

# The Future of the Financial Advisory Business and the Delivery of Advice to the Semi-Affluent Investor

**Research Report**  
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## Acknowledgements

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Although each of these individuals made a major contribution to this paper, any of its shortcomings are solely our responsibility.

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## Executive Summary

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The financial advisory business – the business of providing financial advice to semi-affluent investors – is on the brink of a major evolution. Its staggering growth rate during the past five years, which led to the creation of thousands of proprietorships and small partnerships, is unsustainable. The days of advisory firms openly sharing information are numbered. Cutthroat competition will replace collegiality among these organizations in the near future and push the cost of acquiring clients higher as the industry matures.

A combination of factors will cause this industry to evolve. Clients are better informed than in the past and demanding better advice for their money. Technology is commoditizing many individual services provided by advisory firms and diminishing their value-added. At the same time, many other financial services companies are flocking to this industry.

Brokerages have shifted their businesses from traditional transaction-based compensation systems to fee-based programs in order to compete for semi-affluent clients. Large investment banks and private banking companies that have historically targeted only the wealthy are now vigorously pursuing the semi-affluent. In addition, a host of other organizations such as accounting firms and money management companies have formed their own financial advisory units.

All of these organizations are attracted to this industry because of its immense size and potential value. Semi-affluent households control between \$6T and \$8T in assets that could generate \$50B annually of

**The ability of large new entrants to the advisory business to forgo short-term profitability in order to capture long-term intrinsic value is the most ominous threat**

recurring advisory fees, one of the most attractive kinds of revenue for financial services businesses. The predictability of this type of revenue helps create great intrinsic value that far outstrips the short-term profitability of any transaction-based business.

Unlike many of the small firms that currently make up the financial advisory industry, these larger new entrants have vast resources, brand names and relationships that will facilitate their efforts to compete. More importantly, these organizations also have capital bases that will underwrite the costs of building large advisory businesses.

It is this ability to forgo short-term profitability in order to capture long-term intrinsic value that is the most ominous threat to most current advisory firms. The larger competitors will be able to use their capital to change the basis for competing for clients. They will be able to expand and upgrade their services while lowering fees. Although they may lose money for a period of time, the intrinsic value of the businesses that they are creating will generate more than an adequate long-term return on their capital.

By comparison, most current advisory firms are small and generate only modest profits – profits that are often the proprietors' only compensation. As a result, most current advisory firms lack the cash flow necessary to expand their companies.

While it is impossible to predict exactly how this forthcoming evolution will change the financial advisory industry, we believe that a good proxy for its development exists. The institutional money management business – the business of managing defined benefit pension plan, foundation and endowment assets – was very similar 20 years ago to today's financial advisory business.

Like the advisory business, the institutional money management business was a cottage industry made up of thousands of small proprietorships and partnerships that offered limited services and products. These organizations did not have separate marketing forces and a single individual – usually one of the firm's proprietors – provided all of the firm's services to each client.

As a result, that client's relationship was not with the firm but with this individual, whose continued employment with the organization was essential to the retention of the client. Client relationship management structures are critical issues for both kinds of organizations because the intrinsic values of advisory and institutional money management firms are tied to the sustainability of their client relationships. And the intrinsic values of both businesses are much higher than their book values.

Today, the institutional money management business is much more mature than the financial advisory business. But, 20 years ago, the institutional money management industry confronted many of the same forces facing the financial advisory business today – increased competition by much larger organizations, smarter and more demanding clients and lower fees for expanded services.

The earlier evolution of the institutional money management business could be instructive as to how the financial advisory business might change over the next seven to ten years.

Beginning around 1979, a small number of institutional money management companies began to shift to a new business model. Rather than simply trying to sell products or services, they became solutions providers or consultants to their clients. The goal was to have their clients view them as organizations that understood each client's problems and needs and that helped the client solve his problems.

To meet this goal, these firms had to expand their value-added beyond just investment management services. They had to develop the ability to understand the client's individual circumstances and capably advise the client on a wide variety of issues and strategies. They also had to be able to anticipate the client's future needs.

Shifting to this type of business model forced these institutional money management firms to significantly alter their organizational structures. They created separate, professional marketing forces that not only understood investing but also had deep knowledge about the issues confronting the firm's clients. They institutionalized their relationships with clients by using large teams of people to deliver the firm's services, with each individual providing a different source of value-added. They invested heavily in technology and systems. And they also made large bets on what their clients' future needs would be, investing millions of dollars to develop products that could be sold to clients in the future.

**The financial advisory business will evolve in a similar fashion to the institutional money management business**

By changing their companies, these firms changed the basis for competing in the institutional money management business. While investment performance was still important, it rapidly became a necessary but insufficient condition for success. These organizations emerged from the fragmented ranks of the industry to become dominant competitors. Many of them grew 40- to 50-fold in only one decade. Today, they are large companies with market values in the billions of dollars.

Those organizations that were unable to shift to the solutions provider model have a much more challenging existence today. They are small companies competing for a larger share of a shrinking market. Their fees are under great pressure. Unless they have a defensible niche or consistently exceptional performance, their very survival is at risk.

We believe that the financial advisory business will evolve in a similar fashion to the institutional money management business. From the fragmented ranks of the industry, a small group of 40 to 50 organizations will emerge as dominant competitors. Much like their counterparts in the institutional money management business, they will become solutions providers for clients.

Most advisory firms today provide services that address only a few aspects of their clients' financial situations. They generally limit their value-added to aspects of financial planning and investment management.

**Future dominant competitors in the financial advisory business will look like multi-user family offices for the semi-affluent**

However, most individuals' personal finances are multi-dimensional problems that reach beyond the scope of these services. Taxes, estate planning, charitable giving and insurance issues impact an investor's financial situation as much as the quality of his individual investments. Human capital, or the potential to earn more money, may be the most important asset that a client possesses. Further, non-financial factors such as family, ego, value systems and tolerance for and perception of risk have a large impact on clients' personal financial needs.

Organizations that emerge as dominant competitors in the financial advisory business will look like multi-user family offices for the semi-affluent. They will rely on professional marketing forces to understand their clients' true needs and goals and will provide expanded services that address every aspect of an individual's financial situation. They will also offer this package of services at a price less than most advisory firms currently charge for far less value-added.

Similar to their counterparts in the institutional money management business, organizations that are able to become dominant competitors in the financial advisory industry will experience staggering growth rates. Most will have at least \$15B to \$20B under management after this phase of the industry's evolution is complete in seven to ten years.

Most current financial advisory businesses, however, lack the resources, management skills or desire to change their business models. Life has simply been too easy. Many advisors are making more money than they ever anticipated and are reluctant to make the lifestyle sacrifices necessary to remold their businesses. Changing to a dominant competitor structure would also mean changing the culture of these companies and the roles of their key principals.

Financial advisory firms that attempt to become dominant competitors will likely need to raise capital to fund growth or to seek a strategic partner. Both options entail many hard choices and signify irreversible – and often unattractive – changes to the culture of many of these organizations.

**The reward for successfully building a dominant competitor will be immense**

The reward for successfully building a dominant competitor, however, will be immense. Because of the similarities to the institutional money management business, we believe the financial markets will value these new dominant advisory firms at levels at least equal to dominant competitors in the institutional money management industry.

On the other hand, most financial advisory businesses that are unable to become dominant competitors will find life increasingly more challenging. They will be paid less and have to do more for their clients. Capturing new clients will be much more difficult and retaining clients will be vital to firms' survival.

An exception to this scenario will be those organizations that are able to position themselves as niche competitors. Niche competitors provide complex and sophisticated services that meet the unique needs of a very small portion of the overall market for financial advice.

**The evolution of the financial advisory business will have major implications for all personal financial services companies**

Firms that are able to develop this expertise and capture a substantial share of the market for that service will have very defensible positions that will only gradually change.

Most niches, however, do not last forever. Should the needs of their clients change or become more generic, niche competitors could rapidly find themselves in the same position as all of the other financial advisory businesses that are unable to become dominant competitors.

The forthcoming evolution of the financial advisory business will result in an industry that is far less collegial and far more competitive. While advisory firms today regularly share data and ideas with other organizations, future advisory businesses will be much more Darwinian.

This upcoming evolution also has major implications for many different types of organizations. Crafting comprehensive solutions for clients will become the critical function for all personal financial services companies such as brokerages, accounting firms, trust banks, financial planning organizations and insurance agencies. Companies filling that role will become the key gatekeepers to the client and all other organizations will merely be sub-contractors.

As a result, the advisory business will become an all-out battle across many different industries. All personal financial services companies effectively have no choice but to enter this business or risk losing control of a large number of their clients. Similar to financial advisory firms, they will need to substantially upgrade and expand the quality of their services.

These organizations will also need to find a way to institutionalize their relationships with clients or risk losing many of their top producers and clients to the larger advisory firms. Companies that have always relied on marketing forces made up of individuals rather than teams may find making this shift very difficult, if not impossible.

Finally, just as in any other war, the victors will quickly identify their allies and recognize their enemies. Successful advisory firms will understand that the forthcoming evolution is a battle for the very survival of their organizations. They will build alliances with those companies that can help them succeed and shun anything that could aid their competitors.



## I. Introduction

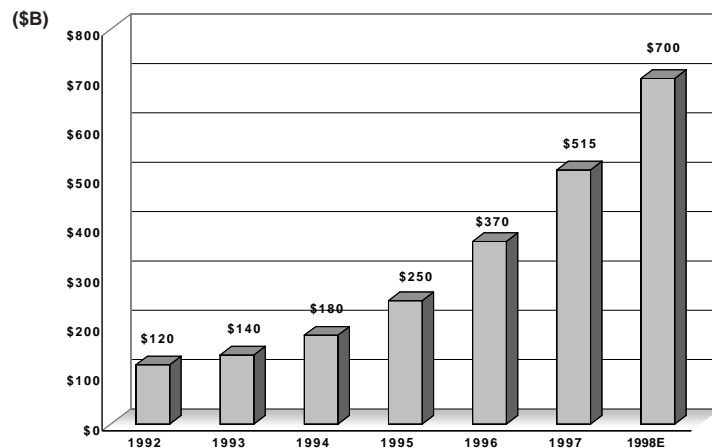
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The financial advisory business in the United States has grown over the past seven years from a small cottage industry into a major financial services industry. Spawned from a variety of other businesses including financial planning companies, trust banks and accounting firms, financial advisory firms in 1992 had only \$120B under management. By the end of 1997, they oversaw more than \$515B in assets – a compounded annual growth rate of 34% over this period. The industry's assets now exceed \$700B.

The rapid growth from small cottage to major financial services industry has been unexpected and caught some advisors unprepared. Assets under management are at an all-time high. Competition is also increasing and advisory firms are searching for ways to capitalize on the accelerating evolution of their industry.

**Exhibit 1.1**

**Growth of Assets in the Advisory Business**



Source: FIAG, Cerulli Associates, Inc., Undiscovered Managers estimates

## What Is the Financial Advisory Business?

The term financial advisor comes from the Investment Advisors Act of 1940, which mandates that people or firms that get paid to give advice about investing in securities must register with the SEC or their state securities agency. Registered advisors, with their clients' permission, may have discretionary authority over the investment management of their clients' assets.

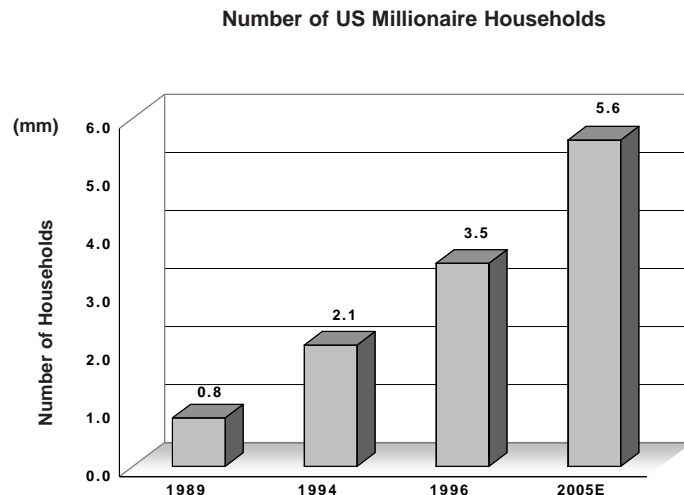
Thousands of individuals and firms are registered with the SEC as financial advisors. They include mutual fund managers, ERISA private account managers and family offices. For purposes of this paper, our definition of the financial advisory business refers to those companies that provide direct financial advice to the semi-affluent.

## The Semi-Affluent Investor - *The Millionaire Next Door*

We consider an individual or household to be semi-affluent should it have a total net worth greater than \$1mm and less than \$10mm. This net worth includes real estate, automobiles, retirement assets and any other investments. According the best-selling book *The Millionaire Next Door*, there are more than 3.3 million semi-affluent households in the United States.

A booming economy and stock market combined with a lifetime of work and savings has created the large number of semi-affluent families in the US. As shown in Exhibit 1.2, in only seven years, the number of millionaire households grew from about 800,000 to nearly 3.5 million. At current growth rates, there will be more than 5.6 million households each with a net worth of at least \$1mm by 2005.

Exhibit 1.2



Source: The VIP Forum, *The Millionaire Next Door*

This proliferation of wealth has not been matched by a similar growth in individuals' capability to manage that wealth. Many new millionaires have little experience or training in managing investments, yet they are approaching retirement age and are skeptical that they will be able to count on Social Security for their retirement. Because some participate in 401(k) or defined contribution pension plans and cannot count on traditional pensions, they realize that they will become increasingly reliant upon their investment income rather than regular paychecks as they age. Millions of households have sought financial advice as a result.

Within the ranks of the semi-affluent, there are many investors who prefer to manage their own portfolios. The growth of businesses such as E\*Trade's Platinum Program – currently with an estimated \$40B in assets – reflects that some individuals still want to trade for themselves. For the purpose of our research, we are considering only those semi-affluent individuals who are "delegators."

Delegators are those individuals who prefer to delegate the management of their money to full-time professionals. While they are very interested in the strategies and closely monitor the investments selected by their advisors, delegators recognize that they lack the expertise in the financial markets and the time necessary to successfully manage their money. They want someone else to worry about their investments as a full-time job.

### **The Traditional Model for Delivering Financial Advice to Clients Was Inadequate**

The financial advisory business' growth is a direct result of the delegators' increased demand for advice and the failure of traditional financial services providers to deliver it in a manner that met the unique needs of each client. Historically, there have been two primary models for delivering advice to individuals – the family offices or intermediaries compensated on the basis of transactions.

The family office is a collection of financial, legal and tax advisors who work exclusively for one (or in some cases, a few) wealthy families. It is designed to manage the assets of the affluent, taking a long-term view to investing and the creation and transfer of wealth. Its responsibilities include hiring outside money managers, overseeing tax planning and preparation, supervising the family's charitable giving and developing and executing an estate plan. Its purpose is to perpetuate a family's wealth across generations.

The problem with a family office is that it is an option generally available only to the very wealthy (net worth >\$50mm). Hiring dedicated, sophisticated investment, tax and estate planning professionals can cost hundreds of thousands of dollars per year, making a family office unaffordable for most semi-affluent individuals.

The historical alternative for getting financial advice relied upon intermediaries, such as brokers and financial planners. In exchange for helping an individual to identify good potential investments, including individual stocks and bonds or mutual funds, the intermediary would be paid a commission or sales charge for each transaction.

**There is a structural  
conflict of interest  
between transaction-  
based advisory firms  
and their clients**

There were numerous flaws with this second model from the perspective of many investors. First and foremost, there is a structural conflict of interest between the intermediary and his client. While the client's goal is to maximize his wealth, the intermediary has a clear financial incentive to maximize the number of transactions. And numerous research studies have shown that wealth is *minimized* when transactions are maximized. Further, even in those cases where intermediaries worked hard to reduce or eliminate this conflict of interest, the perception of conflict often remained.

A second problem with this model is that many brokerages and financial planning firms had historically restricted the investment options that their employees were allowed to offer to clients. Mutual funds from outside vendors were limited to a handful of alternatives and intermediaries were offered incentives to sell only the funds managed by the firm's own asset management company.

Another problem was that, at some firms, brokers were often encouraged to sell products such as limited partnerships or initial public offerings with risk profiles not necessarily appropriate for clients' long-term financial goals. Rather than provide a comprehensive financial solution to clients, in many cases, semi-affluent individuals found that these intermediaries were focused far too much on the short term.

Finally, the model was insufficient to assure investors that they would receive competent financial advice. The qualifications at many firms for financial advisory positions were limited to the ability to get an appropriate securities license. Unfortunately, the exam was designed solely to test an applicant's knowledge of securities laws and regulations and a basic understanding of financial markets and products. It in no way tested for competency as an investment advisor. Consequently, all too often the quality of advice was inadequate.

**Many Sophisticated Intermediaries Created Small Independent Advisory Practices**

Many of the more sophisticated financial intermediaries were frustrated by their lack of control in the delivery of advice to the client and the limited investment alternatives available for implementation. They left large organizations and set up small advisory practices designed to provide independent advice best suited to their clients' needs and unconstrained by other factors.

Commissions, however, were still a large part of their compensation and these organizations had the same structural conflict of interest as the large organizations. In an attempt to reduce at least part of this conflict of interest, many of these new firms over time began shifting their businesses to more "fee-based" compensation, a combination of lower commissions and ongoing asset-based fees. These asset-based fees were designed to reduce the intermediary's incentive to increase the level of transactions in his clients' portfolios.

This shift to relying on fees for compensation ultimately led many new independent advisory businesses to evolve into “fee-only” companies. They received no commissions and were paid a flat fee equal to some percentage of the assets managed for each client.

### **Investors Were Attracted to Better Advice and Fewer Conflicts of Interest with Their Advisors**

Investors were attracted to the high quality, independent advice that these organizations delivered and the lack of structural conflict of interest in how they were compensated. Investors flocked to these independent advisory businesses, leaving traditional financial intermediary organizations in droves.

Many accountants, financial planners, trust officers and brokers recognized the opportunity and started their own businesses. These entrepreneurs were attracted by the operational leverage that the fee-only financial advisory business provided and their traditional businesses lacked. Instead of being paid an hourly fee for the preparation of tax returns or trust documents or for the creation of a financial plan, an advisor is paid based upon the amount of assets under management for as long as the advisor retains the assets.<sup>1</sup>

Although it generally takes a substantial amount of initial work to analyze a client’s portfolio, a financial advisor can as easily oversee \$100mm on an ongoing basis as he can \$10mm. With \$100mm, however, the advisor is often paid 10 times more.

### **Financial Advisory Business Is Extremely Fragmented**

The resulting industry is very fragmented with more than 11,500 firms.<sup>2</sup> It is made up mostly of sole practitioners and small partnerships, each offering a variety of different services. As shown in Exhibit 1.3, its members include current and former accountants, financial planners and trust officers.

At the top end of the industry, the financial advisory business consists of incredibly sophisticated investors. They include numerous PhDs and CFAs and some are even finance professors at major universities and/or the authors of numerous research papers and books on the capital markets.

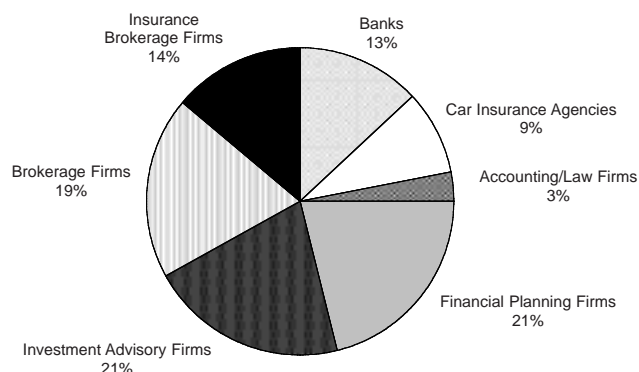
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<sup>1</sup>It is important to point out that we are not suggesting that fee-only compensation structures are appropriate for all clients. The economics of delivering advice to small clients mandate a transaction-based compensation system. Charging a fee equal to a small percentage of assets is impractical if an individual is investing only small amounts of money. By charging 1% of assets annually in exchange for providing advice to an individual with only \$25,000 to \$50,000 of liquid assets would generate fees of only \$250 to \$500 per year and would make it very difficult for an intermediary to provide the ongoing advice expected of a financial planner.

<sup>2</sup>Source: FIAG

**Exhibit 1.3**

**Previous Affiliations of Investment Advisors (1997)**



Source: FIAG

**Exhibit 1.4**

**Financial Advisors' Licenses and Designations by Assets Under Management (1996)**

| Assets Under Management (\$mm) | CFP | CFA |
|--------------------------------|-----|-----|
| \$5 - \$50                     | 75% | 25% |
| \$50 - \$100                   | 71% | 57% |
| \$100 - \$250                  | 27% | 60% |
| Greater than \$250             | 0%  | 71% |

Source: Cerulli Associates, Inc.

There is also a myriad of methods in which financial advice is currently delivered by advisors to the semi-affluent client. There are private money managers who invest in individual stocks or bonds. One group of advisors provides asset allocation services or even comprehensive financial plans and uses outside private account managers or mutual funds to invest their clients' assets. Other advisors provide a mix of individual security selection and use outside managers. One Silicon Valley start-up, Financial Engines, is in the process of developing a business to deliver financial advice over the Internet.

**Most Advisory Firms Are Unprepared for Their Success**

Independent advisory firms are now facing a major problem – they are far more successful than they expected and are unsure of what to do next. Several firms that we interviewed had expected five years ago that they would have \$50mm to \$75mm under management today. Instead, many have \$250mm to \$300mm – and they have been so busy building their businesses that they have had little or no time to plan for the future.

Virtually all of the firms that we interviewed expect that their industry will become significantly more competitive in the future. Although they anticipate that at some point the industry's structure will change from its current fragmented status, most advisors are unsure how the industry will evolve and what forces will likely drive the evolution.

The advisory firms that we interviewed also believe that their companies have intrinsic values that are significantly greater than their book values. But few had ideas on how their businesses should be valued and how to capture as much of this value as possible.

### **Goals of This Paper**

The purpose of this paper is to examine the financial advisory industry today, the forces confronting it and to try to predict how it will likely evolve over the next seven to ten years. We will try to identify what actions advisory firms should consider in order to position themselves to capitalize on many of these forthcoming changes as well as those attributes that will be common to the most successful organizations.

We also will examine how the capital markets in the future will likely value these businesses and those factors that will most affect their valuations. Finally, we will look at what this upcoming evolution of the advisory business could mean for other personal financial services companies.



## II. Forces That Will Drive the Evolution of the Industry

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A particular feature of the financial advisory industry that has made it an attractive business has been the extremely low cost of acquiring clients. Large firms are often inundated with referrals and qualifying potential leads is currently more important than generating new ones. The fact that there are only 24 hours in a day has been the single biggest obstacle to these organizations' growth.

Other costs associated with establishing an advisory business are also relatively small. As a result, unlike most financial services businesses, there are few, if any, barriers to entry. With the appropriate licenses, registrations and office space, a proprietor can set up an advisory practice and pursue clients. The immense demand for financial advice has enabled many of these sole proprietorships to become profitable businesses in less than a year.

The industry's low cost of entry won't last forever, however. A variety of factors will significantly change the industry over the next seven to ten years and will make it much more capital intensive, sophisticated and competitive.

### Forces That Confront the Industry

1. Brokerages are fighting back
2. New, powerful competitors are entering the industry
3. Information and technology are reshaping client perspectives
4. Most of an advisor's value-added is provided during the initial stages of a relationship with a client
5. Indexing is now a popular option
6. Diversification has hurt short-term returns
7. Advisory fees are under pressure

**Most of the larger retail brokerages have developed new programs over the last five years targeted at the semi-affluent investor**

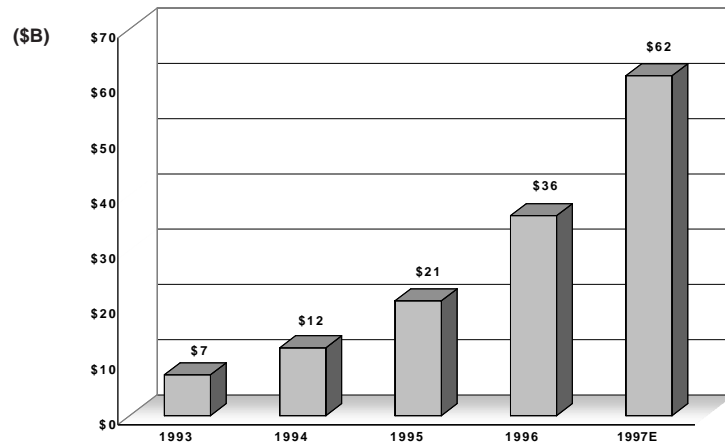
### The Brokerage Industry Has and Will Continue to Fight Back

Brokers have traditionally been advisors' primary competition for semi-affluent clients. And the brokerage industry has not stood still. Nearly all of the larger retail brokerages have developed new programs over the past five years targeted specifically at these individuals.

Most brokerages now offer a wider variety of investment alternatives and managers for their clients. Many have also modified their compensation schemes to reduce the conflict between brokers and their clients. Such changes include mutual fund and separate account wrap programs that allow investors to compensate intermediaries based upon a percentage of assets under management. According to Cerulli estimates, these combined programs had captured nearly \$140B by the end of 1996 and are rapidly growing.

Exhibit 2.1

Mutual Fund Wrap Assets



Source: Cerulli Associates and Undiscovered Managers estimates

Recently, Merrill Lynch launched a flat-fee program that covers all transactions executed by a client. For a minimum annual fee of \$1,500, a client will receive a customized financial plan, unlimited trades in most securities and access to Merrill Lynch original research.

Many brokerages now also offer "C-shares," a class of mutual fund shares that incorporates fee-based compensation into the structure of a load mutual fund. This type of share is an effective tool for helping brokers gradually transition their businesses from transaction-based to fee-based. C-shares are currently the fastest growing class of mutual funds and now total more than \$66B of assets.<sup>3</sup>

**New, Powerful Competitors Are Entering the Financial Advisory Business**

The independent advisory industry is also confronting a flood of new competitors pursuing the same clients. Companies that had not traditionally been in the financial advisory business – such as accounting firms and trust attorneys – have started their own practices. The AICPA estimates that 66,000 CPAs will enter the asset management or financial planning businesses over the next five years. Many trust departments and investment banks such as JP Morgan and UBS Brinson, which had for many years focused solely on the wealthy, have expanded their businesses to target semi-affluent clients. Further, many independent trust departments now believe that capturing the semi-affluent investor is critical to their success.

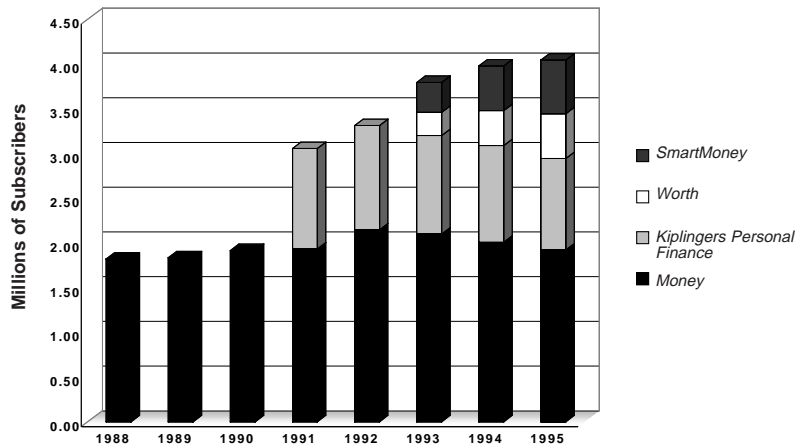
**New competitors will spend whatever is necessary to succeed in this market**

Several of these existing and new competitors are well capitalized and will spend whatever is necessary to succeed in this market. In addition, these organizations have other advantages, such as existing client relationships and brand names, which should help them compete for the semi-affluent client.

<sup>3</sup>Morningstar Principia Pro

Exhibit 2.2

Growth of Financial Magazine Circulation



Source: Bernstein Research

### Information and Technology Are Reshaping Clients' Perspectives and Creating New Demands on Advisory Firms

The improvements in information and technology are reducing much of the mystery surrounding many individual advisory functions

Pressure from other competitors is not the only factor that will change the advisory business. Clients are getting smarter. Magazines such as *Worth*, *Kiplingers*, *Money* and *SmartMoney* have educated the average consumer by addressing a wide variety of issues ranging from mutual funds to tax and estate planning. Similarly, with networks such as CNBC and CNNfn, the electronic media bombards consumers with information on investing.

The increasing power of microprocessors and the Internet are also giving consumers the tools to better analyze this newly available information and have stripped away many of the advantages advisors have had over their clients. With tools such as *Morningstar*, consumers can compare and analyze mutual funds. The same clients can also purchase software packages to develop their own financial plans. Tax preparation software such as TurboTax has also significantly reduced the demand for the services of some accounting firms.

More ominously, several software companies such as Financial Engines and Ibbotson are developing very sophisticated and user-friendly asset allocation tools that incorporate the most advanced financial simulation models. These tools enable an individual investor to conduct a very detailed analysis of various asset allocation strategies. Plan sponsors of large corporations may provide these tools with training to their employees free of charge.

The result of these improvements in information and technology is that much of the perception of mystery surrounding many individual advisory functions is dissipating and will evaporate over time. Potential clients will be more sophisticated about investments and will start from a different reference point than existing clients. They still might not feel comfortable or be capable of managing their own investments, but they will be far

more able to evaluate the quality of the advice that they receive. They also will demand greater value-added from their advisors on a continuing basis.

### **Too Large a Percentage of an Advisory Firm's Value-Added Is Often Provided During the Earliest Part of a Relationship**

Such demands are particularly problematic for many advisory firms because they provide much of their current value-added early in a relationship with a client. This value-added consists mostly of developing a modified financial plan, allocating client assets and selecting managers. A majority of this work is completed in the early stages of a relationship even though the advisor continues to receive the same fee annually.

**An advisor who was initially invaluable does not seem to be doing much in the later years of a relationship**

During the later years of a relationship, these advisory firms mostly monitor existing managers or mutual funds and, at the margins, rebalance asset allocations. Replacing too many managers or mutual funds too often, however, will bring the quality of the advisor's investment advice into question. Such changes – or rebalancing a portfolio's asset allocation too often – can also generate significant tax costs for clients.

As a result, a client will often meet with an advisor and will not see significant changes in his portfolio from the year before. At the same time, the client is still paying the same annual fee. From the perspective of many clients, the advisor that was initially invaluable does not seem to be doing too much for his money in the later years of a relationship.

### **Indexing Is an Option Now Available to the Consumer**

Such perceptions by clients are particularly problematic for advisors that use indexing as part of clients' portfolios. Through the efforts of Vanguard and Schwab, indexing has become a widely used option for individual investors. In the first half of 1999 alone, \$33B of net new assets flowed into index funds.<sup>4</sup>

One of the attractive features about indexing is that it is low cost and simple. An investor is trying to replicate the return of an index and is not trying to beat the market. While determining how to correctly initially allocate one's assets among various index funds might be complicated, over-seeing a portfolio of index funds is not.

### **Diversification Has Hurt Short-Term Returns**

Further exacerbating the challenge for many advisory firms is that a large part of their value-added is to help clients diversify their portfolios through asset allocation. Although modern portfolio theory has shown the benefits of diversification over the long term, the last five years have seen the S&P 500 Index outstrip the returns of virtually every other asset class by

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<sup>4</sup>Simfund

a substantial margin. Clients that are already questioning the value-added provided by their advisors often observe that their best performing funds are those that are indexed to the S&P 500. In the near term, their advisors' advice appears to have lowered their returns.

### **Advisory Fees Are Under Pressure**

Understandably, advisory fees are also under pressure. While many organizations initially charged 1.5% to 2.0% annually of assets under management for their services, the median fee level has fallen over time to 1.0% on average.<sup>5</sup> Most advisory firms now offer price breaks for larger accounts and will even discount their published fee schedule in order to capture a new client. As the industry gets more crowded with competitors, fees will likely fall further.

These new competitors are more focused on capturing the large intrinsic value of this business rather than generating short-term profits. By taking such a long-term view to the industry, they are willing to further compress operating margins by additionally discounting fees while at the same time expanding their services in order to capture market share.

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<sup>5</sup>Cerulli Associates, Inc.



### III. A Potential Proxy for How the Financial Advisory Industry Might Evolve

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The many forces confronting the financial advisory industry will cause it to change. It appears that the resulting business will be ferociously more competitive and that firms will need to expand and upgrade their services. At the same time, they will be paid less for their work.

While no one knows exactly how these forces will change the financial advisory business, we believe that a good proxy does exist.

#### **The Institutional Money Management Business Is Similar to the Financial Advisory Business**

The institutional money management business – the business of managing money for defined benefit pension plans, foundations and endowments – has many similarities to the financial advisory business. Organizations in both industries are paid for providing financial advice to their clients. The institutional money manager's advice is provided through the management of money. While advisory firms often manage money, they are also paid to evaluate outside money managers.

Another major similarity is that the real economic value of a firm in either business is usually much higher than its book value. The book values of most firms in these businesses are negligible. But their economic or intrinsic values can be significant and are tied to the sustainability of the relationships that they have with their clients.

Institutional money management firms' relationships are with the key personnel and decisionmakers at pension plans, foundations and endowments. These individuals are responsible for deciding whether to continue using the services of the money management firm in the future.

At advisory firms, relationships are with individual clients and households. Similar to pension plan decisionmakers, an advisor's clients must decide each year whether to continue using the services of the firm. Relationships are critical because they generate the recurring fees that provide most of the revenues for both types of businesses.

The financial advisory and institutional money management businesses are also similar in that both have substantial operating leverage in one of their core services – investment management. It costs a money management firm or an advisory firm the same to invest \$1B as it does \$1mm. However, the fees received for investing \$1B (spread across many clients) can be as much as 1000 times greater than those for investing \$1mm. As a result, both well-run institutional money management firms and financial advisory businesses can achieve very large operating margins if they are large enough to generate scale.

**The economic value of both types of businesses is tied to the sustainability of client relationships**

## **Both the Institutional Money Management and Financial Advisory Businesses Began as Cottage Industries**

If you look back at the institutional money management business 20 years ago, the similarities between that business and today's financial advisory industry are striking. Both began as cottage industries consisting of sole proprietorships or small partnerships. These companies were often founded by former trust department employees or frustrated academics and were small firms that provided limited services to their clients.

In the case of institutional money management firms, the organization usually provided investment management services employing strategies targeted at one or two asset classes (e.g., large cap growth and small cap growth, small and mid cap value, etc.). Most advisory firms currently provide two or three services, usually limited to manager or mutual fund selection, asset allocation and a modified form of financial planning.

**The similarities between the institutional money management business 20 years ago and the financial advisory business today are striking**

For the institutional money management industry 20 years ago (and for most financial advisory businesses today), the firm's owners usually controlled the organization's relationships. Such narrow control over a firm's relationships proved to be and is currently problematic (for advisory firms) for two reasons.

First, should one of the proprietors die or leave the business, the organization would likely lose a large percentage of its clients. These firms, therefore, have or had little or no economic value as ongoing entities without the proprietor.

Second, the growth of institutional money management firms was – and is in the case of financial advisory firms – dramatically hampered by how their relationships were and are managed. With one or two people responsible for all of an organization's relationships, the number of relationships that the proprietors could oversee limited the firm's potential growth.

Most of these institutional money management firms did not have (and financial advisory firms currently lack) separate marketing forces. Clients were usually generated through referrals from consultants. Similarly, financial advisory clients are usually generated through referrals from current clients or other financial service providers such as accountants or lawyers.

Also similar to today's financial advisory businesses, few institutional money management firms 20 years ago had nationally recognized brand names. They tended to service a narrow range of clients and usually generated most of their business from local markets. Their core client bases often used the same money managers and only occasionally would a firm capture a client outside of its usual geographic area of business.

Over the past 20 years, the institutional money management business has undergone a major evolution that has substantially changed the industry. Today it is dominated by a small number of large firms that each manage often hundreds of billions of dollars and a collection of thousands of small money managers battling to survive.

**Institutional Money Management Industry 20 Years Ago**

| Structure           | Services Provided   | Marketing  | Economic Value  | Development                      | Structure   | Services Provided  | Marketing  | Economic Value                                      |
|---------------------|---|--|---|----------------------------------|---|--|--|---|
| Sole Proprietorship | Limited Services<br>- Product Oriented<br>- Asset Management for single asset class investment strategy | No Marketing Force<br>- All marketing and client service functions done by portfolio manager<br>- No brand name recognition<br>- Regional focus<br>- New mandates sourced through consultant relationships | Proprietor Control of Relationship<br>- Mandate relationship with portfolio manager | <i>Dominant Competitor</i>       | Global Organization<br>- Large companies<br>- Compete for assets in many countries<br>- Invests throughout the world              | Solutions Provider<br>- Understand clients<br>- Create solutions<br>- Anticipate future client needs | Strong Brand Name Recognition<br>- Professional marketing force<br>- Institutionalized relationships<br>- Global focus<br>- New mandates sourced through client and consultant relationships | Very Profitable Companies<br>- High intrinsic value |
|                     |   |  |   | <i>Do Nothing - Remain Small</i> | Domestic Organization<br>- Small companies<br>- Competing for smaller pool of assets<br>- Declining margins<br>- Survival at risk | Product Provider<br>- Limited asset class capabilities   | Limited Brand Name Recognition<br>- Limited marketing force<br>- Regional focus<br>- Compete solely on investment returns  | Future Unclear                                      |

**Institutional Money Management Industry Today**

**Investment Advisory Industry Today**

| Structure           | Services Provided  | Marketing  | Economic Value  | Development                      | Structure   | Services Provided                                      | Marketing   | Economic Value |
|---------------------|--|--|---|----------------------------------|---|--|---|----------------|
| Sole Proprietorship | Limited Services<br>- Product Oriented<br>- Investment selection, asset allocation and modified financial planning | No Marketing Force<br>- All marketing and client service functions done by advisor<br>- No brand name recognition<br>- Regional focus<br>- New clients sourced through referrals from existing clients or relationships with other financial service providers (CPAs, lawyers, etc.) | Proprietor Control of Relationship<br>- Client relationship only with advisor | <i>Do Nothing - Remain Small</i> | Domestic Organization<br>- Small companies<br>- Competing for smaller pool of assets<br>- Declining margins<br>- Survival at risk | Product Provider<br>- Limited asset class capabilities | Limited Brand Name Recognition<br>- Limited marketing force<br>- Regional focus<br>- Compete solely on investment returns | Future Unclear |
|                     |  |  |   |                                  |   |  |   |                |

Many forces that led to the evolution of the institutional money management business 20 years ago are similar to those that confront the financial advisory business today. Back then, a horde of new competitors was entering the institutional money management business. Many clients were shifting large portions of their portfolios to indexed strategies. And fees began to decline as industry competitors began to fight for market share instead of worrying about short-term profitability.

The two industries are clearly not identical. There are, however, too many similarities to ignore. An examination of how the institutional money management business evolved would therefore be instructive when trying to predict how the financial advisory business will likely change in the future.

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**Catalysts That Changed the Two Industries**

| Institutional Investment Management<br>Industry 20 Years Ago | Registered Investment Advisory<br>Industry Today       |
|--|--|
| ERISA  | 401(k): Shifting Pension Responsibility to Individuals |
| Demographics of Companies                                    | Aging of the Population                                |
| Increasing Competition                                       | Increasing Competition                                 |
| Fee Pressures  | Fee Pressures  |
| Rising Costs   | Rising Costs   |
| Declining Margins  | Declining Margins                                      |

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**Evolution of the Institutional Investment Management Industry**

The creation of the institutional investment management industry as it is known today can be traced to two major factors. The first was the ERISA legislation that significantly changed the rules for how companies had to manage their pensions. A sweeping piece of legislation, ERISA was designed to protect the pensions of American workers and ensure that tax dollars would not be needed to make up for the failures of companies to properly manage or fund their pension plans.

Bank trust departments had historically dominated the management of pension assets. Their investment performance could be described as mediocre at best, yet they were usually retained by pension plans because of historical relationships and because the trust department's parent was often a key lender to the pension plan's company.

**ERISA forced many pension plans to consider investment performance for the first time when awarding mandates**

ERISA changed everything. The legislation imposed high standards on pension trustees, making them personally liable for ensuring that the portfolio was managed in a "prudent" fashion. These fiduciary standards were a clear threat to the personal financial well-being of trustees of organizations that tied pension business to the company's other activities. ERISA also forced many pension plans, for the first time, to consider the investment performance and qualifications of money managers when awarding mandates.

The legislation also imposed significant funding requirements on defined benefit pension plans. Companies were required to meet higher standards for funding their pension plans and the government could require them to use corporate profits to meet shortfalls.

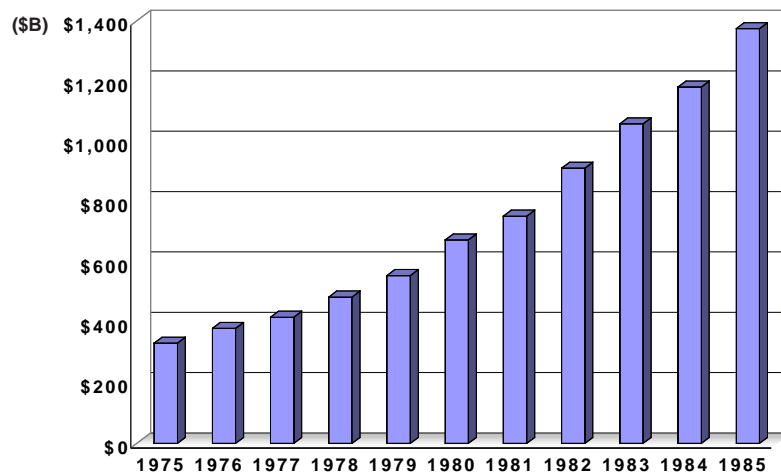
The second factor that changed the institutional money management business was demographics. While ERISA was giving companies and their pension plan trustees a reason to closely examine the quality of their investment managers, many companies also found that their workforces were aging rapidly. These demographics, combined with the poor investment results of the prolonged 1973 to 1974 bear market, meant that many defined benefit pension plans were substantially underfunded. Under pressure from the government, companies began to address their funding shortfalls and as shown in Exhibit 3.2, large amounts of assets poured into pension plans.

The significantly increased demand for money management services combined with a demand for better quality investment management helped spawn a cottage industry of money managers. Hundreds of new firms were launched almost overnight, each offering a specialty approach to investing.

The creation of a cottage industry was further aided by the emergence of an industry of pension consulting firms. Consultants served two roles.

**Exhibit 3.2**

**Growth of Assets in Defined Benefit Pension Plans**



Source: Bernstein Research

First, they helped protect the plan's trustees from some of their fiduciary liability. It was the consultants' duty to advise the plan so that its actions would be viewed as prudent.

The second role of consulting firms was to help corporate pension plans better invest their assets. They advised the plan on the proper allocation of its assets so that it would be able to meet its future liabilities and would be in compliance with all laws and regulations. The consultant also helped identify and evaluate potential outside money managers. In this capacity, consulting firms became the de facto gatekeepers to many pension plans for most money managers.

Consequently, a small investment management firm needed only to build good relationships with a few consulting firms and it could easily capture large amounts of money to manage. Individuals who had worked at a trust department could literally quit their jobs, start a new firm, and in a relatively short period of time, be in contention to capture new assets through their existing relationships with consultants.

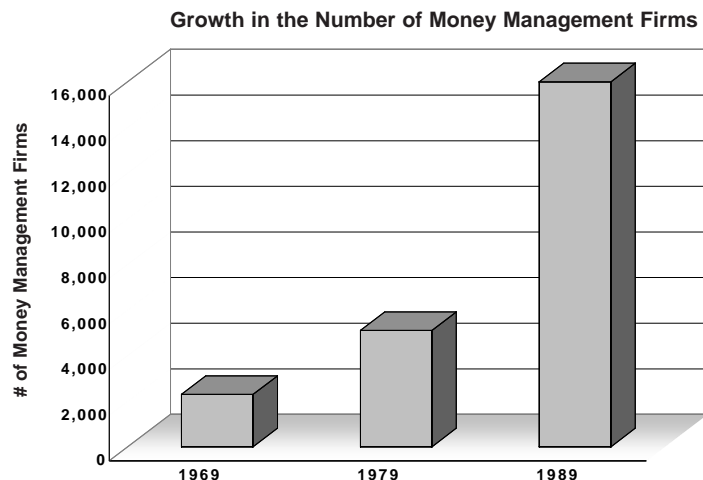
Little or no capital was required to start an institutional management business during this time period. A good money manager needed only office space and an administrative assistant to manage money. There were few, if any, barriers to entry into the business.

### Consultants Helped to Further Fragment the Industry

The consulting industry also encouraged specialization (e.g., growth versus value, large cap versus small, etc.). Firms were viewed as having an expertise in only one or two strategies and their value-added was solely investing money using these investment processes.

These factors combined to create an extremely fragmented industry. As shown in Exhibit 3.3, from 1969 to 1979, the number of investment management companies more than doubled and from 1979 to 1989, it tripled again.

Exhibit 3.3



Source: The VIP Forum

**Plan sponsors recruited sophisticated staffs with broad experience in the financial markets**

About 20 years ago, forces similar to those now confronting financial advisory businesses today began to change the institutional money management industry. The growth rate of new assets in the industry slowed as existing pension plans became fully funded and more companies began to shift to defined contribution or 401(k) plans instead of providing their employees traditional pension plans. More ominously, the new assets available for active managers shrunk even further as more plans began using indexing as a core part of their strategies.

The large number of firms in the industry created intense competition for new mandates and made retaining existing ones more challenging. Plan sponsors also recruited sophisticated individuals with broad experience in the financial markets. In some cases, pension plans decided to manage some types of investments themselves.

The intense competition for client assets also put great pressure on management fees. Managers accustomed to receiving as much as 1% per year for managing generic products such as core equity often found their fees cut in half. In addition, many ERISA plans required that their investment managers sign a "Most Favored Nations Agreement." Such agreements mandated that the manager charge a pension plan a management fee equal to or less than the rate paid by other plans for similar mandates.

Technology also significantly changed the institutional investment management industry. The advent of the microprocessor and the personal computer made it much easier for a company's pension plan staff to track the performance of their investment managers on an absolute basis and relative to other money management firms.

Technology gave pension plans the ability to measure if their investment managers were truly adding value. As a result, institutional money management firms had to develop or purchase sophisticated reporting systems as well as risk management and attribution analysis tools. No longer could a management firm rely on simply selecting investments and generating good absolute returns if it hoped to be retained as the manager for a pension's assets.

**A Handful of Firms Took Advantage of the Forces Confronting the Investment Management Industry**

All of these forces increased the cost of entering and competing effectively in the institutional money management business. A handful of firms, however, saw the forces confronting the industry as an opportunity. They anticipated many of the changes that were about to occur and their visionary strategies helped them achieve incredible rates of growth.

Two examples of such firms include Brinson Partners (now UBS Brinson) and Capital Guardian Trust Company. These organizations changed their businesses in three major ways – and developed into very large companies as a result, managing hundreds of billions of dollars.

### **Brinson’s and Capital Guardian’s Three Changes**

- 1. Institutionalized Their Relationships**
- 2. Shifted from Selling Products to Providing Solutions**
- 3. Reinvested in Their Businesses for the Long Term**

**Marketers at most other organizations functioned like glorified maitre d’s whose job it was to identify potential prospects and then get out of the way**

#### **Change 1 - Institutionalized Relationships**

Instead of simply trying to compete on the basis of the quality of their products, Brinson and Capital Guardian completely changed their approach to marketing. Rather than rely on portfolio managers to serve as the primary relationship managers with accounts, these organizations institutionalized their relationships with clients by developing extremely sophisticated marketing forces and by using a team approach to deliver services to clients.

Their marketing units were staffed by people who had an understanding of investments and of the issues facing their clients. In the case of Brinson, all of its relationship managers had CFAs, many had managed money and some had previously worked at a defined benefit pension plan.

The marketing forces became the key contact points for all clients and were responsible for delivering all of the firm’s services and resources. While portfolio managers were included as part of relationship teams, their relationship responsibilities were limited to specific product questions. The teams also included individuals with specific expertise on issues affecting the client’s business. Instead of viewing the portfolio manager as the only representative of the firm that mattered, the value-added provided to clients was delivered by many different individuals. By diversifying the delivery of value-added, these organizations institutionalized their client relationships.

Creating such marketing forces was revolutionary. At that time, most money management organizations were portfolio manager-centric. They lived and died by their portfolio managers and all other members of the organization were viewed simply as the hired help. Their marketers functioned like glorified maitre d’s whose job it was to identify potential prospects and then get out of the way.

More importantly, relationships served as the key source of power for most portfolio managers over their organizations. Unless a portfolio manager's demands were met, he might leave the organization, and many relationships and their accompanying asset management mandates would follow him to his next firm.

By institutionalizing their relationships, Brinson and Capital Guardian stripped their portfolio managers of much of their leverage. It also elevated the marketing force to the same status and importance as the portfolio managers.

## **Change 2 - Shifted from Selling Products to Providing Solutions**

The second major change that these institutional money management firms made was to shift from selling products to solving client problems. Instead of marketing their services solely on the basis of the quality of investment performance, their focus was on identifying and understanding the issues facing their clients and helping them craft solutions to these problems.

To accomplish this goal, Brinson and Capital Guardian developed a wide range of services not directly tied to their investment products and included providing advice on asset allocation and global investment strategies. These services were designed to enable the money management firms to function as a consultant to the client and not just as a vendor.

**Capital Guardian's and Brinson's exceptional levels of service, combined with a better understanding of client needs, distinguished them from other investment managers**

Transitioning to solutions providers also meant focusing on doing a better job for existing clients. Employees were not (and even today are still not) allowed to use the term "products." Brinson and Capital Guardian did not have products. Rather, they were obsessed with creating "solutions" to client problems. They also changed the compensation structure for their marketing forces so that it placed a premium on capturing additional business from existing clients.

This shift to the role of solutions provider or consultant had several objectives. First, both organizations believed that only by expanding their services to their current base of clients would they be able to build sustainable, long-term relationships.

Second, these organizations recognized that clients are not interested in good investment products. Rather, good investment products serve only as potential solutions to client problems. Brinson and Capital Guardian realized that only those organizations that played key roles in designing solutions to client problems would be in a strong position to compete for the resulting mandates.

## **Most Pension Plans Used Too Many Money Managers**

Another reason these money management organizations shifted their business model was that it was clear that their clients used far too many money managers than they could effectively oversee. Some pension plans had more than 60 or 70 outside managers, each responsible for a

different mandate. Brinson and Capital Guardian correctly anticipated that most major pension plans over time would reduce their number of outside managers and break them into two groups.

One group would do more for their pension plan clients than simply a good job of investing money. They would work closely with clients on a wide variety of issues, in particular those problems that required resources in excess of the normal capabilities of the client to solve. This group, made up of five or six managers, would manage the majority of the clients' assets and would have the most sustainable relationships.

The second group of managers would be those organizations hired solely on the basis of the quality of their products. Their only function would be to deliver the best performance at all times. Their relationships with their clients would be tenuous at best. Should they falter, another high-performance manager would quickly replace them.

It is important to point out, however, that while the organizations in the first group offered substantially expanded and improved services to their clients, they did not do so at the expense of the performance of their investment products. Strong investment performance was a necessary but insufficient precondition to success. Their exceptional levels of service and commitment, combined with a better understanding of client needs, distinguished them from other investment managers with strong results.

**Strong investment performance was a necessary but insufficient precondition to success**

An example of how Capital Guardian shifted from a vendor to a consultant providing its clients with solutions was shown in its work with a large pension plan for an Asian government agency. This government's goal was to create a center for asset management within its country. Consequently, it awarded pension mandates only to those organizations that set up money management operations there.

A key problem for the pension plan was that, although it intended to ultimately shift the management of all of its assets to outside managers, this transfer would occur over many years. In the interim, the plan had to competently invest several billion dollars of assets.

To do so, the pension plan would have to hire teams of investment analysts and research staffs. But, they would need these personnel only until they completely shifted the management of their pension assets to outside organizations. Unlike the United States, however, it was almost impossible in that country for a government agency to lay off these employees once they were no longer needed.

Capital Guardian recognized the problem facing its client and crafted a solution. It provided the pension plan's internal portfolio managers direct access to Capital Guardian's numerous investment analysts and research staff. Instead of having to hire large numbers of employees that would be unnecessary for the long run, the pension plan was able to more effectively manage its assets by taking advantage of Capital Guardian's substantial investment in proprietary research capabilities. Understandably, Capital Guardian is now one of the plan's primary investment managers.

### **Change 3 - Reinvested in Their Businesses for the Long Term**

The cost of creating a sophisticated marketing force and developing a wide variety of non-investment management services that generated little or no revenue was very large. The third major change that both of these organizations made in their businesses was to sacrifice short-term profitability to reinvest in their companies so that they could capture larger market share.

As we have outlined earlier, most money management firms 20 years ago were sole proprietorships or small partnerships. Any reinvestment into the business meant a direct reduction in the income of the firm's owners, a reduction that most were unwilling to consider. Many had lived on minimal incomes as they built their businesses and were just beginning to enjoy the fruits of their success. The level of reinvestment required to build a sophisticated marketing force and to create a wide variety of consultative services was unthinkable to many of these owners.

Even among those money managers committed to reinvestment, many were simply too small to generate the cash flow necessary to fund such investments. The cost of creating and operating a sophisticated marketing force was more than \$5mm per year, far outstripping the profitability of most money management companies. Providing additional consultative services could increase a management company's cost by at least an additional \$6mm per year.

**Brinson and Capital  
Guardian sacrificed  
short-term profitability  
to reinvest in their  
companies so that they  
could capture market  
share**

Few management firms had any capital and most owners were reluctant to even consider selling a stake to an outside investor to fund the company's growth. Further, recruiting and retaining talented marketing and consulting staffs often required giving out equity stakes in the firm – a concept considered outrageous by portfolio manager-centric organizations.

### **Brinson and Capital Guardian Focused on Building Economic Value**

By contrast, Capital Guardian and Brinson Partners focused all aspects of their businesses on the long term. They made significant investments to improve the quality of the services they provided their clients, with the goal of creating substantial economic value by becoming dominant competitors.

Compensation systems were structured to reward activity that would generate the most long-term value for the company. Nearly every professional employee was given an economic stake in the firm and, as a result, both organizations experienced little or no turnover of key personnel.

Large investments were made in technology and systems that would work more efficiently with clients. Research staffs were expanded to upgrade the quality of money management. These companies sponsored conferences focused on major regulatory and economic issues that educated clients on issues affecting their pension plans. Capital Guardian even created a family of benchmarks (used today by investors everywhere) to help clients better measure the performance of certain parts of their portfolios.

Both organizations also made large investments in new products in an attempt to anticipate future client needs. Developing such products was very costly, requiring new research staffs, technology and/or new offices. It was also very risky because they had little certainty that clients would ever use any of these new products.

### Capital Guardian Anticipated the Need for International Investing Capabilities

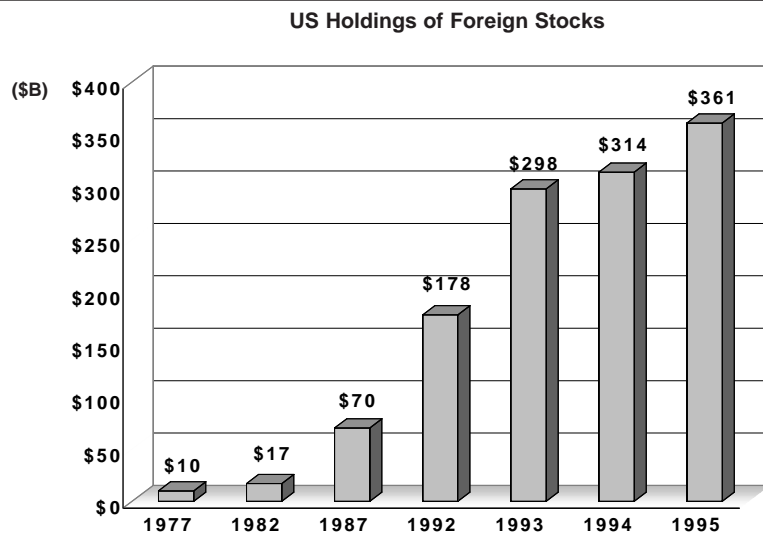
A good example of how these firms made large, risky investments (and showed great foresight) to position themselves to solve future client problems is shown in Capital Guardian's international money management business. It began building the capability to invest in markets throughout the world more than 25 years ago.

**Capital Guardian's international investment management business was unprofitable for 20 years**

There was little or no demand for these services at that time as few US pension plans were interested in investing outside of the United States. The fixed costs of creating a global investing capability were very large. Research staffs were needed throughout the world, each specializing in different regions. To function as single team, these groups needed to be linked on a real-time basis, necessitating an enormous investment in technology and other resources. The high cost of such an enterprise combined with the small initial demand for the product caused Capital Guardian to lose money in its international investment business for nearly 20 years!

Today, investing on a global basis is widely done by both institutional and individual investors. As shown in Exhibit 3.4, US investors in 1977 held only \$10B in foreign stocks. As of 1995, this number had jumped to \$361B, a large percentage of which was owned by defined benefit pension plans.

Exhibit 3.4



Source: Bernstein Research

Capital Guardian's visionary approach to its business positioned it to capitalize on this shift in pension plan investing. Today, its international investment business is its single most profitable unit.

### **Both Brinson Partners and Capital Guardian Became Large Dominant Competitors**

By changing their businesses, Capital Guardian and Brinson Partners were able to emerge from the fragmented ranks of the industry as two of the world's leading institutional money managers. Although they focused on doing a better job for their existing clients and capturing more mandates from these pension plans, they were sought out by other pension plans because of the superior quality of their overall services.

**Brinson Partners and Capital Guardian are two dominant competitors; combined, they manage money for most of the major pension plans in the world**

As a result, both organizations grew spectacularly. In one 10-year period, Capital Guardian's institutional money management unit grew 40-fold. Between 1981 and 1992, Brinson Partners (and its predecessor company) increased its assets under management from about \$1B to \$2B to nearly \$35B. The future for both companies also looks very promising because of the depth and breadth of the relationships they have been able to build with their clients.

Today, the institutional money management business is a very mature industry dominated by a small group of large money management firms. These organizations manage hundreds of billions of dollars of assets and, as stand-alone entities, have market values in the billions of dollars. Brinson Partners and Capital Guardian are two of these dominant competitors. Combined, they manage money for most of the major pension plans around the world.

### **Smaller Firms Have a Difficult Existence Today**

Most money management firms that were unable to make the necessary changes to evolve into dominant competitors have a much more difficult existence today. The industry is shrinking on a cash flow basis and pension plans are indexing a larger percentage of their assets, making the pool of assets available for active management even smaller. As a result, they are small companies fighting for a larger share of a shrinking market, a very difficult business model at which to succeed.

In addition, the fees these small businesses charge are under great pressure as the market for new mandates has become increasingly competitive. Their margins have been further compressed because directed commissions or soft dollars, a traditional source of revenue for many institutional money management firms used to reduce their research costs, are now often controlled by clients and unavailable for managers to use.

The result is that many small firms are battling to simply survive. Their only basis for competing is the quality of their investment returns. Should they falter for even a brief period, small money management firms run the risk of losing substantial amounts of their assets under management. Some organizations that had more than \$4B of assets under management as recently as a few years ago are no longer in existence today.



## IV. The Coming Evolution of the Financial Advisory Business and the Emergence of Dominant Competitors

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**Forty to fifty dominant competitors will emerge from the fragmented ranks of the financial advisory business**

The financial advisory business today, much like the institutional money management business 20 years ago, is at a crossroads. It faces a series of forces that will change the shape and makeup of the industry and will make the criteria for success in this industry fundamentally different in the future. The business will become much more competitive as brokerages increase their efforts to capture semi-affluent clients and new competitors enter the industry. This competition will increase pressure on fees.

Similar to the development of the institutional money management business, we expect that the financial advisory industry's structure will bifurcate. Although there will continue to be thousands of small firms, a small group of 40 to 50 dominant competitors will emerge.

These dominant competitors will capture much of the industry's future growth. Each will have at least \$15B to \$20B of assets under management and some may oversee as much as \$50B. They will be very profitable and many will ultimately have market values in the billions of dollars.

Life for the smaller firms, by comparison, will be extremely challenging. Capturing new clients will be difficult. Existing clients will demand more services and greater value-added in those services on a continuing basis. At the same time, the average revenues per client will fall.

Unsophisticated organizations that add little value will struggle to survive. Financial advisory firms that simply gather assets and rely on outside vendors to provide most of the real value-added – such as manager selection and providing asset allocation templates – will have the hardest time. Their current value-added is so small that technology alone will soon undercut much of their business.

The future will also become more perilous for advisory firms that specialize in market timing. These organizations' value-added is solely an alleged ability to forecast market cycles. One sudden, unanticipated correction in the market could undercut their reason for existing.

### **What Will Dominant Competitors Look Like?**

Semi-affluent individuals are facing a challenge similar to that confronted by defined benefit pension plans 20 years ago. They are deluged by a wide variety of service providers, each of whose products are designed to meet only a portion of an individual's financial needs.

However, individuals are not necessarily interested in good investment, tax, financial or legal advice. They are interested in solving their financial problems, be it paying for their children's college education, managing their retirement assets or organizing their estate. Various forms of good advice are merely tools for solving their problems.

The best solutions for many individuals' financial problems are generated only when all aspects of their particular circumstances – such as retirement and lifestyle goals, tax situation and family considerations – are incorporated into strategies for managing their assets. Providing advice that only considers one or two aspects of the individuals' financial situations can often create unintended consequences and may actually cause more damage than benefit to a client.

Many individuals are also tired of using too many vendors for their financial needs. Much like pension plans 20 years ago, they want comprehensive advice that will solve their problems and be delivered at a lower cost.

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**Seven Sources of Value-Added of Future Dominant Competitors**



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**Future Dominant Competitors Will Deliver Comprehensive Financial Solutions**

Just as the dominant competitors in the institutional money management business became consultants and solutions providers to their clients, we believe future dominant competitors in the financial advisory business will deliver comprehensive financial solutions to their clients. To do so, they will need to provide, at minimum, seven sources of value-added to their client's financial situation: financial planning, investment management, tax planning, tax preparation, insurance, estate planning and charitable giving. Most advisory firms today only provide two or three.

Future dominant competitors will also deliver comprehensive solutions to clients at a price equal to or lower than clients currently pay for only two or three types of financial advice. The quality of advice will also be much higher than that currently delivered by the average personal financial services firm.

### **Six Common Traits of Future Dominant Competitors**

- 1. Understand their clients**
- 2. Utilize professional marketing forces**
- 3. Institutionalize relationships**
- 4. Provide expanded, extremely sophisticated advice**
- 5. Technology is an integral part of their businesses**
- 6. Achieve critical mass or obtain capital to fund growth**

In essence, the dominant competitors will effectively function as multi-user family offices for the semi-affluent. The same services that are provided to the very wealthy through their personal family office will be delivered to semi-affluent clients in a manner appropriate to their net worth. And each of the future dominant competitors in this industry will share the same six traits.

#### **Common Trait 1 - Understand Their Clients**

While the industry's future dominant competitors will provide expanded services to their clients, they also will be more adept at structuring solutions that meet their clients' true needs and goals. Understanding clients, however, is a multi-faceted challenge.

**Human beings and their needs are not driven solely by rational financial decisions**

Human beings and their needs are not driven solely by rational financial considerations. Personal values and ego play prominent roles in human motivations. Individuals do not share the same tolerances for, and perceptions of, risk. And the needs and desires of family members are also major factors in clients' financial situations. To truly understand their clients, advisory firms will need to blend all these factors into their analyses of clients' situations.

The most important common trait of future dominant advisory firms is that they will understand their clients from more than just a financial perspective and will be able to tailor their advice to each client's specific needs. These firms will develop tools and processes that can be used to gauge clients' initial tolerance for risk and how it changes over time. They will also develop the means to evaluate how their clients perceive risk and how these perceptions might differ from those of the firm. Such tools will allow advisory firms to better understand their clients' perspectives, the amount of client education required to have successful relationships and whether the firm is the appropriate advisor for each client.

Future dominant advisory firms will incorporate into their services and capabilities tools and processes that will enable them to factor in all of the constituencies in an individual's financial life when crafting a comprehensive financial solution. One such innovative approach that we uncovered during our research that is currently used by at least two advisory firms

involves the participation of a clinical psychologist as part of the advisory team. Both of these organizations recognize that one of the most stressful events in the life of a family occurs when the parents decide how they will distribute their estates.

The psychologist works with each family member through a counseling process designed to help the family create a consensus as to what they want as their family's "legacy." The legacy includes how the estate should be distributed and how the family's gifts to charity should be structured.

By taking such a comprehensive approach to understanding their clients, these firms are able to better structure investment strategies that will meet the entire family's long-term goals. More importantly, this approach enables these firms to develop relationships with many members of the family and be in a position to continue to manage those assets transferred between generations after their current clients pass away.

### **Human Capital Is as Important as Financial Capital**

While most advisory firms have focused their analyses on their clients' financial capital, human capital – an individual's potential earning power – is often the client's most valuable asset. In some cases, this human capital is embedded in businesses that clients own and has the potential to make them very wealthy. Understanding this intangible wealth and assisting in maximizing it can be as important in the creation of wealth as the management of clients' financial capital.

Future dominant competitors will understand their clients' businesses and careers and, over time, find ways to help them better exploit their human capital. Similar to the relationship between current dominant competitors in the institutional money management business and their pension clients, many future dominant advisory firms will even advise clients on issues affecting their businesses, separate from personal finances. The key objective of these dominant competitors will be to broaden the role that they play in the creation of wealth to increase the likelihood that they will play a role in managing that wealth.

### **Common Trait 2 - Utilize Professional Marketing Forces**

The true business of the financial advisory business is not giving individuals financial advice. Rather, it is getting individuals to pay for financial advice. The quality and breadth of an advisory firm's services are irrelevant if no one is willing to pay for them.

A big difference between future dominant competitors and most current financial advisory businesses will be in how they capture new clients. Most advisory firms today do not have employees whose primary job is to

**An advisory firm's true business is not providing advice, but getting individuals to pay for advice**

market to and service clients. Marketing and client service are not separate functions executed by specialists. Instead, like proprietorships in many other industries, marketing and client service are only two of the many duties of the firms' owners.

Advisory firms to date have not developed marketing staffs because they often have more client prospects than they can pursue. Most larger advisory firms have more client referrals than they can contact and, other than their time, the cost of acquiring clients is almost zero.

As competition for potential clients increases, however, marketing will become a much more complex and critical function. Marketing programs will need to be designed to address the problems of specific groups of potential clients and be structured and presented in a fashion particularly well suited to a target audience.

Many new competitors to this industry have substantial resources and will make large investments in marketing staffs. Potential clients will soon find that they have an overwhelming number of well-qualified alternatives for getting advice. Success in capturing new clients will, therefore, require a significant, ongoing investment of time.

Marketers will play the key role in understanding the issues and problems of potential and current clients. They will advise clients on their businesses and will serve as the conduit for the firm's advisory services. Those organizations that continue to view marketing as only an additional duty for the same person that delivers advisory services will struggle to compete.

Future dominant competitors will create separate marketing forces for their organizations. They will also make the necessary investments of time, personnel and publicity required to develop a brand name for their businesses in the markets in which they compete for clients. Creating a marketing force and building a brand will be very costly activities.

### **Common Trait 3 - Institutionalize Relationships**

A majority of advisory firms today – much like institutional money management firms 20 years ago – rely on a few principals to manage all their client relationships. The same person responsible for providing the firm's value-added to the client is also responsible for all client service and relationship management.

As a result, clients do not have relationships with the advisory firm. They have relationships with a specific individual and these relationships (and all of the intrinsic economic value of those relationships) survive only so long as that individual remains at the firm.

Client relationships with future dominant competitors will be very different. The relationships will be with the firm and not with one specific individual. Although there are many ways of institutionalizing relationships, a key aspect of any such structure is ensuring that the firm's value-added is delivered by many individuals, each specializing in a different aspect of a financial solution.

**Client relationships with future dominant competitors will be with the firm and not with one specific individual**

A potential structure might include delivering advice through a team approach. A client would be assigned a team of experts, each focused on a different aspect of that client's financial situation and needs and each possessing a different expertise.

A relationship manager whose primary function would be to capture new clients and service existing ones would head the team. Similar to how dominant competitors in the institutional money management business operate, a relationship manager's job would include understanding a client's situation, identifying potential needs and marshalling the forces of the organization to construct solutions to those problems. The rest of the team would provide all the financial advice.

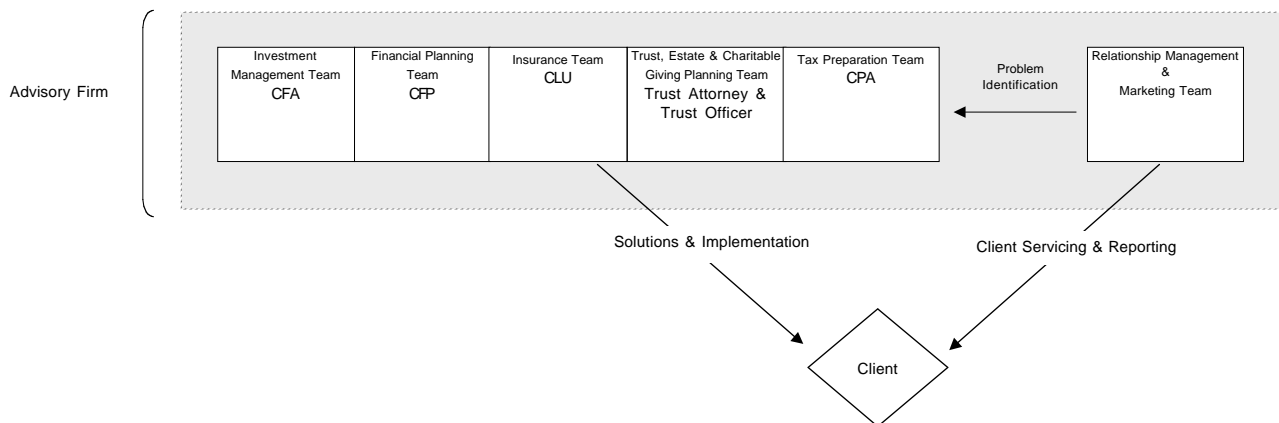
It is easy to underestimate the importance and difficulty of a relationship manager's job. This person would have to be part salesperson and part psychologist and have a broad understanding of a variety of financial alternatives for individuals. During difficult financial markets and other trying times, the relationship manager would be critical to the firm's ability to retain clients.

This type of relationship structure, where the client's relationship is with the entire organization and not just with an individual, is much different than that which exists at most advisory firms today. With this model, should a relationship manager leave the firm, the client will likely continue using the firm's services.

**Common Trait 4 - Provide Expanded, Extremely Sophisticated Advice**

Increased competition will have a two-fold effect on the ability of financial advisory businesses to compete for clients. Not only will it make capturing new clients more costly, it will also make retaining existing clients harder. Advisory firms will need to expand and upgrade the services that

**A Dominant Competitor's Process for Providing Comprehensive Financial Services**



they provide. Otherwise they risk losing their clients to competitors or having their clients decide to manage their own assets going forward.

Advisory firms are no longer just competing with small local organizations. JP Morgan, Goldman Sachs and Strong Capital Management are mobilizing their full resources to capture semi-affluent clients. These organizations are expanding their marketing efforts rapidly and have teams of skilled people providing a wide range of financial advice. Their goal is to advise semi-affluent clients on a national basis.

Clients, at the same time, are demanding better quality advice customized to their particular needs. They are more capable of evaluating the quality of the advice that they receive and recognize that they can get advice from a wider variety of sources.

Dominant competitors in the institutional money management business responded to similar increasing levels of competition for – and sophistication of – clients by upgrading all aspects of their organizations. PhDs and CFAs have become common credentials in these organizations, even for junior members of client teams. These organizations now conduct their own academic research on a wide variety of issues affecting the financial markets and their clients. And they work closely with leading scholars at major academic institutions to identify means of improving their services.

**Advisory firms are no longer just competing with small local organizations**

Future dominant competitors in the financial advisory business will similarly substantially expand and upgrade the services that they provide clients. These improvements will include increased specialization on various financial and legal topics. Instead of having one individual provide advice on investment management, taxes and estate issues, a client team will include at a minimum: a CFA responsible for evaluating potential managers and investments; a CFP responsible for developing a comprehensive financial plan; a CPA responsible for addressing all tax issues; a CLU who is an expert on insurance matters; and an attorney who provides advice on trust and charitable giving issues.

Further, future dominant advisory firms will likely be much more sophisticated investors than today's average advisory firm. Instead of relying on a narrow range of mutual funds and benchmarks, dominant competitors will be able to capitalize on investment opportunities throughout the world and in various parts of the capital markets for their clients.

### **Retaining Future Affluent Clients Will Be Challenging for Advisory Firms**

The necessity to develop special investing capabilities is due in part to a particular challenge facing many advisory firms – many of their currently semi-affluent clients will likely become affluent over the next decade. And advisory firms will need to even further broaden many of their services and capabilities if they hope to retain these newly affluent individuals as clients.

**Future dominant advisory firms will likely be much more sophisticated investors than today's average advisory firm**

Many clients own businesses or have received large amounts of stock options as part of their compensation. Over time, as they realize the value of these assets, they will join the ranks of the affluent.

As competitive as it will be to capture and retain semi-affluent clients, the battle will be even more ferocious for affluent individuals. The level and range of services appropriate for smaller clients will simply be inadequate for competing in this arena. Only by substantially and continually upgrading the breadth and quality of their services will advisory firms be able to retain a large portion of this part of their client bases.

An example of such enhanced capabilities is private equity (venture capital and leveraged buyouts) investing. Present participation in this segment of the capital markets is generally limited to institutions and extremely high net worth individuals.

As a market segment, private equity has been particularly attractive because of historical inefficiencies that have made substantial excess returns possible. These returns have also had an extremely low correlation with most broad market indices. As a result, all but two state pension plans currently have substantial allocations to this asset class.

Private equity investing requires an ability to identify potential transactions in which to invest or an ability to find capable private equity managers and participate in their limited partnerships. Few advisory firms have the ability to successfully directly invest their clients' assets in private equity transactions. Even fewer firms have the capability to evaluate private equity managers.

**A particular challenge facing many advisory firms is that many current semi-affluent clients will become affluent**

Several new competitors in the industry, however, are very experienced in this area. Formidable companies such as JP Morgan and UBS Brinson offer private equity investment services to their clients through direct investment opportunities and funds of funds vehicles. Mainstream advisory firms will have to develop similar capabilities if they hope to remain competitive with such giants over the long term.

#### **Common Trait 5 - Technology Is an Integral Part of Their Businesses**

Our research uncovered an ongoing debate as to whether technology might potentially make most financial advisory businesses, as we currently know them, obsolete. Existing interactive tools already provide investors with the means of formulating asset allocations, evaluating money managers and comparing various investment strategies over a variety of scenarios. But as subsequent, more sophisticated versions of these tools are developed and offered at a low cost, some technology proponents argue that they will eliminate the need for financial advisory businesses.

There is clearly a need for such tools, particularly for investors that cannot afford financial advisors. Their only other current alternative for obtaining financial advice is through transaction-compensated intermediaries, a structure with many failings that we have outlined earlier in this paper. In addition, most participants in 401(k) plans invest their retirement

assets without any financial advice using asset allocation strategies that have no correlation to their own risk profile or financial goals.

The companies that develop sophisticated asset allocation tools will likely find a large demand for their services. The widespread use of their products will significantly change how average individuals approach investing.

### **Technology Will Not Replace the Need for Financial Advisors**

Technology alone, however, will not replace the need for financial advisors for many reasons. The quality of many people's lives will depend upon how successful they are at investing their assets. Large numbers of people, as a result, will continue to want financial advice from experienced professionals and not rely on a "black box."

More importantly, while technological tools can provide very sophisticated financial analyses, they have virtually no ability to understand clients from a human capital, social or psychological perspective. Developing the ability to fully understand each client's true needs and goals will be an incredible challenge for even the best financial advisory firms. It is an impossible one for software programmers.

Further, nearly all of the various technology tools share the same weakness – the quality of their output is no better than the initial assumptions used in preparing the analysis. These assumptions include future levels of inflation, how equities will perform relative to fixed income and the future direction of interest rates. While such tools can be very useful in analyzing investment alternatives, if the initial assumptions are wrong, the resulting answer will be similarly inaccurate.

**Technology will be an integral part of future dominant competitors' businesses**

Future dominant competitors in the advisory business will not be replaced by technology but will instead make technology an integral part of their businesses. They will use it to help craft better solutions for their clients and more effectively leverage their time. Understanding these tools will also be important to understanding potential clients' assumptions about the financial markets.

Today, the expanded use of the Internet has made web sites and on-line access to client accounts a minimum requirement for most advisory firms. Several advisory firms also already use very sophisticated analytical tools to evaluate potential managers and mutual funds. Future dominant competitors will make large investments in a wide variety of other analytical tools that will be used to construct better solutions for clients and that will increase the productivity of various members of the organization.

### **Understanding Technology Tools Will Play a Role in Understanding Client Perspectives**

Understanding these tools will be critical to an advisory firm's ability to understand how potential clients may already view investing. As various investing technology tools become more widespread and are provided to individuals at little or no cost through the Internet, potential clients will

likely start from higher levels of financial knowledge than existing clients. Understanding these tools, their embedded assumptions and how they might have shaped potential clients' perspectives will all be part of understanding each client's particular financial situation.

### **Common Trait 6 - Achieve Critical Mass or Obtain Capital to Fund Growth**

Each of the five previous common traits shares the same attribute – they are very costly. The sixth common trait of the future dominant competitors in the advisory business is that in the very near future they will either achieve critical mass – the ability to fund growth out of earnings – or raise the capital necessary to underwrite the building of their company.

Technology costs alone will likely be in the millions of dollars. Advisory firms will also need to invest large amounts of money in building marketing forces and broad client teams with specialists offering sophisticated advice. At the same time, fees will fall.

The requirement that future dominant competitors make massive investments while their average revenue per client is declining will mean that all but the very largest firms will be unprofitable in the near term. The remaining organizations will need to raise capital to fund their growth – and they will need to do it soon.

While the evolution of the industry will take seven to ten years, only those firms that begin positioning themselves now will be able to capitalize on these changes. Client acquisition costs will never be lower. The larger competitors are just starting to expand their programs to compete for semi-affluent clients on a national basis. And most local competitors are unwilling or unable to shift to comprehensive solutions providers.

In a relatively short time, all of this will change. Advisory firms will find themselves in competition with national organizations, including ones that only a couple years earlier were small, independent advisory firms. Competition for clients will increase significantly and those companies unprepared to broaden their services and expand their marketing efforts will never catch up.

**Many advisory firms  
will need to raise  
capital to fund their  
growth – and they will  
need to do it soon**

## V. The Economics of Future Dominant Competitor Businesses

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**Achieving some minimum scale will be essential for advisory firms trying to become low cost, comprehensive solutions providers**

Forty or fifty firms are likely to evolve into dominant competitors and will capture a disproportionate share of the market for semi-affluent clients. They will be large and profitable companies with assets of at least \$20B. And they will provide their clients with vastly expanded services at a very low cost.

Achieving some minimum scale will be essential for advisory firms trying to become low cost, comprehensive solutions providers. As part of our research, we developed a series of models designed to estimate the size at which future dominant competitors would become profitable, depending upon certain assumptions. We also used our models to try to predict the net operating margins these organizations might ultimately achieve if they became large enough to operate at maximum efficiency.

More than 50 advisory firms from across the country provided us with their private financial data to help us with our research. Most of the assumptions used in these models were developed from this data.

Similar to any other service industry, the profitability of an advisory business can be affected by a variety of factors. The geographic market in which the advisory firm is located, the availability and cost of personnel, the proximity of clients and the competitiveness of the local market are only a few that can impact earnings.

### **Four Major Variables That Affect Profitability and Operating Margins**

- 1. Structure of client base**
- 2. Fee structure, including minimum and maximum fees**
- 3. Ratio of clients per relationship manager**
- 4. Services provided**

## Methodology Used in Economic Models

We built our models around these four variables so that we could measure how they affect the overall profitability and operating efficiency of an advisory business. The models incorporated the four variables in the following manner:

### Variables 1 and 2 - Client Base and Fee Structure

An advisory firm's client base – the number of clients and the amount of assets per client – and its fee structure are the key determinants of its revenues. Since most advisory fees are calculated as a percentage of assets, the larger the average client, the greater the firm's revenues. Also, the higher the fees charged, the greater the firm's revenues will be.

We do not believe, however, that advisory firms will be able to charge clients unlimited fees for advice or that fees will rise in a linear fashion. Future dominant competitors will cap their fees and provide price breaks to clients who invest larger amounts of assets.

As shown in Table 5.1, our model includes a fee structure that rapidly declines as the percentage of assets increases. Our base fee structure caps all fees at \$25,000 per client, regardless of the size of a client's assets. It also assumes that all clients must pay a minimum fee of \$7,500.

Table 5.1

| Fee Schedules Used in Economic Models |          |                             |          |                             |          |
|---------------------------------------|----------|-----------------------------|----------|-----------------------------|----------|
| Low Fee Schedule                      |          | Base Fee Schedule           |          | High Fee Schedule           |          |
| First \$1,000,000                     | 0.60%    | First \$1,000,000           | 0.75%    | First \$1,000,000           | 0.85%    |
| Second \$1,000,000                    | 0.30%    | Second \$1,000,000          | 0.45%    | Second \$1,000,000          | 0.50%    |
| Third \$1,000,000                     | 0.25%    | Third \$1,000,000           | 0.33%    | Third \$1,000,000           | 0.38%    |
| Fourth \$1,000,000                    | 0.20%    | Fourth \$1,000,000          | 0.25%    | Fourth \$1,000,000          | 0.30%    |
| Each Additional \$1,000,000           | 0.15%    | Each Additional \$1,000,000 | 0.20%    | Each Additional \$1,000,000 | 0.25%    |
| Minimum Fee                           | \$5,000  | Minimum Fee                 | \$7,500  | Minimum Fee                 | \$10,000 |
| Maximum Fee                           | \$15,000 | Maximum Fee                 | \$25,000 | Maximum Fee                 | \$35,000 |

Table 5.2

| Structure of Client Base by Investable Assets |                           |                          |                          |
|---|---------------------------|--------------------------|--------------------------|
| Investable Assets                             | Small Average Client Size | Base Average Client Size | High Average Client Size |
| $x \leq \$1,000,000$                          | 62.00%                    | 28.00%                   | 5.00%                    |
| $\$1,000,000 < x \leq \$2,000,000$            | 34.00%                    | 41.00%                   | 19.00%                   |
| $\$2,000,000 < x \leq \$3,000,000$            | 1.50%                     | 16.00%                   | 19.00%                   |
| $\$3,000,000 < x \leq \$4,000,000$            | 1.00%                     | 9.00%                    | 21.00%                   |
| $\$4,000,000 < x \leq \$5,000,000$            | 0.75%                     | 3.00%                    | 11.00%                   |
| $\$5,000,000 < x \leq \$6,000,000$            | 0.50%                     | 1.50%                    | 10.00%                   |
| $\$6,000,000 < x \leq \$7,000,000$            | 0.25%                     | 1.00%                    | 9.00%                    |
| $x \geq \$7,000,000$                          | 0.00%                     | 0.50%                    | 6.00%                    |
| Total   | 100.00%                   | 100.00%                  | 100.00%                  |

x = investable client assets used in calculating advisory fees

### Variable 3 - The Ratio of Clients per Relationship Manager

The third factor common to all advisory firms is the number of clients each relationship manager can oversee. The relationship manager will fill the firm's most important and complex functions – capturing new clients and retaining existing ones. To accomplish these duties, a relationship manager will need to understand each client's needs and goals, as well as their tolerance for risk and various other factors that impact an individual's financial situation. Developing in-depth knowledge about clients and providing them with the necessary on-going service will be challenging and time consuming, and will limit the number of clients that each relationship manager can oversee.

Table 5.3

| Ratio of Clients per Relationship Manager |                               |            |
|---|-------------------------------|------------|
| Average Client Size                       | Relationship Manager Capacity | Clients/RM |
| Small                                     | High                          | 100        |
|   | Base                          | 90         |
|   | Low                           | 80         |
| Base                                      | High                          | 85         |
|   | Base                          | 75         |
|   | Low                           | 65         |
| Large                                     | High                          | 60         |
|   | Base                          | 50         |
|   | Low                           | 40         |

The ratio of clients per relationship manager will not remain fixed. Competition for larger clients will be greater than for smaller ones, and relationship managers will likely need to commit far greater amounts of time to capture and retain wealthier clients.

### Variable 4 - Services Provided

The type and level of services provided to clients are key determinants of an advisory firm's cost structure. The greater the level of services provided, the higher an advisory firm's operating costs.

We do not expect that financial advisory firms will shift from their current business models to those of comprehensive solutions providers overnight for two reasons. First, expanding their services will be very costly and will involve recruiting large numbers of people and building a larger company infrastructure.

Second, these organizations do not need to shift to a new business model immediately to quickly capture more market share. The demand for advice is increasing. Most current competitors offer very limited services and are unlikely to expand them in the near future. Many large advisory firms, as a result, need only increase their marketing capabilities to grow rapidly in the near term.

As the industry evolves and advisory firms have to compete with larger organizations, only then will they need to expand their services. Eventually, these organizations will function as multi-user family offices for the semi-affluent. In the interim, they will shift their business models in stages.

### Four Stage Shift from Current Model to Solutions Providers

Our model assumes that advisory firms will shift to the solutions provider model in four stages:

#### Stage 1 - Create a Marketing Force

The firm continues to offer its current level of services – modified financial planning, asset allocation and manager/mutual fund selection – but also creates a marketing force to expedite the growth of its business.

The firm’s staffing includes relationship managers that oversee all marketing and client service functions; CFAs that are responsible for manager selection; and CFPs that conduct the financial planning and asset allocation services. As the firm grows, it gradually increases the number of relationship managers and CFPs while the number of CFAs remains constant.

#### Stage 2 - Expand Services to Include Comprehensive Financial Planning

The organization expands its services to include developing comprehensive financial plans for each client at no additional cost to the client. The firm increases its number of CFPs to handle the expanded financial planning services.

#### Stage 3 - Provide Tax Planning and Preparation Services

The advisory firm expands its services to include tax preparation and planning at no additional cost to the client. A team of CPAs is added to provide the new services.

Table 5.4

| Client Services/Personnel Additions by Stages |                             |
|---|-----------------------------|
| Services                                      | Personnel                   |
| <b>Stage 1</b>                                |                             |
| Manager Selection                             | CFAs                        |
| Modified Financial Planning                   | CFPs                        |
| Professional Marketing Force                  | Relationship Managers       |
| <b>Stage 2</b>                                |                             |
| Comprehensive Financial Planning              | CFPs                        |
| <b>Stage 3</b>                                |                             |
| Tax Planning/Preparation                      | CPAs                        |
| <b>Stage 4</b>                                |                             |
| Trust Planning/Preparation                    | Trust Attorneys, Paralegals |
| Insurance Planning                            | CLU, Trust Officer          |

## **Stage 4 - Become Comprehensive Solutions Providers**

The organization now functions like a multi-user family office for the semi-affluent. It expands its services to include trust services, developing and implementing charitable giving plans, and providing advice on insurance. All of these services are added at no additional cost to the client. The firm adds a team of internal trust lawyers and paralegals to prepare and review trust plans, and retains outside counsel to approve all finished plans. The firm's staffing at this stage also includes a CLU who is responsible for evaluating insurance-related investment alternatives.

Our model assumes that each person is paid a market-level salary using current wage rates. One important caveat, however, is that we have assumed each dominant advisory firm will have only one CEO, who is paid an arm's length-salary regardless of whether the firm is profitable. All other employees, including principals of the firm, are paid at a rate appropriate for their specific function.

## **Scenario Analyses**

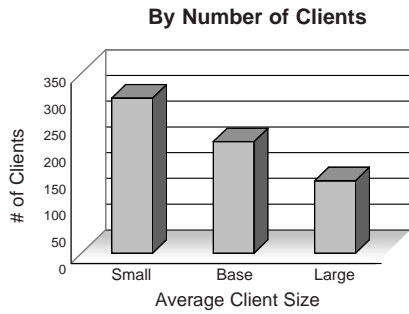
As part of our research, we conducted a series of scenario analyses to measure how changes in each variable might alter the size at which future dominant advisory firms would become profitable. The models also helped us predict their potential level of operating efficiency.

The first phase of our analysis centered on variable four, the level of services provided to clients. It examined the profitability and optimum efficiency of advisory businesses as they move through each of the four stages of shifting from a current advisory business model to a dominant competitor.

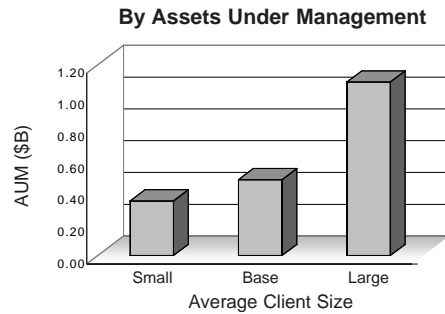
Each stage included three scenarios that measured how changes in the structure of an advisory firm's client base might affect its breakeven point and ultimate operating efficiency. The model used the base fee structure (shown in Table 5.1) for each scenario. Our analysis also assumed that an advisory firm with a small average client size, a relationship manager could oversee 90 clients. For firms with a medium average client size, the relationship manager could oversee 75 clients. For firms with a large average client size, the relationship manager could oversee only 50 clients.

## Stage 1 Breakeven Points for an Average Client Size

**Exhibit 5.1**

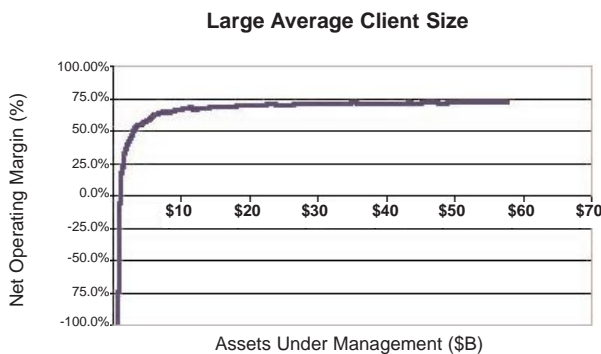
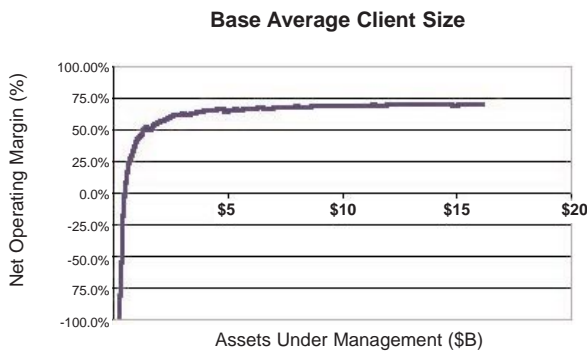
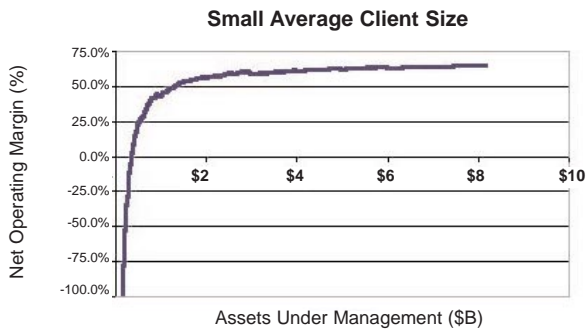


**Exhibit 5.2**



**Exhibit 5.3**

### Stage 1 Net Operating Margins by Client Size



### Stage 1 – Add A Separate Marketing Force

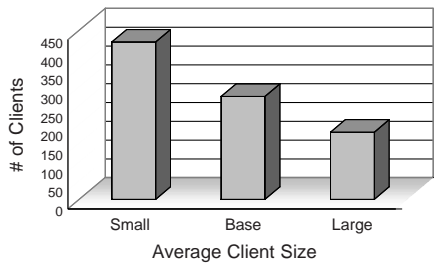
Our three scenarios for this stage show that advisory firms that create marketing forces need only grow a relatively small amount to become profitable. As shown in Exhibits 5.1 and 5.2, even with a small average client size, an advisory firm at this level of service would breakeven with about 302 clients (\$344mm assets under management). If the firm had a large average client size, it would need fewer clients (141) but more assets (\$1.09B) to breakeven.

During Stage 1, an advisory firm continues to provide only limited services to its clients. It would expand its advisory personnel only when client needs exceeded the capacity of the current staff to provide these services. As shown in Exhibit 5.3, delivering such limited services is not very costly and would enable an advisory firm with a large average client size to potentially achieve net operating margins as high as 72%. Even with a small average client size, an advisory firm could still achieve 64% net operating margins.

## Stage 2 Breakeven Points for an Average Client Size

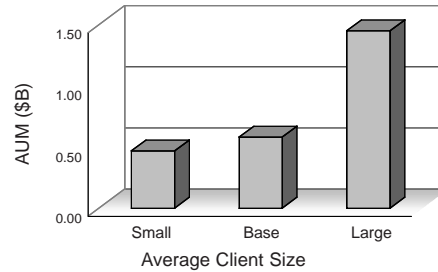
**Exhibit 5.4**

**By Number of Clients**



**Exhibit 5.5**

**By Assets Under Management**



**Exhibit 5.6**

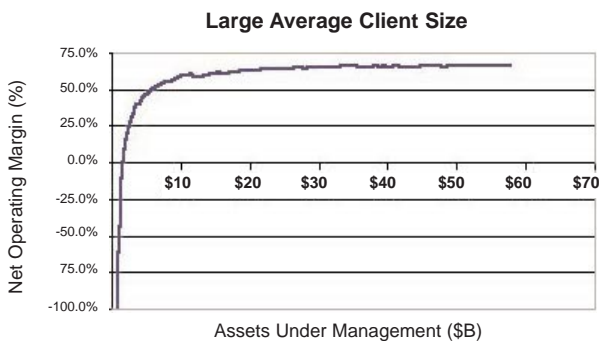
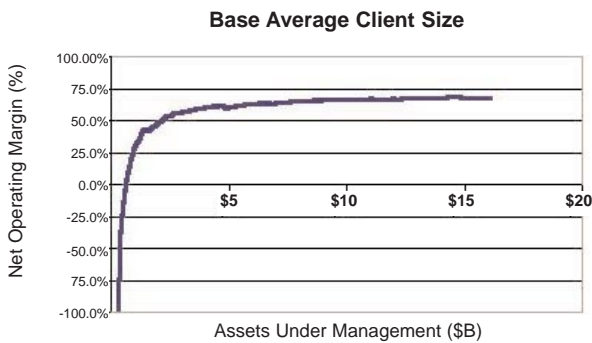
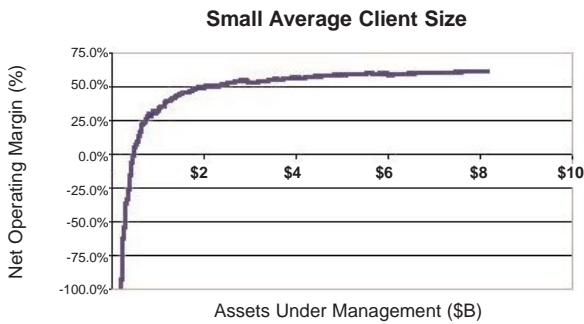
**Stage 2 Net Operating Margins by Client Size**

**Stage 2 – Add Comprehensive Financial Planning**

The move from Stage 1 to Stage 2 entails adding a team of CFPs and assistants to provide comprehensive financial planning services at no additional cost to the client. Although it will increase the fixed costs of operating an advisory firm – and therefore, raise the breakeven point – advisory firms will still be able to achieve significant net operating margins.

As shown in Exhibits 5.4 and 5.5, an advisory firm with a small average client size could breakeven with approximately 419 clients (\$468mm AUM). With a large average client size, a firm needs to capture 179 clients (\$1.45B AUM).

Adding full financial planning services at no cost to clients would also slightly reduce the achievable net operating margins. As shown in Exhibit 5.6, with a small average client size, an advisory firm could achieve net operating margins of 61% at approximately \$7B AUM. With a large average client size, the firm could achieve 70% operating margins.



## Stage 3 Breakeven Points for an Average Client Size

Exhibit 5.7

By Number of Clients

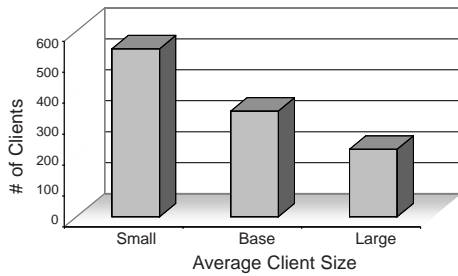


Exhibit 5.8

By Assets Under Management

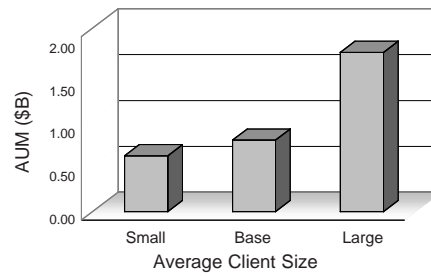
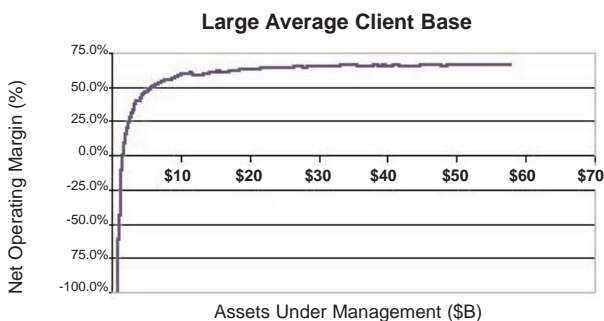
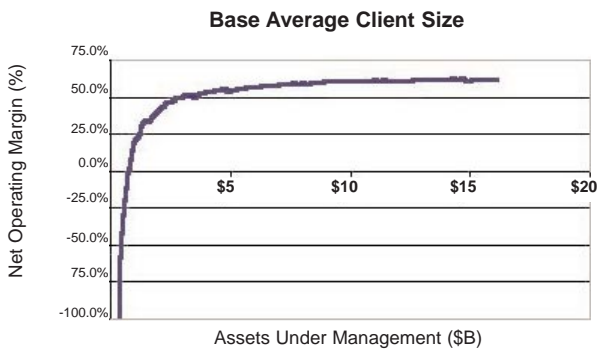
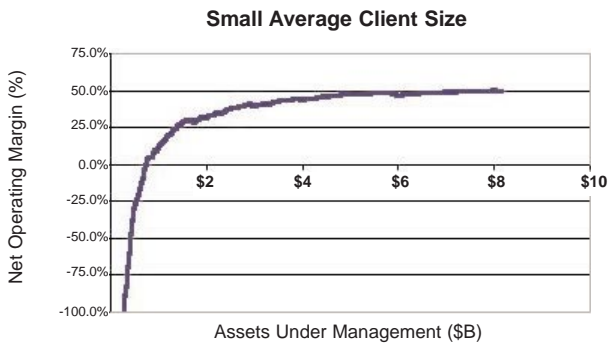


Exhibit 5.9

Stage 3 Net Operating Margins by Client Size



## Stage 3 – Add Full Tax Planning

The move from Stage 2 to Stage 3 should be the easiest for advisory firms trying to become dominant competitors. Assuming they have succeeded at building their marketing units, they should have captured many more clients at this point and be able to benefit from the increased scale of their businesses.

As part of this stage, advisory firms would add a team of CPAs to provide their clients tax preparation and planning services. This shift in their business model would require the smallest percentage increase in fixed costs and, consequently, the smallest increase in total clients to breakeven of any transition between stages.

As shown in Exhibits 5.7 and 5.8, an advisory firm with a small average client size would need approximately 543 clients (\$609mm AUM) to breakeven. A firm with a large average client size would need approximately 219 clients (\$1.74B AUM) to breakeven.

Moving from Stage 2 to Stage 3 does, however, increase an advisory firm's variable costs considerably, reducing the maximum net operating margins that can be achieved. As shown in Exhibit 5.9, organizations with a small average client size could achieve 53% net operating margins at maximum efficiency during Stage 3. Firms with a large average client size could achieve only 67% net operating margins during Stage 3.

## Stage 4 Breakeven Points for an Average Client Size

Exhibit 5.10

### By Number of Clients

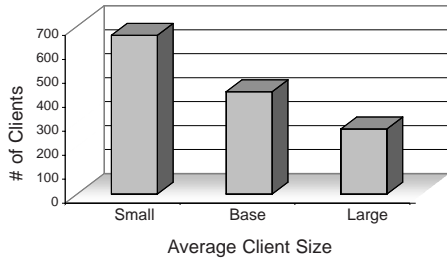


Exhibit 5.11

### By Assets Under Management

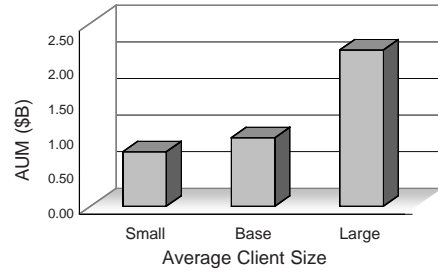
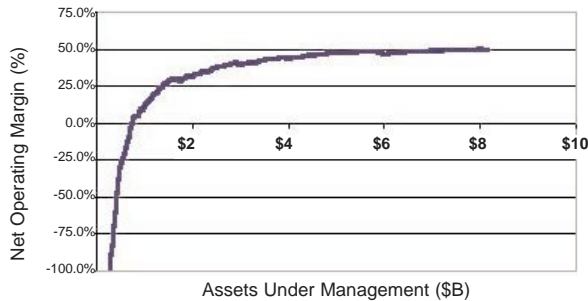


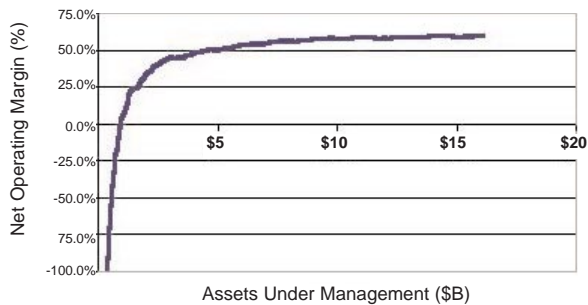
Exhibit 5.12

### Stage 4 Net Operating Margins by Client Size

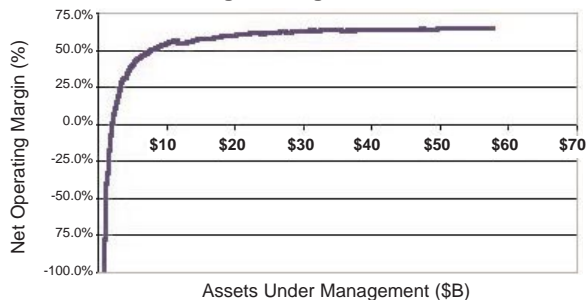
#### Small Average Client Base



#### Base Average Client Base



#### Large Average Client Base



### Stage 4 – Multi-User Family Office

The move from Stage 3 to Stage 4 is the biggest in terms of adding services – requiring the addition of full trust and insurance services to clients at no additional charge. These services, however, are largely fixed or semi-fixed costs. Consequently, while the shift to this stage may raise the breakeven point of an advisory business, it would only marginally lower potential net operating margins.

As shown in Exhibits 5.10, 5.11 and 5.12, an advisory firm with a small average client size in Stage Four would breakeven with 663 clients (\$747mm AUM) and achieve a maximum net operating margin of 50%. A firm with a large average client size, by comparison, would breakeven with 272 clients (\$2.14B) and could achieve a 65% maximum net operating margin.

## The Impact of Fee Structure on Profitability and Margins

The second phase of our analysis focused on how the fee structure of an advisory firm could affect its ability to reach its breakeven point and maximum operating efficiency. The results of slightly altering a fee structure, including minimum and maximum fees, are dramatic. Higher

fees will definitely allow advisory firms to reach profitability much quicker and achieve much greater net operating margins.

As shown in Table 5.1, we created three fee structures. We also assumed that relationship managers for the advisory firms in these examples could oversee the base number of clients for each average client size.

In each of the scenarios we analyzed, the breakeven point in terms of assets under management and number of clients required was at least 50% higher for firms that used a low fee structure than those that used a high fee structure. As shown in Exhibits 5.13 and 5.14, a firm in Stage 4 with a large average client base and using a low fee structure would need \$3.44B AUM and 429 clients to breakeven. A firm with a high fee structure, by comparison, would need \$1.84B AUM and 228 clients to breakeven.

The difference in maximum net operating margins was almost as drastic. As shown in Exhibit 5.15, a firm in Stage 4 with a small average client size and a high fee schedule could achieve a 56% maximum margin. A firm with a low fee schedule, however, could only achieve a 36% margin.

While fees undoubtedly make a substantial impact on profitability, we believe they will ultimately be determined by competitors in the industry.

Exhibit 5.13

Fee Structure Impact on Breakeven  
(Stage 4, Large Average Client Size)

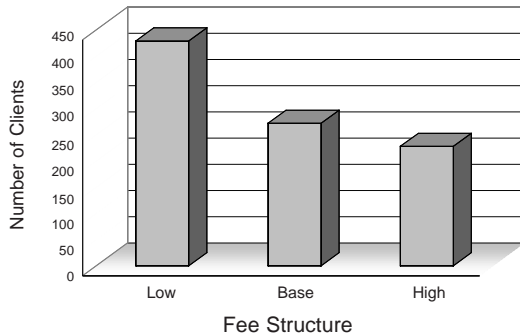


Exhibit 5.14

Fee Structure Impact on Breakeven  
(Stage 4, Large Average Client Size)

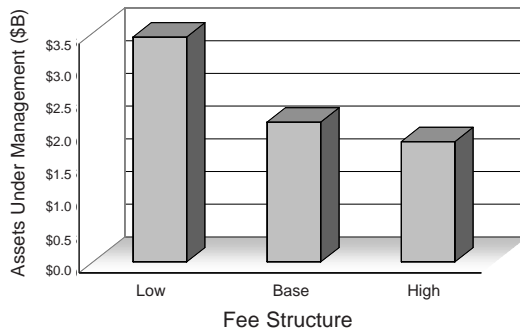
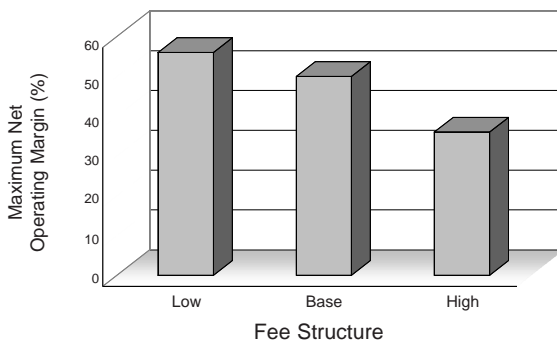


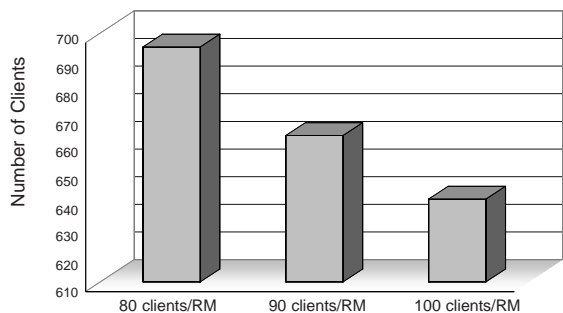
Exhibit 5.15

Fee Structure Impact on Maximum Net Operating Margin  
(Stage 4, Small Average Client Size)



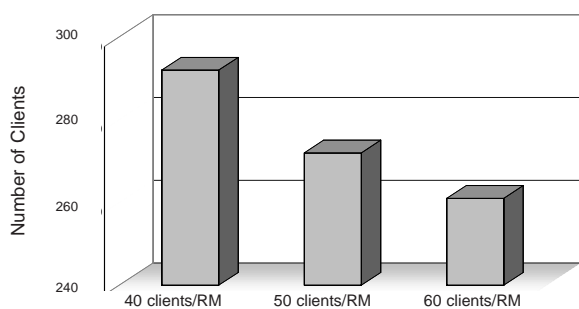
**Exhibit 5.16**

**Impact of Relationship Managers on Breakeven  
(Stage 4, Small Average Client Size)**



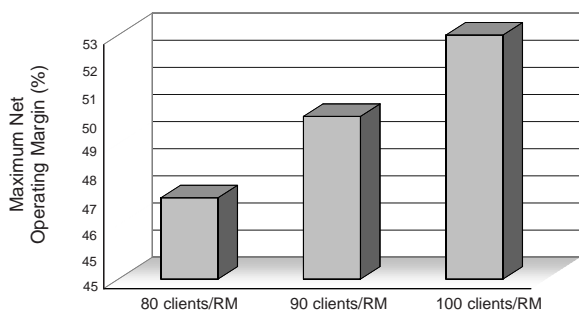
**Exhibit 5.17**

**Impact of Relationship Managers on Breakeven  
(Stage 4, Large Average Client Size)**



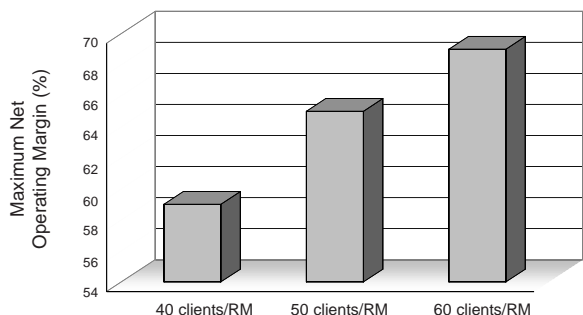
**Exhibit 5.18**

**Impact of Relationship Managers on Maximum Net Operating Margin  
(Stage 4, Small Average Client Size)**



**Exhibit 5.19**

**Impact of Relationship Managers on Maximum Net Operating Margin  
(Stage 4, Large Average Client Size)**



## The Effect of Relationship Managers on Profitability and Margins

The final phase of our analysis was designed to measure how the client-relationship manager ratio would impact an advisory firm's profitability and net operating margins. As part of this analysis, we varied the ratio of clients to relationship manager depending on the average size of the firm's clients. The examples that follow assumed that the advisory firms were at Stage 4, providing comprehensive financial solutions for their clients, and that they charged clients our base fee structure.

As shown in Exhibit 5.18, for each average client size, we analyzed the effect of three different capacity levels for relationship managers. An organization with a small average client size could achieve 53% net operating margins if their relationship managers could oversee the relationships with 100 clients on average. As shown in Exhibit 5.16, this type of advisory firm would breakeven at approximately 640 clients (\$723mm AUM). If the relationship managers in this firm could handle only 80 clients on average, the maximum operating margin would drop to 47% and the firm would need to attract 695 clients (\$779mm AUM) to breakeven.

As shown in Exhibits 5.17 and 5.19, an organization that has a large average client size and relationship managers that could oversee 60 client relationships could achieve 69% net operating margins at maximum efficiency and would breakeven with approximately 261 clients (\$2.11B). If its relationship managers could oversee only 40 client relationships, the firm would be able to achieve only 59% net operating margins and would need approximately 292 clients (\$2.36B) to breakeven.

These scenarios demonstrate that the efficiency of an advisory firm's relationship managers will be a major factor in its profitability. Their ability to capture new clients as the industry becomes increasingly competitive will likewise play a major role in an advisory firm's ability to grow.

### **Three Observations**

Our models are designed only to estimate the future profitability and operating efficiency of a hypothetical advisory organization. Actual advisory businesses will likely evolve in a less formulaic approach and their profitability will be affected by many factors unique to their locations, markets and personnel.

The previous scenario analyses do, however, highlight three important issues for financial advisory businesses attempting to become dominant competitors:

### **Investments in Marketing Forces Today Could Generate High Returns**

Many advisory firms today are debating whether they should create a marketing force for their company. These organizations are already very profitable and the proprietors have more leads for potential clients than they can possibly pursue. Under such circumstances, hiring a professional marketing force now may seem silly.

It isn't. In fact, there will never be a better time for advisors to develop into dominant competitors. The cost of acquiring clients is almost nothing in some cases. The potential operating margins are massive. As our model shows, hiring four, full-time marketers and paying their expenses might cost an advisory firm \$1 million a year. But the marketers would need to capture only a small number of new clients for the company to recoup its marketing investment. And the potential return on its investment is staggering.

The breakeven point for an advisory firm with a small average client size and four marketers is 302 clients (\$344mm AUM), or about 75 clients per relationship manager. If each relationship manager captures 15 additional clients, the firm's profitability would rise by more than \$400,000 per year.

The marginal profitability and thus, the return on investment from adding more relationship managers increases as advisory firms grow. For every additional 90 clients captured, an advisory firm would receive approximately \$661,000 in revenues at a marginal cost of only \$232,000.

The window of opportunity to capitalize on these conditions will not remain open indefinitely. In fact, it has already started to close. All advisory firms will require marketing forces in two or three years to compete. Increased competition for clients will drive the cost of acquiring clients higher and potential margins lower – a combination that makes an investment in a marketing force today potentially even more exceptional.

## **An Advisory Firm's Ability to Recruit or Develop Relationship Managers Will Be Key to Its Growth**

The limit on the number of clients per relationship manager, combined with the unique skills necessary to fulfill this role, will be an important factor in constraining the growth of many organizations. The other key functions in an advisory firm have substantially more operating leverage than that of the relationship manager. Evaluating managers or investments can be conducted by a small number of CFAs, regardless of assets under management. Similar scale is available with CLUs evaluating insurance alternatives.

The number of CFPs, CPAs, and trust attorneys necessary to prepare comprehensive financial plans and tax filings for clients is more closely tied to the total number of clients. But these functions also have some degree of operating leverage because they can use assistants to input large amounts of data in software models or paralegals to prepare initial documents.

Clients also do not need completely new comprehensive financial plans, trust documents or tax plans each year. The value-added of these functions in the later years of a relationship is more focused on updating existing documents and adjusting to changes in clients' situations.

Relationship management, by comparison, requires providing service on an ongoing basis. The issues affecting clients change over time, and good relationship managers will work closely with each client to identify and understand any new problems that affect them. These demands will limit the number of clients that any relationship manager can oversee at one time.

Consequently, an advisory business' ability to become a dominant competitor is constrained by its ability to recruit or internally develop relationship managers. Only those firms that are able to build large, capable relationship management units will be able to achieve the scale necessary to be profitable and operate efficiently.

## **Transition Between Stages Will Not Be Linear**

Although the movement of advisory firms from one stage to the next will be distinct, the shift will not occur in a linear fashion. It will be very fast, and less aggressive advisory firms may quickly find that the level of services they provide is no longer competitive.

The catalysts that will accelerate the shift between stages are large, well-capitalized companies entering the industry. Many of the larger brokerages and accounting firms that have recently formed their own advisory units or programs have one key advantage over most advisory firms today – capital. These large organizations will use their capital to make significant investments in expanded services and are willing to forgo short-term profitability for many years. The quicker that these companies can expand their firms, the harder it will be for smaller advisory firms to compete with them.

**An advisory business' ability to become a dominant competitor is constrained by its ability to recruit or internally develop relationship managers**

A further incentive for these larger companies to shift to multi-user family offices is that, if they are able to capture a significant share of the market, they will not have to forgo profitability for very long. As shown in Exhibit 5.10, advisory firms can provide comprehensive solutions to their clients and still achieve very high (as much as 65%) net operating margins. As a result, they will likely focus on the long-term economic value of this business and measure their success in terms of market share.

It will take some time for many of the larger competitors to recruit and train the necessary people to build advisory units that compete for clients on a national basis. But once these organizations are fully staffed and trained, the shift from the traditional advisory business model to that of the multi-user family office for the semi-affluent will accelerate.

Relationship managers clearly have a major impact on a firm's profitability. In all cases, the more efficient a firm's relationship managers are, the higher the net operating margins it will be able to achieve. The impact of good relationship managers is more prevalent as advisory firm's grow larger, however, which may limit the ultimate profitability of future dominant competitors since good relationship managers are in limited supply. Firms more successful at recruiting and training relationship managers will have an advantage over their competitors.

## **VI. How the Market Might Value Future Dominant Competitors - Factors and Benchmarks**

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Building a dominant competitor will be challenging and costly. Those organizations that succeed, however, will be large and profitable and will have great economic value.

But it is impossible to exactly predict how the market will value these kinds of organizations in the future. Calculating the value of advisory businesses today, much less future dominant competitors, is difficult. There is no liquid market for this type of company. There is little or no data available on previous transactions. And no advisory firms are currently publicly traded.

### **Recurring Fee Revenues Create High Intrinsic Value**

Advisory firms potentially have very high intrinsic values because of the stability of their revenues and the low marginal cost of delivering services. Their revenues result from annual fees that their clients pay for as long as they use the firm. If an advisory firm is able to retain most of its clients – and to date, most advisory businesses have had very stable client bases – its revenues will be fairly predictable.

As we demonstrated in Section V, while future dominant competitors will have relatively high fixed costs, their marginal costs will be quite small. Our models show that approximately 60% of the costs of future dominant competitors will be fixed or semi-fixed and organizations that can achieve scale will be able to generate net operating margins as great as 65%.

This combination of stable revenues and relatively low marginal costs will make the profitability of future dominant competitors fairly predictable. It will also somewhat insulate them from the various economic cycles.

While we expect that it will be more costly for advisory firms to acquire clients in the future, the growth prospects for dominant competitors are still very bright. Advisory firms currently manage only 10% to 20% of the \$4T to \$5T market for advice that is estimated to develop by 2007. It will be those dominant organizations that capture most of the growth in the total demand by the semi-affluent for financial advice.

But what will investors pay for this kind of company?

### **Different Factors Will Affect the Valuations of Individual Advisory Firms**

Businesses that have predictable earnings and great growth potential will clearly be very attractive to investors and acquirers, regardless of their industry. Predictions of how attractive these companies will be to the financial markets, however, are complicated by dozens of factors. Investors are buying a right to a share of the company's future earnings, which can be affected by everything from its location to the age of its executives. But there are four factors that will be particularly important to the valuation of future dominant advisory businesses.

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## Valuation Factors

1. Institutionalization of relationships
  2. Size
  3. Client base
  4. Brand name
- 

### Valuation Factor 1 - Institutionalization of Relationships

Most advisory firms currently have little or no value as businesses. Potential purchasers or investors are, in reality, entering into an employment agreement with the owner and not buying a stand-alone businesses.

The most important factor that will affect the valuations of future dominant advisory businesses is the degree to which they have institutionalized their relationships. Nearly all of their intrinsic value is tied to the strength of these relationships. The more durable these relationships are, the more likely clients will continue to use their advisory firms in the future, which, in turn, generates recurring fees.

The durability of relationships is tied directly to whether the firm's clients view their relationship as being with the organization or with an individual who works at the organization. If it is the latter, the sustainability of the organization's earnings is less certain.

Most current advisory businesses fall into this latter category. They are more like proprietorships than businesses. The market views them as risky investments – and less attractive – because their financial health depends upon the continued employment of one or two individuals.

Only those organizations able to institutionalize their relationships will have great potential value as businesses. They will be capable of using many different individuals to deliver advice and will be able to take advantage of their companies' incredible operating leverage to grow. Potential acquirers or investors will also view investments in such companies as having less risk because the firm's future success is less dependent upon any one individual.

### Valuation Factor 2 - Size

Size will affect valuations in at least two ways. First, the size required to remain a dominant competitor will increase over time. Once this phase of the industry's evolution is completed, there will be 40 to 50 large organi-

zations competing for the same clients. The ensuing battle for clients will require even greater investments into these organizations and will drive fees even lower.

The larger a firm is, the greater its capability to make the investments necessary to compete in the next phase of this industry's evolution. Therefore, the market will likely pay a premium for larger firms and will discount the value of smaller organizations.

**Strategic acquirers will pay premiums for larger advisory businesses**

Second, many larger organizations not currently in the advisory business will fail in their attempt to build their own advisory firms. Their failure, however, will not lessen their need to participate in this industry. They will instead become "strategic acquirers" of advisory firms.

Strategic acquirers traditionally pay substantial premiums for acquisitions because the broader benefits of a transaction substantially outweigh the short-term costs. For an acquisition to have any real impact on a large company, however, the takeover target must be large enough to significantly affect the acquirer's long-term profitability. As a result, only fairly large businesses are the primary targets of strategic acquisitions.

**Exhibit 6.1**

**Institutional Money Manager Acquisitions:  
Comparison of Valuations with Levels of Pre-Tax Income**  
December 1997 - January 1999

| Target                                     | Acquirer                          | AUMs When Acquired (\$mm) | Pretax Income (\$mm) | Potential Purchase Price to Pretax Income |
|--|-----------------------------------|---------------------------|----------------------|---|
| Progress Investment Management Corporation | Liberty Financial Companies, Inc. | \$2,500                   | \$2.2                | 10.0                                      |
| Carret and Company Inc.                    | Matrix Global Investors           | \$750                     | \$2.9                | 6.8                                       |
| Harris Bretall Sullivan & Smith            | Value Asset Management, Inc       | \$2,800                   | \$5.1                | 8.4                                       |
| Rorer Asset Management LLC                 | Affiliated Managers Group Inc     | \$3,700                   | \$6.0                | 10.8                                      |
| ANB Investment Management & Trust          | Northern Trust Corporation        | \$28,000                  | \$8.4                | 6.0                                       |
| 1838 Advisors, Inc.                        | MBIA Inc.                         | \$6,000                   | \$9.3                | 9.1                                       |
| <b>Average</b>                             |                                   | <b>\$7,292</b>            | <b>\$5.7</b>         | <b>8.5</b>                                |
| Tweedy, Browne & Co.                       | Affiliated Managers Group         | \$4,584                   | \$27.2               | 11.0                                      |
| GT Global Asset Management                 | AMVESCAP PLC                      | \$55,000                  | \$34.7               | 37.5                                      |
| Oppenheimer Capital LP                     | PIMCO Advisors, LP                | \$103,100                 | \$89.0               | 13.4                                      |
| Mercury Asset Management Group pic         | Merrill Lynch & Co.               | \$177,000                 | \$301.0              | 17.6                                      |
| Rosenberg Capital Management               | Dresdner Bank AG                  | \$25,000                  | \$30.0               | 20.0                                      |
| <b>Average</b>                             |                                   | <b>\$72,937</b>           | <b>\$96.4</b>        | <b>19.9</b>                               |

Source: PaineWebber Inc. & Undiscovered Managers estimates

Dresdner Bank's purchase of Rosenberg Capital Management (RCM) and Merrill Lynch's takeover of Mercury Asset Management are examples of strategic acquisitions in the institutional money management business. Both Dresdner and Merrill Lynch paid premiums over historical valuations of these kinds of companies because they felt compelled to participate in the institutional money management business for strategic reasons related to their other businesses. In the case of RCM, Dresdner paid nearly 20 times adjusted EBITDA – EBITDA after paying all of an organization's principals a market-level salary – and Merrill paid more than 17 times adjusted EBITDA for Mercury. The historical average paid for institutional money managers has been about 10 times adjusted EBITDA.

While size will significantly affect valuations, exactly how large will an advisory business need to be in order to capture its full intrinsic value? Once again using the institutional money management business as a proxy, the key factor in measuring the size of a firm is not its assets under management or its number of clients. Rather, it is tied to the amount of an advisory firm's adjusted EBITDA. Adjusted EBITDA is important because it represents the cash flow that can be sold to investors while still allowing the company to function like any other business.

The historical effect of size on the valuations of money management businesses is shown in Exhibit 6.1. Acquired companies with adjusted EBITDA greater than \$25mm were sold at multiples that were one and a half to two times greater than those with adjusted EBITDA less than \$10mm. We anticipate that the financial markets will similarly reward large companies in the financial advisory business.

While it is impossible to predict with perfect accuracy at what level the same type of inflection point will occur, we believe that an advisory firm will need to have at least \$25mm of adjusted EBITDA to capture the market's full valuation.

### **Valuation Factor 3 - Client Base**

The make-up of an advisory firm's client base will be just as important as its size in determining valuation. Investors will consider the diversity and stability of an advisory firm's client base. They will also closely scrutinize how advisory firms acquire clients and factors that might hamper their future growth.

Those organizations with widely diversified client bases and large numbers of relationships will understandably be more attractive to potential investors. Their revenues are less dependent upon any one client or type of client.

Equally important to the valuation of an advisory business will be the perceived future stability of its client base. The market will penalize those organizations that have had historically high levels of client turnover.

Potential investors will also likely place a premium on those organizations that historically have been able to retain assets as they pass between generations of families. Retaining clients' assets after they have passed away reflects an ability to develop broad relationships with the family members of clients and demonstrates that these organizations have very stable sources of revenue.

### **Diversity of Referral Sources Is Also Critical**

A major factor in the valuation of future dominant competitors will be the diversity of its means and sources of acquiring clients. While investors are concerned about an advisory business' ability to retain existing clients, a firm's ability to grow its earnings also plays a large role in the price the market will be willing to pay.

**An advisory business' most important clients are often individuals or organizations that refer potential clients to the firm**

One of the most important – and overlooked – parts of an advisory firm's client base does not necessarily include individuals who pay for receiving advice from the firm.

An advisory business' most important clients are often individuals or organizations that refer potential clients to the firm. Many advisory businesses source nearly all of their new clients from referrals. Other personal financial services companies such as accounting or legal firms often generate these referrals.

Maintaining a diverse group of referral sources will become increasingly challenging in the future as more personal financial services companies develop their own advisory businesses. Many organizations that were once primary sources of an advisory firm's growth will instead become direct competitors.

#### **Valuation Factor 4 - Brand Name**

As many traditional sources of potential clients become inaccessible as new competitors enter the business, advisory firms will need to develop other means of attracting clients. Brand names will, therefore, become increasingly important factors in the growth of advisory businesses and will play significant roles in the valuation of future dominant competitors. Brand name reflects the strength of a firm's reputation within a particular geographic or client market. The better the reputation, the more likely it will continue to attract new clients.

**An advisory firm's success is not based on providing good advice but the perception that the firm provides good advice**

As we discussed earlier, an advisory firm's true business is not providing advice, but getting individuals to pay for advice. Similarly, a critical factor to an advisory firm's success is not just that it provides its clients with good advice, but that current and potential clients perceive that the firm provides good advice. A strong brand name is a measure of how clients view the quality of the organization's services.

Few advisory firms currently have strong brand names. Acquiring clients has simply been so easy that these organizations have not had to develop the media, public relations or advertising strategies necessary for building a brand name.

That is changing. Many of the industry's new or future competitors (such as Vanguard, JP Morgan, Strong and Northern Trust) have national reputations and are using them to compete for clients. Existing advisory firms will need to develop strong brand names to be considered, much less selected, by many potential clients. Ultimately, brand names may be critical to survival.

#### **Potential Proxies for How the Market Will Value an Advisory Business**

Assuming an advisory business meets each of the four key valuation factors – that is, it has institutionalized relationships, is large, has an attractive client base and has developed a strong brand name – how might the market value this kind of entity?

There are other kinds of publicly traded personal financial services companies that have units very similar to financial advisory businesses. These companies provide valuation benchmarks that can be used in estimating the value of future dominant advisory firms.

### **Units at Some Brokerages Are Similar to the Advisory Business**

Divisions within many large brokerages – such as Merrill Lynch, PaineWebber and Raymond James – are very similar to those in financial advisory businesses. These large companies have retail brokerage units that provide advice to the semi-affluent as a core part of their businesses. They have also developed mutual fund and separate account wrap programs, and sell C-class mutual fund shares that generate fee streams similar to the annual fees paid to advisory firms.

They also have, however, numerous other lines of business that make them a less than perfect proxy for the financial advisory business. Investment banking and trading, transaction-based businesses that involve institutional clients and not semi-affluent investors, are core activities of each of these organizations. These functions are highly cyclical and substantially increase the volatility of a brokerage's earnings.

As a result, these brokerages have less predictable earnings than advisory businesses. Because financial services companies with more predictable profits have historically been valued by the market at higher earnings multiples than more volatile businesses, we expect future dominant advisory firms to trade at a premium to most brokerages.

### **Mutual Fund Companies Are Also Similar to Advisory Businesses**

Another potential proxy for valuing future financial advisory businesses is the mutual fund industry. Mutual fund companies provide asset management services to thousands of individual investors, including semi-affluent investors, through mutual fund families. Many even provide advice directly to individual retail clients through their direct marketing and advisory businesses. Their revenues come almost entirely from recurring management and fund administration fees that are very similar to advisory fees.

Mutual fund firms, however, have a degree of operating leverage far greater than advisory businesses, which allows them to grow much larger and more quickly. They can manage \$10B in a mutual fund with the same number of personnel that it takes to manage \$1B.<sup>6</sup> Advisory firms cannot achieve this kind of scale. As a result, successful mutual fund firms should trade at slightly higher multiples of earnings than future dominant advisory firms.

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<sup>6</sup>To be clear, while a mutual fund company can as easily manage \$10B as it can \$1B in a fund, it may not necessarily deliver as good of returns to its investors. However, to date, few large mutual fund companies have suffered the consequences of being too large, despite delivering consistently mediocre returns to their investors.

**Exhibit 6.2****Historical Earnings Multiples of  
Mutual Fund Companies and Brokerages**

| <b>Mutual Fund Companies</b> | <b>1994</b>  | <b>1995</b>  | <b>1996</b>  | <b>1997</b>  | <b>1998</b>  |
|------------------------------|--------------|--------------|--------------|--------------|--------------|
| Franklin Templeton           | 13.01        | 14.96        | 16.80        | 22.85        | 21.25        |
| T. Rowe Price                | 16.63        | 19.57        | 21.46        | 25.21        | 24.17        |
| John Nuveen                  | 13.65        | 14.57        | 12.97        | 15.13        | 15.53        |
| Alliance Capital             | 14.07        | 11.05        | 11.73        | 23.56        | 18.80        |
| Nvest                        | 13.62        | 15.89        | 12.91        | 13.07        | 13.99        |
| PIMCO <sup>(1)</sup>         | 14.00        | 8.00         | 11.00        | 16.50        | 20.48        |
| <b>Group Average</b>         | <b>14.16</b> | <b>14.01</b> | <b>14.48</b> | <b>19.39</b> | <b>19.04</b> |

| <b>Brokerages</b>    | <b>1994</b> | <b>1995</b>  | <b>1996</b> | <b>1997</b>  | <b>1998</b>  |
|----------------------|-------------|--------------|-------------|--------------|--------------|
| Merrill Lynch        | 6.42        | 11.26        | 8.58        | 11.71        | 14.82        |
| Morgan Keegan        | 5.61        | 9.47         | 8.98        | 15.49        | 15.02        |
| A.G. Edwards         | 7.55        | 10.96        | 9.53        | 12.59        | 12.98        |
| Paine Webber         | 8.22        | N/A          | 9.83        | 9.86         | 12.39        |
| Raymond James        | 7.25        | 9.68         | 8.21        | 9.99         | 13.01        |
| <b>Group Average</b> | <b>7.01</b> | <b>10.34</b> | <b>9.03</b> | <b>11.93</b> | <b>13.64</b> |

Source: Bloomberg, Standard & Poors and Undiscovered Managers estimates

P/E ratios = Average of quarter-end P/E ratios

<sup>(1)</sup>PIMCO P/E ratios calculated as an average of high and low year-end P/E ratios (1994 - 1997)

In Exhibit 6.2, we have listed several leading brokerages and mutual fund companies and their historical earnings multiples. Brokerages have historically traded at price/earnings ratios of 7 to 14 while mutual fund companies have been valued at significantly higher levels of 14 to 19. If our analysis is correct, advisory firms should trade at a level between these two types of companies.

This level, by coincidence, is similar to that at which institutional money managers have historically been valued. These types of companies have traded at slightly lower earnings multiples than mutual fund organizations but at higher levels than brokerages.



## VII. Options Available to Financial Advisory Firms

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Advisory firms need to make some choices to prepare for the industry changes that are looming on the horizon. These choices will affect the size, culture, profitability and future valuation of their companies. The choices made by an advisory firm today may determine whether they still exist 10 years from now.

Although each advisory firm's particular business is unique, there are three general strategic options available to all such companies:

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### Strategic Options Available to Advisory Firms

1. Do nothing
2. Undertake a niche strategy
3. Try to become a dominant competitor

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#### Option 1 - Do Nothing

Most firms will probably choose to do nothing. They are far too busy trying to keep up with their current business opportunities to worry about long-range planning and strategies. Their businesses are far more successful than they ever imagined and their future seems very bright.

These organizations, however, face a very challenging future – and not because they run the risk of suddenly losing their clients. A large competitor does not need to take away an advisory firm's clients in order to harm its business. The large competitor need only change the smaller firm's pricing structure and life at the smaller firm will become a lot harder.

As dominant competitors expand their services and provide them at a lower cost, smaller firms will experience substantial fee pressure. While their clients may want to continue using the firm's services, they will not be willing to pay an above-market price. And while smaller firms will be forced to lower their fees, their costs will increase because improving the quality of their services will become essential to retaining clients. The combination of falling revenues and rising costs will mean that some advisory firms may be only one-third to half as profitable in the future as they are today.

Consequently, smaller firms will shift from rapidly growing companies to organizations whose primary focus is retaining their existing clients. The partners in these firms will make less, work harder and be in constant peril of losing their businesses.

## Option 2 – Undertake a Niche Strategy

Undertaking a niche strategy would require the least amount of change to an advisory firm's current business. Such a strategy involves providing complex and sophisticated services that meet the unique needs of a very small portion of the overall market for financial advice. If a firm is able to develop this type of specialized expertise and is also able to capture a dominant (>60%) share of the market for that service, it will have a very defensible niche.

During our research, we came across a good example of an advisory business that employs a niche strategy. This firm targets Canadian citizens who retire in the southwestern United States. Its clients need specialized advice that addresses many tax and legal issues when investing their assets.

The demand for this advice is fairly limited and this advisor has captured a significant amount of the market for this service. Therefore, it is very unlikely that another organization will develop a similar specialty to compete for this firm's current and future clients.

**Niche strategies  
involve significantly  
less change for  
advisory firms**

Niche strategies are particularly attractive because, for those organizations that already employ them, the future will involve significantly less change than for other types of advisory firms. While firms with niche markets may need to gradually expand their services over time, the unique needs of their clients combined with the limited demand for their services will allow them to slowly evolve their businesses.

### Niche Opportunities Can Dissipate Over Time

The problem with many niche strategies is that a niche can become less specialized over time. These firms may suddenly confront a flood of competition for their clients. A good example of how the advantages of a niche strategy can dissipate over time is shown in the computer workstation industry.

For many years, Silicon Graphics had carved out a niche in the computer business focused on developing and manufacturing very fast workstations. Their clients included engineering design firms and animation graphic artists who needed extremely powerful personal computers to operate their businesses and were willing to pay a premium price for these products. Silicon Graphics dominated this small market.

Over time, however, the power of the average desktop computer jumped dramatically and many of Silicon Graphics' clients no longer needed the company's unique products. The company's niche disappeared and it has been forced to completely revamp its strategy and product line.

### **Option 3 – Try to Become a Dominant Competitor**

The third alternative for advisory firms is to try to become dominant competitors. Making such a jump will be very challenging.

Dominant competitors will be very different than the organizations that preceded them. Culturally, they will operate like large businesses instead of small family-run companies. The founders and current owners of many of these companies will not run them on a daily basis in the future. Their ownership structure will also change as many become part of the larger financial services organizations or will include outside investors.

Personnel recruitment and training will be a primary focus for the management of future dominant competitors as they try to expand. These organizations will also employ very different compensation systems than used by most current advisory firms. While the financial rewards of successfully building a future dominant competitor will be immense, so too will be the obstacles. Some of the larger barriers will include:

#### **Owners of Advisory Firms Will Need to Redefine Their Roles**

The largest obstacles to converting an advisory business into a future dominant competitor are the current owners of these organizations. They are far better suited to providing investment advice and conducting financial planning than managing large, high-growth companies. These individuals generally do not enjoy the wide administrative responsibilities that such a job entails and often lack the patience or desire to become enmeshed in the day-to-day details of running a large business. They are also generally unwilling to delegate authority to other individuals in the firm and often personally select all of the organization's employees.

Changing a current advisory business into a dominant competitor will be particularly difficult because most firms are structured to be small businesses. Their current structure cannot support the exponential growth that would be required to become a dominant competitor. It is analogous to starting with the skeleton of a mouse and trying to grow it into an elephant.

In addition, the development and execution of such a strategy is probably beyond the core competence of most individuals that currently run advisory firms. Their personalities, in many cases, are also better suited to recruiting clients and providing financial advice on a very personal basis instead of overseeing a large company.

An obvious alternative is to hire an outsider to run the company. Most advisory firms, however, are currently run by entrepreneurs who are unwilling to cede the necessary authority to an outsider to run the firm. The principals of organizations who hope to become dominant competitors will need to understand their own strengths and weaknesses and be willing to redefine their roles.

**The largest obstacles to converting an advisory business into a future dominant competitor are the current owners**

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## Barriers to Becoming a Dominant Competitor

1. Current Owners
  2. Cultural Barriers
  3. Recruiting Qualified People
  4. Compensation Systems
  5. Capital to Fund Growth
- 

### Cultural Barriers Will Be Hard to Overcome

Building an advisory business from a small partnership or proprietorship to a dominant competitor will also involve numerous – and often unwelcome – cultural changes. Many current advisory firms are small family businesses with ill-defined responsibilities for their employees. The proprietors personally oversee every function and regularly hire family members, regardless of their training or experience. Many current proprietors also hope to pass the company's ownership on to future generations of their families.

Future dominant competitors, by comparison, will need to function as efficient machines. They will be large companies with hundreds of personnel, each with specific responsibilities. Their ownership will be widely held and they will have policies that ensure advancement in the organization is based on merit and not nepotism.

The future roles of nearly every current employee will also change, as specialization will become essential to the delivery of better financial advice. These companies will have hundreds of employees with several layers of management. And many of each organization's current employees may no longer be the right people for the long-term success of the company.

The cultural barriers to building a dominant competitor may be too large for many current advisory firms to overcome. Culture is a primary reason that many current owners and employees work at these companies, often even more important than their level of compensation. Owners enjoy running a small company and having the final say over how it is run. The employees often prefer the paternalistic culture of these kinds of companies to the more Darwinian environment of big organizations.

These cultural obstacles make trying to build a dominant competitor very risky for many current advisory firms. They run the risk of losing some proprietors and key employees if they try to change their business structures.

**The cultural barriers to building a dominant competitor may be too large for many current advisory firms to overcome**

**Ideal relationship managers will be more than just good sales people**

### **Recruiting Qualified People to Build an Advisory Firm Will Be Difficult**

An equally vexing obstacle for those advisory firms that want to become dominant competitors will be identifying and recruiting sufficient numbers of qualified individuals to build the organization. Most people who have the expertise necessary to give financial advice already own their own firms and would not relish the prospect of becoming an employee of another organization.

Recruiting qualified individuals to serve as marketers will be particularly challenging. Ideal relationship managers will be more than just good salespeople. They will also have at least a general level of knowledge of financial planning, investments, taxes and trust issues and will understand the needs and issues confronting their target client bases.

Nearly 20 years ago, Brinson and Capital Guardian faced similar challenges when trying to develop their marketing staffs. Over the following years, Brinson had some success in recruiting experienced outsiders as part of their initial marketing staff. Capital Guardian, on the other hand, concluded early on that they would need to train existing employees to fill these roles.

Those advisory firms successful in becoming dominant competitors will likely fill their needs for relationship managers with a mix of outside hires and people that they have developed internally. This development process will require large investments in training and continuing education programs that will need to be conducted simultaneously with trying to rapidly build a business.

**The ownership of future dominant competitors will be spread throughout the organization**

### **Compensation Systems Will Need to Change**

As advisory firms try to become dominant competitors, they will also find that the competition for talented employees will skyrocket. Other potential dominant competitors will also need qualified individuals to fill their ranks. As advisory firms invest more in developing and training employees, they will find that they have a greater stake in retaining those employees.

Very low turnover of personnel was a major factor in Capital Guardian's and Brinson's success and was directly related to the broadly shared ownership of the organization. This low turnover was, in no small way, attributable to the fact that virtually every key employee had a stake in the future success of the organization. Ownership stakes also encouraged these employees to focus on building the long-term value of the company and not their short-term compensation.

Currently, the equity of most advisory organizations is usually held entirely by only a few individuals. Broadening the ownership of the firm is an unthinkable event. Advisory firms that hope to become dominant competitors will need to completely revamp their compensation systems with a particular emphasis on fostering long-term loyalty.

These businesses cannot remain family-owned companies. Their ownership will need to be broadly shared if they want their employees to act like owners and not simply the hired help.

### Capital May Be Needed to Fund Growth

We have already mentioned the last major obstacle to most advisory firms evolving into dominant competitors. They are not large enough to fund the many changes needed to build this type of business out of current earnings.

**Today's advisory  
business is comparable  
to a land grab**

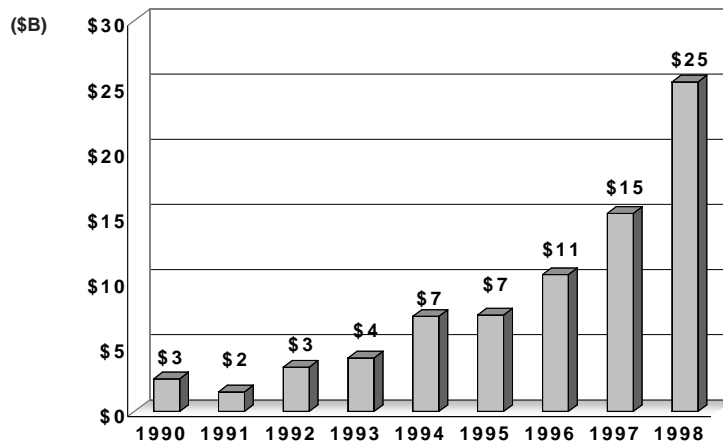
While advisory firms are profitable businesses, some of the larger organizations earn only \$2mm to \$3mm per year – and that is before paying their principals any compensation. After deducting market-level salaries for the firm's owners, most organizations have less than \$1mm of cash flow to reinvest in the business. This level of investment will be inadequate to finance the broad changes required to become a dominant competitor.

Though somewhat risky, the payoff for raising capital now could be potentially enormous. Today's advisory business is comparable to a land grab. With no cost of client acquisition, advisory firms should be trying to capture as many new clients as quickly as possible. To do so, advisory firms will need to immediately recruit marketing forces and rapidly expand their staffs that provide advisory services to clients.

The good news is that there is no shortage of capital available for good businesses. As shown in Exhibit 7.1, the level of new money going into venture capital funds has surged during the past five years. The booming economy has also created a large group of individuals who have only recently become affluent and are seeking opportunities in which to invest their newfound wealth.

Exhibit 7.1

Capital Commitments to US Venture Funds



Source: 1999 National Venture Capital Association Yearbook

**Being able to rapidly expand an advisory firm's operations to locations in several states is a benefit of incalculable value**

The real challenge for many advisory firms that attempt to become dominant competitors is not getting capital but deciding which individuals or organizations will be the best potential investors in their organizations. Regardless of how potential dominant competitors fund their growth, these organizations need to expand in a step function fashion rather than gradually. This very low cost of client acquisition will not continue indefinitely, and those organizations that fail to take advantage of the current favorable conditions may never catch up.

### **Strategic Alliances Offer Opportunities and Challenges**

One alternative for raising capital might be to form a strategic alliance with a larger organization in a different part of the personal financial services industry. By partnering with a large accounting firm, for example, an advisory business might be able to grow at a much more rapid rate, benefiting from access to its partner's client base as well as its capital.

Should this partner have offices in many locations, the advisory firm might also be able capitalize on its new partner's existing infrastructure. Being able to rapidly expand an advisory firm's operations to locations in several states is a benefit of incalculable value.

### **Strategic Alliances Can Be Risky**

Not all partnerships succeed, however. History is littered with strategic alliances that failed because of cultural and economic impediments. Just as in marriage, advisory firms that decide to enter into strategic alliances need to be careful when picking their mates. Both organizations have to be committed to making the partnership work. And both must have a significant stake in the economic success of the venture.

Creating such an alignment of interests often means that the strategic partner must acquire a substantial position in the ownership of the advisory firm. The partner will, in many cases, demand the right to ultimately acquire most of the current owners' shares in the company.

Large companies often enter into alliances to enhance their strategic positions. A right to ultimately acquire a majority of an advisory firm's equity would be necessary to protect the long-term interests of the larger organization from the success of the advisory firm.

In addition to the right to acquire the majority of an advisory firm's equity, potential strategic partners will also likely want to have a role in the governance of the advisory firm. As part of the strategic alliance, the larger organization will have made a significant investment into the advisory firm and will want the ability to protect that investment. The new partner's view of what is best for the advisory firm, however, may not always coincide with that of the firm's current owners.

## **Raising Capital from Angels Is Another Alternative**

Another alternative source of capital would be from individual investors. The recent boom in the US economy has created large numbers of wealthy individuals who are seeking opportunities in which to invest their newfound wealth. Because many of these newly affluent individuals made their fortunes by starting small companies and building them into large ones, many would be excited about investing in an up-and-coming financial advisory business.

Individuals who invest in small and start-up businesses, often called "angels," could be a low cost source of capital for advisory firms. Angels offer their potential investments no strategic value. They provide only money, the ultimate commodity. And unlike investments made by venture capital firms, all of the return generated by the investment goes to the angels and is not shared by intermediaries. Consequently, they will often accept much lower levels of projected returns for their investments than strategic partners or venture capitalists.

Similar to strategic partners or venture capitalists, however, angels will want to participate in the oversight and governance of the companies in which they invest. Their participation as potential board members will be a difficult adjustment for many current owners of advisory businesses. These proprietors are accustomed to operating their organizations as the sole decisionmakers, not requiring the approval of any other parties. Accepting capital from outsiders will mean surrendering at least a part of that independence.

## VIII. Some Implications of the Coming Evolution of the Financial Advisory Business

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**The multi-user family office structure will be a fundamental threat to the survival of many personal financial services companies**

If our forecast for the future of the financial advisory business is correct, this evolution will have many implications for a wide variety of financial services companies. A battle involving many firms that peacefully co-exist today is about to commence. Advisory firms, accounting firms, trust attorneys, insurance agencies and brokerages will fight to provide the same services to semi-affluent clients. Not all of these organizations will survive.

### **The Financial Advisor Will Become the Gatekeeper**

The transition to the multi-user family office structure will mean that clients will have access to "one-stop shopping" for all of their personal financial needs. It will also lessen the need for many personal financial services businesses – accounting firms, trust companies, insurance brokerages and trust law firms – as stand alone entities.

The shift to providing comprehensive solutions will also change how personal financial services companies acquire new clients. The entity responsible for crafting the solution will become a gatekeeper. It will influence the selection of other organizations that provide financial services to semi-affluent clients.

The emergence of the multi-user family office structure will be a fundamental threat to the survival of many personal financial services companies. Unless they find ways to become gatekeepers themselves, or are allied with other gatekeepers, they risk losing control over their relationships with potential clients.

Stand-alone financial services businesses must, therefore, find ways to integrate their businesses into the process of delivering comprehensive solutions for clients. Some larger organizations may develop or acquire their own financial advisory businesses. Smaller financial services companies may enter into strategic alliances with existing advisory businesses.

We are not forecasting that all future dominant competitors will be fully integrated businesses. In fact, our cost analysis assumed that a large portion of the trust work in our models in Section V was outsourced on an arms-length basis. Alliances with other service providers may also prove to be the preferred means of delivering financial advice to clients, especially if other service providers serve as good sources of client referrals.

Whether part of a fully integrated organization or a strategic alliance, the key decision-makers in the future will be those organizations that are able to understand their clients' true financial needs and to blend various services to create customized solutions. All other financial services providers will be merely sub-contractors to those decisionmakers.

## The Advisory Business Will Become More Competitive and Less Collegial

Another obvious implication of the forthcoming evolution is that the advisory business is going to become much more competitive and less collegial between firms. Advisors currently meet and regularly share information with their competitors as part of continuing education programs and various associations. These meetings involve advisory firms from other parts of the country and also, in some cases, direct competitors from the same geographic markets.

As the advisory business shifts from a small cottage industry to institutionalized businesses, industry participants will act more like competitors in mature businesses. They will jealously guard information about their companies and will make an ongoing effort to better understand their competitors. Employees will likely be required to sign non-compete and confidentiality agreements. Meetings involving multiple advisory firms will function more like trade groups than study groups.

### Know Your Ally and Know Your Enemy

Competition will change more than just the way advisory firms attract clients and interact with their counterparts. Today's advisory firms will often use investment management services or other products from companies that directly compete with them for clients. Advisory firms in the future will carefully evaluate their vendors to avoid aiding their competitors.

Organizations such as JP Morgan, Strong and Vanguard now have their own advisory units and are pursuing semi-affluent clients on a national basis. These companies also have very successful investment management units. Many advisory firms currently invest client assets in these larger organizations' mutual funds.

By investing in their mutual funds, advisory firms help to underwrite the cost of these organizations' efforts to build national financial advisory businesses – businesses whose primary goal is to compete with current advisory firms for clients. The advisory firms' actions are analogous to American firms wanting to help build steel plants in Japan in 1941.

**Advisory firms buying their future competitors' mutual funds is analogous to American firms wanting to help build steel plants in Japan in 1941**

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### Companies That Sell Mutual Funds to Advisors and Also Market Advice to Semi-Affluent Individuals

| Investment Management Company                 | Program  |
|---|--|
| Vanguard Group<br>Strong Funds                | Vanguard Asset Management & Trust Services<br>Strong Advisor Program                       |
| Fidelity Group                                | Portfolio Advisory Services Program<br>Portfolio Advisory Services Special Options Program |
| American Century Investments<br>Scudder Funds | Private Client Services<br>Scudder Private Investment Counsel                              |
| Neuberger Berman<br>JP Morgan                 | Neuberger Berman Trust Company<br>Private Client Services                                  |
| Brinson<br>Warburg Pincus                     | Private Banking Division<br>Private Client Group   |

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## **Fund Companies in the Brokerage Channel Must View Brokers as Their Clients**

In contrast, vendors in the brokerage channel must view brokers as their clients if they hope to have any chance to compete for their business. And they must never be perceived as competing directly or indirectly with the brokers.

**With no other practical investment alternative, advisory firms were forced to ignore that their clients could buy the same funds directly**

Investment management companies such as AIM, Franklin/Templeton and the American Funds (Capital Guardian's sister company) do not provide financial advice or brokerage services to potential investors. Their clients are the brokers who sell their products to end-users. And the wholesaling efforts of these investment management companies are solely focused on helping brokers to build their businesses.

These mutual fund companies not only avoid competing with the brokers directly, they assiduously avoid competing indirectly. For example, their mutual funds are not sold directly to individuals on a no-load basis. Although the no-load fund business has historically been very lucrative and is growing rapidly, these companies logically fear that brokers would cease using these firms' mutual funds if they found out that clients were able to circumvent paying sales charges.

## **Advisory Firms Buy Products from Organizations that Compete with Them for Clients**

Advisory firms do not look at their relationships with big investment management companies in the same way. The self-destructive behavior of investing in competitors' mutual funds can be traced to the high growth of the advisory industry and the limited investment alternatives available to these companies when they first opened their businesses.

Advisory firms were some of the earliest companies to charge fees for financial advice that were not embedded in transactions or paid as a part of an investment. Their compensation is paid independent of the investments chosen for clients' portfolios.

No-load funds were the logical investments for most advisors to use at that time when creating client portfolios. Unlike load funds, these were the only kind of mutual funds that did not include any additional fees or expenses that would be rebated to the organization or individual providing financial advice. The problem with no-load funds, however, is that they are also sold directly to investors.

With no other practical investment alternative, advisory firms were forced to ignore that their clients could buy the same funds through the mail or through mutual fund supermarkets, circumventing the advisor's services and fees. Over time, the use of no-load funds by advisory firms has become fairly commonplace.

At the same time, the incredible growth in demand for financial advice has lessened the perceived risk from potential competitors. Advisor businesses have been growing so fast that they have not had to closely scrutinize their vendors.

### **Advisors Will Shun Competitors' Products in the Future**

The coming battle for the semi-affluent client will likely change all of that. Successful advisory firms will demand that their vendors play a role in helping build their businesses and will quickly shun those organizations that are not committed to viewing the advisor instead of the end user as their primary client.

More importantly, organizations that decide to compete directly with the advisor's core business will be far less successful in marketing their other services to advisory firms. No more than Paine Webber will help subsidize Merrill Lynch's business will advisory firms help underwrite the costs of their large competitors' efforts to exterminate them.

### **Life Will Be Very Challenging for Financial Services Companies That Have Not Institutionalized Their Client Relationships**

In the upcoming battle among all personal financial services providers for semi-affluent clients, a key factor for success will be the ability to institutionalize client relationships. As we outlined earlier, the cost of developing and delivering a comprehensive solution for clients will not be trivial. In order to make a reasonable return on such levels of investment, organizations must be able to capture the intrinsic value of their client relationships.

Individual salespeople and not the organization, however, control client relationships at many personal financial services companies. Similar to partners at small advisory firms, should the salesperson leave the organization, many clients – and the intrinsic value of their relationships with the organizations – will transfer their business to the salesperson's next organization.

Such departures will likely occur more frequently once there are publicly traded financial advisory firms. As we outlined in Section VI, future dominant competitors will likely trade at earnings multiples at least comparable to those of institutional money management businesses. With a publicly traded stock, these advisory firms will have a currency that will allow them to raid their competitors.

**The salespeople that are most critical to the profitability of brokerage firms will be the prime targets of advisory firms**

These raids will be particularly problematic for many brokerages because those brokers most likely to leave and join advisory firms are also extremely critical to the profitability of their brokerage firms. They are usually the most sophisticated salespeople in the organization and are the most capable of building fee-based businesses. They would be the prime targets for advisory firms trying to rapidly expand their businesses in new markets.

We are not suggesting that all top producers will likely leave their current organizations once advisory firms are in a position to poach them. Rather, the cost of retaining these top producers is going to go up significantly. And higher retention costs at a time when they are having to make significant investments in technology and expanded services will pose a major challenge for many brokerages.

## IX. Conclusion

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The advisory business is on the brink of an evolution that will completely change the delivery of financial advice to semi-affluent individuals. Multi-user family offices will provide low-cost comprehensive solutions to clients' financial problems. These organizations will better understand their clients and possess significant resources that will be used to craft strategies customized to each individual's particular needs.

The forthcoming evolution will affect every aspect of the personal financial services industry. Financial advisors will become the key gatekeepers to many clients. Personal financial services organizations that fail to build their own advisory businesses may quickly discover that they have lost control of their clients as well as their own destiny.

An evolution is inevitable because of the forces that now confront the industry. A combination of better technology, increasing competition and the rising sophistication of the average investor will cause this business to change.

### **The High Intrinsic Value of Client Relationships Will Be a Catalyst for Change**

**If the Efficient Market Hypothesis is at all correct, the cost of acquiring clients must rise**

A good example of why changes to this industry are inevitable is shown in the negligible current cost of client acquisition. The intrinsic value of an advisory firm's relationships with its clients is far too valuable to cost nothing to acquire.

For example, if an advisory firm is able to charge a client with \$1mm in investable assets 0.75% annually, it would generate an incremental \$7,500 in revenue per year. As our analysis showed in Section V, even after providing a full comprehensive solution to their clients, future dominant competitors will be able to achieve pre-tax, net operating margins as high as 65%. The new client, as a result, would generate approximately \$5,000 of incremental adjusted EBITDA for the firm.

#### **Exhibit 9.1**

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##### **The Value of Client Assets to an Advisory Firm**

|   |                 |
|---|-----------------|
| New Client                                    |                 |
| Total Investable Assets                       | \$1,000,000     |
| Fee   | 0.75%           |
| EBITDA  | \$7,500         |
| Adjusted EBITDA @ 65% Margin                  | \$4,875         |
| <b>Incremental Value Created @ 10X EBITDA</b> | <b>\$48,750</b> |

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As we outlined in Section VI, the institutional money management and financial advisory businesses are very similar from an economic perspective. These similarities make it likely that future, publicly traded dominant competitors will be valued at multiples of earnings at least equal to those of institutional money managers, who have historically been valued at about 10 times adjusted EBITDA. At that multiple of adjusted EBITDA, the relationship with a new client who has \$1mm of investable assets would have an intrinsic value of about \$50,000 to the advisory firm.

If the Efficient Market Hypothesis is at all correct, conditions that allow organizations to capture assets worth \$50,000 at no cost will not persist indefinitely. The cost of acquiring clients over time should rise significantly. Eventually, advisory firms should expect that they would only generate normal market returns from new clients on their investments in personnel, technology and infrastructure.

### **No One Knows Who the Winners Will Be**

Predicting which organizations will emerge as dominant competitors from the fragmented ranks of the advisory business – or for that matter, any segment of the personal financial services industry – is almost impossible. Success in becoming a dominant competitor will also be dependent on a firm's ability to market its services and to execute a high growth strategy as an organization. Those firms that give the best financial advice will not necessarily succeed.

Many of the newer entrants to this business such as the large accounting firms and brokerages start with significant advantages including capital and a variety of other resources. But, their size is also a disadvantage because it limits their ability to quickly make decisions and adjust their organizations to changes in the market. They also face numerous internal cultural obstacles that will make it hard for many of them to institutionalize their relationships and to make the advisor the focal point of the organization's activities.

Brinson Partners is a good example of how relatively small firms can grow into dominant competitors. Gary Brinson began reshaping the organization that later became Brinson Partners in 1981. He started with less than \$2B of assets under management – a relatively small business for that industry. Through a combination of far-reaching vision and good management, he built one of the world's most respected and dominant institutional money management businesses in little more than a decade.

What is clear is that in seven to ten years, the financial advisory industry's structure will be very different from that of today. While there will still be thousands of small advisory firms struggling to get by, the industry will be dominated by 40 or 50 very large firms.

These organizations will deliver advice far superior to that provided today to their clients at a much lower cost. These companies will also have immense economic value and many of their founders will join the ranks of the *Forbes 400*.



Appendix

Scenario Analyses – Breakeven Point

| Breakeven By Number of Clients<br>With High Fee Schedule |                     |      |       |
|--|---------------------|------|-------|
| Stage of Services  | Average Client Size |      |       |
|  | Small               | Base | Large |
| 1  | 264                 | 188  | 124   |
| 2  | 340                 | 245  | 159   |
| 3  | 427                 | 279  | 179   |
| 4  | 561                 | 358  | 228   |

| Exhibits 5.1,5.4,5.7,5.10<br>Breakeven By Number of Clients<br>With Base Fee Schedule |                     |      |       |
|---|---------------------|------|-------|
| Stage of Services   | Average Client Size |      |       |
|   | Small               | Base | Large |
| 1   | 302                 | 217  | 141   |
| 2   | 419                 | 274  | 179   |
| 3   | 543                 | 342  | 219   |
| 4   | 663                 | 428  | 272   |

| Breakeven By Number of Clients<br>With Low Fee Schedule |                     |      |       |
|---|---------------------|------|-------|
| Stage of Services                                       | Average Client Size |      |       |
|   | Small               | Base | Large |
| 1   | 432                 | 311  | 214   |
| 2   | 599                 | 410  | 279   |
| 3   | 873                 | 504  | 335   |
| 4   | 1121                | 650  | 429   |

| Breakeven By Assets Under Management<br>With High Fee Schedule (\$mm) |                     |       |         |
|---|---------------------|-------|---------|
| Stage of Services   | Average Client Size |       |         |
|   | Small               | Base  | Large   |
| 1   | \$300               | \$427 | \$952   |
| 2   | \$386               | \$523 | \$1,297 |
| 3   | \$476               | \$587 | \$1,449 |
| 4   | \$630               | \$813 | \$1,844 |

| Exhibits 5.2,5.5,5.8,5.11<br>Breakeven By Assets Under Management<br>With Base Fee Schedule (\$mm) |                     |       |         |
|--|---------------------|-------|---------|
| Stage of Services  | Average Client Size |       |         |
|  | Small               | Base  | Large   |
| 1  | \$344               | \$478 | \$1,092 |
| 2  | \$468               | \$581 | \$1,449 |
| 3  | \$609               | \$780 | \$1,736 |
| 4  | \$747               | \$937 | \$2,138 |

| Breakeven By Assets Under Management<br>With Low Fee Schedule (\$mm) |                     |         |         |
|--|---------------------|---------|---------|
| Stage of Services  | Average Client Size |         |         |
|  | Small               | Base    | Large   |
| 1  | \$482               | \$727   | \$1,717 |
| 2  | \$669               | \$906   | \$2,245 |
| 3  | \$982               | \$1,160 | \$2,662 |
| 4  | \$1,262             | \$1,434 | \$3,440 |

| Total Expenses at Breakeven<br>With High Fee Schedule (\$mm) |                     |        |        |
|--|---------------------|--------|--------|
| Stage of Services  | Average Client Size |        |        |
|  | Small               | Base   | Large  |
| 1  | \$2.25              | \$2.23 | \$2.21 |
| 2  | \$2.86              | \$2.83 | \$2.81 |
| 3  | \$3.57              | \$3.26 | \$3.22 |
| 4  | \$4.68              | \$4.23 | \$4.07 |

| Total Expenses at Breakeven<br>With Base Fee Schedule (\$mm) |                     |        |        |
|--|---------------------|--------|--------|
| Stage of Services  | Average Client Size |        |        |
|  | Small               | Base   | Large  |
| 1  | \$2.39              | \$2.37 | \$2.35 |
| 2  | \$3.39              | \$2.98 | \$2.95 |
| 3  | \$3.85              | \$3.54 | \$3.44 |
| 4  | \$4.74              | \$4.42 | \$4.25 |

| Total Expenses at Breakeven<br>With Low Fee Schedule (\$mm) |                     |        |        |
|---|---------------------|--------|--------|
| Stage of Services   | Average Client Size |        |        |
|   | Small               | Base   | Large  |
| 1   | \$2.49              | \$2.46 | \$2.48 |
| 2   | \$3.45              | \$3.24 | \$3.20 |
| 3   | \$5.06              | \$3.99 | \$3.84 |
| 4   | \$6.50              | \$5.14 | \$4.93 |

**Exhibit 5.14**  
**Impact of Fee Structure on Breakeven**

| With Large Average Client Size (\$mm) |         |         |         |         |
|---------------------------------------|---------|---------|---------|---------|
| Fee Structure                         | Stage 1 | Stage 2 | Stage 3 | Stage 4 |
| Low                                   | \$1,717 | \$2,245 | \$2,662 | \$3,440 |
| Base                                  | \$1,092 | \$1,449 | \$1,736 | \$2,138 |
| High                                  | \$952   | \$1,297 | \$1,449 | \$1,844 |

| With Base Average Client Size (\$mm) |         |         |         |         |
|--------------------------------------|---------|---------|---------|---------|
| Fee Structure                        | Stage 1 | Stage 2 | Stage 3 | Stage 4 |
| Low                                  | \$727   | \$906   | \$1,160 | \$1,434 |
| Base                                 | \$478   | \$581   | \$780   | \$937   |
| High                                 | \$427   | \$523   | \$587   | \$813   |

| With Small Average Client Size (\$mm) |         |         |         |         |
|---------------------------------------|---------|---------|---------|---------|
| Fee Structure                         | Stage 1 | Stage 2 | Stage 3 | Stage 4 |
| Low                                   | \$482   | \$669   | \$982   | \$1,262 |
| Base                                  | \$344   | \$468   | \$609   | \$747   |
| High                                  | \$300   | \$386   | \$476   | \$630   |

**Exhibit 5.13**

**Impact of Fee Structure on Breakeven  
With Large Average Client Size (# of clients)**

| Fee Structure | Stage 1 | Stage 2 | Stage 3 | Stage 4 |
|---------------|---------|---------|---------|---------|
| Low           | 214     | 279     | 335     | 429     |
| Base          | 141     | 179     | 219     | 272     |
| High          | 124     | 159     | 179     | 228     |

**Impact of Fee Structure on Breakeven  
With Base Average Client Size (# of clients)**

| Fee Structure | Stage 1 | Stage 2 | Stage 3 | Stage 4 |
|---------------|---------|---------|---------|---------|
| Low           | 311     | 410     | 504     | 650     |
| Base          | 217     | 274     | 342     | 428     |
| High          | 188     | 245     | 279     | 358     |

**Impact of Fee Structure on Breakeven  
With Small Average Client Size (# of clients)**

| Fee Structure | Stage 1 | Stage 2 | Stage 3 | Stage 4 |
|---------------|---------|---------|---------|---------|
| Low           | 432     | 599     | 873     | 1,121   |
| Base          | 302     | 419     | 543     | 663     |
| High          | 264     | 340     | 427     | 561     |

**Impact of Relationship Managers on Breakeven  
With Large Average Client Size (\$mm)**

| # of Clients/RM | Stage 1 | Stage 2 | Stage 3 | Stage 4 |
|-----------------|---------|---------|---------|---------|
| 60              | \$1,091 | \$1,341 | \$1,617 | \$2,105 |
| 50              | \$1,091 | \$1,449 | \$1,736 | \$2,138 |
| 40              | \$1,091 | \$1,569 | \$1,844 | \$2,357 |

**Impact of Relationship Managers on Breakeven  
With Base Average Client Size (\$mm)**

| # of Clients/RM | Stage 1 | Stage 2 | Stage 3 | Stage 4 |
|-----------------|---------|---------|---------|---------|
| 85              | \$478   | \$581   | \$744   | \$907   |
| 75              | \$478   | \$581   | \$780   | \$937   |
| 65              | \$478   | \$618   | \$807   | \$967   |

**Impact of Relationship Managers on Breakeven  
With Small Average Client Size (\$mm)**

| # of Clients/RM | Stage 1 | Stage 2 | Stage 3 | Stage 4 |
|-----------------|---------|---------|---------|---------|
| 100             | \$344   | \$468   | \$586   | \$723   |
| 90              | \$344   | \$468   | \$586   | \$747   |
| 80              | \$344   | \$492   | \$609   | \$779   |

| Exhibit 5.17                                  |         |         |         |         |
|---|---------|---------|---------|---------|
| Impact of Relationship Managers on Breakeven  |         |         |         |         |
| With Large Average Client Size (# of clients) |         |         |         |         |
| # of Clients/RM                               | Stage 1 | Stage 2 | Stage 3 | Stage 4 |
| 60  | 141     | 172     | 206     | 261     |
| 50  | 141     | 179     | 219     | 272     |
| 40  | 141     | 193     | 228     | 292     |

| Impact of Relationship Managers on Breakeven |         |         |         |         |
|--|---------|---------|---------|---------|
| With Base Average Client Size (# of clients) |         |         |         |         |
| # of Clients/RM                              | Stage 1 | Stage 2 | Stage 3 | Stage 4 |
| 85   | 217     | 274     | 319     | 411     |
| 75   | 217     | 274     | 342     | 428     |
| 65   | 217     | 295     | 353     | 445     |

| Exhibit 5.16                                  |         |         |         |         |
|---|---------|---------|---------|---------|
| Impact of Relationship Managers on Breakeven  |         |         |         |         |
| With Small Average Client Size (# of clients) |         |         |         |         |
| # of Clients/RM                               | Stage 1 | Stage 2 | Stage 3 | Stage 4 |
| 100   | 302     | 419     | 520     | 640     |
| 90  | 302     | 419     | 520     | 663     |
| 80  | 302     | 440     | 543     | 695     |

**Scenario Analyses – Maximum Net Operating Margin**

| Maximum Net Operating Margin |                     |      |       |
|------------------------------|---------------------|------|-------|
| With High Fee Structure (%)  |                     |      |       |
| Stage of Services            | Average Client Size |      |       |
|                              | Small               | Base | Large |
| 1                            | 69%                 | 74%  | 76%   |
| 2                            | 66%                 | 72%  | 74%   |
| 3                            | 59%                 | 67%  | 71%   |
| 4                            | 56%                 | 64%  | 69%   |

| Exhibits 5.3,5.6,5.9,5.12    |                     |      |       |
|------------------------------|---------------------|------|-------|
| Maximum Net Operating Margin |                     |      |       |
| With Base Fee Structure (%)  |                     |      |       |
| Stage of Services            | Average Client Size |      |       |
|                              | Small               | Base | Large |
| 1                            | 64%                 | 70%  | 72%   |
| 2                            | 61%                 | 68%  | 70%   |
| 3                            | 53%                 | 62%  | 67%   |
| 4                            | 50%                 | 59%  | 65%   |

| Maximum Net Operating Margin |                     |      |       |
|------------------------------|---------------------|------|-------|
| With Low Fee Structure (%)   |                     |      |       |
| Stage of Services            | Average Client Size |      |       |
|                              | Small               | Base | Large |
| 1                            | 55%                 | 61%  | 62%   |
| 2                            | 51%                 | 58%  | 60%   |
| 3                            | 40%                 | 51%  | 54%   |
| 4                            | 36%                 | 47%  | 52%   |

| Impact of Fee Structure on<br>Maximum Net Operating Margin<br>With Large Average Client Size (%) |         |         |         |         |
|--|---------|---------|---------|---------|
| Fee Structure  | Stage 1 | Stage 2 | Stage 3 | Stage 4 |
| Low  | 62%     | 60%     | 54%     | 52%     |
| Base   | 72%     | 70%     | 67%     | 65%     |
| High   | 76%     | 74%     | 71%     | 69%     |

| Impact of Fee Structure on<br>Maximum Net Operating Margin<br>With Base Average Client Size (%) |         |         |         |         |
|---|---------|---------|---------|---------|
| Fee Structure   | Stage 1 | Stage 2 | Stage 3 | Stage 4 |
| Low   | 62%     | 58%     | 51%     | 47%     |
| Base  | 70%     | 68%     | 62%     | 59%     |
| High  | 74%     | 72%     | 67%     | 64%     |

| Exhibit 5.15<br>Impact of Fee Structure on<br>Maximum Net Operating Margin<br>With Small Average Client Size (%) |         |         |         |         |
|--|---------|---------|---------|---------|
| Fee Structure  | Stage 1 | Stage 2 | Stage 3 | Stage 4 |
| Low  | 55%     | 51%     | 40%     | 36%     |
| Base   | 64%     | 61%     | 53%     | 50%     |
| High   | 69%     | 66%     | 59%     | 56%     |

| Exhibit 5.19<br>Impact of Relationship Managers on<br>Maximum Net Operating Margin<br>With Large Average Client Size (%) |         |         |         |         |
|--|---------|---------|---------|---------|
| # of Clients/RM  | Stage 1 | Stage 2 | Stage 3 | Stage 4 |
| 60   | 76%     | 74%     | 71%     | 69%     |
| 50   | 72%     | 70%     | 67%     | 65%     |
| 40   | 65%     | 64%     | 60%     | 59%     |

| Impact of Relationship Managers on<br>Maximum Net Operating Margin<br>With Base Average Client Size (%) |         |         |         |         |
|---|---------|---------|---------|---------|
| # of Clients/RM   | Stage 1 | Stage 2 | Stage 3 | Stage 4 |
| 85  | 74%     | 71%     | 65%     | 63%     |
| 75  | 70%     | 68%     | 62%     | 60%     |
| 65  | 66%     | 64%     | 58%     | 56%     |

| Exhibit 5.18<br>Impact of Relationship Managers on<br>Maximum Net Operating Margin<br>With Small Average Client Size (%) |         |         |         |         |
|--|---------|---------|---------|---------|
| # of Clients/RM  | Stage 1 | Stage 2 | Stage 3 | Stage 4 |
| 100  | 68%     | 64%     | 56%     | 53%     |
| 90   | 65%     | 61%     | 53%     | 50%     |
| 80   | 61%     | 58%     | 50%     | 47%     |

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