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Has the Value Proposition of the Financial Services Industry Changed?

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There is no question the financial services industry is experiencing its most difficult operating environment since the early 1970s. Back in the 70's, the deregulation of brokerage commission rates from 40¢ per share to 10¢ per share forced the industry to move from a largely manual process in the administration of trade execution to a largely automated process. Many of the legendary firms of the day, some with their roots in the previous century, found they could no longer run their business as a collegial partnership. The days of firms being run as socially well-connected old boys clubs were ending. The once lucrative partnership bonuses disappeared as firms found they could not hire enough administrative personnel to manually administer trade execution; they had to redeploy millions of dollars to automate when millions of dollars was a lot of money. The economics of the brokerage industry and its culture were forever changed. The industry was no longer the genteel gentlemen's business of old, serving the carriage trade of well-to-do clients with substantial resources. This was the beginning of the democratization of the financial services industry. A new generation of financial advisor was emerging, who was not necessarily of the privileged class and who would serve a very large and growing middle class with the affluence to invest.

THROUGH PROCESS AND TECHNOLOGY, WE EMPOWER THE FINANCIAL ADVISOR TO ADDRESS AND MANAGE INVESTMENT CONSIDERATIONS THAT ARE NOT OTHERWISE HUMANLY POSSIBLE TO ADDRESS AND MANAGE

Yet, the changes and operating complexities we face today are far more profound than those in the 70's. The industry of the 1970's, and even the industry we know today, is still fundamentally the same transactions-based commission brokerage enterprise of the 1840's, driven by trade execution and the ability of the financial advisor to execute those trades. The industry's fundamental value proposition has not materially changed; it has just become more automated. But from the automation initiated in the early 1970's, the subsequent advances in technology and the emergence of the internet, a far more robust value proposition has emerged that greatly elevates the financial advisor and the counsel they provide. Today a much higher level of professional investment and administrative counsel has become possible. By leveraging the financial advisor through process and technology, the typical financial advisor today can address and manage a broad range of investment and administrative values as required by regulatory mandate in order to fulfill their fiduciary responsibilities. Through process and technology, we empower the financial advisor to address and manage investment considerations that are not otherwise humanly possible to address and manage. This opens the industry to an entirely new competitive landscape, which is a once-in-a-lifetime marketing opportunity for those firms and advisors who choose to adapt to today's rapidly evolving marketplace.

Back in the 1970's, few would argue that the changes and efficiencies initiated through automation were not beneficial but an economic necessity. Yet, for those who were affected at the time, the changes were sufficiently radical that many firms and advisors chose not to adapt to the new realities of the marketplace. In doing so, these firms and advisors lost their will to compete. Look at the old tombstone ads of the underwriting syndicates of 25 years ago. Virtually all of the highly venerated, most prominent major bracket firms of 25 years ago no longer have a market presence today. The genius of the free enterprise system is that the consumer drives the marketplace and what the consumer wants is rarely denied. It should come as no surprise that investors prefer their financial advisors to add tangible, quantifiable value in terms they understand and that advisors who can address and manage a broad range of investment and administrative values, as required by regulatory mandate, have a huge competitive edge relative to those that can't. It may have taken a few decades for the automobile to render the buggy whip obsolete, but today we have the next generation of faster, better, cheaper computers every six months. In today's internet-based world, it's very difficult to keep secrets. The consumer will be served; either by us or someone else. Thus, our success as financial advisors and the success of the firms that support us is

directly tied to making sure the investor is well served. So, the question every financial advisor and every financial services support firm must resolve is whether executing trades for a commission is the advisor's or their firm's strongest value proposition.

The scale and technological innovation initiated in the 1970's, which has driven down trading and operating cost, is now being offered directly to investors. As a consequence, commission brokerage rates have declined 60% over the past decade, requiring the financial advisor to be 2.5 times more productive today just to maintain their earnings of a decade ago. Because of technological advances, investors are now finding it easy to enter all their holdings in a web-based account and, at no cost, obtain real-time analytics to evaluate how all their assets look as an investment portfolio. The transparency of the internet is making account performance and the quality of counsel increasingly clear to the investor. The investor is beginning to understand that it's not humanly possible for a commission broker to add value if they have no understanding of all the client's holdings as an investment portfolio and do not have access to the processes and technology necessary to add value. How can the commission salesperson add value if they cannot determine whether their investment recommendation improved overall portfolio performance, reduced its risk or enhanced its tax efficiency, liquidity or cost structure of the client's assets as a whole. If the advisor is not accountable for their investment recommendations and does not report on the range of values required and necessary for the investor's success, then there is no value that is being added. Can we fault investors for reasoning, "If no value is being added through 'full service' commission brokerage, why should we pay several hundred dollars to execute a trade when we can achieve the same result for $10 or less, or even for free?" This is why commission brokerage rates are declining in a free market and will continue to decline, to eventually approach zero. The transparency of the internet makes this a certainty. The business model of the 1840's, tied to commission brokerage, will eventually go the way of the buggy whip. This is how free markets work. It is not only a question of how the financial advisor can sustain themselves in a declining commission brokerage rate environment, but a question of whether the fundamental investment needs of the investor are being addressed as required by regulatory mandate. The convergence of events that are repricing commission brokerage rates and facilitating a higher level of counsel represent a far more formidable challenge to the industry today than the automation of the commission brokerage industry in the 70's. In the 70's, the industry automated the functionality of an established commission brokerage business model. In the first decade of the 21st century, we face the reality of creating an entirely new business model built around the advisor engaging their professional investment and administrative counsel for an on-going advisory fee. This is highly disruptive because a different skill set, technology and support infrastructure is required in order for the advisor to add value than to facilitate trade execution in volume. If advisors choose to engage their professional investment and administrative counsel for an on-going advisory fee, rather than charging a commission to execute a trade, then the technology, infrastructure and pricing of the organizations supporting financial advisors must change in radical ways as will what the advisor does on a day-to-day basis. The order of magnitude of this change doesn't just entail technological innovation; it incorporates a fundamental change in the industry's value proposition.

IT IS NOT ONLY A QUESTION OF HOW THE FINANCIAL ADVISOR CAN SUSTAIN THEMSELVES IN A DECLINING COMMISSION BROKERAGE RATE ENVIRONMENT, BUT A QUESTION OF WHETHER THE FUNDAMENTAL INVESTMENT NEEDS OF THE INVESTOR ARE BEING ADDRESSED AS REQUIRED BY REGULATORY MANDATE

Similar to what occurred in the 70's, many of our industry's most prominent firms and many of our most successful advisors will find this change to be so disruptive to today's conventional commission brokerage model that they will prefer the traditional commission brokerage model and, by extension, not be responsive to the most fundamental needs of the investor. Few would argue that the new emerging value proposition doesn't greatly elevate the level of counsel the investor receives or that the new fee-based advice business model is an economic necessity for the advisor. Nevertheless, the changes required will be radical, even more radical than in the 70's as all investors want value to be added. The consumer does not care how painful or disruptive it is for product-driven commission brokerage organizations to evolve to process-driven advisory service organizations. The investor just wants value to be added. Yet, because of the pain and disruption associated with a new culture, many firms will lose their will to compete. Thus, this translates into a once-in-a-lifetime opportunity for those who choose to compete because the investor wants value to be added, and it is not possible to add value in the old commission brokerage model. Over the course of the next several years, the entire financial services industry will be reordered around a new advice business model that, by definition, cannot and will not look even remotely close to the old commission brokerage business model.

As advisors, we are tempted to hope our supporting firms would not "get it" and evolve their technology, organization structure and pricing around a new advice business model because we would then only have to compete against a relatively small number of very capable advisors, rather than every advisor in the business. But because there are far more clients who want value to be added than there are advisors capable of adding value, this would not serve the investing public's best interests. Yet, the fact that large advisor support firms don't "get it" is indeed very conducive to advisors building very large fee-based advisory services practices. An advisor who is capable of adding value in a marketplace where the

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industry's leading financial services firms still have a commission brokerage culture, structure and technology, is like having a license to steal any client you wish. The flip side of that argument is the enhanced economies of scale, lower cost structure and skill development facilitated by a larger firm devoted to the new advice business model.

Economies of scale dictate that firms comprised of a large number of advisors built around the new advice business model will have a far lower cost structure, higher margins and better technology than individual practitioners can achieve on their own. These firms will have a vested interest in the processes and technology necessary to add value and will have the resources to be far more responsive in adopting new technological innovation. There are business models being formulated by electronic crossing networks (ECNs) which would provide unlimited product access as a means to attracting fee-based advisors and their assets to a low-cost custody, clearing and reporting platform for as little as five basis points. This would give an advisor a 60+ basis point pricing edge relative to advisors working within the cost structure of a "full service" commission brokerage firm, where advisors are employees and facilities management services are offered in return for 60%+ of the advisor's gross revenues. Neither the ECN nor the "full service firm" would offer the infrastructure or support necessary for the advisor to fulfill their fiduciary responsibility. The ECNs pay out would be 100%, like that of a Charles Schwab, because it would not act as a broker/dealer that would house one's brokerage licenses. This ECN structure which provides product access and custody, clearing and reporting would be best suited for advisors who are totally fee-based registered investment advisors. This ECN structure will likely be the structure around which the industry's largest self-sufficient advisory services practices, which have brought their technology in-house and have high-level technical and administrative capability, will be built.

Culturally, most advisors would like to associate and work with other advisors who share common interests. Half the fun is the collegial interaction and exchange that elevates and motivates all parties to a higher level of client service and, by extension, more assets under advisement. Thus, the most dynamic business environment would be a firm for advisors built around the new advice business model that both captures the economies of the ECN and offers the process (asset/liability study, investment policy, strategic asset allocation, manager search and selection, performance monitor, tactical asset allocation), the technology (see "How Do Our Industry's Top Advisors Continue to Grow Their Business in Today's Difficult Environment," *Senior Consultant,* April 2003) and the support infrastructure necessary to add value for 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, profit sharing, public funds, foundation and endowment, Taft Hartley) investor markets. This next generation firm would have a process management organizational structure that recognizes it is what you do with the investment product – or process – that adds the value, not the investment product itself. This process management organizational structure would be designed to support the

advisor in adding value and fulfilling their fiduciary responsibilities through the development and support of an investment process and expert systems for each market segment the advisor wishes to serve. Thus, the process management organizational structure designed to add value easily preempts and trumps the commission brokerage model in which it is not possible to add value by virtue of its narrowly focused product management organization structure. Importantly, because the process management organizational structure leverages the financial advisor through process and technology, the cost structure of the next generation firm with scale would be less than half that of the conventional product management organizational structure. Given that the earnings multiple of firms with recurring fee revenues is three times that of firms built around commission revenues, a firm of 500 advisors averaging $600 million under advisement would have a quarter of the assets of Merrill Lynch but about the same market capitalization. So, just as a new order of firms emerged with the reordering of the financial services industry in the 1970's around new technology and the democratization of product access via commission brokerage, a new order of firms will emerge in the 21st century as the industry is being reordered around fulfilling fiduciary responsibility and adding value through the engagement of the advisor's fee-based counsel.

The new metric, in addition to assets under advisement, will be marketshare by market segment. Many of the new industry leaders will focus on just one market segment, developing extraordinary expertise and capability in, for example, defined contribution plans, fostering very large marketshare. There would be very few advisors or firms capable of competing with the cost structure, expertise and value proposition of these firms. By extension, this makes it painfully clear that the financial services industry has not yet begun to market in the same sense as leading consumer product companies like GE. Through GE's famous Six Sigma Program, they continually focus on client satisfaction by honing and positioning the value proposition of each product. In the new advice business model, the advisor is just now being empowered to add value, so client satisfaction has been very difficult to measure. In the future, the threshold level of client service required to compete will be objectively assessed by third-party firms like Dalbar, which will establish client satisfaction ratings based on an objective audit of client perception against the execution of professional standards incorporating best practices and fiduciary responsibility. Dalbar has, in fact, been granted the authority by the SEC to develop client-driven service ratings by market segment that can be used by the advisor in marketing without violating the SECs advertising rules. An advisor, who earns a rating of eight on a ten-point scale in client satisfaction based on an objective audit of 40 defined contribution plan clients, is very likely to win many more defined contribution clients than advisors who are not as adept or who currently serve no defined contribution plan clients.

IT IS NOT ONLY TRUE THAT WHAT WORKED IN THE PAST WILL NOT WORK IN THE FUTURE, BUT WHAT WORKED IN THE PAST MAY WELL PRECLUDE ONE FROM SUCCESS IN THE FUTURE

Who will be the leading firms in the new advice business model? No one knows. But we do know that culturally, structurally and technologically all the leading firms in the industry today are deeply committed to the old commission brokerage business model. Some of these firms are irrevocably committed to commission brokerage, while others face the almost impossible task of re-engineering the entire firm around the new advice business model. This requires firms to be outstanding in areas that are totally foreign to their business today. It is not only true that what worked in the past will not work in the future, but what worked in the past may well preclude one from success in the future.

So, given the conflict in cultures, where does the market leadership come from? It could come from existing firms that can spin off a new firm built around the new advice business model with enough advisors to make it self-sustaining and autonomous with a totally different culture, structure and technology. The problem with this option is the remaining commission brokerage operations would be faced with a significant increase in cost and reduced margins that would eventually cause the brokerage firm to fail as brokerage commission rates continue to experience extraordinary downward pricing pressure.

The other option for market leadership is to create a next-generation firm around the new advice business model. Of course, in this option you, the advisor, provide the industry leadership as you shape the course of the next-generation firm. The first of such firms, Nashville-based PowellJohnson, has already emerged. It is well capitalized, run by Jeff Powell (former CEO of J.C. Bradford) and David Johnson (former Director of Research at J.C. Bradford), and has an exciting vision. PowellJohnson embraces the value proposition of the new advice business model. Because there are far more investors who prefer value to be added than there are advisors capable of adding value, PowellJohnson fills the leadership vacuum within the industry for advisors who are interested in fulfilling their fiduciary obligations and engaging their professional investment and administrative counsel for an on-going advisory fee. PowellJohnson is sincere about fiduciary responsibility and in elevating the financial advisor and the counsel they provide. They are sponsors of the High Net Worth Standards Initiative where the Society of Senior Consultants, along with the Center for Fiduciary Studies, Dalbar and leading industry advisors and technologists are defining professional investment and administrative counsel for the high net worth market segment. The technological blueprint created by the High Net Worth Standards Initiative will be invaluable to technologists in creating the technology necessary for the financial advisor to fulfill their fiduciary obligations, execute best practices and reduce the labor intensity of advice. There are tens of thousands of financial advisors who would like to add value for their clients, who understand the compelling logic of engaging their counsel for an on-going advisory fee and whose efforts are thwarted by the labor intensity of advice and/or their firm's fear of fiduciary responsibility. PowellJohnson seeks to answer those questions. Its major firm competitors cannot respond in kind to its value proposition because PowellJohnson is engaged in a different business enterprise with an entirely different value proposition than commission brokerage. And thus, by extension, there is no question that the financial services industry's value proposition has changed as there are now firms able to support the new advice business model.

Is PowellJohnson the next-generation firm? Only you can answer this question, because you are the marketplace. The only thing we know for sure is that in a free market the industry's value proposition has changed and that the investor/consumer is rarely denied, if one can delineate and articulate what they want. Given investors want value to be added, and given a different culture, structure and technology is required to support the financial advisor in adding value, PowellJohnson represents a significant breakthrough for the investor, the advisor and the industry. This changes the industry's value proposition, elevates the financial advisor and the counsel they provide, and begins the industry's evolution toward the fulfillment of its fiduciary responsibility. There could not be a better time to articulate a new value proposition tied to accountability and fiduciary responsibility. There are far more investors who want value to be added than there are advisors who are capable of adding value. ■

Notes

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