

# SENIOR CONSULTANT

The Voice of the Investment Management Consultant

## Can The Managed Account Business Cross the Chasm Into The Financial Services Mainstream?

### Growing the Managed Account Business from \$0.5 Trillion to \$5 Trillion

*Stephen C. Winks*

**Editor's Note:** In a keynote address last week to the Managed Account Summit in New York, Stephen Winks, publisher of *Senior Consultant*, advanced a construct within which the managed account industry can grow from \$0.5 trillion to \$5 trillion and become a core mainstream investment product. This presentation has been widely acclaimed by leading figures within the industry who were in attendance. We hope you will find this presentation to be as provocative and timely as those in New York found it to be.

This is truly an extraordinary time to be in the financial services business. Consider the events that are unfolding.

1. Nobel Prize-winning investment theory is converging with advanced systems technology to empower you and your financial advisors to deliver an unprecedented level of professional investment counsel.
2. The transparency of the internet is making it clear to the investor that returns are actually being generated in their commission brokerage accounts, and for the first time, investors are beginning to understand who is adding value and who isn't.
3. In an investment environment that is devastating to commission brokerage, the only constituency of financial advisors who continue to grow their business at a double-digit rate are advisors who are capable of addressing and managing a broad range of investment and administrative values for an on-going advisory fee.

If you listen, the marketplace is trying to tell us something.

Reason with me for a moment. As human beings, we are only capable of thinking in three-dimensions. If we try to think in the fifth or tenth dimension, we cannot fathom 25 or 100 possible interrelated outcomes. Now put yourselves in the shoes of a financial advisor. Let's suppose you wanted to manage one objective – retirement – for 500 clients. You would

naturally want to address and manage the six investment values of risk, return, tax efficiency, liquidity, cost structure and time, as they are necessary in order for your clients to achieve their goals and objectives; and those six values are required to be addressed and managed under the Uniform Prudent Investor Act (UPIA). You would also likely want to use the 20,000 investment options at your disposal, each having at least 100 description points. In order for you to add value for those 500 clients, you would have to manage a 6-billion dimension equation with 36 quintillion (that is 18 zeroes) interrelated investment outcomes.

Clearly, today's financial product and service menu has become so mind-boggling that no one can understand it in its entirety, much less articulate it in terms a client would understand. Clearly, a process is needed in order to manage all this information in terms clients can understand so that

it is humanly possible for the financial advisor to add value. It has only been recently that the financial services industry has come to the understanding that if we leave the financial advisor to their own devices, if we limit the financial advisor to three dimensions, there is, in fact, little, if any, value that can be added.

If you listen, the marketplace is trying to tell us something .... The marketplace is telling us that all investors, whether institutions or individuals, want value to be added. You have to go no further than yourself as a financial services consumer to confirm this. Put yourself in the shoes of the investor. How would

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you react if an advisor were to query you, "Mr. Prospective Client, does your present financial advisor make their investment recommendations in the context of all your assets and liabilities? Because only then can they determine if their recommendations improved overall portfolio returns, reduced risk or enhanced the tax efficiency, liquidity and cost structure of your assets as a whole. If your advisor is not or cannot make their investment recommendations in the context of all your holdings, then it is not possible for them to add value. Has your advisor ever talked to you definitively about risk? Do you know if you're taking 150% of the market's risk for 50% of its return? Do you know if your assets are structured in an income and estate tax-efficient manner? There is an important trade-off between tax efficiency, liquidity, cost structure and performance that must be reconciled to your liking. Does your financial advisor fully disclose all their compensation from all sources and act on your behalf to aggressively manage the cost structure of your portfolio? Are you heavily exposed to mutual funds, insurance and annuities? Did you know mutual funds are at least three times more expensive than managed accounts, and ETFs and folios are just 60% of the cost of managed accounts? If you are heavily invested in high-cost mutual funds, insurance and annuity products, you might want to explore ways to enhance your portfolio's performance with lower cost institutional quality investment vehicles. Do you have an investment policy statement as required by the Uniform Prudent Investor Act?"

The point is that the open-ended questions raised by a skilled consultant adept at adding value to illustrate their relative ability to add value, are endless. And, in this market, it is open season on all investors. Very few investors have advisors who can address and manage a broad range of investment and administrative values. Thus, for financial advisors who are capable of adding value, in today's difficult investment environment every account is in play, even if your brother-in-law is your advisor. This is why advisors who are capable of adding value are the only constituency of financial advisors who are growing their earn-

ings, asset and client base at a double-digit rate, while commission brokers have suffered a 52% decline in earnings.

So, if you are one of the 5,000 financial advisors capable of addressing and managing a broad range of investment and administrative values as required under regulatory mandate, things could not be any better, even in today's difficult investment climate. These 5,000 financial advisors are arguably our industry's best and brightest. They have pioneered the processes, technology and methodology necessary to add value. They have made managed accounts their investment vehicle of choice. They alone account for 60%-70% of all managed account assets. But therein lies our challenge in growing the managed account

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business. Our ability to grow the managed account business is constrained by the number of advisors who are capable of providing high level, comprehensive, expert advice. Growth in the managed account business is a function of the skill of the financial advisor. It is not the financial product that adds the value; it is what one does with the product that adds the value.

If growing the managed account business were simply a matter of sales, then all the advantages of using managed accounts in portfolio construction would be lost, and managed accounts would just be another investment product sold on the basis of its return. We would lose the advantages of tax lot accounting that makes it possible for one to address the question of tax efficiency. We would lose the advantage of style discipline that allows us to manage risk and return in ways not possible with mutual funds. We would lose the advantage of a cost structure that allows us to

construct more cost-efficient portfolios and provides us with the latitude to be reasonably compensated for our professional investment and administrative counsel.

Don't get me wrong. Selling the "hot dot" is alive and well in the managed account business, but the "hot dot" is just one of a far larger range of values being considered. The reason why managed accounts have not suffered in this downturn like other products is that managed accounts are judiciously recommended by a highly skilled financial advisor, in the context of an all encompassing investment policy and strategy, designed to address and manage a broad range of investment and administrative values. The consultant is not selling anything. They are engaging their professional investment and administrative counsel for an on-going advisory fee.

The inherent value of managed accounts is that they allow one to address and manage values like risk, return, tax efficiency, liquidity and cost structure in ways not possible in mutual funds, and by extension, addressing and managing these values require the skill of the financial advisor. Thus, the success of managed accounts is tied to the skill of the financial advisor which, in turn, is tied to the process and technology necessary to add value. Therefore, the key to exponentially growing the managed account business is taking breakthrough technology that empowers the financial advisor to add value, from a small number of early adopters into the mass market of financial advisors. We are not talking about growing the industry incrementally at a 10% or 20% clip a year. We are talking about growing it 10-15 times in five years. Thus, if we are serious about growing the managed account business, we need to get very serious about creating much greater access to the processes and technology that would empower a far larger number of financial advisors to add value. We need to go from a small number (5,000) of early adopters who are capable of adding value to a larger number of financial advisors in the financial services mainstream who are capable of adding value. Thus, growing the managed account business is largely a technological issue. Virtually all of



today's successful consultants have had to create their own process and technology through which they add value. Virtually all the technology necessary to add value exists, but our industry has been very slow to adopt labor-saving technology, which empowers the financial advisor to add value. I am sorry to say the No. 1 performance reporting technology is the Excel spreadsheet. In this day and age of advanced technology, the financial advisor still has to create their composite performance monitors incorporating all the client's holdings by hand. Asset studies are done manually. Policy statements are done manually. The reason why all financial advisors are not adding value is not that they are not interested in acting in their client's best interest, it is because the labor intensity of adding value is daunting. If we could reduce the labor intensity and provide web-based access to technology that would make it far easier to add value, we could easily grow the managed account business from \$0.5 trillion in assets to over \$5 trillion in assets. Importantly, all this technology is within our reach today.

This idea of taking breakthrough technology that empowers the financial advisor to add value from a small number of early adopters to the mass market is the primary focus of venture capitalists and technology firms. Much has been written on the topic of taking breakthrough technology across the massive chasm that separates the small number of early adopters to a large number of users in the mass market, because the difference between a technology being worth billions and one being worthless entails one crossing the huge chasm between early adopters and the mass market. I encourage you to read a brilliant book on the subject entitled *Crossing the Chasm* by Geoffrey Moore. This is the bible for high-tech firms who want to cross the chasm between early adopters and the mass market. In *Crossing the Chasm*, Moore describes the differences between the visionary early-adopter and the pragmatic, early majority in the mass market. These differences tell us what our enabling technology should look like, if we are going to fully realize the potential of managed accounts and grow the industry from \$0.5 tril-

lion to \$5 trillion, and what the industry will look like as technology evolves.

Moore tells us that visionary early-adopters take pride in being first to see the opportunity to leverage breakthrough technology into a competitive advantage, but they are more interested in the associated breakthroughs in productivity and client service than in the technology itself. While the more pragmatic financial advisors in the mass market don't want to be first; they want to make sure everything works well and that there is plenty of market confirmation to establish the technology's usefulness. Visionary early-adopters are charismatic leaders who are redefining the industry, while pragmatic advisors in the mass market are followers who view themselves as cogs in a wheel and go with the flow. Visionary early-adopters build their technology from component parts; they don't expect standards to be established, procedures to be established, support groups to be in place or third party support to share the workload. Pragmatic mass market advisors expect all of the above. Visionary early-adopters want state-of-the-art

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