Valuation of Fee Based Advisory Accounts Is the Traditional Approach Dead?

In the past, the value of a Financial Advisor's (advisor) practice was primary based on total assets under management and recurring revenues. It was almost purely a quantitative approach and it assumed among other things:

- Rate of retention
- Recurring annual revenue
- Average life of an account
- A net profit margin

Assume for a moment that the firm earns 1% on a $1,000,000 account, with an average tenure of 20[1] years and the firm's profit margin is 20%. The math is simple:

$10,000/year for 20 years = $200,000 x 20% profit margin = <u>$40,000 Lifetime Value</u>[2]

The caveat, of course, is that the firm is able to meet and maintain all the assumptions noted above.

In recent years, many new factors have been introduced that can profoundly affect the lifetime value of an advisory client or better put, what a buyer is willing to pay. Advancements in technology, the explosion of publicly accessible information, instability in the financial markets, "robo" advisors, rapid fee compression and changing demographics have diminished the reliability of traditional valuation methods.

To further complicate the matter, litigation and regulatory risk have recently increased dramatically.[3] Regulatory and legislative trends are pointing to even more aggressive surveillance and enforcement in the financial services industry. Now, more than ever, it is essential to consider liability exposure associated with acquisition of customer accounts.

The last 15 years have brought very significant change in products, services, technology and regulation in the financial services industry. A natural outcome has been increased consolidation and attrition among FINRA member firms and registered representatives. Those

[1] 20 year tenure imputed from 95% retention (firm loses 5 of 100 clients/year)
[2] Example taken from The Kitces Report "Quantifying the Value of Financial Planning Advice"
[3] FINRA arbitrations 2016 year to date have increased 20% over same period 2015

that remain have employed a number of strategies and new business models to accommodate the inevitable trend of fee compression and increased cost of doing business resulting in shrinking margins.

A critical common denominator shared by these individuals is adaptability. In order to sustain the economic pressure of increased regulatory and litigation risk coupled with shrinking fee revenue and increased cost of doing business, they need to increase the gross volume of business they conduct and fees they receive.

Growth in gross revenues comes from three primary sources:

- Client Retention
- Acquisition of New Business
- Organic Growth of Assets Under Management

In addition, increased operational efficiencies that can accommodate the increased volume of business are essential. This is accomplished by a combination of employing highly skilled staff, applying prudent fiscal management and utilizing state of the art technology.

A very important predictor of future success and value of an advisory practice is client retention. In recent years this issue has been studied in various sectors of the financial services industry, including securities, insurance, financial planning and investment advisory firms. A declining number of players create an opportunity of increased market share for those that remain.

Factors Affecting Client Retention by Independent Advisors

Depth of Relationship

- Frequency of contact – Retention improves with increased number and consistency of meetings and contacts.
- Type of relationship – Retention is higher in fee based advisory accounts as opposed to brokerage only. The highest retention occurs in blended accounts where the client is both brokerage and fee based.[4]
- Number of accounts – Retention is higher where there are multiple accounts within the same household. For instance, individual accounts for husband and wife, joint accounts, children and grandchildren, etc.

[4] Supported by results of 2013 "Fiduciary Impact Survey" conducted by the Leadership Center for Investments Stewards

- Number of services – Retention increases with cross selling. For instance, within the household, the advisor is providing multiple financial services such as financial planning, investment advisory services, life and health insurance.
- Stewardship - Studies of best practices consistently demonstrate that client satisfaction and retention are greatly affected by the level of engagement between the advisor and client. In addition to the factors noted above, ancillary contact is also a positive contributing factor, such as birthday cards, anniversaries, and social events for clients, educational seminars, newsletters and client accessible tools.

Fees and Expenses

The client's perception of value relative to fees being paid is critical. Highest retention corresponds with the median management fees of 1 to 1.5% of asset value per year.

The probability of retention falls on both the low and high side of the mean, with the lowest occurring at 2.5% and higher. The second lowest is .5% and lower.

Larger clients display less sensitivity to price than smaller clients.

Performance

Meeting client expectations is more important than raw performance. Having well defined goals and strategies, communicating them and periodically reviewing them is an essential component of a prudent process. Retention is higher in a model with regular monitoring than one that is simply trying to "outperform the market".

General Observations

- Retention is highest in the first 12 months (circa 95%). Attrition is highest between 12 and 24 months (falling steadily to 70% at 5 years)[5].
- Small clients are less likely to be retained and having an excessive number of small accounts negatively impacts overall retention.
- Retention is higher where advisor engages an client retention strategy.

[5] Taken from PriceMetrix Study "Stay or Stray" December 2013

- Fee based accounts have higher retention than transactional (brokerage) accounts. However, the highest retention occurs where the client has both types of accounts with the advisor.
- Older clients are more likely to be retained than younger ones.
- An industry survey conducted by the Aite Group in September of 2013 found that both independent and wire house financial advisors that purchased practices, reported an average of 76% retention.

Summary

Computing the lifetime value of advisory clients is complex and dependent upon many qualitative factors in addition to standard quantitative approaches. It would be very simple if recurring revenue per account was reliable and predictable. For all the aforementioned reasons, it is neither. It is beyond argument that current industry trends are shrinking profit margins for financial advisors. Many industry experts speculate on where and when that will end, but most agree that this trend is causing attrition of financial advisors and firms and will continue for some time.

Qualitative Factors

More attention and study is being directed to qualitative factors that affect investor sentiment and perception of value. Because of limited statistical data, this remains the wildcard that significantly skews valuation models. Industry studies to date suggest a very high correlation between advisor's beliefs, values, and acceptance of duties and the size and depth of their practices. As shown in the data of the Fiduciary Impact Survey, (attached with the gracious permission of Don Trone), advisors that manage larger and more profitable practices embrace and deploy fiduciary duties at a higher frequency than those that do not.

The industry has placed almost all of its attention on serving the "Baby Boomers" market as it represents the largest portion of investable assets in the market. Naturally, the most successful practice models have been optimized to serve that market. The next two decades will dramatically change the market as boomers fade and are replaced by millennials. More study is required to understand their behavioral characteristics, sentiments and preferences in order to optimize the provision of financial services to them. This too, should be seen as a wildcard in the valuation process.

Difficulty Quantifying Risks

Anyone that has been involved in a customer complaint knows that decades of profit can evaporate instantly in litigation, even when the defendant prevails! Simply put, the cost and frequency of litigation is increasing and expected to rise with the adoption of the new DOL Fiduciary Rule. At present, there is insufficient data to estimate the potential litigation costs and regulatory fines that will likely follow the adoption of the DOL rule.

In conclusion, thoughtful consideration and negotiation between two parties, at arm's length, may be the best method of establishing fair value of a book of business. This is especially true when both parties share similar experience in the industry, awareness of the risks and benefits that accompany customer accounts and common business models.

FIDUCIARY IMPACT SURVEY – EXECUTIVE SUMMARY

Donald Trone
CEO/Chief Ethos Officer
don@3ethos.com
860-333-3401

Warren Cormier
CEO/President
warren@bostonresearch.com
617.835.4264

Dorothy Hinchcliff
Managing Editor
dhinchcliff@fa-mag.com

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FIS Advisory Panel

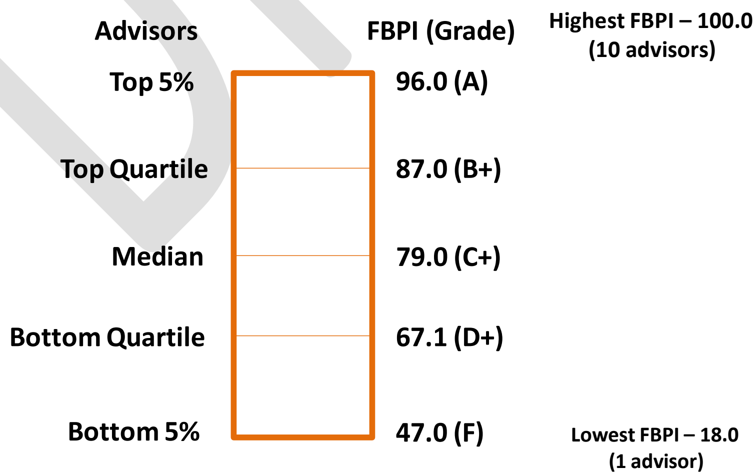
A panel of industry experts was formed to help in the drafting and editing of the questions that were used in this survey:

David Bellaire	FSI, General Counsel and Director of Government Affairs
Bradford Campbell	U.S. DOL, Former Assistant Secretary of Labor for Employee Benefits Security
Bill Chetney	LPL, EVP Retirement Partners
Ron Hagan	Founder, CEO, Investment Fiduciary Leadership Council
Martin Kurtz	FPA, Past President
Elizabeth Piper/Bach	NADA Retirement Administrators, Vice President and Chief Operating Officer
George Revoir	John Hancock, Senior Vice President, Retirement Plan Services
Skip Schweiss	TD Ameritrade Trust Company, President
Mark Tibergien	Pershing Advisor Solutions, CEO
Sean Walters	IMCA, Executive Director and CEO
Gib Watson	Envestnet | Prima, Group President

The Fiduciary Impact Survey (FIS) had four objectives –
Two of the four objectives were accomplished, and two remain ongoing:

Objective	Status
1. Benchmark best practices associated with a fiduciary standard	**Accomplished:** Sixteen best practices were identified; and, each best practice was analyzed for the number of respondents who had indicated that they implement with the practice.
2. Measure the rate of adoption of best practices associated with a fiduciary standard	**Ongoing:** Since this is the first annual survey, the rate of adoption cannot be determined until there are subsequent surveys.
3. Measure the impact best practices associated with a fiduciary standard have on the success of an investment advisory practice	**Ongoing:** Additional surveys will need to be conducted to prove conclusively that fiduciary best practices have an impact on the success of an advisor.
4. Publish survey results in the form of a "Fiduciary Best Practices Index (FBPI)"	**Accomplished:** The 2012 FBPI has been calculated – see below

2012 FBPI (Fiduciary Best Practices Index)



500 advisors completed the survey, representing an excellent cross-section of the industry:

By Registered Status

25.0%	RIA, Federal SEC oversight
32.0%	RIA, State SEC oversight
27.0%	IAR (dually registered)
16.0%	Registered Rep

By Practice Area

47%	Financial Planners
41%	Wealth Managers
12%	Retirement Advisors

By Size (Assets under management)

26%	$20 mil or less
22%	$20.1 mil - $50 mil
28%	$50.1 mil - $150 mil
24%	More than $150 mil

Distribution of FBPI and Grades

Grade	Percentage	Number of Advisors	Net Whole Grade Percent/ # of Advisors
A+	4.8	24	
A	9.2	46	19.4/ 97
A-	5.4	27	
B+	8.0	40	
B	11.0	55	28.8/ 144
B-	9.8	49	
C+	8.8	44	
C	10.0	50	22.6/ 113
C-	3.8	19	
D+	6.4	32	
D	9.0	45	15.4/ 77
F	13.8	69	13.8/ 69

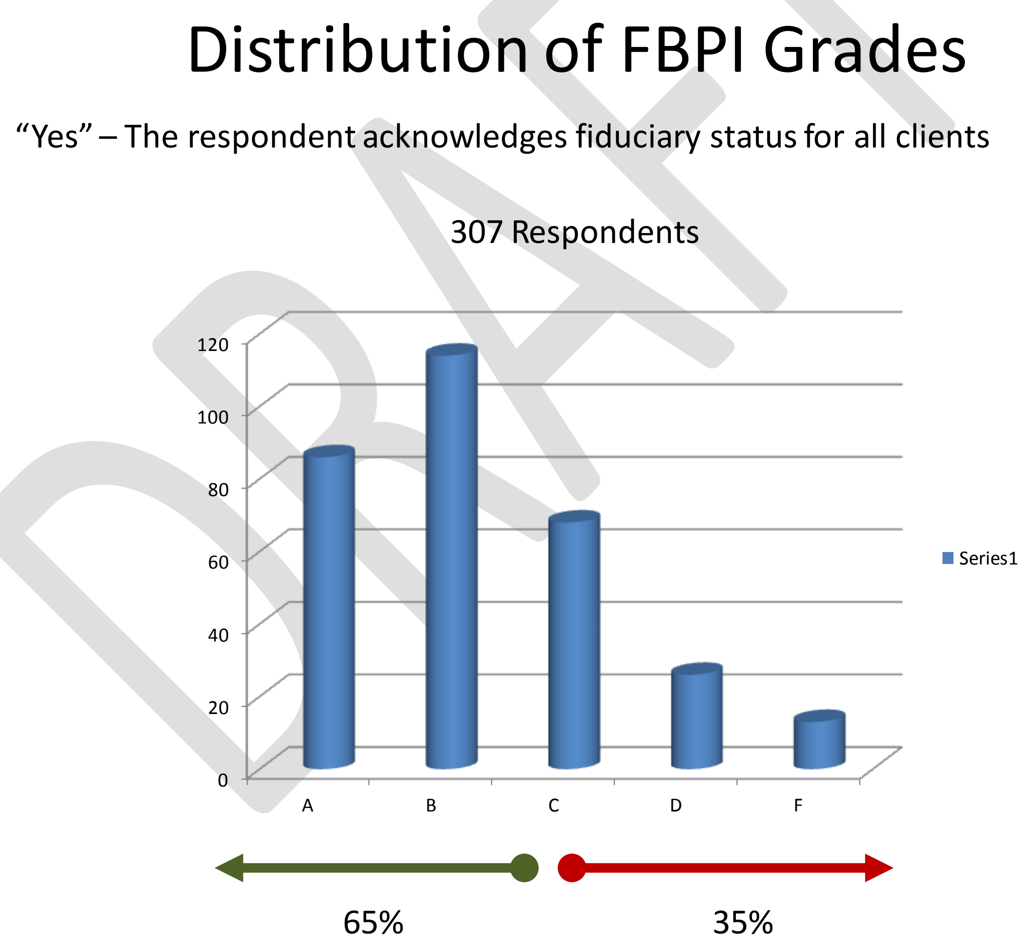
Grading Scale for Converting FBPI

A......... 93% –100%
A– .... 90% – 92%
B+....... 87% – 89%
B......... 83% – 86%
B– .... 80% – 82%
C+....... 77% – 79%
C......... 73% – 76%
C– .... 70% – 72%
D+....... 67% – 69%
D......... 60% – 66%
F .... 0% – 59%

Summary of Findings

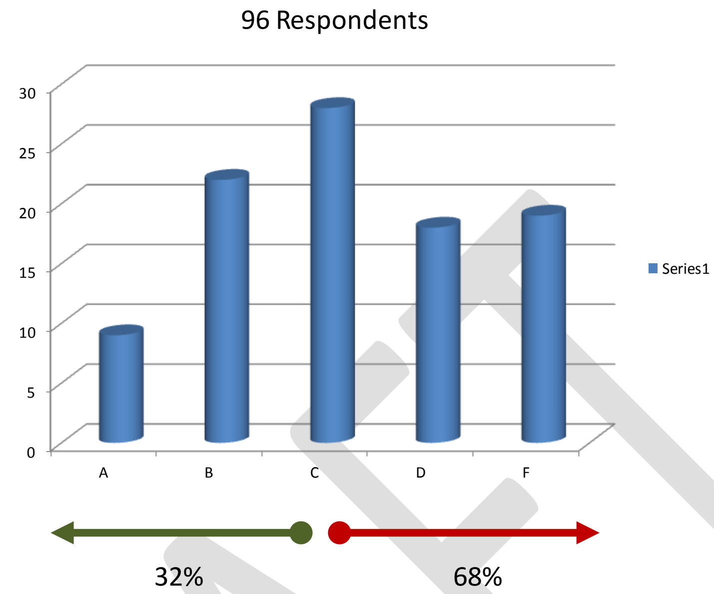
1. There is a strong correlation between the acknowledgement of fiduciary status, and the respondent's FBPI (Fiduciary Best Practices Index):

Percent	Fiduciary Acknowledgement	FBPI Grade
61.0%	Acknowledge fiduciary status for all clients	**B**
19.0 %	Acknowledge fiduciary status for some clients	**C-**
20.0%	Do not acknowledge fiduciary status	**D**



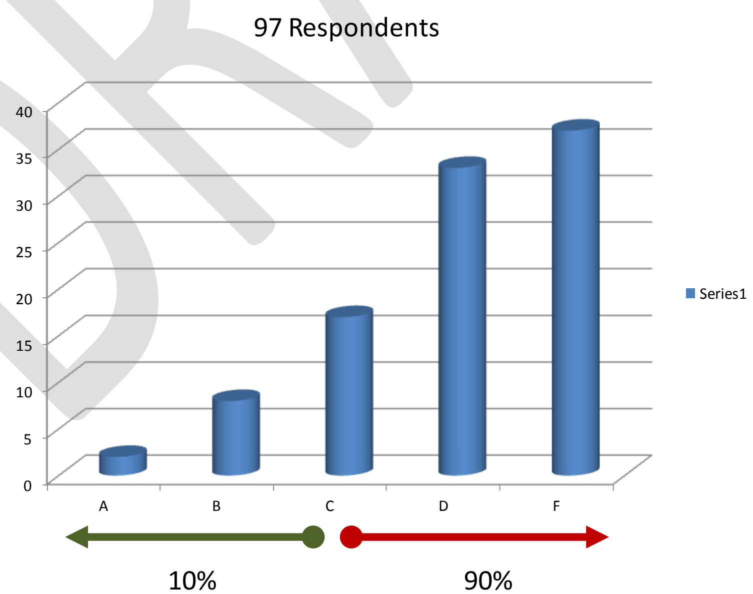
Distribution of FBPI Grades

"Some" – The respondent acknowledges fiduciary status for some clients



Distribution of FBPI Grades

"No" – The respondent does not acknowledge fiduciary status in writing



Four questions on the survey dealt with the principles associated with a fiduciary standard of care (in contrast, the remaining questions dealt with the practices):

Question	Percent of respondents who answered “Yes”
a. Do you place the best interests of your clients above your own interests?	**99.8%**
b. Do you avoid conflicts of interest?	**97.8%**
c. Do you claim that you are an objective advisor?	**95.3%**
d. Is it important to you that you work with people who are ethical, and who have integrity?	**99.4%**

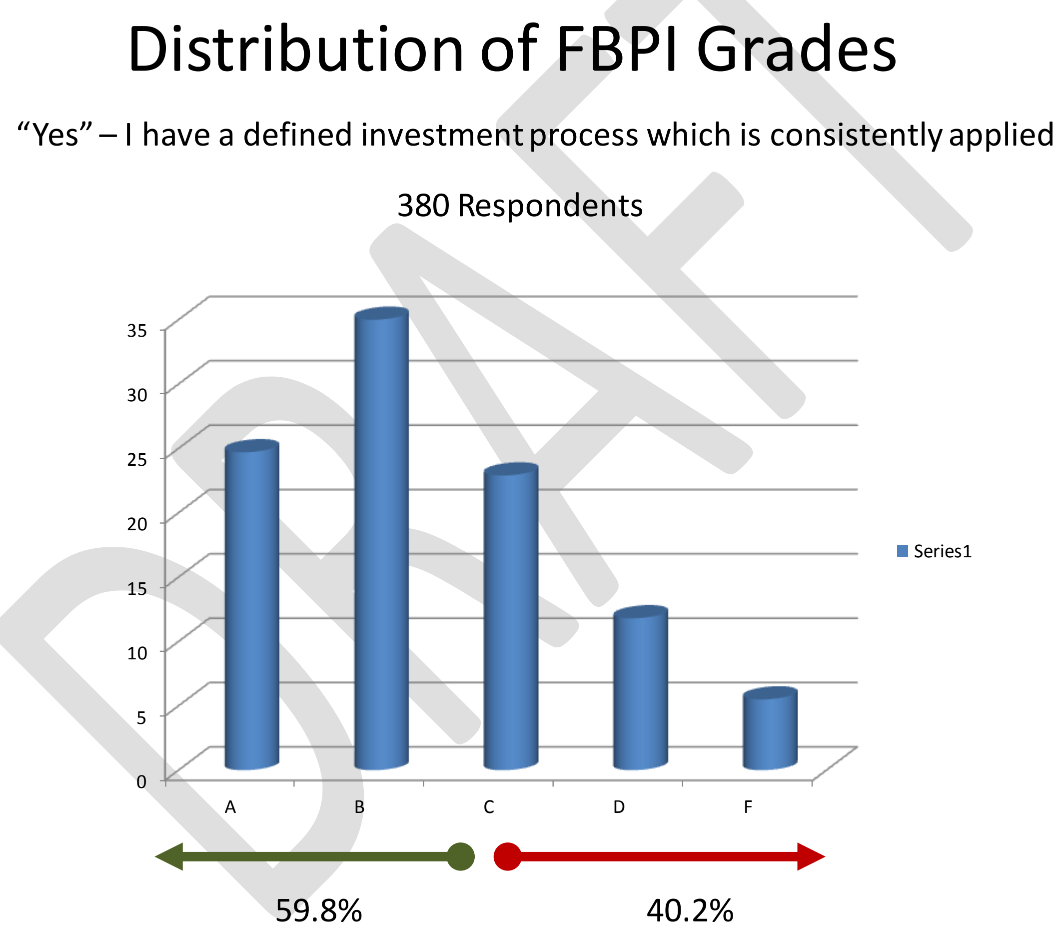
It is important to note that respondents clearly identity with the principles associated with a fiduciary standard of care. However, the Survey results demonstrate that respondents are not as familiar with the practices associated with a fiduciary standard of care.

2. There is a strong correlation between a respondent’s knowledge of fiduciary Acts and case law, and their FBPI:

Percent	Legal Knowledge	FBPI Grade
23.5%	Familiar with fiduciary Acts and case law	**B**
69.0 %	Somewhat familiar with fiduciary Acts and case law	**C**
20.0%	Not familiar with fiduciary Acts and case law	**F**

3. There is a strong correlation between the respondent having a defined investment process, and their FBPI:

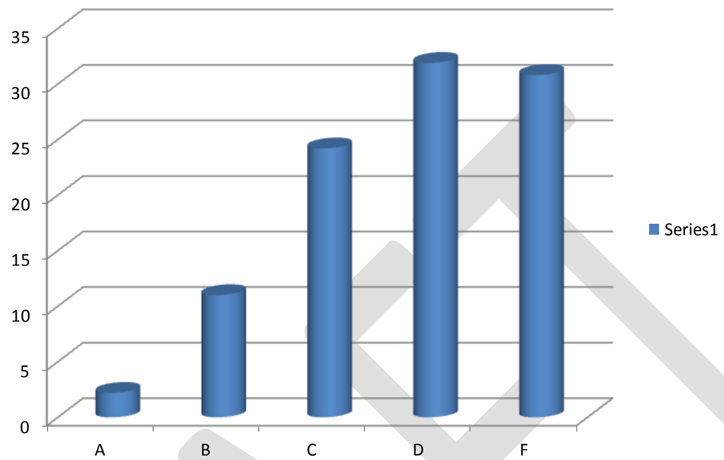
Percent	Defined Investment Process	FBPI Grade
77.0%	Have a defined investment process for all clients	**B-**
18.5%	Have a defined investment process for some clients	**D**
4.5%	Do not have a defined investment process	**F**



Distribution of FBPI Grades

"Some" a defined investment process for some clients

91 Respondents



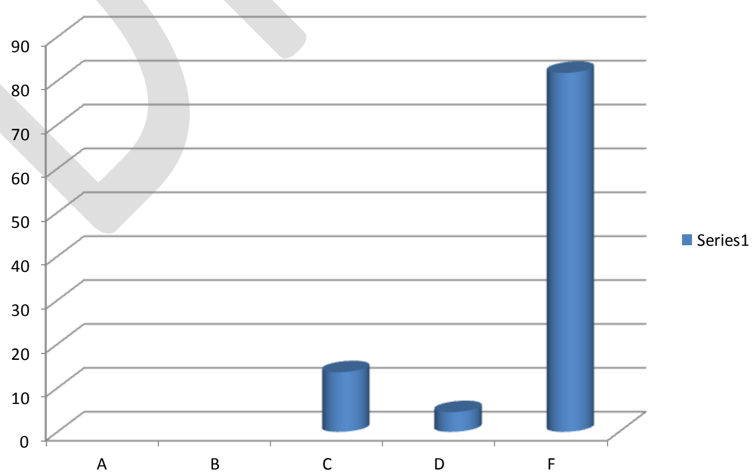
13.2%

86.8%

Distribution of FBPI Grades

"No" defined investment process

22 Respondents

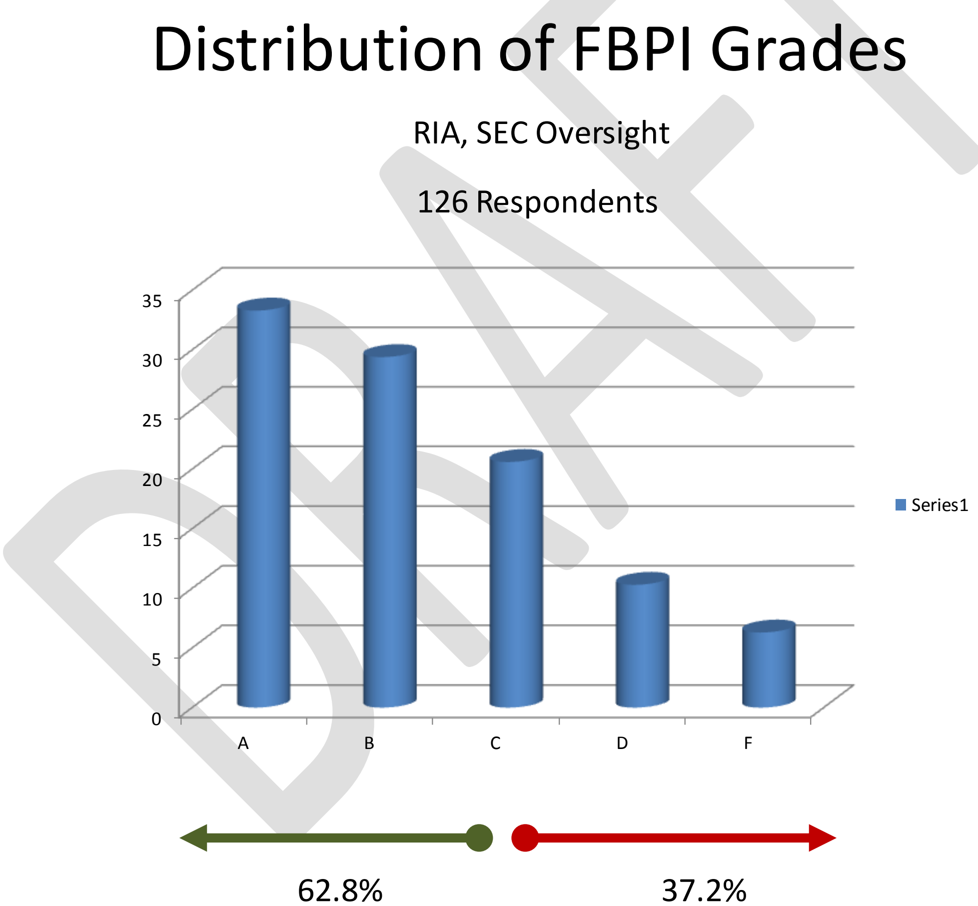


0%

100%

4. There is a strong correlation between the respondent's registered status, and their FBPI:

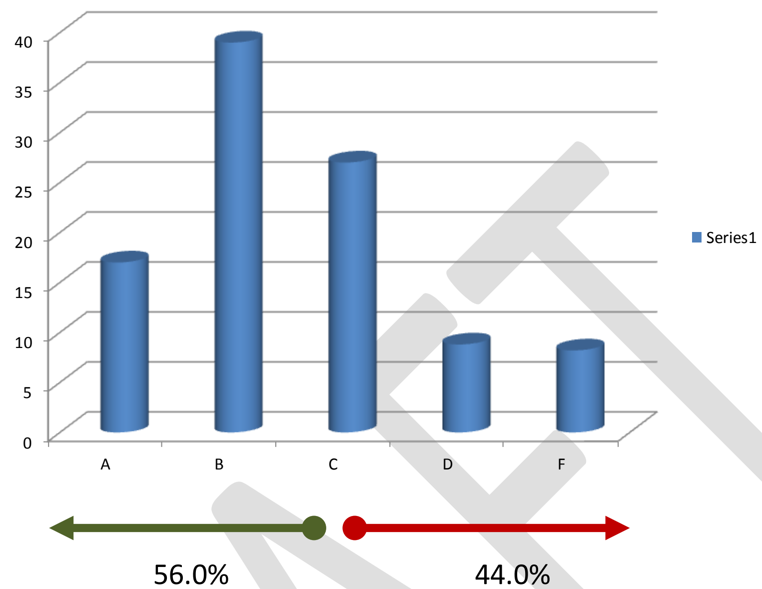
Percent	Registration	FBPI Grade
25.0%	RIA, Federal SEC oversight	**B**
32.0%	RIA, State SEC oversight- a listing of the 36 states by FBPI has been compiled.	**C+**
27.0%.	IAR, dual registration	**C**
16.0%	Registered Representative	**D**



Distribution of FBPI Grades

RIA, State Oversight

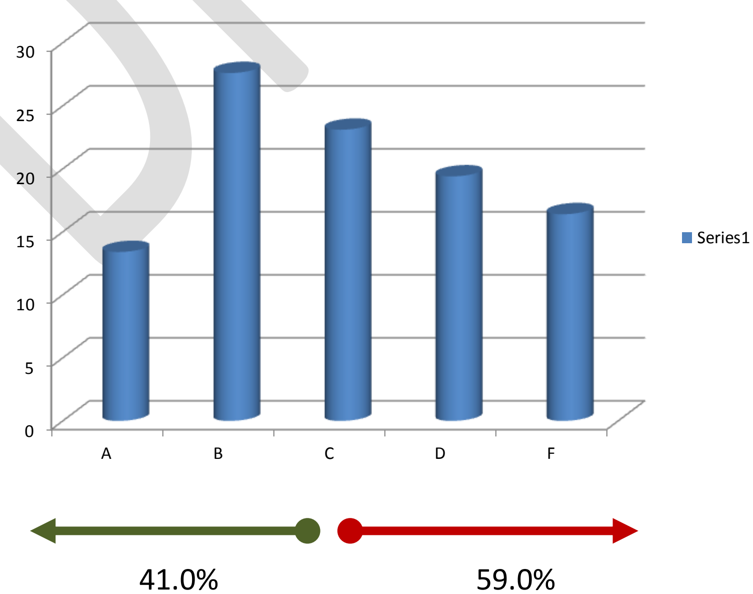
159 Respondents



Distribution of FBPI Grades

IAR, Dually Registered

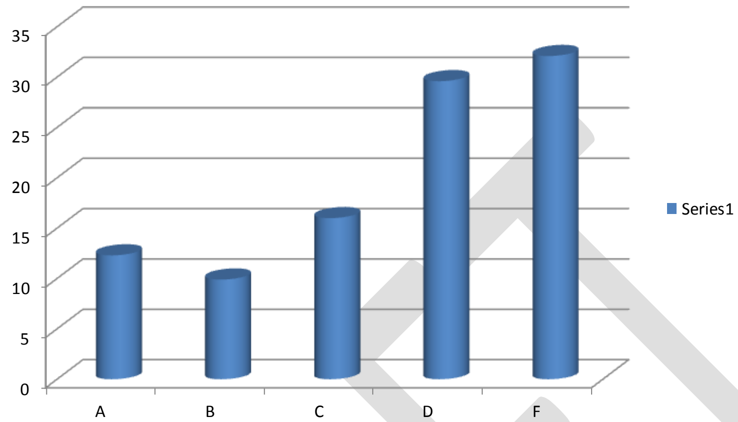
134 Respondents

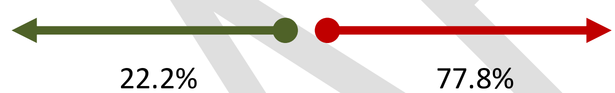


Distribution of FBPI Grades

Registered Representative

81 Respondents





Note: The following Table was constructed by analyzing the FBPI of respondents who are subject to SEC State oversight: (a) The number of respondents per state is very low, and therefore the state rankings are not statistically significant; and (b) Only 36 states are represented by respondents.

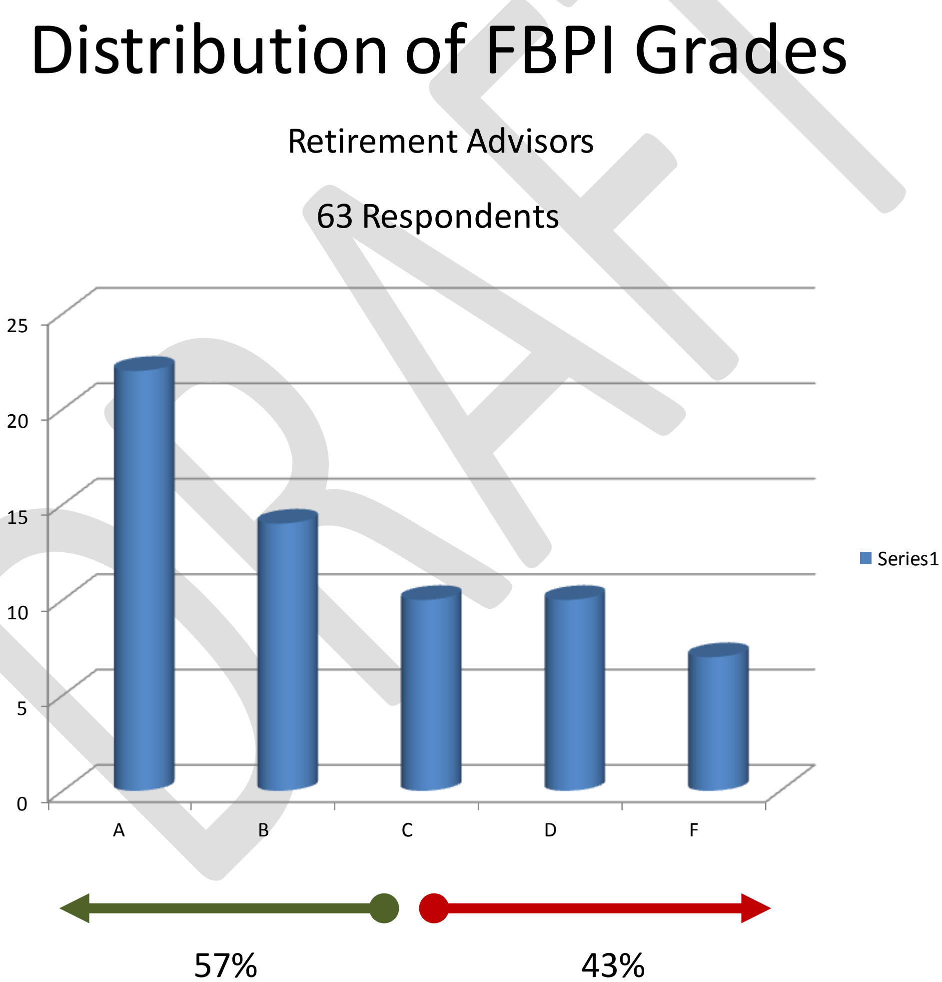
State	Does State Impose Fiduciary Standard on Brokers?	Average FBPI	Grade
AR	No	89	B+
NV	No	88	B+
TN	No	87	B+
WI	Some sort of standard	87	B+
MI	Yes	85	B

VT	No	85	B
CT	No	84	B
IN	No	84	B
AK	No	84	B
KY	No	84	B
TX	No	84	B
OH	No	84	B
NC	Some sort of standard	83	B
GA	No	83	B
MI	No	82	B-
AL	No	81	B-
AZ	Some sort of standard	81	B-
OR	Some sort of standard	81	B-
ID	No	79	C+
FL	No	78	C+
SC	Yes	78	C+
CA	Yes	78	C+
OK	No	77	C+
CO	Some sort of standard	77	C+
NH	No	77	C+

PA	No	74	C
VA	No	73	C
MN	Some sort of standard	72	C-
WA	Some sort of standard	72	C-
NY	Some sort of standard	71	C-
IA	No	71	C-
NJ	No	71	C-
IL	No	70	C-
MA	Some sort of standard	68	D
DC	No	62	D
MD	No	62	D

5. Respondents who identified themselves as a "retirement advisor" tended to have a slight edge over wealth managers and financial planners:

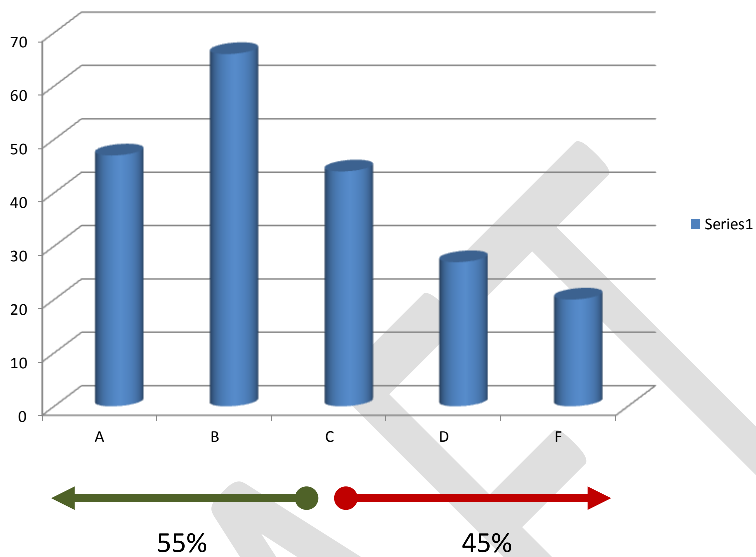
Percent	Practice Areas	FBPI Score	FBPI Grade
12.0%	Retirement advisors	79.4	**C+**
41.0%	Wealth managers	79.0	**C+**
47.0%	Financial planners	73.0	**C**



Distribution of FBPI Grades

Wealth Managers

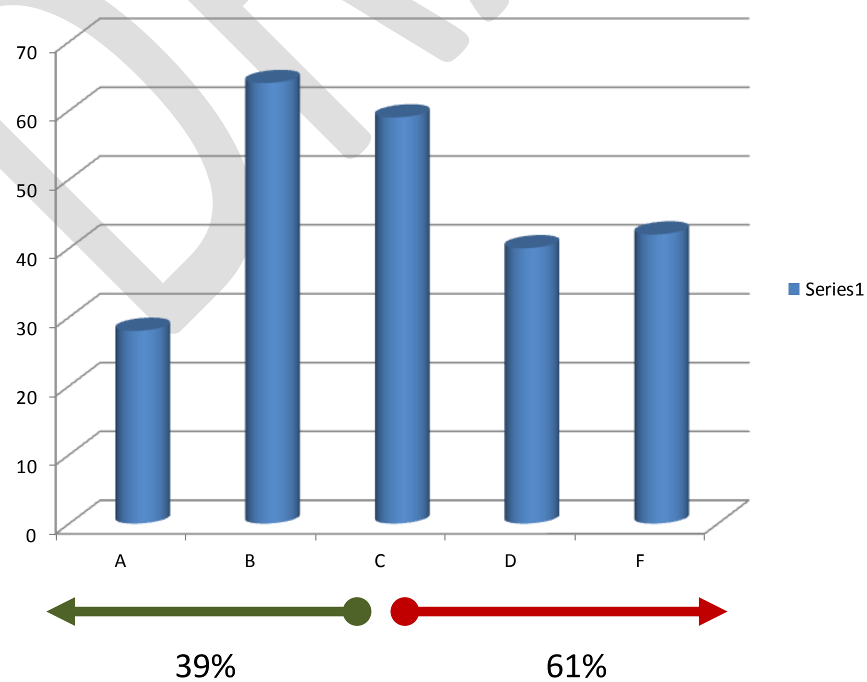
204 Respondents



Distribution of FBPI Grades

Financial Planners

233 Respondents



6. Respondents who crossed over to other practice areas tended to have a significant edge over other advisors:

Percent	Practice Areas – Sub Groups	FBPI Score	FBPI Grade
2.0%	I am a retirement advisor with some wealth management, foundation and endowment accounts	85.0	**B**
18.0%	I am a wealth manager with some retirement, foundation and endowment accounts	84.0	**B**
6.0%	I am a retirement advisor with some wealth management accounts	82.0	**B-**
10.0%	I am a wealth manager	80.0	**B-**
8.0%	I am a financial planner with some wealth management, retirement, foundation and endowment accounts	78.0	**C+**
5.0%	I am a retirement advisor	76.0	**C**
14.0%	I am a financial planner with some wealth management accounts	75.0	**C**
13.0%	I am a wealth manager with some retirement accounts	74.0	**C**
14.0%	I am a financial planner	72.0	**C-**
11.0%	I am a financial planner with some retirement accounts	71.0	**C-**

7. There does not appear to be any correlation between the number of client's a respondent services, and their FBPI:

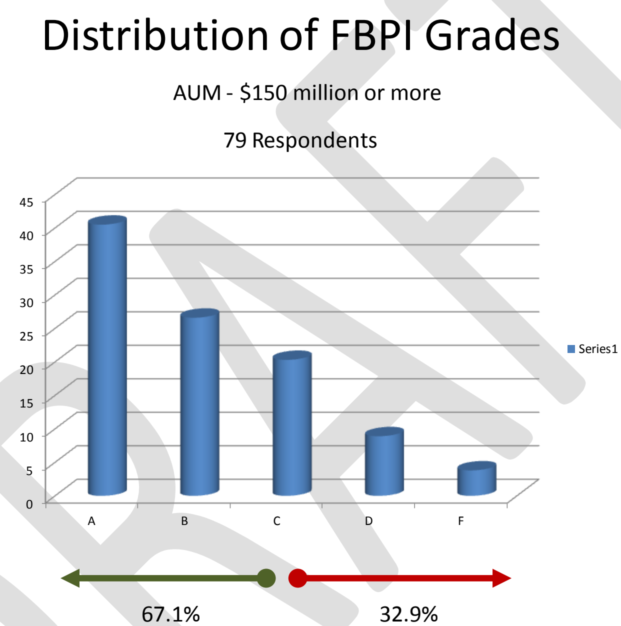
Percent	Number of clients	FBPI Grade
24.0%	1-39 Clients	**C**
24.0%	40-99 Clients	**C+**
26.0%	100-199 Clients	**C+**
26.0%	200+ Clients	**C+**

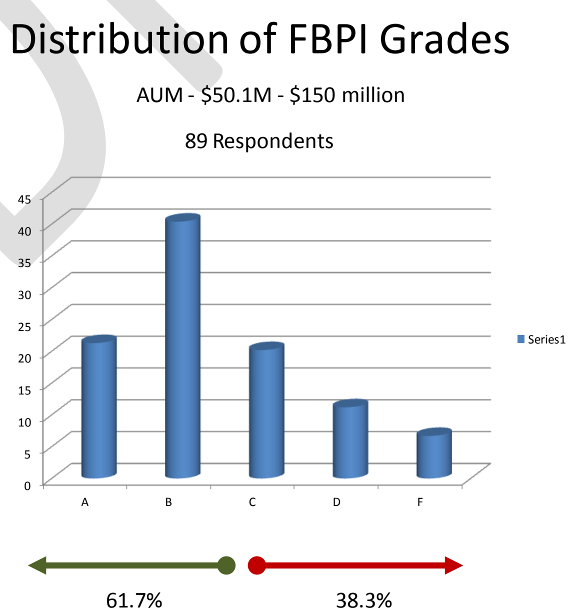
8. There appears to be a strong correlation between the respondent's minimum account size, and their FBPI:

Percent	Assets Under Management	FBPI Grade
41.0%	$0k - $50k	**C+**
18.0%	$50.1k - $250k	**C**
25.0%	$250.1k - $1 mil	**B-**
16.0%	$1.1 mil +	**B**

9. There appears to be a strong correlation between the respondent's assets under management, and their FBPI:

Percent	Assets Under Management	FBPI Grade
26%	$20 mil or less	**C**
22%	$20.1 mil - $50 mil	**C**
28%	$50.1 mil - $150 mil	**B-**
24%	More than $150 mil	**B**

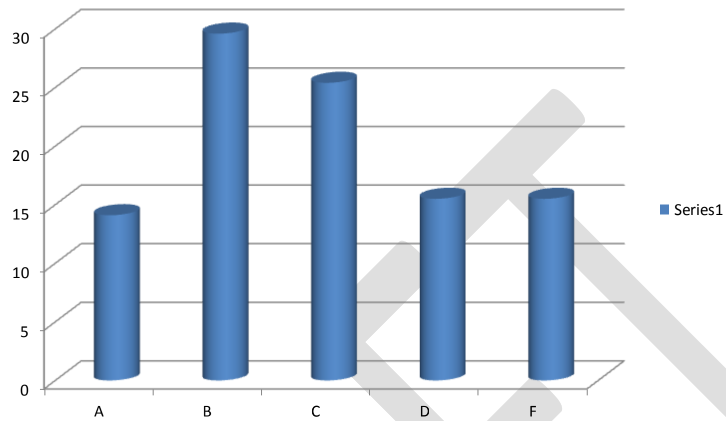




Distribution of FBPI Grades

AUM - $20.1M - $50 million

71 Respondents

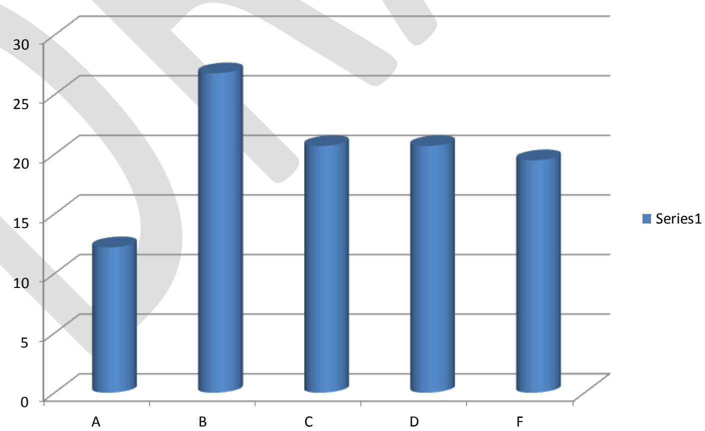


43.4% 56.4%

Distribution of FBPI Grades

AUM - $20.0 million or less

82 Respondents



39.0% 61.0%

10. When implementing a fiduciary standard, respondents indicated the following preferences for financial products:

Percent	Product Preferences	FBPI Score	FBPI Grade
7.0%	Collective Trusts	86.0	**B**
9.0%	Hedge Funds	85.0	**B**
14.0%	Unified Managed Accounts	80.0	**B-**
9.0%	Private Placements	80.0	**B-**
75.0%	ETFs	79.0	**C+**
8.0%	Proprietary Products	79.0	**C+**
92.0%	Mutual funds	78.0	**C+**
55.0%	Individual Stocks and Bonds	78.0	**C+**
33.0%	Separate Accounts (including Wrap Fee Accounts)	78.0	**C+**
22.0%	Commissioned Products	71.0	**C-**

11. When implementing a fiduciary standard, respondents indicated the inclusion of the following best practices:

Percent	Best Practice
96.0%	**a.** Align investment process to avoid conflicts of interest
96.0%	b. Delegate to an expert when lacking expertise
94.0%	c. Use a formal client data gathering checklist
94.0%	d. Monitor investment options on a quarterly basis
88.0%	e. Apply a due diligence process to each recommended investment option
87.0%	f. Use a risk-measurement questionnaire
87.0%	g. Use an independent custodian
80.0%	h. Have a process for monitoring conflicts of interest
79.0%	i. Provide clients a quarterly performance report in addition to the custodial statement
78.0%	j. Provide clients the option of implementing a portion of their portfolio with a passive strategy
77.0%	k. Provide clients with an Investment Policy Statement (IPS)
66.0%	l. Use asset allocation software or third-party modeling
62.0%	m. Have a formal process for determining when a manager should be terminated
55.0%	n. Provide clients the option of implementing a portion of their portfolio with a SRI strategy
55.0%	o. Have a succession plan
49.0%	p. Benchmark each client's fees and expenses

12. For respondents who have not implemented a particular best practice, there is a strong correlation to lower FPBI Grades:

When Best Practice Has Not Been Implemented	**FBPI Grade**
a. Align investment process to avoid conflicts of interest	F
b. Delegate to an expert when lacking expertise	D
c. Use a formal client data gathering checklist	D
d. Monitor investment options on a quarterly basis	D
e. Apply a due diligence process to each recommended investment option	D
f. Use a risk-measurement questionnaire	C-
g. Use an independent custodian	C-
h. Have a process for monitoring conflicts of interest	D
i. Provide clients a quarterly performance report in addition to the custodial statement	C-
j. Provide clients the option of implementing a portion of their portfolio with a passive strategy	C
k. Provide clients with an Investment Policy Statement (IPS)	D
l. Use asset allocation software or third-party modeling	C
m. Have a formal process for determining when a manager should be terminated	C-
n. Provide clients the option of implementing a portion of their portfolio with a SRI strategy	C
o. Have a succession plan	C
p. Benchmark each client's fees and expenses	C