The Race to Scalability 2018

Advisor Research on Investment Management Trends

FlexShares®

Built by investors, for investors

Since 2010 this survey has gauged financial advisors' attitudes about the use of external investment management. The 2018 survey finds that advisors continue to need more time to spend with clients and grow their practices.

A growing minority of advisors (43%) derive great value from their use of third-party investment management solutions, and report a 97% satisfaction rate with their provider. We also report on the majority of advisors keeping the investment function in-house.

For those who may be considering — or reconsidering — the use of external investment management, we hope this research helps inform your decision or provides ideas for creating efficiencies within your business.

There are many growing demands on financial advisors from fee compression, regulatory issues, changing technology to new competition and growing client expectations.

Our ongoing research provides insights on how advisors are adjusting their business models to achieve better scalability and a higher level of service for their clients.

Not surprisingly, our 2018 results reveal a continued focus on delivering service with a fiduciary mindset. Firms are altering their compensation strategies and making changes in how they conduct manager due diligence and oversight. This year, we also sought to understand advisors' use of digital advice platforms. We found that while adoption is low, advisors utilizing these solutions are satisfied with their decision and are attracting new clients.

FlexShares is committed to sharing this long-term research with our advisor and asset manager clients. We encourage advisors to reach out to us for additional information to help with practice benchmarking. And we welcome opportunities to share insights into the outsourcing advisor community with asset managers. For details, please visit flexshares.com/outsourcing or contact us at 855-353-9383.

Laura Gregg
Director of Client Development
FlexShares Exchange Traded Funds

2018 SURVEY HIGHLIGHTS AT A GLANCE

	2014	2016	2018
Use of External Management	40%	41%	43%
Satisfaction of External Solutions	90%	96%	97%
Hours Spent Weekly on In-House Management		28	25

What Advisors Wanted from Outsourcing ...

More time for business and clients	61%
Institutional-level due diligence/monitoring	47%
Variety of investment product strategies	43%

... And What They Received

More time with clients	63%
Institutional-level due diligence/monitoring	50%
Consistent investment management process	62%

Source: "The Race to Scalability 2018," FlexShares Exchange Traded Funds, 2018

MORE ADVISORS USE THIRD-PARTY MANAGERS

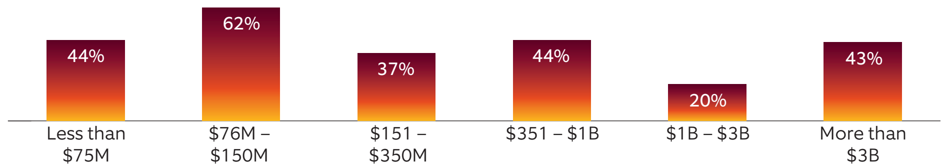
Consistent with the results of previous surveys, a growing minority of advisors are opting for third-party managers for all or part of their investment management needs. The proportion of such advisors has gradually increased to 43%, up from 41% in the 2016 survey and 40% in 2014. On average, advisors who turn to external investment managers, now delegate 57% of their assets under management, compared with 53% of those assets in 2016.

Usage varies by firm type and size

Among firm types, dually registered investment advisory firms (also known as hybrid RIAs) are the most likely to incorporate the use of external managers (57%), followed by firms affiliated with independent broker-dealers (51%). Next were insurance-owned broker-dealers (39%), regional broker-dealers (47%), and registered investment advisory firms (33%).

By size, advisory firms managing between $76 million and $150 million in assets had the highest rate of usage of third-party managers — 62%.

PERCENTAGE OF ADVISORY FIRMS THAT USE EXTERNAL INVESTMENT MANAGERS (BY AUM)



Source: "The Race to Scalability 2018," FlexShares Exchange Traded Funds, 2018

Smaller firms likely turn to third-party managers because of the constraints their size imposes in providing a full range of proprietary investment management solutions.

Second among external-manager users are advisors managing less than $75 million in assets. These smaller firms likely turn to third-party managers because of the constraints their size imposes in providing a full range of proprietary investment management solutions. Specifically, 53% say that access to institutional quality due diligence/monitoring as a primary driver behind their decision to outsource. Another 44% of these firms point to access to investment product strategies as their rationale.

Among advisory firms with very large assets under management — those with AUM of $1 billion to $3 billion, and those with AUM exceeding $3 billion — usage was 20% and 43%. This may represent that many large advisory firms consider investment management to be the centerpiece of their offering, and that the largest firms often choose to combine their own specialized investment expertise with the complementary expertise of others. However, using third-party investment managers and having investment management expertise as a core value proposition seem to coexist only at the largest RIA firms.

54%

OF ADVISORS USE A TAMP AS EXTERNAL MANAGER

A Variety of solutions partners are used

Of firms using external managers, 54% partner with a turnkey asset management program (TAMP), 34% with an RIA, 29% with an ETF strategist firm, 8% with a digital platform and 8% with another type of provider.

Advisors are using mix of active and passive portfolio strategies

At a time when index investing has grown in popularity among investors and advisors alike, it's interesting to note that the majority (61%) of firms that turn to third parties for investment management use a combination of passive and active management approaches to fulfill their portfolio construction strategies. Of such firms, 29% use mostly active strategies while 11% use mostly passive strategies. A majority — 59% — believe their firms won't change their strategies over the next two to five years.

Advisors outsource a variety of strategies

Of the firms that turn outside for investment management solutions, about one-quarter (26%) use external managers for equity strategies, with a similar percentage (24%) turning to outsiders for alternatives strategies. Responsibility for income strategies and global/emerging market strategies are delegated to third parties by 18% and 13% of advisors, respectively.

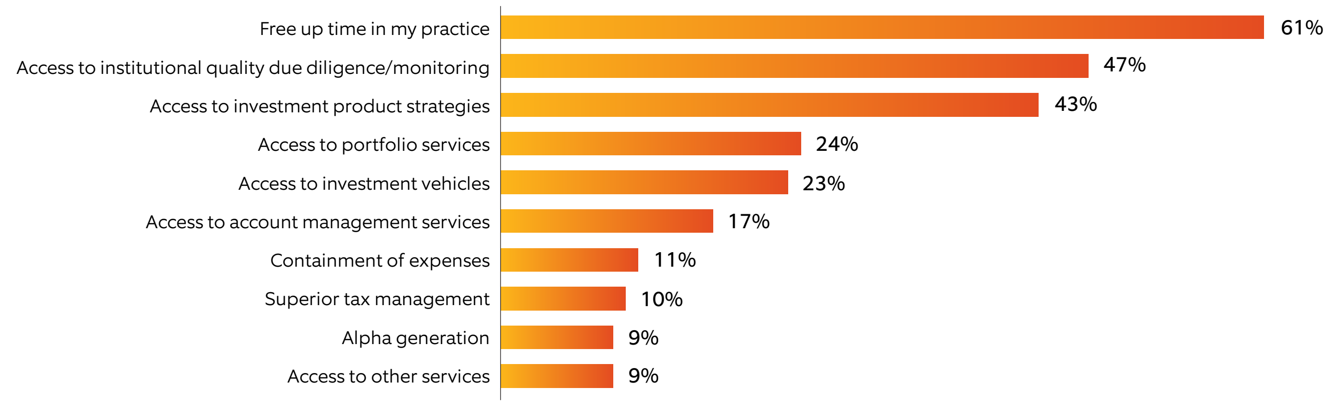
61%

OF ADVISORS CITE ‘FREEING UP TIME’ AS TOP REASON FOR USING AN EXTERNAL MANAGER

NEED FOR FREE TIME DRIVES USE OF EXTERNAL MANAGERS

As managing a successful advisory business becomes more challenging in the face of several factors — regulatory complexity, technological change, more demanding clients and greater competition — advisors must focus on their key differentiators to remain competitive. It’s not surprising, therefore, that advisors cite “freeing up time in my practice” as the leading reason (61%) they choose to use an external investment manager. Among those looking to free up time, 71% say they want to spend more time with clients, 56% say they want the time for business development, and 51%, want to provide personalized financial planning services.

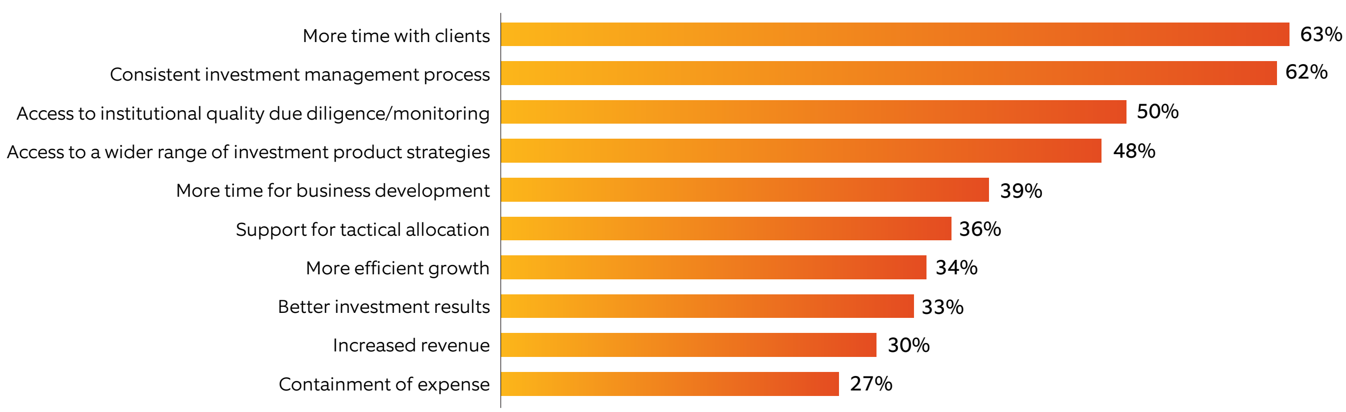
DRIVERS OF ADVISORS’ DECISION TO USE EXTERNAL INVESTMENT MANAGEMENT



Source: “The Race to Scalability 2018,” FlexShares Exchange Traded Funds, 2018

Having access to institutional due diligence and monitoring (47%) and access to investment product strategies (43%) in which specialized expertise — such as in alternatives — may better serve their clients also ranked high in importance.

BENEFITS OF EXTERNAL MANAGEMENT CITED



Source: “The Race to Scalability 2018,” FlexShares Exchange Traded Funds, 2018

ADVISORS USING EXTERNAL MANAGERS ARE SATISFIED

Among advisors who have turned to third-party managers, satisfaction remains at very high levels. Overall, 97% of them report being "very satisfied" or "satisfied" with choosing to go outside their firm for investment management solutions, with a growing percentage (38% vs. 31% in 2016), saying they are "very satisfied."

Leading to high levels of satisfaction are the 43% who cite that having more time to focus on their business most positively affected their experience, while 86% indicate that all of their anticipated needs were being met by the expert managers they chose. Among the most satisfying outcomes is that their client base has grown has a result of using external investment management solutions, which was cited by 62% of advisors. And among the approximately 30% who saw their revenue increase since using third parties for investment management, the average annual increase was 28%.

Finally, more than one-third of advisors using external managers (37%) indicate that the fees charged by managers have decreased. Of advisors who experienced such decreases, 71% lowered their clients' fees as well.

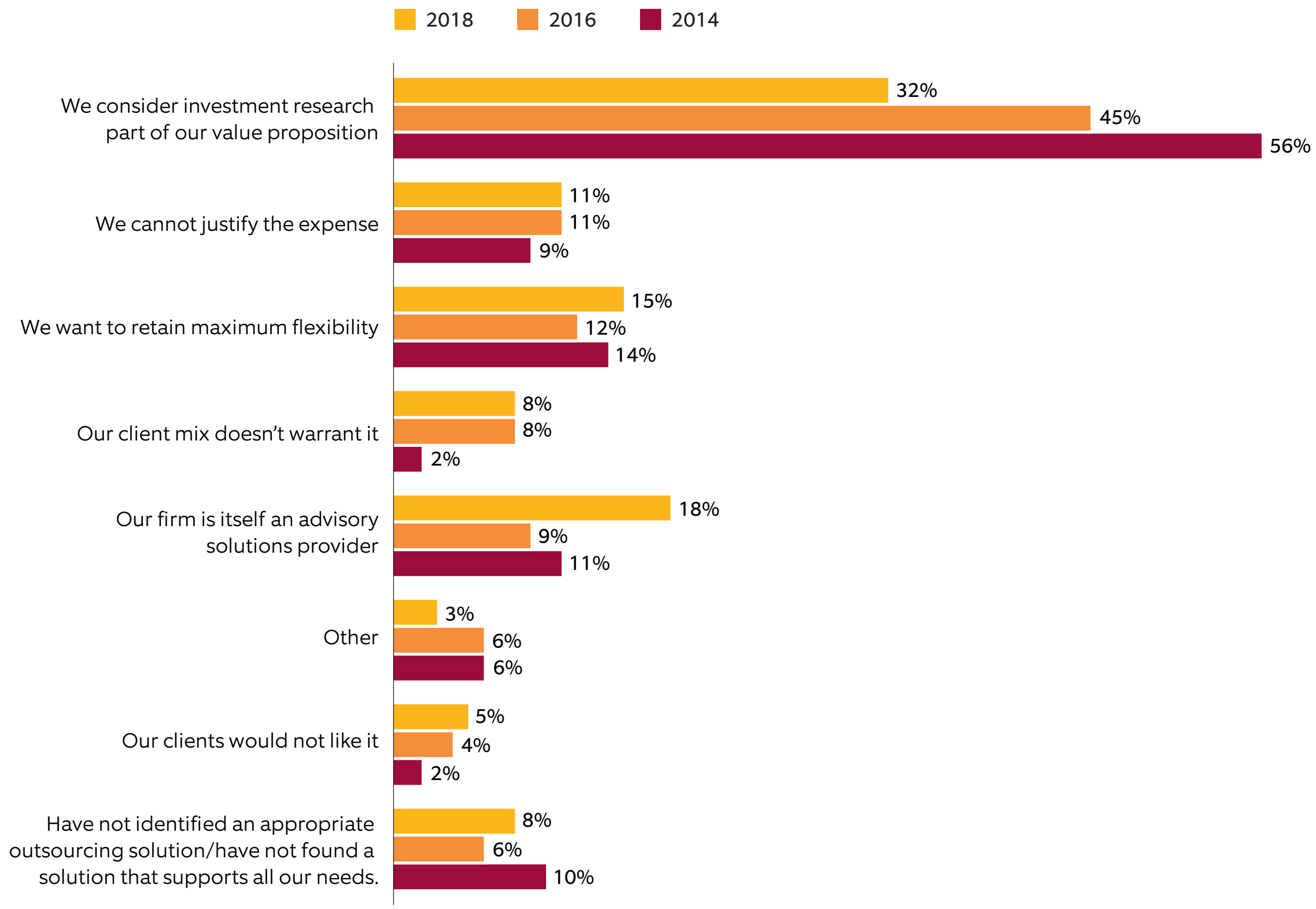
Source: "The Race to Scalability 2018," FlexShares Exchange Traded Funds, 2018

IN-HOUSE MANAGEMENT REMAINS CORE VALUE FOR SHRINKING MAJORITY

Despite the growing popularity of using external investment managers, a majority of advisors (57%) still opt to perform core investment management functions themselves. And since investment management has been central to the advisory business for so long, it seems eminently sensible that the top reason advisors don't use third parties for this function is because investment research is part of their value proposition, if not central to it. Perhaps due to the changing economics of the advice business, however, the percentage of advisors who cite this reason has declined sharply — from 56% in 2014, to 45% in 2016, to 32% this year.

The second most frequently cited reason for not using an outside manager — among firms that are not themselves an advisory solution provider — is that firms wish to maintain maximum flexibility.

TOP REASONS ADVISORS DON'T OUTSOURCE INVESTMENT MANAGEMENT FUNCTIONS



Source: "The Race to Scalability 2018," FlexShares Exchange Traded Funds, 2018

Of the firms that do not use external managers, 24% have decided against such a move, 11% are currently considering it, and a majority (55%) say they have not considered the issue, but have not necessarily ruled in out. And about a third (34%) say their opinions won't change, down from 43% in 2016.

A growing number of advisors are now providing third-party investment solutions to other advisors.

Cost factors are a hurdle

Among non-users, the greatest hurdle to possible usage is cost. Of those currently considering a third-party solution, 34% said they would need more affordable options.

In somewhat of a twist, one reason some advisory firms are not considering using third-party providers is that a growing number of advisors — 18%, up from 9% in 2016 — are now providing third-party investment solutions to other advisors.

Managing investments in-house requires a serious commitment

Advisors that keep the investment management function in-house devote a considerable amount of time and resources to it. This year we saw a slight shift down in the average total hours spent by advisors on investment-related activities to a little over 25 hours per week, down from about 28 hours per week in 2016. This is related, primarily, to less time being spent on technology and portfolio monitoring functions. We attribute that decline in time to more efficient tools and/or more familiarity with digital tools to help with these functions.

Time spent varies by firm size

The time spent on investment functions varies by the size of the firm. There are a few inflection points that we see. As firms grow their client base they of course spend more time on investment activities. However, at certain points we see a decline in time spent on these activities which suggest that the firms have been able to create efficiencies with either better technologies or more experienced and efficient staff. We see this as advisors move beyond $150 million in assets and then again at the $3 billion in assets level.

TIME DEVOTED TO INVESTMENT FUNCTIONS BY FIRM SIZE

	LESS THAN $75M	$76M - $150M	$151M - $350M	$351M - $1B	$1B - $3B	MORE THAN $3B	TOTAL
Manager research	4.2	5.5	4.9	3.9	4.9	4.9	4.6
Portfolio construction	6.0	6.1	5.6	6.2	8.1	7.4	6.3
Portfolio monitoring	8.3	9.2	5.1	8.4	8.9	6.6	7.7
Working with technology	6.4	7.2	7.2	7.2	8.3	6.0	6.7
Total weekly hours spent	**24.9**	**27.8**	**22.6**	**25.6**	**30.1**	**24.8**	**25.2**

Source: "The Race to Scalability 2018," FlexShares Exchange Traded Funds, 2018

45%

OF ADVISORS CITE ATTRACTING NEW CLIENTS AS THE PRIMARY BENEFIT OF USING A DIGITAL ADVICE PLATFORM

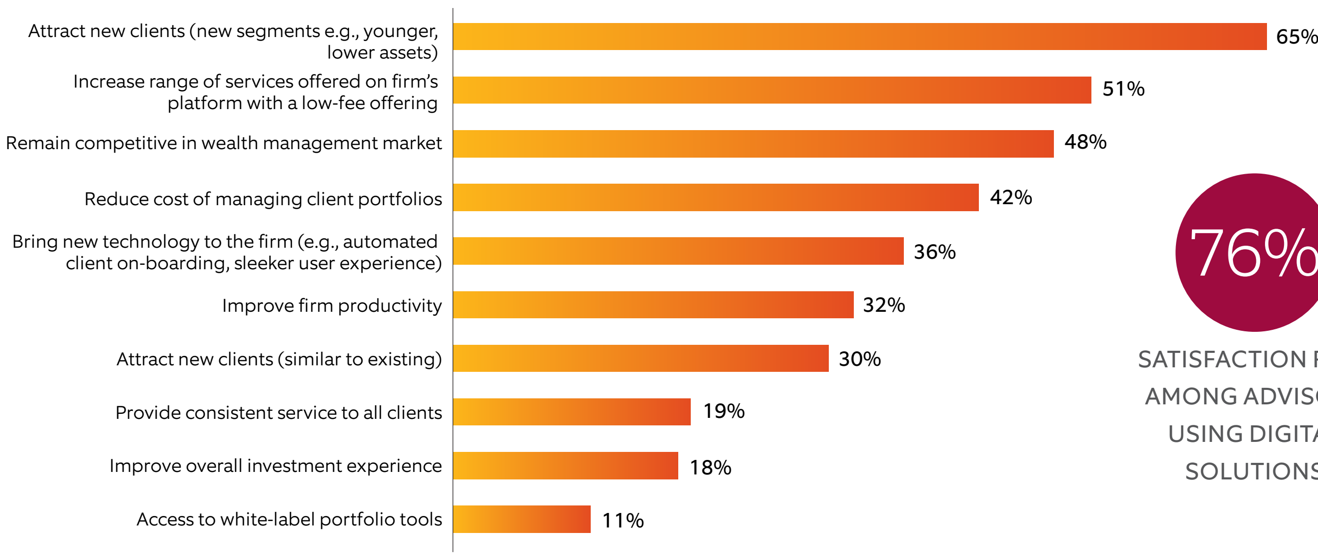
WHAT ABOUT DIGITAL PLATFORMS?

In 2016, based on our conversations with advisors, we added 'Robo Advisor' as a survey selection in the external investment solutions provider question. In that year 6.7% of our respondents indicated they utilized a digital advice platform within their practice.

This year we wanted to learn more. We were of course curious about whether that adoption rate had grown, the reasons driving advisors to utilize such a platform and their experiences in doing so. We added a grouping of questions to the 2018 survey focused on digital advice platforms and share some of our insights here.

Whatever label is placed on digital platforms – automated advice, robo advice, algorithm-based advice – advisors for the most part have not in great numbers incorporated such platforms into their practices. Of those surveyed, 82% of advisors do not offer a digital solution as part of their service offering. Another 6% currently offer one and 12% plan to add a digital component over the next one to two years.

PRIMARY DRIVERS FOR OFFERING A DIGITAL ADVICE PLATFORM



76%

SATISFACTION RATE AMONG ADVISORS USING DIGITAL SOLUTIONS

Source: "The Race to Scalability 2018," FlexShares Exchange Traded Funds, 2018

Implementation and Adoption of Digital Platforms

We asked advisors how their firm implemented or planned to implement their digital advice solution. The majority (39%) cite using a broker/dealer, followed by a third-party provider (26%), custodian (15%) and 11% citing an in-house build.

For those not currently using a digital advice platform, about a third say their opinion won't change but a majority (58%) say they would consider using one if there was demand from their current or prospective clients. Another 23% cite openness if the platforms were proven to be affordable and profitable.

CONCLUSIONS

In our survey we asked respondents what contributed most to client retention and satisfaction. Not surprisingly, the top three answers were customer service (74%), financial planning (51%) and investment performance (41%). The business model advisors used to deliver satisfaction varied but we noticed some trends across the board.

More fee compression

Higher fee income from assets under management, due in good measure to rising asset values, not organic growth, has obscured the fact that margins of financial advisory firms have been under pressure in recent years. That trend is likely to continue, as are consumer expectations that advisors offer broader wealth management services in a fiduciary context, regardless of how regulation evolves. If advice, rather than product sales, is to become the chief revenue generator, how is that best accomplished?

A need for scalability

Growing client expectations and greater competition is causing advisors to focus on ways to better scale their business. In this environment, advisory firms wishing to attract and retain clients, as well as maintain or increase margins and firm revenue, are considering many alternative in the areas of technology, human resources, operations and providers – not to mention assessing their own unique business strengths and areas of possible vulnerability. They must find ways to serve a larger and more demanding client base who have 24/7 access to information.

When external investment managers make sense

While many advisors are able to meet these needs organically, a growing number of advisors are choosing external money managers to concentrate on investments while they focus on other value-added aspects of the business.

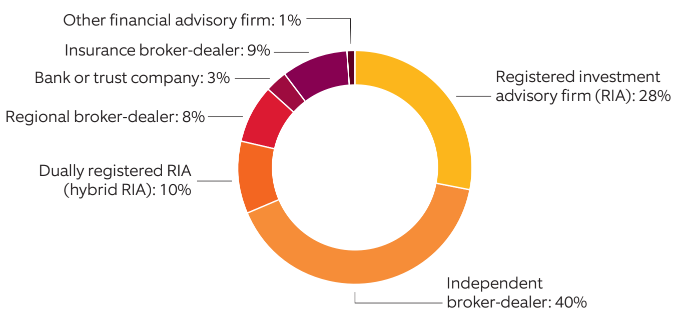
For advisors considering external investment management there are three compelling takeaways from the 2018 survey to consider.

1. **Positive bottom-line impact.** The free time created by using external managers — cited as an advantage by 61% of the respondents — allows advisors to strengthen relationships; focus on attracting new clients and provide the personalized financial services that clients value.
2. **Fiduciary support.** Our survey highlights the growing importance of using external managers to access institutional-level due diligence and monitoring and to provide access to investment products and strategies that individual advisors are not able to offer in-house - often at a lower cost.
3. **High Satisfaction.** Advisors and advisory firms that use third party investment managers are increasingly satisfied. This year, satisfaction reached a high of 97%.

ABOUT THIS SURVEY

To conduct this year's survey — the fifth in a series examining advisor views on external investment management — we worked with *InvestmentNews,* which fielded the electronic survey to more than 170,000 advisors across the United States from a variety of firm channels, sizes, and service models between February 13 and March 3, 2018. Nearly 600 responses were collected with 539 completed responses included in the final report. The sponsor was not identified in the survey.

SURVEY PARTICIPANTS BY FIRM TYPE



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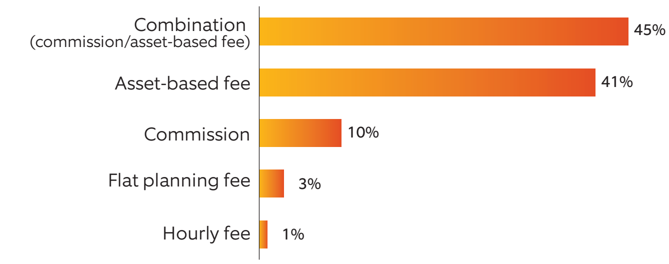
SURVEY PARTICIPANTS BY COMPENSATION TYPE



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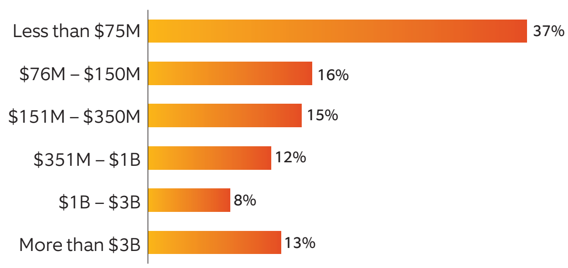
SURVEY PARTICIPANTS BY AUM



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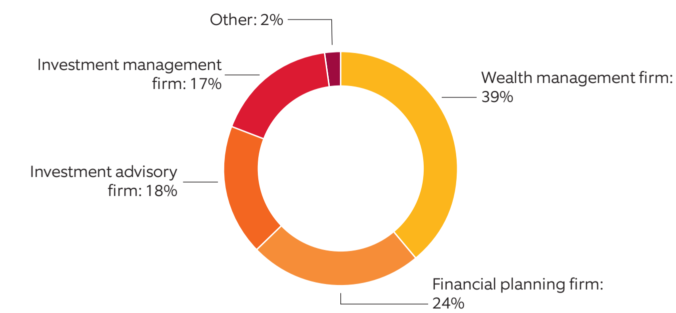
SURVEY PARTICIPANTS BY FIRM SERVICE MODEL



Source: "The Race to Scalability 2018," FlexShares Exchange Traded Funds, 2018

Helping to Put this Research to Work for You

FlexShares is committed to sharing this research to assist financial intermediaries.

ADVISORS: We can provide additional detailed information to help you benchmark your practice against your peers and the advisory space overall — Whether you outsource or not.

ASSET MANAGERS: This research can provide insights on advisors' outsourcing preferences segmented by firm size, type and business model.

To learn more, please visit flexshares.com/outsourcing or contact us at 1-855-FlexETF (1-855-353-9383).

FIND OUT MORE

FlexShares is committed to helping advisors guide investors through the stress of the financial markets to pursue their long-term goals. The FlexShares approach to investing is, first and foremost, investor-centric and goal oriented. We pride ourselves on our commitment to developing products that are designed to meet real-world objectives for both institutional and individual investors. Please don't hesitate to call us at 1-855-FlexETF (1-855-353-9383) or visit **www. FlexShares.com**.

IMPORTANT INFORMATION

Before investing, carefully consider the FlexShares investment objectives, risks, charges and expenses. This and other information is in the prospectus and a summary prospectus, copies of which may be obtained by visiting www.flexshares.com. Read the prospectus carefully before you invest.

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Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns.

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