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SENIOR CONSULTANT
The Voice of the Investment Management Consultant

House Votes To Eliminate Estate Tax, Focus Of The High Net Worth Market Shifts To Investments From Form Of Ownership

The U.S. House of Representatives has overwhelmingly passed the Death Tax Elimination Act, House Bill 8, by a lopsided vote of 279 to 136. The bill will phase down tax rates and repeal estate tax, gift tax and generation-skipping transfer taxes within 10 years. The bill reduces the 55% estate tax by 5% each year until it is eliminated by 2010. Estates which would be subject to a 35% estate tax rate will see the estate tax eventually eliminated by year 2007. The primary beneficiaries of the repeal of estate taxes are small businesses which are the primary source of new job creation in the U.S. Ninety-one percent of all small businesses are family-owned, but the majority of these businesses fail after the death of the founder. In nine out of ten cases, the major reason cited for the failure of the family business is the children could not afford to pay the estate tax. More than nine in ten American voters believe the federal estate tax is unfair, and nearly eight in ten support the repeal of estate taxation. A similar measure was passed last year by both Houses of Congress and was vetoed by President Clinton. President Clinton promises to again veto this year's estate tax repeal legislation, despite large bipartisan majority support in both the House and Senate. Though the Senate will easily pass the bill, it does not have the 66% majority sufficient to make the bill veto-proof. Thus, estate tax repeal becomes a significant election issue. If enacted, the elimination of estate taxes greatly simplifies financial advice to the high net worth and ultra high net worth market segments. Today, advice is more focused on creating the appropriate configuration of forms of ownership in which assets should be held in order to minimize estate taxation than on investment policy and strategy. Without estate taxation, investment management consulting becomes the core discipline of high level, comprehensive, expert advice. Estate planning and forms of ownership are still important but will play a much different role. The focus is more on issues like the legacy the client wishes to leave with their wealth and how much they should leave their children without

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Merrill Lynch Begins Reengineering Its Brokerage Division Around High Level, Comprehensive, Expert Advice

Merrill Lynch, the nation's largest brokerage firm, is beginning to make the transition from an old economy company to a new economy company by selectively cutting 5.4% of its 37,000 brokerage division workforce, or 3% of Merrill's 68,600 employees. The firm will cut as much as $150 million and as many as 2,000 jobs, primarily from non-field related jobs such as sales, marketing, strategy as well as some cuts in back office processing systems. Merrill's compensation and benefits at 52% of net revenues is the highest on the street and compares unfavorably to its peer group of Morgan Stanley Dean Witter at 39% and Goldman Sachs at 49%. The cuts come as Merrill CEO David Komansky establishes firm-wide goals to cut expenses and reflects the growing clout of Stan O'Neal who succeeded long-time brokerage chief Launny Stefans in February. O'Neal, the former CFO of the firm and an expert in corporate reengineering, is also the leading candidate to take Komansky's spot in 2004, upon Komansky's retirement. Thus, O'Neal's success in reengineering the firm will literally define the firm's leadership and vision for many years to come. This is different from

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reduce potential conflicts with their auditing practice, while maximizing the value of the enterprise by retaining a minority interest in business that is sure to grow much larger without the cultural inhibitions of an accounting firm.

Jay Nisberg, managing director of Accountants Financial Services Group, a Ridgefield, Connecticut-based group of 50 accounting firms that work with CIBC Oppenheimer, said, "Creating a broker/dealer like Capital Professional Advisors is very complex because there are capital issues, expense issues, supervisory issues and regulatory issues that must be managed in creating a broker/dealer which is made all the more complex by there being ten firms involved." Smaller accounting firms may not find it feasible to create their own broker/dealer, particularly when they are getting started. Thus, Nisberg's Accountants Financial Services Group, which serves as a broker/dealer for small accounting firms would be an attractive avenue for smaller accounting firms.

The success of Capital Professional Advisors, in large part, will be a function of the advice it provides. If it approaches advice as simply executing a series of disjointed, unrelated translations where it is not possible to add value as in a commission brokerage model, its investment advice will prove to be inferior to its accounting advice which will run the risk of ruining the relationship capital the accounting firms have worked hard to create with their traditional accounting business. If, Capital Professional Advisors understands high level, comprehensive, expert advice offered by senior investment management consultants who compete on the basis of the investment and financial values they address and manage, then it will be a huge success. Thus, the cultural considerations in attracting, compensating and keeping highly skilled investment management consultants will be the primary challenge in Capital Professional Advisors offering a high level of comprehensive, expert advice. Each of the participating firms will have to spend significant capital resources in building its own technology and support infrastructure for high level advice or more cost effectively build a centralized platform that would attract world-class senior consultants. Once the platform is created, even if consulting practices are acquired, Capital Professional Advisors must get comfortable with its most successful consultants earning a half million dollars or more. If Capital Professional Advisors is successful in creating the culture, structure and technology conducive to high level, comprehensive, expert advice, it could become a very powerful delivery platform for highly successful consultants who are looking for a liquid exit strategy with a multiple, where they can maximize the value of their practices. How Capital Professional Advisors defines itself, its technology, its support structure, its culture and its cost structure will determine its success.

If it first aligns its interest with its clients and a process through which value can be added, rather than with financial products, it is on the right path. But there is so much that remains to be done. It will be months before one can determine whether high level expert advice can be delivered to its business and high net worth clients. Capital Professional Advisors could be yet another iteration of what the next generation of financial services firm looks like. ■

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ruining their incentive to achieve. It has been said that wealth without meaning is materialism, and thus a new role for financial consultants will emerge which will help high net worth investors find meaning in their wealth. Without the formality and technicalities of estate taxation, estate planning is far less encumbered by legal and accounting convention, freeing tens of thousands of financial consultants to facilitate a renaissance in philanthropy and charitable giving. This totally American virtue of providing a helping hand to those who may need it will greatly elevate the American spirit.

Estate taxation from almost its very inception has been voluntary because, for investors who have assets in excess of $675,000, or $1.35 million for couples, a much higher level of financial advice is required that goes beyond investment advice to minimize estate taxation. This higher level of financial counsel is focused on placing assets in the forms of ownership appropriate to minimize or eliminate estate taxation. Once the family foundation, multi-generational wealth transfer strategy and philanthropic trusts have been put in place, then the investment management consulting services can be engaged to construct investment portfolios for each of these ownership vehicles.

The Family Enterprise Center of Kennesaw State College near Atlanta has found that the average annual cost per business of life insurance contracts designed to avoid estate taxation is $45,000. It also found the typical family business will initially pay more than $33,000 to engage the professional counsel of attorneys, accountants and financial advisors to execute an estate plan. These costs divert precious resources that could be redeployed for far better use within the small businesses which are always seeking ways to expand and to create more jobs. Thus, the estate tax is one of the most harmful taxes in the U.S. to economic growth. When measured on a per dollar of revenue raised basis, it exerts a disproportionately negative impact on the economy. It not only diverts capital from small business expansion, but it costs nearly as much to comply to estate tax law as the tax it brings in. In 1998, the estate and gift tax raised about $24 billion but cost about $23 billion for compliance. In 1999, estate taxes accounted for only 1.3% of all federal revenues. The U.S. has the second highest estate tax in the world at 55%. Only Japan is higher at 70%. Even countries like Sweden and Denmark which have much greater government involvement in welfare programs for its citizens have lower estate tax rates of 30% and 15%, respectively. Canada has no estate tax. Given the small amount of revenue it raises, its high compliance cost, its negative impact on the economy and its high tax rates, it is difficult to reason why one would not be for the elimination of estate taxes. The argument and public support for the repeal of estate taxation is compelling.

With the repeal of estate taxation, there will no longer be a need to divert substantial assets to life insurance contracts necessary to circumvent estate taxation. Whole life contracts, with a 1% mortality charge, typically have a relatively low fixed income-like return that make them a poor investment choice. Insurance companies are structured to earn the difference between what they earn on their investments and what they pay out in policy returns and claims. With mortality costs running 1%, the insurance companies are motivated to keep guaranteed returns on the policy at low levels to maximize their earnings and reserves. In fact, the Big Five accounting firms have specialists who evaluate life insurance contracts to keep mortality cost down and to improve the investment economics of the insurance contracts, which has been the catalyst for a significant decline in recent years in the cost structure and commissions built into insurance contracts.

Variable life contracts have the same 1% mortality cost plus a mutual fund-like cost structure. Like mutual funds, variable life contracts offer variable returns tied to the performance of a money manager. Variable life contracts are a very expensive investment option, incurring both fund expenses and mortality cost, and are not designed for portfolio construction where investment managers and investment management styles are frequently reweighted during the course of any given year. In variable life, you are stuck with the manager and their management style, regardless of what the market is telling you or how well they may be performing. So, from an investment management consultant perspective, insurance contracts which are the byproducts of estate planning are not particularly attractive investment options. They are expensive, their returns are not attractive, and they are inflexible in a dynamic investment environment, requiring frequent portfolio adjustments. Without estate taxation, these inefficiencies in portfolio construction can be avoided, and investment strategy becomes much more straightforward. In fact, without forms of ownership like insurance contracts which superimpose their own investment discipline, investment strategy becomes more of a pure investment consideration. Forms of ownership are still important, but their purpose changes materially. Estate planning is no longer a code for insurance sales. Instead, its focus becomes creating a lasting legacy with one's assets which gives meaning and fulfillment to one's life work.

The repeal of estate taxation would be a huge boon to the investment management consulting industry because the competitive focus of the financial services industry now becomes how adept one is in constructing investment portfolios. Insurance agents now have a new accountability for account performance mandated by the transparency of internet reporting. Trust officers, CPAs, attorneys and insurance agents who have been the primary architects of estate planning, will now either play a diminished role over the next 10 years, or they will seek to compete on the basis of the value they add in portfolio construction. Their expertise in forms of ownership to minimize estate taxation now has a much lower value when it is reconstituted as legacy planning.

REPEAL OF ESTATE TAXATION WOULD BE A BIG BOON TO THE INVESTMENT MANAGEMENT CONSULTING INDUSTRY BECAUSE THE COMPETITIVE FOCUS THEN BECOMES HOW ADEPT IS ONE IN CONSTRUCTING INVESTMENT PORTFOLIOS

Legacy planning is much more appropriately and cost effectively delivered by the investment management consultant. With the transparency of the internet making accountability for account performance an imperative, the role of the investment management consultant is greatly elevated with estate tax repeal, as is that of other investment professionals such as financial planners and stock brokers who evolve their practices toward high level comprehensive, expert advice. The depth and breadth of high level advice will still require estate planning, but legacy planning will not be driven by estate tax minimization after 2010.

The repeal of estate taxation will change the financial services industry in many important ways. The six financial services (asset study, investment policy, strategic asset allocation, manager search and selection/form of ownership choice and selection, performance monitor and tactical asset allocation) that comprise the investment process through which the consultant addresses and manages the values most important for each client to achieve their goals and objectives, will be reordered in their significance. Form of ownership will take a much more prominent role within the investment process. With the estate tax issue off the table, a much different and far less demanding technical skill set is required to address the legacy that one wishes to leave. Without complex estate tax intricacies to manage, there are now tens of thousands of financial services professionals who can become advocates of a new type of estate planning called legacy planning, designed to help their clients find meaning in their wealth by leaving a lasting legacy. This will not only lead to a renaissance in philanthropy and enrich the work of the financial services professional, but more importantly, it will also stimulate an unprecedented boom in work for the legal and accounting professions pertaining to philanthropy and trusts. Banks are quick to acknowledge that trust officers are not particularly effective advocates, which is the strength of financial services professionals.

By removing the technical requirements of estate taxation which inhibits the execution of estate planning, we gain far greater and better advocacy for philanthropy. This is the democratization of estate planning, where the number of advocates is potentially expanded by hundreds of thousands of financial consultants in their work of providing high level, comprehensive, expert advice to all clients. This service is the ultimate in self-actualization for the individual investor and puts the investment management consultant in the most fulfilling role of being a catalyst that would foster clients to give back to their communities. The creation and management of foundations and endowments will become perhaps the most personally meaningful aspect of the consultant's work. Rather than inefficiently diverting assets to insurance contracts to avoid estate taxation, an entirely new approach to philanthropy will emerge.

The emergence of this new wave of philanthropy also illustrates the importance of our industry moving from a product management organizational structure to a process management organizational structure. In an environment where estate taxation is repealed, there will be extraordinary activity in creating foundations and endowments to support the wishes of high net worth investors who find it meaningful to leave a lasting legacy that will effect lives for many years to come after they leave this earth.

The repeal of estate taxation also changes the competitive character of the financial services business. Today, high level, comprehensive, expert advice to high net worth individuals has two components. One deals with creating the appropriate form of ownership necessary to avoid estate taxation, the other deals with managing those assets within the appropriate forms of ownership to assure the client's goals and objectives are met. Once the estate planning is done, 90% of the ongoing work pertains to asset management. Because professional counsel on legal, accounting and trust issues are central to creating an effective estate plan, firms like U.S. Trust, Northern Trust, MyCFO.com and Big Five accounting firms have traditionally been the most adept in estate planning. Only in recent months have CitiGroup and Chase Manhattan become effective in executing high level estate planning through their respective Solomon Smith Barney and Chase H&Q brokers for ultra high net worth clients. But, with the repeal of estate taxation, U.S. Trust, Northern Trust, et al. still have an edge in offering high level, comprehensive, expert advice, but they will be measured differently. Achieved investment results will become a much more significant issue. The investment results derived from estate planning vehicles such as insurance contracts, designed primarily around estate taxation, will be disappointing. This means these accounts will be increasingly vulnerable to investment management consultants.

The hands-on portfolio monitoring and management work of the investment management consultant and their high level of local personalized service will likely prove to be a more formidable competitive edge relative to more passive trust service and accounting business models in financial services. The entrepreneurial motivation of the consultant armed with high level investment processes assuring the highest level of professional investment counsel will make the investment management consultant the most powerful purveyor of financial products and services within the financial services industry. Everyone wants high level, comprehensive, expert advice, and investment management consultants, empowered with high level process management, are the total package.

The passage of House of Representatives Bill 8 and the repeal of estate taxation will have a most profound impact on the financial services industry and investment management consulting. It becomes one of many converging trends that are shaping high level, comprehensive, expert advice and making investment management consulting the financial product and service delivery platform of the 21st century. The repeal of estate taxation will shift the emphasis of high level advice from forms of ownership to portfolio management. It will be a catalyst for a renaissance in charitable giving and yet another motivation for firms to move to a process management organizational structure from a product management structure (where it is not possible to add value). As firms align the tactics of high level advice with the strategy of high level advice, the competitive stature of the old commission brokerage business is greatly enhanced as budding investment management consultants supported by the right process technology become the most powerful competitive force within the financial services industry. They become the most reliable and accessible source for objective, comprehensive, expert advice. ■

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past efforts to simply manage expenses more aggressively. It is the beginning of the reengineering of the firm that would align the firm's tactics of advice with its brilliantly conceived strategy of high level, comprehensive, expert advice.

As internet brokerage drives commission brokerage rates down more than 60% over the next three years, Stan O'Neal must not only find a way to more aggressively manage expenses, he must facilitate the Merrill brokers' transition from commission brokerage to high level advice. He must make it easy for the broker to engage their professional investment counsel, thus minimizing the implications of declining commission rates (which will approach zero within the decade) on the firm and its brokers. So the cuts in personnel are not just an aggressive management of expenses but are highly strategic cuts in the marketing, sales, strategy and technology bureaucracies, which are central to reinventing the culture, structure and technology of the firm around high level advice. Strategic changes in these areas are important, and they should be sufficiently deep to begin to change the way the bureaucracy works and thinks. They should be deep enough to bring in new blood with new ideas and new ways of doing things.

Merrill Lynch is the perfect example of how commerce in an old economy company and in a new economy company hasn't really changed in 500 years. People sell and people buy, whether it's from a wagon or the internet. New economy dom.com companies with new business paradigms that challenge convention start with no revenues, lots of expenses for advertising, warehouses and service centers, and are totally revenue-dependent. Conversely, as the old economy company starts to digitize its operations, its expenses drop and its margins soar. Both models will converge into one; all companies are internet companies. But, we have yet to see the stock market recognize the store of value within traditional old economy firms. Stan O'Neal is about to unlock the fabulous value of Merrill by exploring the lower cost structure associated with reengineering the culture, structure and technology of the firm around advice and expanding its earnings multiple by a factor of three by building a recurring fee revenue steam from its advice. The key to the new economy is that all companies are indeed internet companies, not just the dom.com's, and the old economy companies have the most to gain in productivity and marketshare by reinventing themselves before a start-up does it for them.