

# THE STATE OF THE ADVISORY SERVICES INDUSTRY

by | [steve c. winks](#)

**QUESTION:** What is the state of the advisory services industry?

**WINKS:** For the first time ever, a distinction has been drawn between commission sales and advisory services. On March 30, 2007 the DC Court of Appeals settled who can provide investment advice, how they can be paid and what standard of care they can use. The DC Court of Appeals ruling in the FPA's suit of the SEC has ended a six year controversy over what has been called the Merrill Lynch Rule. Since 1999 the SEC has allowed brokers to use fee based compensation without being regulated as investment advisors. Advisors were being held to a fiduciary standard and were required to act in the consumer's best interests, but brokers were not. The DC Court of Appeals has brought much needed clarity on the role of the broker and the role of the advisor. Advisors are held to a fiduciary standard of care, may use fee based compensation reflecting the ongoing nature of their advisory services and are obligated to act in their client's best interest. Brokers are not held to a fiduciary standard of care, cannot use fee based compensation and are not obligated to act in their client's best interest. The court of Appeals ruling is consistent with the new SEC disclosure statement required of all advisors early last

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year. On January 31, 2006 the SEC required all advisors, whether they be brokers, bankers, financial planners or investment management consultants, to either acknowledge they are acting in a fiduciary capacity in advising their clients or they have to use a consumer warning which states to the effect, " I am acting in a sales capacity and am not obligated to act in your best interest." Thus the caveat emptor question of whether the consumer can rely on the advice of their advisor has been resolved. The consumer can rely on the advice of the advisor who is held to a fiduciary standard of care. Conversely, the broker is acting in a sales capacity and is not obligated to act in the consumer's best interest.

**QUESTION:** Many suggest the brokerage industry, the SIFMA (the old SIA) and the SEC will fight the Court of Appeals rulings?

**WINKS:** Each brokerage firm must decide how it will respond. The SIFMA has decided on behalf of the brokerage industry it will not challenge the court ruling. The SEC's right to appeal expired May 24, 2007 and it would have been unlikely they would argue against themselves and their new advisor disclosure statement requirement just put in effect January 31, 2006. It would be very difficult for the brokerage industry and the NASD to argue against the best interests of the consumer. The ruling is profound indeed, as every broker will want to be a fiduciary and every brokerage firm must now have a fiduciary affiliate, based on the nature of innovation and the competitive nature of the marketplace.

**QUESTION:** Has the consumer been confused on the role of the broker?

**WINKS:** Yes. The consumer has not been aware that it is a violation of the internal compliance protocol of NASD member brokerage firms for their advisors to either acknowledge their fiduciary obligations or that they render investment advice. The role of the 658,000 licensed advisors within NASD member brokerage firms who serve the vast majority of the investing public is simply to make investors aware of their investment alternatives. It is up to the consumer to determine investment merit, regardless of how limited their investment knowledge and experience may be. Of course the consumer is looking to the investment advisor for investment advice yet the responsibility of the advi-

advisor working within a NASD member brokerage firm is limited to offering trade execution services. Any investment advice provided is considered incidental to trade execution services provided by NASD member brokerage firms. No investment advice is intended, provided or implied. Because brokers engaged in commission sales call themselves investment advisors, the consumer and many advisors themselves are confused about the role and responsibilities of the advisor and the broker. The SEC has provided much needed clarity. Thus the state of the advisory services industry has never been better. The courts and the SEC, the industry's controlling regulatory authority, are advancing an entirely new and much clearer understanding of advisory services.

**QUESTION:** Can you explain why this is important?

**WINKS:** The courts and the SEC are tying the trust of the investing public to the fiduciary responsibility of the advisor. The trust of the investing public is essential to the health and well being of the financial services industry, the capital markets and our economy. An advisor who acknowledges their fiduciary obligation to act in the consumer's best interest is providing advice. An advisor who is not acting in a fiduciary capacity is by definition acting in a transactions mode. They are only compensated when they sell something. Their motivation is geared to selling an investment product more than how well their investment recommendations perform. There is no accountability for performance. There is no mechanism in place for a broker to even determine if their recommendations added value or not. So, should the consumer place their faith and trust in the investment advice of an advisor; when the advisor is neither allowed to provide investment advice nor act in the client's best interest in fulfilling their fiduciary obligations? Can the consumer determine when an advisor is acting in a fiduciary capacity and when an advisor is acting in a sales capacity? Isn't the investor always at a disadvantage in commission sales as the advisor's knowledge is far greater than that of the consumer and the consumer is left to their own devices to determine investment merit? Thus, it is in every one's best interest that advisors be held to a fiduciary standard of care. This is the beginning of enterprising advisors making the consumer aware of who can add value and act in the client's best interest

and who cannot. This is the beginning of the evolution of the industry towards a more responsible approach to advisory services.

**QUESTION:** So, 2007 is a hallmark year for advisory services, like 1974 is for ERISA. The state of the advisory services industry is materially different this year from years gone by because of the new clarity of who is providing advice and who isn't.

**WINKS:** Absolutely, there is a new level of accountability for the advisor. Though historically fiduciary responsibility has been largely based on the vagaries of good intentions, effective March 30, 2007, there are very specific responsibilities, 265 in all, entailed in fulfilling ones fiduciary obligations and acting in the client's best interest. This year, for the first time, advisory services have become synonymous with fiduciary responsibility. This materially changes how we look at the advice provided by advisors in the banking, brokerage, planning and consulting businesses. Bankers, brokers, planners and consultants can all act in a sales capacity, so advice and the declaration of fiduciary status is not a given based on what an advisor calls themselves. Every consumer wants their advisor to act in their best interest, add value in terms they understand and fulfill their fiduciary obligations. But if advisors cannot or are not allowed to fulfill their fiduciary obligations, they are now required to say they are acting in a sales capacity and are not obligated to act in their client's best interest. This is now made clear to the consumer by the new SEC consumer warning which must be put in writing in every client communication, prominently positioned, in bold letters.

**QUESTION:** Because all of this is so new it seems like there are not many advisors who are prepared to provide fiduciary counsel.

**WINKS:** That is true as the industry is being reordered around fiduciary principles and requires a different approach than commission sales. Either new industry leadership in fiduciary counsel will emerge or the commission sales business model must evolve to support fiduciary counsel. Though ultimately fiduciary responsibility and acting in the client's best interest will be taken for granted, that is not the case today as evidenced by the number of advisor's who can acknowledge their fiduciary status.

Today a very small number of advisors are allowed by their supporting firm to have discretion to manage client portfolios. These advisors (PMers) are providing advice and are held to a fiduciary standard of care. A very small number of advisors who work with clients who are held to a fiduciary standard (such as sponsors of defined benefit plans, defined contribution plans, foundations and endowments, Taft-Hartley plans, public funds (states and municipalities) and profit sharing plans) are held to a fiduciary standard of care and provide advice. Advisors who advise participants of qualified plans or advise trust assets are held to a fiduciary standard of care and provide advice. In principle a fairly large number of advisors should be acting in a fiduciary capacity, but in practice very few will either be allowed to acknowledge their fiduciary status or are provided the enabling support necessary to provide fiduciary counsel. This is both good and bad. Good that acknowledgement

of fiduciary status is taken seriously, bad that very few are capable or empowered through enabling resources and support to act in a fiduciary capacity. This latter consideration can be fixed, if there is a will to act in the consumer's best interest and to create the necessary large scale institutionalized support for fiduciary counsel.

**QUESTION:** *Doesn't every advisor want to act in their client's best interest?*

**WINKS:** Yes they do, but they are at the mercy of the policies, procedures and support infrastructure of the firms within which they work. This is why the actions of the courts and the SEC are so important. There is now a strategic imperative to support fiduciary counsel. If it is a violation of the internal compliance protocol of a NASD member brokerage firm for an advisor to acknowledge they render advice or acknowledge their fiduciary obligations—then it is not possible for the advisor to add value or to act in their client's best interest. When you ask top management of NASD member brokerage firms whether they support fiduciary counsel, no one will disagree that it is important to act in the client's best interest. But, they just don't want to take the necessary actions to create the support infrastructure required to support fiduciary counsel. This is because those actions are highly disruptive to the long established commission sales culture within the financial services industry. To the consumer it doesn't make a bit of difference how difficult it is for an advisor or the advisor's supporting firm to provide advice, add value and act in their best interest. They just expect their advisor to fulfill their fiduciary obligations. This is why the new SEC consumer warning is so important in confronting and fighting the industry's complacency to support fiduciary counsel. Unless the consumer protections in the Investment Advisors Act and ERISA are changed, which is unlikely, the brokerage business model is inconsistent with advisors rendering investment advice.

**QUESTION:** *Do our largest financial services institutions understand that action must be taken to protect their competitive market position?*

**WINKS:** Disruptive innovation is especially difficult for our largest institutions as they are somewhat insular by their sheer size. They are so large and profitable they don't have to change. NASD member brokerage firms will do just fine in the short term if they do nothing. Harvard's Clayton Christensen has written eloquently on this in his best seller, the Innovator's Dilemma, on why this inertia and disruptive innovation is the mechanism that always fuels exponential growth for emerging visionary market leaders. The inertia makes exponential growth possible, because more conventional firms are vulnerable to disruptive innovation. Because the financial services industry is sales and marketing driven, faster, better, cheaper innovations affording a preemptive and predatory value proposition is what every advisor and every CEO dreams of. Every financial services institution's market share, competitive market position and certainly the professional standing of its advisors are put in play by firms that have the will, the courage and the leadership to create large scale institutionalized support for fiduciary counsel. This large-scale support for fiduciary counsel brings fiduciary counsel within the reach of all advisors by making it easy for the advisor to provide fiduciary counsel. It lowers the barriers

of entry for the highest level of counsel by not requiring each individual advisor to make significant capital expenditures to create their own audited prudent investment process. Advisors would no longer be required to be a technical expert in the processes and technology of fiduciary counsel, they can rely on an audited prudent investment process created, managed and audited by objective prudent experts that certify fiduciary counsel. New leadership is required for a faster (real time), better (acknowledgement of fiduciary status) and cheaper advisory services business model that affords higher, earnings, margins and multiple and a far more dynamic growth rate than the old commission sales business model.

**QUESTION:** *Is the industry up for it?*

**WINKS:** The industry is not operating in a vacuum. Large custodians covet the assets of advisors working within NASD member brokerage firms who are not allowed to provide advice or fulfill their fiduciary obligations. Large scale institutionalized support for fiduciary counsel is the means by which those major custodians can win the best and brightest advisors from the brokerage industry, who have the most assets. Banks have lost a massive asset base to best in class money managers offered by the brokerage industry and they want those assets back. Through the use of overlay management and model portfolios, banks now have a way to wean themselves off of proprietary asset management without losing its attractive profit margins. RIAs who have been out executing both the banking and brokerage industries, believe they can continue to do so. RIAs are more richly compensated than either bankers or brokers and with large scale institutionalized support; their practices become scalable and far more profitable. Thus there are compelling strategic reasons why custodians, bankers, brokers and RIAs believe large scale institutionalized support for fiduciary counsel and a faster, better, cheaper approach to portfolio construction and management is not only inevitable but imminent.

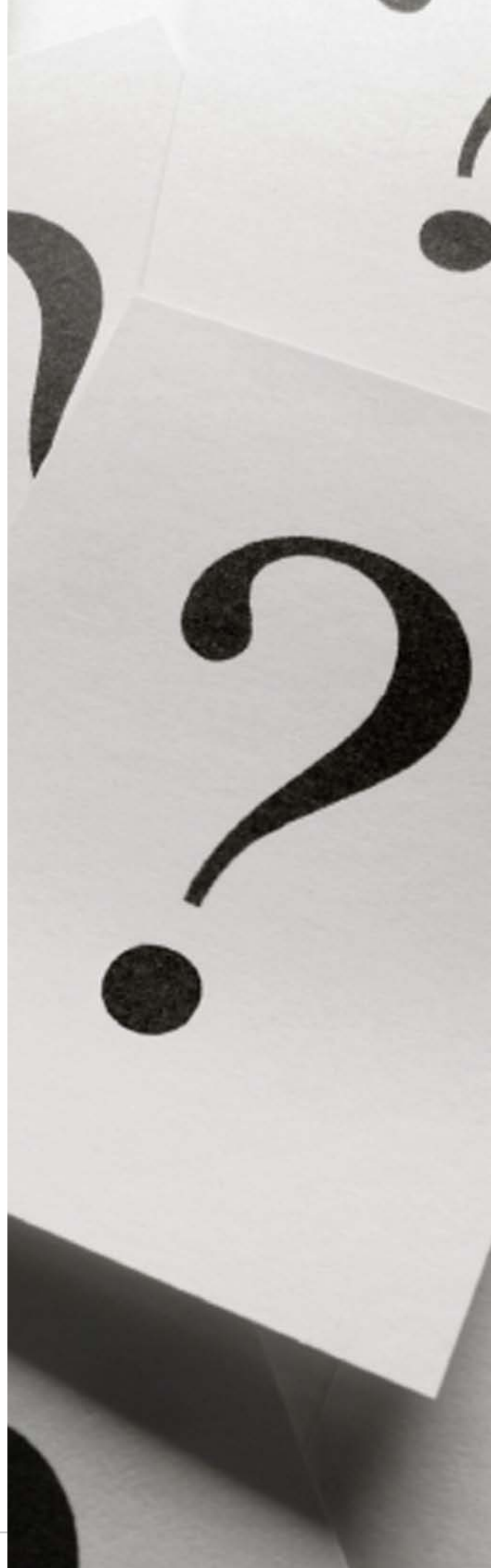
**QUESTION:** *What makes large scale institutionalized support for fiduciary counsel more viable this year than a few years ago?*

**WINKS:** During the course of the past year several

things have fallen into place which are essential for large scale institutionalized support for fiduciary counsel: (a) fee based counsel now requires acknowledgement of fiduciary status, (b) SEC acknowledgement of fiduciary status is now required, (c) fiduciary counsel has been defined by the Society of Fiduciary Advisors so for the first time advice is both scalable and auditable, (d) the Pension Protection Act of 2006 has established the precedent of an audited prudent investment process which allows for conflicts of interest if disclosed and provides a safe harbor for advisors to provide fiduciary counsel, (e) a substantially automated audited prudent investment process that assures the consumer that the advisor is performing the 265 duties entailed in fulfilling their fiduciary obligations is within the reach of the individual advisor with or without the support of their NASD member brokerage firm, and (f) importantly the advisor has come to the understanding that it is not possible to add value in terms each client understands unless they are empowered through process and technology. The convergence of these events makes large scale institutionalized support for fiduciary counsel possible. Importantly, the advisor can gain direct access to the resources necessary for large-scale institutionalized support for fiduciary counsel. The intellectual capital of large scale institutionalized support for fiduciary counsel is being democratized. The genie has been let out of the bottle. Our best and brightest individual advisors have been creating their own prudent investment processes and are growing massive businesses. The cultural reticence of the brokerage industry in supporting fiduciary counsel is both a massive opportunity and self defeating for the industry. Every advisor is compelled to act in their client's best interest with or without their supporting brokerage firm, bank, custodian providing support—that is inevitable. This is why the 3,000 RIAs at Schwab institutional who are providing some level of advice, last year garnered more net new assets than all 60,000 brokers at the major wirehouses combined. It is in the enlightened self interest of the banking, brokerage and custody businesses to support fiduciary counsel because if they don't they will not have a seat at the advisory services business table which will reorder the industry around fiduciary principles. Large scale institutionalized support for fiduciary counsel is inevitable and imminent because of the (a) highly competitive nature of the financial services industry, (b) the need for disruptive innovation within highly incented corporate cultures in order to achieve the much desired exponential growth, (c) the need within large corporate cultures to achieve higher earnings, margins and multiple not possible in brokerage but available through advisory services and (d) the pre-emptive and predatory nature of fiduciary counsel relative to commission sales.

**QUESTION:** Is there an early mover advantage?

**WINKS:** Yes. The reason why RIAs are building billion dollar practices is they know there are a limited number of qualified clients and they presently have no competition. There are only 17 million households with \$100,000 of liquid investable assets, which is the threshold of the economic viability of an advisor providing advisory services. Many advisors have a \$500,000 or \$1 million investment minimum. If an advisor can provide continuous comprehensive counsel to 200 clients, this means there are only enough clients to sustain 85,000 of the industry's 568,000 licensed advisors. The more qualified clients the early adopter takes off the table, the smaller the client pool and the more difficulty for those advisors who follow to



build their business. Once a relationship is established it is very difficult to dislodge. The only way to dislocate assets is to offer an even higher level of counsel. Thus for those who wait, they will be in a commission sales mode which is fast becoming a commodity, left with smaller clients—a very difficult way to earn a living or add value for the client.

This is why advisors, particularly the more successful ones, within NASD member brokerage firms feel so vulnerable.

**QUESTION:** Given advisors within NASD member brokerage firms can't acknowledge they provide advice or that they have a fiduciary responsibility, is fiduciary counsel necessarily more prevalent among RIAs?

**WINKS:** Yes, but not because of consumer demand, because demand for fiduciary counsel is universal. It is because there is no prohibition of RIAs to acknowledge their fiduciary status that RIAs are more able to provide fiduciary counsel than advisors at NASD member brokerage firms. NASD member brokerage firms do not want their advisors to be held to objective criterion for fiduciary counsel. There is no objective criterion for fiduciary counsel for the few brokerage firms that acknowledge the fiduciary status of their advisors—it is whatever they say it is. Certainly RIAs who have built a prudent investment process are building very large practices, often in the billions. But fiduciary counsel is not pervasive in the RIA world because it is so demanding. In the absence of large-scale institutionalized support for fiduciary counsel, each RIA has had to reinvent the wheel every step along the way in creating their own prudent investment process to the best of their ability. This is why advice is not scalable. And why a distinct minority of RIAs are able to acknowledge their fiduciary status based on objective criteria. Every advisor who acknowledges fiduciary status has their own unique approach based on their interests and technical proficiency. Almost every RIA will readily acknowledge there are holes in their prudent process and there are better ways to perform their duties, they just don't know what they are and how to perform those duties. There is no question that RIAs and institutional Investment Management Consultants are the laboratory for the

development and adoption of an audited prudent investment process. To better understand why fiduciary counsel is so rare today, this is what a RIA has to do:

1. Most advisors have had no option but to relinquish their brokerage licenses and register with their state or the SEC as a Registered Investment Advisor (RIA), so it is possible for them to acknowledge their fiduciary responsibilities and acknowledge that they render investment advice.
2. They then have to be experts in fiduciary counsel in order to build their own six financial services prudent investment process (asset/liability study, investment policy, strategic asset allocation, manager search and selection, performance monitor, tactical asset allocation) based on objective criteria.
3. They have to be experts in the enabling technology necessary to facilitate the continuous comprehensive counsel required, which requires a skill set that has not been necessary in commission sales. Many of the structural considerations here require scale and have not been universally pervasive in the RIA community as they should be.
4. They have to be brilliant managers of human resources to facilitate a division of labor within their practice in order to create a high performance business team for the CEO, CAO, CIO functions, which require different skill sets.

It is clear why only our best and brightest are capable of providing fiduciary counsel. A Herculean effort is required. In order for a profession to emerge, and fiduciary counsel to be brought within the reach of every advisor and consumer, large scale institutionalized support for fiduciary counsel is required.

**QUESTION:** Is large-scale institutionalized support for fiduciary counsel so disruptive that large financial services firms will find it difficult to execute?

**WINKS:** In the event it is for some firms, let's hope so, as those firms will be the source of market share for firms that are willing to do whatever is necessary to execute a preemptive and predatory value proposition. This is what makes exponential growth possible and why the industry is sure to be reordered around fiduciary principles. Disruptive innovation is typically the catalyst for exponential growth and what CEO isn't interested in exponential growth, higher earnings, margins and multiple and a preemptive and predatory value proposition for their advisors?

**QUESTION:** There is the sense within the industry that the other shoe is about to drop and an entirely new level of investment and administrative counsel is about to emerge. Do you sense we are on the verge of something big?

**WINKS:** The demand for large scale institutionalized support for fiduciary counsel is insatiable. Advisors do sense there is far more powerful business model out there than the conventional commission sales business model. A FPA survey found that 87% of CFP holders want to be held to a fiduciary standard of care, but 70% of CFP holders work within NASD member brokerage firms where they

can neither acknowledge fiduciary status nor provide investment advice. A National Financial (Fidelity) survey found 60% of brokers want to divorce themselves from a commission brokerage business model where they can not act in a fiduciary capacity and avail themselves to a fee based advisory services (RIA) business model where they can add value, act in the client's best interest and fulfill their fiduciary obligations. Charles Schwab had a similar finding several years ago but did not want to make it public. Last year just 3,000 of the 6,000 RIAs at Schwab Institutional, who provide some level of advice and have at least \$100 million under advisement, garnered more net new assets than the 60,000 advisors at the five major wirehouses combined. This is market confirmation that advice in a marketplace that does not acknowledge advice translates into massive market share. Consumers and advisors get it, and that is the only thing that is important in winning market share. Again it makes no difference to the consumer how difficult or disruptive fiduciary responsibility may be to execute, they just want assurance that their advisors are acting in their best interests.

**QUESTION:** Then fiduciary responsibility becomes an important marketing and advisor efficacy issue in a competitive marketplace?

**WINKS:** The larger financial services industry is built around commission sales and spends untold millions on sales and marketing, client development, professional development, advisor productivity, all of which go for naught in impacting advisor effectiveness when the advisor can not provide advice, add value or act in their client's best interest. If the advisor's role is limited to trade execution and the processes and technology are not in place for the advisor to know whether they are adding value or not, how can an advisor add value? Clients want their advisors to add value and fulfill their fiduciary obligations as required by regulatory mandate. The formula for success is simple, advisors who can add value, act in their client's best interest and acknowledge fiduciary status will be able to win accounts at will, and they are. Exhibit A is the RIAs at Charles Schwab.

**QUESTION:** What is required in order for the advisor to fulfill their fiduciary obligations?

**WINKS:** To provide the continuous comprehensive counsel necessary for one to fulfill their fiduciary obligations, the advisor must have five things in place.

1. The advisor must be able to make investment recommendations in the context of all their client's holdings, in order for their counsel to be comprehensive. This requires access to client holding data in real time so advice is continuous. Without real time data on all the clients holdings it is not possible to determine if a recommendation improved over all portfolio returns, reduced overall portfolio risk or enhanced the tax efficiency, liquidity, cost structure of the clients portfolio as a whole. It is literally not possible for an advisor to add value unless their recommendations are made in the context of all their client's holdings.

2. The advisor must be accountable for their investment and administrative recommendations. If an investor were not to buy what an advisor recommended, in the amounts recommended, when recommended, the consumer has let the advisor off the accountability hook. The same applies to sell recommendations. If the advisor does not have discretion to manage their client's assets, then the advisor cannot be held accountable for performance that is controlled by the consumer. If the consumer wants advisor accountability and wants the advisor to add value they must grant the advisor the latitude and responsibility to do so. This is a premium service, a much higher level of counsel that clients understand and will pay for. This is why brokers feel their margins are being squeezed—they are not allowed to acknowledge or provide the service that adds value. Trade execution is a commodity and advice is not a product. Brokers are beginning to understand they are selling advisory products but are leaving 90% of the value on the table. Advisors are managing a prudent process that constitutes fiduciary counsel.

3. The advisor must have access to the necessary technology and analytics, often referred to as open architecture technology that empowers them to do account administration at the client level, in real time, for an unlimited number of custom accounts. Very specific technology is required in order for it to be possible for the advisor to offer continuous comprehensive counsel for a very large number of custom accounts. The Society of Fiduciary Advisors has defined the enabling resources necessary for the advisor to fulfill their fiduciary obligations, all of which is within the reach of the individual advisor or group of advisors with \$65 million under advisement. The average wirehouse advisor has between \$50 and \$80 million under advisement thus the risk NASD member firms have in not supporting fiduciary counsel, is that their advisors can create their own faster, better cheaper prudent investment process and take home more money with a superior value proposition than they can using their firm's advice product.

4. The advisor must be able to work within an audited prudent investment process, comprised of (a) an asset/liability study, (b) investment policy statement, (c) strategic asset allocation, (d) manager search and selection, (e) performance monitor, (f) tactical asset allocation, that can be audited every year by a prudent third

party expert against objective criteria for fiduciary counsel. This makes it possible for the advisor to demonstrate and assure the consumer that their fiduciary obligations are being fulfilled. There are over 240 duties entailed, averaging 40 duties in each of the six financial services that comprise the audited prudent investment process.

5. It would be helpful if advisors did not have to re-invent the wheel every step along the way in creating their own audited prudent investment process. If there were large scale institutionalized support for fiduciary counsel that provided a ready made audited prudent investment process in which advisors could work, the barriers to entry for advisors who wanted to act in their clients best interest would fall so fiduciary counsel is within the reach of all advisors.

**QUESTION:** Is all this possible today?

**WINKS:** Yes it is. This is how.

Fiduciary counsel changes how we think about asset management in that the advisor is responsible for addressing and managing a broad range of investment and administrative values required by client directive, regulatory mandate and professional imperative. The continuous comprehensive counsel required requires real time access to all a client's holdings that makes the advisor's counsel continuous (real time) and comprehensive (the entire client's holdings). The most effective way to manage the incredible degree of portfolio detail required for fiduciary counsel for an unlimited number of client portfolios is to use the model portfolios (real time buy/sell research) of managed account managers that are managed through overlay management technology (Smart Leaf) either decentralized at the advisor level with a CIO within in a large practice or distributed through a centralized chief investment officer function supporting a large number of advisors.

Managed accounts are perfectly suited for fiduciary counsel because they are the only actively managed investment vehicle where the investor actually owns the individual investment holdings in each manager's portfolio used. This provides real time access to account holdings which makes it possible for the advisor



to direct the buying and selling of individual holdings so a broad range of investment and administrative values can be managed as required. The challenge in using managed accounts for portfolio construction is the advisor must go upstream to each managed account manager with instructions on how to customize each managed account in the context of each individual client's overarching investment strategy. This is very complex, and managers are often reticent to adjust individual client portfolios because it creates dispersion in their performance composite, which translates into higher volatility/risk, which is undesirable. The way to resolve this is to use the model portfolios of managers, which are not part of the manager's performance composite. Through overlay management, the advisor rather than the manager is managing the manager's real time buy/sell research in the context of a large number of custom client portfolios. Thus the advisor is no longer at the mercy of a multitude of managers and their varied technological sophistication to execute instructions consistent with the overarching investment strategies of a multitude of individual client portfolios. Rather than expensive and redundant account administration being done at the manager and the advisor level it is done once more effectively and far less expensively at the advisor level.

Through sleeveless overlay management technology like SmartLeaf, each morning the advisor receives actionable instructions with accompanying written rationale on what actions are required to keep each of their client portfolios in compliance with the investment and administrative parameters like risk, return, tax efficiency, liquidity, cost structure cited in investment policy. This written rationale for each action taken creates an audit path for all recommendations necessary for an audited prudent investment process. Outsourced investment methodologies like RowPyn's EIR which has been authenticated by the University of Chicago to outperform the index by 300 basis points at the same risk, can be incorporated into the chief investment officer function. Thus there is a means through engaging outsourced investment methodology for the advisor to perform well relative to a custom performance benchmark for each client portfolio. Alternatively, services like Prima Capital or Capital Market Consultants can be engaged to construct each client portfolio on behalf of the advisor so the advisor

can have the performance burden removed yet control their investment process. Both Prima and CMC will assume fiduciary responsibility while allowing the advisor to manage and brand of their own proprietary prudent investment process. Of course large scale firms may choose to have their own proprietary CIO function utilizing model portfolios and overlay management. Essentially the deconstruction of investment vehicles so the value of the managers intellectual capital is separated from account administration, allows for a much higher degree of portfolio detail to be managed in real time at the advisor level, drives down the traditional cost of asset management to 25 basis points or less and eliminates redundant account administration cost that adds no value.

Sleeveless overlay management avoids the complexity of using model portfolios that are structured as sleeves. Model portfolios structured as sleeves require the advisor to still go upstream to a multitude of managers with instructions to manage an unlimited number of custom client portfolios. Clearly a much higher degree of portfolio detail can be managed at far less cost if the advisor can directly manage real time buy/sell research. The continuous comprehensive counsel required of advisors to fulfill their fiduciary obligations is not possible if the advisor has to manage through mutual fund packaging and managed account sleeves.

The benefits of using model portfolios and sleeveless overlay managers are profound: (a) the cost of active asset management is dropped to 18 to 25 basis points relative the average mutual fund cost of 150 basis points not including trade execution cost, (b) redundant account administration cost at the client, manager and trustee level that adds no value is eliminated and just done once, (c) managed account investment minimums per manager, which can be in the millions, are eliminated (d) continuous comprehensive counsel is provided so fiduciary counsel is possible, (e) an audit path is provided for each trade which document tax efficiency, the effectiveness of investment methodology/strategy, etc, which makes an audited prudent investment process possible (f) the advisor gains control of pricing, margins and their value proposition, (g) the advisor becomes the value added.

But this is only half of the equation.

**QUESTION:** What is the other half?

**WINKS:** Making it possible to provide fiduciary counsel and providing fiduciary counsel are two different things. To provide fiduciary counsel against objective criteria requires a prudent process that is capable of being audited by an objective prudent expert. This has been the missing link that has been made possible by (a) the precedent of an audited prudent investment process being advanced by the Pension Protection Act of 2006 and by (b) the Society of Fiduciary Advisors defining fiduciary counsel based on statute, case law, regulatory opinion letters, establishing best practices, process, procedure, work flow and task which makes advice scalable and auditable for the first time and serves as objective criteria for fiduciary counsel. The industry's technology focus on open architecture is just the foundation that makes fiduciary counsel possible. Without an audited prudent investment process, even with open architecture—fiduciary counsel is not pos-

sible. So, a prudent process is indeed the missing link essential for fiduciary counsel.

Spectrem Group research tells us that 78% of mutual fund sales are the result of a process or program recommendation. This means process has already trumped product as the principle driver of financial services industry. The cultural disconnect is the industry still has a very expensive product management organizational structure designed for product distribution not a process management organizational structure designed to add value and fulfill the advisor's fiduciary obligations. To foster fiduciary counsel, the process used for investment recommendations must become "prudent" and "audited" so a safe harbor can be achieved for advisors rendering advice.

**QUESTION:** Has anyone taken objective fiduciary criteria and created an audit path for what is required for each of the six financial services that comprise the audited prudent investment process? For example, what are the 40 duties entailed in creating an investment policy statement, so it can be audited?

**WINKS:** There are several firms that have created investment policy capability, but none that can be audited back to statute, case law, regulatory opinion letter, best practices, process, procedure, work flow and task.

Spencer Segal of Actifi has done seminal research in creating electronic wizards to automate the eighty percent of the 265 duties required to fulfill our fiduciary obligations, which are disclosure and reporting related. The Actifi research tells us what to do and how to create the wizards to create an audited prudent investment process. This makes it possible for an advisor to (a) fulfill their fiduciary responsibilities automatically by working with in an audited investment process, (b) makes the advisor look brilliant relative to the market by virtue of a well structured chief investment officer function that provides continuous comprehensive counsel, (c) provides an audit path so a prudent third party expert can audit the process annually and assure the consumer the advisor is acting in their best interests, (d) brings fiduciary counsel within the reach of all advisors who wish to act in their

clients best interest. By necessity, the audited prudent investment process must be customized for each firm. The 265 duties that must be performed are known. Decisions must be made as to how each firm would prefer to approach the 265 duties entailed in fulfilling fiduciary responsibility. Thus, each firm has a proprietary audited prudent investment process that would both empower their advisors to acknowledge and provide fiduciary counsel. Either the advisor or their supporting firm has a centralized chief investment officer function that not only makes continuous comprehensive counsel possible but makes the advisor look brilliant at portfolio construction relative to the capital markets they have to work within. The industry is looking for leadership that will bring this level of fiduciary counsel within the reach of all advisors of good will who are compelled to act in their client's best interest. This innovation levels the playing field and is even more likely to come from a smaller firm as a means to pick up market share than a large firm adverse to disruptive innovation.

**QUESTION:** What is the core technology that makes it possible for the advisor to electronically manage in real time an extraordinary degree of portfolio detail for an unlimited number of custom client portfolios?

**WINKS:** The core asset management technology is a sub accounting, trade and order routing and reporting technology. You may know it as SunGard, Advent, CheckFree APL, Market Street Advisors, etc. Through gating technology, electronic gates are created for each value such as risk, return, tax efficiency, liquidity, cost structure and time, which we are obligated to manage as cited in investment policy and required by regulatory mandate. Thus when ever the advisor wants to buy or sell an investment across a large number of portfolios, say 500 client portfolios, the orders are routed and blocked into an omnibus block trade and executed with the proceeds being reallocated back through the sub accounting system to each appropriate account. Omnibus block trades drop trading cost to one five hundredth of the cost of 500 individual trades and protect the identity of each investor, which is another discussion. If a trade takes an individual portfolio out of compliance with the values set forth in its investment policy statement, then the gating technology electronically suppresses the trade, so the advisor's CIO can manage the portfolio on a management by exception basis. Technologies like Bull Run Financial can actually provide the advisor's CIO with alternative investments, which would bring each portfolio into compliance. There are vendors like State Street, which provide unlimited real time performance analytics on large numbers of live portfolios. Thus the advisor can tell a client anything they want to know about their portfolios, anytime they wish to know it and what they should do about it.

**QUESTION:** You mention the CIO function, tell us more?

**WINKS:** Large RIAs or groups of RIAs with \$100 million or more under advisement typically have a division of labor within their practice. There is an advisor/CEO who is the rainmaker who leverages through a Chief Administrative Officer and a Chief Investment Officer, which are partner level positions that entail different skill sets. The CIO function continuously and comprehensively monitors all cli-

ent portfolios utilizing advanced technology so continuous comprehensive counsel is provided. For smaller advisors in larger firms, a centralized CIO function should be created perhaps affording even greater economies of scale and perhaps an even higher level of sophistication in investment methodology, which can be brought to bear presuming there are no internal conflicts, which would discourage innovation.

**QUESTION:** Omnibus block trading capability is interesting. Do you think trading cost are coming down and what does that mean for fiduciary counsel?

**WINKS:** If an advisor is working in a fiduciary capacity they are obligated to act as a prudent expert on behalf of the client. Thus, trade execution cost is treated as a cost center rather than a profit center. Through omnibus block trading and other mechanisms trading cost can be driven down to almost zero. Even retail trade execution cost have declined over 90% since 1974 when they were deregulated from forty cents a share to ten cents per share to today when three cents per share is common. This means brokers have to be more than ten times more productive today than in 1974 to maintain their 1974 compensation, and they are. But trade execution is very much of a commodity and there are increasingly ways for investors to get trade execution services for free. In the institutional market, plan sponsors own trade execution cost and use it to fund the services of investment management consultants. Any revenue derived in excess of the consultant's fee accrues to the benefit of the plan. CALPERS, an excellent steward of plan assets, actually has achieved a negative trading cost environment. With the advent of fiduciary counsel, the advisor seeks to minimize trade execution cost and is compensated with an ongoing advisory services fee. Some advisors have gone to a retainer fee, which is even preferable to an advisory fee.

**QUESTION:** Because commission sales drive the financial services industry, and because trade execution services are becoming a commodity service, do you see a fundamental shift in the financial services industry to advisory services particularly given the DC Court of Appeals ruling?

**WINKS:** One of the major custodians has done research establishing it can be profitable and actually increase its margins if it did not charge for trade execution services by extending its value proposition. For example, by creating an audited prudent investment process, a major custodian could charge more for the intellectual capital of supporting those value added services and waive trade execution cost entirely. Because the advisor is being leveraged through the intellectual capital of an audited prudent investment process and the necessary supporting technology for fiduciary counsel, there are significant cost advantages and a superior value proposition relative to the brokerage industry. The major custodians would not have a massive product infrastructure and overhead like in the brokerage industry yet would offer the RIA a preemptive and predatory value proposition. It is in the enlightened self interest of the industry's major trade associations to advance six-sigma certification training built around the audited prudent investment process for each of the ten major market segments the advisor wishes to serve. The resulting advisory services business model is far more attractive than the commission sales business model, where trade execution is becoming a commodity. Advisory Services has three times the multiple of commission brokerage and depending on the investment methodology and investment products used has half or less the cost and far higher earnings and margins. Consider this very real scenario. Do you think advisors would respond to an audited prudent investment process where you could give the broker a 50% increase in compensation, a 25% reduction in cost to the consumer, a significant increase in the custodians earnings and a preemptive and predatory value proposition for the consumer relative to the conventional commission broker? The famous Tully Committee Report to the SEC a decade ago predicted such an evolution to fee based advisory services. Dan Tully, former Chairman of Merrill Lynch, Warren Buffet, legendary investor and Chairman of Hathaway Berkshire, and Chip Mason, Chairman of Legg Mason observed, "If the retail brokerage industry were being created today from the ground up, a majority of the committee that developed this report would not design a compensation system based on completed transactions. The most important role of the registered representative is to provide investment counsel, not to generate transactions revenues. The prevailing commission based compensation system inevitably leads to conflicts of interest among the parties involved."

**QUESTION:** Who are the advisory firms who are providing market leadership in creating large scale institutionalized support for fiduciary counsel?

**WINKS:** Frank Russell has been the leader in the use of model portfolios in managing a very large number of institutional quality custom investment portfolios. Merrill Lynch Asset Management used model portfolios before it was acquired. Northern Trust, which must

manage an extraordinary degree of portfolio detail, is reengineering the entire firm around model portfolios to achieve the resulting economies, superior management of portfolio detail and enhanced advisor value proposition. Wells Fargo, Bank of America, JP Morgan and many higher end advisory services firms are adopting faster, better, cheaper models/overlay technology.

**QUESTION:** Could you describe the audited prudent investment process and explain why it is a preemptive and predatory value proposition to commission sales?

**WINKS:** The audited prudent investment process is comprised of six financial services each of which add value in their own right, but when aggregated they constitute an extraordinary level of counsel that can be held to a fiduciary standard of care. The six financial services that comprise an audited prudent investment process are: the asset/liability study, investment policy, strategic asset allocation, manager search and selection, performance monitor, tactical asset allocation. Each of the six financial services are structured as a client deliverable designed to articulate and quantify the value they add. Each of these six financial services entail on average 40 duties each, a little more than 240 duties in all, which structurally make a prudent process auditable. There is a different audited prudent investment process with the same six elements for each of the ten major market segments: mass, retail, HNW, ultra HNW, defined contribution, defined benefit, public funds, profit sharing, foundations and endowment, Taft-Hartley. The central thesis is that it is what you do with investment products, or process, that adds value not investment products in and of themselves. None of the 265 duties entailed in fulfilling your fiduciary responsibilities are particularly complex unless you have to do them (a) manually, (b) for a very large number of clients, (c) in real time, which of course is required and is not humanly possible. Clearly process and technology is needed to empower the advisor to address and manage the broad range of investment and administrative values necessary to fulfill our fiduciary responsibilities and provide the continuous comprehensive counsel required. Without enabling processes and technology, fiduciary counsel based on objective criteria is not possible. Good intentions are

no longer good enough.

**QUESTION:** How do each of the six financial services that constitute an audited prudent investment process add value? Why is it preemptive to commission sales? Let's start with what is the asset/liability study?

**WINKS:** All good questions.

How would you like to create instant credibility at will? Most investors, both individuals and institutions, have never had all their assets and liabilities looked at as an investment portfolio. Remember the large institutional consultants just focus on portfolios of \$100 million and up, so the vast majority of investors are underserved.

Because most advisors are not held to a fiduciary standard of care and do not provide advice nor have the necessary support infrastructure to provide advice, most investors cannot tell you, (a) what they are invested in, (b) the returns they have actually achieved, (c) the risk exposure they are taking, (d) the cost structure of their portfolio, (e) whether their assets are structured in an income and estate tax efficient manner, (f) how liquid or illiquid their assets are, (g) what their goals and objectives are, or (h) in general how well they are performing.

Essentially 9 out of 10 investment portfolios are a mess. No one has been accountable for addressing and managing the fundamental investment and administrative values so essential to the client's success. There is no cohesive investment focus. If you were to do an asset/liability study on almost any client portfolio, you would find at least 20 to 30 ways to materially improve the client's financial well being. This is because the consumer has been forced to be their own investment counsel and they do not have the knowledge or experience to do it, and the advisor in most cases is not allowed to provide advice.

The opportunity for improvement is immense:

1. What if you could tell the investor the precise rate of return they were achieving on all their assets as a whole?
2. What if you could show the investor they were taking 150% of the markets risk for 50% of its return?
3. What if you could show the investor that their portfolio was not structured in an income and estate tax efficient manner or ...
4. That their tax planning created far more problems than it fixed, crippling investment performance, dramatically increasing cost structure, greatly reducing portfolio liquidity?
5. What if you could show them the cost structure of their portfolio? Do they know mutual funds at 150 basis points not including trade execution cost are three times more expensive than managed accounts at 50 basis points, five times



more expensive than ETFs at 30 basis points and six times more expensive than model portfolios at 25 basis points and fifteen times more expensive than index funds at 10 basis points?

6. What if you could show the investor hundreds of administrative values required by regulatory mandate that were not being addressed and managed, that were automatically managed by your audited prudent investment process?

If you could do all that, what is the likelihood you could win client accounts at will? That is what the asset/liability study is. It is the before photograph of a client's portfolio and serves as the reference point you use to establish the value you add. Pretty powerful, huh.

**QUESTION:** How about Investment Policy, how does it add value?

**WINKS:** Investment policy is the control document of a prudent investment process that establishes the scope of the advisor's engagement. This makes fiduciary liability manageable by virtue of its documented and auditable processes and results in a scalable cohesive investment focus—which is lacking in most portfolios. This is the difference between a broker and an advisor; between commission sales and advisory services, between advice as a product and advice as a service/process that must be managed. Investment policy (a) establishes the roles and responsibilities of all parties, (b) defines the client in very intricate terms and their goals and objectives, (c) establishes hiring and firing criteria for all vendors, (d) establishes the investment and administrative values to be addressed and managed and the evaluation metrics to be used, (e) introduces the investment strategy, discipline and methodology to be used to achieve the client's goals and objectives, and (f) in concert with the new SEC required advisor disclosure statement, constitutes the control documents for the advisor's audited prudent investment process. Without this cohesive investment focus it is not possible to have the investment discipline to construct investment portfolios which could (a) achieve the clients goals and objectives (b) be held to a fiduciary standard of care and (c) perform well relative to the capital markets and the client's long term custom performance benchmark. The funda-

mental premise of investment policy is if you can define investments in terms of risk, return, tax efficiency, liquidity and time and can define investors in the same terms you have a mechanism in place in which you can construct client portfolios which can achieve each client's goals and objectives. Investment Policy is the heart and soul of advisory services.

**QUESTION:** How does Strategic Asset Allocation add value?

**WINKS:** Strategic asset allocation is the investment strategy part of investment policy, but it is such an important contributor to the value added it is considered a standalone element or financial service in the six financial service audited prudent investment process. Brinson, Hood and Beebower tell us that 93.6% of the value added in portfolio construction is in determining the right asset classes in which to invest. Though client's ascribe great value in their advisors picking specific stocks or money managers and believe that is where all the value is added, it actually only accounts for something less than 6% of the value added. Knowing what type of money managers to select is where 90% plus of the value is added. Strategic asset allocation is based on the long term performance characteristics of asset classes and has become somewhat of a commodity service. Now that we are in post Modern Portfolio Theory, real time data and the much more dynamic management of shorter term information, we are lead to investment methodologies that supercede many of the long term passive asset allocation strategies of the past, which takes us to tactical asset allocation which we will discuss later.

**QUESTION:** How does Manager Search and Selection add value?

**WINKS:** As we discussed, most clients think picking managers is where all the value is added, but it isn't. Once a strategic asset allocation has been established that tells you what asset classes in which to invest and what investment styles in the asset classes in which to invest and in what quantities in which to invest, all the heavy lifting has been done. This is where significant conflicts of interest can occur, such as banks and brokerage firms investing in proprietary investment options rather than the best investment options available at the lowest possible cost. The investor should be given three investment alternatives and there must be an objective manager selection process used and documented to avoid any conflicts of interest associated with self-dealing.

The management selection criterion in portfolio construction is so specific and transparent that it would be very difficult not to be objective in manager selection. The advisor is looking for the most consistent and best performing manager in a specific investment management style, with the lowest risk, lowest cost structure and most tax efficient strategy. Any single criteria can preclude a manager from consideration. This has increasingly lead advisors to use ETFs, model portfolios and index funds as proxies for investment management style mandates. A recent Yale study has found that 75% of active managers can explain 85% or more of their performance by an index. With so many active managers being closet indexers and the cost of active management being far more expensive than passive managers, the popularity of using the model portfolios (real time buy/sell research of



managers unbundled from the managers account administration responsibilities) of active managers is increasing with the advent of overlay management technology. Because of transparency in an audited prudent investment process, only the best active managers can meet the objective manager selection criteria for portfolio construction. The use of proprietary product is only possible in the rare occasion the advisor's firm has one of the top three best in class managers of a specific management style.

**QUESTION:** How does the performance monitor add value?

**WINKS:** The Performance Monitor is where the advisor earns their on-going advisory fee. It is here the advisor zeros in on investment policy and strategy. It is here the advisor instills the investment discipline of the investment strategy. It is here the advisor establishes confidential privileged information that empowers them to add value in ways no other advisor can. It is here that the advisor literally becomes the value added. Let's explain.

1. Investment Policy Refinement: In order to get the investment strategy right the advisor must get investment policy right. Clients consistently overstate their ability to assume risk until it manifests itself as a real loss in their investment portfolio. Risk tolerance can only be determined by recording the client's actual reaction to the capital markets each quarter when their portfolio's performance is reviewed. If the investor is disappointed in portfolio performance does that mean the client is taking too much or too little risk? Only then can we determine their risk tolerance and evolve investment policy and strategy so it is best suited to the client's needs.

2. Investment Discipline: There is the natural tendency of investors to chase hot short-term performance, which can never be sustained. The value of the performance monitor and the advisor is in keeping the client focused on a well-conceived long-term investment strategy. In the mid 1990's, MorningStar did a survey of the 219 growth funds they monitored. They found investment returns were 12.5% over a five-year period ending in 1995, but investor returns were just 2.5%. Rather than buying low and selling high, MorningStar found investors bought high and sold low. Attracted by the allure of extraordinary returns investors were buying funds that had gone up the most. Disappointed when the promise of extraordinary returns never materialized, investors sold when the funds went down, only to repeat the cycle again and again. By definition extraordinary returns cannot be sustained, that is why they are extraordinary. That is why only 5% of investment returns are attributable to picking specific investments. Importantly, because advisors are accountable for their recommendations, they bring much



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needed discipline in their audited prudent investment process.

3. Confidential Privileged Information: After several years of reviewing portfolio performance with the client at least quarterly if not more frequently and evolving investment policy and strategy, the fiduciary advisor starts developing confidential privileged information that allows the advisor to add value in ways no other advisor can. For Example, if a competitor were to approach your client with a 58% return investment, you would have trained your client to ask a few questions. Is the performance of that 58% return investment sustainable? What risk exposure am I assuming and how does that affect the overall risk exposure of my investment portfolio? What are the tax ramifications of this investment and how does it affect my portfolio's tax structure? What is the cost structure of this investment and how does it affect my portfolios overall cost structure? Of course, in order to answer any of those questions your competitor would have to have a thorough understanding of all the client's holdings as a portfolio—which is confidential privileged information created by you the fiduciary advisor who created investment policy and constructed and managed all the client's holdings as an investment portfolio. This means you the fiduciary advisor can add value in ways no one else can. This is why the performance monitor and an audited prudent investment process make you the fiduciary advisor indispensable in adding value.

**QUESTION:** How does Tactical Asset Allocation add value?

**WINKS:** Tactical asset Allocation makes the advisor look brilliant relative to an objective performance benchmark in portfolio construction.

Strategic asset allocation is based on the historical performance characteristics of asset classes. But what happens when current market conditions contradict historical precedent? For example, historically equity investments typically outperform fixed income investments. Yet there are periods of time of declining interest rates like between 1982 and 1999 when fixed income returns often rivaled and even outperformed equity returns, which is counter to historical precedent. In such a period, by overweighting fixed income you both enhance return and reduce risk contrary to historical precedent upon which strategic asset allocation is based.

With the introduction of overlay management, the use of model portfolios, real time information and expert systems necessary to manage investment values like risk, return and tax efficiency and administrative values like trading cost, a much higher level of portfolio detail required for fiduciary counsel can be managed. All these portfolio adjustments are tactical in nature, falling outside the long term performance characteristics of assets.

Many advisors are concerned about their ability to perform well in constructing portfolios, which will be regularly evaluated against custom benchmarks using real time metrics for each client. There are outsourced investment methodologies that the advisor can obtain access to such as ROWPYN's EIR, authenticated by the University of Chicago, which has outperformed the market by 300 basis points over ten plus years in good markets and bad. Outsourced investment methodologies like EIR can be integrated in the CIO function as part of the overlay management technology or the advisor can engage third parties like Frank Russell, SEI or Prima Capital to construct portfolios on the advisors behalf so they assume any related fiduciary responsibility. Prima allows the advisor to retain control of the investment process, while SEI and Frank Russell require the advisor to sell their process as a product. All these outsourced options are tactical in their approach to portfolio construction. They all make the advisor look brilliant at portfolio construction without the advisor having to do all the work they are least comfortable with.

**QUESTION:** Wow, an audited prudent investment process indeed adds incredible value, but isn't it terribly labor intensive?

**WINKS:** Eighty percent of the 240 plus duties required to fulfill one's fiduciary obligations are disclosure and reporting related that readily lend themselves to automation. Not that it is easy, but it is not overwhelming to create the electronic wizards that would automate a large part of the audited prudent investment process. Thus by simply working within the process, a large part of the advisors fiduciary duties would be automatically performed electronically. The more complex aspects such as portfolio construction can easily be managed as previously discussed. So large scale institutionalized support for fiduciary counsel minimizes the intellectual capital and monetary capital required of the advisor to act in a fiduciary capacity. By leveraging the advisor through process and technology an unprecedented level of investment

and administrative counsel can be provided as we have just described.

**QUESTION:** How do you counter the argument that fiduciary counsel is an abstract idea that doesn't matter to the advisor or the consumer?

**WINKS:** That is just a rationalization of convention and status quo. There is not a CEO alive who is compensated on performance that is not interested in disruptive innovation as a means to achieve exponential growth. Advisory services have half the cost structure and higher earnings margins and multiple than commission sales. The challenge is for the industry to move from a product management organizational structure where it is not possible to add value to a process management organizational structure designed to add value. The result is exponential growth coming from the market share of those who subscribe to convention and status quo. The famed Jack Welch, the former CEO of GE who won the mantle of America's most capable manager, built his entire career around disruptive innovation that fosters exponential growth.

When asked to express his management philosophy, Welch said, "You cannot simply maintain status quo. Somebody is always coming up with another product, or consumer tastes change, or the cost structure does, or there is a technological breakthrough. If you are not fast and adaptable, you are vulnerable. This is true for every segment of every business in every country in the world."

Welcome to the new world of advisory services.

STEPHEN C. WINKS is Chairman of PCT Research and Consulting, Publisher of SENIOR CONSULTANT at [www.SrConsultant.com](http://www.SrConsultant.com), and Founder of the Society of Fiduciary Advisors. Steve helps advisory services firms align enabling resources, processes and technology with the value proposition they desire, creating an audited prudent investment process. He may be reached at [s.winks@SrConsultant.com](mailto:s.winks@SrConsultant.com) or at 804-643-1075.