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The Future of the Financial Advisory Business Part II: Strategies for Small Businesses

Research Report
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This paper was researched and written by a team of nine people over the last ten months. We were assisted in our process by more than 100 different advisory organizations that shared their insights and ideas on the industry. Many of these companies have built or are in the process of building very successful niche advisory businesses. They helped educate us on the challenges and issues they have confronted in converting traditional advisory practices into successful niche companies. Although it is impossible to list every person that played a role in the production of this paper, there are several individuals we want to thank for their extraordinary help:

Tim Littlefield of Cranial Technologies, Inc., **David Lauderbaugh** of Corrugated Gears and Services, Inc., and **Dawn Westerberg** of Micro Information Products, Inc., helped us understand the intricate details of why their niche businesses have been so successful. Each of these people gave us a great deal of their time and patience and allowed us to include in the paper examples of organizations that epitomize the traits that are common to successful niche companies in other industries.

Janet Briaud of Briaud Financial Planning is an innovator in the development of niche strategies for advisory business. Her firm's specialties include services that help clients maximize their careers and best utilize their money. She was kind enough to share with us her vision for developing niche strategies and the many potential pitfalls that advisory businesses face when doing so.

Mark Tibergien of Moss Adams Advisory Services is the leading authority on maximizing value in advisory businesses. He has been a consultant to hundreds of firms on strategy and valuation and is a co-author of a recent study of the profitability and economics of the industry. He shared with us his many insights on strategies for maximizing the operating efficiency of advisory firms and alternatives for developing niche strategies.

Tony Batman is the founder and CEO of 1st Global, Inc., an independent advisory organization that partners with accounting firms to quickly create advisory units. His firm provides turnkey solutions including personnel, products and technology and has built a $5 billion advisory business. Tony shared his firsthand knowledge of the challenges of forming strategic partnerships and making them work, as well as the proper use of vendors to maximize the value of businesses.

Charlie Haines of Haines Financial Advisors has a well-deserved reputation as an innovator in the financial advisory business. He has incorporated into his firm a series of cutting-edge services that help families better benefit from their wealth. He shared many of his insights on the challenges of developing an array of services that is adequate to meet client needs and that is also narrow enough to allow niche firms to remain profitable.

Tom Connelly of Keats, Connelly & Associates, Inc. has built one of the top niche advisory businesses in the country. His company advises Canadian retirees that live in the United States on the many complex cross-border issues. He also provides them with comprehensive financial advice. Tom helped us better understand the challenge of building a brand as a niche firm and the difficulties of creating a specialty practice.

Norm Boone of Boone Financial Advisors, runs a very successful West Coast advisory business. He helped us better understand the challenge of repositioning an existing advisory business while at the same time continuing to meet a firm's duties to its existing clients.

Jim Sandager of Syverson, Strege, Sandager & Company oversees a fast growing Midwest advisory firm. Jim helped our team better understand the economic trade-offs of different service alternatives.

Deena Katz of Evensky Brown & Katz, along with her partner and husband **Harold Evensky**, is in the process of building a dominant advisory business. In an earlier life, however, she formed a very successful niche practice that worked with women in transition. Deena shared with us her broad understanding of brand development and practice management.

Patrick Kujawa, Managing Director and Principal at Undiscovered Managers, helped frame the paper and edit several drafts. **Tom Chauvin**, Director of Broker/Dealer Internal Wholesaling and Principal at Undiscovered Managers, and **Darian Thomas**, Regional Marketing Associate and Principal at Undiscovered Managers, helped edit several drafts of this paper.

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

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I. Introduction

Last September we published a white paper, *The Future of the Financial Advisory Business and the Delivery of Advice to the Semi-Affluent Investor* (Undiscovered Managers, September 1999), which ignited a firestorm of controversy. It prophesied that the financial advisory business was on the brink of a major transformation.

For most of the last decade and still today, the industry has been largely insulated from traditional market forces. The supply of potential clients exceeds the demand for them. Consequently, advisory businesses face no real competition.

A tidal wave of changes is completely reshaping the advisory business

This benign operating environment has lulled industry members into a false sense of security and harmony. Participants succeed without making investments in marketing or brand building. Most firms operate inefficiently and are only marginally profitable despite having no excess operating capacity. Competitors openly discuss their businesses and share trade secrets with one another.

Our study predicted that over the next six to nine years, a tidal wave of changes will completely reshape the advisory business. A hostile, competitive environment will emerge and organizations that peacefully co-exist today will battle for clients and employees tomorrow. Successful participants will focus their resources on capturing and retaining clients. They will also carefully guard information on their strategies and closely study their competition.

Our prognostications were understandably not welcomed in all quarters of the industry. Life is so good and clients so plentiful in the advisory business today that it is hard for many participants to take such a draconian forecast seriously.

In particular, our predictions about the industry's future structure have been a source of heated debate. We projected that the industry's extremely fragmented nature will change. A small group (40 to 50) of large companies will emerge and capture a disproportionate amount of the industry's future growth. Each of these firms will acquire at least $15 billion to $20 billion of assets under management and many will have more than $50 billion. Some industry participants who failed to actually read the paper took this to mean that we believe that size is the only determinant of future success and that small advisory firms will not survive.

To the contrary, our paper forecasted that a very large group of small firms will compete with large organizations. The small firms will include thousands of businesses in communities across the country.

Although small firms will survive, their future will be very different. Their owners will work harder and earn less as their firms try to function in a much more costly and competitive environment. The key challenge facing small advisory businesses is not survival, but prosperity.

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We also forecasted that there will be many very profitable, small advisory firms in the future – but they will be niche competitors. They will have special capabilities or expertise that will be essential to solving very complex problems of selected groups of clients. They will also have great economic value.

The vast majority of firms are committed to remaining small – so they can continue to provide the best possible service to clients and keep company cultures intact. The challenge is making these good intentions economically viable in the industry's increasingly competitive environment.

The purpose of this second paper is to provide a roadmap that smaller advisory businesses can use to position themselves to become niche competitors. We will examine the basic concepts that underlie all niche strategies and try to identify traits common to all successful niche competitors. We will also propose a five-step process for analyzing and converting an existing advisory business into a niche competitor.

Margin Compression Will Force All Advisory Firms to Change

Margin compression is the primary threat to the profitability of all companies that function in a competitive environment. As companies battle for clients, they must constantly improve their products (and thus, raise their costs) and/or lower their prices.

Large companies slow the rate of margin compression through scale. It allows them to spread their fixed costs across larger bases of revenues and become the lowest-cost producers.

Niche companies, on the other hand, are too small to compete solely on the basis of scale. They instead fend off margin compression by selling their products at premium prices. But clients will only pay premium prices for products they perceive as essential to meeting their needs and that include necessary features not available in generic products.

Six Traits Common to Successful Niche Firms

Consequently, while advisory firms can remain relatively small and still prosper, they cannot remain the same. Successful niche competitors will:

1) Create the perception that they possess the special expertise necessary to solve the most complex and critical problems shared by a select group of individuals;

2) Continually improve the quality of their services and, more importantly, communicate these improvements to their target client bases;

3) Anticipate their clients' future problems so they will be able to meet their most complex needs over the long term;

4) Develop efficient operating structures that include alliances with strategic partners and vendors that enable them to provide comprehensive solutions to their clients, in addition to their special expertise, and still remain profitable;

5) Achieve sufficient scale within their niche (in most cases at least $400 million to $500 million of assets under management) to defray their fixed costs; and

6) Capture a dominant share of the market for their special expertise to create a barrier to entry into the market segment by potential competitors.

Most advisory businesses are inefficient, have limited marketing capabilities and do not operate as businesses

Achieving these six goals will not be easy and will not occur by accident. Most advisory businesses today, both large and small, are inefficient, have limited marketing capabilities, and do not operate as businesses. They are proprietorships or books of business dependent upon the continued employment of one or two principals.

Future successful niche advisory firms will need to reinvent themselves so they become specialist organizations that also can solve their clients' generic problems. They will be profitable, efficient companies. Strategic planning will be integrated into their day-to-day operations. They also will be sustainable businesses that survive long after the departures of their current principals and will be able to meet their commitments to work with their clients over the long term.

Danger Versus Opportunity

We have encountered two distinct reactions to our earlier paper from the advisory community. A large number of industry participants hear our forecasts and feel like their businesses and livelihoods are in danger. A smaller group has considered our prognostications and sees opportunity.

The next five years offer advisory firms a once-in-a-lifetime opportunity

We believe the next five years offer advisory industry participants a once-in-a-lifetime opportunity to build great businesses. Only a handful of niche businesses currently exist. Literally hundreds of niche segments lie waiting for the taking. And the current benevolent operating environment in the industry provides a window for advisors to reposition their businesses.

This window of opportunity, however, is very small. The all-out war for clients will likely commence in the next three to five years and create an environment that will require advisory businesses to operate in a fundamentally different manner to survive.

Organizations that hope to prosper in the future need to take steps now to prepare for the coming changes to the industry. Those that wait too long will quickly find themselves swept away by the overwhelming force of a competitive market.

II. Background

This decade will bring massive changes to the financial advisory business. It will evolve from a collegial cottage industry to a cutthroat business consisting of a small group of very large competitors and a large group of small companies.

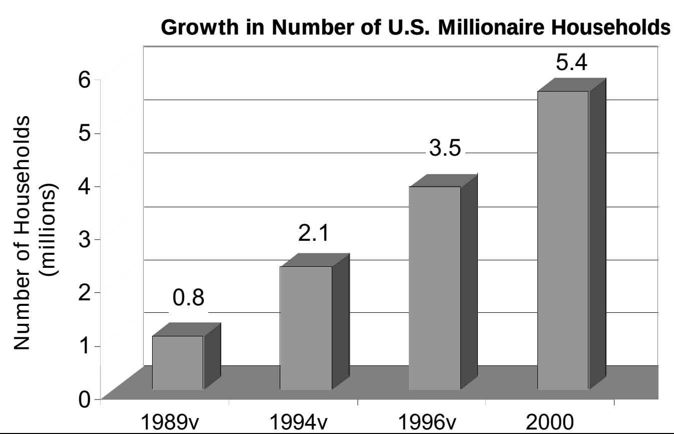
Two catalysts will drive these changes. The first – competition for current and potential clients – will force industry participants to function for the first time as businesses instead of practices. It will cause both large and small industry participants to become much more efficient and consequently change their operating structures. The second catalyst – technology – will commoditize the value-added of most advisory businesses and force them to upgrade the quality and breadth of their services and specialize in the types of clients they advise.

Technology and competition are forcing the industry to change

To date, advisory businesses have been largely insulated from traditional market forces because the supply of potential clients has significantly exceeded the demand for them. This imbalance was caused in part by a dramatic increase in the supply of potential clients (net worth of $1 million to $10 million) for advisory businesses during the past decade. In 1989, there were about 800,000 millionaire households in the United States, of which 95% had a net worth less than $10 million. As of 2000, there are an estimated 5.4 million millionaire households, with about 5 million having a net worth less than $10 million.[1]

Exhibit 2.1

The growth in the supply of potential clients has insulated the advisory industry from traditional market forces



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

Advisors Have Operated in a Benign Business Environment

This competition-free environment has persisted because large companies best positioned to compete with advisory businesses – traditional diversified financial services companies such as brokerages, banks and insurance companies – generally ignored the growing demand by semi-affluent clients for comprehensive financial

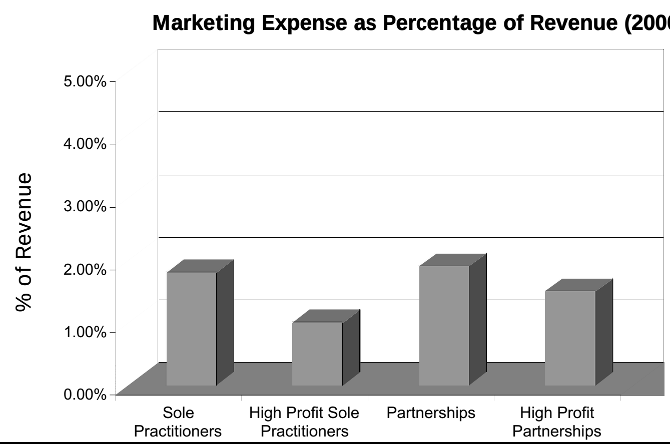
[1]VIP Forum, *The Millionaire Next Door*

advice. They instead focused on short-term profitability and had their retail forces sell high margin products such as equity underwritings, mutual funds with large sales loads and insurance products that compensated intermediaries on a transaction basis.

The failure of large competitors to respond to the surging demand for comprehensive financial advice resulted in a very benign business environment for the thousands of small firms that compose the financial advisory industry today. Participants had almost no risk of failure during the past decade. There has been little competition for clients and some firms have captured hundreds of millions of dollars of client assets without incurring any marketing expenditures. Today, most advisory businesses are operating at near capacity levels and have more leads for potential clients than they can possibly pursue.

Exhibit 2.2

Advisory firms have not made large investments in marketing



Source: Moss Adams Advisory Services

Most advisory firms have no specialty, and the average fee-only partnership operates at only 5.7% pre-tax margins

Consequently, advisory businesses have not had to focus on their true business – getting people to pay them for financial advice. The innocuous environment has afforded advisors the luxury of focusing on those aspects of their services and industry that they find most intellectually interesting. Some advisors spend most of their time studying arcane aspects of the financial markets. Others invest large amounts of energy on industry-wide issues such as accreditation and practice standards and in attending conferences and seminars, although such activities play only a small role in building their businesses.

Functioning in a business environment virtually devoid of competition has allowed these companies to operate inefficiently and as generalists. The average fee-only partnership operates at only 5.7% pre-tax margins, according to the recent Financial Planning Association study conducted by the accounting and consulting firm of Moss Adams Advisory Services.[2] By comparison J.P. Morgan and Merrill Lynch, which function in very competitive environments, operated at 35.1% and 18.6% pre-tax margins, respectively, in 1999.[3]

[2]Moss Adams Advisory Services, *The 2000 FPA Financial Performance & Compensation Study of Financial Planning Practitioners*

[3]Bear Stearns Research

Unlike companies in most other industries, few advisory firms have strategic plans and even fewer have professional marketing forces. Rather, advisory businesses have been content to rely on word-of-mouth advertising and informal referrals from other financial services companies. Advisors have also been able to pick and choose the types of clients they want and many organizations have routinely "fired" lower margin customers.

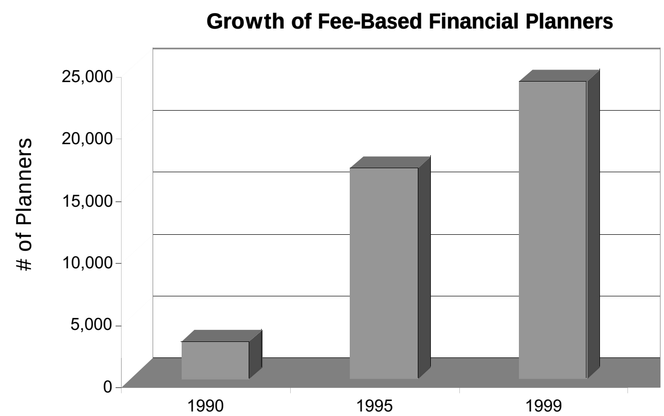
Supply Will Soon Equal Demand

Many firms' referral sources are creating their own advisory businesses

But the competitive environment is about to change dramatically. A flood of new entrants to the industry, both large and small, combined with a substantial expansion in capacity by several existing competitors will soon increase the demand for clients to a level that equals and, eventually, exceeds the supply. Traditional brokerage firms such as Morgan Stanley Dean Witter, Merrill Lynch and Paine Webber have re-engineered their programs specifically to compete for advisory business clients. Companies that have historically focused almost exclusively on high net worth individuals, such as J.P. Morgan, Goldman Sachs, Northern Trust and Sanford Bernstein, have launched all-out assaults on the market for semi-affluent investors. Money management companies such as Strong, Vanguard and Scudder have created their own financial advisory units. Insurance companies, including AXA, New York Life and Northwestern Mutual Life, are transforming their traditional agency distribution systems into financial advisory companies. And many of the largest current sources of referrals for most advisory firms – accounting practices and estate law firms – are creating their own advisory businesses.

Exhibit 2.3

The number of advisory firms has grown more than seven-fold over the past decade



Source: Bernstein Research

Competition is also increasing among current industry participants. A small number of advisors are substantially expanding their capacity to service clients. Some of them have raised large amounts of capital to finance rapid and substantial growth. Many are actively acquiring smaller firms in different markets that will serve as platforms for growth in those locations.

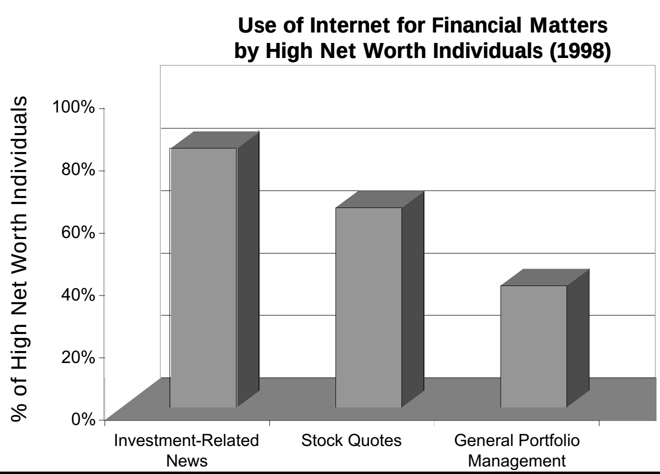
Technology Is Commoditizing Advisors' Value-Added

At the same point that the industry is facing real competition for clients for the first time, a second force – technology – is commoditizing the value-added of many advisory businesses. The primary value-added of most advisory businesses has been a combination of financial planning and investment management services – functions that clients can now easily and competently do on their own due to an incredibly rapid evolution of financial services technology. Companies such as Financial Engines, Morningstar (with Clear Future) and Morgan Online are just a few of the developments in technology that will expand the alternatives that individuals have for developing their own financial strategies.

To be clear, individuals will still seek advice, in particular advice customized to their unique needs and circumstances. The key issue will be what they will pay for the functions that they can perform on their own.

Exhibit 2.4

High net worth individuals are embracing technology when investing their money



Source: Bernstein Research

Margins Will Be Compressed

Advisory firms must achieve scale or develop a specialty that allows them to charge a premium price

The result of increased competition and advancing technology is that advisors' costs are going to increase and their fees are going to be compressed. They will have to provide more services at lower prices than they currently do, which threatens the profitability of all advisory businesses, regardless of size. In response, advisory firms must either become much more efficient by achieving substantial scale or develop a specialty that allows them to charge a premium price.

Organizations that fail to position themselves for the industry's inevitable evolution may soon find that, while their organizations may survive, their compensation may be cut in half or two-thirds. They will not necessarily lose their clients. Their owners will just work much harder and earn far less than they do today.

The Opportunities for Advisory Firms

Although the changes taking place in the industry clearly pose a major threat to the profitability of all advisory businesses, they also provide a once-in-a-lifetime opportunity. First, however, firms will have to make a choice:

1) Become a national or regional dominant competitor;
2) Do nothing; or
3) Become a niche competitor.

Become a Dominant Competitor

The first alternative entails immense changes to the current culture and operations of most organizations and may require substantial outside capital. While several firms have already embarked on this type of strategy, most lack either the desire or the resources to become mammoth organizations.

Dominant competitors will have a financial advantage because of their scale and operating efficiency. They will be low-cost producers and will rely on high volumes of clients to sustain their long-term profitability.

Do Nothing

Most advisory firms will choose the second alternative. Although they will still have businesses, owners of small generic firms will work much harder, earn far less and struggle to retain and attract clients. As dominant competitors emerge in the industry and there is competition for current and potential clients for the first time, small generalist advisory firms will have to broaden their services (thus raising their costs) or expect to be paid lower fees by their clients.

Become a Niche Competitor

The challenge of becoming a niche competitor is to position the company so that it can conserve its current culture and still capitalize on the flood of changes about to sweep through the industry. These firms must identify an unsatisfied and unique segment of the market – or "niche" – and capture it before other organizations are able to fill this void.

Niche competitors must identify and capture a unique, unsatisfied segment of the market

Organizations that succeed in becoming niche competitors will be relatively small companies (albeit larger than they are today) that are extremely profitable. Their market positions will be highly defensible. They will have great economic value as companies and will be able to maintain most of their traditional culture and working environment.

III. Six Traits Common to Successful Niche Competitors

Niche competitors are specialists. They provide goods or services targeted at select groups of people or companies. They are rarely the largest companies in any industry, and they do not attempt to compete on the basis of price. Rather, they employ strategies that rely upon offering unique or special products for which clients are willing to pay a premium price.

Niche competitors exist in nearly every industry, ranging from electronics (Harmon Kardon) to automobiles (Porsche) to chocolates (Godiva). Successful ones are small, highly profitable organizations with significant economic value.

Client Problems Define Advisory Niches

In the financial advisory business, the term *niche competitor* refers to an organization that targets select segments of the population that share similar, complex problems. It creates a perception within these segments that it possesses a special expertise or capability essential to solving these clients' problems.

Clients do not want good financial advice – they want their problems solved

It is important to emphasize that client problems – not wealth, age nor occupation – are the defining factors in determining niches in the financial advisory business. Advisory clients do not want good financial advice. They want their problems solved. Good financial advice is a necessary but insufficient tool for solving individuals' problems.

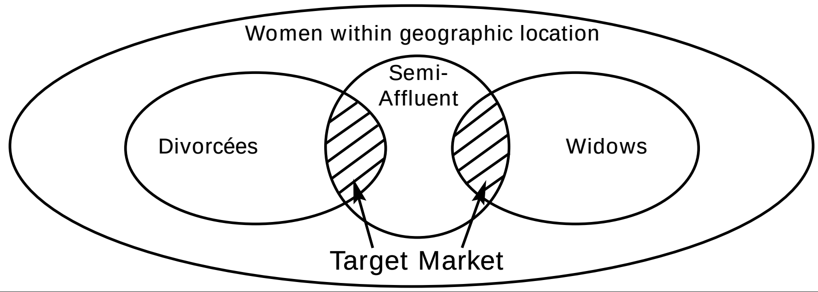
An ideal niche client base will share very complex problems for which a solution is essential to the success of the clients. The more complicated and specialized the problems, the greater the defensibility of the niche. Unlike dominant competitors that will vie for market share on the basis of price and breadth of service, advisory niche competitors will compete for clients seeking premium, specialized services with attributes that generic alternatives do not include.

This is not to say that net worth is an unimportant factor when identifying potential clients. It only makes sense to pursue individuals who have the net worth to make an advisory firm's services affordable or practical. Niche competitors will first identify market segments that share the same complex problems. They then will select as potential clients individuals within these groups who possess the financial resources necessary to make a relationship with an advisory firm sensible.

For example, there are two prominent advisory firms that have developed strong niche businesses servicing widows and divorcées – groups of people who tend to face similar issues and share similar problems. As shown in the following diagram, these firms start their client selection process by identifying all women within their geographic locations. They then identify those that are either divorced or widowed. Finally, they select as clients those divorcées and widows who have a sufficiently high net worth to make a relationship mutually beneficial.

Exhibit 3.1

Identifying a Target Market –– Semi-Affluent Widows and Divorcées



Niche Strategies Are More Complicated Than Just Specialized Expertise

The basis for developing all niche strategies, however, goes far beyond just developing and offering specialty services. Niche competitors face a constant challenge to their continued profitability. Other niche organizations compete for the same clients. Generic competitors regularly upgrade the quality of their products, lessening the need for specialty goods or services. In fact, they often develop their own specialty units that provide similar products but also benefit from their scale.

History is replete with examples of formerly successful niche competitors. Companies such as Silicon Graphics, ClubMed and People's Express once dominated niches of their markets that today are overrun by competitors.

Sustaining a niche business model is in many ways similar to that of a generic competitor, except that niche companies pursue only small market segments that have special needs. Like the generic organizations, product improvement and development, operating efficiency, brand, scale and market share all play major roles in the long-term profitability of niche competitors.

Successful niche companies are well-run businesses that constantly adapt their products and strategy to the market

Successful niche companies are well-run businesses that constantly adapt their products and strategy to the market. There are six traits that are common to these organizations:

Six Traits Common to Successful Niche Competitors

1. **Perception That Their Products Are Essential**
2. **Continual Improvement of Quality and Perception of Products**
3. **Ability to Anticipate Clients' Future Needs**
4. **Operate Efficiently**
5. **Possess Adequate Scale**
6. **Dominant Market Share Within the Niche**

Niche advisory firms must anticipate the most complex future problems of clients

1. **Perception That Their Products Are Essential**

   Clients perceive successful niche companies' goods and services as essential to meeting their needs and that generic alternatives will not suffice. This perception leads clients to pay an above-market price for the niche companies' products.

2. **Continual Improvement of Quality and Perception of Products**

   Successful niche competitors continually improve the quality of their products. More importantly, they communicate these improvements to their clients.

   The basis of all niche strategies is that clients will pay premium prices for the niche companies' products. Generic companies will upgrade the quality and breadth of their products over time. Successful niche companies likewise will improve the quality of their products so that they will not be replaceable by a generic alternative. The niche companies also must ensure that their clients remain aware that their products continue to offer additional unique benefits that merit a higher price.

3. **Ability to Anticipate Clients' Future Needs**

   Successful niche competitors are also able to anticipate clients' future needs. As their needs change over time, clients want products that solve their current and not just their past problems. Anticipating the future needs of clients is particularly challenging for niche advisory firms because they must identify their clients' most complex future problems and develop the capability to solve them before clients even know themselves what these problems will be.

4. **Operate Efficiently**

   Although niche companies target a select group of clients, they still face strong competition from other niche organizations. This competition limits the size of the premium that niche firms may charge their clients and creates the same risks of margin compression faced by generic organizations. Successful niche competitors are very efficient companies with strong cost controls. They continually improve their operating efficiency to lower their operating costs and, in turn, boost their margins.

5. **Possess Adequate Scale**

   Although niche companies are relatively small organizations, successful ones possess the necessary scale to be profitable. All businesses have some level of fixed operating costs. In order to make money, they must spread these fixed costs across a sufficient base of revenues. Consequently, there are minimum scale requirements in every business that must be met for niche competitors to prosper.

6. **Dominant Market Share Within the Niche**

   Market share is also an important factor to the long-term profitability of niche competitors. Organizations that are able to capture and maintain a large part of a niche market for a specific good or service will have a significant and potentially sustainable competitive advantage. Any company that wants to enter a specific niche business must first acquire a high level of specialized expertise and build a brand name within that niche – both often very costly activities. Organizations that capture dominant market shares within niches can create formidable barriers to entry. They make it difficult for potential competitors to attempt to achieve an adequate return on their sizeable investment in developing expertise and brand name.

Lessons from the Evolution of the Healthcare Industry

An analogous way of thinking about niche segments within the financial advisory business is to consider the healthcare industry. Fifteen years ago, it was a very fragmented market dominated by small generalists. Today, the industry largely consists of enormous competitors such as HMOs and PPOs, general practitioners who are controlled by these organizations and thousands of small specialists.

Patients do not want the low bidder when selecting a brain surgeon

The specialists are the niche competitors. The successful ones – which include plastic surgeons, ophthalmologists, cosmetic dermatologists, cardiologists and neurosurgeons – have small, highly profitable businesses and are known for their ability to solve complex medical problems.

The value proposition of healthcare specialists is that they possess special capabilities that provide a high level of value-added for which potential patients should be willing to pay a premium price. Healthcare specialists do not compete on the basis of price. They recognize that patients do not necessarily want the low bidder when selecting a brain or cosmetic surgeon. And like all other niche businesses, reputation (or brand) and perceived value-added are their most important success factors.

However, medical specialists, like all other niche competitors, are not immune from market forces. They must compete with other, similar specialists for patients and therefore do not have unlimited pricing power. The pricing of other specialists who possess comparable brand names limits the premium that they can charge for their services. Consequently, the profitability of many specialty practices is tied to the ability to operate efficiently and to perform as many high margin procedures as possible.

Corrective Eye Surgery Industry Highlights Importance of Six Traits

One segment of the market for specialty medical services, corrective eye surgery, demonstrates that no matter how complex a product may be, specialization alone is inadequate to create a sustainable niche business. This industry highlights the importance of the six common traits of successful niche businesses and, in particular, how failing to continually improve the quality and perception of products and to capture a dominant share of a niche market can destroy the long-term profitability of a niche business.

RK Procedures Create a New Industry

For many years, glasses and contact lenses were the only options for those who wanted better eyesight. With the advent of new technology two decades ago, vision correction became possible through surgery. Radial Keratotomy (RK) was the first refractive surgery used to permanently correct nearsightedness. Since its introduction in 1978, about 1.5 million people have undergone the procedure at a cost of $750 to $1,800 per eye.

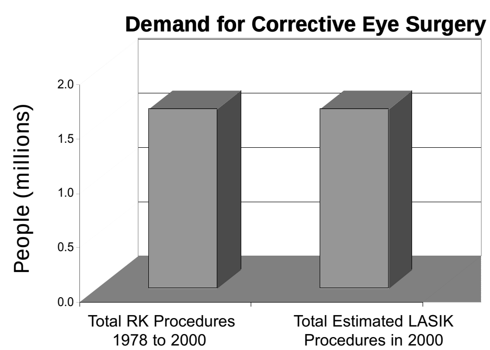
The surgery involves placing a series of spoke-like incisions in the cornea with a microknife, allowing the central cornea to flatten. The procedure permits light rays entering the eye to focus directly on the retina instead of in front of the retina, correcting nearsightedness. RK requires an extremely precise hand, and compromises the integrity of the cornea with its invasive nature, resulting in a long recovery time and a high risk of negative side effects.

At its inception, there were very few doctors who had the skills or the training to perform the procedure, and RK was considered a specialty within the specialty field of ophthalmology.

As specialized as RK was, a new technology, LASIK, supplanted it almost overnight.

Exhibit 3.2

New technology can destroy existing niche businesses



Source: American Academy of Ophthalmology and International Society of Refractive Surgery

LASIK Procedure

Since its introduction in clinical trials nine years ago, the demand for LASIK (Laser In Situ Keratomileusis) surgery has exploded. In 1999, doctors treated about 960,000 eyes with LASIK. In 2000, that number is expected to surpass 1.5 million – an increase of 62%.

The procedure involves an incision to make a thin, circular flap on the eye's corneal lens, pulling it back and then using computer-controlled pulses of laser light to reshape the cornea. Because it involves a laser, LASIK is less invasive than RK, requires less post-operative treatment, reduces the risk of associated blurriness and light sensitivity, and has a rapid recovery time with little or no pain. More importantly, it preserves the eye's structure by allowing the protective layers of the cornea to remain intact. Because of these

RK physicians who did not develop additional value-added suffered an enormous drop in demand

factors, LASIK has replaced RK as the preferred method of vision correction surgery.

Ophthalmology practices with an expertise in RK procedures that failed to develop the ability to perform LASIK suffered an enormous drop in demand for their services. Today, the RK procedure is only recommended to correct minor nearsightedness, and organizations that just offer RK can only compete for those patients who have this specific condition – a drastically-reduced pool of potential clients.

How Competition Led to Commoditization of LASIK

Those ophthalmology practices that also developed the ability to perform LASIK met – at least initially – the test of continually improving the quality and perception of their products. However, they failed to capture a dominant market share for this service and also did not further improve the perceived quality of their services. Their failure destroyed their niche and made LASIK a commodity.

While performing LASIK requires specialized training and equipment, the demand for the service is immense. Doctors who initially marketed the procedure were unable to meet the demand and their failure opened the door to new competitors. Today, more than 5,000 doctors and centers offer this service.

Competition has reduced fees and increased the cost of capturing new patients

As the number of competitors providing this procedure has grown, the industry has seen significant price competition. A procedure that originally cost as much as $4,000 per eye is now offered for as little as $499 per eye. While some providers can still charge a premium to this low price, their perceived level of incremental value-added relative to other ophthalmologists caps what they may charge.

This competition has significantly reduced the operating margins of many practices, lowering the fees and increasing the cost of capturing new patients. As a result, many ophthalmology practices now operate like factories, processing as many clients as possible. Others now make large investments in radio and television advertising to attract prospective patients. Still others have resorted to offering "walk-in" services designed to capture potential impulse buyers who might decide to have the procedure done on the spur of the moment.

Although LASIK remains a complicated procedure requiring high levels of expertise, the abundance of competitors able to provide LASIK has made this expertise a commodity. Had the initial providers of this procedure been able to capture a dominant share of the market for this service – likely an impossible feat given its demand – they might have been able to prevent the entry of so many competitors. Similarly, absent a dominant market share, had the initial providers of LASIK been able to improve the quality and perception of their services – as compared to new entrants to the business – they might also have not endured such severe fee compression.[4]

[4] American Academy of Ophthalmology, EyeNet web site; International Society of Refractive Surgery web site; Northwest Vision Laser Vision Specialists web site: Stanford Eye Laser Center web site

IV. Examples of Niche Competitors in Other Industries

From butchers to haberdashers, niche companies have flourished since the dawn of commerce. In this section we will examine three examples of successful niche businesses outside the financial services industry.

Case Study: Cranial Technologies, Inc.

The Problem

What doctors are calling a bizarre epidemic has created a niche market for Cranial Technologies, a medical device manufacturer.

In 1992, the American Academy of Pediatrics (AAP) recommended that infants sleep on their backs to reduce the risk of Sudden Infant Death Syndrome. As a result, over the last eight years, the medical community has seen an almost 300% increase in children with flat spots on or near the back of their heads, a condition known as positional plagiocephaly. Recent reports estimate that more than 1 in 100 infants have this condition, and research has identified the positioning of a child's head against hard and soft surfaces as the primary culprit.

The Solution

To solve this problem, Cranial Technologies created a device called the Dynamic Orthotic Cranioplasty (DOC) Band™ – a helmet worn on the infant's head that distributes pressure more evenly when the child lays down. The band helps round out flattened areas. It is normally worn by infants 23 to 24 hours a day for an average of 4½ months, and is available only by prescription at a cost of about $2,600, which is usually not covered by insurance plans.

Cranial Technologies found that through scale, it could mass-produce yet still customize a solution

Originally, only craniofacial departments at medical centers produced helmets to correct positional plagiocephaly. However, these organizations were not specialists at manufacturing helmets and the demand for their product was limited to their own practices. Consequently, they either had to charge an unaffordable price or manufacturing helmets was uneconomical.

Cranial Technologies recognized this opportunity to build a niche business. Through sufficient scale, the company could mass-produce yet still customize the product more cheaply than craniofacial centers by using a flexible manufacturing process. By providing helmets for centers across the country, the demand for its product was sufficient to defray Cranial Technologies' fixed costs, and allowed the company to offer the DOC Band™ to patients at an affordable price.

As the only producer of an FDA-approved device to treat positional plagiocephaly, Cranial Technologies has created a perception among doctors that its product is the only acceptable alternative for solving the problem. The company has developed a relationship with parents and the doctors who treat the infants and, as a result, has captured a dominant share of the market.[5]

[5] Tim Littlefield, Cranial Technologies, Inc., American Academy of Pediatrics web site; Plagiocephaly.org web site

Cranial Technologies has captured a dominant market share and has created a competitive barrier to entry

Cranial Technologies, Inc. and the Six Common Traits of Successful Niche Competitors

Perception That Products Are Essential

Cranial Technologies' clients are the parents and doctors of children who suffer from positional plagiocephaly. From the perspective of parents, reshaping their children's heads is essential to meeting their needs. From the perspective of doctors, Cranial Technologies offers the only FDA-approved device for treating this condition.

Continually Improve Quality and Perception of Products

The company has invested large amounts of money studying positional plagiocephaly, its causes and alternative cures. It incorporates this research into improvements of its products and is a frequent presenter on this topic at conferences for pediatricians and craniofacial physicians.

Ability to Anticipate Clients' Future Needs

The founder saw that production of devices to treat positional plagiocephaly was only performed by craniofacial centers on an ad hoc basis, and that the market for these devices was rising rapidly due to the AAP's recommendation that infants sleep on their backs. The company continually modifies its manufacturing process so it can produce customized products that treat variants of this condition.

Operating Efficiency

From a distribution standpoint, the company has only 15 treatment centers – a large enough number of locations to capture most of the market for the product but a small enough number to not have excess capacity. Patients outside of these areas travel sometimes hundreds of miles to the centers.

The company has also developed a very efficient manufacturing process that balances the need for customization with profitability. Through a combination of pricing and efficient manufacturing processes, the company can mass-produce a customized product to suit each patient's particular needs, and be profitable at the same time.

Scale

Cranial Technologies identified this niche market after realizing that craniofacial departments were unable to meet the market's demand for a device to treat positional plagiocephaly for a reasonable price, and still make money. In response to this opportunity, the company mass-produces the customized DOC Band™ and last year, the company sold more than 4,500 for revenues of nearly $12 million.

Market Share

Cranial Technologies is the single largest producer of solutions to treat positional plagiocephaly. It is currently the only producer of an FDA-approved device and has captured enough market share so that no other company has made the necessary investment to build a credible alternative to the product.

Case Study: Corrugated Gears & Services, Inc.

The Problem

Corrugated paper producing companies that rely on original equipment manufacturers (OEMs) are often unable to get necessary spare parts in a timely manner to maintain older lines of equipment.

The process of manufacturing corrugated paper is completely automated and done in high volumes. Stoppage of the production line can cost as much as $25,000 per hour. There is limited demand for replacement parts for older machines, but when they are needed, they are needed immediately.

Since the bulk of their revenues are generated by producing new machines, the limited demand for replacement parts for older equipment often makes it uneconomical for OEMs to maintain adequate inventories of spare parts. In approximately 25% of the instances that a corrugated paper manufacturing company requires a spare part, its OEM is unable to quickly provide it. And spare parts not in inventory can take up to 14 weeks to manufacture.

The Solution

Corrugated Gears & Services (CGS) has created a series of patent-protected manufacturing processes that allows it to quickly and cost-efficiently manufacture spare parts for all older machines across all 35 U.S.-based OEMs. It can produce some parts in less than 24 hours.

CGS has 100% of the U.S. market for spare parts that corrugated paper machine OEMs cannot fulfill

OEMs do not usually share their machine specifications with other organizations. Because of relationships created by the company's founder, CGS representatives are invited to go to OEM factories and inspect their machines to learn the intricacies of each piece of equipment. It is through this thorough knowledge that CGS is able to develop a manufacturing process to produce spare parts more efficiently than any potential competitors.

CGS has captured 100% of the U.S. market for spare parts that OEMs cannot fulfill in a timely manner. Currently, there are 800 corrugated paper producing plants that operate older lines of equipment. CGS is the only non-OEM parts provider to U.S. corrugated paper manufacturers.[6]

[6] David Lauderbaugh, President and CEO, Corrugated Gears & Services, Inc.; Corrugated Gears & Services web site

CGS is able to leverage its relationships and manufacturing technology

Corrugated Gears & Services, Inc. and the Six Common Traits of Successful Niche Competitors

Perception That Products Are Essential

Corrugated paper manufacturers face a crisis when they are unable to quickly obtain the necessary parts to keep their machines functioning. CGS is able to provide selected spare parts to clients faster than any of the OEMs.

Continually Improve Quality and Perception of Products

Because of its strong relationships, CGS obtains original machine specifications from OEMs – a privilege not afforded any other company. OEMs also allow CGS representatives to go to their factories and inspect the machines to better understand how the equipment works. Their knowledge enables CGS to build parts more quickly and at a lower cost. The company also builds its brand by regularly sponsoring and appearing at trade shows and conferences.

Ability to Anticipate Clients' Future Needs

By spending an extensive amount of time at clients' shops learning about their machines, CGS is able to better predict which spare parts will be needed by clients most often. The company is then able to produce an adequate number for its inventory so that clients do not have to wait more than 24 hours for a part.

Operating Efficiency

There are 35 OEMs in the U.S., and the bulk of their revenues is generated from producing new equipment. It is uneconomical for each OEM to also produce large numbers of spare parts for their own equipment because the market for individual spare parts is minimal. As a manufacturer of spare parts for all 35 OEMs, CGS is able to develop manufacturing processes that make production of spare parts cheaper.

Scale

OEMs do not have enough scale to produce spare parts for their own equipment and still make a profit. CGS is able to leverage its relationships and manufacturing technology and produce spare parts for older machines of all 35 U.S. OEMs.

Market Share

CGS's market consists of companies that need spare parts which OEMs don't produce. Of these potential clients, CGS claims 100% market share, creating an incredible barrier to entry.

Case Study: Micro Information Products, Inc.

The Problem

Nonprofit organizations face three distinct problems related to accounting: tracking, managing and reporting on funds from multiple sources across multiple budget periods. Traditional commercial accounting software does not offer the flexibility to meet these needs.

The Solution

MIP has a larger percentage of software installments in its market than any competitor

Micro Information Products, Inc. (MIP) offers NonProfit Series, a specialized fund accounting software designed specifically for nonprofits. NonProfit Series allows companies to track multiple sources of funding over multiple budget periods, and features pre-formatted, audit-ready Financial Accounting Standards Board (FASB) and Governmental Accounting Standards Board (GASB) reports required by funding sources and auditors. Optional settings on this Windows-based software include automatic allocation of expenses across several projects and tracking of restricted or unrestricted funds for funding sources. NonProfit Series is also compatible with other products nonprofits use such as donor tracking and fundraising software.

MIP guarantees extensive phone support for clients' questions and problems, and users stay current on new FASB and GASB reporting requirements with the company's annual software maintenance program. Of the approximately 1.5 million nonprofit organizations in the U.S., about 90,000 have complex accounting requirements. MIP has a larger percentage of software installations in this market than any of its competitors.[7]

[7]Dawn Westerberg, Marketing Manager, Micro Information Products, Inc.; Micro Information Products web site

MIP regularly upgrades its software to reflect changes in compliance rules

Micro Information Products, Inc. and the Six Common Traits of Successful Niche Competitors

Perception That Products Are Essential

Nonprofit organizations have complex accounting needs that traditional commercial accounting software cannot handle. Without specialized accounting software such as NonProfit Series, these nonprofit organizations cannot effectively run their businesses.

Continually Improve Quality and Perception of Products

MIP recognized that Windows was becoming the operating system for most software. In response, the company was the first to develop a Windows-based platform for nonprofit accounting software. MIP stays current on compliance issues, such as government reporting guidelines and tax laws, and upgrades its software to reflect these changes. The company was named by *Accounting Today* as one of the "Top 100 Software Solutions" for five consecutive years.

Anticipate Clients' Future Needs

MIP recognized that nonprofit organizations were becoming more financially complicated as they received funding from multiple sources over many fiscal years. In anticipation of this problem, the company developed NonProfit Series, which can be customized to fit any nonprofit organization's unique recording and reporting needs. The system can be used with third-party products such as donor tracking and fund-raising software. The company continues to add features to its software as the industry evolves, such as the Forms Designer module, which allows clients to create customized accounting forms.

Operating Efficiency

It can cost close to $20 million to design an original software system, and more than $10 million to upgrade the product. Since MIP can mass-produce NonProfit Series but still allow customization of the product, it is able to provide the software at a lower cost than competitors.

Scale

In a market of more than 90,000 nonprofit organizations, MIP has the largest percentage of software installations for nonprofits with complex financial accounting problems. Revenues generated from these sales more than adequately cover fixed costs such as software manufacturing and upgrade expenses.

Market Share

MIP has the largest percentage of software installations for nonprofit organizations with complex financial accounting problems. As a result, there are only two major competitors, and it is an unattractive market for additional competitors to enter.

V. Developing a Niche Advisory Business

While advisory businesses can remain relatively small, none can remain the same if they hope to prosper. They must reengineer themselves into specialty organizations that can also solve generic problems and still make money. They also must become businesses instead of just practices.

While there are many different ways of building a successful niche business, our approach uses a five-step process.

5-Step Process to Building a Successful Niche Business:

1. **Develop specialty practices designed to solve very complex problems of clients;**

2. **Broaden generic services to also solve clients' generic problems;**

3. **Improve efficiency of operating structure;**

4. **Formulate a strategic plan that creates a sustainable competitive advantage; and**

5. **Institutionalize business.**

Step 1 – Develop Specialty Practices

Good financial advice is a necessary but insufficient part of solving clients' problems

Organizations that will prosper as niche competitors in the financial advisory business will design services to solve the most complex and difficult problems of their clients. As we discussed earlier in Section III, clients do not retain advisors to get financial advice. They employ financial advisors to help solve their problems. Good financial advice is a necessary but insufficient part of solving clients' problems.

The field of medicine again offers a good analogy to how an advisor's value-added will evolve. Few patients ever visit their doctors just to get good medicine. They visit their doctors to get well. While good medicine is a necessary and even essential requirement for getting well, the doctor's primary value-added is the ability to correctly diagnose the patient's illness to prescribe the correct medicine. Since any doctor can prescribe almost any medicine, the true value-added is not the prescription. It is instead the ability to determine the cause of the patient's illness and to then formulate a solution to help the patient get well.

The most important part of an advisory firm's value-added is its ability to diagnose clients' problems and structure solutions. Once the problem is diagnosed and a solution identified, implementation (i.e., financial planning, investment management, insurance, taxes, etc.) is relatively easy. Over time, because of increased competition and advances in technology, this ability to diagnose problems and formulate solutions will be advisory firms' only sustainable value-added.

Niche advisory clients' problems should be so intricate that generic providers of advice cannot understand and solve them

Consequently, the first step in developing a niche strategy is identifying the particular problems that the advisory firm wants to build its business around. Ideally, it should target very complex problems that materially affect its clients' lives and are shared by a large number of people within a community. These problems should be so intricate that generic providers of advice are perceived as unable to understand and solve them.

Human and Personal Capital Offer Niche Strategy Opportunities

Two areas offer particularly attractive opportunities for advisory niche strategies – human capital and personal capital. Human capital is the ability of clients to build wealth through their work as opposed to their investments. For most clients of advisory businesses, human capital is their most valuable and often most under-exploited asset. While they may have $1 million of financial assets, clients' ability to make money is their greatest tool to build wealth.

Personal capital involves how money affects (both positively and negatively) clients' quality of life. For most people, money is just a means to an end. But many individuals are far better at building wealth than at employing it to meet their goals and needs. Personal capital services are designed to help clients best use their wealth to improve their lives.

Human capital and personal capital each encompass very complex problems that can materially impact people's lives. Both are very fertile areas for potential niche strategies.

Examples of Human Capital Niche Strategies

An example of a successful human capital niche strategy involves an advisory business that works with physicians. While there are hundreds of advisory firms that target these types of clients, this organization has teamed with a consulting company to help solve a major problem shared by many sole practitioner doctors.

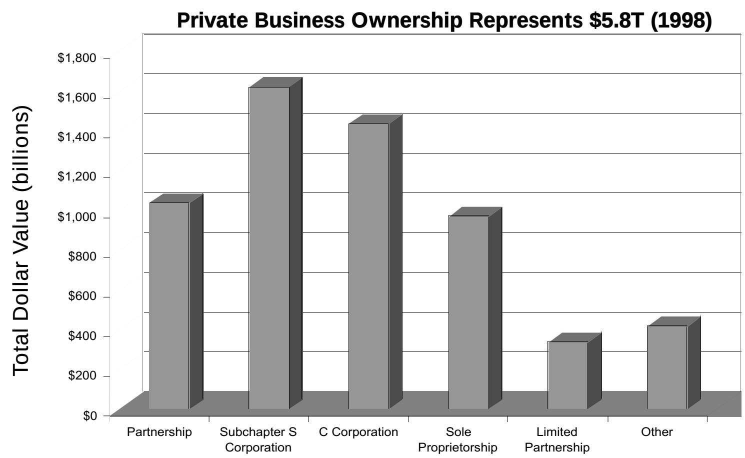
Billing and collecting fees from HMOs, PPOs, Medicare/Medicaid and patients is a complex activity. It involves a series of codes which, if incorrectly applied, can result in far lower reimbursements for the physician and even potential legal liability. Consequently, doctors must either recruit a top-level (and expensive) office manager to oversee their billing or spend several hours each week reviewing and correcting numerous invoices.

Such use of time by physicians does not maximize their earning power. But the high cost of employing a qualified office manager can also be impractical for sole practitioners.

An advisory business recognized this problem as a great opportunity to build a niche strategy. It teamed with a company that allows doctors to outsource their coding and billing. The company has groups of specialists that understand the intricacies of maximizing potential billings by different medical specialties. The advisory firm includes this service as part of its offerings to physicians.

Exhibit 5.1

The majority of the wealth of many private business owners is in their companies



Source: Bernstein Research

An advisor in the Southwest also built a large niche business based on human capital by helping small business owners maximize the value of their companies. He noticed almost all of the wealth of many of his clients was in the businesses they owned instead of in their liquid assets. Many of the businesses were small, family-owned companies and the owners did not have corporate boards to help them formulate strategies and tackle tough issues. The advisor recruited several retired executives to serve on informal advisory boards for these small companies. Their owners found this advice invaluable and prospered as a result.

One advisor recruited retired executives to serve on informal advisory boards for his small business clients

The advisor's business also prospered. Within the community of small business owners in his part of the country, his firm quickly earned the reputation of truly understanding their issues and challenges. And potential clients flocked to his company.

Examples of Personal Capital Niche Strategies

Personal capital niche strategies employed by advisory businesses can help clients solve the many family problems often associated with wealth. Wealth can result in conflicts among family members over its use and distribution. Some advisory businesses have expanded their services to include counseling newly-wealthy individuals on how to educate their children about money and preserve their value systems. Another advisory business is building a specialty that works with second-generation wealthy families in conflict. In addition to helping these households properly invest their assets, the advisor’s staff plays a key role in facilitating the resolution of disputes within the family that result from the distribution of wealth.

Another advisor believes there is a great opportunity for her to build a niche business by having her firm serve as an extension of clients’ families. She has begun to modify her business after asking many of her clients about their greatest fears. She was surprised to learn the problem that most concerned many of them was the prospect of winding up in a long-term care facility alone and far away from any family members. She recognized an opportunity to reposition her firm as an extension of these clients’ families. Because her firm would be proximate to her clients, it may be able to fulfill some of the roles that family members would perform if they lived in the local area, such as shopping for and spending time with the client.

High Touch Service – Not a Sustainable Niche

Advisors relying solely on “high touch” strategies to sustain margins will find their profitability in grave peril

A common refrain from many advisors that we interviewed in the course of our research was that their niche is the "high touch" aspect of their services. They believe that their clients will be willing to indefinitely pay a premium for the advisors’ generic services simply because of the high level of personal attention the company’s principals provide to each client.

We are very skeptical about the sustainability of such a strategy. There is no doubt that some clients will be willing to pay a premium price for very personalized service. The key question, however, is just how big of a premium will they be willing to pay? And, more importantly, how big is the market for individuals who are willing to pay very high fees for high touch service?

As competition drives down fees and raises costs, it will be difficult for nearly all firms to maintain their margins. Generic providers of advice relying solely on a high touch strategy to sustain margins will find their profitability in grave peril should clients demand even small decreases in fee schedules or increased services at the same price.

Fifteen years ago, many general practitioners of medicine likewise predicted that their patients would place so high a premium on the high touch nature of their service that they too would be unaffected by market forces created by managed care. After all, maintaining one’s health is probably the single most important aspect of an individual’s life. And many physicians had been treating the same individuals for years and had developed a close relationship with many of their patients.

While today there is a small group of wealthy patients willing to pay a premium price for very high touch generic medical services, most general practitioners have been forced into HMOs and PPOs. They have seen their fees cut dramatically, their costs increase, and many earn only a fraction of their previous incomes.

As much as their patients preferred a high touch delivery of medicine, they were unwilling to pay a very high premium for it. We expect that most advisory clients will be similarly reluctant to pay a great enough price for generic services to sustain an advisory firm's margins regardless of the degree of high touch.

Step 2 – Broaden Generic Services

In addition to developing special skills or expertise for solving very complex problems, successful niche advisory firms will also broaden their generic services so that they are able to meet the less complex needs of their clients. Most small advisory businesses currently offer only one or two services – usually financial planning and/or investment management – that do not address all aspects of clients' generic financial problems. While clients of niche advisory firms need special help with their most complex problems, they also want solutions for their tax, estate planning, insurance and charitable giving issues.

Most small advisory businesses offer only one or two services which do not address all aspects of clients' problems

If a niche competitor cannot solve these generic problems, its clients will likely look elsewhere for advice. While they will retain the niche firm for its specialty advice, they will also employ a large, generic provider of advice to serve as their primary financial advisor. Under such arrangements, niche advisory businesses are at risk of becoming de facto vendors to larger advisory firms.

Exhibit 5.2

Advisory firms do not currently offer an adequate array of services to continue to serve as advisor and not just as vendor

Source: Moss Adams Advisory Services

Niche Competitors Are Not Vendors

The role of a vendor can be profitable, but it is very different from an advisory business. Vendors have no control of their pricing and hence, must be the low cost producers of their service or product to survive. They also function largely like a utility – simply providing a service and having no sustainable relationships with clients. Their profitability is tied to volume and their services are focused on one specialty. Should another specialty organization be able to deliver the same service at a lower price, the vendor's survival would be imperiled.

Step 3 – Improve Efficiency of Operating Structure

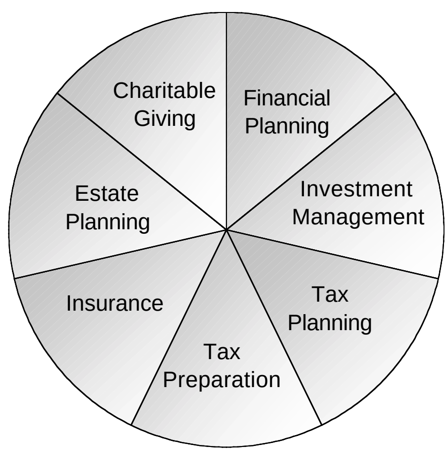
Operating efficiency can generally be described as a firm's ability to maximize the profitability it generates per client. The more efficiently a firm operates, the more services it can offer and lower the fees it can charge and still remain profitable.

Our first study predicted that large, well-capitalized competitors in the advisory industry will provide a minimum of seven services (financial planning, investment management, tax planning, tax preparation, insurance, estate planning, and charitable giving). Similarly, successful niche advisory businesses must also offer a sufficient array of services so that their clients use them as their primary advisor. The challenge in offering such a broad range of services, as well as a special expertise or capability, is finding a way to do all these things and still make money. To achieve this goal, successful niche advisory businesses will have very efficient operating structures, utilize strategic partnerships and vendors and build enough scale to adequately cover the organization's fixed operating costs.

A vendor will likely not survive if another organization can deliver the same service at a lower price

Exhibit 5.3

Seven Sources of Value-Added of Future Dominant Competitors



Today, the typical advisory firm is transitioning to a fee-only practice, but still derives a substantial portion of its revenues from insurance commissions, financial plans and consulting fees. The migration is fast, however, as evidenced by the nearly 700% growth in fee-only practices since 1990.[8]

Most Advisory Firms Operate Inefficiently

The industry's transition toward operating efficiency is not moving nearly so quickly. Moss Adams recently conducted a survey of the operating efficiency and profitability of advisory businesses. The survey involved 703 firms, ranging from small proprietorships to partnerships with more than $10 million in annual revenues. If this comprehensive survey's data is an accurate reflection of the industry

[8]The VIP Forum, *Eyes on the Prize: The Challenge of Serving the "Decamillionaire,"* 2000

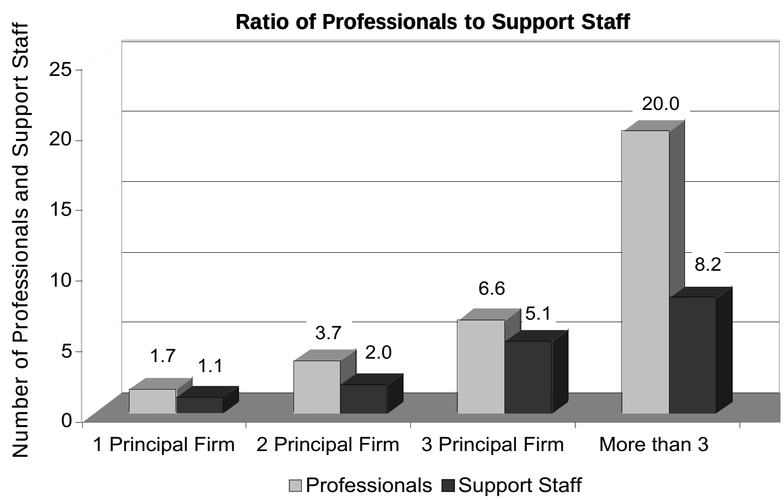
as a whole, there are few advisory firms that will be able to provide a broad range of generic services and remain profitable, much less bear the costs of developing a specialty expertise or capability.

According to the Moss Adams study, the typical fee-only advisory firm has four professionals and two support staffers. The firm's professionals do everything from answering phones to sending out mailings to bookkeeping and marketing. They rarely concentrate on a specialty. This ratio of two professionals to one support staff person is substantially higher than in most developed service industries, where support staffers almost always outnumber professionals – sometimes by as many as five to one – to leverage the professionals' time and ability to focus on revenue-generating activities. The advisory business has yet to embrace this model.

Advisory firms must embrace technology and leverage professionals' time to prosper

Exhibit 5.4

Most advisory firms use inefficient operating structures



Source: Moss Adams Advisory Services

As advisory firms expand the range of services they offer to clients to compete with large firms, they will also need to fundamentally change their operating efficiency through the employment of technology. As we discussed earlier, recent developments in technology are revolutionizing the structure and implementation of solutions to client problems. Organizations such as J.P. Morgan (with Morgan Online), Morningstar (with Clear Future) and Financial Engines have developed the first of many software systems designed to substantially automate many of the traditional functions of advisory businesses. Properly used, these systems will significantly leverage the time of key professionals in advisory businesses and allow them to give broader and better advice to larger numbers of clients more efficiently. Successful niche advisory firms will quickly embrace such technology and incorporate it into their regular operations to counteract the industry's inevitable margin compression.

Strategic Partners Also Play Key Role in Operating Efficiency

From the perspective of many organizations, the multi-user family office structure in which advisory businesses take a holistic approach to advice, addressing all of a client's problems, will make the advisor a critical gatekeeper. While the advisory business will likely sub-contract out some services such as tax preparation and estate legal work, organizations that are not serving as the advisor to the client will be relegated to the role of vendor to advisory firms. Consequently, many non-financial advisory services organizations will seek strategic partnerships with advisory firms.

Organizations that are not serving as the advisor to the client will be relegated to the role of vendor to the advisory firm

Successful niche advisory firms will recognize that these non-advisory organizations can play a central role in their long-term success. While there will be an outright war for clients, the winners will not necessarily be the largest and strongest firms. Instead, the winners will have the vision to select the right partners and fight using a coalition approach.

An important aspect in selecting potential strategic partners is identifying organizations that sell other products or services to the same target client base as the advisory business but have not yet created their own advisory units. Many are likely considering trying to enter the advisory business but are concerned that economic costs and cultural barriers may limit their ability to succeed.

By teaming with the right strategic partners, niche advisory businesses can accelerate their growth and lower their operating costs. From the perspective of the advisor, the strategic partner's employees can serve as marketing forces for the advisory firm's services. For the strategic partner, a partnership with the advisory firm provides a cost effective means for entering this business and can also serve as a regular source of referrals for the partner's services.

Several coalitions have already begun forming. One large independent broker/dealer partners with accounting firms, providing turnkey financial advisory business set-up, including trained personnel, legal registrations and marketing materials. The partnerships give accounting firms the ability to create their own advisory units almost overnight.

Another advisor recently struck a strategic partnership with a large insurance agency. The partnership involves equity ownership and revenue sharing between the organizations. From the perspective of the insurance agency, it does not have to make the investments nor take the risk of trying to build its own advisory business but it still receives comparable revenues. The advisory firm now has a 300-person marketing force selling its services throughout its primary geographic territory.

Arrangements that make perfect sense on paper often are disasters in execution

A very large trust company has de facto revenue sharing arrangements with a majority of the top trust attorneys in one region of the country. In exchange for referring clients exclusively to this trust company, the attorneys are paid exceptionally high fees for their legal work for clients of the trust company. The trust company has been so effective in recruiting trust attorneys to exclusivity agreements that it is now difficult for other advisory businesses to find local attorneys to perform estate work.

Partnerships Are Fragile and Often Fail

Clearly, all partnerships are fragile and fraught with the danger of failing. Arrangements that make perfect sense on paper often are disasters in execution. In addition, if an advisory firm becomes too dependent on its partner for the marketing of its services and its partner is acquired and/or breaks off the partnership, the advisory business could face a difficult time attracting new clients.

An important factor to any successful long-term partnership is ensuring an alignment of interests that includes a significant stake in the future success of the relationship for both firms. Should the partnership structure provide greater benefits to one partner or both partners do not deliver their end of the bargain, the partnership is doomed to failure.

Vendors Must Be Allies

An equally important part of the long-term success of niche competitors – and a highly controversial part of our first paper – is the rational use of vendors by advisory businesses. The current complete lack of competition within the advisory business has created an environment in which participants make virtually no demands on their vendors. Organizations such as mutual fund and insurance companies are currently able to sell large amounts of their products to advisory businesses and provide no value-added – except maybe for trinkets such as "stress balls" that bear a company's logo – beyond their products.

The fundamental value proposition of vendors is that in addition to having good products, they help clients become more successful

In almost every other business, simply the right to be a vendor – much less the actual sale of product – has enormous value. Companies that sell jet engines have teams of experts that work with the airlines on improving maintenance and efficiency so that they might have a chance to sell some of their product in the future. Investment banks conduct numerous strategic analyses for their clients on a regular basis, whether or not there is a potential transaction that might come out of the analysis. Drug companies have teams of representatives that help doctors set up their practices and provide them with some initial equipment and even business cards. And they do all of this before the doctor has even written a single prescription and with no assurance that the doctor will ever prescribe their product.

The fundamental value proposition of vendors in most industries is that in addition to having good products, they help clients become more successful. To be clear, the client is not obligated to use the vendors' products. The vendor provides the value-added services so that the client will utilize some of its limited time and resources to examine and consider employing the vendor's products.

Successful companies in other businesses also limit the number of and carefully choose vendors so that they can extract as much possible value from them in addition to their products. They recognize that vendors will not continue indefinitely to provide value-added services if they do not sell any product. Hence, successful companies in other industries usually limit their vendors only to those that have acceptable products. They then aggregate all of their business with this limited number of providers, which enables them to make significant demands from these vendors.

Successful Niche Advisory Firms Will Demand Value-Added Services From Vendors

Future successful niche advisory businesses will likewise require that their vendors play a key role in their success. They will demand that vendors change their value proposition from simply "we have great products" to "in addition to having great products, we can help your business become more successful." These value-added services will likely range from helping develop marketing programs and strategic plans to providing technology (at no cost) to the advisory business.

Organizations that fail to properly use their vendor relationships will find themselves at a significant disadvantage to their competitors

Today, many of the core providers of goods and services to advisory firms not only provide no additional value-added services, they also directly compete for clients. In the future, such vendors will have to meet an even higher standard. They will be required to demonstrate that the benefits that they provide through their value-added services outweigh the costs of their competition to the advisor by such an amount that it is the self-interest of the advisor to continue using the vendor's product instead of shifting to a non-competitor.

It is critical that niche advisory firms take advantage of their vendors' resources. Although they face less competition than other types of advisory businesses, they will compete ferociously with other niche firms for the same clients. Organizations that fail to properly use their vendor relationships as key tools to their success will find themselves at a significant disadvantage to their more prudent competitors.

Owners' Salaries in Jeopardy of Falling

Competition will compress margins in two ways – by forcing advisors to charge lower fees and expand their services. As part of our research, we built a financial model that mimics the results found in the Moss Adams study. We discovered that current firm structure matters little in the battle to survive in the advisory industry's increasingly competitive climate. The margin for error is narrow. Sole proprietors and partnerships alike – even those the study classifies as "high profit" practices – face the prospect of having their profitability, and owners' compensation, shrink dramatically or disappear completely if they do not greatly enhance their operating efficiency.

As shown in the Moss Adams study, a typical "high profit" sole proprietorship operates at 23% pre-tax margins and its owner's total take-home pay is $119,522. The average "high profit" partnership operates at 33% margins and each of its owners' total take-home pay averages $224,200. These margins might appear high, but they are particularly problematic given that most of these firms are already

Principals will lose 40% in compensation if fees fall 20 basis points

operating at capacity and typically provide only one or two generic services. According to the financial model we developed for this study, should fees fall by slightly more than 20 basis points, the principals in typical "high profit" partnerships would suffer a nearly 40% drop in their compensation. Similarly, if these partnerships are forced to add services such as tax preparation and estate planning to attract and retain clients, they could lose all but a few thousand dollars of their take-home pay.

Methodology

We believe that financial advisory firms will continue to move toward the fee-only model, providing a bundled service for an asset-based fee. Our financial model is based predominantly on the fee-only information in the Moss Adams study. It is also built on some very generous assumptions for advisors.

1) Services - Although the vast majority of advisory firms currently do not provide insurance advice or comprehensive financial planning, we've assumed that the typical advisory firm of the future will provide these missing services at no additional cost. We have also assumed that the firm will be able to develop, at no extra cost, a specialty for which premium prices will be charged.

2) Fees - As we indicated earlier, the typical dominant competitor will likely provide at least seven services for a bundled fee. Larger, fee-based financial advisors currently charge approximately 85 basis points for a $1 million account. According to the model we created for our previous study, dominant competitors will be able to operate at nearly 65% margins under this fee schedule if they achieve sufficient scale.

Owners of advisory firms will be fortunate to earn $50,000 per year unless their businesses achieve sufficient scale and become more efficient

But there is little chance of the fees and operating margins staying that high as the industry gets more competitive. Labor costs will increase substantially as more companies enter the market and compete for the best available talent. Fees will also be compressed as larger competitors cut their prices in an attempt to gain market share. We believe it's reasonable to assume that dominant competitors will ultimately charge approximately 50 basis points, or $5,000, on a $1 million account. Assuming labor and other costs increase by 20% over time, dominant competitors will still be able to operate at 24% margins under this fee schedule if they achieve sufficient scale.

Niche competitors, because of the higher costs associated with developing a specialty service, must be able to charge a premium price to survive. But there are limits to the premium advisors can charge for specialty services. Other advisors with similar specialty services will target the same clients. Dominant competitors will likely offer more services at a lower cost. Given this environment, we've assumed that the typical premium going forward will be approximately 25% over generic providers, or 62.5 basis points on a $1 million account.

Even with these assumptions of limited cost increases and fee compression, owners of advisory firms will be fortunate to earn more than $50,000 per year – or about 23% of their current salary – unless their businesses achieve sufficient scale and become much more efficient. Efficiency allows firms to process more clients, which permits them to achieve greater scale. This combination will help owners maintain their current earning power.

Scenario Results

The firm described in the following scenarios approximates a typical "high profit" advisory firm, as described by the Moss Adams study, with the following characteristics:

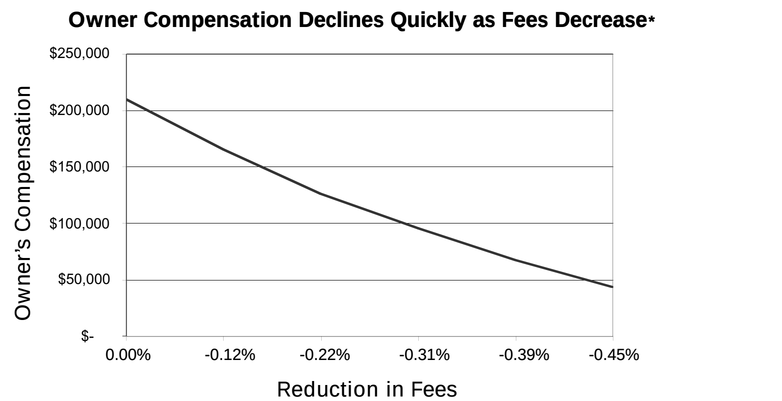
- Generates roughly 90% of its revenues from asset-based fees
- Six employees (two owners, a planner, an investment manager and two support staff)
- 185 clients
- $104 million in assets under management
- $909,975 in annual revenues
- Operates at 25% margins
- Two owners who each earn $209,626 per year in salary and bonuses

While the high margins might lead many to believe that it is easy to be successful in the increasingly competitive environment, it isn't. As shown in the following three scenarios, a slight drop in fees or increase in costs can wipe out the healthy salaries owners of advisory businesses currently earn.

Scenario 1 – Fee Compression

If the firm's fees are compressed by competition to the level shown in Exhibit 5.5 (i.e. the blended fee on a $1 million client falls from 85 basis points to 62.5 basis points), the owners lose nearly 40% of their take-home pay, and each earns $126,128. The firm would have to increase its client base by more than 107% to 383 clients ($212 million AUM) to allow the owners to return to their original compensation level.

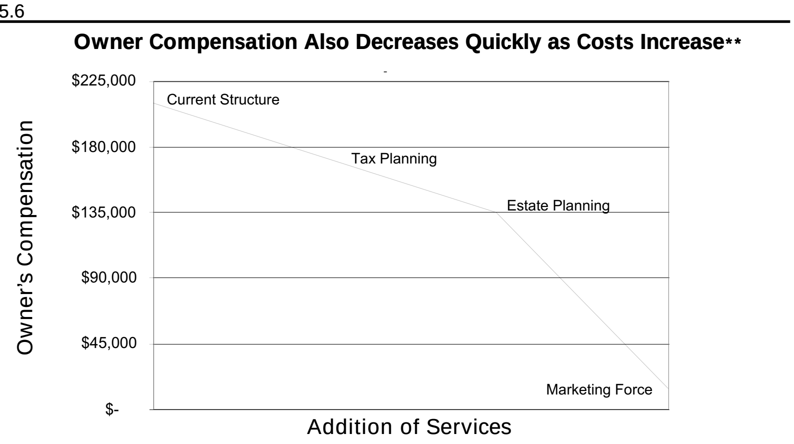
Exhibit 5.5



Scenario 2 – Service Additions

If the firm is forced to provide tax return and estate planning services (and provide these services internally), the owners' compensation would drop by nearly 36% to $134,626. Due to the labor intensive nature of these services, the firm would have to increase its client base by nearly 175% to 508 clients ($277 million AUM) to allow the owners to return to their original compensation level.

Exhibit 5.6



*The effect of the fee compression is illustrated by moving our fee schedule from our base fee schedule, Fee Schedule I, to Fee Schedule VI, while keeping our costs and clients constant. Please refer to appendix for complete fee schedule.

**The base fee structure is held constant. Services are expanded at no additional fee to the client (see appendix for fee structures) and the client base is held constant. Tax preparation increased costs 11%, estate planning increased costs another 10% and the addition of a marketing force increased costs another 29%.

Scenario 3 – Fee Compression and Service Additions
We believe this is the most likely outcome for the industry. Fees are compressed such that a niche competitor can charge approximately 62.5 basis points for a $1 million account. The firm is also forced to add tax preparation and estate planning to its general services. In this scenario, each owner's compensation is reduced by more than 75% to $51,128, or less than the typical advisory firm currently pays its entry-level financial planners. Most owners won't work for that salary and will question the long-term viability of their firm. If the owners did decide to continue to operate the business as an independent firm, they would have to increase its client base by 504% to 1,117 clients ($613 million AUM) to get the owners back to their original compensation.

Niche competitors face intense competition from other niche organizations

It is painfully obvious that even niche companies are not immune to the impact of competition. While they will face *less* competition than generic providers of advice because of their highly specialized services, they will undoubtedly battle other niche firms and generic competitors that upgrade services.

Competition leaves niche companies with three options if owners want to maintain their current wages:

1) Change the way they are structured in terms of technology and employees (i.e., add more support personnel) to leverage the professionals' time and allow them to focus on revenue-generating activities. To do so, advisors must redefine their roles in their firms. They must delegate everything they can to unskilled and semi-skilled people and limit their own activities to those that are essential to attracting and retaining clients. Our calculations indicate that owners of firms that increase the number of support people per professional – and thus increase the ability of the professional to produce – earn considerably higher total compensation than do owners of firms that maintain their current operating structure.

2) Enter into strategic partnerships with lowest-cost providers of services such as tax preparation and estate plan preparation, so that they don't have to support the high variable costs of these services internally. Advisors will never have the scale or expertise required to be the low-cost provider of these functions. By partnering with other organizations, they can both limit their costs and capitalize on their partner's marketing efforts to the same client base. This combination will help owners of firms negate the effects of fee compression and cost increases. According to our calculations, owners of companies that outsource tax preparation and estate planning make more money than owners of companies that bring those services in-house.

By partnering with other organizations, firms can both limit their costs and capitalize on their partners' marketing efforts

3) Achieve greater scale, so that the fixed costs of providing a sufficient group of generic services, in addition to a special expertise, are spread over a larger asset base. As shown in Exhibit 5.7, as this typical firm grows in size, its profits per client

increase significantly. This is because approximately 50% of the firm's expenses are fixed or semi-fixed costs, and as the firm grows, it is able to spread these fixed costs over a larger base of assets.

Exhibit 5.7

Scale allows firms to increase profitability per client*

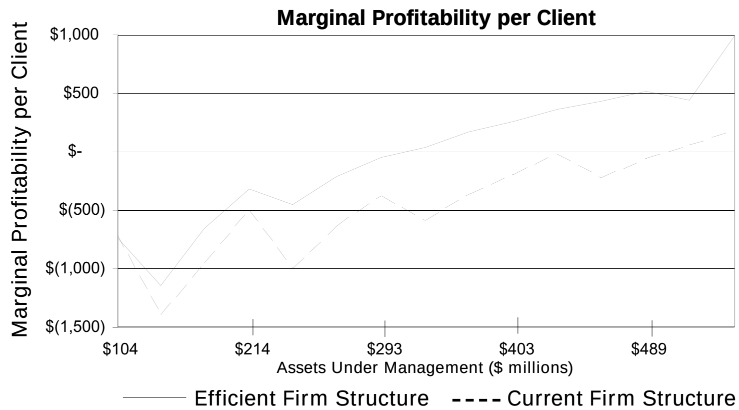


Exhibit 5.8 shows the combined effect of these three options. The efficient firm has been constructed so that the ratio of support people to professionals is three times greater than in the inefficient firm, thus increasing the productivity of the professionals. The efficient firm sub-contracts out its tax preparation and estate planning functions to a low-cost partner, whereas the inefficient firm provides both services using its own personnel. As the exhibit demonstrates, the more efficient the firm is, the quicker it can counteract the combined effect of fee compression and and service additions (i.e., the fewer assets it must gather before its owners regain their original level of compensation).

Owners of niche advisory firms will not maintain their current compensation with assets of less than $400 million

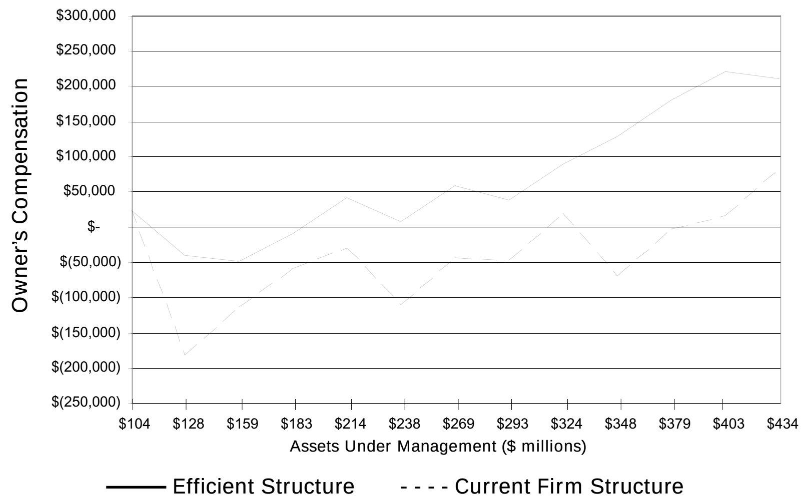
The profitability of niche firms will be affected by specialty and geographic region. Our analysis indicates, however, that owners of most niche advisory firms will not maintain their current compensation unless they are able to achieve significant scale of $400 million to $500 million.

The data in these scenarios highlight the low efficiency at which most advisory businesses currently operate. They process clients in a manner similar to how cars were manufactured before Henry Ford created the assembly line. While clearly the personal nature of client contact demanded by the advisory business precludes an operating structure as efficient as an assembly line, successful niche companies will achieve some sort of middle ground that substantially reduces their operating costs per client but also keeps clients happy.

*The fee structure of both firms is decreased from the base structure, Fee Schedule I, to the future structure, Fee Schedule III (see appendix for fee structures). Tax preparation and estate planning services have also been added at no extra cost to the client. The current firm structure provides these services in-house. The efficient firm structure outsources tax and estate planning and increases the ratio of support to professional staff by three times.

Exhibit 5.8

A combination of scale, operating efficiency and outsourcing will allow niche advisory firm owners to maintain current levels of compensation*



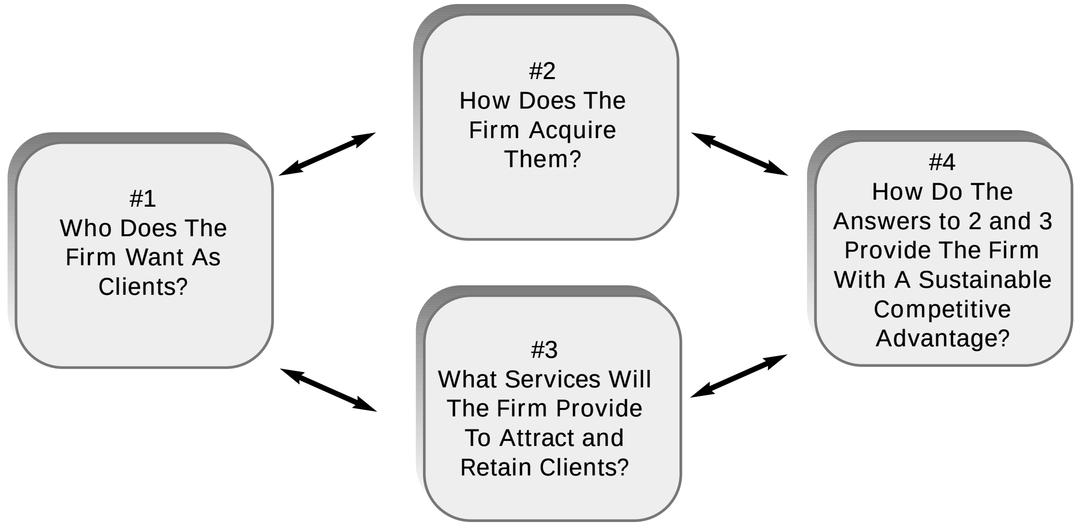
Step 4 – Formulate a Strategic Plan That Creates a Sustainable Competitive Advantage

Successful niche advisory firms will not be successful by accident. Their strategies will rely on comprehensive strategic plans designed to provide them with a sustainable competitive advantage. In working with more than 100 advisory firms on their strategic plans, we have found that there are four key questions that are essential to building a successful plan:

1. **Who does the firm want as clients?**
2. **How does the firm acquire them?**
3. **What services does the firm need to offer to attract and retain its target client group?**
4. **How do the answers to questions 2 and 3 provide the firm with a sustainable competitive advantage against current and potential competition?**

Formulating the answers to these four questions is an iterative process. The answers to one question might change an organization's response to another. The purpose of answering them is to generate inputs for the company's financial model that enables a business to measure what is truly feasible and the cost/benefit trade-offs of various strategies.

*The fee structure of both firms is decreased from the base structure, Fee Schedule I, to the future structure, Fee Schedule III (see appendix for fee structures). Tax preparation and estate planning services have also been added at no extra cost to the client. The current firm structure provides these services in-house while the efficient firm structure outsources them. The current firm structure operates at three times the number of professionals to support staff to that of the efficient firm.



Question #1 – Who does the firm want as clients?

As we discussed earlier, niche advisory businesses identify potential clients on the basis of their problems. The first step in this analysis is to identify clients who share the problem that the firm specializes in solving.

One of way of approaching this analysis is to think of every community as being made up of sub-communities of people who share similar problems. The goal of this analysis is to identify the sub-community of people who share very complex problems that the advisory business is especially well-suited to solve.

A key part of this analysis is identifying organizations that allow individuals who share the same problems to affiliate. Examples of such organizations include the Young Presidents Organization, small business owners groups, the Junior League, retiree groups and other professional organizations.

A client's net worth is only a secondary criterion for defining potential clients

Clearly, it is important that potential clients have the financial means to make the advisor's services practical for both the client and the advisor. A client's net worth, however, is only a secondary criterion for defining potential clients. It is used to identify individuals within the target sub-community who the advisory business should pursue.

To date, potential clients have been so plentiful and competition so minimal that few, if any, advisory businesses have conducted market analyses to determine their current market share and their potential to grow. At the point that the demand for clients exceeds supply, such analyses will be critical to determine the best and most profitable opportunities to grow an advisory business as well as to replace clients lost to competitors.

In selecting a niche, an advisory business must consider the potential market for that specialized advice within the geographic region that the firm hopes to compete for clients. As part of this analysis, an advisory firm must consider the current and future demographics of the target client base, their locations and the percentage that has not yet been captured by a competitor. They must also determine a reasonable market share for the firm to aspire to capture within this base of potential clients.

Question #2 – How does the firm acquire these clients?

The real business of the advisory industry is not giving advice. It is getting paid for giving advice. In many ways, the perceptions of current and potential clients matter far more to the economic success of an advisory business than the quality of the advice provided.

Clearly, the quality of advice provided can affect an organization's ability to retain clients over the long-term. However, the success of a firm depends far more on its ability to market itself. Because the true quality of advice can only be measured over a long time period, most clients will not realize they are receiving inadequate advice until it is too late. Similarly, when clients make this realization, advisory businesses that have focused solely on improving the quality of their advice instead of capturing new clients will likely no longer exist. Consequently, the most successful advisory businesses – both niche and dominant competitors – will be very good at marketing their services.

Marketing in the advisory business today is an afterthought. Participants face little or no competition for existing clients and generally suffer less than 5% client turnover per year. Other financial services companies routinely refer qualified clients and expect no direct compensation in return. Few firms have professional marketing forces and even fewer have made a concerted effort to develop a brand name. The chief crisis facing most advisor businesses is inadequate capacity to process as opposed to the ability to capture more clients.

The upcoming competitive environment for current and potential clients, however, will be far different. Once the demand for clients catches up with the supply, current and potential advisory clients will be bombarded with solicitations by advisory businesses of all types and sizes.

The primary goal of niche competitors' marketing strategies is to reach, on a cost-effective basis, those individuals who share a complex problem that the firm is especially well-suited to solve. Most importantly, it is vital that the firm creates the perception within the sub-community that it possesses the specialized expertise necessary to meet their needs, and that such expertise cannot be obtained from a generic provider or a similar niche competitor.

There are two key aspects to a successful niche competitor's marketing strategy. The first involves determining how to make potential clients aware of its services. The second challenge is building a brand within the target client base so that potential clients the firm has never contacted will seek it out on their own.

Push Communications Strategies

Advertising companies commonly refer to the first aspect of marketing as a "push" communications strategy. The company is trying to push its message onto consumers through a combination of marketing forces, direct mail and advertising so that they will consider the firm's services.

As we said earlier, most advisory businesses currently have no marketing strategy, much less a push communications plan. They instead rely almost entirely on client referrals from other financial services companies such as accounting and law firms and insurance agencies.

Advisory firms cannot rely on other organizations to serve indefinitely as their marketing arms

Advisory businesses should not expect to rely on these organizations to serve indefinitely as their de facto marketing arms. Several financial services organizations are developing their own advisory units. Others are entering into strategic partnerships with competing advisory firms or will soon refer their clients only to those firms that rebate to them a substantial portion of the advisory fee.

As part of their push communications strategies, successful niche competitors will create small, proprietary marketing units to identify and recruit potential clients. Successful niche competitors will be judicious in how they spend their limited advertising dollars. They will also work closely with organizations that help people who share the same problems to affiliate.

Niche advisory businesses, however, will find that they cannot rely solely on push communications strategies to grow their firms. They will not be able to match dominant competitors' expenditures in advertising, seminars and direct mailings. Their resources will also limit the number of personnel they can employ as professional marketers. And their margins will already be under tremendous pressure, so competing for referrals solely on the basis of revenue sharing may be impractical.

Pull Communications Strategies

Consequently, successful niche competitors will find a way to create demand for their services from individuals who they do not contact directly through their push marketing effort. Many marketing companies refer to creating such demand as a "pull" communications strategy.

Intangibles are why clients pay premiums for brand products

Pull communications strategies underlie all brands. In building a brand, a company creates a perception of the organization that goes beyond its products. Instead of just creating the belief that it offers a good product for the price, brand building involves convincing potential clients that the company offers intangibles such as safety, dependability and quality.

Why do individuals buy Coca-Cola instead of generic cola? Or Clorox instead of a private label bleach? Or any brand product instead of a usually much lower-cost generic? In many cases the same manufacturer of a nationally branded product also manufactures a generic using virtually the same inputs. Customers seek out and are willing to pay a premium for the branded products because they ascribe various intangibles to the product that they believe are necessary to meeting their needs.

Exhibit 5.9

Branded products often sell for much higher prices than their similar generic competitors

Survey of Prices of Brand Products vs. Generics

Popular Brand Product	Price	Private Label/Generic	Price	Brand Premium	% Premium over private label/generic
Non-Aspirin Pain Killer					
Aleve	$ 6.49	Major Grocery Chain Naproxen	$ 4.99	$ 1.50	**30%**
Advil	$ 6.39	Major Grocery Chain Ibuprofen	$ 4.49	$ 1.90	**42%**
Tylenol	$ 6.99	Acetaminophen	$ 4.49	$ 2.50	**56%**
Beverages					
Tree Top Apple Juice	$ 2.69	Major Grocery Chain Apple Juice	$ 1.99	$ 0.70	**35%**
Cereals					
General Mills Honey Nut Cheerios	$ 3.99	Major Grocery Chain Honey Nut Toasted Oats	$ 2.49	$ 1.50	**60%**
General Mills Cocoa Puffs	$ 3.99	Major Grocery Chain Cocoa Crunchies	$ 2.49	$ 1.50	**60%**
Kellogg's Corn Flakes	$ 3.79	Major Grocery Chain Corn Flakes	$ 2.39	$ 1.40	**59%**
Garbage Bags					
Glad Tall Kitchen Bags	$ 4.29	Major Grocery Chain Tall Kitchen Bags	$ 2.99	$ 1.30	**43%**

Source: National supermarket chain in Dallas, TX, September 2000

Building brand goes beyond advertising a firm's capabilities – it focuses on potential clients and their needs

Potential clients are worried that they do not understand all of the nuances of the challenges they are confronting. If clients truly understood all of their problems, they would have already done something to solve them. An advisory business' brand convinces prospective clients that only through its broad experience in diagnosing and solving such problems can clients be confident that all of their needs are being met. Consequently, building brand goes beyond just advertising a firm's capabilities. It instead focuses on potential clients and their needs.

Successful niche advisory businesses will invest great amounts of their time and resources in building their brand. Instead of marketing their services by emphasizing the quality of their advice, they will present themselves as experts on the issues facing a particular group of clients. The breadth and scope of these firms' understanding will allow them to identify issues that clients would never have thought of and to direct them to the correct expert should the firm not possess the capability to solve a particular aspect of an individual's problems.

These organizations will also have well-thought-out media plans, targeted at publications that are widely read by potential clients. The goal of a media plan is to have the firm included in articles about specific client problems.

In addition, advisory firms that create successful niche businesses will be active in events sponsored by groups that help people who share the same problems to affiliate. The firms' presentations will not focus on their services. They will instead focus on the challenges facing the group's members. The niche advisory firm's goal is to create such a perception of expertise in the sub-community that potential clients seek out the organization on their own.

A Brand as Advisor to Widows and Divorcées

A great example of niche advisory businesses that have built strong brands within a sub-community of people are two firms that target widows and divorcées as potential clients. These organizations recognize that many recently widowed or divorced women are in a quandary. In addition to the emotional trauma that a divorce or death causes, these women are often completely unprepared to handle their personal finances, as well as other aspects of their lives. They also are looking for advice from someone who understands what they are going through.

Both of these organizations have invested a great deal of time in cultivating relationships with members of the media who work at publications that are read by widows and divorcées (women's magazines, columns in local papers, trade publications for women's groups) so they are regularly quoted on issues facing these women. These organizations are also regular participants at events for women's groups as well as those sponsored by divorce and estate attorneys. Both have published and widely distributed pamphlets that highlight issues facing divorcées and widows that go beyond the scope of their businesses.

Their efforts have created substantial brands for their organizations within the divorcée and widow segment of their communities. The firms are perceived as having more than just a competence to solve these women's problems. Rather, these organizations have created a perception that their experience has given them a deep understanding of the nuances of the challenges facing recently divorced or widowed women. As a result, women who have never been contacted by these firms regularly seek out their services.

Question #3 – What services does the firm need to offer to attract and retain its target client group?

Niche advisory businesses are facing several challenges in developing the list of services that they need to provide to clients. They must identify the specific expertise necessary to solve their target client base's most complex problems. Such expertise is the basis for their niche strategy.

Offering more services does not necessarily equate to more success

As we outlined earlier, their services also need to include solving their clients' generic problems. Although they are attracted to these companies because of their special expertise in solving complex problems, niche advisory firm clients also require many of the same services (financial planning, tax planning and preparation, investment management, etc.) offered by generic providers of advice. Future successful niche competitors will provide a broad range of generic services – as part of their standard services – that meet their clients' basic needs.

In addition to solving their clients' current problems, they also must correctly anticipate their clients' future problems and develop the necessary services to solve them. As Professor Clayton Christensen of Harvard University points out in his seminal work, *The Innovator's Dilemma* (Harvard Business School Press, 1997), clients will not pay for services or products that only meet their past needs. Successful advisory businesses must make strategic bets on the services and capabilities that they must create if they want their current clients to continue to use their services in the future.

At the same time niche advisory businesses must offer a sufficient range of services, they have to somehow remain profitable. And they must do so at a time when margins will be under severe pressure.

In developing a list of services that they should offer, many advisory businesses tend to simply believe that more is better. Some organizations are expanding their services to include everything from refinancing homes to dog walking, regardless of the actual demand from or importance to clients.

One of the most respected consultants to the financial advisory business, Mark Tibergien of Moss Adams Advisory Services, refers to this tendency as the "Maginot Line approach" to developing services. The Maginot Line was a series of fortifications developed by the French before the Second World War along the Franco-German border that were designed to prevent a German invasion of France. Despite changes, such as the advent of mechanized forces and aircraft that made such fortifications obsolete, France poured a disproportionate amount of its defense budget during the 1930s into building and expanding the Maginot Line. Of course, in 1940, the Germans simply went around the line and defeated France more quickly than they did Poland.

Instead of a "more is better" approach to developing a list of services, successful niche advisory businesses must identify the minimum number and types of services that are essential today and in the future to attract and retain clients. Any more than the minimum would be a waste of valuable corporate assets that should be used in other areas of the firm.

Firms that focus too much on perfecting services and too little on marketing will fail

Equally important, it is neither the type nor the quality of services that an advisory firm provides its clients that ultimately matters. Rather, it is current and prospective clients' perceptions of what the firm does that determine the firm's success. Hence, while advisory firms must be competent in the services that they provide, those that spend too much of their resources perfecting their services and too little marketing them will ultimately fail unless their clients perceive and demand the higher-level quality of advice.

Question #4 - How do the answers to questions 2 and 3 provide the firm with a sustainable competitive advantage against current and potential competition?

Advisors in very few regions of the country have experienced true competition for clients. With the exception of a few highly populated areas and parts of the Northeast, most advisory businesses operate in a fairly benign environment and, thus, have never had to do an analysis of their competition. In many communities, competing advisory firms even meet on a regular basis to discuss their products and businesses and to share ideas.

Once the supply of potential and current clients is exceeded by the demand, all of this shall change. Advisory businesses will battle to capture new clients and retain existing ones. They will also have to distinguish what they do and provide a basis for their selection in lieu of their competition. The primary objective of the strategies developed under questions 2 and 3 is to provide an advisory firm with this kind of a competitive advantage.

The first step in conducting a competitive analysis is identifying organizations that will pursue the same groups of clients. True niche competitors, as a rule, generally have fewer competitors than do generic providers of advice. In the current non-competitive environment, there are very few companies attempting to build specialty practices. Companies building niche strategies may find that they are, at least for now, unopposed.

For niche firms that have competition, understanding the competitors' existing services, marketing capabilities, resource base and brand/reputation within the target base is critical to developing a competitive advantage. Some organizations we have worked with in developing strategies have found that their competitors' marketing materials are often good sources for this information.

Any service offered by one organization could be replicated by another as long as the competitor is willing to bear the costs of building it

The second step is to determine whether the client acquisition and services strategies outlined under questions 2 and 3 will create a sustainable competitive advantage. The concept of sustainability is particularly important when building competitive advantages. A key part of a competitive analysis is not just considering what current and future competitors do today, but how they will react once they learn of an advisory business' strategy.

Many advisory businesses that we interviewed as part of our research claimed that their sustainable competitive advantage was that other organizations "do not do what we do." These businesses will soon find that they have no sustainable advantage. Any service offered by one organization could be replicated by another so long as the competitor is willing to bear the costs of building it.

Higher Levels of Expertise, Brand, Pricing and Market Share Create Barriers to Entry

One way of building a sustainable advantage as a niche competitor is to make it economically unattractive for another organization to compete for the same clients. Developing expertise and specialty services can be very expensive. Similarly, there are large investments required to build a brand within a niche. A niche firm will have a competitive advantage when other organizations find it hard to justify the expense of pursuing the same niche.

Like all other specialists, niche advisory businesses will continually upgrade the quality of their services and expertise. In addition to being able to better serve clients, these upgrades will constantly raise the costs of entry and/or continued participation in the niche segment.

Likewise, successful niche competitors will regularly communicate their improvements to current and potential clients and will continually expand their brand presence within their target bases. Just as continual upgrades in expertise and services raise the cost of participation in a niche segment, so do improvements in brand and perceived quality of a company's capabilities.

Proper pricing and market share strategies can make it very unattractive for competitors to enter or to continue to participate in a niche segment. Successful niche firms will dominate their niches. Through a combination of operating efficiency and pricing, they will make it difficult for their competitors to make any money.

Most advisory businesses are not businesses at all – they are books of business

Successful organizations will also use market share to create barriers to entry for new competitors. Acquiring clients that already use an advisory business is much more difficult than acquiring individuals who have not yet been captured by any firm. The first type of client must be so dissatisfied with their current firm that they are willing to endure the aggravation of starting over with another advisor. The second type is already seeking advice but has no existing investment of their time or money in a relationship with a competitor. Strategies based on taking clients away from competitors are far less attractive and far more expensive than simply trying to seize uncaptured market share.

In all cases, successful niche advisory businesses must formulate a combination of expertise, services, operating efficiency, brand, client acquisition capabilities and market share so that they have a sustainable advantage over competitors. They must assume that their competitors will quickly understand their strategies and will take actions to respond. Successful firms will design their strategies in such a manner that they anticipate their competition's response and still provide a clear-cut advantage to their clients.

Four Questions Create Inputs for Financial Model

As we discussed earlier, these four questions should be used in an iterative process. The answers to one question often will change what is appropriate for another. Further, while strategy in theory may be interesting, advisory businesses must ultimately formulate action plans that will be profitable. The most important objective in answering each of the four questions is to derive inputs for a financial model that will allow management to see what is practical.

We have found that most advisory firms have had to adjust their strategies to reflect economic reality. Strategic planning is nothing more than an exercise in identifying a firm's future needs and allocating its resources. It is only through a comprehensive financial modeling of one's business after addressing these four questions that a firm can truly understand its alternatives and formulate a realistic strategy.

Step 5 – Institutionalize Business

The fifth step in building a successful niche advisory firm is to institutionalize the business. Most current advisory businesses are not really businesses at all. They are instead proprietorships or small partnerships that would not survive the departure of one or two key individuals. Successful niche advisory firms will structure themselves so that their clients' relationships are with the organization as a whole.

Institutionalization of an advisory business is an emotional topic for many advisors. It involves both structural and cultural changes that many advisors find unattractive. Clients are no longer the province of one or two individuals who control the survivability of the organization through the threat of their departure. Each client, instead, has a sustainable relationship with several people within the organization. Unlike most current advisory firms, successful niche competitors will not consist of one or two advisors and a group of "hired help." Rather, they will include a number of different professionals who work in teams and who each provide distinctive value-added.

Firms that do not institutionalize their business are violating their fiduciary duties to their clients

Institutionalization of relationships is critical to building economic value in a business. Such value is crucial to retaining and attracting the necessary personnel to survive. Those organizations that fail to institutionalize their businesses are also violating their fiduciary duties to their clients.

Competition for Employees Will Soon Surge

The lack of competition within the advisory business for current and potential clients has provided a less obvious, but very important, benefit to industry participants. To date, there has been only limited competition for employees. Once the demand for clients catches up with the supply, the labor market for advisory employees will suddenly become very competitive.

The first signs of a shortage of experienced professionals and semi-skilled staff for the advisory business are already evident. In markets as diverse as New York City, Columbus, Ohio and Northern California, advisors are already having difficulty attracting additional qualified personnel.

Several firms are raising large amounts (more than $40 million) of capital with the intent of expanding their businesses on either a regional or national basis. While some of these organizations include acquisitions as a part of their strategies, all intend to significantly increase their capacity to capture and service clients. In order to do so, they will need to aggressively recruit qualified employees.

The large demand for personnel will quickly change the labor markets in this industry. Advisory businesses will need to revamp their compensation programs to keep their best people and have any chance of attracting new ones. An important part of such programs will include providing all key employees ownership in the organization.

Advisory businesses will need to revamp their compensation programs to keep their best people and attract new ones

As currently structured, however, most advisory firms have no value as businesses. The market views them as books of business that are tied to the continued employment of the proprietor and that trade at a fraction of the value of real businesses. Without creating economic value in the business, providing employees with ownership stakes will not be effective in attracting and retaining personnel. Lacking such economic value, the firm will be at a significant disadvantage to competitors.

Long-Term Commitments Mandate Institutionalization of Advisory Businesses

Niche advisory firms also have a duty to their clients to institutionalize their businesses. The fundamental premise of an advisory relationship is a long-term commitment by an organization to the success of its clients. They are helping people optimize their finances and, in many ways, improve the quality of their lives over the long-term. Clients of niche advisory firms are particularly dependent upon these organizations to help them solve their most complex and vexing problems.

Consequently, as traumatic as it would be for an advisory business to lose a key principal or employee, it is a disaster for the client. At advisory firms that are not institutionalized, generally only one person truly understands the issues and challenges facing the client. The loss or departure of this principal or employee for any reason (including death, illness or retirement) forces clients to start over with a new organization or person that potentially lacks a real insight into their needs.

The departure of a principal or employee can be disastrous for a client

Worse still from clients' perspectives, as the economics of the industry change, an advisory firm that has not institutionalized its business may find that it is unable to attract and retain the necessary people to function effectively. Such firms may have to choose between providing inadequate advice and service or going out of business – both very negative outcomes for clients.

Successful niche advisory firms will change their relationship and operating structures so that they can build true economic value in their companies. And while they have an enormous economic incentive to change their firms, they also have an equally important fiduciary duty to their clients to do so.

VI. Conclusion

The advisory business is about to undergo a radical transformation. It will soon shift from a collegial, almost academic environment to a total war for current and prospective clients. While these changes threaten the profitability of every firm, they also offer owners of advisory businesses immense opportunities to build great economic value and personal wealth. Future successful firms will take steps now – either become large, dominant competitors or niche businesses – to capitalize on the industry's evolution.

For advisors who lack the ambition or resources to become dominant competitors, niche strategies are alternatives that will allow firms to remain relatively small and profitable. There are literally hundreds of potential niches within the advisory business. Becoming a niche competitor, however, will not be easy nor will it occur by accident.

Few organizations have made investments in marketing or brand-building

Few firms today are prepared to become niche competitors. Most are generalists that define their clients by net worth as opposed to problems. They are also inefficient organizations with low operating margins that are very susceptible to the inevitable fee compression or increases in costs that will accompany the industry's increasingly competitive environment. In a business that will ultimately define success in terms of the ability to get clients to pay for advice as opposed to the ability to provide quality advice, few organizations have made investments in marketing or brand building. Moreover, most firms have yet to develop a long-range strategic plan.

That will change quickly. Future successful niche competitors will completely redesign their businesses. They will identify a sub-community of people who share the same complex problems that require special expertise to solve. These firms will create brands within these client bases that lead clients to seek out their services. They will create the perception that only they possess the breadth of experience and expertise to understand the unique issues and challenges facing their potential clients, as well as the ability to formulate solutions that truly meet clients' needs. And their clients will believe that these firms' services are worth a premium price.

Successful niche competitors will also continually upgrade the quality of their services and communicate these improvements to clients. An essential part of this upgrade will be anticipating and creating services to solve their clients' most complex future problems.

In addition to specialty services, these organizations will also broaden their services to include a minimum number of generic services. Only by expanding both their specialty and generic capabilities will they be able to serve as their clients' primary advisor, capable of solving all their problems.

An equally important step for these organizations that decide to become niche firms will be to re-engineer their operating structures so they have the ability to do more for clients and still remain profitable. A key part of their restructuring will be to consider strategic partnerships with other financial services organizations and re-evaluate relationships with vendors. Organizations that succeed in the coming battle for clients will rely on a coalition strategy that capitalizes on the strengths of strategic partners and demands that vendors play a key role in their success.

In terms of size, niche businesses will be relatively small organizations. But they will achieve a minimum level of scale necessary to defray the high fixed costs of serving as the primary advisor to their clients. Although the actual size required will vary by region and specialty, we estimate that successful niche competitors will need to have at least $400 million to $500 million under management.

The actual size will also vary by the magnitude of the potential niche segments. Niche advisory firms will face competition from other specialty advisory businesses pursuing the same clients. Scale within a niche can provide an advantage in pricing over competitors. Ideally, successful niche competitors will capture a dominant share of the market for their services, thereby providing a financial advantage over their competition and creating a barrier to entry for other organizations.

Organizations that lie dormant will work much harder and earn substantially less in the future

Future successful niche competitors will also be real businesses instead of books of business. Clients will have relationships with the organization instead of one or two individuals. Key employees will have a material economic stake in the long-term success of the firms, and firms will survive this generation of ownership.

In summary, the future is extremely bright for advisory firms that soon decide to reposition themselves for a very different future. As niche competitors, they will be highly profitable companies that provide services that significantly improve the lives of their clients. Their owners will create immense personal wealth and build sustainable organizations that are able to meet their obligation to help clients over the long-term.

Organizations that lie dormant, failing to prepare themselves for the coming changes to the advisory business, will face a much harsher existence. They will work much harder and earn substantially less. They will face a day-to-day struggle to retain clients and to attract new ones to replace those lost. Their companies will have little economic value as businesses and will be under constant risk of losing key employees.

In either case, owners of advisory businesses hold their destinies in their own hands. The winners will seize the opportunity that lies before them.

Appendix

Fee Schedules & Client Distribution

Fee Schedules Used in Niche Firm Model

Fee Schedule I (Base Fee Schedule)	
Less than $250,000	1.00%
$250,000 - $499,999	0.90%
$500,000 - $999,999	0.75%
$1,000,000 - $1,999,999	0.60%
$2,000,000 - $2,999,999	0.40%
$3,000,000 - $3,999,999	0.20%
$4,000,000 or Greater	0.15%

Fee Schedule II	
Less than $250,000	0.86%
$250,000 - $499,999	0.77%
$500,000 - $999,999	0.65%
$1,000,000 - $1,999,999	0.52%
$2,000,000 - $2,999,999	0.34%
$3,000,000 - $3,999,999	0.17%
$4,000,000 or Greater	0.13%

Fee Schedule III	
Less than $250,000	0.74%
$250,000 - $499,999	0.67%
$500,000 - $999,999	0.55%
$1,000,000 - $1,999,999	0.44%
$2,000,000 - $2,999,999	0.30%
$3,000,000 - $3,999,999	0.15%
$4,000,000 or Greater	0.11%

Fee Schedule IV	
Less than $250,000	0.64%
$250,000 - $499,999	0.57%
$500,000 - $999,999	0.48%
$1,000,000 - $1,999,999	0.38%
$2,000,000 - $2,999,999	0.25%
$3,000,000 - $3,999,999	0.13%
$4,000,000 or Greater	0.10%

Fee Schedule V	
Less than $250,000	0.55%
$250,000 - $499,999	0.49%
$500,000 - $999,999	0.41%
$1,000,000 - $1,999,999	0.33%
$2,000,000 - $2,999,999	0.22%
$3,000,000 - $3,999,999	0.11%
$4,000,000 or Greater	0.08%

Fee Schedule VI	
Less than $250,000	0.47%
$250,000 - $499,999	0.42%
$500,000 - $999,999	0.35%
$1,000,000 - $1,999,999	0.28%
$2,000,000 - $2,999,999	0.19%
$3,000,000 - $3,999,999	0.09%
$4,000,000 or Greater	0.07%

Fee Schedule of Future Dominant Competitor	
First $1,000,000	0.50%
Second $2,000,000	0.25%
Third $3,000,000	0.20%
Fourth $4,000,000	0.15%
Each additional $1,000,000	0.10%

Client Distribution Assumption	Percentage of Clients
Less than $250,000	50.00%
$250,000 - $500,000	24.00%
$500,000 - $1,000,000	14.00%
$1,000,000 - $2,000,000	6.00%
$2,000,000 - $3,000,000	3.00%
$3,000,000 - $4,000,000	2.00%
$4,000,000 - $5,000,000	1.00%
$500,000 or Greater	---
	100.00%