FIRST ALLIED SECURITIES, INC.

Achieving Profitable Growth

Discipline in financial management is a defining characteristic of a successful independent advisory business. Because it is easy to ignore in the face of the many demands on the financial advisor/owner, it is also absent in most firms and one of the contributing factors to the large number of small practices that dominate the industry. The stakes are high when it comes to a firm's success in careful management of its finances; practices that generate a comfortable profit margin can sustain reinvestment in support of growth at a rate their peers envy and ultimately command a higher multiple in a liquidity event.

first allied

The benchmarks for a healthy independent advisory practice have been well established for years. As Mark Tibergien and Rebecca Pomering noted in their book, *Practice Made Perfect,* a healthy business will have a gross margin of around 40 percent and an operating margin of 20–25 percent. The cost of delivering advice, as measured by the salary and incentive compensation paid to financial advisors in the firm (including owners working as advisors), should be roughly 40 percent of total revenues. And overhead, including administrative and other staff, rent, software, benefits, marketing and other expenses should amount to no more than 40 percent of revenues. This leaves a healthy margin of 20 percent or more to support profit distribution to the owners and retained earnings that will support the firm's ability to reinvest and grow.

Total Revenue	**$500,000**	**100%**
Direct Expense (financial advisor or advisors' salaries)	($200,000)	40%
Gross Margin (cost of goods sold)	$300,000	60%
Overhead (admin and other salaries, rent, software, benefits, etc.)	($200,000)	40%
Operating Profit (to owner(s) and retaining earnings)	$100,000	20%

Source: Adapted from Practice Made Perfect, byMark Tibergien and Rebecca Pomering

But what strategies and tactics help a firm reach these metrics? Sound financial management is grounded in several disciplines, including:

- Sound pricing practices
- Alignment of the service model and client revenues
- A sound compensation strategy
- Investing at a measured pace

This report examines four of the practices that are key to driving positive financial results in an independent advisory practice, offering an analysis of the challenges facing the owner and suggestions for addressing them.

Sound Pricing Practices

The Problem

Poor pricing practices are the most significant mistake a financial advisor can make in the management of their business. In a fee-based or fee-only environment, fixed revenue means there is no way that an owner can sell their way out of a problem with operating margins. Without sacrificing service or taking on low-level tasks themselves, there is only so much the advisor/owner can do to cut back on expenses to meet a profit goal. And every new client will magnify the problems that exist in the alignment of revenue and expense in the practice.

Some independent advisors make a strategic decision to undercut the prices of their competitors. They tend to have one of two goals: becoming the Walmart of financial services, or simply accelerating their growth by reducing the impact of pricing on client acquisition. Both strategies tend to be losing propositions. Modeling your firm after Walmart succeeds if—and only if—you have significant capital to scale rapidly and on a national level. Your competition will be banks and online, low-cost broker/dealers that can bury you with their ability to deliver even more services than you can and at an even lower price.

Pricing low to accelerate business development sets up an equally bad scenario. A client may be paying less but they still have the same expectations as the client paying a market rate price to a competitor. The fee they pay you doesn't change the financial planning problems you must tackle. Whether a client pays you 1 percent or 1.5 percent in advisory fees does not alter the fact that they still have college, retirement and estate planning needs you must address. Advisors who pursue this strategy find themselves either facing one of two scenarios:

- **Low margins** as they need to deliver the same services as competitors but at a lower price, or
- **High attrition** as they find themselves unable to meet the service demands of these clients without the necessary revenue to invest in their human capital and advice infrastructure to keep up with client needs.

Despite the obvious drawbacks of low pricing, most financial advisors cannot bring themselves to consider raising their pricing. The irony is that satisfied clients are almost always open to revisiting pricing, particularly if a re-pricing is tied to tangible benefits to them. Simply going to clients and asking for a higher fee will yield a predictable result. But bundling a pricing increase into a reintroduction of your firm's services and an expansion of your advice offerings yields results in almost every instance. When clients see tangible benefits, which may include access to a real-time balance sheet and document vault through services such as eMoney, coordinated meetings with an attorney and CPA to develop an estate plan, or simply higher-touch service, they do not challenge a fee increase.

The Solution

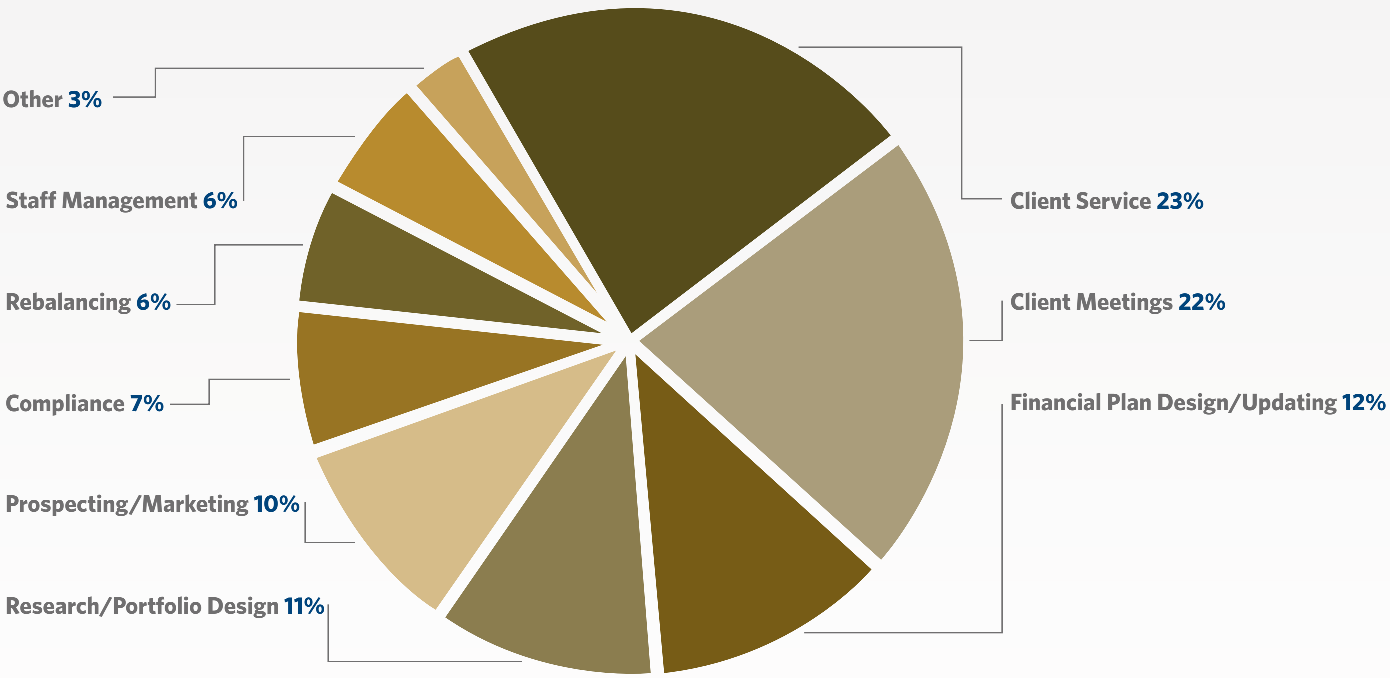
Good pricing practices begin with a basic understanding of what it costs the firm to serve its clients and cover its overhead while leaving a reasonable profit. And ultimately, they are tied to the owner or owners' ideal client profile and proposed services—decisions that are central to the firm's strategy. Sound pricing policies are the outcome of a process that follows the steps below:

1. **Identify the Target Wealth Market:** To begin, the owner must know who they intend to serve. A narrow wealth demographic is ideal in that the owner can avoid having to build a firm that serves clients with radically different needs, which drives up the cost and complexity of managing the firm. The segment that will be the focus of the advisor's attention is the one that will drive the cost of serving clients.
2. **Determine Services Required by Target Market:** Dedicating time to researching the problems of your target market in order to know what services they need, rather than what services you would like to provide, is critical not only to competitive positioning but also to pricing. Without an honest and complete accounting of the services to be rendered and the infrastructure (human capital, systems, etc.) required to deliver them, an advisor is left in the dark guessing as to what price will cover the cost of serving the client.

3. **Estimate Cost of Service:** This is a critical step even if the service model is already set in stone. Ideally, the owner should estimate the number of hours (or fractional hours) required from each member of the firm to deliver the services that have been promised or planned. Based on target total compensation cost for each employee and the total number of clients, establishing the cost of the service becomes a straightforward calculation.

4. **Set Fees:** Combining the human capital cost of serving the client (professional and administrative or operations staff hours) with the proportion of non-compensation related overhead per client gives the owner the break-even level for the fee. As a healthy practice should generate an operating profit of 20 percent or greater, the fee should be grossed up accordingly to create a comfortable margin for the firm.

There are several shortcuts to get to profitable pricing practices without the effort of a more intensive strategic planning exercise. First, you can use industry averages to understand where the average advisor spends their time.



Source: Advisor Best Practices Report: Retirement Income and Transition Support by GDC Research and Practical Perspectives

Combined with a basic assumption about the hourly rate the advisor would like to generate based on an annual income goal, a basic time-spend breakdown can help you estimate the cost of your time, (i.e., the cost of goods sold for your practice). The following example breaks down the amount of time the average advisor will spend per “A” client in a practice with 100 clients and one advisor, illustrating that a practice with these characteristics generates a healthy gross margin with a sound fee.

Sample Client Service Model Validation

Client Assets	$1,000,000
Advisory Fee	1.00%
Annual Gross Fee Revenue	$10,000
Client Meetings	4 hours per year
Financial and Investment Plan Design	4.5 hours per year
Research and Portfolio Management	4.2 hours per year
Portfolio Rebalancing and Trading	2.3 hours per year
Total Hours	19.6 hours per year
Cost of Service at $150/hour	$2,940
Gross Margin (Gross Fee — Cost of Service)	$7,060
Gross Margin (Assuming a 90% Payout)	64%

Sources: Best Practice Research and GDC Research

Alternative shortcuts include referencing industry averages and targeting a net fee of 1 percent after a broker/dealer override if there is one. Industry averages are a helpful place to start for those that need a quick validation of their fee schedule. Asset-based pricing is a mature pricing model that has been widely adopted, and average fees have, over time, gradually migrated toward levels that cover expenses and sustain acceptable expenses. Similarly, starting with a goal of a 1 percent fee after any overrides generally leaves enough revenue to create a profitable business. Both shortcuts do have drawbacks. Industry averages are counterproductive for firms attempting to build a unique service model, particularly one that is high touch or requires more staffing overhead than normal. And aiming for a 1 percent fee after overrides can result in un-competitive fees for clients with more than $1 million in assets.

Alignment of Service Model and Client Revenue

The Problem

The second common profitability challenge facing independent advisors is overbuilding their services relative to their clients' affluence and needs. This is akin to someone who lives in a warm climate and does not ski or hunt yet has an expensive four-wheel drive vehicle. They have no use for the features that drive the price premium for the vehicle, but bought it nonetheless. Owners of financial planning and wealth management firms are similarly sometimes guilty of building a Lamborghini for a client who needs a Toyota.

The problem of aligning the financial and investment planning services of a firm with its clients typically begins with one of two issues:

1. The owner's or owners' passion for a service that is overly complicated or unnecessary for their core clients, or

2. A lack of discipline in sticking to client minimums and focusing on a specific wealth segment.

The most common offense in the category of overly complicated services is investment management. Many owner/advisors love managing money and have overcomplicated their asset management model relative to their clients' investment planning problems. A common example of this is an advisor who customizes portfolios for every client regardless of whether there is a compelling investment planning rationale (e.g., a concentrated or restricted stock position that must be accommodated). But investment management can have other downsides. For example, some advisors have created intensive trading or tactical models on which they hang their hat. Often, an objective assessment of the performance of these time-consuming portfolio management processes proves that they did not add value relative to more traditional or third-party managed portfolios. The fundamental question is whether the fees received justify the time-spend. And yet advisors commonly slam the door on consultants and coaches who shine a bright light on this problem because of their attachment to their own investment process.

With respect to a disciplined approach to client minimums and target wealth segments, many advisors are guilty of an opportunistic approach to client acquisition. They would like to work with clients who have $1 million or more in investable assets—and have likely built their firm's advice model specifically for these target clients—but will accept a broad range of clients. This approach is common as the firm grows from a startup to around $50 million or so in managed assets, at which point its weaknesses start to show. The financial advisor is weighted down by the demands of serving a sizeable base of clients outside their target market. And they find that the number of target clients they serve is small enough that they haven't developed strong procedures and processes to drive the services reserved for their target clients. In the worst cases, the financial advisor brings his or her premium service model down market, applying investment and planning services best aligned with higher networth clients downstream to their smaller clients. The consequences are stunted growth in the target market of the firm and a model in which the larger clients are essentially subsidizing the small clients rather than benefiting from the premium service model envisioned for them.

The Solution

To correct or prevent problems stemming from a poor alignment of services and clients, the best place to start is with the firm's strategic plan. An honest assessment of your target market, its needs, and your willingness to impose discipline in the client acquisition process, can help you avoid these pitfalls. While detaching yourself from the problem is difficult, getting the alignment of services and clients right is critical to profitable growth. Clients outside the firm's target market are certainly acceptable and a necessary compromise for many firms in their growth, but there should be a proper alignment of expense and revenue in serving them. For example, most firms will move all smaller accounts to a junior advisor once they reach $750,000 to $1 million in gross revenues, aligning the lower revenues from the accounts with a lower-cost resource within the firm.

A Sound Compensation Strategy

The Problem

Ineffective compensation strategies often have their roots in the early years of an independent advisory business, sowing the seeds of problems that result in poor staff retention, sloppy financial management, and stunted growth in later years. This usually begins with taking cash for your personal expenses as you need it rather than paying yourself a salary. It may seem like an academic question initially—after all, who cares how you pay yourself as long as you meet both your personal and business spending needs? But it is this kind of thinking that causes problems down the road.When the expenses begin to grow with the practice, it becomes more difficult to predict your own income and to determine whether your annual budget will deliver the revenue you need personally while still covering the operating expenses. The owner ends up with whatever is left over at the end of the day.

For many owners, a lack of discipline in compensation truly begins to show as they grow, although they seldom see the link between this and the problems in which it is reflected. Not paying themselves a market rate salary makes the financial performance of their business hard to pin down. And with no discipline around their own compensation, making decisions on when and how to invest in additional staff and other overhead becomes difficult. In the worst cases, the owner's lack of structure in how they pay themself means that there never appears to be enough money to make badly needed strategic investments to grow the business.

Compensation plan design problems can also contribute to unexpected volatility in the firm's earnings. Poorly crafted incentive compensation programs may lack triggers that protect the owner or owners from having to pay bonuses if revenues or profits fall below a certain threshold. In the worst scenarios, owners pay substantial bonuses for an individual employee's results, regardless of the fact that the firm's revenues and profits are down. Other common problems are over paying for a particular role either to retain an employee or because an employee has asked for more money because of growing personal expenses or because they think they aren't where they should be when it comes to pay. All reflect a lack of discipline in aligning compensation with the work performed and all will come back to the owner in the form of lower profits and stunted growth.

The Solution

Good compensation practices begin with an objective, dispassionate assessment of the roles needed, industry benchmarks for base and incentive pay, and the firm's current financial position. If the owner or owners pay themselves a salary for their work in the business, modeling the impact of the firm's compensation model, including any variable compensation plan, becomes a straightforward exercise giving the owner(s) certainty around the firm's profits given basic assumptions about market performance and new client acquisition. Sticking to the goal of a gross margin of 60 percent and an operating margin of 20 percent gives the owner guidelines for assessing their total compensation costs. And comparing your staffing structure, compensation by role and key financial performance ratios to peer group medians available in industry reports can help you assess whether your firm has a reasonable cost of compensation and total staffing level.

Investing at a Measured Pace

The Problem

In sustained bull markets, the rate of client acquisition accelerates along with the growth of asset-based revenues and revenue per client. As a result, independent advisory firms have a tendency to become aggressive in the pace at which they add staff and advice infrastructure through hiring and investment in additional overhead (e.g., software). While most firms will hire when they are at or close to their capacity constraints—the point at which the ability of the firm can no longer take on new clients without reducing its service levels—in good times advisors often hire well ahead of their capacity constraints. The result is that in years such as 2008 and 2009, firms may find themselves forced to reduce staffing levels through layoffs of recently hired staffers. Avoiding situations in which the firm must either suffer serious margin compression or lose its investment in its greener staff is critical to solid financial performance and to staff morale and the growth momentum of the firm.

Compensation costs are the largest expense in any independent advisory firm, accounting for as much as three quarters of the firm's total expenses, so any mistakes made in hiring relative to capacity needs and revenue per client can have a dramatic impact on its margins. The potential consequences are severe for firms of all sizes. Small firms that are forced to reduce staff find their owner forced to take back many low-level tasks they had finally transferred to others. And large firms are sometimes torn apart by disagreements among partners about how closely to manage to margin as opposed to sustaining investment in the firm through hard times. And the consequences of layoffs are more culturally disruptive in larger firms, where survivors who are not owners begin to look elsewhere for work as soon as times improve.

The Solution

In normal times, the hiring process should ideally begin by the time an owner or employee has reached 90 percent of capacity, as measured by its ideal number of clients per advisor and per total staff. Capacity constraints should be manifest in declining service levels, longer hours, increased errors, and a lack of initiative in improvements and strategic initiatives. But they can also be predicted based on median industry ratios for staffing levels relative to clients and revenue per client. If you aren't sure where you might top out with respect to your current capacity, these can be helpful planning guides. Having time to plan a hire means the difference between putting together a sound compensation plan and job description—not to mention waiting for the right fit—and a poor fit in a poorly constructed role. And if layoffs must happen, owners must be clear in their communication with their remaining staff about why the decision was made to reduce staffing levels and the measures they have taken with respect to financial controls to give them confidence that they can sustain their staffing levels going forward.

Summary

Top-performing independent advisory businesses do not succeed purely on one trait, such as a truly unique advice model, a charismatic leader, or dominance of a particular niche, but all firms will surely flounder without solid financial management. It begins with the owner practicing discipline in managing the balance of the firm's expenses with their personal expenses even in the early days when the stakes are not as high. And as the firm grows, laying a solid foundation with strong pricing practices, a well-conceived compensation strategy, and careful planning for reinvestment in the firm will yield a business that thrives and can ultimately command a premium if sold.

While some financial advisors are hard-wired not only to be entrepreneurs, but also to attend to strategic planning and the management of their firm's finances, many advisors are not. For those struggling to generate profitable growth in their business, engaging a consultant or finding one among their existing business partners is a critical step toward righting the ship.

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About First Allied Securities

At First Allied we're here to help our advisors grow their businesses. We offer a wide range of programs and solutions to help them take their businesses to the next level. Lead generation programs, integrated wealth management solutions and access to subject matter experts are just some of the tools our advisors leverage to grow their businesses.

First Allied is committed to maintaining an environment that serves and nurtures select advisors who want to increase the productivity, size, and profitability of their individual practices.

We are dedicated to helping our independent advisors achieve their individual goals; therefore, our focus is on the individual advisor and delivering the resources necessary to potentially maximize individual success. The collective individual achievements of our advisors is the best measurement of First Allied's success.

More than five years ago, we made a strategic decision to grow our advisors' revenue by investing in integrated wealth management solutions and a top-rated education platform that delivers solutions for clients. Our investment has paid off.

For additional information visit
www.joinfirstallied.com
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