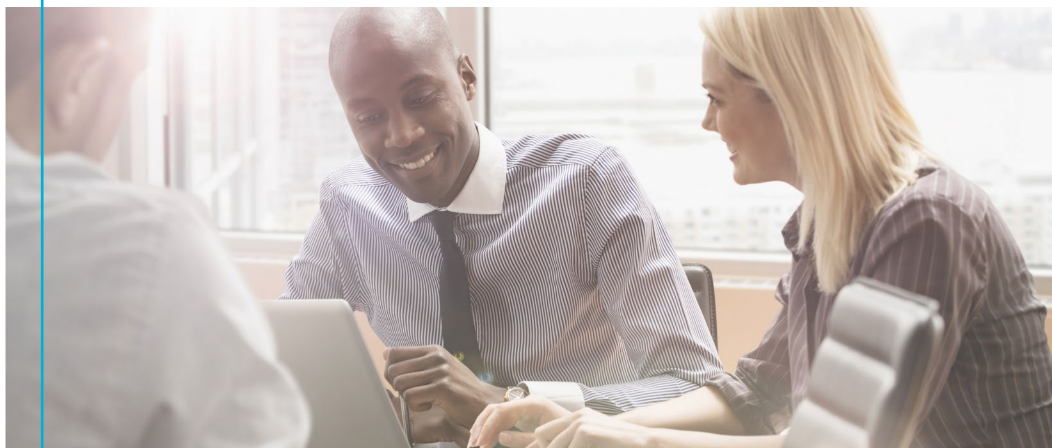
2017: POSITIONING YOUR FIRM FOR GROWTH MOVING FORWARD

Mercer has identified 10 priorities that wealth management advisory firms should consider in order to best serve their clients in 2017, and to help them stand out in an increasingly competitive environment.



1

ARE YOU READY FOR PENDING REGULATORY CHANGES?

Regulatory change continues to dominate the agenda for wealth managers around the world. In the US, wealth managers have until April 10, 2017, to comply with the Department of Labor's Fiduciary Rule, while MIFID II legislation will place additional onerous regulatory requirements on wealth managers in Europe. Amid these changes and ever-increasing pressures on fees, wealth management firms should take this as an opportunity to revamp and differentiate their businesses as more robust relative to the competition as well as clearly communicate this as their value proposition. Regulations increasingly demand that the investment recommendation process be documented and that financial advisers fully understand the benefits and risks of the products they discuss with their clients and ensure that these risks are consistent with the client's risk profile.

2

ARE YOUR REVENUE AND COMPENSATION MODELS ALIGNED FOR CLIENT SUCCESS?

Recent regulatory actions have brought an increased focus on identifying and mitigating conflicts of interest in interactions with retail consumers, while also supporting growth and profitability. On the revenue side, the trend from a transactional to a fee-based business has been accelerated by new regulations, particularly in the US, as the traditional brokerage business, which has higher revenue per transaction, is replaced with a more relationship-oriented and lower-initial-revenue fee-based business and firms have had to adapt their models to focus more on scale in order to maintain profitability. Firms should explore technological and outsourced solutions to enhance their business models and allow their advisors to focus on client service and new client acquisitions. On the compensation side, firms should not only consider how their programs attract, retain and incentivize sales talent, but also the unintended consequences of their programs.

3

IS ACTIVE MANAGEMENT STILL WORTH IT?

The industry continues to see large flows moving from active to passive management. The move has been driven by a focus on lower fees as well as recent underperformance by active managers. From an ex post view, strongly upward markets are environments in which indexes will perform better than active management. Now that we are nearly eight years into a bull market and interest rates are at all-time lows, the prospects for return from beta (passive management) have diminished and the time for alpha (active management) is now. In particular, active strategies that seek to protect downside risk and focus on idiosyncratic return streams should be emphasized within a portfolio. Given the increased pressure on fees, we recommend fee budgeting — using active management more efficiently — in the asset classes that have the best prospects of producing alpha as a way to maximize your expected alpha, given a total fee constraint.

A number of passive "smart beta" products have come onto the market in recent years, and while these releases purport to fix the issues of standard index products, they remain rules-based and rely on the persistence of the factors incorporated into their process. We believe that these smart beta products can supplement active managers in attaining appropriate portfolio-level risk-factor exposure.

4

ARE YOU LEVERAGING TECHNOLOGY TO PROVIDE ECONOMIES OF SCALE AND TO CATER TO CHANGING CLIENT COMMUNICATION PREFERENCES?

The fintech revolution is here to stay, and there are a variety of technology companies that can provide back-end and front-end solutions. Some of the new solutions aim to support compliance efforts with new regulations, streamlining process and decision documentation. The more wealth managers can successfully automate to free up their time for clients, the more scalable their businesses will become. However, the choice of outside providers must be done very carefully, as this decision is considered a fiduciary decision. When selecting a technology solution, it is of the utmost importance to complete operational (and investment, where appropriate) due diligence, particularly if the solution will form the backbone of your own operations.

5

ARE "ROBO ADVISORS" A GOOD FIT FOR YOUR OPERATION?

Computerized investment, or "robo advice," continues to attract assets at a swift pace. Instead of viewing it as a threat to existing business models, we believe wealth managers should embrace this technology as part of a firm's long-term strategy. We have already seen an uptick in robo-advisory solution integration (through both in-house development and acquisition) into existing traditional wealth advisory firms. Advisors should be seeking ways to incorporate a robo advisor option for less complex client segments. As more millennials begin investing their money and look for greater comfort with online financial services in other market segments, they will actively seek easier, low-cost, do-it-yourself ways to build their wealth.

Advisors are increasingly looking for ways to segment their books, and a robo-advisor solution provides them the opportunity to seed relationships for when the investment portfolio is of a scale that could benefit from additional sophistication and time. The time to consider the impact of this technology on your firm's long-term growth is now. We believe that wealth management firms that embrace this technological change (whether they implement a robo-advisor or not) and serve their clients through rigorous due diligence will be well-positioned for growth.

6

WOULD PARTNERING WITH OTHER PROVIDERS BETTER SERVE YOUR NEEDS?

In addition to implementing technological solutions, wealth management firms should consider how they staff their investment functions and equip them with resources. A re-evaluation of genuine competitive advantage will enable wealth managers to focus on core strengths and develop the optimal blend of internal resources and outsourced or delegated research and investment solutions. Tougher regulatory requirements may necessitate greater governance and documentation around investment decision processes. Covering these processes may require too large of an investment or too long of a timeline to develop in-house.

7

WHEN INVESTING IN A LOW-RETURN ENVIRONMENT, ARE ALTERNATIVES PART OF YOUR STRATEGY?

High valuations in the equity market after a nearly eight-year bull market combined with low yields in fixed income markets will make it more difficult for portfolios to reach their return objectives. In a low growth world, returns across asset classes are likely to be lower over the coming years. Some approaches to addressing the market issues are shortening duration risk, reducing leverage, increasing allocations to floating rate instruments, as well as incorporating currency hedging programs. In addition to these strategy changes, we believe that alternatives will increasingly play a key role in portfolios as investors take on additional/differentiated risk in order to capture the type of returns generated in the past. Advisors will need to note the types of risk they are taking on — alternatives tend to carry some combination of illiquidity and alpha risk. As wealth managers allocate more client capital to alternatives (both liquid alternatives and illiquid private markets), greater analysis and understanding of their clients' overall factor exposures is critical. Alternatives can provide different sources of returns and risks, but they also tend to offer far more flexibility than traditional, long-only investments.

8

ARE YOU INCORPORATING ESG INTO YOUR INVESTMENT ADVICE?

Overall, firms are responding to client demand as assets continue to shift toward millennials and women. In the US, the DOL provided guidance in 2015 that explicitly allows fiduciaries to consider environmental, social and governance issues when making their investment decisions. We believe that this fits well within the shift in the industry to a more goals-based wealth management process that can incorporate both financial and non-financial goals in an investment program.

The number of ESG-conscious funds is also growing as managers look to further differentiate their offerings to wealth management providers among a growing trend toward platform rationalization. One of the key changes in the product offerings to wealth management firms is less negative screening and more ESG and impact investments, as clients seek to effect positive change rather than just avoid the typical SRI criteria.

9

ARE YOU DISCUSSING GOALS-BASED ADVICE WITH YOUR CLIENTS?

Objective or outcome-based advice and solutions, tailored to different demographic and risk-profiled client segments, have become established and will increasingly act as the default solution in wealth management, challenging the traditional "one size fits all" model. We anticipate that the providers will increasingly include postretirement portfolios that focus on investor draw-down (income generation). The most successful solutions will be designed to achieve clearly identifiable objectives related to an individual's capacity to enjoy an adequate and sustainable income in retirement, at a reasonable cost. These solutions are specifically designed to manage the multiple risks faced in retirement, such as inflation risk and sequencing risk.

Wealth advisors should be aware of clients' non-financial goals related to their investment program. Are they looking to ensure that their investments are not causing harm to the environment or to workers' lives? Or are clients looking to have a positive impact on the world with less of a focus on maximizing portfolio returns?

10

ARE YOU TAKING ADVANTAGE OF DISCRETIONARY PORTFOLIO SOLUTIONS?

The volume of assets held in discretionary or managed accounts continues to increase each year. This is largely the result of changes in the market environment and intergenerational wealth transfer. More wealth managers are offering discretionary portfolio solutions as a way to capture a bigger share of their clients' wallets. Assets in discretionary portfolios also tend to be stickier, providing a steadier stream of recurring revenue. Nevertheless, some clients are still not comfortable relinquishing full control of investment decisions and allocations. This is giving rise to the quasi-discretionary model, also known as active advisory.

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