THE VALUE OF ADVICE

Navigating a new era of opportunities for "active" advisory firm managers

CAMBRIDGE

IN RESEARCH

INTRODUCTION

The pace and velocity of change in the advice industry over the last 18 months has forced many advisers to rapidly re-evaluate their business strategies and outlooks. Regulatory, technology and investment pressures are re-shaping the business of advice – seemingly in real-time. Coupled with a large wave of advisers approaching retirement in tandem with their baby boomer clients, this uncertain outlook accentuates the shifting landscape facing many advisers.

On the surface, investing, client demand and the possibility for regulatory impacts, changes the economics of the advice business for many advisers whose revenue streams have relied heavily on commissions. The rise of so-called robo advisers and low-cost digital investing platforms has introduced new pricing and service dynamics to many investors and clients – while also shaping expectations for the digital experience individuals now have with financial services firms. At the same time, strong, relatively stable equity markets and the subsequent appeal and performance of passive investment strategies have altered the way many investors view active investment management and advice.

80% of firms surveyed indicated that they believe their business will be worth more three to five years from now, with organic growth and market appreciation being the primary drivers

There is a common thread that runs through each of the external forces: Value. From different directions, each shines a light on pricing or performance – and ultimately, the relationship between the two.

More than ever, financial advisers are being asked to demonstrate and validate the value of the services and results they provide to clients. We believe that the advice business is at an evolutionary inflection point, with substantial changes to the industry's landscape already underway. To better understand the way advisers are responding to these tectonic changes, we conducted a survey of financial advisers in the second quarter of 2017 – shortly after the June 2017 implementation of the DOL fiduciary rule – and corresponding analysis that focuses on the "value levers" advisers can pull to re-position their businesses and potentially accelerate growth.

Specifically, we focused on three levers throughout our research: fees, mergers and acquisitions, and succession planning. Throughout each, we sought to understand value in several ways, including the literal value of services provided by an adviser directly to clients, an adviser's perceived value, and the actual overall value of a financial advisory firm.

In our research, we uncovered that many advisers are aware of the disruption and sources of change in the advice industry. However, there is only a small portion of the adviser universe that is focused on proactively managing and altering their overall value structure – with a number of advisers taking a more passive position on growth and accelerating their future value. A few key findings from our research of particular note:

- 80% of firms surveyed indicated that they believe their business will be worth more three to five years from now, and they are citing organic growth and market appreciation being the primary drivers
- Surprisingly, only 31% of advisers feel that their core business will change over the next five years
- 39% of advisers believe their firm needs to refine their pricing model to more clearly align with the specific services they provide – and notably, only 30% agreed that their model needed tweaking.
- When it comes to mergers and acquisitions, there are currently seven times as many buyers as there are sellers represented in our survey
- 27% of advisers say that the regulatory environment is accelerating their retirement from the business, or a sale of their business – a 50% increase compared to the 18% who said the same in our 2012 *InvestmentNews* Succession Planning Study
- On a scale of 1-to-10, advisers score their own retirement "preparedness" at an average of 6.9
- About two-thirds (64%) of advisers currently have a succession plan in place or are "planning to plan" – meaning they are considering, if not acting on a potential transition. That is a marked shift from our 2012 *InvestmentNews* Succession Planning Study when just 50% of firms had or intended to develop a succession plan

If four out of five advisers think that their firms will be worth more in five years, it is important to understand the key contributors to this bullish overall sentiment. Our findings highlight a gap between active and passive advisory firm management – adding a new angle to an active vs. passive debate – and also underscoring an industry that is in transition.

The goal of this paper is to highlight the opportunities for firms that are committed to increasing the long-term value of their overall businesses. Specifically, we will focus on the types of changes that active advisory firms are making to their businesses, while highlighting opportunities that will emerge in the passive portion of the industry.

FEES

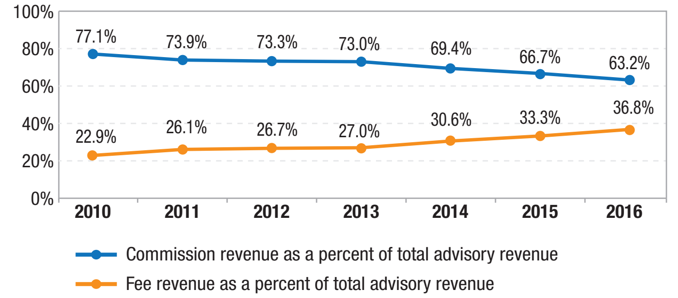
Overall, the financial advice industry has seen a significant movement to fee-based businesses and services in recent years. As we have seen in our annual independent broker-dealer (IBD) research, for example, the balance of total revenues in that channel generated from both fees and commissions has shifted considerably: In 2010, 23% of average independent broker-dealer revenue was generated by fees, while 77% was generated by commissions. In 2016, 37% of revenues were derived from fees and just 63% of revenues came from commission-based business, as illustrated in Figure 1. That 14 percentage point difference accounts for an estimated $8 billion shift in revenue.

> In 2016, IBDs saw 37% of their revenues come from fees, up from 23% just six years earlier.

Investing client demand expected to accelerate the emphasis on fee-based revenue, with more disclosures and discussions around commission-based compensation now required as a direct result of the regulation. In our survey, the decline varies based on channel, but Figure 2 illustrates advisers' anticipated changes in revenues streams for year-end 2017 vs year-end 2016:

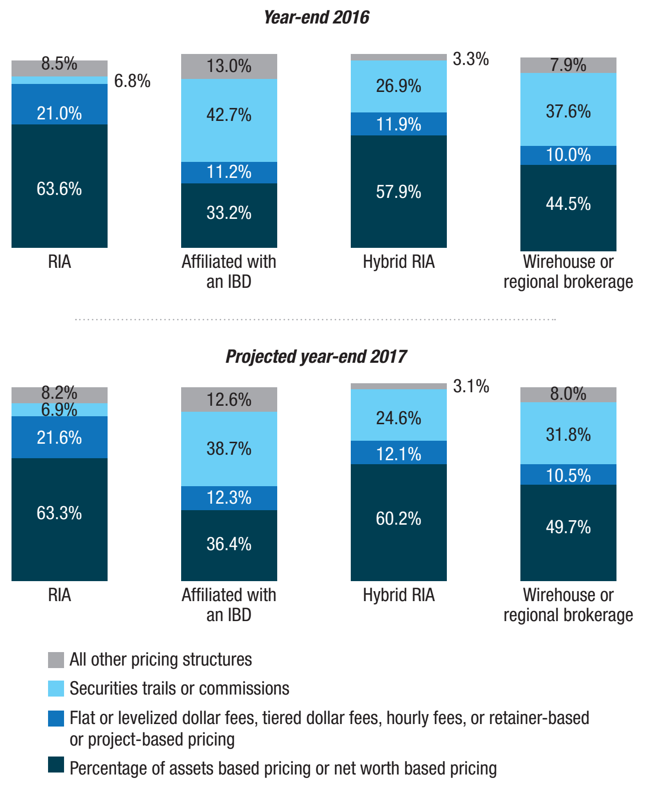
The most notable anticipated change is expected to take place in the wirehouse channel, with asset-based fees estimated to comprise 50% of revenues at the end of 2017, up from 45% of revenues in 2016. Collectively, the percentage of asset-based revenue generated by all advisers in our survey is expected to increase from 42% to 45% at the end of 2017, while advisers anticipate commissions-based revenue to decline from 31% to 28% during the same period.

FIGURE 1: 2010–2016 IBD advisory revenue sources



Source: *InvestmentNews* Research

FIGURE 2: Current vs. projected revenue mix, by firm type



With this ongoing shift to fee-based revenue, it's critical to focus on current and future fee models to understand how – and where – advisory firms are assigning value to the services they provide to clients. Among those advisers who currently generate some form of fee-based revenue, an asset-based fee is by far the most common type, with 71% of firms relying on this pricing structure Figure 3.

FIGURE 3: **Breakdown of fees-based pricing options**

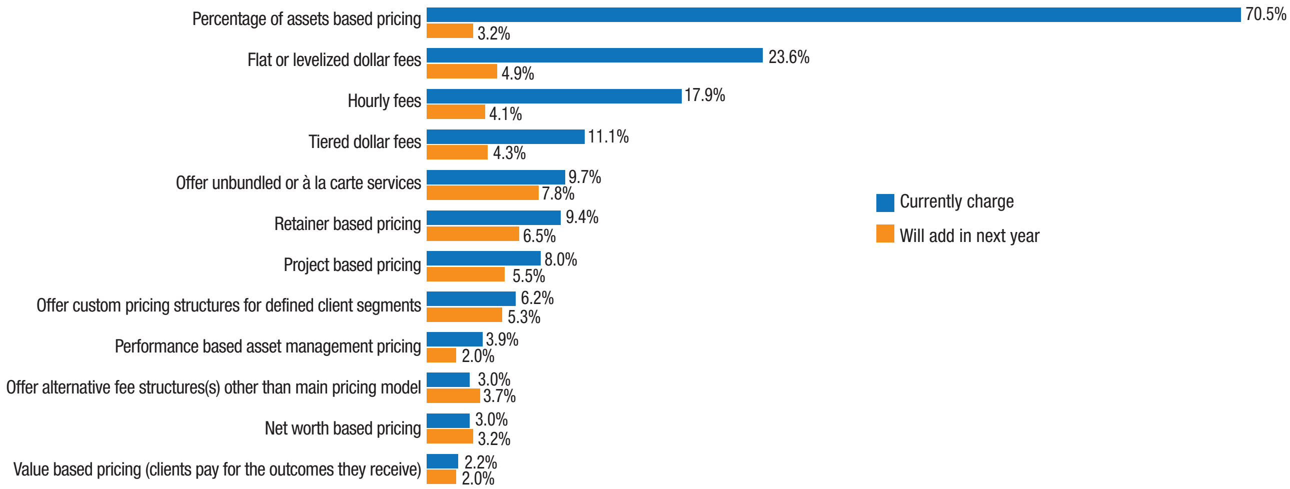
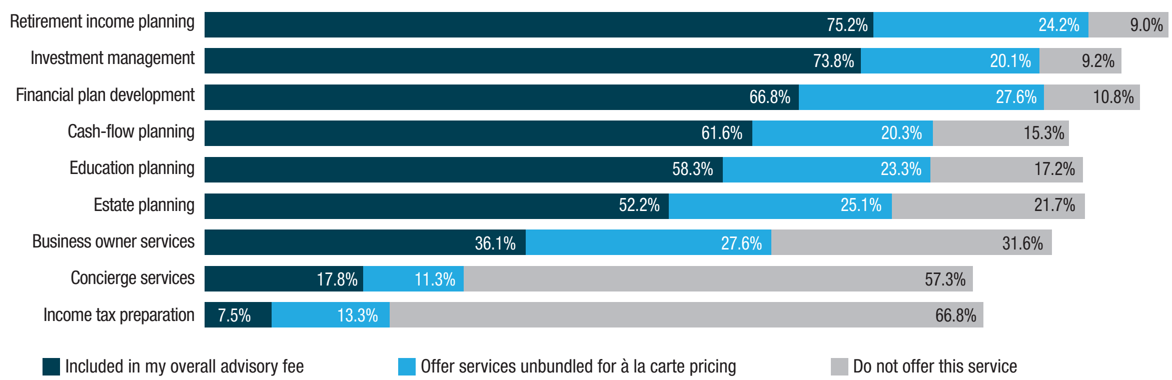


FIGURE 4: **Service fees: Unbundled vs. included in overall fee**



While there has been more discussion in the last 12–18 months surrounding flat or level fees – which would be based on services provided vs. assets managed or under advisory – currently just 24% of advisers who charge fees offer this as an option to clients, while 18% charge hourly fees. It appears to be a small portion of the industry that is moving toward these fee structures, but it serves to diversify pricing options – and ultimately has the ability to change the way clients and prospects assign value to the delivery of financial advice. The asset-based fee, for instance, implies a more direct delivery of investment management services, whereas a flat fee could be more directly applied to holistic or comprehensive financial planning.

Along these lines, as we look at the "active" firms – or those that have or plan to make changes to their fee structure or pricing – we anticipate that there will be a greater movement toward "unbundling." While a range of services are often included in an overall asset-based fee, 51% of firms in our survey offer at least one service that they charge for in addition to, or outside of, their asset-based fee. Figure 4 illustrates the services that are currently in an asset-based fee, as well as the services where advisers have been able to command a fee for separate, standalone services. Today, the top unbundled fees – financial plan development (28%), business owner services (28%), estate planning (25%) and retirement income planning (24%) – provide a perspective on the services that clients value most, above and beyond the general asset-based fee.

Among those advisers who plan to make changes to their fees over the next year, 16% plan to unbundle at least one service. By presenting their services in an unbundled form, firms are shifting their clients' mindset by treating more services as standalone menu items while more specifically defining the services they are delivering.

Just 5% and 8% of firms plan to add flat fee or à la carte fees, respectively, to their fee menu by next year. Rounding out the top four most added fee options advisers plan to add are retainer (7%) and project-based pricing (6%). In a recent *InvestmentNews* Research survey of primarily mass affluent and high-net-worth investors, 31% of those who currently work with an adviser say they would prefer to pay a flat fee, even though only 16% of them currently do so – the biggest disconnect among investor clients and how they pay their advisers. Switching to a levelized structure – while also offering tiered or à la carte service packages – could be a way to easily transmit the value of advisory services, without devaluing them, in a way that's easy for investors to understand and accept.

We believe these offerings present significant opportunities for proactive firms to either alter their future pricing and service strategies accordingly – or simply change how they communicate the most valuable components of their asset-based fees. **The more clearly an adviser can articulate the services that are being delivered, the easier it will be to define the value for these services.**

FEE CHANGES

Despite the emphasis on, and rising importance of fee revenues for many advisers, the majority of advisers in our survey have not recently made changes to their fee structure and have confidence in how their fees are represented to their clients:

- 83% of firms indicated that their existing pricing model accurately reflects the value of the services they provide
- 82% indicated that their fees and pricing are easy to understand
- 62% of advisers have made no changes to their fee levels or fee structures over the last two years
- 39% of advisers currently believe their firm needs to refine their pricing model to more clearly align with the specific services they provide.

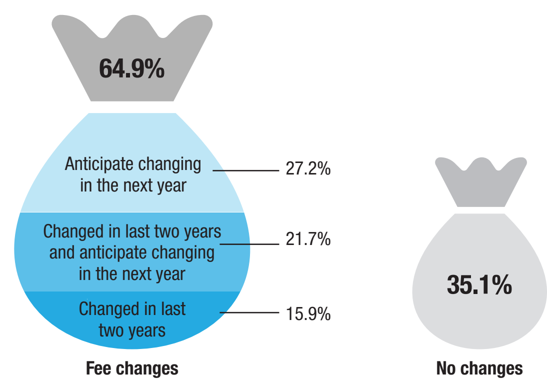
At the same time, the majority of respondents acknowledged that they are now being tasked with an increased workload and delivering more customized services to each of their clients. In addition, they also indicated that they are spending more time explaining their fees and fee structures:

- 57% of advisers say that their clients are demanding more customized services than five years ago
- 73% of advisers feel that clients today desire more clarity and transparency around fees and investment management than five years ago

Although most firms have held constant with their fees, advisers are not ignoring client's rising demands around service and transparency with 78% of advisers reviewing their pricing structure at least once a year. Of those anticipating making changes, the most common were adding a minimum assets level (29%), adding a minimum fee (20%), and unbundling services (16%).

Additionally, there is a subset of advisers who are highly proactive when it comes to their fee structure. This includes 22% of respondents that have made changes to their fees in the last two years plan on making a change within the next year as well. In total, only 35% of firms will touch their fees in any way over a three-year span as shown in Figure 5.

FIGURE 5: Changes in fees in the last two years and anticipated changes in the next year



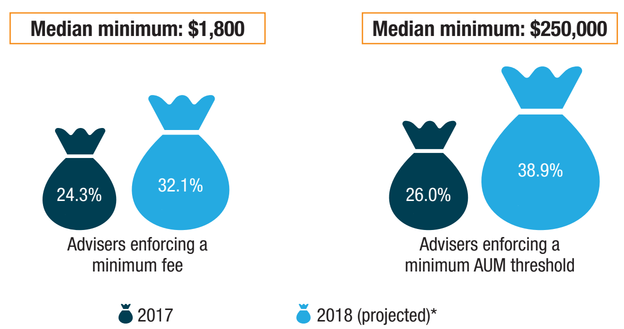
FEE MINIMUMS

With these increased demands, more firms appear to be looking at subtle changes that might not involve adjusting fee levels or fee structures. **Many advisers are looking to implement account or fee minimums, which would ensure higher levels of profitability per client** – and ultimately improved profitability margins and increased firm values.

At the moment, 24% of firms have a minimum fee per client 26% have minimum asset levels, with7% having both. Respondents reported that the median minimum fee is $1,800 while the median minimum asset level is $250,000.

Looking ahead, we see that more firms – particularly in the independent broker-dealer channel – will be putting minimums in place. Almost 30% of the firms that will make changes to their fees by June 2018 will be adding a minimum asset level in place and 20% will add a minimum fee. Figure 6 below illustrates the current and expected use of account minimums.

FIGURE 6: Minimum AUM and fee requirements, 2017 and projected 2018



**Projected 2018 minimum rates were calculated by the percent of advisers who anticipate adding a minimum in the next year less those who anticipate removing a minimum.*

While minimums will help to enhance the value of individual client relationships, advisers are mixed on the actual pricing levels that they extend to clients. Over the last two years, 17% of advisers indicated that they have increased fees, while 21% have decreased.

However, if needed, advisers do see an opportunity to increase the fees they currently charge to clients in order to drive increased revenues. As Figure 7 below highlights, less than 25% of advisers feel that their clients would object to an increase in their fees.

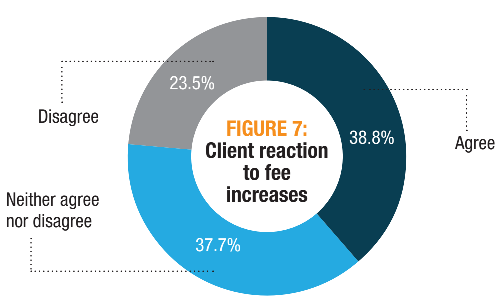


FIGURE 7: Client reaction to fee increases

Note: Respondents were asked, "If my firm increases its fees, our clients understand the value we provide and are not likely to object."

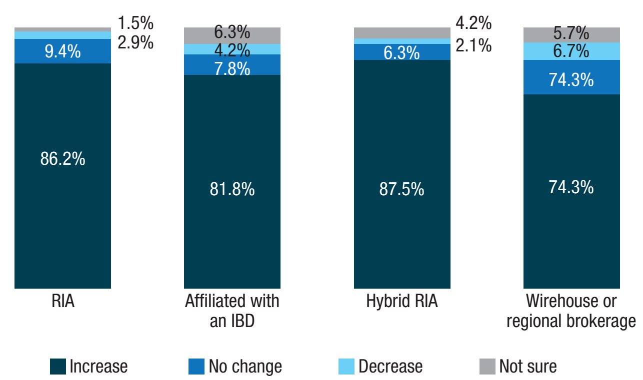
This sentiment and confidence level could lead more firms to gradually increase their overall fees, or unbundle fees for specialized services. More firms see an opportunity than a challenge, essentially, when it comes to revising their fee levels – which speaks to the underlying value of the services provided to clients, as well as the core relationship with existing clients. Firms that see this as an opportunity do not need to justify the value of their services; that has already been demonstrated and solidified through a strong relationship. Rather, they need to focus on communicating the value of the advice they provide – and how they will continue to add value, evolve and support the changing and increasingly complex needs of their clients moving forward.

MERGERS & ACQUISITIONS

While our focus on fees provides direct insights into the value of the services advisers provide to clients, we also sought to understand how advisers are looking to grow their businesses and increase the overall value of their firms.

As noted earlier, 80% of the advisers in our survey believe that their firm will be worth more in five years. This confidence level is consistent across channels, as Figure 8 below indicates.

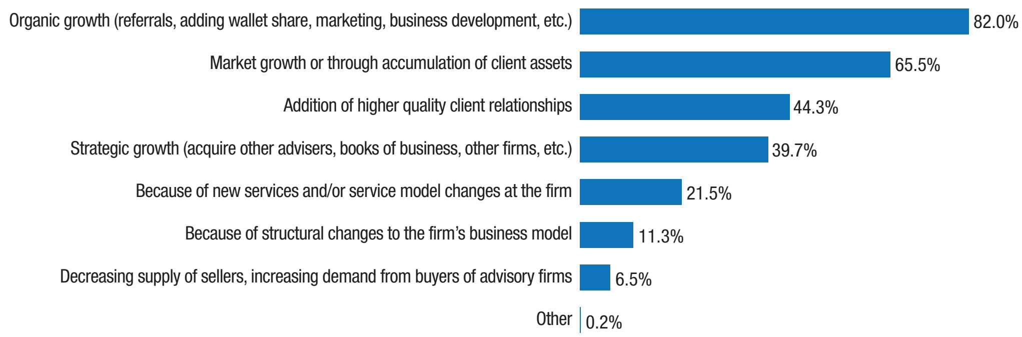
FIGURE 8: How advisers believe their firm valuation will change over the next three to five years



The drivers behind this expected increase in valuations vary, but highlight a marked divide between firms that are actively and strategically working to increase the value of their firms – and those that are relying on more passive approaches to enhance their valuations. Only 40% of participants noted that "strategic growth" will play a role in increasing the value of their firm (Figure 9).

The number one contributor to an expected increase in firm value cited by respondents was "organic growth" (82%) which would include referrals, marketing and business development, among other more traditional activities. Right behind organic growth was "market growth" at 66% of respondents.

FIGURE 9: **Drivers behind the belief that firm value will increase**



Looking ahead, the rate of deal activity is expected to double over the next 12 months.

These findings highlight a considerable opportunity for proactive advisory firm managers – specifically for those firms looking to grow through various forms of mergers and acquisitions. There has been a heightened level of merger and acquisition activity over the last 18 months, as many firms have looked to take advantage of shared economies of scale, leveraging technology, operations and firm management, for example. At the same time, more advisers are approaching and accelerating their own plans for retirement: As we noted in the outset, 27% of advisers say that the regulatory environment is causing them to consider an earlier-than-planned retirement, or outright sale of their business. This is a 50% increase from 2012, when just 18% of advisers noted that the regulatory environment was forcing a premature exit from the industry.

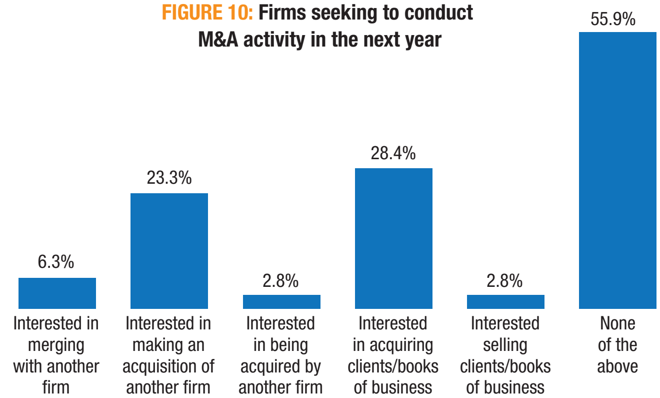
According to our research, 22% of firms we surveyed executed a merger or acquisition within the last 12 months. Among these firms, 85% were acquirers, 17% were sellers and 6% were involved in a merger. It is worth noting that 84% executed just one transaction in the last year, while 16% were engaged in multiple deals.

With a number of firms, individual advisers, or books of business potentially in transition, advisory firms should have a number of strategic growth options to consider as they evaluate merger and acquisition opportunities.

Looking ahead, the rate of deal activity is expected to double over the next 12 months: 44% of advisers surveyed said they will seek a merger or acquisition in the next year. Nearly 90% of advisers plan to be acquirers, 12% plan to sell and 14% indicated that they intend to be involved in a merger. Among those firms that made an acquisition or merged over the last year, or the "active" firms, 85% are interested in making another deal in the next year.

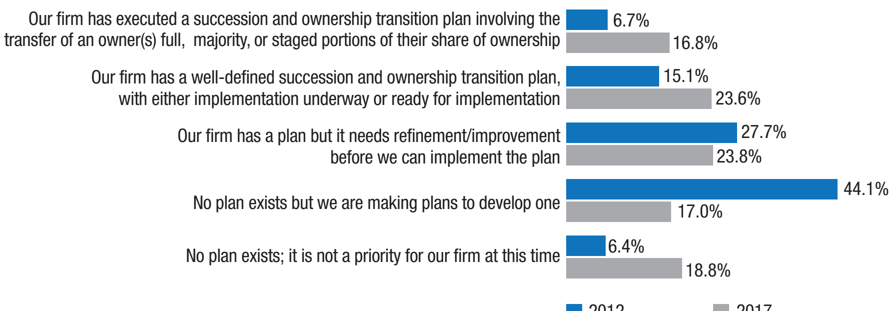
The most common transaction is likely to be an acquisition of clients or a book of business (28%), which we believe is fueled by the opportunities that are emerging from planned retirements and early retirements. Acquiring another firm outright is the second most likely, cited by 23% of respondents. We do expect, however, that there will be significantly more demand than supply, as noted in Figure 10, which shows that **there are seven times as many buyers as there are sellers at the moment.**

FIGURE 10: **Firms seeking to conduct M&A activity in the next year**



This could, of course, be another key contributing factor that will drive increasing values in the advisory industry over the next several years. With just 6% of advisers indicating that they are interested in selling either their firm or books of business, sellers should be able to command a premium from potential suitors – particularly if they are firms that are well-prepared for a transition and can clearly demonstrate the value and strength of their client base.

FIGURE 11: Firms succession planning preparedness, 2012 vs. 2017



Note: 2012 numbers are from the 2012 InvestmentNews Succession Planning Study.

SUCCESSION PLANNING

While for years, many advisers and firms took a "wait and see" approach to either developing or executing a formal succession plan, our research illustrates a change succession sentiment.

In addition to the accelerated pace of overall merger and acquisition activity, we have seen an uptick in the number of advisers and firms that have executed a succession plan in recent years. Specifically, 18% of the advisers in our survey reported that they have completed some level of their succession plan – **roughly 2.5 times the number of firms that indicated as much in 2012 *InvestmentNews* Succession Planning Study.**

In addition, while we have seen an increase in the number of firms who have no succession plan and indicated that it is not currently a priority, we have also seen more firms that have a well-defined succession plan in place – and are ready for a transition, or are in the midst of a transition, as illustrated by Figure 11 above.

As one would expect, a relationship exists between how prepared advisers feel for their own retirement and their succession plan preparedness see Figure 12 below. Those who have no plan but are planning to plan feel the least prepared for their own retirement, an acknowledgement that they are uncertain about the future of their business. On the other hand, those who have actively executed a plan feel significantly more prepared for retirement, on average, than their peers.

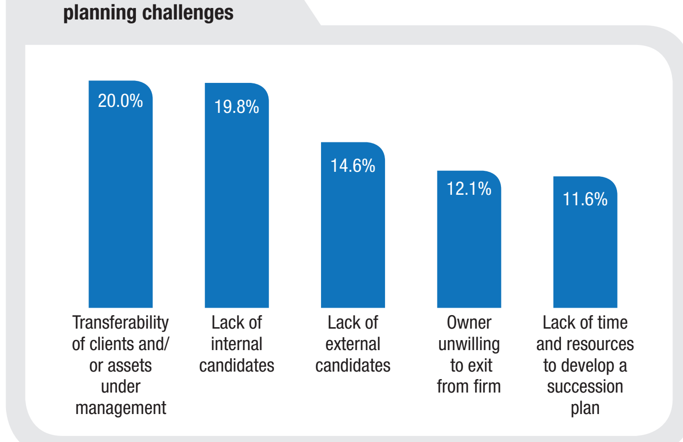
FIGURE 12: Retirement readiness by succession preparedness

7.6	7.1	6.7	6.7	6.3
Our firm has executed a succession and ownership transition plan involving the transfer of an owner(s) full, majority, or staged portions of their share of ownership	Our firm has a well-defined succession and ownership transition plan, with either implementation underway or ready for implementation	No plan exists; it is not a priority for our firm at this time	Our firm has a plan but it needs refinement/ improvement before we can implement the plan	No plan exists but we are making plans to develop one

Note: Retirement readiness was rated by each respondent on a scale of 1 to 10, with 10 being the most prepared for their own retirement, and 1 being the least prepared.

This trend line suggests that overall, the advice industry is maturing – both in the literal transition to another generation of ownership, as well as the general approach to preparing for a transition. For those firms that are actively developing and adopting a succession plan, there are a number of potential benefits. The largest challenge surrounding succession planning is an adviser or firm's ability to transfer their clients and assets, followed by their ability to identify an internal successor, as Figure 13 shows.

FIGURE 13: Top succession planning challenges



On the issue of transferability, those firms that have embraced succession planning should have a higher likelihood of transitioning clients and assets: Having a formal plan in place allows an adviser to proactively communicate details of a transition years in advance of their retirement or exit plan. In particular, if an internal candidate exists, he or she has the ability to develop a relationship with the firm's existing clients. If the future owner is an external candidate or acquiring firm, the succession and communication plan could involve a transition period in which the legacy adviser maintains primary client relationships over a pre-determined period of time before a full exit, for example. In either scenario, the presence of a formal succession plan may make an adviser or firm more attractive to a potential suitor – and ultimately command a greater value because of their ability to retain and transfer their clients and assets.

TAKEAWAYS & CONCLUSIONS

- **The advisory industry is at an evolutionary inflection point:** many firms are adding – or raising – their client minimums as regulatory burden and descending investment management fees make assisting smaller clients (especially on a strictly assets-based fee model) less profitable. Firms are responding to this by adding minimums – 44% of firms have a minimum, and another 27% say they plan to add one over the next year – meaning that as many as 2 out of every 3 advisers could have a client minimum by the middle of 2018. Adding to that, many advisers – 41% – feel that clients expect more service for the same or less amount of money, a sentiment that is rooted in hard data – the typical revenue yield, or the measure of the amount of revenue earned for every dollar in AUM managed – is, at 74 basis points, the same today as it was in 2012.

  Finally, 73% agree that clients desire more clarity and transparency around fees than they did five years ago, and 57% agree that clients demand more personalized and customized service than they did five years ago. The majority of advisers feel that they are under more pressure than they have been in the past to deliver more at a lower cost.

  If firms are actively focused on **defining the services that are being delivered, the easier it will be to define the value for these services – an important takeaway as more advisers will be making changes to fees and fee structures over the next 1-2 years.**

> 57%
> agree that clients demand more personalized and customized service than they did five years ago.

- To that end, the clear majority (65%) of advisers have either made changes or plan to make changes to their fee structures to address the evolving landscape. While some advisers may be shoring up around their core client, these shifts can also pose an opportunity for advisers who are able to utilize broader fee offerings and leverage the latest adviser technologies available to service clients slightly smaller than their core, offering tiered levels of service, such as for high-earners under a certain age whom the firm sees potential to one day grow into a profitable relationship. The right efficiencies can help advisers service clients who opt for lower levels of service more profitably – perhaps through a junior adviser – and many will be exposed to, and often opt for, the level of sophistication that a broader – and more expensive – wealth management offering.

  Adding flat fees and a la carte fees for services, a trend already underway, is another means of readily translating a firm's value and services profitably in an era where such models are the norm, and simplicity is the guiding principle among how investors expect their services to be priced.

- As an added bonus, **a nimble fee structure that allows for a profitable, repeatable client acquisition process also bolsters the value of the firm.** Firms who believe the value of their firm will increase because of changes they're making to their business or service models are much more likely to be adding to their fee menu in some way – 41% vs. 30% – and more particularly, they are twice as likely to be adding custom pricing for defined client segments or an a la carte offering (22% vs. 9%).

- **More consolidation within the industry is expected:** One out of every five firms has executed a strategic growth initiative in the past year, whether buying or selling a book of business, or acquiring/merging with another firm. Another 26% anticipate such activity in the next year, suggesting an overall increase in such activity; 51% -- the majority of advisers – are undertaking M&A activity in some fashion. as advisers look to accelerate their exit and retirement plans. For firms that are looking at active expansion plans, more strategic opportunities will emerge. Acquisition – of either firms or individual advisers – will be a key driver of growth for proactive firms, but acquiring firms may soon encounter issues with firm valuations, as there is just one seller for every seven buyers in the industry at the moment.

- An internal succession is the other option for advisers mulling the future of their business adviser – and their own retirement. While the retention of clients during a transition is a top concern, we believe firms that have a formal succession plan in place – one that is proactively developed and communicated to clients – will have higher valuations and will be able to command premiums. With so many advisers approaching retirement age, the relative scarcity of younger advisers, and the number of firms foregoing a succession plan – not to mention the long lead time in identifying and executing a viable succession plan – there is ripe opportunity for buyers and sellers to connect in the M&A market.

- Regardless of exit strategy, firms that maintain focus on continually refining their service offerings, their core value proposition, and delivering those services and value through a pricing model that clients can easily understand and appreciate will be in the strongest position to build value for both their firm and their clients into the future.

IN RESEARCH

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