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LPLA - Q4 2018 LPL Financial Holdings Inc Earnings Call

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PRESENTATION

Operator

Good afternoon, and thank you for joining the fourth quarter and full year 2018 earnings conference call for LPL Financial Holdings Inc. Joining the call today are our President and Chief Executive Officer, Dan Arnold; and Chief Financial Officer, Matt Audette. Dan and Matt will offer introductory remarks, and then the call will be opened for questions. (Operator Instructions) The company has posted its earnings press release and supplementary information on the Investor Relations section of the company's website, investor.lpl.com.

Today's call will include forward-looking statements, including statements about LPL Financial's future financial and operating results, outlook, business strategies and plans as well as other opportunities and potential risks that management foresees. Such forward-looking statements reflect management's current estimates or beliefs and are subject to risks and uncertainties that may cause actual results to differ materially. The company refers listeners to the safe harbor disclosures contained under the caption Forward-Looking Statements in the earnings press release as well as the company's latest SEC filings to appreciate those important factors that may cause actual financial or operating results or the timing of matters to differ from those contemplated in such forward-looking statements.

During the call, the company will also discuss non-GAAP financial measures governed by SEC Regulation G. For reconciliation of such non-GAAP measures to the comparable GAAP figures, please refer to the company's earnings release, which can be found at investor.lpl.com.

With that, I will now turn the call over to Mr. Arnold.

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

Thank you, Latif, and thank you, everyone, for joining our call today. In 2018, we remained focused on our strategic priorities of growing our core business and executing with excellence. This focus positioned us to grow organically, complete the onboarding of NPH, stay disciplined on expenses and benefit from a favorable interest rate environment. This combination led to EPS prior to intangibles of \$5.33, up over 80% from the prior year.



Now let's look more closely at our progress in fourth quarter, starting with our financial results. Gross profit increased 26% year-over-year as a result of growth across all of our major revenue lines. And we also stayed disciplined on our expenses while increasing investment in organic growth. As a result, fourth quarter EPS prior to intangibles was \$1.49.

Moving to our fourth quarter business performance. Our brokerage and advisory assets were \$628 billion, up 2% year-over-year. This increase was driven by the combination of organic growth and assets from NPH, which was greater than the impact of lower equity markets.

In the fourth quarter, organic net new assets were \$5.9 billion, which translates to a 3.5% annualized growth rate. This included advisory inflows of \$5 billion or 6.5% annualized growth rate.

As for our asset mix, advisers continue to increase their use of advisory, corporate and centrally managed solutions, which enhance our return on assets.

We also want to share some perspective on the market volatility in the fourth quarter. Now while we are not immune to market movements, our diversified revenue streams provide some natural hedges. We saw this in December when our client cash balances and transaction volumes increased as equity markets declined. We also positioned our balance sheet and cash sweep portfolio to operate better in volatile markets by lowering our leverage and increasing the duration of our ICA balances. This combination of our business model and balance sheet strength increases our capacity to absorb short-term market volatility while continuing to invest to execute our strategy and drive long-term growth.

Now let's move to our strategic priorities of growing our core business and executing with excellence. With respect to core business growth, we think about that primarily as adding new advisers, helping existing advisers grow and driving a better return on assets.

Today, we will focus our remarks on recruiting new advisers and providing new capabilities that help existing advisers to differentiate and grow their businesses. In the fourth quarter, our recruited assets were \$8.6 billion, bringing us to \$27.3 billion for the year, which was the highest annual total we have recorded. The primary drivers of our improved outcomes were enhancing the performance of our business development team as well as aligning our transition assistance with financial returns. We believe these types of structural changes will drive more sustainable and repeatable results going forward. As we look ahead, our pipeline looks solid, and we believe our team is executing well on those opportunities.

Let's next move to our efforts to provide new capabilities that help our advisers differentiate and win in the marketplace. In order to do this, we are focused on 3 key areas: digitizing adviser practices to lower their costs and increase their scalability; enriching the quality of advice as a catalyst for growth; and modernizing practice management so they can optimize how they execute their business.

As part of these efforts, our vision is to digitize the 5 primary workflows in adviser practices. The first one is transforming how advisers turn prospects into clients. We are working to integrate this multistep process into a single digital workflow with several components, including CRM, goals-based planning, portfolio analytics, proposal generation and client onboarding. For each step, we will provide our advisers with the required technology at no charge. To accelerate the delivery of this technology, we acquired AdvisoryWorld and its industry-leading solutions for proposal generation, investment analytics and portfolio modeling. And we believe this digital workflow will help our advisers to increase the efficiency and scalability of their practices, which in turn will help them grow.

We're also helping our advisers to enrich the quality of their advice by embedding a planning-centered approach in the ClientWorks. As context, across the wealth management space, retail investors are evolving from focusing on a savings target to planning for life goals. To position our advisers to more easily address these changing needs, next month, we will roll out a new goals-based planning solution. This will enable our advisers to more efficiently take a planning-centered approach with all of their clients as it will be embedded in ClientWorks and provided at no cost. We believe this solution will help our advisers differentiate and win in the marketplace, which will contribute to our long-term growth.

Let's now turn to our second strategic priority, executing with excellence. We think about this as enhancing ClientWorks, driving continuous improvement, evolving our service model and transforming our culture. ClientWorks is our core operating platform that we will continue to invest in and evolve over time.



Within version 1.0, we focused on improvements that increase the functionality, performance and resiliency of the system. In version 2.0, we're increasing the value of our platform to advisers by introducing new capabilities. In the fourth quarter, these capabilities included streamline account transfers, enhance search and navigation and new client reporting. We also continue to plan for version 3.0 with the goal of turning ClientWorks into an industry-leading platform. We envision that this platform will integrate with third parties in a broader ecosystem and incorporate additional features such as machine learning, artificial intelligence and adviser control over workflows.

Turning to continuous improvement. Our focus last year was on delivering improvements that help streamline processes, modernize policies and enhanced ClientWorks. As a result, our service performance improved through the year. While operational volumes increased, call volumes decreased, which was primarily driven by fewer service escalations and ClientWorks becoming easier to use. These trends reinforce our progress on taking friction out of our system.

To ensure that continuous improvement becomes a permanent capability, we made a structural change by establishing a dedicated team to continue making improvements while also addressing larger, more meaningful opportunities. Examples of these include upgrading our annuity order entry system and improving operational efficiencies on our advisory platforms. We will stay focused on consistently delivering improvements that will continue to make it simpler and easier to do business with us.

Looking ahead, we have a large agenda for our service model. Our aspiration is to deliver a differentiated service experience to our advisers that they can't get anywhere else in the wealth management space. Now this vision led us to rethink our service model and to leverage outside-in thinking to learn how respected companies in other industries manage their service experiences.

Starting this year, we intend to evolve our current service model to more of a customer care model. Our vision is to deliver a multichannel service experience where our advisers can get answers to their question using a variety of different service channels and methods. The new model will leverage artificial intelligence and other digital solutions to ensure they get the right information in a consistent way that is more accurate and more accessible. This gives us the flexibility to improve the use of our human resources. Instead of a call center model, we can shift to more of a case management model where highly skilled and highly trained professionals are accountable for managing our advisers' inquiries from start to finish.

This vision for a new service model was the catalyst for change in the senior leadership team of our Service, Trading and Operations organization. We've hired Dayton Semerjian as a Managing Director and Chief Customer Care Officer, who will join the management team on February 28. Dayton is a 30-year customer service veteran, who helped implement and lead a customer care model at CA Technologies. He also has prior experience at Intel and Oracle. As part of this transition, Tom Gooley will be retiring in March. We thank Tom for his many contributions over the past 3 years, and we wish him well in his retirement.

Before closing, I want to review our efforts to transform our culture, which is instrumental to executing our strategy. We are taking a structured approach by instilling a client-centric mindset, logic-based thinking and mission-driven alignment. We took an important step in this journey late last year when we introduced a new mission statement: we take care of our advisers so they can take care of their clients. We wanted to make it simple and clear to all of our employees that we are here to serve and support our advisers.

Looking ahead, the work on our culture will focus on introducing new behavior-based values, evolving how we attract and develop extraordinary talent to our service teams and creating new rewards and recognition programs that reinforce the culture we want to shape. We believe our efforts to transform our culture will instill the mindset and capabilities that will set the foundation for success for many years to come.

In summary, we are pleased to deliver another quarter of business and financial growth as part of a solid year. We plan to remain focused on our strategic priorities of growing our core business and executing with excellence. We believe this focus positions us well to serve our advisers, drive profitable growth and create long-term shareholder value.

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



Matthew Audette - LPL Financial Holdings Inc. - MD & CFO

Thank you, Dan, and I'm glad to speak with everyone on today's call. We finished 2018 with another strong quarter of business and earnings growth. We grew assets organically, acquired AdvisoryWorld and stayed disciplined on expenses to drive operating leverage. As a result, our Q4 EPS prior to intangibles was \$1.49, nearly double our level from a year ago. We are pleased with these results as we continue to focus on our strategy of growth and execution.

Let's now review our Q4 business results in greater depth, starting with total brokerage and advisory assets. We finished the quarter at \$628 billion, down 8% sequentially, driven by the decline in equity markets. Total net new assets for Q4 were \$5.9 billion, which was our highest level of quarterly growth, and we continued our trend of increasing net new assets throughout 2018.

Looking at organic growth in greater detail. Net new advisory assets were \$5 billion or a 6% annualized growth rate. These results were primarily driven by inflows to our corporate and centrally managed platforms. Our results also included \$1.4 billion in conversions from brokerage to advisory. These results highlight 3 positive trends that benefit our gross profit return on assets over time: assets converting from brokerage to advisory, growth in corporate advisory and greater usage of our centrally managed platforms.

Now let's turn to our Q4 financial results, starting with gross profit. It was \$508 million, up \$15 million or 3% sequentially. This was primarily driven by increases in cash sweep and transaction revenues, partially offset by lower trailing commissions and sponsor revenues.

Moving to commission and advisory fees net of payout. They were \$151 million in Q4, up \$28 million from Q3. The increase was driven by a lower payout rate as the market decline in Q4 drove a negative mark-to-market impact to our adviser deferred commission expense. As a reminder, this decline is offset in other revenue, so the net effect on gross profit is 0. Prior to deferred commission expense, net commissions and advisory fees were down \$3 million, primarily driven by the seasonal increase in production bonus expense.

Looking ahead to Q1, I would highlight that advisory fees are primarily priced off of prior quarter corporate advisory assets, and they declined by about 7% in Q4. Also, we previously announced that we would broaden the price reduction on our corporate advisory services effective January 1. This pricing investment will reduce gross profit by about \$2 million per quarter initially. Over time, we believe the improved pricing will attract additional assets to our platform, which would offset the cost at this investment.

Turning back to Q4 and asset-based revenues. Sponsor revenues were \$118 million, down \$4 million from Q3, primarily driven by lower average assets.

Moving to cash sweep revenues. They were \$148 million, up \$21 million or 16% sequentially as both our yields and balances grew in Q4.

Looking at cash rebalances. They were \$34.9 billion, up \$6.7 billion sequentially. This was primarily driven by advisers repositioning client portfolios to hold more cash. Looking ahead, advisers have begun moving their clients back into the market, and cash sweep balances have decreased by over \$2 billion so far in January.

Looking at our cash sweep yields for Q4. Our ICA yield was 215 basis points, up 26 basis points from Q3. This increase was driven by the Fed rate hikes in September and December and the progress we made on our ICA duration extension program. As a reminder, last quarter we began shifting our ICA portfolio to have more fixed rate balances as we are deeper into the interest rate cycle. During Q4, we executed several more fixed rate contracts, which brought our mix of fixed rate balances up to about 35% of our ICA portfolio.

Looking ahead, we do not have many ICA contracts up for renewal in 2019. So while we expect to increase our fixed rate balances even further over time, we do not have many opportunities to shift additional balances this year.

Looking ahead to our Q1 ICA yield, we will have the full quarter benefit from the balances we moved to higher fixed rates in Q4 as well as the December rate hike, partially offset by a recent increase in deposit rates. Given those factors and assuming no further interest rate increases or changes to our deposit rates, we anticipate our Q1 ICA yield will be around 240 basis points.



Let's now move on to Q4 transaction and fee revenues. They were \$119 million, up slightly from Q3 as the expected \$5 million decline from conference revenue was more than offset by increased transaction revenue from heightened levels of market volatility.

Now turning to expenses, starting with core G&A. In Q4, core G&A expense was \$216 million, including \$2 million related to our acquisition of AdvisoryWorld. Prior to those costs, core G&A increased \$5 million sequentially. This is primarily driven by our investments in service and technology. For full year 2018, core G&A prior to costs related to AdvisoryWorld was \$817 million, which was within our outlook range of \$810 million to \$820 million.

Looking forward to 2019, we plan to stay disciplined on expenses while continuing to invest in technology and service to help drive growth. Our spending plans are unchanged from our initial outlook range of \$845 million to \$870 million. However, we are updating our outlook to include annual operating expenses for AdvisoryWorld, which are approximately \$5 million. This slightly increases our 2019 core G&A outlook to a range of \$850 million to \$875 million. And as a reminder, Q1 can be one of the higher quarters of the year given the seasonal increase in payroll taxes.

Moving on to Q4 promotional expenses. They were \$45 million, down \$7 million or 14% sequentially. This is primarily driven by a decrease in conference expense, slightly offset by increased transition assistance. Looking ahead to Q1, we expect conference expense will increase by about \$6 million as we have one of our larger adviser conferences of the year in March. We also expect transition assistance amortization to increase by about \$2 million, driven by our fourth quarter recruiting.

Now turning to regulatory expenses. They totaled \$10 million for Q4, up \$2 million from Q3. The increase was primarily driven by a matter for which a portion of the expense was not eligible for captive coverage. As a reminder, the nature of regulatory expenses makes them inherently difficult to predict. Our actual expense could move up or down in any given quarter or year based on the size and timing of matters and available captive coverage.

Moving to share-based compensation expense. It was \$5 million in Q4, down \$1 million from Q3. Looking ahead, the timing of our equity grants typically makes fourth quarter share-based compensation the lowest level of the year and the first quarter the highest level of the year. So as we look at Q1, we expect share-based compensation to increase by a few million dollars sequentially.

As for interest expense, it was \$32 million in Q4, relatively flat to Q3. Looking ahead to Q1, we expect interest expense to increase by about \$2 million as LIBOR rates rose in Q4 and our loans reset towards the end of the quarter.

Looking at our EBITDA margins relative to our gross profit. Over the past year, we generated EBITDA of \$866 million, up 40% from the prior year. Over the same period, our EBITDA margin was 44.4%, up 470 basis points year-over-year as we continue to manage expenses to drive operating leverage.

Moving on to capital management. Our balance sheet remained strong in Q4. Cash available for corporate use was \$339 million, and our credit agreement net leverage ratio was 2.1x, down 0.1x from Q3, which is at the lower end of our target range of 2 to 2.75x.

Turning to capital deployment. Our priorities remain investing for organic growth first and foremost, taking advantage of M&A opportunities if they arise and returning capital to shareholders. Looking at our organic growth, our investments are focused on recruiting new advisers to LPL, helping existing advisers grow and enhancing our technology.

As for M&A, we deployed \$28 million to acquire AdvisoryWorld. This investment will accelerate our development of industry-leading digital workflows that can help our advisers more efficiently turn prospects into clients.

In addition to our investments for growth, we returned excess capital to shareholders in Q4 through \$118 million of share repurchases and \$22 million of dividends. Our continued repurchases reduced our average share count to 88.2 million in Q4, down 2% sequentially and 5% year-over-year. For 2018, we returned more than \$0.5 billion to shareholders through \$418 million of share repurchases and \$88 million of dividends.



Also as a reminder, in early December, we announced that we increased our share repurchase authorization to \$1 billion, and we anticipate completing it over roughly 2 years. Just note that the pace of our repurchases could vary from quarter-to-quarter depending on all other capital allocation opportunities we have across organic growth and M&A as well as movements in our stock price.

In closing, we are pleased we have delivered strong business and financial results for Q4 and 2018. We remain focused on growing assets and gross profit, investing to drive organic growth while staying disciplined on expenses and returning excess capital to shareholders.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Steven Chubak of Wolfe Research.

Steven Chubak - Wolfe Research, LLC - Director of Equity Research

So I wanted to kick things off with a question on the recruitment outlook. So I guess first off, I just want to congratulate you on the record quarter of organic and new asset growth. Certainly, you're seeing a lot of really good progress there. But Dan, I was hoping to get your updated thoughts on the current competitive landscape for improvement and how we should think about the sustainability of that fourth quarter recruiting momentum and the impact that you might have seen from the market volatility.

Dan Arnold - LPL Financial Holdings Inc. - President, CEO & Director

Yes. So let me take maybe the second part of your question, and then I'll circle back with the first one. So I think if you look forward, as I said in the remarks, we feel good about our pipeline. It looks solid. So with a little color as to how we think about that and why we think about, well, I think you look at the end of the second half of the year, Q3 and Q4 were our best recruiting quarters on record. So we've got a lot of momentum as we entered the year. I think we're also challenging ourselves to think about how do we produce at a pace bigger and stronger than that. And I think -- so we entered into '19 with that momentum but with a challenge that how do we continue to think about improving what we do to drive bigger and stronger results with respect to recruiting. And so when we sort of peel that back and look at that, I think the primary drivers of those results in the second half of the year are the continued work and evolution of the performance of our business development team matched with aligning transition assistance to financial returns. And those are structural changes that we actually think are repeatable and sustainable and we carry forward into the new year and again continue to work on improving and enhancing our performance. So based on that context and based on our goals relative to recruiting, we feel good about sustaining that pace and continuing to work to challenge ourselves to produce higher and better results with respect to recruiting. So that's the kind of the second half of your question. If I miss something, I'm happy to come back to it. The first part of your question relative to the competitive landscape. We continue to look at the competitive space, and our go-to-market today is based on offering a traditional corporate RIA solution and institutional solution and a hybrid solution. We think that's a smart go-to-market strategy for us. It gives us nice breadth and reach into the marketplace and ensures that we've got an appealing model to a broad set of prospective advisers. And we're very committed to continuing to evolving and investing in each of those models. I think when we see where our opportunity is coming from, it continues to come from other independents who see LPL as an opportunity to perhaps have an access to an enhanced set of capabilities. We continue to benefit from the movement from an employee-based model to an independent model, so we see success in recruiting both from the wirehouses and the regionals. So that sort of competitive landscape and opportunity set remains pretty consistent as it has in the past. Let me pause there and see if I missed anything in your question.



Steven Chubak - *Wolfe Research, LLC - Director of Equity Research*

No, that was a very fulsome update, Dan. Maybe just switching over to you, Matt, just wanted to dig into some of the commentary you gave on the ICA cash extensions. Certainly, the 240 basis point guide was a nice surprise. I was hoping you can provide some detail on really 3 key inputs as we look to build out the model. One is the current spread differential on fixed and floating balances. The second is the level of ICA extensions up for renewal this year. And the third is just longer term how we should think about the optimal target of fixed versus floating. So current spread differential, one; two, the level of ICA extensions for this year; and third, the long-term target, fixed versus float.

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

So you're challenging me with that 3-part question, Steven. This is exciting. I'm going to take that. So when you look at the current spreads, if you look at just where we executed in the fourth quarter, we did it in early December, and we put in the key metrics. We executed a duration of around 4 years. If you look at where the swap curve was at that point, it was in the low 300 range when the Fed funds was in the low 200s. So it's about 100 basis point spread at that time. I think when you look at that today, I mean, at certain points of the curve, it's flat to inverted. So that's in the, call it, maybe 20 basis point range depending on what spot you look at. So it's really come back pretty meaningful, but I'm sure it's not a surprise to you. But where we execute at least going from 10 to 35 was before that occurred, which is one of the big drivers of that 240 basis points. I think when you look at the level of -- so part 1. So part 2, the level of opportunity in 2019. There's really very little. We had a lot of opportunity in Q4 as we had contracts coming up for renewal. We really don't have a meaningful amount in 2019. I mean, there's always tactical things that you could do. But I wouldn't assume that much is going to happen there. Over the longer term, I think we want to get to a higher percent fixed. And we're at 35%, and longer term, I think we think something higher than that makes sense. I don't have a number for you today, but I would emphasize wherever we do land, we're likely to target a range and not a specific amount because we want to be flexible. And while we think long term being in a high fixed percent makes sense, but at the same time, we always want to make sure we can move back and forth depending on where the market is, as the last 5, 6 weeks are perfect example with those strong movements in the yield curve. So I think I got all 3 of them.

Operator

Our next question comes from Bill Katz with Citi.

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

Just staying on the core deposit theme for a moment. Thanks for the guidance. Just one thing. In the supplement, I presume the difference between the guidance last quarter and this quarter might be the net effect of the extension program. I just want to make sure that that's true. But more broadly, if we're now sort of facing a flatter yield curve with the potential for rate cuts into 2020, what, if anything, happens behaviorally in terms of core deposit trends in your minds?

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

Yes, I think on the change in guide, I think you're referring to the \$35 million to \$45 million probably going down to \$15 million to \$25 million, and that's exactly it. It was the change in fixed rates. On behavior, I mean, I don't think we see really any difference in behavior. I mean, when you think about it from a high level and sweep cash balances, these are relatively small balances. There are operational cash awaiting for deployment or held for a position like we -- positioning for the market like we saw in December, and it's really not a lot of rate-sensitive cash. Maybe the final point I would highlight, if you look in the key metrics that we did put out on that same page you're referring to on left-hand side, the last couple of hikes, including the most recent one, we're operating at around a 30% deposit coefficient or deposit beta. And that's on average. At the higher balances, we've got a higher beta; at the lower balances, lower. And we really haven't seen that move of late and don't expect it to either.



William Katz - Citigroup Inc, Research Division - MD

Okay. And then just maybe now you -- and a question for you just -- and Dan as well. But just in terms of the capital triangulation, I guess on one hand, you're seeing really good return on investment from the technology and other investments you're making. And on the other hand, your sort of gross profit is improving and your stock has bounced back a little. Where are you between just sort of M&A, the need for that just given the really strong organic growth trends that are developing versus the buyback at this point in time?

Matthew Audette - LPL Financial Holdings Inc. - MD & CFO

Yes, Bill, I'll start it off. And then I think when you think about our capital allocation framework and even factoring the dynamics that you just walked through, it really is unchanged. I mean, I think the investments in allocating capital for organic growth, we think, is by far the best return on capital. And I think you're starting to see that bear out off in the results. And a lot of the things that Dan talked through in his prepared remarks are where and how we're deploying capital to drive a better experience and capabilities and service experience or customer care experience for our advisers, and that really has a great return on capital. On the M&A side, I think our philosophy is unchanged. We think that is an area that can help add to our growth. We look at it from a financial lens, strategic lens and operational lens, and we'll do things like you saw us do with AdvisoryWorld this quarter. We can do a capability acquisition that helps move the strategy forward. So I don't think -- we see that really unchanged. And I think the third area, on share repurchases, you see us pretty consistently deploying capital on the share repurchases in the low \$100 million per quarter range. And if you take our point on \$1 billion authorization over 2 years, it's about at that level with the caveat that, of course, it can move around. So I think we feel good about how and where we're deploying capital and most notably on the organic side and the results that are coming from it.

Operator

Our next question comes from the line of Craig Siegenthaler of Crédit Suisse.

Craig Siegenthaler - Crédit Suisse AG, Research Division - MD

For my first one, we just want to get update on IFP and your ability to retain your advisers.

Dan Arnold - LPL Financial Holdings Inc. - President, CEO & Director

Yes, sure, I will take that one. It's Dan. And so in short, we're making progress. And the retention rates are similar to what we talked about last quarter. So with that as context, let me give you a little more color. And just as a reminder, if you look at the assets, IFP started out this process at around \$12 billion of brokerage and advisory assets. The advisers managing those assets need to make a decision by somewhere in the first quarter, that time frame can vary, as to whether they will stay with us or change broker-dealers. To date, the advisers that manage about 2/3 of those assets have made the decision, and approximately 75% of those assets are staying with us. Now that still leaves about 1/3 of the advisers that are working through the process, and we're focused on making sure we're educating them on what their options and alternatives are in the spirit of helping them make an informed choice. So hopefully, that gives you a good update as to where we are. I think the actual date of transition is subject to when IFP will be ready to start their own broker-dealer. So there's not a perfect science in the first quarter, but that's our best estimate.

Craig Siegenthaler - Crédit Suisse AG, Research Division - MD

Dan, just as my follow-up, you made several tweaks to your transition assistance offering last quarter. And I just wanted to see if you could comment on if you've seen any changes in your recruiting results so far just based on those changes.



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

So I'll provide some color. And then, Matt, please add anything that you think is helpful. I think as we think about our transition assistance, I think the core principle is aligning that transitional assistance with financial returns, right? And we've continued to tweak that, experiment as to how we position that out in the marketplace. But I do think at the end of the day, with respect to being smarter around how we align that around financial returns, that does have a bigger contributor on the heavier mix of corporate RIA versus hybrid RIA that we saw pretty much for the balance of last year and certainly in the second half of the year. So I think that's probably the biggest place that you see some realignment or rebalancing based on those changes. I don't know, Matt, if you want to add anything to that.

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

No, I think you hit the key points.

Operator

Our next question comes from Alex Blostein of Goldman Sachs.

Alexander Blostein - *Goldman Sachs Group Inc., Research Division - Lead Capital Markets Analyst*

First question for you guys around the trends in recruited assets. The data you guys provided was quite helpful again. So around \$9 billion, I guess, for the last 2 quarters in a row. How much of that is reflecting -- how much of that is already reflecting, I guess, client asset balances? And any sort of breakdown you guys can help us think through brokerage versus advisory and sort of the impact these assets might have on the gross profit ROA as they come in?

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

Yes, I'll start. I mean, I think our typical ramp on a recruited -- a new advisory coming onboard, those are the assets that come over in the first 6 months. So I think that's probably the best proxy to give you on how that ramps. So similar dynamic last quarter for the \$9 billion, the 6 months following that. And advisers typically come in throughout the quarter. The only nuance in the fourth quarter is December is usually a little bit slower, especially the second half, where really no advisers can move. I think from a mix standpoint, we typically see on the recruiting side, the brokerage mix is a little bit higher than our overall mix. And then over time, as we've talked through, you do have some brokerage-advisory conversions. But from a recruiting asset standpoint, the brokerage mix is usually a little bit higher.

Alexander Blostein - *Goldman Sachs Group Inc., Research Division - Lead Capital Markets Analyst*

Got it. And then just a follow-up question around the ICA dynamic. Can you guys talk a little bit about what's going with bank competition for brokerage deposits, sort of kind of like the spread that is paid over benchmark rates today, whether or not there's an opportunity to pick up a little bit of incremental yield that way? And if there's no more interest rate hikes in the cycle, should we think about the 240 ICA yield you highlighted as kind of reasonable run rate for the rest of the year or if there's something that can move it sort of up or down?

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

Yes, I think on the bank demand or competition for deposits, I mean, I think over the past several years, you've definitely seen that move up. I mean, just using spreads over Fed funds on those type of deposits as a proxy, you go back to before rates started moving up, and they were bouncing around in the 5 to 10 basis points over Fed funds. I think when we look at the market today, you can typically get in the 20-plus. There's -- it's a technical markets. It depends on who needs what, when. But it's definitely moved up. I think with respect to the 240 basis points, so that is our estimate assuming no more hikes, no more changes in deposit rates. There's always movements to the first part of your question, there's always



movements in funds even if we're not fixing anything out or changing rates that way. Funds can be placed with different banks that can drive a little bit movement there, but that's probably relatively minor. But it could move it a little bit.

Operator

Our next question comes from the line of Christian Bolu of Bernstein.

Chinedu Bolu - *Sanford C. Bernstein & Co., LLC., Research Division - Equity Analyst*

Organic growth clearly slowed meaningfully in December. You guys are tracking around 5% to 6% in the prior months. So curious what drove the slowdown in December. And then as we've seen equity markets lift up here in January, is growth going back to trend?

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

Yes, that's a good question. And I think as you said, if you take the quarter as a whole, a pretty solid quarter from an NNA standpoint. We've seen a continued trend upward, which is a good thing. I think we definitely saw a slowdown in December. And that's not so illogical for a couple of reasons. One, you typically see the seasonal impact of the holidays. It just reduced the number of opportunities for advisers to gather assets. You also see a heavier focus on tax planning with the coming of the year-end, which again has a similar type of impact. I think then you add to that the markets turned to the downside in December, which definitely had an impact on same-store sales NNA as advisers were focused on helping their existing clients kind of manage through that market volatility. And we saw some of that continue into the early part of January. I think when you hit mid-January though, we began to see same-store sales NNA ramping back up. And you add to that the solid recruiting pipeline that we talked about. And we believe that those are certainly 2 helpful factors that should contribute to solid NNA growth going forward. So hopefully that helps.

Chinedu Bolu - *Sanford C. Bernstein & Co., LLC., Research Division - Equity Analyst*

Yes, that's very helpful. And then maybe just a clean-up question here for Matt. Advisory yields, that ticked down a couple of basis points to, I guess, 103 basis points. And just curious, like what drove that? And is that a good number to think about going forward?

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

Yes. I mean, I think that number naturally moves around from quarter-to-quarter. So a basis point or 2 pickup or drop-down is pretty normal. When you look at it on a full year basis, 2018 versus 2017, it's relatively flat. So I just look at that as more quarterly noise, and you can always have that on future quarters as well.

Operator

Our next question comes from the line of Chris Shutler of William Blair.

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

In recent weeks and months, I think we've seen one of the wirehouses starting an effort around fee-only RIA effort. A couple of your broker-dealer competitors are tapping into that area also. Just give us an update on where you yourselves playing in the fee-only RIA space at some point. And if so, how?



Dan Arnold - LPL Financial Holdings Inc. - President, CEO & Director

Yes, it's again a good question. And we think about our go-to-market strategy. We're constantly exploring where the opportunity set lies across the 300,000-plus registered advisers that are out in the marketplace and where those opportunities are. And if we're not either competing in where advisers are moving from one model to another, that would give us a challenge to think about that differently. And so I think with respect -- that is a backdrop to how we think about that. We would tend to look at different models and explore how should we add them to our portfolio. Certainly, the RIA only or the fee based only, we have a model today that exists where if someone wants to drop their broker license and they can continue to operate on our platform today, we can facilitate and support that type of solution. So we have a solution today. What I would tell you though is the question we're challenging ourselves on is, can we improve it? Can we transform it? Can we materially rethink it such that we reposition it into a more compelling and competitive offering out in the marketplace? So we're in the process of doing just that. So more to come on that, but we do think it's an interesting possibility that we should be considering relative to improving and enhancing our offering today.

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

Okay. And then if I could sneak in a couple of quick ones. What was the amount of advisory loans in the quarter that would show up on the cash flow statement? And can you talk about the reduction in the adviser headcount in the quarter?

Dan Arnold - LPL Financial Holdings Inc. - President, CEO & Director

You can take the loan one and I'll take the headcount.

Matthew Audette - LPL Financial Holdings Inc. - MD & CFO

Yes. So Chris, the loan one, we'll have that information in the 10-K. I don't have that for you today. But it will be out soon.

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

Matt, could you think about disclosing that going forward in the -- because it's an important number.

Matthew Audette - LPL Financial Holdings Inc. - MD & CFO

Of course.

Dan Arnold - LPL Financial Holdings Inc. - President, CEO & Director

All right. And with respect to the adviser count decline, our adviser count for Q4 was down 65. And that thing's a bit illogical when you look at the solid quarter from a recruiting standpoint and the consistency around our retention from quarter-to-quarter. So to sort of give you the drivers around that, we had 50 advisers in the quarter left that were previously with IFP. They were retirement plan focused and didn't have a lot of assets from a brokerage and advisory standpoint. So they tend not to make a lot of difference on our advisory balances. But certainly, they make noise in the adviser count. The second driver was we had about 30 advisers that left from the previously discussed small group of hybrids that we weren't strategically aligned with, and we've been going through the process of separation there. And then finally, thirdly, we had kind of a typical year-end noise where you'll have some low-producing advisers that just decide to leave the business because they don't want to go through the renewal process of their licenses and incur some fixed cost going into the next year, and that was about 30 advisers. So when you begin to summarize those or sum those up, that creates a noise in the overall numbers. When you back those out, the growth in terms of the number of advisers would correlate better with what you see from the asset growth, the NNA, the recruiting and the retention.



Operator

Our next question comes from Chris Harris of Wells Fargo.

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

So your cash balances, customer cash balances, they went up a lot in the quarter. At the same time, it looks like customers were actually net buyers of securities. So just wondering if you could explain that dynamic a little bit. I would think that if advisers were net buyers, you wouldn't have such significant growth in the cash balances.

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

Yes, sure, Chris. So well said. And if you look at -- we put in the key metrics. If you look at the months, when you saw the majority of that cash that grew, grew in the month of December, and we actually had net selling for the first time in quite some time in the month of December. So that was the big primary driver in that month. And then when you put it all together, at least when you look at the trends, we've been hovering in the net buying zone of \$8 billion to \$9 billion a quarter. And with the less net buying in October and November as well as net selling in December, that's what dropped you by about \$7 billion quarter-over-quarter. So that's the change, and that's probably the key driver what drove that cash up.

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

Got you. That makes sense. And quick follow-up on your base payout rate. I know in any one quarter, it can kind of just jump around. If we think about the bigger trends here and your corporate advisory assets continue to grow faster than hybrid, should we assume that, that base payout rate ticks up a little bit over time?

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

Yes. I mean, I think historically, the mix there drove a little bit more change. But when you look at the pricing changes we made in the past couple of years, really the difference between those 2 is a lot more minor. So it's not likely to be a big, big driver.

Operator

Our next question comes from the line of Devin Ryan of JMP securities.

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

Just another one maybe on the ICA and just trying to understand the mechanics of the contracts and why there isn't much up for extension this year. You still have roughly 2/3 that are tied to short-term rates, but it sounds like you still have a commitment for a fixed period of time. So I'm just trying to get a sense of what the average length on the short duration contracts is. And then could you potentially extend duration with some of those existing banks? Or is that just not something we should be thinking about?

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

Yes. So I think you hit it well in your question, right. So even though there's contracts that are at floating rates, there's a commitment to have the funds there for a certain period of time. And we didn't break out the exact duration of the rest of the contracts, but there's very little opportunity in '19. But I think you're right. On the second part of your question, there certainly can be opportunities. Or even if there's a commitment, if the other side or the counterparty is interested in moving from floating to fixed, that certainly could happen. So that was my point earlier or in the prepared remarks, that there might be some tactical opportunities, but not materially. Also, I'd add to that, that we'll keep in mind the interest rate

environment, right. I think if we're sitting here in early December with a 100 point steepness in the curve, I think we might be more focused on that than where we are sitting today where it's only potentially 20. So I think we're going to keep the interest rate environment in mind as well.

Devin Ryan - JPM Securities LLC, Research Division - MD and Senior Research Analyst

Okay. Makes sense. Appreciate the color. And then just a follow-up on the commissions. So trailing commissions step back because of the market, which we get, but you had pretty healthy sales-based activity, which I would have thought could have been a little quieter just because investors potentially reduced automatic allocations during the volatility and kind of derisked a bit. So I'm just curious, was that seasonal? Or does it somehow benefit from the volatility? And then really I'm just trying to get a better sense of what was helping new sales and if it speaks to anything that might be more sustainable in terms of a trend that you guys are seeing.

Dan Arnold - LPL Financial Holdings Inc. - President, CEO & Director

Yes, those are great, fair questions for questions. And I think as we think about that, you've seen, quite frankly, some stability on both the brokerage flows and the sales-based commissions really over the past 3 quarters. And maybe the primary drivers of that to think about is just as you recruit these new advisers, they're bringing new brokerage assets, and that's going to create obviously more opportunities for commission-based activities. I think you'll also see with maybe some progress on the regulatory front more willingness to use brokerage with -- existing advisers using brokerage as a potential solution to help clients, and I think that's certainly been a contributor. And then finally, I think -- some of the volatility that has occurred in September forward certainly gives the adviser more opportunities to potentially solve for different problems that are arising for clients where commission-based solutions may be an opportunity. But I would think that more around the edges than the first 2 points that I made, which are probably more significant drivers. The third -- the final thing that you see is you always see a little seasonality in traditional insurance in the fourth quarter, just the timing of some of those renewals and how that's done. So you get a little bit of lift. But again, that's a minor point around the edges. So the first 2 drivers are the key ones.

Devin Ryan - JPM Securities LLC, Research Division - MD and Senior Research Analyst

Okay, great. Last just quick kind of modeling one here. We've seen a little bit of an uptick in kind of regulatory targets, and we've seen that for some of your peers as well. And so I'm just curious if that speaks to something bigger going on where it's just kind of we're intensifying once again around certain topics. Or is it really just kind of idiosyncratic? But you did have a reasonable step-up in 2018 over '17, I know specific situations, but just trying to think about the go forward, how you would be advising to model that.

Matthew Audette - LPL Financial Holdings Inc. - MD & CFO

Yes. I mean, I think when you look at the year-over-year trend for us, it's more about the combination of our size and growth combined with our insurance captive where we increase the coverage there and therefore increase the premiums. So that's really the primary driver. There's always going to be the potential for things to come up that are outside of that like we saw a little bit this quarter that you referenced, we talked about in the prepared remarks. And those are going to always be hard to predict and can always come up. I think from an overall standpoint, we feel good about the investments we made in compliance and the technology that we're deploying there and lowering our risk profile overall. And the driver for us of late has really been the captive premiums.

Operator

Our next question comes from the line of Michael Cyprys of Morgan Stanley.



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

I just wanted to circle back on the AdvisoryWorld acquisition. Just strategically, if you could just talk about -- curious to hear about how you're thinking about making the sort of technology-related acquisitions and allocating capital to that and the need to continually invest in the sort of technology acquisition companies that you'd be acquiring versus, say, renting, licensing that software, you kind of get a benefit of -- from going to a lot of larger firm that has those capabilities and the scale to continually invest in core expertise in that area?

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

Yes. So there's a lot there so let me unpack some of that, and if I missed some of it, please just ask again. So look, with respect to AdvisoryWorld, that was -- the logic and the strategy around that was an opportunity to take some really good technology that through an acquisition, we could accelerate our speed to market relative to some of the work that we're doing around digitizing adviser practices. They fill a variety of different capabilities that we wanted in those overall workflows, and so it made a lot of sense for us to take the acquisition route there, bring it in, work on integrating it very quickly, which we just did this week. So that's the first step in that integration, was to get it into ClientWorks and make it easily accessible to our advisers, of which we're charging no fee for. And then that creates a brand and quick new leverage point for them as an example. There's more in the integration than that, but that was the first step, which is encouraging. And so again philosophy, accelerate the speed to market relative to some of these capabilities, take a good foundational platform that we know once inside, we can continue to improve and iterate on it and give something to our advisers that is going to materially help them operate their businesses. So that's the AdvisoryWorld story. I would tell you that would hold true relative to other technology capabilities. I think we think about the world through, yes, we have -- and make a big investment in our own technology organization to build and develop, and that's an important component of our overall strategy. But we're also very open to looking at really good technology out in the marketplace that's either established and commercially available or even finding smaller organizations that are building new tools and capabilities that we actually can strike up a partnership with and have a big influence on the ongoing development and integrate those into our ecosystem where it's not just about, hey, I have access to that technology but can I integrate in and really transform how the adviser works. That's what we think is the key. So we'll continue to do that. The final thing is as I think we do not believe that we have a corner on having all the capabilities that we need from a technology standpoint to figure out the future. It's a fast-moving marketplace. You've got to state nimble. You've got to stay agile. You've got to keep your head up and exploring your options and alternatives. And so we've got strategic partnerships and access to places like Silicon Valley that might have certain expertise or capabilities to complement what we might do internally and might go completely outside to develop some new capability that we bring in. So we've got multiple oars in the water relative trying to increase the pace and the breadth of our technology innovation. I think the one key point I want to make sure I make clear to you is we do all of that with a specific purpose. We go in, trying to solve specific problems. We are not innovating for the sake of innovating. We're clear on what we are trying to solve for. And then we work back from there, and I think that is an important point that keeps us focused and ensures that we're optimizing the prioritization of the work on that portfolio. So I hope I hit your question. If not, fire away.

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

Indeed, super. If I can just ask a follow-up on more of a modeling technical issue. Just on the production expense, can you just walk through the 3 pieces there in the production expense? So we can maybe get a little bit better understanding there. You mentioned you have a deferred commission expense, a little bit volatility in there. If you can just help flush out the mechanics of those 3 lines within the payout ratio and how to think about the level from here, that would be helpful.

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

Yes, sure. I mean, the base payout rate is as defined, right, as the label lends itself. The production-based bonuses are the bonuses that build throughout the year based on advisers' production. So that's one where I'd encourage you to look at the -- if you're looking at Page 14 of the release, that trailing 12 months at the bottom of that table kind of gives you an idea knowing that it's going to build through each individual quarter. The thing I would highlight there is our pricing changes do show up as an increase in the production-based bonus, both the one that we did in 2018 and the one that we spoke about in the prepared remarks today that will begin in Q1 of '19. So when you look at that trailing 12 months, that last row, that's why you see that growing throughout the year. The non-GDC-sensitive payout, that's the item that I spoke about in the prepared remarks.



It was really just a mark-to-market, and it's a gross profit or a revenue item that gets offset here. So in thinking about payout, I'd just encourage you to look at the GDC-sensitive payout line. That's the most relevant piece, and below that is really mark-to-market noise.

Operator

And at this time, I'd like to turn the call back over to Mr. Arnold for any closing remarks. Sir?

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

Yes. Thanks so much, operator, and thanks to everyone for taking the time to join us this afternoon. And we look forward to speaking with you again next quarter. Have a great day.

Operator

Ladies and gentlemen, this concludes today's conference. Thank you for your participation. You may disconnect your lines at this time.

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