

THE SHERIDAN ROAD MAP

The Best Route to Financial Success



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GUNNING FOR GROWTH

RIA firms estimate that they'll see 15% revenue growth this year. An emphasis on efficiency will free principals to go after new business again.

How high is up? That might seem like an odd question for registered investment advisors to be asking midway through a recovery year that still feels tentative and just six months after a year in which many firms endured a double-digit drop in revenue.

But the fact is that despite an admittedly very tough stretch, RIAs have weathered the financial storm far better than their competitors on Wall Street who have lost hundreds of billions in client assets. Indeed, the RIA industry seems to be at a critical inflection point, coming through the past few years remarkably strong and at the threshold of potentially explosive growth as more people—and advisors for that matter—see the strength of the RIA business model. Things look especially promising for RIAs who are focusing on efficiency and finding ways to spend more time serving clients.

Those are some of the headlines from the newly released 2010 Charles Schwab RIA Benchmarking Study. The RIAs we surveyed—870 of our clients, with more than \$300 billion under management—estimated that their revenue will increase by a median of 15% this year, a result of continued client additions and the market rebound, which has done its part to replenish assets under management. In addition, many RIAs expect to benefit as existing clients invest bonuses or money from sales of businesses—windfalls that mostly disappeared during the recession.

The storm clouds are breaking, but before RIA firms can make the most of their growth opportunities there is still some ground to make up. Revenue at the median RIA firm fell by 11% in 2009. By and large, RIA firms did not add enough new clients to compensate for the decline in assets under management. As recently as 2007, RIAs were adding eight new clients for every 100 they had. But the median advisory firm ended 2009 with 103 clients for every 100 clients it had at the outset of last year.

Naturally, with asset levels down, client relationships produced considerably less revenue. Median revenue per client dropped 14.4% in 2009, to \$6,900 from \$7,800 in 2008. In 2007, median revenue per client was \$8,400. But despite the financial metrics at play inside most RIA firms, advisors'

clients were certainly not settling for less service. On the contrary, many clients of RIAs spent 2009 asking more questions and demanding more frequent communication and hand-holding.

Given the twin pressures on advisors to placate clients and staunch lost revenue, one pleasant surprise in our 2010 study may be how well RIA firm profits actually held up in 2009. The operating margin of the median RIA firm was 14.8%—down from 18.1% in 2008. RIAs who had been focused on adding staff and clients between 2003 and 2007 appear to have done a good job of reining in their costs in 2008 and 2009.

All the soothing RIAs did for client nerves in 2009 may well turn out to help them develop business.

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Sharper Efficiency, More Productivity

Another silver lining was the motivation RIAs showed in 2009 to focus on the operational efficiency—or lack of it—in their own firms. The inefficiency so easily pushed aside at a firm when it's growing revenue by 25% a year suddenly becomes harder to ignore when profit margins are squeezed. RIA firms often spend too much time on operational and administrative activities—time that could be better spent working directly with clients and on business development.

Advisors in the survey said they spent 30% of their time on operational and administrative tasks in 2009 and only 10% explicitly developing business—which means they are failing to seize growth opportunities. The lack of time they spent on business development was cited as a barrier to growth by 56% of the study participants. The second most common growth impediment was the lack of time they spent developing a marketing strategy (cited by 44% of the respondents); the third was an insufficient marketing budget (39% of respondents said). (See Figures 1 and 2.)

But despite these barriers, advisors tell us they are absolutely planning to grow: 84% of those surveyed plan to grow either aggressively or moderately in the next five years. But how can RIAs both increase their efficiency and devote more time to business development? According to our study, many of them see technology as the answer.

Just about every RIA in the study uses a portfolio management system (95% of the respondents). No surprise there; advisors have made portfolio management systems a foundation of their businesses for years. Most advisors (78%) also use some sort of e-mail retention software or service, a document management system (65%) and financial planning software (62%). In addition, in 2009, an increased number of advisors maintained Web sites with access to client accounts (41% versus 37% in 2008) used rebalancing software (40% versus 37%) or used trade order management software (23% versus 21%).

There is no question that RIAs can be more efficient when they have these technologies in place. For instance, RIAs who used a dedicated rebalancing system in 2009 said they were able to perform that task in 15% less time (the median reported improvement) than when they were doing rebalancing manually or using nonspecific software. And that is just one example.

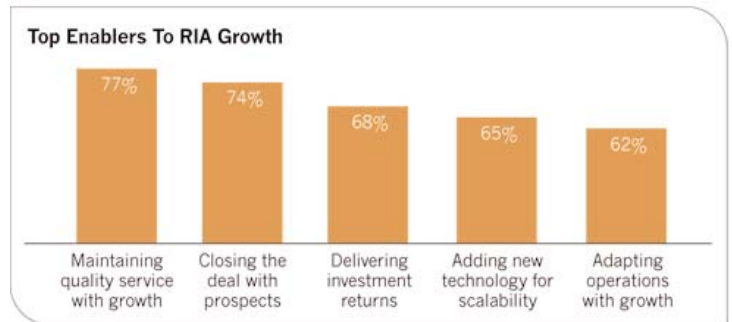
Making More Out Of Technology

This is all good as far as it goes. However, most of the RIAs that have bought these technologies have purchased them only as separate modules and are even then using only a subset of their features. Fifty-three percent of respondents said they faced a challenge in integrating disparate technology systems and components; 47% said they were still figuring out what work-flow and process changes to make to maximize their technology investments (see Figure 3).

It can sap productivity when a firm has its technology systems siloed this way. For instance, if an RIA firm must re-enter client account information multiple times in multiple systems, it adds

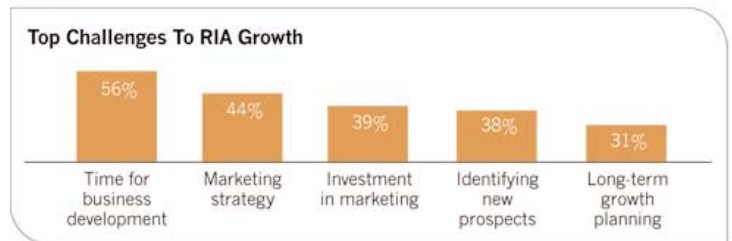
expense, increases the risk of error and draws the firms' principals into activities besides working with clients and growing business. After all, many RIA firms are small, with fewer than ten employees. When something important must be done—with a client's order, with a compliance issue or with a new technology—the people whose names are on the door often have to get directly involved.

Figure 1



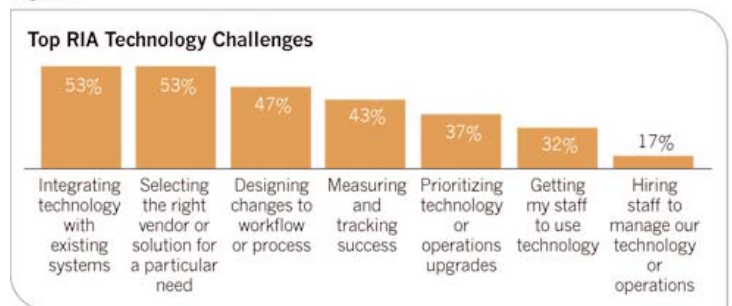
Source: 2010 RIA Benchmarking Study from Charles Schwab, fielded February and March 2010

Figure 2



Source: 2010 RIA Benchmarking Study from Charles Schwab, fielded February and March 2010

Figure 3



Source: 2010 RIA Benchmarking Study from Charles Schwab, fielded February and March 2010

A Focus On CRM

There is no overnight answer to RIAs' technology system challenges. However, one development worth tracking is in the area of client relationship management systems, or CRM. RIAs already clearly recognize the value of CRM systems; nine in every ten advisors regard CRM as being important to their business success, and 84% already use a CRM system.

As the application on the desktops of most employees in an RIA firm, the CRM can become the window into a client relationship, moving well beyond the management of contacts and personal information to include more detailed client information, transaction and performance history, holdings information and client correspondence. Furthermore, with its work-flow management capabilities, CRM software can help manage

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those daily business processes that really take operational efficiency to the next level.

But as it happens, few of the CRM systems at advisory firms today are set up like this. Like other technology, these systems are underused and unintegrated. Nevertheless, they will become more important to advisors and help them narrow the gap between efficiency and scale of service that now still favors the technology-deep wirehouses.

The Time Is Now For Advisors

This brings us back to growth opportunities. There is little doubt that many clients of Wall Street firms are thinking about moving their business after being shaken by the market. According to other research we have done, former clients of full-service brokerage firms remain RIAs' No. 1 source of new assets (according to the Schwab Independent Advisor Outlook Study, January 2010). That may not have amounted to much in 2009, when investors were reluctant to take any action with their assets, in many cases putting off the decision altogether.

However, fortune seems to favor the independent advisor. Cerulli reports that RIAs, independent broker-dealers and

dually registered advisors will nearly match wirehouses' market footprint by 2012, taking a 39.3% market share of assets under management while the wirehouses take 40.7% (according to the Cerulli report, "Advisor Migration: The Changing Landscape of Retail Distribution," 2009). And even though people are taking longer to make the switch, the RIAs in our study remain very confident in their ability to close new business: 74% of advisors report that closing success is a top enabler to growth—the second-highest enabler behind quality of client service. (See Figures 1 and 2.)

In this respect, all the soothing RIAs did for client nerves in 2009 may well turn out to help them develop business. In 2009, 83% of new clients coming into RIA firms came from referrals. That number holds pretty steady in this business every year. But in order to find the time to engage and serve customers in today's new reality, advisors have to pay more attention to efficiency and productivity. Their ability to do that will likely answer the question of how high "up" really is for the RIA industry.

By Bernie Clark • Financial Advisor Magazine, July 2010

ULTRA-WEALTHY PREFER RIAs

Not only are the independent RIAs stealing brokers and assets from the big Wall Street wirehouse firms, they also seem to have greater favor with the super-rich. According to an Aite Group survey of 402 financial advisors from the fourth quarter of 2009, independent RIAs have a greater share of high-net-worth (HNW) and ultra HNW clients than either wirehouse brokers or independent brokers. But the mass affluent own a greater share of the country's wealth. HNW clients, defined as those

with assets of between \$1 million and \$10 million, represent 20% of retail advisory client assets, says the Aite report. Mass affluent clients, those with between \$100,000 and \$1 million in assets, represent 30% of all retail advisory client assets. Mass retail clients, those with fewer than \$100,000 in assets, are a significant client segment for independent b/ds, but also for self-clearing b/ds outside the wirehouse space like Ameriprise and Edward Jones, the report says.

Q: WHAT IS THE SIZE OF THE AVERAGE CLIENT IN YOUR BOOK OF BUSINESS?

Client assets	All segments	independent RIAs	wirehouse b/ds*	independent b/ds	other self-clearing b/ds
< \$100,000	18%	5%	6%	19%	33%
\$100,000 - \$249,000	24%	12%	18%	31%	32%
\$250,000 - \$999,000	32%	38%	39%	31%	22%
\$1 mln - \$9 mln	16%	25%	21%	13%	10%
\$10 mln - \$29 mln	5%	9%	11%	N/A	N/A
\$30 mln+	5%	11%	6%	N/A	N/A
\$100,000 - \$1 mln	56%	50%	57%	62%	54%
\$1 mln+	26%	45%	37%	19%	13%

*Some columns add up to greater than 100% due to rounding.

Source: Aite Group report, April 2010, "New Realities in Wealth Management: Has the Dust Settled?"

CONGRESS GRAPPLES WITH GRATs

The use of GRATs to beat estate and gift taxes still offers some benefits but a new bill could eliminate those advantages

Even with the federal estate tax repealed in 2010, savvy taxpayers are continuing to do estate planning because the tax will roar back to life in 2011, with a new maximum rate of 55%, which is higher than before, combined with a new exemption of only \$1 million, lower than before.

The Senate is currently considering a bill that would cut back on the tax savings generated by one technique that is especially popular with sophisticated individuals and their advisors: The grantor retained annuity trust, or GRAT. The Small Business Lending Fund Act of 2010, which the House of Representatives passed earlier this summer, requires a minimum 10-year term for all new GRATs, eliminates the ability to create a GRAT without causing a taxable gift and requires that the annuity amount payable to the grantor not decrease during the first 10 years of the annuity term.

The GRAT Technique

A GRAT enables an individual to transfer assets to his or her children or other beneficiaries at little or no gift tax cost. To use this technique, the grantor creates a specially designed trust (the GRAT) and transfers assets to that trust. The grantor receives back an annuity each year during the term of the GRAT. That amount is based on the length of the trust and the interest "hurdle rate" set by the IRS for the month in which the GRAT was created. For instance, GRATs created last month have a hurdle rate of 2.8%.

The annuity amount typically is structured so that the value of the annuity coming back to the creator equals the value of the property contributed to the GRAT, so there is little or no taxable gift. If the grantor survives the annuity term and the assets in the GRAT appreciate at a rate higher than the hurdle rate, at the end of the GRAT, the assets will remain to be distributed to the remainder beneficiaries (typically, the grantor's children), outright or in further trust and free of any estate and gift tax.

For example, say in July 2010 an individual puts \$5 million into a GRAT that lasts for three years. Say he receives an annuity of \$1,760,863 per year for each of the three years. Assume the assets in the trust grows at 10% per year. The result: \$826,510 will go to the individual's children at the end of the GRAT, free of any gift and estate tax, which is a savings of over \$450,000 in tax.

If the appreciation of the assets in the GRAT does not exceed the hurdle rate, the GRAT fails but the grantor has lost little or nothing.

In other words, if structured in this way, GRATs are a "heads-I-win-tails-I-don't-lose" proposition. If the grantor does not survive the annuity term, the GRAT fails at least in part, depending on how far into the term the death occurs and the performance of the assets. Again, however, a failed GRAT leaves the grantor (or the grantor's estate) no worse off from a tax perspective than if the GRAT had never been created.

Legislative Complications

Many people opt to create multiple short-term "rolling" GRATs, rather than one long-term GRAT. The use of short-term GRATs minimizes the likelihood that the grantor will die during the trust term and shifts short-term gains in the value of the GRAT assets to the remainder beneficiaries.

But the Small Business Lending Fund Act would eliminate the advantages of short-term GRATs by requiring a minimum 10-year annuity term. This longer term increases the possibility that the creator of the trust will die during the annuity term, thus eliminating some or all of the tax benefit.

The Act also would require the value of the taxable gift caused by the creation and funding of a GRAT to be "greater than zero." Although this requirement would eliminate the possibility of creating a GRAT without making any taxable gift at all, the Act does not specify how much greater than zero the gift must be. Thus, it seems a client would still be able to structure a GRAT to generate a minimal taxable gift (e.g., a few dollars). Finally, the Act prohibits the annual annuity amount payable to the grantor from decreasing during the first 10 years of the annuity term. This would eliminate an advantageous variation on the GRAT theme in which GRATs made large payments to the creator of the trust in the early years, and smaller payments in the later years.

Planning Opportunities

Individuals owning assets that have lost value because of the economy but have the potential to recover and grow in value over the long-term should consider GRATs. GRATs work particularly well when interest rates are low, as they are now. As long as the assets in the GRAT grow more than the hurdle rate (again, 2.8% in July) the excess growth escapes estate and gift tax. The GRAT legislation appears to have been fast-tracked in Congress, although the situation is fluid. In short, creation of a short-term GRAT is an opportunity to save estate and gift taxes for your family that may not be available much longer.



NEW TAX STRATEGY DEMANDS MULTI-YEAR PLANNING

With two tax jumps coming in 2011 & 2013, it's time to examine what is in your control



For example, say an employee has an option on 1,000 shares with an option price of \$20 and the current price is \$35. After 35% income taxes, he would net \$13,000 if he exercises the option in 2010. But if he waits until 2011, and the price goes to \$38 per share, he will pay taxes at 39.6% but he will net \$13,892. This employee needs to think about whether the stock price has the potential for increasing after 2010.

For those doing a Roth conversion, there is the opportunity to pay tax in 2010 or spread the income into 2011 and 2012 (at higher tax rates). If you are already in the maximum tax bracket it might make sense to pay the tax today and not take advantage of the two-year spread alternative. For those who are not in the maximum tax bracket, some projections of 2011 and 2012 income tax are in order (it may make sense to take advantage of the two year spread).

For those with significantly appreciated assets there are several things to keep in mind. First, think about a 5% higher rate in 2011 (15% versus 20%) and an 8.8% higher rate in 2013 (15% versus 23.8%). You need to factor in how soon you might otherwise sell the asset and compare rates and use of money considerations. As with the stock option exercise example, a rise in the asset value could easily erase the added tax burden.

Now is the time to start thinking about taxes for the next several years and begin some strategic planning. And be forewarned, this will be the exact opposite of traditional income tax planning because this year, we are going to accelerate income and delay deductions.

A quick review of the highest tax brackets tells the tale. Tax rates on regular income will increase to 39.6% next year, from 35% this year. Since income will be taxed at higher rates next year, deductions will save more next year also.

There is another tax bracket jump in 2013 when an additional 3.8% Medicare tax is imposed on investment income and another .9% Medicare tax is imposed on earned income (wages). And don't forget that capital gains rates go to 20% in 2011 from 15% this year, and then will get hit with an additional 3.8% in 2013 (for a 23.8% tax rate within the next three years.)

The two-phased tax bracket jumps (2011 and 2013) mean that you need to be thinking of multi-year strategies.

Accelerating Income

Accelerating income can be tricky and goes against most instincts. Business owners have the most flexibility. They can bill earlier and try to collect prior to year-end. Salaried employees have few opportunities to accelerate income, except perhaps stock options.

By exercising stock options during 2010 (rather than 2011 and beyond) the income might be taxed at a 5% lower rate. The most critical issue with stock options is, of course, the share price. A stock price increase after 2010 could easily erase any additional income taxes associated with the option exercise.

Delaying Deductions

Deductions go further when tax rates are higher. It makes sense to delay deductions into 2011 and beyond. The only danger with this strategy is that a 2009 proposal from the Obama Administration was to cap the tax benefits of deductions at a 28% rate. But, this proposal has gone nowhere.

Start thinking about what expenses can be delayed until 2011. Business owners should consider what supplier payments can be delayed later this year (or partial payments made). This is especially important for cash method taxpayers. Accrual method taxpayers need to plan well ahead when it comes to expenses. Put the checkbook away in November and December. Don't pay real estate taxes that can be delayed until 2011. Delay charitable contributions until 2011 when possible.

Examine what variables are within your control—income and deductions. Do a multi-year analysis to determine tax brackets in 2010 and 2011. Set up a plan now with planned execution dates between now and the end of the year.

By Bill Fleming • OnWallStreet.com, August 2010



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