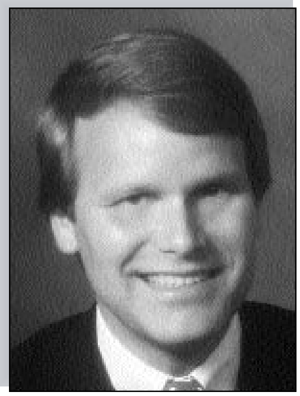
Industry Trends

What Is Professional Investment Counsel Worth And Where Does That Take the Industry?



Steve Winks

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The economics of high level, comprehensive, expert advice is somewhat of a mystery. To investors, reliable high level advice is rare and can be very expensive. At the high end of the advice market, ultra high net worth investors create family offices that engage legal, accounting, investment and management professionals on a part-time or full-time basis to manage their financial and personal affairs. The family office's principle limitation is that it is very expensive, even with $50 million or $100 million driving economies of scale, and the fixed element of overhead is often fixed in its vision and perspective of service which might not reflect the best thinking or execution available. As a solution, many ultra high net worth investors have found that senior investment management consultants provide the highest level of comprehensive, expert advice available, drawing upon the considerable fiduciary, philanthropic and trust services resources of their firms. These senior investment management consultants are faster, better, cheaper and more comprehensive in their advice than the plethora of disparate options with which the ultra high net worth investor is bombarded. The consultant can pull all the disparate forms of advice into one easily understood solution where the consultant is accountable for results.

Yet, for the more typical investor, without millions of dollars to invest and with less complex circumstances, senior investment management consultants must ask the questions: "What is their professional investment counsel worth?" This is somewhat of a role reversal. Usually the client asks, "How much does it cost?" But today, professional investment counsel must ask how much does it cost to service the account and provide high level advice. Though pricing for a $50 million ultra high net worth client is much different than a $50,000 client, the consultant must ask: "Given the finite time of 2,000 manhours available during the course of the year, how much time can I afford to spend with a $50,000 client?" This is not a question of what the consultant can charge but how much time they can afford to spend in serving the client. A 1.5% consulting fee, not including the cost of the investment vehicles, on a $50,000 portfolio generates $750 in gross consulting fees to the consultant which buys five hours a year of the consultant's time at $150 per hour. If the firm takes half the fee, the consultant can only afford to spend 2.5 hours with the client during the course of each year. This means just a half hour is spent in each quarterly performance update to include preparing and presenting the update; interviewing the client for changes in their financial condition, circumstance and risk tolerances; and in making the appropriate changes in policy, strategy and investment portfolio – all for $375 per year. This would be typical of a consultant operating within a major financial services firm which retains half or more of their gross revenues.

From the client's perspective, a 1.5% consulting fee in concert with the embedded cost of a mutual fund of 2.0% means they are spending 3.5% for advice on a $50,000 account. In this year's equity market where, at this writing, the market is down 1.4% for the year, the client would be down 5% or $2,500 by engaging professional investment counsel. For clients who have little investment experience, who would benefit the most from engaging professional investment counsel, the cost of advice is a significant issue, especially in down markets. The client needs hand-holding, but the consultant cannot afford to provide the needed perspective necessary to stay the course. Consultants are very likely going to come under significant pressure to spend more time with less sophisticated clients, while pondering the very question whether it is cost-effective to provide the $50,000 client with advice. If the consultant drops his fee to 1% and uses exchange traded funds, the resulting 1.3% cost (assuming a 30 basis point cost structure for a diversified ETF portfolio) to the client would be cheaper than a mutual fund and would offer high level personalized advice, but the gross consulting fee would just be $500 on a $50,000 portfolio or $250 after the firm takes its half. Surely the client

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discipline, process and methodology of investment management consulting and high level advice will define the industry.

SEI has provided the financial services mainstream an important model on how it may evolve from commission brokerage to high level advice. If the financial services industry were to expand its research function so that it is funding vehicle neutral, incorporating all investment vehicles; and if its firm's assumed responsibility for portfolio construction and individual account performance; and if it were to further move to a process management organizational structure from a product management organizational structure; the competitive character of the financial services mainstream would be greatly enhanced because it could actually compete on the basis of the value it empowers its financial consultants to add in each client account. If this new process management organizational structure were also tied to advanced systems technology, the firm could cuts its cost structure by 50% or more. By moving to ongoing advisory fees associated with high level on-going advice, the firm also expands its earnings multiple to three times that of commission brokerage. By managing all the client's assets and liabilities, rather than executing isolated, disjointed trades, the assets and the earnings of the firm are greatly increased. So, not only is the client well served by providing high level advice, but the firm enjoys higher earnings, margins and multiple. It is the emergence of firms like SEI which trigger an unflattering comparison to mainstream financial services organizations which will cause the mainstream to evolve in a more dynamic way. This is the next generation of financial services firm. ■

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would require more than 1 2/3 hours of service for the year. Some may reason: "Forget advice; mutual funds are indeed the best option because it implies no personalized advice." Yet, clients with $50,000 have a greater need for advice and are more prone to very costly mistakes than the more seasoned, well-advised investor. The smaller the client assets, the greater the need for advice but the less feasible advice becomes.

This conundrum tells us much about how the financial services industry will evolve its structure; how pricing of support, products and services will evolve; and how consulting practices will evolve. In order for a consultant to provide high level, comprehensive, expert advice, it will require at least 10 hours of their time per client during the course of the year. This means if the consultant works a conventional 40-hour week, or 2,000 hours a year, that they can serve 200 clients. If the consultant has a minimum fee of $1,500 per client (in effect, billing their time at $150 per hour) and requiring a $100,000 account minimum, they would generate a minimum gross revenue of $300,000 a year. From this $300,000, the consultant must pay for services which leverage their time. They pay their firm half or more of their gross revenues for office space; systems; administrative and operations support; fiduciary, philanthropic, trust and investment services support; and an investment process methodology and technology through which they add value. Also from this $300,000, the consultant must pay for a technical analyst who makes all the unintegrated technology function as a system and who helps construct, manage and report on client investment portfolios. Also needed is an operations/administrative person who may or not may not be provided by their firm. If the consultant is to leverage the number of clients that the practice can manage, they will also hire a relationship manager who will work with existing clients. This practice model of successful senior consultants focused on high net worth and ultra high net worth individuals is driven by an average client base of 120 investors and $500 million assets.

IF WE ARE GOING TO PROVIDE HIGH LEVEL ADVICE IN THE ADVICE BUSINESS MODEL, THE CONSULTANT MUST FIND A MORE EFFICIENT MEANS TO SUPPORT HIGH LEVEL, COMPREHENSIVE, EXPERT ADICE

The advice business model is much different than commission brokerage, and if we are going to provide high level advice, the consultant and the industry must find a far more efficient means to support high level, comprehensive, expert advice. Today, highly successful consultants have been required to exert an almost Herculean effort to provide high level advice within firms which are not structured for advice but for commission brokerage. Technology breakthroughs are such that at $30 million in assets, it is actually less expensive for consultants to spend $150,000 on hardware and software and to hire a technical analyst at $60,000 and an administrative/operations person at $40,000 than it is to spend 75-90 basis points on using the advice support technology and infrastructure of their firm's wrap fee programs. Importantly, the consultant ends up with a better funding vehicle neutral investment process that empowers them to add far more value than they could using the firm's technology. The 50% of gross revenues that consultants provide their firms for support can and must be far more effectively deployed as today's decline in commission brokerage rates will inevitably make it impossible for firms to sustain their present overhead. Firms must develop a new and more efficient business model that facilitates economies of scale in providing high level, comprehensive advice.

The future is high level advice, not commission brokerage. The consultant must receive commensurate value for the share of gross revenues they provide. Access to financial products, trade execution and facilities management are commodity-like services which can no longer command even a small fraction of the 50% or 60% of gross

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earnings the firm now retains. By the law of economies of scale, in no circumstance should it be more cost effective for the broker to create an investment process that is superior to that of their firms. Firms have to provide high level, robust technology, processes and support for consultants which will require a significant reorientation of their organization and cost structure. The cost of advice incorporating the consultant, their support infrastructure, their outside support infrastructure (including the firm's cost and the cost of investment vehicles) are the determinants of whether high level, comprehensive advice can be profitably provided. The financial services industry must streamline its organizational structure around the processes and technology of high level, comprehensive advice, significantly reducing its cost structure while empowering the consultant to deliver high level advice. This reduces the cost of advice while making it possible for the consultant to address and manage the investment values necessary for the client to achieve their long-term goals and objectives. The competitive stature of firms will increasingly be driven by the depth and breadth of its advice which, in turn, is driven by its processes and technology which makes it efficient to deliver. The more labor-intensive and complex the firm's support, the more costly the service and the smaller the market being served. The more efficient the firm is at providing high level advice, the larger the market for advice. We know the financial consultant and the consumer will gravitate toward high level, comprehensive, expert advice. The firm's role will be determined by whether and to what extent they can and will respond. This embedded cost structure of the mainstream financial services industry may make it impossible for the industry to serve all the investing public with high level advice.

Today, there are 16 million individual investors who have more than $100,000 in liquid net worth that are profitable candidates for high level advice. Assuming the average retail consultant can handle 200 clients and $50 million in assets (generating $500,000 in gross revenues), there are only enough clients to go around for 80,000 consultants. This means the other 570,000 financial advisors are going to try to profitably provide advice to the other 90% of investors who have less than $100,000 to invest. (This also tells us the institutional markets which, under ERISA, require very high level advice, are going to become extremely important to firms in establishing their competitive character in the new advice marketplace.)

TODAY, THERE ARE 16 MILLION INDIVIDUAL INVESTORS WHO HAVE MORE THAN $100,000 IN LIQUID NET WORTH THAT ARE PROFITABLE CANDIDATES FOR HIGH LEVEL ADVICE

In order to profitably provide high level advice to individuals with less than $100,000 in liquid assets, a totally different model is required that cannot be driven by highly skilled and highly compensated senior consultants. Salaried employees working at call centers, using advanced systems and process technology in an internet-based delivery of financial products and services, can construct customized investment portfolios and provide performance monitoring while offering core services of checking, cash management accounts, accounting, credit cards, mortgages, lines of credit, bill payment wrapped into a virtual real-time balance sheet and income statement. These accounts are secure; the advice is comprehensive and can be executed in a cost-efficient manner if the client aggregates all their assets and liabilities into one account. This account is a feeder system, or incubator, for higher level advice triggered when the client goes to $100,000, $1.3 million or $30 million. The advisors in this incubator develop extraordinary credentials in client service and can graduate to client service professionals working with established consultants who have more assets and address more complex financial needs. The incubator market is defined by clients with less than $100,000. The retail market is $100,000 to $1,300,000. The high net worth market is $1.3 million to $30 million. The ultra high net worth market is $30 million or more. At $1.3 million, more complex estate planning services are needed. A $30 million family office-like services are required which include estate planning and personal services like lending, tax preparation, walking a dog, buying a car, maintaining an out-of-state vacation home, and hiring/firing domestic services.

For brokers who have to retool their commission brokerage book around high level advice, they need to redouble their efforts in performing asset studies and creating investment policy and strategy for all their clients who have more than $100,000. If the firm doesn't have an established investment methodology around which to construct portfolios, they must find an outside source in which they have confidence.

The cost of investment vehicles will also greatly influence how the industry evolves because the cost of the investment vehicle determines pricing to the client and ultimately the latitude the consultant has in pricing their services. A mutual fund at a 200 basis point structure, including trading cost, is four times more expensive than a managed account at 50 basis points. An exchange traded fund at an average of 30 basis points is 40% cheaper than an managed account, and the cost of individual securities (used within the right technological environment with a model portfolio, where trades can be routed, blocked and crossed before execution at institutional rates) have very little, if any, cost. The degree of complexity in portfolio construction is moot because third party investment methodology exists that allows one to be equally effective in using individual securities in constructing portfolios using, say, Ed Kirshner's model portfolio at PaineWebber to construct individual securities portfolios versus using Allen Shaw's sector rotation research at Solomon Smith Barney to construct ETF portfolios. Both beat the S&P 500 by 300 basis points or more; but with individual securities having little or no cost, the consultant can maximize their margins by minimizing the cost of the investment vehicle used. Thus, high cost investment vehicles such as mutual funds, variable annuities and insurance contracts which severely limit the ability of the consultant to charge for their services will not likely participate in this new evolution toward high level, comprehensive, expert advice.

As major financial services firms wrestle with their technology and support infrastructure to facilitate high level advice and manage their cost structure and pay-outs, making it more conducive to successful consulting practices, they will be unfavorably compared in pricing, culture, structure and technology to highly successful consulting organizations like CapTrust, EnvestNet or Chase H&Q. There is the distinct possibility that major mainstream financial services firms steeped in the tradition of commission brokerage and not consulting-driven could take five years or more to assimilate their commission brokerage culture into a new consulting culture that will allow consultants to grow professionally. If mainstream financial services firms do not quickly develop and execute a vision of a new sophisticated, high level advice delivery platform, aggressively reengineer their organization and cost structures, and execute with a vengeance, senior level consultants are, in effect, leaving two to three times the assets they are presently managing on the table, not to mention becoming increasingly vulnerable to competition from consultants at firms like CapTrust. If firms are charging more than 20 basis points for their funding vehicle neutral investment process which includes trading cost, fiduciary, philanthropic and trust services; and are providing less than an 80% pay-out, they don't have it right yet. The margins, support and technology available to consultants will improve exponentially because it is there today for the taking, and it is a buyer's market. Don't forget: In a down equity market, the absence of accountability for account performance in commission brokerage is highly conducive to growing a consulting practice.

The economics of providing high level, comprehensive, expert advice provides great insight into how the financial services industry will evolve. There is universal agreement that commission brokerage rates are going to fall to zero or close enough to zero to, in effect, be zero within the next 5-10 years. And, as a consequence, there is no question the industry will have to make a transition from commission brokerage to providing advice for a fee, which is a totally different business model that requires a broad range of investment values to be addressed and managed, and tangible, quantifiable value to be added. This radical transformation of the commission brokerage business to providing high level, comprehensive, expert advice presents many challenges in the culture, organizational structure and technology for large, established organizations which have a tradition of thinking "inside the box" at a time when thinking "outside the box" is mission-critical.

What we learn in looking at the economics of advice is that virtually all the old paradigms do not work. In commission brokerage, mutual funds are a core product. In consulting it is difficult to cost effectively use traditional, non-ETF, mutual funds. In commission brokerage, products are everything. They define the industry's product management organizational structure. In consulting, process is everything. Consulting recognizes there is no inherent value added in products; it is what you do with products, or the process, that adds value. Thus, in consulting, there is a process management organization structure that empowers consultants to compete on the basis of the value they add. In commission brokerage, high level, objective advice is promoted, but brokers act as salesmen. Success is measured by trade execution. In consulting, high level, objective advice is promoted, and the consultant's professional investment counsel is engaged for an on-going fee. Success is measured on the basis of the depth and breadth of financial values addressed and managed, and the tangible, quantifiable value added. In commission brokerage, there is no accountability for investment recommendations or account performance. Investment management consulting is built around accountability. Thus, everything the commission broker has learned and has done for the past several decades may not be particularly helpful as they move to providing high level, comprehensive, expert advice.

COURAGE, VISION, LEADERSHIP AND A PASSION FOR HIGH LEVEL, COMPREHENSIVE, EXPERT ADVICE THAT IS COST EFFECTIVELY DELIVERED, WILL WIN THE DAY

The broker's success in making this transition will be greatly increased if they are enthusiastically supported by their firm. The firm has to simultaneously make radical changes in its operations to facilitate high level advice, while its brokers have to move to providing high level advice. There is no proven track on whch the broker can run or safety net of highly successful colleagues from whom to learn to soften the rough edges of making an all-or-nothing bet on an entirely new enterprise of high level advice and investment management consulting.

This is an extraordinary time to be in the financial services industry, as it is being reordered for the next 50 years. There will be spectacular successes, firms coming from nowhere to extraordinary success. as well as spectacular failures of established organizations that fail to see the changing economics of the industry and who dismiss the totally new culture, structure and technology of advice necessary in order to add value. Courage, vision, leadership and a passion for high level, comprehensive, expert advice that is cost effectively delivered, will win the day. There is no question that highly successful, seasoned senior investment management consultants are ready and eager to aggressively grow their businesses. The question is which consultant-support organizations will be the firms that will be the spectacular successes. It is around those organizations that the financial services industry will be reordered for the next 50 years. ■

Clarification

In our article last month on RunMoney.com, we applauded the efforts of Robert Jorgensen in taking the message of managed accounts and high level advice directly to the public to combat mutual fund and invest-direct promotions in the mass media that have become so omnipresent. Very simply, if our industry is to grow, it is imperative we get our message of high level, expert advice out. Lockwood has reminded us that though it supports its advisor, Robert Jorgensen, in his efforts to build his web site RunMoney.com, Lockwood's business is to support all its financial advisors, just as it has Jorgensen, in using the Lockwood support platform. Lockwood is not going directly to clients nor will it deal directly with clients. Lockwood only deals through financial advisors. RunMoney.com is an investment advisor, independent of Lockwood, which uses the Lockwood platform. ■