WITH VOLATILITY HERE TO STAY, ADVISORS CAN HELP LOCK IN INCOME AND PROTECTION FOR INVESTORS

By Melissa Kivett
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Everyone’s talking about the inverted yield curve—it’s either the first sign of an imminent recession, or possibly a red herring signaling nothing more than that the Federal Reserve is holding too many Treasuries. Few seem to agree on what it means to the U.S. economy and investors, yet advisors are on the hook to help clients prepare and tackle whatever challenges the markets may present in the coming weeks and month.

THE BEARS VS. BULLS DEBATE

First—what’s really going on here? Are we headed for a recession? The market bears say that we are and point to history. Yields on long-term Treasury notes fell below...
those of short-term notes just before every U.S. recession since 1955. Add to that key warning signs about a slowing economy: Beginning in January 2019, several large U.S. companies began cutting earnings forecasts and in July, 77% of companies issuing second quarter earnings guidance warned that they’d fall short of expectations, delivering the second-worst quarter since 2006, according to FactSet. Finally, some recent data points to slowing economic growth, fueling fears of a downturn.

But optimists say other reliable indicators, like initial unemployment claims and high yield credit spreads, don’t paint the same picture. And, they point out, yields have been impacted by international investors buying Treasuries in their search for any yield at all, which is far from a referendum on the U.S. economy.

Still, the endless chatter is fueling fears of a recession and could well drive the U.S. toward one if the day-by-day handwringing begins to erode consumer confidence. If the bears are correct, it’s important to keep in mind that the average correction for the S&P 500 since World War II lasts four months with a 13% drop in the market. Bear markets typically last 13 months with an average loss of 30.4% and take 22 more months to recover.

The reality is that a recession, which the National Bureau of Economic Analysis finds occurs every five years or so, will come sooner or later. And given that, since the end of the recession in 2009, we’ve enjoyed one of the longest economic expansions in U.S. history, we’re long overdue. But for now, the U.S. economy continues to grow. Importantly, the Federal Reserve has reversed course after a modest hiking cycle and is trying to foster growth by cutting rates.

VOLATILITY IS THE NEW NORMAL

Whether there’s an imminent recession or not, a few things are clear. The tug of war between economists and other market experts will continue, and that tug of war will contribute to uncertainty. Add to that seemingly endless trade issues that sway markets daily, along with a political environment that will continue to heat up as we move toward the 2020 presidential election. If nothing else seems certain, we can expect that volatility is here to stay.

For investors already staring down the challenge of securing consistent retirement income, volatility throws a wrench in their planning. Some might consider fleeing the stock markets in favor of bonds, which can provide a haven and provide steady cash flow, at least until interest rates begin to rise and their value declines.

Now, more than ever, financial professionals need to serve as counselors to their clients, providing experienced, objective perspective to help keep them from making knee-jerk financial decisions based on emotion. Instead, advisors can offer data and historical perspective on markets over time, while suggesting solutions that can help protect client financial interests even amidst uncertainty.

ANNUITIES – A HEDGE AGAINST UNCERTAINTY

Of course, while no one invests to lose money, some clients have no problem watching their portfolio balances rise and fall, able to bear risk over the long term. But many investors no longer have the time or risk tolerance to wait for a recovery from falling portfolio values.

Annuities may provide an answer for many clients, with so many now in the stage of their lives when they need to secure a steady stream of income in retirement and build lasting financial security—while protecting against market risk.

Within a decade, all baby boomers will have reached retirement age. Many are today rightfully focused on ensuring they’ll have consistent income through retirement against the backdrop of current market trends, increasing longevity and risks to Social Security. Even millennials, with many nearing their 40s, building families and planning for the future, may be too risk-averse to tolerate the constant market shifts, having come of age during the Great Recession.

Longer lifespans mean the average retiree will likely live through several bear markets. Since 1945 there have been 27 market corrections of greater than 10% and eight bear markets with losses that exceeded 20% (two with a loss greater than 40% in just the last 20 years). With the future so uncertain, it’s important to remember that losses in the early years of retirement can devastate a portfolio, increasing the likelihood that an investor will run out of money in
their lifetimes. Income guarantees, meanwhile, can support financial wellness, protecting investors against the risk of retiring into a down market and helping to ensure their money lasts.

SIMPLICITY, TRANSPARENCY, ACCESSIBILITY

When planning, investors should always consider both the benefit and the cost when selecting any financial solution. While it may be tempting to compare investments based solely on expenses, it’s important to consider the unique value that annuities offer as part of an overall strategy. Here, advisors play a critical role in helping clients understand whether the guarantees and other benefits offered by annuities, like added security, are worth the cost, given financial goals.

Consumers have taken notice. Notably, across the industry, sales have especially increased for fixed annuity products, while variable annuities continue to provide compelling solutions to many needs. Not only are investors increasingly buying annuities as they seek to lock in the market’s upside while protecting against any downturn, they’re also counting on the ability to invest underlying assets in subaccounts that own stocks and bonds to hedge against inflation risk.

Many insurers, including Prudential, have been working to make annuities simpler, more transparent and easier to understand—for advisors and for investors. They’re also easier to work with and more accessible—now available on digital platforms like Envestnet and right at the fingertips of financial professionals using these platforms.

DON’T FORGET THE TAXES

Recent tax changes have made it easier for fee-based advisors to offer annuities as well. Historically, fee-based advisors have been rightfully reluctant to suggest annuities because of tax implications for clients, but the Internal Revenue Service has provided relief.

In August, the IRS issued a private letter ruling to each of the petitioning companies clarifying that certain fee arrangements can qualify as a contract expense and not be treated as a taxable distribution. The change in treatment by the IRS lifts a tax burden for consumers and makes it easier for advisors to recommend a broader range of solutions.

With this ruling, annuities can provide an effective and efficient way to help manage taxes, no matter who is selling them. Annuities provide tax-free rebalancing and the ability to defer taxes on any growth in the portfolio until income begins. Because annuity investors generally take income over time, they’re often in a lower tax bracket, and many clients may prefer the prospect of a guarantee with a firm understanding of tax implications, compared with the uncertainty of volatility for the foreseeable future.

For advisors reluctant to recommend annuities as part of an overall plan, it’s important to consider that those receiving income from an annuity have the highest levels of satisfaction compared to all investments, according to IRI’s 2016 study, “It’s All About Income, Inaugural Study on the American Retirement Experience.”

Advisors and their clients should consider annuity income the foundation of a comprehensive retirement income portfolio, not the entire income plan. Naturally, a comprehensive plan for achieving financial wellness in retirement should include sources of guaranteed income and non-guaranteed investments. Ideally, a strategy would ensure that essential expenses can be covered, freeing investors to devote remaining capital to long-term growth.

And the current market environment, no matter whether the bears or bulls prevail, gives advisors and clients an opportunity to explore whether annuities are the right solution for complex financial needs, including providing for guaranteed lifetime income that’s insulated from market losses and can’t be outlived.

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2 CNBC, “Companies are warning that earnings results are going to be brutal,” 7/2019, https://www.cnbc.com/2019/07/01/companies-are-warning-that-earnings-results-are-going-to-be-brutal.html


Wealth managers, insurance and annuity companies, asset managers, financial technology providers, and retirement plan sponsors and recordkeepers are combining forces and leading in improving client confidence and investment outcomes.

The coordination of human and digital advice, modern product design, aggregated data, and technology-enabled solutions are helping clients visualize their entire wealth landscape and empowering advisors to provide greater clarity on how clients can improve financial results across all holdings in a household.

The quest among industry leaders to engage a large population of clients who are without an advisor – but who have the means and need for professional advice – is rapidly moving ahead. Smart multi-account solutions are being built where planning, a variety of product types, and optimal ways to implement these solutions are now available for the express intent of increasing the likelihood of financial success.

Industry leaders are moving away from recommending individual financial and digital products in a vacuum, and are now offering household-level solutions in a cost-smart, risk-smart, and tax-smart way, showing how to generate a higher and more predictable level of income in retirement, and thereby improving client confidence.

This new generation of solutions-oriented advice, guidance, product design, smart packaging, and digital optimization tools enables advisors to help investors make and keep more money up to and through retirement.

This article discusses the fundamental change now underway that enables financial advisors to provide comprehensive solutions for improved financial outcomes and greater investor confidence.

PRIMER ON HOW TO IMPROVE FINANCIAL OUTCOMES

Let’s start with understanding the investor. For most consumers, their savings and investment portfolio are part of a complex web woven over time. They’ve bought different financial products at different times for different reasons from different people – and therefore, don’t have any measure of a coordinated household retirement plan. How could they?

The typical investor has five to six accounts, multiple products and custodians, and two or three advisors managing their assets. Looking at what they’ve assembled over time with no real overarching strategy, it appears these investors may be unable to achieve their goals.
In truth, there are only a few ways to improve investor results and increase confidence:

1. Consistently beat the markets
2. Reduce investment costs
3. Manage risk
4. Minimize taxes
5. Provide guarantees
6. Address goals and expectations over time

Two key aspects this paper will cover in detail include risk and taxes. We will show how advisors can address risk and reduce taxes (generally the largest expense investors incur) in client portfolios, potentially enabling them to keep more of their money.

Additionally, we will address: 1) how to incorporate guarantees into a portfolio to provide protected lifetime income, and 2) the importance of working closely with a financial advisor who can provide comprehensive guidance to help ensure that clients stay on track to meet their end goals.

Managing all these factors is complex; the human brain alone cannot be as thorough and complete as the advanced software now available. But just as significant, software can’t engage in a dialogue of personal and family priorities like an advisor can. For this, the human connection between an investor and trusted advisor is critical. That’s why the future of advice lies in leveraging people, data, and technology in order to organize, coordinate, and optimize a household’s products, accounts, and holdings over multiple financial milestones to improve outcomes.

**HOW WE GOT HERE**

Over the past 50 years, some investors have put short-term accumulation needs over longer-term retirement goals through a haphazard combination of mutual funds, advisory programs, insurance, and alternative investments.

By diversifying in an ad hoc way, sometimes based upon buying what recently worked and selling what didn’t, investors may have found themselves unintentionally doing three things:

1. Underperforming the markets
2. Taking on unintended risk
3. Paying unnecessary taxes

Let's start with underperforming the markets. The 2018 DALBAR Quantitative Analysis of Investor Behavior found that the average investor was a net withdrawer of funds in 2018, but poor timing caused a loss of 9.42% on the year compared to an S&P 500 Index that lost only 4.38%. The same DALBAR study found that, annualized over a 30-year period, they also underperformed by 5.88 percentage points compared to the S&P 500 Index over the same time period. The report indicates investors tend to chase performance, and as a result, fall short of their objectives.

In a quest for diversification, investor households may have also opened multiple taxable and tax-advantaged accounts over time, with products often purchased from different advisors with virtually no coordination. This can result in them having a risk profile that could be inconsistent with their objectives and may also lead to them paying unnecessary taxes.

“ Wealth managers realize clients expect more than just strong investment performance but struggle to communicate the value of their offerings and services,” according to Ernst and Young. “The answer is not simply lowering fees, but rather a combination of increasing transparency and predictability when it comes to pricing models, and equipping advisors with ways to communicate value beyond investment returns.” Industry leaders are working on communicating value, aggregating data, and combining capabilities to create better outcomes from a cost, risk, and tax standpoint.

**LEVERAGING INSTITUTIONAL SCALE AND CAPABILITIES TO MANAGE RISK**

Investors face six primary risks as they transition from accumulation to efficiently generating sustainable income in retirement:

- Market volatility
- Interest rate fluctuations
- Tax-smart asset location
- Efficient sourcing and sequencing of withdrawals
- Rising costs, including health care and inflation
- Longevity

Clients and advisors are recognizing the critical need to create a comprehensive household-level plan with a holistic approach to addressing these risks. But given the complexity of managing at the household level, advisors are moving to a wealth management approach that leverages the modern design of investment and insurance solutions, at both the product and platform levels.

Combining the advisor’s knowledge with the institutional scale and the risk management acumen of an insurance company, this modern approach facilitates deeper client relationships, helps differentiate advisors from commoditized investment planning, and can add more consistent revenue.

**THE SOLUTIONS EVOLUTION**

As more consumers demand lower costs, simplicity, and greater flexibility in their financial solutions, modern annuities have become a vital tool in complementing a household portfolio.

**Growing Demand in an Evolving Marketplace**

Demand for these insured solutions has grown as more traditional sources of protection and lifetime income (e.g. pension plans) have disappeared, and more and more people are nearing or entering retirement. Product design options have greatly improved –

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including fee-based product options, lower cost structures, flexible designs, and modern withdrawal benefits – and these advancements have become integral to addressing risks, costs, and taxes within a retirement planning ecosystem.

Annuities need no longer be viewed as an independent transaction; they can now be managed, billed, and reported together with other assets in the portfolio to facilitate a goals-based, relationship-driven practice model.

Yet these recent developments are generally unknown, or little understood, to a large segment of financial advisors who nonetheless recognize the importance of leveraging the institutional scale and risk-management capabilities of an insurance company with a proven track record of fulfilling lifelong promises.

Modern annuities can be incorporated into household-level portfolios and viewed in the context of a broader, more comprehensive plan to help address the challenges clients face as they prepare for and manage their retirement:

1. Varying levels of asset protection with direct or indirect market exposure to help reduce portfolio volatility, without introducing new risks often associated with other alternatives
2. Tax-deferred accumulation for clients who’ve maxed out contributions to qualified plans and want to reduce capital gains taxes
4. Guaranteed lifetime income that can supplement or defer the need for Social Security, and take pressure off other assets in the portfolio
5. Opportunities for increasing retirement income (after payments have begun) to mitigate the corrosive impact of rising costs

Leveraging an insurer’s unique ability to pool risk and match assets and liabilities on a large scale

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**IRI FAST FACTS**

**THE NEED FOR RETIREMENT SAVINGS GUIDANCE**

TWO-THIRDS OF BABY BOOMERS EITHER DON’T KNOW HOW THEY WILL USE THEIR RETIREMENT SAVINGS, OR PLAN TO LIVE BY JUST WITHDRAWING MONEY WHEN THEY NEED IT.

<table>
<thead>
<tr>
<th>Description</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Withdraw as needed for basic expenses</td>
<td>39%</td>
</tr>
<tr>
<td>Withdraw only for emergency or lifestyle expenses</td>
<td>28%</td>
</tr>
<tr>
<td>Full IRA rollover</td>
<td>6%</td>
</tr>
<tr>
<td>Partial IRA rollover</td>
<td>4%</td>
</tr>
<tr>
<td>Use a portion to purchase annuity</td>
<td>6%</td>
</tr>
<tr>
<td>Use workplace lifetime income option</td>
<td>8%</td>
</tr>
<tr>
<td>Don’t know</td>
<td>28%</td>
</tr>
</tbody>
</table>

Source: “Boomer Expectations for Retirement 2019” (IRI, April 2019)
scale can help manage longevity risk more efficiently, meet core income needs, and potentially lower overall portfolio volatility. In turn, cost and complexity can be reduced and a level of certainty is provided that cannot be replicated by other products. And this certainty is reflected in the belief investors have that their money will last – 45 percent of baby boomers who own annuities are confident their retirement savings will last for their entire lives, versus only 18 percent of those who don’t own annuities feeling confident that this will be the case for them.

TRENDING APPROACHES TO IMPROVING OUTCOMES

The future of advice lies in creating value by leveraging people and technology to coordinate and optimize the products, accounts, and holdings that make up a household portfolio – to deal with critical life moments and the evolving complexity of a client’s financial life – for the end objective of improving outcomes. The financial services industry transformation is addressing this by focusing on the development of two frameworks: Platform Solutions and Technology Enabled Client Solutions.

Wealth managers, annuity companies, asset managers, retirement plan sponsors, and technology providers are working together to drive the evolution of both approaches for comprehensive solutions.

The Platform Solutions available today are designed to help advisors optimize, aggregate, and quantify the financial benefit of managing multiple household accounts and products in a risk-smart and tax-smart way. This approach requires operational infrastructure that connects and integrates multiple capabilities to help advisors help investors improve outcomes.

Technology-Enabled Client Solutions combine a simplified planning approach with shared control of investment decisions and optimized products and accounts. Using easy-to-understand software tools, advisors can customize a potential solution for investors to chart their course toward improved outcomes.

Both approaches highlight a clear path forward and show client benefits that can be quantified in dollars and cents.

PLATFORM SOLUTIONS

The industry is connecting investments, products and capabilities to create comprehensive and coordinated platforms that may include the following:

- Financial planning, budgeting, and cash flow tools
- Account data aggregation
- Risk management/asset allocation guidance
- Investment and product proposal generation
- Tax optimization across multiple products and account types to ensure tax-smart asset location
- Annuity products to provide a combination of guarantees, tax mitigation strategies, and risk management
- Ongoing household-level management and rebalancing of all holdings, products, and accounts, including advisory models, brokerage holdings, and annuities
- Optimal income sourcing and sequencing from multiple accounts, products, and other income sources such as Social Security and pensions, as well as Roth individual retirement account (IRA) conversions
- Trading platforms
- Household-level reporting

The technology exists. What’s been missing until recently is the connective tissue. Not just tools and data flow but also the connection that only a human advisor can provide – a personal relationship founded on empathy and understanding, interpretation, experience, and guidance.

Financial advisors who focus on managing all of a client’s finances likely enjoy greater practice efficiency, increased retention of a client’s current assets, and an increased likelihood of attracting their held-away assets. Increased asset consolidation is a key driver behind this megatrend, because the software exists to demonstrate a quantified financial benefit for both the investor and the advisor.

TECHNOLOGY-ENABLED CLIENT SOLUTIONS

Client-facing tools have been developed that incorporate an aggregated, multi-account view of a client’s holdings and a simplified planning experience for determining an appropriate combination of investment and annuity products in coordination with maximizing Social Security benefits.

This approach is referred to as “optimal income sourcing” and is designed to help chart the client’s course toward improved outcomes.

Typically, the first question investors ask when developing a retirement strategy is when to start Social Security benefits. Social Security optimization tools have been designed to engage clients with a simplified planning conversation to suggest filing strategies for enhancing benefits given different spousal situations and retirement objectives. For most investors, that recommendation may be to defer benefits until age 70 because the Social Security Administration provides an 8% increase in benefits per year between age 62 and 70.

The focus for these advanced software tools is to not only quantify the advantages of deferring benefits, but to have an income-sourcing conversation of where and how to draw income from a combination

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of annuity and investment products to fill the gap while waiting, and to start Social Security benefits to help increase the client’s income stream over the course of their retirement years.

As an example, if the client decides to defer taking Social Security benefits until age 70, a layered income strategy can be implemented where a guaranteed annuity income stream would be set in motion between the ages of 62 and 70 to ensure the same level of income as would occur if Social Security benefits were initiated at age 62.

If more income is needed, annuity or investment accounts can be tapped to increase income. The software requires only a few inputs to conduct “what-if” scenarios to determine the level of guaranteed income as well as utilizing other accounts to continue to grow and be tapped later in retirement for future income. In keeping with the client’s objectives and comfort level, the software suggests the optimal sequence of withdrawal to maximize income from annuities, investment accounts, and Social Security benefits for the different layers of income.

CONCLUSION

Evolve your practice with a focus on goals-based, household-level solutions.

Help facilitate greater confidence through holistic wealth management that may deepen client relationships and set you apart from commoditized alternatives.

Leverage institutional scale to integrate risk management capabilities in your practice.

Yes, you can manage some risk on your own, but outsourcing to gain scale and efficiencies will allow you to focus on other components of the portfolio.

Take another look at modern insurance products available on the market today.

Annuities have come a long way with fee-based designs, competitive costs structures, greater flexibility, contemporary withdrawal benefits, and income guarantees that may allow for greater risk tolerance in other parts of the client's portfolio.

Consider technological wealth management advancements as a complement – not competition – to your practice.

Only advisors who act like robots can be replaced by them. Your core value proposition of personal advice can be augmented by the latest digital tools.

"The financial services industry is undergoing significant transformational change. Advancements in risk mitigation strategies and deeper integration of products in the advice ecosystem are helping improve financial outcomes and increase client confidence. Financial advisors now have better tools and resources to enhance their level of service to their clients, allowing them to manage their assets in a more holistic manner at a household level."

– Corey Walther, President, Allianz Life Financial Services, LLC

Annuity guarantees are backed by the claims-paying ability of the issuing company.

Purchasing an annuity within a retirement plan that provides tax deferral under sections of the Internal Revenue Code results in no additional tax benefit. An annuity should be used to fund a qualified plan based upon the annuity’s features other than tax deferral. All annuity features, risks, limitations, and costs should be considered prior to purchasing an annuity within a tax-qualified retirement plan.

For registered investment advisor use only – not for use with the general public.

Please visit www.myirionline.org to download the full white paper.
Today’s investor communities are changing rapidly. They are multigenerational, multicultural, and include veterans, members of the LGBT (Lesbian, Gay, Bisexual, Transgender) community, and more. It’s important for advisors to understand the unique needs of all investors to help clients pursue their financial goals.

As communities change, now is the time to incorporate diversity and inclusion strategies into your practice. LGBT adults have the largest recorded disposable income of any investor market segment. And the greatest inter-generational transfer of wealth in history is approaching. Given the fastest-growing type of marriage is between those of mixed heritage, and nearly half of millennials identify as nonwhite, this wealth transfer will impact a diverse group of individuals and families.¹

With these dynamics in mind, advisors who focus on the unique needs of diverse investor segments can help provide needed financial guidance to clients, and expand the growth potential of their businesses.

Since the very beginning, LPL Financial has been on a mission to provide more Americans with access to independent financial advice. That is why LPL is taking a leadership role in building the industry’s most diverse network of advisors, and equipping them with the tools, training, and support they need to help individuals and families in underserved markets achieve their goals in life.

LPL was recently awarded top honors from WealthManagement.com for Broker Dealers Corporate Social Responsibility/Diversity and from

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InvestmentNews for Excellence in Diversity and Inclusion, based on its commitment to build advisor communities, grow a diverse advisor base, and support advisors who serve diverse populations of investors.

LPL launched a firm-wide advisor diversity and inclusion initiative focused on providing advisors with resources, opportunities, and relationships that will help them grow their business and support their clients in increasingly diverse communities. Advisors have shared how important relationships are to driving business growth. Connecting with other advisors helps everyone learn and grow together, and this is especially true for those with shared backgrounds and experiences. As a result, LPL has built an Advisor Inclusion Council and established a variety of Advisor/Ally Business Communities.

Grace Yung, CFP®, a managing director and wealth advisor at Midtown Financial Group LLC in Houston, Texas, explains the benefit of connecting with other advisors at events: “Because we’re all from varying backgrounds and experiences, we share ideas on what’s working in each of our practices. The more we know, the more that we can draw from our resources, and ultimately that will impact our clients in a positive way.”

LPL also has a team dedicated to diversity and inclusion, bringing a diversity lens to everything LPL does to drive growth for advisors and for the firm. They’ve enhanced their recruiting process to attract the most diverse network of advisors to reflect the changing community of investors.

The overarching theme advisors have highlighted is that through LPL’s intentional efforts to share the importance of serving diverse communities of investors, people who previously felt invisible and disengaged are feeling valued and supported.

Laura LaTourette, CFP®, of North Georgia Wealth Management Group, in Dahlonega, Georgia, primarily serves LGBT clients in her practice and serves on LPL’s Advisor Inclusion Council. “The message I took away personally and for my clients was, ‘You are welcome. We want you here,’” Laura says.

Inclusion Council member Stanley Funches, CFP®, ChFC, CRPC, of Birmingham, Alabama, primarily serves high-net-worth African American investors in his practice, INTELUS Wealth Management LLC. He shares Laura’s concerns. “A lot of the people I serve have been traditionally underserved or ignored,” Stanley explains. “They haven’t received the financial education that the majority of investors have. So resources from LPL, being one of the larger financial players in the industry, are a significant help for people who have not had the information before.”

The need is great, and the time to connect is now. To help build a successful business and have more resilience in a changing market, connecting authentically with investors is the key.

A common misconception about diversity and inclusion is that you have to be a member of a specific demographic to serve that community, but that isn’t the case. Creating an inclusive environment means that everyone is at the table together. One way to understand the diverse needs of investors is to engage with people who are different from you. This enables you to broaden your perspective, build understanding and empathy, and be better equipped to authentically and effectively serve your clients.

Here are some tips for working with diverse investors:

• Be empathetic and authentic
• Learn more about the client’s personal and professional wants, needs, and objectives
• Practice active listening
• Be open to new ideas
• Avoid making assumptions
• Demonstrate your support
• Get involved with local and national organizations that support diverse communities

For more information, visit www.LPL.com or connect with LPL’s Advisor Diversity & Inclusion Team via email at Lplfinancial.advisorinclusion@lpl.com.


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Midtown Financial Group LLC, North Georgia Wealth Management Group, INTELUS Wealth Management LLC, and LPL Financial are separate entities.

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INTEGRATING ESG FACTORS INTO THE INVESTMENT PROCESS MOVES THE NEEDLE FORWARD

By Guillaume Mascotto
Vice President
Head of ESG and Investment Stewardship
American Century Investments

Environmental, social and governance (ESG) investing is an evolving concept that currently lacks standardized definitions, consistency and a solid baseline for analysis and measurement. Despite recent progress at the regulatory level and higher levels of issuer ESG disclosure, investors are increasingly relying on ESG information about companies, which can differ per third-party ratings, scores and other beta-type filters. Much of that data hasn’t been audited or contextualized around financial materiality and company fundamentals. In fact, overreliance on that type of guidance may limit investors’ ability to understand which ESG factors and their time horizons are financially material for companies.

FILLING IN THE INFORMATION GAPS

ESG risks and opportunities are typically identified at the sector level (we call this “top-down ESG exposure bias”). To assess downside or upside risk management at the issuer level, third-party ESG ratings tend to rely on issuer-level disclosures (e.g., policies or programs and environmental ratios, such as carbon emissions/sales) that aren't always integrated with company fundamentals.

Integration of ESG disclosures and company fundamentals is an essential component in the evaluation of an issuer’s ability to mitigate a given ESG risk or capitalize upon an opportunity. Not surprisingly, large and well-established issuers with the ability to dedicate greater resources to preparing extra-financial disclosures tend to achieve higher ratings than smaller issuers or those with complex business models that don’t easily fit in a top-down ESG evaluation framework.

While investors would undoubtedly benefit from additional disclosure about companies’ ESG-related risks and opportunities, it’s essential to distinguish between the quantity and quality of disclosure. We believe active ESG integration can fill in the gaps.

ACCOMPLISHING MORE WITH INTEGRATION

Beyond reliance on disclosures and ratings, we believe focusing on bottom-up risk management analysis in tandem with integrated financial and ESG variables constitutes a more substantive understanding of an issuer’s financial risk exposure to given ESG issues.

For example, if an investor determined that an energy issuer’s high carbon emissions were a material risk, then the investor should review the issuer’s carbon intensity profile through public disclosures per third-party frameworks such as MSCI or SASB. Equally important, investors should also consider the potential impact on earnings visibility through supply/demand assessments and on balance sheets. This could be accomplished through stress testing issuers’ ability to service debt amid the potentially rising costs associated with the decarbonization shift affecting the energy and electric power sectors.

IDENTIFYING DOWNSIDE AND UPSIDE POTENTIAL

Even though ESG issues are often characterized as risk inputs, they may also offer opportunities. It’s possible that exposure to a risk or opportunity arising from an ESG issue may not materialize for five, 10 or even 15 years. Given those time horizons, it’s important to target the capability of the company to manage ESG-related potential cost hikes or liabilities, as well as the appropriate strategic

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direction for adapting to evolving market dynamics within a defined investment time period. Generating risk-based and forward-looking ESG assessments may help evaluate an issuer’s downside ESG risk propensity and capture ESG upside potential.

For example, instead of focusing solely on an issuer’s level of ESG disclosure or negative externalities (e.g., carbon emissions or product recalls), analysts should dive deeper into the issuer’s ability to manage any potential current or future costs associated with exposure to ESG issues. This analysis could involve evaluating whether a given ESG issue would alter an issuer’s solvency and growth trajectory over the medium to long term. If the ESG exposure resulted in an immediate to short-term cost to the company’s market valuation, analysts could then assess management’s remedial actions and whether any decrements to the company’s fundamental business profile would be warranted.

Similarly, a dynamic integrated ESG approach could allow analysts to measure an issuer’s risk mitigation programs and whether an issuer’s practices were improving or worsening over time. For instance, new regulations or technological innovations could affect supply and demand fundamentals, thereby exposing companies to potential risks. But those trends could also influence companies to innovate or repurpose assets toward business lines with lower regulatory compliance risks and stronger competitive advantages.

**GENERATING ROBUST ESG ASSESSMENTS**

Two highly ESG-exposed sectors offer insightful case studies of ESG integration:

**Energy**

The decarbonization of global energy use patterns presents risks and opportunities for upstream energy companies.

Investors can gauge a company’s potential to capture opportunities either in the form of compliance/operational risk reduction or growth inflection in new business lines by analyzing several important characteristics:

- Reserve mix diversification toward natural gas away from oil
- Carbon emissions intensity profile and projected reduction outlook
- Stranded asset coverage
- Renewable energy investments

In this sense, while ESG integration may help evaluate potential risks at the macro (climate change) and sector (regulation, market conditions, negative externalities) levels, it should also identify those companies likely to succeed in the future. Such businesses would likely exhibit solid margins of safety, quality characteristics and possess documented strategies for adapting to the global BTU transition and International Energy Agency’s 2°C Scenario.
Pharmaceuticals

Key areas for pharma companies include their approach to supply chain custody issues, international quality standards certifications and regulatory compliance.

A significant product recall can become an expensive ordeal between lost sales, replacement costs, government fines, and litigation expenses. If a company has recorded major product recalls and/or received regulatory warnings, investors should assess whether such actions could result in material costs. If so, they should also determine if the company can absorb litigation costs, withstand brand reputation damage and deploy the proper remediation steps to replace and fix defective products.

In short, if a company endured a significant public flogging as a result of gaps in product quality and safety controls, an integrated process would allow for a deeper assessment into whether the company is taking proper steps to prevent another damaging event.

If this assessment revealed positive results, ACI’s ESG desk would then look for risk management upside potential in the form of spread-tightening or growth inflection, based on this new course of behavior.

"Integration of ESG disclosures and company fundamentals is an essential component in the evaluation of an issuer's ability to mitigate a given ESG risk or capitalize upon an opportunity."

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