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The Big Profit Squeeze All Advisors Face

The industry is evolving, shown most obviously and painfully through margin compression. Smart firms are embracing the inevitable rather than fighting it

Follow these three Cs to alleviate margin squeeze. (Illustration by Michael Austin/© theispot.com)

As the industry looks ahead to 2017, many executives are concerned about profit margins. The cost of complying with new Department of Labor regulations adds to the inexorable upward march of costs, while new competition from digital advisors (yes, we're talking about robos) has advisors and service providers worried about fees. Costs up, revenues static or down — it's your classic margin squeeze, which causes small firms to suffer and medium to large firms to band together in search of scale.

This squeeze is stressing out financial services providers of all types and sizes, from "solopreneur" advisors to behemoth asset managers and custodians. And the market upheaval caused by political uncertainty at home and abroad doesn't help — markets are unlikely to roar to the rescue.

Some of the squeeze is, in our opinion, self-inflicted. The industry is misreading the impact of emerging competitors that offer digital advice. Robos are happy to feed the perception that they're a disruptor, but they are not. Instead, they are the latest iteration of the technology that brought us online trading, turnkey asset-management platforms, ETFs and ETF strategists. Robo technology is also a direct intellectual descendant of the debate over active versus passive management and the Bogleheads' contention that low-cost investing is always best. Nevertheless, the emergence of robos has certainly pushed the entire financial services industry to evolve, and the smart organization embraces the inevitable rather than fighting it.

At our consulting firm, Strategy & Resources, we view this evolution through three lenses, which we've dubbed "The 3 C-Drivers." They are:

- Consumer Demand

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So let's use these lenses to look at margin compression and come up with some effective ways to fight it.

CONSUMER DEMAND: THE TRUE BOTTOM LINE

"We need to provide the user experience offered by robos, with their easy to use, paperwork-free, always-on front ends, while bringing human intelligence and empathy to the fore when delivering advice."

Do you know what your customers care about? Are you delivering the services that really matter to them? If you are, price is less of an issue and you will be paid well. If you're trying to hang on with an outdated client-service model circa the pre-internet, pre-cell phone era, good luck.

Okay, we admit it: That's easy to say, harder to act on.

We've talked to a lot of advisors who have said that their clients don't leave them because of costs and that they aren't really concerned about fees. And yet, anecdotally, advisors tell us that clients ask about robo-advisors or reference the flat performance of the stock market over the past couple of years, and are more sensitive to erosion of their account value due to fees. The lack of investment growth heightens their sensitivity.

Some advisors opine that if we were in a strong bull market, their clients wouldn't care about fees. Others believe that notion is also an example of outdated thinking. The reality of the new normal is that advisors who are listening to their clients now understand that they have to justify their fees notwithstanding market performance.

The coming fiduciary standard aggravates advisors' concerns. The perception in general is that they will have to be more transparent, and as every type of advisor (think rep/agent/advisor) willingly or reluctantly migrates toward a fiduciary model, they will have to show that they're keeping costs down for the client.

Pundits may blame the DOL, and speculate that a President Donald Trump and a Republican Congress may stall or terminate the DOL fiduciary rule, but advisors are really struggling with a confluence of events, including what the next generation wants from an advisor or financial services firm.

The millennial generation is approaching their high-earning years when financial advice really matters. They are starting families, founding new businesses, buying homes. They are embarking on their financial life journeys having been molded by an economic environment that is radically different from the one that informed their parents. When millennials were in college, their families or their friends' families were battered by the market meltdown and Great Recession — it may be their parents couldn't help them with college, or their grandparents had to become “unretired.” For the first time since the 1930s, thousands of American families lost their homes. At the time millennials started paying attention to getting a job, the economy and financial system were in disarray. They still haven't fully recovered.

This generation's history is one of system failures, and of politicians who have earned their bones by beating up on Wall Street — not that the financial industry shouldn't own some responsibility for that.

What's more, millennials haven't seen the value of a prolonged bull market, and have no context to ameliorate the past decade of underperformance. Add in the emergence of robos and this generation's comfort with technology, sometimes over human interaction, and it's clear these are not the clients who will spend three hours going through paperwork and discussing their financial goals. These are not the clients who will trust the markets to build wealth for them over time.

On the contrary, with the millennial generation the trust gap is wide. They come into financial planning discussions with a major dose of skepticism. They’re like our parents and grandparents who were permanently affected by the Depression. You’ve heard the stories of jars of cash buried in the back yard or stuffed into mattresses. What will be the millennial equivalent — bitcoins?

The industry will have to earn back this generation's trust by being responsive, available and transparent.

In other words, we need to provide the user experience offered by robos, with their easy to use, paperwork-free, always-on front ends, while bringing human intelligence and empathy to the fore when delivering advice.

Furthermore, bear in mind that the new generation of financial planners, many of whom hold degrees, were also personally affected by the market meltdown and recession of 2008. As a result, these advisors want to help people and often don't care all that much about the current business model. Advisors and broker-dealers who are trying to attract next-generation advisors as well as investors need to ask themselves: What do they care about? Am I aligned with providing that? The allure of financial advice today goes well beyond money.

COMPLIANCE: ANOTHER DAY, ANOTHER RULE

“Are you getting squeezed out of your core business because of regulation, or is this an opportunity to pick up advisors and clients whose broker-dealers or vendors are getting squeezed?”

Yes, the Department of Labor's new fiduciary regulations hit much of the industry like a bolt from the blue. But why is that? It's not as if the government hasn't been working on these regulations since the asset markets imploded in 2008, almost taking the world economy with them. The fight by some in the industry to preserve legacy business practices are translated by the consumer (and next-gen advisor) as “suing to protect the right *not* to work in investors’ best interests.”

To be sure, some of those fighting the DOL have fair arguments that the rule isn't sufficiently clear, and it is reasonable to expect the DOL to clarify key issues so that those held to the new standard are able to comply. That said, this prolonged effort to fight the DOL, exacerbated by hopes of repeal of the fiduciary rule and even Dodd-Frank under President Trump, though perhaps well-intentioned by some, makes us all look bad. There are advantages to embracing this change and advocating for clients.

Ask yourself: Are you getting squeezed out of your core business because of regulation, or is this an opportunity to pick up advisors and clients whose BDs or vendors are getting squeezed?

Now is the time to get creative. Some firms will innovate and find new ways to reinvent themselves. The courageous will look back at this time as when they really broke out. The stubborn stragglers may eventually acknowledge that the inception of the DOL fiduciary standard was when they really got off track. These lagging firms either don't understand or have chosen to ignore the competitive environment and what advisors and consumers want, and may find themselves marginalized in the process. So ask yourself into which category you fit: Are you an innovator, an evolver or a dinosaur? If you're looking around the industry and see fewer and fewer firms like yours, you could be unique and special — or an endangered species.

Think about market bubbles for a moment — not that we're in one. From the perspective of bubbles, you see the indicators in hindsight. Can you solve your business issues by accelerating growth or are we looking at a systemic change that requires more adaptation from business models? Banks, insurance companies, wires, indies, RIAs — are we in the midst of the time when we'll look back and say, "That DOL issue really changed the industry"? We believe that the forward-thinking and creative businesses will prevail.

COMPETITION: MORE THAN A ROBO BATTLE

"If you go deep into your existing capabilities, we find it helpful to separate those you manufacture from those you source externally."

Financial services firms often have a hard time positioning themselves in terms of their value-adding slot in the supply chain. If you're feeling pressure on margins, getting pushback on pricing or wincing at renewal contracts from essential providers, there's an indication that there's something wrong with your value proposition. Of course, you have to pay taxes and the rent. And yes, you must comply with regulations. But if the costs you can't control are rising faster than your revenue, you may find yourself on the outside looking in.

For a lot of firms, the knee-jerk reaction is to maintain their fee structure but differentiate by adding services. For instance, investment managers are adding free financial planning or even concierge services for their top HNW clients. They are valiantly trying to improve the client experience so they can show their value. This is true of the largest firms as well as retail wealth managers.

Look at the leading custodians: They're constantly adding new services, and working with technology and service providers to increase wallet and market shares. These firms want not only to protect their turf, but also to position themselves as a conduit to the latest and greatest services and technology.

It's great to provide value, but what is it costing you? If you go deep into your existing capabilities, we find it helpful to separate those you manufacture from those you source externally. As you do this you may find that you are working with too many intermediaries (e.g., multiple clearing firms, duplicative technologies). If you are not taking advantage of new technology that's available in the marketplace, if you are not sensitive to your cost of client acquisition and support, if you are not aware of every intermediary in your system that's eating away at your gross revenue, you are likely not enjoying the same margins you did just a few years ago.

For advisors, the problem is often one of duplication. Your trading platform may add reporting, data-aggregation and billing capabilities that may also be embedded into other packages you have purchased. Your CRM may provide practice management analytics that are also bundled as part of your internal accounting system. With a deep dive, you may find that you can eliminate duplication and run the firm more economically while creating a better advisor and client experience.

Broker-dealers have a tougher time with cost control. They are intermediaries who use intermediaries. Most broker-dealers don't have a direct relationship with the consumer, and have a hard time making a direct impact on the end client's satisfaction. It's the advisor — who may or may not work for the broker-dealer — who has the most control, but the broker-dealer may be the entity dealing with the squeeze.

A perfect example is the “rep as portfolio manager” trend. In theory, they help advisors reduce costs and preserve margins, but none of that reduced expense flows back to broker-dealers. The reality may be that broker-dealers often assume more risk in the form of rep-as-portfolio-manager underperformance relative to professional management.

Broker-dealers have a limited set of levers they can pull to preserve margins. Their best cushion used to be spreads on cash, but those went away eight years ago and they’re not coming back. If you’re a broker-dealer and the sources of your profits were spreads on cash, marketing allowances or placement fees, these have all dried up — or they will once the DOL regulations take effect, and you’ll definitely feel the squeeze. If you rely on a supply chain of services from outside providers (custody and clearing, three to four tech vendors, possibly a TAMP, etc.), your margins are compromised even further.

How are broker-dealers dealing with the squeeze? Many are adding services, but that may squeeze them more before they see their way to profit. Others think consolidation is a strategy, but unless they reposition themselves, they’re really just creating a larger marginal firm. *Big* isn't a strategy.

THE WAY FORWARD

How do you make money? Does it match what your clients believe they’re paying for? If you ask most financial service professionals how they or their firms create profits — and about which activities contribute or detract from their bottom line — they’d be hard pressed to give a substantive answer that comes close to matching how their customers would answer that question.

With financial firms of all types feeling the margin squeeze, it's more essential than ever to understand where your firm's profits come from, and how to take a scalpel to your costs.

Most important is a truly solid understanding of what drives the levers in your business, what your costs are and how the resources you choose contribute to your revenues. The old answer to low profitability — "I'll sell more" — doesn't work. At best, it may be a short-term solution, but it doesn't solve deteriorating margins and may in fact accelerate them.

Take, for example, the hidden fees in a client's account from asset managers: the 12b-1s, the platform fees, etc. If the client had to write a separate check to cover them, rather than having them buried in other costs, would they? We are not being facetious here, but calling attention to the many things clients pay for that have no bearing on their service experience. This is a question every provider in the industry ecosystem should be asking itself on a regular basis.

Where do you fit in the financial-services supply chain and why do you matter? When the user and purchaser of a product are two different entities, we question if the business model is really sustainable, as the firm may be commoditized. In addition, if clients are forced to do business with your firm, or pay for a service by regulation, or one they used to get for "free," rather than clients being excited about your value, you might be on the outside looking in. There are numerous examples of services that were provided as part of an industry standard package, tied to an account or registration.

A margin squeeze is like squeezing a balloon. Costs get pushed around but they don't go away. If there's an argument over who's going to pay a certain cost in the supply chain, it's a pretty good indication that there's a problem with its value. If nobody wants to pay for something, what is it really worth?

At Strategy & Resources, we look at such "nomadic fees" as part of our strategic consulting process: Is an expense necessary and is the firm paying for the same or similar services more than once? If you're not contributing to the value in the process you may be the one feeling the squeeze.

As we turn our attention to the next three to five years, these questions and considerations will play a crucial part in the success or failure of many financial services firms. As always, we welcome your questions and comments.

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