The Age of Independent Advice

The Remarkable History of the Independent Registered Investment Adviser Industry

Chapter Five: An Industry Comes of Age

This is the fifth of six chapters excerpted from Schwab Institutional's book on the history of the RIA industry. The economic policies implemented during the Reagan era were at least partly responsible for the dramatic change in the U.S. economic picture during the 1980s and 1990s. These were also the decades when the baby boomer generation entered its prime earning years. These two booms—economic and demographic—powered an unprecedented expansion in market participation and propelled the striking growth of the independent adviser industry.

Within weeks of his inauguration in 1981, President Ronald Reagan declared that the United States was in "the worst economic mess since the Great Depression."[1] He quickly set about implementing policies he believed would turn the tide—chiefly tax cuts, a reduction of federal regulations, spending restraints, and a stable monetary policy. Known collectively, and sometimes derisively, as "Reagonomics," these policies were at least partly responsible for the dramatic change in the U.S. economic picture during the 1980s and 1990s. (In fact, some of the monetary policy changes had been initiated at the end of the Carter administration.) The economic malaise of the 1970s evaporated, inflation and interest rates dropped sharply, and the financial markets responded enthusiastically to Reagan's leadership. From their low point in August 1982, when the Dow Jones Industrial Average closed at 776.92, the markets began a vigorous and historic rally that lasted until 2000—the longest bull market in American history.

Not coincidentally, the 1980s and 1990s were also the decades when the largest demographic cohort in American history—the post–World War II baby boom generation—entered its prime earning years. Accustomed virtually since birth to being the center of media and marketplace attention, boomers approached investing with their characteristic blend of skepticism and self-assurance. "The boomers are uncompromising," observes Dan Leemon, Charles Schwab & Co.'s former chief strategy officer. "They think they could do anything if they only had the time, and they won't compromise between advice and control as much of the industry—from the discount brokers to the full-commission guys—has required them to do."

The two booms—economic and demographic—powered an unprecedented expansion in market participation. And more than any other stimulus to date, they propelled the striking growth of the independent registered investment adviser industry. Suddenly, there seemed to be a dizzying array of investment products from which to choose: not only the increasingly popular money market mutual funds, which had been introduced in the early 1970s, but also bond funds, equity funds, and the exciting new technology stocks. Investors who had first ventured into the markets in the 1970s, when banks were paying 5 percent interest and money market funds were paying double-digit rates, were now migrating to longer-term investments such as bond and stock funds, whose returns now outpaced those of the shorter-term money market funds. And boomer investors—whose self-image included the concept of "independent spirit"—were less likely than their elders had been to seek out traditional sources of investment advice. Instead, they turned in growing numbers to independent advisers, in whom they found the ideal combination of advice, comprehensive reporting, transparent pricing, and a sense of control in the form of performance measurement.

By 1983, the stage was set for independent advisers to play a significantly more important role in the industry. To make that happen, the profession would need accessible technology, a centralized exchange for no-load mutual

funds, and a new approach to financial planning. Within just a few years, all three needs would be met.

THE TECHNOLOGY SOLUTION

The first *deus ex machina* to come to the rescue was literally a machine: the IBM Personal Computer. Until its advent, independent advisers—who hadn't been able to afford the expensive mainframe computers used by large financial institutions—had been awash in paper. Information from clients, brokers, and custodians came into the office on paper forms and was processed by hand, transferred to other paper forms, and later consolidated and reconciled by hand. Many independent advisers had put their clients' investments into no-load mutual funds; lacking an electronic clearinghouse, they had to plow through paperwork required by individual fund companies every time shares in the fund were bought or sold. The work was slow and laborious—and it severely limited the number of clients an independent firm could serve.

The IBM PC, introduced in 1981, and its ever-more-powerful successors changed all that. The PC made quick work of portfolio accounting. Gradually, many advisory firms automated many of their primary functions, from financial planning to customer relationship management to asset allocation and account rebalancing.

One of those firms was Fisher Investments of Woodside, California, which manages assets for institutions and affluent individuals. Kenneth L. Fisher—who is also known as a *Forbes* columnist and the author of four books about finance—founded the firm in 1979 as a small independent shop. "When PCs emerged with rudimentary hard-disk drives," Fisher recalls, "you could see the potential to do things that before only a bigger firm could have done, and to provide a new level of professionalism. Before then it had been very hard for a little firm to grow—it was way too labor intensive and too hard to have a high degree of accuracy. The PC allowed us to think big. I remember sitting down with my wife and showing her on a marker board how I could eventually have $100 million under management. That seemed like a heck of a lot of money. That would be pretty good thing." As of March 2007, Fisher Investments has more than $37 billion in assets under management.

Although the IBM PC was not the first personal computer to run spreadsheet programs (the earlier Apple II and the Osborn had had their own versions), it popularized them among advisers. Spreadsheets automated the tedious item-by-item hand-calculations advisers had performed when they did financial projections for their clients. Joel Bruckenstein, a consultant on adviser technology issues and the publisher of *Virtual Office News*, an industry newsletter, recalls that "before commercial financial planning software existed, advisers simply designed their own spreadsheets." As the programs evolved, from VisiCalc to SuperCalc to Lotus 1-2-3 and eventually to Microsoft Excel, their capabilities and computing power grew exponentially.

But one critical task—portfolio accounting, which tracks which clients own which securities in which accounts—was not efficient for do-it-yourself spreadsheets. Indeed, portfolio accounting had for decades vexed independent advisers, especially those with individual clients. In many instances, a client household would have a portfolio of investment accounts—regular taxable accounts as well as tax-deferred retirement plans, IRAs, and annuities. There could also be trusts and custodial or college accounts for children and grandchildren. Before computers, advisers tracked this portfolio of accounts with manual entries in ledgers—or, by the 1960s, on three-by-five-inch index cards. It was far from a perfect solution. For one thing, the banks and broker-dealers that held client assets in custody provided only basic information. "All you typically got from a custodian was a statement of account, with your holdings and current values," says Bruckenstein. "They didn't track performance, cash flows, or the cost basis of your holdings for tax purposes. To do any of that you needed portfolio-management software."

Now, with the PC gaining acceptance, that software began to materialize. Early offerings of portfolio-management programs running on the PC's disk operating system included dbCAMS and Captools, and Advent's Professional Portfolio. In 1983, Stephanie DiMarco founded Advent Software in San Francisco, and the firm's Professional Portfolio product became the first portfolio-management software built specifically for the PC. A decade later in 1993, Advent redeveloped its core product for the Microsoft Windows operating system, branded it Axys, and it subsequently became the industry leader. Eventually,

portfolio-management systems became ubiquitous among independent advisers. In its 2006 study of advisory firms, the consulting firm Moss Adams found that portfolio reporting was the least likely of major advisory firm functions still to be performed manually.

Veteran independent advisers like Rick Keller, president of The Keller Group Investment Management of Irvine, California, remember the dramatic impact portfolio-management systems had on their businesses. "We brought in Advent's original portfolio-management solution, and that changed everything," Keller says. "We were able to produce client statements in a more timely manner. And when a client came in, instead of having to get on the telephone and call all the fund companies to give me the value of the client's accounts, I'd have it that morning from the previous day's close. It saved us a couple people, which was huge. I could have those people focus on value-added services instead of mundane bookkeeping chores."

SIMULATION, DIVERSIFICATION, AND OPTIMIZATION

Beyond simply keeping track of clients' investments, PC technology allowed advisers to bring a much greater degree of sophistication to their financial planning services and private-client investment advice. For the first time, they had the computing power to make complex calculations about asset allocation and portfolio diversification. Advisers could also simulate scenarios and project outcomes—all without leaving their desks.

It wasn't the theories that were new, only the tools. Modern portfolio theory, for example, had been developed in the early 1950s as a way to quantify the "don't put all your eggs in one basket" axiom. Portfolio-management theory showed how to measure the risks of various securities and combine them to produce optimal returns for an investor's level of risk tolerance, based on theoretical models. But it wasn't until the early 1990s that computer programs known as mean-variance optimizers brought portfolio theory within the reach of independent advisers. By the end of the decade, the software was advanced enough to generate recommendations based on specific client goals and circumstances.

How advisory firm functions are performed

	Packaged software	Custom software	Manually performed	Outsourced or automated
Portfolio reporting	56%	10%	10%	24%
Financial planning	59	19	19	3
Account aggregation	47	12	19	22
Accounts payable/ receivable	56	8	27	9
Client relationship management	57	10	32	1
Data storage/ document management	37	14	33	17
Trade confirmation processing	26	6	34	34
Asset allocation	35	24	35	5
Investment policy/ proposal generation	23	28	43	6
Account processing and rebalancing	26	15	45	14
Alternative investment planning models	11	16	58	14
Compliance	9	7	59	25
License and registration management	6	4	69	21

Source: *Financial Performance Study of Advisory Firms*, Moss Adams (Seattle: 2006), 46.

Note: Rows have been re-ranked in ascending order of the "manually performed" results.

During the early 1990s advisers gained a second powerful tool: Monte Carlo simulations. This statistical technique, first used during World War II when the atomic bomb was being developed, helps forecast the range and probability of future uncertain outcomes. The complexity of Monte Carlo models and the need to repeat the simulations

thousands of times require substantial computer power, which by the 1990s was finally available on desktop PCs. Independent advisers could use Monte Carlo models to estimate the probability that a client would run out of money during retirement, taking into account the client's age, life expectancy, current assets, spending rate, inflation, and the expected returns and risks of various investments.

Technology advances enabled advisers to do more than just serve clients more effectively. They also transformed businesses. The number of clients a small firm could serve grew by an order of magnitude, and advisers turned their attention to building their businesses.

THE CLEARINGHOUSE SOLUTION

Mutual funds had first gained modest popularity in the 1960s, during the last big bull market. Money market mutual funds, introduced a decade later, proved especially popular among investors and independent advisers alike, especially as yields rose in the early 1980s. Individual investors found no-load funds—which charged no commission on transactions—especially appealing, because all their money could go to work for them. But if they invested in more than one no-load fund, things got complicated. Investors in funds from six no-load companies, for example, had six phone numbers to call and six sets of statements to manage.

Brokerage firm Charles Schwab & Co., Inc., which served do-it-yourself investors, saw the problem as an opportunity. In 1984 Schwab launched the Mutual Fund Marketplace® to give investors a convenient place to buy and sell no-load funds from multiple fund companies. Customers received a single statement and a centralized platform with access to 140 no-load funds. (By 2007, the funds and fund families numbered in the thousands.) In exchange for the convenience, customers were asked to pay a small transaction fee for each trade, even though no-load funds could be purchased directly from each sponsoring fund company.

At first, Schwab did not aggressively promote the Mutual Fund Marketplace. The company advertised the service only through small weekly ads in an inside section of the *Wall Street Journal*. "We had mixed feelings," recalled John McGonigle, a Schwab senior vice president who in the mid-1980s was head of the firm's mutual fund business. "Because we were a discount broker, it was awkward for us to also be the world's most expensive place to buy no-load funds. So most of our clients didn't know we offered that service."

Do-it-yourself customers may have been slow to learn about Mutual Fund Marketplace, and reluctant to pay the transaction fee when they did learn about it, but independent advisers—in particular, those who charged fees rather than commissions—quickly grasped its advantages. Even more than individual investors, they were hampered by the lack of a centralized exchange through which to purchase no-load funds. "We were managing no-load mutual funds, but the assets were custodied at the individual fund companies," says David H. Bugen of Regent Atlantic Capital, an independent advisory firm in Chatham, New Jersey. "It was very cumbersome to reduce the allocation in one fund or stop using a fund and move to another fund group. First we had to get signature guarantees, then the check would go back to the client, and then the client would have to fill out another application."

Not surprisingly, some fee-only financial planning firms in effect threw up their hands; they limited their work to planning and didn't offer advice about security selection. "We used to tell clients, 'You need to invest the money in mutual funds, stocks and bonds, and other products,' " says Peggy Ruhlin, of Budros Ruhlin & Roe, an independent registered investment adviser in Columbus, Ohio. "Then we'd say, 'So, do you know any brokers? Why don't you go to one of them?' And clients would ask us, 'Why don't you guys do it?' Well, we didn't have the tools." When the firm finally agreed to help clients with investments, it had them open accounts with a number of no-load mutual funds, Ruhlin says. "They'd get statements from this fund company, that company, all the other ones. We would receive copies as well."

The paperwork burden was overwhelming. "We had only about ten clients," says Mary A. Malgoire, president of The Family Firm in Bethesda, Maryland. "But the volume of paperwork was so heavy that we couldn't deal with growing the business." Malgoire was an early president of the National Association of Personal Financial Advisors, whose members are fee-only financial planners. "I had what I thought was a great idea at the time," she recalls. "We had five or six no-load fund exhibitors at one conference. I got them all in a meeting and said, 'If you could create an

organization that would allow automatic transfers between your fund families for our clients, that would be so helpful. We would put our clients' money there and all the different funds would be available. That would just break this whole thing wide open.' And they all looked at each other and they said, 'Well, I don't want to be doing anything with other fund companies.'"

Malgoire's idea for automated transactions among no-load fund families was, in fact, what Schwab offered with its Mutual Fund Marketplace—an innovation now seen as a watershed in the history of independent advisers. "Prior to the 1980s there weren't any ways for investment advisers to deal with a handful of mutual fund companies," says Kurt Cerulli, president of the financial-services research firm Cerulli Associates. "It was the emergence of the service-agent platform, initially from Schwab, that enabled them to grow."

It worked like this: An adviser would instruct his or her clients to open brokerage accounts and transfer their investment assets to Schwab. The adviser would obtain legal authorization from each client in the form of a limited power of attorney allowing the adviser to make buy and sell transactions in the account. Advisers could manage the accounts with phone calls to Schwab. It was a huge advance, says David Bugen of Regent Atlantic Capital: "The consolidation with a centralized custodian enabled advisers and their staffs to become more efficient and more effective, and to spend more time on client issues as opposed to paperwork."

Interestingly, Schwab had not promoted Mutual Fund Marketplace among independent advisers. In fact, Schwab had had very little awareness of the advisers' very existence. The company discovered that some advisers were availing themselves of the new Mutual Fund Marketplace only after it conducted a review of accounts with limited powers of attorney. All of a sudden, advisers began to look like a very real business opportunity. After all, each adviser represented much more than a single new customer bringing one household's investment assets to Schwab. Rather, an adviser might bring the assets of fifty or a hundred households—often wealthy ones. The idea of providing custody, trading, and related services to these advisers began to seem very attractive. Even more attractive was the fact that no major competitors had an eye on the business.

"We saw an expansion in the number of startup investment advisers—firms with $10 million to $50 million," says Jim Hackley, a former Schwab senior vice president closely involved with the launch of the company's adviser business. "These shops were too small to interest an institutional custody provider. Nobody other than Schwab seemed to want their business, much less seek it out. For the most part we serendipitously jumped on a wave as it was surging."

Actually, it wasn't quite that simple. Schwab's computer systems were set up for individual customers. They could not recognize or handle groups of customers that needed to be aggregated for trading and recordkeeping purposes. It took more than two years, and a substantial financial investment, to develop the kind of accounting, known as master/sub, that could accomplish this task. By this time, PCs for data communications were well established, and Schwab began work on SchwabLink®, a system enabling daily downloads of client account information directly into the PCs and portfolio-management programs of independent advisers.

In 1985, Schwab opened its custody business for advisers, originally known as Financial Advisors Service; the formal launch was in 1987. (In 1993, the business was renamed Schwab Institutional® to better reflect the services offered to investment managers.) It owed its success to service, technology, and Schwab's willingness to listen to and learn from advisers looking for a better way to buy mutual funds. "In the beginning, we didn't know anything at all about their business," admits John Philip Coghlan, a former president of Schwab Institutional. "So we sat down with advisers and asked questions about the problems in their business. We'd hear, 'I'm drowning in a sea of paper as I grow my business. I can't even add people fast enough, nor can I pay them to keep up with this exponential avalanche of paperwork and forms that I'm creating.' By being completely ignorant about a potential new business that was right there in front of us, we created an entirely new approach to the business. It was all about asking questions—and listening to the answers." One thing Coghlan and his Schwab colleagues discovered was that "once a quarter many advisers had to shut down their offices for three days to a week to send invoices to their clients. And every quarter clients had an opportunity to say, 'I don't know, this quarter I just really

don't feel like writing this check. The performance wasn't as good as I've seen in the past.'" To address this problem, Schwab developed client-authorized direct debiting of advisers' fees from client accounts. "Once we learned about the problem, we were able to move quickly to fix it," says Coghlan.

Mary Malgoire remembers the pace at which Schwab rolled out enhancements to its new adviser platform. "I was one of the first members of the Schwab advisory board," she says. "It was an interesting experience because they were really tapping us: 'What do you guys want? We'll put it together. We'll make it happen.' We said, 'We want more funds. We want transfers to go faster. We want to be able to buy a bond.' Schwab was picking our brains and then moving on it. And they moved fast."

The industry began to change perceptibly as leading independent advisory firms adopted Schwab's platform. "Investment advisers in the mid-1980s started to get much more powerful thanks to the service-agent platforms," says Kurt Cerulli. "They stopped being a sleepy cottage industry and started to emerge as an alternative to large, established competitors."

In those early years, Schwab had the independent adviser business to itself. "Schwab was very much the Henry Ford of brokerage firms," says Coghlan. "You could have any color you wanted as long as it was black. Schwab had this single transaction-processing machine, and it did wonderfully on investments that could be run right through the machine. So stocks were fabulous through that machine, and later options. Mutual funds required a very different system, but Schwab made the necessary [technology] investment. But anything that didn't fit within the basic 'factory' model was more of a challenge. And advisers, because they were knowledgeable and because they had access to other investment opportunities, wanted Schwab to be able to handle those other assets. Schwab recognized that one of its strengths was this fabulous scale. And yet the adviser business required a customized approach that took the scale out of the system."

MUTUAL FUND ONESOURCE: THE KEY TO GROWTH

By 1992, when Schwab launched its next major innovation, Mutual Fund OneSource®, independent advisers were no longer a minor, overlooked constituency. On the contrary, they played an important role in the development and eventual success of Mutual Fund OneSource.

Mutual Fund OneSource had a straightforward yet radical mission: to offer no-load mutual funds without a transaction fee. The fund companies paid Schwab an asset-based fee for transaction, recordkeeping, and shareholder services it provided; customers paid no transaction fees. To entice "star" funds into the program, Schwab invited only the top twenty fund families as measured by Schwab client assets in the Mutual Fund Marketplace, and gave them an exclusive contract.

Advisers welcomed the new service, and their enthusiasm encouraged more no-load fund companies, which initially had been reluctant, to participate. "When we first approached the no-load fund companies and said, 'Look, if you pay us so we can eliminate the transaction fee, we'll do a lot more business,' they were lukewarm," says John McGonigle. "They asked us, 'Why should we pay you to get between us and the customers?' But they also saw that the adviser business was beginning to grow and become more important. Through Mutual Fund OneSource, they had a way to appeal to advisers. And so they said, 'OK, we'll sign up.' It's clear to me that Mutual Fund OneSource never would have happened had we not already had the independent adviser service."

One no-load fund executive who was quick to spot the advantages of Mutual Fund OneSource was Peter Sundman, now president of Neuberger Berman Funds. Still, he admits that the concept "was a very tough pill to swallow" at first.

"I remember vividly the day [the Schwab team] came into our offices and said, 'All right, tonight's your final shot,'" Sundman says. "'We've got five [fund] companies and we're going to go live with them.' My boss didn't think we could take that kind of a hit to revenue. He politely kicked the guy from Schwab out of his office. I got our CFO and a few other senior people from Neuberger and started arguing. I said if it was a 50 percent cut to our revenue, 50 percent on a much bigger number still meant a lot of

revenue. And that if we didn't do this, we were going to be left on the sidelines.

"I could clearly see from my dealings with independent advisers that Mutual Fund OneSource was going to change the world. And in the end we called the guy from Schwab in his hotel room and signed on as the sixth fund company in that original grouping.

"My boss had said, 'All right, big shot, what do you think the number is?' I said, 'If they're successful, we could raise several hundred million dollars on the platform.' Little did I know that in three years we'd have billions."

As fund companies signed up for the no-transaction fee program, independent advisers stood in the middle of a virtuous circle of accelerating growth. "All of a sudden our offering to advisers, and therefore their offering to *their* clients, became more powerful and more appealing, and so they grew," says McGonigle. "That growth benefited us as well as the fund companies that had signed up early. So more fund companies wanted to sign up, and the next thing we knew we had a thousand funds in Mutual Fund OneSource."

At that time three lines of business accessed the Mutual Fund Marketplace and Mutual Fund OneSource: retail, 401(k), and advisers. "Advisers were my most important clients," says McGonigle. "I spent as much time as I could with them understanding their needs and wants. I paid some attention to retail and some attention to 401(k), but I focused on advisers, because they were doing this full time. They were students of the game. They knew what they wanted and they were at the leading edge. If I could evolve the Mutual Fund Marketplace to meet their needs, two years later I would have what retail needed, and the next year I'd have what 401(k) needed. So I was really focused on helping those advisers."

Before long, other providers took note of Schwab's success and looked for ways to emulate it. Among the firms that introduced custody offerings for independent advisers in the 1990s were Jack White & Co., Waterhouse Securities, and Fidelity Investments. "Whether through market research or from observing Schwab, Fidelity had a strategic intent to get into the adviser business," says Jay Lanigan, former president of Fidelity Registered Investment Advisor Group, who had been with the firm since 1980 and joined its investment adviser group in 1993, a year after Fidelity launched its advisory business. "We'd started it as part of our retail brokerage business, but by 1993 we decided to focus on our adviser business as part of our institutional business. At that time, we had $400 million in custodied assets for advisers—really quite small. By the time I left the company, at the beginning of 2005, that figure had grown to $140 billion. It's now well over $200 billion."

Lanigan and others in the industry agree that technology has been a key component of the custodial business. "The custodians in this industry are continuing to come out with better and better technology," says Tom Bradley, president of TD Ameritrade Institutional, the successor organization to the adviser businesses at Jack White and Waterhouse. "All our platforms are living entities. We're constantly making enhancements to them. What started as an interface to some portfolio-management systems has blossomed into full-blown platforms that enable advisory firms to run incredibly efficient and effective businesses."

FINANCIAL PLANNING AND MONEY MANAGEMENT JOIN FORCES

The third dramatic change in the independent adviser industry occurred among firms offering financial planning. Though the number of financial planners grew rapidly in the 1980s, financial planning itself was not turning out to be a highly remunerative profession. Planners typically charged fees for what amounted to very technical, labor-intensive work gathering large amounts of information about their clients' finances, analyzing it, and preparing detailed recommendations. Financial plans tended to be one-time-only sales; the client was unlikely to purchase a second plan. And while in a perfect world planning would be an ongoing process, many clients were unwilling to pay a retainer fee for continuing advice. "As financial planners, our earnings were limited by the number of plans we could do," recalls Elaine Bedel, president of Bedel Financial Consulting, an independent advisory firm in Indianapolis. "You could build a firm if you kept leveraging yourself, but you were still limited."

Of the 7,000 financial planners registered as investment advisers in 1987, only 2,100 said they provided money-management services, according to a 1988 Securities and Exchange Commission report. "A financial planner usually does not manage client assets," the study reported.

"Instead, the planner's primary service is to prepare a financial plan for the client, and to offer advice as to the purchase or sale of specific financial products appropriate to the implementation of the plan."[2]

Financial planners generally fell into two broad business types: those working on a commission basis and those who were fee-only planners. Commissioned planners typically operated as representatives of independent broker-dealers. Sometimes they also had their own registered investment advisory firms while offering commissioned products through their broker-dealer affiliates. Fee-only planners, in contrast, did not accept commissions and operated solely as independent registered investment advisers. They generally implemented their plans with no-load products. As the SEC report noted, "With some financial planners the process ends with the presentation of a financial plan, for which the planner is compensated by a fee. In the more typical situation, however, once the client is presented with the plan, the implementation of the plan includes the purchase of investment or insurance products specifically recommended by the planner. Thus the planner may be affiliated with a broker-dealer, or with an insurance company, or both. And the planner's remuneration for the client may come more from commissions on the sale of products than from fees generated by the presentation of the plan."[3]

Indeed, implementation was the way most financial planners were able to stay in business. According to Dr. William Anthes, president of the College for Financial Planning during the 1980s, "If you can combine the planning process with implementation of that process, the chances of your being more successful are going to be much higher. It's a lot easier for an individual or firm to be viable if they can link the planning process with the step that involves implementation."

Before the spread of back-office technology at independent firms, implementation for most financial planners meant having a broker-dealer affiliation and a commission-based business model. Broker-dealers provided support and investment products to their independent commissioned planner representatives, while fee-only advisers were on their own. As a result, most financial planners at the time worked on commission. "Being a fee-only financial planner was very rare," recalls Bedel. "When I first opened my own shop, people around the country told me, 'You're a fool, Elaine. You're leaving all this money on the table [by not taking commissions].' And they probably were right, but it just wasn't comfortable for me. I came through a fee-only route to doing financial planning, where many others came from the insurance industry or the brokerage industry, and charging commissions was just part of what they did."

Then came desktop computing, and with it a transformation of the financial planning business. Thanks to computers, commission-based planners no longer needed the support of their broker-dealer affiliates and could operate solely as investment advisers. This freed them to base their businesses on asset-based fees and enabled them to become truly independent in terms of their operations and the products they recommended for clients. Sometimes, this transition would take a number of years, as it did for Moneta Group Investment Advisors of St. Louis, Missouri. (See the company history on page 10.) But the effort was widely seen to be worthwhile.

As independent advisory businesses became more viable, brokers at large full-service firms began migrating to it. The trend began slowly but grew steadily throughout the 1990s and early 2000s.

The back-office capabilities inherent in desktop computing had another beneficial effect: they made it possible to combine financial planning and money management profitably under the same roof. Asset-based fees from money management services supported ongoing financial planning and made possible a level of profitability that assured success. "People with financial planning backgrounds had been charging, say, $2,000, to develop a financial plan for a client—a book that then sat on the client's shelf," says former Schwab Institutional president Coghlan. "Clients began to realize that they wanted help in implementing the plan's recommendations. And advisers, in turn, asked themselves: 'Do I want to sell a $2,000 book to one client and then look for somebody else to sell to? Or would I rather take care of the first client's bigger investing problem and be paid on a regular basis as the assets grow?'"

Handling investments enabled firms to expand their range of offerings. Financial planners who catered to wealthy customers came to be known as wealth managers, offering services such as estate planning, tax planning and preparation, asset-protection planning, sophisticated investment strategies, advice to business owners, assistance to clients in philanthropic activities, and even family office services such as property management and travel planning. Firms that started as small planning shops eventually found themselves topping the $1 billion mark in assets under management.

No single factor accounts for the remarkable recent growth of independent advisers, notes Peter Sundman of Neuberger Berman Funds. “The Schwab platform enabled financial planners to take it to that next step and implement for clients,” he points out. “But more significant in the end was the fact that advisers could get paid a percentage of the assets rather than an hourly or flat fee. That’s what made the industry really take off.”

Harry Markowitz: Pioneer of Modern Portfolio Theory

In 1952, Harry Markowitz, a 25-year-old economist with the RAND Corporation, published an article called “Portfolio Selection” that examined the effects of risk and diversification on portfolio returns. The article became the cornerstone of modern portfolio theory (MPT), which says that portfolio diversification reduces risk and enhances expected return over time—a concept that seems obvious today but was revolutionary when Markowitz introduced it.

Markowitz had never intended to become an economist. Growing up in Chicago, the son of grocery-store owners, he enjoyed reading popular physics and astronomy. In high school he read Charles Darwin’s *The Origin of Species*, which impressed him with its “marshaling of facts and careful consideration of possible objections,” as he later put it. He also began reading the works of serious philosophers, including David Hume, who observed that “though we release a ball a thousand times, and each time, it falls to the floor, we do not have a necessary proof that it will fall the thousand-and-first time.”

During his first two years at the University of Chicago, Markowitz studied philosophy. He settled on economics only as an upper-division student. His instructors included four giants in the field, all of whom influenced him greatly: Milton Friedman, Jacob Marschak, L. J. Savage, and Tjalling Koopmans.

Markowitz later wrote that the basic concepts of portfolio theory came to him one afternoon in the library while he was reading John Burr Williams’s *Theory of Investment Value*, which proposed that the value of a stock should equal the present value of its future dividends. “But if the investor were only interested in expected values of securities,” Markowitz wrote, “he or she would only be interested in the expected value of the portfolio; and to maximize the expected value of a portfolio one need invest only in a single security. This, I knew, was not the way investors did or should act. Investors diversify because they are concerned with risk as well as return. Variance came to mind as a measure of risk. The fact that portfolio variance depended on security covariances added to the plausibility of the approach. Since there were two criteria, risk and return, it was natural to assume that investors selected from the set of Pareto optimal risk-return combinations.”[4]

In 1990, Markowitz and two colleagues were awarded the Nobel Prize in economics for their work in this area. Today, portfolio managers everywhere routinely use techniques based on Markowitz’s insights.

Moneta Group Investment Advisors: Evolution of an Industry Leader

Like many other advisory firms, Moneta Group Investment Advisors of St. Louis, Missouri, began life as something else entirely—in this case, a company handling employee benefits, insurance business, and planning for physicians. Its evolution into a large independent investment advisory and financial planning firm is the history in microcosm of the investment adviser industry.

The story begins in 1974, when Peter Schick left the Air Force and joined his father at the firm in St. Louis. Schick’s approach, popular at the time, was called needs-based selling, a precursor to financial planning in which the salesman prepares a profile of the client and calculates the appropriate amount. “The problem,” said Moneta Group president Joe Sheehan, “was they couldn’t get over thinking that once a sale was made, they were done. In fact, financial planning has to be an ongoing process.”

The seeds of transformation were planted in the early 1980s, when Schick heard a presentation about a multidiscipline financial planning practice and decided to implement the concept at Moneta. By 1986 the firm had added CPAs, an attorney, and a trust officer to its staff and was doing comprehensive financial planning.

Moneta Group’s second big change occurred after one of its new CPAs, Jay Ring, attended a Chartered Financial Planning conference. He proposed to Schick that Moneta start charging fees for advice—which meant the firm would have to become a registered investment adviser. It took some persuading, but in the end Schick paid what Sheehan calls “the whopping sum of $15,000” to form a registered investment adviser, Moneta Group Investment Advisors. *Moneta* is the Latin word for a mint in which coins are made.

The notion that clients would pay for advice wasn’t an easy sell, Sheehan says. Some principals left the firm. In response, “Peter began recruiting people who were more interested in providing advice and long-term financial planning and less interested in transaction selling,” said Sheehan.

“In the very early days we would put half the client’s money in commissioned products and half into non-commissioned products, charging a fee on the non-commissioned products,” Sheehan recalled. “It was a challenge: the no-load funds didn’t recognize us, and we had no central custodian, since our broker-dealer would not hold no-load funds.”

One of the Moneta principals went to a Schwab convention and discovered that Schwab would act as custodian for the firm’s no-load business. “Next we learned about Axys, the portfolio-management system from Advent,” Sheehan said. “Those two advances allowed us to expand our ability to provide service, information, and advice.” Although slow to take effect, the change was dramatic. “Productivity went through the roof,” Sheehan said. “All of a sudden, all those investment issues became scalable.”

In the mid-1990s Moneta Group’s revenue was 85 percent from commissions and 15 percent from fees, says Sheehan. “Today it’s 100 percent fees. And we have $6.2 billion in assets [as of April 2007]. The reinvention of Moneta Group turned out to be a pretty good deal.”

1. “The 36¢ Buck Stops Here,” *Time*, Feb. 16, 1981.
2. U.S. Securities and Exchange Commission, *Financial Planners: Report of the U.S. Securities and Exchange Commission to the House Committee on Energy and Commerce’s Subcommittee on Telecommunications and Finance* (Washington, DC: 1988), 7.
3 Ibid.
4. Quotes are from Markowitz’s autobiographical statement on the Nobel Prize Web site, http://nobelprize.org/nobel_prizes/economics/laureates/1990/markowitz-autobio.html.

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