CLS Advisor IQ Series

PROPEL YOUR BUSINESS FORWARD:

The inside track to choosing and implementing ETF strategists

in collaboration with iShares by BlackRock

advisor IQ
By CLS Investments

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Executive Summary

- Financial advisors face a broad set of industry challenges that may have an impact on overall profitability. These include: volatile markets, increasing client demands for service, a tougher regulatory environment, rising costs, and a lack of scalability.
- Leading advisors are adapting their businesses to meet these challenges by embracing new investing innovations. They are focusing on what they do best – managing client relationships – while looking for ways to partner with third-party providers to bring institutional-caliber support to their investment process.
- Advisors are partnering with leading third party money managers who are innovative by specializing in managing portfolios of Exchange Traded Funds (ETFs). There are now over $55 billion in assets with ETF Strategists (as of September 2012), with that figure expected to more than double to $120 billion over the next two years.*
- Working with ETF Strategists allows advisors to gain institutional access to the complex trading environment for ETFs, which can result in lower trading costs.
- Outsourcing to an ETF Strategist also enables advisors to manage accounts under $175,000, a level at which an advisor may typically lose money by managing in-house.

ETF STRATEGIST | DEFINED*

Registered Investment Advisors (RIAs) or asset managers offering ETF asset allocation models at the core of an outsourced investment solution business. These firms also offer additional services including portfolio management/construction, client asset allocation, rebalancing, performance reporting, and investment research.

- When considering ETF portfolios, advisors should understand the role ETF Strategists play. Advisors manage the client relationship, provide financial and investment planning advice, and determine implementation. ETF Strategists are a key part of that implementation, as they bring a deep understanding of the ETF marketplace and contribute their trading expertise to construct model portfolios of ETFs, while managing the day-to-day research, trading, and operations.
- Due diligence considerations for ETF Strategists include having a consistent investment process and the requisite size, scale, and track record (GIPS compliance) to implement that process with an institutional presence to ensure best execution.
- Due to the flexibility and choice an ETF Strategist brings to portfolio construction, advisors can determine exactly how to use an ETF Strategist in a way that complements their specific skill set and business focus, including using a "multiple manager" approach.
- By outsourcing investment management, advisors remain the quarterback of the client relationship, while ETF Strategists take on the day-to-day research, trading and operations. Some leading advisors categorize this approach as, "I can extend my back office to a team of specialists who are skilled in portfolio management and who have the institutional presence to bring my clients results."

* iShares ConnectSM Guide to ETF Investment Strategies, December 2012

* The Growing Marketplace for Outsourced ETF Investment Strategies: An iShares ConnectSM Research Study.

Introduction

As part of our joint commitment to helping advisors succeed in today's challenging operating environment, CLS Investments and iShares® are working together to create actionable content designed to help financial advisors enhance their service offering and run a better business.

This report will identify the key industry issues facing advisors today that are threatening profitability. These include: volatile markets, increasing client demands for service, rising costs, and a more complex regulatory framework.

To succeed in these challenging times, leading advisors are adopting new practice management philosophies and innovative approaches to portfolio management by partnering with third party money managers who specialize in modern investment vehicles, such as ETFs.

These "ETF Strategists" can provide a cost-effective, scalable, and differentiated service offering that can help decrease the time an advisor spends on portfolio construction and maintenance, while increasing the time he or she allocates towards building profitable client relationships.

We invite you to learn more at www.clsinvest.com and www.ishares.com.

Industry Issues

Being a financial advisor these days is becoming increasingly challenging, particularly as we continue to experience volatility in the markets. Investors have seen their money take an intense ride through two severe bear markets in just the past decade. Despite the recent run up in equity values over the past couple of years, investors are still reeling from this market roller coaster.

As a result, clients are increasing demand for their advisor's time to help them navigate these ups and downs. In particular, as the massive baby boomer demographic continues to cycle toward retirement, advisors will be pressed to find the capacity in their firms to take on more clients, while at the same time managing a more complex business operation.

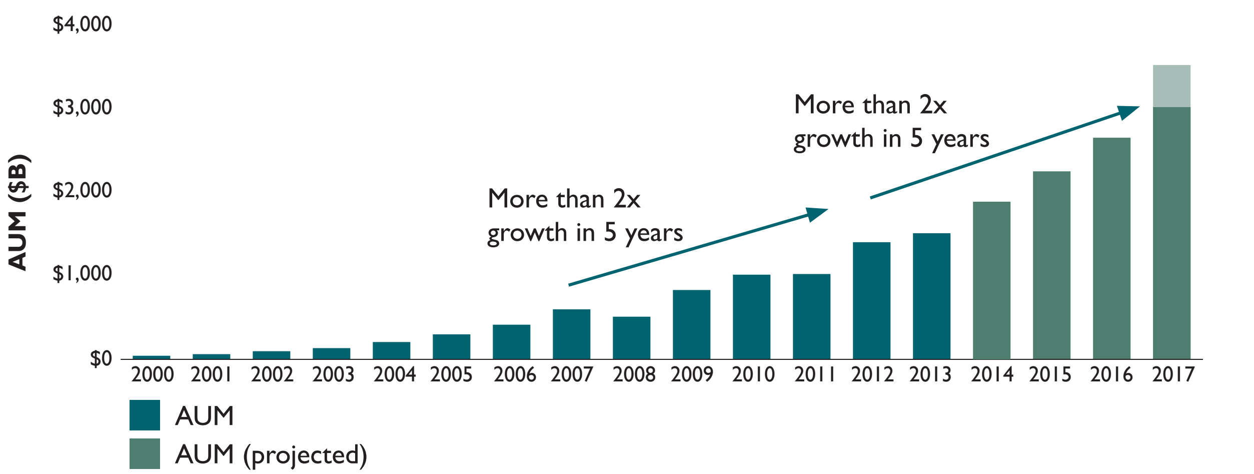
Historically, advisory businesses have focused on a high level of personal service and a reliance on manual processes. Add in the ever-changing compliance requirements from a more complicated regulatory environment, as well as increasing costs for advisor and service professionals, and advisor profitability is under pressure.

In addition, clients these days are looking for new investment approaches, particularly after experiencing the extreme volatility in their investments over the past decade. For many clients, traditional buy and hold strategies have not delivered the results they needed to fund their goals, nor managed their risk as they approached retirement.

As a result, innovation in investment products, services, and managed solutions is expanding rapidly. The use of ETFs in client portfolios is an example of this growth, as ETF assets are expected to exceed $1.8 trillion by 2014.* This ETF growth is a result of the many advantages they offer, including low cost, transparency, tax efficiency, and precision for gaining exposure to specific sectors and asset class segments. These powerful features and benefits make ETFs a critical tool advisors need to consider as they manage client portfolios.

ETF Growth

ETF assets could more than double to $3.5 trillion by 2017



Source: As of May 31, 2013. Source: BlackRock and Bloomberg

** As of May 31, 2013. Source: BlackRock and Bloomberg*

ETFs, however, represent a different market to enter and exit than with which most advisors are familiar. With the proliferation of over 2,700 ETFs globally*, it can be a difficult process for advisors to manage efficiently.

So, what are leading advisors doing to not only survive these challenging times, but to also strive to profitably grow their businesses? They are adapting their firms to embrace new investing and technology innovations. They are focusing on what they do best, which is managing client relationships, while looking for ways to partner with best in breed third-party providers to bring institutional-caliber support to their investment process.

Advisors are increasingly partnering with leading innovative third party money managers specializing in ETF portfolio management. This solution is rapidly growing due to the experience, knowledge, and institutional presence ETF Strategists bring to the relationship. In fact, there are now over $55 billion** in assets with ETF Strategists (as of September 2012), with that figure expected to more than double to $120 billion by 2015.***

** Advisors Turn to ETF Investment Strategists - Growing Assets and Increasing Client Value: iShares*
*** iShares ConnectSM Guide to ETF Investment Strategies, December 2012*
**** The Growing Marketplace for Outsourced ETF Investment Strategies: An iShares ConnectSM Research Study*

The Benefits of Using an ETF Strategist

ETF Strategists are third party money managers who utilize ETFs at virtually every stage in the investment process, from building comprehensive asset allocation models to executing tactical strategies. ETF Strategists are emerging as a popular solution for financial advisors because of their experience and knowledge of the ETF marketplace, along with their ability to complement the portfolio management and investment process of advisors.

ETF Strategists have formed a market niche by thoroughly understanding the intricacies of ETF structures, as well as how to deploy ETFs to help minimize trading costs, improve tax efficiency, and meet a variety of investment objectives.

Additionally, using ETF Strategists can provide savings to clients because of their ability to lower trading and execution costs. Because of their institutional presence and ability to interact directly with trading venues and counterparties, ETF Strategists can bring a significant trading cost advantage compared to what an individual advisor receives when executing client ETF trades. These savings include the elimination of typical trading commissions as well as the ability to achieve better execution.

CLS internal analysis shows that, due to their sheer trading volume, ETF Strategists can absorb the typical $10 - $15 ticket charge that the advisor's client would pay if the advisor did the trade on his or her own. In addition, an ETF Strategists' direct access to trading venues and market makers means their execution costs can be as low as 2-3 basis points per transaction, while individual advisor trades that go through the exchanges can be in the 10-15 basis point range. For smaller accounts, such as those less than $50,000, the trading costs can be as high as 70 basis points for advisors and their clients.*

On the practice management front, when advisors partner with an ETF Strategist, they free up valuable internal resources and are able to redirect toward enhancing their client service offering and spending more time on business development. These practice management benefits can actually be quantified in terms of portfolio size and when it makes sense to outsource smaller portfolios.

Based on industry data*, the cost to service the average account is roughly $2,250 per year. This figure is derived by including the average costs for portfolio construction, monitoring and reporting, as well as other client servicing costs, and is calculated based on internal CLS analysis. When this cost is compared to the average fee revenue generated (according to CLS, approximately 1.18 percent, based on the average cost that advisors charge, including both fees and commissions), then the breakeven account size for advisors is roughly

$190,000. Therefore, advisors are basically losing money on any account under that amount. This underscores the benefit of outsourcing management of those smaller accounts to a third party. By doing so, advisors recover, on average, added business development time that translates into a roughly a 6 percent revenue increase in the first year, with that number expected to compound over time.

Lastly, compliance risks are increasing. Popular “Rep as Portfolio Manager” programs are creating exposure to potential liability issues for firms, particularly as the industry is moving towards a fiduciary standard of care. ETF Strategists are regulated entities that have fiduciary and other compliance responsibilities as independent, fee-based Registered Investment Advisers and can play a role in helping to minimize risk. Of course, advisors should do their own due diligence on the ETF Strategists they utilize.

**CLS Trading Review & Trade Execution Effectiveness Report, January 1, 2013 - March 31, 2013*
***An aggregation of Tiburon, Pershing, and Northern Trust advisor productivity metrics*

BENEFITS OF ETF STRATEGISTS

- ETF knowledge, experience, and trading expertise
- Portfolio construction suited to client profile and investment needs
- Client cost savings by helping minimize trading commissions and execution costs
- Ability to free up advisor time for client service and business development
- Potentially profitable channel for accounts under $175,000 enrollment support

The Role of ETF Strategists

When constructing portfolios, it is important to understand what roles the ETF Strategist and advisor will play, and how the role of an ETF Strategist compares to a traditional asset manager.

ADVISOR	ETF STRATEGIST
Manage client relationships and provide planning	Provide ETF market analysis and trading expertise
Define investment objectives and strategy	Construct model portfolios of ETFs
Determine implementation	Manage day-to-day research, trading, and operations
Select ETF strategist	Implement strategies

Advisors manage the client relationship, provide financial and investment planning advice, define investment objectives, and determine how portfolio recommendations will be implemented.

ETF Strategists are a key part of that implementation, as they bring a deep understanding of the ETF marketplace and contribute their trading expertise to construct model portfolios, while managing the day-to-day research, trading, and operations for the advisor-designed strategy implementation. In addition, ETF Strategists typically provide dedicated phone lines for advisor service, as well as direct access to ETF analysts for questions and other portfolio implementation information.

When compared to a traditional asset manager in a mutual fund construct, ETF Strategists have a number of advantages. With actively managed mutual funds, advisors and their clients may run the risk of "style drift," which is when a mutual fund's holdings "drift" from one asset class to another. Since mutual funds are only required to disclose holdings once per quarter, a portfolio holding the fund may be subject to unintended asset class concentrations that vary from its stated objective and change the risk/return characteristics of the portfolio without the advisor's knowledge. This may not seem important on the surface, but it could create unwanted additional risk and over or under exposure to an asset class in the portfolio. Additionally, with mutual funds, investments are sold at the discretion of the fund's manager, potentially creating unnecessary capital gains and tax inefficiencies for shareholders, whether they wanted them or not.

Conversely, due to the way ETFs are built and traded, these style drift and tax problems are minimized. ETFs also provide precision in matching investments to specific asset classes as they are designed to hold the exact securities that make up an index, sub-index, key benchmark, or other requirement. However, ETFs of common stock or individual securities have associated management and transaction fees. ETFs carry similar risks to those of stocks and returns will fluctuate and are subject to market volatility, so an investor's shares, when redeemed or sold, may be worth more or less than their original cost. These underlying funds are selected based on the security selection methodology used by each fund's advisor.

ETF Strategist Due Diligence

Since not all ETF Strategists are created equal, it is important that the advisor conduct due diligence on the firms he or she is considering. Advisors should look for firms with a consistent investment process, as well as the size, scale and track record (compliance with Global Investment Performance Standards (GIPS)) to implement that process.

DUE DILIGENCE CHECKLIST

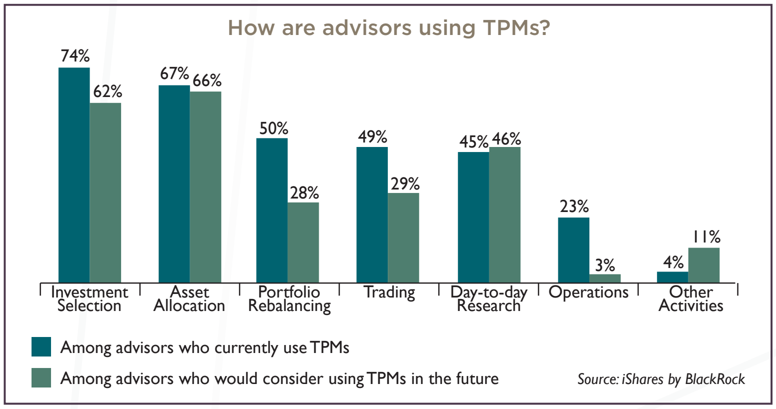
- Consistent process
- Size, scale and track record (GIPS)
- ETF knowledge and expertise
- Investment strategies that meet needs of client and advisor
- Client service approach
- Advisor advocacy
- Ease of implementation
- SSAE 16 compliant

Additionally, the firm should have deep knowledge and expertise in ETFs and how they are traded, as well as an institutional presence to ensure best execution. ETF Strategists should also have the investment strategies and model portfolios that meet the specific needs of the advisor and client.

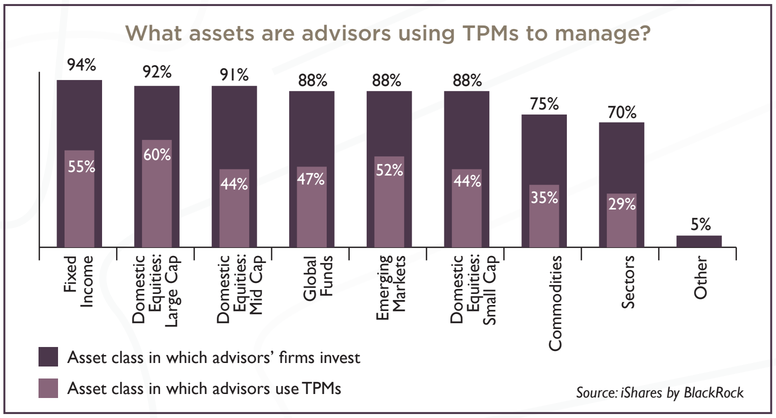
On the client service front, the ETF Strategist should be easy to work with, support the advisor's business and provide a strong technology and operational foundation to simplify the advisor's back office.

ETF Strategist Options: Flexibility and Choice

Multiple options exist for deploying ETF Strategists in portfolios and it's important to remember that it isn't an "all or nothing" proposition. Due to the flexibility and choice an ETF Strategist brings to portfolio construction, leading advisors are determining the optimal positioning for an ETF Strategist that complements their specific skill sets and business focus.



When advisors are determining the best way to invest in a specific asset class where they don't have the expertise or internal resources to manage, they can bring in an ETF strategist to specifically address that specialized sector, such as small cap or large equities, commodities, real estate, and international. In this case of "portfolio completion," advisors can efficiently use an ETF Strategist to complement the overall portfolio they are constructing.



Using an ETF Strategist also gives advisors the ability to construct a "multi-strategist" portfolio in which the advisor deploys multiple ETF Strategists to address various aspects of the portfolio. Advisors can select best-in-breed ETF Strategists for each asset class they are looking to gain exposure. A top ETF Strategist communicates not only with the advisor, but also with other ETF Strategists regarding the best fit for a portfolio.

For advisors who are looking to outsource the entire portfolio construction and implementation, they can look to an "Outsourced CIO" model. In this case, the ETF Strategist manages the entire client portfolio.

One of the more popular and emerging approaches among advisors is to use the multi-strategist approach. Advisors are using multiple ETF Strategists, many of whom are Third Party Managers (TPMs) who specialize in various asset classes or investing styles. According to iShares Brand Tracker Survey from 2011, almost 60 percent of retail advisors are using TPMs and the majority of these advisors claim to be using more than one. The highest use of multiple ETF Strategists is in the regional wirehouse and bank brokerage channels. Almost 40 percent of independent broker dealer advisors use more than one ETF Strategist and/or TPM.

According to the report, the majority of financial advisors are using ETF Strategists for investment selection and asset allocation, across all asset classes. Use of ETF Strategists for fixed income is higher among RIAs (68 percent) and wirehouses (72 percent) compared to other channels (44 percent – 50 percent).

Implementation

In some cases, financial advisors have been reluctant to place investment management responsibilities in a third party's hands, particularly if it is a key part of their value proposition to clients.

However, as previously mentioned, it is not an all-or-nothing proposition. Advisors can remain the quarterback of the client relationship, while ETF Strategists can take on the day-to-day research, trading, and operations for the portions of the portfolio invested in an ETF managed account. Some leading advisors categorize this approach as, "I can extend my back office to a team of specialists who are skilled in portfolio management and who have the institutional presence to bring my clients the best results."

Other ways advisors are introducing the concept of using an ETF Strategist to their clients is to highlight their depth of experience, credibility, and track record. According to Andrew Oster of Triton Wealth Advisors, "these specialists can bring all of that experience to bear on one goal, which is the objective of your portfolio."

Research with advisors reveals some compelling reasons why they are working with ETF Strategists. As Oster points out, "we know that ETFs have significant advantages, however we grew up fluent in the mutual fund world. When it comes to ETFs – how to access them, how to trade them, how to use them for a client's advantage – the complexity is remarkable. There is no Morningstar for ETFs."

Additionally, advisors are pointing to the fiduciary standard of care for why they need to have a consistent investment process and how they actually implement that process, client by client. Oster says, "if we need to make a change in our portfolios, we don't want to be in the position of having to decide who goes first and who goes last. Using a third party removes that potential conflict for us."

CLIENT CONVERSATION STARTERS

- "I can extend my back office to a team of specialists who are skilled in portfolio management and who have the institutional presence to bring my clients the best results."
- "These specialists can bring all of their experience to bear on one goal, which is the objective of your portfolio."
- "As part of our investment process, our philosophy is to implement a consistent money management style, which can be done on a daily basis. Whether someone here is sick, or traveling, or no matter what's happening in the markets, your institutional money manager is available 24 x 7 to ensure that your portfolio is being monitored and managed. All of this for a reasonable cost."
- "These specialists share our philosophy for investment management and have a wealth of resources to manage portfolios."

Conclusion

As the operating environment for the financial advice industry continues to be impacted by client demographics, regulatory changes, and new investment products and investing approaches, advisors will need to continually examine how they can harness the best of what's available to continue to move their businesses forward.

Leading advisors are transforming their firms by looking to innovative solutions to build a solid infrastructure for growth, scalability, and enjoyment. As part of that process, these leading firms are embracing ETF Strategists as one way to facilitate their evolution, gain scale in their businesses, and capitalize on growth opportunities.

Advisors owe it to themselves, their clients, and their businesses to learn more about how to harness the practice management and client service benefits of working with these innovative investment firms.

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