

ADVICE FOR THE ADVISER

Private banks need to earn wealthy clients' trust by being more accountable and transparent. Otherwise, a newly risen clan of independent financial advisers might just steal the fireworks.

By **STUART E LUCAS**



As a fourth-generation member of a wealthy family and a wealth management educator, I ask myself, “Are we crazy to entrust our hard-earned assets to financial institutions that have collectively lost hundreds of billions of dollars and shaken the foundations of our global financial system?”

It’s a fair question, given the implosion of Bear Stearns and over US\$500 billion of reported credit losses at brand-name institutions like Citibank, UBS, Merrill Lynch, HSBC, AIG and many others. Even if we have been fortunate enough not to own the securities at the centre of the crisis — sub-prime, auction rate preferreds, insured municipal bonds, structured investment vehicles (SIVs) and other structured products — we feel the knock-on effects of declining stock

market values. Although most of these calamities originated in the investment banking divisions of these financial institutions, not private banking, this isn’t exactly a track record that gives private investors confidence.

Most of the wealth owners that I teach at the University of Chicago’s Executive Education Programme created their fortunes as businessmen, not as investors. When they convert those business assets to financial assets, the transition is unsettling, regardless of the macro environment. The stakes are high, their experience is limited, and it’s really complicated. Today the anxiety is especially acute. The markets feel unsettled, and the same firms that are rocking the financial system are the ones clamouring to advise us about our money!

The Asia-Pacific wealth management business today is dominated by the

private banking operations of large banks and brokerage houses. It’s been great business for them. According to The Boston Consulting Group (BCG), these firms have faster growth and higher profit margins in the Asia-Pacific wealth management market than in either the US or Europe. Top players in Asia have pre-tax margins above 60%. Median profitability is above 45%; in the US the median is roughly half that figure.

In addition, Asian wealth markets have experienced double-digit growth, and once the current turmoil passes, they will do so again. But the current headlines and increased client turnover suggest that, for many large banks, the values of their brands are eroding and their private banking businesses are under threat. I believe there is opportunity for private banks to regain the confidence of wealth

owners. Turmoil is a catalyst for change. Innovative institutions that seize this opportunity and build truly differentiated business models to serve their private clients better will be rewarded.

As wealth owners, you must encourage this change. If the change is too slow or too insufficient, you owe it to yourselves, to your families, and to the continued development of efficient Asian financial markets to seek out alternatives, whether they are well managed market leaders, large institutions entering your market with better solutions, or emerging independent financial advisers.

Here are four recommendations for improvement within the private banks:

Get the incentives right.

You, the client, should pay me well and pay me upfront for my advice, but you

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take the investment risk if things don't work out" is a standard fee structure in many financial businesses. Many of the hands involved in packaging, syndicating, rating, insuring and selling sub-prime loans, collateralised loan obligations (CLOs) and other securities central to the current financial crisis, were paid on this basis. So are most private banking firms that manage or trade your assets. I don't find it very comforting when people who claim to be the experts allocate risk and reward in this way.

I much prefer that my financial interests are aligned with my advisers'. There are other fee structures where advisory firms participate in the long-term profitability of the investments they recommend. Some even invest meaningful amounts of their own capital alongside their clients. While this doesn't guarantee success

(witness the mortgage losses), I generally prefer the alignment of interests.

Most wealth advisers have less money than their clients, and they need to earn money to eat. But some firms compensate more for bringing in new business while others remunerate client retention. It is still the rare private bank that measures and rewards long-term client value added, even though this has been the standard in investment management for decades.

Interestingly, BCG's 2007 Global Wealth Report (which is distributed mostly to business managers not clients) lists four recommended 'Performance Levers' to measure the productivity of private banks. Not one of them assesses the quality of clients' results or client satisfaction.

If you don't already know, the next time you see your financial advisers, ask them how their firms generate revenue

from your assets. Ask how they measure client value added. Ask how their year-end bonuses are calculated. Ask if they invest their own money alongside yours. (Sometimes they legitimately cannot or should not.) Then ask yourself "Do my advisers' incentives serve my interests as well?"

Retain top people.

Virtually every wealth owner I know prefers to have a long-term, stable relationship with a competent financial adviser. Yet advisers switch from firm to firm chasing ever-higher compensation. With that, they face intensified pressure to generate greater revenues. With all that pressure to generate revenue, advisers can get stuck between serving their clients and meeting the demands of their employers. We see this in the US.

We also see this in Asia, where wealth management talent is in particularly short supply.

In the US, firms like Charles Schwab, LPL Financial and Morningstar have created robust platforms that give wealth advisers another option: They can become independent advisers with an outsourced back office. When they do so, many become business owners, not employees. If they are successful their businesses grow, they remain independent and clients gain stability. This is attractive to both parties. To give you an idea of the scale of this shift, in the US in 2008, Schwab expects to add US\$18 billion in new assets brought by advisers breaking away from private banks and brokerage houses.

In October 2002 the Singapore Government passed the Financial advisers Act authorising the establishment of independent financial advisory firms (IFAs). To date, the number of independent firms has grown to about 70. Already, IFAs oversee 13% of total Singapore mutual fund assets, according to Cerulli Associates. Innovative IFAs like Provident, Abacus Capital and Republic Investment Management offer differentiated value propositions, are owner-operated and are filling niches in the market. As the platform providers expand into Asia, the number of independent financial advisory applications could accelerate quickly.

Measure the right things, correctly.

The concepts of global custody and comprehensive performance measurement are still untested in much of Asia. Global custody is a straightforward concept. The idea is to safe-keep all one's financial assets with a single, secure institution. Asset management responsibility can still be delegated to as many advisers as you want, but the actual assets remain with the global custodian. This infrastructure makes it easier to track asset allocation and to execute transactions.

Global custody is also the platform on which comprehensive performance measurement can be added. In business you want key performance indicators (KPIs) to tell you quickly how the

INTERVIEW

company is doing. The concept is the same in wealth management. Yet I never cease to be amazed at how few private investors and their advisers have robust KPIs in place to assess — accurately and efficiently — their investment performance.

This is especially true of long-term performance. My family office monitors quarterly performance, but we focus on three-, five- and 10-year data. Asian investors have a reputation for being short term (measured in days, weeks or months) and trading oriented. Yet in the US one of the indicators of mutual fund

is now aggressively advertising their index capabilities, going toe-to-toe with Vanguard, the index fund market leader. This nearly trillion dollar market in the US gives retail consumers access to these funds at annual fees of 0.10%, or even less. This is probably less than one-tenth of the management fees you are paying!

Why is the market so large and growing? Because investors are learning what academics have demonstrated time and again: Low-cost, broadly-diversified index funds outperform active managers most of the time. Yet in Asia, the market for index funds is virtually non-existent.

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underperformance is high turnover. Is short termism really working for you? How do you know?

The whole concept of correct measurement is so important, in my view, that we spend an entire session of my course discussing it. We talk about benchmarking to assess advisers' value added, measuring cash flow as well as assets, and tracking consolidated asset allocation. Historically in Asia there has been a premium on privacy, security and even compartmentalisation. But as Asia continues to develop both economically and politically, the advantages of global custody integrated with KPIs will grow quickly.

Don't over-complicate.

Fidelity and Vanguard, two of the three largest mutual fund companies in America, are battling each other to sell low-cost index funds. These products are simple to understand, broadly diversified, liquid, and transparent.

Fidelity, traditionally dominated by a culture of active investment management,

Are your investments outperforming the indexes? If the status quo changes in Asia and the appetite among private investors for index funds grows, what will happen to higher cost, complex alternatives — especially those that can't match the indexes? Would fees fall and value to the customer increase?

In wealth management, this is just one of many examples where simplicity, transparency and liquidity have distinct advantages over highly engineered alternatives. The simple solution is also a great way to benchmark the presumptive value added of complex alternatives.

So I go back to my original question: "Should we entrust our financial assets to large private banks?" My answer is: "It depends." If these institutions use the current turmoil as an opportunity to rethink their business models to better serve both their shareholders and their clients, then the answer is "Yes".

If they don't, new entrants from abroad and growing numbers of local IFAs will capitalise on the large institutions' vulnerability by addressing my four

points in more client-centric ways. In the United States and Europe, successful adviser/entrepreneurs have built impressive organisations, chipping away at the client base of the big private banks. Equally impressively, they have created a competitive environment that has given investors greater choice, sometimes at lower cost.

Asian entrepreneurs have created a lot of wealth for themselves in the past 50 years. Businesses they created are being sold or are generating lots of excess cash. Managing substantial financial assets is a new challenge for many of them. In addition, they are faced with business succession and the family dynamics of multi-generational wealth. More and more are striving to educate themselves and their families about wealth and how to manage it effectively.

Education is good for their families — educated clients are also good for the wealth management industry. We ask the tough questions and demand clear answers, free of the jargon that practitioners sometimes lean on to impress or to intimidate. It takes courage for clients to say, "I don't understand, explain it again in terms I can relate to." It also takes skill, and often greater knowledge, to reply accordingly. It is in the industry's interest to regain our trust, which will be earned over years and decades.

In the meantime, we wealth owners owe it to ourselves to learn, to protect our own interests and to hold our advisers accountable. Then, trust will be a by-product of fact rather than hope. ■

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