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SENIOR CONSULTANT
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The Financial Services Food Chain

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Remember the chart in school where little fish were consumed by big fish that were consumed by bigger fish? Well, that illustrated the laws of natural selection. The principle was that individuals possessing characteristics advantageous for survival in a specific environment constitute an increasing proportion of that species with each successive generation. Although we do not think of ourselves as being part of the financial services food chain, in the highly competitive financial services industry, there is also a "survival of the fittest" analogy when it comes to providing service.

> **THE PRINCIPLE ILLUSTRATES THAT INDIVIDUALS POSSESSING CHARACTERISTICS ADVANTAGEOUS FOR SURVIVAL IN A SPECIFIC ENVIRONMENT CONSTITUTE AN INCREASING PROPORTION OF THAT SPECIES WITH EACH SUCCESSIVE GENERATION**

There are at least four successive levels of service which provide increasing levels of added value to the client. Each successive level of service is vulnerable to the next, constituting a form of natural selection. Knowing where you and your clients are on the financial services food chain will help you to not only identify what is required to win a client's business but to be aware of your vulnerabilities with your existing client base. The four levels of service are: trade execution, professional money management, passive investment management consulting and active investment management consulting.

Not withstanding its virtues, the transaction business should not be confused with professional money management. The things that make an investment highly salable do not necessarily make it a good investment. Because there is no buy-or-sell discipline as transactions are unrelated, there is no performance accountability. Simply, clients do not buy what you want them to, when you want them to, or in the amounts you want them to. So how can you expect to be held accountable for the ultimate outcome? This is the vulnerability of the transactions business and the benefits of professional money management.

Professional money managers would argue that there is no added value in disjointed, unrelated transactions with no point of reference to a portfolio or accountability as to performance or risk exposure. Essentially, the value added is the application of the transaction to the portfolio, not the transaction itself. The professional money manager thinks in the context of the portfolio as a whole.

With a definitive management style, money managers can be held accountable for performance, and risk can be managed based on the appropriateness of the manager's style to the investor. Yet, the vulnerabilities of professional money management come in the form of suitability and accountability. Clearly, all investors are not equally well suited to a "one size fits all" management style. Further, given professional money managers will not fire themselves, there is the question of whose interests they serve.

By the investment management consultant conducting the client interview that intricately defines the client in terms of risk, return, tax efficiency, liquidity, cost structure and investment time horizon, and by defining investment options in the same terms, you gain a mechanism to construct custom portfolios which will address the values most important to the client. This passive investment management consulting technology is based on the historic performance of asset classes and offers a much higher degree of objectivity, accountability and investment suitability, something not possible in professional money management.

In investment management consulting, the focus shifts from money management to the investment process and the values that are most important to the client. As a result, the money manager becomes incidental to the investment process, and then only if they acquit themselves well relative to objective selection criteria. Interestingly, taxable clients place the highest value on their consultant's ability to establish the appropriate trade-offs between tax efficiency and liquidity in determining the extent to which the portfolio should be fully taxable, tax deferred or estate tax-free.

Notwithstanding the value added by the consultant using passive investment management consulting technology, the question then becomes one of not just managing risk, return, tax efficiency, liquidity and cost structure in achieving the client's objectives, but how good are you in doing so. Active investment management consulting technology recognizes when current market conditions contradict historic precedence (fixed income rivals or outperforms equities because of declining interest rates or poor equity markets), the portfolio should be restructured to reflect the market timing as hourly, daily, weekly, monthly and even quarterly trends are not long term enough to be meaningful. An awareness of the major long-term forces at work in the marketplace does have a profound impact on how one manages a portfolio. That is what factor analysis and arbitrage pricing theory is all about. Brinson suggests that 90% of the value added is achieved through active, not passive, asset allocation.

Although major brokerage firms and consulting firms work with investment technology as distribution and software management companies, respectively, they typically do not create it. Active portfolio construction technology comes from the money management side of the business. Firms such as SEI, Frank Russell, Advisory Consulting Group and Lockwood Financial Services use a more active approach to portfolio construction with very attractive results in both risk and return relative to the index. Because of the nature of active portfolio construction technology, even institutional consulting firms are vulnerable to a consultant armed with such capability.

So where does the consultant fit into the financial services food chain? They could not be better positioned.

If the consultant wants to win transactions business, they raise the accountability question. If the consultant is competing with professional money managers, they raise the suitability and objectivity issues. If consultants are competing with each other, whoever has the best active portfolio construction technology wins. If the consultant competes against the institutional consultant, which is rare, they raise the tax efficiency question, personalized service and active portfolio construction technology issues, which are the institutional consultants' weaknesses. Eventually, the consultant whose firm has the best active portfolio construction technology wins, and the laws of natural selection will ensue. ■

Notes

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