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Wachovia-Prudential Merger Promises New Industry Leadership

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The merger of Wachovia and Prudential Securities into a new firm that retains the Wachovia name (and much of its management) has resulted not just in the creation of the nation's third largest brokerage firm but represents a new generation of industry leadership. Wachovia Securities is the fastest growing brokerage firm in the industry because, in a period of extraordinary change, it has become the most responsive firm in the industry to the changing needs of the financial advisor.

The industry has changed more over the past decade than it has in the previous 50 years. Over the past decade, commission brokerage rates have declined 60%, which requires brokers to be 2½ times more productive today just to maintain their earnings of a decade ago. In the second worse investment environment in history, we have also seen commission brokerage revenues drop 50% over the past three years. Thus, brokers find themselves having to be now five times more productive in order to maintain their earnings of a decade ago. With the transparency of the internet, it has become clear to the investor that their advisor has not been accountable for their investment recommendations, and investment performance has not been as promised. Without access to the enabling processes and technology necessary to add value, it is simply not possible for the commission broker to add value. Our industry's best clients are beginning to ask, "If no value is being added, why should I pay a commission broker hundreds of dollars for trade execution when it can be obtained for $10 or less, or even free?" This is why commission brokerage rates have declined and will continue to decline. The marketplace is telling us it will pay financial advisors handsomely, but only if they can address and mange a broad range of investment and administrative values as required under regulatory mandate. Though investor preferences have changed significantly, the financial services industry has been slow to respond. The industry is so married to the commission sales/product distribution model and to doing business the way business has been done that it cannot see that the commission brokerage model is out of sync with rapidly changing investor and advisor preferences. The irony is: The advisors who are adding value don't fit into the commission brokerage model, yet those same advisors who can engage their profession investment and administrative counsel for an ongoing advisory fee are the future of the industry. This implies change of an even more significant proportion is in order.

NEW FIRM TO DERIVE 75% OF ITS EARNING FROM RECURRING FEE REVENUES, WHICH WOULD GIVE IT DOMINANT MARKET CAPITALIZATION AMONG ITS COMMISSION BROKERAGE COMPETITORS

Wachovia has observed these extraordinary industry changes and views them as an opportunity. It has listened intently to the financial advisor and has become responsive to their needs in ways that will forever change the industry as its competitors cannot or will not respond in-kind. This has placed Wachovia in a leadership role that is conducive to it picking up significant marketshare. This represents a new generation of leadership in a rapidly changing business environment where what worked in the past has no bearing on what will work in the future.

In the mid-1990's Wachovia Securities' top management, Danny Ludeman (CEO), David Monday (Operations, Clearing and Correspondent Services), Peter Quinn (Private Client Group) and David Loeper (Strategy) started to listen to a new emerging group of financial advisors who were at or near the top of productivity at most firms. These advisors were typically working at the higher end of the market with individuals and institutions with substantial assets, where fiduciary responsibility was viewed more seriously. These advisors had cobbled together their own processes and technology through which they could address and manage the broad range of values required in order to fulfill their fiduciary responsibilities. They engaged their professional investment and administrative counsel for an ongoing advisory fee. Virtually all had developed their own support staff and thought of themselves as invest-

ment management consultants. They essentially were providing the same level of counsel as institutional consultants who served the $100+ million market, only they served clients with less than $100 million who otherwise did not have access to high level counsel. Many of these advisors worked at the major wirehouses, and they all shared a common problem. The technology they acquired and the staff they hired that made it possible for them to add value had to be paid for out of their 40% share of gross revenues, retained as their pay-out (compensation) from their firm. They were not using most of the services their firms provided that were geared for commission sales, and the services they needed were not available. They, in effect, had to incur twice the operating cost working within a commission brokerage firm and work far harder in order to add value for their clients.

Wachovia understood the asset base these advisors represented, saw the opportunity and had a brilliant response. They would attract these advisors with massive asset bases and massive recurring fee revenues by creating a new program called Profit Formula. Profit Formula unbundled the services of the firm and allowed the fee-based advisor to only pay for the services they used. This repricing of the firm's services allowed fee-based advisors to elect to pay for specific services like custody and clearing, and achieve a pay-out of as high as 80% which, in turn, would be redeployed to cover the cost of staffing and technology necessary for the advisor to add value.

Profit Formula made the old commission brokerage model look increasingly inflexible and out of touch. In fact, to this day, some firms view it as heresy to suggest that the commission brokerage model does not work for every advisor. Profit Formula introduced a new service culture to the industry. Advisors are treated as clients who are engaging the services of the firm rather than the all-too-often "take it or leave it" attitude of the industry. It also established that advisors with substantial assets could facilitate a far higher level of counsel and greatly increase their earnings by developing their own proprietary investment process (offering legitimate policy statements and performance monitors to incorporate all their client's holdings, etc.) rather than using product silo-focused wrap-fee programs geared to advice of the lowest common denominator. The investment in staffing and technology became a fixed cost, which was easily offset by the increased pay-out. Rather than paying the firm 90 basis points on all assets held within a series of unintegrated wrap-fee programs commonly available within the industry, many advisors found it was faster, cheaper and better to create their own processes and technology through which they added value. Clearly, in a dynamically changing business environment, innovation is required to keep the industry healthy, continually evolving and relevant to the changing needs and preferences of advisors. This is why Wachovia Securities represents a new generation of industry leadership.

THE PROMISE OF THE NEW WACHOVIA SECURITIES AS AN INDUSTRY LEADER IS NOT IN WHAT IT HAS DONE IN THE PAST, BUT WHAT IT DOES IN THE FUTURE

The promise of the new Wachovia Securities as an industry leader is not in what it has done in the past, but what it does in the future. The merger of Prudential and Wachovia into a new firm gives Wachovia the scale necessary for an industry leader. Wachovia increased its number of financial advisors and revenues by 50% without experiencing a corresponding increase in expenses. This is a feat the legendary Citigroup Chairman, Sandy Weil, would be envious; but unlike the Citigroup strategy of brilliantly managing its portfolio of banking, brokerage and insurance firms as detached financial assets, Wachovia Securities has not lost its focus on the changing investor and advisor preferences. Rather than refocusing on mobile home lending or another business unit when the brokerage industry is not performing well, Wachovia is focusing on building the leading brokerage firm in the industry by becoming as responsive as possible to the advisor's needs. Because all financial advisors are never at the same place in their careers, Wachovia doesn't just have one "take it or leave it" model, but five models that will accommodate all financial advisors, regardless of how the advisor may choose to grow professionally and build their business. The advisor will never have a reason to leave Wachovia because there is a better option in support or a better financial basis for their relationship with the firm. Wachovia offers the best combination of flexibility and pricing in the industry. If you are new to the business, do not have a well-grounded understanding of financial products or services and do not have an established client base, you can develop your knowledge and build a client base by working with the Wachovia bank branches serving the investment needs of the branch customer base referred to you by the branches you serve. Once you gain confidence in your product knowledge and your ability to work with and win new clients on your own, you can then transfer as an employee to a local branch of Wachovia Securities, taking your clients with you and profiting from your initiative in building your book of business as a commission broker. If you have grown professionally and want to offer a higher level of counsel than is possible in a commission brokerage firm, you can join their Profit Formula program previously discussed.

Profit Formula also works for commission brokers engaged in specialized business that does not use the full scope of services of the firm. If you build a substantial business, Wachovia will help you to create your own firm with your own shingle, and you can become a correspondent firm of Wachovia Securities. You would still have access to all supporting services, but you are responsible for all the administration and operation costs of the enterprise as a firm separate and distinct from Wachovia. Or, you could choose to join Wachovia Financial Network, an independent broker/dealer, where you are an independent advisor who engages the support services of Wachovia Securities, but in return for the higher pay-out you would have to pay for your own office and staffing expenses. In today's very difficult business environment, where many advisors are dropping below $300,000 in gross revenues, the economics of the independent broker/dealer model allow advisors with more than $150,000 in gross revenues to profitably rebuild their business without leaving the Wachovia support network. By

having your own independent office and your name on your shingle, you control your commute, your environment, and how you wish to build your business. Many advisors completely circumvent the commission brokerage model and choose to become fee-based advisors from the start, which is best done in the Wachovia Financial Network model because of its higher pay-out and operating latitude in how resources are deployed. By building a value proposition that is most responsive to the advisor's needs in a period of extraordinary change, Wachovia Securities is, in fact, fast becoming the leading firm in the industry by virtue of its direction, if not yet by empirical data.

It is important to note that Wachovia is not mandating that everyone somehow instantaneously move toward fee-based advice. That would be just as much of a "take it or leave it" proposition as some major wirehouses viewing fee-based advisors as heretics or the misfits they are in the commission brokerage model. The consumer will be the ultimate arbiter of whether they prefer value to be added or not. Wachovia just wants to make sure that for those advisors who wish to add value, that they can find an environment within Wachovia in which to excel. There is no question that investors will, in fact, prefer value to be added. The question is: "How does the industry elevate the level of counsel the advisor provides?" This is not something Wachovia can do for the advisor. The advisor must first want to add value and engage their professional investment and administrative counsel for an on-going advisory fee, and then they must become good at it. This is ultimately the area in which Wachovia's leadership has the most promise.

Up until now, Wachovia has created a financial model that provides highly skilled financial advisors the financial latitude to hire staff and acquire the technology that makes it possible for them to add value. However, the only way Wachovia can achieve its mission and have 75% of its earnings be derived from recurring fee revenues is if it institutionalizes the processes, technologies and methodologies necessary to add value, so it becomes possible for all its financial advisors to add value. Wachovia must find a way to help all its advisors to add value without requiring the advisor to be technologically astute beyond necessity or to understand all the technical nuances of fiduciary responsibility as well as industry experts. It is like asking a doctor to create an x-ray, a heart and lung machine, or a CAT scan for each patient in order to practice medicine. Advisors should not have to reinvent the wheel on what technology to use, or what should be in an investment policy, or how to pull all the client's holdings together in a performance monitor and/or an asset/liability study. This is leadership in its most tangible form, and it is the difference between an advisor being able to or not being able to add value. Yet, for the commission broker and the commission brokerage firm that is geared to facilitating trades in volume, not to adding value, the concept of adding value would make them just as much of a misfit in the new advice business model as fee-based advisors are in a commission brokerage model. However, there is a big difference. In creating the enabling processes and technologies necessary to add value in the new advise business model, it is still possible for advisors to engage in commission sales; but without enabling processes and technology, it is not possible for the fee-based advisor to add value in the commission brokerage business model. So, the democratization of advice that would empower all financial advisors to add value is the course of action through which Wachovia can, in fact, emerge as the leading firm in the industry. Accounts, assets, advisors, revenues and marketshare will soon follow. It is as simple as asking the investor whether their present advisor is adding value and doing an asset/liability study to determine if they are. Fortunately or unfortunately, depending upon your vantage point, most advisors are not adding value; and it is terribly easy to prove it.

The brilliance of the Prudential/Wachovia merger that is not talked about is that Wachovia obtained far more sophistication in the area of fee-based advice than previously existed. Judy Rice, who runs all the product areas at Prudential, invented the technology at E.F. Hutton that made wrap-fee programs possible, which were the genesis of fee-based advice. Prudential, as a firm, was the first to start a retail investment management consulting enterprise on Wall Street, before the better known E.F. Hutton. John Roosevelt, FDR's son, created the first performance monitor, PortWatch, at Prudential. Keitha Kenne is widely recognized as a leading figure in innovation in investment management consulting services. She is a leading advocate of a product neutral consulting platform so advisors can counsel and add value on all of a client's holdings, held both inside and outside the firm, rather than just the mutual funds the client holds in a mutual fund wrap-fee program. Janet Mariconti is leading the industry on the development of a standardized protocol on the secure transmission of data that will facilitate real-time information on any client holding — assets or liabilities, whether custodied in-house or not. Prudential Securities has the necessary industry statesmanship on fee-based advice to make Wachovia the leading firm in the industry. But does Wachovia have the will as it faces the same deeply entrenching bureaucracy steeped in commission sales as other firms? I believe it does and this is why.

The merger of Wachovia and Prudential requires the new firm to evaluate its component parts and to reconfigure itself. The evaluation will explore cost savings, which technologies are best, opportunities to improve advisor support and enhance the firm's market position. In the two firms morphing into one, there is the opportunity for extraordinary dynamics not usually welcomed unless by necessity. Yet, in this case, necessity may well be the mother of invention. If the new Wachovia Securities were to move from a product management organizational structure to a process management organizational structure by creating the processes and technology necessary to add value, it could cut its cost structure in half again, greatly enhance its earnings and margins, and grow its earnings multiple by a factor of three. (Recurring fee revenues are valued three times more than one-time commission revenues, in the public capital markets.) Importantly, by leveraging its advisors through processes and technology, it would empower its financial advisors to deliver an unprecedented level of professional investment and administrative counsel. If Wachovia's competitors could not respond in-kind, Wachovia gains dominant marketshare in accounts, assets, revenues and advisors because investors simply prefer value to be added. The market capitalization of the resulting firm would easily dwarf its commission broker competitors.

Is Wachovia the leading firm in the industry? In many respects it already is. But if by extension, it would just play to its strengths and take the initiative to empower its financial advisors with the processes and technology necessary to add value, it would not only elevate its financial advisors and the counsel they provide, but it would lead Wachovia to dominant marketshare and market capitalization. In periods of extraordinary change, what worked in the past has no bearing on what will work in the future.

Wachovia Securities is perfectly positioned for the extraordinary innovation necessary to respond to changing investor and advisor preferences and, in the process, could well emerge as the leading firm in the industry. If Wachovia were, in fact, to derive 75% of its earnings from recurring fee revenues, it would easily achieve dominant market capitalization among its commission brokerage competitors unless they, too, decided to empower their financial advisors to compete on the basis of the depth and breadth of the investment and administrative values they address and manage. ■

Notes

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