

Phoenix(s) Rising

Wealth Management Trends Emerging from the Financial Crisis

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Since the capital markets turned upside down about a year ago, long-lived U.S. investment banks have disappeared (anyone remember Bear Stearns?) while formerly strong and independent investment houses such as Wachovia and Smith Barney have become neither. Business on, maybe off, the Street is not the same.

This fundamental rearrangement of the U.S. financial services industry is stressing firms and advisors up and down the line, putting all sources of income under pressure and squeezing all manner of margin. Commission income is down, asset management fees are down, revenue from product companies is down. These conditions are requiring everyone in the business to take a serious look at how they do business.

It's reasonable that more than a few firms and a good number of advisors are still in peril. In other words, many that were in the investment business six months ago are not going to be in it six months from now. The survivors will be the fittest: those companies and advisors that—despite the complexity, confusion, and uncertainty of this marketplace—carefully assess the landscape and move forward with a smart strategy. That strategy will not rely on reputation, sheer size, or brand but on the quality of product, advice, and service offered. These are all good things for investors.

Setting aside the inevitable pain that comes with this transition, I think the result will be a stronger, much leaner industry. We're in the early stages of this evolution, but a number of distinct strategic developments are shaping a new order for the wealth management industry.

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There'll Be Fewer Advisors ...

When major players such as Merrill Lynch & Co., Inc. and Wachovia can't survive on their own—the former now acquired by Bank of America Corp., the latter absorbed by Wells Fargo—and Smith Barney and Morgan Stanley are left to create a joint venture, advisors know the brand-name brokerage world is hurting. For many, the thrill simply is gone—and ultimately they may be gone, too, either to another broker-dealer or to head out on their own. A growing number are “selling” their books upstream; others are leaving the business altogether.

At the same time, though, good financial advice is needed more than ever. And that means the demand for top-producing advisors will be stronger than ever. It's logical that a successful advisor, after years of working for a big corporate firm, very well may want to take control of his or her own destiny. The result likely will be a dramatic dislocation of good advisory talent away from what's left of the big brands.

To their collective credit, wirehouse firms are stepping up with aggressive retention package offers and improved payout ratios. But the trend toward independence is already in motion. Independent broker-dealers such as Commonwealth Financial Network and

Raymond James Financial Services Inc. are indicating record levels of interest from brokers and advisors, a good number, I suspect, weary of bad press and tarnished brands.

All of this favors the industry's most productive advisors. Lesser producers are likely to be increasingly deselected from the population through reduced payouts and declining income. Many broker-dealers are downwardly adjusting compensation formulas, and they're differentiating more between low production and high production. It's probable these payout models will shift to become even more differentiated and to reward even fewer advisors doing the specific kinds of business that particular broker-dealers want.

One way or the other, fewer investment professionals will be delivering nonproprietary product to the marketplace. That means the recruiting environment is ripe for certain regionals, independents, the private bank model, and boutiques. Nimble players will benefit. So will their customers.

... and Fewer Firms ...

Meanwhile, wealth management firms up and down the scale are feeling the pinch of declining revenues. Since the stock market peaked in October 2007, company



executives and their reps have watched assets and fees dwindle, with many facing a drop of 20–40 percent in revenue that roughly corresponds to the S&P 500's decline of 40 percent through the end of 2008. It has to be worse for those operations that made risky bets in subprime mortgages, private partnerships, and the like. They're not only looking at a loss of cash flow but the strong likelihood of stepped-up regulation that will require heavy investment for compliance.

All in all, plenty of firms out there may need a lifeline. Of the 5,000 or so firms registered with the Financial Industry Regulatory Authority (FINRA), around 90 percent are considered "small," meaning they have fewer than 150 employees and less than \$50 million in assets under management. At least half of that group could be described as "micro," with 10 or fewer employees. Surely, these smaller independents are realizing that they need scale to survive. The result likely will be a rash of deals involving firms that desperately need capital. As the number of sellers grows, the number of buyers surely will consolidate.

In the end, the firms that survive will be those that are well-differentiated from the competition and capable of attracting and retaining talented investment professionals. Firms unable to distinguish themselves are going to have a difficult time in this market. It will get more difficult as firms try to find their roles in an evolving more competitive industry.

But this isn't really about size. There's likely to always be room for small niche players, really large firms that can (or try to) be all things to all people, and those in the middle. The good bet's on the middle. Mid-sized firms tend to be large enough to fund infrastructure but small enough to stay focused on what they and their advisors do best.

... Dealing with Intense Regulation ...

Washington has assumed a dramatically expanded, and likely permanent, role in the business of financial markets.

Policy makers and the Obama administration have attempted to stabilize the monetary systems, support individual companies whose failure might pose systemic risks, and prevent a deep economic downturn. I've no idea how well Washington will work with the Street to develop effective regulatory and monetary policies, or what those responses may mean for the long-term health of the global capital markets, but major structural reforms are on the horizon.

While the true extent of reform remains to be seen, executive pay caps and uniform advisor standards are just the beginning. The summer Department of Labor-Securities and Exchange Commission hearings on target date funds understate the pressure on elected officials to scrutinize the financial services sector. Bank oversight, risk management process, and hedge funds are likely to be on regulators' radar. For firms operating under this scrutiny, the value of self-policing and well-designed best practices procedures

in the next year or so, no matter what happens with the market.

... through Open Architecture

The great, and I hope permanent, takeaway of this market meltdown will be an enduring appreciation by investors and advisors for objectivity, quality, and broad diversification in their portfolios. The upside, in other words, will be the complete and final migration from proprietary-only platforms to open architecture. In-house offerings and programs will still have their place, of course, but from here they'll succeed or fail on investment merit—not marketing.

If nothing else, the one-size-fits-all model has been put to rest. I can't imagine that any survivor of the recent mayhem will be satisfied with having someone simply sell them a product. Today's and tomorrow's investors will be looking for comprehensive solutions to their unique financial problems. And they've realized that conflicts of interest too often occur when financial institu-

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cannot be overstated. Three general guidelines to consider, especially regarding fees and investment processes, include the following: increase disclosure, increase transparency, and avoid conflicts of interest.

More regulation may result in some good, but advisory firms will need to adjust for the impact on their businesses. For smaller firms reeling from plummeting fees and shrinking revenues, increased compliance costs may wipe out any remaining profits. Those without a capital-rich corporate parent, or a capital cushion, will have to find one or risk going under. I suspect lots of firms will be looking to offload most of this new regulatory burden on a partner

tions offer only proprietary products, or when analysts are pressured to appease their firms' investment banking departments. Informed objectivity, in other words, will be the key to meeting investors' needs for intelligently diversified portfolios, quality investments, and quality advice.

Open architecture is the only intellectually honest approach to that end. Open architecture opens clients' options to best-in-class money managers, at the same time ensuring that their advisors remain unbiased. The better platforms go even further by looking beyond simple performance and emphasizing qualitative due diligence and process.

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Forward-thinking firms already are creating “investment strategy teams” to access collective expertise in answering clients’ concerns, even if those solutions are not under the institution’s in-house money management umbrella. Open architecture, if unchecked, can be unwieldy if platforms are allowed to become supersaturated with investment products. Vast numbers of products don’t necessarily translate into growing, profitable wealth management businesses because resources are required to support these products operationally and with research, monitoring, and risk management.

All of this takes expertise and a good number of research tools, but those financial institutions that submit to an open architecture investment philosophy are ready to take their businesses

to the next level. Due consideration also should be given to other important industry trends such as goal-based planning, fee transparency, and holistic portfolio-level advice. The result, I think, will be a new—and improved—definition for the term “trusted advisor.”

This disorder, unpleasantly enough, has temporarily leveled the wealth management playing field by flattening the features of the players. In the short run, this collapse of distinction opens the competition for affluent investors in a meaningful way to a whole bunch of non-Wall Street sorts such as financial planners, CPAs, lawyers, insurance agents, and bankers. And that’s not a bad thing—competition always strengthens the species. But I’m confident that quickly enough—say, in the next year or two—new wealth management leaders

will emerge. They will have demonstrated the most flexibility and the most awareness and they will have survived. And the result will be a stronger, and much leaner, industry. And that’s probably good for investors. 

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