THE OUTSOURCED CHIEF INVESTMENT OFFICER

Taking on the Big Firms: How Small and Mid-Size Advisors Can Win the Battle for Clients

Part 1: Today's Advisor Challenges

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For many small to mid-sized advisors, getting over a plateau in assets under management can be challenging and intimidating. There is the constant competition from larger, deep-pocketed firms, and the nipping at the heels by smaller upstarts, including the faceless robo-advisors that have burst onto the scene. Meanwhile, advisors must not only attend to client needs and prospect for new clients, they must also take care of administrative tasks and, let's not forget, keep track of the markets and client portfolios. The result is either stagnating assets under management, poor investment performance, or a combination of the two – neither of which is a good situation to be in.

But there are firms out there that are succeeding in growing their assets under management, which in turn, drives revenues, and creates yet more flexibility to continue to grow. Depending on each advisor's value proposition to clients, there are several ways the SMID advisor can compete and size isn't necessarily a limiting factor if you think outside the box.

Many advisors have taken a step back and revisited their business model and value proposition to better position themselves in a rapidly evolving industry that includes heightened regulation and automation. One such solution is to outsource some of the non-core functions of the firm. (non-core defined as any activity that doesn't drive growth) But before you put this paper down thinking that outsourcing is not the right solution for you, bear with us for a moment as we highlight an option you may have not considered yet. It is still a form of outsourcing, but we refer to it as an extended workforce solution, and it allows advisors to maintain control over their investments, eliminates the need to transfer assets to another platform, and prolongs the time, sometimes indefinitely, when you have to hire an in-house investment expert.

Introduction

In this two-part series, I will provide an overview of the investment advisory industry and although I will primarily be referring to the registered investment advisory world, the same concepts and challenges apply to broker-dealers and family offices that provide investment advice to clients on a fee-based arrangement, even though the concepts can be equally applicable to brokers and a commission based fee structure.

In Part 1, I will review the challenges faced by the investment advisory industry and although they may not surprise any readers, it is important that I highlight the specific issues that some advisors face so we can properly address potential solutions in a latter part of the series. The challenges faced by advisors include regulatory issues, client specific obstacles, and inadequate infrastructure.

In Part 2, I will focus on how successful advisors of all sizes are continuing to outpace other advisors in asset growth and revenues. While some of these advisors have created an infrastructure to succeed, smaller advisors with limited resources have also been able to apply creative solutions to free up their time and expand their platform to acquire new assets.

Advisory Firm Challenges

The one thing that is certain for advisors, like death and taxes, is that it is becoming more challenging to effectively deliver investment advice to individual clients. If it's not the regulatory environment on one side, it is the rise of terminator-like robo-advisors on the other. Throw in a generation of millennials that have revolutionized how traditional financial advice is being provided and you have a unique situation that is full of risk and yet ripe with opportunities if you are well positioned to take advantage of 'money in motion'. Furthermore, studies show that many advisors are reaching retirement age and forecasts warn of a dearth of financial advisors in the next decade or so. For the advisors that endure, the opportunities could be fruitful.

Regulatory Requirements

Fiduciary!!!– 'nuff said. At the time of writing this paper, the Department of Labor's fiduciary rule was delayed so that the rule can be further evaluated for intended and unintended consequences. Whether or not the rule goes into effect as planned, the industry undoubtedly is moving towards a higher level of care for providing investment advice to clients. Some advisors are implementing new processes and procedures, changing their compensation and fee structures, or eliminating some products and services altogether. Those that have historically followed the suitability standard are taking pains to focus on applying the fiduciary standard within their practices, usually by changing from a commission to fee-based compensation structure. Without getting into a debate about the benefits and potential costs of the rule to end clients, I think we can all agree that the cat is out of the bag and client awareness regarding the difference between both standards is probably at its highest ever.

To comply with the fiduciary standard, advisors must keep client's best interest in mind when rendering investment advice. Sounds simple enough but many clients are surprised that their advisor hasn't had to adhere to that standard in the past. Essentially, the fiduciary standard requires an advisor to know more about the client's situation and the investments being made within client portfolios than they otherwise would have under the suitability standard – so they can provide the advice that is in the client's best interest. According to the CFA Institute, the essential information about a client that would be typical of a fiduciary approach could be captured in an investment policy statement, which includes investment objectives, risk tolerance, time horizon, liquidity needs, tax considerations, special situations, and anything else that would be relevant in making investment recommendations and decisions for a client. Preparing an investment policy statement isn't required by the fiduciary rule but you get an idea of the depth of information an advisor may want to know before giving advice. The same level of information isn't necessary under the suitability standard because an advisor only needs to know that a recommended product is suitable, not necessarily that it is in the client's best interest.

An advisor must also perform enough analysis on the investments recommended or included in a client's portfolio (discretionary or non-discretionary) to make sure the investments are the best options to fulfill the client's given objectives and unique circumstances. The greater level of analysis leads to an even greater amount of time away from client facing activities that are essential to asset growth, as I'll mention later. There's more - Unlike the suitability standard, which only requires a broker to make sure an investment is suitable for an investor at the time of sale, the fiduciary standard implies ongoing monitoring of investments in a client's portfolio. If an investment falls out of favor, the broker following the suitability standard isn't required to recommend selling the investment, but the advisor under the fiduciary standard is. To maintain their fiduciary responsibility, therefore, advisors must continue to research and monitor investments or hire a 3rd party to provide research that will aid in the monitoring process.

Size Matters

Let's face it, size matters. Larger firms can leverage their size and are capable of providing broader and more sophisticated services to clients at prices which smaller firms cannot - And to an advisory firm, larger clients are more profitable because much of the work that goes into a client with a smaller portfolio is the essentially the same as that which goes into a client with a larger portfolio – without the benefit of the higher fees.

One benefit exclusive to larger firms is the cost advantage of being able to pay $150K in salaries plus benefits for an in-house investment professional that can manage the investment platform, process, and portfolios to free up the advisor's time to service clients. Most of the time these investment professionals have little direct revenue generating responsibilities so they end up being an expensive but necessary cost that small firms can't afford. In fact, only 16% of firms between $250MM-$500MM have a Chief Investment Officer and only 9% of those with less than $250MM – and most of the time, advisors with AUM less than $500MM that do have an investment professional on staff usually only have one. Having one is a good first step but it is becoming increasingly difficult for one person to manage all asset classes in an increasingly complex environment.

It's no wonder then that firms with less than $100MM in AUM spend the highest percentage of time on investment management tasks and least amount of time on client-facing activities when compared to larger firms. The $100MM mark is typically where a small firm's growth slows dramatically if they don't ensure that client-facing activities remain a priority. At this asset level, they are big enough where attention must be given to managing portfolios more efficiently but not so big they can afford to start hiring in-house investment personnel.

The other advantage large firms have is less sensitivity to fee compression because of the additional services they can offer and the broader more sophisticated platform they provide. Clients are balking at a 1% fee for portfolio management that focuses only on traditional mutual funds and ETFs. Throw in a few alternative investment options and tactical or thematic positions and the 1% fee becomes more palatable and more justified in the eyes of clients. Big firms can do that, small firms cannot.

Time Constraints

I mentioned earlier that the fiduciary standard will probably require more attention to specific client needs and better understanding of the investments both at initial purchase and on an ongoing basis. These responsibilities take client-facing time out of an advisors schedule into less productive tasks. According to a study by Cap Gemini, a typical financial advisor spends about 67% of her time on client facing activities, but 29% on non-core operational and administrative tasks such as investment research. For successful advisors, a non-core function is any activity that takes you away from meeting with clients and prospects and identifying and implementing wealth management solutions for them. Minimizing the time spent on research and other non-core tasks will free-up an advisor's time for delivering better investment advice to their clients, which generally leads to higher client satisfaction, increased share of wallet, more qualified referrals, etc. And client-facing activities could be extended to referral sources as well – such as centers of influence.

The fastest growing firms not only spend more time with clients, but also spend a greater amount of time with centers of influence than those advisors that have remained stagnant. A Schwab study showed that advisors who nurture their COI relationships have shown 3.6 times more growth than those that do not. Other studies also showed that advisors know they must spend more time on client-facing activities to grow but find it increasingly difficult to do so. Two solutions are to work more hours or hire more staff. The first will have a negative effect on work/life balance while the second can be extremely costly.

According to another study by RIA in a box, 89% of RIA firms indicated growth as a priority for the coming year. Of those surveyed, 73% intend on achieving growth through organic growth – This doesn't make sense – If RIA's don't have the time to spend on client acquisition they are disillusioned into thinking they can continue the status quo and continue to grow. Unfortunately, as advisors acquire more clients, the administrative tasks also grow – until not much time is left for growth initiatives.

Advisors who refuse to outsource some of the investment activities or are constrained budgetarily to hire in-house end up continuing to spend a good amount of time on investment management or having an admin person spend half their time on portfolio analysis and other tasks. A word of warning to those advisors: Investment management should not be a part-time activity by a quasi-specialist.

Inadequate Research

Investment research is a time-consuming process. Not only do you have to search for relevant information - once you find it, you must peruse through it, make sense of it, figure out the implications, and identify ways to implement any ideas drawn. And this isn't a one-time process. It takes ongoing monitoring and updating to properly manage investments and oftentimes the research isn't always available or updated as often as we would like – particularly when it is provided by a 3rd party.

Many advisors revert to using sell-side research and pay for it outright or receive it based on some soft-dollar arrangements. A study by Cap Gemini highlights a well-known problem with this practice - using sell-side research may result in questions regarding conflicts of interest not to mention the research reports aren't even as good as you'd expect. The study shows that most sell side research contains plenty of quantitative data but lacks high level qualitative details and analysis. Independence of thought of external research providers is therefore emerging as the key selling point for delivering high quality insightful research but once again, small firms lose out to larger firms because of the cost of getting that research. And it still doesn't solve the problem of having to sift through the research for implementation ideas.

Yet other advisors get investment ideas from articles written in publications such as the Wall Street Journal, Barrons, or websites such as Seeking Alpha (www.seekingalpha.com). The problem with generating ideas from these sources is that advisors have no control over how often these 'journalists' will revisit these investment ideas and are left having to independently research and monitor the idea indefinitely.

Client Demands/Expectations

In today's highly volatile environment, clients expect their firms to demonstrate high investment performance and more frequent updates and communication. Investor inquiries about their portfolios are on the rise, increasing around 64% since 2009. Even if portfolios are managed on a discretionary basis, clients increasingly want to know why their portfolios are positioned the way they are. This higher level of engagement facilitates conversations between advisor and client and strengthens the relationship. When the client knows the 'why' behind portfolio strategy, it is much easier to discuss performance, even when that performance turns out to be subpar. The problem is that understanding the portfolio positioning requires research, analysis, and monitoring. At the risk of sounding like a broken record, this takes time away from client-facing activities.

A report by the CFA Institute confirms that investors want more context to understand specific portfolio management strategies reflecting their increasing desire to be engaged. The top client service attribute retail investors want is that a firm 'helps me understand why my portfolio is positioned the way it is". 70% of investors want this but only 46% say that firms are adequately delivering on it. One of the biggest differentiators for firms, therefore, is the ability to communicate proactively about the market dynamics and their effect on a portfolio.

> *"It is all fine until you can't explain why things are not working – you have given up all control and reduced your value to the relationship".*

There has also been growing interest for investments outside the cookie-cutter ETF and mutual fund approach that many advisors offer. After all, how can an advisor differentiate themselves from the other advisor down the street? Relationship building goes a long way, but clients are increasingly asking for more specialized investment capabilities.

Advisors struggling to build relationships with ultra-high-net-worth clients are also realizing that traditional approaches and investment strategies might be safe, but they are too common to attract the attention of the UHNW investor. These investors want alternative investments, which may include hedge funds, private equity, or even investments in private offerings only available to accredited investors.

Many advisors don't have the time or expertise to properly analyze these investments so they avoid including them in their portfolios or platform. The result is that the UHNW investor moves most of his assets elsewhere if they don't entirely close the account.

Summary

In summary, there are really just two main drivers of revenues for the independent financial advisor: acquire a greater number of clients or acquire clients with much larger portfolios.

To acquire more clients, it has been well documented that the biggest driver of client acquisitions is the amount of time spent on client-facing activities. Advisors who spend more time on client-facing activities have grown exponentially more than those who get sidetracked on other tasks. But this isn't necessarily the best approach to AUM growth, after all, it is far more efficient to acquire one client with $10MM in assets than 10 clients each with $1MM in assets. But that leads us to the second challenge: that without an adequate offering of alternative investments, advisors simply lack the sophisticated platform the UHNW investor seeks.

There are platforms available form which an advisor can choose alternatives that have already been vetted. But these platforms pose another set of challenges, namely that the advisor still has to choose which ones are the best fit for client portfolios, and perhaps just as importantly, these platforms can be very expensive. I will touch on this later.

In part 1 of this series, I highlighted some of the challenges faced by investment advisors. As I mentioned at the beginning, I'm sure I didn't provide any breakthrough insights for many advisors. But I did want to set the stage for what I'll be covering in Part 2 – What Successful Advisors are Doing to Grow AUM.- regardless of size. I'm warning you now that I'm not going to reveal an overnight solution. Some of the approaches being taken by successful advisors will require advisors to rethink their business models, implement new go-to-market strategies, invest resources, and otherwise think outside the box. Hopefully this whitepaper is a catalyst for those thoughts.

Send us an email to receive Part 2 directly in your inbox: info@theoutsourcedcio.com