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SENIOR CONSULTANT

The Voice of the Investment Management Consultant

J.C. Bradford Merges With PaineWebber And Cites Internet Brokerage Changing Economics Of The Business

J.C. Bradford, the largest independently owned brokerage firm in the southeast and one of the industry's few remaining partnerships, has been acquired by PaineWebber. PaineWebber will pay $620 million to acquire the Nashville, Tennessee-based securities firm with offices in 14 states. PaineWebber doubles its presence in the southeast with a new cadre of 800 highly accomplished J.C. Bradford brokers who are much like their own, primarily catering to the affluent client market with investable assets of $500,000 or more. In this era of $100 billion global mergers and acquisitions, the J.C. Bradford acquisition is not of sufficient weight to have global impact, but its significance is tremendously important in illustrating the direction of the U.S. brokerage industry and the underlying motivations and challenges facing the venerable old regional firms. The strength of the major quality regional firms is in their collegial, almost family, atmosphere. They have a strong identity of interest with their clients and their communities, provide highly personalized support and have engendered a wonderfully warm rapport with their brokers. The forces at work which lead to the sale of J.C. Bradford, a first quality regional brokerage firm with an important southeastern franchise are instructive as to how the industry is evolving.

THE SIGNIFICANCE OF THE J.C. BRADFORD ACQUISITION IS TREMENDOUSLY IMPORTANT IN ILLUSTRATING THE DIRECTION OF THE U.S. BROKERAGE INDUSTRY

As a broker one would be hard pressed to find a better environment than J.C. Bradford in which to work. Yet, with the advent of internet brokerage which has forever re-priced trade execution, J.C. Bradford faced the prospect of the average price of a trade dropping from $80 in 1998 to $28 in 2003 to less than $15 by 2005. The implications of internet brokerage are profound. It is not just that over the next five years, brokers will have to work five times as hard to maintain their present earnings, but the entire culture, structure and technology of the old commission brokerage industry must change.

Last May when Jeff Powell assumed the reins as chief executive officer from Jimmy Bradford, son of the firm's founder and namesake, there was not even a remote thought of merging or selling the firm.

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SSB Loses Cusack To Schwab As It Gears Up Its Separate Account Management Business

Jeff Cusack, one of the most experienced senior persons in Solomon Smith Barney's storied Consulting Services Group, has been lured away by Schwab Institutional to become general manager of Separately Managed Accounts. Cusack will be working with John Coughlin, Gerald Graves, Phil Nicolaou and others who are shaping the technology, products and services that Schwab Institutional will be providing their broker/dealer, money manager and independent financial advisor clients. This small group of senior level managers at Schwab has arguably changed the course of the financial services industry and affords one of the most dynamic environments within the financial services industry in which to work. They are not limited by conventional thinking and have the resources and intellectual property to challenge the rationale of the financial services business.

Schwab was the catalyst for the wide acceptance of internet brokerage and today's rapidly declining commission brokerage cost. It was Schwab that created the first mutual fund supermarket and the first zero-trading cost environment that was conducive to charging a fee for high level advice. It was Schwab that understood that financial products didn't add value; it is process or what you do with financial products that adds value. With Schwab's

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INSIDE

Sixty-nine percent of the public sees through the Justice Department's allegations and supports Microsoft. The most disturbing question of all is how did this get so far? The answer is that Microsoft will never again ignore the expensive but necessary Washington, D.C. lobbying machine which welds massive power and could have effectively nip this in the bud.

Microsoft's integration of many applications in its operating system greatly simplified the use of personal computers and aggressively drove down the cost of technology. In effect, by Microsoft controlling 90% of personal computer operating systems, it created a standard for operating systems that was crucial in creating a mass market for technology. This was the catalyst for our new economy growing at a record pace. Microsoft is the goose that laid the golden egg and has every reason to believe Judge Jackson's decision will be reversed. Whether it is the public, the Appellate court or the Supreme Court, there is great comfort that the facts, the law and the reason are on Microsoft's side. The question is why is this action being taken and what does it tell us about the Justice Department? Does this action build your trust, faith and confidence in the federal government or erode it? Does it say that too much power has been vested in individual judges? Does it mean that every free enterprise is subject to the prospect of federal regulation by any means necessary, whether warranted or not? Does it mean that our economy and free enterprise system is slowly losing its free market status as the U.S. regresses toward the federalized malaise of England and Europe? These are disturbing questions that lends one to the conclusion that as a matter of public policy, the anti-trust laws of old may not be well-suited to today's new economy, depending on whether power or the public's well-being is the respective consideration. If the public good is to be served and if America is to remain preeminent in technology, then free markets should be protected at all cost. ■

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Their entire focus was how to move the company forward. As national sales manager, Powell had nearly doubled the size of the firm in five years by successfully recruiting against the major firms and had every reason to believe the sky was the limit. They had outlined a plan to remain independent and eventually take the partnership public in an initial public offering. One month after Powell assumed the reins at J.C. Bradford, Merrill Lynch & Company announced plans to plunge into the world of on-line trading, offering trades at $29.95. Not only did J.C. Bradford not offer on-line trading but in a matter of days, the dynamics and economics of the business had changed radically. Powell advised Mr. Bradford that if the firm matched Merrill's move it would cut its profits and value by a third. This bad news came on the heels of a hot IPO market, attracting Wall Street's powerhouse investment banking firms to fledgling technology firms in the southeast. Bradford knew those firms and had relationships with their principals, but their banking and technology focus was on the old economy and the more reliable industrial companies it knew so well. As underwriting demand for old industrial companies faltered, the number of Bradford's stock-and-bond offerings dropped from its high of 55 in 1996 to 16 last year. The combined impact of declining commission rates and dwindling investment banking revenues painted a much different picture than the firm was used to seeing. Earnings last year were $41 million on record revenues of $600 million, which compares with profit of $65 million on $475 million in revenue in 1996. Jeff Powell and Jimmy Bradford immediately recognized there was the potential for a significant and on-going earnings squeeze while concurrently the firm needed to make a sizeable investment in technology and increase its capital base to be more competitive in investment banking and corporate underwriting.

Bradford and Powell initially thought that rather than remaining independent and eventually going public as planned, they would instead focus on finding a strategic partner. A firm like Lehman Brothers or Hambrecht & Quist that had a strong capital base, strong banking and syndicate operations but no retail brokerage franchise would be a perfect fit. But just as they began to consider their choices, Chase Manhattan acquired Hambrecht & Quist, and Jimmy Bradford concluded the best option was to sell Bradford outright. He reasoned he could not afford to waste any time pursuing prospective strategic partners as the longer he waited, the less valuable the Bradford franchise would become. With the decision having been made to sell, it was up to Jeff Powell to pick the firm's new partner.

Powell and Jim Graves, his chief operating officer (a former investment banker) and No. 2 in command, whittled a list of 84 potential partners down to 20. Each visited ten and in the ensuing weeks, they huddled constantly, debating the merits of various companies. By mid-January, two-page letters were sent to five interested bidders (a bank, three securities firms and an "out of the box" firm that would not take "no" for an answer) for a formal proposal. In a few weeks, this list of five was whittled to two, PaineWebber and Morgan Stanley Dean Witter. PaineWebber won because it was a better cultural fit. PaineWebber is primarily a brokerage franchise without a massive investment banking business and had spent millions in building its on-line trading platform called "Edge." It has a strong fee-based consulting business and a PMer business which would give J.C. Bradford access to processes which would minimize the impact of declining commission brokerage rates for trade execution. PaineWebber was the right choice for the time and had expressed interest in J.C. Bradford months before Bradford had any interest in selling.

The insight we can glean from J.C. Bradford's experience tells us much about how the industry will unfold. First, the retail and institutional brokerage operations of all firms will be similarly affected by the declining prices for trade execution, so the squeeze in commission brokerage experienced by Bradford will be universal. Within the next 10 years we will have seen the average brokerage trade go from $80 to less than $10. This means that brokers have to work 10 times as hard to generate the same

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revenue or they will have wisely transitioned their business from commission-based trade execution to fee-based advisory services. The brokers evolution from recommending a series of disjointed, unrelated transactions where it is not possible to add value to fee-based investment management consulting where the consultant competes on the basis of the tangible, quantifiable investment values they address and manage, requires a much higher level of technology than most old-line, quality regional firms have or envision. Thus, the challenge that the major regional brokerage firms have is not just eroding business economics but gaining access to technology that will allow the broker to make the transition toward advice. Commission revenues are going to drop 60% or more per trade in the next five years, profit margins are going to disappear, and expenses, even when held constant, are going to seem to explode relative to revenue. Yet the hidden challenge is that even the major brokerage firms do not have in place the technology that will allow the most fundamental investment values, like risk, return, tax-efficiency, liquidity, cost structure and progress relative to goals and objectives, to be addressed and managed in terms specifically meaningful to each client. The commission brokerage industry doesn't yet understand that it is not presently adding value and that significant cultural, structural and technological changes are required in order for their brokers to be able to engage their professional investment and administrative counsel for an on-going fee. In order for this level of change to occur, the commission brokerage industry is going to have to have a epiphany that the new advice business model is significantly different than commission brokerage and that significant fundamental changes are in order.

> **BRADFORD SAW A TOTALLY DIFFERENT BUSINESS EMERGING THAT REQUIRED OPERATING EFFICIENCIES, TECHNOLOGY AND AN OPERATING PLATFORM TOTALLY FOCUSED ON ADDING VALUE THAT WAS MATERIALLY DIFFERENT FROM HIS PRODUCT DISTRIBUTION PLATFORM**

J.C. Bradford represents an important wake-up call for the industry and is the first of a series of epiphanies that the financial services must have if the industry is to remain vibrant and responsive to the needs of the investor and the financial consultant. The first epiphany is that the economics of commission brokerage is radically changing for both the financial consultant and their firms. Quality brokerage franchises like J.C. Bradford, a venerable old name in the southeast, the pride of its controlling family, a firm anyone would be proud to be associated with, a rare collegial partnership that doubled in size in the last five years, are typically not for sale at any price. But as the son of the firm's founder and namesake, the controlling shareholder and managing partner of J.C. Bradford, Jimmy Bradford has far better vision than a dispassionate manager with less at stake. What Jimmy Bradford saw was not simply a change in retail pricing, Bradford saw a totally different business emerging that required operating efficiencies, technology and an operating platform totally focused on adding value that was materially different from his product distribution platform that is driven by commission brokerage. Jimmy Bradford didn't have the layers of lieutenants who were hired to only tell him what he wanted to hear or who had a vested interest in maintaining status quo. His 40+ years in the business told him, if you are going to sell, now is the time to do it.

PaineWebber was not foolish in buying J.C. Bradford, but their bet becomes that they are going to successfully make the transition en masse to fee-based advisory services or sell to another firm. Yet, in order for PaineWebber to be successful, there has to be a second epiphany, that radical cultural, structural and technological change is required in order for them to empower their brokers to compete on the basis of the range of investment values they can address and manage.

The good news for PaineWebber and the remaining major independent regional firms (Legg Mason, Gruntal, Tucker Anthony, Morgan Keegan, Raymond James, Dain Rauscher, E.D. Jones, Sutro) is that the technological vacuum between commission brokerage and fee-based advisory services can be filled by The Investment Source Company (see *Senior Consultant,* March 2000). PaineWebber doesn't have to take years to learn the high end of the advisory services business and slowly evolve its technology so high level professional investment counsel can be consistently and routinely provided by its brokers. Brokers who are watching the cost of trade execution fall cannot afford to wait. The technology of high level advice can either voluntarily be obtained by its brokers from The Investment Source Company; or PaineWebber can offer The Investment Source Company's comprehensive investment process technology, but this still leaves PaineWebber with the difficult task of reconfiguring and managing the culture and structure of the firm to best support the firm's financial consultants' efforts in adding value for the full range of client market segments (defined contribution, high net worth, foundation and endowments, defined benefit, profit sharing, public funds, Taft Hartley, ultra high net worth) in which they are active. This epiphany will not take many years to evolve, as some time between a market turndown and 2003, when the average retail trade hits $28 (down from $80 in 1998), the retail broker will begin to ask the same questions Jimmy Bradford and Jeff Powell saw coming. How can the commission broker make a living with today's compensation formulas? A 60%-80% decline in gross commissions means an 80%-90% drop in compensation. Where is the virtual real-time balance sheet and income statement technology which is necessary in order for the broker to engage their fee-based advisory services to add value? Where is the comprehensive investment process technology (asset study, investment policy, strategic asset allocation, manager search and selection/form of ownership choice and selection, performance manager, tactical asset allocation) mandated by ERISA and required by all discerning investors through which the investment values most important to the investor can be addressed and managed? Where is the customized technical and marketing support for each of the eight major market segments of the institutional and high net worth markets (high net worth, defined contribution, foundations and endowments, defined benefit, ultra high net

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worth, public funds, profit sharing and Taft Hartley) in which the broker-cum-consultant is active? When the broker sees their earnings drop by 65% over five years, they will want answers and will not be able to wait years for a response.

If firms are not overtly responsive to the new advice business model, then the broker-cum-consultant is forced to question which firms best supports their consulting business at the most favorable cost structure, facilitating the highest form of professional investment counsel that maximizes their margins and the value of their practices. If PaineWebber just offers process and technology and keeps its current cost and support structure in place, it will become a high cost/low service provider. If it has process and technology but does not support, it will have an increasingly expensive commission brokerage operation. To be effective, PaineWebber has to reinvent itself around the new advice business model committing the entire resources of the firm to support its investment process and technology through which its advisors are empowered to add value for their clients. By definition, this changes the culture and structure of the firm.

The same investment process which empowers the broker to add value also streamlines organizational structure. Everything is organized around process management and adding value for each of the major market segments of the institutional and high net worth markets in which the financial consultant is active, rather than product management and distributing products. Success is measured by providing the highest level of professional investment and administrative counsel and value possible for each client as well as assets under management and marketshare in each market segment. With a process management organizational structure at half the cost, much higher level service and three times the earnings multiple, PaineWebber could actually increase pay-outs to 80% and still have a higher market capitalization than it does today.

J.C. Bradford is the first sign that the economics of commission brokerage are deteriorating for both the brokerage firm and the broker. This leads the broker to ask the question: "Where is the advice platform and technology that would mitigate the decline in commission brokerage rates by empowering us to charge advisory fees for our on-going investment and administrative counsel? The broker then asks, "Where is the support for this advice platform which will help me win business in each market segment in which I wish to compete?" The broker then asks, "How good is my firm at supporting my consulting practice and are there better, more cost-effective options?" These are the tough questions for which Jeff Powell and Jimmy Bradford had no answers. These are the questions which will shape the financial services industry.

The industry must become passionate about adding value and about addressing and managing the needs of the clients and the financial consultants. It has always been whoever adds the most value wins. It is just that the commission brokerage industry is now coming to understand that there is not a lot of value to be added in commission brokerage. A new era in financial services is emerging that is built around advice, and its future is in competing on the basis of the value the industry empowers the financial consultant to add. ■

Achieving And Living The ''A'' Level Game

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team approach. Simply stated: Some people "get it," and most people do not.

Fully admitting the influence of Dr. Abraham Maslow, I developed my own version of an evolution continuum. Since my professional experience revolves around helping people reconfigure their lives and finances into what they really want and need to be happy and fulfilled, I've made some appropriate adjustments (see Figure 1).

To begin to play the "A" level game, you and every member of your team must embrace and live the principle of interdependence. The greatest outcomes are identified and achieved by people who live in the realm of self-actualization or self-transcendence. These higher levels cannot be achieved without first embracing and deploying the principle, behavior and environment of interdependence.

So, here is my simple translation of a very complex issue. In spite of all the professional mediocrity, the world seems to move along just fine. Consumers who fail to see themselves as "A" level clients are unable to discern great professionals from the average or even those at the bottom of the barrel. Just as water seeks its own level, we humans seem to surround ourselves with those who share our perception of performance, service, talent or competence.

Using the "evolution continuum" visual aid (Figure 1), we can determine whether or not someone has evolved their thinking at least to the level of interdependence. Please understand that true success or effectiveness can only occur when we apply this sound business principle: "Nobody is capable of "A" level performance in all essential areas." The path toward excellence begins when we realize that to achieve excellence we must secure a team consisting exclusively of proven "A" level performers. This is critical if we truly desire "A" level outcomes.

The above principles are often more readily accepted and applied within successful corporations than in the lives of individuals or families. So here is a business example to help drive these points home.

Several years ago, I was reading an article in *CFO Magazine* which touched on this issue. The article explained that in order for many companies to achieve full potential they might have to change CFOs or perhaps other members of the management team. I believe the example was this: If a $10 million company wants to move to $100 million, it will often need people with greater talent, skill and professional connections. The cycle then repeats itself. If the company has potential to grow to $5 billion dollars, it will likely have to change and/or add some higher skilled, perhaps brighter, and more influential personnel to get there.

Some people become so emotionally attached to certain advisors or colleagues that they choose not to move up to other people with greater capabilities. A CEO who behaves this way risks being terminated by the shareholders or board of directors. Such behavior rarely persists within public

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