PART I

The State of the Advisory Business

CHAPTER 1

Key Business Trends

Assumptions

Back in the day when individual investors were buying stocks and bonds instead of packaged solutions like mutual funds and ETFs, there was an investment analyst Mark knew in Seattle who was locally famous for his contrarian bets. His inclination was to look at companies currently out of favor with the investing public; assess their management, their culture, and their market; then take a long view of their business to determine whether it was an opportunity worth owning.

The stockbrokers who worked for this particular firm adored the man, whom we will call "Conan the Contrarian," because his reverse approach always made them look good with their clients. Today, whenever we hear some industry pundit spout conventional wisdom, we try to channel Conan. We find it helpful to ask, "What would Conan do?" whenever we see our profession fleeing from or toward an idea.

Among the beliefs most often repeated are:

- Advisors are reducing their fees.
- Young employees lack a work ethic.
- Robos/digital platforms will make it difficult for advisors to compete.
- The industry will benefit from a huge generational transfer of wealth.

There are many more, of course, but we examine these questions in light of the facts and the reality on the ground. No doubt, our opinions will stir the ire of some but that's exactly what Conan would do—cause people to challenge convention, then act with the wisdom they've gained from the analysis.

Advisors Are Reducing Their Fees

While there are a number of advisors who claim to be experiencing some fee compression, we have found that the top-performing advisory firms have actually increased their fees in each bracket of client. Much has been written about fee compression in the industry but we struggle to find signs of such a trend. In fact, in 2010, the yield on AUM (revenue divided by AUM) was 78 basis points, compared to 77 in a 2014 study and 75 in the 2015 study.[1]

It appears those firms most under pressure are the ones whose value proposition is tied to investment performance. There are also some wealth management firms who have had more difficult conversations in the past year with clients who are experiencing percentage returns of less than 5 percent.

Those who have raised their fees claim they have had very little attrition because they have been able to demonstrate value beyond the investing relationship and even beyond the basics of financial planning. They may be giving their clients unique access to private banking or alternative investments, or they are creating a community of clients in which others want to be part.

As we have learned from observing other industries that have been commoditized (for example, coffee, retail grocery, medicine, tax accounting), those who can command a premium are those who can deliver a premium experience and who are perceived to be offering more value.

Young Employees Lack a Work Ethic

It is a curious claim among industry elders that it is a challenge to find young people who work as hard as they do. Having interacted with thousands of advisors over our careers, we would agree that advisors born in the Baby Boom era tend to value motion over movement and equate time in the office with hard work. But the amount one perspires is not a measure of perseverance.

Gen X, Y, and now Z employees seem to eschew the illusion of industriousness created by their forerunners as they seek more balance in their life to pursue other interests and devote time to their important relationships. They consistently ask their bosses to evaluate them on output, not input. This is a

[1] *Investment News*, "The 2015 Investment News Compensation and Staffing Study," October 18, 2015. Available at: www.investmentnews.com/section/specialreport/20151018/COMPSTAFF.

very difficult mindset for founders of advisory firms whose blood, sweat, and tears created their practices and resulted in the advisory business as we know it today.

Over the past couple of years, we have observed a number of advisory firms transferring to the next generation with little fanfare and minimal disruption. Firms that seem to be growing the fastest according to surveys done by *Investment News*[2] and *FA Insight*[3] have been investing in better hiring, retention, and development programs to ensure business continuity and stronger growth.

Fortunately, many business leaders in this industry will acknowledge that the old way of managing through carrot and stick may not be as effective as creating opportunities for personal growth, recognizing that the desire for employees to have a life outside work, investing in their career development, and rewarding fairly does pay off. The challenge is that such a systematic approach requires more disciplined management, which frankly, is not the job that most advisors aspired to when they formed their own practices.

Robos Will Make It Difficult to Compete

Every decade presents new obstacles and new challenges for financial services. Mark started in this business in the 1970s just before the disappearance of fixed rate commissions. Since then, we've also seen a number of other disruptors.

Off the top of our heads, we think of the RIA custody model, the self-directed platforms, the emergence of ETFs and index mutual funds, rebalancing software, and account aggregation as examples of ideas that caused disruption to different segments of the business. At Pershing alone, which is the largest securities clearing firm in the United States and a division of the largest custodian in the world (BNY Mellon), we have seen advisory assets grow from 5 percent of our total in 2007 to more than 50 percent today.

Furthermore, we have seen regulatory reform influence how many conduct business in the United States as well as overseas. In the United Kingdom, for example, with the introduction of the retail distribution review (RDR), platforms may no longer obtain reimbursements from the fund companies for whom they provide access to advisors and their clients. This has forced a new economic relationship between all the parties, but has also created greater transparency in costs and deliverables. In Australia, the Future of Financial

[2] Ibid.

[3] FA Insight Study of Advisory Firms: People and Pay and Growth by Design Studies.

Advice (FOFA)[4] requires advisors to tell their clients what they can expect to pay in actual dollars for the services to be rendered in the coming year. Now that these financial professionals cannot hide the charges clients are charged, they have to do more to demonstrate value.

The point is that robo-advisors—or digital platforms—are just another step that automates what was a manual and labor-intensive experience. Using algorithms, their model portfolios may even be able to outperform the strategies that human advisors deploy. But this is not the only reason why individual clients choose to work with a financial professional.

The complexity of a person's life—especially the wealthier they are—requires judgment and insight. What clients want is an easier way to access these points of view along with a simpler way to conduct business. For most advisors, leveraging technology to deliver the best of robo combined with the best of humans will likely be the model for advisory firms. Of course, the pure technology plays will get their share of business just as the self-directed platforms at places like Schwab, TD Ameritrade, and Fidelity have. The challenge and the opportunity for advisors is not to concede that ground to those investing so much in competitive solutions, but rather partner with providers who can enhance the client experience while at the same time keeping the advisor at the core of the relationship.

The Profession Will Benefit from the Pending Transfer of Wealth

Depending on what you read, you will find there is upward of $40 trillion of wealth in the United States alone that is expected to go from the Baby Boomer generation to their children and grandchildren.[5] As a result, pundits are urging advisory firms to create a process for capturing this asset movement by positioning their firms properly in the minds of the inheritors and their benefactors.

While money in motion can be great for those prepared to be in the middle of it, the reality is that most of this wealth will be distributed in fractions to their beneficiaries. And not all of the beneficiaries will be the offspring of the rich folk. Much of this will go to charities and other causes the creators of wealth hold dear. Bill Gates (Microsoft) and Mark Zuckerberg (Facebook)

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[4] http://asic.gov.au/regulatory-resources/financial-services/future-of-financial-advice-reforms/fofa-background-and-implementation/.

[5] Accenture Consulting, "The 'Greater' Wealth Transfer: Capitalizing on the Intergenerational Shift in Wealth," 2015. Available at: https://www.accenture.com/us-en/insight-capitalizing-intergenerational-shift-wealth-capital-markets-summary.

are great leading examples of people who want to make an impact with their legacy. Their kids will also see a large inheritance upon the death of their parents, of course, but the point is that what is left over will be distributed in much smaller chunks.

Furthermore, the suggestion that advisors should be on a death watch waiting for their Baby Boomer clients to croak is insulting to younger prospective clients. The greatest amount of wealth creation will come from the efforts of Gen X, Y, and Z directly. We are seeing great examples of innovation and consequently wealth accumulation that has little to do with being born with a silver spoon.

So the opportunity for growth from inheritance is a very dark strategy when one considers the opportunity for growth from betting on the next generation of wealth accumulators. A balanced approach seems to be the best strategy.

While skepticism about conventional wisdom is healthy, your wariness will prove useless if you don't take a constructive approach to what you perceive as threats. Being a professional naysayer adds little value to business decisions.

Granted, there are many other examples of conventional wisdom that deserve challenge. They at least deserve to be questioned as we observe a profession that is going through one of its most profound changes in decades. Advisory firms of the future, however, will not be replicating each other's business strategies, but will be challenging convention, deciding based on facts, and finding cracks in the market that will result in big openings to do more business.

What Should You Consider?

That's why it is so critical to review what you know about the business and try to understand what the data and trends are telling you about its future, and your role in it.

There are several irrefutable facts that should be informing the strategies for leaders in financial services.

- The business is experiencing margin compression.
- Growth for mature firms is coming more from existing clients than new.
- There is an oversupply of clients and an undersupply of people to provide advice.
- The industry in general has a tarnished reputation among prospective employees and clients.

- Compliance and regulation is a growing component in a firm's financial statements.
- Industry consolidation is inevitable as age and economics drive owners of advisory firms to make difficult choices.

Margin Compression

At a time when the average advisory firm is growing and the average advisor is making more money than ever, it is not always obvious when an advisory firm is suffering profitability challenges. This is why we recommend that advisory firms maintain proper financial statements with key ratio reports that show trends in gross profit margin and operating profit margin.[6]

Profitability in advisory firms is affected by several forces. Earlier in this chapter we rebutted the notion of price compression for the best-performing firms, but the reality is that the average advisory firm has not been able to keep the prices aligned with their rising costs of doing business or adjusted for the added services an advisory firm may be delivering to clients. Furthermore, with most fee structures tied to asset values, it is difficult for many advisory firms to keep pace with inflation in a low-return environment.

In addition to pricing, five other variables that affect profitability the most are:

1. Poor service mix
2. Poor productivity
3. Poor client mix
4. Poor cost control
5. Low revenue (sales) volume

In our experience, most advisory firm leaders do not actively manage to profitability and as a result are unaware of the insidious nature of some of their decisions. For example, it is common to introduce new services or take on new clients because of a perceived opportunity, not because of a conscious strategy. As a result, substantial resources and attention get diverted to a new initiative that costs more than it generates.

The advisory firm of the future will need to be more disciplined about the investment decisions it makes in its own business, much like it creates a framework for making investment recommendations for clients based on risk, reward, diversification, and other drivers.

[6] Mark C. Tibergien, *Practice Made (More) Perfect: Transforming a Financial Advisory Practice into a Business* (Hoboken, NJ: Bloomberg Press, 2011).

Growth for Mature Firms

As advisory firms evolve through their life cycles, they take on the same characteristics as the humans who manage them. In the early years, it runs on energy, not on wisdom. In the teen years, the firm acts with an insouciance derived from the belief that nothing bad can happen. When it arrives at adulthood, the business acts with confidence and wisdom. In the later years, its energy begins to wane and the decisions that emanate from the business seem to be focused on conserving rather than growing.

For advisory firms that have not invested in the development of people, it reaches a limit in regard to the number of active client relationships that can be served effectively. Depending on what is being delivered and how the clients are being served, that limit is somewhere between 50 and 150 clients per advisor.

Once advisors reach capacity, they tend to slow their efforts to develop new business. In firms containing multiple professionals, all with responsibility for getting new clients, this is not a concern. However, in firms in which all the advisors have reached their peak, it's not uncommon to see revenue from new clients drop from 15 to 20 percent of the total to 5 to 10 percent.

Why is this a concern? Often in parallel with the aging of the advisor is the aging of the client. There comes a point that with limited renewal of the client base, most clients shift into withdrawal phase away from accumulation. The old rule of thumb was that investors could afford to withdraw 4 percent of their wealth in order to live their lives comfortably. Assuming this as your guide, and assuming your revenue is tied to assets under management, advisors would need to replace these assets each year just to stay even. But of course, this gives no consideration to death or termination of the client relationships, let alone the rising costs of doing business.

It is clearly important for advisors to define reasonable growth objectives in clients, assets, and revenues, and manage them all to a goal. Without a conscious target, it is possible to become complacent about the need to refresh one's center of influence, seek out referrals, and urge everyone in the firm to be aware of the need to grow each year.

An Oversupply of Clients, an Undersupply of Providers

Every industry would love the unique dynamics of the financial profession. Throughout the world, we have seen a marked increase in the number of millionaires. Simultaneous with this trend, we are seeing a decline in the number of advisors guiding these individuals whose lives have become more financially complex.

For example, in the United Kingdom since the implementation of Retail Distribution Review (RDR) in 2013, 10,000 independent financial advisors (IFA) have left the business. In the United States, since the market collapse of 2008, there are 40,000 fewer financial professionals in all channels.

Many of these clients are seeking do-it-yourself (DIY) solutions that they can obtain online, but there is still considerable demand for the wisdom and insight that come from working with a professionally trained advisor—especially when their decisions go beyond the investment realm.

The talent shortage is a risk for advisory firms that are seeking to grow because it is more difficult to find the right people to do the work they seek. It also means that compensation costs are rising in order to create the right inducements for people to join these organizations.

The talent shortage is also an opportunity for advisory firms that are able to position themselves as the employer of choice in their markets. They can establish a presence on college campuses where personal financial planning or related disciplines is a legitimate major. They can recruit from other firms by promising a career path, an opportunity to work with more challenging clients, and the appeal of greater financial rewards.

For advisors contemplating the future of their business in a sea of uncertainty, being positioned clearly among prospective employees and partners creates an opportunity unique in our business.

Tarnished Reputation

In a recent survey, most investors believe the financial services industry puts profits ahead of client interests.[7]

The reputation of financial services has diminished a lot over the decades. The financial crisis of 2008, the nefarious activities of players like Bernie Madoff and his compatriots, the mortgage crisis, the collapse of previously trusted financial institutions have all contributed to a negative image. Even those who have held themselves out as fiduciary advisors got caught in the mix, with several leading advisors being indicted and convicted for illegal behavior.

As much as Main Street advisors try to distance themselves from the stink of corruption, both the trade press and Main Street media highlight the misdeeds of people in the business constantly. Furthermore, members of Congress and regulators persistently cite the abuse of elders and the less informed as reasons to tighten the rules on bad behavior.

[7] http://blog.aaii.com/most-investors-believe-financial-services-industry-puts-profits-over-client-interests/.

Of course, it doesn't help that industry regulators have diluted the terminology, thus making it difficult for the average consumer to truly understand whom they are dealing with. For example, the term *advisor* was meant to be the province of those registered with the SEC but when broker/dealers purloined that nomenclature as a replacement for the term broker, no one objected. Yet broker/dealers operate under an exemption that says their registered reps can give advice as long as it is incidental to their business. Imagine holding yourself out as an advisor without having to register as one because it's not considered core to what you do.

Other terms that tend to confuse is fee-only versus fee-based. Or suitability versus fiduciary standard. If you are the average client without reason to understand the jargon of this business, it may come as a surprise to you when you are recommended or sold something that doesn't fit your goals, your risk profile, or your level of comprehension.

This is not to imply that one segment of the business is less trustworthy than another. It would be as if a chiropractor held himself out as an osteopathic doctor. Chiropractors and osteopaths are both medical professionals who treat patients with a focus on the musculoskeletal system. But the two disciplines require different levels of certification.

A chiropractor is a medical professional trained in chiropractic medicine, typically in a three to four year program. An osteopath, on the other hand, must be a licensed physician and is able to perform surgery and prescribe medicine.

The parallel to financial services is that clients do not know if they are being served by someone who gets paid based on the products they sell them, or paid for the advice they give regardless of which financial solution they use. Furthermore, when a bad act is committed, the press usually uses the word "advisor" in the headline, which reinforces the idea that the entire business is suspect.

In the end, advisors and brokers who are able to convey confidence and trust and who are transparent in how they conduct business will go a long way toward giving comfort to clients, prospects, and centers of influence. But the apprehension people have in dealing with financial services providers remains a headwind in the conduct of business.

Compliance Costs Are Rising

Regardless of which business model financial professionals operate under, the cost of compliance continues to rise. For independent firms, this cost can represent 2 to 4 percent of all expenses. For the most part, it is a variable cost, meaning that it goes up and down based on the volume of business one is doing.

Much of what has to be done in the advisory profession is prophylactic and not to remedy bad deeds, but the cost of surveillance and enforcing rules of behavior is meaningful. To be effective, it requires at least one individual whose sole job is to monitor activities and take remedial actions when something is amiss. It's like having a traffic cop on every corner.

Most advisors would say they are honest and ethical, so the cost of compliance seems especially burdensome. But the myriad rules in place to ensure both brokers and advisors are acting in the best interests of their clients require well-trained specialists to educate, inform, and direct partners and employees to stop, look, and listen before acting.

Consolidation Is Inevitable

All of these forces of change contribute to the need for advisory firms to become bigger. "Bigger" is a relative term, of course, since for the most part, advisory firms are small businesses, even micro businesses.

But complexity and costs require firms to be managed professionally. Adding layers of process and management to a business means that revenues also have to increase to cover those costs. The need to generate more requires the addition of people and thus begins a never-ending cycle of growth.

Many firms have grown naturally by adding layers as needed, but others have found benefit in merging[8] with like-minded firms to more efficiently consolidate certain costs, gain operating leverage, and establish a bigger market presence more quickly.

Firms like Hightower moved quickly to create a semi-national Registered Investment Advisory firm focused on recruiting people out of wirehouse brokerage firms. Focus Financial was an early roll-up firm that has acquired numerous large advisory practices around the country though it has not tried to merge them into a singular brand or common client experience. Middlewear providers such as Dynasty serve as a bridge between advisors and their providers, providing outsourced solutions to those not yet big enough or disciplined enough to create their own management infrastructure for this purpose. Numerous advisory firms throughout the United States and in other countries have merged, as the founders of one looks to retire but seeks to provide continuity to their employees and clients.

[8] www.fa-mag.com/news/mergers-and-acquisitions-continue-on-pace-21238.html.

While we do not predict the end of the solo-practitioner, it is clear that there will be a divergence in size and presence in different markets. It is not unfathomable to see some truly national advisory firms much like we see in the accounting profession with its Big 4 CPA firms. More likely, we will see the emergence of super regional advisory firms—what the accounting profession labels as "Group B" firms.

These super regional advisory firms will be managed professionally with a branch manager system not unlike the brokerage industry. While there will be some that are scattered across the frontier, more likely the best-performing super regional firms will have a geographic concentration that provides for tighter management, tighter branding, and operational leverage.

We expect there will also be smaller, local advisory firms that find value in banding together with other advisors to create some economies of scale and continuity of practice. Many of these will be formed by second- and third-generation advisors who do not have the same fear of working with others that many of the industry pioneers seemed to have.

What the Assumptions Mean for You

One thing is clear in any business: What got you here will not get you there. In our mind, this means that the assumptions about the advisory business over the past 100 years have changed dramatically.

Think of what has transpired since the 1970s alone.

In 1975, fixed commissions, which were the standard of practice for brokerage firms for decades, were eliminated. Discount brokers such as Schwab, Scottrade, and TD Ameritrade (Waterhouse) emerged as major players in the delivery of financial products. Many well-known brokerage firms subsequently went out of business.

This was one of the catalysts for the creation of the independent broker/dealer movement, in which registered reps were switched from being employees to becoming independent contractors. Their average payout went from 35 percent to 82 percent, which changed the economics of many broker/dealers.

Late in that decade and into the 1980s, the retail-oriented Registered Investment Advisor (RIA) emerged along with new support models, which we have come to know as "custodians." These custodians, like Schwab, TD Ameritrade, Fidelity, and Pershing Advisor Solutions, replaced institutional brokers and providers by wrapping in technology, practice management support, and service teams as well as best execution capabilities. Today, the RIA segment represents almost $4 trillion[9] in total assets, or roughly 20 percent of the U.S. retail market.

In the 1990s, no-load mutual fund platforms emerged, in which advisors could get access to packaged products for no commission payments. This reduced the cost of access. So, too, did the emergence of index funds provided by the likes of Vanguard and Dimensional Fund Advisors.

In the early part of this century, ETFs emerged as a threat to the mutual fund model because of its liquidity and low-cost appeal. Once again, traditional providers were undermined and the custodians saw their margins compressed as the revenue went from 12(b)1 fees provided by the mutual fund companies to their fund supermarkets to transactional revenue.

The point of this short history is that change has proven to be the one constant in financial services.

It is clear that client attitudes, technology, staffing requirements, business economics, and regulation are once again challenging leaders in this business to conceive of business models that will be competitive, profitable, and sustainable for the long term.

How the landscape has changed will inform the strategies of every firm, but not every firm will deploy the same strategy. At least they shouldn't. The ideas presented throughout this book will help you clarify and deploy your strategy. We will stress the importance of tried and true business management principles—have a vision, know and serve your client well (the ones today and tomorrow), and inspire leadership at every level.

We have tried to narrow broad best practices and view their implications on the business of financial advice. We seek to provide actionable ideas to prepare the leaders of financial advisory businesses and advisors for the future, ensuring that they are clear on their optimal client, new ways to differentiate from their competitors, and their definition of success.

[9] The Cerulli Report: "Advisor Metrics 2015. Anticipating the Advisor Landscape in 2020."