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LPLA - Q2 2017 LPL Financial Holdings Inc Earnings Call

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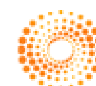

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the LPL Financial Holdings Second Quarter Earnings Call. (Operator Instructions) And as a reminder, this conference call is being recorded. I would now like to introduce your host for today's conference, Mr. Chris Koegel, Head of Investor Relations. Sir, you may begin.

Chris Koegel - *LPL Financial Holdings Inc. - SVP of IR*

Thank you, Sandra. Good afternoon, and welcome to the LPL Financial Second Quarter 2017 Earnings Conference Call. On the call today are Dan Arnold, our President and CEO; and Matt Audette, our CFO. Dan and Matt will offer introductory remarks, and then we will open the call for questions. (Operator Instructions) Please note that we have posted our earnings release and supplementary files on the Events & Presentations section of the Investor Relations page on lpl.com.

Before turning the call over to Dan, I'd like to note that comments made during this call may include certain forward-looking statements concerning such topics as: our future revenue, expenses and other financial and operating results; the regulatory environment and its expected impact on us; industry growth and trends; our business strategies and plans; as well as other opportunities we foresee. Underpinning these forward-looking statements are certain risks and uncertainties. We refer our listeners to the safe harbor disclosures contained in the earnings release, and our latest SEC filings to appreciate those factors that may cause actual, financial or operating results or the timing of matters to differ from those contemplated in such forward-looking statements.

In addition, comments during this call will include certain non-GAAP financial measures governed by SEC Regulation G. For a reconciliation and discussion of these measures, please refer to our earnings press release.

With that, I'll turn the call over to Dan.

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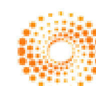

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Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

Thank you, Chris, and thanks to everyone for joining today's call. I'd like to start my remarks with a summary of our second quarter results. We remained focused on our strategic priorities of growing our core business and executing with excellence. The macro environment was also supportive, again, as markets rose and the fed raised rates further. Our core business continued to grow as total assets reached $542 billion at the end of the quarter. Assets were up 11% year-over-year and 2% sequentially.

Total net new assets were $0.4 billion and advisory net new assets were $5.9 billion. Demand for our advisory services remain strong, which is a favorable trend for our business. These results include the impact of the client departures, which we anticipated and spoke about over the last 2 quarters and are now complete. Excluding those departures, second quarter total net new assets were $2.1 billion, net new advisory assets were $6.1 billion, our advisor count increased by 2 and our production retention was 97%. These business results, especially on our advisory platforms, reflect the continued success of our advisors in the marketplace.

Let's now turn to our financial results for the quarter. Gross profit was up year-over-year driven by increased revenue from advisory fees, cash sweep, sponsors and transaction and fees. Our EBITDA continued to grow faster than gross profit as we stayed disciplined on expenses and generated operating leverage. These results led to $0.74 of earnings per share in Q2, up 40% year-over-year.

Matt will go into further depth on our financial results. As we look forward, we plan to stay focused on driving business growth and delivering operating leverage. I'd now like to talk more about our ongoing work in support of our first strategic priority, growing our core business, starting with how we are helping advisors to differentiate themselves through an enhanced investor experience. This work includes continuing to innovate on our advisory solutions and transforming our client account statements.

On the advisory front, we have made changes on our centrally-managed platforms to enhance investment content, improve workflows and lower cost, all of which, make for more appealing solutions for investors. These platforms also enable our advisors to outsource portfolio construction and trading to us, which gives them more time to spend with clients and prospects and create more growth opportunities. As a result, we have seen an increase in the utilization and growth of the assets on our centrally-managed platforms.

In Q2, we had more than $1 billion of net new asset flows and finished the quarter with more than $27 billion in balances. Given that progress, our work here will continue as we add more investment content and capabilities.

At the same time, we are making a series of similar enhancements to our separately-managed account platforms. We recently reduced platform fees and introduced new lower cost active management investment options, and we will also make additional manager fee reductions throughout the remainder of the year. These changes will enable advisors to offer a robust set of customized, tax-efficient portfolios to a broader array of clients. These solutions will also provide another option for advisors to outsource investment management, so they have more time to spend with clients and grow their practices.

We're also working to transform our client account statements. We know our advisors' clients expect access to information about their financial life in ways that are clear and meaningful to them. Next month, clients will receive reengineered statements offering them a streamlined and more focused perspective on their progress toward achieving their financial objectives. We believe these changes to our advisory solutions and client statements will help advisors delight their clients and grow their practices.

Another key element of growing our business is supporting our advisors through the DOL fiduciary rule transition. As you know, the effective date was June 9, and our implementation work is going according to plan. Our strategy remains to make our advisors compliance work simpler and more efficient, so they can focus on running their business. The early feedback we hear from advisors is, they feel well prepared for the transition and are seeing opportunities to win business based on our approach.

We are also working hard to be prepared for the expected January 1, 2018 implementation date and to roll out our new mutual fund-only brokerage platform early next year. As we shared earlier this month, this solution is intended to preserve choice for retail investors, while offering enhanced

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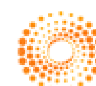

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functionality and pricing. Additionally, this solution will standardize brokerage mutual fund compensation for advisors. We believe our mutual fund-only offering will also help advisors differentiate and grow their practices.

We continue to anticipate that industry changes like the DOL rule will create more advisor movement and opportunities for industry consolidation. We have been winning business by building on these themes, and we like the opportunities we have in our recruiting pipeline to gain market share. We believe our size and scale are a competitive advantage that positions us to provide our advisors with better capabilities at lower costs. We are also prepared to deploy our excess cash and balance sheet capacity to growth opportunities that make sense both strategically and financially.

I would now like to discuss our second strategic priority, executing with excellence. Our team is well aligned on the core competencies that will drive our execution, efficiency, quality and innovation. Let me share a couple of examples of our progress. On the efficiency front, we are on track for another year of modest expense growth. We are funding most new investments through productivity and efficiency gains in other areas, and we remain committed to diligent expense management.

As for innovation, we continue to enhance our cash sweep program. Last summer, we introduced our DCA program that extended FDIC insurance to certain advisory retirement accounts with about $4 billion of client cash balances. As we continue to innovate, we are pleased to announce the launch of our ICA business account program allowing us to provide FDIC insurance to more clients. Earlier in July, about $1 billion of client cash moved from third-party money market funds to ICA. This is an example of our focus on innovation in our work every day.

Finally, to better align our executive team on serving our clients and executing our strategy, I was pleased to recently announce 2 leadership changes. First, Michelle Oroschakoff's role expanded to Chief Legal and Risk Officer. Michelle has a proven ability to achieve outcomes in the best interest of investors, advisors and the company all while managing through a tremendous amount of change in the regulatory environment. Secondly, Scott Seese joined us at the beginning of July. Scott was previously CIO of American Express' Global Consumer Business and prior to that, he was CIO at eBay and held senior technology roles at Bank of America and GE. In Scott, we hired a seasoned technology leader, who has demonstrated his ability at leading organizations to embed client-centric solutions in digital platforms and products. We are looking forward to working with Scott as he focuses on transforming our technology from utilities to strategic assets.

Our management team is now highly integrated and empowered to deliver for our advisors and our organization. In closing, we had another quarter of business growth and increased operating leverage. We remain focused on growing our core business and executing with excellence. We believe, if we succeed on those priorities, we can create long-term shareholder value.

With that, I'll turn the call over to Matt.

Matthew J. Audette - *LPL Financial Holdings Inc. - CFO and MD*

Thank you, Dan, and I'm glad to speak with everyone on today's call. Our business performed well again in Q2, and the macro environment remained strong. Equity markets continue to rise and interest rates increased following the fed rate hike in June. With this favorable backdrop, we grew assets, increased gross profit, stayed disciplined on expenses and drove operating leverage. This led to $0.74 of earnings per share in Q2.

Looking at our progress over the past year, we are pleased to have delivered 11% year-over-year asset growth, 13% gross profit growth, 29% EBITDA growth and 40% EPS growth. These results reflect our focus on growing our core business and executing with excellence.

Let's now go into our Q2 business results in greater depth, starting with brokerage and advisory assets. We finished the quarter at $542 billion, up $12 billion or 2% sequentially. Net new assets were $0.4 billion, and we had another strong quarter of net new advisory assets at $5.9 billion, including $2 billion in conversions from brokerage. I also want to provide a final update on the anticipated departures we discussed over the last 2 quarters.

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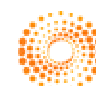

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As a reminder, we expected about $6 billion in mostly brokerage assets and 210 advisors to leave during the first half of 2017. In Q1, we had $3.9 billion in assets and 118 advisors to leave related to those departures. During Q2, we had an additional $1.7 billion in assets and 100 advisors depart. So in total, we had $5.6 billion in assets and 218 advisors depart, and we do not anticipate any future material impact from those departures.

Excluding those departures, net new assets were $2.1 billion or an annualized growth rate of 2% with advisory a net inflow of $6.1 billion. In brokerage, a net outflow of $4 billion. Also excluding the departures, advisor count increased by 2 and production retention was 97%.

Before we walk through our Q2 financial results in greater depth, I want to highlight an update we made to our press release this quarter to provide additional clarity into our financial performance. Our business model drives 2 primary types of revenue: commission and advisory revenues, which have a payout to advisors; and attachment revenue, which does not have a payout. To make this simpler, we updated our management P&L by moving commission and advisory expense up and adding a subtotal for net commission and advisory fees after payout. This view makes it easier to see the gross profit we keep, and we hope you find this updated disclosure helpful.

Turning to our Q2 financial results. Gross profit was $389 million, up 3% sequentially. This is primarily driven by higher advisory fees, cash sweep and sponsor revenues. Looking at commissions, they were $421 million, relatively flat sequentially. This is primarily driven by higher trailing commissions, which increased along with equity markets and was mostly offset by slower sales commissions.

As for advisory fees, they were $347 million, up $17 million or 5% from Q1. Advisory fees are mostly billed off prior quarter balances, so Q1 market growth and recruiting benefited these revenues.

Turning to payout rate. It was 86.4% in Q2, up from 85.9% in Q1, primarily due to seasonally higher advisor production bonuses. Looking ahead to Q3, we anticipate advisor production bonus expense to continue increasing seasonally. And as a reminder, last year in Q3, the advisor production bonus payout rate increased by about 0.5 percentage point sequentially, and the expense increased by about $4 million.

Turning back to Q2, net commissions and advisory fees were $104 million, down $2 million sequentially. Net commission and advisory fees also represented about a quarter of our gross profit in Q2, and attachment revenue made up the remaining roughly 3 quarters.

Moving on to asset-based fees, which includes sponsor and cash sweep revenues. Sponsor revenues were $102 million, up $4 million from Q1. This increase is primarily due to higher market levels, which drove up average billable assets. As for cash sweep revenues, they were $72 million, up $12 million from Q1. This growth was driven by higher yields following the March and June fed rate hikes, partially offset by lower balances. While client cash as a percent of assets has averaged about 6% over the long term, Q2 finished at 5.1%. This is down from 5.7% in the prior quarter as advisors put more money to work in the market for their clients.

As we look forward, I want to highlight a couple updates on our cash sweep program. First, we launched our new business account ICA program, which provides FDIC insurance for more clients. As such, we had about $1 billion in cash balances transfer from money market funds to ICA earlier in July.

Next, the June fed rate hike was the third rate increase in the last year, and market deposit rates increased modestly following that rate hike. So it made sense to move our deposit rates up as well. We increased our deposit rate slightly to a range of 2 basis points for smaller accounts to 10 basis points for larger accounts, effective August 1. This will increase payments to depositors by approximately $5 million annually.

With those updates in mind, the main driver of our cash sweep revenue going forward remain short-term interest rates, primarily the fed funds effective rate. For the last few rate hikes, we anticipated generating at least $40 million of annual gross profit benefit per rate hike, approximately $35 million from ICA and DCA, and about $5 million from money market funds. In practice, the benefit has been higher than that as market deposit rates have not moved as much as we had assumed.

Going forward, our money market fund balances have now reached their max yield of around 70 basis points as the business accounts that transfer to ICA had higher max yields. So we anticipate $35 million of annual gross profit benefit from future fed rate hikes driven by our ICA and DCA balances. Just remember that these balances can move up or down in any quarter, but $35 million is a good, rough estimate.

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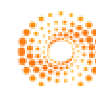

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As for Q3, we anticipate our ICA yield to be approximately 120 basis points. This includes the remaining impact of the June rate hike, the impact of our deposit rate increases and business accounts moving to ICA in July. This outlook also assumes no further fed rate hikes and no further changes to deposit rates in Q3.

Now turning back to Q2 into transaction and fee revenues. They were $109 million, up $1 million or 1% sequentially. The increase was driven by a new account fee for alternative investments in non-retirement accounts, similar to what we already charge in retirement accounts. We implemented this fee in the second quarter effective at the beginning of 2016. So our Q2 results include approximately $5 million related to 2016 and Q1 2017, and we expect an ongoing benefit of about $1 million per quarter. Mostly offsetting this increase, transaction volumes were down sequentially, and we had $2 million of account termination fees in Q1 that did not repeat.

And as a reminder, our national advisor conference Focus is in Q3. So we expect conference revenues will increase by approximately $6 million sequentially.

Let's now move to expenses starting with core G&A. In Q2, core G&A expense was $176 million, down $1 million from Q1. So for the first half of the year, our run rate has been slightly below our 2017 core G&A outlook range of $710 million to $725 million. However, we do expect to increase our spending modestly in the second half of the year with our focus on DOL rule implementation, client works rollout and other enhancements. We also continue to look for efficiency opportunities. And in Q3, we are planning to reduce our real estate footprint in Boston. This will save us about $1 million of core G&A per year starting in Q4, while also increasing depreciation by about $1 million in Q3.

Given our continued focus on opportunities like these and our progress on expenses through the first half of the year, we have narrowed our 2017 core G&A outlook to $710 million to $720 million.

Moving on to Q2 promotional expenses. They were $32 million, down $5 million sequentially. This is primarily due to lower conference expense as we had 2 major advisor conferences in Q1, but none in Q2. Looking ahead to Q3, we expect conference expense to increase by approximately $14 million, as we have Focus in Q3. And as a reminder, transition assistance, which is based on our recruiting success and is somewhat more difficult to predict could also move promotional expense up or down on a quarterly basis.

Moving to regulatory-related expenses for Q2, our total is $5 million, relatively flat sequentially. Looking forward, regulatory expense remains difficult to predict especially on a quarterly basis, but we continue to expect our 2017 full year results will be closer to our 2016 total of $17 million rather than our 2015 total of $34 million.

Looking at other expenses for Q2, interest expense was $26 million, up $1 million sequentially. Our March debt refinancing lowered our interest expense by about $1 million per quarter all else equal. At the same time, we have $1.7 billion of floating rate debt, while short-term interest rate increases have benefited us overall, they have also increased our debt cost slightly by about $2 million sequentially.

Next, let's turn to capital management. We remain focused on balance sheet strength and allocating capital to drive growth in shareholder returns. Our leverage ratio declined to 3.1x, due to our continued earnings growth. Cash available for corporate use decreased seasonally to $527 million, as we had 2 federal cash tax payments in Q2 following no federal payments in Q1. Our long-term goal for cash available for corporate use is to be closer to $200 million, and we are currently below our target leverage range of 3.25 to 3.5x so we are in a strong financial position with significant capital available to deploy. We continue to see a number of opportunities that could drive growth and value for shareholders. We plan to stay flexible, strategic and disciplined in our approach investing for profitable long-term growth.

For capital deployment in Q2, we increased the pace of our share repurchases to $36 million, up from $22 million in Q1. Though our amount of repurchases will likely vary quarter-to-quarter. We also paid $23 million in the form of regular dividends, and had $28 million of CapEx mostly on technology.

In closing, we are pleased to have delivered another quarter of strong business and financial results. We remain focused on growing assets and gross profit, staying disciplined on expenses to create operating leverage and deploying capital to drive growth and shareholder returns.

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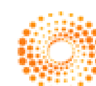

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With that, operator, please open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Bill Katz with Citigroup.

William R Katz - *Citigroup Inc, Research Division - MD*

Okay. Just staying with the -- maybe some of the top line dynamics. On the FA side, so strip away the -- also the known attrition, so the core level was about flat quarter-to-quarter, and we are seeing -- we're hearing some very good recruitment trends elsewhere. Could you talk a little bit about how you sort of see the pipeline looking ahead?

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

So Bill, thanks for the question, I'll take that one. So I think when you think about the recruiting for the quarter, if you compare it to Q4 and Q1, which were good solid quarters, it was down slightly for Q2. We think the biggest driver of that was the significant sort of uncertainty that occurred in late Q1 and early Q2, relative to the regulatory outlook and more specifically, the DOL, which just caused advisors to slow down on their decision making. I think as we fast-forward up today, we've seen some reduction in that level of uncertainty, and certainly, when you have lack of -- reduction in uncertainty, that's better for the pipeline. Our team continues to focus on this as a lever of growth, and we feel good about growing via recruiting over the long term.

William R Katz - *Citigroup Inc, Research Division - MD*

Okay. And then my follow-up question is, just as you think about core G&A, and I appreciate the updated guidance. I guess, maybe two-part question. One is what kind of flex do you have into the second half of year to the extent that the revenue picture were to potentially get a bit worse from where we are today? And then how should we be thinking about core growth into next year, if we start to think through that dynamic?

Matthew J. Audette - *LPL Financial Holdings Inc. - CFO and MD*

Yes. Bill, this is Matt. I mean, I think on next year, we'll cover that in a future call. I mean, I think, that the primary drivers from a strategy standpoint of growing our business and executing with excellence, I mean, as part of that delivering operating leverage, I think, it's the core of where we're focused. So in periods where revenues are moving up and down, I think, our expense focus is going to be tied to that to make sure we're delivering operating leverage. I think, hopefully, we've seen that over the recent quarters of what we've been doing and we would have that same focus going forward. So I think the levers are there if needed going forward, but I think, we feel comfortable with our core G&A guidance because there -- our revenue outlook was factored in that.

Operator

And our next question comes from the line of Steven Chubak with Nomura Instinet.

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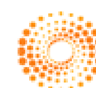

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Steven Joseph Chubak - *Nomura Securities Co. Ltd., Research Division - VP*

So Matt, wanted to kick-off with a question, actually, I'd asked the last quarter, but now that you've officially announced the launch of your mutual fund-only solution, can you give us an update on maybe how we should be thinking about the various puts and takes in terms of what's going to -- what sort of economic benefit you could see beginning next year once that goes into effect?

Matthew J. Audette - *LPL Financial Holdings Inc. - CFO and MD*

Sure. I mean, I'll give a couple of the numbers. But I think, it's a strategic capabilities. And I think, Dan, I'm sure will jump in add. But I think when we think through MFO, I mean, the pricing is generally line with the commissions that we earn today, right. So 3.5 upfront, 25 basis point trail. I think the big opportunity of moving assets that are currently off platform, on platform is a key part of that driver. But I think, from an economic standpoint, I think, we see it as an opportunity to grow the business at rates roughly in line with what we earn today.

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

Yes. So thanks, Matt. And just from a strategic context, which may be helpful. Obviously, this -- the mutual fund-only solution is a great example of our commitment to preserving choice both across -- both brokerage and advisory solutions in a post-DOL world. It also creates a replication of the reason why advisors would use a direct solution for mutual funds or off our custodial platform. So thus, when we move into that post-DOL world, we now have a solution that has standardized commissions within the mutual fund solution, which is important from a -- in terms of making sure that you don't have conflict. Secondly, it creates a solution that doesn't have the fees, like IRA fees and trading fees, that makes it much easier for advisors to place those mutual funds on our custodial platform. And again, we think it creates a really differentiated solution out in the marketplace for advisors to use to gather assets. So in a post-DOL world, we're very optimistic that the mutual fund-only solution will help drive growth, and do it in a very profitable way.

Steven Joseph Chubak - *Nomura Securities Co. Ltd., Research Division - VP*

And just for my follow-up on the topic of capital return, given the significant cash flow generation coupled with the fact that you have your excess cash today. Can you speak to your current appetite to accelerate share repurchase? It looks like you had some capacity to do that this quarter and maybe you didn't optimize it to the full extent. So how should we think about your share repurchase capacity going forward? And maybe, how that priority stacks up relative to other alternatives?

Matthew J. Audette - *LPL Financial Holdings Inc. - CFO and MD*

Yes. Sure. So I think, when we think about our capital management strategy, it's really unchanged, right. We want to have a strong balance sheet that supports both business growth and driving shareholder value. So when we think through where to deploy that capital, it's really in the 2 fronts, one of which you mentioned. The first is really growing the core business, whether it'd be through organic recruiting and the transition assistance that goes with that or investing in technologies, so CapEx to drive capabilities or on M&A, to really accelerate our growth. And we think the returns in doing that are quite good. At the same time, returning capital to shareholders we've seen also generate good returns. So I think we've balancing and focused on those 2 approaches. I think the key that we're focused on is being very dynamic in our approach and making sure that we deliver capital in the right places. So I think, we view both of those as good opportunities.

Operator

And our next question comes from the line of Conor Fitzgerald with Goldman Sachs.

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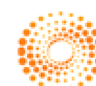

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Conor Burke Fitzgerald - *Goldman Sachs Group Inc., Research Division - VP*

Just wanted to ask about a trend that you and your competitor saw this quarter with a very engaged client base and cash balances coming down. Would be great to hear what you're seeing out of clients as being them more optimistic, what type of assets they're buying? And then on the lower cash balances as a percent of assets, just -- I know it's tough to guess from quarter-to-quarter, but long term, what direction do you think trends?

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

Yes. So let me take the first part of that, this is Dan and then Matt, you add any color you want to. So I think, the premise around an engaged investor certainly was there in Q1, and it remained in Q2. We saw it really coming out of the end of the year where the macro backdrop changed. And I think, we've all seen good momentum through the first half of the year. So we agree with that premise. I think we see, again, it show up in 2 places. We're seeing our advisors have really good success, continuing to gather new assets from clients. And we're seeing a big allocation of those newer assets going to advisory solutions. And, hence, I think, that continued driving of net new assets across our advisory platforms. I think the second place you've seen it is any existing monies they already had from clients that were sitting on the sidelines in cash balances, more of those have been deployed and put to work to drive returns for clients. And thus, we've seen that, that balance go from -- in our cash balances from about 6% of total assets down to -- closer to 5%. I think that is the typical range, which we've seen cash balances move at historically between that 5% and 6% number. And that's probably a reasonable way to think about it going forward. That said, I don't want to suggest that I have a precise view of exactly what that is, but I think those are a good framework of which to think about it. I don't know, if you want to add anything to that, Matt?

Matthew J. Audette - *LPL Financial Holdings Inc. - CFO and MD*

No. Well said.

Conor Burke Fitzgerald - *Goldman Sachs Group Inc., Research Division - VP*

All right. That's helpful. And then there were a couple of press articles out, I think, over the last month, that you and a competitor had changed your payout grid in reflection of some of the higher costs you've incurred post the DOL. 2 questions on that. One, just when you evaluated the merits of the change, how'd you think about the competitive dynamics of you versus the wirehouses and some of the smaller IBDs? And then two, any financial impacts we should be thinking about on the change?

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

Yes. So I'm not sure that our changes were truly captured in the most accurate way with respect to those reports. I think the changes that we were making were more related to the DOL, and ensuring that we were standardizing compensation within a product category. And the second thing is making sure that those compensation structures were aligned with the expectations of the DOL rule. So I'm not sure that you saw a material adjustment and a change in the payout to advisors. Again, it was more of a principle around standardization of those compensation or commissions within a product category. And that's what we were trying to solve for. And so I'm not sure that those headlines accurately reflected what we were doing.

Operator

And our next question comes from the line of Yian Dai with KBW.

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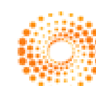

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Yian Dai - *Keefe, Bruyette, & Woods, Inc., Research Division - Assistant VP, Equity Research*

I joined late, so apologies if you addressed this in your prepared remarks. But I did have a question on -- you guys bringing Scott Seese in as CIO. I guess, I'm just wondering what his initial points of focus will be? And does it reflect in some way how you guys are going to kind of pivot and try to use leverage technology as an asset? And I guess, what you envision in doing that?

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

Yes. So we did address some of it, but let me just give you the highlights of that. So the leadership changes that we made were very much taken with an eye toward our strategy. We see technology as being a very important component of that strategy. And wanted a CIO who had a proven track record in contributing to the commercial growth of a company as well as its strategic evolution and Scott's resume certainly fits that profile. And we very much see him leading our work on taking and transitioning our technology from being more of a utility to support our advisors and their clients to truly being an asset. So we think about improvement enhancements to the investor experience and the advisor experience as being big opportunities for him to help us evolve and continue to improve and enhance our value proposition.

Yian Dai - *Keefe, Bruyette, & Woods, Inc., Research Division - Assistant VP, Equity Research*

Okay, great. And my follow-up, I guess, is back to kind of Conor's point on the comp ratio -- I'm sorry, the payout grid. And I understand that you guys didn't really make kind of sweeping changes. And it was more geared towards DOL. But I guess, as you think about investing more into technology and you already have invested a lot to comply with DOL and other regulatory items and whatnot. So at some point, as -- does it make sense to say, "Hey, we are spending more to help the advisors make their businesses more efficient and comply with the regulation and maybe we do need to move those grids slightly, and we could still do that and be above market?"

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

Yes. So I think -- when you think about strategically positioning your business, right, we're always looking at the environment and constantly assessing it. You look at different trends in the industry, you look at competitive positioning and movement that's going on. And I think, we look and explore how do we enhance and provide new capabilities that will help our advisors differentiate, right, and delight their clients. We always look at price as a lever of which to, again, continuously help our advisors differentiate and create very compelling solutions at competitive prices. And then we ultimately look at our own value proposition and how we get paid for that. And I think we continually explore and look at the competition to ensure that, that we're doing that in a smart bright way. We try to leverage our scale. We try to leverage the advantage of having a self clearing platform of our own, advisory platforms and using those advantages of which to create better economics for our advisors or better economics for the investors. So that's a long winded way to answer your question that we look at price across the entire spectrum both from how we help differentiate the advisors, delight the investors, as well as ensuring that from a competitive standpoint, our pricing makes sense relative to the value that we're offering. And finally, we're always looking at how do we generate more value that we can charge for to create additional economics.

Operator

And our next question comes from the line of Devin Ryan with JMP Securities.

Devin Patrick Ryan - *JMP Securities LLC, Research Division - MD and Senior Research Analyst*

Just several here. I guess, first, going back to the point around technology-as-an-asset and maybe to tie in that into some of the comments around M&A as an opportunity and then just given your capital position today, is there any interesting technologies and I'm not sure if you want to give this away, but technologies that you don't have today or maybe a solution that you feel like you could acquire and be more disruptive as obviously that's one of the goals here?

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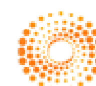

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Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

Yes. So I won't be specific. But I think if I give you some categories, we continue to see automation as a way, again, to continue to evolve the end client or the investors experience, right. There's a variety of different ways from, what I would call, using and modernizing the digital experience and being a leader there. I think, the second area of opportunity is to continually how do you help transform the advisors' experience? And if we can lower the cost and create their capability to increase the capacity of their practices, those are interesting opportunities from an automation standpoint. Now whether you build those or you go rent that capability or you go buy that capability is always a consideration to think through. And again, I think Scott brings a unique vantage point and experience in the prior businesses that he's been involved in. And so he gives us a great way to think about solving in those areas that I just mentioned and then ultimately, the best and most optimal way to do it: build, rent or buy.

Devin Patrick Ryan - *JMP Securities LLC, Research Division - MD and Senior Research Analyst*

Got it. Okay. That's great color. And then follow-up here, there has been a lot of talk really over the past several quarters about the amount of money in motion, I think, we're seeing it in some of the net flow statistics, but the discount brokers are clearly going after some of this and with their strategy. And one of your larger wirehouse peers you spoke about, really making a concerted effort to focus on the children of these existing clients. And so really the question is, what are some of the specific things you're thinking about when you're -- obviously, you're building your business for your clients today, the clients of tomorrow or the millennials were kind of just starting this generational wealth transfer. And so how do you kind of go after that as well in addition to all the things you have to do for the existing clients? And I don't know if there's anything specific you can kind of point to.

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

Well, yes, it's a great question. And I think it's an opportunity for us all. As we look forward, we see the growing demand for advice getting bigger, right, which creates an overall macro opportunity for us all. I think the even better news is we see that demand for advice growing across all market segments. In fact, the millennials have a higher propensity to seek advice than their parents and grandparents. And so we see that as a fertile ground of which to create value for them. If you're successful at creating value well then, obviously, that creates a positive return for both the advisors and us. And so we see things, for example, of engaging in them in a different way using automation as a way of which to, ultimately, both give them access to your capabilities, give them -- and solve what we think is a way that they engage and utilize technology, a little different than their parents and grandparents to do research, to access information and to even build a relationship via automation. But ultimately, make sure then your positioned when they need [do] advice to have that personal relationship in contact. So great ways we do that is to give automation and new capabilities to our advisors, which they can leverage in their practice to reach that generation. And they have the opportunity today through the kids of their existing clients, sort of the grandkids of their existing clients. They are positioned in markets where they can go after new market segments, where you have rising millennials who have a certain demand for advice, and we're providing them technology like a robo-type solution as an example, where they can leverage and access those clients to provide certain capabilities today. And then package that with that personal access and advice that, I think, differentiates them from others in the marketplace who are not at a local level, but have those technology capabilities and can match that local level service with that automation.

Operator

And our next question comes from the line of Chris Shutler with William Blair.

Christopher Charles Shutler - *William Blair & Company L.L.C., Research Division - Research Analyst*

On the sponsorship and record-keeping line, if we were to assume that the active to passive trend continues as it has, and that the VAS that's remained relatively consistent from here, how should we think about that line trending in terms of absolute dollars in yield?

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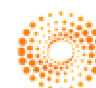

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Matthew J. Audette - *LPL Financial Holdings Inc. - CFO and MD*

Yes. Chris, this is Matt. I mean, I think, at a high level, when we think about just looking at the numbers for the quarter, up 4%. There's 2 key drivers there, of course, of which you've hit both of them. But on the record-keeping side, it's really driven by advisory overall, right. We've seen a lot of net new asset growth there as well as the impact of the market itself is driving that up. The revenue share side has been slower growth for some of the reasons that you highlighted. We also have certain sponsor contracts in there depending on the volume and size and amount of assets with them, where those rates would get updated. We had a little bit of a couple million dollar benefit in the quarter related to that. But I think, those are going to be the big drivers there financially. And Dan, anything to add on that active, passive trend?

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

Yes. I will say that I think second quarter was a better quarter for active management, which was encouraging. And it's probably the first time we've seen in a good year plus. And I think, how we think about that or what we do about is help our advisors create other solutions that are, again, going to create a certain level of value that are competitively priced that they can continue to successfully gather assets, right? So whether that's the things that we do on the advisory platform, whether that's preserving choice and ensuring that brokerage is an option or an alternative where passive is really not an influence in brokerage solutions or whether what we just rolled out and made changes to, which is our separately-managed account platform, right, where we've put new content on there, that creates lower cost active management solutions using individual securities in a very customized and tax-efficient way. And that creates a really interesting way of which to provide an alternative solution to just a pure passive portfolio in an advisory solution. So we're doing things of which to, again, ensure that our advisors have an array of different solutions that can effectively differentiate them and provide them at a very competitive price.

Christopher Charles Shutler - *William Blair & Company L.L.C., Research Division - Research Analyst*

Okay. And then similar question on the transactional revenue line, just how should we think about that line going forward? And correct me, if I'm wrong, but it sounded like there might have been a onetime item in the quarter around the alternatives?

Matthew J. Audette - *LPL Financial Holdings Inc. - CFO and MD*

Yes, that's right, Chris. Using Q2, about $5 million relates to the implementation of that fee on the alternative investment side and that's an ongoing fee. So ongoing about $1 million a quarter, but there is about a $5 million in the quarter -- in the second quarter. The other item just to highlight is just volumes in general were down. So those were the 2 trends that I'd focus in on for the second quarter numbers.

Christopher Charles Shutler - *William Blair & Company L.L.C., Research Division - Research Analyst*

And then just going forward on that line?

Matthew J. Audette - *LPL Financial Holdings Inc. - CFO and MD*

Yes. That's all I could point you to, Chris. We don't have guidance on that particular line, but I just highlight the alternative investment color as well as transaction levels were down this quarter.

Operator

And our next question comes from the line of Chris Harris with Wells Fargo.

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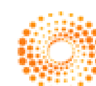

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Christopher Meo Harris - *Wells Fargo Securities, LLC, Research Division - Director and Senior Equity Research Analyst*

So your cash sweep fee rates, I think, surprised most folks to the upside. And if we look at your ICA fee rate, in particular, that far exceeded the guidance you guys gave and it was up 20 basis points versus 13 basis points for fed funds. So just hoping you guys can clarify what happened in the quarter? Why did the ICA fee rate appreciate so much relative to average fed funds?

Matthew J. Audette - *LPL Financial Holdings Inc. - CFO and MD*

Yes. Chris, I mean, I think, going back to last quarter, I think, we said about approximately 100 basis points for the second quarter with no additional rate hikes. So we had a rate hike, it happened towards the end of the quarter, but there is a few basis point benefit to that, so that brings you up to 102 or 103-ish. And then keep in mind, there's a lot of contracts behind or that make up the ICA accounts, different banks at different rates. So those rates can move out -- move around a bit. So I think when you factor in those 2 things, I think that's what had us land at 108 basis points. The drivers going forward and behind the 120 basis point guidance for Q3 are really the same drivers we've talked about the past few quarters, which are, remember, keep in mind, that while most of the balances as far as indexes go are tied to fed funds. But there also we've got balances on 1-month LIBOR, 3 months LIBOR as well as the small amount of fixed balances. So all those dynamics are going to play out. But back to your question, I think, given the rate hikes that occurred and mix shifts that can always happen, I think, 108 basis points makes sense to us at least.

Operator

And our next question comes from the line of Ken Worthington with JPMorgan.

Kenneth Brooks Worthington - *JP Morgan Chase & Co, Research Division - MD*

In terms of the new content you're rolling out to the advisors like the managed account services or the robo solution, are those costs born directly by the end client? Or are the fees paid by the advisors directly? And if they are absorbed by the end brokerage client, what sort of all-in fees are they ultimately paying?

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

Yes. So I think, when we talk about platform fees, right, those are inherent within the overall fee to the end client. And I think you can see from the data that we provide to you that that's roughly in the 100 to 105 basis points range for what they pay on those advisory platforms on our corporate RIA. And then with respect to the robo solution, it would be the same concept in which you have an overall fee to the client, and then the advisor would add their fee to it. And I think that one would be significantly less than the 100 to the 105 basis points as we shared with you as we thought about this offering. It's going to be more similar to the other robo solutions you have out there, where there is 30 basis points fee and then to the extent that the advisor could differentiate themselves in any way relative to that robo offering then they can add to that overall baseline fee.

Kenneth Brooks Worthington - *JP Morgan Chase & Co, Research Division - MD*

Okay. But it's not like the advisors charging a 100 basis point fee and then on top of it, there's another 30 or 40 or 50 basis point fee for the other things that the broker is now getting through LPL?

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

Yes -- no. So the fee that we're describing to you would cover all of our fees. If they're using certain assets then those fees wouldn't be covered in that 100 to 105 basis points range. So if I've got mutual funds that are 25 basis points then you would have to add that to it, as an example.

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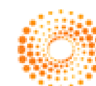

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Kenneth Brooks Worthington - *JP Morgan Chase & Co, Research Division - MD*

Okay. And then the advisory business has been highlight as part of the financial services industry, where pricing has held up particularly well since the financial crisis, but there seems to be some examples more recently where that 100 basis point-or-so fee charged by the advisors may be coming under a little bit of pressure. I guess, to what extent are you as LPL hearing about fees, a pressure on those fees from your advisors? And is there maybe a way as corporate that you think, you can help them best manage those fees in this sort of environment?

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

So yes, I think, the premise around pricing trending down and the overall industry is given any variety of different reasons, right, is something that's been talked a lot about over the last couple of years. And I certainly think, we as -- we make the assumption that there will be pressure on pricing. I don't think we've seen a lot of that all the way down to the client level as of yet, now that's a rash generalization. So I think you're seeing pockets of it happen and occur, whether that be because of a larger account or a certain advisor's strategy. But over the macro level, I think it's reasonable to assume that pricing will come down. And I think, you'd see the entire ecosystem from asset managers, to distributors, to advisors thinking through what their sets of choices are relative to that pricing pressure. You can either reduce your pricing, you can modify your value or expand your value, thus to give you more stability in your pricing. Certainly, if you lower pricing, then you explore how you lower cost in order to absorb that pricing and create capacity that handle more clients. And I think you're seeing the entire ecosystem wrestle with that. I think the good news is that the -- you need asset managers, you need distributors and you need advisors. And I think what we're trying to do is make sure we're working collaboratively together to ensure that we can create solutions that provide the capabilities the clients need at competitive prices. So as we think about that and how we try to drive that, I think, this is where examples of lowering our platform fee on our centrally-managed solutions is a great example of that, lowering the strategist fee, right, eliminating IRA fees, as an example, on centrally-managed solutions. This is a great example of where we just used the separately-managed accounts, and we've lowered the platform fees there, and we're going to lower the manager fees there. So that's where you see us participating with the asset managers to lower the overall cost. What we're also doing is finding new ways and features of which to help the advisors both lower their cost and increase the scalability of their practices. So again, they can absorb some of that pricing pressure, and to the extent that they have to discount their pricing by 25% but they can double the capacity to handle more clients, that's a good concept to think about. I'm not saying those are the right ratios, but that's a good way of which to help them make the pivot and make the adjustment to continue to be successful. So again, we're tying to provide them product and platforms that provide more capabilities at a lower cost and also provide them more services and support that help them operate their businesses at a lower cost with more scalability.

And that's how we help within the ecosystem, I think, continue to ensure that we meet clients' needs and we delight them, and we create real value for them over the long term.

Operator

And our next question comes from line of Doug Mewhirter with SunTrust.

Douglas Robert Mewhirter - *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

My first question was a numbers-related question, although it's more of a product-related question. I've seen in your commission schedule, if you look at the sales-based commissions, the fixed and variable annuity category continues to be down fairly significantly year-over-year, which was not unexpected but it seems to be flattish or even slightly up sequentially. Does that imply that, maybe, we've sort of found a new level after the dislocation caused by uncertainty around the DOL rule? Were there any seasonal factors? Or do you think that they -- there is still the risk that they could trail off some more? So what were the advisors are saying about or thinking about these products?

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

Yes. So it's a great observation on your point in terms of this is the first sequential lift we've seen in probably a good 1.5 year relative to, specifically, variable annuities. And I think there's a couple of things going on. You're right, significant dislocation around a lot of the structural changes and

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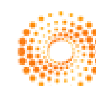

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the uncertainty in the regulatory environment, comp changes on the product, which created pressure over the last 1.5 year. We've also had the extended low interest rate environment, which has really limited any product innovation that has occurred with respect to those products. And so there were tough headwinds, right, as you described. I think in the last quarter, it's the first time we've seen now some green shoots, if you will, relative to those product categories. I think still the uncertainty around the DOL is a headwind there with respect to that product category, but perhaps, people are getting more accustomed to thinking about it and now recognizing that in a post-DOL world, there's great value to be delivered by an annuity. And so they're beginning to pivot. I think, the second thing that occurred is we did see a little bit of product innovation that occurred in May, that also probably helped stimulate some additional activity. All that said, one quarter does not make a trend. And I think it's too premature and too early to declare victory and see that you're going to have an ongoing positive trend there, but it is at least one positive step forward. Anything to add to that?

Matthew J. Audette - *LPL Financial Holdings Inc. - CFO and MD*

No, well said.

Douglas Robert Mewhirter - *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

My second question on M&A, and it's really the trade-off between M&A and recruiting. So I imagine that there are a number of independent -- small independent broker-dealers, which are not doing well right now even with a more diluted DOL rule, they're probably sort of caving in under the weight of regulatory pressures and cost pressures. So I'd imagine that, that sales prices out there were probably pretty inexpensive, although then you would have to buy all the brokers and not just the brokers you want. So could you just describe your thought process between sort of cherry picking the brokers you want for some transition assistant payments versus buying a broker, getting maybe all the brokers but also getting significant synergies from cost saving -- the back office cost savings?

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

Yes. So as Matt said earlier, we're very focused on growing in our core markets. We see opportunities to do that both organically and through M&A activity. We continue to be very focused on driving growth through recruiting and look across the entire spectrum of opportunity from anywhere from employee-based models all the way down to independents at other firms to affirm that maybe operating their own broker-dealer, that's a small broker-dealer as you described that maybe struggling for any number of reasons. And I think we explore the opportunity and the potential of working with those firms either through an organic solution or through M&A type of activity. I think, we're also looking and have shared with you, our belief that we'll see more consolidation across the entire landscape of broker-dealers. And we continue to look for larger properties that may be thinking about the -- strategically differently going forward that may create an opportunity that, again, if it creates the right economics and drives financial contribution and strategic alignment, then we would be very interested in exploring M&A activity that will help us leverage our scale advantage further. So we see prospects across both the organic and the M&A fronts.

Operator

And our final question comes from the line of Michael Cyprys with Morgan Stanley.

Michael J. Cyprys - *Morgan Stanley, Research Division - Executive Director and Senior Research Analyst*

You mentioned some changes that you've made to your separate account and centrally-managed platform such as on the fee side. So I guess, just how far along are you in terms of making changes there? And as you look out from here over the next couple of years, what sort of enhancements or additional changes you could make from here such as new features or products that could better help your advisors?

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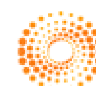

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Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

Yes. So, again, I think we see the advisory area as being a great place with innovation as we seize the continued allocation of new assets to advisory solutions. So we believe that is an area that we will continue to innovate in and try to improve and enhance our platforms today. One advantage is, is we have our own advisory platforms and so we've talked a lot about the work we've been doing in our centrally-managed platforms to both lower cost, enhance the investment content and improve workflows. And so we continue to see opportunity across all 3 of those of which to drive better capabilities that will increase the utilization of those platforms and that is good for advisors, it's good for investors, and it's good for us. So our centrally-managed platforms we'll continue to work on and focus on. I think our separately managed accounts, we actually have seen a low demand -- sorry, a low pickup of our solution today, and we saw a real opportunity to enhance this solution. We actually believe it's a great way for advisors to create customized tax-efficient solutions using individual securities. And typically, they had targeted those at $500,000 and above clients. By lowering the platform fee, we've just now brought their ability to provide those types of solutions down to as low as $150,000 or $200,000 clients. So hence the opportunity to enhance the utilization of those solutions. What we've also done is used an improved and enhanced the investment content to give the advisors much more options in terms of how they might solve for our clients' needs. And there is, again, some cool new low cost options or alternatives that we've built on that platform that, I think, give our advisors another way of which to solve using individual securities and lowering the cost of overall the asset management component of their offering. So again, we see advisory as a great place to invest in, to continue to help advisors differentiate themselves, provide additional investment content at lower prices that drive scalability and efficiency into their practices and that are ultimately great for the investor.

Michael J. Cyprys - *Morgan Stanley, Research Division - Executive Director and Senior Research Analyst*

Great. And just lastly, if you could just update us on the digital tools that you've been rolling out such as the digital advice solution. What's been the take up amongst your advisor base and their clients?

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

Yes. So -- and it's a good question, a very fair question. I got asked that last quarter and it is in pilot today. We expect a full rollout in the coming quarter. So too early to tell you the uptake now, but we're excited about the progress we've made there and the ability to roll that out more fully.

Operator

Thank you. And this does conclude today's Q&A session. I would like to return the call to Mr. Dan Arnold for any closing remarks.

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

Yes. Thank you, operator, and thanks, everyone, for taking the time to join us this afternoon. And we look forward to speaking with you again next quarter. Have a good evening.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may all disconnect. Everyone, have a great day.

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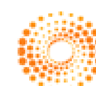

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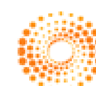

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