

WHAT'S AHEAD IN 2010?

Economic Predictions, Financial Services Regulation and Enhanced Product Offerings

Economists' predictions for next year: a mixed bag

In this current recession, economists are clear about which economic sectors will need to improve for a full-fledged recovery – notably employment and housing. However, the agreement seems to end there, and predictions vary widely depending on which statistics the economists believe are important.

Employment

Optimists see an improving U.S. labor market based on reports released in early December.

On December 4, the Labor Department announced the unemployment rate had dropped to 10.0% in November. Only 11,000 payroll positions were lost, compared to the average monthly job losses of 135,000 a month for each of the prior three months.¹

Pessimists, on the other hand, are looking at the lack of job creation and continuing high levels of unemployment. David Rosenberg, formerly a top economist at Merrill Lynch, expects the unemployment rate could reach 12%-13%. He cites structural issues in the U.S. labor market as well as job seekers who are currently not counted in the official numbers.²

The government will continue to work toward stimulating job growth. In a December 2 *Wall Street Journal* opinion piece, the chair of the president's Council of Economic Advisers acknowledges that "the job market remains very weak." She recognizes that American businesses have increased productivity (with fewer workers) and are hesitant to hire. To spur job growth, a White House Jobs Forum is focusing on ideas to increase home energy conservation and helping small businesses find more credit and save on taxes.

Where will U.S. employment go in 2010? Most economists recognize the slow turnaround in employment levels and do not expect any real improvement until mid-2010 at the earliest.

Housing

Like the employment sector, some housing statistics show improvement over last year but economists agree that there is a long way to go.

On the plus side, economists cite low interest rates and government tax credit stimulus as factors that will help housing. A positive forecast by the National Association for Business Economics (“NABE”) shows housing to increase by 36% and housing prices to go up by 2%. Economists surveyed said that 2010 would be the first year since 2005 that the housing sector contributes to overall growth.³

On the other hand, about 23% of all homeowners are “under water”: they owe more on their mortgages than their home is worth. Many of these homeowners have received notices of default. This situation will keep prices down and contribute to a drawn-out housing recovery, according to experts. On November 24, economists from J.P. Morgan Chase & Co. said that they didn’t expect U.S. home prices to hit bottom until early 2011, citing the prospect of oversupply.⁴

The big picture: GDP, interest rates and the stock market

GDP shrank by 5.7% in the first quarter and was revised to a 2.8% growth rate in the third quarter. So the trend is definitely positive. Christina Romer, chair of the president’s Economic Council, has quoted a 2%-3% growth rate in 2010.

One area of agreement among economists is that the Fed will not raise interest rates in the near future, and that inflation is not an immediate threat.

Contributing to a strong GDP and stock market, NABE economists forecast robust business growth – with a 12.4% gain in corporate earnings (which would in turn spur stock market gains). Businesses have bottomed out on inventory levels and will need to replenish. NABE economists also expect businesses to invest more in equipment and software.

In addition – although many economists do not share this view – NABE expects the S&P 500 to rise by 9.5%.

Financial Services Regulation

Foreclosures and job losses are not the only result of the economic crisis. Spurred by the ill winds of 2008-09, legislators are looking for ways to prevent the next economic emergency and perhaps further their own political agendas at the same time.

The only financial law actually enacted in 2009 has been the Credit Card Accountability, Responsibility, and Disclosure Act, which is designed to curb credit abuses.

It is clear, though, that 2010 will bring many more new rules and regulations. The concept of a “super agency” that oversees all financial affairs was floated in early discussions. That idea has now been replaced with the initiative that regulation among agencies should “harmonize” even if it is not exactly identical.

Under the banner “Financial Regulatory Reform: A New Foundation,” the proposed agenda addresses top-line economic issues such as regulation of derivatives, registration of hedge fund managers and modifying the mission of the Securities and Exchange Commission. The administration would like to

see the Federal Reserve's role increased to more directly supervise financial companies that fall under the "too-big-to-fail" category and to take a more active role in preventing economic risks to the U.S. financial system.

For the benefit of families and individuals, a Consumer Financial Protection Agency would be created to coordinate and supervise a host of retail financial functions that currently are scattered among different agencies.

Financial advisors could see a decades-old division between RIAs and broker-dealers resolved in 2010. Or – depending on their point of view – they will see a more complex set of regulations in place that attempt to balance the fiduciary responsibilities assumed by an RIA with the agent role of a broker. In addition, the current system of mandatory arbitration for settling disputes with consumers could receive a thorough review and potentially be revised.

New fiduciary standards that will impact advisors

Investment adviser? Broker-dealer? Although both of these groups are conduits for individual and small-business investors, they actually function with distinct sets of standards and responsibilities, under separate regulatory bodies.

But U.S. consumers and investors do not understand the differences. This confusion is documented in detail by a RAND Corporation study for the Securities and Exchange Commission. As the report says, "... investors typically fail to distinguish broker-dealers and investment advisers along the lines that federal regulations define."⁵

Most retail investors expect that a broker – who is typically paid a commission for a financial product – is functioning in the best interest of the clients. In fact, the broker's commitment is to conduct the transaction on behalf of his or her firm. Broker-dealers are generally exempt from the fiduciary responsibilities that registered investment advisers assume. Their obligation is to provide products that are "suitable" for clients. In general, broker-dealers are regulated by the Securities Exchange Act of 1934 and the Financial Industry Regulatory Authority.

Registered advisers, on the other hand, are committed to a "fiduciary standard of care" under the Investment Advisers Act of 1940. They are regulated by the SEC or state securities commissions.

Broker-dealers are not happy with:

- Any proposal that conflicts with the current business model. That would include the rigid concept that firms must act only in the interest of their customers, disregarding their own financial objectives.

Concerns voiced by advisors include:

- The current fiduciary standard will be watered down to fit what some perceive as the lower requirements of broker-dealers.

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- The fiduciary standard would be defined too narrowly, closing out options for individual situations.

And many industry insiders are leery of higher expenses and the accompanying time-consuming and legal issues that would accompany the new regulation.

What will the legislative of this apples-oranges issue be? As a political reality, Congress will pass legislation. If history is a guide, it will be a compromise that aligns the two sides more closely together but leaves many functions separate.

Regulatory requirements for both sides will move closer together, although they might not be identical. This would be consistent with the SEC-RAND study which found that the two are already overlapping more closely than in the past.

A second issue with a direct effect on financial advisors is arbitration. The administration has come out on the side of allowing the SEC to prohibit mandatory arbitration, which is often required in broker-dealer and advisor contracts.

Currently, bills are under discussion in both the House and Senate, and the consensus is that many of these financial services issues will be legislated in some way – most likely in versions that are the result of legislative compromise.

Looking ahead: Investment Products in 2010

One of the remarkable qualities of the financial industry is its ability to develop new products. In some cases, these are new ways to package an existing product. But at other times, products are developed that can help investors deal with new vagaries in the financial markets.

With the market back to normal levels, it might take a small effort to recall the emotional response to the market nosedive of late 2008 and early 2009. However, investment products and tactics emerged in 2009 to counter these events and may gain stronger traction in the year to come.

- Tactical investing. When portfolios dropped severely a year ago, many investors questioned their long-term investment strategy. In response, tactical programs were developed which were sensitive to near-term financial events. Advisors found that diversifying with these short-term strategies helped clients balance the rest of their portfolio with a longer-term horizon.
- Revised view of risk. Clients who felt that a 60-40 portfolio represented moderate growth now look at the same allocation levels as a more aggressive portfolio.
- Socially Responsible Investing (“SRI”). Although SRI has been available for years, investors now expect a fair ROI (return for investors). No longer only for “do gooders,” a stronger connection between governance and positive returns for investors is being made.

What stays the same?

- Due diligence is more important than ever. PMC, Envestnet’s investment arm, provides due diligence services which can help advisors meet the fiduciary standard. PMC will run due diligence for selected separate account portfolios, ETFs and alternative investments. To meet re-set risk tolerances, models can be reevaluated and potentially reclassified.

- Asset allocation. Looking into 2010, the conservative strategies adopted for 2009 are expected to continue. Long-term strategic investing is still a viable approach with the potential addition of a tactical overlay.

For appropriate investors, alternative, non correlative investments can be useful, although possibly to a lesser extent than in past years.

- Clients want personal contact. Platform providers like Envestnet can help advisors spend more one-to-one time with their clients by optimizing efficiencies through integrated technology.

Looking into 2010, the crystal ball is not always clear. Economists are divided about many parts of the U.S. financial picture, but most agree that we have turned the corner toward a stronger economy. Legislation will attempt to address causes of the recession. Consumer and investor have lowered their expectations. "Win by not losing" has replaced anticipated 10% annual returns.

The worst of the "worst recession since the Great Depression" is most likely behind us. The year to come offers plenty reasons for optimism.

¹ Press release, December 4, 2009, Bureau of Labor Statistics, U.S. Department of Labor, www.bls.gov/news.release/empsit.nr0.htm.

² "U.S. Unemployment Rate Headed to 12%-13%, Economist Says," Wall Street Journal, <http://blogs.wsj.com/economics/2009/11/11/us-unemployment-rate-headed-to-12-13-economist-says/>

³"Robust earnings to boost S&P 500 by 9.5% next year: economists," Associated Press, November 23, 2009, www.investmentnews.com/apps/pbcs.dll/article?AID=/20091123/FREE/911239995/0/rss02

⁴ "One in Four Borrowers Is Underwater" by Ruth Simon and James R. Hagerty, Wall Street Journal, November 24, 2009, <http://online.wsj.com/article/SB125903489722661849.html>

⁵ Hung, Angela et al, Investor and Industry Perspectives on Investment Advisers and Broker-Dealers. RAND Corporation, 2008.



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