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The Independent Fee-Based Financial Advisory Industry: What Is It, Where Is It Going, And Why You Might Want To Go Along

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While many of you have been toiling away at one of the wirehouses and slowly moving your practice to one of consulting, the independent fee-based financial advisor industry has grown at a spectacular rate to over 15,000 advisors managing in excess of $1.3 trillion. Consumers love this new independent fee-based model, choosing financial planners and independent fee-based advisors as the most reliable sources of financial advise and rating their own advisors an 8.7 on a 10-point scale.

All indications suggest this is just the beginning. A recent piece of consumer research showed that they do understand the difference between fee-based advisors and traditional stockbrokers. They said, "My image of a broker is that he calls me up a few minutes after being in his manager's office, have been told what he must push today. Brokers don't look out for your best interests. Brokers aren't financial advisors, they just execute orders." We didn't make up those quotes; consumers said them.

> ... THE INDEPENDENT FEE-BASED FINANCIAL ADVISOR INDUSTRY HAS GROWN AT A SPECTACULAR RATE TO OVER 15,000 ADVISORS MANAGING IN EXCESS OF $1.3 TRILLION

In the paragraphs that follow, we will present you with a view from the outside, from the perspective of an observer of the independent fee-based financial advisor industry. We will deal with the following issues:

- What has created this huge new opportunity to manage private client money for a fee?
- Why have so many independent financial advisors been so successful over the past ten years?
- Why is it that you may have a different impression of their success and sophistication?
- What are the issues of concern to today's independent fee-based advisors?

We are not simply presenting our opinions, but rather we base our thoughts on the best practices of your brethren, successful independent fee-based financial advisors (5,000 of whom custody their client's assets at our former employer, Charles Schwab & Company).

Basis Of Discussion

Most of you primarily serve the U.S. private client market. Do you know the total of the investable assets of today's U.S. households? Would you believe it's upwards of $12 trillion? Yes, that's trillions. As a result, the private client market is by far the largest pool of assets in the U.S., far outdistancing the retirement plan and endowment/foundation markets.

Where are all of these assets? Most of them are at the full-commission brokers and in the banks. Seventy-six percent of consumers' $12 trillion of investable assets are in these two places. Furthermore, banks and full-commission brokers account for 60 of the 100 largest financial institutions. We don't know about you, but we think that is good news on the competitive front. Do you feel confident in going head-to-head with your old brethren stockbrokers and some CD-oriented bankers to win over private clients? (See Figure 1.) Those fee-based advisors who are going head-to-head are winning. The independent fee-base financial advisor channel far outgrew other channels from 1994-1996 (especially the other full-service channels). Over the three-year period, independent financial advisors (IFAs) grew 36% while the other "full-service" channels grew 12%, 8% and 5% respectively. (See Figure 2.)

We have never been more excited about the private client market, and it is the fuel for this change. The Baby Boom generation knows that they need to save for retirement, and it's these assets that should push the savings rate up and continue to drive the financial advisor industry further. We also expect there to be a major liquefaction of wealth. What's that? Well, it may be your ticket to a larger practice. Substantial new wealth has been "created" but not "realized," and it is these dollars that account for greater than 50% of all inflows to fee-based advisors. We are talking about

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401k rollovers, exercised stock option plans, the sale of small businesses, etc. There is also this huge inheritance coming; I know you've read about it - the $11 trillion. In a recent study of clients of financial advisors, we found that more than half brought "new money" to their relationship with the advisor, so it is important to track this money in motion.

The New Breed Of Discount Brokers

Since the mid-1970s, two investment models have dominated the financial services landscape: (1) full-service at Merrill Lynch and the other wirehouses and regional brokers, and (2) self-service at Charles Schwab and a few other discount brokers. You may or may not be surprised to learn that the full-service guys still maintain the lead where it counts. Full-commission brokers dominate the larger accounts; they are named as primary investment providers by greater than 50% of all investors with more than $500,000, and almost 80% of millionaires claim to have a full-service broker.

Now don't think we are dismissing the self-serve movement; we are not. But don't misread it either. Most investor still need advice. In a recent piece of research that we did, consumers revealed that they were "confused, scared, frustrated, clueless, helpless," and even "tired" when it comes to investing. As a result, most discount brokers are no longer content to be just "order takers," rather they are beefing up their offers to capture the "validator" segment (see article on Charles Schwab, *Business Week,* May 25, 1998). Schwab, for instance, is offering multiple channels, tools and information to novice investors. These investors used to be the domain of the full-service channel, but the discounters are moving quickly to grab this segment with:

- Low (or no) commissions,
- On-line trading supported by multiple channels,
- Open architecture and wide product breadth like that found in mutual fund supermarkets, and
- A variety of tools and information.

So how will you distinguish yourself from these new discount brokers? We suggest that you focus your efforts on the 74% of investors who still rely on a financial pro -most of whom are being served by stockbrokers and bankers today – and offer them exceptional fee-based financial advice.

The Full-Service Solution: Fee Based Advice

The real interesting question is whether the fee-based model will prevail over the traditional commission-based model. We believe in the future of fees and point to two trends - the emergence of the independent fee-bases financial advisor channel and the competitive response of the brokerage firms and banks.

There are now 15,051 independent fee-based financial advisors. Most have less than $50 million in assets (75%), but a solid share have $50-$200 million (19%), and a few even have $200 million-$1 billion (5%) or even more than $1 billion (1%). So while the average independent fee-based financial advisor has $66 million, and the median is $26 million (not terribly different than brokers or consultants), 2,813 have $50-$200 million, 812 have $200 million-$1 billion, and 175 have above $1 billion. (See Figure 3.) So why might this be a surprise to you? Well, we spoke at the IAFP's Advance Planning Conference last week (a very diverse group of folks and not those I've seen for years at Schwab conferences), and something became clear. We can't group all Registered Investment Advisors (RIAs) together and make any meaningful comments other than "yes, they are all RIAs" (and that's not even true!). Let me do us all the service of defining three separate segments of RIAs.

- Financial Planners lead with the planning process; often sell insurance products and commissioned mutual funds; focus on a variety of financial needs, and may or may not consider investment management to be a crucial part of their business; often belong to the IAFP or ICFP.
- Financial Advisors deliver limited amounts of financial planning; often start with retirement planning and asset allocation; typically pick third party managers for their clients using either mutual funds or separate accounts; probably the most like "consultants;" often belong to NAPFA, IIMC or IMCA.
- Investment Managers deliver limited amounts of financial planning (like financial advisors); often start with retirement planning and asset allocation (like financial advisors); typically pick individual securities for their clients; may also manage style-specific portfolios for pension plans an/or mutual funds; often belong to the AIMR.

Figure 1. Consumer Investable Assets $11.6 Trillion in 1996

Full Commission Brokers	$4,300	37%
Retail Banks	3,406	29%
Mutual Fund Companies	1,132	10%
Independent Fee-Based Advisors	1,000	9%
Bank Trust Departments	851	%7
Insurance Companies	485	4%
Discount Brokers	468	4%
	$ 11,600	100%

Source: IMS Analysis

Figure 2. Distribution Channel Growth 1994-1996

Independent Fee-Based Financial Advisors	36%
Discount Brokers	35%
Mutual Fund Companies	31%
Full-Commission Brokers	12%
Banks (Retail and Trust Departments)	8%
Insurance Companies	5%

Source: IMS Analysis

Figure 3. Mid-Tier and Large FAs Dominate Assets

	Number	$Billions
Micro-Managers with $0-$50 Million	11,251	108
Small Managers with $50-$200 million AUM	2,813	169
Mid-Tier Managers with $200 Million-$1 Billion AUM	812	233
Large Managerw with $1 Billion + AUM	175	490
	15,051	1,099

Source: IA Info; IMS Analysis

There are successful firms in all three categories such as Evensky, Brown & Katz (Coral Gables, FL) at $300 million, whom I'd define as a "financial planner;" Brouwer & Janachowski (Tiburon, CA) at $500 million, who, I'd define as a "financial advisor;" and

[Graphic omitted]

Condor Capital (Morristown, NJ) at $250 million, who, I'd define as an "investment manager."

So why have many brokerage firms, brokers and consultants been looking down their noses at this broad market of RIAs? I'd argue that it is because they are only seeing the "financial planners" and are measuring them in terms (assets under management) that are not relevant for their planning-oriented businesses.

Let me give this further definition. Almost all of the "financial planners," many of the smaller "financial advisors" and many of the "investment managers" custody at Schwab and the other discounters. The rest of the "investment managers" custody at the bank trust departments. So, do you see now why this market must be looked at in total before judgment is passed?

Also, only about 30% of all financial advisors used to be brokers (although they have 36% of the assets); smaller percentages were accountants, bankers, researchers and lawyers. Given the above distinction that we've drawn, you are probably not surprised to learn that some financial advisors consider themselves to be financial planners, while others prefer the titles "investment consultants, financial advisors, investment advisors, investment managers," or even "money managers." You also specifically see that more of the "money managers" (as the term was in this study) or "investment managers" (as we have named them here) are former stockbrokers. (See Figure 4.)

To complicate the fee-based advisory industry even further, a group of firms called Turnkey Asset Management Providers (TAMPs) has emerged. TAMPs are a little like the independent advisors' version of wrap accounts. Unlike in the wirehouse world though, mutual fund TAMPs (e.g., RWB, ADAM and SEI) came first, and more recently separate account TAMPs (e.g., Lockwood, Callan IMC and CapTrust) have emerged. No wonder this industry is so confusing. Maybe, the most amazing thing about this "fee revolution" though is that the brokerage firms and banks are copying the independent advisors. Mutual fund wrap accounts are booming. Everyone is suggesting that they will soon account for hundreds of billions of consumer dollars. Smith Barney has TRAK; Merrill Lynch has Consults, Mutual Fund Advisor and now even Financial Advantage for the non-discretionary customer who just wants to pay fees. Prudential claims to have the best mutual fund wrap account. LPL is aggressively marketing its SAM Account, and Bank of America just went cold turkey with their sales force being converted exclusively to fee-based products under the title Fund Strategies.

There is one major distinction between "financial advisors" as we defined them above and "consultants" as independent, fee-based advisors who have the ability to build equity in their practices. We tell "financial advisors" that no matter what you call yourself and no matter what your business model is, you should be seeking to add value for your clients first, and to build value for yourself second. There are three distinct levels of strategic planning that are necessary for financial advisors:

- How do I grow? Marketing and growth strategies.
- How am I doing?" Benchmarking.
- How can I realize the value I've built? Valuation and exit strategies.

Marketing And Growth Strategies

So you want to get started, or grow from $50 to $250 million, or from $250 million to $1 billion? Let's start with your target market.

Averages

Do you know that the average U.S. household has almost $120,000 of investable assets? Surprised? We were too. So we dug a little deeper into this often-reported statistic. Here's the facts. The "average" U.S. household may have $120,000 of investable assets, but that is the average being pulled way up by the wealth of a few folds named Gates and Buffett. The "median" (or the middle household) in the U.S. only has just $12,000 of investable assets. Do you understand why you need to target a market now?

So What Segments Should You Tackle?

Well that depends. Based upon the facts above, you won't be surprised to learn that the mass market makes up 97% of all households, but only has 48% of all investable assets. The sweet spot, in our opinion, is the affluent market; its three million households with between $500,000 and $5 million of investable assets account for 42% of all investable assets. Of course, if you think you have an "in" to the super affluent segment, go prospect there. They account for just 0.1% of households (about 100,000) and have north of $5 million in investable assets. But most of us will be better off leaving that dog fight to U.S. Trust, Northern Trust, JP Morgan and a few others, and targeting the households receiving $500,000 rollovers, or $1 million inheritances. (See Figure 5 on next page.)

A complete marketing plan is the first step to reaching your goals. Be sure to include your goals. Be sure to include your strategies on the following points:

- Unique target markets/segments marketing
- Advertising and web sites
- Client referral solicitation
- Centers of influence
- Media relations

Growth strategies are all about leap-frogging to the next level. As you get going, you

Figure 4.
Previous Occupants
Independent Fee-Based FAs

	All	Financial Planners	Money Managers
Law	2%	3%	2%
Research/Analysis	6%	3%	8%
Insurance	7%	12%	4%
Banking/ Trust	13%	7%	16%
CPA/ Accounting	15%	27%	8%
Brokerage	27%	18%	32%
Other	30%	31%	29%
	100%	100%	100%

Source: 10/97 Schwab Advisor Practices '97; IMS Analysis

[Graphic omitted]

Figure 5
Concentration of Consumer Investable Assets:
94.5 Million U.S. Households with $11.6 Trillion in Investable Assets

- Mass market: 97% of households, 48% of assets
  - Investable assets of less than $500,000
  - 91 million households
  - $61,000 per household
  - $33.6 trillion in total assets
  - "Goes to mass advertising"
- Affluent Market: 2.9% of households, 42% of assets
  - Investable assets between $500,000 and $5 million
  - 3 million households
  - $1.6 million per household
  - $4.9 trillion in assets
  - "The Sweet Spot"
- Super Affluent: 0.1% of households, 10% of assets
  - Investable assets of more than $5 million
  - $11.6 million per household
  - $1.2 trillion total
  - "Excellent but mostly locked up"

Source: IMS Analysis

may conclude that it would be easier to jump in $50-$100 million increments than to build your advisory practice one investor at a time. Here's some "growth strategies" to consider:

- Taking on a new partner
- Acquiring another firm
- Establishing a mutual fund

As your practice matures, you'll also want to benchmark your operations versus those of your peers.

Benchmarking

Many financial advisors have grown their practices to a significant size and want to compare their operations to the best practices in the industry. Give the cottage nature of the financial advisor industry, it is difficult to know how you are doing. The following industry data may help address that.

Financial advisor clients are fairly wealthy with average incomes of $92,000 and investable assets of $334,000. Fifty-eight percent are male, and the average age is 58 years old. "New money" accounts for greater than 50% of all new accounts, and the most common source is rollovers and inheritances. "Old money" most often is transferred from a full-commission broker.

Not surprisingly, financial advisors get most of their clients from referrals, but when we ask the clients, we found out that they did shop (61%), did consider a commission-based solution (66%), and that it was "trustworthiness" (94%), not the referral alone or investment performance, that cause them to chose their advisor.

Financial advisors have a large share of wallet (71%), but most of their clients keep some money at banks, at full-commission brokers ("to get IPOs") or at discount brokers ("my gambling money").

Most financial advisors talk with their clients monthly (34%) or quarterly (37%). Twenty-one percent (21%) speak with their clients more often than monthly (a sure profit killer), and a few (10%) have clients demanding less than quarterly attention. Surprisingly, many increase their level of contact over time.

Financial advisor clients are satisfied, rating their fee-based advisor over the coming 12 months. Satisfaction is driven by performance, although they are unable to articulate how they measure such performance.

So that's it for an introduction to benchmarking; you can imagine that we could go on all day with these data points. Your ultimate goal though (beyond delivering superior investment advice to your clients) should be to build value in your business. There is a growing market for financial advisor practices, and you should know what yours is worth.

Valuation And Exit Strategies

Rising multiples, the high value of financial advisory firms relative to their owners' total wealth, and a more active acquisition market are making many of today's independent advisors think about selling out. To create transferable value, financial advisors have built their practices around an investment process and integrated client service professionals into their business. Many valuation drivers exists:

- Client base (e.g., average size, average tenure)
- Financial issues (e.g., revenue/asset ratio)
- Business structure issues (e.g., institutionalization of processes)
- Deal structure (e.g., employment contracts and non-compete clauses)

Nineteen deals took place in 1996, and seventeen more were completed in the first six months of 1997. These advisors have sold for 0.9% of assets, 2.3x revenues and 8.1x pre-tax earnings. There is a growing list of acquirers interested in fee-based financial advisors. They fall into three buckets:

- Financial buyers (e.g., firms like United Asset Management and Value Asset Management)
- Financial institutions (e.g., banks like Mellon and National City)
- Financial advisors (e.g., advisors like Assante/RWB and Graver, Bokfoff, Goodwing & Sullivan)

Conclusion

So in conclusion, we believe that:

- The retirement revolution will be good for all full-service financial professionals.
- Consumers are voting for the fee-based model, and it is likely to grow as a percentage of all full-service models.
- Brokerage firms, brokers and consultants should study the successful models, whether they be "financial planners, financial advisors" or "investment managers."
- Independent fee-based financial advisors should focus on marketing, benchmarking and valuation strategies, with an end goal of creating transferable value.

Needless to say, we believe that is a great time to be an independent fee-based financial advisor! ■

About the Author

Chip Roame has a unique perspective on the independent fee-based financial advisor market. As a former Vice President at Charles Schwab in charge of developing strategies for the financial advisor and financial institutions, Chip was instrumental in the development and growth of the mutual fund supermarket and its zero trading cost environment which has redefined the independent advisor market and has influence the trend toward investment management consulting on Wall Street. Chip recently left Schwab to open a management consulting firm, Investment Management Strategies. To contact,call Chip at Investment Management Strategies, 415-435-5109.