

The Age of Independent Advice

The Remarkable History of the Independent Registered Investment Adviser Industry



Chapter Six: At the Crossroads

This is the last of six chapters excerpted from Schwab Institutional’s book on the history of the RIA industry. The confluence of events of the late 1990s and early 2000s marked a turning point in the independent advisor industry. Today, the industry is experiencing unprecedented growth with robust and innovative diversification in business models and investment offerings. While there are challenges ahead—developing new advisor talent, growing competition, managing growth, succession and transition of firms as advisors themselves begin to retire—the future of the industry is bright.

First, devastation. Then—silence.

The trading floor of the New York Stock Exchange, usually frenzied on a weekday morning, was empty and echoing.

The computers at NASDAQ, which had glowed nonstop during the recent dot-com boom and collapse, were dark.

The bond markets stopped trading. The telephones of stockbrokers, investment bankers, and financial advisers stopped ringing.

On the morning of September 11, 2001, as the twin towers of the World Trade Center burned and collapsed, shock waves reverberated from lower Manhattan to the rest of the country—and the world. Just blocks from Ground Zero, Wall Street virtually shut down, crippled by damage to communication systems and stunned by the loss of hundreds of financial services employees whose offices were destroyed in the attacks.

The stock and bond markets opened briefly that Tuesday morning, then closed. The New York Stock Exchange remained shuttered for three more business days—only the third time in history it had been closed for so long, and the first time since 1933. When Wall Street did return to work, the stock indices betrayed the nation’s fear and concern, closing sharply down.

For anyone working in the financial markets—or investing in them—it was a dark and anxious time. Patriotic displays and the Bush administration’s quick military response in

Afghanistan helped rally spirits, but investors, already sobered by the bear market that had begun in 2000, remained wary.

Economic recovery was slow and incremental, hampered by ongoing concerns about terrorism and the challenges of military involvements in Iraq and Afghanistan. Investors in particular had reason to worry: in the early years of the new century Wall Street was still reeling from the collapse of the dot-com economy; the implosion of high-profile companies such as Enron, Tyco, and WorldCom; and the loss of several trillion dollars in stock values that followed. Beginning in 2002 the financial community faced a new challenge: a series of investigations, most notably by New York attorney general Eliot Spitzer, into the practices of mutual fund companies and investment banks. Hundreds of lawsuits were filed against securities houses whose analysts had allegedly misrepresented stocks during the bull market. There was political uncertainty as well, as President Bush’s popularity dwindled from its post-9/11 high and the country prepared for a contentious 2004 national election.

In the end, corporations and investors proved surprisingly resilient. The wave of scandals, and the resulting legislation and regulation, forced companies to tighten their governance and increase their internal controls. Investors, toughened by recent experience, learned to adapt to more frequent bad news at home and abroad—changes in the terror “threat level,” higher oil and gas prices, the 2004 Madrid bombing, the 2005 London transit attack, the

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December 2004 tsunami in Indonesia—without fleeing in panic. The stock markets began to turn around in October 2002, but it was not until after a new, steep downturn in March 2003 that a new bull market commenced in earnest.

Among those who helped guide the recovery's course were independent advisers, whose prudence and moderation had been a steadying force throughout the “new economy” mania of the late 1990s. A confluence of trends had propelled them to the forefront, making their profession one of the fastest-growing sectors in financial services. New business models, including the emergence of the wealth-management specialty, and new types of investments gave independent advisers greater flexibility in their services. The Internet—responsible for so many lost fortunes at the end of the twentieth century—turned into a tremendous boon for independent advisers and their clients. A huge population of baby boomers, now entering their fifties and sixties, brought their iconoclasm and skepticism into independent advisers' offices, seeking guidance from professionals who didn't fit into the “big business” mold. And as global markets continued to expand, the independent advisory profession found new markets around the world, in countries as disparate as China and Australia.

For a century that had begun in flames and fear, it was looking like a very promising era indeed.

GROWTH AND DIVERSIFICATION

The most obvious indication of that promise was statistical. In 1999, according to research done by Cerulli Associates, 11,728 independent adviser firms were registered with the SEC or with state agencies. After several years of modest growth, the number shot up to 13,920 in 2003; by 2005 it had reached 15,540. “The independent advisory industry has quietly grown into a financial powerhouse over the last 25 years,” observed the authors of a 2005 study conducted by J. P. Morgan Asset Management. “Driven by an exploding demand for non-conflicted, competent financial advice and further fueled in its earlier years by a roaring bull market, independent advisers today control over \$1 trillion of assets.”¹

But numbers told only a small part of the story. Even more important to the industry's success has been a robust and innovative diversification in business models and offerings. Not only are there more types of advisory firms than ever

before, in a greater variety of specializations, but—happily for the industry and its clients—all of them are flourishing.

The trend began in the late 1980s, when some independent advisers began combining financial planning and money management into a single service. Now other business models emerged. Some firms emphasized financial planning and delegated investments to outside money managers, others did the reverse. Some, in particular the new category of advisers known as wealth managers, developed and implemented financial plans, working directly with clients to select individual securities and funds and making referrals to outside experts as needed.

Other independent advisers have chosen to provide neither financial planning nor money management, operating instead as investment consultants. Like institutional pension consultants, they offer their affluent and sophisticated clients comprehensive investment-management services, including evaluating, selecting, and monitoring outside money managers. They may also offer estate and tax planning, assist clients in developing investment policy statements, and prepare asset-allocation plans.

Yet another type of independent adviser is the money manager who serves individual clients (and sometimes institutional clients such as pension funds and endowments). Some money managers apply specific portfolio strategies to all their clients—for example, investing for small-cap value or large-cap growth—while others create portfolios customized for each client's unique situation. The latter group includes firms that operate in the same manner as investment counselors, the original form of independent advisory firm that emerged in the 1920s. The direct relationship with the manager adds value, said Doug Lane, head of Douglas C. Lane & Associates in New York City:

You're dealing directly with the people who are making the decisions on the stocks, doing the research, and handling your portfolio. People worth \$1 million or \$2 million get tired of mutual funds. They want to own a portfolio of individual stocks. They should have a direct relationship. We think it's an advantage if the people who are doing the research know the clients, because then they'll find better companies for them. And communications and performance will be better because of that direct relationship.

Increasingly, however, many independent advisers see themselves not as portfolio managers but rather as financial quarterbacks for their clients, coordinating services from a range of specialists who may include lawyers, accountants, and portfolio managers. This is the service-delivery model employed by advisers known as wealth managers. They are among the most successful of the independent advisers—some now have more than \$1 billion in assets under management—and their numbers are growing rapidly.² They offer affluent clients comprehensive, integrated menus of services, including financial planning, investments, tax planning, estate planning, and much more. “Wealth management includes financial planning, but it’s much broader in scope,” said Tim Kochis, president of the San Francisco wealth-management firm Kochis Fitz and author of *Wealth Management: A Concise Guide to Financial Planning and Investment Management for Wealthy Clients*.³

It includes implementation steps for the plan and particularly the management of investment portfolios all as part of a package. Ten years ago it was an avant-garde term. Now everyone uses it. I think eventually it will be considered the optimum service offering from the standpoint of the consumer.

Each wealth management firm sets a balance between the services on its own payroll and the services it refers to others, optimizing for the most successful and cost-effective client relationship. For a small wealth-management firm, referrals make good sense financially and strategically. If a client wants tax preparation, for example, a conscientious adviser doesn’t hand over a list of accountants. Rather, he or she refers the work to an accountant while controlling and coordinating the relationship, stipulating that the accountant not solicit business from the advisory firm’s clients without permission. The firm is able to expand its service menu without building another costly capability.

According to a benchmarking study of more than twelve hundred independent advisers performed in 2006 by Schwab Institutional, the wealth-management segment is growing at roughly the same rate as financial planning and money management, and large firms are growing at the same rate as small firms.⁴ “What does vary,” noted former Schwab Institutional president Deborah Doyle McWhinney, “is the growth rate of the fastest-growing firms.” Those firms are growing at double the rate of their peers for three

reasons, McWhinney said: they are well managed, with business strategies focused on a distinct group of target clients; they’ve built scale into their businesses, allowing them to grow efficiently; and they’ve built “a solid discipline around how they approach marketing and business development.” The ability to focus on the needs of specific clients—whether it’s wealth management, retirement planning, or investment consulting—is the most salient of the three factors, says McWhinney.

Accompanying the growing diversity of adviser types has been a wider range of investment offerings. Some advisers use a variety of actively managed funds, some use index funds, some use a single family of funds, and some use individual security portfolios tailored to the individual client. Other advisers are introducing an even wider variety of investment vehicles, including structured products, venture funds, real estate, or even insurance products.

Structured products have been an increasingly popular option, said Tom Winnick of DWS Scudder Mutual Funds, which provides such products to independent advisers. Structured products are hybrid investments that may combine a fixed-income return with an equity return from a derivative, such as an option based on a stock index or commodity index. Some include a fixed rate of return or other characteristics that make them attractive to certain types of investors. “Part of our job is to augment the product lineup of the independents so that they can provide the right solutions to their clients no matter how wealthy they may be,” Winnick said. Jay Lanigan, former president of the Fidelity Registered Investment Advisor Group, said custodians have improved their ability to deliver such products to independent advisers. “They’re now focused on upgrading their delivery of the whole gamut of alternative investments,” Lanigan said. “The advisers are going to be able to offer anything that their larger competitors have in their product lines.”

TECHNOLOGY: THE NEXT GENERATION

Beginning in the 1980s, powerful new technologies such as portfolio-management programs from Advent, Schwab Performance Technologies®, and other companies helped independent advisers enhance their services. Since then, continued advances in computational power have enabled them to keep improving their efficiency. Data aggregation, for example, allows advisers to consolidate client financial data from outside sources and to automatically generate

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complete financial statements with balance sheets and income statements. Customer relationship management systems help advisers stay in touch with clients, monitor workflow and quality control, and meet important deadlines. Paperless office technologies enable documents to be filed, stored, and retrieved electronically. “You’re not necessarily seeing the death of paper yet,” said Joel Bruckenstein, a consultant on adviser technology issues and the publisher of *Virtual Office News*, an industry newsletter. “But you are already starting to see a slow death of the copy machine, because in most cases today cutting-edge advisory firms are scanning everything into the system and if they need a copy they just print it.”

No single technology development has been as influential as the Internet, which changed the way advisers accessed and used the technology itself. As services moved online they became cheaper and more flexible, scalable, and reliable. Broadband technology dramatically increased the speed of communications between independent advisers and their service providers. As a result, services delivered via the Internet moved well beyond basic desktop-computing services such as portfolio accounting and trade-order management that advisers had adopted in the early days of PCs. For example, Schwab and other service providers now use the Internet to deliver statements, trade confirmations, market research, prospectuses, and compliance and regulatory notices. Automated Internet-based systems also alert advisers to wire transfers of funds in and out of client accounts to satisfy client financial obligations.

“Today an adviser can’t be in business without being on the Internet,” said Bruckenstein. “Typically, advisers are now communicating with 80 to 90 percent of their clients at least occasionally by e-mail. Five years ago that number was as little as 25 percent.”

Beyond e-mail and data transfer, some independent advisers are using online collaboration and Web conferencing technologies to provide personal service. Collaboration capability, built into some financial planning programs, allows two people to work on the same document from different locations. Web conferencing technology offers an efficient way to stay in contact with clients without having to travel to meetings.

Thanks to the Internet and 24-hour financial broadcasting, investors today have more access to market information than ever before. They expect their advisers to have similar access—and to act on it. As clients continue to demand that their advisers provide them with regular updates, advisers in turn will demand that service providers deliver information in real time, with customization options that allow greater flexibility for specific client requirements. Technology will play an increasingly important role in narrowing the gap between data and action, while at the same time allowing advisers to work more efficiently and profitably without adding extra staff.

THE NEW FACE OF RETIREMENT

Joel Bruckenstein’s speculation is likely to become a certainty as technologically savvy baby boomers enter retirement. The 76 million people born between 1946 and 1964 currently control an estimated \$15 trillion in assets.⁵ The first wave of the biggest-ever generation will reach age 62 in 2008, and boomers will continue to enter retirement over the next two decades. Serving their financial needs will be big business, and advisers need to prepare, says Kurt Cerulli, president of the Boston financial services research firm Cerulli Associates.

The issue on investors’ minds is shifting from “How do I accumulate enough for retirement?” to “What do I do with it and how do I structure it properly so that I generate the income I need to live on?” Everyone is struggling with that issue, and independent advisers need to position themselves to offer those kinds of services. It’s an area where they could do well because they’re good at customized, personalized guidance and advice. They need to be positioned for those assets because that’s where the growth is going to be.

The coming retirement boom represents both a challenge and opportunity for advisers. For one thing, retirement will be longer, riskier, and more complex for baby boomers than for previous generations. It’s “uncharted waters,” said David Hunt, managing director of the consulting firm McKinsey & Company—and not only because of “the demographic bulge”:

Retirement today is different because of the change in the structure of the retirement and pension system. The demographics simply underscore the change. We have seen a massive shift of risk from Social Security and defined-benefit pension plans to individuals and defined-contribution plans.

And then there's the dramatic change in health care, both in government and in the reduced number of companies offering medical plans to their retirees. It adds up to a set of risks—investment risks, health care risks, inflation risk, and counterparty risk related to whether or not your defined benefit plan will survive—that my father, when he retired, couldn't have dreamed of.

The process of retirement has changed, too. No longer a single definitive moment that culminates with a handshake and a gold watch, it's more likely to be a gradual transition over several years, from full- to part-time employment and finally full retirement much later than the traditional age of sixty-five. Financial firms understand this trend but many have yet to adapt to it, a recent McKinsey study observed.

They still operate under the old definition of retirement, with one set of options for workers and another for retirees. The new definition of retirement means people entering the transitional phase will have more complicated needs. This raises the bar substantially for advisers, if they are to become the credible, trusted financial guides that their clients will seek.⁶

Among those “more complicated needs” is the need to adjust investment goals from aggressive growth to risk mitigation. Investors' risk tolerance changes dramatically as they move from working life to retirement and begin to confront higher medical costs and the very real possibility of serious illness. Advisers can play an important role in protecting their clients from catastrophic risk during retirement.

This means independent advisers will be busier than ever in the decades to come. Without corporate pensions to support them, retired clients will need more advice about making good investment choices. “There's an inflection point when someone stops working,” said Dale Yahnke of Dowling & Yahnke in San Diego.

They've been getting W-2 income their whole life. They've done a great job of saving and they have enough money. But it's hard, psychologically, for people to stop working and say, “OK, I'm just going to passively take money out of my savings account.” It's a tough barrier to get over. There are a lot of people who aren't very comfortable with that, even though they have enough money.

Post-retirement counseling is more complicated than advising clients during the years they are working and accumulating assets. Retirees need help calculating and managing mandatory withdrawals from retirement accounts and in making quarterly estimated tax payments. They may need reverse mortgages or income annuities, and they may want to make charitable gifts whose structure may require advisers to turn to outside specialists. Independent advisers may have to answer questions about Social Security, Medicare, long-term care insurance, and lifestyle options.

All these services represent a tremendous growth opportunity for independent advisers, said Deborah Doyle McWhinney. “The independent adviser industry is ideally poised to capture more and more affluent investors,” she said. “Not only are investors focusing more on retirement planning, but according to the McKinsey research, the next two generations of retirees are two to four times more likely than their parents were to use an adviser for retirement planning.”

Along with the opportunity comes formidable challenges. For example, financial planners disagree about the maximum sustainable long-term withdrawal rate from investment portfolios. Some say it's 5 percent or more; others consider a 3 or 4 percent withdrawal rate to be safer. Better and more sophisticated tools for retirement income planning are clearly needed. A second challenge will come from clients who haven't saved enough during their working years to have a comfortable retirement. In addition, advisers will need to balance their retiree client base with younger clients to ensure consistent—and consistently growing—assets under management.

GLOBAL EXPANSION

The need to offer guidance to a large population on the brink of retirement isn't exclusively an American phenomenon. The independent adviser model is finding fervent advocates around the world, often in places that would have seemed improbable just a decade ago. In 2006, when the number of Certified Financial Planner (CFP) professionals topped 100,000 for the first time, half of those planners worked outside the United States. And the growth rate of CFP professionals is faster overseas than in the United States. “The trends that drove a lot of interest in financial planning in the United States are the

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same ones driving it around the world,” said Noel Maye, chief executive of the Financial Planning Standards Board, which licenses Certified Financial Planner professionals outside the United States.

Governments and employers [overseas] are moving away from guaranteed employment and guaranteed pension schemes. People are living longer and products and services are more complicated. The changes have made people realize, “We’re going to be more personally responsible for our own financial future.” So they need advice.

Nowhere has the shift from cradle-to-grave protection to individual responsibility been more striking than in China, where interest in professional financial planning services has exploded in the last few years. China’s central government still exerts extraordinary influence: four state banks control 80 percent of the country’s financial assets, and the country had no stock exchange between 1949 and 1990. Yet vigorous economic growth—10 percent a year for the last thirty years—has created a huge pool of new wealth and a corresponding demand for financial planning. In response, China started its first CFP certification training program in 2004, with three classes and 188 students. The following year 1,500 people enrolled; in 2006 that number grew to 10,000. And by the end of 2007, said Feng Liu, deputy secretary general of China’s Financial Planning Standards Council, the number of CFP professionals in China will probably reach 2,000. The number of Associate Financial Planner certificants (the first level in the two-level CFP program) will reach 15,000. Most CFP professionals in China work for major banks, which have enthusiastically supported the financial planning movement. But the profession’s expansion is constrained by a lack of qualified instructors for CFP certification-education classes. “The demand is so huge, if I had the capacity I could recruit 100,000 people for the program,” Feng said. “But we want to maintain the quality of the program, so we need good instructors. Our other challenge is how to provide continuing education for licensed CFP professionals. What kind of content, and how do we organize this activity?”

Elsewhere, financial planning reflects national or regional histories and money-management styles (see “Tim Kochis: An Eye on Global Professionalism,” page 12). Noel Maye of the Financial Planning Standards Board pointed to one

development in nations where regulators look at standards of care:

A lot of countries are benefiting from what we call supra-regulators, like the Financial Services Authority in the UK, or the monetary authorities in a lot of the Asian Pacific countries. Regulators there are able to take a more holistic view of the financial services marketplace. Regulators are taking an interest in the competency of financial practitioners and in ensuring that they treat customers and clients fairly. The regulators are saying, “It’s not enough for you to say, ‘I complied with the basic knowledge requirements’ or, ‘I complied with the basic licensing requirements’ to either sell products or give advice. We’re requiring a further level of care. How can you show you are qualified to offer the advice you give or the services you provide? Was the product or advice you gave appropriate for that client situation, and if it was, how can you show me that it was?” And firms are asking themselves, “How do we create a mechanism that gives rise to this culture of competency and treating customers fairly?” There’s a very natural step there. And the regulatory environment is driving increased interest in financial planning.

That’s less likely to be the case in the United States, Maye said, with its fractured regulatory scheme and focus on regulation of products. He added that this is an area where the U.S. advisory industry could learn from its overseas counterparts.

REGULATION FROM WITHOUT AND WITHIN

Regulation of independent advisers has worked remarkably well for the investing public since the passage of the Investment Advisers Act of 1940. Yet many advisers say the regulations governing them could work more effectively. “There’s a deficiency in our regulatory scheme today,” said Donald B. Trone, president of the Foundation for Fiduciary Studies in Pittsburgh.

It’s because we’re still being regulated by a law that was written sixty-seven years ago. Sixty-seven years ago we had brokers who were executing transactions and selling financial products. And we had investment advisers who were money managers. The public knew the difference between the two and there wasn’t any problem.

Since then, Trone said, the investing world has given rise to new types of advisers who are neither brokers nor

money managers. For example, the Employee Retirement Income Security Act of 1974 (ERISA) helped create the investment consulting industry, which started in the pension fund world and has since branched out to serve private as well as institutional clients. “Unfortunately, though this industry now has been around for thirty-plus years,” Trone said, “the NASD [National Association of Securities Dealers] and the SEC [Securities and Exchange Commission] haven’t carved out an appropriate regulatory scheme for this new body of professionals.”

So we have brokers calling their folks financial advisers. We have wealth managers, we have financial consultants, we have trust officers, we have financial planners. I would describe them all as people who are providing comprehensive and continuous investment advice. And there is no regulatory scheme that fits them.

There may be need for regulatory reform, but there has been no consensus within the industry or in Congress about what form it might take. A self-regulatory organization for investment advisers that might address some of Trone’s concerns has found little support in Washington. And efforts to establish a specific regulatory framework for financial planners have so far been unsuccessful.

In contrast, industry initiatives such as professional certification and practice standards—for example, the Certified Financial Planner credential—have gained acceptance by some independent advisers, particularly those operating as financial planners. Such standards have helped improve the quality and consistency of financial advice. They also have helped independent advisory firms compete against representatives of banks and brokerage houses, who in the past had been slower to seek credentials such as the CFP mark, relying instead on their firms’ brand names and institutional presence to attract clients.

As a result, there has been solid support over the years for enhancing professional standards. For example, the Certified Financial Planner Board of Standards, the governing body that oversees the CFP certification process in the United States, recently strengthened its practice standards. The new SEC proposal makes it clear that CFP professionals engaged in financial planning will be held to a fiduciary’s duty of care. And the Pension Protection Act of

2006 imposes fiduciary obligations on firms offering advice to retirement plan participants.

Applying fiduciary standards to different types of clients requires skill and experience, says Donald B. Trone. “You have to develop a process for managing these decisions,” he said. “And it doesn’t make sense to have one process for 401(k) plans, another process for personal trusts, and a third for high-net-worth clients. Develop one process that’s good for all of them.”

Trone would also like to see stronger requirements for advisers’ education and training. Most states require that advisers obtain only a Series 65 registration to become investment adviser representatives. “Barbers and beauticians today have higher education and training requirements than investment advisors,” Trone pointed out. “If you study for fourteen hours you can pass the Series 65 exam and be fully qualified in the eyes of regulators to advise a 401(k) plan about its investment options or advise a university about managing its endowment.” That’s simply not good enough, Trone asserted.

THE CHALLENGES AHEAD

Like members of any other thriving industry, independent advisers must avoid becoming victims of their own success. One consequence of rapid growth is the talent gap: a shortage of educated, experienced professionals to fill available positions at advisory firms. According to many advisers, finding qualified professionals is their number one issue. “There are lots of people capable of handling smaller clients,” observed Steve Lockshin, chairman and chief executive officer of Convergent Wealth Advisors in Rockville, Maryland. “Finding people who can attract a wealthier and more sophisticated clientele is far more difficult.” To groom a new generation of professionals, the adviser industry will need to work with colleges and universities to establish or expand their financial planning and wealth-management curriculum—something some trade groups in the adviser industry already have started to do.

Success has also bred imitators both large and small. Of the smaller competitors, Steve Lockshin observed that “there are a lot of people getting into this business, all dying for the next client, so they’re killing themselves. They lower their fees to the point where they offer sub-par solutions and force other quality firms to lower their fees.” Pricing, Lockshin said, “is one of the industry’s biggest problems.”

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On the opposite end of the spectrum are large brokerage firms and banks that, until the 1990s, could afford to ignore independent advisers. No longer. To stay competitive, and in response to client demand, large national brokerage firms have been adopting the fee-based model of independent advisers. More attention was brought to this issue in 1999, when the SEC's Division of Investment Management, which directly regulates investment advisers and investment companies, provided "no-action relief" that enabled brokerage firms to offer fee-based accounts without triggering the Investment Advisers Act regulation. At the same time, the SEC proposed a rule, now known as the Merrill Rule, that allows brokerage firms to charge fees for advice that is non-discretionary and "incidental" to traditional broker-dealer services—such as custody, trade execution, and account maintenance—without registering as investment advisers under the Investment Advisers Act.

Between its proposal in 1999 and its adoption in April 2005, the Merrill Rule has been the subject of contention between broker-dealers who support it and investment advisers, financial planners, and others who oppose it. In protest, the Financial Planning Association filed a lawsuit against the SEC and scored a victory in March 2007, when the U.S. Court of Appeals for the District of Columbia Circuit ruled that the SEC had exceeded its authority in adopting the Merrill Rule.

In May 2007, the SEC indicated that it would not pursue an appeal of the federal appellate court's overturning of the Merrill Rule. Some industry observers believe that legislative intervention is the only answer to clarify the regulatory framework that exists in the converging broker-dealer and investment adviser space. "Congress probably will need to get into this fray to sort it out," said David G. Tittsworth, executive director of the Investment Adviser Association.

Meanwhile, the SEC is conducting a study with the RAND Corporation that will compare levels of protection afforded retail customers of financial service providers under the Securities Exchange Act and the Investment Advisers Act; the study will recommend ways to address investor protection concerns that arise from material differences between the two regulatory regimes.

"At a minimum," said Tittsworth, "the study should confirm what everyone already knows—that investors are very

confused about the basic differences between investment advisers, brokers, and financial planners and the legal standards that apply to each."

Outside the courtrooms and the legislative chambers, industry insiders acknowledge that the competition is a sign of independent advisers' success. "One of the most flattering things independent advisers are seeing is how much their model, lingo, and practices are being imitated by other players in the advice-giving business," said Don Phillips, managing director of Morningstar. "It's the independent advisers who are writing the template for what financial advice is going to look like in the future."

David Hunt, managing director of McKinsey & Company, said he sees a growing convergence. "The large firms are increasingly taking a page out of the book of the independents," he said. It's not only fee-based pricing: Hunt says big firms are also building teams of fee-based brokers to serve clients as a group and stepping up local community-building and referral networks—both typical practices of entrepreneurial independent advisers.

Nevertheless, Deborah Doyle McWhinney said national brokerage firms will have a difficult time matching the kind of relationship independent advisers offer their clients.

I'm constantly struck by the passion that independent advisers have for serving their clients and their insistence on doing what's right for them. It's a powerful experience for a client to work with an adviser who is sitting on the same side of the table with him or her. Clients really appreciate it. This isn't something that can be replicated overnight.

Most industry observers say national brokerages won't succeed in wooing away independent advisers' clients. "Competition is more of an issue in terms of bringing on a new client," said Tom Bradley, president of TD Ameritrade Institutional, a custodian and service provider to independent advisers. "It's highly unlikely that a large firm could introduce some advice service that could attract clients away from registered investment advisers, because they have such strong relationships."

Bradley and others also pointed to the continuing trend of "breakaway" brokers who leave large firms to start their own independent advisory businesses. In recent years, leading brokerages have encouraged the formation of teams of brokers who serve clients as a group. The team

structure helps brokers specialize and provide better service to clients; it also makes it easier for them to leave as a group and start independent practices. The most important factor causing brokers to leave is the desire for a more autonomous and objective environment to serve their clients.⁷ “Essentially, they’re marketing themselves as advice givers,” Bradley said.

But they also are employed by large firms with investment banking arms that need their distribution capabilities. So how do you do both? How do you act as the fiduciary advice giver and also as your firm’s salesperson? How do you always ensure that you’re doing the right thing? It’s a tough balancing act. And I think it has resulted in some dissatisfied stockbrokers who want to do the right thing for their clients, but don’t like the position they’re put in.

Are the big firms meeting the challenge of the independents? To some observers the answer is yes. Correctly or not, their offerings are often perceived to be comparable. According to the authors of the J. P. Morgan white paper:

While what these organizations now provide to their clients may in many cases differ from that of independent advisory firms, it is hard for the uninformed client to differentiate the offerings. This factor combined with massive marketing and advertising budgets has made [national] and regional broker-dealers more effective competitors in certain markets.⁸

Here’s a case in point: One of the authors of that study, Mark P. Hurley, is the former president of Undiscovered Managers, a mutual fund company. In 1999 Hurley wrote a controversial white paper, “The Future of the Financial Advisory Business and the Delivery of Advice to the Semi-Affluent Investor,” which predicted the advisory industry would consolidate as it matured, leaving a few big players, causing problems for smaller advisory firms. His firm was later acquired by JPMorgan Chase.

Consolidation is a fact of life in maturing industries, and the independent advisory industry is unlikely to be an exception. The principals of many firms are in their fifties or sixties; realizing their firms’ value may be their best chance for a comfortable retirement. Other factors, such as rising costs and increased competition, may also persuade advisory firm owners to sell. Although they may prefer to sell to junior employees, they may not be able to:

it can take five to ten years—or longer—to complete an internal sale, and many advisers wait too long to start the process. Once a firm reaches a certain size, it’s almost impossible for employees to buy out the principals. An external sale may become the best—or only—option.

As J. P. Morgan Asset Management said in its 2005 white paper:

We believe that the combination of increased business challenges, a graying owner population, the importance of the asset to funding these individuals’ retirements and the long time period inherent in any transition has placed the industry at a tipping point. Over the next few years, many advisory firm owners will likely sell their firms. It will also lead to significant consolidation at the top of the industry.⁹

Not all industry observers concur. “There are some people who say all these small firms will all end up being rolled up into big national chains,” said David Hunt of McKinsey.

I’ve never been a particular buyer of that idea. I think there’s something really special and unique about the small independently owned firms that are very focused on what they do. They do it well. They have strong relationships in the communities that they’re in. Many of them don’t want to work for a larger organization. It’s one of their primary motivations. If you look at the motivation of the owner-practitioners it’s not actually the type of people who want to work for larger organizations. So the notion that they’re all going to be rolled up into large national chains I personally find very difficult to believe. The independent smaller owner-operator has a very important role to play and will continue to be a very attractive option for many consumers.

If advisory firms do choose to sell, who will buy? “Banks have been reaching out and attempting to buy these [independent advisory] firms. And they’ve been willing to pay wonderful prices,” said John Philip Coghlan, a former president of Schwab Institutional.

In some cases it works out. In many cases instead it follows the model of banks trying to buy investment banking practices. After a short period of time, it doesn’t fit with the way that those investment bankers served their clients in the past. So the principals go off and leave, and you try to reconstitute it in such a way that it works going forward.

At the Crossroads

One of the problems with banks and other large buyers, say some industry observers, is that the unique relationship between independent adviser and client is hard to replicate. Large firms that promise “personal” attention and “custom” plans may in fact be constrained by their business volume to provide standard offerings in several sizes. That’s very different from the truly customized plans independent advisers have offered their clients. San Francisco executive Saul Feldman, a longtime client of an independent adviser, calls the adviser-client relationship a “holistic” approach, in his case one in which the adviser “understands my family situation, is responsive to my concern about socially responsible investments, and comes up with interesting ideas about what we ought to do going forward.”

There’s another option for some independent advisers who feel a need to sell yet want to retain their independence: selling to a holding company. One adviser who made that decision was Howard Sontag, founder and managing partner of Sontag Advisory in New York. After twenty years in the corporate world and ten years at the helm of his own firm, Sontag asked himself, “How is this business going to prosper going forward?” The answer took the form of an acquisition offer from National Financial Partners, a network of more than 175 independent firms, including several independent advisers. “In my business, I’m always telling clients to take money off the table when they have the opportunity to do so, and to strike a balance between fear and greed,” Sontag said. “The offer from NFP allowed me to do exactly that, as well as create a clear succession plan and an exit strategy.” Most important, the deal allowed Sontag Advisory to remain fully independent, with long-term management contracts. “As far as my clients are concerned, it’s transparent,” said Sontag. “It’s as though the deal never happened.”

Sontag’s buyer, NFP, is one of several holding companies—others include Focus Financial Partners, Boston Private, Convergent, and WealthTrust—that have made multiple acquisitions of large advisory firms in recent years. Observers speculate that holding-company acquisitions may change the industry landscape, and not necessarily for the worse. Holding companies are generally committed to maintaining advisers’ independence; they’re more interested in maintaining cash flow—and eventually adding value and “recycling equity” to a successor

generation—than in daily operations or decision making. When they evaluate potential acquisitions, they look for strong management teams that will continue to run their respective businesses.

There’s another way to look at consolidation, says Mark Tibergien, a principal with the accounting and consulting firm Moss Adams, in Seattle. He believes mergers among peers will become an important trend. “Whenever a market is fragmented like this business is, there will be consolidators,” he pointed out.

But you’re dealing with people who have feelings about control and other issues, and at an income level very different from that of, say, a funeral-home owner. These are people who are making serious money. And for them to cash out you’re going to really have to get their attention. I think that the real consolidation is going to occur among like-minded advisory firms through mergers, as happened in the accounting profession, rather than having financial buyers be the players.

THE ROAD AHEAD

The independent advisory industry is nearly a century old, yet in real terms it’s quite young. The majority of firms active today were founded within the past twenty-five years and are still under first-generation leadership. That means the industry is still very much an exciting work in progress, and its future over the next twenty years and beyond isn’t easy to predict.

“I’ll give you a ninety-five percent probability that our business will be unrecognizable in ten years,” said Roger C. Hewins of Hewins Financial Advisors, a wealth management firm in Foster City, California.

We’re a national company, with headquarters in California, and thanks to technology it’s no problem at all. Ten years ago we were getting big boxes of paper delivered. It’s totally different now. It’s a different business environment and there will be a lot of people who’ll control a lot of wealth through computers—e-mail, instant messaging, the Web, maybe teleconferences with people in other parts of the world.

What shape this industry will take is anybody’s guess, but I can’t help thinking it’s got to become more efficient. That there’s got to be more scale.

Deborah Doyle McWhinney echoed Hewins's speculation, saying that the most successful firms will make the smartest use of technology.

You need to do all you can to automate functions so you can spend more time with clients. Firms that adopt technology are not only serving their clients and managing their businesses more efficiently, they're also growing more profitably.

Technology also allows easier entry into the independent adviser profession, noted Ken Fisher of Fisher Investments.

You've got a computer, you've got some software, and you've got Internet access. It's easy to get a few clients. From there the question is, What do you do?

For Rick Keller, principal of the Keller Group Investment Management in Irvine, California, the answer to "What do you do?" is reflexive: it's all about building and maintaining relationships.

It's not about the numbers. It's about the people. And it's about the relationship and who cares about you. I think our clients are with us because we care. You take good care of your clients, and they feel it.

Rich Steinberg of Steinberg Global Asset Management elaborated:

We love helping people get from Point A to Point B. It may involve leaving money to charities, transferring wealth to the next generation, building financial security, reducing stress in their lives, helping widows or widowers, being a backstop when they have a problem, or even being like a family member. We had a client recently whose husband died and the kids live up in Boston. We were called in not to deal with the funeral arrangements but to work on everything else. And we don't get paid for that. It's just part of the relationship with that family that we developed over the years.

The challenges to the industry aren't trivial, as many advisers have pointed out; they include consolidation, competition, and succession issues. Yet since its inception in the second decade of the twentieth century, the independent adviser profession has proven to be remarkably flexible, innovative, and resilient. That's why many successful independent advisers today agreed with Tim Kochis of Kochis Fitz:

I don't see the future in terms of challenge. I see it in terms of opportunity and excitement. I'm as eager to get out of bed to get to work today as I ever was—maybe more so. I'm very enthused about the future of this business. I think it's going to become more sophisticated. I think we're going to do a better job for our clients. I think we have a very real opportunity to work with a manageable number of even more interesting clients over time. So the challenge, if there is one, is to continue to develop the skills and use the technology that will be necessary to respond to that opportunity.

But I have no doubt that we'll be able to do it.

These advisers' optimism and concern for "doing a better job for our clients" echo the prescient assertions of Arthur M. Clifford, Theodore Scudder, and other investment-advice pioneers. As Scudder's original partner, Haven Clark, put it, "[We] conceived the idea of starting a firm which would...advise clients how to invest money in an intelligent way." He added, almost as an afterthought: "The question was how to make any money out of it."

Nearly a century later, intelligent investment advice is still the most valuable product independent advisers offer, and their focus on the client remains center stage. And monetary success is no longer in question. An ever-expanding client base, ever-improving technology, and ever-higher professional standards have combined to make independent advisers one of the twenty-first century's pre-eminent providers of financial services. "Today's investors are increasingly looking for sound, individualized investment advice," says Charles Schwab, Chairman and Chief Executive Officer of The Charles Schwab Corporation. "When I think about the essential role independent advisers can play in the lives of their clients, I feel nothing but optimistic for the future."

Tim Kochis: An Eye on Global Professionalism

After more than thirty years in the financial planning profession, Tim Kochis could be excused if he chose to rest on his impressive laurels, which include the first Charles R. Schwab IMPACT Award®, given in 2006 for outstanding individual leadership in the independent advisory profession. Kochis also has been included in *Worth* magazine's list of the country's best financial advisers each year since the list was first published, in 1994. But taking it easy is the furthest thing from his mind. In addition to being the co-founder and CEO of Kochis Fitz, a prominent San Francisco wealth-management firm, Kochis—who earned a law degree and an MBA and ran financial planning practices at Bank of America and Deloitte & Touche before forming his own firm—devotes much of his time to improving professional standards both in the United States and abroad.

“The industry largely grew up while I've been participating in it,” Kochis said. “When I started, there was no standard body of knowledge or standard of practice. We were building as we went along.”

A co-creator, at UCLA in 1980, of one of the first accredited financial planning programs in the United States, Kochis served for eleven years on the Certified Financial Planner Board of Standards and was chair of the body's board of examiners for five years. In that capacity he helped develop the CFP certification examination. Not long after, he began focusing on standards elsewhere in the world.

Recently, Kochis has chaired the Foundation for Financial Planning, the Financial Planning Standards Board, and the International Advisory Panel for the Financial Planning Standards Council of China. He says the development of financial planning in countries outside the United States has varied widely. “Canada and Australia are very much like the United States,” he explained. “They have similar demographics and social expectations. It's not surprising that the development of financial planning in those countries has been similar to what it has been in the United States.”

Japan presents a somewhat different picture, Kochis says. “There are a large number of financial planning professionals in Japan. The Japan Association for Financial Planning, for example, has more than 160,000 members. But the level of sophistication of financial planning in Japan is still largely focused on household-level financial planning, making sure you've got enough savings and insurance. Still, the Japanese are very disciplined about it, and they take financial planning at that level very seriously.”

As for the European Union, Kochis said, “Europe offers sophisticated private banking for very wealthy people. But the broad availability of financial planning in Europe is limited and still emerging as people are just now beginning to recognize the need to plan their own financial affairs.”

Throughout the world, Kochis says, one thing remains constant. “No matter where they live, people increasingly recognize the need to take responsibility for their financial well-being,” Kochis said. “If we as a profession can be there to support their needs, that will be a wonderful accomplishment.”

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