Current Trends in Investment Management Outsourcing

A Summary of the October 3 Advisor Perspectives Webinar

“Investors simply don’t believe that advisory firms can do it anymore, especially your $150 million [AUM] firms and smaller. They just don’t believe that you have the resources, the research, the ability to do globally diversified portfolios.”

“Every advisor should ask themselves, can I do it best?… And if not, how do you fire yourself?”

And with those comments, first from Leo J. Dolan, Jr., a principal and the national sales director for Brinker Capital, and the second from Sean Hanlon, chairman, CEO and chief investment officer of Hanlon Investment Management, yesterday’s “Current Trends In Investment Management Outsourcing” Webinar was well underway, with Advisor Perspectives Publisher Robert Huebscher moderating.

The occasion for the Advisor Perspectives Webinar was the release of Northern Trust’s updated research on investment management outsourcing trends.

In a July/August 2012 survey of Advisor Perspectives readership, Northern Trust revisited research questions originally asked in 2010 about advisors’ use of investment management outsourcing. That work produced two whitepapers: “Outsourcing And Loving It!” and “Full Outsourcing Is Not For Everyone.” (See www.northerntrustinvestments.com/outsourcing.) This year the survey asked additional questions about the outsourcing advisory practice and advisors’ outsourcing experience versus expectations.

On the following pages, we weave in a synopsis of the panelists’ comments with the high-level research findings presented by Laura Gregg, Northern Trust Vice President, Direct Distribution. The full report, “Investment Management Outsourcing: The State of the Art in 2012,” was distributed to all Webinar registrants.
Access and Alpha
Access and alpha are what's driving investment management outsourcing in 2012, according to Gregg. She identified the 2012 top outsourcing drivers as:

- Access to asset allocation models
- Access to managers firms could not access on their own
- The potential to generate alpha through best investment ideas

The leading reason advisors provided for not outsourcing: Investment management is central to the firm's value proposition.

While more than half of the advisors surveyed outsource all investment management activities, just 20% outsource all investment management-related back-office operations.

“What's Outsourced
Outsourced Investment Management Activities
As a percentage of outsourcing responses

50% outsource all investment management activities;
20% outsource all back-office operations

Top outsourced back-office operations
- Custody services
- Statements
- Performance reports
- Portfolio operations

“Where's the easy button?”
Sean Hanlon
According to Gregg, six out of ten advisors outsource more than half of their clients’ assets, with the investment products selected for the client dictating which assets and which accounts.

“ Outsourcing is what allows advisors to compete,” Dolan said. He cited recent research on the affluent investor that points to heightened expectations of advisors, of the strategies they recommend and of their effective management of risk.

Advisors whose firms keep investment management in-house make substantial time commitments, and the demands are building at larger firms, especially, Gregg reported. Advisors from larger firms now spend the equivalent of nearly two full workdays a week on investment manager research, portfolio construction and monitoring.

Hanlon characterized the outsourcing decision as a natural move for advisory firms that strive to be “elite.” The elite advisor, he said, spends 80% of his productive time in client- or prospect-facing situations, 15% of his time on research, education, selection and monitoring of investment solutions and no more than 5% of his time on business planning, property planning and staff.

### How Much Is Outsourced

6 out of 10 advisors outsource more than half of their clients’ assets

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<tr>
<th>The Outsourcing of Clients’ Assets</th>
<th>Percentage of all responses</th>
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<td>Less than 10%</td>
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<td>11%-24%</td>
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<td>25%-50%</td>
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<td>51%-74%</td>
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<td>75%-100%</td>
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<tr>
<th>Percentage</th>
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<td>62%</td>
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<td>25%</td>
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<td>18%</td>
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<td>12%</td>
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<td>8%</td>
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### What Keeping Investment Management In-House Entails

- Heightened demands on their time—advisors from larger firms spend 15 hours a week on investment manager research, portfolio construction and monitoring.

- In order to change their position, today’s outsourcing solutions need:
  - Added capabilities (20%)
  - To be more affordable (19%)

### Our Opinion Won’t Change

Is there a weakening resolve in the most common leading response?

<table>
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<th>Year</th>
<th>Percentage</th>
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<td>2012</td>
<td>34%</td>
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<td>2010</td>
<td>67%</td>
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Better for the Client Seeking Global Diversification, Better for the Firm Seeking to Equitize

The panelists presented outsourcing as a solution that better serves the client and is ultimately beneficial for the advisor and his or her practice.

“Investors simply don’t believe that advisory firms can do it anymore, especially your $150 million [AUM] firms and smaller,” said Dolan. “They just don’t believe that you have the resources, the research, the ability to do globally diversified portfolios.”

And, he said, advisors thinking about succession planning and looking to equitize their business need to consider the risks of positioning themselves as “the stock-picking genius.” That’s not sustainable, Dolan said, and will give the impression to a potential acquirer that clients may very well follow a founder out the door. “A repeatable, sustainable, institutional investment process allows for a smoother transition and ultimately a higher multiple for advisors looking to equitize,” said Dolan.

Satisfaction and Investment Performance

As was reported two years ago, outsourcing seems to agree with advisors. Gregg noted that 94% of advisors are satisfied with their solution. Where it exists, dissatisfaction centers on investment performance—one-third of those surveyed say investment performance is the single most negative impact of outsourcing.

In their response to the surveyed advisors’ disappointment over investment performance, both panelists suggested that advisors may be erring by evaluating the performance of their solutions’ diverse asset classes against the Standard & Poor’s benchmark. “The real benchmark should be the wants and needs of the investor,” Dolan said. Agreeing, Hanlon said advisors need to be educated to pay more attention to risk-adjusted returns and investors’ cash flow needs and expectations.
According to Hanlon, most advisors are surprised by clients’ reactions when they broach the topic about needing to partner with deeper investment management resources. Some clients say, “You know, I was wondering the same thing. I don’t know how you do it. I actually started thinking about going to somebody else who uses outsourced solutions.”

Dolan gave an example of some of the templates and scripts that Brinker offers. “Dear Investor: We restructured your portfolio a number of years back and made some changes that were right for the times. We’ve made changes over the last few years and market cycles but consider what has happened since the inception of your portfolio…”

The letter includes a bulleted list that might include the Euro, the Arab spring, the Middle East crisis, the price of oil, the fiscal cliff, political logjams, zero interest rates, etc.

“You offensively go to the client and suggest a portfolio review,” Dolan said. “We expect some changes and we expect to be working with some partners that can help us diversify into asset classes that can provide better downside protection with upside potential. …No apologies. We’ve been on the case and we’re looking at making some changes for positioning for the next five to 10 years.”

Remember, Hanlon said, the firm that repositions itself as performing sophisticated due diligence expands its value proposition. As opposed to performing the actual money management, it is now demonstrating its ability to hire and fire money managers.

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Defending Fees—The Transition to Outsourcing

Some of the richest discussion had to do with the transition to outsourcing, how advisory firms introduce the concept to their clients and how, as one audience member phrased the question, outsourcing advisors could “defend” their fees.

In fact, Gregg said Northern Trust learned that outsourcing does lead to fee changes.

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For 4 Out Of 10 Advisors, Outsourcing Has Led To Fee Changes

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Outsourcing’s Effect on Fees Charged

As a percentage of outsourcing respondents

- 28% Fees have increased
- 57% No change in fees
- 15% Fees have decreased

IN THEIR OWN WORDS: ADVISORS’ COMMENTS ON FEES CHANGED

“I, as the FP, make less since I charge the same and pay the third-party money manager from my comp.”

“Fees have increased compared to buy and hold mutual fund accounts.”

“We have reduced some client fees due to less work required on our part to manage the assets.”

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