

# The Age of Independent Advice

## The Remarkable History of the Independent Registered Investment Adviser Industry



### Chapter One: Investing with a Difference

**Schwab Institutional® is proud to share this excerpt from its chronicle of the growth of the independent advice practitioner. This is the first of six chapters that span almost 100 years in the evolution of the RIA industry. Chapter One uses the lessons learned as a result of the market euphoria of the late '90s to introduce the reader to independent advisers and their client-centric model.**

They called it a new paradigm for business, built on “network effects” and “mind share.”

“Not since Bill Gates took Microsoft public in 1986 has Wall Street witnessed anything like the wealth-creating power of today’s Internet stocks,” wrote a *Time* magazine reporter in June 1998. “Internet or Bust,” proclaimed the cover of *Fortune* magazine in December of that year. “Every category is being inundated,” an analyst told the *New York Times* in September 1999. “No one wants to miss the boat.”

There were tales of fledgling companies spending \$30,000, \$50,000, even \$250,000 on self-congratulatory parties. Of day traders making fortunes in minutes with a few clicks on a keyboard. Of traditional industries—natural gas, groceries, toys—being transformed by information technology.

In the late 1990s, investors by the thousands were caught up in a soaring, exhilarating ride. As the new century dawned—and fears of a “Y2K” technology disaster turned out to be baseless—the markets continued to inch their way upward. The Dow Jones peaked at 11,722.98 on January 14, 2000, the technology-heavy NASDAQ Composite hit an all-time high of 5,048.62 on March 10, and the broader Standard & Poor’s 500 index reached 1,553.11 on March 24. Many entrepreneurs and investors reveled in their sudden wealth: one dollar invested in the S&P 500® in 1995 had grown to \$3.50 by January 2000.<sup>1</sup> Investors who had focused on technology stocks often did even better: some boasted of eightfold or greater gains. The media were swept up in the excitement. Some market-watchers foresaw “a long boom”<sup>2</sup> or predicted that the Dow would eventually reach 36,000.<sup>3</sup>

And then, just as the days were lengthening into spring, the ride stopped short.

The U.S. stock market’s reversal didn’t come as a sickening one-day plunge like Black Friday in 1929, which signaled the beginning of the Great Depression, or like the 508-point fall in the Dow on October 19, 1987, the largest one-day market drop in history. But this skidding decline, which took 18 months to hit bottom, was a shocking wake-up call nonetheless. By late September 2002, when the NASDAQ closed at 1,185, the bear market had resulted in the loss of \$4.4 trillion in market value. It was the largest stock market collapse in the history of industrial capitalism.<sup>4</sup>

Yet when the dust settled, one group of investors found itself in surprisingly good financial shape. Throughout the bull market, these investors’ portfolios had been diversified, asset allocated, and lacking the riskier “new paradigm” holdings. Now, as dot-com businesses were going bankrupt and stock values dwindling to near zero, this group of investors found themselves relatively unscathed and marveling at their good fortune.

But it wasn’t luck that had led to their survival. Rather, it was foresight, prudence, and invaluable professional assistance. Diverse as they were—families planning for retirement, businesspeople charting a course for success, institutions seeking financial guidance—these investors had one important factor in common: they were clients of independent registered investment advisers.

## Investing with a Difference

### A BREED APART

Throughout the bull market of the 1990s, many independent advisers had been skeptical about dot-com enterprises that seemed built on nothing but promises. They'd spoken up for balance and moderation—even when their clients urged them to jump on the dot-com bandwagon. But independent advisers maintained their independence and persisted in focusing not on the sale of investment products to a client but on their clients' investment goals.

For independent advisers, there was nothing radical about this approach. It was the same strategy they had been taking since “investment counselors” first emerged as a profession during another fabled bull market: the reckless 1920s. Then, too, many independent advisers counseled prudence and balance. Then, too, some advisers' clients felt envious of their “luckier” counterparts—and were vindicated when they weathered the crash and the Depression with relatively lighter losses.

Why was this so? Where did independent advisers get their independence? How did the profession emerge, develop, and thrive? What challenges did it face on its path to growth? What makes independent adviser firms different—and successful?

First, though, a more basic question: what are independent advisers, and what do they do?

Perhaps it's easiest to answer that question by saying what they are not and what they don't do. Independent advisers generally don't sell specific products; rather, many emphasize a personalized financial plan and investment strategy as a means of controlling their clients' financial risk. Rather than depend on sales commissions, as traditional brokers do, they generally charge a defined fee, and their fee structure is fully disclosed to clients. Fee-based independent advisers sell advice, pure and simple. (Although, to be sure, advice about the financial markets is rarely a simple matter.) In short, they make more when their clients' assets increase.

They also are entrepreneurs with the natural eagerness of small-business owners to satisfy their customers and the nimbleness to innovate quickly.

For decades, many independent advisers have arrived at the profession from financial planning, which values

idealism, strict ethical standards, and strategies to assist clients in meeting financial and life goals. To compete with major financial institutions, many of them have obtained professional credentials such as the Certified Financial Planner certification and Chartered Financial Analyst. They've shown they are eager to learn and share insights from the academic world.

These elements add up to a client-driven service model distinctly different from the product-driven service model that has traditionally dominated the financial services industry. Clients perceive the distinction, says Mark Tibergien, a principal with Moss Adams, an accounting and consulting firm to the adviser industry. “It's the difference between whether advice or product is the leading-edge offering,” Tibergien said. “The typical client of an independent registered investment adviser appreciates that the adviser is an advocate for the client—not for a particular solution.”

Don Phillips, a managing director at the mutual fund data service Morningstar, who joined that firm in 1986 as its first mutual fund analyst, agrees. “Independent advisers have flourished because they put the investor's interest first,” he said. “That's been the mission of many of the people who choose to go the independent route. They genuinely want to do what's right for their clients. I take great joy in seeing our clients succeed in the marketplace, because it shows that the investment world is ultimately a meritocracy. People who do the right thing win in the long run.”

Studies show that consumers give higher ratings to independent advisers—on both objectivity and skill—than to advisers at large financial institutions. A recent research report on retirement issues by management consulting firm McKinsey & Company found a widespread belief among consumers that most financial advisers are primarily interested in “pushing products” rather than providing unbiased advice. The report also said fewer than one-third of survey respondents “received even the most rudimentary forms of retirement advice from their financial providers.” There was one notable exception to this disappointing picture, the report said: the independent adviser segment. “Here retirees and pre-retirees alike claimed to be receiving a significantly higher level of retirement advice than consumers utilizing any other segment. At the same time, independent financial advisers scored the highest

marks along such key customer satisfaction dimensions as product knowledge and overall advice capabilities.”<sup>5</sup>

There’s a good reason independent advisers get better ratings, says David Hunt, director of the McKinsey study: they do a better job. Americans are coming up against serious risks, and “in the face of those retirement risks, you can see independent financial planners stepping forward.” He continued:

What our research shows, and what other people have also observed and written about, is that independent advisers were among the first to understand these demographic trends. They were among the first to put together teams of people who could handle retirement advice. They are more likely to talk with their clients about retirement. They are more likely to raise these sensitive issues than either investment firms or brokerage firms. They’re more likely to have a referral network of people who can talk about health care or trusts or insurance as well as investments, so that the client is getting a holistic package. They have an entrepreneurial spirit, so there’s a real drive that you find in small businesses of all kinds for client service. And they have a pricing mechanism that has given them the ability to be seen by their clients—we can argue whether this is truth or perception—as being more independent.

And they are the fastest-growing segment. We believe that over the last couple of years they have continued to put a distance between themselves and the brokerage and investment management firms.

**Table 1 Financial Services Firms Have a Credibility Gap with Consumers on Retirement**

Q: What is your overall impression of the ability of the following institutions to address your household’s needs for retirement-related products and advice?			
	Positive	Neutral	Negative
Independent financial advisers	43%	10%	47%
Top three investment companies	40	5	55
Top five brokerage firms	28	16	56
Top five life insurers	24	9	67
Top five banks	18	8	74

Source: McKinsey & Co., *Affluent Consumer Survey*, 2004; team analysis

**Table 2 Consumers’ Perceptions of Financial Firms on Their Retirement Capabilities**

Q: How would you describe the ability of the following institutions to address your retirement needs?		
	Percent perceived as “able” in 2006	PCT change in perceived “ability” since 2004
Independent financial advisers	69%	+4%
Top three investment companies	67	-17
Top five brokerage firms	61	-21
Top five life insurers	57	+4
Top five banks	48	-12

Source: McKinsey & Co., *2006 Consumer Retirement Survey*

**LEARNING AND INNOVATING**

To stay ahead, independent advisers have had to be good advocates for their clients. They’ve had to be willing to learn, to try new techniques, and to share their ideas with peers. They’ve also been able to adopt new practices quickly.

Independent advisers in general tend to favor lower-cost investment vehicles when appropriate for their clients. For example, independent advisers were early and important champions of both index funds and exchange-traded funds, two low-cost passive investment vehicles. They encouraged Morningstar to develop an investment style grid, which became its now-famous mutual fund Style Box, and then pioneered its use as a tool both to analyze funds and to explain complex investment concepts.

New ideas spread quickly among independent advisers because they are active networkers and enthusiastic participants in industry associations that encourage ongoing education. The Financial Planning Association, which has more than a hundred local chapters, sponsors study groups—a common feature in the legal, medical, and accounting professions, but rare among large financial institutions. So does the National Association of Personal Financial Advisors, whose members are fee-only advisers. Study groups usually meet monthly or quarterly to analyze hypothetical case studies, an exercise that sharpens advisers’ skills. Group discussions encourage the sharing of best practices and insights and allow participants to benefit from their colleagues’ expertise. Sometimes a guest speaker will talk about specific financial planning topics, investments,

## Investing with a Difference

or practice management issues such as technology or regulatory compliance. A few study groups are regional or even national in scope; some, such as the Alpha Group and the Capstone Group, have evolved into prestigious, invitation-only organizations with limited membership.

“I’m amazed by how open financial advisers are to learning about different topics,” Morningstar’s Phillips said. “Not just the legal information you need to know for estate planning, or the mathematics of investing, but also the psychology of working with clients. And none of it with the short-term, let’s-close-the-sale mentality. It’s done with a view toward creating a better experience for the investor.”

Not only do independent advisers constitute a community of learners, Phillips added, “but it’s a community full of people who are eager to share what they’ve learned with their peers.”

### FOCUSED ON THE CLIENT

Gary Furukawa, the president and chief investment officer of Freestone Capital Management, an independent investment advisory firm in Seattle, Washington, is an accountant by training. But what he likes best about his job isn’t the numbers. His favorite challenge and biggest enjoyment, he said, lie in helping clients understand—and realize—their goals:

It’s a puzzle I like figuring out. Often clients will tell you one thing but mean something else. It’s fun to figure out their true objectives. And then it’s really fun to figure out how you’re going to get them there.

People don’t spend their days thinking about this stuff. So when you first meet with someone, there’s a process of uncovering the real issues. We always say that part of our role is to be a psychiatrist. And that part is very interesting to me—to get to the bottom of it and figure out what’s really important to them.

One of the most challenging areas, even for advisers who’ve been trained as counselors, is investment risk. Gauging the desirable risk level of an investment portfolio involves understanding the client’s time horizon—how soon the assets must be available for spending. The longer the horizon, the riskier a portfolio can afford to be. A second factor is the client’s capacity for risk. Substantial assets may provide a cushion against a loss. But that cushion is meaningless if the client has a low tolerance for

risk. And that factor is the most difficult to quantify: With how much risk is the client emotionally comfortable? To answer the question, some advisers administer questionnaires (although many experts and practitioners are skeptical of their validity or practicality). Others use questionnaires simply as the basis for discussion, a practice known as risk coaching.

One successful advocate of risk coaching is Evensky and Katz, an independent advisory firm based in Coral Gables, Florida. The firm’s thirteen-page risk tolerance questionnaire focuses clients on investment goals and time horizons. It also helps them understand the trade-off involved between return and risk.

“It’s simply a framework for us and the client to have a meaningful discussion about risk,” said Deena Katz, principal and former president of the firm. “It’s not useful to ask a client to rate on a scale of one to a hundred how much investment in equities he or she would feel comfortable with. How do they know? And their comfort level changes. If the market’s going up, they may have zero concern about risk. And if the market’s going down, they may have zero tolerance for risk.”

Because risk tolerance will vary over time, Evensky and Katz sees risk coaching as an ongoing part of its job, not just a topic to discuss with new clients. “We take all our clients through risk coaching, though some need coaching much more often than others,” Katz said. “We’ll have that discussion once a year or when there is a big change in the market. We go back and ask some key questions to see if everybody is still singing from the same hymn book.”

Many independent advisers offer more than counseling and advice. Indeed, they are client advocates. For example, independent advisers have pressed the mutual fund industry to make many changes to benefit investors. One such change was fund naming. “The labeling of funds used to be sloppy,” Morningstar’s Phillips said. “Janus, Windsor, Magellan—they’re nice names, but they don’t tell you anything about how the fund is going to be managed. Advisers demanded a higher level of precision. They wanted more institutional quality and they wanted more truth in labeling.” With encouragement eventually from the U.S. Securities and Exchange Commission, the industry began more consistently to use names—*growth*, *value*, and so on—reflective of the funds’ investment objectives.

In the early 1990s, as client counseling was growing in importance, independent advisers began to investigate a new field of study, behavioral finance. As its name suggests, behavioral finance is a marriage of psychology and economics, and it takes a skeptical view toward both disciplines. It questions the concept of efficient markets that underpins much of modern finance. And it asks whether individual investors act rationally to maximize their returns.

Innovators by definition, many independent advisers became ardent students of the new discipline. Prominent researchers, such as psychologist Daniel Kahneman of Princeton University and behavioral-finance theorist Richard Thaler of the University of Chicago, began to speak at meetings of independent advisers. Their studies showed how people can be hobbled by emotions, cognitive shortcuts, and mental mistakes where money is concerned. A frequent research topic of behaviorists was regret. Their studies found that people make decisions with an eye toward avoiding regret down the road, a course of action that may cause them to act against their best interests. For example, investors tend to hold on to stocks that have lost money while selling winners. Why? Until the loss is realized, they can avoid facing the pain of regret caused by a failed investment.

Except for the pocket of enthusiastic support among independent advisers, behavioral finance remained an academic discipline generally ignored by Wall Street and the rest of the investment community. Then, in 2002, Kahneman was awarded the Nobel Prize in economics—despite his being a psychologist, not an economist. The award confirmed the significance of behavioral finance research and confirmed what independent advisers had discovered years earlier: behavioral finance helps them do a better job for their clients.

### **A FORCE TO BE RECKONED WITH**

Long before *behavioral finance*, *asset allocation* and *risk tolerance* entered the lexicon, independent advisers were already focused on “doing a better job for clients.” As a result, the profession has evolved from a niche service catering to a small group of wealthy Americans to one of the fastest-growing and most influential segments of the financial services industry. Independent investment advisers and their client-centered approach have already transformed the world of financial services. Now one

capability of independent advisers—financial planning—is expanding outside U.S. borders and becoming an important global force.

It’s been a remarkable trajectory from the profession’s modest yet ambitious beginnings just after World War I, when a few pioneering firms on the East and West coasts separately yet almost simultaneously began focusing on financial counseling, analysis, and planning rather than on the traditional emphasis of investment firms: product sales. Over decades of slow growth, congressional investigations, regulatory challenges, and internal development, the profession gradually solidified and strengthened. The 1974 passage of the Employee Retirement Income Security Act, the growing importance of mutual funds, and the 1975 abolition of fixed brokerage fees set the stage for watershed growth and innovation between the 1980s and early 2000s. Beginning in 1987, brokerage firm Charles Schwab embarked on a pioneering association with independent advisers and their clients, offering them custody and back-office services that helped independent firms thrive. New mutual fund supermarkets enabled independent advisers to select funds from among many no-load families, with centralized record-keeping and consolidated client statements. And the technology boom of the 1990s—and the downturn of the early 2000s, exacerbated by the September 11, 2001, disasters—created unprecedented demand for independent financial advice.

Today, the number of affluent investors with complex and sophisticated requirements continues to grow, particularly as millions of members of the baby boom generation approach retirement age. Meeting these opportunities and challenges are a growing number of independent advisers, joined by those in the new category of “advisers turning independent,” who are contributing significantly to the growth. Although managing growth—and competition—poses its own demands, independent advisers have never been better positioned to succeed in the United States and around the world.

How did they arrive at this promising juncture? To answer that question, we need to go back nearly a century to the very beginnings of the independent investment advisory industry, when a few individuals, dissatisfied with the status quo, decided they could create something different—and better.

## Investing with a Difference

### WHO ARE INDEPENDENT ADVISERS?

Independent advisers are as diverse as the clients they serve. Some manage hundreds of billions of dollars in assets for institutions such as mutual funds, pension plans, or endowments. Others are hedge fund managers who serve both institutional and individual clients.

The largest category comprises advisers whose clients are mostly individuals. Their firms generally are small—two employees to a few dozen—and are not owned by or affiliated with larger organizations. Their annual revenue ranges between \$1 million and \$10 million. Most are local businesses with a strong connection to their community. That connection is often most apparent in times of crisis:

For example, after 9/11 and Hurricane Katrina, independent advisers (a number of whom were themselves affected by the catastrophes) responded quickly and generously.

Independent advisory firms fall into four general practice types, according to Cerulli Associates, a leading financial industry research firm.<sup>6</sup>

**Wealth managers** oversee 53 percent of the investment assets managed by independents. They provide comprehensive planning and asset-management services, primarily to high-net-worth individuals.

**Money managers** represent 27 percent of assets. Their clients are predominantly individuals, but they also serve small institutions such as retirement plans and endowments.

**Financial planners** manage 12 percent of investment assets. They provide comprehensive planning, but don't necessarily oversee investments or otherwise implement the plans they create.

**Investment planners**, a relatively new hybrid type, control 8 percent of assets. They combine money management services and planning and investment advice.

According to the Cerulli report, the once-distinct line between institutional advisers (such as pension fund managers) and advisers catering to individuals has blurred. As defined-benefit plans have dwindled, and their asset growth slowed, some institutional managers have turned to individual clients for new business. And firms that once served only individuals now find they can attract institutional business as well.

### THE FIDUCIARY ROLE

Every independent registered investment adviser acts as a *fiduciary*, a term that implies specific rules and legal duties. As fiduciaries, advisers must put their clients' interests first under all circumstances. They also have a duty to act conscientiously on the client's behalf.

Other fiduciary obligations of advisers have emerged from court decisions and SEC regulatory rulings. Advisers are required to:

- have a reasonable basis for the investment advice provided to clients;
- offer investment recommendations free of outside influence or undisclosed conflicts;
- render advice suitable to clients' needs, objectives, and financial considerations;
- seek to obtain from brokers the best execution (including price and other terms) for the clients' securities transactions directed by the adviser;
- make a full and fair disclosure to clients of all material facts, particularly regarding potential conflicts of interest.

Every independent registered investment adviser is held to a fiduciary standard based on interpretations of the Investment Advisers Act of 1940. The emphasis is on the process, not the investment outcome. According to the Foundation for Fiduciary Studies, "Even the most aggressive and unconventional asset can meet the standard if arrived at through a sound process, while the most conservative and traditional one may not measure up if a sound process is lacking."<sup>7</sup>

Registered investment advisers are also governed by rigorous rules that include disclosures about the firm's business practices, including total assets under management, biographies of key investment personnel, the firm's disciplinary history, and description of the firm's code of ethics. "Disclosures required of advisers registering with the SEC alone are without precedent in other regulated professions," said David G. Tittsworth, executive director of the trade group Investment Adviser Association. "Requiring other professions to disclose their fees—in and of itself—would generate major lobbying efforts to keep the heavy hand of government from bringing down the American system of capitalism."

<sup>1</sup> S&P 500® the Standard & Poor's index. For a graph of the S&P 500 performance since 1950, see <http://finance.yahoo.com/q/bc?s=%5EGSPC&t=my&l=on&z=l&q=l&c=>.

<sup>2</sup> Peter Schwartz, Peter Leyden, and Joel Hyatt, *The Long Boom: A Vision for the Coming Age of Prosperity* (Reading, MA: Perseus Books, 1999).

<sup>3</sup> James K. Glassman and Kevin A. Hassett, *Dow 36,000: The New Strategy for Profiting from the Coming Rise in the Stock Market* (New York: Three Rivers Press, 1999).

<sup>4</sup> Maggie Mahar, *Bull: A History of the Boom, 1982–1989* (New York: HarperCollins, 2003) and John Cassidy, *Dot.con: The Greatest Story Ever Sold* (New York: HarperCollins, 2002), quoted in Brent Goldfarb, David Kirsch, and David A. Miller: “Was There Too Little Entry during the Dot Com Era?” Working Paper RHS-06-029 (University of Maryland, Robert H. Smith School of Business, April 2006).

<sup>5</sup> McKinsey & Co., *Cracking the Consumer Retirement Code* (New York: 2006) 14; <http://www.mckinsey.com/client-service/banking-securities/latest-thinking/retirement.asp>.

<sup>6</sup> Cerulli Associates, *The Cerulli Report: Retail Registered Investment Advisers in Transition* (Boston: 2004), 69 et seq.

<sup>7</sup> Foundation for Fiduciary Studies, *Prudent Investment Practices: A Handbook for Investment Fiduciaries* (Pittsburgh, PA: 2004), 8.

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