The Opportunity in the Independent Financial Advisor Channel

From the days of the Buttonwood Agreement in 1792, people have earned a living by providing investment guidance to individuals. Through the 1990s, those people were overwhelmingly "registered representatives" of broker-dealer firms, and their role was primarily that of salesman. Brokerage firms were regarded as distribution channels for financial products of all types, including new issuances of securities to raise capital for companies and governmental entities. The nature of the business was transactional, and revenue was generated by commissions charged on those transactions. Registered representatives typically operated independently, supported only by a sales assistant that was often a shared resource. Support for registered representatives came from research done on individual debt and equity securities, from product marketing groups providing due diligence and strategies in mutual funds, limited partnerships, options and commodities, and product origination groups such as corporate finance, public finance and syndicate. Financial advisors tended to offer their clients those products that they knew best.

In 1995, the SEC formed a committee chaired by Daniel Tully, chief executive officer of Merrill Lynch, to explore compensation practices in the industry. The Tully Report, as it came to be called, highlighted the conflict of interest inherent in a transaction-based revenue model. Instead, the report advocated a fee-based system in which revenues would be based on fees on assets under management. The logic was that fees only increased when asset values increased, thereby linking the advisor's success to that of the client.

The impact of the Tully Report was significant as it drove changes in compliance and compensation practices. Many experienced advisors chafed at the changes, viewing them as needlessly restrictive. Beginning in 1998 and 1999, many of these financial advisors began leaving the wirehouse firms to start their own firms. Some opted for hybrid registration as both broker-dealers and registered investment advisors. Some went all the way to "fee only" as RIAs. Most of the independent firms have remained small. According to Cerulli Associates, there are approximately 30,000 RIAs in the U.S. and they have an average of two financial advisors.

The second regulatory change that shaped the financial advisory business came in 1998, when Citibank merged with Travelers Group in clear violation of the Glass-Steagall Act, which prohibited any one institution from owning any combination of banks, investment banks and insurance companies. The following year, the Graham-Leach-Bliley Act was passed, revoking Glass-Steagall. This led to massive consolidation, most often in the form of banks acquiring investment firms. All of the wirehouse firms are now part of banks, as are many of the large regional investment banking and brokerage firms.

The changes wrought by these pivotal regulatory shifts have driven new client service models. Financial advisors migrated away from selling select products to their clients and toward a holistic approach to managing the client's wealth. The advisory role split into two distinct paths, based on the strategies of their firms.

Banks seek to capitalize on their considerable resources, and the client service model is to market those capabilities to the client. The financial advisor role in those firms has morphed from salesperson in a distribution system into one of relationship manager.

The FA's job is to maximize the firm's "share of wallet" with his clients by cross-selling, and he does this by introducing product specialists in areas such as mortgages, alternative investments, insurance, trusts and lending. This model makes sense for the institutions, and it is attractive for certain clients and financial advisors.

Meanwhile, the client service model in independent firms today is a high-touch, consultative model based on financial planning and investment management. There is wide variance in the expertise and sophistication of client service offerings across the independent firm landscape. Financial planning capabilities may be as simple as software programs, but in some firms, financial planning consists of certified financial planners with subject matter expertise in trusts and estates, multi-generational planning, life insurance analysis, and health insurance, including Medicare. Sophisticated financial planning capabilities allow financial advisors to provide value-added advice throughout a client's life. Investment management capabilities have a similarly broad range. Some independent firms primarily deploy fund managers and exchange-traded funds in client investments, relying on their custodian firms or other information services to provide due diligence and research. Others have chartered financial analysts doing their own manager and ETF research, as well as managing model portfolios of individual securities.

The role of the financial advisor in these two models, large, bank-owned firms and small, independent firms could not be more different. In 2014, Cerulli Associates reported that the average age of financial advisors was 50.9. This means that the average financial advisor began his or her career when the role of financial advisor was that of a salesperson in a distribution system. From that same initial role, some financial advisors have evolved into relationship managers in the "bank/wirehouse" model while others took the route of consultative advisor. Despite their common origins, it would be extremely difficult for either advisor type to switch to the other at this point.

In addition to differences in advisor roles, there are sharp cultural and philosophical differences that make such switches all but impossible. Simply put, advisors in independent firms treasure their independence above all else. Given the average advisor age and the typical independent firm tenure of 18 to 20 years, such advisors are extremely unlikely to join large firms.

Regional firms operate in the landscape between the large, bank-owned firms and independent firms and have features of both. Regional firms typically afford advisors a degree of flexibility in client decisions, but they have most of the large firm resources, should advisors opt to cross-sell them. Certain of the regional firms are known for strong corporate cultures and their support of their advisors, making them attractive to advisors who eschew the large firms but chose not to take the risks associated with independence.

In addition to demographics, the bifurcation of the advisory role, and cultural shifts, a lingering industry custom affects financial advisor behavior in all type of firms. Harking back to the decades of financial advisor as salesperson in a distribution system, the industry created a star system that celebrated successful advisors. Advisors were often ranked in terms of their production – "he's the number one producer in this office", "she's in the top five producers in this state". In the 80's and 90's, it became common for top financial advisors to develop a brand name for their teams within the context of the larger firm; e.g., the "Smith Group" at Morgan Stanley. This industry star system acknowledged a fundamental truth, which is that clients tend to be loyal to financial advisors and not to firms. Industry data shows that when a financial advisor changes firms, 95% of the client base moves with him within 18 to 24 months. The combination of that fundamental truth and the star system has created a problem for firms, as their biggest revenue generators are vulnerable to recruiting efforts from other firms and to the possibility of independence.

Given these complexities and dynamics, prospective entrants into the financial advisory business might be daunted. The reality is that the opportunity couldn't be greater.

First, there is the inexorable march of time. Cerulli Associates estimates that 41% of financial advisors in the U. S. are over age 55, with 33% in the 45 to 55 age range. Advisors between 35 and 45 comprise 16% and only 10% are under 35. There are two obvious takeaways from this data: a huge percentage of advisors are likely to retire within the next 15 years, and there is likely to be a shortage of financial advisors when that occurs. Herein lies the opportunity.

As the Old Guard retires, the "advisor as rock star" will retire with them. The current advisor model in the large, bank-owned firms still rewards and reveres the most successful revenue generators, but the very nature of the model itself – relationship manager providing access to and from the firm's experts – minimizes the importance of the advisor in favor of the importance of the firm. Similarly, the high touch advisory model in independent firms necessitates continued migration from the "advisor who does it all" toward a team approach.

Second, there have been irreversible changes to the way in which new hires enter the financial advisory business. In the old "advisor as salesperson in a distribution system" days, new hires were run through training classes in which they were taught how to cold call and how to pitch products. The advent of the "Do Not Call" list in 2003, along with the demise of land lines in favor of unpublished cell phone numbers, eliminated the effectiveness of that approach. New hires in the large firms are given a modest amount of training, then assigned to teams. New hires in small firms generally join in either financial planning or investment research with the prospect of moving into client management after developing some expertise. In both instances, new hires are trained to be team members instead of salespeople.

As the financial advisor population turns over in the coming years and team models perpetuate, client loyalty will shift away from individuals in favor of firms. Hence, advisor migration, and attendant client migration, will be much reduced. In short, market shares will stabilize. Therein lies the opportunity.

The large, bank-owned firms and the regional firms are doing quite well, and there are few, if any, strategic acquisition opportunities among them. The opportunity for strategic acquisition lies with the independent firms. According to Keefe, Bruyette and Woods, independent advisory firms controlled 22.3% of invested client assets in the U. S. in 2014. KBW predicts that this market share will rise to 29.1% by the end of 2019.

Again, the irresistible force of demographics comes into play. The shareholders in independent firms have created significant enterprise value in the past 15 to 20 years, but they have limited options for unlocking that value. Most firms do not have successor employees of sufficient number or financial resources to purchase the equity of selling shareholders as they move toward retirement. This means that liquidity, in the majority, must come from outside strategic or financial investors. An added complication is that, because client assets are still loyal to advisors, prospective investors or acquirors insist that financial advisors remain for a period of years after any transaction. Consolidators provide liquidity, but not all have client service models that are consistent with those of the selling advisors. Other financial institutions may be able to provide both capital and a consistent client service model, but at the cost of independence. One cannot overestimate the value that advisors in such firms place on their independence. It is a core tenet to most and often a deal-breaker.

What, then, are the criteria for the successful acquisition of a meaningful market share among independent financial advisory firms? The first and most important criterion is a willingness to allow successful firms continued self-determination within agreed-upon guidelines. The second criterion is capital to fund both growth and shareholder liquidity needs. The third criterion is a resource base that might enhance the client service level, whether the resources are in-house or outsourced. The fourth criterion is the potential for equity upside. The final criterion is a culture that understands and embraces entrepreneurship.

The most logical candidates for success in consolidating independent financial advisory firms are regional banks. However, regional banks can only succeed if they adopt a tactical approach that is atypical of most banks. Advisors in independent firms do not want to work for a firm that operates under a bank brand. They do not want to operate in the cross-sell model of the large, bank-owned firms. They do not want to be told what to offer their clients. They want to own equity in the enterprise that acquires their firm, not in the bank. Conversely, they do want the opportunity to offer some of the banks products and resources, especially lending, to certain of their clients, but they want to be the ones making the determination. In short, they want to be respected as successful financial professionals who know their clients. A regional bank who can embrace the high touch advisor model based on in-depth financial planning and investment management can be wildly successful. That is best done by investing in an independent firm with experience in growth by recruiting and by acquisition.

Change is constant and inevitable in the financial advisory business, but it seems likely that the two client service models described above will thrive for the foreseeable future. Embracing the consultative approach of independent firms and employing an aggressive acquisition strategy is likely to result in significant and profitable market share over the next five to ten years.