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There Is a Quiet Shift in Power to Fee-Based Advisors with Substantial Assets. Have You Fully Explored Your Options?

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The difference between our talents and our expectations is our ambition to better serve our clients in the engagement of our professional investment and administrative counsel. Our industry's vitality is largely an outgrowth of our interest as financial advisors in adding value and growing professionally. By our never-ending efforts to continuously improve our counsel, we grow professionally, enhance our value proposition, better serve our clients, advise more assets, make more money and elevate the industry. The financial services industry would find itself in a terrible state if its financial advisors were not continually searching for ways to enhance the depth and breadth of our counsel and the value we add. This is the reason why advisors are always ahead of their firms when it comes to adding value and why it seems our firms are always struggling to catch up.

THE DIFFERENCE BETWEEN OUR TALENTS AND OUR EXPECTATIONS IS OUR AMBITION TO BETTER SERVE OUR CLIENTS IN THE ENGAGEMENT OF OUR PROFESSIONAL INVESTMENT AND ADMINISTRATIVE COUNSEL

Though it is important for us professionally to add value, there has been a historical disconnect within our firms to support us in adding value. Historically our supporting firms have been agnostic as to whether we add value. Going back to the 1840s, the industry's primary focus has been trade execution and more recently, since the deregulation of commission brokerage rates in the early '70s, the emphasis has been highly structured product distribution – also to facilitate trade execution. The historical economic reality of our support firms has been whether investments are bought and sold in a sufficient volume to make the enterprise economically viable and hopefully profitable. Though it would be nice if value were actually added, it is not essential for the firms that support us. In fact, with fiduciary liability emerging as a significant issue in the early '70s, many supporting firms have gone to great lengths to diminish the role they play in assisting the financial advisor in adding value and in fulfilling our fiduciary responsibility. By maintaining that their advisors offer no advice and are just making clients aware of the investment opportunities available, the role of supporting firms has been largely limited to providing product access and trade execution services. Technically, the client must rely on their own counsel in making their own informed investment decisions. This puts the advisor in an untenable professional position of wanting to add value but the firm not supporting us in doing so. Our clients are most receptive to our counsel in helping them make informed investment decisions in the fulfillment of our regulatorily mandated fiduciary responsibility. Yet our supporting firms neither acknowledge fiduciary responsibility nor assist with the processes and technology necessary to add value.

So, if value is to be added and our fiduciary responsibility fulfilled, we as advisors have to personally elevate our counsel and thereby elevate the industry. We must have the business acumen to understand fiduciary responsibility and develop our own process through which we address and manage the full range of investment and administrative values. We must be technologically adept in developing and managing the supporting technology necessary to add value and fulfill our regulatorily mandated fiduciary responsibility. We must be astute enough to engage outsourced research and investment methodology that enables us to be adept in adding value through portfolio construction. In essence, each of us has to reinvent the wheel every step along the way in order to add value and fulfill our fiduciary responsibility. In this age of the internet, account transparency and technological innovation – this seemingly impossible task – has been made easier and is actually possible to execute. Every successful financial advisor wants to act in the client's best interests, wants to fulfill his fiduciary obligations, wants to address and manage the full range of investment and administrative values, wants to provide continuous and comprehensive counsel and wants to add value – and our clients

are eager for us to do this. The internet has torn down the cultural, technological and capital barriers to entry for financial advisors with limited resources, which have been so great historically that only a small number of our industry's most capable advisors have been able to execute high level counsel. Today, it is possible for you to bring in-house, within your practice, the professional staff, the processes and the technology necessary for you to add value and to articulate a value proposition that is preemptive to that which is possible within commission sales – and you can do this less expensively than what you are now paying your firm to participate in their wrap fee programs. This development will positively change your relationship with your firm. Rather than acting as a salesman or an employee with limited or no say-so in the resources made available, you are now the executive of an advisory services firm that has developed and is executing a superior value proposition which cannot be replicated if one is solely at the mercy of the resources and support made available by their brokerage firm. In the article "How Do Top Advisors Continue to Grow Their Practices In A Difficult Environment?" (*Senior Consultant,* April 2003, http://www.srconsultant.com/Articles/2003-04-Top-Advisors-Grow.pdf), we outlined in detail the economic viability and the specific technology and staffing required for one to develop this preemptive value proposition. We, as financial advisors, have always strived to elevate our counsel and value proposition. Today, our desire to be outstanding is no longer limited to the support our firms are willing to provide. The ability to create your own infrastructure within your practices changes our industry in many profound ways and creates extraordinary opportunity for those who embrace and foster innovation, to include the very firms that are presently supporting you. This does not necessarily mean you have to divorce yourself from your firm, but it does mean your firm must start treating you as a client and a constituent who has compelling options to consider. The balance of power has clearly shifted to the successful fee-based advisor with substantial assets. This is a positioning to which every financial advisor in the industry aspires. Consider the options and the changing dynamics of the unfolding competitive landscape.

Establish Your Own Independent Advisory Services Firm

If an advisor is going to engage their professional investment and administrative counsel for an on-going advisory fee and chooses not to engage in commission sales, the advisor no longer has to be licensed to sell securities or necessarily be affiliated with a brokerage firm. They just have to be a registered investment advisor (RIA) in order to receive fee-based compensation. Charles Schwab has built a massive business (Schwab Institutional) by (1) providing RIAs a 100% pay-out, (2) providing access to basic enabling technology (Centerpiece, etc.), and (3) providing access to the full array of financial products – all in return for the privilege of custodying the RIA's assets and executing trades at a discount relative to the major wirehouses. The RIA is neither an employee of Schwab nor does Schwab house their licenses. Schwab simply provides access to financial products and the basic technology

and administrative support that constitutes an outsourced back office for RIAs in return for trade execution at the high end of the discount brokerage range. The premium charged in trade execution is the equivalent to soft dollar compensation from RIAs to Schwab to offset the cost of product access and technological support.

Build Your Advisory Services Firm Within a Major Established Firm

Established advisor support firms like Wachovia Securities have unbundled their product and service menus for advisors who choose to pay for just the services they use. For the advisor who does not avail themselves to all the firm's services, a higher pay-out can be achieved and the difference can be redeployed into the staffing, process and technology not provided but which are necessary to add value. Thus, within an established firm, there is the latitude to bring in-house, within your own practice, the staffing, process and technology necessary to add value. This will increasingly become an option within all major firms. You are still an employee of Wachovia and have access to all its support, but have a wider latitude to execute.

> **VISION AND LEADERSHIP CANNOT BE OUTSOURCED AND FOR THAT REASON WE MAY BE ENTERING A VERY UNUSUAL PERIOD IN TECHNOLOGICAL INNOVATION WHERE FEE-BASED ADVISORS ACTUALLY HAVE THE EDGE RELATIVE TO THE INDUSTRY'S LARGEST FIRMS**

Become a Correspondent with Your Firm

Rather than be an employee of a major firm like Wachovia, you can remain affiliated with your firm and become a correspondent of the firm. By creating your own firm, you are no longer limited by commission brokerage compliance limitations, which may have precluded you from writing investment policy statements and other regulatory mandated deliverables. Of course, this independence reinforces our obligations to act in a prudent, legal, moral and ethical fashion because you are the business. As a correspondent, you would achieve a 100% pay-out, and simply pay your former firm to clear and custody your assets. One consulting practice with $2+ billion in assets just became a correspondent to their former firm because they wanted a better hedge fund menu and wanted to build better technical support in hedge funds, going beyond their support firm's menu and capabilities. In becoming a correspondent there was a seamless transition with no interruption in client service, but they gained the latitude to develop and gain access to capabilities in hedge funds that would not have been available to them as employees.

Pricing and Cost Structure of Support Firms

Offering technological support is only an advantage to advisor support firms, if their technology is best-in-class. If it is not, it actually detracts from their offering. Firms like Ameritrade, that have a higher trading volume, superior technology and a far lower cost structure to other discount brokerage firms like Charles Schwab, could easily become a major factor in the independent RIA space. They see Schwab's high cost structure and its exclusive, wholly owned Centerpiece technology, which is not web-based and does not have tax lot accounting, as Schwab's Achilles heel. By building links to best-in-class technology (Eagle, IDS) and by going to a fixed cost pricing mechanism for custody, trade execution and reporting, Ameritrade can become a high value added, low cost competitor to Schwab. If Ameritrade were to offer product access, custody, trade execution and reporting for the greater of a $25,000 flat fee (based on $100 million or more in assets) or 2.5 basis points, Ameritrade would out-Schwab Schwab. This combination of product access, superior technology and pricing would attract a good chunk of Schwab's 3,000 advisors who have most of Schwab's assets. Ameritrade would also become the best strategic ally of fee-based advisors who find they must aggressively manage custody, trade execution and reporting cost to control their profit margins. This triggers a chain reaction that reprices those services throughout the industry and plays to the strengths of firms that have the best web-based technology, lowest cost structure and massive scale. The scale of many of our industry's largest firms has been neutralized by their equally massive cost structure. As an independent RIA, if trading, custody and reporting cost can be reduced from 25 basis points to 2.5 basis points, you haven't just cut your cost by 90%, but you have raised your compensation by 22.5 basis points. This is $225,000 direct to your bottom line. A flat fee of $25,000-$50,000 is far more attractive than paying 60+% of one's gross revenues for product access, custody, clearing, reporting and facilities management.

Technology

In the new world of the internet, where old technologies and methodologies compete with the new, innovation is the most important and essential element to success. James McKinney of Harvard observes, "Brokerage systems are notoriously inefficient. In a period where systems cost are falling like a stone, brokerage systems cost are increasing. This is because brokerage systems are built to respond to particular needs but have no overall design in mind." It is universally accepted that a radical change in technology is required in the brokerage industry. This is why Morgan Stanley spent a billion dollars to develop its web-based Lydia Technology and why Merrill Lynch has engaged Thompson Financial to create their billion-dollar system. But if, as McKinney observed, the overall design was commission brokerage rather than fee-based investment counsel, the billion-dollar technology investment would add little value for fee-based advisors. It costs no more to build a system for fee-based counsel that is designed to add value than it does to build one that is designed for trade execution. It is just a matter of vision and leadership. Though it is possible for a commission broker to execute trades in the new advice business model, it is not possible for fee-based advisors to add value in a commission brokerage model. Vision and leadership cannot be outsourced and for that reason we may be entering a very unusual period in technological innovation where fee-based advisors actually have the edge relative to the industry's largest firms. This is because their vision and understanding of the process and technology necessary to add value is outside of the conventional trade execution technological mandate of the brokerage industry. Just as third world countries have bypassed stringing telephone lines and have gone directly to cell towers, it is very likely, with the industry's existing culture and organizational structure tied to commission sales and product distribution, that fee-based advisors can generate a far superior technological support infra- structure, including professional staff within their own practice with far deeper and broader capability than is possible with web-based trade execution technology, even if it does cost a billion dollars. In order for the technology of major financial services support organizations to be competitive, it must be designed to reduce the labor intensity of the advisor adding value through the engagement of their counsel, and must facilitate the advisor to fulfill their fiduciary responsibility and to execute best practices. This would require the culture, structure and technology of major advisor support firms to be built around the new advice business model, a radical transformation not likely to occur.

Clayton Christensen of the Harvard Business School noted in his best selling book, *The Innovator's Dilemma,* "Under traditional planning processes, it is impossible to justify enormous investments to compete in emerging, yet-to-be profitable markets. Investing in disruptive technologies is not a rational financial decision for established companies. But by the time the new markets are large and profitable enough to justify the investment, it is already occupied by deeply entrenched competitors." Ultimately, the spoils of the advice revolution will go to the innovators. Innovation is not easily achieved by established firms, thus what we are experiencing is Christensen's "innovators dilemma." This argues in favor of advisors bringing within their practice their own process, technology and the professional staff necessary to add value.

It is important to note that compelling technology actually exists today, but access is typically denied by firms because of its cost, not because of its application. Yet advisors who find these tools mission critical have no difficulty in spending $5,000 or $75,000 where their firm's consideration is in the tens of millions of dollars, even with selective advisor access. If adding value is the advisor's primary focus, then a far higher value is ascribed to enabling technology by the advisor than would be ascribed by their firm.

Next Generation Support Firm

The challenge the advisor faces in bringing supportive technical and professional resources in-house, within their practice, is similar to that of their firm – which is vision and know-how. Ultimately, the advisors' capabilities will be constrained by their own vision and knowledge of process and technology as well as the outsourced product access, custody, trade execution and reporting capability they engage. Virtually all financial advisors would much prefer to leverage through best-in-class process, technology and support infrastructure provided by a third party than to have to create and/or manage it on their own, as there is a never-ending need for continuous innovation. Because there are no commission brokerage firms structured to support advisors in fulfilling their fiduciary responsibility and to execute best practices in adding value in each of the ten major market segments of the individual and institutional investor markets; it would seem a group of highly accomplished enterprising advisors would collaborate to create such an organization within their city/market area or, even better, a national firm would be created to provide acces to best-in-class process, technology and support infrastructure. Nashville-based Powell Johnson has such a mission and with their first offices being billion-dollar consulting practices in major markets, they are off to a good start. There is no reason why the financial advisor has to reinvent the wheel every step along the way. If our clients want value to be added and advisors are compelled by regulatory mandate and moral imperative to fulfill their fiduciary obligations and act in their clients' best interests, clearly a different culture, organizational structure and technology is required than that embodied by commission brokerage. The early adopters are indeed able to fully exploit their preemptive value proposition in addressing and managing the full range of investment and administrative values relative to those engaged in commission sales.

Conclusion

There is no question fee-based advisors, who are capable of working within the regulatory mandates of UPIA, ERISA, UMPERS and UMIFA, are shaping the course of the larger financial services industry. The industry's evolution is in the hands of pioneering advisors who can see beyond the lowest common denominator of commissioned sales. Over the next several years we will advise more assets, execute a far higher level of counsel and make far more money than we ever dreamed of, if we just choose to avail ourselves to the resources and support that is emerging. ■

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