Financial Professional Outlook

Tracking the opinions, conversations and market sentiment of U.S. financial advisors since 2010.

The pursuit of income: How are advisors navigating the risks and challenges of generating yield?

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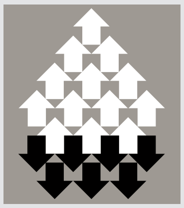
Many advisors are facing greater investor demand for income solutions than ever before. In past iterations of the *Financial Professional Outlook* we've explored how advisors are approaching income for retired clients, but in this survey we wanted to broaden that question to talk about all investors with a preference or need for income. We discovered some very interesting insights, particularly given where we stand today with an imminent interest rate rise (yes, this time we think it will happen!)

In the low interest rate environment we've been in for some time, many investors have begun to prioritize short-term income over long-term portfolio growth, and that can come with a set of risks that investors might not be considering fully. We think this is an important time for advisors and their clients to be having better conversations about striking a balance between portfolio growth and income, and we have a few ideas that might help.

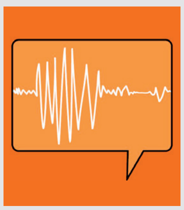
The latest *Financial Professional Outlook* survey was fielded from October 6, 2015 to October 21, 2015. During that time we heard from 297 financial advisors working for 213 investment firms nationwide. In addition to their perspectives on yield-focused investment strategies, we heard loud and clear that the recent market volatility is having a heightened impact on advisor-investor discussions as well as their expectations for market performance going forward. In this report, we will explore some of the ways advisors can help clients gain a better understanding of the market environment and refocus conversations on the topics that can have the most impact on their financial security.

Russell's survey snapshot

In this report, gain insight into the latest opinions, conversations and market sentiment of U.S. financial advisors, including:

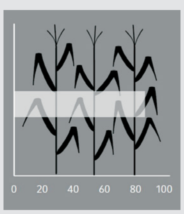


Advisor market optimism drops to all-time survey low while investors remain persistently uncertain.



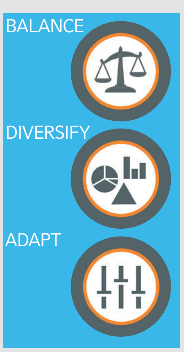
Advisors have an opportunity to refocus client conversations, as market volatility and performance concerns threaten their ability to hold proactive, well-planned discussions.

Advisors continue to face challenges in serving clients near or in retirement, such as providing diversified investment strategies that may balance income and growth.



Likely in response to investor demand, many advisors say yield-focused investment strategies are a good option for clients, but their reasoning raises some questions.

Advisors might not be fully considering the risks of chasing yield, pointing to an opportunity for stronger industry education and better client conversations.



Advisors likely need more support in finding strategies to help generate a responsible level of yield, which Russell believes requires consideration of these factors: balance, diversification, risk and adaptability.

SECTION 1

Volatility weighs on market sentiment and advisors' client conversations

Advisors' optimism falters in the face of market challenges

In each edition of the *Financial Professional Outlook* survey (FPO), we ask advisors how optimistic or pessimistic they feel about the performance of the capital markets over the next three years. We also ask advisors to assess how they think their clients feel about the markets over that time period.

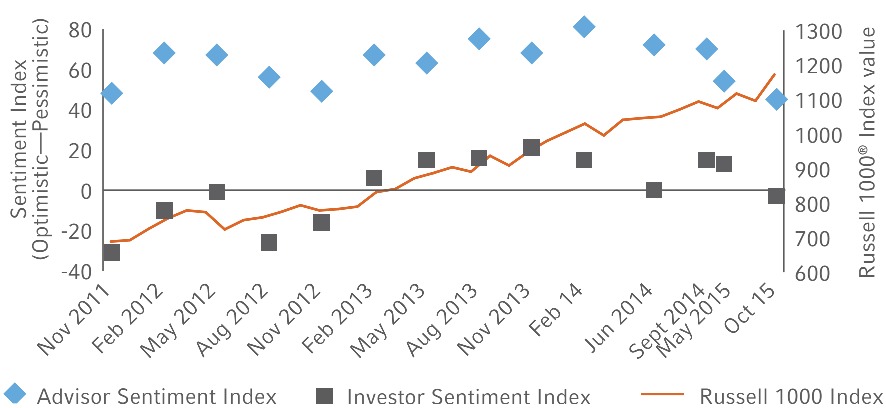
Since we began this survey in 2010, the markets have certainly seen their ups and downs. But considering that the U.S. equity market has risen fairly steadily over that time period (barring the intermittent swings of volatility) we were surprised to see advisor optimism so low in the latest survey[1]. In fact, the 64% of advisors who say they are optimistic about the markets is about as low as in the November 2012 survey, when the U.S. "fiscal cliff" and European debt concerns were rocking the markets.

They are optimistic about the markets over the next three years

[1] Source: Russell 1000® Index five-year return as of Sept. 30, 2015 is 13.42%

EXHIBIT 1: MARKET SENTIMENT—SENTIMENT INDEX* TREND: ADVISOR VS INVESTOR

In general, how optimistic or pessimistic are you about capital markets over the next three years?



*The Sentiment Index provides a point-in-time measurement of advisor and investor sentiment about capital markets over the next three years. The Sentiment Index takes into account both those who are optimistic and those who are pessimistic, and is calculated in this way: Sentiment Index = (% of group that is optimistic) – (% of group that is pessimistic).

	2011	2012				2013				2014			2015	
	Nov	Feb	May	Aug	Nov	Feb	May	Aug	Nov	Jan	May	Oct	May	Oct
Advisor: Optimistic	66%	78%	76%	68%	65%	72%	75%	83%	79%	87%	83%	78%	70%	64%
Advisor: Uncertain	15%	12%	14%	20%	20%	22%	13%	10%	10%	7%	7%	13%	14%	18%
Advisor: Pessimistic	18%	10%	9%	12%	15%	6%	12%	8%	11%	6%	11%	9%	16%	18%
Investor: Optimistic	9%	18%	21%	11%	16%	21%	32%	31%	36%	30%	24%	32%	31%	25%
Investor: Uncertain	51%	53%	58%	51%	51%	64%	51%	53%	50%	55%	52%	52%	51%	53%
Investor: Pessimistic	40%	28%	22%	38%	33%	15%	17%	16%	14%	15%	24%	16%	18%	22%

This chart was created by asking advisors to indicate how optimistic or pessimistic they are about the capital markets looking out over the next three years, on a 5-point scale of "extremely pessimistic to extremely optimistic." Then we asked them to gauge the sentiment of their clients on the same scale.

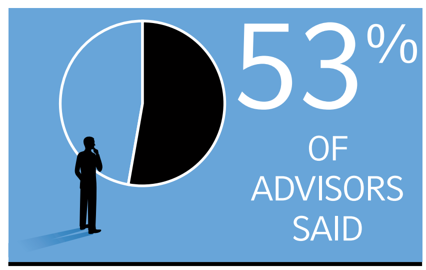
While advisors are likely reacting to expectations around interest rates rising in the U.S. and the recent market volatility largely generated by concerns about China and emerging market economies, we think this shift toward pessimism may be a bit drastic.

Russell's team of global investment strategists expects the U.S. Federal Reserve to raise rates modestly in December 2015 and several more times in the coming years. But it's important to note that the Fed's signaling about a pending rate increase appears to be linked to strong employment and low inflation expectations, both of which can generally be seen as positive economic signals. While advisors should certainly consider the investment impacts of rising rates, it's important to help clients understand the positive aspects of this impending change.

Finally, while many people have focused on the potential impact of China's apparently slowing economic growth may have on the global markets, Russell's investment strategists continue to believe that all signs still point to a continued soft landing. And as always, moments like this can provide unique buying opportunities for globally diversified investors.

Information can be a powerful cure for investor uncertainty

Going into year-end conversations, we would encourage advisors to help clients see a balanced view of the markets and what may lie ahead. Just 25% of advisors reported that their clients are optimistic about the markets, while 53% said clients are "uncertain." This has been a persistent theme throughout the life of the FPO survey, as at least 50% of advisors have reported client uncertainty in nearly every survey.



Clients are uncertain about the markets over the next three years

Uncertainty is often the result of a struggle to process information and concerns. And thanks to the powerful impact that "recency bias" can have on human behavior, investors are likely to consider each new headline-driving issue to be the most concerning. This creates a cycle of fear and uncertainty that can distract advisors and their clients from important financial planning conversations.

This is particularly challenging in an environment like we are in today, when market swings often have more to do with policy decisions than economic fundamentals. At Russell we believe we are largely seeing positive economic news in the U.S., such as strong jobs numbers recently, and yet the markets aren't reacting as positively as we might expect. This makes it hard for investors to understand the investment landscape and what they can anticipate in the future.

When addressing this type of uncertainty, it can be helpful to provide context for what is historically "normal" for market, asset class and economic performance. Moments of doubt can also be opportune times to remind investors of one of the tenets of investing: it is often during the times you feel the most uncertain, such as market dips, that potential investment opportunities arise that can support a disciplined investment strategy.

Advisors have an opportunity to refocus client conversations

The factors weighing on advisors' and investors' market views have clearly been a driving force in their recent discussions. When asked about the top topics of conversation initiated by clients in the past three months, 56% of advisors pointed to market volatility, no doubt driven by the recent spikes we've seen. In August, month-end market volatility (as measured by the CBOE VIX) rose to 19.43%, the highest since 2012. In September, month-end market volatility crept even higher with the VIX hitting 24.53%. Volatility concerns likely fed into other popular topics of investor-initiated conversation, including portfolio performance (48% of advisors) and global events (35% of advisors).

Advisors are largely raising the same issues in the conversations they are initiating with clients. The most-cited topic was portfolio performance (42% of advisors), followed by portfolio rebalancing (38% of advisors) and global events (37% of advisors). Since all eyes were on the Federal Open Market Committee meeting in September, it also wasn't surprising to see an uptick in the number of advisors broaching the subject of rising interest rates (34% of advisors compared to 21% in the October 2014 FPO survey).

When it comes to performance conversations, investors have likely been struggling to understand why their portfolios might not be performing in the same way they did in 2014 when we saw strong equity market returns[2]. Overwhelmed by uncertainty, investors are likely anxious for information to help them understand what they see in the news about volatile markets and events around the globe. But rather than holding structured, deliberate conversations with clients, advisors may be spending a lot of time in defensive mode—and that doesn't leave much room for effective financial planning.

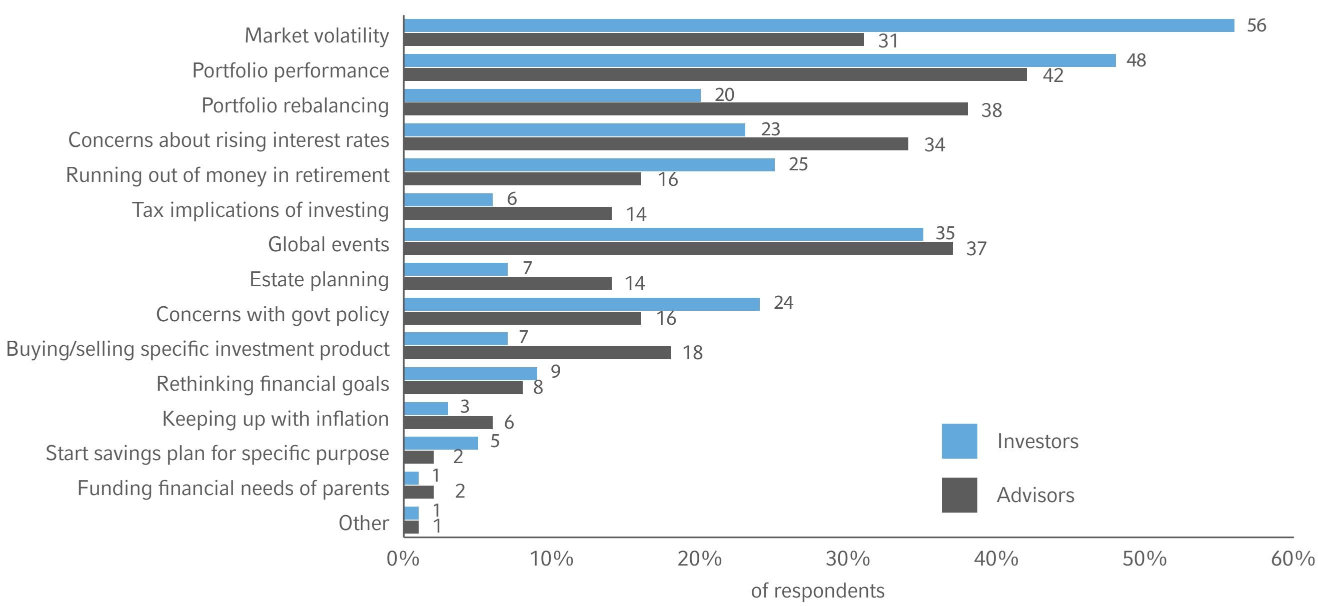
56%
OF ADVISORS SAID

Market volatility is one of the top topics raised by clients.

[2] Source: In 2014, the Russell 1000® Index returned 13.24%

EXHIBIT 2: WHAT ADVISORS AND INVESTORS ARE TALKING ABOUT

When thinking about conversations you've had with your clients over the past three months, which of the following have been the most common topics of conversations initiated by you? Initiated by your clients? (Up to three responses)



The good news is that advisors can take control by creating the right environment for purposeful conversations. When a discussion starts to drift down a less-than-constructive path, advisors can help clients pivot to a more productive approach by exploring these questions:

› **What are your goals?** Refocus on the client's overall investment objectives.

› **How much time do you have to reach those goals?** If their investment time horizon allows, remind clients of the benefits of a long-term perspective on investing rather than short-term reactions.

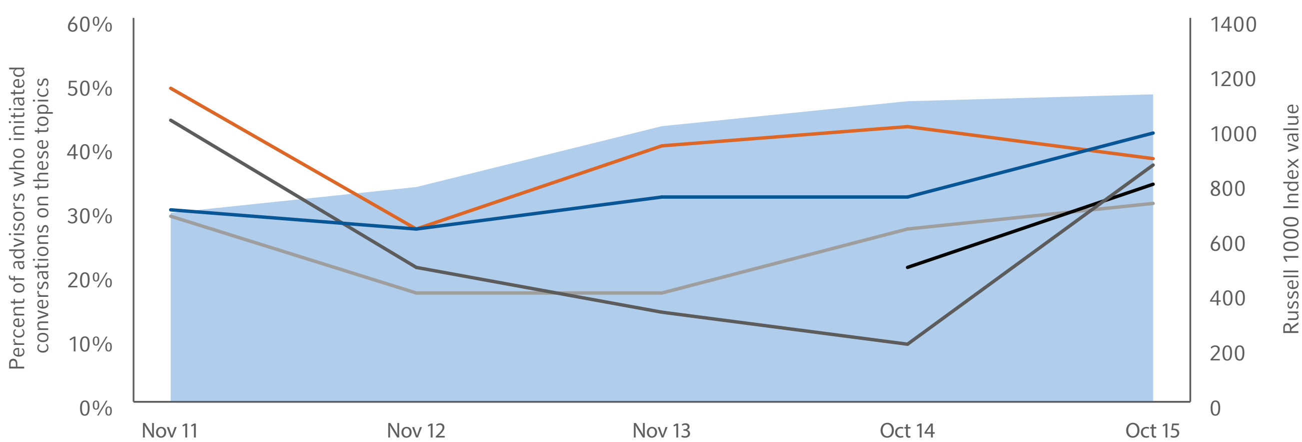
› **What can historical context tell us about current issues?** Use history to provide perspective and help calm clients' fears.

› **What tools are at our disposal?** Review the financial plan in place and any additional strategies to help pursue investors' goals.

RUSSELL'S PERSPECTIVE:
We may continue to see market volatility in the coming months, but there are many indicators that support a positive view on the U.S. and global economies in the longer term. As such, Russell's investment strategists do not believe we are heading into a cyclical downturn and believe that many potential opportunities remain for globally diversified investors. Refocusing clients on a long-term, disciplined investment perspective founded in an understanding of relevant history can be impactful.

EXHIBIT 3: ADVISOR-INITIATED CONSERVATIONS TOPICS: TREND

(Top tier: how often are advisors bringing up these topics with their clients?)



	Nov. 11	Nov. 12	Nov. 13	Oct. 14	Oct. 15
Portfolio performance	30%	27%	32%	32%	42%
Porfolio rebalancing	49%	27%	40%	43%	38%
Global events	44%	21%	14%	9%	37%
Rising interest rates*				21%	34%
Market volatility	29%	15%	17%	27%	31%
R1000 Index	689	783	1005	1096	1121

* This question wasn't asked in 2011, 2012 and 2013

SECTION 2

Financial security and the search for yield

Nearly 1/3 of advisors say some clients aren't on track for a secure retirement

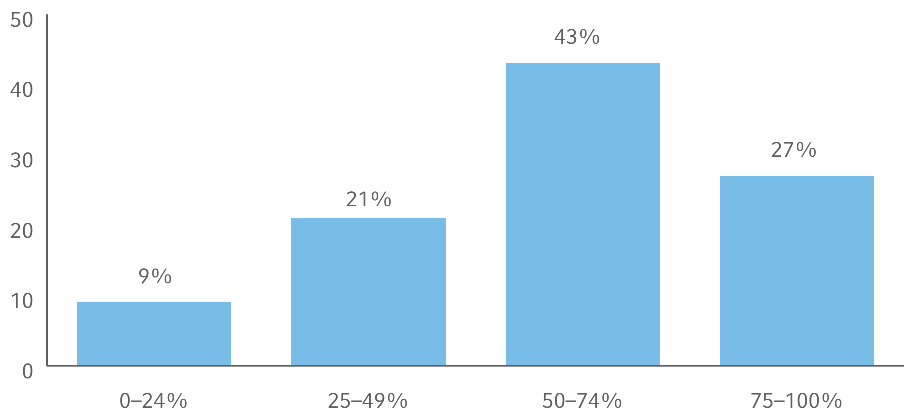
While it is encouraging that 70% of advisors said that the majority of their clients near or in retirement are on track for a sustainable retirement, we would like to see this number much higher. This means that nearly 1/3 of advisors (30%) feel that a notable portion of their clients are not on a path to maintain enough assets to support their preferred lifestyles without making significant changes.

Advisors may want to challenge themselves by asking: what if you could feel confident that all of your clients were on track for a secure retirement? Wouldn't that make your job, not to mention your day-to-day client meetings, more satisfying? If so, what do you need to get to that level of confidence?

It's likely that what advisors need is more support from the investment industry in tackling the challenges they face in working with retired clients.

EXHIBIT 4: CLIENTS ON TRACK FOR SUSTAINABLE RETIREMENT

What percentage of your clients near retirement or in retirement do you believe are on track for a sustainable retirement (i.e., are on track to maintain enough assets to support their preferred lifestyle without making significant changes)?



Turning retirement challenges into opportunities

In serving clients near or in retirement, advisors say they have no shortage of difficulties. More than half of advisors (55%) said that one of their key challenges is setting reasonable expectations with clients around spending policies. And once expectations are set, keeping a plan on course seems to be a struggle as well—44% of advisors pointed to the challenge of maintaining sustainable plans, given factors such as increasing life spans, escalating health care costs etc.

Many advisors (46%) also said they struggle in developing diversified investment strategies that balance income and growth. This is a challenge we hear about a lot in our conversations with advisors, and it is one that we dug into deeply in this iteration of the *Financial Professional Outlook*.

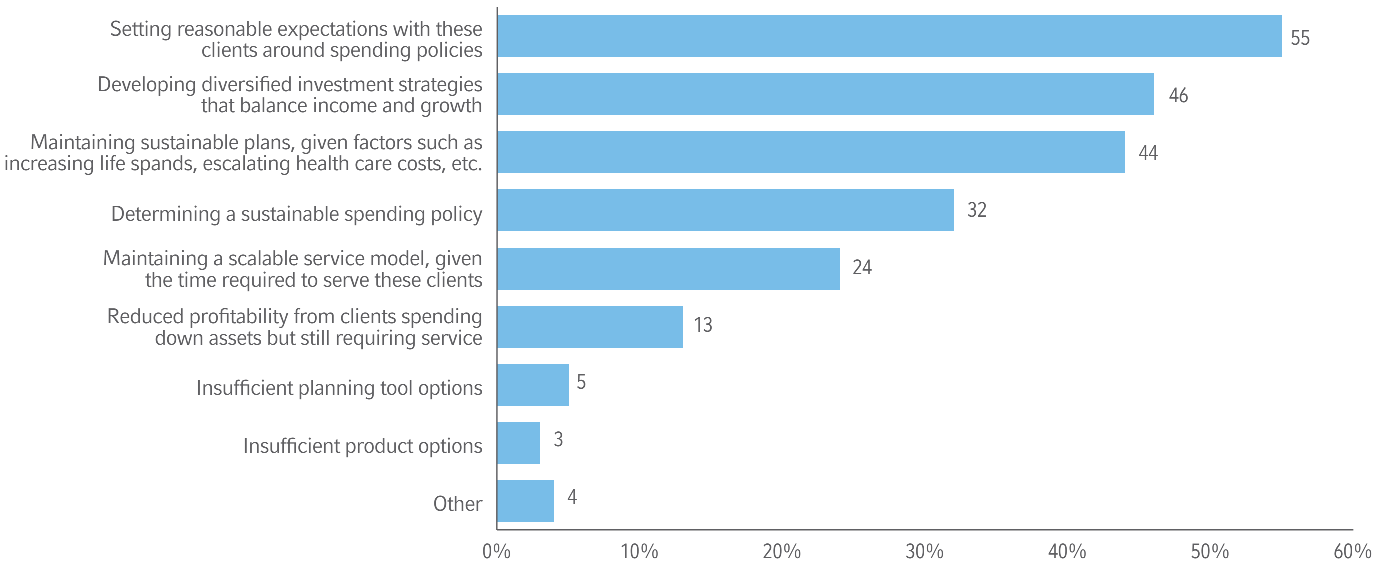
46%

OF ADVISORS SAID

Developing diversified investment strategies that balance income and growth is a challenge.

EXHIBIT 5: KEY CHALLENGES

What are your key challenges in serving your clients near or in retirement? (Multiple response)



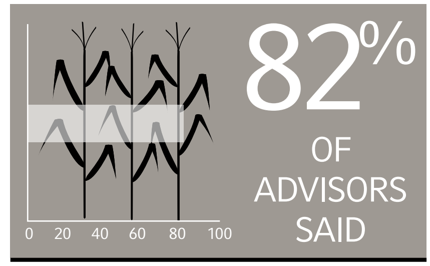
The demand for yield continues to heighten

It's no secret that investors are increasingly demanding income from their investment portfolios. And as we heard from advisors, it can be challenging to find strategies that strike the right balance between generating portfolio growth and income.

In the survey, 82% of advisors said that yield-focused investment strategies (or strategies that rely on dividends and interest alone to provide income) are a strong option for some or all of their clients.

Of those advisors, the primary reasons cited for yield-focused strategies include the belief that these strategies are simple for investors to understand and that they may be able to protect the initial investment in the portfolio while being a more sustainable approach. In part, this isn't surprising. It is fairly easy to explain yield-oriented products and many investors appreciate an income stream that simulates a paycheck without appearing to impact the initial investment—it's straightforward and comfortable. But we would argue that simplicity and comfort aren't the most important factors in financial planning.

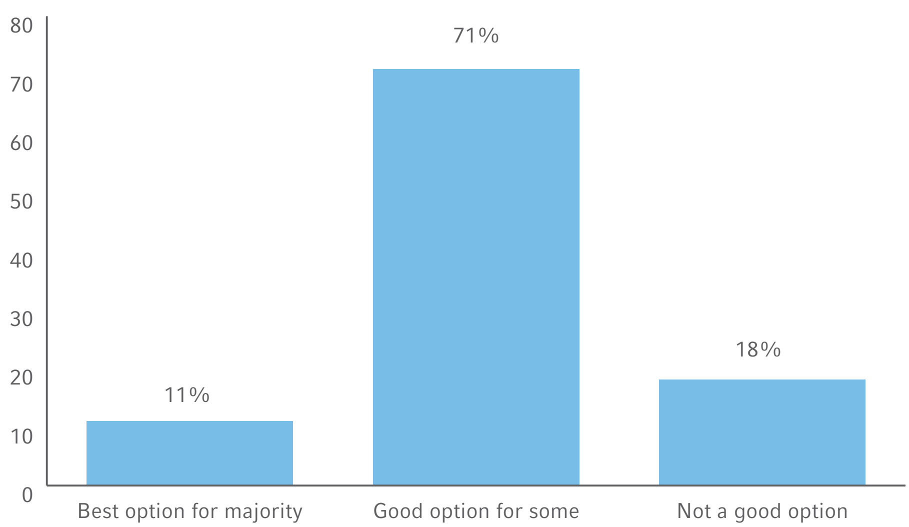
Only a small portion of these advisors actually said that they recommend yield-focused strategies because they are superior to other strategies. This finding points squarely at one of the primary hazards with being overly focused on yield: it's not always an optimal investment approach and these strategies can actually put sustainable income at risk.



Yield-focused investment strategies are a strong option for some or all of their clients.

EXHIBIT 6: YIELD-FOCUSED INVESTMENT STRATEGIES

For many investors who need their investments to provide income, yield-focused strategies (relying on dividends and interest alone to provide income) is an appealing way to invest. In general, what is your view on yield-focused investment strategies for clients?



Considering the risks of chasing yield

From an objective, academic perspective, prioritizing yield over all else in a portfolio almost never makes sense. In fact, Russell's research has shown that the total expected return of a portfolio often declines when the yield objective surpasses 3.5%[3]. That's because the constraints and risks often associated with yield-oriented strategies can lead to the opposite of the simple, comfortable financial situation investors are seeking.

Some of these risks and considerations depend on the approach to generating yield. Of the products advisors said they use to generate income in client portfolios, the top selections were dividend paying stocks (83%), REITs (61%), corporate bonds (61%), high-yield bond funds (53%) and traditional open-ended funds and ETFs (53%).

Each of these products has the potential to play a role in a well-diversified portfolio. However, the search for yield can introduce risks to the portfolio that might erode the "safety" and sustainable income investors are seeking. It's essential to consider where yield is coming from within a portfolio to help understand and manage the potential risks and benefits. Some of these risks include:

- **RISK OF TRADING SHORT-TERM INCOME FOR LONG-TERM PORTFOLIO GROWTH**
  In many ways, focusing on generating short-term income can weaken the long-term growth of a portfolio. Consider the example of dividend yield investing. Investors often overlook the fact that dividend payments are simply excess profits that a company distributes rather than reinvesting for future growth. As such, by prioritizing immediate needs and trying to avoid "invading principal," investors may actually be reducing the future value of their portfolios.
- **RISK OF "HIGH YIELD" BECOMING "JUNK"**
  High-yield bonds typically have higher yields than corporate bonds to compensate for additional risks, such as uncertain company prospects. It's easy to remember that this is the case when you consider these bonds are called "high yield" when their performance has been good, but "junk" when their performance has been poor. Depending on an investor's risk tolerance, allocating a large portion of assets to high-yield bonds may be a risky approach.
- **RISK OF ASSET CLASS OR SECTOR CONCENTRATION**
  A focus on yield can lead to the selection of a narrow band of investments. It's not uncommon to see yield-oriented investment products with up to 60% of assets invested in a single asset class[4]. Investments like dividend-paying stocks can also be highly concentrated in certain sectors such as utilities, telecommunications or energy. As with any type of excessive concentration, a lack of diversification can leave a portfolio more susceptible to volatility.

[3] Source: "Is a Portfolio Built to Produce Yield a Sensible Retirement Income Portfolio?" by Sam Pittman, Ph.D. August 2014.

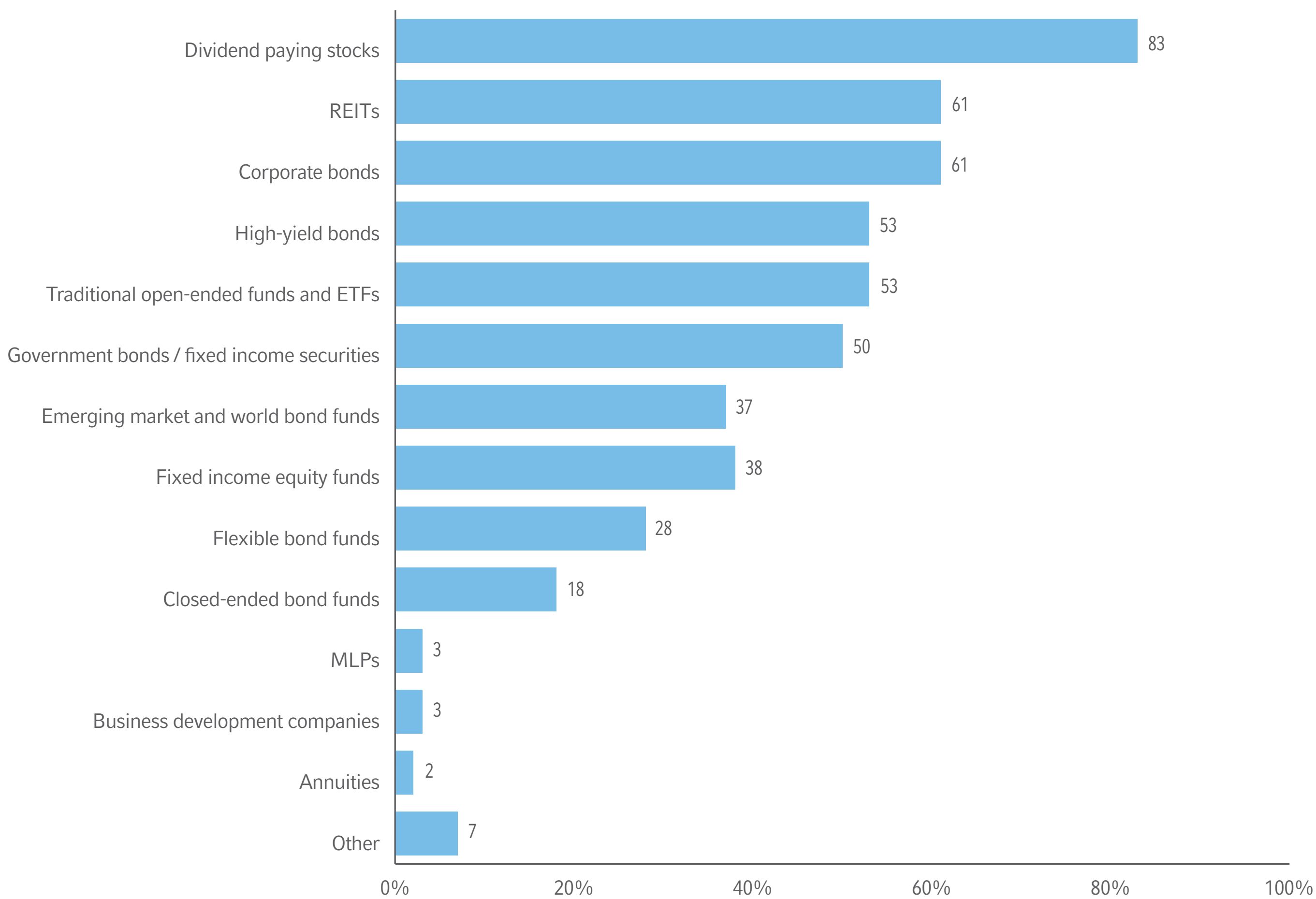
[4] Source: FactSet

› **RISK OF HOME COUNTRY BIAS**
Home-country bias can be a common trait for many investors. When it comes to yield-oriented strategies, this bias may cause U.S. investors to miss out on yields that may be higher in investments beyond their own country's borders.

› **RISK OF LIQUIDATION ISSUES**
Many income mutual funds available today tend to be relatively large in terms of assets under management. While that might sound like a positive thing, it's important to remember that larger mutual funds can often be more constrained in their ability to liquidate positions. This lack of flexibility can make it harder for a portfolio to nimbly adjust to changes in the market environment.

There's no denying that advisors are facing a difficult scenario: clients are demanding income and the industry hasn't provided a simple solution to balancing income and portfolio growth. We think the answer lies in finding a way to produce a responsible, sustainable level of yield based on the investor's needs and circumstances.

EXHIBIT 7: INCOME-FOCUSED PRODUCTS USED TODAY
What income-focused products are your clients using today?



Generating a responsible level of yield

Given the importance of the risks associated with the search for yield, we were surprised to see that only 18% of advisors said they don't believe yield-focused investments strategies are a good option for most of their clients.

Underscoring their reasoning, these advisors indeed pointed to risks, such as the belief that focusing on yield doesn't offset the risk of capital erosion due to inflation (53% of advisors) and that reaching for higher yields may sometimes generate better near-term returns, but at the cost of higher credit risk (40% of advisors). Yet even with this acknowledgement, we would hope that more advisors and investors are aware of the risks that can be at stake.

To help reduce the level of risk and portfolio volatility, we believe income solutions should pursue a responsible level of yield through a well-diversified, multi-asset approach. At Russell, we like to talk about key considerations in generating a responsible level of yield:

› **Balance:** Balance today's income needs with the portfolio's longer-term objectives of growth for tomorrow.

› **Diversification:** Make sure a portfolio relies on a mixture of strategies, asset classes and globally diverse investments.

› **Risk:** Beware of overreaching for yield. The appropriateness of risk should be aligned to an investor's individual ability to tolerate and weather risk.

› **Adaptability:** Yield-producing assets may require dynamic asset allocation adjustments. Be sure that such a portfolio has the ability to be adjusted with appropriate frequency.

Reaching for higher yields may sometimes generate better near-term returns, but at the cost of higher credit risk.

* Percentage of advisors who indicated they don't believe yield-focused strategies are the best option for some or most of their clients

EXHIBIT 8: YIELD-FOCUSED STRATEGIES

Not a good option for most investors because...	4Q15 investors who have a need for income
Current yields are not high enough to meet retirement income needs	60%
Focusing on just yield doesn't offset the risk of capital erosion due to inflation	53%
Reaching for higher yields may sometimes generate better near-term returns, but at the cost of higher credit risk	40%
Retirees likely give up return for the amount of risk they take in a yield portfolio	34%
Producing retirement cash flows from yield is less tax efficient than withdrawing cash flows from a portfolio	34%
Yields change over time which can make it challenging to support consistent spending needs	30%
Spending only yield limits a retiree's options around bequests	9%
Other	6%

In our view, the best way to manage these four factors is by taking a *total-return* approach to managing a portfolio. A total-return approach looks at the sum of interest, dividends and capital appreciation when considering the ability to generate income. By thinking about those distributions from a total-return perspective, investors can have more flexibility in how they generate income and can manage some of the risks associated with a too-narrow focus on income.

But how can advisors make a total-return approach as easy for clients to understand as a yield-oriented one? As in many conversations, asking the right questions may be the best place to start. If a client expresses a need for yield, try to dig deeper into that issue by asking questions such as:

› Why do you feel that you need income from your portfolio?

› How much income do you need?

› Do you expect the amount of necessary income to change over time?

› Are dividends the only way you want to generate that income, or are there other options to explore?

The first question is perhaps the most important, because it can enable advisors to drill into the emotional driver behind their client's request. Once an advisor can refocus the conversation on the investor's goals, circumstances and preferences, they are better equipped to design a disciplined investment approach that helps meet a client's short-term needs without jeopardizing the ability to reach their desired financial outcomes.

RUSSELL'S PERSPECTIVE:

For most advisors, investing is not an academic exercise—it's a careful balance of addressing clients' needs and desires while also guiding them on a sustainable financial path. When it comes to the challenge of generating income, it's important to consider all the risks and potential opportunities and encourage clients to balance today's concerns with the strategies that might help them create a more financially secure future.

Methodology

Russell Investments conducted the *Financial Professional Outlook* survey between October 6 2015 and October 21, 2015. The survey was sent to a broad group of U.S. financial advisors. Having a financial relationship with Russell was not part of the criteria for being included in the survey. In total, 297 survey responses were received representing 213 firms. The sample size of 297 is sufficient to provide 95% confidence that the results will be within plus or minus 5.8%. In other words, if we repeated this survey 100 times we would expect to find similar results in 95 of the 100 trials.

About Russell Investments

Russell Investments, a global asset manager, is one of only a few firms that offers actively managed multi-asset portfolios and services which include advice, investments and implementation. Russell Investments stands with institutional investors, financial advisors and individuals working with their advisors—using the firm's core capabilities that extend across capital market insights, manager research, asset allocation, portfolio implementation and factor exposures to help each achieve their desired investment outcomes.

Russell Investments has more than $237 billion in assets under management (as of 9/30/2015) and works with more than 2,500 institutional clients, independent distribution partners and individual investors globally. As a consultant to some of the largest pools of capital in the world, Russell Investments has $2.4 trillion in assets under advisement (as of 12/31/2014). The firm has four decades of experience researching and selecting investment managers and meets annually with more than 2,200 managers around the world. Russell Investments also traded more than $1.7 trillion in 2014 through its implementation services business.

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Russell 1000® Index: Measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 92% of the U.S. market.

Performance quoted represents past performance and should not be viewed as a representation of future results.

The Chicago Board Options Exchange Volatility Index (CBOE VIX) measures annualized implied volatility conveyed by S&P 500 stock index option prices. The indicator value reflects a month end reading of the trailing daily average for the month.

Non-U.S. markets, which may include developed, emerging, and frontier markets, entail different risks than those typically associated with U.S. markets, including currency fluctuations, political and economic instability, accounting changes and foreign taxation. Non-U.S. securities may be less liquid and more volatile than U.S. securities. The risks associated with non-U.S. securities may be amplified for emerging markets securities. Because frontier markets are among the smallest, least developed, least liquid, and most volatile of the emerging markets, investments in frontier markets are generally subject to a greater risk of loss than investments in developed or traditional emerging markets.

Bond investors should carefully consider risks such as interest rate, credit, default and duration risks. Greater risk, such as increased volatility, limited liquidity, prepayment, non-payment and increased default risk, is inherent in portfolios that invest in high yield ("junk") bonds or mortgage-backed securities, especially mortgage-backed securities with exposure to sub-prime mortgages. Generally, when interest rates rise, prices of fixed income securities fall. Interest rates in the United States are at, or near, historic lows, which may increase a Fund's exposure to risks associated with rising rates. Investment in non-U.S. and emerging market securities is subject to the risk of currency fluctuations and to economic and political risks associated with foreign countries. Emerging markets debt has higher default and repayment risk than traditional bond markets.

Diversification does not assure a profit and does not protect against loss in declining markets.

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