



Advisory Practice Management: Profitability is the new Paradigm

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Executive Summary

Over the course of the last year, as a result of the significant market decline, the typical fee based RIA firm has experienced substantial erosion in top-line revenue as asset values of their client base has decreased in some cases by as much as 40%. Based on our analysis, we estimate that the average firm has lost a minimum of 25% of year-over-year revenue. The continued volatility in the market remains as a potential threat to the sustained profitability of RIA firms even at current asset levels, not to mention at levels measured as of October 2007.

This white paper highlights steps RIAs are taking to mitigate the negative impact of current market conditions in an effort to retain and or return to profitability.

When growth was not an option

While asset accumulation by individuals isn't new, over the course of the last five years, the growth in assets held by individuals has been the primary driver behind the growth in the number of RIAs selecting to practice in the independent channel. During this time frame, most advisory firms have benefited from the following macroeconomic trends driving growth within the independent RIA channel:

- A shift in investor sentiment in recent years has led to an increase in the demand for objective advice provided by independent RIAs.
- As the baby-boomer generation enters retirement, there is a transition or "rollover" of assets accumulated in traditional pension plans to self managed accounts.
- As pensions continue to decline as an option offered by corporations, more individual investors are taking on the responsibility to accumulate wealth for their retirement in self managed accounts.
- Post baby-boomer generations transition jobs more frequently than baby boomers, creating an opportunity to "rollover" assets accumulated in corporate sponsored plans to self directed plans.

RIAs in the independent channel have clearly benefited from their positioning in this high growth market segment and most didn't have any choice but to grow their businesses significantly. One Moss Adams study highlighted firms which on average were able to triple their assets under management (AUM) over the course of the last five years.

As firms were able to grow assets at this pace, they benefited from a corresponding increase in revenue over the course of the same time frame. During the course of this expansion what many of these RIAs didn't consider, however, was the implementation of scalable operations within their practices. As a result, while these firms were busy expanding their top-lines, they did so with compressed profit margins as the cost of acquiring and serving new accounts increased.

The primary contributor to decreased profit margins was that most advisory practices had a lack of focus on the profit drivers and as a result, didn't invest in the infrastructure which would create long term value for their business. Many firms maintained manual processes in their operations specifically in multiple areas of portfolio management including portfolio construction, portfolio monitoring, cash management, rebalancing, asset location, tax management, trading and reconciliation. Accordingly, as accounts and assets grew, most advisory practices were forced to grow their staff to support their current client base. There is certainly nothing wrong with this approach, so long as RIAs understand that they will be leaving money on the table. Let's consider some key questions:

- What is the true cost of the manual process in terms of time and salary? (Include the opportunity cost of spending less time with clients and referrals)
- Will that staff support two- or three-times the number of accounts and assets as their firm continues to grow?
- If not, what additions to staff will need to be made? What will that cost?
- How easy will it be to find and retain competent and reliable staff members?
- Will it be easier or harder to implement an operational change when double or triple the size?
- What impact will turnover of key staff members have on my business continuity and what cost do I incur to train and retrain staff?
- What impact does a recurring manual processes have on my long term value creation and how will this ultimately impact the owners exit strategy?

Most firms don't address these and similar questions because it often seems more important to just keep growing.

The majority of RIA firms operating in the independent channel are effectively a small business in terms of staffing, as the average firm managing \$150 million in assets has approximately 5 staff members and firms managing \$500 million on average have 15 staff members. It is not surprising that when faced with the decision of capturing growth or investing in infrastructure, which will enable more efficient growth, most firms choose the former and defer the latter to be addressed at a point in time when it is considered more urgent. Few RIAs felt this urgency when growth was achieved at levels seen over the last five years.

“ The efficiencies Tamarac has brought to our firm mean we aren't hiring another person this year – saving us over \$55k. ”

STEPHEN CRAFFEN, PARTNER
STONEGATE WEALTH MANAGEMENT, LLC

Postponement of infrastructure investments is a riskier and more costly approach than most firms realize. The average small firm is a relatively new business (less than 10 years old), and like most young businesses, the founding members tend to focus solely on whatever it takes to add and retain clients.

This usually means taking on whatever assets and accounts a new client holds: legacy stocks, 401Ks, variable annuities, alternative assets, etc. This young firm will probably have investment recommendations for the client, but is more focused on keeping the client happy than enforcing their own investment philosophy. The result is a set of unique accounts in which legacy assets, exceptions and outside accounts far outweigh the advisory firm's investment selections in the client portfolios. Each account takes more work to monitor and trade, but the process 'feels manageable' because the advisory firm is still able to support its current account base.

Contrast this to actions taken by many of the best managed advisory firms which have carefully considered these same questions and made appropriate investments in their infrastructure which enabled them to operate at a much more efficient level while taking advantage of decreasing cost. These firms recognized early on that regardless of their size, the investments they made would provide them with a competitive advantage in hyper growth periods, normal growth periods and periods of contraction.

“The business model of RIA firms is in line with the needs and demands of today's

wealth management customers, and has resulted in substantial growth opportunities for the firms,” says Alois Pirker, senior analyst with Aite Group. “However, only firms that have scalable technology and efficient business processes will be able to grow significantly while maintaining high-quality service.”

There are proactive steps some of the best managed firms are taking in systems to boost profitability and at the same time, preparing the firm for efficient long term growth. Unfortunately, far too many RIAs continue with their manual high-cost approach because they are unaware of any alternatives and old habits die hard.

Retooling for Profitability

Many RIAs have made a conscious choice to address the issues raised above and thoroughly evaluated their internal processes in search of ways to increase their operating efficiencies. While these firms have diverse profiles ranging from size as measured by AUM, stage of their life cycle from a “break-away-broker” to a mature established firm or investment philosophy of active to passive, they all are focused on driving operating efficiencies for the sole benefit of increasing profitability. While the tactics vary, common themes addressed are:

- Increasing standardization in portfolio construction
- Introducing more sophisticated investment strategies
- Increasing consistency in applying investment recommendations across accounts
- Investing in processes and systems that improve scalability of existing firm resources

Different firms will apply different tactics when appropriate at different stages, but this is the direction in which almost every firm has moved to drive efficiency. Furthermore, the most successful and profitable firms made these adjustments ahead of their peers. They invested the time and money necessary to grow before, not after, they added staff.

“We cannot go from 0 to 60 MPH without first understanding acceleration,” says Bruce Moulton, Moulton Strategic Partners and XLR8 Online. “It is crucial for the savvy firm to stay ahead of the technology curve by constantly evaluating, selecting and implementing solutions in preparation for the imminent need. As we have espoused for the last 5 years, ‘Information Management success is the combination of people, process and technology.’ If your definition of success includes efficient scalability, then you better be proactively looking for technology that will free up your current staff to focus on the relationship and service building that all clients expect. Technology is something that should be constantly evaluated so the firm is not to be caught off guard by either the demands of a volatile market place, or a rampant growth cycle in client acquisition. Successful implementation of technology involves defining the process that will leverage it and training the staff in addition to the technology itself. The firm that begins this process well in preparation of the need, will be in a better position to make confident choices, minimize the implementation costs and obtain a return on their investment more quickly than their peers, and without having sacrificed any part of the client relationship. The balance of people, process and technology ultimately defines the efficiency and scalability of a firm.”

Make no mistake, it certainly requires effort for firms to transition their operations to

the next level. However, the alternative is growth of the firm with continued margin constraints, where increased AUM only leads to increased head count and negative margin expansion. Does that make you more or less competitive as you grow your business? The leading firms are embracing scalability, meaning they have more profit to invest in marketing, research, recruitment, etc. Profitability may be difficult to sustain, or take advantage of, for those who fail to adapt in this competitive environment.

Operating Efficiency takes Center Stage

It isn't news to anyone reading this that the market conditions over the course of the past year have done nothing but wreaked havoc on the majority of investor's portfolios. But even in the face of what has been the most challenging investing environment in our lifetime, an overwhelming majority of RIAs are counseling their clients to remain in the market as they believe this is the best chance their clients have to accumulate wealth in the long run.

While RIAs deliver this message to their clients, RIAs themselves will have to address a significant investment decision of their own, as they focus on steps they can take to retain and or increase income within their firms. Where the recent market decline has had a significant and potentially lasting impact on investors asset values, a direct bi-product of the market declines is the loss in revenue RIAs generated on these assets which is the primary source of income for their firms.

It is clear that a decrease in revenue of this magnitude can be devastating to some advisory practices, particularly smaller firms. As RIAs have seen their top-line revenue erode, short of an unlikely market rebound over the course of the next few months, there is a sobering recognition that much of this lost revenue will ultimately be reflected by a corresponding loss of profits within these firms for an extended period of time. Accordingly, RIAs are starting to focus on the new reality of managing their practices more efficiently and profitably, which over the course of the last five years has not been a priority for many firms.

The following diagram shows the time and resource spent on just the act of rebalancing between a manual process and an automated process using Tamarac Advisor. This graph is only assuming the firms are rebalancing once per year.

	FIRM 1: 750 Accounts	FIRM 2: 1,500 Accounts	FIRM 3: 2,900 Accounts
MANUAL	Annual hours spent on manual portfolio rebalancing		
	PROFESSIONAL: 250	500	967
	STAFF: 750	1,500	2,900
	\$56,250	\$112,500	\$217,500
TAMARAC	Annual hours spent on rebalancing with Tamarac		
	PROFESSIONAL: 50	100	193
	STAFF: 50	100	193
	\$7,500	\$15,000	\$29,000
Gross Salary Savings:	\$48,750	\$97,500	\$188,500

In preparing the above analysis, all of these three RIAs were previously performing their rebalancing process on a quarterly basis. Subsequent to implementing Tamarac, while the analysis quantifies the benefits in terms of time and salary savings of their quarterly rebalancing, it is important to note that all of these firms are able to perform a rebalance on all their accounts daily if desired. While this may seem excessive to some, we can confirm that the frequency of rebalancing has increased over the course of the last three months due to the significant market volatility. In addition, a primary benefit that's not easily quantifiable is the increase in time available for key resources, including staff, to dedicate towards revenue generating activities, such as spending time with clients and prospects.

Automating Portfolio Management

All too frequently most confuse portfolio management with a portfolio accounting systems (PAS), when in fact there are multiple processes involved in portfolio management outside of the functions of a PAS, most of which are performed manually including the following:

- Portfolio construction
- Portfolio monitoring
- Portfolio rebalancing
- Tax management
- Trading
- Post-trade reconciliation
- Risk management
- Compliance

All of these tasks, many performed on a daily basis, consume a significant number of employee hours.

In an era where technology has been adopted by most industries as an agent of change for the benefit of increased operating efficiencies, there has been little adoption of technology by RIA firms over the course of the last decade and a half. As a result, most RIA firms continue to invest heavily in human resources to perform these and other operating tasks on behalf of the RIA.

Tamarac has developed software solutions which eliminate most, if not all, of the manual effort within portfolio management required by RIAs as outlined above. In the sections which follow, we will provide a brief overview of how Tamarac automates the portfolio construction and the rebalancing processes of RIA firms. The result, RIAs experience increased profitability and are able to continue growing without increased cost in areas of portfolio management.

Portfolio Construction

Some RIAs consider portfolio construction an art, while others consider it a true science. The legacy of many RIA firms is rooted in investment oriented research, so they dedicate significant internal resources to the development of the portfolio construction process on behalf of their clients. Other RIAs believe the best use of their time is spending more time with clients and prospecting, and as a result, outsource their portfolio construction

process to a third party vendor. Yet other firms take a hybrid approach and combine internal research with alternative offerings provided by third parties to round out their portfolio construction process. Regardless of the RIAs viewpoint, portfolio construction is consistently recognized as the cornerstone of most RIA practices.

While there are many aspects of portfolio construction, one of the time consuming aspects of this process lies in how an RIA applies the results of this process to each individual investor's accounts. In addition, a lack of ability to react in a timely manner can expose the RIA and their client to negative market moves resulting in a less than favorable outcome for both the RIA and their client.

To understand how technology can support the portfolio construction process, let's first define some common criteria that most RIAs deal with when implementing the portfolio construction process with their clients.

All RIAs incorporate a process within their practice which addresses the critical aspect of selecting investment vehicles suitable to investors who fit a certain risk profile. The investment decisions are typically established by the investment committee of the RIA firm. Once defined, the investment decisions are applied to the portfolio construction process with the result being the development of a "model" or "strategy." The RIA will end up with multiple models to accommodate the majority of their individual investors who have different risk profiles and goals. These models become the primary tool of the RIA and are the product of the portfolio construction process.

Models can be either structured or unstructured. Structured models are typically deemed to resemble style-based portfolios under the influence of modern portfolio theory and the capital asset pricing model. A survey by Cerulli indicates that approximately 90% of RIA use some form of style-based models in their practice. Unstructured models can be defined as tactical asset allocation, which incorporates a more active management strategy when selecting investments on behalf of their clients, but doing so in a manner which addresses asset allocation.

In consulting with our clients over the course of last eight years, there has been one consistent theme we have recognized which is the individual security positions in clients' accounts rarely are representative of the model constructed by the RIA in the portfolio construction process. This constant typically isn't representative of a lack of discipline of the RIA, however it is representative of the flexibility needed on behalf of the RIA in terms of the way they manage their clients' portfolios.

RIAs recognize that no two investors are truly alike and therefore don't offer cookie cutter investment solutions. As a result, most RIAs are beholden to a process which is primarily manual as they are resigned to the fact that many accounts require some level of customized attention. This reality has led to a practice which has to date limited an RIAs ability to automate portfolio management for the masses.

This is where automation through technologies like Tamarac Advisor becomes a critical

“Tamarac has made the process of rebalancing our models extremely efficient. The confidence level that I have reached with this system far exceeds the prior trading system. Being able to customize our models and accounts allows us to trade in the fashion that we strived to, but had never succeeded in the past”

SUZIE DEAN, HEAD TRADER
EMERALD ASSET ADVISORS

ally to the RIA, particularly a firm that manages hundreds if not thousands of accounts. Tamarac Advisor has been designed to allow exceptions to be considered in the overall analysis while enabling the RIA to continue to manage the entirety of the investor's security holdings. The objective is to have timely access to results which enable the RIA to take action as effective portfolio construction doesn't end once the portfolio has been built.

Whether the RIA chooses a structured or unstructured approach, the RIA wants to incorporate a disciplined process into the portfolio construction method they choose. The key to an effective portfolio construction process is for the RIA to have tools at their disposal which enable them to be proactive as opposed to reactive. Ultimately it is important for the RIA to understand how the investment decisions they make are impacting their clients' accounts when measured against the individual goals, risk tolerances and tax consequences which differ for each individual investor.

Some RIAs fail to recognize the underlying cost to the organization in implementing the portfolio construction process, particularly with respect to the incremental time incurred to monitor each account in accordance with the models they design. What surprises some RIAs is that exceptions and unique account characteristics need not be abandoned. Software can accommodate all kinds of exceptions and account rules; it's simply a matter of using the right system to "mass customize" your sophisticated approach.

Portfolio Rebalancing

Rebalancing has long been the standard method of managing risk through diversification. It maintains the level of diversification, and agreed upon risk, required by a strategic model. Portfolio drift is a major worry of investment RIAs when markets are volatile or sectors display entangled behaviors. Rebalancing is hard evidence of an advisor's good stewardship of their clients' life savings.

Technology has had a transformative effect on rebalancing, which was once a laborious spreadsheet process done on an account-by-account basis. Software now allows RIAs to use rebalancing as an always-on tool, assessing the health of a client's portfolio with daily spot check-ups and click-of-a-button realignments.

However, despite evidence that rebalancing technology delivers better management performance, the historical reliance on manual rebalancing dominates the field. RIAs understand that rebalancing ensures appropriate risk management for clients. Yet, only 23% of respondents to Financial Planning's December 2007 software survey said they use rebalancing software—and some of those are using proprietary, in-house software, which leaves them responsible for maintenance and development costs.

The differences between manual and technology-driven rebalancing are dramatic, with technology showing an impressive advantage. Tamarac's research indicates proficient RIAs average roughly twenty minutes to manually rebalance one account and over a day for more complex households; an advisor solely dedicated to rebalancing can work through about 25 accounts per day. In contrast, top-tier platforms like Tamarac Advisor® offer an exponential increase in rebalancing power, rebalancing thousands of accounts in just minutes.

The following diagram is citing data from actual client firms using Tamarac and the cost savings they experience looking only at the time/cost savings of the rebalancing process of portfolio management.



The savings in advisor time alone justifies technology solutions, yet the question remains as to why more RIAs haven't opened the door to technology that will help them grow their business?

An evolving wealth management landscape

A best practice in any sector isn't an unchanging doctrine. Changes are driven partly by theoretical work, partly by trial-and-error discovery. With the arrival of a fully customizable portfolio management technology, the day has come when manual process no longer constitutes a best practice or even an acceptable practice.

For the financial services industry, software technology adoption isn't simply inevitable – it's good sense. The less time RIAs spend using spreadsheets to crunch numbers, the more they can focus on their clients and growing their business. Clients need help understanding the options available to them and RIAs need to ensure the clients are happy with their investment's performance.

While it may be hard to retrain and refocus RIAs accustomed to weeks or months of portfolio management per year, it's increasingly clear that companies which don't take advantage of new technologies will soon find their profitability impaired and growth stalled. The good news is that the RIA who seize upon the potential and promise of new technologies, provide the best evidence of better productivity, capacity and capability.

The increase in profitability derived from the efficiencies gained by replacing manual portfolio management processes with automation through software expand well beyond replacing, what many firms consider, a once or twice a year rebalancing process.

Operational evaluation and change is virtually inevitable for any RIA looking to succeed in the next five years. Take solace that you do not have to undertake transformation alone. Leading vendors will offer consultative support (not just technology) to make the adoption of a new process as efficient and easy as possible. That is why many

Tamarac clients, after having gone through the process, express how they wish they had committed sooner to the changes needed to support asset and revenue growth.

Next steps

For a complimentary diagnostic of your portfolio management process, call us today at 866-440-9607 or visit us online at www.tamaracinc.com.

About the authors

Stuart DePina is currently the CEO at Tamarac and was previously a Partner at KPMG, LLP working in the Los Angeles and Houston offices serving clients in the financial services practice consulting with investment advisors, broker dealers and mutual fund companies. Matt Springer is currently the President and Founder of Tamarac and was previously the Director of Trading at Parametric Portfolio Associates, where he managed over 1200 accounts valued at \$1.2 billion in AUM and oversaw the trade desk which executed domestic and international trades for over \$4 billion in AUM. Tamarac is a leading consulting and software provider to the RIA market place providing services to hundreds of firms with a combined AUM of over \$100 billion.