DRIVING PROFITABILITY IN THE COMPLEX ADVICE INDUSTRY

If you've worked in financial services over the past couple of decades as I have, you know that *change* doesn't begin to describe what's happened in our industry. Increased complexity of products, new distributors and new approaches to distribution and corresponding compliance requirements, combined with a low interest rate environment, have put a squeeze on the profitability of many firms.

A (VERY) BRIEF RECENT HISTORY OF THE ADVICE INDUSTRY

The business of selling investments was simpler back in the 1990s. Advisors sold individual equities or funds and maybe did a bit of an annuity business. The Dow was on an unbelievable run and no-load, direct mutual funds were huge (remember the 1-800 mutual fund days?). For all but a small segment of the market, retail investments was a selling business.

As the late 1990s became the early 2000s, mutual fund types multiplied and the ETF market began to gain momentum. The industry began to see the merits of recurring revenue and thus fee-based, WRAP and Managed accounts were on their way to becoming the dominant market trend that they are today. RIAs were becoming vogue and the traditional captive channel began shrinking (and has continued to do so). The Independent model was growing and evolving: the hybrid-RIA was accelerating, the OSJ and Super OSJ model was expanding and the shift to multi-channel was underway.

The dot.com excitement of the late 1990s also brought more Americans to the markets and in turn investment dealer and manufacturers enjoyed upticks in their business.

In what was to be the first in a series of major, industry-wide compliance issues, the Global Analyst Research Settlement – agreed to in early 2003 – required ten large investment banks to separate their investment banking arms from sales of research due to conflicts of interest. The banks all paid large fines, but more profoundly, they effectively agreed to a new compliance regime that changed the compliance landscape in the industry forever.

In 2003, the mutual fund scandal erupted, following the discovery of illegal late trading and market timing practices of certain fund companies. Mutual funds were again at issue in 2004 when the mutual fund breakpoint issues were discovered. It was now clear that the regulator was prepared to intervene and began raising concerns about how investment products were being sold and advice provided to everyday Americans.

Meanwhile, RIAs continued to grow, and insurance companies and banks began to realize they needed to get a bigger piece of their customer's wallet, so many when from dabbling in investments sales to acquiring or building full service securities arms.

The Great Recession of 2008 shook the industry, and the country, to its foundations. It also triggered a massive industry restructuring, leading to the disappearance of many well-known firms, both large and small. Since then, we've seen a constant ratcheting up of regulation and compliance requirements in the financial services sector – Dodd-Frank, the DOL fiduciary rule, etc.

And what about the economics? Despite remarkable drops in many costs (trade execution costs fell 90 percent during the period), custody costs more than cut in half and technology support for back-office efficiencies, margins for distributors were fairly stagnant.

A PERFECT STORM FOR PROFITABILITY

To summarize, we've seen a huge increase in breadth and depth of products and the associated complexity that comes with understanding and advising on the use of those products over the past two decades. There's also been a corresponding increase in the regulatory compliance burden on advisors. At the same time, we've witnessed a consumer technology revolution that has increased client expectations around wealth advice and how it is delivered.

Financial firms are facing increased distribution and compliance costs to support all these products and, perhaps the most deadly, an interest rate environment that took away, arguably, the top revenue line in 2008. Many have nibbled at the edges to find ways to grow revenues and profits, but that goal – excluding the high risk/return proposition of recruiting-based growth – has remained elusive.

WHAT'S A FIRM TO DO?

Profitability is the challenge facing every distributor. Firms are looking at advisor headcount – whether there are 50, 500, or 5,000 – and trying to find ways to drive profit direct from that investment.

But their options are limited. Externally driven costs (eg., compliance) are up. Many expenses have been reduced throughout the business model, so there's not much more left to cut. You can't do it by playing with net interest margin any more. You can't generate profit by negotiating a new distribution deal with product manufacturers – that's off the table. And you can't generate profit by favoring an in-house product that has a more favorable revenue stream – as long as the DOL fiduciary rule exists and has teeth, or another version of a best interest standard arises.

Instead, firms must now turn to the final frontier. They have to find ways to get every bit of performance possible out of their sales force – in fact more performance than even the advisors would believe possible. We think about this as performance per seat. But there is a catch. People. You have to recognize that you're dealing with human beings and they are providing advice, so you can't just squeeze them and expect results – you have to empower them.

Unfortunately, the traditional tools for running a financial services business have not kept up and businesses need to rethink their go-to-market playbook to match the way modern investment professionals conduct business.

You do this with smarter, more strategically aligned incentive compensation. You do this with faster and smarter identification of performance opportunities. And you do this by finding minutes in each advisor's day – everyday – though smarter and more user-focused technology. You do this by giving them opportunities to learn and improve that are both expert and crowdsourced and you find ways to substitute for the advisor to make them more efficient. You need to connect advisors and the firm to their preferred (and hopefully the best) technologies wherever and whatever those are. And you empower the entire organization to support this happening. Simple, right?