5 Trends Changing Financial Services

Introduction

The financial services industry is in the midst of reinventing itself. Generational change is affecting business models; technological change is compressing margins while it creates new possibilities for services and businesses. Regulatory change is…well, who knows what the real effects, foreseen and unforeseen, will turn out to be, other than that they'll be expensive.

How can you deal with the uncertainty caused by the tumultuous pace of change? Start by lifting your sights from your workaday stresses and think about the major trends affecting our industry. Right now, there are five trends important enough to require that you think proactively.

It's important to know what the trends are, and it's important to know what's driving them: consumer preferences, competitive threats, compliance/regulatory noise or some combination. Then, whether you're an advisor or part of a firm that serves them, you can decide if (1) you're looking at a fad and you can wait it out (2) you can beat the trend or (3) you must join the trend because it represents a systemic change to which you must respond.

Take so-called robo-advisors: They are capturing investors' imaginations (and advisors', too) while putting up powerful competition to your pricing model. They'll either carve out some market share or expand the pie—and one way or another, you'll have to deal. Ask yourself: How do the new algorithmic platforms affect my business? If you have a tech-intensive practice, you might be more sensitive. And if you are looking at working for only five or so more years, maybe you don't have to spend a lot of time on the issue.

My resource partners (see open architecture structure at www.StrategyAndResources.com) and I recently had the opportunity to discuss the five trends that matter with an impressive group of industry executives while at the FPA Major Firms Symposium. Here, in order of importance, are the top five trends—and some ideas of how to deal with them. After that, please read the roundtable discussion of the trends.

TREND #1: REGULATORY PRESSURES

Many people equate regulation with the Department of Labor and its emerging version of the fiduciary standard. Certainly that's the big fight going on now, but it's far from the only set of rules that affect our industry. Regulations change in ways that may be unanticipated and even counterproductive. Regardless of your business model or how successful you are, you can still be derailed by regulatory over-reach. Think about the evolving focus on cybersecurity: are you certain that you know what you need to do?

In a recent survey tha that my firm, Strategy and Resources, LLC, executed for the Financial Services Institute (FSI), CEOs ranked regulation as their number-one problem because they have the least amount of control over it and the least ability to prepare. The political circus makes for interesting discussions in boardrooms, but insofar as creating a strategy, it's hard to implement meaningful change. Take the coming Department of Labor (DOL) rules on 401(k)s. For years, you may have thought you knew the way the landscape was going to work. But there was no rule yet—and even now, the rule has not been finalized. How do you convince your board, which represents your shareholders, that you should change the firm in anticipation of rules that may morph dramatically, or be killed in the cradle by Congress?

When thinking about fiduciary regulation, or regulation in general, it is helpful to understand that there are two drivers. One is the obvious fact that administrators need to justify their existence. But Two—the reason for the regulatory over-reach—is important. Ultimately, the reason the fiduciary fight has traction is the trust gap that exists between consumers and the industry—this really is Main Street versus Wall Street. Years of self-inflicted wounds, from Bernie Madoff's Ponzi scheme to the 2008 market meltdown—which came so quickly on the heels of the 2000 tech collapse and bear market--have fostered distrust in the markets in general. People lost a lot of money and suffered a great deal. Retirees had to scramble and workers lost jobs and homes. Even if your firm was not directly to blame, it's important to acknowledge that the financial industry overall did not serve our society well at that moment.

What's worse, the industry did not step up to remedy its problems internally, within the family of firms. Instead, it's drawn lines in the sand and each side has thrown the other under a bus. The result is then that consumer advocates like Barbara Roper, director of investor protection at the Consumer Federation of

America, come out and say that the entire industry is tilted against the consumer, like casinos, and the little guy won't ever get a fair deal. This is something the industry has to face, with some courage, and figure out together. It's not good for us to fight among ourselves—especially in a language people don't understand.

In addition, our communications are buried in gobbledygook. The industry has not helped itself by avoiding the obligation to create an informed consumer. We just haven't done the job. As a result, regulators see an aging population that doesn't understand what they're buying, that may have cognitive issues, that may be working longer and doesn't have time to lose money or to recoup. If the industry doesn't try to solve the problem, the regulators will. And it creates room for a disruptor to step in.

TREND #2: SUCCESSION ISSUES

Most advisors fail to plan effectively for succession. Owing to a lot of misinformation in the marketplace, there's a belief that even the smallest solo practitioner has built actual transferable equity and he or she will enjoy a plentiful liquidity event when it's time to go fishing or golf full-time. In most cases, that equity is just not there. This misapprehension creates two issues: one, the advisor's expectations will not be met; and two, the clients and possibly staff are abandoned when the principal retires or dies.

Like investors, advisors have suffered from the impact of the Great Recession. Some have successfully rebounded and others are not as effective as they once were. Most advisors are accidental entrepreneurs who are great at business development but not as great at operations—they don't want to run a business and they don't develop the skills.

Today, the better advisors have a new succession opportunity: they can sell their firms to consolidators and institutional players. Over time there will be increased exit options on both the buy and sell side for advisors, as well as for broker/dealers.

The various consolidators have different strengths and focus. Some can solve for operational efficiency, some for business development, some provide a pathway to becoming a hybrid. But bear in mind that there's only so much money out there. First Republic Bank may have paid $125 for Luminous Capital, but there are only a few firms that merit mega-deals and most advisors really shouldn't get big eyes.

Consumers are driving this trend as well. According to research by Cambridge Investment Research and *InvestmentNews*, more than 70% of affluent consumers say they'd rather do business with a team or institution, not a solo practitioner. At this time, 40% of advisors say they're part of a team, and 30% plan to join a team going forward. Building a team positions advisors to transfer equity in their practice when they retire, and helps them create a consistent client experience.

To deal with this trend productively, ask yourself these questions: Do I want equity out of my practice? Do I need partners to help? Do I need a partner that has infrastructure to help me?

If you're not looking to sell to an outside firm, you have a different challenge: making your business attractive enough to interest next-generation successors. People entering the financial services industry today are, for the most part, different from the first generation. They are university-trained, with degrees in personal finance or financial planning. Their background is rarely a sales background—they haven't been through a wirehouse or insurance agency. They haven't had that moment when they realized that they had to do things another way.

But if you think about the deal many advisors offer, it goes something like this: "You can follow my path, work 100 hours a week, live on rice and beans for a few years and walk uphill to and from the office—and then, maybe I'll give you the opportunity to borrow money from me to buy my business." Would you go for that? Of course not.

The typical next-generation advisor doesn't want to do business the way the last generation did. Instead, he or she wants a career path upon which the ability to serve the end client is clear, compensation is fair, and the ability to grow wealth is visible. These are terrific goals. Instead of trying to make the next generation just like the last one, I strongly encourage joining them. They are well versed in technology, both the software that is endemic to financial services and the new communications platforms that their generations seem to use as naturally as the older folks breathe air. Adapting the business to suit the needs of a next-generation successor may make it more sound. The drawback is that you'll need capital—and many advisors may need an institutional partner's help in that regard.

TREND #3: CHANGING ADVICE MODELS

A lot of misinformation about advice models is floating around. For instance, it has been said that most advisors will move to charging by the hour; however, in my experience, I'd say that's not likely—although there is an important shift toward separating the value of advice from the bundled way business has been done before, when compensation was baked into the product structure. By separating out and charging for a financial plan, advisors are putting the revenue where it belongs in their business model.

Part of this shift has been driven by advisors' self-interest. Consumers are moving to less expensive investment products, such as ETFs and other passive products. As a result, 12b-1 trails are drying up. Advisors are rethinking their fee structure to accommodate the change.

Some advisors are adopting a family-office approach and moving to retainer-based pricing. They may not even manage the assets, or they use a separate service. Others are going in the opposite direction and taking portfolio management and stock selection into their own hands. These advisors are keeping some of the compensation that used to go to asset management firms—and their clients still come out ahead on costs. The big question mark, however, is their performance. Thus far, the statistics are not so impressive.

In addition to costs changing, clients are changing.

Women will control $22 trillion in assets in less than five years. The industry is only starting to pay attention to what they want, and still assumes that most women will gain control of these trillions through inheritance. Today, though, many women are creating their own wealth and are the source of the wealth. They are executives; they are entrepreneurs. And these women think differently from women who inherited their wealth. They're involved in accumulation, are better informed, and are living longer. What does this mean for the way you deliver advice? Should you hire staff? Change focus? This is both a demographic issue and a consumer issue, and deserves real attention.

TREND #4: NEW MARKETING METHODS

Yes, everybody has a website now. But that's just the first step toward a new marketing paradigm. If you want to attract new clients who are under 50, you have to think about social media and digital communications. This is what consumers prefer and the expectations will only become stronger.

I use my daughter Tara as my one-woman focus group. She's in her twenties, living in a major city, and working in her chosen field—she's a successful Millennial. For Tara and her friends, if something's not on an iPhone it doesn't exist. And if you recommend a business that doesn't have a Yelp review, they won't use it. They completely distrust any traditional marketing methods, and place trust in peers instead. This means they're giving the cold shoulder to the institutions in the industry.

A couple of years ago, a friend's Millennial daughter called her to ask about starting to invest. Rather than talking about banks, brokers or mutual funds, she asked about two names: LearnVest and Wealthfront. She thought these brands were more relevant for her needs, because she thought she could use them from her phone.

We live in a new era where old financial institutions are losing their control. Everyone has access to markets. Everyone has access to timely data. You can launch IPOs without a bank. Getting recommended on LinkedIn or liked on Facebook, in many cases, has more power than being the good guy in the community. So if you're running a broker/dealer, bank or custodian, or any firm that serves financial advisors, marketing is getting pretty interesting.

In the FSI survey, we asked broker/dealers if they allowed their advisors to use social media, and whether they provided support for advisors who wanted to use the new digital communications tools to reach more people. The respondents revealed that the two major concerns are compliance and practice management.

In 2011, 70% firms allowed social media for business purposes. In 2014, that number was 95%. In 2011, 44% of firms provided social-media assistance. In 2014, that number shot up to 85%.

This is despite the fact that social media is essentially unregulated—there's guidance but few rules. For years, broker/dealers prevented their advisors from using social media and blamed regulations: FINRA's not clear about what you can say. FINRA's still not clear, but it seems that, more and more, nobody cares. Finally, broker/dealers have recognized that advisors are going to have to use these tools and that the need is consumer-driven—millions of people are on social media and advisors don't want to be on the outside looking in. Consumer preference is outweighing the perceived compliance risk.

If you want the next generation of clients to find you, and the next generation of advisors to work with you, you have to deal with and embrace social media. Outsourcing it, at least to some degree, is an option. The outperforming financial firms now employ social media to convey their message and build their brand.

Firms still have to get clarity about their message, though. They need to get their content out, and to express their points in a meaningful way. This is why branding in the age of robos is such an important topic. Every firm has a brand, whether they know it or not. Care must be taken to deliberately define and promote that clear and distinctive brand.

TREND #5: FEE COMPRESSION

Clearly all the data being published, and from my firm's own research, confirms that there is fee compression in the advisory space. Who's experiencing it—everyone in the supply chain? No. Are the cost savings being passed through to end clients? No again.

This is why robo-advisors are so compelling. Robo-advisors could be perceived as a threat—but are they really?

Are consumers attracted to robos because of lower cost? Convenience? Desire for control? Simon Roy, president of Jemstep—a robo for advisors, now owned by

Invesco—says that the improved user experience and ease of onboarding that robos provide “makes it easy for the client to say yes.” This doesn’t sound like such a bad thing—so long as you are strategic in how you go with the trend.

Others are trying to beat the trend. Some advisors have made fee adjustments out of a sense that they should compete on cost—which means that they’re giving up margin. This is more of a tactical response, and one that’s not fully informed. Why enter a race to the bottom?

Advisors who are concerned about fee compression have to take a hard look at their own value proposition. If they are plumping their margins by acting as a portfolio manager, in a Rep-as-Portfolio-Manager structure (RAPM), is their performance up to snuff? Unfortunately, data suggests that typical performance in RAPM accounts is just below that of self-directed investors.

Ultimately, if regulation forces advisors to become completely transparent and disclose clients’ actual investing costs, the question for the advisor is this: will the business model hold up to the clear light of day? If you actually had to paint a complete picture to your clients, it would go something like this: there are five people who are involved in providing this fund, and here’s my fee, plus the transaction fee, the platform fee and the 12b-1 fee. What if you couldn’t deduct these fees from the account and instead, your client had to write a separate check to cover investing costs? Would the industry actually hold up? If clients actually had to approve that investment fee each quarter, then we’d really be talking about fee compression.

So now, strategic advisors should be thinking, how do I get ahead of that change? Can I be a disruptor by providing more transparency around fees, and then if I provide a clear value-add, charge an hourly rate or project fee? An estate review, life planning services ... I can charge extra for these services, and not hide my costs in a fee that’s shielded from the reality of an invoice?

Advisors who are holding firm on pricing and figuring out how to be more efficient are actually expanding their margins. They can streamline their operations by maximizing their use of technology. They can lower the cost of investing by switching to less-expensive products. That’s not such good news to the providers of products that can be cut out—I wouldn’t like to be introducing a domestic large-cap mutual fund today. Smart firms should be asking if they’re part of the problem or part of the solution. Otherwise, they will be vulnerable to being marginalized.

Take some time to think about how these trends affect your firm. Break down each element of the services and products you deliver. What really needs to exist and who needs to be responsible? What are the costs? Should you outsource? Ultimately, you can make your firm more efficient, more strategic and more effective, and pass the cost savings to your clients.

If you are interested in drilling down further into these five trends that matter, a full transcript of the resource partners' roundtable dialog, along with corresponding video clips, may be found on www.AdvisorsThinkTank.com.

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