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SENIOR CONSULTANT

The Voice of the Investment Management Consultant

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Merrill Lynch Realigns Its Support Infrastructure To Facilitate Adding Value

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Why is it that most financial advisors and most financial services firms are quick to insist that they add value when, in fact, it is very difficult, if not impossible, for the financial advisor to add value?

As human beings, we are only capable of thinking in the three dimensional. If we try to think in the fifth or tenth dimension, it is not humanly possible to phantom 25 or 100 possible interrelated outcomes. So, today, if a financial advisor were going to advise 500 clients on one objective – retirement – and were to address and manage the six investment values of risk, return, tax efficiency, liquidity, cost structure and time, as required under UPIA and ERISA, and if the advisor were to use the 10,000 investment options at their disposal, each having at least 100 points of description, then in order for the investment advisor to add value, they would have to manage a three-billion-dimensional equation with nine quintrillion (yes, 18 zeros!) possible interrelated investment outcomes. Clearly, process and technology are required in order for it to be humanly possible for the financial advisor to add value.

Only recently has the industry come to the understanding that if we leave advisors to their own devices and limit ourselves to the three dimensional, there is very little, if any, value we can add. It has been the hope of adding value that has driven financial advisors to specialize in very narrow product and service areas Yet today, thanks to advances in process and technology, an extraordinary level of professional investment and administrative counsel can be provided, incorporating all financial products and services. This high level, comprehensive, expert advice that all investors desire is actually within the reach of all financial advisors.

The most difficult aspects of adding value have been resolved. There is a very specific six financial service investment process (asset study, investment policy, strategic asset allocation, manager search and selection, performance monitor, tactical asset allocation) required under UPIA, ERISA and MPERS through which the advisor is empowered to add value as well as four levels of very specific enabling technology (virtual real-time balance sheet and income statement; portfolio management technology to include subaccounting, trade and order routing and reporting; gating and portfolio compliance technology and investment methodology) that reduce the labor intensity of adding value. The remaining hurdle is the institution imperative to empower the financial advisor to add value; the financial services industry has largely left the financial advisor to their own devices in developing the processes and technology necessary to add value.

... THERE MUST BE BREAK-OUT INNOVATION, WHERE FINANCIAL SERVICES FIRMS REALIGN THEIR SUPPORT INFRASTRUCTURE SO IT IS CONSISTENT WITH THE INVESTOR'S AND FINANCIAL ADVISOR'S INTEREST IN ADDRESSING AND MANAGING A BROAD RANGE OF INVESTMENT AND ADMINISTRATIVE VALUES

This disconnect between the consumer and the financial advisor wanting value to be added and the financial services firm not supporting the financial advisor in adding value has resulted in only one-half of 1% of today's 750,000 licensed financial services professionals providing high level, comprehensive, expert advice. These 4,000 senior consultants who have pioneered the processes and technology necessary to add value are primarily focused on the very high end of the market, where the most discerning investors are and where the highest level of sophistication is required. Though these senior consultants advise 25% of all U.S. assets, there are not enough consultants to serve the 10% of all investors who have 90% of all investable assets. In order for these investors to be well served and value to be added, there must be break-out innovation, where financial services firms realign their support infrastructure so it is consistent with the investor's and financial advisor's interest in addressing and managing a broad range of investment and administrative values.

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There are firms that understand the strategic imperative of empowering their financial advisors with process and technology necessary to add value. In an industry that must assimilate many industry-redefining changes, in a marketplace looking for leadership, Merrill Lynch is providing a path for the rest of the industry to follow. Merrill wisely understands that there are only enough U.S. households (15 million) with more than $100,000 in liquid investable assets (where it is economically viable to provide fee-based advice) to support 75,000 of today's 750,000 licensed financial services professionals (assuming each advisor can serve 200 clients). By Merrill Lynch focusing on the 10% of investors who have 90% of all investable assets and by realigning its support infrastructure to empower its financial advisors to add value, Merrill Lynch is creating a new business model that will be widely emulated. Most importantly, by being first to market, Merrill will capture significant marketshare which immediately reduces the size of the advice market for those who follow. This supercharges the competitive business environment for the remaining marketshare among major firms who hope to compete in the lucrative high margin, high net worth and ultra high net worth markets.

In a brilliant series of moves conceived and directed by Stan O'Neal from the very top of the Merrill Lynch hierarchy, Merrill will triple its earnings multiple, significantly drive down its cost structure and empower its financial advisors to deliver an unprecedented level of professional investment counsel, by realigning its support infrastructure with the thesis of adding value. By leveraging through process and technology, Merrill Lynch will empower its brokers to address and manage a broad range of investment and administrative values as required under UPIA, ERISA and MPERS.

Seventy percent of Merrill's advisory programs and 95% of advisory program profits have been reassigned to Bob Dineen. Dineen will collapse Merrill's mutual fund and managed account programs into Merrill's Unlimited Advantage platform, creating the first product neutral, fee-based, consulting platform in the industry. This simplifies and streamlines Merrill's advisory service menu, drives down the firm's cost structure and refocuses the firm's support on the processes and technology through which Merrill will empower its brokers to add value. The old "consults (managed account wrap fee) program" investment process (client profile, manager search and selection, and performance monitor) will be greatly expanded upon by Doris Meister, who heads the Wealth Management Group and is responsible for evolving the process (the full six financial service investment process) and support infrastructure (including technology) necessary to serve clients with more than $10 million in investable assets. In times of extraordinary change, where commission brokerage rates have declined 53% since 1991 and the transparency of the internet making it clear that it is not possible to add value in a commission brokerage account, Merrill knows what has worked in the past will not work in the future, so Merrill is seizing the opportunity, blazing a path for others to follow. The strategic implications for the industry and the advisor are huge as Merrill refocuses the firm on assuming accountability for investment recommendations.

BY LEVERAGING THROUGH PROCESS AND TECHNOLOGY, MERRILL LYNCH WILL EMPOWER ITS BROKERS TO ADDRESS AND MANAGE A BROAD RANGE OF INVESTMENT AND ADMINISTRATIVE VALUES ...

In commission brokerage, it is simply not possible to add value through a series of disjointed unrelated transactions. This is because if one makes an investment recommendation without knowledge of all the investor's assets and liabilities, it is not possible for them to determine if the recommendation improved overall portfolio returns, reduced overall risk or enhanced the tax efficiency, liquidity and cost structure of all the client's assets as a whole. Merrill understands if their brokers are going to add value, they must be able evaluate an investment recommendation in the context of all their clients' assets and liabilities. They must accept clients as they come. Clients have assets in insurance contracts, in trusts, stocks and bonds, mutual funds, 401(k) assets, IRA rollovers, etc. Thus, wrap fee programs that only include mutual funds or managed accounts, that only have a small portion of the client's total assets, do not position the financial advisor to add value. Through the investment process (client profile, manager search and selection, and performance monitor) incorporated into the wrap fee program structure, thousands of financial advisors have learned the fundamentals of adding value. The invaluable contribution of wrap fee programs is that it is process, or what we do with the investment product, that adds the value – not the investment product itself. Thus, a narrowly focused mutual fund or managed account wrap fee program is like providing advice in a product silo, only adding value to the extent all the client's assets are in the mutual funds or managed accounts in those programs. In order to add value in the larger sense, Merrill has evolved its Unlimited Advantage Program which provides trade execution and reporting for an on-going fee, so it is now possible to incorporate all the client's assets into the investment process. This fee-based product neutral consulting platform will evolve over the next several months to include all assets, whether custodied at Merrill or not. Now, for the first time, it will actually be possible for a Merrill Lynch advisor to address and manage a broad range of investment and administrative values incorporating all their client's assets. This materially changes the relationship between the financial advisor and the investor.

The most profound implication of the Merrill financial advisor advising their clients on all their assets and liabilities, on assuming responsibility and accountability for all their investment recommendations, and on addressing and managing a broad range of investment and administrative values, is that the Merrill advisor is providing a far higher level of value and service than they performed as a commission broker. While the commission broker simply sold investments for a commis-

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sion without accountability for results, the Merrill Lynch advisor is accountable for results and is engaging their professional investment and administrative counsel for an on-going advisory fee. The commission broker is in a non-discretionary role where the investor is, in effect, acting as their own investment counsel. Because the investor does not buy or sell every investment recommendation in the amounts recommended, when recommended by the commission broker, the investor cannot hold the commission broker accountable for overall portfolio results. But, in engaging the professional investment and administrative counsel of the Merrill financial advisor for an on-going advisory fee, the advisor assumes discretion and responsibility for addressing and managing a broad range of investment and administrative values. The value proposition is simply whether the client prefers value to be added or not. The engagement of the trade execution services of a commission broker will cost the same as it does today, but the engagement of the on-going professional investment and administrative counsel of a senior investment management consultant would command a significantly higher fee than that of a commission broker. There is a different level of responsibility and a different relationship the financial advisor has with the client in acting as an investment management consultant. As a consequence, Merrill is developing "relationship pricing" which reflects the much higher level of service provided by the investment management consultant. Importantly, relationship pricing will also differentiate commission brokerage services from investment management consulting services. The new Merrill relationship pricing model will establish an entirely new compensation model for financial advisors industry-wide.

WHILE THE COMMISSION BROKER SIMPLY SOLD INVESTMENTS FOR A COMMISSION WITHOUT ACCOUNTABILITY FOR RESULTS, THE MERRILL LYNCH ADVISOR IS ACCOUNTABLE FOR RESULTS AND IS ENGAGING THEIR PROFESSIONAL INVESTMENT AND ADMINISTRATIVE COUNSEL FOR AN ON-GOING ADVISORY FEE

From the client's perspective, Merrill's move toward high level advice is welcome. In commission brokerage, it has always been "caveat emptor" or "buyer beware." The broker doesn't get paid until the investor buys something, thus there is great interest in the development and promotion of sales stories that promise extraordinary returns which will move clients to take action. Yet, the course of economic events that make an investment into a great sales story rarely can be perpetuated. Indeed, that is why the returns were extraordinary. What makes for a good sales story rarely makes for a good investment. Thus, the promise of extraordinary returns is rarely achieved. Not only is the broker's self-interest in earning a commission in conflict with the broker acting in the client's best interest, but the investor is required to exercise extraordinary judgment on matters with which they are not familiar. The client is far better served by engaging an advisor who is acting in their best interests, who is accountable for their investment recommendations, who is responsible for addressing and managing a broad range of investment and administrative values, who fully discloses all compensation assuring best execution and who fully discloses any and all relationships they may have with money managers. This level of service has become the standard modus operandi at the higher end of the institutional market and will increasingly become the minimum expectation for financial services providers who hope to compete for the high net worth and middle market institutional business.

Merrill's strategic plan could not position their advisors any better nor could it better position the firm. Because the capital markets value on-going advisory services revenues three times more than commission brokerage revenues, there is significant economic motivation for Merrill Lynch to empower their financial advisors to address and manage a broad range of investment and administrative values for an on-going advisory fee. The fact that commission brokerage rates continue to decline and that the transparency of account performance brought by the internet make it clear that little, if any, value is being added by commission brokerage, leaves little room for Merrill to conclude anything other than the firm's future must be in driving of as much of its client's assets as possible to toward fee-based advice and Unlimited Advantage. Presently, Merrill has a quarter of a trillion dollars of its $1.6 trillion in assets in Unlimited Advantage, and by the end of the next year, it will have a quarter of all the firm's assets in Unlimited Advantage. It is not a stretch for Merrill to have more than half its assets in Unlimited Advantage within the next two years. This would not only give Merrill a significant edge in market capitalization relative to its commission brokerage competitors, but it would give Merrill significantly lower operating cost relative to its commission brokerage competitors.

By leveraging its brokers through the process and technology necessary to add value, Merrill Lynch has to reconcile that its very expensive, highly layered, product management organizational structure is not conducive to adding value. The product management organizational structure is comprised of many autonomous product business units designed to help the financial advisor to sell a specific investment product-like mutual funds or life insurance or annuities. If the financial advisor wanted assistance in helping his client achieve their overall financial goals and objectives, no one could help the financial advisor cut across all the firm's product and service areas in construing an investment portfolio that addresses and manages the investment values necessary for the client to achieve their goals and objectives. The mutual fund department could only help the advisor sell mutual funds but nothing else. It was not anyone's job to help the financial advisor add value. Thus, Merrill's logic in moving to a product neutral advice platform was not just to focus on the process that actually empowers its advisors to add

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> *"Less is more."* – Miles van der Rohe
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> **Merrill will actually deliver far more value, at far less cost, at far richer margins, at a far higher multiple**

value, but to redeploy product distribution overhead of the firm in more productive ways for the advisor and the client. In the process, Merrill has found opportunities to significantly reduce overhead. Merrill can reduce its product infrastructure cost by 50% to 75% and far more productively redeploy those remaining resources through a process management organizational structure which empowers the financial advisor to add value. The net effect is Merrill is evolving toward a process management organizational structure from a product management organization structure. This will result in a significantly lower cost structure while empowering its financial advisors through process and technology to deliver an unprecedented level of professional investment an administrative counsel. As Miles van der Rohe once said, "Less is more." Merrill will actually deliver far more value, at far less cost, at far richer margins, at a far higher multiple.

It is a triumph for those of us who have pioneered investment management consulting, that Merrill is taking advice in a serious way into the financial services mainstream. Yet, for the many of us who have nurtured investment management consulting within the wrap fee program franchise of major firms like Merrill, this represents the end of wrap fee programs. The wrap fee program was the only means by which the concept of investment management consulting was kept alive within the major commission brokerage firms. But the reality is that investment management consulting is no longer a niche of the commission brokerage business but is the successor to commission brokerage. Sometimes you have to take two steps backward to take five steps forward. Many of the pioneers of investment management consulting, notably David Ferrier and Alan Sislen at Merrill, who headed managed account research and the entire managed account consulting initiative, respectively, have retired too young. David, Alan and Don Tabone (who ran managed account marketing for years) are Merrill's institutional memory for its much storied history in investment management consulting. In the 60's and 70's, Merrill Lynch and A.G. Becker vied for market leadership in institutional consulting. Merrill was second, and Prudential was third to A.G. Becker. In the mid-60's, Nobel laureate Bill Sharpe and many other pioneers of modern portfolio theory around which investment management consulting was built, were actually engaged by Merrill to train its institutional brokers before they became icons. John Roosevelt, FDR's son, developed the first performance monitor, PortWatch, at Prudential in the late 60's. ERISA was passed in 1974. In 1978, Merrill sold its institutional consulting business to SEI who had earlier bought A.G. Becker. David Ferrier actually left Merrill for six months, going to SEI and was brought back to start Merrill's retail consulting effort. (A non-compete with SEI kept Merrill out of the institutional consulting business for a while.) Many of the top institutional consulting firms today, to include Dick Charlton's New England Pension Consultants, go back to the days of Merrill Lynch's institutional consulting. The work of Alan Sislen, David Ferrier and many others who kept consulting alive at Merrill and other firms are now themselves revered figures in the industry for advancing the thesis of adding value to the point of it becoming the core business strategy of the firm. In doing so, investment management consulting became far more important than a niche business unit. They became so successful that the entire firm has assimilated the values, the processes, the technology and the ethic that is necessary for the firm to add value. The loss of Alan, David and many other pioneers in key leadership roles in the industry is a loss for the entire industry because the prospective they bring and the uncommon wisdom gained by their experience. We are about to enter a period of extraordinary change. Indeed, what worked in the past will not work in the future. In this environment, it will be clear who is adding value and who isn't, and the vision and skill set of Alan, David and other pioneers who know from whence the thesis of adding value has evolved will be crucial to taking the industry where it needs to go. Better than anyone else, these pioneers understand the inhibitors to innovation and how to evolve the commission brokerage culture.

Merrill Lynch, under the direction of Stan O'Neal, is boldly charting a new course which is aligning the full resources of the firm around the thesis of adding value through fee-based advice. Merrill's move to a product neutral consulting platform, initiation of relationship pricing, moving toward a process management organizational structure, constitutes the formulation of a far more attractive business model than commission brokerage. It offers higher earnings, margins and multiple with a lower cost structure, while empowering their advisors to provide an unprecedented level of professional investment counsel. Stan O'Neal's vision, leadership and dynamic execution make Merrill an industry leader. Given Merrill has more million-dollar producers than all other major firms combined and given Merrill's vision, there is no question that Merrill has become the undisputed leader in delivering high level, comprehensive, expert advice within the global financial services industry. This is why highly successful firms like Goldman Sachs view Merrill Lynch as their most formidable competitor. Ultimately, the competitive market stature of a firm is determined by the quality of their financial advisors and the values the firm empowers their financial advisors to address and manage. In realigning its support infrastructure to facilitate an extraordinary depth and breadth of professional investment and administrative counsel, Merrill forces the industry to respond in-kind. If investors prefer value to be added than not, then Merrill has positioned its advisors well relative to commission brokers as the Merrill advisor will become predatory in addressing and managing a broad range of investment and administrative values which are not possible for those in commission sales to address. This is leadership in its most powerful form. ■