CHAPTER 1

The Financial Advisory Business

What's Next?

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Much has changed since *Practice Made Perfect* was first published in 2005. Back then, the average advisory firm was growing at a compound annual rate of 18 percent. Advisory firms were transforming in record numbers from solo practices to ensembles, with multiple professional staff. The markets were moving at an inexorable pace to reach new highs. Business profits were strong, and owner income was increasing year after year. Little did advisors know the seeds of destruction were being sown.

Starting in 2007 with the collapse of the housing bubble, the world economies went into a tailspin of such velocity that many financial professionals were unprepared. Then in 2008, the securities and banking industries started to bite the dust at a more rapid clip. Bear Stearns was bought in a fire sale by JP-Morgan; Lehman Brothers shut its doors; AIG unraveled and put in peril many of its counterparties around the world. By November of that year, the S&P500 was down 45 percent from its 2007 high. The Troubled Asset Relief Program (TARP), with $700 billion of funding for financial institutions, was implemented by the Bush administration to fend off a total collapse of the U.S. economic system. In the midst of this, Merrill Lynch was sold to Bank of America, and Bernie Madoff emerged as the biggest fraudster of all time, further adding to the idea that Wall Street could not be trusted.

In the aftermath, the landscape for financial services appeared much different for good reason. Anyone associated with stocks and bonds, synthetic securities, financing, securitization, or any permutation of Wall Street was held in contempt by individual investors. Organizations that were once trusted and respected were

vilified by Congress and the press. Consumer organizations pressed for tighter controls. Meanwhile, clients began asking their current and prospective advisors to demonstrate why they should be trusted.

Banks and wire house brokerage firms still dominate the landscape in sheer numbers of assets and financial professionals, but a large and growing population of independent advisors own their own businesses and are operating as registered independent advisors (RIAs) or are affiliated as independent contractors with Introducing Broker/Dealers (IBDs). In the United Kingdom and other countries in Europe, Australia, and Asia, there is an emerging market of independent financial advisors (IFAs) and multi-family offices (MFAs) that operate much like independent advisors in the United States, free of proprietary products but with an increased responsibility to manage their own businesses as well as serve their clients well. There continues to be a persistent migration out of the captive environments into independent businesses, where the advisors can create their own brands, deploy resources the way they see best, and exercise judgment that they feel is in the best interests of their clients.

Of course, a huge body of independent pioneers led the way, but the average age of those practitioners continues to rise, and the business pressures continue to increase. This is both a blessing and a curse. The aging population of financial professionals creates opportunities for growth among younger practitioners and perhaps even opportunities for acquisitions and mergers. The curse is that many of the older generation of advisors have not adequately prepared for their succession, so what they ultimately transfer to a successor may be an aging pool of clients heavy into their asset-withdrawal cycle. The good news is that the aging pool of clients is also transferring assets to their heirs, which provides a new opportunity for serving accumulators.

But being an independent in financial services at this time is not without its challenges. Foremost is the belief by most industry observers that we are in a slow-growth market environment for a long time, or at least until corporate earnings improve dramatically, unemployment comes down, interest rates go up for the benefit of savers, and the market becomes less volatile. Many advisors today are making growth assumptions of 4 to 6 percent compounded annually for their client portfolios.

Exacerbating the challenge is that the cost of doing business for advisors is also increasing because of rising labor costs, a tougher regulatory climate, and heightened scrutiny by clients and prospects regarding their ethics and way of doing business. This, after taking a beating in the market right along with their clients, has driven most to work extra hard during the intervening years to rebuild assets and income.

The blame for this added pressure could go to the larger banks and brokerage firms who were at the fore of the crisis, but that's like blaming fellow travelers for the cold you got. It may feel good to point fingers, but it does little to

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ameliorate the situation. In fact, it may have created an opportunity for independent practitioners to distinguish themselves in the market with clients and staff.

What Are Top-Performing Firms Doing?

In 2010, Pershing Advisor Solutions sponsored a survey conducted by *InvestmentNews*/Moss Adams on the financial performance of financial advisory firms. As the dust settled, the survey revealed that the leaders of top-performing advisory firms were able to raise their heads out of their foxholes and capitalize when others were tentative. This serves as a good baseline to begin measuring improvements in advisory firms for the foreseeable future.

- While average advisory firms saw their overhead expense ratio increase to 44.9 percent of revenue, the top-performing firms kept their operating expenses to 29.3 percent.
- Top-performing firms generated more revenue per professional staff member.
- As further evidence of greater productivity, the top-performing firms generated almost 20 percent more revenue per client than the average advisory firm.

The combination of greater operating leverage and expense control allowed the top-performing firms to spend more on the client service experience as well. The top-performing firms spent more per client than the average firm. The top-performing firms also spent more of their total expense dollars on their own people at a ratio of 70.3 percent of total expenses compared with 61.2 percent at the average advisory firm.

It doesn't take a CFA to deduce that a greater investment in clients and the people who serve them yields a higher probability of retaining both—and attracting others. The big takeaway from these statistics: The top-performing advisory firms have not only the right discipline in managing their businesses but also the right people to execute their management plan.

Often, advisors and firm rainmakers are oblivious (at best) or dismissive (at worst) of the people not working directly with clients, those responsible for running the business and managing operations. Many mistakenly perceive them as overhead and do not see the value they contribute to the brand and client experience. Data from most industry studies seem to refute this thinking.

In fact, the *InvestmentNews*/Moss Adams study showed that those firms with multiple owners and a commitment to professional management were growing faster than the average advisory business. This makes intuitive sense. With multiple owners, an advisory firm has multiple points of contact, multiple centers

of influence, and multiple clients to drive more revenue. A multiowner firm also allows specialization among the partners, freeing up each to take on specific management responsibilities to oversee critical areas like human capital, operations, the client experience, investment policy, financial planning, and other disciplines that are core to the firm's success.

The Business as Client

Another thing the *InvestmentNews*/Moss Adams study revealed is what happens when advisors view their own business as a client rather than an afterthought. This means they plan, they execute, they monitor, and they adjust as needs dictate—just as they would for a client.

Unfortunately, time constraints for those who are both managing individual clients and attempting to manage the business are an impossible barrier for many. The typical advisory firm is already at capacity in terms of the number of clients it can handle, so there is no leeway for adding more management duties. How do you find time to ensure the business is performing to its optimal level when confronted with a schedule filled with client appointments, concerns about volatile markets, and urgent decisions? Even more significantly, how do you find the time to think strategically about the business—let alone implement a plan?

It is within this context—market pressures, management challenges, rising labor costs, new regulatory environment—that owners of advisory firms must ask the question: Is my strategy still relevant? To begin this process, there are 10 big things to think about how you would address in your own business. The outcome may be a mere refinement of your strategy, or it may require a wholesale shift in how you do business to ensure you are building a business to last.

10 Things to Think About

One of the challenges of managing a business is the necessity of analyzing the firm and making plans about where to focus your attention and resources. Even though it is an inexact science, we can probably draw some conclusions about where the business of financial advice is heading, based on some essential observations. Our vision of the typical advisory firm includes the following:

- Most are small businesses (even at $10 billion of assets under management, the revenue level would qualify a firm as small).
- Most are owner-operated (though with the emergence of consolidators, this is changing somewhat).
- Most have experienced rapid growth in clients.

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- Most have experienced a meaningful increase in headcount.
- Overhead costs in general have gone up dramatically, particularly compensation-related expenses.
- Clients are expecting—if not demanding—more from their advisors without allowing for a commensurate increase in charges.
- Firm owners and staff are getting older.
- These trends are expected to continue.

If you agree with any or all of these assumptions, then what do you think the future holds for your firm?

1. Managing Growth

Much of the growth in advisory firms before 2008 came as a result of market increases, but a fair amount also came from new clients, which required the addition of new people to serve them.

While growth provides the opportunity for staff development, increases in profits, more succession options, and an exciting atmosphere, it brings with it the potential for stress fractures. When an owner's span of control is stretched, quality, consistency, and effective leadership suffer. Often, the firm's sense of purpose gets derailed as well because there is no time to inculcate new associates with the firm's philosophy on the right way to do business, or for leadership to evaluate what's working and what's not. Unmanaged growth can be more dangerous to a business than no growth at all because of the reputational, financial, and compliance risks.

The question advisors should ask is whether their business is structured right to effectively manage growth. Do you have the right people doing the right things? Have you examined your processes, procedures, and methods of ensuring consistency? Are those responsible for managing doing their job well, or do they require more training? How fast can you grow without fundamentally changing your management structure? And if you do have to change your structure, who will you put in place to ensure you execute this well?

2. Hiring Professional Management

As an owner, you will know your practice is at a crossroads when you do not have time to both serve the clients well and manage the business well. For many firms, the business has become the biggest client, and it has many moving parts: strategy, human capital, financial management, operations, sales and marketing, client service, and compliance. If you evaluated your business management by the same standards your client uses to assess your ability to provide sound financial advice, how would you rate? Your challenge now is to decide whether to give

up one to focus on the other. Data shows that advisory firms with professional management grow at a substantially faster rate than the average firm, and logic affirms that.

"Mission Possible II," a white paper published by Pershing Advisor Solutions in 2009, reported that 14 percent of advisory firms with more than $1 million of annual revenue added dedicated management. As firms increased in size, this has become more common. At $3 million to $5 million, 76 percent of firms added professional management, and over $5 million, 88 percent had this capability. It is hard to say if this is cause or effect, but it is clear that as firms become larger, they require more specialization and focus and more accountability around the different disciplines within the business.

The question is whether one of the principals who heretofore was working with clients while managing the business part-time will step into a full-time management role or whether the owners will cede some control and hire professional management from the outside. With qualified individuals dedicated to a job, the outcome will almost always be better. The process of deciding who should perform certain management functions should be no different than evaluating who should be the chief investment officer or chief compliance officer. It is a function that requires vision, empathy, attention to results, and a passion for performing the work well.

3. Improving Operating Efficiency

It is becoming accepted wisdom that most advisory firms have plenty of tools but are not utilizing technology to the optimal level. The failure to interface and integrate, train properly, plan, or budget for acquiring software and hardware all contribute to the inefficiencies. Having made multiple steps forward, most advisors now need to take at least one step backward to assess workflow and determine how technology can be optimized to improve productivity and client service. There is a high likelihood that the solution will not be a proprietary creation but better usage of what currently exists in the marketplace.

The independent advisory business has transitioned from being a technical business to a relationship business. And the key to relationships is how clients are treated. As your practice grows, that increasingly means operations—encompassing everything from client intake, to execution of the plan, to trading and reporting, to compliance and financial management. These days, operations is rising in importance and strategic value for many advisors. When Pershing Advisor Solutions commissioned "Mission Possible I," we learned from detailed interviews with leading advisory firms that their processes can't keep pace with client demands and firm growth. Most of these advisors told us they are mostly reactive and not strategic about how they address operations issues and that their staffs are overwhelmed.

Ultimately, as advisors and their practices grow, advisors' frustration with low morale, errors, exceptions, and staff turnover boils over, and they look deep inside to find several things:

- Staff jobs, and therefore expectations, are poorly defined.
- Staff is viewed as a cost to be controlled, not an investment on which to get a return.
- They lack interest or ability to prepare their staff for success.
- There is no clear leadership and certainly no training.

How do you know when you reach a point of transformation? There are several key signals, seen as increases in:

- Client complaints
- Exception reporting
- Staff turnover
- Response time to clients
- Overhead as a percentage of revenue

What occurs is that as an advisory firm matures, the capabilities of its staff get left behind. Your decision is whether to outsource or hire talent. The dilemma is that while you might be able to afford the technology tools, you can't necessarily afford the staff unless you make some fundamental changes in your business model.

To solve the problem, advisory firms need to deconstruct and then rebuild their operations to keep pace with their growth. A good first step is defining your optimal client. When this is clear, then you can build a client service experience that fits this client instead of inefficiently trying to serve multiple classes of clients with a diffused service approach. As desirable as it might be to customize the experience for each client, it is very difficult and costly to do this until you achieve a level of critical mass.

4. Building Value

Advisors realize value in their business through current income and capital gain upon sale. The vast majority of advisors are not contemplating the sale of their business anytime soon, however. Therefore, the key is to build a business to last. This means consistent repeatable income, sustained profitability, continuity of management and client service, and a systematic process for generating new growth.

This is not to say that advisors cannot sell their book of business and receive an adequate return. But there are elements beyond assets and clients that determine whether one can maximize value. The key is to understand that value is a function

of the future, not the past. When one asks for a multiple of revenue, by implication one is valuing the business based on what it has done rather than on what it is about to do. Buyers are becoming increasingly aware of this challenge and, as a result, are looking at the client demographics more closely and making judgments about what it will cost to service those clients once acquired.

In addition, buyers—including internal successors—are attempting to understand what the advisory firm's growth engine is. If the practice is entirely dependent on the current owner for new business, and if the clients are dependent on that owner for advice, then what is really being transferred and how much is it worth?

Further, how is a volatile market or low-return environment going to impact the valuation compared with the past? Is history likely to repeat itself? Are the clients now in a withdrawal phase, or are they for the most part still accumulating?

Business value in its simplest form is determined by dividing cash flow by risk minus growth ($V = CF \div [R - G]$). To build value, then, one should focus on enhancing cash flow, minimizing risk or uncertainty, and managing growth. If these elements are missing, then transferable value will be diminished.

5. Differentiation

Everybody—from traditional brokerage firms to insurance salespeople—uses the term *wealth manager.* Their processes, offerings, pricing, and approach to client service vary, however. In fact, many of these wealth managers are not even dealing with wealthy people! But in some maddening way, the madding crowd persists in using this term to describe what they do. (At least we're not hearing them use the term *quarterback* quite as often—it seems nobody wants to be a guard, linebacker, or tackle.)

To dig a little deeper into an advisor's perceived differentiation, one hears things like experience, depth of relationships, plan design, quality service, and ethics. Frankly, those qualities are the basic threshold for being in this business. Real positioning comes from being known for something, having a recognized brand or technical superiority or unique way of generating new clients and serving existing clients. It's hard to separate one's message from the noise, but with so many very good competitors seeking the same clients, a growth-minded firm needs to resolve what distinguishes it in the marketplace.

As an exercise, it's helpful to look at the web sites and collateral material of organizations that are attracting the same types of clients you are interested in. See whether they are using the same language as you do. See who is expressing their positioning in terms of outcome for the client.

Ultimately, the real test is how your centers of influence, including your clients, describe what makes your business unique and so valuable that they would recommend you to their friends. Chances are, your business has evolved

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over the years to where you are viewed differently—or perhaps you should be. When you are clear on this, it may make the way you structure your business, hire and develop your talent, and measure your success clearer as well.

6. The Talent Shortage

The problem is acute: There is an oversupply of clients and an undersupply of qualified advisors. According to studies that Pershing Advisor Solutions LLC commissioned from Moss Adams in 2008, there is a need for 9,000 net new financial professionals within RIA firms alone. And this segment represents only 15 percent of the total retail advice population! When you add retirement, death, and disability to the equation, the actual number of new advisors increases dramatically. And when you add staffing needs within broker-dealers, the problem is almost overwhelming.

Growth-minded firms must position themselves as the employers of choice in their market and seek ways to recruit from nontraditional sources and invest in retention and development. It is not practical or feasible to keep recruiting against each other or to accept a high rate of turnover. Compensation alone will not be an adequate substitute for active management and the opportunity for individuals to develop a career in this business. Advisors who participate in the industry's professional associations need to steer these groups back to the practical battles that will create more lasting benefits for the members, such as actively promoting this business to college graduates over "sexier" choices.

7. Reinvigorating the Sales Process

The advisor has come a long way from when all financial service professionals were regarded as producers. Unfortunately, the shift away from being known as a salesperson also resulted in a whole generation of advisors who are uncomfortable with the notion of business development. Their lack of sales ability is camouflaged by the flow of referrals into the firm based on the reputation of the founder or partners. Most referrals are passively generated, as many advisors can digest only so much new business. The point is that every business needs a growth engine. In professional services, this means having partners and associates who can create new centers of influence and attract new business to the firm. When the founders of these firms start phasing out, the absence of a systematic business development process will become apparent for many advisory businesses.

8. Managing Profitability

While overhead costs are rising faster than revenues for most firms, this is mostly a function of investing ahead of the growth curve. The real challenge for advisors

is managing the gross profit margin, the measure of profitability after separating direct costs related to professional compensation from revenue. As advisory firms experience more growth, they will need to retain price integrity, monitor and manage productivity of staff, improve client selection and retention, and avoid offering one-off solutions for which they lack expertise. It is important to know that minor changes in the gross profit margin usually have a meaningful impact on the net profit of the enterprise.

9. Redefining the Service Offering

Over time, client demographics and characteristics change. Typically, advisors attract clients their age or older, though that does not always have to be the case. What one may have regarded as an optimal client in the start-up or growth phase of the business may not be the optimal client going forward. If you were to identify the characteristics of your top 25 existing clients, what would be the pattern? And if you were to acquire those top 25 clients today, what would your service offering be? What gets a business to one level is not the same as what will carry it to the next, primarily because of changing client needs, perceptions, and expectations. The question for every advisor today should be: Is my strategy still relevant?

10. The Pricing Strategy

As one's client mix changes, so, too, will the profitability of these relationships. Let us assume for a minute that all your clients are boomers who made it through the accumulation phase and are now in the distribution phase. Will it still be appropriate to charge an asset management fee? Will that still work for you if they are demanding more from your staff and you while drawing down principal? Will your pricing strategy communicate the value of your offering and reflect the economics of what you are offering? It is possible that there are always enough new clients coming into the pipeline to offset the income shift from older clients, but ultimately every business wants most clients to be profitable.

So as you ease into the new era for your business and begin thinking about the adjustments you need to make to build an enduring relationship with your clients, take the time to reflect on your own business and its impact on your own pursuit of financial independence and peace of mind. Often, current processes are working, and there is no need to change. But generally, every business must periodically make changes in order to show marked improvements in how the business performs. These 10 things to think about should serve as fodder for your deliberations.