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High Net Worth Standards Initiative Established: Advisors To Develop Best Practices, Enabling Technology Fostered

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Do you feel you are alone, on your own, when trying to add value for your clients? If you are like most of us, you are. The financial advisor who would like to address and manage the values of risk, return, tax efficiency, liquidity, cost structure and time, as well as comply with the disclosure requirements mandated under the Uniform Prudent Investors Act for hgh net worth individuals, find themselves alone in their endeavor to add value. Though their supporting firms will gladly help with individual investment considerations, they are not structured to help the advisor in evaluating all their clients' assets as an investment portfolio. Yet, this is necessary in order to make it possible for the advisor to address and manage values like risk and return that the client can now actually track on their own. Thus, the burden of adding value is largely the responsibility of the financial advisor for, without support from their firm, it is only through their own initiative that it is possible for the financial advisor to add value.

Certainly any advisor can make an investment recommendation. The question is whether it is possible for the advisor to determine if their recommendation added value. In most cases, there is no means provided by their firms to do so. Only through the personal initiative of a very small number of financial advisors (the 5,000 investment management consultants who comprise just 2% of the 250,000 active advisors but who advise 25% of all U.S. assets), who are capable of working within the regulatory mandates of UPIA, ERISA and MPERS, is the industry fulfilling its fiduciary obligations. This is by design. The fear of supporting financial services firms incurring fiduciary liability from their advisors making investment recommendations has caused most firms to structure themselves as commission brokerage firms, where they can characterize any counsel offered as being incidental to their core trade execution business.

ONLY THROUGH THE PERSONAL INITIATIVE OF A VERY SMALL NUMBER OF FINANCIAL ADVISORS ..., WHO ARE CAPABLE OF WORKING WITHIN THE REGULATORY MANDATES OF UPIA, ERISA AND MPERS, IS THE INDUSTRY FULFILLING ITS FIDUCIARY OBLIGATIONS

Most firms deny that their advisors act in a fiduciary role, and thus their advisors' recommendations are simply making investors aware of investment opportunities. The ultimate investment decision is solely the investors. Though this *caveate emptor* ("buyer beware") approach to investing works well in a forgiving bull market, it does not work well in a less forgiving bear market, as advisors who solely rely on their firm's support are precluded from adding value. With today's prolonged bear market and with the increased transparency of account performance brought by the web, investors for the first time are beginning to see it is not possible for an advisor engaged in commission sales to add value. This has led to a loss in investor confidence in the financial advisor, the decline in commission brokerage rates and an unprecedented volume of litigation associated with failed investments and/or poor investment counsel.

In this difficult business environment, the only constituency of financial advisors who continues to grow their business at a double-digit clip are those advisors who can work within the regulatory constraints of UPIA, ERISA, MPERS and UMIFA to fulfill their fiduciary responsibilities. In today's very difficult investment environment, certainly every financial advisor wants to put their clients' best interests before their own, wants to address and manage a broad range of investment and administrative values required by regulatory mandate, wants to fulfill their fiduciary obligations and wants to add value, but without the necessary enabling processes, technology and support infrastructure, it is like trying to play golf without golf clubs.

The central issue in providing the financial advisor with the processes, technology and support infrastructure necessary to add value is finding a way for supporting financial services firms to manage fiduciary

liability so they will be comfortable in their advisors assuming fiduciary responsibility in engaging their professional investment and administrative counsel for an on-going advisory fee. This is accomplished by advice being defined in such a way that fiduciary liability can be managed and best practices assured. In the process, the financial advisor and their counsel are greatly elevated, and investor confidence is again restored. To that end, the Society of Senior Consultants (an affiliate of this publication), in concert with Dalbar, the Center for Fiduciary Studies, leading financial advisors, technologist and venture capitalists have created a high net worth standards initiative which will:

1. provide a framework to manage fiduciary liability,
2. establish best practices and a blueprint of technologies necessary to empower the financial advisor to add value, and
3. create a parallel group of technologists and venture capitalists who are interested/engaged in developing/integrating the technology necessary to add value.

This makes the concept of standards less of an abstract exercise because it leads to very concrete enabling technology which will facilitate a very larage number of financial advisors to add value and fulfill their fiduciary obligations.

From the prospective of technologists and venture capitalists, who are motivated to find commercial applications for technological innovations, the high net worth standards initiative is invaluable as it provides a blueprint for technologies which are essential for the financial advisor to manage fiduciary liability, execute best practices and reduce the labor intensity of high level professional investment and administrative counsel. The enabling technology necessary to add value is the ultimate commercial application as the technology is required by both regulatory mandate and consumer preference that value be added.

It is important to note that the sequence of the technology adoption cycle is 16% of financial advisors are early adopters, followed by 33% who are the early majority, followed by 33% who are the late adopters, followed by 16% of financial advisors who are laggards. The high net worth standards initiative blueprint which describes the technology that empowers the financial advisor to add value is the key for technologists "crossing the chasm," from early adopters to the early majority. This is the difference between a technology having a limited application to a technology becoming essential in order for one to be in busness. Thus, the strategic importance of the standards initiative cannot be overstated.

The industry's leading senior investment management consultants, who have taken the personal initiative to create their own processes and technology necessary to address and manage a broad range of investment and administrative values necessary to fulfill their fiduciary obligations, are the leading authorities on professional investment and administrative counsel. We are honored to have ten leading financial advisors, who have extensive experience working with the Uniform Prudent Investor Act, graciously agree to help develop standards for professional investment and administrative counsel for the high net worth and ultra high net worth markets. They are **Hugh Anderson** of Merrill Lynch, **Dick Smith** of Capstone Investment Group, **Guy Cumbie** of Cumbie Advisory (FPA chairman), **Harold Evensky** of Evensky, Brown and Katz (past chairman of the CFP Board of Governors), **Robby Hazzard** of Brock-Hazzard (leading architect of much of Salomon Smith Barney's consulting technology), **Bob Rowe** of Morgan Stanley (an authority on investment policy and investment methodology), **Rich Todd** of Innovest (former ICIMC board member) and **Jim Pupillo** of Salomon Smith Barney (the incoming president of APIC and former president of ICIMC, which is now IMCA). These advisors average well over a half-billion dollars under advisement.

> **TO THAT END, THE SOCIETY OF SENIOR CONSULTANTS (AN AFFILIATE OF THIS PUBLICATION), IN CONCERT WITH DALBAR, THE CENTER FOR FIDUCIARY STUDIES, LEADING FINANCIAL ADVISORS, TECHNOLOGIST AND VENTURE CAPITALISTS HAVE CREATED A HIGH NET WORTH STANDARDS INITIATIVE**

As a starting point, the standards initiative will use the Center for Fiduciary Studies' definitive research on what is required for one to fulfill their fiduciary obligation under the Uniform Prudent Investors Act, which cites the specific statutes, case law and regulatory opinion letters as supporting documentation to authenticate each of the 27 practice standards which have been established. The ten advisors who comprise the high net worth standards work group will establish best practices or the qualitative considerations of adding value that will go beyond the 27 specific requirements under UPIA, necessary for one to fulfill their fiduciary responsibilities to high net worth investors. For example, the advisor work group will determine best practices in the disclosure of all forms of compensation. The disclosure of all transactional costs would lead to the best practice of documenting best execution for each executed trade. Though this level of detail would be onerous for each advisor to monitor and manage, best execution is, in fact, a required fiduciary responsibility that is easily managed through technology, which would facilitate an automated level of reporting not possible today. Many of the fiduciary responsibilities that must be managed are largely structural in nature and deal with managing considerable detail and disclosure requirements that are best automated and managed electronically through expert systems.

This level of disclosure and the detail that must be managed, has led to the development of six financial services which, by design, complies with the previously referenced 27 practice standards necessary to manage one's fiduciary responsibility. (See "Center for Fiduciary Studies Proposes Practice Standards, SEC and DOL Very Receptive"), *Senior Consultant,* December 2000/January 2001.) Each of the six financial services (asset/liability study, investment policy, strategic asset alloca-

tion, manager search and selection, performance monitor and tactical asset allocation) adds value in its own right; but when aggregated into an investment process, they constitute the architecture of managing fiduciary liability and addressing and managing the broad range of values required under regulatory mandate. This is the architecture of professional investment and administrative counsel. In defining best practices which constitute professional investment and administrative counsel (establishing the qualitative considerations of one fulfilling their fiduciary responsibilities), there is a wonderful opportunity for technological innovation to create labor-saving technology. An electronic asset/liability study, an electronic investment policy statement, an electronic manager search and selection, an electronic performance monitor – all would manage fiduciary liability and empower the financial advisor to address and manage a broad range of investment and administrative values which would fulfill their fiduciary obligation and structurally incorporate best practices. By leveraging the financial advisor through expert systems, we greatly elevate the level of professional investment and administrative counsel provided, making it possible for a large number of advisors to add value and empowering them to execute at a level that would otherwise not be possible. Through technology, we can resolve fiduciary liability, access and competency issues. Importantly, the technology necessary to create an electronic asset/liability study or an electronic investment policy statement, an electronic manager search and selection engine, or an electronic (real-time) performance monitor is +80% developed as of this writing. The last 10% is where 90% of the value is derived for the financial advisor and where technology firms can fully capitalize on their work.

Pat Gardner at By All Accounts, using client permissioning, can reliably aggregate all a client's assets and liabilities within hours. Though this is not in real-time, it is possible for any advisor to have a point of reference to all of a client's holdings, thus making it possible for the advisor to literally add value. Pat Gardner has done 90% of the difficult account aggregation work necessary to create an asset/liability study. The 10% of the work that is missing are the analytics that can diagnostically evaluate the risk, return, tax efficiency, liquidity and cost structure of all the client's assets and liabilities as an investment portfolio, which represents 90% of the value to the advisor. It tells the advisor and their clients what the aggregated account information means. It establishes the "before" photograph or the base metric point from which the consultant can demonstrate and quantify the values they address and manage from that point forward. For early adopters, there is extraordinary value to be added, as most investment portfolios have significant room for improvement. Thus, the market application is massive, notwithstanding the fact that in creating an asset/liability study, one is fulfilling part of their fiduciary obligation (Practice Standards 1.1 through 1.6) as documented by the Center for Fiduciary Studies.

IN DEFINING BEST PRACTICES WHICH CONSTITUTE PROFESSIONAL INVESTMENT AND ADMINISTRATIVE COUNSEL ..., THERE IS A WONDERFUL OPPORTUNITY FOR TECHNOLOGICAL INNOVATION TO CREATE LABOR-SAVING TECHNOLOGY

Bob Padgette at Klein Decisions and founder of Mobius is very close to creating electronic web-based investment policy capability. Using conjoint reasoning and utility theory, Bob can mathematically quantify each investment consideration of each investor, much like medical diagnostic technology, so that the values to be managed are not only established but are ranked in how important each value is to each investor. This is a huge breakthrough in executing high level counsel. **Bob Rowe** of Rowe Decision Analytics has created an excellent documentational framework which creates custom institutional quality investment policy statement with legal opinions, establishing that the resulting portfolio is in compliance with the appropriate regulatory authority (UPIA, ERISA, MPERS, UMIFA). Rowe Decision Analytics has created 27 policy templates that can support a consultant engaging their services in each of the ten major market segments of the individual (mass, retail, high net worth, ultra high net worth) and institutional (defined contribution, defined benefit, public funds, profit sharing, foundations and endowments, Taft Hartley) investor markets. These technologies have a universal application. In outlining the role and responsibilities of the advisor, the client and the money manager, as well as the scope of the engagement, investment policy becomes the principal tool in managing fiduciary liability. In the face of unprecedented litigation now being experienced within the financial services industry (based on failed investments and/or questionable counsel), the wisdom of an investment policy statement has not heretofore been fully appreciated. Investment policy is essential to fulfilling one's fiduciary obligations (Practice Standards 2.1 through 2.6 and 3.1 through 3.6), as documented by the Center for Fiduciary Studies.

Gib Watson of Prima Capital is very close to creating an electronic manager search and selection process that incorporates mutual funds, ETFs, folios and managed accounts. BullRun Financial provides real-time attribution analysis and four investment methodologies that would give an advisor extraordinary judgment on the tactical repositioning of assets. Style-based attribution analysis develped by **Ron Surz** of PPCA, Inc. goes further to evaluate whether each manager's performance is attributable to skill or luck. What is missing is the incorporation of all investment vehicles to include stocks, bonds, trusts, insurance contracts and alternative investments, as part of the investment consideration so that clients can be accepted as they are, with whatever holdings they may bring. Much of this will be resolved with an industry protocol for data transfer (the virtual custodian as envisioned by Pat Gardner), which will make the investment consideration more transparent and data more transferable, fulfilling one's fiduciary obligation (Practice Standards 4.1 through 4.4) of providing unbiased objective counsel without self-imposed constraints, as documented by the Center for Fiduciary Studies.

We are very close to creating a web-based electronic process for each of the six financial services that comprise the investment process as required under regulatory mandate. Through these expert systems, the advisor is empowered to both manage fiduciary liability and to add value using best practices. If there were an electronic iteration of the investment process (electronic asset liability study, electronic investment policy, etc.) via the web, we would greatly reduce the labor intensity of high level professional investment and administrative counsel and provide unlimited access to the technology that would facilitate an unprecedented level of professional investment counsel. The challenge has been that none of these technology vendors knows what the others are doing, and none have a definitive vision of a complete technological solution so that there is no context to determine how all these technologies interrelate as one easy-to-use technology/system.

To foster this innovation, a parallel group of technology development and venture capital firms will be working in conjunction with the high net worth standards initiative. The standards initiative will, in effect, create a blueprint of the technologies necessary to manage fiduciary liability and to add value, utilizing best practices. Thus, the standards initiative provides the invaluable context for technologists and venture capitalists to understand how these technologies interrelate. This is important because technologists and venture capitalists would not have the practical occasion to fully understand what is required in order to add value; that is the domain and highly refined skill set of our industry's most accomplished investment management consultants. The parallel technology group has agreed to develop/integrate labor-saving expert systems that manage fiduciary liability and empower the financial advisor to add value, using best practices. These expert systems will reliably manage a level of detail that would otherwise not be humanly possible to manage by virtue of the body of knowledge and skill required and/or the sheer physical nature of collecting, evaluating, managing and reporting data. The parallel technology group to the standards initiative will also address other macro issues pertaining to advice, such as universal standard for data transmission via the web. This will dramatically reduce the cost of data aggregation, AIMR compliant reporting, etc., by assuring the reliability of the data transmitted. The technology group will also address the issues of technology integration into one user-friendly interface as well as data warehousing, client relationship management and AIMR compliant reporting. The advisor work group that will drive the standards initiative will have a dynamic interaction with the parallel technology group. The advisor work group will determine where technologies like Monte Carlo simulation fit. Is it a subset of the asset/liability study or the performance monitor, or both? Similar considerations will be weighed in evaluating real-time attribution analysis and style-based attribution analysis. If one views the asset/liability study as a reciprocal of the performance monitor, then both would use the same technology, incorporating Monte Carlo simulation, real-time attribution, style-based attribution, etc. Just as AIMR-compliant reporting will be used throughout, many of these technologies will be core tech-

nologies, becoming synonymous with high level counsel.

There is no constraint on the technology and venture capital firms that wish to participate. All firms that have an interest in creating web-based expert systems that greatly reduce the labor intensity of advice and elevate professional investment and administrative counsel are welcome. As of this writing, the firms shown in Table 1 have expressed interest in participating in the development of the processes and technology necessary to add value.

Table 1.
Firms Interested In Participating The Development of Expert Systems

Electronic Asset/Liability Study

- By All Accounts – Pat Gardner
- Adhesion – Glenn Walthall
- Yodlee – David Aufhauser
- Evare.com – Craig Welch
- I-Core – Mark Gresack
- BullRun Financial – John Michel
- PPCA – Ron Surz

Electronic Statement of Investment Policy

- Rowe Decision Analytics – Bob Rowe
- Klein Decisions – Bob Padgette
- Center for Fiduciary Studies – Don Trone

Electronic Strategic Asset Allocation

- Parametric – Brian Langstraat
- PlaceMark – Lee Chertavian

Electronic Manager Search and Selection

- Prima Capital – Gib Watson

Electronic Performance Monitor

- Market Street Advisors – Bevin Crodian
- BullRun Financial – John Michel
- Investment Score Card – Joe Maxwell
- CheckFree – Jamie Waller
- SunGard – Chad Battison
- Effron – Scot Kelly
- IAN – Russ Isaac
- PPCA – Ron Surz
- I-Core – Mark Gresack

Electronic Tactical Asset Allocation

- BullRun Financial – John Michel
- Rowpyn – Bob Rowe

The standards initiative facilitates the architecture of advice, establishing what is required to add value and fosters the technology that makes it possible to comprehensively address all the necessary values and reporting detail in such a fashion that it would constitute best practices. Providing unlimited access to this technology for a very large number of advisors is essential to elevate the financial advisor and the counsel they provide and to restore investor confidence.

The Progress Center and Dalbar also have very important roles to play in the high net worth standards initiative. The Progress Center and other web-based training firms close the loop by helping each individual advisor become truly outstanding by providing training (via the web 24/7) to develop the skills necessary to add value and to articulate the values they address and manage. Professional development is largely a function of the support infrastructure relied upon by the advisor and the technology accessible to the advisor, that empowers the financial advisor to manage details that would not otherwise be possible. For example, advisors do not have to be experts on tax planning, but through expert systems and support, they just have to be able to articulate the virtues of income and estate tax efficiency. By having access to expert systems and support infrastructure, the advisor can assure best-in-class counsel on managing assets dealing with income and tax efficiency in a most efficient manner. Thus, professional development is not necessarily an impediment in fostering the 140,000 financial advisors necessary to add value for the 14 million households that have more than $100,000 in investable assets where advice becomes economically viable. Much of the technical consideration can be structured in the enabling processes and technology. Empowering the advisor to address and manage a broad range of investment and administrative values need not necessarily be intellectually daunting, complex to execute or labor intensive, *if* the advisor has access to the right tools.

Dalbar, a leading institutional research firm, which has been very active in measuring client satisfaction for financial services firms, has worked with the Society of Senior Consultants in defining advice for the foundation and endowment market and the defined contribution market, and will also be actively involved in the high net worth standards. Dalbar is the only firm authorized by the SEC to create client-driven service ratings of financial advisors, which can be used in marketing without violating the SEC advertising rules. With standards in place for the high net worth markets, with the necessary processes and technology in place to add value and fulfill one's fiduciary obligations and with training being available 24/7 via the web, a new, far more dynamic value proposition is possible. The vision is that financial advisors who become adept at adding value can have an objective third party, such as Dalbar, survey their client base and rate client satisfaction on a 10-point scale against professional standards, as well as rate their client's perception of service. The advisor would, in turn, use that rating as a way to differentiate themselves from advisors who are not as adept in addressing and managing a broad range of investment and administrative values in the high net worth market segment as required under UPIA. Though we are years away from facilitating that level of professional investment counsel and measuring advisors and their support organizations on the basis of client/advisor satisfaction, it all starts with a definition of advice that is responsive to one fulfilling and managing their fiduciary obligation to their clients.

Several well-known national research firms have expressed interest in publishing white papers on the high net worth standards initiative which would define advice, define the enabling processes and technology, and address infrastructure issues pertaining to data transfer protocol and technology integration. No decisions have been made on which firm(s) would best articulate and disseminate the findings of the high net worth initiative.

The standards initiative is made possible in part by the generous sponsorship of Powell Johnson, LLC, a next-generation financial services organization based in Nashville, TN, which seeks to elevate the financial advisor and their counsel through innovation in advisor support. The high net worth standards initiative is an important laboratory for firms interested in supporting their financial advisors in engaging their professional investment and administrative counsel for an on-going advisory fee. All major financial services firms are invited to participate as sponsors, including firms whose advisors are employees and those whose advisors are independent contractors of support services.

Over the next 60 days, the high net worth standards intiative will be organized so that the process of creating standards can be more tightly orchestrated, and firms interested in sponsorship can be accommodated. The best practices standard will then be formulated over the ensuing 90 days, concluding in August. With the resulting technology blueprint, which will facilitate best practices and fiduciary liability management, the parallel technology group will then commence their work.

Today's difficult market conditions could not be more conducive to stimulating the interest of financial advisors to elevate the level of professional and administrative counsel they provide. The loss of investor confidence in commission brokerage and in the role of the commissioned broker, has led to an even more fundamental loss of public trust. Only by assuming our fiduciary obligations to our clients, where we address and manage a broad range of investment and administrative values as required by regulatory mandate, can we restore investor confidence and public trust. Times and circumstances are changing. Faced with overwhelming litigation associated with the market downturn that must be defended one investor at a time, there is not a compliance or legal officer in the industry that does not see the virtues of using regulatory mandated investment policy as a primary means to managing fiduciary liability. Thus, working within the regulatory framework of UPIA, ERISA, MPERS, UMIFA to define advice and to elevate the counsel of the advisor is a sound business proposition, both operationally and financially. A new dawn is coming. Let us all work together to elevate the stature and professional standing of the financial advisor. ■

Notes

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