic markets.

"Time for growth, baby!" a wealth manager says.

Others, however, say Trump's actions and comments have made clients more "worried," particularly about investing in global equities. This has proved frustrating for planners who see buying opportunities in international markets due to more-favorable valuations. One planner was blunt about the president's effect on

clients: "Trump is scary."

Another adviser says: "Our clients are varying in vacillating opinions due to the recent presidential changes ... more clients are adamant in their choices regardless of financial advising."

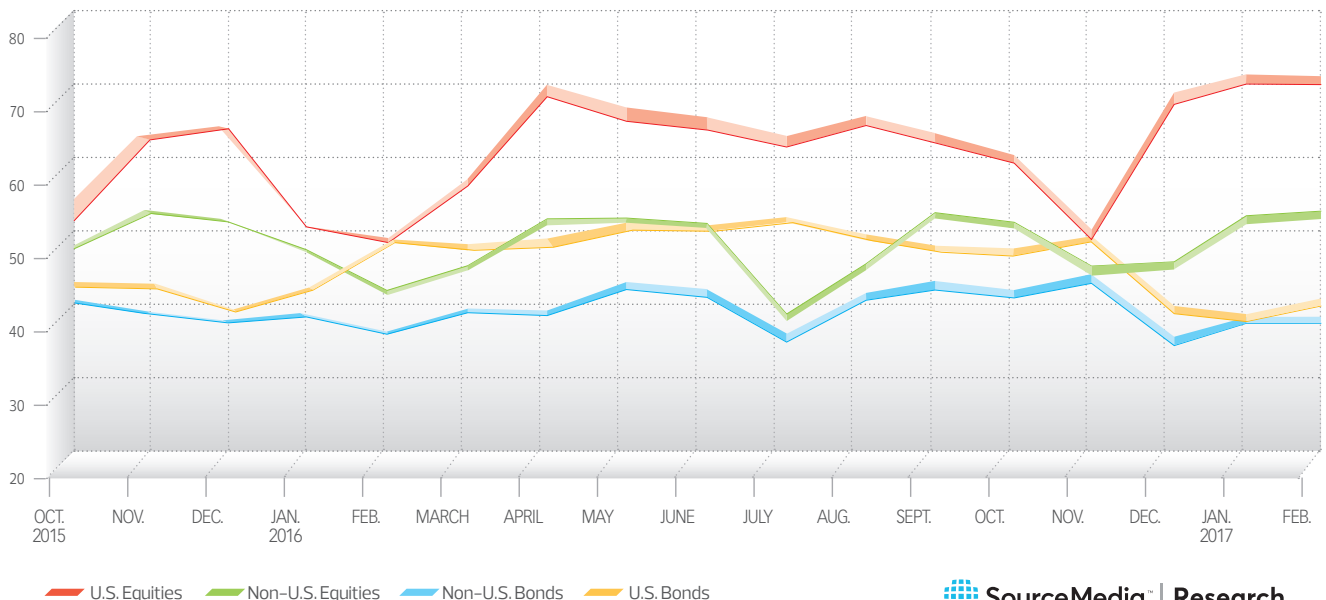
Several planners cited "tremendous uncertainty" about how new policies could affect foreign markets and U.S. companies with overseas business.

A few planners, however, shrugged off the ups and downs of this political moment. "My asset allocation is based on a client's long-term goals, not the current fad," one adviser says.

—Andrew Welsh

**FP**

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## INDUSTRY INSIGHT **VERES**

# The Word That Sets Off Regulators

Sobering results from a light-hearted survey show that advisers may need to change how they use the term “retainer,” Bob Veres says.

**FOR YEARS I’VE BEEN PREDICTING THAT** the planning profession is eventually going to have to convert its revenue model from AUM to retainer fees.

People push back when I say retainers entail fewer conflicts of interest than asset management fees. But I have personal experience with trying to hire an adviser, only to have this well-respected professional immediately bury his nose in my portfolio statements. Every time I would try to redirect his attention to my planning questions, he would guide the conversation back to the importance of having him manage my assets.

I’ve always thought it was interesting that consumers who hire AUM-compensated planners happen to always need that planner to also manage his or her retirement account.

Retainers have other advantages. They can be more precisely aligned with the actual work or value an advisory firm provides. Every planning firm I’ve talked with has a few clients with the happy combination of a large portfolio and an undemanding nature, which makes them extremely profitable.

### **AN UNFAIR MODEL**

Clients with smaller portfolios may require a lot of hands-on work helping them move through important life transitions. Is it fair that one should be subsidizing the other?

Most important, retainers allow advisers to be paid for providing advice to Gen X and millennial clients who wouldn’t otherwise

meet AUM minimums. If you paid attention to *Financial Planning’s* January survey of large advisory firms, you know the profession’s growth rate has suddenly and dramatically declined. I think a big reason is that the advisory firms that have portfolio minimums and are compensated exclusively through AUM fees are forced to turn away young accumulators with plenty of cash flow.

Few advisory firms have a model that lets them market their services to the enormous Gen X and millennial client pool at a time when wealthy baby boomers are either decumulating or dying off. Is that any way to foster dramatic future growth?

But now, alas, it looks as if I’m going to have to change my tune about retainers.

### **COLLECTING HORROR STORIES**

On my website, I asked readers to tell me their best horror stories about state regulators who completely misunderstood their fiduciary business model, or otherwise came back with examination results that made no sense. I heard from fee-only advisers who were asked where they were hiding their commissions.

I also heard from firms whose examiners didn’t believe it was ethical for state-registered RIAs to bill clients for planning work or any other service than managing assets.

In Hawaii, some advisers have been deemed to have custody over client assets because the client and custodial agreements permitted them to bill their fees directly

**Retainers can be more precisely aligned with the actual work or value an advisory firm provides.**

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from the accounts.

In the end, I handed out Regulators Amok awards to Vermont, North Carolina and Arkansas for, among other things, requiring advisory firms to stop billing for planning services, and for insisting the firms change their revenue model to something that would cost clients more money than they had been paying before the regulators walked in the door.

In all, it was a sobering exercise. What I learned is that, even though the profession has been around for more than three decades, many regulators still don't quite understand the value of planning advice, or the transparency of a fiduciary client relationship.

But, in the process, something very interesting came up about retainers. Many advisers who bill their clients quarterly based on total assets, or the complexity of the client's situation, said they were getting pushback on their retainer fees.

As I was digging deeper into the whys and wherefores, I heard from Michael Kitces, a *Financial Planning* contributing writer who's co-founder of the XY Planning Network, a turnkey practice model that has processed registration paperwork on behalf of almost 200 state-registered advisers. Kitces said that, in his experience, the states are almost uniformly pushing back on the retainer model. And here's the kicker: The states may actually have a point.

### WHY THE CONFUSION?

To see why, consider for a moment what the word "retainer" means in the common vernacular. Lawyers request an upfront retainer before they start work on your behalf. This money is carefully put in escrow, to be drawn out in pieces to pay for services the lawyers provide at various times in the future. If the lawyers don't spend as much time on your case as estimated, some of the retainer fee may be returned to you.

That, of course, is not how the retainer model works in the planning world. But when a state regulator sees a planning firm charging fees that it refers to as retainers, it's not unreasonable for that person to assume that advisers

are collecting, every month or quarter, an amount of money that will be set aside to pay for services that may or may not be rendered. And then the advisers put that retainer money in their pockets and charge a new retainer the next month or quarter – and so on.

You can, of course, explain to your state's on-site examiner that the retainer is nothing more than a quarterly fee for providing ongoing asset management and planning services. But to the regulator, isn't it interesting that the amount of work you do just always happens to eat up that ever-replenished upfront retainer you're collecting?

And if you charge a retainer based on a client's total wealth, this really seems to set the state regulators off. Why? Because, hey, are you also managing that client's house? Are you doing hands-on management of the assets in the 401(k) plan?

What to do? The solution, I think, is to probably just switch to a different term.

### A MORE PALATABLE PHRASE

The XY Planning Network has taken "retainer" off its members' Form ADV and replaced it with a lengthier, but more palatable, phrase: "fixed annual fee, payable monthly, for financial planning services."

I recommend that, if you're state-registered, you also base the size of this fee on something other than a client's total assets. Clunky? Of course it is. But it's a revenue model description regulators could much more easily relate to the services you provide.

Meanwhile, this exercise tells me the profession has a lot of work to do educating the states on what, exactly, planners do for clients – and especially helping them understand that the most valuable part of that service is advice about retirement preparedness, goal planning, taxes, tax-aware distribution in retirement and all the other issues lumped under the confusing term financial planning.

NAPFA has started doing that work on a state-by-state basis and is addressing the issue of retainer fees. Will the CFP Board and FPA join the effort? If not, why not? **FP**

**State regulators are almost uniformly pushing back on the retainer model – and they might actually have a point.**

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**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*. Visit [financial-planning.com](http://financial-planning.com) to post comments on his columns or email them to [bob@bobveres.com](mailto:bob@bobveres.com). Follow him on Twitter at @BobVeres.



## ELITE ADVISER **BOWEN**

# A Crash Communication Plan

By acting immediately when stocks turn, you can position yourself to receive significant additional assets, John J. Bowen Jr. says.

**WHEN THE DOW CLOSED ABOVE 20,000** in January, it was big news, even though many wealth managers pointed out that it was just another number.

But that comment did not register with many would-be stock buyers. When the equities markets are doing well, investors tend to feel giddy. A rising market seems to foster a feeling that the market will certainly rise some more, even though that doesn't make a lot of sense.

I'm no market prognosticator, but here is something I can promise you: At some point stock prices will dive. How ready are you for client questions and demands the next time the market plummets?

### **READY FOR A FALL?**

To fulfill your duty as a trusted adviser, you need to have a crash communication strategy ready to execute. Ideally, you have this strategy in place before that next sharp decline occurs.

Your communication efforts will have a big impact on clients' confidence and trust in you. The difference between advisers who excel during difficult times and those whose businesses suffer lies in how well they communicate. Advisers who do so successfully will bring in substantial new assets.

Indeed, the market's ups and downs can be very useful. Sharp fluctuations provide you with an opportunity to call your clients and remind them that their investment

plans have been designed to hold up over the long term and that short-term market moves are not terribly relevant.

A turbulent market offers a chance to review clients' plans, to revisit asset allocation and rebalance if needed, or simply to help them see that everything is still on track. In some cases, you may position yourself to receive significant additional assets from high-net-worth clients.

The key to success is having a plan in place and knowing what to focus on so you can reach out immediately with confidence.

Research by my firm, CEG Worldwide, shows that advisers who maintain frequent contact with their clients generate much more satisfaction and loyalty than advisers who focus mostly or entirely on the financial markets themselves. This client-centric approach leads to more assets under management from those clients, more introductions to ideal prospective clients and ultimately a more successful practice.

During the market downturn of 2001, for example, advisers who focused on client contact rather than investment strategies captured 30 times as many additional assets as their industry peers who focused solely on investments.

This finding was further reinforced by another CEG Worldwide survey, which clearly shows that highly successful advisers have more client contact.

Specifically, the survey found that just

**During the market downturn of 2001, advisers who focused on client contact captured 30 times as many additional assets as their peers who focused solely on investments.**

# PROBLEM

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29% of moderate-income advisers have contact their top clients at least once a month, compared with 59.4% of high earners.

More than a quarter (27.1%) of the moderate-income group make with contact each of their top 20 clients just two or three times a year or even less. Among the high-income group, only 8.1% neglected client contact to this degree.

It seems that increasing client outreach is the smart move when markets are volatile. But how will you go about making contact in a smart, systematic way that assures clients and gets good results?

## HOW TO MAKE CONTACT

I suggest you start by calling the top 20% of your clients as well as those clients who you think will need the most hand holding (also any clients who may be active traders). You might even want to schedule in-person visits with these clients.

Then work your way down the list to smaller clients and those who are less sensitive to market fluctuations. Remember that even your most rational clients may begin questioning their strategy if market events are scary enough. Don't skip clients simply because you think they're not worried. Trust me, if something comes along to remind investors of 2008, they'll all be concerned.

Make contacts with clients your top priority, even if it means that you have to devote a significant portion of your day to them.

The reason: It's likely that most of your affluent clients have multiple financial providers. Many of these other financial providers will fail to be proactive and will not reach out to these clients.

By contrast, you will be the one who is actually there when they need you. By focusing and acting immediately, you will not only help your clients get through a tough period, you will position yourself to receive significant additional assets.

Conversely, let's say your clients' other advisers do reach out to them right away. If you fail to do the same, you risk damaging the client relationship and losing assets.

Prepare notes of what you'll say to each client. Be ready to discuss the particulars of the market and the recent events, of course, adding your own perspective as well as insights from any trusted sources you rely on, such as your custodian or other institutions you work with, economists, and money managers you use or respect.

## THE ACTUAL DISCUSSION

That said, don't focus entirely on the markets or get too analytical and wonkish. The fact is, a lot of your clients will simply want to hear from you and be reassured that the sky isn't falling. You can remind them of their long-term plan or of the investment policy statement you carefully created with them (if you have done so). You might even remind them of the fact that many investors panicked and moved to cash in 2008 and 2009 and later missed out on a big part of the market rally that followed.

Perhaps most important, let them know that they are still well on the way to meeting their long-term goals. This is a perfect opportunity to strengthen that all-important emotional connection that clients want from their advisers. And whatever you do, don't use the market's bad news to try to sell clients a new product or service. That can damage trust quickly.

Finally, make sure to ask about something personal – their families, their business, any recent vacations they've taken and so on. This tells them that they're more than just numbers to you and that you care about them as people.

That deeper level of interest can help promote better client satisfaction and loyalty in any environment – and especially when times are uncertain.

In the end, reaching out effectively to your clients right after a major market decline will not only reassure them and help them to manage during an uncertain time, it will also provide you with valuable opportunities to capture additional assets and bring new clients to your door.

But you have to be ready to roll. **FP**

**It's likely that most of your affluent clients have multiple financial providers, and many may fail to reach out in times of trouble.**



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## HUMAN CAPITAL **CRUZ**

# Bend, So Your Firm Doesn't Break

Sabbaticals and flextime are increasingly needed to attract and retain valuable talent, but they are underused at advisory firms, Kelli Cruz says.

**THERE'S A WORRISOME SHORTAGE OF** talent in our profession. Take a look around: More advisers are retiring, there's a lack of new planners yet there's growth in demand for financial advice. The consulting firm Moss Adams has estimated that the industry could face a shortfall of more than 200,000 advisers by 2022. Now, more than ever, attracting and retaining talent is essential to an advisory firm's success.

One strategy I don't see used nearly enough by advisory firms is offering flexible work options. When I interview employees and ask them what they would change about their firms, I frequently hear the theme of providing more flexibility. But when I report this employee feedback, I often get pushback from firm owners. There is a mindset that because this is a client-focused business, employees have to physically be at their desks from 8 a.m. to 5 p.m. Monday through Friday.

"Baby boomers and Gen Xers are leading most advisory firms," says Caleb Brown, a partner at New Planner Recruiting. "And they are managing – as they were managed – by walking around and observing employees."

### **DEMOGRAPHIC TRENDS**

Flexible work arrangements encompass both work hours and work locations. Demographic trends indicate that demand for flexibility will continue to rise among both young and old workers.

For example, many members of the millennial generation – now in their late 20s and early 30s – put off marriage and child bearing during the Great Recession. Now that things have recovered, they're looking to start their own families. Meanwhile, baby boomers may be seeking flexibility to take care of an aging parent or relative.

These and other trends are likely to continue to fuel the demand for flexible work options. In a 2016 study by the Society for Human Resource Management, the top three benefits that employees rated as very important to their job satisfaction were paid time off (63%), health care and medical benefits (62%) and flexibility to balance life and work issues (53%).

One trend that has created a need to think outside the box about work is the growing use of technology. The client base has grown more tech savvy and is able to access email and files 24/7, and as a result clients are expecting real time responses from their adviser. As Yonhee Gordon, COO and partner at Chicago-based JMG Financial Group puts it, "getting technology in the hands of our employees so they can respond to clients in a timely manner is a priority for our firm."

This, in turn, has created a need to become more flexible about how work gets done and where. Flexibility is extremely important for staff members who work remotely. JMG provides laptops or notebooks to all staff to ensure they can be avail-

**Demographic trends indicate that demand for flexibility will continue to rise among young and old workers.**

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able for clients. For the support employees who work in the office, the firm uses staggered work hours to ensure coverage for the core work hours of 8:30 to 5:30.

The idea of being able to respond 24/7 is echoed by Wallace Williams, CFO at Trust Company of the South in Greensboro, North Carolina. "Advisers will work remotely from home at night in exchange for taking work off early to attend their child's soccer game or ballet recital," she says.

### COMMON APPROACHES

The most common flexible work arrangements are:

- Flexible hours. For example, an employee works from 10 a.m. to 6 p.m. rather than from 8 to 4.
- Compressed workweeks. This arrangement allows an employee to work 40 hours over a shorter span than the usual five-day workweek – for example, four 10-hour days instead of five 8-hour days.
- Part-time work. This allows an individual to work as few as 21 hours a week while retaining some or all benefits.
- Job sharing. This is a structured form of part-time work, with various models. A 50/50 split is common, but this is not the only option. For several smaller firms, this option works well with the planner role or the paraplanner role. I've also seen this arrangement used effectively with operational roles like client service administrator or receptionist/administrative assistant.

The major benefits of flexible schedule arrangements for the employees include avoiding rush-hour commutes, working during quiet times to increase productivity, gaining more control over their time off to take care of a sick child or to schedule doctor or dentist appointments.

Two keys to success in using workplace flexibility are having trust in your employees and creating standardized workflow procedures to ensure that tasks are completed accurately and that deadlines are met. Ensuring you have documented goals for each employee and providing ongoing feedback are best practices of successful firms.

If your mindset is "if I can see them, I know they are working," then chances are you're not a candidate for flexible work arrangements. It's important to focus on the quality of your employees' work results rather than number of hours worked.

### OTHER IDEAS

There are other ways firms are increasing flexibility for their employees that improve work-life balance. Summer hours from Memorial Day through Labor Day are becoming more commonplace practices in our industry. One increasingly popular approach is to have the Friday workday end at 3 p.m. for a majority of the firm while a skeleton crew remains until the official closing time.

Admittedly, your firm may not be large enough to make this work, but some variation of this practice could be very engaging for your team.

I am also starting to see more firms incorporate sabbaticals into their benefits and rewards system. The definition of a sabbatical is any extended period of leave from one's customary work, for rest or to acquire new skills and training. The leave period can range from four to eight weeks and is typically based on years of service as the main criterion for eligibility.

One advantage for the firm is that the employee returns refreshed and renewed. In addition, tenured-based sabbaticals encourage loyalty and increase employee retention.

Further, several firms are starting to use this time off vehicle as a succession-planning tool. Younger employees have the opportunity to grow in their roles when senior advisers are on a sabbatical. This may also help to motivate those nearing retirement who may be reluctant to start to transition their clients to others on the advisory team.

I highly recommend taking a step back and reassessing how flexible your current work environment is and to start making plans to incorporate more flexibility into your human capital plan. Your business model is built on client retention, which in turn means it is built on employee retention, as well.

**FP**

**Ensuring you have documented goals for each employee and providing ongoing feedback are best practices of successful firms.**

## Big-Time M&A Game Is Changing

What RIA buyers want, and what sellers need to know.

BY CHARLES PAIKERT

### THE BIG RIA BUYERS ARE BECOMING MORE DISCERNING.

"Acquiring firms, with over \$1 billion in AUM, are looking for really high-quality firms," says David Canter the executive vice president of Fidelity Clearing & Custody Solutions' practice management and consulting arm. "There's been an evolution in how these firms are approaching mergers and acquisitions, and they've become much selective in the kind of firms they want to buy."

In fact, the number of deals involving firms with over \$100 million dropped 25% last year to 104 deals, from 130 in 2015, according to Fidelity's 2016 Wealth Management M&A Transaction Report.

Sellers who were hoping to cash in on what they thought was a hot M&A market may need to reconsider their business model, according to the report, citing five major turn-offs for buyers, including a history of limited AUM growth; an aging

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client base; insufficient adviser talent; no viable succession plan; and a spotty or tainted compliance record.

What are buyers looking for? They're seeking firms that provide a really good client experience; RIAs with a similar investment philosophy and capabilities, such as comprehensive financial planning; a common philosophy on how employees are treated, compensated, trained and utilized; and compatibility between personnel in the merging firms.

As for the defining characteristics of discerning major buyers, having access to "substantial and sophisticated capital" has become critical, the report says.

"Today, few large RIAs are executing transactions by relying solely on existing cash flow," the report states. "Instead, these acquirers are drawing on available capital from sophisticated private equity firms and parent investors who find the wealth management space an attractive investment opportunity."

Buyers with over \$1 billion in AUM are also taking a more strategic and deliberate approach to pursuing targets, focusing on three priorities, according to the report. First,

expand geographically to efficiently build a presence and brand in a new and distant market. Second, acquire next-generation talent, who can potentially help supercharge organic growth by providing an array of technical and client-facing skills and leadership potential. Third, build density in markets where the acquirer has an existing presence in order to increase scale and gain efficiencies and elevate their brand profile is the third priority.

## VALUATION AND DEAL TERMS

When it comes to price and actually negotiating a deal, terms are more important than a valuation, Canter says.

A valuation of the firm will probably include multiple of earnings before owners' compensation, Canter says.

But when structuring the deal, buyers and sellers have to agree on key issues and incentives like client retention, future AUM growth, control and voting rights, a philosophical alignment of how to do business and timing and method of payments, Canter says.

In the end, "deal terms rule," he asserts.

FP

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

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**BY ANDREW WELSCH**

**I**s it too late to overturn the fiduciary rule?

That question might seem a bit far-fetched in the wake of President Trump's memorandum instructing the Department of Labor to review the regulation once again, with an eye toward killing or aggressively scaling it back.

But since it was unveiled last year, the regulation has prompted an industrywide re-evaluation of business strategy that looks unlikely to abate.

Ameriprise spent tens of millions of dollars and assigned more than 500 people to oversee compliance. Betterment and Merrill Lynch invested in advertising campaigns to broadcast their embrace of the rule.

The regulation even penetrated pop culture; the comedian John Oliver last year dedicated an episode of his weekly HBO show to its benefits.

Just as the president has moved to delay the rule's implementation, more clients are asking for lower fees, greater transparency and a higher standard of care. And fiduciary advocates have been strategizing on how to continue to push for higher standards of client care.

"Regardless of whether the rule goes into effect, we will be operating in the fiduciary era," says Valerie Brown, executive chairwoman of Advisor Group, which recently rolled out platform changes for its 5,000 advisers.

"For our firm, we have spent untold numbers of hours and dollars to get ready for this rule," Brown says.

# FIDUCIARY FORWARD

*After investing millions in new platforms and preparing thousands of advisers, executives say they've come too far to reverse course.*



HighTower CEO Elliot Weissbluth says his firm has been embracing fiduciary duties for years. "If you go back and look at our marketing materials in 2008, we have been consistently on this message from Day One," he says.

As a result of President Trump's memo, the Labor Department will review the rule and possibly issue a new one. It's currently not clear what may replace the regulation as a result.

But regardless of what happens in Washington, every executive contacted by *Financial Planning* before and after Trump's action said they would keep many, if not all, of the changes they've been implementing. Firms have been lowering fees, increasing transparency and making multimillion-dollar investments in revamped platforms and new technologies, chiefly around communications and supervision.

"The bigger issue for us is that there are macro trends requiring a transformation," says Adam Antoniadis, president of Cetera Financial Group. "Whether it's under the fiduciary rule [or not], we are going to continue down that path."

Executives note that pressure on fees has been mounting for some time, and there are demands for greater transparency around compensation. Preparations that were being made for the Labor Department's rule accelerated those trends.

### CUTTING FEES

Over the past year, some firms have cut fees on their platforms. For example, LPL eliminated fees charged for LPL Research models in its Model Wealth Portfolios, resulting in a 15 to 20 basis point cost reduction, according to the company.

Among other changes, LPL is creating a mutual fund-only tool for its advisers, says Bill Morrissey, managing director of business development. The tool will offer about 20 mutual fund families, an "enormous menu of options" for clients, Morrissey says.

LPL says it anticipates the mutual fund-only tool will have a level upfront load of around 3.5%, with a 25 basis

point trail payment. There will also be no IRA custodial fees or trading costs.

Morrissey says these and other changes are only possible because of LPL's size. With over 14,000 advisers, it's the nation's largest independent broker-dealer.

"Those are examples of some of the things we have done that I think will have broad applications beyond the DoL fiduciary rule," he says.

### NARROW RANGE

For its part, Advisor Group unveiled major platform and pricing changes in January. "Our transaction charges are now bundled into an all-in cost that, for advisory and brokerage, is on average reduced by 50% to \$9 and \$15 respectively, and our Genesis platform brings minimums down from on average \$50,000 to as low as \$5,500," the firm said in a statement.

"We spent an enormous amount of time working on our platform and

attracting new assets.

Consultants, vendors and other firms have also jumped into the marketplace to help IBDs, RIAs and other wealth management firms prepare for the rule's implementation.

Since the rule was issued in April 2016, Tim Slavin, senior vice president of retirement services at Broadridge Financial Solutions, has met with more than 60 firms. The regulation led executives to re-evaluate their strategies, says Slavin, whose firm specializes in investor communications.

"What funds am I going to offer? Will I offer T shares? Will I cut the number of funds offered? Those are all strategic questions that [were] going on," he says.

Like many other industry insiders, Slavin says executives preferred changes be made to the rule. But he anticipates many would keep the bulk of the improvements they had made.

"The vast majority of our clients are moving forward," he says. "I had one cli-



Advisor Group Executive Chairwoman Valerie Brown says her firm will be operating in the fiduciary era no matter what the regulatory environment is.

PHOTO BY JEFF SCIORTINO

with our partners to figure out how to do this economically," Advisor Group CEO Jamie Price says.

Cutting prices may affect profits in the short term. But Brown says there are long-term benefits to this approach. Advisor Group's investments, she says, will appeal to new recruits and help advisers grow by

ent say, "I didn't spend \$5 million on a consulting firm in order to do nothing."

Many firms and consultants have worked hard at improving communications and the delivery of advice.

"It's going to be far more important moving forward to have strict processes and procedures," says Matt Schulte, senior vice president of financial plan-



Principle 3

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ning at eMoney, a planning software provider owned by Fidelity.

"There is a lot of individualism in terms of how folks deliver their advice and services. I think they will need to be operating a little more consistently, and understand where there could be gaps in how they deliver the advice."

Executives at eMoney say a framework they created to help advisers and firms operate under the fiduciary rule's requirements will have lasting benefits.

CEO Ed O'Brien points to the firm's aggregation and planning tools as ways advisers can ensure clients get the advice they need.

And he says the firm's framework-based approach helps planners systemize policies and procedures.

"We think this helps more advisers do more planning for more clients. At the end of the day, that's in everyone's best interest," he says.

### ADVICE-CENTRIC EXPERIENCE

Implementing the rule was just one part of Cetera's strategy, Antoniadis says. The firm is also working on new client-facing technologies that will roll out later this year. Antoniadis declined to go into detail, but emphasized that this goes beyond new regulation.

"I think too many firms are focused on the status quo, rather than understanding what it will mean to deliver advice in the future. In our opinion, it will be a fundamentally different engagement model," he says.

Advisers who have been fiduciaries, and are advertising themselves as such, face an additional challenge: How can they maintain their edge?

"Ten years ago, saying that you were a fiduciary adviser with \$600 million was a differentiator," says Shirl Penney, CEO of Dynasty Financial Partners, which serves wirehouse

breakaways and RIAs.

### TOUGH COMPETITION

Competition, he says, is getting tougher as more advisers join the independent space and market themselves as fiduciaries.

It's still an advantage with clients, he says, but it's a shrinking one. "The world is becoming more informed, and the big firms are finding more ways to muddy the water," he says.

This point has also been on the mind of HighTower CEO Elliot Weissbluth. "Believing in a fiduciary standard was embedded in our very DNA," he says. "We were designed to embrace a fiduciary duty. If you go back and look at our marketing materials in 2008, we have been consistently on this message from Day One."

In one such ad, a white board video from 2012, the firm promotes and explains what a fiduciary is to prospective clients. The ad compares the difference between a broker and a fiduciary adviser to that between a butcher and a nutritionist: If you want the healthiest recommendation, you see a nutritionist, not someone likely to suggest roast beef in lieu of a salad.

HighTower doesn't sell proprietary products. The firm's efforts to comply with the rule did not require huge overhauls, he says. HighTower only spent a few million dollars doing so, according to Weissbluth.

But Weissbluth thinks the Labor Department's rule didn't go far enough in promoting a true fiduciary standard. He worries that too many exemptions were created.

"If you were to take that standard and start chipping away at it and you started to make exceptions, or as one of my mentors referred to it, Swiss cheese a rule, then the rule starts to

lose its credibility," he says.

Worse, exemptions such as the best interest contract exemption create confusion for investors, Weissbluth says. "The point is that, if you have a fiduciary standard, it's pretty straightforward. It's not that you get to be a fiduciary on Mondays and Tuesdays, and Wednesdays you get to be a salesman," he says.

HighTower remains committed to putting clients' best interests first, and intends to promote what it calls "beyond fiduciary" in marketing campaigns. Weissbluth declined to discuss the details, but said the intent is to foster a conversation about what it means to really take care of clients' interests.

### 'FIDUCIARY ERA'

Changes to the Labor Department's regulation might not matter where it counts most for firms: More and more clients are aware of the rule and asking advisers about standards of care and how their planner is compensated.

And it's not just advisers. LPL's Morrissey says his neighbor recently asked him about it, too.

eMoney executives say robo advisers are also playing a role in making clients more price conscious.

"The idea around this concept is becoming more mainstream at the consumer level, and the trend toward transparency will continue," O'Brien says. "That's why we like our framework regardless of whether a specific ruling sticks around or not."

Market forces will also accelerate change. If more clients demand fiduciary services, then the industry will supply them – with or without regulatory prodding. In short: The fiduciary genie is out of the bottle.

"I think its full steam ahead regardless of what happens in Washington," Slavin says. **FP**

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Andrew Welsch is senior editor of *On Wall Street*. Follow him on Twitter at @AndrewWelsch.

# Robo Advisers: We Can't Be Stopped

Digital advice firms will continue to market themselves as white knights in the financial services industry, observers say. By Suleman Din

Digital wealth management and fintech firms shrugged off President Trump's move to potentially delay and possibly reverse the fiduciary rule, arguing it was no hurdle to their own growth.

"Everyone sees the need to offer a better digital experience, so the investment in better technology will only continue," says Jon Stein, CEO of Betterment.

During debate over the rule, industry analysts predicted robo advisers would get a windfall from its enactment, picking up small accounts deemed by large firms and RIAs to be too burdensome to service.

Though that scenario is now in doubt, Trump's action on the rule does

not hurt digital advice firms, even if it eventually leads to a complete replacement of the regulation, says Sean McDermott, senior analyst at research firm Corporate Insight.

"The delay of the rule preserves digital advice providers' ability to market themselves as white knights in the financial services, committed to putting their investors' interests ahead of their own," he says.

"Digital advice providers can continue to focus on the fact that they operate as affordable fiduciaries that bring conflict-free advice to the masses, a powerful differentiating feature and marketing narrative," he adds.

Stein was among several leaders in digital wealth management adopting that refrain. "[It was] a sad day for individual investors," he says. "Repeal means favoring the bottom lines of the financial services industry over the American people, who deserve financial transparency and honesty.

"We'll continue to act in our clients' best interest as a fiduciary, regardless of whether or not it's required," he adds. "That resonates with customers."

## DIGITAL TAILWINDS

Trump recently instructed the Department of Labor to review the rule's impact on investor choice and the industry, and to possibly issue a new rule. The DoL subsequently moved to

delay the regulation's implementation.

But delaying the fiduciary rule will not slow technological change in wealth management, argued Rob Foregger, co-founder and executive vice president of NextCapital.

"If you believe the regulatory, industry and consumer winds are still pushing toward personal advice, then the tailwinds are still very much with the digital wealth management providers," Foregger says.

"Our market observation is that the industry has embraced the new fiduciary rule, and very few players want to actually go backward now — the core investment has already been made," he adds.

Mark Trousdale, executive vice president and commercial director at InvestCloud, wonders about the effectiveness of any delay. "Even if an executive order is signed that repeals the fiduciary rule, it doesn't change anything for digital advice. At this point, the genie is out of the bottle," he says.

Wealth managers and large financial institutions have realized the opportunity of digital advice, he says, as it is an industry expected to have as much as \$8 trillion in assets by 2020, according to various analyst predictions.

"Whether you're a bank looking to attract investors who prefer a fiduciary, looking to increase your scale or simply managing your margin on record-keeping accounts, digital advice is a better way to do business," Trousdale says.

## COMBATIVE TONE

Some took a more combative tone, voicing concerns about the intent of the delay. In a company blog post, Personal Capital CEO Bill Harris took swipes at Gary Cohn, a Trump adviser and director of the National Economic Council. Harris mocked Cohn's analogy to junk food in describing his opposition to the fiduciary rule, stating, "Encouraging people to die younger is one way to solve our retirement crisis."

Next, Harris noted the stock price of Cohn's former employer Goldman Sachs went up after the announcement of the order. Finally, Harris added that it was "equally troubling the nominee for secretary of the Department of Labor is not known for upholding the work of the Labor Department.

"It's tragic that providers of retirement accounts, who benefit from tax advantages bestowed by Congress to encourage retirement savings, so often charge high fees and put participants in inappropriate investments for the benefit of their own bottom lines," Harris wrote.



Personal Capital CEO Bill Harris wrote a pointed blog that took swipes at Gary Cohn, a Trump adviser and director of the National Economic Council.

Suleman Din is managing editor of SourceMedia's Investment Advisor Group. Follow him on Twitter at @sulemandin.

# PRACTICE

ALSO IN PRACTICE: P. 38: Turn Fear Into Action

## When Clients (or Advisers) Jump

Despite their growing market share, many RIAs are finding that the biggest competition is right in their own backyard.

BY PAUL HECHINGER

**THE FLOW OF ASSETS AND CLIENTS FROM** wirehouses and brokerages to RIAs is one of the most intensely watched trends in the wealth management industry. But what about the movement of clients and assets between RIAs?

"The RIA channel has grown at twice the pace of any other channel, and RIAs in the channel will compete more with each other," says Alois Pirker, research director for Aite Group's wealth management practice. "There's no question about it."

The RIA sector increased its market share 5.4% from 2007 to 2015, the greatest surge of any advisory channel and the only one to gain every year, according to Aite. Client assets in the independent RIA channel more than doubled to \$2.8 trillion in 2015 from \$1.3 trillion in 2007.

As RIAs grab more market share, it's only natural to assume that more clients will come not just from wirehouses or broker-dealers, but also from competitors.

"It's a sign of the maturation of the industry," says Gail Graham, chief marketing officer of United Capital. She adds that "some old-fashioned RIAs are getting left in the dust."

### CLIENTS' MUSICAL RIA CHAIRS

Over the second half of 2015, 20% of new RIA clients came from other RIAs, according to TD Ameritrade. That number more than doubles to 47% for firms with more than \$250 million in assets under management.

Does this have an impact on how firms approach marketing and attract new clients? The answer is yes, according to advisers, marketers and other industry observers, but there are many factors to consider.

Location is a major factor, Pirker says, because the market tends to be concentrated in classic wealth centers like New York, San Francisco, Chicago and Los Angeles.

In those places, many RIAs are already finding themselves competing for similar clients based on geography alone, he says.



"Some old-fashioned RIAs are getting left in the dust," says United Capital CMO Gail Graham.

The size of a firm is probably the most significant factor. "We see a growth differential in RIAs," Pirker says. Some firms are able to grow faster through leveraging technologies and successful mergers and acquisitions, he says, but many smaller firms will not be able to do that.

"The fastest-growing demographic within the space will certainly receive a good chunk of accounts from other RIAs," he predicts, adding that "it's not an equal playing field." Cost-conscious advisers might not be able to invest in improvements to aid future growth, he says.

### A TREND TOWARD CONCENTRATION

"I think that will lead to concentration," Pirker says. "You'll see an 80/20 type of space, where 20% is actively pushing and growing, while the other 80% is sitting under \$100 million in assets and shying away from paying for better platforms and more efficiency, feeling that they don't need to grow any further, while those 20% get bigger and will swal-

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low up more of the market.”

Size is a big advantage because the economies of scale can be essential for investing in technology and professional marketing. While many smaller firms can't afford such extras, some are tapping those services via affiliations with larger firms.

## 'DOUBLE-EDGED SWORD'

Yet size is only one factor and it can be “a double-edged sword,” says John Anderson, managing director, practice management solutions for the SEI Advisor Network.

Larger firms with marketing budgets tend to be broader in their messaging, Anderson says. “The danger there is that you get lost in the noise. People have trouble telling one from the other, because they typically all say the same thing the bigger they get.”

The strength of smaller firms is that they can be more focused and specialized.

“The bigger you get, the broader you tend to have to be with your services,” Anderson explains. “If you look at a \$2 billion or \$3 billion RIA, they're trying to be everything to everybody. If it's up to the \$750 million range, it's still small enough to be nimble and to be more focused on a niche, and that focus is great for differentiating yourself.”

RIAs, say advocates, can more finely tune themselves than brokerages to serve niches, which might be defined by geography, industry or even a specific company.

That's the case for Diversified Financial Consultants, a Wilmington, Delaware-based RIA. The firm, which has assets of some \$350 million, has developed an expertise in working with DuPont executives.

## KNOWING THE CLIENT'S BUSINESS

Andrew Rosen, a firm partner, says he has fielded many calls from clients and prospects about a DuPont pension plan, an issue with which his firm is intimately familiar. It's a niche he owns.

“We have another arrow in our quiver,” Rosen says. “We're not only doing holistic advice, but we have a leg up in knowing our client's business, their industry, even their 401(k)s.”

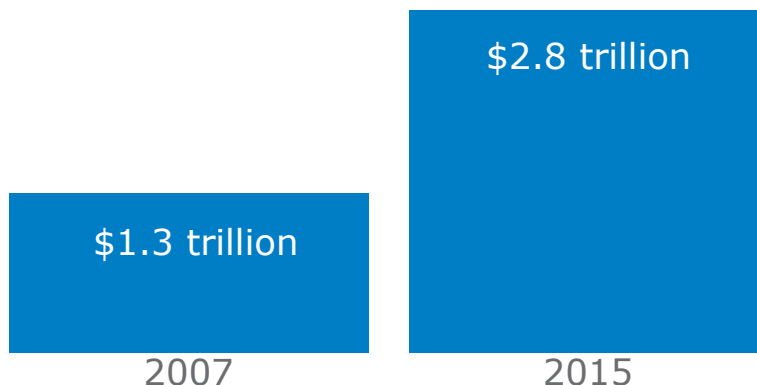
That kind of very specific experience also colors hiring and recruiting, as well as merger activity. “It's an interesting fraternity – there's a respect level among RIAs that's very different than a bunch of advisers in a wirehouse,” says recruiter Ryan Shanks, who estimates that three-quarters of his services involve RIAs. Shanks says he is acutely aware of firms' distinct personalities. “If I come across a firm I respect, and you're an adviser working with that firm, it's almost a prequalification,” Shanks says.

Indeed, among RIAs, competition for adviser talent might be more direct than competition for their clients, and most insist it's not about poaching clients. “We do not

**Advocates say that RIAs can more successfully serve niches – which might be defined by geography, industry or even a specific company – than brokerages can.**

## Client asset growth

The independent RIA channel saw large gains between 2007 and 2015.



Source: Aite Group

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target other RIAs,” United Capital’s Graham says. “We don’t think like that. I don’t know anyone who has a singular strategy of poaching from other RIAs, but we all do compete for clients.” That competition is tougher for a number of reasons, Graham says.

### EYEING THE COMPETITION

First, since most RIAs offer investment advice, holistic planning and fiduciary responsibility, those features have now all



Oxford Financial Group’s J.P. Simmons says, “We’re not looking at other RIAs and asking, ‘How are we going to get their clients?’”

become clients’ baseline expectations.

“They’re the table stakes,” Graham says. “It gets you in the door, but it’s not a big differentiator anymore and it doesn’t actually get you the client.”

At the same time, she says, almost every channel of the wealth management business has taken on the trappings of RIAs.

“The name on the door could be, wealth management from a private bank, or an RIA,

or Merrill Lynch or Morgan Stanley – any one of those models can be effective for a client, or not effective,” Graham says. “There’s no guarantee that an RIA will be better than the other models. Within the RIA world, where we used to be able to say, ‘I’m an RIA, and that makes me better because I do wealth management,’ that’s just not true anymore.”

Graham says the key to an RIA’s marketing success is making sure that the approach is personal, specific and clear. She takes her cues from broader consumer marketing trends.

One trend, she says, is that people are demanding accessible technology. She says many “old-fashioned” RIAs insist on face-to-face meetings and do not use a lot of videoconferencing. That is changing, though, as some smaller advisers have embraced video, realizing it is a necessity to better compete in a changing RIA world.

Despite intensifying competition within the channel, most RIAs see focusing on client satisfaction and differentiation as recipes for success, rather than luring clients from other firms.

“We’re not looking at other RIAs and asking, ‘How are we going to get their clients?’” says J.P. Simmons, director of practice management of Oxford Financial Group in Carmel, Indiana.

In fact, he says, the strategy at Oxford embraces working well with other RIAs.

“We don’t really see ourselves as replacing any RIAs as much as being complementary to them,” he explains. “We have a lot of RIAs that work with us. We receive and give referrals to them as well, when appropriate. If we’re not a good fit for somebody, we would be more than willing to recommend another RIA.”

Still, he concedes, “We probably wouldn’t recommend another delivery channel.” **FP**

**“If we’re not a good fit for somebody, we would be more than willing to recommend another RIA,” says J.P. Simmons of Oxford Financial Group.**

## Turn Fear Into Action

Millennials are largely pessimistic that Social Security will pay off for them, and advisers need to use this viewpoint to spur more saving.

BY PAUL HECHINGER

**MANY YOUNGER CLIENTS ARE DEEPLY SKEPTICAL** about the future of Social Security. Nearly three-quarters, 74%, of millennials believe Social Security will not be there for them when they retire, according to the 2016 Wells Fargo Millennial Study.

Advisers say that such sentiments are overly pessimistic. But at the same time, they think younger clients are correct not to expect Social Security to be the same for them as it is for today's retirees.

"Millennials have cause to be concerned about Social Security benefits," says Lauren Locker, the principal of Locker Financial Services in Little Falls, New Jersey. "We know that some changes need to be made in the system. The question is how and when the changes will occur."

Discussing the likelihood of long-term changes and the possibilities of reduced benefits offers advisers opportunities to impress the importance of savings strategies on younger clients. This can be challenging when many millennial clients don't even ask about Social Security.

"It so rarely comes up," says Sophia Bera, the founder of Gen Y Planning in Austin, Texas, who specializes in working with younger clients. That is only natural because, "we don't put a lot of time and energy into things we don't have a lot of control over," she says.

"Honestly, I don't even talk to my clients about Social Security since they're not going to be eligible for 30 or 40 years," Bera says.

The point is to get younger clients thinking about all the other important ways to increase their savings, she says. "If Social Security is still around, then it will be some bonus income, but my clients plan on funding their own retirements," Bera says.

Social Security benefits will still be around for millennials, predicts Anthony Ogorek, the chief investment officer and founder of Ogorek Wealth Management in Williams-

ville, New York. But he foresees significant changes, including increases in the FICA ceiling, later start dates for retirement benefits and some forms of means testing.

"The program is antiquated, and it's being asked to do what it was never conceived of doing," Ogorek maintains. "Now, there's a recognition that life expectancies have increased way beyond what the original framers of Social Security ever expected – and it's not unreasonable to expect changes to occur."

### SIGNIFICANT CHANGES AHEAD?

But uncertainty about changes can be positive if it spurs younger clients to plan for retirement earlier, advisers say.

"If millennials are concerned that the program will change radically over their lifetime, it's an additional incentive for them to be saving at least 10% or 15% of their pay in tax-deferred vehicles," Ogorek says. "That's where advisers can assuage fears about Social Security and boost savings rates for younger clients at the same time.

"It's important for millennials to develop the habit of saving that eluded many of the boomers for so long," Locker says. "It's also critical for them to understand the concept of budgeting and the value-related choices that come with setting spending limits for yourself."

Millennial trends toward postponing or eliminating home and car purchases can in some cases provide opportunities to save more money for a retirement nest egg, Locker says.

Fears about Social Security can help advisers to make younger clients see the benefits that even small savings can make, when started early enough.

"Small, sustainable, incremental changes in lifestyle options can make a big difference over a lifetime, and millennials are well-positioned to make the shift toward more frugal and less consumer-driven choices," Locker says. **FP**

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Paul Hechinger is a writer for *On Wall Street* and *Financial Planning*. Follow him on Twitter at @PaulHechinger.



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# TECH ZONE

ALSO IN TECHZONE: P.43: Raymond James Turns to Robos

## RIAs To Benefit From Tech Tools

TD Ameritrade Institutional makes a splash with its revamped Veo One and a new iRebal Model Market Center.

BY JOEL BRUCKENSTEIN

**TD AMERITRADE INSTITUTIONAL, LONG CONSIDERED** a leader among RIA custodians for its open access integrations of third-party software, has unveiled important updates to its Veo One platform and a new iRebal Model Market Center.

The firm's announcements came at the its National LINC Conference, an annual gathering for independent RIAs, which had more than 3,200 people registered this year, including more than 2,000 RIAs.

Perhaps the most significant announcement was the general release of VEO One, TD Ameritrade's next generation platform for advisers. The platform, which has been in beta testing, provides a unifying technology experience that is unique among custodial offerings. No other RIA custodians offer the depth and breadth of providers that VEO One does.

The platform is relaunching with virtually all of the functionality of its predecessor, with the rest to follow shortly. VEO One currently includes 14 integrated partners: Junxure, Redtail, Salesforce for CRM; eMoney, Envestnet/FinanceLogix and MoneyGuidePro for financial planning; Advent/Black Diamond, Morningstar and Orion for portfolio management; and DocuSign, LaserApp, Laserfiche for digital enterprise content management. TD Ameritrade's iRebal rebalancer and ThinkPipes trading platform are also part of the VEO One ecosystem. A 15th integration partner, AdvisoryWorld, will be added shortly.

Additional partners will be added to the system on a regular basis. TD Ameritrade estimates that most, if not all of the

over 100 current VEO integration partners will be onboarded over the next several quarters.

So what makes VEO One different from its predecessor? It "got the data moving," according to Jon Patullo, the managing director of technology product management at TD Ameritrade Institutional. By this he means that third-party providers could pull data from the TD Ameritrade platform and use it in their applications. In some cases, third-party software could also push data to TD Ameritrade.

### MIND THE GAP

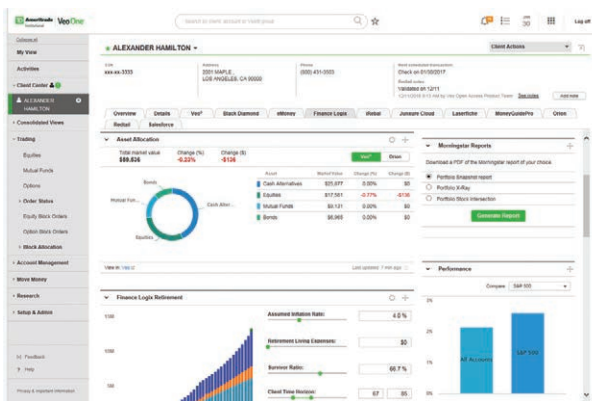
VEO Open Access is a major improvement over what preceded it, but there are a few major gaps that advisers and the third-party vendors wanted addressed.

For one, advisers didn't necessarily have a unified view of all relevant data. For example, if you were a planner and spent most of your time in your planning software, the status quo was probably OK. However, if you needed to see relevant data that resided in your CRM

displayed on your computer screen with financial planning and portfolio management software displayed, you'd need to toggle back and forth between programs.

VEO One addresses this gap by bringing widgets to the VEO One system from your various software vendors. Advisers can customize their VEO One dashboards so that the widgets containing the information relevant to their needs are displayed at all times.

Another gap is related to sharing information across applications. Under the previous framework, if you changed



Advisers can customize their dashboards with key data

Source: TD Ameritrade Institutional

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a client's address in your CRM, the change could be pushed to the TD Ameritrade platform, so the two platforms were in sync. Changes originating on the TD Ameritrade platform could likewise be sent to the CRM. But what if you made a change in the CRM and you wanted it reflected not only at TD Ameritrade, but also in your planning software and your portfolio management software? That was not previously possible, but it is now.

What if there is a change in household members? This appears straightforward at first glance, but that isn't always the case. Why? Because the household in CRM might be different from the household for portfolio management purposes. VEO One is powerful enough to let the user specify, when a change is made in one application, what, if anything it should communicate to each other connected application.

Yet another positive change is that it empowers co-creation. In the past, third-party providers that wanted to integrate with VEO or enhance their integrations required TD Ameritrade employees to collaborate with them. This created bottlenecks when demand for TD Ameritrade resources exceeded supply. Now vendors will be able to do more of the development with less required of TD Ameritrade once they are admitted to the platform. This should lead to more rapid deployments.

Large RIAs can make use of these development tools as well. To cite just one example, they could create their own robo adviser by leveraging TD Ameritrade's digital account opening tools, and leveraging iRebal for trading and rebalancing.

### **TRANSPARENT WORKFLOW**

Both advisers and TD Ameritrade have been anxious to have more transparent operational workflows. With VEO One, advisers will be able to track all open case files from within VEO One. They will be able to see what has been received by TD Ameritrade, where it is in the workflow process, and if it is in good order or not. If a client sends a check to the adviser as part of an account funding process, the adviser can now scan the check

for processing at TD Ameritrade.

Later this year, TD Ameritrade will provide an analytics and benchmarking tools from FA Insight, according to Chris Valleley, the director of technology solutions at TD Ameritrade. TD Ameritrade acquired FA Insight last year.

By inputting some data points, advisory firms will be able to benchmark themselves against peers in the region, similar firms nationally and against other demographics. VEO One will also provide operational analytics. For example, the platform will include a "NIGO Report Card." This report will indicate to advisers which workflows between the firm and TD Ameritrade are working well and which ones aren't.

Analytics will also address client segmentation, what technologies they are using and what technological opportunities exist, as well as the percentage of business processed electronically. The goal is to make advisers more successful at leveraging the technology available to them through TD Ameritrade and their partners.

### **IREBAL SUPERMARKET**

Another major innovation announced at the conference and launching soon is the iRebal Model Market Center. This new offering, which will be made available to the over 10,000 users at over 2,500 RIA firms can be thought of as a supermarket of model portfolios constructed by well-known asset managers. This platform will lower the barrier to entry for managed accounts, says Danielle Fava, the director of institutional product strategy & development at TD Ameritrade Institutional.

"Today, the separately managed account purchased through a turnkey asset management program is fairly inefficient," she says. There are trading and administration fees. The adviser has no discretion over what the sub-account manager does. The adviser gives up control.

The iRebal Model Market Center allows advisers to pick a model and add it into an existing iRebal process. When a manager makes a change, it will be reflected immediately in iRebal. One significant difference between the typical TAMP subaccount pro-

**The new platform is the foundation upon which future enhancements will be deployed.**

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cess and the iRebal process is that in the former case, the trades just happen. In the case of iRebal, the adviser can review the proposed changes before they happen, and the adviser has the discretion to override trades when necessary.

The iRebal Model Market Center will offer models developed by product manufacturers and others. These models will be available to all iRebal users at no charge, and will be the only models available initially. Fava declined to name the initial list of product manufacturers, but indicated there will be at least five providers at the outset.

In the second phase of the rollout, third-party investment managers will be able to offer their models on the Model Market Center. Advisers will typically pay a fee to make use of this intellectual property. Providers are likely to include managers that advisers are familiar with from various TAMP programs, but it could also include new entrants, including RIA firms that have developed their own models. TD Ameritrade will not impose any fee for this service. Advisers will only pay the fee charged by the third-party manager.

One appealing aspect is that it is not an all-or-none proposition for advisers. Firms can use a sleeve approach to blend some in-house management with Market Center models. So, for example, if a firm has a successful domestic strategy of their own, but no expertise with international equities, they can blend multiple strategies and manage it all in iRebal.

According to Fava, the iRebal Model Market Center addresses a number of trends that are taking place within our industry: the move to passive investing, the move to a model-based approach to managing assets, and lower fees. Managing models of ETFs is easy and inexpensive with iRebal.

### **BROAD IMPLICATIONS**

Although Fava did not specifically mention it, the Model Market Center could have broad implications for how advisers manage

money. As third-party managers become available, in many cases it will be cheaper to buy their portfolios through the Model Market Center than, say, through a mutual fund offering with an identical strategy, while offering the adviser greater control over tax-related decisions and cash levels.

"Increasingly, clients are deciding that their time is not best spent on stock picking," Fava says.

RIA firms that custody at TD Ameritrade might not be the only ones that leverage iRebal Model Market Center. A number of digital advice platforms, including those of Riskalyze and Adviser Engine use, or plan to use iRebal as their rebalancing engine.

### **NOT A PLUS FOR EVERYONE**

While this new development is clearly good news for advisers, it might not be welcome news to TAMP providers currently providing services to TD Ameritrade clients.

When I asked Fava about this, she provided a predictably neutral answer: "With regard to Managed Accounts, we see advisers falling in two distinct categories: advisers who want to outsource management and trading versus advisers who want to retain discretion. The advisers who desire a true outsourcing arrangement will continue to be directed toward and partner with a TAMP. Advisers who want to retain discretion and control of the trading are better suited for the iRebal Model Market Center."

It is difficult to imagine that any TAMP will welcome this news. For advisers that already custody with TD Ameritrade, use iRebal, and currently have portfolio management and reporting capabilities, iRebal Model Market Center should be more efficient and less expensive.

The competition among RIA custodians on the technology front remains fierce, but TD Ameritrade's ability to innovate and differentiate has proven noteworthy. With their latest announcements, they continue their tradition of delivering the tools their advisers want.

**FP**

**The Model Market Center could have broad implications for how advisers manage money.**

## Raymond James Turns to Robos

Planners will have control over the service, which will not be directly available to clients.

BY ANDREW WELSCH

**RAYMOND JAMES WILL PUT ROBO ADVISER TOOLS** in the hands of its planners by the end of the year, making it one of the last major brokerage firms to announce digital wealth management plans.

The firm says the technologies, which have been developed in-house, will be used at the discretion of its more than 7,100 independent and employee advisers. There are no plans to offer a standalone service, according to Bella Allaire, executive vice president of technology and operations.

"The client will be able to, from the standpoint of the technology, sign up online, create a model online, execute the model, but they will get there through an invitation from a financial adviser," she says. "The financial adviser will have the final say over whether the models are appropriate."

Advisers will have control over the price charged to clients, and they will be compensated the same as with other assets, according to Raymond James.

Allaire says the technology is designed to be compliant with the Department of Labor's fiduciary rule, which goes into effect April 10. There is much industry speculation the rule could be delayed or reversed, given President Trump's memo request for the department to review it. For now, Raymond James continues to prepare for it.

The firm's move to add a robo platform, even if it's not standalone, comes after many of its largest competitors unveiled their own similar plans.

Lex Sokolin, partner and global director of fintech strategy at Autonomous Research, says his firm projects the digital wealth market could be between \$500 billion and \$1.5

trillion by 2020. "The big variable in those numbers is the DoL fiduciary rule," he says.

### ROBO IN EVERY PRACTICE?

CEO Paul Reilly previously said Raymond James would not have a robo adviser, but would explore technologies that would help its planners gather assets.

Allaire says the firm's technology plans have been in the works for a while. She couldn't specify how much the firm spent on developing these technologies, but says Raymond James spends about \$250 million per year on its tech budget.

In developing the technology itself, the St. Petersburg, Florida-based firm is bucking an industry trend. Many of its competitors

have opted to tap outside talent.

"It is very important to us to provide ease of use and accuracy of data. In my experience, you can only accomplish that by creating your own data platform. If you start switching data between your platform and a tech provider, you end up with inconsistencies," Allaire says.

She also points to the uncertainty around the fiduciary rule. "That's another reason to have your own software. We can move so much easier, and it's much easier to adjust with your own platform rather than working with a vendor. It's much more conducive to not disturb the financial adviser," she says.

But no matter which route they take, every firm is moving toward developing some kind of digital platform, Sokolin says, from pure standalone robos to hybrids to robo tools in human hands.



Raymond James is joining the digital advice race.

BLOOMBERG NEWS

Andrew Welsch is senior editor of *On Wall Street*. Follow him on Twitter at @AndrewWelsch.

# CLIENT

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## A Turnaround on Philanthropy

Tax-wise strategies for charitable contributions can take a 180-degree turn when it comes time to create an estate plan.

BY DONALD JAY KORN

**FOR CLIENTS WHO ARE CHARITABLY INCLINED, SOME** donations may be better than others. Tactics that excel during a client's lifetime might not be ideal at death.

"Changing plans for charitable bequests, as opposed to lifetime contribution choices, can be a smart strategy," says Cheryl Holland, founder of Abacus Planning Group in Columbia, South Carolina.

During life, one established ploy is to contribute appreciated assets rather than cash. "By donating appreciated securities that have been held for more than one year, clients can get a charitable deduction for the market value of the security," says Benjamin Sullivan, a CFP and Austin, Texas-based portfolio manager with the Palisades Hudson Financial Group. "These clients also avoid paying the capital gains tax they would incur if they were to sell the assets."

The charitable recipient can sell the securities and owe no tax, while the built-in gain is never taxed.

Advisers often encourage clients to hold onto tax-deferred retirement accounts such as IRAs. Tax-deferred compounding builds wealth, and there's a possibility that, in retirement, future withdrawals will be more lightly taxed.

### FLIPPING THE SWITCH

Philanthropy needn't stop with a client's heartbeat. The Giving USA Foundation reports charitable bequests reached \$31.76 billion in 2015, up more than 28% since 2013. When clients want to leave assets to a favorite cause, the lifetime donate-appreciated-securities-and-retain-IRA parlay can be turned on its head in estate planning.

"Because the cost basis of assets is adjusted to their fair market value at death, there's no benefit to donating appreciated securities at death," Sullivan says. The purpose of a lifetime donation of appreciated assets — avoiding tax on capital gains — ceases to matter, as the heirs can sell inherited assets without paying tax on pre-death appreciation.

"From a tax perspective, it's better to have the children



Cheryl Holland, founder of Abacus Planning Group, sometimes meets with a client's attorney to discuss and amend estate plans.

inherit appreciated assets held in taxable accounts at the parent's death," says Mike Piershale, president of Piershale Financial Group in Crystal Lake, Illinois. "The kids will then receive a step-up in cost basis, which will wipe out all capital gains on the inherited assets up to the date of the parent's death. This can be a huge tax savings for the heirs, on a future sale of those assets."

If charitable bequests aren't fulfilled by appreciated assets, tax-deferred retirement plan dollars might take their place. Those plans don't get a basis step-up at death: human IRA beneficiaries must take distributions and pay tax on pretax dollars.

If an 80-something IRA owner leaves the account to a 50-something offspring, the IRA beneficiary may be at a career peak, in a high bracket, so those IRA distributions could be heavily taxed.

"Assets left to beneficiaries in a pretax retirement account such as an IRA will be taxed as ordinary income when they take distributions," Piershale says. "In most cases it should be a goal of advisers to help clients minimize assets left in

such accounts, whenever possible, as long as that doesn't reduce the amount that the heirs would otherwise receive."

Once explained, the idea of bequeathing untaxed assets to charity while leaving appreciated assets to heirs, with a basis step-up, is grasped by clients.

"It's pretty intuitive," Holland says. "However, many people are not aware of this strategy. We often review estate plans that call for a certain percentage of net worth to go to charity, but without the extra step of specifying that those dollars come from retirement plans. When appropriate, we'll sit down with the client's attorney, work together to amend the estate plan and follow up with the beneficiary designations."

#### DECIDING ON THE DESIGNATION

As Holland's comments indicate, bequeathing IRA money to charity generally is done through beneficiary designations.

"There are two ways this can be done," she says. "One is to state that a percentage of the IRA is to go to a certain charity or charities. Many IRA custodians won't permit a dollar amount to be stated, probably for fear that the account won't be large enough at the IRA owner's death, but most will allow a percentage to go to charity."

No matter how long the IRA owner lives, taking distributions, if there is some money

in the account at death, then it will be possible to pay, say, 25% of the balance to charitable recipients named on the form.

The alternate approach is to carve off a new IRA, which will have one or more charities as designated beneficiaries.

"We prefer retirement money left for charities to be in a separate account, one that has no human co-beneficiaries," says Marilyn Dimitroff, CFP, principal and director of wealth management at Planning Alternatives in Bloomfield Hills, Michigan.

"We have clients who have moved some retirement funds to an IRA with charities as beneficiaries," she adds. "The paperwork is relatively straightforward. On the other hand, if someone decides that a charity will get, say 25% of their existing IRA, adding the charity to their listed beneficiaries, then the human beneficiaries may have to use a shortened withdrawal plan."

Depending on the IRA owner's age at death, the balance of the account might have to be distributed by the end of the fifth year following the year of death. However, well-advised clients can see that any charitable beneficiary has received its entire benefit before Sept. 30 of the year after the year of the IRA owner's death. Then the remaining beneficiaries may be able to take RMDs over their life expectancy, stretching out valuable tax deferral.

"Our preference is to keep the IRA money in one pot," Holland says. "That approach requires regular monitoring of the IRA, to see that the percentage left to charity is consistent with the client's desires."

#### MISSING OUT

Advisers also should be aware that not all IRAs fit this strategy. "Roth IRA distributions can be tax-free," Dimitroff says, "so they are not appropriate assets to leave to charity."

When a client inherits a Roth, an RMD schedule applies, but previous contributions may be withdrawn, untaxed. Withdrawn earnings also will avoid income tax, once five years have passed since the Roth was established. If a Roth is left to charity, heirs could miss decades of tax-free cash flow. **FP**

**"It's better to have the children inherit appreciated assets held in taxable accounts at the parent's death," says Mike Piershale of Piershale Financial Group.**

### Charitable Bequests

Inflation-adjusted donations, in billions.

2006	\$25.75
2007	\$27.19
2008	\$34.39
2009	\$21.12
2010	\$25.43
2011	\$26.53
2012	\$25.44
2013	\$24.77
2014	\$31.16
2015	\$31.76

Source: Giving USA 2016: Annual Report on Philanthropy for 2015

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

## Coordinating the Players

When elderly clients appoint others to aid them with financial decisions without their planner's input, it can lead to conflict and dysfunction.

BY MARTIN M. SHENKMAN

**THERE IS A GROWING PROBLEM WITH HOW AGING** clients are appointing people to assist them with financial matters. Fortunately, it's a problem that advisers can play a vital role in helping to fix.

Often clients appoint surrogates for when, at some indeterminate date in the future, the client becomes incapable of making financial decisions.

There can be one, two, three or even more people appointed as surrogates.

For example, what if a client names one child as agent under a durable power of attorney, another child as lapse designee on her long-term care policy, a sibling as a representative payee for Social Security and a neighbor for yet another financial matter? Just the difference in names used in different contexts is enough to completely confuse most clients: agent, representative payee, lapse designee, surrogate, co-owner, etc.

The end result of these various appointments, made without the benefit of guidance and coordination with their advisers, could be a potential disaster for the client.

What happens in terms of managing an incapacitated client's financial affairs? What becomes of the potential conflicts of authority? Who will make which decision?

Given how dysfunctional many families are in the face of crisis, a lack of coordination could be, for many, a time bomb of financial confusion, and even conflict.

Because of this potential for disaster, planners should be sure to consider each of the following with their clients, and help them coordinate with all the players:

- **Social Security Representative Payee:** The Social Security's Administration has a representative payee program that provides financial management for an incapacitated recipient of Social Security and SSI payments. The SSA website states that "we look for family or friends to serve as representative payees." A representative payee, who must be 18 or older, can complete the Representative Payee Accounting Report online.



BLOOMBERG NEWS

- **Long-Term-Care Insurance:** Long-term care lapse rates are surprisingly high, and a major cause is incapacity of the policyholder. The industry has responded by permitting the insured to designate someone as an alternate payee. Long-term-care insurance companies now permit policyholders to name a person, called a lapse designee, who can receive notice if the premium has not been paid.

- **Agent for Funeral Decisions:** Some state laws permit the appointment of an agent to manage the disposing of a person's remains. The agent can give special directions, such as that the person will be cremated or that their body will be buried in a particular grave at a specified cemetery, or that a specific funeral home will handle the arrangements. Historically, such instructions have been specified in a will. But because so many people fail to craft a will, and due to the cost and formality of amending a will to include missing instructions, there is a movement toward permitting such a designation in any document.

- **Power of Attorney:** A power of attorney is a document in which a client designates an agent to handle legal, tax and financial matters. Sometimes these powers are drafted



to become effective only when the client becomes disabled. However, because of the problems of defining exactly when someone becomes disabled, more powers are being drafted to become effective when signed. This avoids the complications of having to prove a client's disability, but it also creates more potential conflict with the other appointments noted in this article. This is because the agent who can act immediately may act earlier to control the client's finances thereby running into the alternate payee or representative payee who may be acting to assist an aging or infirm client who still has mental capacity.

• **Bank Accounts:** When a client opens a bank account, clerks often encourage joint accounts, pay-on-death or other variations, to help avoid probate. Too frequently, clients open accounts at financial institutions that

are convenient to them, but without consulting with their advisers. The consequences of this are a half-dozen or more accounts at various institutions. These multiply as clients move over the years to different homes, buy vacation homes, and so forth. With disparate institutions involved the likelihood of disjointed account titles (for example, some in joint name with a child, others in joint name with a different child, and still others established as POD accounts, etc.) grows. As accounts proliferate often, so does the potential for conflicting agents or co-owners.

The practical advice is for planners to proactively address everything on this checklist and to help guide clients to coordinate all of these appointments. In the end, this should help make things easier – particularly in a time of crisis – for both their clients and their clients' families.

FP

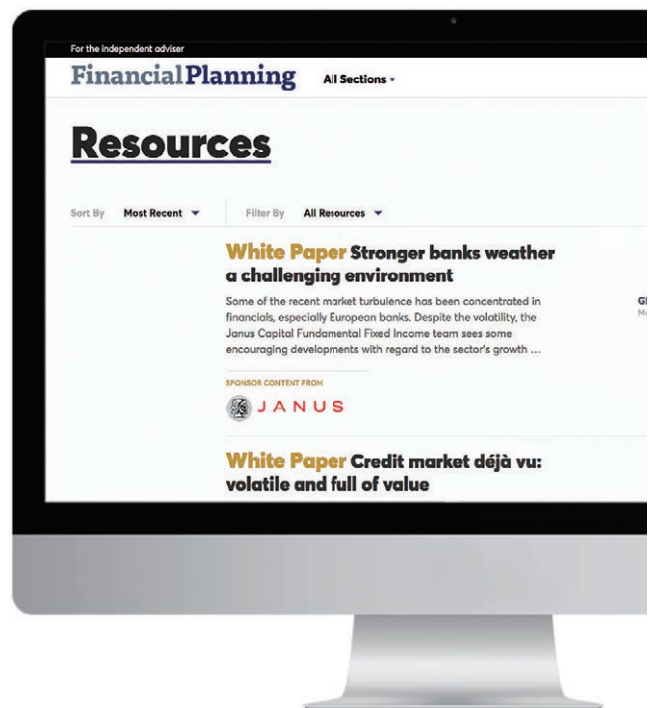
**Long-term-care insurance companies now permit policyholders to name a person who can receive notice if the premium has not been paid.**

**Martin M. Shenkman**, CPA, PFS, JD, is a *Financial Planning* contributing writer and an estate planner in Fort Lee, New Jersey. He runs laweasy.com, a free legal website.

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## Taboo IRA Investments

Clients who make prohibited transactions from retirement accounts, even unintentionally, can face devastating penalties.

BY ED SLOTT

**MOST CLIENTS MAKE INVESTMENTS WITHIN** conventional IRAs by using such commonplace vehicles as stocks, bonds, mutual funds, ETFs and CDs. But IRA investors actually have a lot of latitude; they can put their money toward pretty much anything other than life insurance and collectibles.

But there are potential dangers in making unconventional investments within IRAs, and financial advisers should alert clients to these risks.

Unintentionally making a prohibited transaction can have a devastating effect on a client's finances, and advisers want to have it on the record that they raised appropriate concerns before such an the investment was made.

In December, the Governmental Accountability Office issued a report in December recommending the IRS improve its guidance on IRA investing in unconventional assets. Here are some of the red flags.

### PROHIBITED TRANSACTIONS

What is, or isn't, a prohibited transaction can be a bit complicated. That is why clients often need good explanations from their advisers.

For example, a client can invest IRA funds in a house, but he can't live there or let relatives or business associates have the space in a manner that would provide a direct or even an indirect benefit to the IRA owner.

The penalty for this is quite severe: The entire IRA

account will be deemed distributed as of Jan. 1 of the year the prohibited transaction occurred.

For example, if the IRA had a balance of \$1 million, and only \$15,000 was used in a prohibited transaction, the entire \$1 million balance would be deemed distributed. That's a tax on \$1 million (assuming the IRA had all pretax funds) and the end of the account.

In addition, if the client is under the age of 59½, a 10% early distribution penalty could apply, adding more pain to the situation.

A prohibited transaction would also occur if a client purchases her own property for an IRA, borrows money from her IRA or lends money to it. These acts are considered self-dealing.

Be sure to differentiate this form of borrowing from the 60-day IRA loan, in which a client withdraws funds from their account

for a short-term need. Those funds must be returned as a rollover back to an IRA or other qualified retirement account within 60 days, or the distribution becomes taxable.

This is not a prohibited transaction, because it is a rollover. But taking a long-term loan from an IRA, with terms and interest, is indeed a prohibited transaction.

If a person other than the IRA owner engages in a prohibited transaction, he can then be liable for a 15% excise tax on the amount of the transaction, but not for the entire account balance. The penalty becomes 100% if the transaction is not quickly corrected.

Be aware: These penalties can apply to those advisers who commit a prohibited transaction with a client's retire-

**Form 990-T Exempt Organization Business Income Tax Return (and proxy tax under section 6033(e))** CMBI No. 1545-0687  
**2016**  
 For calendar year 2016 or other tax year beginning \_\_\_\_\_, 2016, and ending \_\_\_\_\_, 20\_\_\_\_  
 Department of the Treasury Internal Revenue Service  
 ▶ Information about Form 990-T and its instructions is available at [www.irs.gov/forms990](http://www.irs.gov/forms990).  
 ▶ Do not enter SSN numbers on this form as it may be made public if your organization is a 501(c)(3).  
 Open to Public Inspection for 501(c)(3) Organizations Only

**A**  Check box if address changed  
**B** Exempt under section:  501(c)(1)  501(c)(2)  501(c)(29)  501(c)(30)  501(c)(31)  
**C** Book value of all assets at end of year: \_\_\_\_\_  
**D** Employer identification number (Employer's trust, see instructions): \_\_\_\_\_  
**E** Unrelated business activity codes (See instructions.): \_\_\_\_\_  
**F** Group exemption number (See instructions.): \_\_\_\_\_  
**G** Check organization type:  501(c) corporation  501(c) trust  401(a) trust  Other trust  
**H** Describe the organization's primary unrelated business activity: \_\_\_\_\_  
**I** During the tax year, was the corporation a subsidiary in an affiliated group or a parent-subsidiary controlled group? . . .  Yes  No  
 If "Yes," enter the name and identifying number of the parent corporation: \_\_\_\_\_ Telephone number: \_\_\_\_\_  
**J** The books are in care of: \_\_\_\_\_

Part I. Unrelated Trade or Business Income		(A) Income	(B) Expenses	(C) Net
1a	Gross receipts or sales			
b	Less returns and allowances			
2	Cost of goods sold (Schedule A, line 7)			
3	Gross profit. Subtract line 2 from line 1c			
4a	Capital gain net income (attach Schedule D)			
b	Net gain (loss) (Form 4797, Part II, line 17) (attach Form 4797)			
c	Capital loss deduction for trusts			
5	Income (loss) from partnerships and S corporations (attach statement)			
6	Rent income (Schedule C)			
7	Unrelated debt-financed income (Schedule E)			
8	Interest, annuities, royalties, and rents from controlled organizations (Schedule F)			
9	Investment income of a section 501(c)(7), (8), or (17) organization (Schedule G)			
10	Exploited exempt activity income (Schedule I)			
11	Advertising income (Schedule J)			
12	Other income (See instructions; attach schedule)			

ment account.

Generally, income earned within an IRA is not recognized for tax purposes. But when a business is operated within the traditional or Roth IRA, that income, in excess of a \$1,000 exemption, can be taxable as unrelated business income.

In addition, if funds are borrowed to purchase an asset in the IRA (for example, a mortgage on a rental property), income produced by that asset could be subject to an unrelated debt-financed income tax.

The tax is paid by the IRA, not personally by the IRA owner. UBIT and UDFI taxes are reported on Form 990-T, which is usually prepared by the IRA custodian. Advisers should double-check that this is done. The tax money is withdrawn from the IRA, but this is not counted as an IRA distribution.

It is an expense of the IRA the same as investment management fees are. The client should be informed that this is an extra cost of making this type of investment with their IRA funds and take this into consideration when evaluating the potential return. Even though the tax is remitted by the IRA custodian, it still comes from the client's IRA funds and reduces the overall return.

When an IRA needs to borrow funds in order to purchase IRA assets, that loan must come from outside financing, without a personal guarantee from the IRA owner.

A recent case illustrates an example of this scenario. James and Judith Thiessen, through their self-directed IRAs, acquired the stock of the newly formed Elsara Enterprises, which then bought the operating assets of a company, with the Thiessens guaranteeing repayment of a loan Elsara received from the seller as part of the deal.

The IRS asserted that the Thiessens' guaranties, which had not been disclosed on their tax returns, were prohibited transactions that resulted in deemed distributions of the IRAs' assets to the couple.

The Tax Court agreed, holding that the guaranties were indirect extensions of credit to their IRAs. They were found liable for a \$180,129 deficiency, attributable primarily to unreported IRA distributions.

The Thiessens also owed the 10% addi-

tional tax on early distributions, because neither spouse was at least 59½ years old during the year when their deemed distributions occurred.

### IRA-OWNED BUSINESSES

Advisers should also alert clients to the risk of using IRA funds to invest in a business. Yes, it can be done, but there are too many tax traps that are easy to fall into, even with professional guidance. The biggest such trap is unknowingly committing a prohibited transaction.

The IRS has been looking closer at these transactions for years, especially as they pertain to a Roth IRA. The income inside a Roth can eventually be withdrawn tax free, thereby turning otherwise taxable business income into tax-free retirement savings.

Advisers need to warn clients about the dangers of setting up an IRA to own a busi-

**Advisers must alert clients to the potential dangers of making unconventional investments in their IRAs.**

### Who Is Responsible?

Responsibilities of account owners and custodians in the purchase of unconventional assets in an IRA

Responsibility	Account owner	Custodian
Determining the appropriateness of an asset	X	
Determining the risk associated with an asset	X	
Reviewing for potential prohibited transactions	X	
Arranging with the investment sponsor to purchase an asset	X	
Providing documentation to support the asset purchase	X	
Providing direction to disburse funds to purchase asset	X	
Verifying that funds are correctly invested	X	
Determining an asset's administrative feasibility		X
Disbursing IRA funds to purchase assets		X
Ensuring a purchased asset is titled in the name of IRA		X
Facilitating the safekeeping of certificates, notes, or deeds		X
Providing periodic statements showing an account's value		X

Source: GAO analysis of custodian information

ness or a corporation, even if there are no loan guarantees. There is still the likelihood of self-dealing by benefiting personally from the business.

One common trap is taking a salary from the IRA-owned business. Another one is providing direct or indirect financing to the IRA-owned corporation. Yet another easy trap to fall into is providing services to the business owned by the IRA, such as fixing up rental properties. It's best to have the IRA hire outside contractors.

## VALUATION ISSUES

The GAO report also found that clients could have difficulty in obtaining fair market values for hard-to-value IRA assets.

For instance, if the real estate in an IRA is converted to a Roth IRA, the IRA owner would have to provide the fair value for tax purposes. Now these assets are flagged through mandatory IRS reporting on Form 5498, IRA Contribution Information. The fair market value, as of Dec. 31, must be reported each year.

One reason for the increased enforcement here was to track the potential for grossly undervaluing multimillion-dollar IRAs invested in business entities or private investments where public valuations were not readily available.

In addition to valuations, IRA owners must provide updates when the value changes. Otherwise, to the taxpayers' detriment in some cases, distributions may be valued at the last known number.

In at least two Tax Court cases in 2014, the current values were not provided to the IRA custodian, resulting in a tax bill on worthless IRA investments.

The custodian did not receive a valid updated valuation, and reported the investment as distributed with the value based on the original investment. The IRA owners in both cases had to pay tax on value that didn't exist, because valid information was never given to the IRA custodian who requested it.

These valuations are very critical for all IRA distributions, including RMDs and Roth conversions.

## IRA INVESTMENT LIQUIDITY

The GAO reports that some unconventional retirement assets are difficult to distribute, because they cannot be sold as easily as publicly traded securities.

For example, the report cites the difficulty of trying to liquidate a private equity investment. It may not be easy to find investors to purchase that asset.

Once IRA owners reach age 70½ and must begin taking their RMDs, liquidity can become a problem. Advisers should ensure a client's IRA contains funds that can be withdrawn when they need to be.

While assets can be distributed in kind to satisfy RMDs, valuations are necessary to make sure there is enough to cover that RMD. These valuations may involve additional fees, which are an expense of the IRA.

For RMD purposes, undervaluation can result in a 50% penalty for not taking the full amount. The penalty is based on the amount of the RMD deemed not withdrawn.

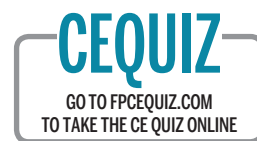
## CLIENT RESPONSIBILITIES

When clients choose to purchase unconventional assets in an IRA, they often don't realize the new responsibilities that go with their investments.

The GAO highlights these responsibilities as follows: "IRA owners investing in unconventional assets must locate an asset, determine its suitability for their retirement goals and conduct due diligence on the investment and the investment sponsor. In addition, to finalize the purchase, these IRA owners must collect, review and prepare all purchase documents and provide them to the custodian to execute the purchase on behalf of the IRA."

It is the adviser's job to make sure that their clients fully understand these responsibilities, so that they can avoid the potentially disastrous consequences. **FP**

**A recent GAO report found that clients could have difficulty in obtaining fair market values for hard-to-value IRA assets.**



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

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## Get Real About Health Care

Client concerns about medical expenses are sky-high, but there are many solutions advisers can provide.

BY KAREN KROLL

**HEALTH CARE IS A TOP-OF-MIND ISSUE FOR MANY** clients. Respondents to a recent Transamerica survey ranked health – not financial security or peace of mind – as the most essential component of a strong financial future.

Not coincidentally, health care costs are growing faster than overall inflation. Between 2015 and 2025, the Centers for Medicare and Medicaid Services predict that per-capita health care costs will increase about 4.9% annually.

Overall inflation for the 12 months ending in November stood at 1.7%, according to the U.S. Bureau of Labor Statistics.

What's more, Americans are living longer, and using more health care services than ever.

What should advisers do to help their clients incorporate health care concerns and costs into their long-term financial plans?

### EASING INTO CONVERSATION

Advisers should first understand that health care-related topics do not always make for very easy client conversations.

"When it comes to planning, we're used to incorporating assumptions about wishes," such as kids heading to college or a breadwinner retiring early, says Fran Levine, a CFP and family wealth adviser with Morgan Stanley Wealth Management in Atlanta.

But talking about planning for a cancer diagnosis or any other kind of health shock can be much more challenging, she adds.

If possible, "start the conversation when the clients are healthy and the atmosphere is relaxed," advises Peter

Creedon, CEO of Crystal Brook Advisers in Mt. Sinai, New York. The goal is to deal with all health-care-related questions before an emergency occurs and client emotions are running high, Creedon says.

Ellen Siegel, a planner with Legacy Wealth Management in Miami, uses open-ended questions when she broaches the health care conversation with her clients.

"I often will ask clients, 'What frightens you, what keeps you up at night?'" Siegel says.

These questions can help clients overcome their resistance to speaking openly about an inherently difficult and often uncomfortable topic.

### SHOW, DON'T TELL

If clients are feeling skeptical about the need to include targeted planning for potential health care issues, Levine says that she'll show them what their plans look like with and without certain potential medical expenses.

The difference, spelled out clearly with actual numbers, helps persuade clients that planning ahead for medical issues could save them from experiencing a lot of financial worry in the future.

Discussions become even more difficult when they shift from the abstract – such as a healthy young couple trying to project their health care costs for when they retire decades in the future – to the concrete, including conversations that occur when a client is diagnosed with a serious illness or is already struggling with debilitating injuries.

Rick Kahler, an adviser with Kahler Financial Group in Rapid City, South Dakota, has several clients with cancer.



Rick Kahler says some clients don't want to deal with the "bad mojo" of health care costs.

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Those clients are, understandably, doing all they can to remain alive.

However, Kahler must examine the potential impact on spouses and other family members if the client passes away.

The reactions when Kahler broaches this possibility range from thankful and realistic – “Yep, we need to think about this” – to outright denial. “Some don’t want the bad mojo,” Kahler says.

Resistance such as this often indicates that the planner is moving the conversation more quickly than the client can currently handle, Kahler says.

He’ll table the discussion for the moment, while remaining engaged with the client and their family.

Planners need to be ready to alter, or even temporarily ignore, financial plans when clients’ lives are upended by a serious diagnosis.

### **LONG TERM VS. RIGHT NOW**

Danielle Howard, a planner with Wealth By Design in Basalt, Colorado, met with a new client to deliver a comprehensive plan, only to learn that the client had recently been diagnosed with cancer and had only months to live.

“The conversation changes,” she says.

Rather than plan for the long term, the focus shifts to living a life of no regrets right now, Howard says.

That often means ensuring that all end-of-life documents are in order.

“You walk alongside the client in a very intimate place,” she says, and let them know about actions that can provide some peace of mind in the midst of an extremely tough situation.

Because these conversations can be both emotional and complicated, Siegel often tells clients that they should bring a trusted friend who can take detailed notes and ask questions.

“When clients are dealing with serious news, their brain shuts down,” she says. If there is a note-taker present at the meet-

ing, the client can review all the material at a later time, rather than having to face it all at once.

### **WHICH OPTIONS WILL WORK?**

Advisers should also dig deep for options that will work for their clients.

“Knowing there’s a way out often makes whatever they’re dealing with more tolerable,” Siegel says.

For instance, annuities can be one way to pay for long-term care for some clients who may have trouble getting an insurance plan but have amassed significant savings, she says.

A client of Barry Kaplan, wealth manager and principal with Modera Wealth Management in Atlanta, had saved enough to retire early.

However, the client’s medical history made it difficult for her to get insurance on her own.

Kaplan talked with the client’s employer and learned that, at her current age of 60, she’d be able to continue her health coverage through age 65 at the same cost she was now paying.

When incorporating health care costs into clients’ plans, most advisers take a conservative approach.

Siegel, for example, typically budgets between \$5,000 and \$10,000 in ongoing, annual expenses once her clients hit the retirement stage. “We build that into the plan,” Siegel explains.

As health care becomes ever more expensive and complicated, planners need to keep up to speed on its many – and fast-changing – aspects, or know which experts they should call in order to stay informed, Howard says.

And, most important, advisers can’t ever lose sight of the need for empathy and sensitivity when talking to clients about health plans.

“Investments aren’t that hard,” Kaplan says. “The other stuff – everything about someone’s life – is.”

**FP**

**Advisers should first understand that health care-related topics do not always make for easy client conversations.**

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**Karen Kroll** is a financial writer in Minneapolis–St. Paul. She’s also written for AARP Bulletin.com, Bankrate.com and CFO. Follow her on Twitter at @karenkroll.

# PORTFOLIO

ALSO IN PORTFOLIO: P.57: A Portfolio for Rising Inflation

## The Mystery of Alpha

Everyone knows about investments that produce better than average returns, but behavioral biases keep us from taking advantage of them.

BY MICHAEL KITCES

### NO MAJOR LEAGUER HAS BATTED OVER .400 SINCE

Ted Williams did it 76 years ago, despite what experts agree is a clear increase in the average skill of baseball players since then. The reason for the dichotomy: the so-called paradox of skill. When the whole playing field is lifted higher, it's harder than ever to stand out as a superstar.

Similarly, a growing base of data suggests that the amount of available investment alpha is shrinking. This is attributed to a combination of the paradox of skill itself and the mere fact that more and more investment research is revealing previously unknown factors that, once known, can no longer be exploited the way they were in the past.

Despite this trend, though, a number of widely known investment advantages have continued to persist. For instance, it's well-documented that over time the small-cap outperforms large caps, that value generates a long-term premium over growth, and that stocks exhibit momentum effects.

Yet however common that knowledge is, investors still fail to fully take advantage and arbitrage them away.

And why not?

The answer lies in the growing field of behavioral finance, which has revealed a multitude of ways that we fail to invest rationally – despite having all the available information.

What follows is a look into what forms of alpha may be sustainable precisely because our behavioral biases limit us from ever investing efficiently enough to eliminate the known opportunity.

### THE PARADOX OF SKILL

One of the fundamental challenges of today's investing landscape is that there are lots of smart people involved, with

increasingly sophisticated tools.

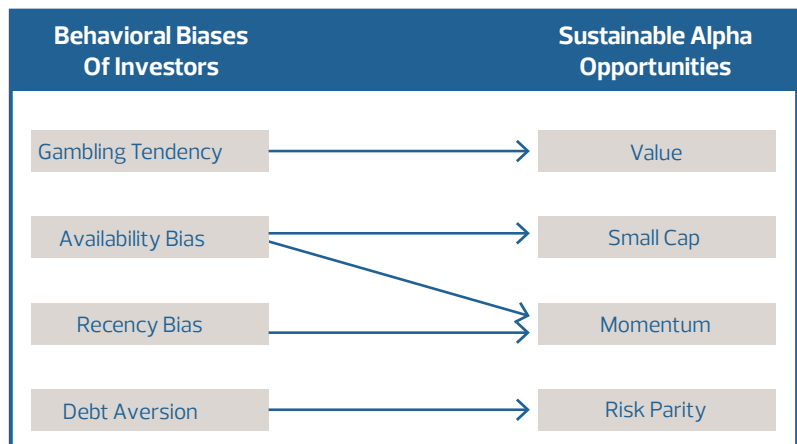
While one might think that smarter people with better tools would lead to more superstars, the reality, as articulated by Michael Mauboussin in his book "The Success Equation," is that a paradox of skill emerges: The better the average talent pool, the harder it is for standouts to emerge. It's difficult to be that much better than everyone else, when the others are also very smart people.

Consequently, even as our capabilities to identify good investment opportunities get better, the pool of available alpha appears to be shrinking. This was articulated most eloquently by Larry Swedroe and Andrew Berkin in their 2015 book "The Incredible Shrinking Alpha."

The greater the shift of investing away from individuals and over to institutions – in the 1940s households held 90% of U.S. corporate equity, whereas now it's down to 20% – the

### Where to Look

Here are the sustainable alpha opportunities created by behavioral biases.



Source: Michael Kitces



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fewer investing mistakes leading to market mispricings (that is, alpha opportunities) there are. Meanwhile, more institutions are trying to carve up the same fixed alpha pie, resulting in each getting an ever-smaller share.

In the logical extreme, some have suggested that eventually available alpha will go all the way down to zero – or at least to an imperceptibly low level.

In that situation, virtually no investor will be able to effectively capitalize on pricing discrepancies. Simply put, with so many investors competing at the same time with so much capital, it may become almost impossible to see an investment opportunity by having a better grasp of the information than everyone else.

### **BEHAVIORAL BIASES**

Notwithstanding the rise in the capabilities and average skill level of investors, it's not entirely clear that alpha can go all the way to zero. Such a path presumes that all alpha is derived by simply better using available information than everyone else, while ignoring the fact that a material number of investors aren't making their investment decisions based solely on information alone.

After all, one of the hottest disciplines in recent years has been behavioral finance research, a study of all the various ways that we do not invest rationally.

As just a brief list of our problematic tendencies, we tend to:

- Exhibit a recency bias, where we overweight what happened recently and extrapolate it into the future.
- Show an availability bias, making us more willing to invest in stocks we can readily recall.
- Perceive less risk in something we have familiarity with, thus helping to explain why so many are so comfortable in keeping concentrated positions in their employer's securities.
- Pursue gambles that have significant upside potential, despite their improbable outcome – explaining why we continue to buy lottery tickets with a highly negative expected value.

- Exhibit a significant aversion to losses and debt.

- Move with the herd, showing a strong bias to do what everyone else is doing and avoid the risk that comes with being singled out – especially if there's a bad outcome and someone needs to be blamed.

All of these behavioral biases, along with many others, mean that when we make investment decisions, we may do so in a manner that contradicts the available information – or at least, does not fully assess the available information.

In other words, behavioral finance suggests that there are a material number of investors who are not playing along with the shrinking alpha dynamic, because they're not investing consistently with the available information.

### **SUSTAINABLE ALPHA**

The significance of behavioral biases leading to irrational investing – trading in ways that are not consistent with available information and investment fundamentals alone – is that these biases not only create the potential for the mispricing of assets, but that it can result in persistent investment opportunities as long as the behavior itself persists. And in this context, persistence appears quite likely, given that these are hard-wired investing mistakes.

The idea that available alpha is shrinking as investors become more skilled and get better tools presumes that those investors are carving up an ever-shrinking pie of available alpha as markets more efficiently price in the available information. But in a world where mispricings are created at least in part due to behavioral biases that are simply part of our human nature, then no amount of information and expertise can make them entirely disappear.

In fact, the persistence of behavioral biases helps to explain why many risk premiums and investment factors continue to persist, even long after they're known to exist.

For instance, the small-cap premium – that small cap stocks outperform large caps in the long run – arguably should not exist once everyone knows that it exists

**Behavioral finance has revealed all the ways we fail to invest rationally, despite having all the available information.**

and subsequently anticipates that they'll be fully rewarded for any short-term risk they take. However, the availability and familiarity biases help explain why the small cap premium persists: because people who are looking to invest are more likely to invest in stocks they have heard of and are familiar with and these stocks tend to be large caps.

For instance, if an investor wants to buy a tech stock, he's more likely to think of Apple, Google or Amazon than a small-cap company he's never heard of. This means the small cap stocks get less buying demand than they might merit based on fundamentals alone.

Even for an investment manager, there is a similar dynamic. As professional, you're not as likely to be fired if you bought Apple or Google and it went down than if you lost money investing in a small-cap tech company that was perhaps more promising but not widely known.

## THE VALUE PREMIUM

Similarly, the value premium – that value stocks tend to outperform growth stocks in the long run – is another opportunity for outperformance that logically shouldn't exist, given how well documented the phenomenon is.

Yet it's not difficult to see why investors would keep buying high-flying growth stocks because of our tendencies toward gambling. Growth is exciting and has unlimited upside, while value is boring and doesn't stir our animal tendencies. Again, we also persistently buy lottery tickets, despite the fact that they too have a negative expected value over time.

Continuing this theme, it's also easy to see why a persistent momentum effect exists. After all, the recency bias leads us to persistently overweight the recent trend of the market, and assume it will continue. Or viewed another way, if our brains are hard-wired to assume that recent market trends will persist, we invest accordingly, and it becomes a self-fulfilling prophecy even if

there's no rational basis for it. Thus John Maynard Keynes' famous observation: "The markets can remain irrational longer than you can remain solvent."

And the impact of behavioral biases on investment opportunities isn't exclusive to the Fama and French three-factor model or Carhart's four-factor model with momentum. For instance, the somewhat controversial risk parity strategy also has a behavioral underpinning. As Cliff Asness of AQR Capital Management notes, most investors have a natural aversion to leverage (debt) and this aversion causes an underinvestment in risk parity strategies that are mathematically more efficient but psychologically or behaviorally unappealing.

## WHY ALPHA PERSISTS

All of this suggests that even as some forms of available alpha are shrinking – and active managers continue to struggle – the end game is not a world in which the opportunity for alpha goes to zero. Instead, the existence of behavioral biases means that at least some forms of alpha can persist – even after they're known and exploitable – but that alpha opportunity will be sustainable only if it is in fact predicated on a behavioral bias.

If the alpha is based on expert information alone, the investor will inevitably be outperformed by increasingly sophisticated competition.

Of course, the danger in recognizing that the most sustainable alpha opportunities are the behaviorally derived ones is that they will also be the hardest ones for other human beings to take advantage of.

Whether it's a matter of succumbing to the very biases that create the opportunities, or simply trying to move against the herd – and as an adviser, risk being fired by most of your clients, even if you're right in the long run – behaviorally driven alpha is one of the riskiest forms of alpha to try capturing. This perhaps explains exactly why it provides a persistent risk premium in the first place, even when it's known to all.

**Behavioral biases mean that when we make investment decisions, we may do so in a manner that contradicts the available information.**

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## A Portfolio for Rising Inflation

A revealing look at how a two-asset portfolio may be fine when inflation is low, but a multi-asset grouping seems to be needed when inflation is high.

BY CRAIG L. ISRAELSEN

**WHAT EFFECT DOES INFLATION HAVE ON A PORTFOLIO,** and what kind of portfolio is better built to withstand it?

In recent years, inflation has been on the lower end of the scale. Of course, that will change eventually, and if the past 47 years are any guide, when inflation ticks back up, we may see a distinct shift in the performance of various asset classes. So how might advisers adjust their clients' portfolios as inflation rises again?

First, a bit of background. From Jan. 1, 1970, through Dec. 31, 2016, the 47-year average annual inflation, as an arithmetic mean, was 4.07%, whereas the 47-year median CPI was 3.27%. The average annualized growth rate of inflation (the geometric mean) between 1970 and 2016 was 4.03%.

Here we will focus on the 3.27% rate. Doing so will facilitate the analysis of asset class performance during the years of both low and high inflation. The median rate of inflation during the 23 years with below-median CPI was 2.09%; it was 4.54% during the 24 years with an equal-to-or-above median CPI. Please see "Inflation: Low Years and High Years" for an illustration.

### MODEST LEVELS

As shown in "Annual Inflation," the most recent year with inflation above 3.27% was 2007, when it increased by 4.08%. Since then, through 2016, we have experienced very modest levels of inflation: 2008 at 0.09%, 2009 at 2.72%, 2010 at 1.50%, 2011 at 2.96%, 2012 at 1.74%, 2013 at 1.50%, 2014 at 0.76%, 2015 at 0.73% and 2016 at 2.09%, using the U.S. Bureau of Labor Statistics all-urban, non-seasonally adjusted CPI data.

In fact, since 1990, there have been only five years in which the annual rate of

inflation was over 3.27%.

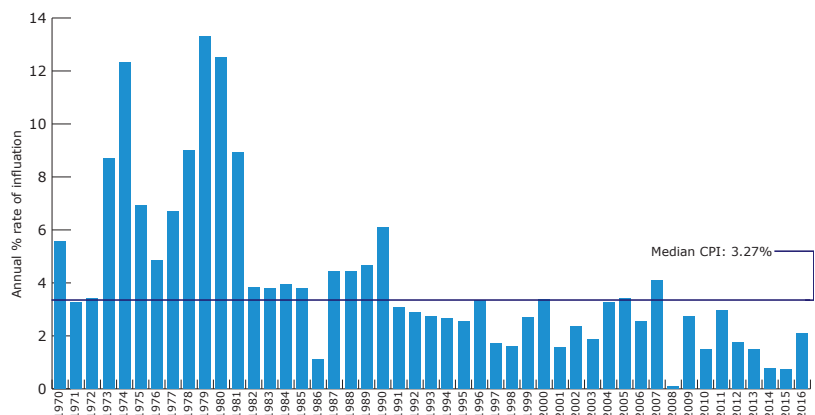
We will now review inflation and asset performance over the 47-year period from 1970 through 2016. The performance of seven major asset classes will be reviewed during the 23 years of low inflation, as well as the 24 years with higher inflation. The seven asset classes include large-cap U.S. stocks, small-cap U.S. stocks, non-U.S. stocks, U.S. bonds, U.S. cash, real estate and commodities.

Large-cap U.S. equities are represented by the S&P 500, while the performance of small-cap U.S. equities was captured by using the Ibbotson Small Companies Index from 1970 to 1978 and the Russell 2000 from 1979 to 2016.

The performance of non-U.S. equities is represented by the Morgan Stanley Capital International EAFE Index (Europe, Australasia, Far East). U.S. bonds were represented by the Ibbotson Intermediate Term Bond Index from 1970 to 1975 and the Barclays Capital Aggregate Bond Index from

### Annual Inflation

Year-to-year inflation as measured by CPI



Source: Steele Systems Mutual Fund software, calculations by author

# PORTFOLIO

1976 to 2016. Cash was represented by three-month Treasury bills. The performance of real estate was measured by using the annual returns of the NAREIT Index from 1970 to 1977 and the annual returns of the Dow Jones U.S. Select REIT Index from 1978 to 2016. Finally, the historical performance of commodities was measured by the Goldman Sachs Commodities Index. As of Feb. 6, 2007, it has been known as the S&P GSCI.

In addition to the seven individual asset classes, we will also review the performance of two portfolios. The first portfolio is composed of all seven asset classes in equal allocations of 14.28%, rebalanced annually.

The second portfolio consists of 60% large-cap U.S. stocks and 40% U.S. bonds – the classic 60/40 portfolio.

As shown in “Asset Performance,” large-cap U.S. stocks had an average nominal annual return of 12.70% during the 23 years when inflation was low. By comparison, they had an average real return of 10.42% during the same time period. Both performance figures are impressive.

## TURNING THE TABLES

Now, let’s turn the tables and look at performance during the 24 years in which there was higher inflation. We observe that large-cap U.S. stocks had an average nominal return of 10.82%, but an average real return of just 4.70%. These results clearly do not support the notion that large-cap U.S. stocks have been a standout performer during inflationary times.

The performance of small-cap U.S. stocks has been better than large-cap U.S. stocks during years with low inflation (refer back to “Asset Performance”). The average nominal return for U.S. small stocks was 13.73%, whereas the average real return was 11.41%.

When looking at performance during years with higher inflation, the superiority of U.S. small-cap stocks versus U.S. large-cap stocks increases; the average nominal return was 12.61%, compared with 10.82%. Even more dramatic is the difference in average real returns during years with higher inflation rates: 6.26% for small-cap U.S. stocks versus 4.70% for large-caps. If inflation protection is your goal, U.S. small-caps have been a better defender than U.S. large caps.

But the real story here is commodities. Very simply, broad-based commodity indexes suffer when inflation is low. When inflation is high, com-

modity indexes and funds perform admirably. This correlation is very likely precisely because energy and commodity prices have gone higher, thus effectively creating inflation.

The average nominal return for commodities during the 23 low-inflation years was -2.31%, compared with a 21.98% nominal return during the 24 years when inflation was higher. The average real performance of commodities was

## Inflation: Low Years and High Years

The ups and downs of inflation as measured by CPI.

Year	23 years with lower inflation (below median CPI of 3.27%)	Year	24 years with higher inflation (equal or above median CPI of 3.27%)
2008	0.09	1971	3.27
2015	0.73	1996	3.32
2014	0.76	2000	3.39
1986	1.10	1972	3.41
2010	1.50	2005	3.42
2013	1.50	1983	3.79
2001	1.55	1985	3.80
1998	1.61	1982	3.83
1997	1.70	1984	3.95
2012	1.74	2007	4.08
2003	1.88	1988	4.42
2016	2.09	1987	4.43
2002	2.38	1989	4.65
1995	2.54	1976	4.86
2006	2.54	1970	5.57
1994	2.67	1990	6.11
1999	2.68	1977	6.70
2009	2.72	1975	6.94
1993	2.75	1973	8.71
1992	2.90	1981	8.92
2011	2.96	1978	9.02
1991	3.06	1974	12.34
2004	3.26	1980	12.52
		1979	13.29
Median inflation rate during "low" years	<b>2.09</b>	Median inflation rate during "high" years	<b>4.54</b>
Overall 47-year median inflation rate of 3.27%			

Source: Steele Systems Mutual Fund software, calculations by author

-4.36% during low-inflation years and 15.13% during high-inflation years.

Commodities serve as a protector against inflation – and, in that role, completely dominate any other asset class. The next-closest performer using real returns is real estate, at 6.93%.

As we have been in a low-inflation environment in recent decades, it's not surprising that commodities have performed relatively poorly. This will change.

### MODEL PORTFOLIO PERFORMANCE

Taking into account that advisers don't generally build one-asset portfolios for clients, it is important to consider how a multi-asset portfolio performs during periods of low and high inflation.

Toward that end, we now evaluate two different portfolios: a seven-asset portfolio and a two-asset portfolio. The equally weighted seven-asset portfolio underperformed the 60/40 portfolio during periods of low inflation, both in nominal and real terms.

The average nominal return for the seven-asset portfolio was 8.06%, with a 5.87% average real return, during the 23 years with low inflation – nearly all of those years being recent.

The two-asset 60/40 portfolio had an

average nominal return of 10.23% and an average real return of 8.01%. The two-asset model did not have commodities dragging it down.

### HELPFUL CONTRIBUTORS

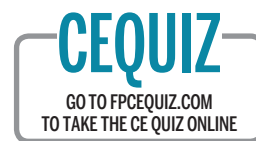
Now, let us turn our attention to the years when there was higher inflation. The seven-asset model had an average nominal return of 12.35%, compared with 10.10% for the two-asset portfolio. More important, the seven-asset portfolio had an average real return of 6.08%, compared with 4.02% for the two-asset portfolio.

Commodities, real estate and U.S. small-cap stocks – all missing in the two-asset model – were helpful contributors in the seven-asset portfolio during those inflationary years.

As an adviser, if you believe inflation will remain low forever, stay with a two-asset portfolio. However, if you believe inflation will rear its ugly head again, it would be wise to build a portfolio that has demonstrated an ability to defend itself against inflation.

This will require a wider variety of asset classes – including real estate, commodities and small-cap U.S. stock. In short, over the long term, it's beneficial to build a broadly diversified portfolio.

**If you believe inflation will rear its ugly head again, history suggests it would be wise to build a multi-asset portfolio that includes commodities.**



## Asset Performance

Average nominal and real returns when Inflation is low and high. Nominal return ignores inflation, and real return takes inflation into account.

47-year period from 1970 to 2016		Large U.S. Stocks	Small U.S. Stocks	Non-U.S. Stocks	U.S. Bonds	U.S. Cash	Real Estate	Commodities	7-Asset Portfolio	60% Stocks 40% Bonds
Low inflation years: 23 years with below-median CPI	Average nominal return	12.70	13.73	10.30	6.52	2.54	12.97	-2.31	8.06	10.23
	Average real return	10.42	11.41	8.07	4.40	0.50	10.67	-4.36	5.87	8.01
High inflation years: 24 years with above-median CPI	Average nominal return	10.82	12.61	11.33	9.03	7.41	13.29	21.98	12.35	10.10
	Average real return	4.70	6.26	5.21	3.00	1.34	6.93	15.13	6.08	4.02

Source: Steele Systems Mutual Fund software, calculations by author

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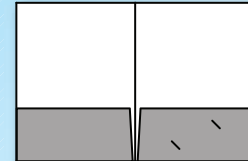
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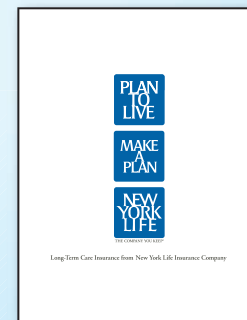
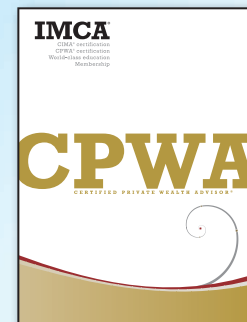
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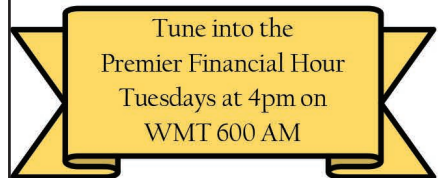
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## FROM: A PORTFOLIO FOR RISING INFLATION

**1. When was the last year inflation was above the CPI average of 3.27% from 1970 to 2016?**

1. 2015
2. 2007
3. 1995
4. 2002

**2. What was the average real return of a two-asset portfolio (U.S. bonds and U.S. stocks) during the periods of low inflation reviewed in the analysis?**

1. 8.01%
2. 10.02%
3. 5.87%
4. 6.93%

**3. During times of high inflation, what was the average real return of a seven-asset portfolio (large-cap U.S. stocks, small-cap U.S. stocks, non-U.S. stocks, U.S. bonds, real estate, commodities and cash)?**

1. 7.50%
2. 6.08%
3. 4.02%
4. 8.02%

## FROM: TABOO IRA INVESTMENTS

**4. How much is the early-distribution penalty for an IRA owner younger than 59½?**

1. 10%
2. 15%
3. 5%
4. 12%

**5. Which is not a prohibited IRA transaction?**

1. Investing funds in a house where the IRA owner lives.
2. Lending money to an IRA.
3. Taking a long-term loan from an IRA.
4. Taking a short-term loan from an IRA.

**6. What is the excise tax that someone other than the IRA owner may have to pay if they make a prohibited transaction?**

1. 20%
2. 15%
3. 25%
4. 10%

## FROM: THE MYSTERY OF ALPHA

**7. Which of these investor behaviors makes clients more willing to invest in the stocks that they can readily recall?**

1. Recency bias
2. Availability bias
3. Debt aversion
4. Gambling tendency

## FROM: SOCIAL SECURITY REDUCTIONS ARE CLOSER THAN YOU THINK (online only)

**8. What is the maximum taxable amount of wages for Social Security in 2017?**

1. \$150,300
2. \$200,500
3. \$127,200
4. \$180,300

**9. At what rate are wages taxed to both the employee and employer (at the maximum wage amount) for Social Security?**

1. 5.5%
2. 6.2%
3. 4.5%
4. 7.2%

## FROM: MAXIMIZE THE IRA STRETCH (online only)

**10. What is the prime advantage of a bypass trust?**

1. To restrict a spouse's access to IRA principal while preserving the marital deduction.
2. To plan for future incapacity.
3. To have the flexibility to allocate where the IRA will go after death.
4. To shelter future growth from federal or state estate taxes.

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# Financial Planning



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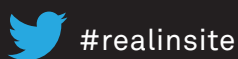
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# SELFIE

## Putting the Puzzle Together

Sometimes clients must be guided to see the big picture – and solve the big problems.

BY JASON SILVERBERG



**AS A CHILD, I WAS TAUGHT ABOUT THE AMERICAN** dream. My parents told me that, to earn a good living, I had to work hard, come in early, stay late and appreciate what I had. But I found out very quickly that having a good work ethic alone doesn't always produce success.

Many of our clients are often similarly working with outdated rules. They are not able to see the big picture. As life events happen, they react without a coordinated plan to guide them. Between paying for college for their children, taking care of their parents, paying down debt and maybe even experiencing a divorce or surprise medical event, it's no wonder they are falling behind.

But there's still hope. I believe it helps to think of financial planning as a jigsaw puzzle. When I put together a puzzle with my kids, I guide them by telling them to focus on the picture on the puzzle box. I ask my son to start out by finding the four corner pieces, and I ask my daughter to group all like colors together.

### **A CLEAR VISION OF SUCCESS**

The same is true for our clients' finances. We have a better chance of success with a clear and concise strategy that itemizes all of their financial pieces and provides a coherent vision of what success will look like to them.

I once worked with a client who was missing some of her financial pieces. She needed more life insurance and didn't have enough saved for retirement.

I began by using the puzzle analogy in our discussions. This helped her identify the missing pieces of her financial plan. Now she has adequate insurance, and she's well on her way to increasing her retirement savings.

Another client told me she felt so frustrated by her finances that she believed there was no hope for her. By listening and talking, I was able to help her identify what was lacking.

In her case, it was her personal "why." It was as if she was missing the picture on her own personal puzzle box. I was able to guide her in crafting a financial plan that gave her finances purpose. She now has a totally different attitude, and she actually enjoys working toward her goals. By coordinating our clients' actions, objectives and core values, we can help them create a plan that will fuel their life passions.

### **THE PERSONAL 'WHY'**

My own personal "why" is my family: my kids, my wife, my brothers, my parents and all my extended family. I include my clients in this definition, too. My purpose is to help as many people as I can to become the best versions of themselves. I specifically do this with my clients by helping them navigate through financial roadblocks and obstacles standing in the way of success.

Many people give up on completing a puzzle for a variety of reasons. They might be missing pieces, or they may lack a clear vision of what the puzzle should look like, or they just don't have good direction.

We owe it to our clients to create a planning process that gives them the best chance of success. By helping them achieve small financial wins early, you can help create a feedback loop of successes. Clients will be more motivated to meet with you and open to your recommendations. It will create better relationships and, ultimately, provide you with a more enjoyable practice.

**FP**

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Jason Silverberg, CFP, CLU, ChFC, is vice president of financial planning at Financial Advantage Associates in Rockville, Maryland.

To submit a Selfie commentary, email [fpeditor@sourcemedia.com](mailto:fpeditor@sourcemedia.com). Post your comments online at [financial-planning.com](http://financial-planning.com).

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