NORTHERN TRUST

EXTERNAL INVESTMENT MANAGEMENT 2016

NOW, NEVER OR WHEN?

FINANCIAL INTERMEDIARY THEMES

This advisor research is part of our Financial Intermediary Themes (FIT) program. We identify emerging trends and provide a unique perspective that can help financial intermediaries grow their businesses.

In our 2016 survey of investment advisor views on external investment management, a consistent and sizeable minority of advisors (40%) say they find great value in using third-party providers of investment management solutions. These advisors are highly satisfied with the benefits that external asset managers deliver to their clients and their businesses. For advisors who may be considering, or reconsidering, whether to use external investment management, this research may help make more informed decisions by shedding light on the experience of their peers.

MARIE DZANIS, CIMA®
Senior Vice President,
Head of Intermediary Distribution,
Northern Trust Asset Management

LAURA HANICHAK GREGG
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Changing regulation, especially the impending Department of Labor (DOL) Fiduciary Rule, as well as the rise of index investing and robo alternatives, and the increase in the number of ETF strategists, are reshaping the way advisors deliver advice, offer investment management services and recommend products.

In addition, the scale of the business has changed. Larger teams are now handling larger pools of assets, which makes scalability a real focus. Advisors have to do more with less, which often means serving clients who now have access to real-time information around the clock and around the world. That means becoming better, stronger and faster.

In this year’s survey of investment management advisory trends, Northern Trust sought to understand the impact these changes have on investment advisors. We also continued to take the pulse of advisors on the use of and experience with external investment management to provide an ongoing perspective on this important issue. The full results of this year’s survey can be downloaded at northerntrust.com/outsourcing.

We are delighted to share the findings of our investment management outsourcing survey in this paper. It is part of Northern Trust’s commitment to serving advisors as a resource and providing them with objective, impartial information that is helpful regardless of their approach.”

MARIE DZANIS, CIMA®

MORE TIME FOR CLIENTS AND BUSINESS DEVELOPMENT

Based on those advisors who rely on external investment management solutions, the single biggest benefit of outsourcing is the time it frees up. Overall, 59% of the advisors who completed the study cite freeing up time as the number one reason for outsourcing investment management, with 36% specifically citing having more time to spend with clients and 31% citing more time to spend on business development.

We believe it can be helpful for firms to identify ways to free up time in their practices, as advisors are facing ever-growing complexity in terms of regulation, technology and client expectations while also experiencing fee compression. To stay competitive and meet client needs, advisors need to identify their differentiators … and maintain these as their primary focus. Among smaller firms (those managing less than $150 million in assets), a significant 69% of advisors cite freeing up time as a benefit generally, with 57% saying they have more time for business development.

At mid-size firms — those with assets under management (AUM) of between $150 million and $750 million — 48% cite greater free time, with 79% specifically citing have more free time to spend with clients. Similarly, at the largest firms (those whose AUM exceeds $750 million), 48% of advisors say that outsourcing frees their time, while 62% say it permits them to provide more personalized service to their clients.

This evolution from business development to client face time to personalization is reflective of the firm's own lifecycle. We find it is fairly common for a firm's focus to evolve as its business matures and becomes more established.

Advisors find that outsourcing all or part of the investment management function frees time to devote to client service and business-building.

59%

OF ADVISORS CITE FREEING UP TIME AS THE NUMBER ONE REASON FOR OUTSOURCING INVESTMENT MANAGEMENT.

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One key question among investment advisors concerns the role of investment management: Is it a central business function that must be conducted in-house or is it a function best conducted by third-party managers?

To give advisors the tools necessary to address this critical investment management question, Northern Trust has studied financial advisor adoption of external investment management since 2010. The results and findings of this year's study, the fourth, constitute the basis of this white paper. Both Northern Trust and InvestmentNews Research, which distributed the study, aim to provide information and insights that help advisors grow their businesses and serve their clients more effectively – whether they choose to handle investment management in-house or use a third-party manager. So many changes have taken place in the advice business in recent years that it is more important than ever that advisors have the research-based, impartial information they need to understand the changing environment and to remain competitive. That is the intention of what follows."

MARK BRUNO
Associate Publisher
InvestmentNews

In today's competitive environment, advisors who turn to third-party asset managers find that outsourcing all or part of the investment management function frees time to devote to client service and business-building. These are two essential functions that are difficult, if not impossible, to outsource. For advisors facing manpower and time constraints, therefore, investment management outsourcing may be a choice to consider.

55%

OF ADVISORS CITE ACCESS TO A WIDER RANGE OF INVESTMENT STRATEGIES AS A KEY BENEFIT OF WORKING WITH A THIRD-PARTY ASSET MANAGER.

ACCESS TO A WIDER RANGE OF INVESTMENTS AND STRATEGIC OUTCOMES

Close behind freeing up time, the second most-cited benefit for advisors is the ability to access a wider range of investment strategies (55%), including alternative investments (37%). In this era of ultra-low fixed-income returns, many advisors find having access a broader mix of strategies especially helpful. They also believe that clients benefit from third-party asset management in other ways:

- Having institutional-quality due diligence and monitoring;
- Opportunities for better investment results;
- Support for tactical allocation; and
- Superior tax management.

Advisors find that outsourcing all or part of the investment management function frees time to devote to client service and business-building.

Firm size shapes advisors' view of the value of using an external manager in this area. Advisors at mid-size firms, for example, place a higher value on the due diligence expertise of outsourced managers than do larger firms (more than $1 billion in AUM), which say they benefit from third-party product selection advice.

In sum, many advisors say that turning to third-party providers for investment management allows them to create more effective portfolio strategies. These strategies help them meet their clients' needs for income, wealth accumulation and diversification.

In many cases, the advisors we speak to do not have the size and scale necessary to offer a full range of investment capabilities without using an external asset manager to supplement their in-house expertise. Others struggle with non-investment activity such as compliance, marketing or administration.

Furthermore, managing client portfolios in 2016 is very different than it was just 20 years ago. It is no longer a simple 60/40 split between equities and bonds. Advisors now need to be more strategic, building portfolios customized to their clients' needs, be they income or long-term stability; a desire to meet responsible investing criteria; or a need for short-term flexibility. Today, time, experience and creativity are crucial.

OPERATIONAL BENEFITS

Beyond gaining time and access to a broader array of investment options, a sizeable number of advisors cite advantages in the area broadly related to practice management and operations.

Almost one-third of advisors (31%) cite "more efficient growth" for their business as a benefit of investment outsourcing. Following in importance are the containment of needs and/or expense in staffing (26%), compliance (23%) and technology (19%), and the containment of expense in general (17%).

These operational benefits are likely to increase in the future as advisory revenue shifts more to a fee-based model due to pressure from regulators and as a result of changing client preferences. In an increasingly fee-based world where price competition becomes more intense and the value of assets under management is only growing slowly, the significant economies and efficiencies that can accrue from outsourcing can make it a more useful choice for more advisors.

31%

CITE "MORE EFFICIENT GROWTH" FOR THEIR BUSINESS AS A BENEFIT OF INVESTMENT OUTSOURCING.

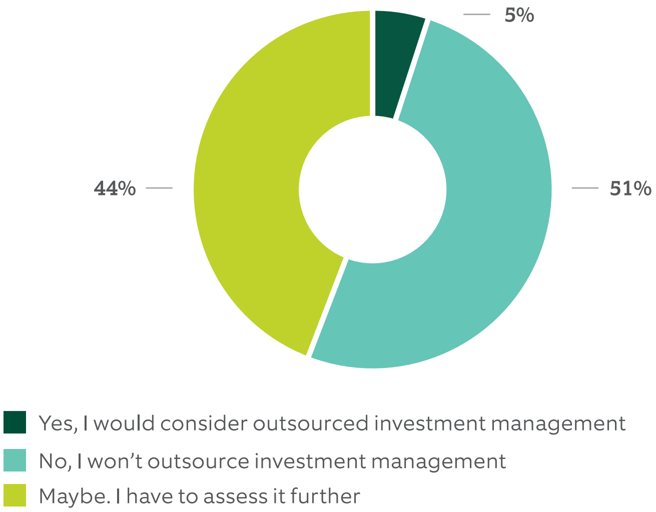
IMPACT OF A CHANGING REGULATORY CLIMATE

With regulatory change being such a focus of advisors and their firms, this year's survey asked about one of the most sweeping regulatory changes in recent years — the impending fiduciary requirements imposed by the Department of Labor on advisors who deal with retirement accounts.

While two-thirds (67%) of outsourcing advisors in the registered investment advisor (RIA) channel report that the new rule will have no effect on their decisions concerning investment management outsourcing, advisors in other channels appear less certain. Among hybrid RIAs, for example, 41% are unsure of the rule's impact and 26% say they plan to outsource more. In the independent broker/dealer channel, 49% are unsure and 19% say they would outsource more.

The DOL Fiduciary Rule is not likely to translate into significant shifts in the use of third-party asset managers, at least not immediately.

COULD THE DOL FIDUCIARY RULE AFFECT THE DECISION TO OUTSOURCE IN THE FUTURE?



Source: "External Investment Management: Advisor Attitudes and Adoption," Northern Trust, 2016

Opinions of nonoutsourcing advisors are mixed when considering whether the DOL Fiduciary Rule will cause a change in their in-house investment management. About 44% say it might result in a change, but that they plan to assess the rule and its implications prior to making any decision, and 51% say they will maintain in-house investment management. Just 5% indicate the DOL Fiduciary Rule may make them consider third-party asset management.

Essentially, while the DOL Fiduciary Rule is top-of-mind for advisors and undoubtedly will change many aspects of the advisory business, the new regulation is not likely to translate into significant shifts in the use of third-party asset managers, at least not immediately. But a significant 47% of advisors want more education around the new rule.

It is unsurprising that the results in this area were quite diverse, as it is still unclear to many exactly how the DOL Fiduciary Rule will affect their businesses. Over time, as advisors and asset managers better understand the rule's implications, the opportunity or need to bring in additional support will become clearer.

5%

OF NONOUTSOURCING ADVISORS INDICATE THE DOL FIDUCIARY RULE MAY MAKE THEM CONSIDER THIRD-PARTY ASSET MANAGEMENT.

THE ADVISORY VALUE PROPOSITION AND EXTERNAL INVESTMENT MANAGEMENT

How an advisory firm defines the principal value it delivers is probably the key factor in whether or not it decides to consider third-party investment managers.

"In our conversations across the industry, we find that most financial advisors view their in-house investment management as a competitive advantage," said Marie Dzanis. "They're able to customize their offerings to meet their end clients' needs and make portfolios that are scalable. They feel confident that they're delivering exactly what their clients want."

For advisors whose focus is anything other than investment management — such as financial planning, retirement or perhaps serving a demographic niche or other specialty market — outsourcing can be adopted with little business or philosophical disruption. But for advisors whose core value proposition is investment management, outsourcing can be problematic.

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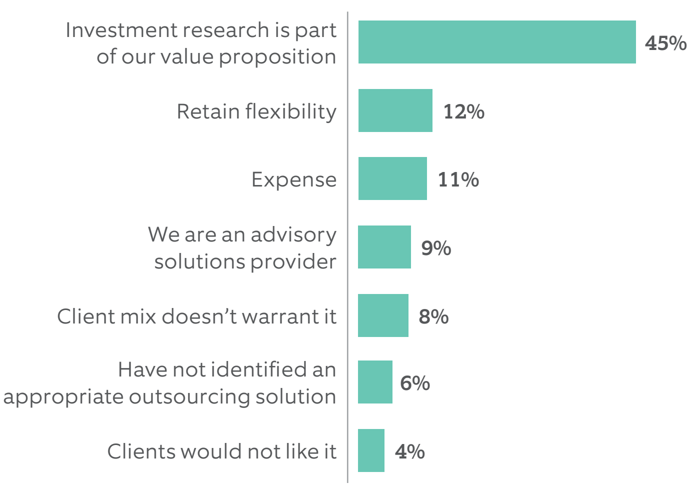
MARIE DZANIS

WHY FIRMS CHOOSE NOT TO OUTSOURCE INVESTMENT MANAGEMENT



Source: "External Investment Management: Advisor Attitudes and Adoption," Northern Trust, 2016

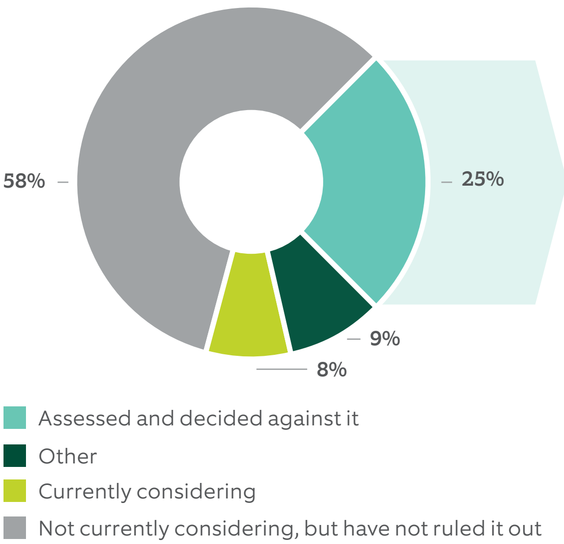
45%

OF ADVISORS MANAGE INVESTING THEMSELVES AS "INVESTMENT RESEARCH IS PART OF OUR VALUE PROPOSITION."

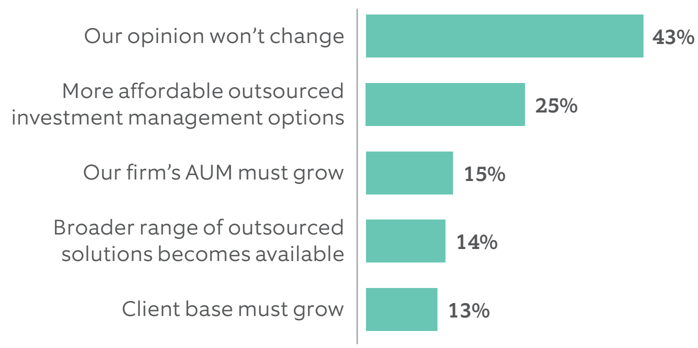
For those who manage investing themselves, the overwhelming reason advisors give for not outsourcing is that "investment research is part of our value proposition" (45%), as well as "we are an advisory solutions provider" (9%). Advisors cite other reasons less frequently, including the desire to retain flexibility (12%), the expense of outsourcing (11%) and having a client mix that doesn't warrant outsourcing (8%).

Are the advisors that don't outsource open to change? A slim 8% is currently considering such a change and the door is ajar among 58% of advisors who don't outsource currently, but have not ruled it out. But 25% of the advisors

WILL FIRMS CONSIDER INVESTMENT MANAGEMENT OUTSOURCING IN THE FUTURE?



WHAT NEEDS TO CHANGE FOR THE 25% WHO DECIDED AGAINST OUTSOURCING TO RECONSIDER?



Source: "External Investment Management: Advisor Attitudes and Adoption," Northern Trust, 2016

that have kept investment management in-house have assessed the option and decided against it. And of that number, when asked what would have to change in order to bring third-party asset management back into consideration, a resounding 43% say that their opinion won't change. Lower management fees by outside managers might trigger a rethinking, according to 25% of advisors who don't currently use third-party asset managers.

Only at large RIA firms do using third-party investment managers *and* having investment management expertise as a core value proposition coexist. At those large firms, advisors use outsourcing to complement in-house expertise in specialized areas where developing such expertise may not be cost effective.

While they express a strong desire to continue managing investments, advisors who currently do not use third-party investment managers may find that time pressure forces their hand. Those advisors report spending approximately 28 hours a week firm-wide on investment management activities, including manager research, portfolio construction, portfolio monitoring and working with technology. As the advice business becomes more competitive and as other business functions consume more management time, some firms may re-examine the use of third parties.

We do not anticipate wholesale shifts in the number of advisors who choose to outsource. However, as advisors begin attracting new types of clients – in different parts of the world and spanning generations – we may see a change in the tools advisors require to support their evolving client bases. The growth of robo-advisory is an example of this evolution.

Only at large RIA firms do using third-party investment managers *and* having investment management expertise as a core value proposition coexist.

ADVISORS SPEAK ON OUTSOURCING EXPERIENCES

While every advisor's perspective is unique, hearing about other advisors' experiences in a particular area can be helpful in clarifying one's own views. In connection with this survey, Northern Trust asked four advisors to comment on their experiences and opinions about using third-party investment managers. Their edited comments follow:

Steve Kellar
Sheridan Road Financial, LLC
Northbrook, IL

After 25 years of experience and working on my own, I decided to bring in third-party asset managers primarily because I saw that my clients' needs and their expectations of me were changing. I had to take a hard look at how they view me — not just how I view myself — and assess the value I was bringing to them. That value was not in the area of portfolio design and construction.

When I conducted my search for the right third-party, I consulted with colleagues and did a lot of digging. I wanted something that was consistent with my own investment philosophy, something that was fair in terms of cost to my clients and, obviously, something that would work.

What I value in the third-party money managers that I've been working with is their ability to come up with creative ideas of how to structure retirement plans to overcome the challenges of today's difficult investment environment. Today, there aren't fixed-income products that can provide what's needed for retirement income. We have to come up with kinds of strategies to safeguard that income, and I welcome the expertise of the third-parties I use to help me help my clients.

Andrew Altfest
Altfest Personal Wealth Management
New York, NY

Three things come to mind when we think about outsourcing: loss of control, cookie-cutter portfolios and lower investment performance. We choose not to outsource our investments because we feel that we're going to lose our advantage of being independent thinkers, customizing portfolios and managing risks. We think that our clients' portfolios will become more middle of the road, less differentiated, and performance will suffer as a result. At our firm, investments are handled through an investment committee which consists of generalists and specialists. We manage the investments through a general value orientation, and look to buy things that are less popular and are unloved.

Having said that, if there was a compelling reason to outsource within our own investment strategy, we would consider that. For example, in our municipal bond strategy we face short supply. We've been speaking

> *"I decided to bring in third-party asset managers primarily because I saw that my clients' needs and their expectations of me were changing."*
>
> STEVE KELLAR

to a municipal bond investment firm whose strategy is similar to ours about managing part of our client portfolios, which would make more municipal bonds available for our clients. Which brings up a key point: When we evaluate outsourcing, it's all about the benefit it provides to clients. If there's a compelling benefit, we'll pay for it.

Scott Morrison
Morrison Nordmann & Associates
East Lansing, MI

Outsourcing has set us up for the future. The world is changing. Employers have shifted the responsibility of retirement income to the employee, who used to have a pension to replace 60%, 70% and as much as 80% of their income. Now they have to figure out how to do that with a 401(k) plan.

Through outsourcing, I can act as the personal CFO for clients, giving them regular updates. It changes the perception of the advisor to someone who is an overseer of the wealth management team. It allows us to make a bigger impact in their lives, which makes them happier clients who are more likely to make better referrals. I think the biggest impact on our clients from using a third-party asset manager is that they feel very connected to us. Importantly, it's made the fee structure very transparent for the client. They rarely are searching for where the fees are, and their CPAs certainly appreciate that transparency as well.

Matt Nordmann
Morrisson Nordmann & Associates
East Lansing, MI

We believe that what our clients want from us most is our advice and our time, so we chose to outsource investment management because it fits with our wealth management formula and consultative process, in which we work collaboratively with clients, their attorney, their CPA and insurance professionals. The goal of this process is to maximize the probability of achieving all that is most important to the client, and we believe that if each member of the team is left to do what they do best, we'll reach that goal. The net impact on our business from using a third-party asset manager has been that it gives us more time to do what we believe we do best, which is to know our clients, their concerns and their goals intimately, and to help them achieve all that's most important to them.

From a practical point of view, the overall costs of using a third-party asset manager is often lower, even with the advisory fee included. In our experience, it's a much better situation for the client. For any firm considering outsourcing, we would definitely recommend it.

"*When we evaluate outsourcing, it's all about the benefit it provides to clients. If there's a compelling benefit, we'll pay for it.*"

ANDREW ALTFEST

The advisors represent a random sample of survey participants. The experiences and views expressed are those of the author(s) and are subject to change at anytime without notice.

CONCLUSIONS

Today, the advisory business has two primary models: advisor as portfolio manager, the choice of the majority of advisors, and advisor as provider of a wide range of wealth management services. The proportion of advisors in each group has been similar since Northern Trust began surveying advisors on the issue of investment management outsourcing, although those who use outside managers are shifting more of their assets to those managers.

From the most recent survey, three trends are clear:

1. Advisors that use third parties for investment management are increasingly satisfied. This year, satisfaction reached a new high of 96%, and advisors with AUM of more than $3 billion are 100% satisfied with their external management arrangements. Their choice gives them a wider array of strategies for their clients and frees valuable time to serve their clients more comprehensively and to build their businesses.
2. Even among those advisors whose value proposition is built on investment management, there is recognition that the advisory landscape is changing. The biggest change is on the regulatory front, where the DOL Fiduciary Rule is leading advisors to re-evaluate the way they do business. If advice, rather than product sales, is to become the chief revenue generator, how is that best accomplished?
3. Greater competition and the changing regulatory environment are forces driving advisors to focus on the scalability of their businesses. To achieve the desired level of profitability, advisory firms are finding that they must serve a larger, more demanding clientele who have round the clock access to information. Advisors that use third-party investment managers for all or part of their AUM find the chief benefit to be the time that it frees for them to serve their clients.

100%

OF ADVISORS WITH >$3B AUM ARE SATISFIED WITH THEIR EXTERNAL MANAGEMENT ARRANGEMENTS.

PUTTING THE RESEARCH TO USE FOR YOUR FIRM

Whether you are currently using external investment management or are committed to keeping the investment management function in-house, we would like to discuss how this research can help you benchmark your practice against your peers and the advisory space overall.

The trends highlighted in this research can help you identify ways to scale your business while maintaining control of the investment management function.

Visit www.northerntrust.com/outsourcing and register to receive more on this topic and to view our historical research.

Northern Trust is committed to serving financial intermediaries. Our ongoing research of advisor attitudes and their adoption of external managers is just one part of the Financial Intermediary Themes program we offer to the intermediaries we serve. To learn more, contact us at 877-867-1259.

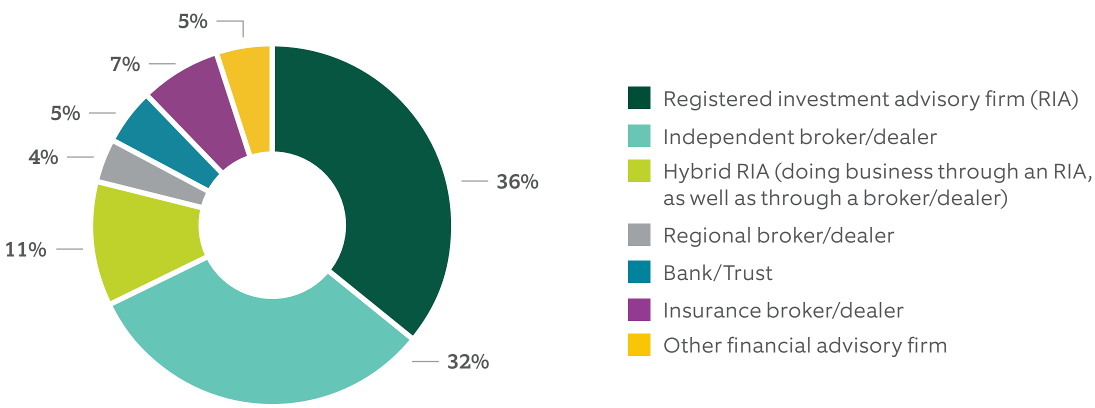
APPENDIX: ABOUT THE SURVEY

To conduct this year's survey — the fourth in our series examining advisor views on external investment management — Northern Trust worked with *InvestmentNews*, which fielded the electronic survey to more than 170,000 advisors across the United States, from a variety of channels and firm sizes. During the three weeks in May and June that the survey was open, nearly 680 advisors responded, and 550 fully completed the questionnaire. Northern Trust was not identified in the survey.

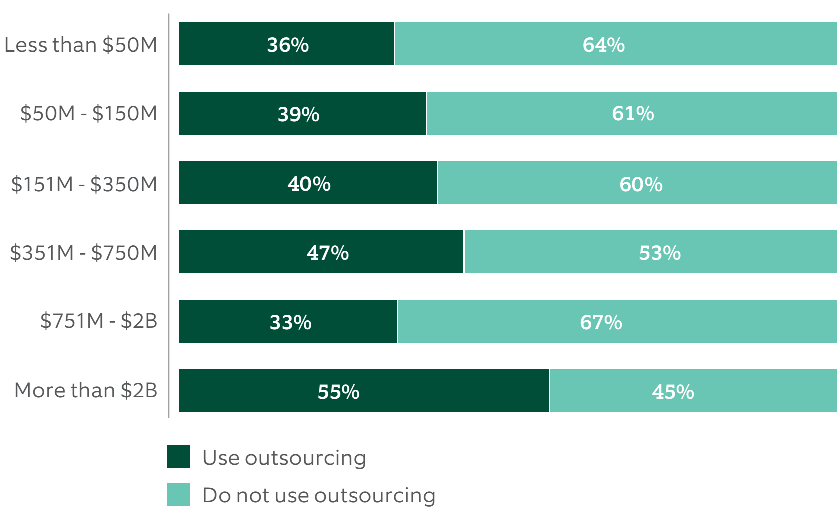
680

SURVEY RESPONSES

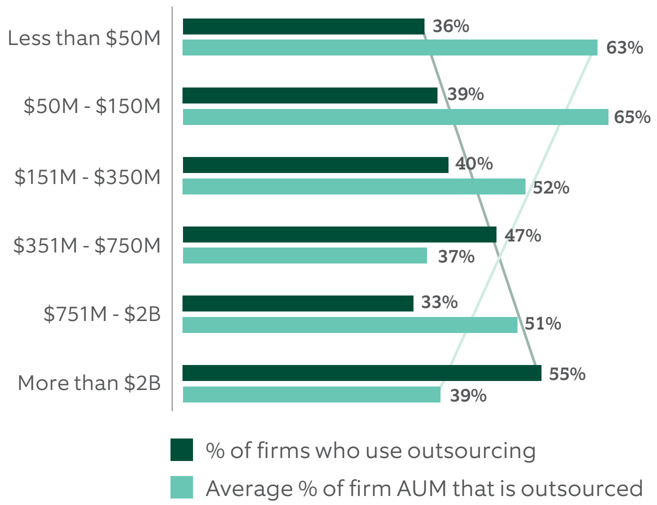
SURVEY PARTICIPANTS BY FIRM AUM



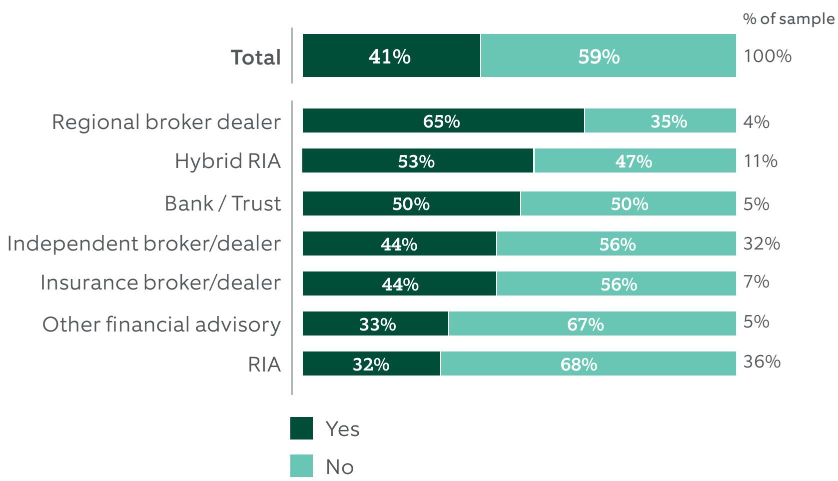
INVESTMENT MANAGEMENT OUTSOURCING USAGE BY AUM



INVESTMENT MANAGEMENT OUTSOURCING USAGE AND AVG. % OF AUM CURRENTLY UTILIZING OUTSOURCING, BY FIRM AUM



INVESTMENT MANAGEMENT OUTSOURCING USAGE BY FIRM CHANNEL



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