



The five new realities of wirehouse advice

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The irony is powerful: Just as client demand for quality advice is reaching an all-time high, the business models that support the selling of advice have never looked worse. Brokerage firm consolidation, endless rounds of cost-cutting and a collapse of client confidence in risk-bearing products will change the wirehouse landscape for years to come.

This environment will affect financial advisers and their business significantly. The following are major themes we think that you will see in the years ahead.

Tough love. With four of the five wirehouses announcing their intent to issue retention bonuses (and with holdout UBS Financial Services Inc. possibly on the way), the economics, culture and career path of producers has begun to change industrywide. Handcuffs have started to tighten on the upper end, and if all goes as expected, an estimated 80% of the wirehouses' million-dollar producers will be locked into contracts of five years or more by yearend.

Many of these high-end producers have taken such a hit in lost assets and production that it will be several years before they rebuild a business that could be sold to pay off the current loan — and stay current with the Internal Revenue Service.

For many, the new arrangements will feel like regular handcuffs rather than the golden variety.

Reduced mobility will set the stage for a wide range of initiatives that tinker with adviser profitability and support models. The big firms' profitability improvement "wish list" is long, but look for savings through branch relocations, branch consolidations and the like to be first out of the gate.

For advisers who didn't get a retention offer, life at the lower end has never been tougher. Merrill Lynch & Co. Inc.'s recent retention exercise was seen as successful because 6,200 of 17,000 brokers signed agreements by the initial deadline.

But what about the other 10,000-plus? The message is clear: Smaller-producers, go home.

The true profitability of producers under \$500,000 has long been suspect. Every exercise in cost mapping, especially litigation and compliance-related costs, ends up attributing a disproportionate share of expense to smaller, transaction-oriented brokers.

But the root of the problem goes beyond a simple accounting game of shifting around internal costs; the real issue is growth.

Over the past decade, fourth- and fifth-quintile producers have increased revenue at a significantly lower rate than the rate of increase of support costs. For brokerage firm chief financial officers, the math is simple: Production must grow faster than its related support costs.

If producers are unable to gather new assets consistently, they will be marginalized as resources are redirected to producers who can.

No seed corn. Consigned to history is the old broker-training model, in which 80% of new representatives don't make it past five years, a pattern that has held steady for decades. Lately, two thirds of trainees don't even make it to the second year.

What has changed in recent years is the nature of the 20% who do make it. Typically, more than half their client assets were already at their firm at the time of their hire.

In other words, most successful trainees make it because they are sponsored in an apprentice role by a larger adviser or team.

If you back out the children of established producers who enter the business as affiliated trainees and the children of their friends or clients, a better picture of the business case for broker training programs emerges. Because of the extraordinarily high failure rate for unsponsored, raw hires, one can make a compelling case that the true cost of creating a successful broker at a major wirehouse can range from \$250,000 to \$500,000 per trainee, per year.

With economics such as that, is it any wonder that the major shops have spent the past decade reducing their investment in new-broker training and redirecting the dollars to hiring established producers? The combination of fewer successful rookie brokers' coming up through the pipeline and more money-chasing established brokers has been the primary driver of inflation in hiring deals over the past few years.

This has been great news for established advisers, but it is a fundamental business model problem that the major houses will have to address.

Salaries? Producer compensation is starting to change from the bottom up, and junior producers are the first to feel the impact.

With the old training model broken, experimentation with new compensation models to support junior advisers already has begun and will continue.

Merrill's latest training program is an unheard-of 43 months long, with base salary provisions that can extend as far as 36 months. By design, some trainees won't operate under a pure commission environment until their fourth year with the firm.

These programs reflect the work/life reality that younger producers often have to build a stable book while trying to manage life events such as building a family and first-time homeownership.

These revamped programs are approaching a tipping point in which they may morph into pure salary and bonus pay schemes. The stability of base/bonus pay schemes hold the prospect of bringing in people with technical abilities who might be scared off by the challenge of pure commission sales.

Some of this isn't news, as many branches are filled with well-paid client associates and investment advisers, often on large teams, who often take home more pay than junior brokers.

The prospect of these programs' being significantly ramped up is news, however. Imagine if all new hires over the next three years were paid exclusively on a salary/bonus arrangement.

The effects of such a compensation plan would be felt on all aspects of branch life. Watch for this trend of large firms' supporting multiple production compensation models to accelerate.

Regimentation. Consolidation will bring a new way of business life at the wirehouses.

The good news is that economies of scale will provide rapid improvement for basic administrative tasks. Expect enhanced product and sales support, upgrades in desktop hardware and application software, and improved product training.

The bad news is that as sales organizations grow, segmentation matters more.

Firms that already require a producer accreditation process for certain client segments will expand oversight. "No-solicitation" lists will grow in importance and be actively policed by management.

A different type of producer will thrive in such a regimented world. While some producers will find a more segmented environment to be a tremendous support in building their practice, others will miss the ready access to senior management, speedy exceptions from administrative policies and the entrepreneurialism of a smaller environment.

Small can be beautiful. Independent brokers and registered investment advisers are thriving. In the six quarters from the start of 2007 through midyear 2008, the three largest RIA custodians (San Francisco-based Schwab Institutional, Boston-based Fidelity Institutional Wealth Services and Jersey City, N.J.-based TD Ameritrade Institutional) gathered more net new client assets than the nation's top four brokerage firms (Merrill, UBS, the Smith Barney division of Citigroup Inc. and Morgan Stanley, all of New York), outpacing them \$215 billion to \$168 billion.

These figures become even more stunning when you take into account that a significant portion of the net new assets flowing into the brokerage firms were effectively shuffled assets resulting from the competitive recruitment of producer talent. Even with the lift of hundreds of millions of dollars of direct investment, the wirehouses have been consistently losing the asset-gathering war.

Why are clients leaving the big shops? Satisfaction is the main factor.

Advances in technology and custodian support have made it possible for advisers to design a client service model that eclipses the cookie-cutter approach of the wirehouses. While large broker-dealers excel at manufacturing and distributing products, smaller firms excel at listening to clients and responding with unconflicted advice.

The collapse of client trust in traditional Wall Street broker-dealers has effectively leveled the playing field. When it comes to client focus and nurturing trust, small is the new big.

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