The Marginalization of the Small Wealth Manager: Future Threats, New Opportunities and How the Game Has Changed.

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Introduction

This report provides owners of wealth management firms with insights on the current and future state of the wealth management business. While markets have recovered and profitability for independent advisory firms has returned, there are significant risks and threats going forward. While the thoughts and points made in this paper may apply to wealth managers of all sizes, this paper is written specifically for the wealth management firm with $100 million to $300 million of Assets Under Management or Advisement (AUM/AUA). This paper is also written with those entrepreneurs in mind whose goal is to maximize their business value and business experience and create certainty for themselves, their clients and their team.

For this paper, Wealth Manager, Wealth Management firm, Advisor or RIA refers to Registered Investment Advisory firms that provide overall financial planning and investment advice primarily, but perhaps not completely through the use of third-party investment managers, mutual funds, and ETFs. We are not directing our comments to portfolio managers running a specific investment strategy, or wirehouse advisers working in the large brokerage firms. This paper is directed at the standalone RIA wealth manager.

Certainly not every reader of this paper will agree with our assertions or conclusions. Regardless, if a wealth management firm has between $100 and $300 million in assets or more, it's worthwhile to take the opportunity to draw your own conclusion on the paper's hypotheses.

Beacon Pointe's View of the Future

The next 10 years in the wealth management business will not be a linear extension of the past 20 years. Whether a wealth management firm thrives or faces an existence of constant struggle, frustration and potential extinction will be determined by the business management choices they make. Almost certainly, just like the clients each wealth manager advises, the choices and decisions will be flooded with emotion. As we all know, emotion can be the worst enemy when professionals seek to make rational and fact driven decisions.

That being said, there are choices that will allow a wealth manager to thrive and ultimately realize transferable enterprise value for their business, allow their team to thrive in the future and very importantly allow for an enhanced client experience for years to come.

Many wealth managers with $100 million to $300 million in assets have reached a fork in the road, whether they know it or not. Depending on the outcome desired, the choice in direction is critical.

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Executive Summary

The independent wealth management business has evolved dramatically over the past 20 years. In the 1990s a wealth manager with $100 million in assets was considered large and in some minds possessed "scale;" that magical term used to signify they had the size, resources, human capital and operational efficiencies to ensure their business would grow profitably. The independent wealth management experiment was in its infancy. Supported by the prevailing winds of a secular Bull Market, many firms were successful. As fiduciaries, paid only by their clients, the fee-only wealth managers hammered out a place in the market as an alternative to the commission based wirehouse brokers. Times were good for the early adopters of the RIA model with the courage to strike out on their own and found a wealth management firm.

Over time, the brokerage firms adjusted and began to emphasize fees, signaling publicly the RIA model was winning. Independent wealth management firms received another boost at the turn of the century when the internet and telecom bubbles popped. Exposed was the conflicted product and commission-driven world of the wirehouse brokers. Wealth management firms would gorge on clients fleeing the brokers. From 2002 until today, the independent wealth management channel has been the fastest growing of all advisory channels. In fact, over the last five years, the RIA channel assets under management has grown at a compound annual growth rate (CAGR) of 8.8%, while wirehouse firms have declined by .4%.[1]

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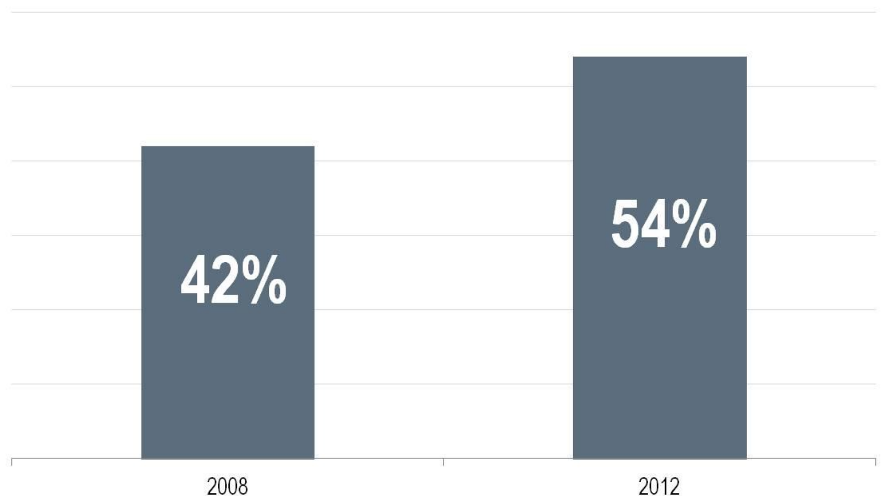
But today's world is very different than what advisors have experienced over the past twenty years. The wealth management space is maturing. $100 million in assets is now considered small. There are over 800 RIAs with more than $1 billion in assets. Many of these firms are wealth managers. In fact, many of these firms have sights on becoming regional, super-regional and national firms. These larger players have the scale and cash flow to invest in people and resources to better serve clients, and more of them. This is evidenced by larger firms growing market share. In 2008, $1B firms controlled 42% of the total RIA market. By the end of 2012, that market share increased to a mind-blowing 54% and is increasing every year.



[1]Cerulli Advisor Metrics 2013

Also, while many of today's wealth managers required a 10 to 20 year period to get to $100 to $300 million in assets, today younger wirehouse advisors are leaving the large brokerages daily to establish RIA firms of greater size, with younger principals and an expertise at client acquisition unmatched by many wealth managers. An outlier example is the Luminous Capital team that left Merrill Lynch in 2009 with $2B in client assets, grew it to $6B in three years and then sold their firm to a bank. Clearly, there are new market entrants that are viewing RIAs as a growth platform and are seeking to achieve superior outcomes for owners, employees, and their clients.

The low hanging fruit for new investor clients that RIAs so easily picked from the wirehouses and broker dealers over the last 20 years is generally over. It's now a much more competitive market for clients and the competition is better.

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Compounding the challenge, the fee-only story once so successful in the early 2000s is a commodity with thousands of new RIAs telling some version of the same story. In addition, the layman US consumer can not differentiate a fee for fiduciary advice an RIA delivers from any other type of fee-based solution from a more "conflicted" platform.

Couple the commoditized fee-only RIA story with a much more expensive and complex business environment, and it's easy to see how some advisors are becoming frustrated and marginalized. Today, the wealth management business requires a much more skilled approach to create a thriving firm positioned to maximize the next 10 to 20 years. It is true an RIA's single most valuable asset is the trust and goodwill that has been built with their clients over time. However, larger firms have the opportunity to build deeper relationships through functional support teams, technology and more holistic and turnkey wealth management solutions.

The threats looking forward are many. Fee compression, cost of talent, cost and risk of compliance, cost of competing with larger better capitalized independent wealth management firms are a few obvious threats. But there are also less obvious threats including the fact that we don't know what we don't know.

- Will the internet significantly change the way wealth management and investment advice are delivered?
- Will pricing as a percentage of assets become obsolete?
- Will wirehouses, through platform change or regulatory reform, start competing on a more level playing field?
- Can the industry attract the right human capital to deliver on the promise of fiduciary advice?
- Will markets hold up or will there be more disruption that can fracture an RIA's P&L?

These are questions that are difficult to answer because there are many opinions and the rate of change in our industry is accelerating.

But there is opportunity looking forward regardless of the fact that the next decade will not be a linear extension of the past. For those advisors who make the correct choices for their firm, the future looks very bright.

What about the great succession dilemma? Is it overdone? It is indisputable that the average age of a wealth manager has risen over the past 20 years. Many advisors are looking to bring in that younger advisor to take over the business and service the clients when the founder retires. But does the supply of younger advisors match the demand? Only 19% of advisors are under the age of 40. What will it take to attract and convince the very best young advisors? Even more importantly, are these advisors equipped, or even have the desire, to be a business owner? Will they pay an existing owner anything near fair market value for ownership?

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One thing is near certain - if the wealth manager sells his firm internally, he will be doing so at a discount to fair market value and with his own money. And if he sells externally, he will disenfranchise the next generation in his firm, and create uncertainty for his team and clients. Advisory firm owners that want to create certainty for employees need to think in long horizons, not short horizons, if they want to maximize their choices instead of having the market dictate less than desirable outcomes to them.

Advisors who founded their own wealth management firm are very independent. They are used to being the sole decision maker and having total control. For many, they are excited about the next 10 years. They still have energy and they feel confident that having grown to $100 to $300 million they can take their firms to $1 billion or beyond. But, the environment is different now and it will not be as straightforward as simply doing what they have always done. The major challenge is to get to the next level; advisory firms must be willing to cede some control, bring in the next level of talent, and invest in their businesses, usually at the expense of their own profitability.

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The good news is there are new solutions for growth and succession that did not exist just a few years ago. There are solutions that can both empower a team and best serve clients. There are also solutions that arguably create more uncertainty than they claim to solve.

The industry is changing for the better for many and the worst for those who choose not to adapt. The good news is the small wealth manager has choices and a great opportunity to seize the future. They will be able to maximize and have certainty on the timing of succession for themselves, their clients and their team.

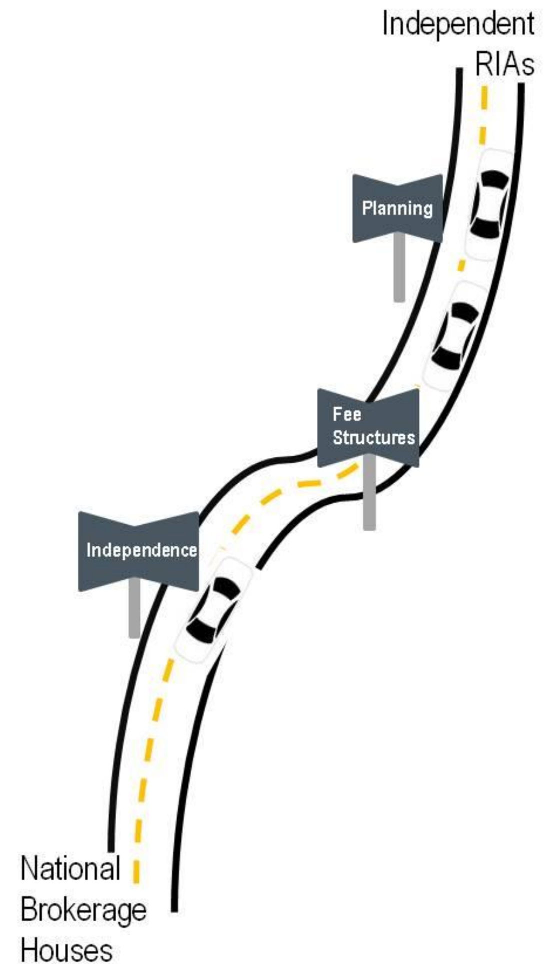
The Past 20 Years - How We Got Here

While the Investment Advisors Act of 1940 is much older than twenty years, it is the past two decades that has seen the rise of the Independent RIA Wealth Manager. Wealth management delivered in an independent, fee-only context was a concept perhaps best helped along through the rise of financial planning married to the age old business of investment advice. While the International Association for Financial Planning (IAFP) first organized in 1970 and the Institute of Certified Financial Planners (ICFP) in 1973, financial planning began to hit stride in the late 1980s when in 1987 the first 20 universities were recognized by the CFP Board to deliver registered educational programs. In 2000 the IAFP and the ICFP would merge to form the Financial Planning Association (FPA). While financial planning expanded, the investment advice business also expanded rapidly helped by a historically strong bull market in the 1990s. This wind in the sails of positive markets allowed individuals with an entrepreneurial mindset and will to serve clients in a fee-only environment, to get established and positioned for the decade of 2000-2009 when two severe bear markets would expose the large brokerage firm advisors and erode the global brand equity of some the of the industry's biggest players.

Over that same time custodians, originally Charles Schwab and then later Fidelity and TD Ameritrade, began to deliver intellectual capital and best practices around starting and running an independent RIA. This led more and more advisors to choose the independent RIA as their preferred model for their business. Today there are thousands of independent wealth management firms in the U.S.; tens of thousands have less than $500 million, and a large percentage of those small firms fall into the vulnerable $100 million to $300 million range.

Technology entrepreneurs, recognizing the need for systems and software to help organize and run the independent RIA firms, rapidly began developing products to help wealth managers better run their businesses and serve their clients. Client Relationship Management programs (CRMs), reporting platforms, Turnkey Asset Management Platforms (TAMPs), Financial Planning software and more has been created specifically for the independent wealth manager and RIA industry.

The severe bear markets of 2000-2002 and 2008-2009 allowed the independent wealth manager to challenge the established brokerage houses and capture clients at a significant pace through the decade. Numbers of new clients were added at an outsized pace, but something else happened over that same time frame. The custodians began an unprecedented campaign to help advisors move from the wirehouses and broker dealers to the RIA world. Thousands of additional RIAs have formed in the last 10 years.



A road to independence was paved from the large national brokerage houses to the independent RIA model. It seems as though now it is more of a freeway than merely a road. Many of our RIA peers are those brokerage firm advisors who were helped to independence by the custodian firms.

The past 20 years has seen significant change within the RIA industry. It was early and the early adopters had many advantages over the last two decades. Is it reasonable to assume that the next ten years will be a continuation of the past? Perhaps, but to do so will certainly seal an advisor's fate and perhaps extinction.

The Current State of the Business for RIA Firms with $100 to $300 Million in Assets

Today the business environment is distinctly different than just five years ago. After the market collapse of 2008/2009, the markets and asset prices in general have recovered and exceeded their highs of 2007. In general, advisors are feeling pretty good. Profitability has risen as revenues from clients has risen, and costs have remained relatively stable. The pace at which wealth management firms are adding new clients may not be fast enough to lower the impact of aging client demographics, but again the rising markets mask all appearance of stress.

According to Schwab Advisor Services, year-over-year median growth rate for number of new clients was 5%. This is net of client attrition. Client attrition rate was 3.1%.

Fidelity Institutional Wealth Services 2013 benchmarking study concludes that the median RIA in the $100 million to $250 million has $146 million AUM and a head count of five people. This includes the owner plus one other advisor.

These wealth managers most likely enjoyed one of their most pleasant years in business in 2013. Markets were up significantly with little to no volatility.

Many RIAs took notice of Bel Air Advisors sale to Fiera Capital for over $100 million just a year after Luminous Capital's similar sale to First Republic Bank. Even at a much lower AUM, revenue and EBOC level, there must be value in a wealth manager with $100 million to $300 million of AUM. But advisors should take stock in the fact that these deals were “outliers” and had fundamentally different operating structures and growth outcomes. External

buyers with meaningful capital have the opportunity to cherry pick top firms in a local market, so RIAs need to be careful about extrapolating a third-party's outcome to their own.

While we enjoy the obvious current state, other forces are moving behind the scenes. The so called "robo-advisor" firms continue to develop and evolve. Advisors continue to leave the broker dealer world and establish new RIAs throughout the country.

RIAs in the $100M to $300M have three strategic options going forward:

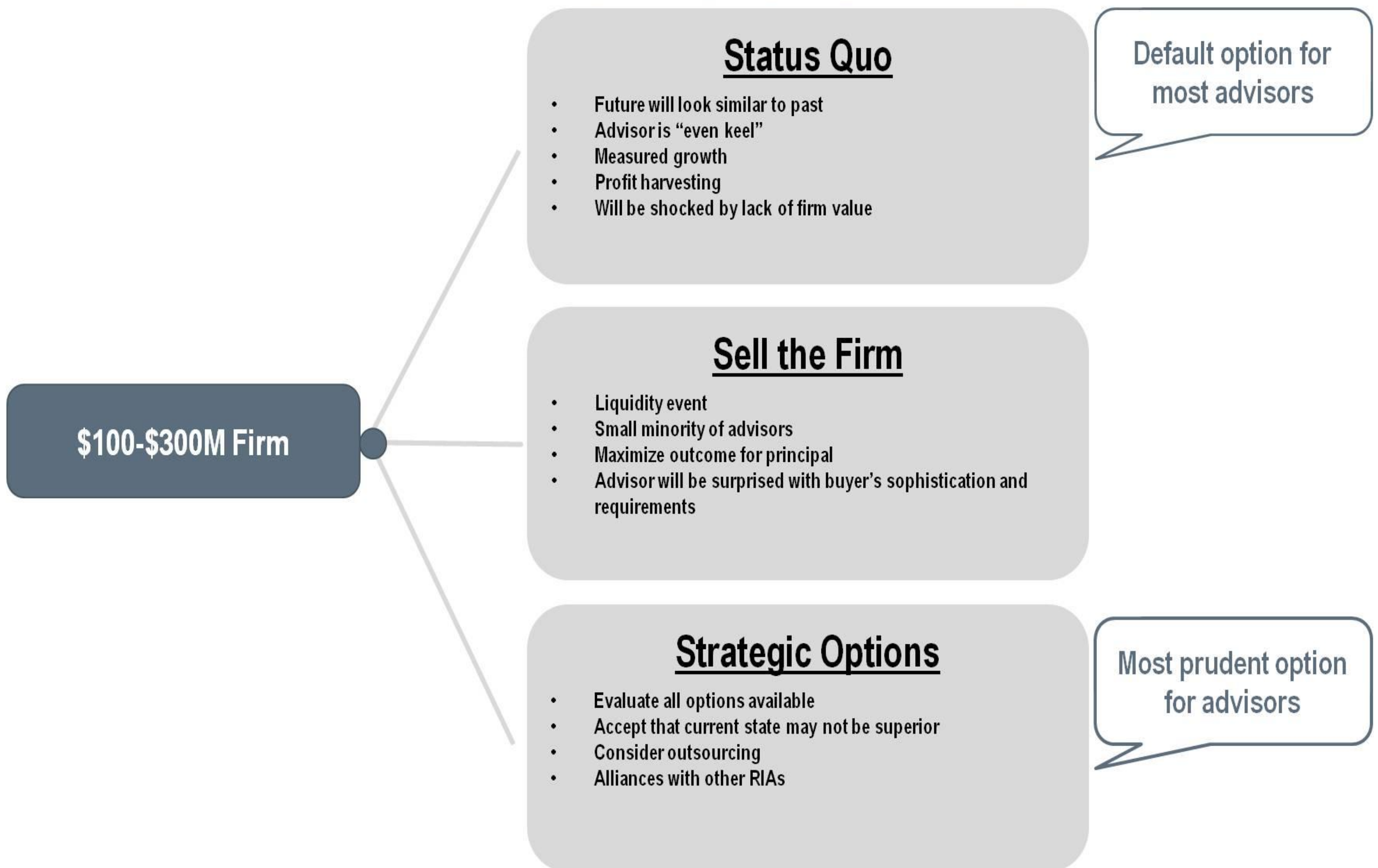
1. **Status quo.** In this option, the advisor violently disagrees with the concepts in this paper and feels the future will be similar to the past. This advisor will remain "even keel" and not make any material changes to their business. Their goal is to grow their business at a measured pace, harvest profits, and hope for no major market dislocation that can harm them. These advisors will usually seek internal succession solutions and may even try to find outside talent to buy their ownership interests.

2. **Sell their firm.** On the complete opposite end of the spectrum, a small minority of advisors will seek to have a cash liquidity event and find an external buyer that will maximize their outcome. The problem in this scenario are buyers are much more sophisticated than in the past. The days of experimenting by local banks buying RIAs for high premiums, while the legacy owners play golf on Friday afternoons are long over. The new financial or strategic buyer will pay with cash, but will also expect performance and growth over time. These arrangements are normally structured in an earn out or claw back scenario.

3. **Evaluate strategic options.** In this scenario, the advisor puts emotions aside and instead looks that their current state of owning their independent advisory firm versus all available choices available to them. This may prove to be the most objective and client friendly option. It may also present choices that maximize long term value, ensure a legacy and empower the next generation.

   It may be as simple as seeking to outsource "non-core" competencies, leveraging the capabilities of turnkey providers and service bureaus, or seeking to partner with another independent advisory firm. The key paradigm shift is advisors must be open to considering that their current state may not be superior to another option available to them. As this paper noted, the independent space has changed materially over the past decade. It is wise and prudent to evaluate other options.

Advisors, who don't make a conscience decision to select a different strategic path, will default to option #1 above. The wealth management world will continue to evolve around them and the consequences may be limited or in some cases severe.



Looking Forward: Threats of the Future

The half-life of changes in private wealth management is accelerating. Advisors will be faced with more innovative providers that will try to redefine wealth management and pry at the strong relationship advisors have built with their clients over the years.

Top Threats:

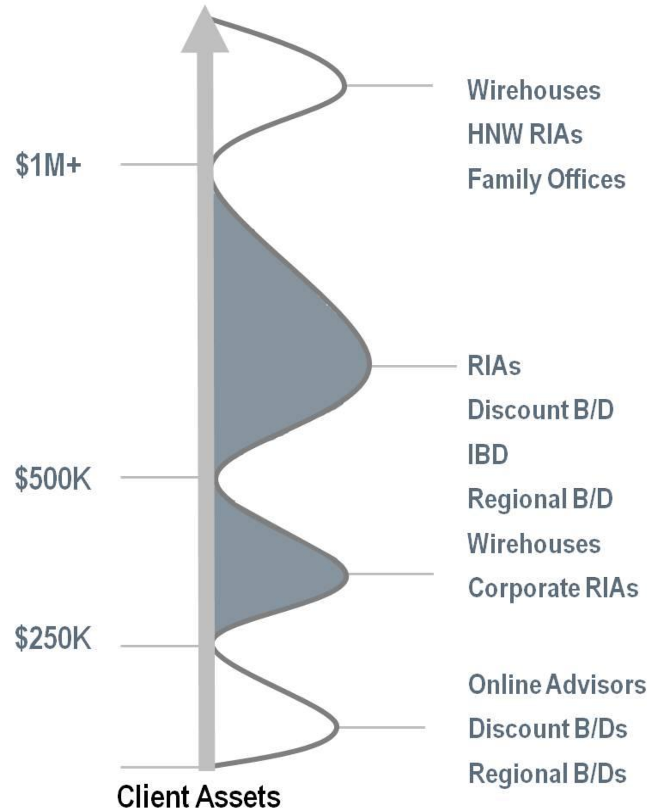
1. **Rise of regional and national RIAs.** Larger independent firms are beginning to build recognizable brands in local markets. Although these firms may not realize the same brand power as a wirehouse, they will still have mindshare in a local market that may become increasingly difficult to deal with. These firms will also take the opportunity (and already have) to build more functional specialty in house. The concept of being the advisor and "bolting" on third-party solutions such as tax, estate, insurance, and lending may be perceived as disjointed, given larger firms have the *true scale* to deliver integrated wealth management solutions.

2. **Redefinition of wealth management (you can't simply allocate a portfolio and deliver a static plan to succeed).** Advisors may have had it easy to this point in time. Can a $100 million AUM advisor simply deliver what is essentially high level investment advice with simple planning any longer? The answer is maybe, but the more important question is, can that service be delivered at the same price? As mentioned earlier, new efficient on-line providers are delivering portfolios at a fraction of the typical 80 to 100 basis point portfolio, and larger advisors with scale are building sophisticated models in house. Advisors will risk "getting stuck in the middle". Outsourcing investments to a third-party to gain scale may be viable, but many advisors reject this notion as well as the sub advisor wants a material amount of the basis point pie.

3. **Wirehouses bite back.** For too long wirehouses have seen their market share get derogated over time. Is it plausible the trend will continue? The wirehouses have shown no ability or willingness to change their conflicted model, they still possess many strengths, the most important being branding and marketing. In addition, there has not been a material disruption to the markets since the upheaval in 2008/2009, which may help these firms repair their brands. These firms are also seeking to integrate lending and insurance in a more meaningful way, which will make assets stickier and less portable. On top of it all, wirehouses have made significant changes to advisor pay and succession; making it more difficult to recruit advisors with attractive books to "tuck-in". Independent advisors should expect less asset flow from these firms in the future.

4. **Inability for older advisors to replenish their client base.** There has been a concept being floated in recent years that as advisors get older, their clients get older and therefore their advisory business is worth less. If an advisory firm Principal is near 60 years of age, should they even care about this? One concept is certain; all things equal, younger clients in accumulation mode (40 to 60) are worth more than clients that are no longer accumulating. If an advisory firm is primarily serving older clients AND their primary rainmaker is also older, will it be easy to "replenish" an advisory business with younger clients that are in accumulation mode and be the lifeblood of the firm? Seems like a questionable proposition. Advisors committed to growth usually have multiple rainmakers working with multiple demographics or have a support team in relationship management that is diversified.

5. **Technology becomes a threat, not a lever for scale.** The half-life of technology growth and change is accelerating. Think of the advances that have occurred with a cell phone to the smart phones of today. We are starting to now see an acceleration in advisory technology. There are robo-advisors, huge changes with portfolio accounting, RIAs that are delivering tablet based education and planning modules, as well as advice delivery happening through social model or remote a/v meetings. It is widely accepted that the next generation of investors will want to leverage technology in a more meaningful way to receive advice. The strategic question is, does the $100MM to $300MM have the ability to evaluate and implement new technology changes to keep up? We have come across too many financial advisors who have not made a meaningful change in decades. This risk to advisors may have a snowball impact over time.



6. **No growth culture, no ability to attract strong human capital.** At the end of the day, the most talented professionals want to be on a winning team. It's true in sports and it's true in business. Unfortunately, smaller firms that have seen growth stagnate may have their ability to attract and retain talent diminish. A Harvard Business Review study has noted that if a firm is not growing top line revenue at least 15% or more, it will struggle to provide the business reinvestment and commitment to human capital to attract and retain key staff. In advisory firms that are not growing, can their P&L support handing out raises of 10% or more to up and coming staff? Without growth, this type of investment would have to come out of the owners' pockets! Few firms will make that investment and the risk is key staff will become frustrated and find their "next, best opportunity".

7. **Lack of next generation of ownership.** For advisors that are seeking long-term continuity (e.g. their business survives post their exit) requires that a next generation is found to buy the business from the owner and successfully operate it. In this scenario, the advisory firm owner must find a worthy successor that they trust enough to "hand the keys over to" and have the capital to buy out the owner. On a positive note, there is financing coming into the independent world to help with capital, however it also requires the next generation to personally guarantee the money. Advisory firm owners will likely need to spend a great deal of time and energy identifying, nurturing, training, and coaching an ideal candidate with no guaranteed outcome of success.

8. **Increased regulatory and compliance pressure.** A significant externality that our industry has no certainty around is where regulatory and compliance systems will go in the future. The probable outcome is more cost and red tape for advisors. The well-documented scandals of the great recession are leading to increased scrutiny. For every change in regulation and compliance guidance, independent RIAs must adapt procedures and protocols accordingly. Wirehouses have the capital and manpower to sufficiently address this change, but a $100-$300M firm may find it more difficult. Add to this the uncertainty around social media, new technology, and the cloud and you have an uncertain future for independent firms looking to evolve.

Many future risks are known and some are uncertain. The $100MM to $300MM advisor should, at a minimum, take the time to understand how these risks can impact their future and build a strategic plan that addresses any future impact. Advisors that are seeking to build real business value and seek the best possible outcome will take the opportunity to evaluate these risks within the construct of other advisory platforms/models to run their business.

Potential Solutions and Opportunities for a Great Future

While no one has a crystal ball and can perfectly predict the future of the wealth management industry, there are solutions and great opportunities for the firms that objectively and proactively seek them.

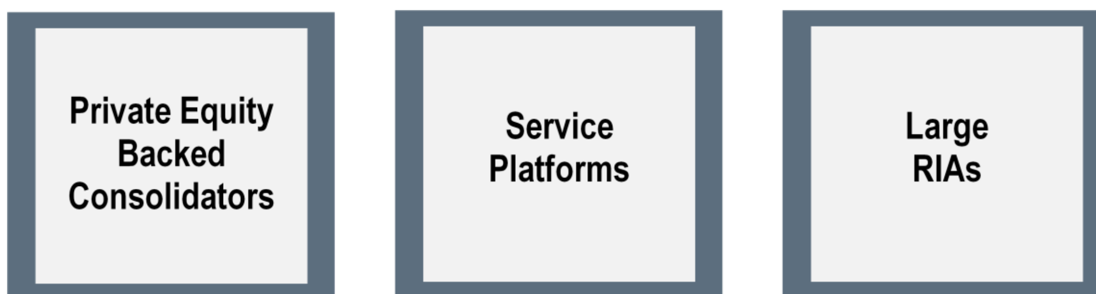
As previously stated, it is our belief that many wealth managers will opt for the status quo. They mostly disagree with the concepts presented in this paper and believe the future will be a linear extension of the past. Sure, there will be continued technological advances, but they believe those advances will only serve the smaller wealth manager, not further marginalize them. These advisors will likely seek an internal succession plan and attempt to hire that ever sought after "next gen" advisor, the same younger advisor that the larger firm with scale can afford to pay more and offer better training and resources to serve clients. We believe this route is the road to frustration and shockingly low value in their business, with the worst case being the evaporation of their business over time.

More optimistically, strategic options exist for the wealth manager who is willing to evaluate all opportunities, accept that their current state may not be superior, and consider outsourcing and alliances with other RIAs. For many, the emotional barriers to openly considering strategic options may be too great, but for those who are not constrained emotionally, they have a slate of great options to create true enterprise value.

The core of the wealth management business is providing advice to clients. For that advice, the clients pay a fee. Everything else within a wealth management firm exists to support the business of giving advice to clients in return for a fee. Compliance, Investment Research, Marketing, Social Media, Financial Planning Platforms... all of these important functions support the relationship between the wealth management firm's advisors and their delivery of great advice to clients. Each of these support functions represents cost to the business, and for some, a distraction from enhancing relationships with clients and gaining more clients. The advisors who recognize this and act on this simple truth will find a road to great business value and a tremendously rewarding experience.

When considering the collection of pressures on the small wealth manager with $100 to $300 million of AUM, it's easy to become pessimistic. Even more dangerous, the smaller wealth manager may choose to ignore or deny these pressures and threats. The good news is neither pessimism nor denial need be the course of action.

Today there are many strategic options to breakthrough and thrive. There are numerous opportunities to outsource, partner with larger firms, merge to create scale and efficiencies. There are several Private Equity Backed Consolidators, Service Platforms and larger RIAs to partner with that all provide opportunity for the small wealth manager to better maximize their future.



Being able to outsource or delegate the non-money making, yet critical business activities, frees the wealth manager to refocus on the most important part of the business, growth. Partnering with the right firm should help and assist the wealth manager to grow. Each of the firms listed above present different models and value propositions. Choosing the right partner should mean enhancing control of the future, not creating more uncertainty than the status quo.
Does the wealth management industry need 10,000+ compliance, marketing and investment research departments? No. Thousands will be eliminated over the coming years, those that act proactively and eliminate duplication and excess costs and distractions have the opportunity to maximize their business and experience in the future.

There is a tremendous opportunity to maximize the business, the business experience and provide certainty at succession for the wealth manager, his or her clients and the team in the business. Being proactive at exploring the strategic options is the best way to find the route forward.

In Conclusion

The rate of change in the independent wealth management space is very likely to accelerate. For owners of firms between $100MM to $300MM, the next two to three years may be an inflection point. These firms will face increasing competition from a variety of sources that have the potential to marginalize a firm's competitiveness.

For advisors that are seeking to maximize firm value and provide exit planning certainty for themselves, clients, and employees, fiduciary advisors should consider other advisory models and compare with their current state. There are many choices beyond the status quo.

We invite any wealth manager with an eye toward the future and a will to maximize that future for themselves, their team and their clients, to reach out with questions or comments.

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