Economic and Advisory Business Outlook

INTRODUCTION

For more than a decade, the AdvisorBenchmarking RIA Trend Study has provided the financial advisory community with analyses of advisor performance and attitudes across a variety of areas critical to their business practices—and offered a current assessment of how the top performing practices differ from their peers across these areas.

This year, the study results are being published on WealthManagement.com in 8 individual chapters providing a comprehensive look at the survey's most relevant measures: practice management and operations; ETFs; alternative investments; marketing and client relations; financial performance; investment management; best practices; and economic and advisory business outlook.

In this chapter we present key findings and insights from our survey questions on financial performance, to which advisors responded with metrics for the years ending 2013 and 2012, including number of clients and assets under management, key income statement line items, and advisor compensation.

ADVISORS' ECONOMIC OUTLOOK

As we did last year, we asked respondents to characterize their outlook for the global, U.S. and regional economies. When we group the bullish and slightly bullish responses together, we find that approximately 60% of advisors fall into this camp for all three geographic categories. However, when we focus only on the bullish response, we find that advisors are more optimistic the closer they are to home. More specifically, 11% of advisors are bullish in their outlook for the global economy, while 15% hold the same view of the U.S. economy. Interestingly, 23% of advisors indicate a bullish economic outlook for their respective geographical regions; this may be a result of greater knowledge of local firms and the specific economic challenges facing each advisor's home region.

Advisors in the West are the most optimistic with 30% in the bullish camp, the highest percentage of bullish managers of any region. However, when we add in the slightly bullish response, the South eclipses the West in overall positive outlook. Relative exuberance in the South region may be in part due to robust economic success in states such as Texas who have seen large improvements in unemployment and fiscal numbers in recent years. Interestingly, it is the Northeast that seems to be the least bullish region in 2014, with only 16% of respondents solidly optimistic about their regional economies and 15% bearish or slightly bearish. As we can see, while the general consensus is that the U.S. economic outlook is viewed favorably by advisors, the sentiment seems to carry some region-specific variability.

FIGURE 1: Advisors' Economic Outlook

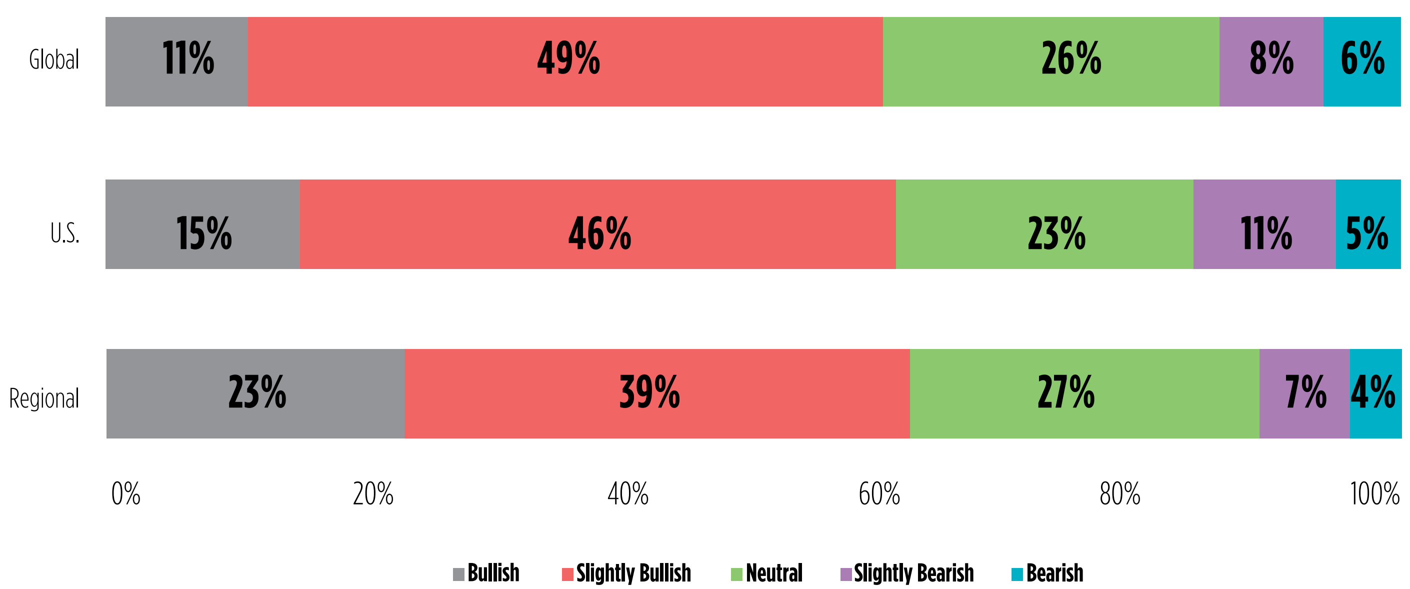
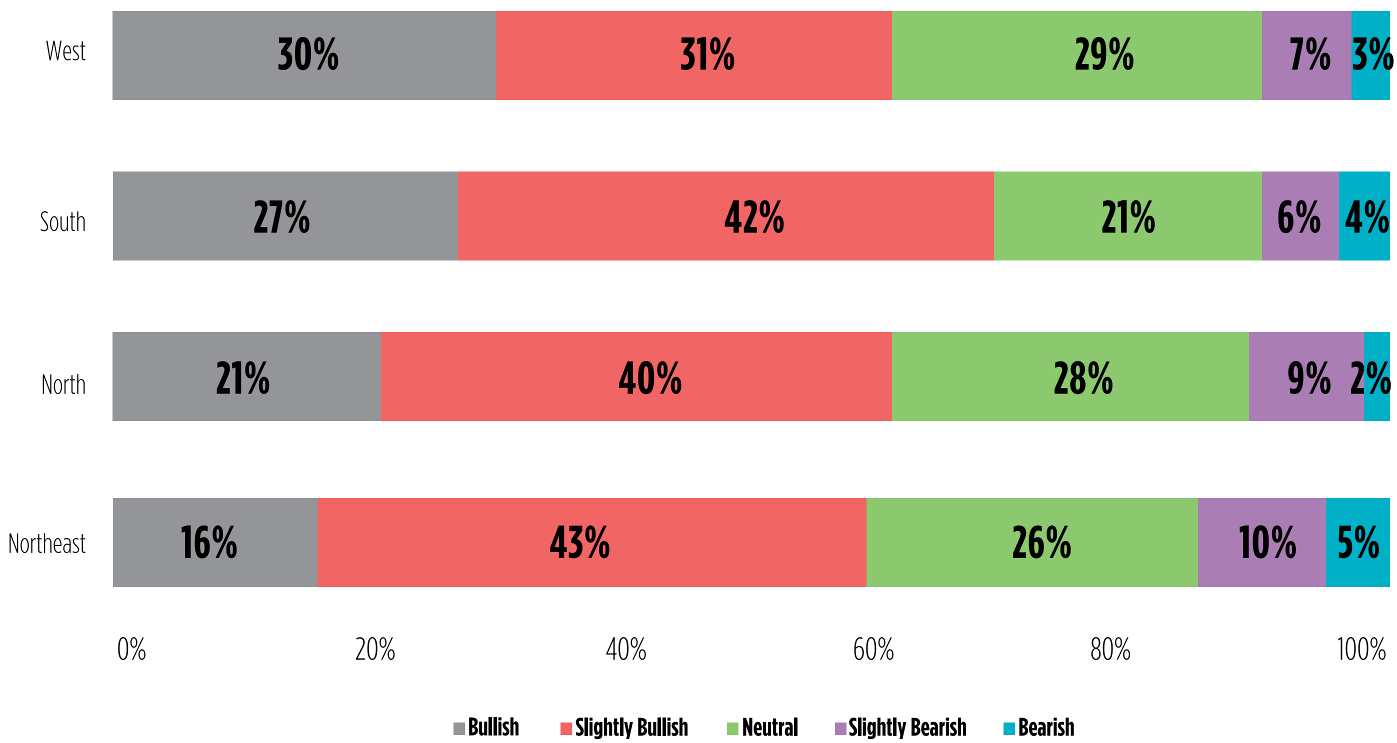


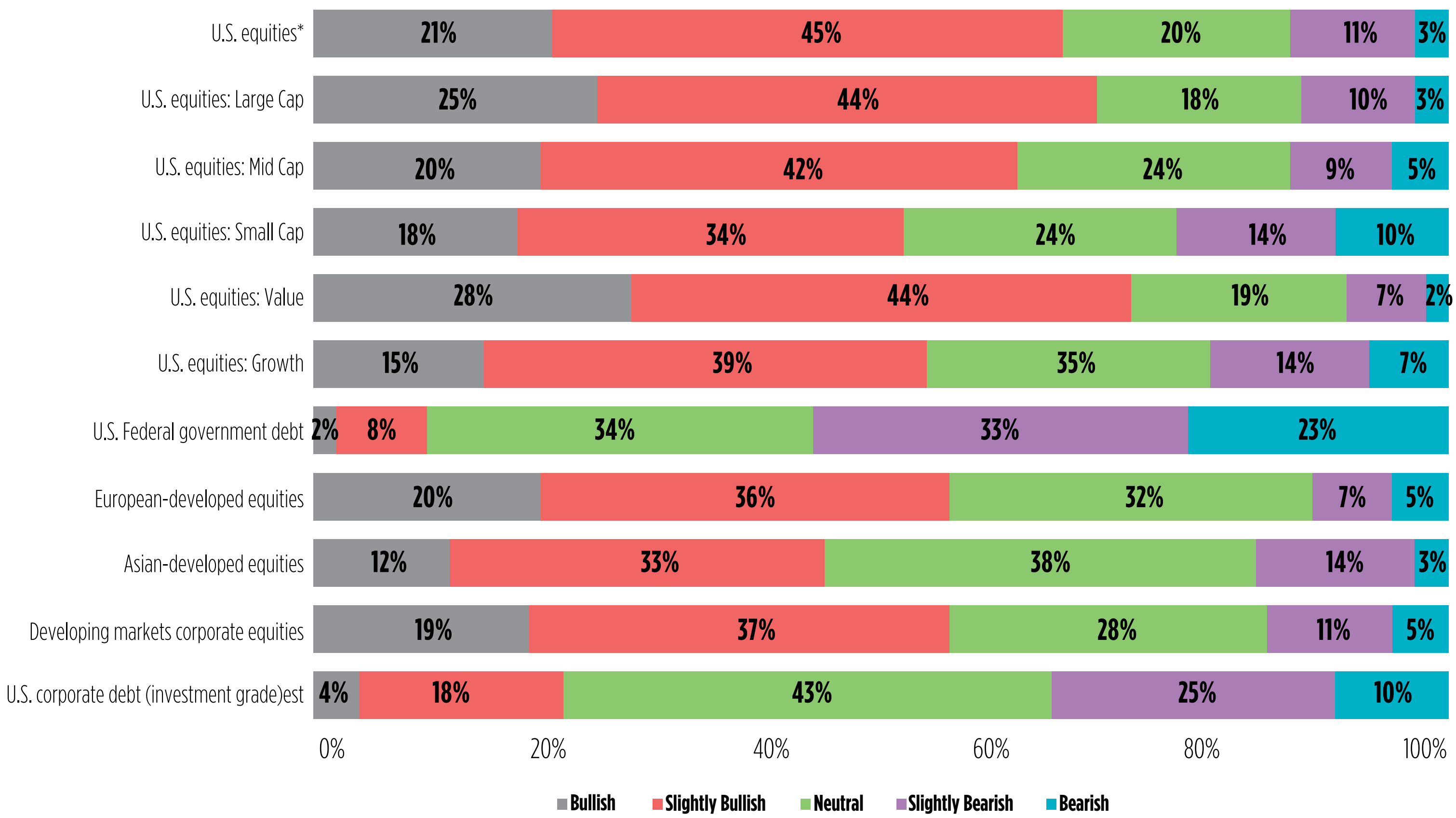
FIGURE 2: Advisors' Regional Economic Outlook



ADVISORS' OUTLOOK TOWARDS VARIOUS ASSETS

Advisors were generally constructive toward all segments of the U.S. equity space, with each registering bullish to slightly bullish readings of over 50%. However, there does appear to be signs of some growing skepticism in advisors' view of the equity markets. Value is now strongly favored over growth, and large cap firms are solidly preferred to small cap, both of which represent shifts to less risky segments of the U.S. equity market. Where the sentiment is truly cautious, however, is toward U.S. federal government debt. Fifty-six percent of advisors state that they are slightly bearish to bearish on treasuries, and only 10% respond as being bullish or slightly bullish. This result is not surprising when taken in the context of what appears to be a winding down of the expansionary monetary regime of the Federal Reserve; indeed, the vast majority market participants expect rates to rise over the next year. Respondents were considerably more bullish, however, on European and Asian developed equities, as only 12% and 17% of advisors report being bearish on these markets, respectively. This is likely in response to a rebound in economic growth expectations in those regions.

FIGURE 3 Advisors' Outlook Towards Various Assets



SENTIMENT TOWARDS ASSET CLASSES UNDER CONSIDERATION IN COMING YEAR

In prior years we have observed that advisors were increasingly willing to utilize alternatives in client portfolios. However, while alternatives remain a popular choice for advisors, RIAs may be slightly less enthusiastic about this asset class in 2014. Specifically, the percentage of advisors considering alternatives for the coming year dropped to 23% from 26% last year. The most notable year-over-year change can be seen in the percentage of advisors considering or evaluating municipal debt for their client portfolios, with 17% of respondents compared to only 11% last year. This likely reflects the perceived relative value, and higher after-tax equivalent yield, of municipals compared to treasuries. Other more esoteric asset classes such as foreign government debt garnered affirmative responses in the low single digit range, demonstrating a lack of appetite for other new assets outside of municipals. Consistent with this finding, 33% responded that they are not considering any of the new assets classes listed in our survey, a result that is fairly close to last year's responses.

As expected, when advisors have positive sentiment towards an asset class they are more likely to be more bullish about the class. Alternatives, commodities and municipal debt each register slightly bullish to bullish responses in the 40-45% range. U.S. corporate debt (high yield) generated the greatest number of negative responses, with over one-third of advisors responding as bearish or slightly bearish. This likely reflects the preponderance of cautious financial media coverage of the high yield market in 2014 and the aforementioned consensus view of the higher interest rates going forward.

FIGURE 4: Asset Classes Under Consideration or Evaluation in Coming Year (2014 vs. 2013)

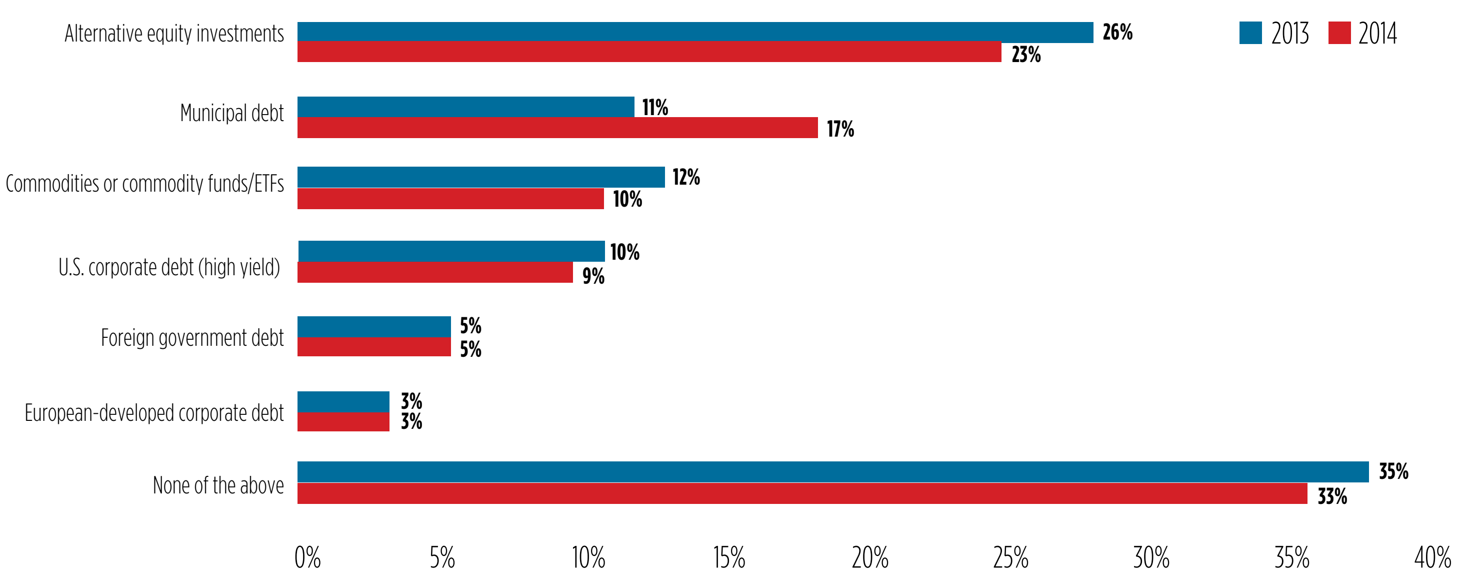
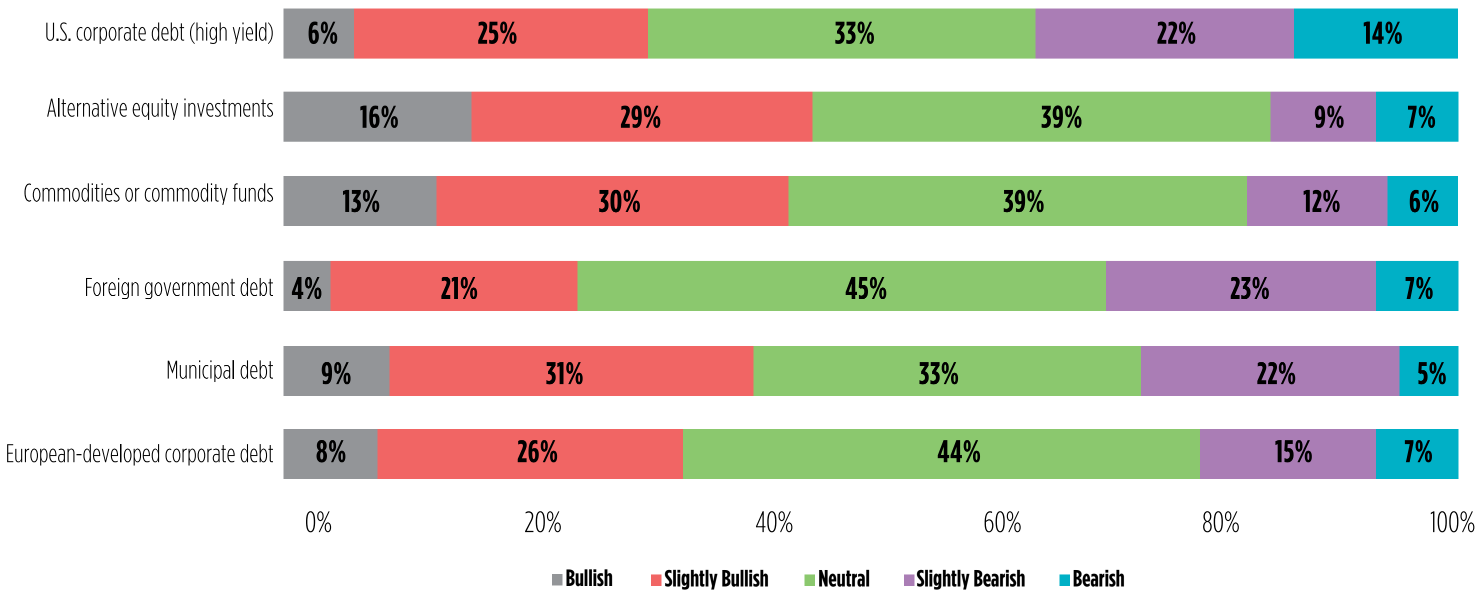


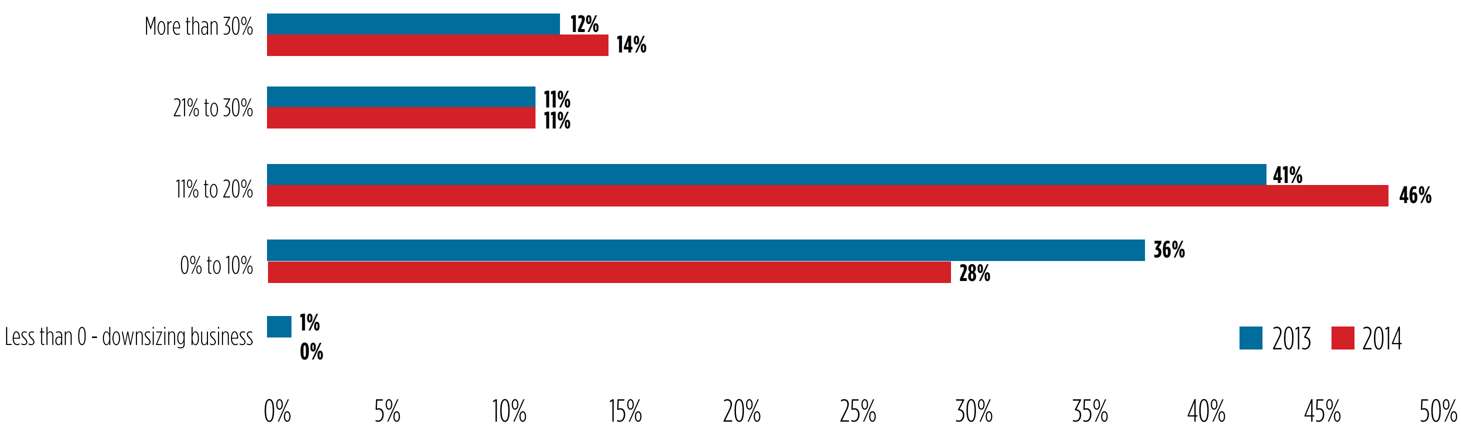
FIGURE 5: Sentiment Towards Asset Classes Under Consideration or Evaluation in the Coming Year



EXPECTED GROWTH RATE OF ADVISORY BUSINESS OVER THE NEXT YEAR

The continued economic recovery and equity market performance has kept growth expectations relatively constant compared to prior surveys. As we observed last year, a large majority of respondents – 77% in 2013 and 74% in 2014 – expect either moderate growth of 11% to 20% or slow growth of 10% or less. However, the mix within these categories reflects a bit more optimism this year, with those expecting 0-10% growth falling to 28% of respondents from 36%, and those expecting 11-20% growth rising to 46% from 41%. In addition, there is also a small increase – 14% this year vs. 12% last year - in the most optimistic segment of advisors who expect growth over the next year to be greater than 30%. The apparent increase in optimism likely reflects solid AUM growth over the past few years and stronger confidence in the sustainability of the U.S. economic recovery.

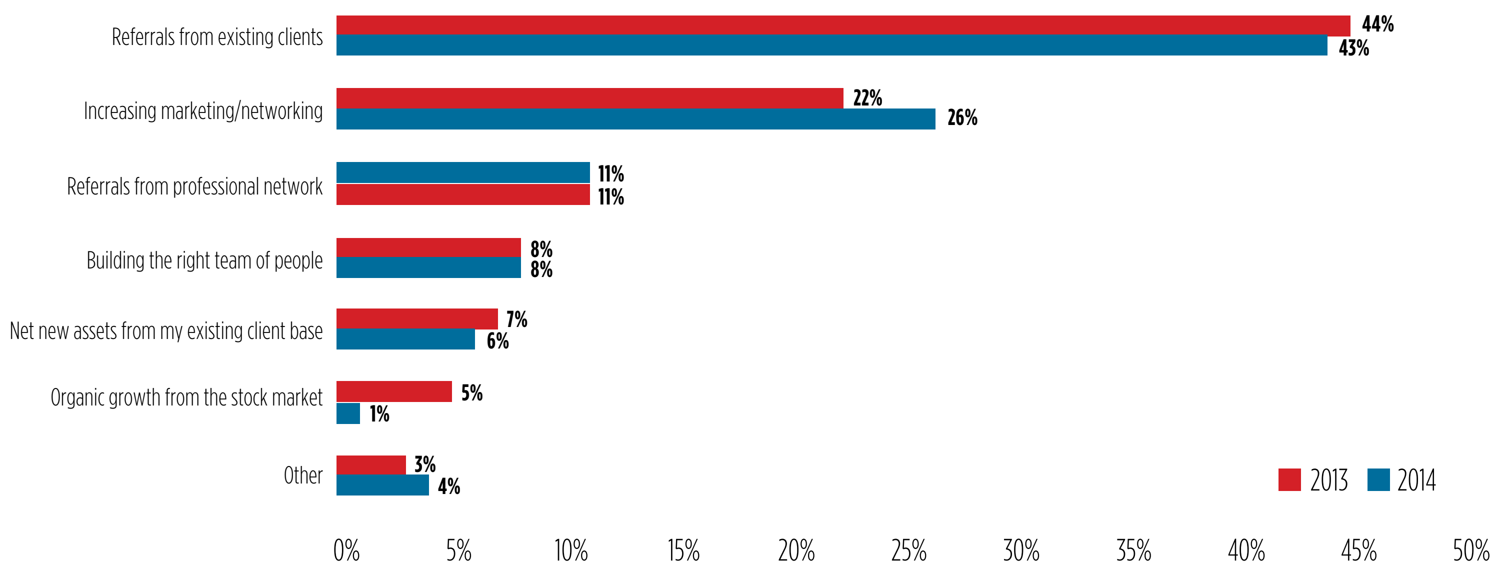
FIGURE 6: Expected Growth Rate Over the Next Year (2014 vs. 2013)



KEY DRIVERS OF GROWTH IN THE NEXT FIVE YEARS

Referrals from existing clients were, by a wide plurality, again the leading driver of sustained growth this year, coming in at 43% of respondents, essentially the same as last year. The previous second place growth driver, increasing marketing/networking, remained in the number two spot, increasing from 22% to 26%. Even though the increase is small, it is interesting when viewed in the context of advisors' view of organic growth due to stock market appreciation, which is down to 1% from 5%. This indicates that advisors are proactively taking steps to ensure they continue to grow their practices even if the equity market momentum begins to wane. With respect to other key growth drivers, the percentage of respondents indicating referrals from professional network, building the right team of people, and new assets from existing clients are very consistent year-to-year.

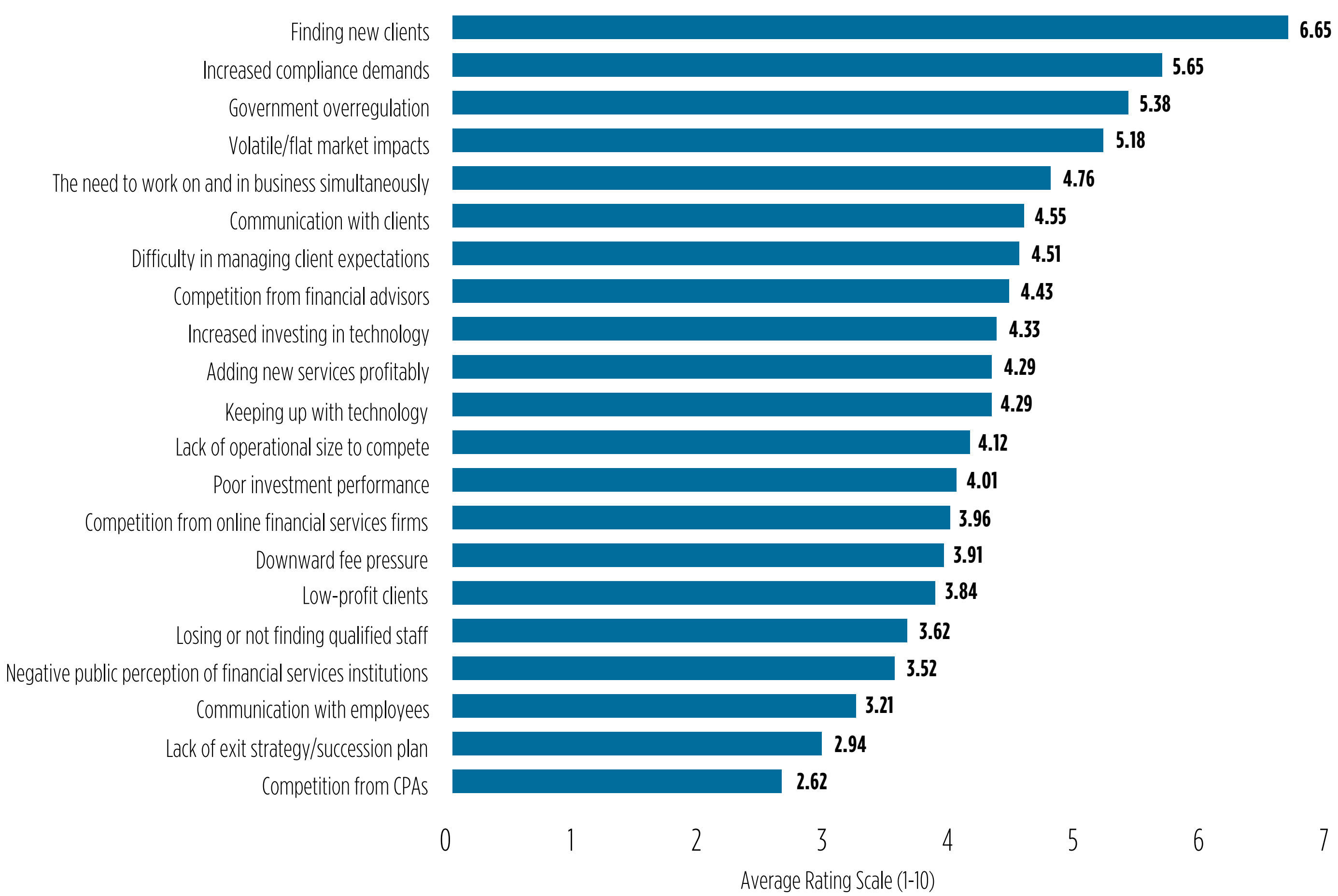
FIGURE 7: Key Drivers of Growth in the Next Five Years (2014 vs. 2013)



BIGGEST THREATS TO ADVISORS' BUSINESSES

The methodology used for this question was consistent with last year's survey. In contrast to naming one or more issues from a predetermined list that were considered to be the biggest threats to their practice, advisors addressed each and every threat, ranking them on a scale of one to ten. Not surprisingly, the top four threats remained the same as last year: finding new clients, increased compliance demands, government overregulation, and volatile/flat markets. One response with notable movement in ranking is communication with clients, coming in at #6 on this year's list compared to #11 in 2013. Factors that appear to of very little worry to advisors include competition from CPAs, lack of exit strategy/succession plan, and communication with employees, also consistent with our observations from the 2013 survey. Nearly all of the other factors are generally tightly bunched in the middle of the distribution of responses and are generally consistent with last year.

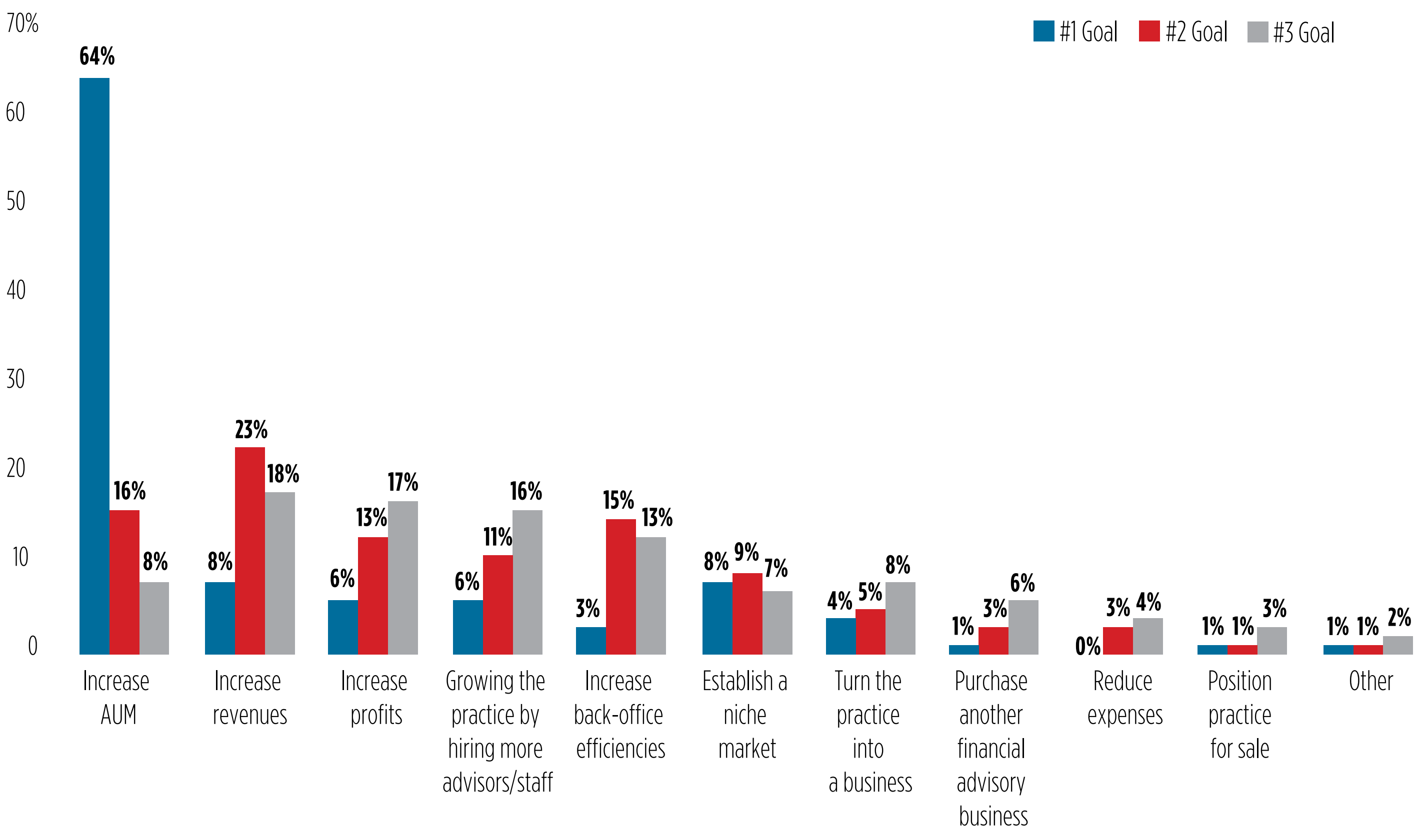
FIGURE 8: Biggest Threats to Advisors' Businesses (2014)



TOP GOALS OF INVESTMENT ADVISORS

As would be expected, the top goal of RIAs this year remains increasing assets under management. With 64% of advisors reporting AUM growth as their primary goal for 2014, and another 24% listing it as secondary or tertiary, nearly all respondents include it on their list of top priorities. Beyond this dominant objective, increasing revenues was listed by almost half of respondents and increasing profits was listed by over one-third. Almost a third of respondents report that increasing back office efficiencies was a top-three goal, a level consistent with those indicating growing the practice by hiring additional staff. Almost none of the advisors surveyed indicate selling their business as an important objective, at least in the near term. Additionally, very few indicate they plan to purchase another financial advisory business. Based on this hierarchy of goals, the RIA space does not look like it will be experiencing an unusually high rate of consolidation in the near future as advisors appear to be more focused on growing their businesses organically and increasing profits.

FIGURE 9: Top Goals of Investment Advisors (2014)



KEY TAKEAWAYS

- Approximately 60% of advisors are bullish or slightly bullish on the global, U.S., and regional economies.
- Advisors in the West are the most optimistic with the highest percentage of bullish managers of any region (30%) whereas only 16% of managers in the Northeast are solidly bullish about their regional economies.
- While over half of advisors are bullish on U.S. equities, value strategies are now strongly favored over growth, and large cap firms solidly preferred to small cap, indicating more risk aversion than observed in last year's survey.
- The percentage of advisors evaluating alternatives dropped to 23% from 26% last year, while those evaluating municipal debt increased to 17% of respondents compared to only 11% last year.
- Seventy-four percent of respondents in 2014 expect either moderate growth of 11% to 20% or slow growth of 10% or less, almost identical to the 77% in 2013.
- The top driver for growth in the next five years for RIAs is still referrals from existing clients, remaining essentially unchanged at 43%.
- Finding new clients, increased compliance demands, government overregulation and volatile/flat market impacts remained the top four threats to advisors' businesses in 2014.
- Sixty-four percent of advisors stated that increasing AUM is their primary goal for 2014, with another 24% listing it as secondary or tertiary; nearly all respondents included it on list of top priorities.