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POINT OF VIEW

WEALTH MANAGEMENT

WINNING AT ALL COSTS – COST MANAGEMENT AS KEY SUCCESS DRIVER

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INTRODUCTION

The market for retail wealth management is undergoing a profound change. Shifts in investor demand, increased regulatory reform, and new forms of competition are working together to change client expectations of what is possible as well as how much they should pay for wealth management services. In the near term, these changes will have the greatest impact on the affluent and mass affluent sectors of the market. They will, however, become increasingly relevant for all wealth segments and the providers that seek to serve them.

We argue that a fundamentally different approach to business design and cost engineering is required for future success. The low and transparent price points of new wealth management models are shifting the convention away from financial advisor as price setter toward market-driven pricing, making profitability increasingly a function of volume and careful expense management. In the new wealth management landscape, we believe successful firms will have to be far more selective with regard to both clients and advisor value propositions. Indeed, in an environment where providers are being asked to do more for less, increased focus around clients, advisors, and expenses will become paramount in delivering a compelling client experience, at the right price point and cost to deliver.

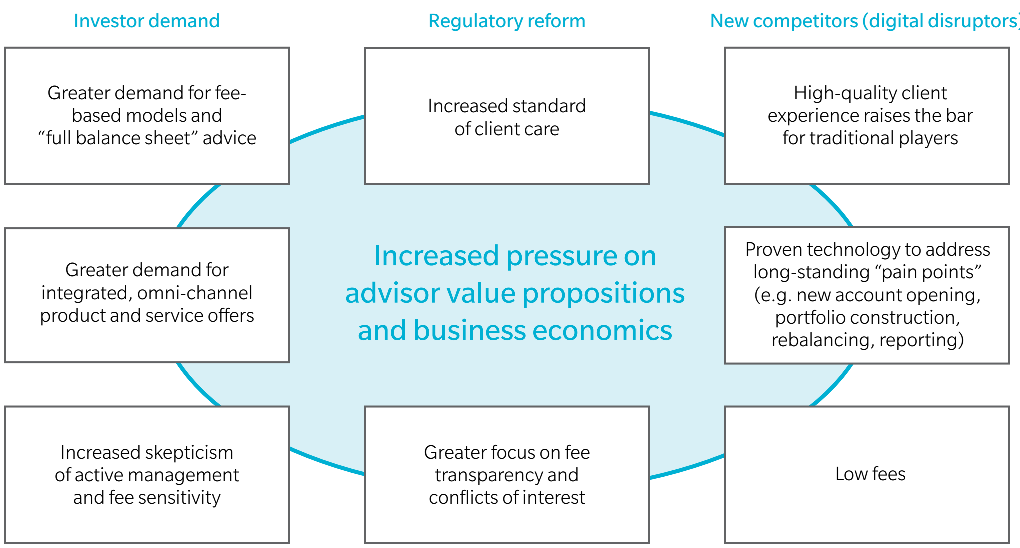
Cost management in the new reality starts with defining the value proposition and pricing for serving a particular investor segment, then engineering the delivery model, infrastructure, and required functions at a cost that ensures an acceptable profit margin. In this Point of View, we will consider some of these market developments and provide recommendations to senior leaders tasked with charting a course going forward.

MARSH & McLENNAN COMPANIES

I. DOING MORE WITH LESS: A NEW MARKET REALITY FOR WEALTH MANAGERS

The wealth management industry is experiencing myriad changes that threaten to increase the burden on wealth managers to deliver greater value at increased cost for less money. While the purpose of this paper is not to provide a full review of these changes, a quick inventory of investor demand, regulatory landscape, and competitors (see Exhibit 1) reveals the forces at work propelling the industry toward a new reality.

Exhibit 1: Traditional wealth manager economics are under pressure



INVESTOR DEMAND

Investors want more advice – not just for investments but for all forms of financial decision making. They also want to interact in ways and at times that are convenient for them. This means greater use of Internet-based communications, apps for smart phones and tablets, call centers, and in-person visits when desired – all seamlessly in synch. Many individuals have also become skeptical of active management, placing value on personalized service, asset allocation, portfolio construction, and ongoing risk monitoring/re-balancing over stock picking.

REGULATORY REFORM

Through the exploration of the Securities and Exchange Commission's (SEC) Uniform Fiduciary Standard, the Financial Industry Regulatory Authority's (FINRA) revised Know-Your-Customer and Suitability rules, and the Department of Labor's re-proposed Conflict of Interest rule, regulators are seeking to elevate the standard of care owed to investors through a combination of increased transparency, heightened disclosure, and greater guidance as to what the terms "suitability" and "fiduciary" mean in relation to the duties providers owe to retail clients.

NEW COMPETITORS: THE DIGITAL DISRUPTORS

So-called "robo advisors" have emerged to challenge incumbents by delivering a high-quality client experience at a fraction of the price of traditional players. Much like online trading firms, which ushered in a new reality for full-commission brokers, the "digital disruptors" threaten to undercut the fee-based advisory models and price points of traditional firms. While total assets in the digital disruptors' new models represent less than 1 percent of all managed account assets (i.e., around $10 billion vs. $4 trillion in total US managed account assets[1]), the low marginal cost of adding new clients and assets, combined with their rapid growth, suggests that the digital disruptors should not be ignored. Importantly, they have demonstrated that a focused, high-quality client experience can be delivered at a low price point. They have also shown that some of the most long-standing pain points for traditional firms, such as account opening, portfolio construction, rebalancing, and monitoring and reporting, can be addressed successfully.

Ultimately, whether the upstart digital startups survive to take a place among the industry leaders, or they become white label partners, acquisition targets, or copied by more established players, we believe the current market changes will come to have profound impacts across the value chain for traditional wealth managers (see Exhibit 2).

Exhibit 2: Current market changes have significant implications across the value chain

Wealth management value chain
Impact of market changes

	Client acquisition/ servicing	Investment planning	Research and analytics	Portfolio management	Trade processing	Accounting	Reporting	Risk and compliance
Increased fee pressure	✓							
Improved client experience	✓	✓	✓	✓			✓	
High-quality, scalable advice with expanded value proposition		✓	✓	✓				
Increased legal and compliance costs	✓	✓	✓	✓	✓	✓	✓	✓
Increased IT/ Ops efficiency	✓	✓	✓	✓	✓	✓		✓
Integrated systems, real-time, omni-channel data	✓	✓	✓	✓	✓	✓	✓	✓

II. NEW WEALTH MANAGEMENT BUSINESS MODELS INCREASE CLIENT CHOICE

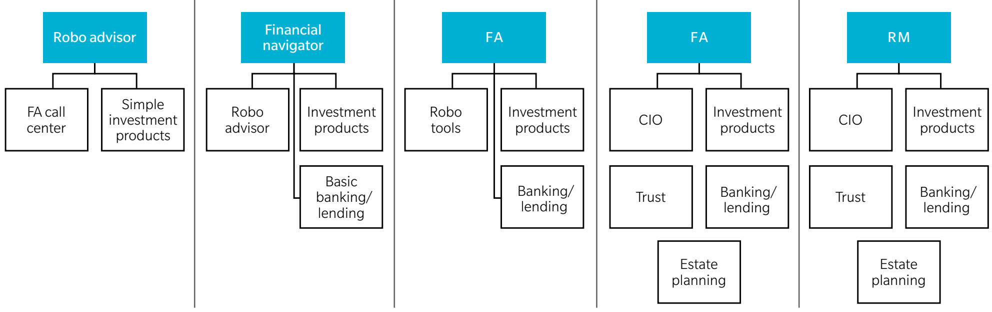
In response to macro trends, new business models have emerged to serve different investor segments based on their means, sophistication of needs with respect to advice and products, and willingness to pay. The defining difference between these models is the role of financial advisors. As shown in Exhibit 3, the new spectrum of offerings ranges from pure technology-based solutions to traditional ultra high-net-worth (UHNW) private banking offers, where the financial advisor (FA) is just one of several experts alongside private bankers, financial planners, and others that comprise a client service team.

1 Source: SEC ADV filings, Cerulli Associates, Oliver Wyman analysis

As a starting point, firms need to decide the clients they will target and with which business model(s) they will compete. Firms with multiple, potentially competing models will need to proactively identify the best fit for clients and help navigate them to the optimal channel, or put these relationships at risk.

Exhibit 3: New wealth management models

Potential end state advisory models



	AUTOMATED ADVISOR	FINANCIAL NAVIGATOR	FINANCIAL ADVISOR	PERSONAL CFO	RELATIONSHIP MANAGER
Advisor role	Call center for support with account opening, funding, service	Basic client relationship manager; automated tools used for business development, research, portfolio construction, risk management, rebalancing	Provides personalized financial planning and investment portfolio construction; robo portfolio management and reporting tools increase advice scalability and increase FA bandwidth for client servicing and acquisition	Personal CFO with investment focus backed by full platform of products and specialists (investments, banking, lending, insurance); automated robo tools leveraged to improve efficiency and effectiveness	Client relationship quarterback; often with banking or trust focus Leads a team of sophisticated financial experts (private banking, investment management, trust and estate planning)
Products	Simple investment products such as ETFs/index funds	Full range of investment and basic banking/ lending products	Full range of investment and basic banking/ lending products	More complex product set requires greater expertise and oversight	More complex product set requires greater expertise and oversight
Pricing	25–50 bps	50–75 bps	75–100 bps	100+ bps	100+ bps
Target client	< $250 K in assets	< $1 MM in investable assets, or with moderately sophisticated needs	~$250 K–3 MM in assets	> $1 MM–2 MM in investable assets	> $5 MM in investable assets

III. SOLVING FOR THE BEST INTEREST OF THE CLIENT

In the future, clients will be less willing to pay for value they don't want or need.

The talent war for financial advisors continues, but the emphasis is increasingly shifting to the end client. In the past, clients usually had to decide whether they wanted to invest on their own or with the help of a financial advisor. If they chose a financial advisor, they typically had few data points to understand the breadth of value propositions available from different financial advisors and largely conformed to the approach of the advisor they selected through a referral or limited interview process. With the advent of new models and explicit choices available to clients, firms must begin to view the world directly through their clients' eyes to get them through the door.

What do clients need in terms of advice and products? What are they willing to pay for? Firms must do a better job of aligning value delivered and cost to serve with the value clients require. For example, with modest amounts to invest, the financial planning needs of many mass affluent clients are limited; they don't require and won't pay for detailed plans – either implicitly or explicitly.

Firms should start with designing the client experience for targeted client types and needs at specific price points. The firm's operating model and processes should then be aligned with the desired client experience. This means clearly defining which products fit relative to a given business model based on client needs, as well as product economics. Fundamental to this approach is an understanding of the total cost to deliver – from the role and compensation structure of financial advisors to the time and complexity involved in selling specific products to the technology and operations infrastructure, and other necessary support functions.

Additionally, firms that support multiple models must become better at channel management to guard against over-delivery on the one hand, but offer an in-house solution for clients whose needs have outgrown a lower support model on the other. Knowing when to have the conversation about a different advisory model and associated higher price point will be critical to the success of this strategy. Practically, this means firms will need to have the right management information systems in place to identify "windows of opportunity," when clients have both a need and openness to switching business models such as receiving an inheritance, the birth of a child, a large increase in compensation, etc.

IV. IMPLICATIONS FOR TRADITIONAL FULL-SERVICE FIRMS

A number of traditional full-service firms have already embarked on strategies to go upmarket in the FA and Personal CFO models, though to-date most of the focus has been on topline growth over increased expense efficiency. Key actions have included investments to help advisors better manage their respective practices in ways such as tiering clients for service, pruning low value clients, and expanding their value propositions to include lending, banking, insurance, and other products. This approach better matches clients' needs with the breadth and sophistication of traditional firms' business models. However, firms are still exposed to significant disruption in several important ways, including new client acquisition, price compression, and an elevated bar for client experience (as described below).

REDUCED CLIENT ACQUISITION

Having an automated advisor and/or financial navigator model may become crucial for new client acquisition

New money flows across the industry suggest that traditional players are already facing challenges with new client acquisition. If competing models such as the financial navigator and automated advisor models win the battle for attracting new clients, traditional firms will have a harder time re-competing for these relationships, if and when clients' needs outgrow these more basic business models. The risk is that over time, traditional players will lose relevance and become increasingly tied to their existing clientele, which is growing older and grayer.

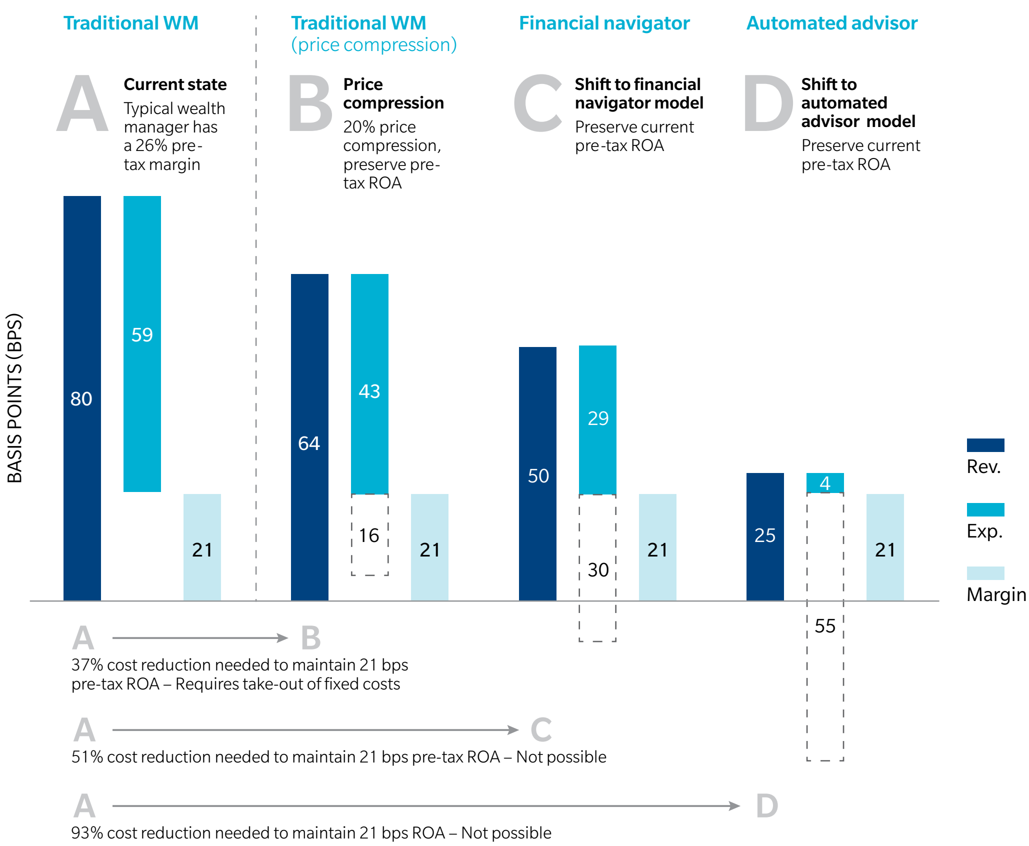
PRICE COMPRESSION

Competing in the automated advisor and financial navigator models requires a fundamentally different cost structure

Pricing is not a popular topic of discussion today – among either clients or advisors. Our research indicates most people do not know how much they pay for the advice and products they use, and most advisors do not like to revisit client pricing after the initial discussion. The new wealth-management business models are likely to change this uneasy equilibrium through increased price transparency, however.

Given increased exposure to the new market benchmarks, we expect clients will be more likely to ask about price and negotiate fees. We can readily imagine many such conversations playing out in the following way. The client says, "I really like my current advisor, but what added value am I getting for an additional 50 to 75 basis points (bps) compared to a robo-advisor or financial navigator model?" Based on our experience with price setting, many advisors are likely to respond by discounting, which results in lower overall industry pricing and revenues, putting further pressure on cost management to preserve profitability. By way of example, a 20 percent reduction in topline revenue would require an approximately 37 percent decrease in expenses to maintain current pre-tax ROA levels (see Exhibit 4).

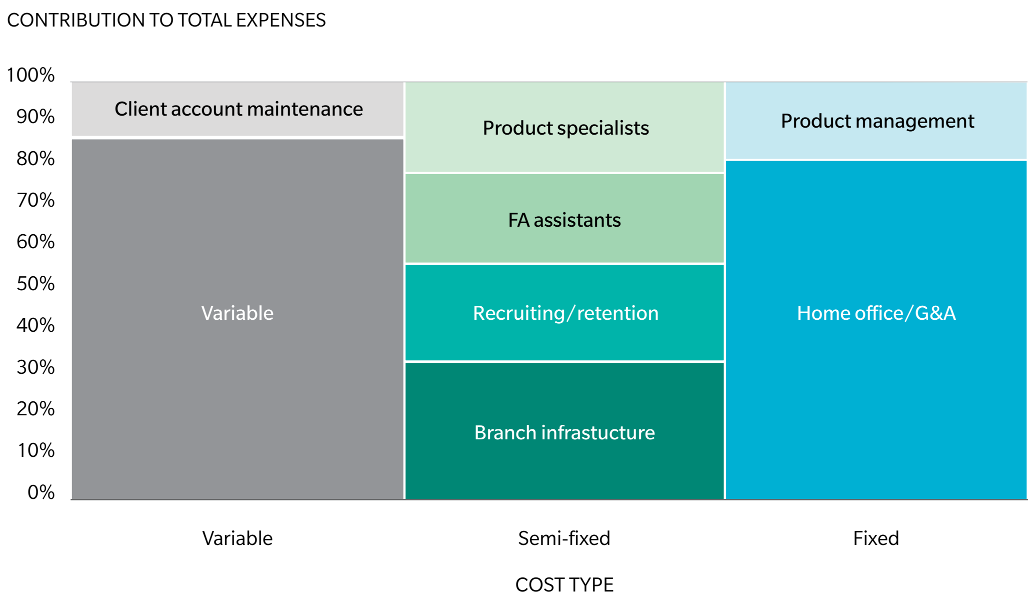
Exhibit 4: Implications on traditional wealth manager economics of price compression and a hypothetical transition to one of the new wealth management models



Currently, only about 30 percent of wealth managers' costs are variable, however, implying that a permanent reduction in revenues would require taking out fixed and semi-fixed costs to maintain profitability levels. To offer some context: A 37 percent expense reduction would require a typical large wealth manager to cut FA compensation, home office/G&A, recruiting/retention, and branch support in half (see Exhibit 5).

Moreover, it won't be possible for providers to evolve from a traditional wealth management model to a financial navigator or automated advisory approach based on their current operating model, where total compensation and benefits can represent as much as 65 percent to 70 percent of total non-interest expense. Such a move could result in a drop from 80 bps to 25 bps on assets under management (AUM) in topline revenue, necessitating a corresponding 93 percent expense reduction to maintain the same pre-tax return on assets (ROA) – a virtual impossibility.

Exhibit 5: Cost structure for a large wealth manager (Illustrative)



In practice, such a rapid change in pricing is unlikely to happen quickly for a variety of reasons (e.g. client inertia, sources of revenue other than investment advisory fees such as mutual fund fees, net interest income, and trading commissions). However, there are strong signs that the market is already moving in this direction – increasing wealth manager reliance on revenue from investment advisory fees combined with declining realized prices, a continuing trend toward lower cost fund products with less economics for distributors, weak net interest income due to persistently low interest rates, etc.

ELEVATED BAR FOR CLIENT EXPERIENCE

More features and functionality means more costs

Similar to the price discussion, if clients see slick user interfaces, fractional shares, tax-loss harvesting, and compelling reporting from lower-cost models, they are likely to look to their current providers and demand something similar, making the technology to support these capabilities table stakes for all advisory models, and increasing costs unless taken in conjunction with other actions to reduce business complexity.

V. RECOMMENDATIONS FOR SENIOR MANAGEMENT

While the changes described above are significant, we continue to see a bright future for full-service firms that proactively address the challenge. To improve quality, increase business scalability, and raise cost efficiency, we recommend senior management undertake a client-focused business optimization program vs. a pure cost-cutting exercise, which can deliver savings of as much as 15 percent to 20 percent of a firm's overall cost base. We offer the following suggestions as guiding principles to aid decision making around the inevitable trade-offs and help manage communications with key stakeholder groups.

1. **Solve for an end-to-end client experience**
   Develop a deep understanding of the client journey. During the client lifecycle, identify the touch points that matter most for clients and drive behavior with regard to acquisition, pricing/willingness to pay, and satisfaction. This work will inform what topline revenues may be achievable and also what expense base the business model can support to provide an acceptable operating margin.

2. **Reduce business complexity by focusing on selected FA value propositions**
   Many traditional firms have historically sought to support a wide range of advisor types and practice models (e.g., Rep as PM, Rep as Mutual Fund Advisor, Rep as Discretionary Advisor) through multiple platforms, products, tools, and reporting configurations. This requires a complex infrastructure to manage and price the various products, systems, vendor relationships, operations, and governance and control oversight mechanisms. Exhibit 6 shows an example of how greater operational complexity and costs associated with different FA practice models can manifest across a range of typical wealth management activities.

Exhibit 6: Operational complexity map

	CATEGORY	CAPABILITIES						
CLIENT FACING	**Client acquisition and servicing**	Lead generation, prospecting, referrals	Account opening	Client due diligence, KYC	Account maintenance	Customer mgmt., e.g. follow-ups	Practice management	Account closing
	Investment planning	Proposal generation	Investment policy statement	Pricing	Financial planning	Tax planning		
	Research and analytics	Investment research and analytics	Security and portfolio analytic	Pre-trade analytics	Allocation model maintenance	Analytics and tool development	Risk profiling	
	Portfolio management	Portfolio construction	Cash Flow assessment and planning	Portfolio monitoring and alerts	Rebalancing	UMA		
NON CLIENT FACING	**Trade processing**	Pre-trade compliance	Trade capture/ order management	Trade execution	Corporate actions	Reconciliation	Alternative investments	Private placements
	Accounting	Trade accounting	Portfolio accounting	Trust accounting	Commissions and fee allocations	Billing	Margining	Disbursement processing
	Reporting	Data management	Data aggregation, e.g. householding	Performance reporting	Client reporting	Ad-hoc reporting	Management reporting	Client self-service reporting
	Portfolio management	Suitability	Legal compliance	Operational risk management	Post-trade compliance and reporting	Regulatory reporting	Risk management and reporting	Monitoring and surveillance

- Different and unique workflows per FA practice model
- Distinct configuration of systems
- Distinct data needs

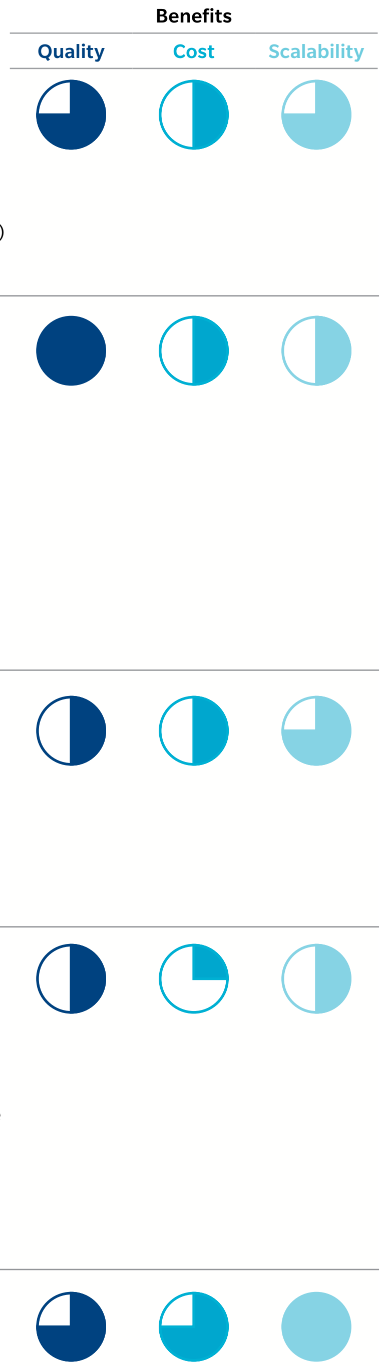
Complexity driven by FA practice model
High operational complexity
Medium operational complexity
Low operational complexity

Firms will need to make difficult choices about what they will and won't do to remain competitive. We recommend prioritizing key decisions in consideration of a holistic cost benefit analysis that includes an understanding of client needs and desired experience as well as total cost of ownership. Examples of decisions that have significant cost structure implications include which advisor models to support, which products to put on the 'shelf', and which IT systems to implement and support.

3. **Redesign the operating model around client insight and prioritized FA value propositions**
   Redesign the operating model around the target client set, desired client experience, and prioritized FA value proposition(s) to gain sharp focus on clients and costs. This may include revisiting client acquisition and servicing interactions; front, middle and back office positions, roles, and compensation schemes; and operating processes, systems, and reporting to provide a winning client experience at an acceptable price point.

POTENTIAL BUSINESS OPTIMIZATION LEVERS

Alongside these high level priorities, we offer the following recommendations as tactical levers for improving quality, increasing business scalability, and raising cost efficiency.



A. Centralize core advice, investment models, and trading

Increase the quality and consistency of advice, remove costs from the field force and associated control functions, and increase business scalability by centralizing asset allocation, model portfolio development, and trading (i.e., new purchases, sales and re-balancing) through the Office of the CIO.

B. Continue to foster best practices among financial advisors

Develop practice-management tools and training to increase advisor adoption of best practices, and harmonize value propositions with desired brand positioning to maximize price realization (while increasing advisor, middle and back-office efficiency). This may include such elements as: best-practice processes for new client acquisition and on-boarding; client tiering and book management; effective use of assistants and specialists; financial planning; client profiling; and the use of model portfolios, client reporting tools, and other topics.

C. Rationalize product and advice platforms and accounts

Many firms have accumulated a number of different product and advice platforms as well as account types over the years as a result of new product initiatives, M&A, and a diversity of advisor types. Eliminate redundancies in these areas to unlock significant cost savings, as well as increased process standardization and automation.

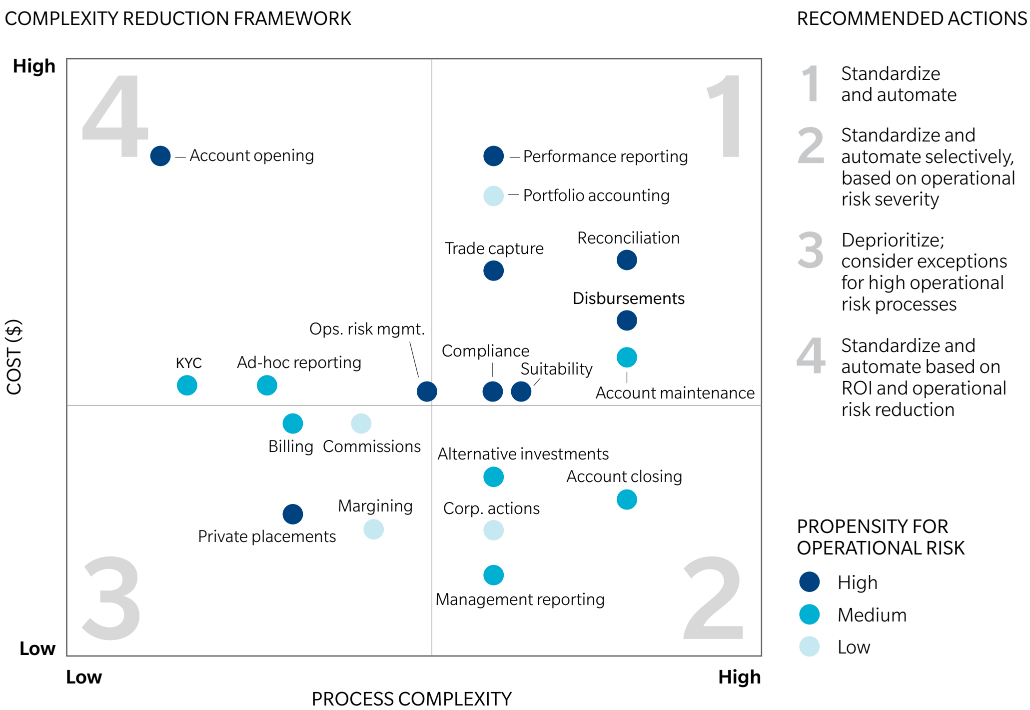
D. Rationalize use of vended tools and models

Related to C (above), many wealth management firms have accumulated multiple vendors via M&A with overlapping capabilities and investment models for activities such as wealth forecasting, risk analytics, and asset allocation, as well as acquiring individuals and teams of advisors. Going forward, firms should seek to streamline the number of vendor relationships to improve cost efficiency and reduce operational risk. This will be increasingly important for bank-owned wealth managers subject to heightened levels of model validation and ongoing monitoring requirements.

E. Standardize operational processes and increase automation of core business functions and controls

Greater standardization and automation of operational processes is key to reducing costs and operating risk, as well as increasing business scalability. While many operational processes can benefit from technology enablement, prioritization is critical for maximizing return on investment. Exhibit 7 shows an example of a simple prioritization framework.

Exhibit 7: Prioritization framework for business process standardization



VI. CONCLUSION

There are likely to be multiple winners in the US wealth management market, but also many losers. Future winners will take share and reduce their cost-to-serve to protect and grow their businesses, while losers will see reduced client acquisition and asset gathering, lower revenues, and deteriorating business economics. To take their place among the ranks of the winners, future market leaders must be proactive in formalizing client-centric business strategies, engineering their firms' operating models to deliver needed capabilities at an acceptable cost, and finding the courage to implement the significant changes required to compete in a new marketplace.

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