April 2018

Financial Planning

THE COMPENSATION ISSUE

INVESTED IN ADVISORS / APRIL 2018

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Fun Committee

FAMILY LEAVE

Volunteer DAYS

Compensation is rising, as are firms' efforts to make work more enjoyable, says Cecilia Williams of Halbert Hargrove

Pay Day

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Financial Planning

Vol. 48 / No. 4

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Halbert Hargrove pays employees $500 a month if they move to within a 20-minute drive of work, says Cecilia Williams, the firm's chief compliance officer.

COVER PHOTO AND PHOTO RIGHT BY PATRICK STRATTNER

Columns

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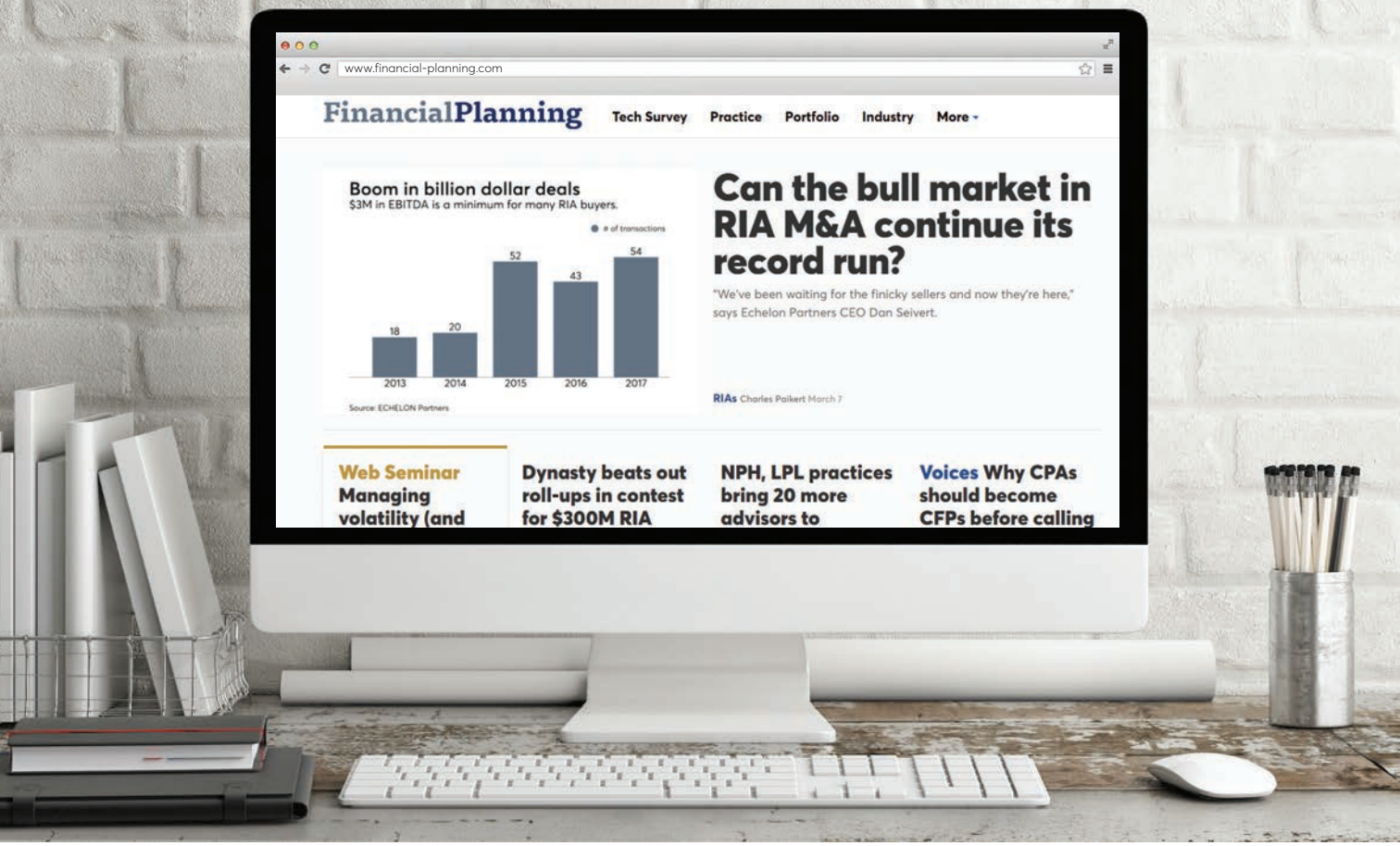
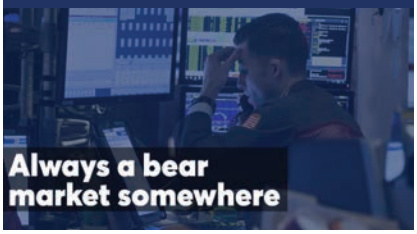


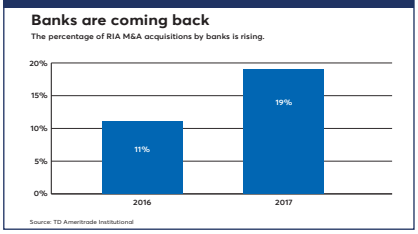
ROCK BOTTOM



Worst Performing Funds Since '08

In the decade since the 2008 financial crisis, the worst-performing funds were mostly found in the natural resources sector, including mining and gold. For some, the financial crisis wasn't even the low point. Click through our slideshow to learn more. Go to http://bit.ly/2FEIgoq

GUIDE TO GROWTH



A Boon for RIA M&A?

Banks could be big players in the coming months. RIA mergers and acquisitions activity by banks rose by 8 percentage points in 2017 from a year earlier, according to TD Ameritrade's FA Insight research unit. To learn more, go to http://bit.ly/2nCDZZQ

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Editor's View

Raising the Bar

Volunteer days and relocation bonuses are just some of the perks firms are offering their planners.

The job market for newly minted financial planners is wide open. Doubtful? Just ask XY Planning Network co-founder Alan Moore.

"There are more jobs than we know what do to with," he tells me, adding that young people don't pursue the career because they still misperceive it as requiring cold calling or even door-to-door sales. "We are having a problem finding enough students to get through planning programs, get their CFP and then get jobs," Moore says. "Right now it's very much a buyer's market."

Even once students realize there's no door-knocking involved, there are certain hoops firms feel compelled to jump through to attract and keep promising talent. Salary is just one part of the equation, according to *Financial Planning* Senior Editor Charles Paikert.

"Millennials entering the workforce are going to want more work-life balance, flexibility and firm involvement in community and charitable causes," Paikert tells me. Firms are paying attention.

Just some of the perks they offer include volunteer days, relocation bonuses for advisors who move closer to the office and "fun committees" that arrange activities such as go-kart racing, according to Paikert, who wrote the main feature, "Pay Day."

"In addition to increasing compensation for employees in a tight job market, RIA firms are making sure employees feel like they're having fun at work and enjoy working for their employer," Paikert says. In his story, Paikert mentioned the coffee bar in Homrich Berg's Atlanta headquarters, but "I wasn't able to track down the juice bar that at least one RIA reportedly has in their offices," he says.

Of course, you can't pay bills with the proceeds from a go-kart race win or savings from free office coffee, so Paikert dived into salary metrics for advisors around the country. In San Francisco, lead advisors' total compensation package runs $193,000. Those in Dallas earn about 9% less. Maybe because they're paying for the fresh-squeezed juice? **—Chelsea Emery**

Retirement Advisor Confidence Index

Client Risk Tolerance Plummets

Stock market volatility was a major factor as the component experienced its largest monthly drop since the index was launched.

By Harry Terris

The return of stock market volatility has prompted clients to recalibrate portfolios and adopt a more defensive posture, advisors say. Client risk tolerance deteriorated sharply, according to the latest Retirement Advisor Confidence Index — *Financial Planning*'s monthly survey of wealth managers.

The component tracking risk tolerance plummeted 20.8 points to 37.2, the biggest monthly drop since the index was launched in 2012. Readings above 50 indicate an increase, while readings below 50 indicate a decline.

"Violent" swings in equity markets have "definitely spooked clients," one advisor says. "A small percentage went to 100% cash, many more to more conservative allocations."

Advisors report they are frequently reviewing risk positions with clients, with a particular focus on those nearing or in retirement.

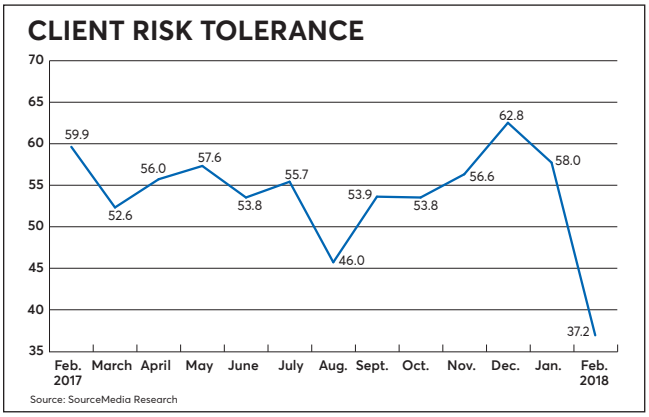
"We're having discussions about moving some funds to annuities" in order to preserve future income, one advisor says.

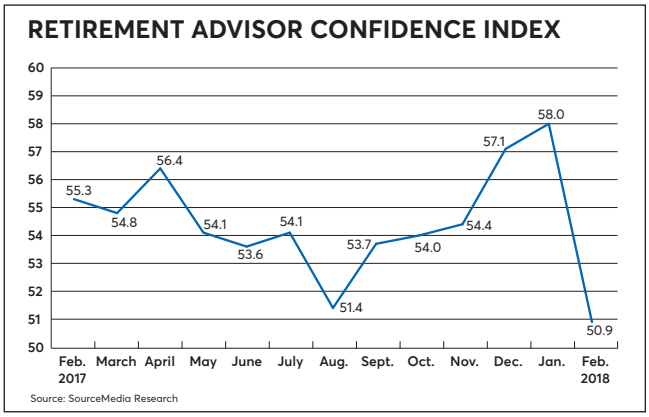
Some advisors say the renewed volatility in stocks after a long period of relative calm has reinforced expectations for a deep correction. The slide in stock prices after the highs set last year "serves as a reminder that the markets can pull back," one advisor says.

The free fall in the risk component was the biggest factor behind a 7.1-point drop in the composite RACI to 50.9 — also the largest retrenchment in the history of the index.

The composite tracks asset allocation; investment product selection and sales; client risk tolerance and tax liability; new retirement plan enrollees and planning fees. Still, at just above 50, the composite remains in expansion territory.

Advisors say that they remain confident about the fundamental strength of the economy and that while they have had to coach some clients not to stray from long-term plans, many have taken higher stock volatility in stride. "My team and I have been telling our clients that the economy is healthy and the outlook looks good going forward. We also did expect a correction — not recession — some-





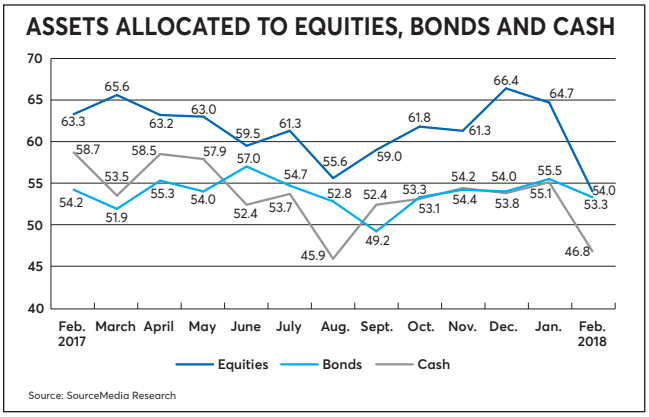
The Retirement Advisor Confidence Index, published in partnership with ADP®, is created by the editors of Financial Planning *and is based on a monthly survey of about 300 advisors. Visit financial-planning.com for more results.*

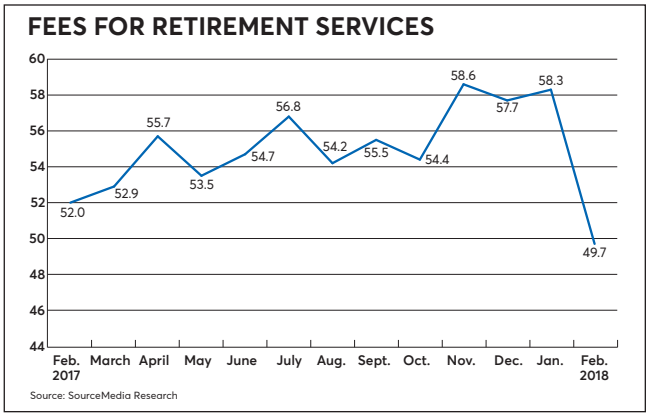
time this year," one advisor says.

Many advisors say clients are taking advantage of stock price swings to buy during the dips — in some cases deploying cash that was accumulated for just such an opportunity.

The RACI component measuring flows into cash fell 8.3 points to 46.8. The component tracking the amount of client assets used to buy equities also fell 10.7 points but remained in expansion territory at 54.

The component tracking fees charged for retirement services dropped 8.7 points to 49.7, the first reading below 50 in more than a year. Advisors say stock price declines have eroded managed assets. Some advisors also note that competitive pressures, including from robo advisor platforms, have compressed fees. FP





Harry Terris *is a* Financial Planning *contributing writer in New York. He is also a contributing writer and former data editor for* American Banker. *Follow him on Twitter at @harryterris.*

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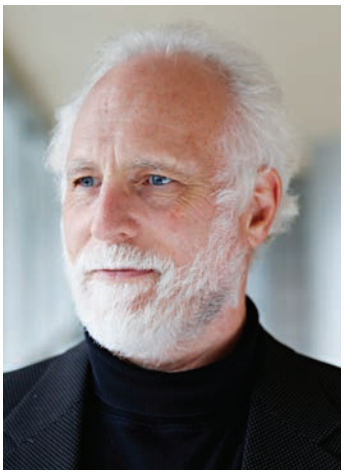

Outgrowing Their Roots

Independent broker-dealers will have to re-examine their business models as a fee-only fiduciary world draws near.

By Bob Veres

As the financial planning industry nears a fee-only fiduciary world, advisors are finally outgrowing the profession's roots — and for the better. In the process, though, independent broker-dealers will face some important choices about their future business models.

First, some brief history. The planning profession was initially made possible by the emergence of the independent broker-dealer business model in the late 1970s and early 1980s, which suddenly gave brokerage representatives a new business option.

They could move their licenses from the brokerage firm to the independent BD, operate their own offices and enjoy much more independence than they did in the bullpen under the supervision of the local branch manager. They could sell the products they wanted to sell, and, more important, they could provide investment advice in the context of a comprehensive financial plan.

Fast forward to today, and it appears that the profession is outgrowing its original facilitator. A growing number of advisors are going fee-only and affiliating with institutional custodians like TD Ameritrade Institutional, Schwab Advisor Services, Fidelity Institutional, Shareholders Service Group and Pershing Advisor Solutions. Many fee-only firms now have more than $1 billion in AUM.

Accelerating the Trend

The Department of Labor's fiduciary rule has only accelerated the trend, causing advisors to drop their Series 7 and forego commission revenue, or enter the business as fee-only from the start.

Meanwhile, new mark-to-market requirements for nontraded REITs, a growing market of no-load annuities and a seemingly endless parade of new FINRA regulatory hassles are making sales activities less attractive or profitable. For independent BDs, it's not hard to read the handwriting on the wall. The number of FINRA member firms has steadily fallen from 5,374 in 2002 to 3,835 in 2016, while the rep count dropped from 662,311 to 635,902.

Fees are clearly the future, and an all-fee planning practice doesn't need some of the things that independent firms have traditionally provided: a place to park your license, access to commission-based annuities and nontraded REITs, and a compliance regime that fussily inspects every outgoing message to clients as if it may be a sales pitch. Why pay 10% to 12% of your top-line revenues for supervision that is no longer appropriate for your business model?

The number of FINRA member firms has steadily fallen from 5,374 in 2002 to 3,835 in 2016.

What to do? I think the independent BDs face some important decisions that will determine their future viability. Their first decision is what kind of advisor they will cater to in the future. In my mind, there are two choices.

First, the firms who have increasingly emphasized fee business, like Cambridge Investment Research or Commonwealth Financial Network, could opt to secede from FINRA altogether and instantly become the equivalent of a national RIA.

I talked with one broker-

dealer executive about the idea and he said that if FINRA were out of the picture, he could remove more than 100 compliance staffers and drop home office overhead dramatically.

The national RIA model would attract advisors and brokers who want to be ahead of the fiduciary curve and still collect residual trail commissions. It would charge a monthly fee for practice management advice, national educational conferences, technology and wholesale custodial services, and that sense of community, which may be the most important service that the best broker-dealers offer their advisors.

The Downside

The potential disadvantages: lose representatives who prefer sales and have to compete on value versus price with independent custodians.

The other option could be called a sales house: a FINRA-affiliated haven for the reps who are determined to remain in sales and say "to hell with the fiduciary trend."

A broker-dealer network like Cetera Financial Group would specialize in servicing sales agents and stock its shelves with the annuities and nontraded REITs that have been their bread and butter for decades. In the short term, this could be a huge recruiting bonanza for reps who are tired of being told to charge fees for their advice.

The firm would provide a compliance overlay to keep the reps out of trouble, deliver excellent sales and marketing assistance and lead generation, and enjoy protected revenue margins from the independent custodial competitors.

The potential disadvantages: a diminishing market share as sales reps age out of the business and greater potential for arbitration claims related to unsuitable recommendations.

Whichever direction the broker-dealer chooses, there will be another branch in the decision tree. Much of the value of a home office lies in the technology that is made available to the affiliates. How these firms choose to add value with their technology suite would distinguish them in the marketplace, perhaps more than any other service-related issue.

I think there are two possibilities. One avenue is to create a proprietary technology suite, which would give the firm more control over the feature set, tighter integration of the CRM, asset management and financial planning components, and a certain stickiness in that it might be harder for advisors or

reps to be lured away and have to start their tech stack from scratch.

But there would be disadvantages to going down this road: notably higher internal expenses to build and maintain the in-house system and the possibility that the legacy software would fall behind the dynamic evolution of independent software solutions.

Follow the other branch, and the national RIA or sales house would commit to creating and maintaining superior integration of off-the-shelf technologies. This would certainly be a less expensive approach than the proprietary technology suite and it would provide a potential recruiting (though not retention) advantage: it would allow the fiercely independent affiliated offices to make their own software choices.

Trying to Keep Up

But there would be disadvantages to this approach as well. How do you keep up with all the new emergent competitive technologies in the software space? Another, perhaps bigger disadvantage is that hanging your hat on great software integration would give you less differentiation from the independent custodial competition who have all been offering off-the-shelf integration technology and who have large annual budgets to apply to the issue.

Anecdotal reports tell me that the independent custodians have recently been growing again as they recruit affiliated advisors and reps from the ranks of the wirehouse firms — people who want to escape the restrictions on the products they can recommend and the advice they can give.

Sound familiar? The difference is that now the BDs are competing with increasingly large independent advisory firms for those brokers, and the fee-only firms have a better story to tell regarding where the future is going.

Like it or not, the business model that helped the planning profession emerge is in danger of being left behind by the progress toward becoming a real profession. As we head toward an increasingly fee-only fiduciary world, I hope I'll see the independent broker-dealers making their contributions to that future professional ecosystem. **FP**

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

Figuring the Right Price

After five changes to my pricing model in five years, I ultimately returned to a strategy I had shunned when I started.

By Dave Grant

The biggest change in my practice since I opened in 2013 is pricing. It's not just me — most new RIA owners have gone through at least one pricing iteration. But why are pricing and service models so hard to figure out?

When I opened my practice, one of my main goals was to get away from the AUM pricing model. At my previous two employers, that accounted for the lion's share of revenue.

However, both firms had turned away clients who wanted to pay by the hour as it wasn't a service they wanted to offer. I never fully understand this as there were hourly planners in our geographic area who were making it work. And we were saying "no" to people who had money to pay for guidance.

As I left the second RIA, I was determined to follow a service model that didn't include AUM. I wanted to work with those who needed guidance but may not have significant assets to manage. So I started a practice offering hourly and ongoing-retainer planning.

I had to face several questions: How would each of these services models be priced? What was my time worth per hour? What would someone be willing to pay per year for my service, but have that pricing broken down into monthly payments? I don't dwell on decisions too long so I decided to make it something easy to remember.

This was for my own sake in marketing and prospecting, but also for consumers who may be comparing multiple planners.

What Did and Didn't Work

I went with a "$200 per hour and $200 each month" model and stayed with this for 12 months. People could either pay per hour or per month, resulting in a $2,400 per year ongoing fee.

After my initial 12 months, I found various situations where this didn't work. First, some clients worked through a financial plan with me and finished the engagement after six months. A comprehensive financial plan for $1,200 — what a bargain! After this, I instituted a 12-month minimum contract.

I was not prepared for the feeling of selfishness or guilt, but I had wanted to help those who needed guidance.

Then some clients came along with significant assets. At other firms, an ongoing retainer would cost them $5,000 to $10,000. They realized the bargain they got with me and signed up immediately. I also knew what a bargain it was, so I decided to implement a tiered retainer structure where pricing increased as assets increased.

Gaining Traction

At various asset levels, pricing increased from $200 to $500 per month. But for clients who hit those levels, it became hard to justify that pricing after the initial year and the majority of the heavy lifting was done.

I then went back to $200 per month but introduced an initial planning fee — first of $1,000, and then increasing this to $1,600 six months later. My hourly pricing turned to project pricing and turned into packages for different client needs. As my

practice struggled to gain traction, I rebranded and started taking referrals from a CPA, which meant doing AUM.

As I entered the most recent calendar year, I increased my prices, got rid of my 12-month minimum, and made my services similar to that of the companies I had left almost five years ago. My pricing and service model has evolved more than five times in the space of five years.

I have learned in talking with other planners that this journey is not uncommon. Many start out with low pricing to get clients in the door only to find some services do not pan out or pricing needs to be increased.

Others have low confidence so they price themselves lower only to find themselves being able to raise prices once they have some clients and years under their belt. Another factor is changing the firm's ideal client. Pricing needs to reflect their financial and life situation so pricing and services adjust up or even downward.

Looking to the Future

Not wanting to go through this adjustment again for a long time, I decided to design my pricing and services based on the clients I want 10 years from now.

As just over 60% of my revenue is now recurring, it has provided an income cushion making this easier to do, but it still doesn't calm my fears completely. It led me to reflect on what clients I desired, how my ideal practice would be designed, and my personal income needs.

I was surprised by how many knock-on effects that tweaking my pricing and services were creating and how it was changing the outcome of my business and personal life.

As I reflected on this, I decided I wanted to work with a small group of clients providing high-end services (financial planning, investment management, and income tax review or preparation) and charge a minimum of $10,000 per year doing so under an AUM model.

I would encourage newer advisors to not change their models if they see they are leaving money on the table.

I would be happy to work on one-off projects for other clients, but if they weren't eligible for this $10,000 minimum fee, then I wouldn't be prepared to work with them on an ongoing basis. This would allow me to cap the number of ongoing clients at 20 to 30. This income would allow me to hire a virtual staff, have income to support my family's needs, and free up time for pro bono work.

Something strange happened in the finalization of this design: It was, and still is, far removed from the initial model I had built. I was not prepared for the feeling of selfishness or guilt but I had wanted to help those who needed guidance and who may not have had the money to pay an AUM fee. And in building a new design, it made it hard to generate significant and reliable income. There is a reason many firms have minimums or only charge AUM, and while it's taken me some time to realize it, these firms have the ability to scale (if desired) and take advantage of increasing stock markets to increase revenue without needing to find more clients to generate more revenue.

It's also become apparent that new prospects seeking out my firm are attracted to the new pricing. They see the value of a higher minimum and an exclusive service model.

They know that the pricing of an advisor delivering comprehensive planning and life planning services isn't going to be cheap but they are accepting of the fee schedule. They don't want their services to be priced on the low end of an industry scale as they realize that detailed knowledge, experience and diligent work will require higher compensation.

But should all owners go through the same process as me, iterating numerous times? I think some iteration is fine, but there needs to be some deliberate design based on the future desired clientele. I think new owners and planners need to get clients in the door in order to fine-tune procedures and services.

The 'Ideal Client' Fee Model

Once this has been done and a comfortable level of recurring revenue has been established, then an "ideal client" fee model should be established. While this may be vastly different from the current structure, it allows for a level of certainty in prospecting, knowing that each new client will be adhering to a service and pricing model that will remain steady for a long period of time.

I would encourage newer advisors to not change their models if they see they are leaving money on the table.

Understand that some clients will pay more, and some will pay less. Some may receive more than what they pay for, and others will seem easy to service in regard to the revenue they generate. Build a pricing and service model that is appropriate for your ideal client but also complements what you see your RIA becoming in the decades to come. The rest will take care of itself. **FP**

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

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Cruz

Compensation Concepts

Specific pay structures can help reward partners for the unique value they provide to a firm.

By Kelli Cruz

If your firm is considering making any changes to your existing partner compensation plan, from a minor tweak to a major overhaul, there are some basic concepts you should keep in mind.

First, you should make a note that there is no magic compensation system that will satisfy all partners, meet all strategic goals and work forever. Your compensation plan is a living, breathing document. Thus, it will need to adjust to meet the demands of our evolving industry and to satisfy partner concerns around fairness, as well as complement and reward compliance with ever-changing firm goals.

A Major Impact

The ways in which owners are compensated can have the single biggest impact on the financials of a firm, and it can also set the terms for future firm partners.

Therefore, getting this aspect of your compensation formula right is essential to the stability and profitability of the firm going forward.

In my experience, partners are almost always the highest compensated professionals in the firm. Their responsibilities include the critical roles of business development: client service and relationship management functions. I recommend the following compensation structures. As most partners are actively working in the business, they should be compensated for the roles or functions they are performing for the firm.

• **Base compensation or salary** is market-rate compensation for the role and corresponding responsibilities. Not paying owners a salary lowers the perceived value of their contribution, and makes it difficult to manage profitability on an ongoing basis. Remember that partners work in the firm, and thus their product needs to be fully valued and accounted for in the firm's cost structure.

In my experience at Cruz Consulting Group, most partners actually perform a blended job role in fulfilling the responsibilities of several vital positions for the firm.

If mentoring young talent is part of the firm's strategic plan, be sure to include some reward in your compensation system, or the message to your partners is that it's not valued.

For example, most owners perform the combination of generating new business, servicing the firm's top clients and running the day-to-day business. A typical blended job role for a firm owner might be 35% rainmaker, 40% relationship management and 25% business management. Additionally, a partner may fill the roles of CEO, COO, CIO or chief compliance officer.

Owners/partners of advisory firms should be compensated like any other person in the firm for the role they are performing as an employee. I see a lot of variation in how firms are determining salary for partners: 1) by a combination of prior year revenue and other contributions; 2) owners receive no salaries — their income is entirely in the form of incentive compensation or

a percentage of profits; 3) salaries are determined yearly based on prior year revenue contribution (draw); 4) salaries for all active owners are equal and not based on market rates.

• **Incentive pay** is variable compensation for meeting or exceeding goals that are tied to the key strategic initiatives of the firm.

It's important to include partners in the incentive or bonus pools to ensure their full contribution is being reflected in their compensation.

I speak with many firms that explain they don't need to pay partners a performance incentive because these partners are already sharing in the firm's profits. They feel this is the perfect way to align each owner with the results of the firm. I can't argue with that logic.

What's left out of that equation, however, is that profit distribution does not account for the individual performance of each partner.

Additionally, you may have some partners who earn a smaller percentage of the profit pool and may not be motivated to contribute at a higher level if they are not rewarded equitably for their efforts.

Keep in mind that incentive pay should be tied to annual goals and results paid out quarterly, semi-annually or annually.

Typical individual drivers of incentive compensation include new clients; new revenue generated; total revenue managed and/or number of clients managed; client retention and satisfaction; developing and mentoring staff; events or milestones and special projects.

• **Ownership distribution** is the return on the owner's investment in the business — it's not compensation for working in the business, or even on the business. Some firms try to manage a bottom line to a certain value by shifting most or all owner compensation into this distribution category.

The lesson here is that owners need to be fairly compensated for their roles first, and then overall business expenses and profitability must be managed from that baseline.

One of the biggest pitfalls firms face is not distinguishing between partners whose roles are diminishing and those who are fully engaged in running and growing the business.

Owner compensation plans should define the role of the owners and the value of the jobs, hold each owner accountable to a certain level of performance, and differentiate between rewards for their labor and of ownership.

Recognizing owners and partners as employees first allows the ownership group to differentiate contributions made by different partners at various phases in their careers.

A Big Challenge

One of the biggest challenges firms face is not distinguishing between those partners whose roles are diminishing as they sunset out of the firm and those who are still fully engaged in running and growing the business.

Partners' compensation should change over time as their job role, performance and contributions shift.

This is the only structure that can accommodate for the changes in partner role and value to the firm that occur over time.

Here are some final considerations to keep in mind when you're making meaningful changes to your partner distribution plan.

Before making these shifts, find out what your partners do and do not want in a new compensation system. You can do this by facilitating a brainstorming session.

As a starting point, you might ask the partners to answer the question, "What do you value the most?"

Before you can develop a successful, comprehensive compensation system, you must have a very clear and agreed-upon credo as to what makes your firm tick.

You may be surprised at how agreeable your partners are once they've made their points of view known and have the opportunity to consider the opinions of their fellow partners.

The compensation system you create should be related to your firm's strategic goals.

For example, if mentoring the next generation of talent is part of the firm's strategic plan, you should include some form of reward for it in your compensation system. If you do not do this, the message to your partners is that mentoring is valueless.

Every type of compensation system has compelling reasons for adoption, and just as compelling reasons for why it should not be adopted. It's up to you to decide what system works best for your firm and your partners.

At the end of the day, your partners want to be compensated fairly and equitably, just as every other employee in your firm does.

Whether you choose to compensate them with a base salary, incentive or a combination of both is up to you and your business strategies.

However, you should always keep in mind that making your partners happy will also help to keep your clients happy. And isn't that the end goal for every firm? **FP**

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Kautt

'Needs-Based' Pay Policy

Use Maslow's hierarchy of needs to help set your firm's compensation approach and prompt growth.

By Glenn G. Kautt

"Show me the money!" is a line you probably remember from the movie "Jerry McGuire." The film focused in a comedic way on a well-known financial objective: exceptional compensation for superior performance.

For advisors, there are many forms of compensation. When you discuss this topic with someone in your firm, you should be clear on what type of compensation you're talking about.

The ways in which people are motivated by different forms of compensation to satisfy physical and emotional needs are described in detail in Abraham Maslow's classic 1954 book, "Motivation and Personality."

The key to your success is understanding how each advisor should be compensated and having a well-thought-out plan so you can elicit maximum performance from employees at any emotional level of Maslow's hierarchy.

The critical question for business owners and managers: How do you develop those advanced levels of advisor compensation?

To develop a completely comprehensive compensation system, a quick review of Maslow's needs hierarchy is necessary. Maslow described his first four levels as deficiency needs (shown in the table "Maslow's Hierarchy of Needs"), because he believed that everyone is initially deficient in these areas.

Satisfying Needs

People are motivated to satisfy their first level needs (L-1), then satisfy L-2 needs, and so on.

I don't write about or suggest things that require work without a good payoff, so I'll tell you about what's happened at my firm, Savant Capital Management, during the past 5½ years.

We increased assets under management an average of about 17% annually to $6 billion from just under $2.5 billion. By comparison, the S&P 500 increased at 13.2% annually during that same period.

A majority of our AUM growth wasn't from acquisitions or market gains. Our total portfolio contains a significant amount of fixed-income securities and our portfolio average annual growth was less than 10% during that period, so about 8% annually had to come from elsewhere.

The winning payment-plan system for your firm must consider the emotional needs of advisors across the wider spectrum.

Our best-in-business organic growth was the result of our advisors bringing in an immense amount of business during this period. A large part of our advisors' motivation for this effort was our comprehensive compensation program.

Want to know what you can do to enhance your own program? Using Maslow's framework, start by creating a matrix mapping the advisor's levels against your current compensation system. This will give you some ideas on how to best meet each advisor's needs.

Here is Savant Capital Management's match to Maslow's hierarchy:

1. L1-L2: Salary, team and

individual bonuses
2. L1-L2: Benefits such as 401(k) and matching; insurance; paid time off; telecommuting; flex hours
3. L1-L4: Equity in the firm and annual dividends
4. L3-L5: Job matching, mentoring, coaching, regular evaluations.
5. L3-L5: Increases in scope of job responsibility and authority
6. L4-L5: Recognition and reward for innovation and being a change agent
7. L3-L5: Community involvement support and recognition
8. L3-L5: Industry involvement support and recognition
9. L3-L5: Professional training inside and outside the firm
10. L3-L5: Marketing growth support – "I care about your future"
11. L3-L6: Professional reputation growth support
12. L3-L6: Supporting professional education outside the firm.

Notice a substantial part of Savant's compensation plan provides emotional motivation in levels L3 to L6, areas not typically considered by HR departments. Your winning system must consider the emotional needs of advisors across this wider spectrum, and formalize compensation that encompasses every level described by Maslow. In Maslow's own terminology, get big in your hierarchy or go home.

Before you change anything about your strategy, however, take a step back and consider what you want to accomplish in the areas of compensation and motivation.

Higher Levels of Motivation

You probably want to pay at or above the industry average salary or bonus, but can you commit to being responsive to your advisors' needs to reach higher levels of motivation?

Expanding your system to include cutting-edge motivational rewards will help ensure your firm isn't left behind.

If your answer is "No," then you might want to carefully consider your overarching business goals. Just don't be surprised if good people leave your firm because you don't change. If the answer is, "I'm not sure" or "Yes," that's a sign you are ready to evaluate and improve your compensation program.

You might think a diversified compensation system that meets every need of every advisor is incredibly complex and highly expensive.

Developing and implementing formalized incentives may increase your expenses somewhat, but it can have a significant positive impact on your company's top and bottom lines.

From an implementation standpoint, it's relatively easy to install if you're already doing some or much of what I have explained but just haven't made it part of a formal program.

If that's the case, I recommend you formalize what you already do, and make sure each advisor knows all about it. If you're still developing your organization, consider adding these additional motivations formally to your compensation program as you grow.

By the time we had 15 employees and four advisors, we were able to use nine of the 12 categories mentioned earlier to motivate them.

Now, with about 10 times as many people, we use all 12 motivational categories. You should also develop and add to yours as time goes on.

The world's currency systems are expanding conceptually and technically – think cryptocurrencies. Whether or not you agree with their purpose, as an advisor, you shouldn't ignore them or the trends they represent.

In the same way, you shouldn't ignore trends in advisor compensation.

Expanding your compensation system to include cutting-edge motivational rewards for advisors will help assure your organization is not left behind. Doing so will propel you into the 21st century as technology, society and client expectations are changing – and the motivational expectations of your advisors are also changing.

Get big or go home. **FP**

Maslow's Hierarchy of Needs

L1	Physical, such as food, shelter, sleep
L2	Safety, including personal, financial and health
L3	Social belonging, including friends, intimacy, family and community
L4	Esteem, such as self-confidence and feelings of joy, hope, curiosity and acceptance
L5	Self-actualization, including the self-realization of full potential personally as well as in others, and transfer of values and beliefs to others
L6	Self-transcendence, including actions of altruism and spirituality affecting others

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The new tax law dramatically changes estate planning, even for those who are not extremely wealthy.

BLOOMBERG NEWS

Tax Law Shifts Estate Plans

Advisors and their clients may not yet realize how much the new regulations change their strategies.

By Martin M. Shenkman

When the new tax law doubled the threshold for estate taxes, you might have naturally assumed estate planning was no longer relevant to the majority of your clients. After all, the new law raised the bar for estate taxes to exclude all but the nation's wealthiest households — those with more than $11.18 million per person or $22.36 million per couple.

But if you were quick to write off estate planning as a top priority for your clients, you might want to think again.

In fact, the new law dramatically changes estate planning in ways advisors and their clients may not yet realize. Without the influence of their advisors, clients are unlikely to understand these important changes and confer with an estate planning attorney in a timely manner.

Take the following scenarios, for example:

• **Income-tax planning** will become a more critical part of most estate plans and require a more active role for planners and CPAs.

• **Many income tax benefits** can be gained by using non-grantor trusts. These are trusts that are their own independent taxpayers. This is a sea change from the grantor trust (the client who set up the trust was generally taxed on the trust income) that had before been ubiquitous in estate planning.

• **Wealth advisors will now have a new pot** with different tax considerations to factor into asset location decisions. Wedged between the qualified plan pots that pay no current tax and the individual client pot that pays current income tax will be a new category that will have a different tax profile.

Income-tax planning will become a more critical part of most estate plans and require a more active role for planners and CPAs.

•**Life insurance will also serve** a new role. In most cases, insurance will no longer be needed to pay an estate tax but it may still be a useful backstop that will become more common in the new trust planning.

New laws, new goals: Many clients will have different goals for their estate planning than they did previously and identifying these goals is essential to structuring these new plans. Consider these three significant objectives:

1. Use new temporary exemptions. The doubling of the exemptions from $5 million to $10 million (inflation-adjusted) (approximately $11 million in 2018) is a temporary benefit. The law by its own terms will sunset after 2025 and

the exemption will return to $5 million (inflation-adjusted). If large deficits occur, a future administration may repeal this and other benefits before that time. Clients should use as much of the new exemption as possible while they can. In most cases, this will require making transfers to trusts that constitute completed gifts for transfer tax purposes. This means the plan will limit the control or strings your client has on the trusts receiving assets to avoid estate inclusion. This will affect the terms of the trusts that are used.

2. Clients must have access to the funds transferred. With exemptions of $22.36 million per couple, few clients will be willing to give up access to the assets they transfer to use their exemptions. That means the client herself, or the client's spouse if married, will have to have options to gain access to trust assets.

3. In many cases, and in contrast to prior planning, some trusts will have to be non-grantor trusts to assist clients in minimizing the negative impact of the restrictions the new law places on standard deductions, including state and local taxes, which are limited to $10,000 per year. Charitable contributions were not directly limited, but few clients will have sufficient itemized deductions to get a tax benefit from donations. This is important to clients of all wealth levels who are charitably inclined, to clients incurring large property taxes on their home and vacation home and impacts state and local taxes. These non-grantor trusts may help maximize benefits from the new 20% income-tax deduction available to pass-through businesses entities.

New planning: Here's how the new objectives may be coordinated in new estate plans.

• **The client will create a trust** naming a spouse and all descendants as beneficiaries. Including a spouse in the trust meets the goal of assuring access to the assets given away. However, the traditional approach of including a spouse will result in the trust being classified for income-tax purposes as a grantor trust with income taxable to the client setting up the trust. Instead, in these new trusts, distributions to the spouse will have to be approved by what the tax laws call an adverse party. That is someone who will be negatively affected by distributions to the spouse, e.g., a child who is a beneficiary of the trust. This will permit non-grantor income-tax status for the trust.

Many income-tax benefits can be gained by clients if they use non-grantor trusts.

• **The client might transfer** part or all of their primary home or vacation home to the trust. Each non-grantor trust should be entitled to its own $10,000 SALT deduction. This technique can salvage most of a client's lost property tax deduction. There are certainly nuances to the planning: The house has to be owned by an LLC, the home sale exclusion will be lost unless the house is sold to the trust or the planning is unwound two years before sale, etc.

• **The client should transfer sufficient investment assets** to the trust in order to earn enough income to pay the property tax owed by the trust and to offset that deduction.

• **Many clients may transfer more investment assets** to such non-grantor trusts to avoid high state income taxes that are no longer deductible.

Charitably inclined clients can use a similar approach to gain the full tax benefit from contributions. These clients can set up a simple non-grantor trust in the state they live in and name a family member as a trustee. They can transfer sufficient investment assets to the trust to generate income to pay charitable donations. They can also name children and grandchildren as beneficiaries. The family member trustee in future years can donate income to charity.

Trusts don't have a standard deduction so the income will be offset by the contribution deduction so long as certain tax law requirements are met. That will provide a full offset for the donation, and for a married client, it will preserve their full $24,000 standard deduction on their personal income-tax return.

If in a future year the client wishes to help a child or grandchild, the trustee can make a distribution to that beneficiary and forgo a charitable gift.

Similar planning can be used to maximize the new 20% deduction for pass-through businesses under new Code Section 199A. If the client's taxable income is too high to gain maximum benefit from this new deduction, they can set up non-grantor trusts for each child and gift a portion of the business to each trust.

The trusts will have their own income level for purposes of calculating the 199A benefit.

The use of these new types of trusts, with different tax profiles than other investment pots will require that planners reconsider asset location decisions.

Estate planning has been transformed by the new law. While an estate plan can and should still achieve asset protection, asset disposition and other goals, it can also now be directed at achieving a range of valuable income-tax planning benefits. **FP**

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Pay Day

In a tighter labor market for advisors, salaries are rising, as are firms' efforts to make work more enjoyable.

By Charles Paikert

RIAs are flush, and odds are that revenue and AUM are up at your advisory firm. So, have you gotten a raise yet?

Many of your counterparts around the country have, along with lots of perks intended to keep them happy at their firms.

Over 90% of RIAs participating in the 2017 compensation study by Fidelity Clearing & Custody Solutions reported giving salary increases as well as bonuses last year. One-third said raises ranged from 2% to 4%, while half reported increases of 4% to 10% or more.

"The labor market for advisory talent has definitely tightened," says Michael Nathanson, president and CEO of Colony Group, the $10 billion Boston-based RIA.

Even as RIAs face an aging advisory force and not enough next-generation replacements, those challenges are compounded by a strong labor market and the likelihood that the dissolving Broker Protocol will diminish the pool of breakaway brokers, further reducing the supply of available talent to meet the voracious demand of fast-growing RIAs.

What's more, advisory firms are finding it harder than ever to attract already elusive college graduates, says Rich Busillo, CEO of RTD Financial Advisors in Philadelphia. "It's not just more competitive for existing advisors," he says. "There's also more competition for new college grads because of the strong job market in a number of industries."

More than two-thirds of RIAs with more than $250 million in AUM made talent acquisition a priority last year, as did nearly all firms with $1billion or more in AUM, according to Charles Schwab's 2017 RIA Benchmarking Study. Few expect the trend to diminish anytime soon.

As a result, compensation is on the upswing. At Colony Group, salary

PHOTO BY PATRICK STRATTNER

Cecilia Williams, chief compliance officer at Halbert Hargrove, says her firm sees vacation time as a "huge part of the work-life balance."

increases averaged 3% to 5% last year, Nathanson says. RTD Financial Advisors' pay increases ranged between 2% and 6%. Salaries for entry-level advisors start at $50,000 to $60,000, Busillo says.

Base salary increases at Atlanta-based Homrich Berg Wealth Management averaged 3% last year, but a number of employees had their paychecks rise 6% to 10%, says Paul Ribes, the RIA's chief operating officer. Base salaries for college graduates at the firm are around $50,000, he adds.

Geography Matters

Where firms are located makes a difference in pay.

Position	Market	Median Total Compensation
Business Development Specialist	San Francisco	$205,000
	New York	$199,000
	Boston	$195,000
	Los Angeles	$195,000
	Chicago	$192,000
	Dallas	$185,000
Lead Advisor	San Francisco	$193,000
	New York	$187,000
	Boston	$185,000
	Los Angeles	$185,000
	Chicago	$180,000
	Dallas	$175,000
Operations Manager	San Francisco	$102,000
	New York	$98,000
	Boston	$96,000
	Los Angeles	$96,000
	Chicago	$94,000
	Dallas	$90,000
Manager Client Services	San Francisco	$76,000
	New York	$73,000
	Boston	$72,000
	Los Angeles	$72,000
	Chicago	$70,000
	Dallas	$67,000
Office Manager	San Francisco	$74,000
	New York	$71,000
	Boston	$70,000
	Los Angeles	$70,000
	Chicago	$68,000
	Dallas	$65,000

Source: Fidelity Clearing & Custody Solutions, ManpowerGroup Solutions, Culpepper and Associates

Across the country, in Long Beach, California, advisors starting at Halbert Hargrove can make $80,000, according to Cecilia Williams, the firm's chief compliance officer.

Such regional differences are not uncommon. Median total compensation for lead advisors in San Francisco is $193,000, according to Fidelity's research, while lead advisors in Dallas make $175,000. The spread is less for positions further removed from clients. Operations managers in San Francisco can expect to receive $102,000, but total compensation for the same job in Chicago isn't far behind at $94,000, the Fidelity report shows.

Regional Pay Differences

Nationally, industry compensation studies are hardly uniform.

Fidelity reports that the median total cash compensation for relationship managers in 2016 was $120,000, while Schwab's Benchmarking Study for the same position in the same year was nearly $30,000 less.

Similarly, FA Insight reports that business development specialists received $180,500 in median total compensation in 2016, while Fidelity's data has that group receiving $163,000 in total direct compensation.

But there's no doubt that CEOs are by far the top earners, followed (not closely) by chief investment officers. The median total direct compensation for the CEO/president position is $630,000, according to Fidelity, while CIOs receive $375,000.

As for the front lines of financial advisory firms, the median total direct compensation for office managers for all firms was $110,200 in 2016, according to Fidelity, while office managers in firms with more than $5 billion in AUM received $123,200.

But money is only one part of the compensation picture. "It's really about

the employer value proposition," says Vanessa Oligino, director of business performance solutions for TD Ameritrade. "When talking with potential employees, the conversation should not be about the dollar amount, but addressing their questions like: 'Do I want to be here every day?' and 'How can I contribute?' and 'Will I be recognized?'"

Fidelity's vice president of practice management and consulting, Anand Sekhar, agrees. "Salary and bonuses are table stakes now," Sekhar says. "People want to be inspired. They want to feel empowered and energized when they go to work."

Firms are increasingly doing that by offering what Sekhar calls "creative benefits." RTD Financial, for example, has a so-called fun committee. The committee has its own budget and meets quarterly to plan events such as a pre-Super Bowl potluck party, an ice skating night out and outdoor happy hours, where employees can socialize and relax.

The committee also plans RTD's annual midyear meeting, which combines business seminars with after-hours activities such as go-kart racing, as well as social-responsibility events such as a 5-kilometer run to benefit the American Stroke Foundation.

"We realized that we're with each other almost as much, if not more, than we're with our families," Busillo says. "So we want to make sure we have fun while we're doing great work."

Being able to make decisions without prior approval from the firm's board of directors has been critical to the committee's success, says Rachel Moran, an RTD advisor and director of the fun committee.

"We have a budget for each year, which gives us the flexibility to plan events on the committee level without prior approval," Moran says. "This aids in efficiency but also in ownership — employees feel empowered to suggest ideas and follow through with their planning and execution."

Homrich Berg also has a "fun workplace" committee to arrange off-site get-togethers, monthly happy hours, and lunch and learn sessions, where employees are treated to a meal while an expert explains various aspects of the advisory business. "Everyone is involved," says Ribes, the COO. "We want people to enjoy being here."

Vacation Time

Another trend that's gaining traction: generous vacation time. Colony wants to be "the leading financial advisory company in the country for clients and employees seeking meaning and joy in their lives," Nathanson says.

Accordingly, the firm allows principals and key senior employees — about one-third of the workforce — to take unlimited vacation time (within reason) if they need it.

"If one year, an employee has to take six or seven weeks off, they can go ahead, as long as they behave responsibly and get their work done," Nathanson explains. "It's a matter of who is in control, and we want the employee to feel they are in control of their life."

And if you were wondering — yes, it's a paid vacation. Nathanson says the firm doesn't track how many employees have taken advantage of the benefit, but he expects most will at some point. "We have not had any problems with this approach," he says. "We expect them to get their work done, and as long as they do, everyone is happy."

At Halbert Hargrove, vacations are seen as "a huge part of the work-life balance, which we want to be as flexible as possible," Williams says.

Employees can take "as much time off as they need, as long as it's responsible and they can get the same amount of work done," Williams says. Not surprisingly, the policy has gotten "a great response," she says, with work-

Don't Forget the Fundamentals

Offering a competitive salary is not the only requirement for an RIA seeking motivated and productive employees. Don't overlook unglamorous but critical fundamentals like employee agreements, industry experts advise.

"The use of employment agreements is generally considered a best practice, but only 50% of firms have employment agreements in place for some executive roles," according to Fidelity's 2017 RIA and multifamily office compensation study. Such agreements should define the job and its requirements, and lay out the terms of employment and the timing of renewals or extensions. The starting salary, the timing for potential increases, a signing bonus, incentives and other compensation should also be addressed, the report says, citing research by Botoff Consulting.

Termination and severance provisions are particularly critical, Fidelity says, as well as definitions of termination "for cause" or "not for cause." Firms also need to spell out how retirement, disability or death affect severance terms.

Many RIAs, such as RTD Financial Advisors and Homrich Berg, use employee agreements to spell out the business relationship between the firm and its advisors regarding clients. "When advisors leave, they should not be walking away with the firm's clients," says Paul Ribes, the COO at Homrich Berg.

ers being "very appreciative."

Homrich Berg's vacation policy is more formal, but also generous. Workers get an extra week off after every five years of employment, as well as a bonus check worth four weeks of pay.

As a long commute is a pain point for many employees, some firms, including Halbert Hargrove, are incentivizing employees to cut their commutes. The firm offers a relocation incentive of $500 per month if employees move to an area within a 20-minute drive to work, Williams says.

"A long commute can wear on you, especially in Southern California traffic," she says. "Living closer to the office makes everything a lot easier."

Halbert Hargrove's family leave policy also makes life easier for new mothers, says Williams, who is pregnant with her first child.

Under California state law, employees receive 12 weeks of paid leave, but Halbert Hargrove has sweetened the pot. Moms and dads of newborns are eligible for a child care reimbursement of $400 a month, provided they submit receipts.

The firm also provides a room where mothers can breastfeed and caregivers can stay with babies when parents return to work. "It's a very family-friendly policy," Williams says, "and a huge benefit for new mothers."

At Colony, returning new mothers and fathers can work part-time for an agreed-on transition period, work from home or, if they prefer, from a nearby Colony office. The firm has secure technology installed in homes to facilitate remote working, and nursing mothers who return to work can request privacy blinds in their offices.

Around the country, RIAs are offering "more progressive family leave policies and support for working parents as they compete for next-gen advisor talent," says Fidelity's Sekhar. "I wouldn't say it's widespread at this point — those that are offering these kinds of benefits are really at the forefront of this space. But it will help establish them as a talent destination, especially as they seek to attract younger, more diverse advisors."

More on Compensation

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Subsidizing Gym Fees

Colony Group pays 50% of employees' gym membership — 100% if they go to the gym at least three times a week, reported on an honor system.

The firm also gives extra days off to employees to volunteer for their favorite charity. Employees decide the causes that Colony supports via its donor-advised fund.

Some firms take employee satisfaction into account when they design offices. Homrich Berg's new headquarters in the Buckhead section of Atlanta, set to open this summer, was configured with employee retention in mind, according to Ribes.

"We saw that people wanted lots of natural light and liked an open concept, where they could get together with their team in their own neighborhood," Ribes says. "We also made sure to include a Starbucks-like café area where people can both collaborate on work if they want to or just relax and take a break."

Homrich and a growing number of innovative firms are clearly taking the advice of Fidelity's Sekhar to heart.

"Firms today have to address how they can most effectively drive and engage their workforce," he says. "They have many options, but they can't be static." **FP**

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

Who Makes What

Compensation varies by position and an RIA's size.

Position	Median Total Compensation (all firms)	AUM<$2B	AUM $2B-$5B	AUM >$5B
CEO	$630,000	$527,500	$800,000	$800,000
Head of Business Development	$367,000	$242,500	$428,800	$506,700
Business Development Specialist	$174,500	$159,500	$163,000	$343,300
Senior Relationship Manager	$265,700	$231,500	$300,000	$319,600
Relationship Manager	$120,000	N.A.	N.A.	N.A.
Office Manager	$110,200	$80,000	$110,400	$123,200

Source: Fidelity Clearing & Custody Solutions, ManpowerGroup Solutions, Culpepper and Associates

How Fees Are Remaking the Industry

IBDs and regional firms have made the biggest changes; RIAs have room for growth.

By Tobias Salinger

It seems a dramatic milestone at first glance: client assets have reached a record high of $20 trillion. But this stunning number obscures a far more significant shift from commissions to fee-based accounts, which is reshaping the advisory industry.

At the end of 2016, 39% of client assets were in fee-based programs, up from 30% in 2010, according to a report last June by Aite Group. The consulting firm predicts that this trend will accelerate, so that at least half of all client assets will be in fee-based programs by the year 2025.

Financial advisor Kim Kropp has watched the industry's shift firsthand since she and her business partner launched their RIA practice in the '90s. Her firm, Moylan Kropp, in Omaha, Nebraska, manages client assets of $440 million, with 60% already in fee-based accounts under Securities America's corporate RIA, she says.

Her firm's share of fee-based assets will rise to about 80% of its client assets in the next five years, she predicts, driven in part by demand for holistic planning rather than robo advice.

"Pretty soon people are going to understand that it's better to have a human being in front of you than a robot," Kropp says. "That's where I want it to be. That's the gratification of our profession."

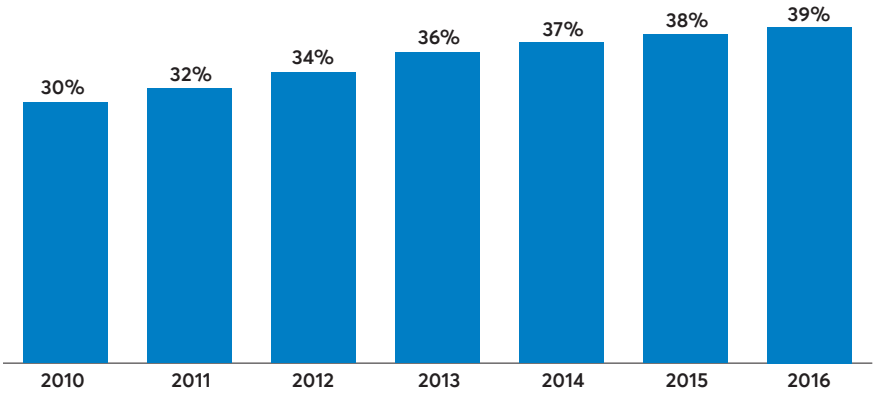
Ongoing Shift

Independent and regional broker-dealers are changing the most in the shift to fee-based planning, with major firms like Advisor Group cutting their commissions and taking on some new issues like planning for increasingly long life expectancies.

Wirehouses preceded them in pivoting to fee-based accounts, and even RIAs have room for more growth in that area. Then there's the insurance industry, where commission-free products have barely made inroads yet.

Fee-Based Assets' Rising Share

The overall percentage grew by nine points in seven years.



Source: Aite Group study, June 2017

Overall, the fiduciary rule and the presence of robo advisors have disrupted the wealth management space, but advisory accounts bring more reliable revenue than products.

In addition, technology offers incumbent firms new avenues for business, says Bill Butterfield, the author of the Aite Group report.

"I do see a continued shift to fee-based as we move forward over the years," says Butterfield, a senior analyst for wealth management.

"For those who just want to buy and sell stocks, or just need the execution piece, that's where the self-directed firms will play," Butterfield continues. "Everything's pointing in the fee-based direction."

A report by Aite Group predicts that at least half of all client assets will be in fee-based programs by 2025.

Fee-based accounts constitute 34% of the assets at self-clearing independent and regional BDs, compared with 38% at the wirehouses, according to Aite Group.

The regional and independent self-clearing firms, which include LPL Financial, Edward Jones and Ameriprise, crossed $1 trillion in fee-based assets in 2016.

Wirehouses' greater resources gave them a head start, according to Butterfield, who estimates that fee-based assets at the largest independent and regional BDs will top 50% by 2027.

Tech tools around services like long-term care, health savings accounts and complex estate planning can help

speed up the move, he says.

Butterfield hasn't yet seen any firm introduce such software on a large scale. With robo advisors suppressing fees for asset allocation and offering well-designed apps for clients, technology around other services would be a boon to incumbents, says Lex Sokolin, a partner at Autonomous Research.

"Brokers have to increasingly become advisors to their clients, whether around financial, health or life planning," Sokolin adds. "Technology that enhances that human relationship for the advisors will win out in the long term."

The lasting role of the fiduciary rule in that mix remains unclear, but many advisors and BDs have argued that it makes it harder for them to compete with robos for smaller clients.

The Fiduciary Rule

The fiduciary rule has already heightened scrutiny on commission-based products in retirement accounts, which has driven the shift to more fee-based accounts industrywide, according to Butterfield's report.

Many firms have already carried out significant changes, even as they retain some commission-based services. At the same time, the fiduciary rule has divided the industry into supporters and opponents, leaving IBDs arguing that their commissions still have a place.

Kropp started focusing on fee-based services in the '90s, when she opened her RIA practice.

The firm's new business now falls almost entirely on the fee-based side, except for 529 plans and guaranteed-income products, she says, noting many of its mutual fund shares are also converting to lower-cost classes.

A member of the Financial Services Institute's board of directors, Kropp says she believes that some of the rhetoric surrounding the fiduciary debate unfairly equates independent advisors with stockbrokers and that, if it's ever fully implemented, the rule could limit an advisor's options.

Kim Kropp, a founder of Moylan Kropp in Omaha, Nebraska, predicts a growing appetite among clients for holistic planning, rather than robo advice.

Even though most of her firm's business falls on the fee-only side, she says she'd still like to offer commission-based products when she thinks they're a better fit. For example, an annuity allowing for guaranteed income plus investment returns would work better for a pensioner than a savings account or a CD, she says.

"I do a plan for every client," Kropp says. "I look at every aspect of their financial picture. Nobody fits in a box. I don't use a template for my plans."

IBDs and regional firms have made similar arguments even as they adjust to changing times. In early February, Ladenburg Thalmann hired the asset management veteran John Blood for a newly created senior vice president position boosting the IBD network's fee-based services and presence in the RIA space.

The same month, Raymond James launched a suite of longevity planning tools. The software integrations include services like estate planning, health care, wellness and protection from elder fraud. Some 40 advisors serving on the firm's Retirement Solutions Advisory

Board had proposed the idea.

At Advisor Group, the share of fee-based accounts increased to 37% by the end of 2017, up from 31% four years earlier, according to CEO Jamie Price. He serves as the chairman of the IBD network's Longevity Council, which Price describes as working on helping its 5,000 advisors with holistic services.

Using fees helps firms "smooth their revenue stream and make it more predictable," says Bill Butterfield of Aite Group.

Commission-based advice fits that description, he says, when it's less expensive and solves the client's need. The Longevity Council, which had its first meeting in January, consists of executives from 16 major insurance firms tasked with trying to address the financial problems posed by people living longer.

Living for decades solely on income received during 40 years at a job is impossible, according to Price, who sees longevity planning as a neglected part of risk management.

Advisor Group is endeavoring to help advisors grow their businesses with a holistic, more fee-based approach, while attacking the difficult longevity issue.

"I think our industry is the industry that has to solve for that," Price says. "We serve the very clients that have the possibility of outliving their money, and this is where I think the insurance industry can play a part. And it can't be about the next whiz-bang product with a nice new bell and whistle on it."

DPL Financial Partners helps RIAs find insurance without bells and whistles like commissions and high fees, CEO David Lau says.

The firm, founded in 2014 by Lau, the former COO of Jefferson National, took more than two years to get to market simply because there weren't enough such products.

Insurance Carriers

Insurance carriers have started offering more fee-based or hybrid products, but they still constitute only about 1% of overall sales, according to Lau. His Louisville, Kentucky-based firm, which has about 50 clients, received a capital infusion from the private equity firm Eldridge Industries in February.

The firm offers commission-free life insurance and annuities, and it's working on health insurance products like long-term care, Medicare supplements and disability.

Jamie Price, CEO of Advisor Group, sees longevity planning as a neglected part of risk management.

Advisors at RIAs have been responsive to what Lau refers to as his personal crusade, he says.

"Insurance is one of the last bastions of commission-based, transaction-based business in the advisory world. You rarely see loaded mutual funds being sold. You don't even have to say 'no-load' anymore — it's assumed," Lau says. "Insurance is the opposite. It's almost exclusively commission-based."

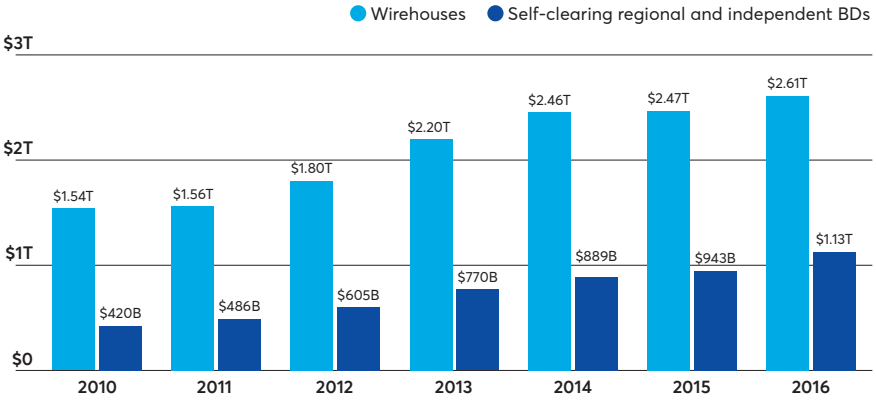
The bottom line will loom large in the next move for firms of any type, says Butterfield, the Aite Group analyst. And fee-based assets look good to firms when compared with the ups and downs of product sales.

"They're able to smooth their revenue stream and make it more predictable, which is usually desirable for any type of business.

"It allows them to deepen that relationship with clients and insert themselves into one financial life," he adds, "more than just selling products." **FP**

Fee-Based Assets by Channel

They nearly tripled at regional and independent BDs since 2010, while wirehouses added more than $1 trillion.



Source: Aite Group study, June 2017

Tobias Salinger is an associate editor of Financial Planning. *Follow him on Twitter at @TobySalFP.*

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ALSO IN PRACTICE: P. 48: HIRING A CYBER EXPERT

ADOBE STOCK IMAGES

Be Transparent About Pay

Here is how one firm structured compensation in a fair and completely open way.

By Carolyn McClanahan

Compensation discussions are often an awkward tap dance. Advisors want to know what others are earning and how that pay is determined. Meanwhile, concerns about pay inequality for women and minorities add to the consternation of the conversation.

Yet firms often don't have a consistent method of determining compensation for employees that is transparent, objective and promotes equality across the board. Small firms without human resource departments face even bigger challenges.

That's why I'd like to suggest a compensation method that's completely open. It's a method that supports equality and aligns employees' incentives with the firm's goals.

In our firm, everyone has access to QuickBooks. We take a team approach to decision-making, setting our firm's budget and revenue goals together.

With access to QuickBooks, employees can easily see what everyone is being paid. But even better? We all set the pay for each other and use an objective formula for determining our quarterly raises. Admittedly, this method is easier in a firm of six people than it might be at a much larger firm. But I believe the same process can work at large firms when executed within smaller teams.

How it works: Our compensation is based on roles — not job titles — within the company. That distinction is important because at small firms like ours, one person often fills multiple roles.

A compensation method that's completely open aligns employees' incentives with the firm's goals.

Consequently, job titles that may be common at larger firms might not necessarily reflect a person's full responsibilities. For full-time employees who are well integrated in their roles, we determine how much of the employee's time is utilized for each part of his or her job. For example, I spend about 60% of my time as a senior advisor, 20% on firm public relations and 20% on other CEO duties.

Next, we use compensation studies from custodians and consulting organizations to determine the appropriate pay for each of those duties.

These reports have a wide variation in pay scales, including base pay and bonuses for each position within a firm. We align that data with each of the responsibilities performed by our colleagues and then weight them accordingly.

Our goal initially was for our pay to match the 75th

percentile for our area of the country. When I made my first hire of an investment manager in January 2009, our pay was about the 25th percentile compensation level. Because he believed in the company, our culture and our open-architecture pay scale, he was willing to take a pay cut from his previous job. I was very lucky. Subsequent employees hired later came in at a higher level.

Every quarter we receive a raise based entirely on revenue growth. We charge flat fees based on complexity, so our revenue stream is very stable. If we receive $40,000 recurring revenue in a quarter, 25% goes to overhead and the remaining $30,000 goes to the pool for raises.

Each raise is determined by a formula based on the employee's current pay scale compared with the 75th percentile. However, raises for newer employees can't exceed the raises for longer-term employees. The newer employees came in at a higher percentile than our investment manager and me, so we make certain our raises get us to goal sooner.

Firms that reward individualistic incentives may have difficulty getting employees to work as a team to achieve company goals.

Our discussion on raises occurs as a team and we all make certain the numbers plugged in are fair to all employees. Recently, we hit the 75th percentile mark for all employees, so we have moved the bar to the 100th percentile going forward.

We also have a part-time hourly employee, and we recently hired a young associate advisor. His initial pay was set at the average rate for his experience and training. He has additional training incentives to get him to the 75th percentile by the end of one year. After that time, he will be placed in the formula for future raises.

Few people enjoy annual reviews, and there is often subjectivity to that approach.

Peace of Mind

Overall, I prefer our approach to the more traditional one that relies on annual employee reviews and individual bonuses as incentives.

Very few people enjoy annual reviews, and there is often subjectivity to that approach. Plus, bonuses that are based on individual goals or employee production (how many assets or new clients the employee brought into the firm), often foster an "eat what you kill" mentality.

Firms that reward individualistic incentives may have difficulty getting employees to work as a team to achieve company goals.

So what are our incentives for rainmaking, then? I believe the traditional business development methods are no longer useful. The key to bringing in new clients is to deliver excellent service and provide true financial peace of mind through education, authenticity and a problem-solving attitude.

Each employee is expected to be their best, and we have weekly meetings to make certain we are all functioning at a high standard. Under this approach, everyone should be rewarded when new clients come on board.

Happiness

When I was solo, my initial clients were people I worked with in medicine and my friends in the running community. Additional clients came from my work in the profession and the press. A majority of clients for the past decade come from referrals. And the beauty of our referral process? We never ask clients for referrals — they ask if they can send people to us.

At one point, our waiting list for new clients was a year. By raising our minimum fee for new clients, the waiting list is down to about three months.

The happiness of our team and the great work we deliver to clients is all the rainmaking we need, and I credit our culture of transparency around pay to part of that happiness. **FP**

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

BLOOMBERG NEWS

Managing Cybersecurity

Should planners handle tech solutions in-house or outsource them to an expert vendor? Here's how to decide.

By Ingrid Case

Regulators and clients alike are eyeing planning firms' cybersecurity provisions. Some practices might even hire someone for that sole purpose.

But if you're like many planners, running a solo business or a relatively small group of advisors and administrative help, you might be able to handle your firm's cybersecurity needs without creating another full-time job. You may already have someone on staff who is comfortable with technology and knowledgeable about the related challenges and solutions. Adding the oversight of IT to this employee's duties could be a sensible way to get the help you need.

That's the situation at 1080 Financial Group in Sherman Oaks, California, where founding partner Stephen Rischall quarterbacks the firm's cybersecurity efforts. "I'm 30 years old, and as a millennial, I'm comfortable with technology and implementing tech solutions," he says.

The measures he executes, he says, are part risk-management protocols and part business-continuity plans. In addition to using his own knowledge, Rischall keeps up with best practices by doing research, talking with other people in the planning industry, working with vendors and consulting with his firm's attorney, who is well-versed in cybersecurity.

The results, he says, are solid. "We just went through a surprise audit with the state of California, and they commended us on the ways we're using technology in our practice," Rischall says.

Your firm may already have someone on staff who is comfortable with technology and knowledgeable about the related challenges and solutions.

1080 Financial Group is in the midst of a merger, after which it will have eight employees. Rischall says he will continue managing cybersecurity, a job that currently takes up no more than 10% of his work time, he estimates. "Twenty advisors might be the place where you need a full-time employee," he says. "It depends on the kind of practice you run, employee turnover and how much financial technology you're using. The more technology and users you have, the more complex your situation."

Learning Cybersecurity

If you don't have Rischall's knowledge base, you can build it, and so can someone who is already part of your team. Rischall suggests reading online about best practices. Check out web-

sites aimed at advisors, but also look at resources that don't have planners in mind, so you can get other perspectives on protecting sensitive information.

'Educate Yourself'

"Educate yourself on the requirements and know the protocols that your broker-dealer uses," Rischall says.

"A consultant or attorney who helps you with filings can also help, as can your custodian," she adds.

Rose Ybarra, a partner at Tranquility Financial, spent time learning about her firm's cyber needs.

Rose Ybarra, senior financial partner at two-planner Tranquility Financial Planning in McAllen, Texas, educated herself about her firm's needs and then set about fulfilling them.

"Before last year, we had a couple of security features in place," Ybarra says. "Then we went to a TD Ameritrade system and realized that there were a ton of holes in our system. We lacked an additional firewall. We shared a router with other offices. There was no encryption on our computers, we had never tested our vulnerability and we had no policies and procedures around cybersecurity."

Ybarra and her business partner, Terrance Martin, started bringing themselves up to speed by talking to vendors at the TD Ameritrade conference. They also read articles online, talked with their compliance person about necessary steps and reached out to vendors of cybersecurity solutions, including financial reporting and planning software firms, cloud-based storage, secure client portals and CRM portals. One vendor gave them a free test that demonstrated their firm's vulnerabilities.

Research best practices online to get up to speed on cybersecurity.

Based on what they learned, Ybarra and Martin put up their own firewall, created an incident report and a manual detailing their cybersecurity policies and procedures, switched from sharing documents with clients through email to using a secure portal, set up security procedures for working from home, installed more robust anti-viral software and starting locking their computers when they left the office.

Ybarra estimates that she and Martin spent 15 to 20 hours educating themselves, another 15 to 20 hours on implementing the cybersecurity measures they chose and three to six hours on quarterly review.

Outsourcing Technology Needs

If cybersecurity is something you don't have the time or desire to learn, a vendor can provide what your company needs. Keener Financial Planning in Keller, Texas, uses the Safe Workplace program offered by True North Networks, based in Swanzey, New Hampshire, to supply its tech solutions.

"I thought our cybersecurity was pretty good, but True North has made it really good," says Jean Keener, the firm's principal.

The vendor, she says, has installed a commercial-grade firewall, which it monitors for intrusions or suspicious activity. It created a secure VPN for Keener, selected anti-viral and anti-malware software, wrote custom policy statements and trained the Keener staff in best practices.

"They provided training videos, and they send us test phishing emails to see if our employees will click on them," Keener says. "You can have all the great technology in place, but really it's the people who are the weakest link."

Managing Costs

Keener declined to say what she spends on True North's services, though she notes there was both a setup cost and an ongoing fee structure.

"I can comfortably say that the total is much less than we would spend on doing the work in-house," she says.

Keener says that she is happy with this solution.

Stephen Rischall, founding partner at 1080 Financial, manages the firm's cybersecurity.

"Not only do we have a high level of security, but we can show that we have a policy and we've implemented it. We were audited last year, and the regulators seemed really impressed."

For the foreseeable future, she says, Keener will be outsourcing its cybersecurity needs. **FP**

Ingrid Case, *a* Financial Planning *contributing writer in Minneapolis, is a former senior editor for* Bloomberg Markets *magazine. Follow her on Twitter at @CaseIngrid.*

On Par with Larger Rivals

New tech tools are helping independent advisors close in on the service capabilities of big wealth management firms.

By Sean Allocca

Technology offerings are closing the gap for RIAs seeking solutions previously found only at the industry's largest firms.

An accounting optimization tool from Orion and new client-facing technology from the Carson Group are examples of tools opening up abilities for independent advisors to compete at a greater scale.

"The notion that wirehouse technology from an investment-ticking standpoint is superior to your typical mom-and-pop retail advisor is changing," says Davis Janowski, a senior analyst at Forrester Research. "It's taken about a decade to get to this point — and Ron Carson is a perfect example of this — of firms being on par in terms of their reputation surrounding technology."

Carson Group rolled out its newest client-facing portal called Digital Client Experience that eliminates duplicate data entry and could save advisors time and money, according to the firm. The tool helps advisors aggregate client balance sheets and streamlines onboarding.

"Having a consolidated balance sheet is a commodity now — that's not new and exciting," says Teri Shepherd, chief operating officer at Carson Group. "Clients are demanding higher value from advisors now."

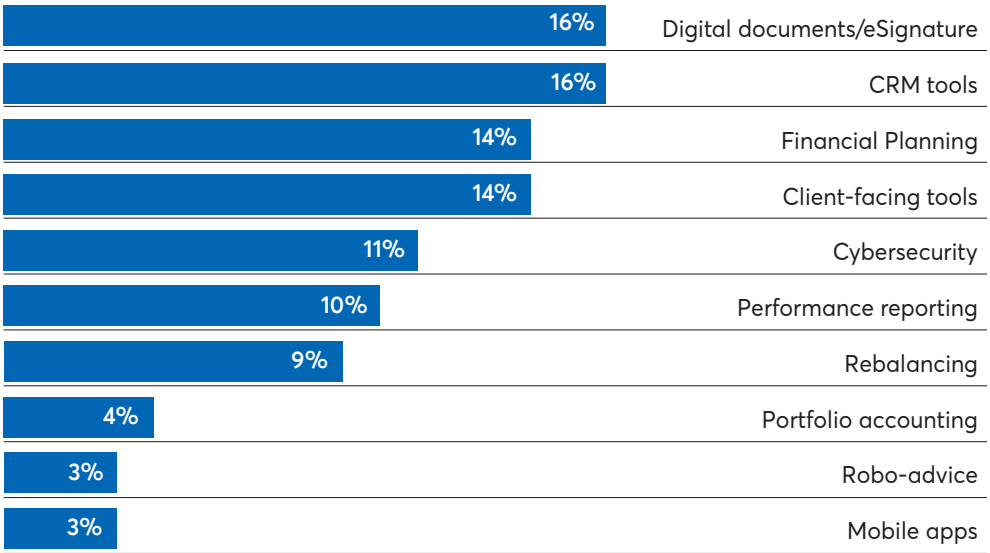
Since introducing the platform, the firm has almost $1.2 billion in new client assets that it at least partially attributed to the new portal, she says.

"Having a consolidated balance sheet is a commodity now — that's not new and exciting," says Carson Group's Teri Shepherd.

Carson has invested $52 million in technology over the past five years, according to the firm.

Reinvesting in Tech

RIAs say these are the top technologies under consideration for 2018.



Source: TD Ameritrade, 2018 RIA Sentiment Survey

Tax Efficiency

Likewise, accounting service platform Orion's newest offering uses direct indexing to create the level of tax efficiency formerly found only at the wires.

The Advisor Strategy and Tax Return Optimization, or ASTRO, tool suggests a set of stocks that mimic a certain index and can automatically harvest more tax losses than with the single fund, says Orion CEO Eric Clarke.

"With an ETF, the tax situation depends on one ticker," Clarke says. "But if you own select sets of securities within that ETF, then sell your losses and replace them with similar stocks that don't change the overall makeup, you're creating significant losses to offset those gains."

The advanced tax harvest-

ing technique known as direct indexing has been utilized by the wires for years. "It's really allowing advisors to scale up their abilities to a level that is getting closer and closer to the multimillion-dollar investments that the wirehouse made in technology," Janowski says. "There is closer parity."

Reaping the Benefits

While this technology is nothing new for the big brokers, RIAs, especially breakaways, are reaping the benefits of the new technology.

"There's no shortage of breakaway brokers who are opening up firms and aspire to continue to work with the level of clientele they did at wirehouses," Janowski says.

"Now, they get to pick their own toolset and can fill in what's missing," Janowski adds.

Orion's ASTRO optimization tool also gives RIAs another new ability — portfolio suggestions that can incorporate legacy holdings.

Normally, an advisor would have to create a customized portfolio to balance out the low-cost basis holdings, something that requires heavy lifting from advisors, says Alex Murguia, managing principal and COO at McLean Asset Management.

"We're seeing tech finally catch up and eliminate the manual processing,"says Davis Janowski, of Forrester Research.

The optimization tool takes those holdings into account when suggesting portfolios so the client can keep their legacy positions and dodge the long-term capital gains tax.

"If a client has legacy positions, it's par for the course to blow up that portfolio regardless of the capital gains [tax]," Murguia says. "Advisors think, 'So, be it. This model is better overall.'"

ASTRO can help mitigate potential risks from legacy holdings without making a sale.

"Now, you're able to keep those legacy positions and construct a portfolio that still follows your overall tracking for a particular index." Murguia says. "It's almost like a personalized index fund, but you are not spending the expense ratios. It basically removes the middle man."

'Leveling the Playing Field'

While the tech could help RIAs get on par with their larger rivals, it won't come cheap, Janowski says.

"Let's be honest, Orion is not an inexpensive offering," Janowski says. "But for the right firm that can make the most use of it, it's good value."

The ASTRO tool is priced at an annual fee of $50 per account, according to the firm. The tool went live March 1.

"In order to do the heavy lifting on an individual account basis, advisors need a powerful engine that is typically available only in the institutional setting at a much higher price point," says Joe Smith, Orion senior market strategist.

"Tech scales in a way that humans don't," says Forrester Research's Davis Janowski.

"We see this direct indexing technology as leveling the playing field between advisors and the large asset managers," Smith says.

Janowski agrees.

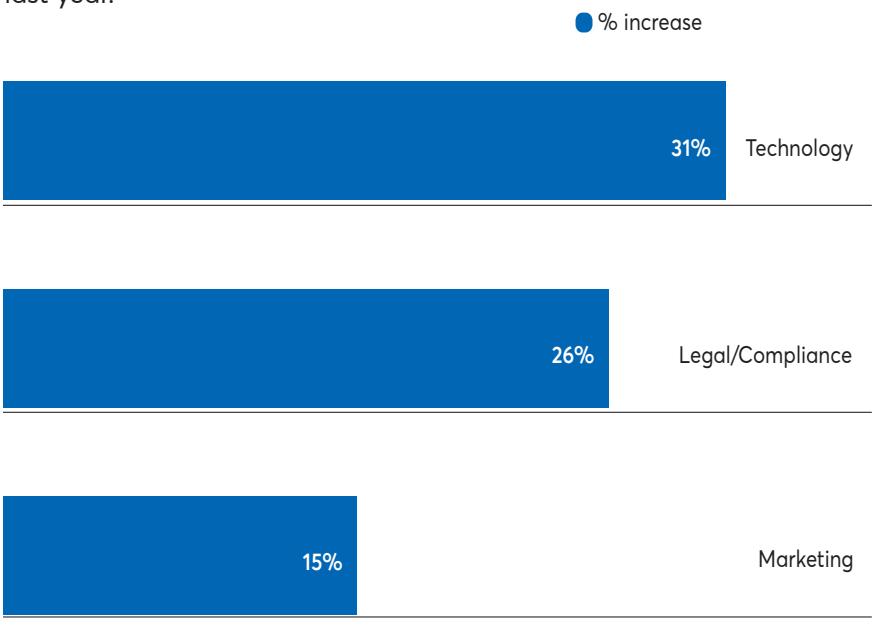
"Tech scales in a way that humans don't," Janowski says.

"For years, the wirehouses didn't have any competition in terms of tech. The advisor facing tech was not up to par and not as good — not as well integrated," he says.

"We're seeing tech finally catch up and eliminate the manual processing and allow firms to grow up and into billion-dollar firms," Janowski adds. **FP**

What RIAs Are Buying

Advisors say they spent more on technology than any other area last year.



Source: TD Ameritrade, 2018 RIA Sentiment Survey

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

ADOBE STOCK IMAGES

A Maligned Fee Is Back

Though largely replaced by the 1% of AUM model, performance-based fee structures are cropping up again.

By Michael Kitces

As advisors face increasing pressure to differentiate themselves in how they work with clients, a once-controversial fee structure is coming back into vogue: the performance-based fee.

Whereas the AUM model determines a fee based on total assets being managed or advised upon, the performance-based fee is calculated as a percentage of upside (on an absolute basis, or relative to a benchmark index), where the advisor's fee is forfeited if they fail to achieve the required threshold or hurdle rate.

The virtue of this form of compensation structure is that it would compel investment advisors to eschew closet indexing and truly work to outperform their benchmarks.

This can be a very compelling proposition to prospective clients — and judging by the assets that firms with performance-based fee structures attract, clients don't seem to perceive much downside.

A Dubious Past

However, performance fees have a dubious past, and the passage of time has done little to eliminate their faults.

This means that, while there are some potential marketing benefits for RIAs to pursue performance fees on investment portfolios, there are also many reasons why they shouldn't do this.

Incentive Alignment

One of the most popular and consumer-friendly aspects of the traditional AUM fee is its alignment of incentives between advisor and client. To the extent that the advisor charges a fee based on a percentage of the portfolio being managed, favorable investment results that grow the portfolio will also grow the amount the advisor can bill, and losses in the client portfolio will decrease the advisor's billable assets.

Advisors charging AUM fees have a strong incentive to be good stewards of their clients' money.

Thus, advisors who are charging AUM fees have a strong incentive to be good stewards of their clients' money, because growth for their portfolios also spells growth for the advisor's business. This could appear to be a win-win situation.

Yet the AUM fee only goes so far to align the incentives of the advisor and client.

To the extent that markets themselves tend to grow — which will often happen independent of any one

advisor's effort — a portfolio's AUM fee tends to naturally rise over time simply due to passive growth of the market itself. Yet the advisor is, in effect, rewarded for growth they weren't responsible for in the first place.

In fact, an advisor who consistently underperforms a benchmark in a bull market will still earn the bulk of their annual fee increases.

For example, if the stock market rises by 10% and the advisor underperforms by 1%, the AUM fee will still increase by 9% for the year, despite this relatively poor performance.

And if the client's portfolio declines, the advisor will still earn a substantial fee, despite the fact that the client has lost money.

As a result, there has been growing discussion around whether advisors, particularly those whose value proposition is built around their investment process, should be charging some kind of performance-based fee instead.

Profit Sharing

For instance, an advisor might charge a performance-based fee that provides for sharing 10% of the portfolio's profits. Thus, the greater the profits, the more the upside for the advisor and the client, and, if the portfolio doesn't earn a return, neither does the advisor.

Alternatively, the advisor might charge a fulcrum fee, which stipulates that the advisor earns a base fee, such as 1%, but will only earn an additional fee if a specific benchmark target is achieved.

Imagine that the advisor is compensated 10% of the outperformance above a return threshold, such as excess returns above a 7% per year hurdle rate, or for beating a certain benchmark — say, generating returns in excess of the S&P 500 for the year. Notably, a fulcrum fee would also penalize the advisor for underperforming; if the portfolio substantially underperforms the benchmark, the 1% base fee might be forfeited altogether, eliminating compensation for underperforming in a bull market.

Yet notwithstanding the intuitive appeal of fees tied to performance, they have a very troubled past. Indeed, many investment advisers are actually banned from charging such performance-based fees outright.

While performance-based fees provide greater reward potential for good managers, those same fees can also incentivize managers to take on more risk.

As Congress noted … performance fees were effectively "heads I win, tails you lose" arrangements.

Consider an advisor who is going to manage a client's equity portfolio, and who will be benchmarked to the S&P 500. The advisor's performance-fee agreement stipulates that they will receive 20% of any outperformance above the benchmark.

If the advisor doesn't beat the benchmark, they earn nothing, as the fee is zero, ensuring the advisor has a very strong incentive to outperform.

A Closet Indexer

However, the advisor's investment strategy is not actually to try to pick superior investments and have a high active share.

Rather, the advisor will be a closet indexer with a rather simple strategy: Because markets go up more often than they go down, the advisor puts all clients' assets into a 2X leveraged fund that typically provides 200% of the daily return of the S&P 500 — e.g., ProFunds UltraBull S&P 500 Fund (ULPIX) — and waits for the bull market's leveraged returns to produce stints of substantial outperformance on which the advisor will earn performance-based fees.

Yet if the investor had started with $1 million in the portfolio, the portfolio of ULPIX paying 20% performance fees would only be worth $1,226,744 after 20 years, for a cumulative return of just 1.1%/year.

Meanwhile, the advisor would have earned performance-based fees of $454,526, thanks in large part to ULPIX outperforming the S&P 500 in 11 of those years.

Buy and Hold

Had the investor simply bought the S&P 500 and held it, the portfolio would have grown to $2,867,761, for an average annual return of 5.7% over this same time period.

Consequently, by taking substantial risk with the client's portfolio and amplifying the volatility, the performance-fee-based advisor was able to demonstrate several years of strong outperformance — for which he generated a substantial profit — while the client alone experienced losses in the down years.

In other words, the advisor was incentivized to and actually profited at the expense of the client's amplified risk, while failing to add any actual value to the investment process.

That performance-based fees would incentivize investment managers to take additional risk is nothing new.

In fact, Congress recognized the problem in the aftermath of the bull market of the 1920s (and the subsequent crash).

When the Investment Advisers Act of 1940 was written, Section 205(a)(1) explicitly established a ban on most performance-based fees for investment advisors.

As Congress noted at the time, performance fees were effectively "heads I win, tails you lose" arrange-

ments. Yet the SEC began to partially relax the performance-fee rules in 1970.

First, the Investment Advisers Act was amended to allow RIAs serving as the investment manager of a mutual fund to charge fulcrum fees under the then-new Section 205(b).

In 1985, the SEC further relaxed the rules by establishing Rule 205-3, which stipulated that investment advisors could charge certain performance-based fees when working with a qualified client.

For the purpose of performance fees, a qualified client is one who meets either an AUM test or a net-worth test, or is an executive or investment-related employee of the RIA itself.

The AUM Test

The AUM test requires that the investment advisor actually be managing at least $1 million of the client's assets. Meanwhile, the net-worth test requires the qualified client to have a net worth of at least $2.1 million, or be a so-called qualified purchaser — e.g., an ultra-high-net-worth individual, or certain institutions/entities — under Section 80(a)-2(a)(51).

This amount is now annually indexed, and, as of 2012, investors may not include the value of their personal residence in meeting this standard,

Lastly, the employee test requires that the qualified client either be an executive officer, director, trustee or general partner of the RIA, or an employee who participates in the investment activities of the advisor.

Notably, a Registered Investment Company — in essence, a mutual fund — is also able to charge performance fees, but only if it meets the fulcrum fee structure requirement of Section 205(b)(2) of the Investment Advisers Act.

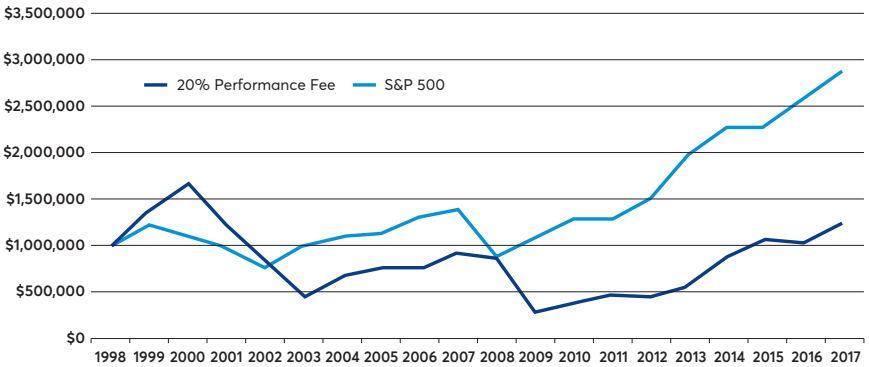
On the other hand, hedge funds are permitted to charge any type of performance fees, although they in turn are limited to only accredited investors.

The Key Point

The key point here is that an RIA that wants to charge performance-based fees to its retail investor clients can only do so if they are considered qualified clients. And of course, Series 6 or Series 7 advisors under a broker-dealer are not permitted to charge performance-based or any advisory fees at all, as they can only be compensated for brokerage services — unless they become a hybrid advisor and separately join or become an RIA as well.

Beating the Benchmark

Leveraged funds may not outperform the S&P 500 in the long run.



	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
ULPIX	43%	30%	-28%	-32%	-46%	55%	18%	3%	24%	1%	-67%	43%	24%	-4%	28%	68%	24%	-2%	20%	
S&P 500	21%	-9%	-12%	-22%	29%	11%	5%	16%	5%	-37%	26%	15%	2%	16%	32%	14%	1%	12%	12%	

Annual Returns

Source: Standard & Poor's, ProFunds; calculations and chart by Michael Kitces

Structuring Performance Fees

For advisors working with the aforementioned qualified clients, it is permissible to charge performance fees, but it's still necessary to determine the actual structure of the fee itself.

The mixed record of actual outcomes still leaves much to be desired.

Some firms simply arrange their fees to participate in a percentage of the upside, while others stipulate that their performance fees are only paid if they exceed a certain threshold.

In some cases the only payable fee is the performance fee itself, while in others the performance fee may include a baseline AUM fee as well — e.g., 1% of the portfolio plus 10% of the excess return above a certain threshold.

In the case of mutual funds, Congress explicitly required under Section 205(b)(2) of the Investment Advisers Act that the fee must provide for:

"Compensation based on the asset value of the company or fund under management averaged over a specific period, and increasing and decreasing proportionately with the investment performance of the company or fund over a specified period in relation to the investment record of an appropriate index of securities prices."

A Set Measuring Period

In other words, a valid performance fee in the realm of mutual funds must have some set measuring period in which investment performance would be compared to the underlying index, and the advisor's compensation must both increase and decrease proportionately and accordingly.

It's also important to note that, since IA Release 721 in 1980, an indirect version of a non-proportionate fulcrum fee — where the advisor just receives a base fee and not a percentage of the performance upside, but forfeits their fee for underperformance — will still be treated as a performance-based fee, necessitating a qualified client arrangement.

That said, a subsequent 2004 SEC No-Action letter to investment firm Trainer, Wortham & Co. affirmed that a "satisfaction guarantee" refund option — whereby the investor can request a refund if they are unhappy with their advisor, regardless of performance results — is permitted as long as the advisor's fee isn't predicated on meeting any specific investment performance threshold.

In the case of performance fees for state-registered investment advisors — RIAs with less than $100 million under management — the RIA must adhere to state-level rules on performance-based fees, which may but will not always conform to the SEC's regulations under the Investment Advisers Act.

Worth It?

While there is some clear intuitive appeal to performance-based fees, the mixed record of actual outcomes still leaves much to be desired.

Congress banned performance-based fees for RIAs more than 75 years ago, because of the consumer harm they ended up causing.

And while the rules have relaxed to some extent, it has only been for more-affluent qualified client investors who — right or wrong — are presumed to be more financially experienced and sophisticated, and at least recognize the risks of the arrangement.

Though in the general context of advisors, performance-based fees introduce non-trivial business execution challenges as well.

For instance, they fan a natural temptation to make trades for the biggest clients first.

After all, in the same favorable trade that outperforms the benchmark, the performance fee is bigger for outperformance on a $10 million portfolio than on a $1 million portfolio.

This is less of an issue for performance fee-based hedge and mutual funds, because all clients participate equally in a pooled investment.

But for an RIA working with retail investors, the issue of how trades are sequenced and allocated — along with fair execution and being able to demonstrate that the RIA meets its best execution obligations — really does matter.

Bookkeeping Nightmares

In addition, while modern technology makes it possible for each performance-based fee to be calculated individually for each client, there may still be substantial bookkeeping nightmares when clients start at different times and thus have performance fees calculated from different starting points.

This is not to mention the sheer revenue volatility that is introduced for the RIA itself, as a year of bad performance can mean no performance-based revenue coming in to pay staff salaries.

And of course, even as performance-based fees come back into vogue, there's little evidence that they actually lead to better investment outcomes.

An especially well-cited analysis by Edwin Elton, Martin Gruber and Christopher Blake in the *Journal of Finance* found that funds charging performance fees tended to have positive stock selection ability, but the best funds tended to actually have lower betas. As a result, the total return was not improved and the incentive fee often wasn't even earned.

Practically speaking, the biggest caveat and limitation to an advisor charging performance-based fees is that — beyond the compliance oversight obligations — it's necessary to be under an RIA and not a broker-dealer, and it limits the firm to working with qualified clients who meet the portfolio and/or net-worth requirements in the first place.

This may be feasible for a subset of the largest RIA firms with the most affluent clients — but the largest RIA firms are already enjoying the fastest growth, thanks to their marketing economies of scale and the fact that more-affluent clients already tend to gravitate to them, regardless of whether a performance-based fee structure is offered.

And of course, focusing on performance-based fees may be very unappealing for holistic planning firms that are trying to focus clients on the broader range of services they provide, rather than accentuate investment results alone.

Nonetheless, for RIAs that want to charge performance-based fees and are ready and willing to work with qualified clients, the option exists under current law.

But it's still crucial to properly manage the firm's conflicts of interest, particularly when it comes to trying to earn performance fees by taking more risk with clients' investment dollars. **FP**

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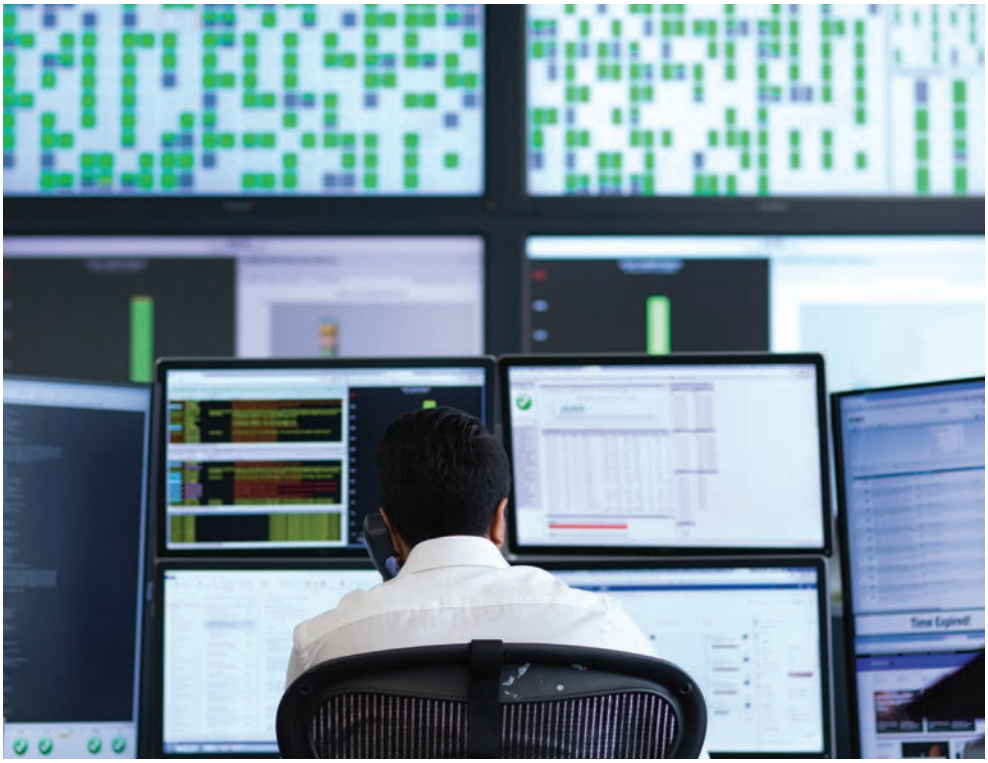
ALSO IN PORTFOLIO: P. 60: A POSSIBLE RED FLAG



BLOOMBERG NEWS

Effective 60/40 Portfolios

Pairing a variety of Vanguard bond funds with an S&P 500 fund may help planners rethink the classic stock/bond mix.

By Craig L. Israelsen

What's the best way to build the classic 60% equity/40% fixed-income portfolio? To answer this question, advisors should evaluate the logic and performance of various combinations of stock and bond funds. Sound complicated? Yes, but I've done it for you, making use of Vanguard bond funds.

As of Jan. 31, Vanguard offered 114 bond funds in the Morningstar database. To be sure, that's a small percentage of the 7,170 total bond funds (both numbers include all share classes).

But Vanguard's market share accounts for fully 23% of the $4.45 trillion in assets held by all bond funds, so the firm is actually a major player in the bond mutual fund and ETF arena. Vanguard's average bond fund expense ratio is 0.12%, compared with 0.87% for all bond funds.

For this analysis, the stock fund chosen was Vanguard 500 Index (VFINX). Each bond fund was then paired with VFINX to measure overall performance over the past 10 years. VFINX was given a 60% allocation, and each bond fund represented 40%.

To keep the allocations constant, the pair of funds was rebalanced at the end of each year. Taxes and inflation were not taken into account here.

In the table "Vanguard Bond Funds: a Sampling," the list consists of the Barclays Aggregate Bond Index followed by 17 of Vanguard's bond funds.

This table attempts to highlight a fund from each of the major bond categories, as classified by Morningstar.

Also included in this table are each fund's 10-year average annualized return along with the standard deviation for the 10 years.

The correlation between each of the Vanguard bond funds and the Barclay's Aggregate Bond Index is also presented.

In this study, the Vanguard Total Bond Market Index Admiral share class (VBTLX) has the highest correlation to the bond benchmark index, with a 10-year correlation of 1.

The listed Vanguard fund with the lowest correlation to the Barclay's index is the Vanguard High-Yield Corporate Admiral share class (VWEAX), at 0.19.

Outpacing a Benchmark

Ten of the Vanguard bond funds in this sample outperformed the Barclay's Aggregate Bond Index over the past 10 years.

But in every case, that performance is at the cost of higher volatility. In the case of Vanguard Extended Duration Treasury ETF (EDV), the

Vanguard Bond Funds: a Sampling

Vanguard offers a wide variety of bond funds in numerous categories, including long-term tax-exempt, inflation-protected and high-yield corporate.

Vanguard Bond Fund	10-Year % Return	10-Year % Std. Dev.	10-Year Correlation to Aggregate Bond Index
Barclay's Aggregate U.S. Bond Index	4.01	2.99	--
VBTLX (Total Bond Market Index Admiral)	3.95	3.02	1.00
VBILX (Interm.-Term Bond Index Adm.)	4.98	4.16	0.97
VFIJX (GNMA Admiral)	3.95	3.32	0.94
VBLTX (Long-Term Bond Index)	7.17	9.50	0.84
VWETX (Long-Term Invest.-Grade Admiral)	7.89	7.85	0.83
VAIPX (Inflation-Protected Securities Adm.)	3.37	6.60	0.81
VBISX (Short-Term Bond Index)	2.30	1.75	0.68
VUSUX (Long-Term Treasury Admiral)	6.46	14.77	0.67
VWIUX (Interm.-Term Tax-Exempt Admiral)	4.08	4.11	0.66
VFIUX (Intermediate-Term Treasury Admiral)	3.70	5.13	0.64
EDV (Extended Duration Treasury ETF)	8.26	31.36	0.54
VWLUX (Long-Term Tax-Exempt Admiral)	4.78	6.30	0.52
VFIDX (Interm.-Term Invstmnt-Grade Adm.)	5.19	6.63	0.50
VFIRX (Short-Term Treasury Admiral)	1.70	1.98	0.47
VWAHX (High-Yield Tax-Exempt)	5.06	8.59	0.42
VFSUX (Short-Term Invstmnt-Grade Adm.)	2.95	4.73	0.24
VWEAX (High-Yield Corporate Admiral)	6.93	14.96	0.19

Source: Steele Mutual Fund Expert, analysis by author

standard deviation of return was more than 10 times higher.

As portrayed in the table, there is considerable variety among the funds' performance over the past decade, with 10-year annualized returns ranging from 1.7% to 8.26%.

While interesting, the real value is in knowing how well a bond fund performs as a teammate of a stock fund in the 60/40 allocation.

The results of the 60/40 analysis are shown in the chart "Vanguard 60/40 Portfolios." The top row of the table shows the annual returns of VFINX, as well as the 10-year annualized return and 10-year standard deviation of VFINX's annual returns.

The remainder of the table shows all of the pairings of VFINX and the 17 Vanguard bond funds that were sampled for this study.

The first 60/40 portfolio is VFINX and EDV. From 2008 to 2017, a 60/40 tandem of VFINX and EDV produced a 10-year annualized return of 10.72%, with a 10-year standard deviation of return of 9.57%.

The Balanced Index

Both of these are better than Vanguard Balanced Index, which had a 10-year annualized return of 7% and a 10-year standard deviation of 12.03%.

As you study the full results, you will observe that 13 of the 17 60/40 combinations outperformed Vanguard Balanced Index (VBINX).

Amazingly, in eight of those 13 tandems, the volatility of return was lower than VBINX, representing better performance with reduced volatility.

Perhaps even more interesting is the fact that four of the 60/40 combos (VFINX/EDV, VFINX/VUSUX, VFINX/VWETX and VFINX/VBLTX) outperformed VFINX by itself. And, of course, the 60/40 combos that did outperform a 100% VFINX investment did so with

Vanguard 60/40 Portfolios

Portfolios have 60% allocation to VFINX and 40% to each Vanguard bond fund; Vanguard Balanced index is the benchmark.

Category	Symbol	Name	10-Yr. 60/40 % Return	10-Yr. 60/40 % Std. Dev.
Large-Cap U.S. Stock	**VFINX**	**Vanguard 500 Index**	**8.37**	**19.22**
Long Government	EDV	60% VFINX / 40% Vanguard Extended Duration Treasury ETF	**10.72**	**9.57**
Long Government	VUSUX	60% VFINX / 40% Vanguard Long-Term Treasury Admiral Shares	**8.72**	**9.27**
Corporate Bond	VWETX	60% VFINX / 40% Vanguard Long-Term Investment-Grade Admiral Shares	**8.71**	**12.18**
Long-Term Bond	VBLTX	60% VFINX / 40% Vanguard Long-Term Bond Index	**8.59**	**11.13**
High-Yield Bond	VWEAX	60% VFINX / 40% Vanguard High-Yield Corporate Admiral Shares	**7.97**	**16.51**
Intermediate-Term Bond	VBILX	60% VFINX / 40% Vanguard Intermediate-Term Bond Index Admiral Shares	**7.57**	**11.31**
Corporate Bond	VFIDX	60% VFINX / 40% Vanguard Intermediate-Term Investment-Grade Admiral Shares	**7.46**	**13.21**
High-Yield Muni	VWAHX	60% VFINX / 40% Vanguard High-Yield Tax-Exempt	**7.38**	**13.72**
Muni National Long	VWLUX	60% VFINX / 40% Vanguard Long-Term Tax-Exempt Admiral Shares	**7.35**	**12.74**
Intermediate Government	VFIUX	60% VFINX / 40% Vanguard Intermediate-Term Treasury Admiral Shares	**7.22**	**9.89**
Intermediate Government	VFIJX	60% VFINX / 40% Vanguard GNMA Adm.	**7.19**	**10.92**
Intermediate-Term Bond	VBTLX	60% VFINX / 40% Vanguard Total Bond Market Index Admiral Shares	**7.15**	**11.26**
Muni National Intermediate	VWIUX	60% VFINX / 40% Vanguard Intermediate-Term Tax-Exempt Admiral Shares	**7.13**	**11.99**
60/40 Benchmark	VBINX	Vanguard Balanced Index	**7.00**	**12.03**
Inflation-Protected Bond	VAIPX	60% VFINX / 40% Vanguard Inflation-Protected Securities Admiral Share	**6.86**	**12.14**
Short-Term Bond	VFSUX	60% VFINX / 40% Vanguard Short-Term Investment-Grade Admiral Shares	**6.58**	**12.84**
Short-Term Bond	VBISX	60% VFINX / 40% Vanguard Short-Term Bond Index	**6.49**	**11.15**
Short Government	VFIRX	60% VFINX / 40% Vanguard Short-Term Treasury Admiral Shares	**6.29**	**10.86**

Source: Steele Mutual Fund Expert, analysis by author

considerably lower standard deviation, because of the bond fund component's naturally lower volatility and/or low correlation with VFINX.

When building a 60/40 portfolio, you can design it by using an S&P 500 clone fund as the 60% equity piece, then insert a variety of Vanguard (or other) bond funds. You can also simply use a prebuilt 60/40 portfolio in the form of Vanguard Balanced Index.

If you build your own, you might consider a bond fund that doesn't attempt to mimic the aggregate bond index. Or you can identify bond funds that have a low correlation to the equity fund that you use.

Of course, as sports fans know all too well, past performance is not always an indicator of future performance. But these strategies are worth a shot. **FP**

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

A Possible Red Flag

A simple 1035 exchange might actually trigger increased scrutiny from regulators.

By Alan J. Foxman

Q: Recently my manager gave me a warning about switching a client from one variable annuity to another. The client did incur a surrender charge, but the annuity I moved him into has higher returns with lower premiums. Even with the additional commission the client paid, he'll still come out ahead in the long run. I thought this was a no-brainer. Why would my manager take issue with this?

While it's great to get a client a better return for less cost, the commission earned on an annuity switch may force regulators to examine very closely whether, in fact, it was in the client's best interests.

A: While it's all well and good to get a client a better return for less cost, the fact is that the commission you earned created a financial incentive for you to make that switch. This alone sends up a red flag to regulators who will look very closely at the transaction to see whether, in fact, it was in the client's best interests.

Variable annuities can differ greatly from one to another, and it can be challenging sometimes to compare differences between variable annuities. A return versus cost analysis may not always tell the entire story.

I am not a mind reader, so it is a little difficult for me to know for certain why your manager might take issue with the 1035 exchange.

Although these are fairly standard, it is possible that the phrase "in the long run" might have something to do with your manager's concern.

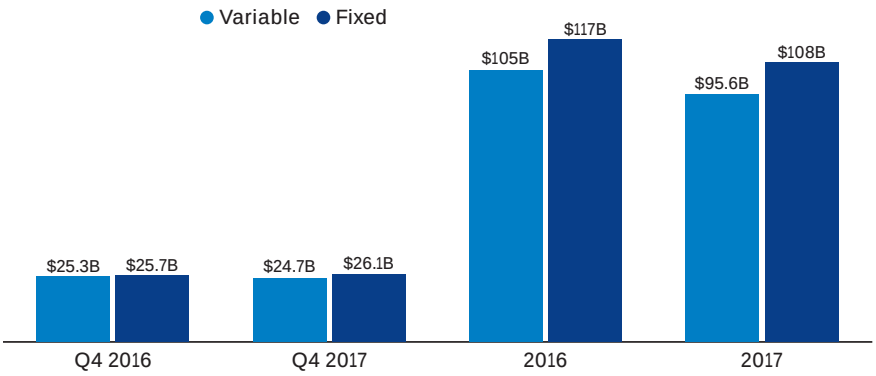
Regulatory authorities could find that the time frame for the client to recoup the surrender charge and commission is unreasonably long and they could conclude that the client would have been better off staying with their original annuity.

There could be other reasons (such as tax issues or the diversification of available funds within the annuity, etc.) that could have made the original annuity more attractive and a better deal than the annuity you moved the client into.

I would suggest that you have a discussion with your manager to get a better insight into what, exactly, was his or her concern. **FP**

Grim Year for Annuity Sales

Purchases of fixed products fell by 8% in 2017 while variable contracts slipped 9%.



Source: LIMRA Secure Retirement Institute

Alan J. Foxman is a senior consultant and vice president at NCS Regulatory Compliance, and a partner at the law firm of Dew Foxman & Haugh in Delray Beach, Florida.

CE Quiz

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From: Effective 60/40 Portfolios

1. From 2008 to 2017, which Vanguard bond fund pairing with the Vanguard 500 index (VFINX) had the best overall return?

1. Vanguard Extended Duration Treasury ETF (EDV)
2. Vanguard High-Yield Tax Exempt (VWAHX)
3. Vanguard Long-Term Treasury (VUSUX)
4. Vanguard High-Yield Corporate (VWEAX)

2. Which bond fund pairing with the VFINX had the worst overall return during the same time period?

1. Vanguard Inflation-Protected Bond (VAIPX)
2. Vanguard Short-Term Bond Index (VBISX)
3. Vanguard Short-Term Treasury (VFIRX)
4. Vanguard GNMA (VFIJX)

From: Are High-Yield and Emerging Markets Bond Funds Worth the Risk? (Online only)

3. During the 2008 financial crisis, which of these fund categories had the best return?

1. Emerging markets bonds
2. Intermediate-term bonds
3. High-yield bonds
4. High-yield muni bonds

From: Tax Law Shifts Estate Plans

4. In which year will the new tax law's doubling of the estate tax exemption end?

1. 2020
2. 2035
3. 2025
4. There is no expiration date

5. Under the new tax law, at what percentage is the income tax deduction for pass-through businesses?

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

From: Our Duty to Protect Seniors, Aided by New Tools for Advisors (Online only)

6. Which new and amended FINRA rules, effective as of Feb. 5, allow advisory firms to place a hold on accounts if they suspect financial exploitation?

1. Rules 2165 and 4512
2. Rules 2015 and 2035
3. Rules 7120 and 7325
4. Rules 4300 and 4525

From: SEC Offers Amnesty Program for Undisclosed Share-Class Conflicts (Online only)

7. To qualify for the Share Class Selection Disclosure Initiative reprieve from monetary penalties, advisors must notify the SEC of their intention to self-report failures to disclose conflicts of interest relating to share classes by what date?

1. Sept. 10, 2018
2. Aug. 15, 2018
3. June 12, 2018
4. Dec. 20, 2018

From: Top-Performing Stock Funds Since 2008 Financial Crisis (Online only)

8. Which of these funds has had the best annualized 10-year return since the 2008 financial crisis, at over 20%?

1. First Trust NYSE Arca Biotech ETF (FBT)
2. Delaware Healthcare I (DLHIX)
3. Fidelity Select Retailing (FSRPX)
4. First Trust Dow Jones Internet ETF (FDN)

From: Kitces: Does the New Federal Budget Help or Hurt Clients? (Online only)

9. As part of the new federal budget, an additional tier of Income-Related Monthly Adjustment Amount Medicare Part B premium surcharges will be introduced, in 2019, at a MAGI threshold of how much for married couples?

1. $500,000
2. $450,000
3. $750,000
4. $1,000,000

10. Which IRS tax-filing form is specifically geared toward filers age 65 or older, who may need to report Social Security benefits, pensions and retirement account distributions?

1. Form 1040EZ
2. Form 1040SR
3. Form 1040A
4. Form 506-T

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To earn one hour of continuing education credit from the CFP Board of Standards, please visit our website and answer the questions above. Planners must answer eight out of 10 questions correctly to pass. Credit will count under CFP Board subject A: financial planning process/general principles. The deadline for participation is April 30, 2019.

In addition, the Investments & Wealth Institute, formerly the Investment Management Consultants Association, has accepted this quiz for CIMA, CIMC and CPWA CE credit. Advisors must answer eight out of 10 questions correctly to pass. The deadline is April 30, 2019.

If you need assistance, please contact SourceMedia customer service at help@sourcemedia.com or (212) 803-8500.

Financial Planning

Winning Over Older Clients

How a young financial planner can use youth to his advantage in appealing to baby boomers. Hint: Don't say "literally."

By Matthew Boersen

Starting out as a young financial planner isn't easy. After all, you have no track record, no referral base and no real-world experience.

The sell-to-your-friends approach often doesn't work, either. When I started out, I was 21 and determined to use a fee-based approach. My friends were unlikely to have the money to generate substantial AUM fees, so I tried targeting baby boomers and older clients. But this came with its own challenges. Many prospects had children, and sometimes even grandchildren, who were older than I. Not surprisingly, they rarely saw my age as a positive when deciding whom to trust with their life savings.

A key transition for me was when I realized my youth could be turned into a positive. It came as a slow realization, but as I read more about the aging industry, it struck me that retiring older advisors created a major opportunity for me and the rest of the younger generation. I then realized I didn't have to wait until the older advisors actually started to retire, but instead could position myself to take advantage of the opportunity now.

Investors ages 55 to 60 will likely need a financial planner for 25 to 30 more years to come, so I started asking prospects, "How long would you like to work with your financial planner?" The typical answer was, "For the rest of my life."

I would then kindly point out they shouldn't be looking for an advisor who might retire in the next few years — they needed an advisor who was still going to be around in 30 years. Many baby boomers haven't thought of it this way before, and this approach gave me the opportunity to book second meetings.

I also focused on planning across the generations. I would spend time with my clients' children, working with them on their 401(k)s and starting Roth IRAs from scratch. These were things that didn't generate revenue for me but let my clients know I cared about their families.

Additionally, by developing relationships with the second generation, my clients gained confidence that I would be a good influence on their children when they eventually received an inheritance.

In courting older clients, I also took care in how I spoke. I became more cognizant of how millennials tend to incorrectly use "literally," for one. I worked at eliminating verbal ticks such as "like" and "um." I wanted to sound less like my clients' grandchildren and more like the professionals they were used to dealing with.

Finally, I became proactive about reaching out to my clients. I routinely scheduled meetings every six months, or even quarterly for my biggest clients. If the market made headlines, I sent personalized updates on my clients' investments and I would take them out to lunch to learn about other areas I could assist in.

When starting out, I also made sure I traveled to my clients instead of asking them to come to my office. This dropped the cancellation rate by 75%.

This strategy also allowed me to see pictures of their children and grandchildren, making it easy to transition into conversations about generational wealth.

Being 30 to 40 years younger than your clients can be challenging, but with some thought and phenomenal service, Generation Y advisors can turn their youth into a positive. **FP**

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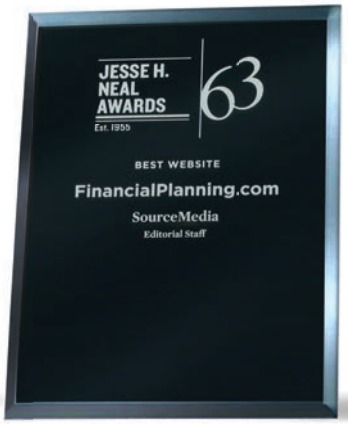

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