NORTHERN TRUST

EXTERNAL INVESTMENT MANAGEMENT

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.

ADVISOR ATTITUDES AND ADOPTION: 2016 EDITION

In second quarter 2016, we conducted our fourth biennial survey of financial advisor views on external investment management. This ongoing research program provides insight into advisors' experiences with using external asset managers – or their decision to keep investment management in house.

- In our 2010 inaugural survey, we focused on understanding advisors' attitudes and experiences to get a benchmark.
- In 2012, we explored advisors' expectations during the external asset manager vetting process and how those compared to their actual experiences.
- The 2014 survey focus shifted to the end clients, and how taking investment management outside affected their experience.

This year, we continue to explore advisors' views and experiences. We also seek to understand what impact, if any, the new Department of Labor (DOL) Fiduciary Rule might have on investment advisors' attitudes about using third-party asset managers when the rule takes effect in April 2017.

The firms that participated in the 2016 survey are comparable to the types that participated in 2014. This year, we segmented advisor channels further and included hybrid registered investment advisors (RIAs) and insurance broker/dealers in addition to other advisor channels. The survey participants comprise a wide span of firm sizes, from less than $50 million in assets under management (AUM) to more than $3 billion. We also asked respondents to identify their business model and compensation structure. (To learn more about the survey participants, see page 16.)

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This research initiative reflects Northern Trust's ongoing commitment to advisors of all types and asset management solutions providers. A special thanks to all advisors whose thoughtful survey participation made this report possible.

Northern Trust thanks Efficient Advisors and 3D Asset Management for their insights on this survey.

EFFICIENT ADVISORS 3D ASSET MANAGEMENT

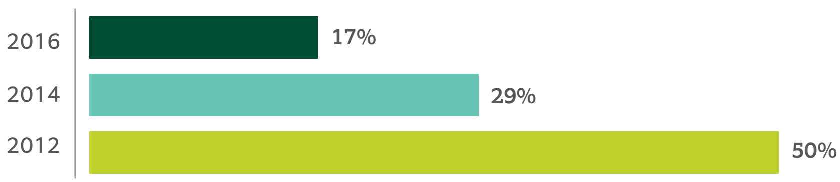
KEY FINDINGS FROM THE 2016 SURVEY

As in the past, roughly 40% of our survey respondents use outside asset management and 60% do not.

ADVISORS THAT USE EXTERNAL MANAGEMENT

- They are very 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.
- They are seeing external management as less of an all-or-nothing decision: only 17% outsource all investment management activities in 2016, but 56% outsource their portfolio management (a new option in this year's survey).

EXHIBIT 1: PERCENTAGE OF ADVISORS USING EXTERNAL MANAGEMENT FOR ALL INVESTMENT ACTIVITIES



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

- They report (55%) that portfolio construction strategies are fulfilled with a combination of active and passive investments, and 53% don't anticipate a change in that strategy over the next several years.
- They're outsourcing a higher percentage of client assets than in the past: 41% report using external management for more than 75% of their client AUM.

EXHIBIT 2: PERCENTAGE OF ADVISORS USING EXTERNAL MANAGEMENT FOR MORE THAN 75% OF CLIENT AUM

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

More than half (52%) of the survey respondents have grown their client base as a result of using an external manager.

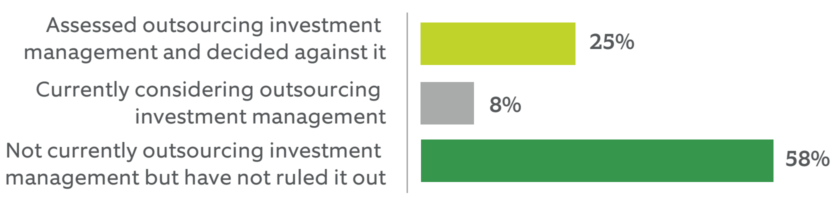
- They are more likely to use turnkey asset managers (52%) and registered investment advisors (41%) than other types of providers. Not too far behind, 29% indicate that they work with exchange traded fund (ETF) strategists, a new option this year. Another new option in this year's survey is robo-advisors, which are being used by 7% of survey respondents.

Advisors that don't use external management are most likely to keep investment management in-house because it is key to the firm's value proposition.

ADVISORS THAT DON'T USE EXTERNAL MANAGEMENT

- They are most likely to keep investment management in-house because it is key to the firm's value proposition (45%).
- They spend approximately 28 hours a week, firm-wide, on investment management activities.
- They are divided on whether they would reconsider their decision. One in four might consider external management if more affordable options become available. But 43% don't expect to ever use external investment management.
- They are still interested in external help in other areas. Those most frequently cited were marketing, compliance and social media training.

EXHIBIT 3: CONSIDERATION OF EXTERNAL INVESTMENT MANAGEMENT AMONG ADVISORS THAT DON'T OUTSOURCE



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

DEPARTMENT OF LABOR FIDUCIARY RULE

Both advisors who currently use external asset management and those who don't are divided in their views on how the Department of Labor's upcoming Fiduciary Rule might affect their practices: 44% of those who currently use external management don't foresee changing their decision; but 44% of those who don't indicate they might reconsider.

IMPACT OF THE DOL FIDUCIARY RULE

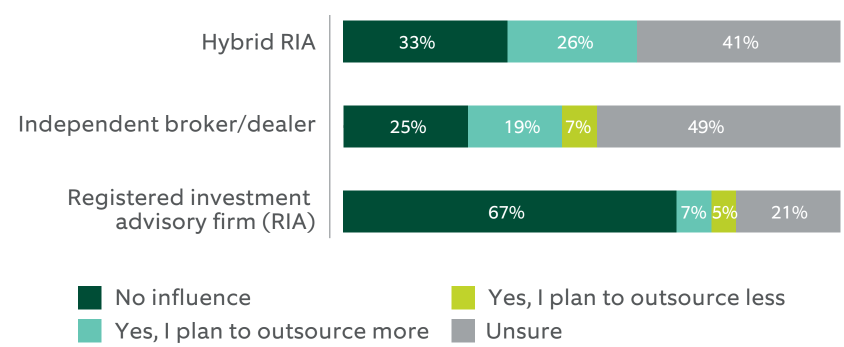
The industry has been focused on the DOL Fiduciary Rule, which is expected to have a large impact on financial advisors when implemented in 2017. To explore the effect this may have on investment management outsourcing, we asked advisors how the rule might influence their business and their decision to work with an external investment management provider.

- Of respondents currently using third-party asset managers, 44% do not anticipate any effect on their use of external investment management, while 17% expect to outsource more and only 5% foresee a reduction in outsourcing.
- About 5% of advisors managing client portfolios in-house state that they would consider outsourcing in the future as a result of the DOL Fiduciary Rule, and 44% say they will have to assess it further.
- Where advisors who currently work with an outside asset manager see a potential change from the DOL Fiduciary Rule is in their sales of commission-based products: 7% say they will no longer sell commission-based products, while 39% expect their commission-based sales to decline but not stop completely.

The perceived impact of the DOL Fiduciary Rule varies significantly by firm type. RIAs using an external provider typically anticipate little change, and almost as many RIAs expect to outsource less as expect to outsource more. However, while the hybrid RIAs and independent broker/dealers show greater uncertainty, about 26% and 19% respectively anticipate outsourcing more than they do currently.

> *We expect to receive tighter scrutiny and review processes as a result of the DOL Fiduciary Rule.*
>
> Hybrid RIA with between $501 million and $750 million AUM

EXHIBIT 4: PERCEIVED EFFECT OF THE DOL FIDUCIARY RULE ON INVESTMENT MANAGEMENT OUTSOURCING



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

Advisors also clearly state that they would appreciate support related to the DOL Fiduciary Rule. Exhibit 5 shows where they feel help would be most beneficial.

EXHIBIT 5: TYPE OF DOL FIDUCIARY RULE SUPPORT ADVISORS WOULD LIKE

Education about the Fiduciary Rule's potential impact on my business	47%
Policy, procedures and training to comply with best interest contract exemption (BICE)	40%
Solutions that facilitate and sustain compliance with BICE	38%
Training on how to navigate through the transitional period	36%
New technology and data solutions to ease the burden of reporting	28%
Special customer service for my firm's IRA or other retirement accounts	23%
Assistance with data aggregation solutions to help me provide more holistic plans	14%
Assistance with helping our firm evaluate digital advice solutions	11%

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

> *We expect to delegate some of the fiduciary responsibility as well as portfolio management when the Fiduciary Rule comes into play.*
>
> Independent broker/dealer with less than $50 million AUM

WHY ADVISORS USE AN EXTERNAL INVESTMENT MANAGER

Over the years, we have tracked the reasons advisors give for using external investment managers. These have shifted over time, but have typically focused on gaining access to investment expertise or strategies that their firms do not have expertise in themselves.

Historically we asked about drivers as they relate to product strategies. Based on feedback over recent years, in this year's survey we include a new option for respondents: the desire to free up time within the investment practice. This represents the most important driver, with 59% of respondents indicating that they use an external provider in seeking this outcome.

What do advisors plan to do with this extra time? They want to:

- Spend more time with their clients (61%)
- Spend more time developing their business (53%)
- Provide a more personalized service for their clients (50%)

Gaining access to investment strategies or vehicles they don't currently offer is another key driver. The investment strategies most in demand, according to our survey results, are:

- Alternatives (67%)
- Emerging or frontier markets (32%)
- Environmental, social and governance investing (18%)
- Factor investing (14%)

Access to portfolio services is also an important consideration, and advisors seek:

- Portfolio construction expertise (76%)
- Access to investment managers (67%)
- Asset allocation (64%)
- Portfolio monitoring (57%)

EXAMINING THE MOTIVATION BY FIRM TYPE AND SIZE

Drivers vary across firm type: access to investment strategies is most critical in bank/trust, RIA and insurance broker/dealer firms, while freeing up time is most critical to hybrid RIAs, independent broker/dealers and regional broker/dealers.

> *Our primary drivers behind the decision to use external investment managers were for more resources and better bench strength.*
>
> RIA with less than $50 million AUM

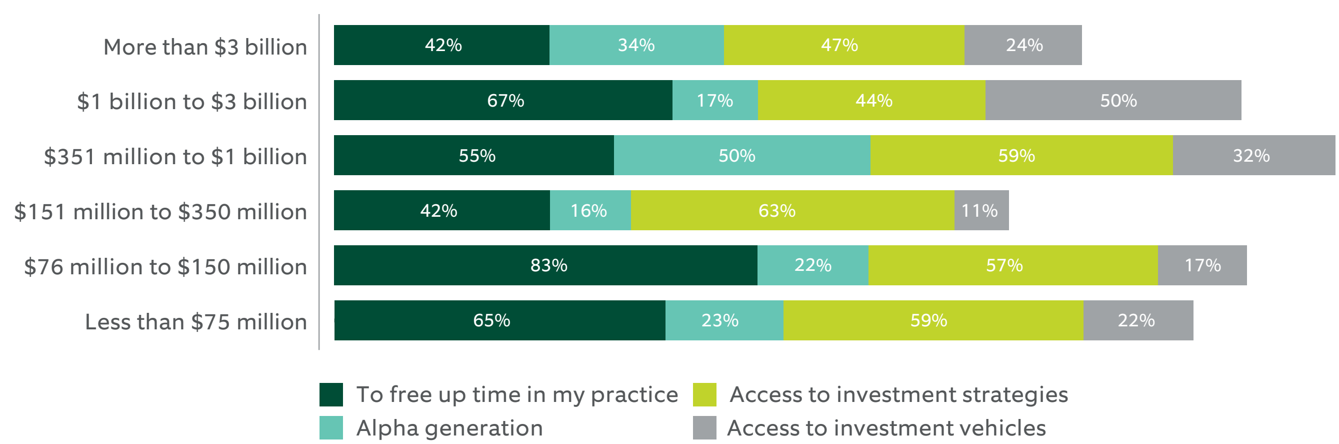
EXHIBIT 6: PRIMARY OUTSOURCING DRIVERS BY FIRM TYPE

	RIA	Independent broker/dealer	Hybrid RIA	Regional broker/dealer	Bank/trust	Insurance broker/dealer
To free up time in my practice	51%	67%	81%	60%	50%	29%
Alpha generation	31%	26%	11%	20%	50%	21%
Access to investment strategies	54%	58%	63%	50%	60%	43%
Access to investment vehicles	25%	19%	19%	30%	40%	21%
Access to portfolio services	15%	32%	26%	20%	20%	21%
Access to account management services	25%	35%	30%	40%	40%	21%

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

The drivers and activities for which advisors use an external provider also vary by firm size. While all firms cite freeing up time as an important driver, 83% of advisors with AUM between $76 million and $150 million cite the need for more available time. Advisors across nearly all AUM levels are fairly consistent when it comes to outsourcing all back-office operations (only 10% on average). The exception: Almost a quarter of advisors with between $351 million and $1 billion in AUM turn to a third party for all back-office operations.

EXHIBIT 7: PRIMARY OUTSOURCING DRIVERS BY FIRM SIZE



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

THE SCOPE OF EXTERNAL INVESTMENT MANAGEMENT

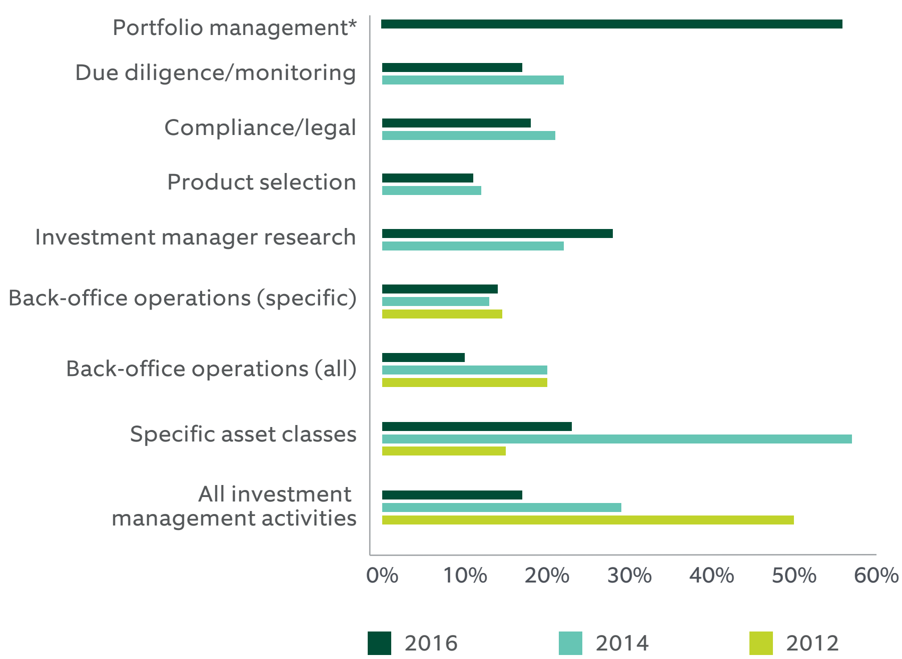
Since the start of our research in 2010, we have tracked the activities and types of accounts advisors have been outsourcing. This year we also look at the portfolio strategies and active/passive strategies accessed through third-party providers.

WHAT ACTIVITIES ARE ADVISORS MOVING TO EXTERNAL PROVIDERS?

We see a substantial decline in the number of advisors reporting that they outsource all of their activities to just 17%, from 50% in 2012. However, as advisors become more comfortable using external managers, they appear to be getting more strategic about how they use them.

- The majority of outsourcing respondents report outsourcing portfolio management (56%). This is a new survey option in 2016.
- Slightly more than one in four respondents is outsourcing investment manager research (28%).
- Advisors are far less likely to move non-investment activities, such as back-office operations (10%), compliance/legal (18%) and due diligence (17%).

EXHIBIT 8: EXTERNALLY MANAGED INVESTMENT MANAGEMENT ACTIVITIES



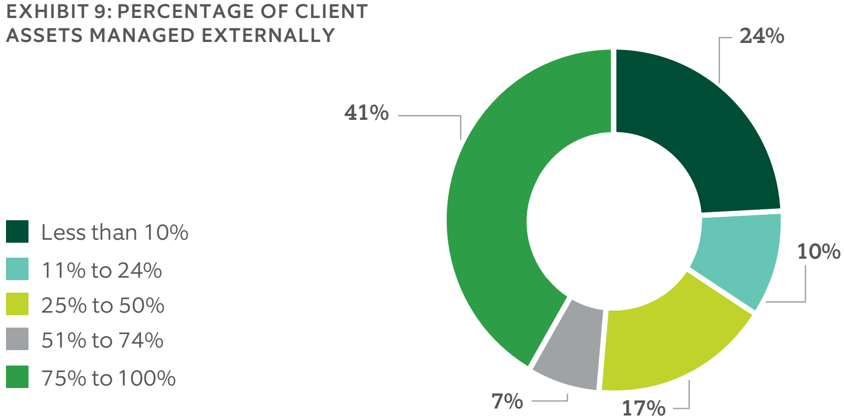
* New option in 2016

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

The level and types of activities advisors outsource are heavily influenced by the type of firm. For example, 19% of independent broker/dealers outsource all activity compared to just 5% of hybrid RIAs; and 85% of hybrid RIAs outsource portfolio management compared to 52% of independent broker/dealers.

While the percentage of advisors outsourcing overall (41%) has remained relatively consistent over the years, the proportion of assets they're outsourcing has risen. In 2016, 41% of advisors report outsourcing between 75% and 100% of client AUM, compared to 36% in 2014 and 37% in 2012. As in 2014, 48% of advisors report outsourcing 50% or more of client assets.

EXHIBIT 9: PERCENTAGE OF CLIENT ASSETS MANAGED EXTERNALLY

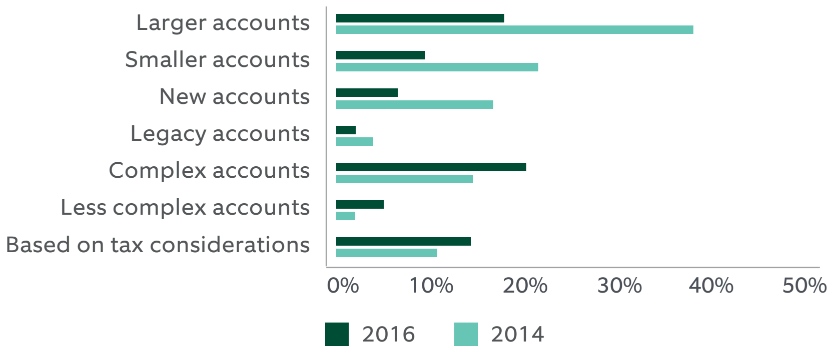


Note: Total does not add up to 100% due to rounding.
Source: "External Investment Management: Advisor Attitudes and Adoption," Northern Trust, 2016

CLIENT ACCOUNTS MANAGED EXTERNALLY

Which client accounts are advisors choosing to outsource? One third of advisors say they outsource all client accounts. Beyond that, advisors are roughly twice as likely to outsource large accounts as they are small ones, and they are more than three times as likely to outsource new accounts as existing. Looking at asset classes, external managers are used for alternative investments most often, but that usage reflected a decline from the 41% reported in 2014. Only 9% of advisors are using external managers for ESG/SRI strategies, a new option in this year's survey. However, 18% of advisors note that ESG is a driver in their decision to use an external manager.

EXHIBIT 10: TYPES OF ACCOUNTS OUTSOURCED BY SIZE, COMPLEXITY

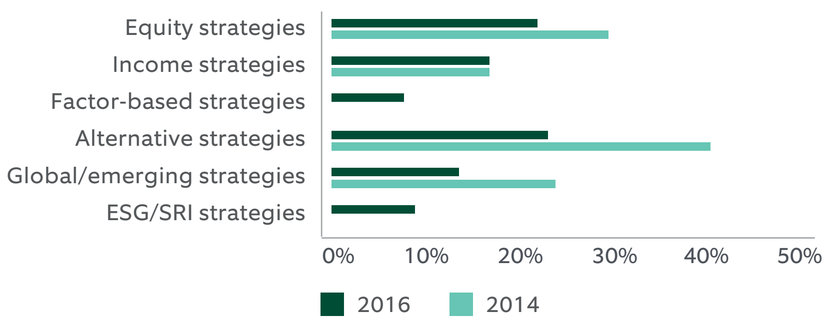


Source: "External Investment Management: Advisor Attitudes and Adoption," Northern Trust, 2016

21%

USE EXTERNAL MANAGERS FOR COMPLEX ACCOUNTS, UP FROM 15% IN 2014

EXHIBIT 11: TYPES OF ACCOUNTS OUTSOURCED BY STRATEGY



Note: Factor-based and ESG strategies were new options in 2016
Source: "External Investment Management: Advisor Attitudes and Adoption," Northern Trust, 2016

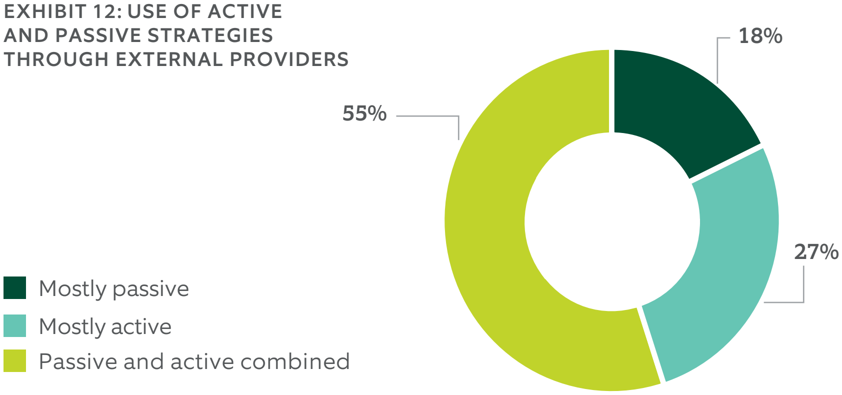
24%

USE EXTERNAL MANAGERS FOR ALTERNATIVE STRATEGIES, DOWN FROM 41% IN 2014

PORTFOLIO STRATEGIES MANAGED EXTERNALLY

New to the survey this year, we seek to understand the portfolio strategies being managed externally and the use of active versus passive strategies. For the most part, advisors are using a combination of active and passive strategies (55%): Active only strategies represent 27% and passive only strategies represent 18%.

EXHIBIT 12: USE OF ACTIVE AND PASSIVE STRATEGIES THROUGH EXTERNAL PROVIDERS



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

Our results show a broad range of portfolio strategies being used, with strategic portfolios more heavily emphasized. With regard to portfolio strategies, nearly half of respondents do not anticipate any major changes.

EXHIBIT 13: STRATEGIES ACCESSED THROUGH EXTERNAL PROVIDERS

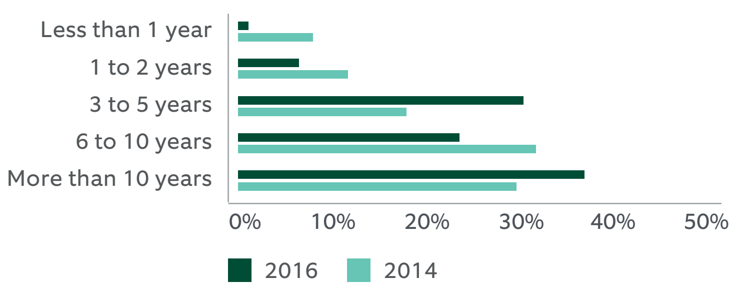
	Strategies currently accessed through external partner(s)	Anticipated reliance in next two to five years on external partner(s)			
		Rely on more	Rely on less	No change	Don't know
Strategic allocation with a tactical overlay	**68%**	32%	4%	**47%**	17%
Strategic allocation only	**54%**	17%	16%	**48%**	18%
Dynamic allocation with a tactical overlay	**53%**	24%	5%	**48%**	24%
Dynamic allocation only	**27%**	11%	12%	**50%**	28%
Tactical allocation only	**39%**	18%	8%	**50%**	24%
Style box strategy	**42%**	11%	12%	**53%**	24%

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

THE BENEFITS OF AN EXTERNAL INVESTMENT MANAGER

Clearly a 96% satisfaction rate of outsourcing advisors suggests significant benefits. It also appears that once advisors begin to outsource, they don't turn back. We have seen the long-term use (more than 10 years) of external asset managers grow over the life of our surveys. In 2016 more than 60% of outsourcing advisors report using an external provider for more than five years.

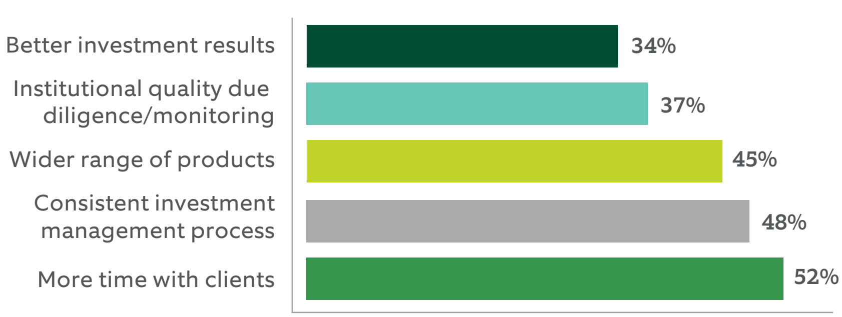
EXHIBIT 14: LONGEVITY OF EXTERNAL MANAGEMENT



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

We asked advisors who outsource to share what they see as the benefits of undertaking an outsourcing program. Although spending more time with clients is the primary benefit they cite (52%), advisors feel they gain in other areas as well. The second biggest benefit of using external investment management, according to our survey, is the consistency of investment management processes (48%). Close behind that, advisors appreciate a wider range of products (45%), institutional quality due diligence (37%), better investment results (34%) and more efficient growth (31%).

EXHIBIT 15: TOP FIVE BENEFITS OF EXTERNAL INVESTMENT MANAGEMENT

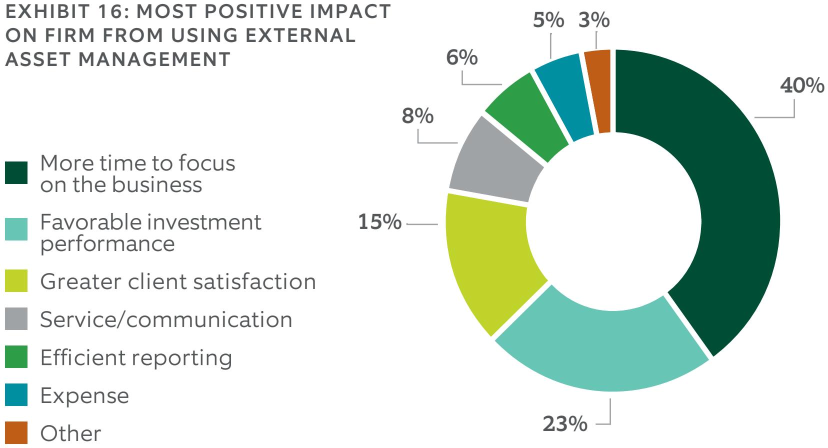


Source: "External Investment Management: Advisor Attitudes and Adoption," Northern Trust, 2016

What do advisors say is the biggest impact on their business from their decision to use external asset management? When asked that question, 177 advisors indicated positive benefits, and only seven advisors cited a negative impact.

The ability to spend more time on their business is the most positive outcome of using external investment managers for 40% of our respondents. The second-most cited benefit (23%) is favorable investment performance, and 15% note an improvement in client satisfaction

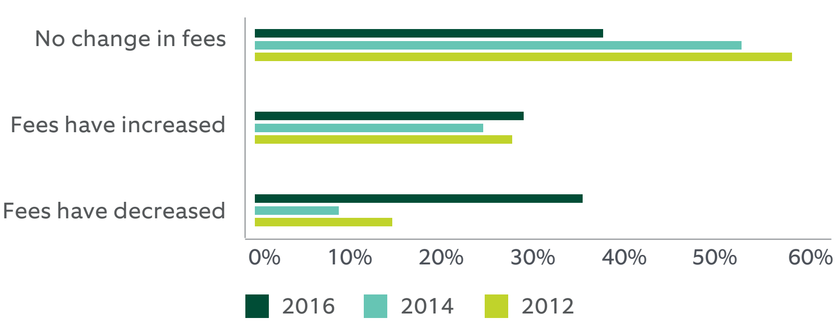
EXHIBIT 16: MOST POSITIVE IMPACT ON FIRM FROM USING EXTERNAL ASSET MANAGEMENT



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

Advisors report a decrease in the fees they pay for external management over time. In 2016, the number of advisors passing these savings along to clients jumped dramatically – to 34% in 2016 from 9% in 2014.

EXHIBIT 17: CHANGE IN FEES CHARGED TO CLIENTS OVER TIME



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

ADVISORS THAT DON'T USE EXTERNAL INVESTMENT MANAGEMENT

Over time the percentage of advisors choosing to keep the investment management function in-house has remained fairly stable at around 60% of respondents. Given the benefits cited by advisors choosing to outsource, we're interested to understand the motivations of those who choose not to use external help.

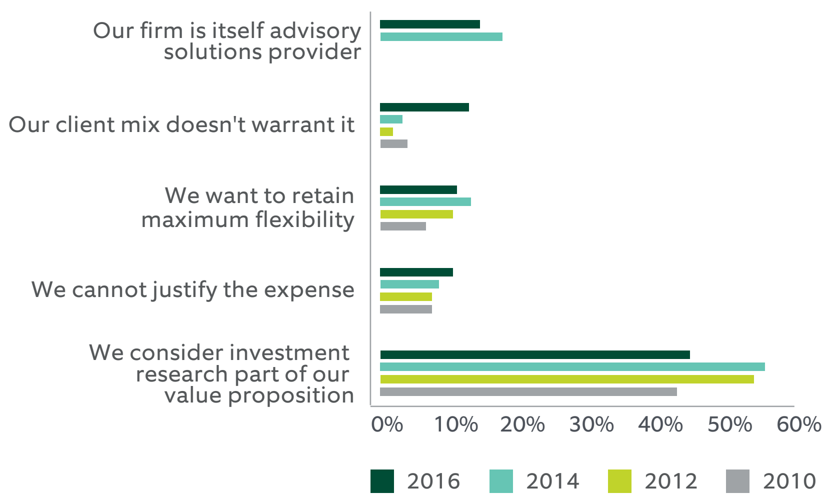
KEEPING INVESTMENT MANAGEMENT IN-HOUSE

Why do so many advisors choose to keep this function in-house? Most often it is because investment management is part of the firm's value proposition. This year, 45% of advisors indicated this is the case.

We choose not to outsource investment management because we have not found a third party that can protect against the downside as well as we can.

Independent broker/dealer with less than $50 million AUM

EXHIBIT 18: TOP REASONS ADVISORS DON'T OUTSOURCE INVESTMENT MANAGEMENT FUNCTIONS



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

WILL OPINIONS CHANGE?

It is interesting to note that advisors who are not currently using third-party managers haven't entirely ruled out doing so in the future. While only a small number (8%) are currently considering outsourcing all or some of their investment management, 58% are not actively considering it, but have not ruled it out as a possibility.

On the other hand, when asked about what might make them change their minds, 43% of the advisors who currently don't use external asset managers also state that their position on outsourcing will not change. Of those who indicate they might reconsider outsourcing, the primary influencer would be the cost of outsourced investment management solutions.

43%

ADVISORS' OPINIONS WON'T CHANGE

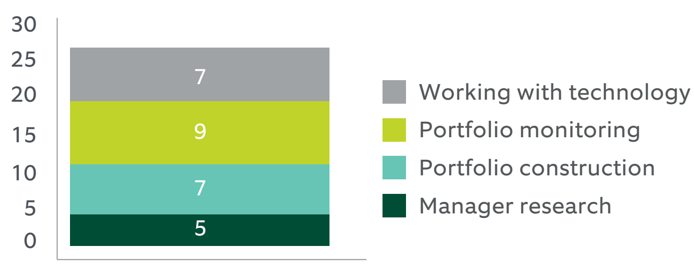
25%

MIGHT CONSIDER MORE AFFORDABLE OPTIONS

THE COST OF SELF SUFFICIENCY

Advisors who choose not to outsource any of their investment management activity report spending approximately 28 hours a week firm-wide on investment management activities. This includes a combination of manager research, portfolio construction, portfolio monitoring and working with technology.

EXHIBIT 19: HOURS SPENT EACH WEEK (MEAN) ON INVESTMENT MANAGEMENT ACTIVITY BY FIRMS THAT DON'T OUTSOURCE

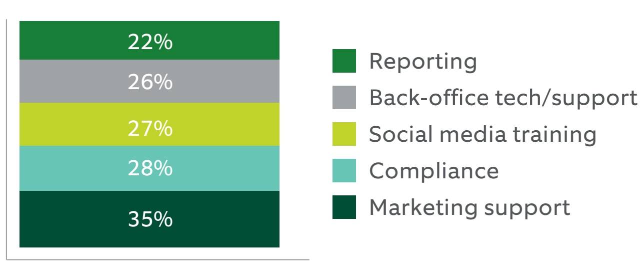


Source: "External Investment Management: Advisor Attitudes and Adoption," Northern Trust, 2016

WHERE HELP IS NEEDED

Some advisors who choose not to seek third-party support for their investment management activities do feel they could benefit from extra help in other areas. The primary areas they highlight are marketing (35%), compliance (28%), social media training (27%) and back-office support (26%).

EXHIBIT 20: TOP FIVE AREAS WHERE ADVISORS WOULD LIKE EXTERNAL SUPPORT



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

ABOUT THE SURVEY

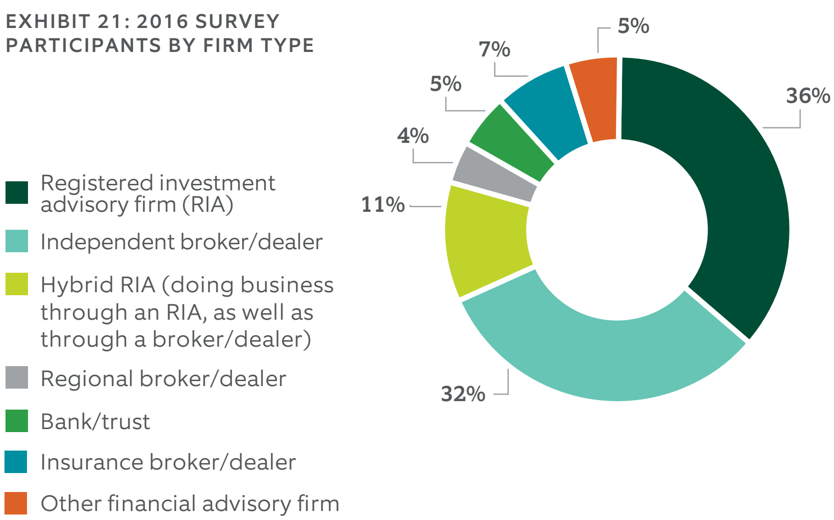
Since 2010, Northern Trust has been conducting research to better understand how financial advisors are managing client investment portfolios. We seek to understand how, when and why some advisors choose external asset managers for the job, as well as the reasons that other advisors commit to keeping the investment management function in-house.

The advisors that participated in the 2016 survey comprise a variety of channels and firm sizes. Within our universe of advisors, 41% report using external providers for their investment management functions while 59% manage investment functions in-house. This breakdown is consistent with past surveys. Of those that outsource, 61% have been outsourcing for more than five years and 37% have outsourced longer than 10 years.

The outsourcing providers most frequently being used are turnkey asset managers (52%) followed by registered investment advisors (41%), ETF strategists (29%) and robo-advisors (7%).

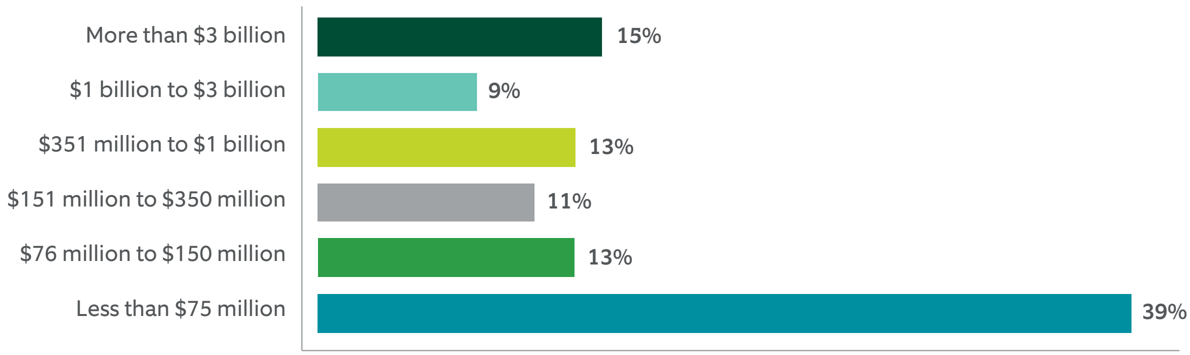
This is the fourth edition in our series examining advisor views on external investment management. To conduct this year's survey, Northern Trust worked with *InvestmentNews*, which fielded the electronic survey to more than 170,000 advisors across the United States. During the three weeks in May and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

EXHIBIT 21: 2016 SURVEY PARTICIPANTS BY FIRM TYPE



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

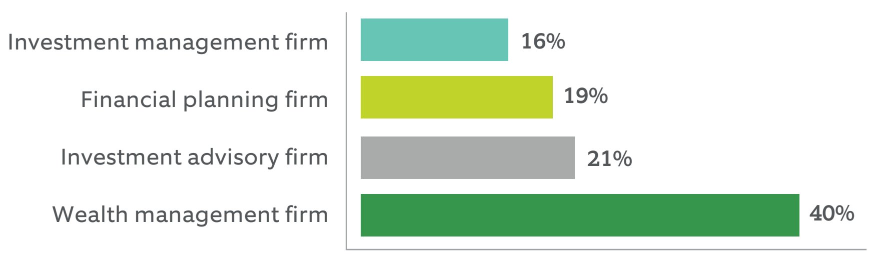
EXHIBIT 22: 2016 SURVEY PARTICIPANTS BY FIRM AUM



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

Respondents to the survey represent a range of AUM sizes with around one-third being under $50 million, one-third between $50 million and $350 million and the remaining third over $351 million.

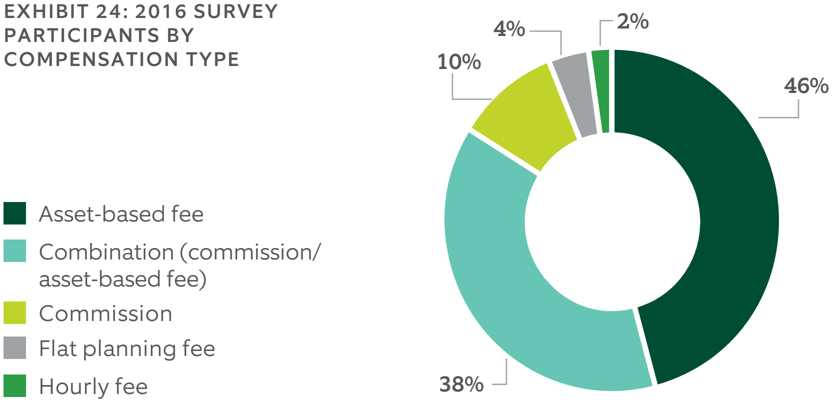
EXHIBIT 23: BREAKDOWN OF RESPONDENTS BY FIRM SERVICE MODEL



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

The largest proportion of respondents were wealth management firms – those that consider their primary focus to be serving as holistic advisers to their clients on tax, estate and personal financial planning in addition to the investment advisory services.

EXHIBIT 24: 2016 SURVEY PARTICIPANTS BY COMPENSATION TYPE



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

Most respondents use an asset-based fee approach to compensation, but a large proportion also use a combined approach with commission and asset-based fees.

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 to 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 of many practice management programs we offer to the intermediaries we serve. To learn more, contact us today at 877-867-1259.

northerntrust.com/outsourcing

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