Snowden Perspectives: *Dis-Economies of Scale*

Small Firm Opportunities in a Changing Market for Financial Advice

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Executive Summary

- Institutional scale in wealth management is no longer a decided operating or competitive advantage
- Smaller, agile firms, enabled by independence, technology, and experienced and focused management can provide superior responsiveness and client focus

By now, the trend of Financial Advisors and client assets moving away from the "wirehouses" (Bank of America Merrill Lynch, Morgan Stanley Smith Barney, UBS and Wells Fargo) and into the independent channel is clear. Cerulli Associates estimates that the wirehouse share of the $11.2 trillion market for individual client assets will decline to 35% by 2013, from its prior 50% share in 2007. That is a channel shift of almost $1.7 trillion.

The attributes of independent financial advice are becoming better understood by advisors and clients. Both groups increasingly appreciate that their interests are better served by firms that do not have embedded conflicts of interest and institutionalized biases that come from originating products and needing to sell or "cross sell" them to clients. As Lyle LaMothe, former head of U.S. Wealth Management for Merrill Lynch, noted in his first interview since resigning last May, advisors who are selling the entire bank - rather than being totally focused on wealth management - will not provide the best possible planning and investment advice to clients.

This accelerating trend can be viewed through another lens, however, across a number of operating, service and cultural issues that Snowden believes may be less apparent, but are attracting advisors, clients and assets to the independent channel. Broadly speaking, institutional *scale* in wealth management is no longer the competitive advantage it has been for the past four decades. In fact, in many ways, size is becoming a noticeable hindrance, resulting in "dis-economies of scale". That "big" may not be "better" is challenging years of accepted industry doctrine.

Since Merrill Lynch introduced the Cash Management Account in the 1970's, industry dogma said the ultimate winner in wealth management would be the firm with the most client assets. This theory was grounded on the premise that across operating platforms, product distribution, systems, technology and support, *scale* created positive leverage and increased profit margins. Hence, Merrill Lynch focused for years on "asset gathering" and was the first wirehouse to break $1 trillion in client assets. Clients happily turned to the large firms based on their reputations for integrity, their breadth of services and in the knowledge that their assets were in large, and secure financial institutions.

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Rob was previously CEO of Clearbrook Global Advisors. Until 2009, he spent 22 years at Merrill Lynch, in New York, Singapore, Hong Kong, and London. He was General Counsel and Chief Business Risk Officer of Global Wealth Management (GWM) and a member of the GWM Executive and Operating Committees. He was previously General Counsel, CAO and Head of Human Resources of International Private Client, and General Counsel for the Asia Pacific Region. Rob started at Merrill Lynch as a lawyer in London (Europe, Middle East and Africa Region) and before that was a Staff Attorney for the U.S. SEC's Division of Market Regulation. Rob has a BA from Franklin and Marshall College and a JD from George Washington University. He is a Board member and former Board Chairman of the American Red Cross of New Jersey and a founding Board member of the Christina Seix Academy, a residential school for underprivileged inner city children. Rob and his wife reside in Princeton, NJ and have four children.

About Snowden

Snowden is a global, independent financial services firm. We provide wealth and corporate advisory services to high net worth individuals, families, institutions, and governments. In the end, each of our clients is trying to get from Point A to Point B — Snowden provides the pathway from point to point.

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. Nonetheless, for a while *scale* worked even better, as long as the large firms kept their clients' confidence, and provided superior support and service.

Client confidence began to diminish as conflicts of interest were exposed, beginning with the large firm scandals of the last decade (eg., research, IPOs, mutual funds, mortgages). This was exacerbated by the 2008 financial crisis and the bank ownership and regulatory, political and public responses that followed. Coupled with technological change that has enabled independents access to industry standard wealth advisory tools, the premise that large scale players will win in wealth management has been turned on its head.

The opportunity is now for smaller, independent firms, who can readily assemble "best in class" operating platforms and advisors and can provide clients access to high quality products and services. Smaller, agile firms can provide the benefits of superior responsiveness and client focus. Snowden believes that this trend represents a structural change in the industry and an opportunity for small firms with the right capabilities.

Separating Advice from Custody

Regarding client confidence, probably the most important small firm operating advantage has yet to be fully appreciated. That is, the separation of advice from custody - or the ability to advise clients in respect of their assets held at multiple custodians. Most clients want to deal with a single, trusted financial advisor. But if the 2008 financial crisis demonstrated anything, it is the vulnerability of very large firms and the prudence of diversifying client assets across multiple custodians, something wealthier clients have done for years. Most small firms, Snowden included, do not hold client assets in custody. They arrange for client assets to be held at reputable custodians (eg., Pershing, Fidelity, JP Morgan) who confirm periodically to clients that their assets are in safe custody. The independent model enables the client to deal with a single advisor and Snowden believes that more clients will seek firms that can provide continuity of advice across multiple custodians.

Technology—The Great "Enabler"

In relation to supporting advisors and servicing clients, a number of variables now favor smaller firms. Much has been written about access to "open architecture" products, and it is true that independents now have access to a broad array of products, akin to what is available at wirehouses, and without the "proprietary overlay".

But it is technology, above all, that has enabled smaller competitors. For many years, large firms had a decided operating advantage with proprietary technology and tools. Smaller players simply did not have the resources to fund and maintain cutting edge technology. Today, there is a proliferation of affordable "off the shelf" technology and tools that are equal or superior to those in the wirehouses. Much of it is provided by custodians, who compete to gain access to client assets. Fewer players seek proprietary technology because it is expensive to create and maintain and difficult to keep up with the pace of change in the open market. Envestnet, an account aggregator and provider of superior, cost effective analytics is a good example of a firm driving change in the advisor space.

Alternatives to the "Culture of Defensiveness"

The current political, legislative and regulatory environment for large banks has resulted in a culture of defensiveness at these institutions that is frustrating to advisors and clients alike. Dodd Frank, for example, has regulated debit card interchange rates that large banks can charge and caused them to push their clients into credit cards, which are more profitable for the banks. It is not lost on advisors that this purely economic decision is not in their clients' interest.

Large banks have always operated layered bureaucracies, and the current environment demonstrates that client focused wealth advisory businesses are not compatible with the process driven cultures of large banks. Large banks typically design policies to the "least common denominator" employee. As numerous advisors have told us, in addition to the pressure to sell bank products, they are challenged to accomplish anything other than standardized 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. Examples include approving new international clients, customized transactions and funds transfers.

Snowden believes that the high end wealth advisory business will thrive in smaller companies with fewer, but higher quality advisors and experienced senior management that is closer to advisors and clients. Such firms can make faster and better decisions about business, compliance and risk. Enabled by new technology, lower fixed costs and an ability to achieve efficiencies, smaller firms now have a decided operating advantage in servicing clients and navigating the financial services landscape.

Commitment to the Wealth Advisory Business

Possibly the greatest "dis-economy of scale" for bank owned wealth advisory businesses results from their management being more focused on, and committed to, their *scale* banking businesses than they are to wealth advisory. Nowhere has this been better illustrated than in connection with a $220 million revolving loan facility that a consortium of banks made in February to Focus Financial ("Focus").

Focus is a firm that provides operating capital to independent wealth advisory firms in exchange for ownership. It recruits wirehouse advisors to go independent and set up their own small firms. Ironically, two banks participating in the loan facility were Bank of America and UBS. Just days afterward, Focus announced the recruitment of a $2 billion (client assets) team from Merrill Lynch. So, Bank of America is apparently funding a competitor to hire advisors away from its own company.

Snowden believes it is no longer scale that will drive future success in the wealth advisory business. The winners will be the firms that can provide the highest quality advice, service and products to their clients. Snowden believes that many of these firms are not yet household names. A number of them will be smaller, more agile companies that are intently focused on wealth advisory and can create a truly advisor and client-centric culture.

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Our wealth advisory services consist of:

- Investment Advisory
- Cash Management
- Aggregated Performance Reporting
- Generational and Financial Planning
- Trust and Estate
- Family Wealth Education
- Social Impact and Philanthropy

Our corporate advisory services consist of:

- Business and Strategic Consulting
- Market Entry and Global Business Expansion Consulting
- Transaction Preparation and Scenario Analysis
- Capital Raise and Sell-side Representation
- Private Placements
- Mergers and Acquisitions
- Company Structuring and Launches

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Questions or Comments? Please direct them to…

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