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Snowden Perspectives: 2014 Landscape for Breakaway Advisors

Another Big Year Shaping Up for Wirehouse Breakaways

Executive Summary

- Hybrid Growth Trend Continues as Advisors Seek Ownership
- What's the Future for Big Banks?
- It's Not the Platform… It's the People

In previous Perspectives, "Dis-economies of Scale," *March 2012*, and "Boutique Advantages," *October, 2013*, we've explored why top financial advisors are choosing independent practice alternatives over working at wirehouses. After slowing in 2013, the trend is again accelerating. Last year, roughly 11% of client assets that moved out of wirehouses ($6.5 billion of $56 billion) went to the independent channel. *Already, in Q1 of 2014, a full 27%* of client assets moving from wirehouses ($5 billion of $18.9 billion) went to the independent channel.[1] While perhaps at a less blistering pace, we believe the trend will continue. So, it's timely to comment on the landscape for breakaways and what we are seeing in the market so far in 2014.

In sum, top advisors who seek independence, along with the substantial and sophisticated client books they represent, are moving at the fastest rate to so called "Hybrid" firms (i.e., Registered Investment Advisers (RIAs) with broker- dealer capabilities). In fact, the asset growth rate of the Hybrid channel has been nearly double that of the pure RIA channel (21% vs. 11.5% in 2012).[2] We believe this trend also will continue. Hybrid firms, with their full range of capabilities, are best positioned to serve advisors and clients who are accustomed to a full service model with a spectrum of advisory, product and execution capabilities.

As the attributes of firm models become clearer, along with choices in the marketplace, *we believe* ***sophisticated advisors will join sustainable partnerships that can provide substantial ownership and equity upside opportunities****, and an environment where they can best represent their clients' interests*. More often than not, these firms will be professionally managed – and who manages them is critical. ***Broad capabilities are "table stakes" - and astute advisors are focusing beyond them – and on the attributes that have always distinguished the most successful firms – culture, values – and most of all people****.*

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About Snowden Lane Partners

Snowden is a client-focused, financial advisor-owned, and national branded independent wealth advisory firm. Through its open-architecture platform, Snowden delivers wealth advisory services to high net worth individuals, families and foundations. For more information about Snowden, please visit www.snowdenlane.com.

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This piece will examine a number of these issues, including:

- Emergence of Hybrid Firms
- Equity Ownership and Firm Culture
- Big Banks and Bank Cultures
- Retention and Recruiting Compensation Disclosure

Why are Hybrids the Fastest Growing Independent Model?

Most wirehouse advisors now understand that they can earn more than they do currently, in an independent financial firm.

More and more advisors *and now even clients* appreciate the benefit of having their advisor in a separate company from the custodian of the client's assets. They appreciate that a professional custodian *focused primarily on custody* is preferable to a custodian that seeks to sell them products through an advisor it employs. Clients understand that the large, bank-owned, wirehouse is not the best place for them or their financial advisor.

Hybrids are the fastest growing independent model because top advisors recognize that servicing high net worth clients today entails more than just providing investment advice – as clients grapple with other complex issues, including increasing longevity and retirement, long term care and disability, financial and estate planning, special needs children and grandchildren, and philanthropic issues. Top advisors want to be independent – and they are looking for viable firms with the broadest range of capabilities.

Hybrids serve clients through a combination of investment advisory and brokerage services – so the advisor acts as a fiduciary when delivering investment advisory services through the RIA (fee-based), and as a broker when executing brokerage transactions through the broker- dealer (commission-based).

Hybrid advisors can offer clients a variety of advisory services and investment products, including:

- Financial planning and investment advice
- Discretionary and non-discretionary portfolio management
- Separately managed accounts
- Alternative investments and structured products
- Syndicate and equity new issues (IPOs)
- Insurance, including life, long term care and disability
- Variable annuities

Many Hybrid advisors are predominantly fee-based or annuitized, but recognize the utility of having a broker-dealer, where it may not be in the client's interest to be managing assets for a fee, for example, where a client may seek to hold a static position or product, outside of their advisory account.

For many advisors, the independent Hybrid model has significant advantages over the wirehouse. Executing fixed income securities, for example, the independent Hybrid advisor is not captive to a large bank's in-house trading

desk and gets competitive quotes from third party dealers. An affiliated broker-dealer can provide a range of investment options, for example, insurance and variable annuities, not typically available to or appropriate for an RIA. Snowden advisors, for example, have access to over two dozen insurance and variable annuity carriers, whereas most wirehouse advisors are limited to a core few that paid something to be on the platform.

All Hybrids are Not Created Equal

But not all Hybrids are created equal. Dually registered advisors exploring Hybrids should consider the relationship between the RIA and the broker-dealer. Many RIA advisors hold their brokerage registrations with distant third party broker-dealers. They have no input into products, pricing or transparency into potential broker-dealer conflicts of interest, like revenue sharing or rebates. **In some respects, signing up as an RIA with a large independent broker-dealer may be akin to signing up with a public utility.** They are also supervised by that large broker- dealer, typically via "one size fits all" policies that may feel similar to the wirehouses they seek to escape. We believe an affiliated and integrated broker-dealer, under common management with the RIA, is an important component of the new model Hybrid. This enables advisors to better provide customized solutions to their clients.

A Higher Standard

Finally, a word about conflicts of interest. Every advisor who is dually registered as an investment adviser representative (IAR) and a registered representative (Series 7), like most top wirehouse advisors, is effectively a Hybrid advisor and must manage conflicts of interest that may arise between the provision of advisory services and brokerage services. We believe these conflicts are readily addressable, typically through active conflicts management and disclosure to clients. Importantly, most independent Hybrids are in a very different position from the wirehouses in that they do not originate proprietary products and do not have a vested interest in cross-selling their owners' banking products.

We find it interesting, however, and somewhat short- sighted, that there are dually registered advisors operating in the independent market place, at Hybrid firms, providing brokerage as well as advisory services to their clients, who nonetheless continue to emphasize their pure standing as "Fiduciaries" when they operate under a "suitability" standard when acting as a broker.

We share the expectations of a number of commentators who believe the SEC will act this year to address issues around a common Fiduciary standard, and we believe that small firms are better positioned than large ones to adjust quickly to any changes. We support changes that would continue to preserve client choice in respect of advice and products and not channel all clients into a single model for investment services.

Equity Ownership and Partnership Culture

As capabilities have become recruiting "table stakes," and payout compares favorably, top advisors are seeking equity ownership in independent firms they believe can provide a substantial equity return. **They are entrepreneurs at heart and their personal "benchmark for success" includes building something of value.** They are therefore looking to firms with solid long-term growth prospects. In our view, sustainable growth correlates strongly to having

growth capital, professional management and a strong firm culture. We also believe that building a single brand is a key component in building equity value.

We believe many **advisors will be challenged to meet their own future value expectations through a stand-alone RIA or individual practice.** It is simply too difficult to manage, service clients, recruit, and grow the business without the benefit of dedicated and experienced professional management.

Such practices typically also face growth capital constraints. However, for established RIAs and some breakaway advisors, capital may be available through an aggregator. In this model, often called a "roll up," an advisor may set up their own RIA (or join an established one already owned by the aggregator), and trade majority ownership in that firm for capital and equity in the aggregator. Here, the advisor is betting on the aggregator compiling and successfully controlling a large enough number of profitable individual firms to achieve a substantial equity return, probably in a future IPO. There are effectively two brands - that of the aggregator, as majority owner of each of the individual RIAs - and the brand of each RIA.

In what we call the "single brand boutique model," outside investors' capital is provided to a single firm. A joining advisor is awarded equity in the firm as part of a transition package, and becomes an owner of and a partner in the firm. The advisor is an employee and the firm operates throughout its geographic footprint as a single company, under a single brand (although typically the advisor team will also market a team name).

The firm is managed directly by dedicated professional management who manage multiple locations, recruit additional advisors and handle the increasingly complex administrative, regulatory, compliance, human resources, operations, technology, finance and other responsibilities that come with running a modern day financial services business. In this model, clearly the management team is a critical element of success.
Down the road, there are a number of ways to monetize equity ownership in the single brand boutique, including IPO, sale, merger, partner buyout, etc. We obviously think this model provides a superior opportunity to grow and create long-term equity value.[3] Whatever model an advisor may be inclined to choose, we believe that growth capital is essential for firm's that seek to grow significantly in the near or intermediate term.

Boutiques Work

Those interested in equity growth prospects of boutique wealth advisory firms, in our view, would do well to look to the example being set in the boutique investment banking industry, where independent advisory firms like Greenhill & Co., Evercore Partners, Inc., and now Moelis & Co. are
succeeding beyond skeptics' expectations, and on the principal selling point that they are not big banks. In fact, in its recent prospectus, Moelis, which was the last of the three to go public, in April, stated that their focus on advisory services frees them from the pressure of cross- selling products. At the time of this writing, Greenhill and Evercore (already public) have p/e ratios around 30x and Moellis has a p/e ratio around 20x, more than double the p/e ratios of Goldman Sachs and Citigroup.

Culture Is Key

But perhaps the greatest driver of long-term equity value is, in our view, firm culture. **We believe the greatest growth and equity upside will come to firms that can create and sustain strong and effective cultures, including a culture of expense discipline and profitability.** To date, in a still maturing independent market, it seems to us that many firms principally market their platforms and business models, their capabilities, and attributes like "open architecture", and the "Fiduciary standard." We believe top advisors now expect independent firms to have these attributes.

Once capabilities have been proven, the best advisors will be attracted to firms that can demonstrate strong values. We believe that a number of "timeless values" will distinguish the most successful firms. **They will be client and advisor-centric, team oriented, uncompromising in their standards and socially responsible. Top advisors will look to associate with like-minded, accomplished advisors and firm leaders who share their values. They will look for selectivity that goes beyond book size and production and focuses on people – and the culture they carry and want to help build.**

The positive bottom line for the industry is that **more advisors are taking the realistic view that equity upside at a number of boutique brands in the independent market place is significantly better than the prospects of the bank-owned wirehouse** where they are working. We believe this sentiment is well founded.

What's Your View of Big Banks?

At the time of this writing, Bank of America (BAC) has just announced a first quarter 2014 loss, resulting in part from another $6 billion of loss provisions relating to mortgage backed securities. BAC's aggregate settlement provisions over the past four years now exceed *$55 billion* and the bank is apparently making provisions for billions more in related costs.[4] This is perhaps only the latest data point in a seemingly endless chain of post-crisis stumbles by big banks around the world.[5]

Nonetheless, the six largest banks in the U.S. (J.P. Morgan Chase & Co., BAC, Citigroup Inc., Wells Fargo & Co., Goldman Sachs Group and Morgan Stanley) have only gotten larger since the financial crisis – and substantially larger. They now hold roughly 67% of all the assets in the U.S. financial system. Since the crisis, they have grown those assets by over 37%, whereas the rate of asset growth in the system overall has been roughly 8%[6].

On top of the continuing settlements, banks operating in the U.S. recently became subject to higher capital standards that may put them at an operating disadvantage to their international counterparts. Dodd Frank is only half-way implemented and in 2015 the Volcker Rule becomes fully effective. It is not unreasonable to think that large banks in this country are on the way to becoming quasi-public utilities. **For financial advisors considering the best place for their clients, it is fair to ask, at what point, politically, will the issue of "too big to fail" be addressed and how? And what are the long-term implications for me and my clients?**

Banks Make Money Selling Bank Products

And strong bank financial performance may not be the answer for financial advisors and their clients. Morgan Stanley, unlike BAC, posted strong first quarter results, and earned $539 million in net interest income in the quarter (i.e., generally what it makes on loans and lending products). This was *up 31%* from the first quarter of 2013. That number now is just about equal to the $540 million the firm earned in the quarter in commission and fee revenue. Clearly, **Morgan Stanley is succeeding at cross- selling its banking products, but is that good for advisors and clients?**

As we noted in "Dis-Economies of Scale" in considering the transformation of wirehouses into banks:

> *"Eventually, the large firms came to appreciate that, in the aggregate, their clients maintained massive cash and money market balances that could generate substantial interest spread as deposits. So, in the late '90s and early 2000's they became banks. Not surprisingly, the firms then started to make vastly more on interest spread than they did on wealth advisory products and services. Sadly, this time marks the beginning of when the large firms began to care more about clients' assets than clients' interests."*

In the trenches, advisor frustrations with big banks are still high. The "least common denominator" approach to policies and procedures endures and advisors are still challenged to accomplish customized business. When they seek approvals, they must often go through layers of people who have no incentive to approve anything– let alone anything out of the ordinary.

So, while some banks are performing and some are not, we are of the opinion that top financial advisors will recognize, in increasing numbers that, long-term, the environment in these large institutions is not the best one for them or their clients.

Retention and Recruiting Compensation Disclosure

Several other factors lead us to conclude that 2014 is likely to see more top advisors leave wirehouses for independence. Wirehouse retention agreements, put in place around the time of the financial crisis, have 1-2 years of payout remaining and, in our view, are not likely to be renewed. More advisors are comparing growth and equity ownership opportunities in the independent market. Further, many advisors have a very solid year of trailing performance behind them and are well positioned to evaluate transition packages from firms that can pay them.

In addition, **on April 18, the SEC's comment period expired for FINRA's recruiting bonus disclosure rule** (Proposed Rule 2243, Disclosure and Reporting Obligations Related to Recruitment Practices), which would establish disclosure and reporting obligations to clients related to FINRA member recruitment practices. **We expect the SEC will approve the rule sometime this year and that it will be implemented late this year or early 2015.** The disclosures contemplated by the rule are stark and we expect that some advisors contemplating a move that involves a transition package will consider doing so before it becomes effective. While we do expect that the disclosure rule will reduce the size of recruiting packages generally, and probably will reduce movement between wirehouses, we believe it will do nothing to slow the steady stream of advisors and clients to the independent channel.

Conclusion

Our conclusions about the 2014 recruiting landscape for breakaway wirehouse advisors are:

- **2014 will likely be another strong year for breakaway wirehouse advisors and client assets moving to the independent channel**
- **The Hybrid independent firm will continue to be the fastest growing firm model because its multiple capabilities serve clients well**
- **Top advisors want ownership in independent firms that can provide substantial equity upside. Capabilities are now "table stakes"**
- **Firm culture will be recognized as a key driver of equity value, and increasingly will be a key consideration for breakaway advisors joining independents.**

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[1] *Investment News, Advisors on the Move, March 31, 2014*
[2] *Cerulli Associates, Meridian-IQ*
[3] *A thoughtful analysis of the independent market is provided in Fiduciary Network's "Brave New World of Wealth Management: Opportunities, More Competition, Demographics and Growth Conundrums," April 2013. This paper projects an impending concentration of advisors in a smaller number of professionally managed firms, characterized as "Evolving Businesses," that are likely to be winners in the independent market place.*
[4] *Merrill Lynch is now the smallest operating division of BAC.*
[5] *Some more recent well reported stumbles include J.P. Morgan Chase & Co. (mortgages) and Citigroup Inc. (stress test failure), along with settlements that have entangled non-U.S. banks operating in this country, like UBS (client tax evasion settlements).*
[6] *Source SNL Financial*