July 2000, Vol. 3, No. 7

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

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.

continued on page 12

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

continued on page 16

INSIDE

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. ■

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

Continued from page 1

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.

Ph 804-795-1642 ■ Fax 804-795-7703

Today, all firms have to think, behave and operate like technology companies. As Bill Gates of Microsoft has taught us, in managing technology you always have to stay ahead of the power curve. You must define the market if you are to lead, rather than having to play catch-up and never quite getting it right. John Chambers, the CEO of Cisco Systems, recently said, "What gets people to change is not knowledge or creativity applying that knowledge, it is emotion and survival." The only problem with faster, better, cheaper products and services stimulated by the internet is that an established organization might find it difficult to adapt to change. Thus, Merrill's motivation to build a flatter, more innovative, more adaptable organization that is highly responsive to the client. So, Merrill's move to cut its overhead becomes an opportunity to innovate, become more adaptable and seize market leadership. This is the opportunity for Merrill to begin to reshape its hierarchical command and control organizational structure that is an impediment to innovation and speed in decision-making, better suited for the Industrial Age. It must create to a new, leaner, more collaborative continuous learning environment which will give its brokers and clients a far better value-added proposition.

This reengineering of Merrill's brokerage operation does not assume everything about Merrill is wrong. It assumes that invention and innovation are the primary and most essential virtues of the organization. Merrill actually has the most difficult part done: They have established client relationships, seasoned professionals serving those accounts and substantial revenues being generated. Their strength and their weakness lie in their ability to provide personalized service. The opportunity and willingness of their brokers to add value is in place, their process and methodology is not, and thus the results their clients actually achieve in their accounts could be greatly improved. Innovation is an imperative, as within the decade commission brokerage rates will approach zero, and the firm will not be able to sustain its present operating overhead. Merrill has no choice; it must rebuild its culture, structure and technology around high level, comprehensive, expert advice. It must become accountable for account performance. It must empower its financial consultants to engage their professional investment counsel for an on-going advisory fee and to compete on the basis of the value they add, rather than charging brokerage commissions to distribute financial products. They must move from a very expensive product management organization structure to a lower cost and more effective process management organizational structure. Their brokers must learn to behave less like salesmen and more like consultants.

Within the next 10 years, as brokerage commissions approach zero, everything Merrill and its brokers know about commission brokerage will become moot. Clients will know by virtue of the evolution of the market that there is no value added in a production distribution business model. It is process or what you do with the product that adds value. Thus, Merrill Lynch and Stan O'Neal embark on an exciting new chapter of the financial services industry. Merrill knows the only way to manage technology is to stay ahead of the power curve. It must innovate; it must redefine the market before someone else does because that is the only way to seize market leadership. If Merrill does not take this opportunity to seize market leadership, it will always be playing catch up, always delivering too little too late relative to faster, better, cheaper competitors.

IN THE INTERNET ECONOMY, WHERE OLD AND NEW ECONOMY COMPANIES COMPETE, INNOVATION IS THE MOST IMPORTANT AND THE MOST ESSENTIAL VIRTUE

In the internet economy, where old and new economy companies compete, innovation is the most important and the most essential virtue. Ideas and speed of execution always wins over status quo. This is not the case in traditional old economy companies where politics and decades of relationships take precedent over ideas. Ideas and speed of execution become the currency for advancement rather than the politics of personality. Substance finally wins over style. It is finally politically correct to challenge the old paradigms of commission brokerage. It is finally acceptable to have an identity of interest with the investor rather than the product manufacturer. Finally, we can openly address and manage issues like the returns actually generated in the client's account, the risk exposure they are assuming, the cost structure of the investment vehicles used in constructing custom client portfolios, the income and estate tax efficiency of accounts, the liquidity of accounts, how responsive the account is to the client's long-term goals and objectives, and how current market conditions effect each client's account. Clearly, a much higher level of process and technology is necessary to address and manage these issues than that which is currently available in a commission brokerage business model.

Jack Welch, the father of the corporate reengineering movement and long-time chairman of General Electric, who has won the mantle of America's Most Capable Manager, shared the essence of his business philosophy which has made the U.S. economy the envy of the world and has been the catalyst for a record-breaking 19-year bull market. Welch observed, "You have to be on the cutting edge of change. You cannot simply maintain status quo, because somebody is always coming up with another product, or consumer tastes change, or cost structure changes or technological breakthroughs occur. If you are not fast and adaptable, you are vulnerable. That is true for every segment of every business in the world." This is the precise environment that Merrill Lynch, the financial services industry and literally every industry has or will find itself. The American economy has gone through a series of rolling recessions, industry by industry over the past 20 years where they have had to reinvent themselves and have gone on to become formidable global competitors. Merrill Lynch must find a way to become fast and adaptable while aggressively managing its cost through process and technology. In seeking to become a first mover, Merrill is, in essence, seizing its leadership role and will define the global financial services market in the breadth and depth of values it empowers its financial consultants to address and manage. Dan Tully, former Merrill Lynch chairman, had the vision of creating a global footprint and in the famed Tully Committee report, saw the role of the broker as providing professional investment counsel for a fee, rather than trade execution for a commission. David Komansky, CEO of Merrill, has the history-making role of assuring Merrill's global leadership role in financial services by managing the transition from a commission brokerage business model to a high level, comprehensive, expert advice business model. Stan O'Neal, president of the Brokerage Unit, will execute the necessary changes to create a new culture, structure and technology of advice and in doing so, will assume the leadership reins of the organization, succeeding David Komansky as CEO.

So, what is in store for Merrill over the next 12 months? Jack Welch suggests that there are three stages to corporate reengineering:

1. the "awakening" during which the need for change is realized;
2. the "envisioning" when a vision of the firm is created and all its employees and capital resources are mobilized to achieve that vision; and
3. the "re-architecturing" which entails the design and construction of a whole new organization.

Komansky and O'Neal are past the "awakening" stage which is always the most awkward. It was at this stage that the highly regarded Herb Allison, who conceived the brilliant Merrill Lynch Unlimited Advantage strategy, got into conflict with the self-interests of the old economy commission brokerage culture that led him to resign. Launny Stefans has since been kicked up stairs, and because of Herb Allison's work, the firm has a much clearer path to execute. The firm is awakened, and O'Neal has a mandate to cut expenses. O'Neal must now envision not only how to cut expenses but must create a new business model that will avoid further deep cuts in operations as commission brokerage rates continue to decline. This will be a new advice business model that will allow the firm and its financial consultants to survive and prosper in a zero-trading cost environment. For Merrill, this new advice business model was made necessary when Charles Schwab surpassed Merrill in market capitalization. Merrill's response with its Unlimited Advantage account, in turn, made Schwab play to its weakness – personalized advice – gave Merrill market leadership. This forced Schwab into buying U.S. Trust, thus redefining high level advice and committing Schwab to a higher cost, higher support delivery platform for its independent advisors. Schwab has absolutely no inhibitions in the execution if its high level advice strategy, thus the ball is in Merrill's court to innovate, and they must not only respond but must beat Schwab to the punch in their vision and its execution.

The challenge in the "envisioning" stage is: Once the strategy of high level, comprehensive, expert advice is developed, every division, every business unit and every key manager must buy-in and own the strategy. It is here that those that impede innovation and invention are of the least value to the organization. Those who cling to status quo become extraordinarily expensive because of terrible impact of lost opportunity cost, and the slowing of the decision-making process in a rapidly changing business environment. Ideas and speed of execution must triumph over politics and personalities.

Jack Welch found at General Electric that the old Industrial Age command-and-control hierarchical organization structure didn't work because it suppressed ideas and innovation and slowed decision-making. In its place, Welch created a "boundaryless organization" to assure the very best ideas always win without compromise. In the financial services industry, this boundaryless organization is a process management organizational structure. Thus, Merrill is at that critical juncture of determining who among their management team in sales, marketing, strategy and technology will be the enthusiastic visionary leaders who will articulate and execute a new strategy of high level, comprehensive, expert advice. It is these high energy managers who are passionate about advice that will mobilize the resources of the firm around a new process management business model that will empower the Merrill Lynch financial consultant to compete on the basis of the values they address and manage.

TO BE A GLOBAL LEADER IN FINANCIAL SERVICES, MERRILL CANNOT EQUIVOCATE OR BE SECOND BEST IN "ENVISIONING" OR "RE-ARCHITECTURING"

Before the "re-architecturing" occurs that results in the "boundaryless organization," everyone within the organization must buy into process management and, in effect, change the firm's culture so that its organizational structure and technology can evolve from that of commission brokerage and product distribution to high level advice, adding value and process management.

Stan O'Neal and David Komansky, sometime later this year or early next year, will begin the "re-architecturing" stage which will be primarily driven by technology, as structure always follows technology. The four levels of technology which must be created to facilitate high level advice are:

1. a virtual real-time balance sheet and income statement incorporating all the client's assets and liabilities from all sources into one account;
2. a comprehensive investment process technology which empowers the financial consultant to address and manage all the financial values most important for the investor to achieve his long-term goals and objectives (see investment process series, *Senior Consultant*, April-September 1998);
3. an internet-based portfolio management technology that seamlessly ties the investment process to a virtual real-time balance sheet and income statement, to a trade and order routing and execution system, to reporting; and
4. investment methodology that assures the consultant will be adept at adding value through custom portfolio construction for each client.

To be a global leader in financial services, Merrill cannot equivocate or be second best in any of these areas. It requires pulling together the total, undivided commitment of the entire organization around high level, comprehensive, expert advice.

Merrill is the best firm in the industry in its ability to rally their troops behind a unifying idea. If Merrill sets its mind to it, they have no peer in the business in their ability to execute. Thus, David Komansky and Stan O'Neal embark on their history-making mission of reinventing Merrill Lynch, and in the process, reinventing the financial services mainstream. Advice will no longer be a function of each advisor's interest, knowledge and ability. Through process and technology, a very high level of comprehensive advice will be provided to the institutional and high net worth markets. This is because the new process management organization structure of the firm is designed to manage and facilitate high level, comprehensive, expert advice. Merrill will be literally empowering the brokers to compete on the basis of the value they add. This is the new advice business model. ■

Ph 804-795-1642 ■ Fax 804-795-7703