

# Fast Forward:

THE ADVISOR OF THE FUTURE

Ideas Without Limits<sup>SM</sup>

Our partner in developing  
this research report:

**Moss Adams LLP**

**Pershing**  
**Advisor Solutions™**

AN AFFILIATE OF THE BANK OF NEW YORK MELLON



# Fast Forward: The Advisor of the Future— Executive Summary

By 2012, most registered investment advisory firms (RIAs) will nearly triple in size. We predict that in the next five years revenue for the industry will grow by \$35 billion, fueled by the unprecedented demand for independent, objective financial advice. The best firms will “fast forward” through the typical evolutionary stages in advisory firm development, fully capturing opportunities presented by the intense demand. Specifically, to prepare for the future, firms may need to address what we have coined the “three C’s”: change, capacity, and culture.

- 1) Make bold organizational changes.** Today’s average independent advisory firm has a staff of five.\* We predict that the typical firm will need to recruit and retain 11 new people by 2012 in order to meet client demand. While adding talented advisors will be of primary importance, some of these new hires will be operations and management staff. In addition, some natural attrition in staff is unavoidable, and the average firm will likely have to retire key employees, not just owners. This significant net addition of people will require a systematic internal process for the development of talent, a well-structured compensation model, and a career path that is fulfilling to all employees in the firm. This emphasis on human capital is only beginning to emerge in some advisory firms, even though it is critical for future success.
- 2) Create and maintain capacity.** A firm that strives to grow quickly must maintain the capacity to do so at all times, and be ready to capture opportunities when they arise. Total compensation for professional positions is currently growing at 12% per year, and there is no sign of it slowing down. In the past, the rapid increase in the cost of labor was largely offset by the even faster increase in the average size of client relationships, resulting in productivity gains that were ahead of compensation increases. In the future, the increased sophistication of clients and the increased service time caused by the wave of retiree clients will require firms to seek more leverage in their service model and eliminate inefficiencies in their service process.
- 3) Foster a culture that supports strategy.** Successful firms will sustain the culture that made them successful, while simultaneously integrating additional employees and responding to clients’ more influential role in defining the advisory relationship. Founders will have to let go of some of their traditional responsibilities, but at the same time find a way to preserve a culture that fosters an intense focus on the client, maintains an entrepreneurial drive, and provides people with ample opportunity to reap individual reward. The best firms will strike

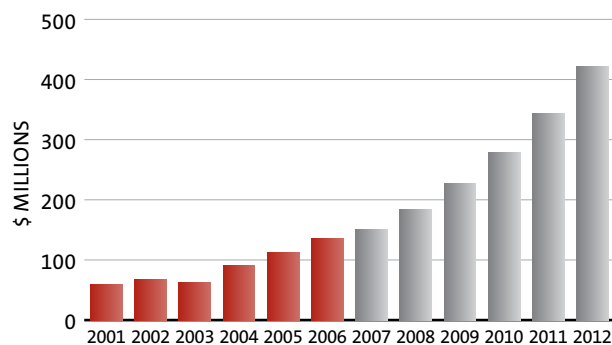
\*Average independent advisory firm data based on Moss Adams’ annual advisory firm survey data, “Moss Adams LLP 2007 Compensation and Staffing Study of Advisory Firms.”

a balance between these goals by articulating and communicating their vision to all employees and developing leaders who passionately believe in it.

Pershing Advisor Solutions LLC commissioned this study as a follow-up to *Uncharted Waters: Navigating the Forces Shaping the Advisory Industry*. This time, we translate our macro-level findings into actionable, firm-level strategies and tactics. We focus specifically on how advisory firms can solidify their success and fully capture market opportunity. For this report, we drew upon statistical data gathered by Moss Adams between 2001 and 2007, as well as our consulting experience. We used statistical and financial modeling to prepare a detailed forecast of the growth path firms will—and should—take between now and 2012.

Any forecast of the future will carry some level of uncertainty. However, our data strongly indicates that the advisor of the future will get there by focusing on the three C's: change, capacity, and culture. By simply extrapolating to 2012 the current trends in the statistical data, we uncovered the magnitude of future industry growth and change. We identified a group of 105 firms that have participated in our surveys each year since 2001, and we examined in great detail what happened to them in the last five years, in order to make predictions about what they can expect in the future. Our goal in this analysis is not only to record historical trends, but also to quantify and present the full impact that unprecedented growth will have on the industry by 2012.

Figure 1: Average RIA Firm Assets Under Management, Historical and Projected, 2001–2012



The 105 firms in our study group range from \$10 million to \$2 billion in assets under management (AUM), with the average firm managing \$150 million in assets. Projecting the current pattern of growth to continue over the next five years, we estimate that the average firm will reach \$422 million by 2012 (Figure 1). In revenue terms, this means that firms will grow from \$1.5 million on average in 2007 to \$4.7 million in revenue in 2012.

The largest firms, those with over \$1 billion in AUM, will grow even faster and reach beyond \$3 billion in assets and \$10 million in revenue. The more rapid growth of larger firms will be due to their natural ability to dominate the sources of referrals, and their advantage in recruiting and retaining people. The presence of these dominating firms will be strongly felt in the local markets, creating competitive challenges for other firms. The effect will be felt primarily in the competition for staff, not necessarily for clients.

### Growth Requires Qualitative Change

Growth requires not just quantitative changes (more people, more clients), but also qualitative changes—decisive management, systematic development of leadership, and a healthy culture. Growth is not just some mechanical process in which you add more of the same ingredients. Eventually, firms cross into a different stage of development where they need to change their organizational structure and management process. These changes can be slower and more evolutionary in nature. At the same time, the market opportunity we expect creates a favorable climate for bold and decisive strategies, including mergers, acquisitions, and strategic partnerships.

Given our prediction of growth in compensation by an average of 12% per year on the professional side and 10% per year for administrative and support staff, we believe that owner income will stay high, but only grow by 4.2% per year over the next five years. Today an owner in our sample is earning \$385,000 in income. In 2012 we forecast they will be earning \$474,000 pre-tax income per owner. The rise in productivity will be slower than the rise in compensation. More important, eventually some of the income will have to be shared with newly introduced owners. This does not mean dilution or decline of the income of existing owners, but it will make income growth slower.

The slower growth in income means slower appreciation in value and lower rates of return on equity, pressing the question of whether to sell. With moderate increases in value, more and more owners will find the various consolidator or bank deals more appealing compared to the uncertainty of running a small business.

## Firms Remain with Advisors

While the industry will see continued consolidation, the firm of the future will still be managed by its advisors, who will retain a significant portion of its equity. There are many active acquirers in the market, and there are more deals for advisory firms than ever before<sup>1</sup>. The pace of acquisitions and consolidation will continue and even accelerate as owners ready for retirement. At the same time, while some equity may transfer to institutional acquirers, there is no danger that advisor-owned and operated firms will disappear or be marginalized: most firms will choose internal succession. Those who sell part of their equity will still be managed by their advisors, and will operate as independent entities.

Growth and the future of the advisory profession are not just market-driven. We recognize that the opportunity in the market will present questions that relate to the personal definition of success for firm owners. When a firm reaches \$1 million in revenue, every owner faces the decision, “Do I want to grow a larger organization, or do I want to focus on enjoying the life I already have?” Many more firms will reach this milestone, and we believe that financial success is possible regardless of the decision.

For many of the firms with over \$1 billion in AUM, the philosophical decision will concern how to leave a legacy while making a significant positive impact on employees and clients. As many owners of large firms look at the future, they face the issue of whether to capitalize on the highest price available, or to create better opportunities for the younger generation of owners, and leave a firm positioned to last.

## From Income to Significance

In our forecast of the next five years, we see an evolutionary pattern of RIAs shifting from a focus on generating high income to creating a significant and lasting presence in the market, and generating opportunities for a large number of people. The past success of RIA firms may have come through the combination of talent and market forces, but the advisor of the future will combine professional talent with managerial skill and strong strategic thinking. The magnitude of the changes predicted is undeniable—on average, firms can expect to triple in size. Advisors of the future will be deliberate and systematic in their approach, focusing squarely on people, organization, and culture. Firms that tackle the three C’s—change, capacity, and culture—will be tremendously successful and see dramatic growth in not just their income, but in their ability to make a positive impact on their clients, their employees, and their communities.

<sup>1</sup> Moss Adams LLP. *Real Deals: Definitive Information on Mergers and Acquisitions for Advisors*. New York: Pershing Advisor Solutions LLC, 2006.



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## Make Bold Organizational Changes

Over the next five years, the typical RIA firm will undergo a rapid transformation. Based on our forecast modeling, we approximate the average firm to triple in size. As we detailed in a previous Pershing Advisor Solutions report, *Uncharted Waters*, firm growth will be driven by strong and increasing demand for objective advice, coupled with continued market migration toward the independent channel. Competing providers will challenge the RIA to define a competitive advantage beyond independence and objectivity. The RIA's ability to understand client issues and frame unique solutions, however, should endure and ensure growing market share.

### Strong U.S. Asset Forecast

Investable assets of U.S. households are forecast to rise from \$22 trillion to \$27 trillion over the next five years, after adjusting for inflation. This \$5 trillion in new asset growth represents a potential revenue opportunity of \$35 billion.<sup>2</sup> Further, not only are investable assets growing, but proportionately more of those assets are poised to come under professional management. With the decline of pensions, individuals now have nearly complete responsibility for assuring their long-term financial security, and the retirement wave has hit: both trends are sending consumers clamoring for advisory guidance.

### RIAs Well Poised if Hiring Keeps Pace

We believe that RIA firms are poised to capitalize on this growing market; however, RIAs' potential inability to continue to differentiate on the basis of independence and objectivity may threaten this assumption. To maintain their edge, RIAs must continue to gain a deep understanding of their clients, and use this understanding to apply specialized expertise and solutions. This is the advantage that will sustain their continued growth in market share.

In addition, more clients with more assets are demanding greater service. The solution for addressing this rising demand is clear: people. Average employment per firm promises to increase from five to 16, resulting in the hiring of at least 11 employees, and likely more, in order to account for turnover. Change will not be restricted to simply adding more people: new types of employees will join the firm in the form of dedicated managers and technical specialists, and existing employees will be promoted to new positions. Finally, employee additions and changes will stress current organizational structures and force more change in the form of structural adaptations and refinements.

Attraction, development, and organization of people will be the primary factors separating success from mediocrity for advisory firms. The market will be intensely competitive, and unlike in years past, the competition will be for staff, not for clients.

<sup>2</sup> Moss Adams LLP. *Uncharted Waters: Navigating the Forces Shaping the Financial Advisory Industry*. New York: Pershing Advisor Solutions LLC, 2007.

## Growth Patterns of the Past Provide Insights Into the Future

Hundreds of RIAs have participated in Moss Adams' annual surveys over the years. Of these firms, a select group of 105 consistently participated in every annual survey for the past five years. The detailed data regularly submitted by this group of firms provides a unique window into how firms develop, and the characteristics that distinguish more successful firms. The data set also reveals the likely future direction of most firms, as well as how firms must adapt in order to remain vibrant and successful.

Applying statistical techniques on the historical data, we modeled how this same group of firms will look five years from now, based on their most recent growth trends. In Figure 2, we present a summary of our findings and highlight the tremendous expansion we expect the typical RIA to undergo over the next five years.

Figure 2: Firm Growth Forecast, Selected Years, 2007–2012

	2007	2010	2012
AUM	\$150,000,000	\$279,130,050	\$422,295,853
<b>Financials</b>			
Revenue	\$1,549,408	\$3,074,505	\$4,651,419
Direct Expense	\$615,267	\$1,391,949	\$2,421,562
Gross Profit	\$934,141	\$1,682,556	\$2,229,857
Gross Profit Margin	60%	55%	48%
Overhead Expense	\$606,340	\$1,092,099	\$1,647,315
Overhead Expense as Percent of Revenue	39%	36%	35%
Operating Income	\$327,801	\$590,457	\$582,542
Operating Profit Margin	21%	19%	13%
Pre-Tax Income per Owner	\$384,924	\$492,211	\$473,932
<b>Staff</b>			
Owners	2	3	5
Professionals*	2	6	8
Total Staff*	5	13	16

\*Includes owners and non-owners

Whether measured by assets, revenue, or staff members, the size of today's firm is expected to roughly triple over the next five years, but rapid growth will continue to place upward pressure on compensation costs, and productivity will not keep pace. As a result, while firms will continue to remain profitable, their profit growth will slow. Growth in income per owner will slow as well, partly due to slower profit growth, but also due to the admittance of new owners at a rate that outpaces profits.

These projections are averages: some firms will grow even faster and more profitably, other firms will grow more slowly than projected—or not at all. The outcome for individual firms ultimately depends on their personal-growth goals and the strategies and tactics they employ in order to achieve these goals.

### Just Adding Advisors Will Not Get You There

#### Job Families, Not Just Singular Positions

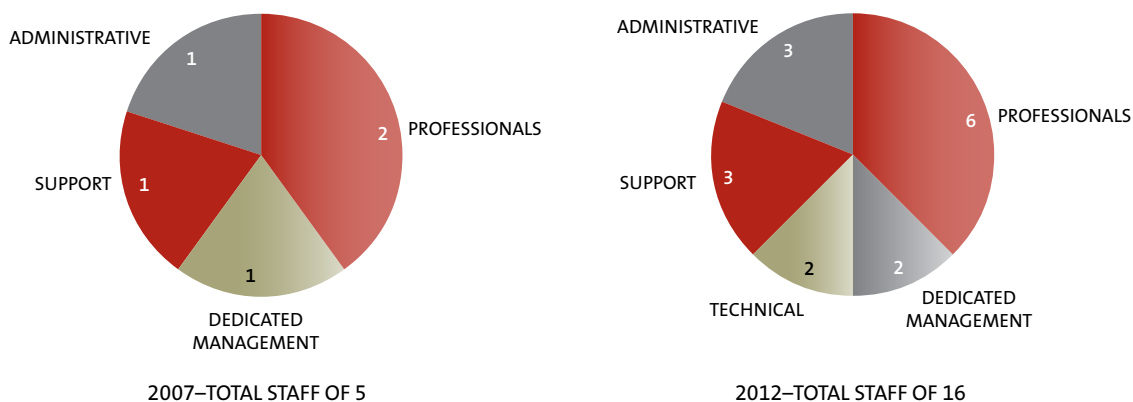
In Figure 3, we provide an overview of the variety of functions that larger firms will require.

Figure 3: Defining Advisory Firm Job Families

JOB FAMILY	PRIMARY FUNCTION	EXAMPLES
Professional	Primarily and directly responsible for client-relationship management, advice delivery, or developing new business	Lead Advisor, Service Advisor, Business-Development Specialist
Dedicated Management	Primary function is to manage the business, rather than develop client relationships or serve existing clients	Chief Operating Officer, Director of Marketing, Operations Manager
Technical Specialists	Support the advisors and professionals with plan preparation, technical analysis, research, or other related functions. May influence advice delivery but do not have primary relationship-management responsibility	Financial-Planning Specialist, Tax Specialist, Portfolio Manager
Support	Support the advisors and professionals with plan preparation, technical analysis, research, or other related functions. Support staff have limited client contact and do not formulate client recommendations	Support Advisor, Research Analyst, Trader, Client-Service Administrator
Administrative	General support of the firm	Office Manager, Receptionist, Executive Assistant

Whether a firm matches or exceeds these expectations depends primarily on how capably its owners are able to add staff. Passive firm owners will not be entitled to automatic growth. To grow revenue and owner income, firms must add people and add them in a sophisticated way. Firm management must hire thoughtfully—stretching beyond the tendency to simply add more advisors—in order to expand capacity while enhancing the overall organizational structure of the firm and its ability to efficiently deliver service. In Figure 4, we provide a high-level overview of how expansion in staff should transpire.

Figure 4: Projected Staff Growth, 2007–2012



Our forecast model did not account for changes in the average firm’s professional “support ratio” or number of non-professionals per professional. In reality, however, this ratio will increase, and professionals will make up a decreasing share of the firm’s staff, especially for the largest and most profitable firms. We see evidence of this happening already, and the trend should only accelerate in the years ahead as firms respond to a shrinking talent pool and realize the benefits of leveraging their staff.

Support, technical, and dedicated management positions, for example, accounted for 41% of those working in the industry in 2006, up sharply compared to 32% one year prior. In contrast, the share represented by professionals dropped from 45% to 40%.<sup>3</sup> For our constant sample of 105 firms, professionals as a proportion of all staff shrunk from 50% to 36% over the last five years. None of this should be construed to mean demand for hiring professionals is not strong—it is. However, several factors are at work to suggest that certain non-professional positions will grow at a more rapid pace.

<sup>3</sup> Moss Adams LLP. *Uncharted Waters: Navigating the Forces Shaping the Financial Advisory Industry*. New York: Pershing Advisor Solutions LLC, 2007.

## Increased Specialization

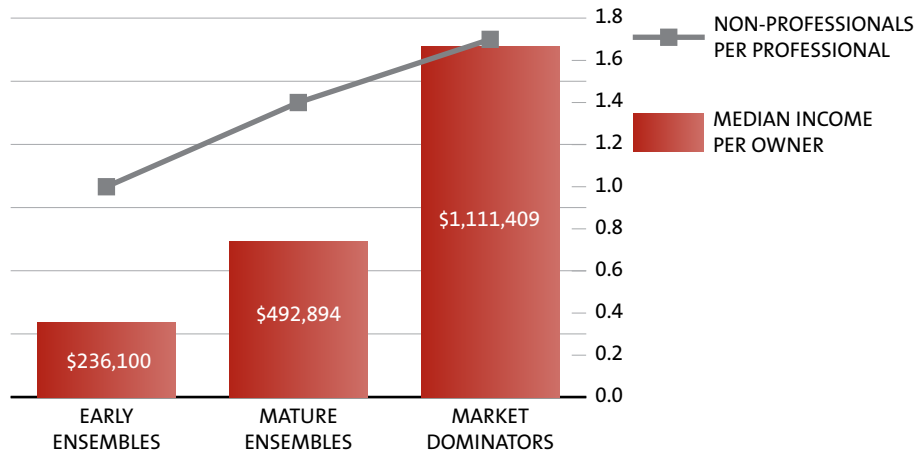
A movement toward specialization is driving growth of non-professionals, and is accelerating demand and use of what we call “skilled non-professionals.” Skilled non-professionals include technical specialist positions, such as financial planning and tax specialists, as well as dedicated management positions, with the CEO and operations manager positions the most common. Factors driving growing demand and use of skilled non-professionals include the following:

- **Advisor scarcity.** Perhaps the strongest driver behind the growing use of skilled non-professional positions is the increasing scarcity of experienced advisors. (One reason advisors represent a declining proportion of a firm’s staff is that there are simply fewer of them to go around.) Surrounding these advisors with a network of specialist support enables the advisor to give near-exclusive focus to clients and revenue-generating activity. An advisor’s time is a precious and limited commodity. Firms must look for any and all opportunities to delegate non-essential tasks to others within the firm.
- **Client service complexity.** As we detailed in *Uncharted Waters*, the typical client is requiring increasingly complex servicing. This trend is fueled by a growing expectation for more customized service, larger portfolios, and larger numbers of retirees demanding a variety of services that go far beyond wealth accumulation. Without specialist support, an advisor acting in a generalist capacity is ill-prepared to sufficiently handle these demands.
- **Firm size.** As the typical firm continues to increase in size, its scale alone creates more opportunity to form specialist positions. At less than \$1 million in revenue, for example, a firm does not have the scale and complexity to support a full-time operations manager. The job is typically a part-time responsibility for one of the firm’s owners or advisors. With greater size, the firm can afford a dedicated manager.

## The Power of Leverage

Leveraging professional staff through the thoughtful application of non-professionals can be a powerful advantage for firms. In Figure 5, we demonstrate why:

Figure 5: The Power of Leverage



Notes: "Early Ensembles" are multi-professional firms earning less than \$2 million revenue. "Mature Ensembles" earn between \$2 million and \$5 million. "Market Dominators" are ensembles who earn more than \$5 million in revenue. Source: 2007 Moss Adams LLP Compensation and Staffing Study of Advisory Firms.

As firms evolve, their professional support ratios tend to increase. While the smallest multi-professional firms (Early Ensembles) have an average support ratio of 1.0, this ratio increases to 1.7 for the largest ensembles (Market Dominators). The greater leverage that large firms achieve plays an important contributing role toward the appreciably higher incomes earned by large firm owners. The importance of leverage will only increase for firms as the industry progresses.

## Adapt the Role of Advisor

Change will not only require more people and new positions—it will also require adaptations in the traditional definition of an advisor. Driving the transformation of the advisor are many of the same forces we reviewed in *Uncharted Waters*—the trend toward wealth preservation and de-accumulation, aging clients with needs that go far beyond investment management, and an increasing expectation to deliver customized expertise. The exact responsibilities and skill set demanded of an advisor will vary from firm to firm. Overall, however, we can make a few broad generalizations. We summarize some of the more obvious transitions needed in Figure 6:

Figure 6: Same Title, Different Job

TODAY'S ADVISOR	TOMORROW'S ADVISOR
Investment-centric	Client-centric
Managing money	Managing risk
Accumulating wealth	Preserving wealth, hedging inflation, minimizing taxes
Generating return	Balancing cash flows
Doing it yourself	Leveraging specialists and strategic partners
Financial planning	Life planning
Technical advice	Technical and emotional advice

In general, the advisor of the future will transition away from a near-exclusive focus on assisting clients in accumulating enough assets for a new home, childrens' education, or retirement. Technical knowledge of investments will still be required, but so will skills related to taxes, estates, charitable giving, insurance, and long-term care. To adequately provide deep expertise around all these topics, advisors will need to coordinate a network of specialists, strategic partners, and outsourcing providers.

Further, beyond coordinating delivery of new types of technical expertise, tomorrow's advisor will need to be equipped with a softer set of skills. Increasingly, advisors will be called upon to help clients identify overall life goals and sort through the emotional aspects of money as it relates to leaving a legacy, assuring that loved ones are cared for, or determining the fate of a long-running family business.

## Put the Right People in the Right Places

As firms add and revise positions, their organizational structures must evolve accordingly. Striking an appropriate balance between professionals and non-professionals is only a starting point. For a firm to grow from five to sixteen people, a more formal organizational structure will be required in order to effectively coordinate and distribute work activity. Determining the right people for the right places is ultimately dependent on the firm's culture and strategy.

For example, if employee development and retention is a high priority, a firm may choose to organize by functional departments. Within such departments, well-defined levels of responsibility can provide the opportunity for lower-level employees to focus on a skill set, learn from those above them, and advance when ready.

Regardless of how a firm chooses to structure, the trend toward specialization will extend beyond positions. Firm organizational structure will likely evolve toward specialization by functional departments or dividing by service teams to specialize on certain client groups. Some firms may even adopt a hybrid structure, utilizing both teams and departments, administration, operations, planning, and investments are some of the most commonly formed functional departments. For the largest firms with multiple locations, geographic regions may form another layer of the organizational structure.

As we previously noted in *Uncharted Waters*, teamed service delivery can be advantageous from two perspectives:

- 1) **One advisor cannot possibly be an expert in all areas of expertise demanded by today's client, and certainly not tomorrow's.** Teams with each individual playing a specialized role are better equipped to deliver on the promise of expertise.
- 2) **Teams can also serve to institutionalize the client relationship, extending it to the firm as a whole beyond any one advisor.**

## Create a Path to Ownership for the Best Advisors

As firms grow, add employees, and adopt more sophisticated organizational structures, they must also develop employees who can drive cultural change and enter leadership roles. This new generation of leaders has to be closely tied to the success of the firm, both financially and culturally, and there is no better way to create that tie than a path to firm ownership. Expanding partnership to include the best advisors who have grown inside the organization will provide firms with renewed energy and a desire to grow, new leaders who can drive growth, and an extended span of control.

When it comes to your best people, failure to create a path to ownership puts your firm at risk. Without a chance of ownership, your best employees:

- May not be as fully dedicated to firm goals
- Will more likely consider leaving
- May not see their personal goals as tied to the firm goals

The unwanted result will be turnover, leadership gaps, and slower growth—perhaps even stagnation. With compensation increasing rapidly, not introducing advisors to ownership may also lead to a “wirehouse-type” compensation system, in which the advisors collect such a high percentage of the revenue they generate that firm profitability is threatened.

Beyond the negative consequences of not providing an ownership career path, there are four positive, compelling reasons why firms should develop new owners. By creating an ownership path, you:

- 1) **Ensure succession.** The average owner today is 51 years of age, so advisory firms have to create options for ownership succession. No matter whether the firm will choose to sell to an external buyer or transition internally, a new generation of owners is critical to maximize the value of the firm.
- 2) **Retain your best employees.** No other compensation method or title can create a better tie between the best advisors and their firm than ownership.
- 3) **Extend the span of control.** For every seven employees, the firm will need a new leader—someone who can lead and manage new hires. For every million dollars in revenue, the firm will need a new practice leader who can provide the knowledge, quality control, and, most important, the compliance oversight. As firms grow they need new leaders, and leadership comes best from the owners, who have a vested interest in business success.
- 4) **Renew the firm’s energy and drive.** As partners age, their knowledge and contacts grow, but their energy and desire to change typically declines. A strong firm can combine the energy and fresh perspective of its younger partners with the experience of the older generation.

The path to ownership has been the key to success for law firms, CPA firms, consulting firms, and other professional services firms. Advisory firms are well on their way toward the same system.

### **Ensuring Succession**

Whether the current owners are planning to sell to an external buyer or looking for internal succession, the presence of a committed group of professionals that is capable of maintaining client relationships and growing revenue is critical for succession. While there are many buyers of advisory firms in the market, all types of buyers—from consolidators to strategic acquirers—look for the presence of capable successors. Some acquirers require the sellers to train and develop their successors before they can cash out of the business and retire. In fact, an acquirer often becomes the catalyst for transitioning the most talented professionals into owners, as they have an interest in ensuring that the firm can continue to operate once the founding generation retires.

Today's RIA industry offers compelling careers for its young professionals, and will continue to generate opportunities for ownership, even if banks and consolidators continue to increase their presence in the industry. The acquisitions over the last five years by banks and consolidators have resulted in a higher number of firms under holding company ownership. Seven percent of the firms in our research are owned today by parent companies. The parent company firms had 18% of the total assets in the sample and represented several of the largest firms in the group we studied.

It is important, however, to understand that in many cases, the sale or partial sale of the firm does not necessarily dramatically alter the control or the management of the firm. In many cases, the sale of the firm to an acquirer introduces passive corporate ownership, which continues to rely on the founders still actively working in the firm to grow and manage it. In turn, the acquirer will share a significant portion of the profit with these original firm owners. This model of shared ownership is currently espoused by practically all consolidators, and is becoming increasingly used by banks and other acquirers who initially were looking to acquire the firm and supplant the existing management structures with bank-like hierarchical management.

Thus, no matter whether a firm is looking for internal or external succession, it will need to promote new owners from within. Even after the initial transaction (sale of the firm or a portion of its equity), the process of growing new leaders from within does not stop, as acquirers are equally interested in creating a retention process for the best advisors.

### **Retaining Your Best Employees**

Revenue is tied to the labor and skills of the professionals. Therefore, retention of the best advisors is key to the growth and success of the firm. Successful advisors generate revenue that is several times higher than their compensation, and productive advisors are tremendously profitable for the firm.

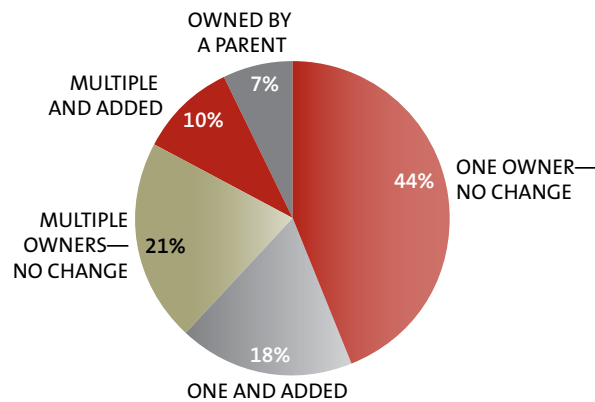
In fact, as we saw in the previous section, an advisor will generally manage \$500,000 to \$600,000 in revenue and receive \$150,000 to \$200,000 in compensation. This ratio of 25% to 33% between advisor compensation and revenue means that the firm has to eventually share some of the profitability with the advisor or risk a competitor coming from the outside with a higher compensation offer. If advisors are not participating in firm profits, compensation will eventually grow to the point where the firm may actually prefer to have them as owners. This is the case with wirehouse firms where compensation for the top advisors exceeds 55% of the revenue they generate.

Furthermore, this is the one characteristic that differentiates the independent firms from the wirehouses—the fact that the advisors, and not some abstract corporate entity, own and manage the firms that they have built and continue to build.

Another benefit for advisory firms is that the participation in profits and value creates alignment between the firm and its best advisors and prevents the type of crisis that wirehouse firms often find themselves in—namely, the fact that they constantly have to increase the cost of compensation, but are unsuccessful in shifting any of the business, compliance, or economic risks to advisors. This leads them to seek “secondary” sources of profitability—e.g., proprietary product, which in turn brings them into conflict with their advisors and clients.

As RIAs grow, they are approaching the size of regional wirehouses, and more and more, the billion-dollar RIA firms will have to look at what organizational characteristics make them different or superior to their competitors. We strongly believe that the answer lies in the career track and opportunities for ownership in the firm. Without that opportunity, the talent will not be there. More important, the current, compelling passion to do what is best for the client will be replaced by the familiar tangled web of disparate interests within the firm. Ironically, this is the same tangle that created the independent RIA in the first place and the model they rejected when they chose to go independent.

Figure 7: Changes in Ownership as Percent of All Firms Over the Last Five Years



Ownership additions are expected by firm owners, but they are becoming an expectation for the advisors in the industry as well (Figure 7). In the last five years, 35% of the firms added owners, and this created a snowball effect that other firms will feel. The more firms add owners, the more ownership becomes an expectation among professionals in the industry, adding pressure to the firms who have not made any ownership additions.

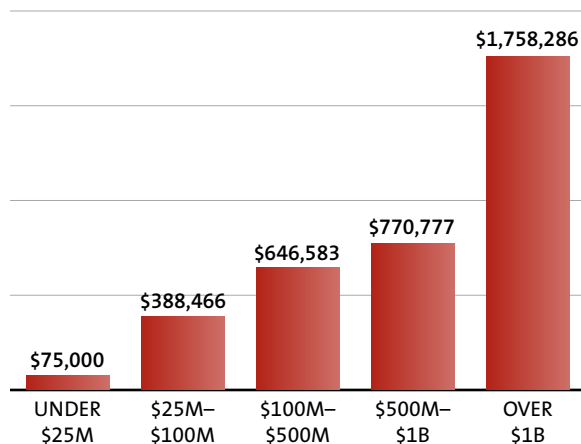
## Extending the Span of Control

As the revenue of a firm increases and its headcount grows, firms need new owners to exercise control over this increased scope of operations. Management science studies suggest that a manager can only maintain up to seven direct reporting relationships before he becomes ineffective at controlling the activities that he is meant to supervise. If we equate managers with owners, this means that for every seven employees, the firm should have one owner. As the number of employees increases, so should the number of owners. Naturally, professional management will also play a role in most firms, and many large firms already have professional chief operating officers, compliance officers, chief financial officers, and even CEOs. Still, most of the time, equity, or equity-like incentives are also necessary for these positions.

The relationship between revenue and the number of owners again comes down to the issue of control. How many clients can an owner control and influence? When does the firm need another owner in order to be able to retain and influence another group of clients? As the revenue per client increases, the firms are able to increase the revenue per owner, since the span of control tends to be measured in terms of number of relationships or clients, rather than revenue. As a result, the revenue per owner increases.

Today, on average, firms have one owner for every \$500,000 in revenue, with the size of the firm influencing the relationship of owners to revenue. While the billion-dollar and other large firms have over \$1.7 million in revenue for every owner, smaller firms with AUM between \$500 million and \$1 billion have \$770,000 in revenue per client (Figure 8). The revenue per owner has been rising as well, with the average near \$350,000 in 2001. This ratio will continue to increase as the industry grows.

Figure 8: Revenue Per Owner by Firm AUM Size



We fully expect the revenue per owner to continue to rise as firms grow and mature. By 2012, we expect the revenue per owner to be at \$750,000 per owner for the average firm, and on its way to \$1 million per owner for larger firms.

### Renewing Energy and Drive

Finally, firms need to replenish the energy and drive of the owner group. Typically, as professionals mature, their knowledge and contacts grow; however, their interest in change and their energy level tend to decline, as illustrated in Figure 9. In an ownership group of the same age, this means that the firm will eventually come to a point where it has a lot of knowledge and business development ability but lacks the ambition to grow. A more diverse group of owners will be able to capitalize on both the contacts of its more senior owners and the energy of the younger generation.

Figure 9: Knowledge and Contacts vs. Energy

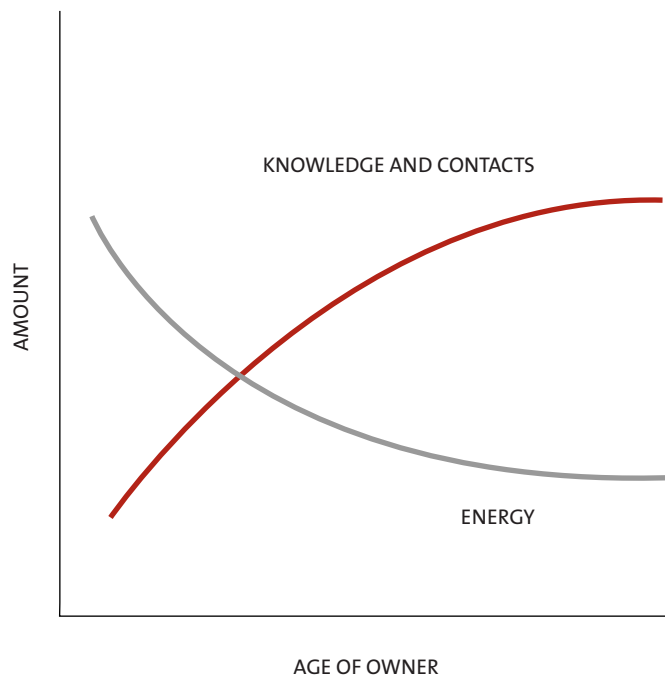
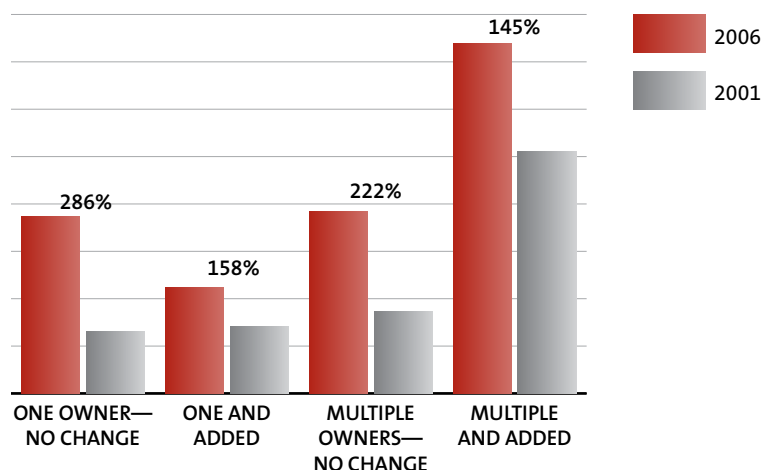


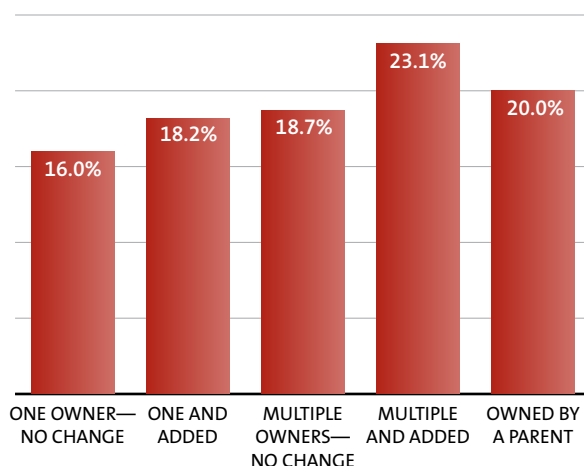
Figure 10: Pre-tax Income Per Owner by Changes in Ownership, 2001–2006



Adding owners has been critical for the success of independent firms. Between 2001 and 2006, multi-owner firms that continued to add more owners were successful in achieving the highest income per owner (Figure 10). In 2006, on average, these firms had close to \$740,000 in income per owner, compared to other multi-owner firms that didn't add more owners had nearly half the income, \$385,000. Firms that started with one owner in 2001 and expanded to more owners and firms with multiple owners that did not expand ownership both had close to \$140,000 in pre-tax income per owner. By 2006, the firms that added a second owner had pre-tax income of \$222,000, compared to \$373,000 for firms that did not change ownership.

While this result seems to imply solo firms are better off not adding owners, note that pre-tax income per owner is the simple division of total income by the number of owners in the firm. Therefore, the lower average income per owner for firms who added a second owner does not mean that the original owner had his income diluted. In reality, the income of the original owner likely continued to grow, and in fact, the total income generated by the firms that added a second owner was higher than the total income generated by the one-owner firms. As shown in Figure 11, the addition of new owners is strongly correlated to the growth of the company.

Figure 11: Five-year Annualized Growth by Changes in Ownership, 2001–2006



Firms that went from one owner to multiple owners had annual growth of 18.2%, outpacing peers who remained one-owner firms and had 16.0% growth. Firms that started with multiple owners and added more owners in the last five years grew at an annual rate of 23.1%, much faster than the 18.7% of firms that had multiple owners, but made no addition.

Whether the growth allows for more owners, or whether the presence of ownership opportunities motivates growth is almost immaterial. Ultimately, we believe that firms have no choice but to expand ownership if they want to grow. To a degree, even a sale to a consolidator can be seen as expansion of ownership. In fact, firms that sold to corporate parents achieved 20.0% growth.

The ascension to ownership will be the pinnacle of the career track for advisors inside independent firms, and will create the link between the success of the firm and the personal success of the advisors. Current owners of RIAs have to remind themselves that the same drive and entrepreneurial spirit that prompted them to become independent likely drives their best employees. If channeled toward the goals of the firm, this drive can become the engine of future success. If left untapped, it may lead to both employee and client turnover.

## Position for Change

Major opportunities await firms that are proactive about adding and developing people and adapting their organizational structures accordingly. We offer several recommendations to help firm owners implement these needed organizational changes:

- **Growth projections:** Start planning for change by developing your own specific growth projections. In preparing your firm's forecast, consider how large you want to be, as well as how your specific circumstances would merit variances from the aggregate projections presented in this report.
- **Productivity ratios:** Understand the relationship between revenue and your staff, and how the addition of new clients or assets will affect these ratios. Understand how your firm's productivity ratios compare with those of your peers, and estimate how these ratios must evolve as the firm grows.
- **Intelligent hiring:** Anticipate hiring, but be cautious and deliberate in order to have the right people at the right time. Monitor productivity ratios to gauge when a hire is appropriate. Be cautious in your interpretation—rising revenue or clients per professional could mean gains in efficiency, but it could also mean your professionals are over capacity. Know whether or not professional time is being put to its best use. If not, ensure supporting staff is adequate, and facilitate delegation of non-essential tasks. Look to hire specialists when multiple individuals perform parts of a job that could add up to one.
- **Structural change:** Develop a plan for organizational change, based on your firm's business strategy and growth projections. Consider the maximum span of control and reporting layers appropriate for your firm. Consider new processes, if any, that your larger and more complex organization will require.
- **People development:** The best source for new talent will likely be home grown. Have an internal process for actively developing people and improving retention. Provide training and conduct regular performance evaluations. Work toward an organizational structure that offers well-defined and meaningful career paths, including a path to ownership for your best people.
- **Employer of choice:** Lastly, but perhaps most important, create a natural magnet for recruits and improve retention by becoming the employer of choice within your region. To do so, offer a value proposition to employees that is as well-defined and consistently delivered as the one you offer your clients.

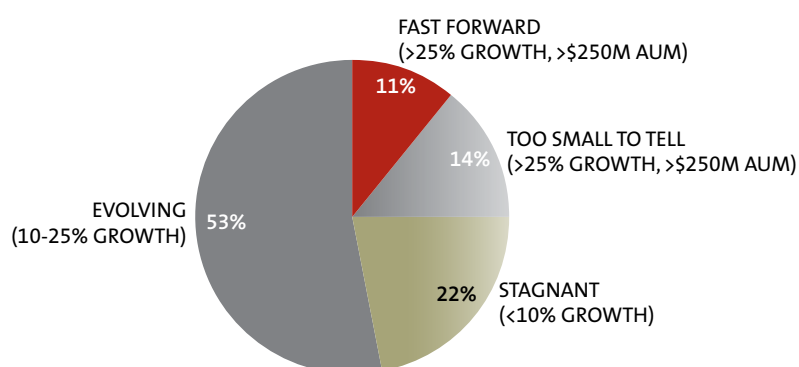
## Create and Maintain Capacity

While firms have grown well in the past five years, growing systematically—rather than opportunistically—is the next challenge. The rising tide has lifted all boats, but as competition for clients and staff intensifies, and as the organizations themselves become more complex, owners need to systematically create and capture opportunities. Our research shows that the best practices for systematic growth are hiring early and capturing the opportunities the market presents.

### Growth Patterns

When we examine the growth patterns experienced by firms over the last five years—between 2001 and 2006—we find four distinct patterns, as shown below (Figure 12). This pie chart is based on a sample of 105 firms that have participated in Moss Adams' surveys every year since their inception. The firms are distributed according to annualized growth rate. The annual growth rate that over a five-year period would have compounded to the exact actual growth experienced over the last five years. The fastest-growing firms are further divided by 2006 asset size.

Figure 12: Firms by 2001–2006 Compound Annual Growth Rate<sup>4</sup>



- > **Fast-Forward Firms (red area)** For a small and elite group of firms (11%), growth and development took on an entirely different meaning. These fast-forward firms grew by 32.1% on average per year, resulting in a total growth of 301%. In other words, they tripled in size over the five-year period. These “fast-forward firms” went from having \$115 million in assets and \$865,000 in revenue in 2001 to \$380 million in assets in 2006 with \$2,459,000 in revenue. The growth was stunning, and these formerly small firms skipped the evolutionary process and exploded into elite status. Some of that growth came from acquisitions, but the result remains unchanged: these firms are now larger and more competitive.

<sup>4</sup>The annual growth rate over a five-year period would have compounded to the exact actual growth experienced.

- **Evolving Firms (dark gray area)** For nearly half of all firms (53%), the last five years were a period of significant growth in which they averaged 18.6% per year, compounding to a total of 135% over the five-year period. These firms followed the typical pattern of progressing from small, or in some cases solo firms, to larger ensemble firms. The firms we examined that followed this pattern of evolution went from a median of \$70 million in assets and \$622,000 in revenue in 2001 to \$190 million in assets in 2006 and \$1,150,000<sup>5</sup> in revenue.
- **Stagnant Firms (green area)** Growth benefited all firms in the industry. However, over one quarter (26%) of the firms stagnated, unable to take full advantage of the industry-wide opportunity. Some firms averaged less than 10% annualized growth and, as a result, fell significantly behind the rest of their peers. Stagnation affected both small and large firms; in fact, some of the stagnant firms are also some of the largest in our sample.
- **Too Early to Tell (light gray area)** The industry is still young, and there are many firms (10%) who are yet too small and too young to be classified. There is certainly a subset that has grown very fast, but these firms are very young, and perhaps they are still taking advantage of the simple mathematics of growth: it is easier to grow percentage-wise when you start with a smaller number.

While some firms leveraged the industry-wide trend to leapfrog in their development, others balked and did not benefit to the fullest extent. What these growth patterns imply for the future is that while the opportunity will certainly be there, the extent to which firms can capture the opportunity is skewed toward a few elite competitors.

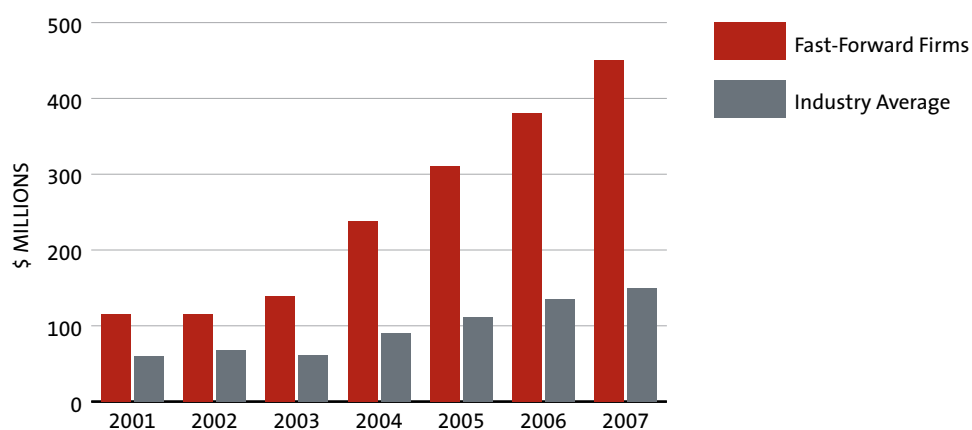
Two chief characteristics enabled the spectacular growth of the fast forward firms: their ability to capitalize on a market opportunity when it arose and their move to create capacity early.

<sup>5</sup> Throughout this report, we use median statistics to describe the typical firm. The median statistics do not calculate to each other (i.e., the median assets divided by the median number of clients is not equal to the median revenue per client). Also note that we report both median and average revenue, with average revenue used in the financial statement presentations.

## Capturing the Big Years

Consider the growth rates of the different categories of firms year by year. As shown in Figure 13, all lines of growth were more or less flat until 2003—that was the critical year and the turning point for the RIA industry. The macro climate became favorable: the equity market returns went up after two years of steep decline, investors returned to the capital markets, and the concepts of financial planning and strategic asset allocation took hold. The year was a turning point for all firms, but fast-forward firms took full advantage of the opportunity.

Figure 13: The Growth Patterns, AUM 2001-2007



The “big years”—the periods of dramatic opportunities created by either changing behavior of consumers or great equity markets—can either jump-start the growth of a firm or, if missed, cause a firm to lag behind the rest of the industry.

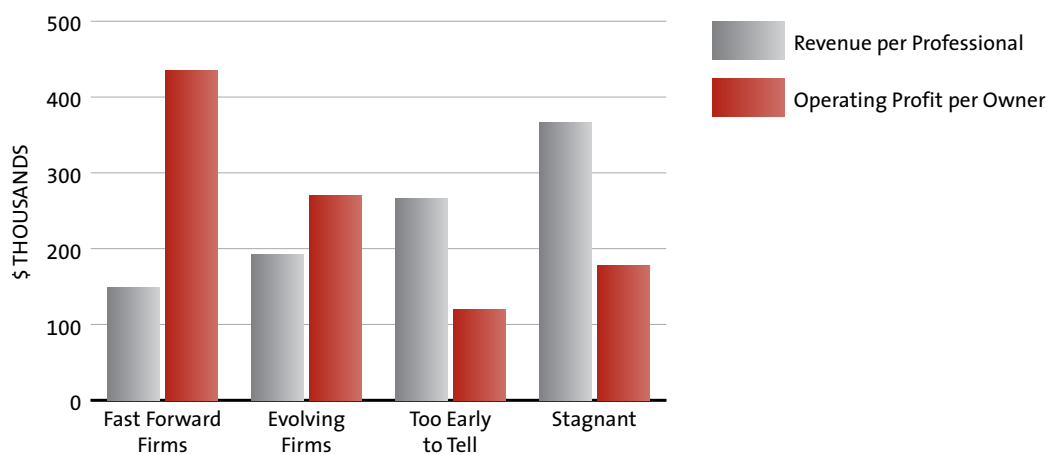
We cannot predict the turning years in the market or the years of increased opportunity in the investment behavior of consumers. Thus, a firm that has the ambition to grow quickly has to maintain the capacity to do so at all times, and wait for the right time to present itself. This may sound like a sacrifice of profitability in the name of growth, but as we will see, that is an oversimplification of what happened and what is likely to happen in the future.

## Creating Capacity Early

The key to fast growth is having professionals who can take full advantage of opportunities when they are available. In examining the data from 2001 to 2007, we found that firms with excess capacity in 2003 had the best growth results over the “big year” of 2004.

Figure 14 details the average revenue per professional in 2003 for the four types of firms—Fast Forward Firms, Evolving Firms, Too Early to Tell, and Stagnant Firms. The firms that had the highest rate of productivity, \$366,000 per professional, had the most difficult time growing from that point on. At the same time, the firms who grew very fast in the next five years had a lot of excess capacity and very low productivity levels, since they had just added people. Drawing from this, it seems to us that the first key to becoming a fast forward firm is the presence of professionals who can take full advantage of opportunities as they arise.

Figure 14: Revenue per Professional in 2003



Another factor at play is that there is always a period of adjustment and “skilling-up” with every new employee. We can call this the “lag” effect. The lag is even more critical with an advisor, since every advisor, in a sense, represents an economic unit inside the firm. We do not know the exact length of the average adjustment period, but if we assume that training and complete adjustment take a year to make an advisor fully productive, then the hires that were made in 2003 were ready to take on a full load of work in 2004. Those hired in 2004 were still acclimating.

In fact, we hypothesize that it may take **two years** between the time an opportunity presents itself and the time new advisors in a firm can take advantage of that opportunity. The first year is the year of recognition, the time that it takes for the management of a firm to recognize that an opportunity is presenting itself. The second year is the year of acclimation. New professionals need to become established in their firms, acclimate to the firm’s business management style, get to know their colleagues, and begin to understand their firm’s differentiation and position.

Most important, they must get to know the driver of business development, whether it is internal or external referral sources. The point is that by the time the professional is ready to be productive, a year is spent on the adjustment process. This process may be somewhat faster with experienced hires, but still, adjustment is time-consuming.

Hiring indiscriminately for the sole purpose of having employees at the ready is of course not prudent. However, a firm that has confidence in its strategy should seek to create capacity systematically and in anticipation of demand, rather than in reaction to it.

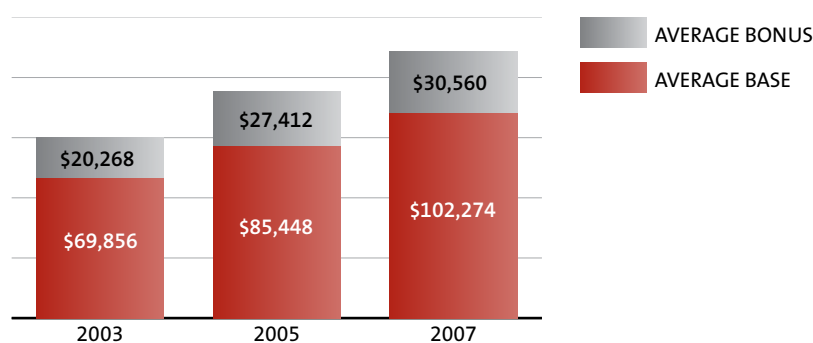
The key lesson from the last five years should be that when the opportunity arises, a firm can take full advantage of it if—and only if—it has a solid foundation of financial success, standing capacity to take advantage of the opportunity, and bold management that is not afraid to take risks.

### Productivity in Race With Compensation

The increased competition for talent will continue to drive compensation growth in the years ahead. We expect compensation to grow by 12% per year over the next five years—a pace of growth that will result in total compensation for advisors increasing by 76% by 2012. Therefore, productivity has to grow just as fast or faster, or firms will face a significant profitability challenge. To date, productivity gains in advisory firms have been driven mainly by increases in the size of client relationships. In the next five years, firms will have to deploy better leverage (use of multiple levels of professionals) and a better process to keep up with the rise in compensation.

### Growing Compensation

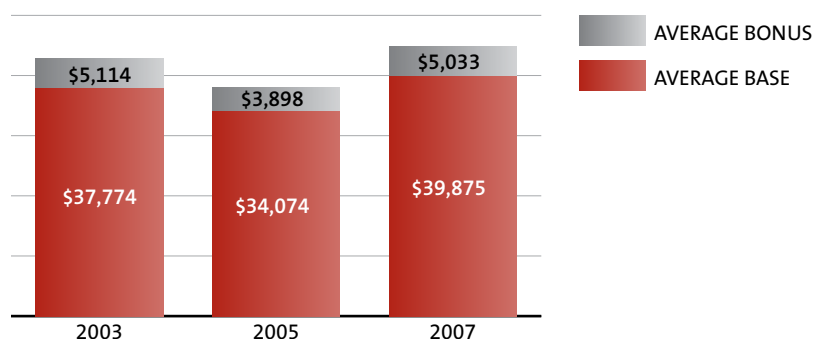
Figure 15: Average Base and Average Bonus for Advisors, 2003–2007



Between 2003 and 2007, compensation for employee advisors has grown by 12% per year—a rate that is likely to continue in the next five years (Figure 15). The compensation for non-owner advisors went from slightly more than \$90,000 in 2003 to \$132,000 in 2007.<sup>6</sup>

<sup>6</sup> Moss Adams' annual advisor studies alternate in focus each year between financial performance and compensation and staffing. Thus, we used compensation and staffing data up to 2007 and financial performance data to 2006.

Figure 16: Average Base and Average Bonus for Client Service Administrators, 2003–2007



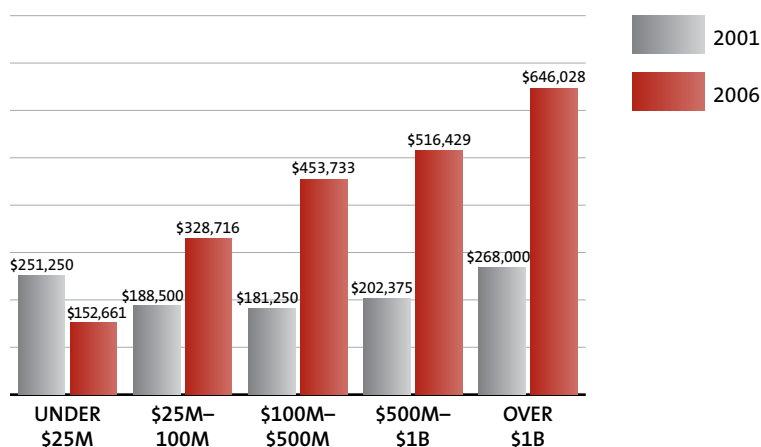
While professional compensation grew quickly, client service and operations staff experienced very little change in compensation (Figure 16). Between 2003 and 2007, the total increase in compensation was less than 5%, and in 2005, the compensation seemed to drop. In reality, this does not mean that the salaries of existing employees were reduced, but rather that a number of new operations people were hired with salaries lower than those of incumbents. The low cost of operations staff further helped profitability and fueled growth.

It is unrealistic to expect that compensation for advisors will slow. The shortage of advisors is already being felt throughout the industry, and compensation growth may even accelerate. At the same time, there still seems to be many qualified operations people, and the pressure on salaries there is not apparent, at least not in our data. Thus, there is an opportunity to leverage the advisor positions and use operations staff more effectively. Historically, increases in client size have fueled all productivity increases—now leverage creates a new opportunity.

### Productivity Fueled by Client Size

Compensation costs have increased in the past five years, but productivity increases have been outstanding. As a result, firms today are more profitable than they have ever been, but client size cannot continue growing at this pace over the next five years. In 2001, average per-professional productivity was \$202,000, and it more than doubled by 2006 (Figure 17). At the same time, on average, a client had \$250,000 under management in 2001, while the typical client had close to \$900,000 in AUM in 2006. Independent firms have been successful in attracting more affluent and higher net worth clients, and as a result, the revenue per client growth far outstripped the growth in revenue per professional.

Figure 17: Revenue Per Professional by Firm AUM Size



To keep up with the growth in compensation (forecasted at 12%), the average client size will need to grow from \$900,000 AUM per client in 2007 to over \$1,600,000 in 2012. While such a client size increase is possible, there is also an opportunity to grow productivity. The best clients are those that enable advisory firms to develop their people, demonstrate leverage in their service model, and create opportunities for the less experienced advisors to grow and assume higher levels of responsibility. The issue facing most firms, however, is whether this means getting larger clients—who by virtue of the large volume of work will allow more advisors to participate in the relationships—or whether they should find leverage in smaller relationships.

### Creating Leverage is Critical

Leverage means that a firm can use lower-cost professionals for some of the work, creating capacity at the higher level of compensation. In most simplistic terms, if a client requires 20 hours of work, and if 10 of those hours can be performed by a non-owner, this creates additional capacity at the owner level and improves the gross margin.

The size of the firm plays a role in the ability to leverage staff effectively. This relates to the fixed-costs components: the infrastructure necessary to communicate information and the processes and systems governing the work. The ability to recruit and retain advisors is a factor as well: all things being equal, a larger firm is more likely to hire a professional (given the same client service model and same ratios of clients per professional), creating higher leverage in the larger firms.

Figure 18: Non-owner Compensation as Percent of Total Direct Expense by Firm AUM Size

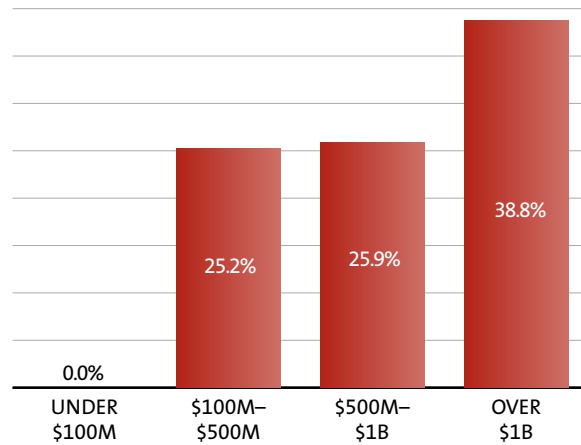


Figure 18 shows the percentage of total direct expense that goes to non-owner compensation. The percentage for smaller firms is zero, as they are mainly solo firms in which the owner is the only professional. As the size of the firm increases, an increasing percent of the total compensation is allocated to non-owners. It is still remarkable that the percentage never exceeds 40%, indicating that 60% of the compensation to professionals still goes to owners even in the largest firms, meaning that even in the largest firms, the opportunity to leverage exists.

Figure 19: Clients Per Professional by Firm AUM Size

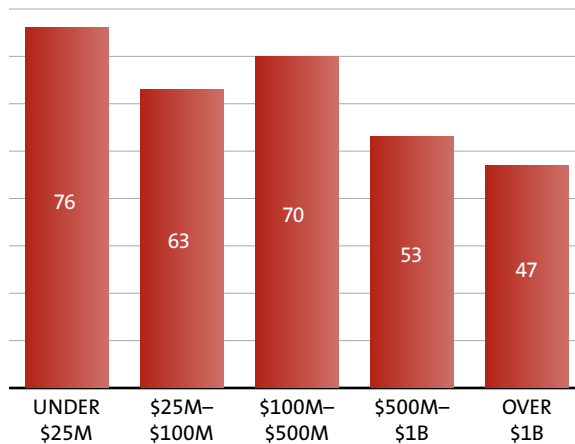


Figure 19 shows that the relationship capacity of an advisor is between 45 and 80 relationships. The capacity is heavily influenced by the size of the relationship, but also by the presence of level 2 and level 3 advisors, advisors who focus more on routine client service. As the number of people involved in each relationship increases, the number of clients per professional will decline, but the actual revenue per professional increases, as shown in Figure 17. In Figure 19, note that firms with AUM over \$1 billion had on median 47 clients per advisor or professional, whereas firms with \$500 million to \$1 billion had 53 clients per advisor. On the other side of the spectrum, the smallest firms had 76 clients per professional, and the firms with \$25 million to \$100 million in AUM had 63 clients per professional.

The productivity of independent RIAs has grown considerably and will continue to increase as technology automates many manual tasks and as firms create the infrastructure to better support their professionals. Infrastructure in terms of technology and systems, and also service staff such as customer service representatives, will continue to drive up the revenue per professional. We believe that by 2012, the revenue per professional will grow to \$600,000 per professional. In order to keep up with the increases in compensation to advisors, productivity has to go up, or margins will start to decline.

## Foster a Culture That Supports Strategy

Advisory firms are becoming larger and more complex organizations with a diverse group of job positions, skills, and people. The glue that holds employees together is the culture of the firm. Growth challenges the culture of a firm by testing its ability to adapt to new organizational goals, testing the ease with which it can integrate new people. Often, rapid growth creates a “cultural vacuum.” The cultural vacuum is the collection of new situations that the firm has not experienced before and for which new goals have to be defined, new values have to be articulated, and new leaders need to emerge.

### Preserve “Family” Culture as You Grow

At present, the culture of most firms can still be described as family-like. Close relationships, familiarity, and a long, common history of experiences define the firm. Leadership is paternal—unchallenged in its decisions but caring for its own. As the scope of operations increases, the ability of the owners to observe and manage every aspect of the firm declines. As the number of clients increases, and the number of people serving them grows, the probability of service failures, or even compliance problems, grows. As the number of employees triples, their ability to know each other well and relate to each other personally declines. In order to tackle these challenges, firms must define a new culture—one that can preserve the same values, but does not rely on the closeness and immediate contact of the familial office environment. The process of cultural change will define the ability of an organization to attract people and retain them in the long-term.

The simplest definition of culture is “what happens when no one is watching.” Thus, culture will be the biggest challenge for rapidly growing firms as their size will make it impossible for the owners to be “watching” all the time. Cultural change is not a destructive process by definition, and moving away from a family-like culture does not have to represent a setback for the environment a firm can provide. A larger firm can preserve the same values of a smaller organization, but it must find a different way of communicating those values to more people. This creates opportunity for more employees and ensures less dependency on one or two key people.

### Manage Cultural Change

Culture can seem intangible and elusive. It is difficult to measure and assess, yet it has a dramatic effect on the financial and other tangible results produced by a firm. While difficult to measure, culture can be managed, and it should be managed to ensure that the culture of the organization supports its overall strategy. In fact, it is said that during the turnaround effort at Ford Motor Company, someone put a sign in the war room that read, “Culture eats strategy for breakfast.” Firms have several critical tools at their disposal in the management of culture:

- 1) **Lead by example.** The behavior of the leaders sets the tone for the entire organization.
- 2) **Define success appropriately.** Employees generally want to be successful in their organization, and their behavior will always gravitate toward the definition of success. Success is measured not only by the monetary reward. In fact, recognition may be just as effective. Rewarding the right behavior and showing no tolerance for non-compliance goes beyond compensation. The critical question is: “Who in the firm is held in highest regard in the firm, and why?”
- 3) **Articulate and communicate goals and values clearly.** The clearer the values are, the more likely it is that they will be shared.
- 4) **Embrace new employees.** This allows the firm to grow beyond its core set of staff, adjusting its culture to accommodate new people with new ideas.

### **Leading by Example**

The job of the future leaders of advisory firms is to maintain and promote the culture of the firm in their area of control and practice. As firms increase their staff numbers, the direct exposure of each employee to the founding owners will decline. That’s why it is critical for every area of the firm to have its firm leader—a person who will lead by example, communicate the goals of the firm to the staff, and instill shared values. In the absence of such leaders, the firm is at risk of suffering turnover, service problems, and stagnation.

In a previous Pershing Advisor Solutions report titled *Mission Possible: Finding the Optimal Operations Model for Your Advisory Firm*, we found that the operations area in advisory firms often suffers from lack of leadership, resulting in more than 30% turnover in staff and multiple inefficiencies. In the same report, we discussed how the presence of a Chief Operating Officer (COO) strengthens firms’ leadership abilities and gives them a competitive advantage. The same is true as firms grow and enter into situations where they have new departments or practice groups, new offices, or new service models. Every area of the practice needs someone who participates in the leadership of the firm and can act as the cultural agent for the practice.

### **Define Success Appropriately**

The definition of success in an advisory firm must reflect the organizational goals, and it should filter these goals through the prism of shared values. In our consulting experience, problems occur in an organization when the priorities of the firm have changed, but the definition of success has not changed. Thus, the new organizational goals are sometimes culturally less accepted. For example, many advisory firms are trying to encourage their younger advisors to be more active business developers and help grow the firm. At the same time, many firms have historically had a distaste for “sales” and do not in any way track individual business development activity or contribution. In addition, the performance evaluation process does not reflect on the business development role or contribution of the advisor, and finally, no pay mechanism exists to encourage higher activity.

When a firm tries to reprioritize toward encouraging more business development, it faces a cultural challenge, and the place to begin cultural change is not always the compensation system. A bonus for business development will not be a good enough motivator if it works against the culture that sees “sales” as unacceptable, as it creates a conflict between the monetary and social reward. Instead, a more effective mechanism would be to first articulate growth in revenue as an organizational goal, being sure to measure and report it. Second, the firm would need to create a process for measuring marketing activity and business development contribution, and reporting the level of success achieved. Recognizing the successful new business developers will do more to encourage cultural change than simply creating a bonus.

Pay, however, is an important component in this process. Generally, compensation is a powerful motivator, and if it acts in the same direction as the culture, it will drive employee behavior. If compensation works against culture, the firm is in danger of creating cultural conflict. Long-term, cultural conflict results in turnover, frustration, and poor morale. The key to change is to first declare the right measure of success and then translate that measure to the personal level through the performance measurement and evaluation system.

### **Articulate and Communicate Shared Values**

The shared understanding of values in an organization creates the foundation for employees to make consistent decisions in situations where they have to exercise judgment. This is the “when no one is watching” component of culture. Values are articulated implicitly through the behavior of the leaders, and through what behavior is rewarded and held as successful; but values are also effectively communicated through explicit statements made by the firm. Many large service organizations actually develop simple and effective statements about their values that are then displayed consistently on company materials and presentations. These “commandments” serve as an effective check to make sure the actual values have not drifted away from their initial intention. To further elaborate, often the desire to “always put the interest of the client first” eventually turns into “we do whatever the client asks us to do.” If the first statement was made by the CEO and then reaches the employee through the statements made by three vice presidents, the message can become very distorted. Explicit and direct communication preserves integrity.

Explicit communication of shared values also applies to compliance. With the increased number of advisors delivering service, firms will inevitably discover that culture is the best compliance mechanism. Once the number of advisors increases beyond the original close group of founder and staff, firms face the same problem as their biggest competitors: any one advisor can create compliance problems that can significantly affect the entire firm, both financially and from a regulatory perspective. Compliance can fundamentally change the firm as it is growing. While a small group of professionals can generally trust each other’s judgment, a large group of employees cannot easily function this way and needs to rely on more processes and procedures, more checks and internal oversight, to create a safer environment.

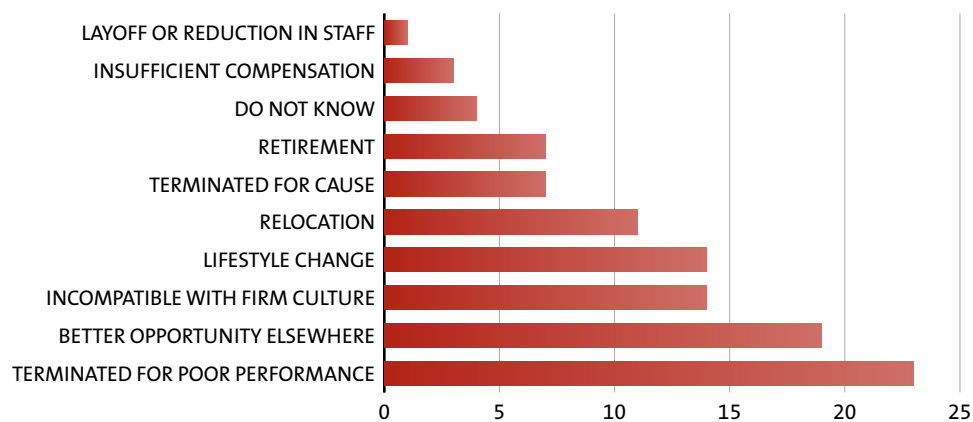
The culture of the firm will define the behavior of the employees, and if the culture is one of safety and compliance, the firm will be safe and compliant. If the firm, however, shows a cultural propensity for taking risks with clients, compliance oversight will always be difficult, and problems will eventually occur.

The same is true for reputation. While in smaller firms, each owner and professional tends to have his or her own identity and reputation in the community, as the firm grows, identity will inevitably be related to the firm rather than the individual. The behavior and reputation of one owner can affect the others through shared reputation. Again, culture plays a significant role in preventing problems for the firm.

### Embrace New Employees

One of the leading causes of employee turnover in advisory firms is “incompatibility with firm culture.”<sup>8</sup> In fact, close to 15% of departing employees are lost due to a cultural problem, as demonstrated in Figure 20. This indicates either a problem with the ability of the firm to properly assess the person during the recruiting process, or a culture that is exclusive and unwelcoming.

Figure 20: Why Advisors Leave



Source: Moss Adams LLP, 2004 FPA Financial Performance Study of Advisory Practices, Sponsored by SEI Investments.

<sup>8</sup> Moss Adams LLP, 2004 FPA Financial Performance Study of Financial Advisory Practices, Sponsored by SEI Investments.

Use the following set of questions to test your culture's ability to retain people:

➤ **Is the culture accepting and welcoming of new people?**

The culture of many small firms can be somewhat cliquish, making it difficult for new employees to feel accepted. Signs of such behavior include: isolating new employees from meetings or social interactions, excessive emphasis on tenure in compensation or promotions, and dismissing the opinions and suggestions of newcomers. This is often manifested by a small group of “permanent” employees and a rotating group of positions that seem to have a high turnover.

➤ **Is the culture encouraging social interaction and closeness between employees?**

Employees who form friendships develop mutual trust and also help each other through the more difficult and challenging times. This closeness is often fostered by social situations. The firm does not have to “require” friendships and social activities, but creating situations in which people can naturally form those can catalyze the process.

➤ **Does the culture give people second chances?**

Every employee will go through difficult times. A culture that gives people a second chance, and does not permanently damage their perception in the organization, will be more successful in retaining people.

➤ **How much internal competition is desirable?**

Some competition is desirable in every organization, but excessive competition tends to retain only the “winner” and ultimately destroys the ability to collaborate.

Culture will drive the collective behavior of the firm and define its ability to expand without compromising quality of service and professional integrity. In times of fast growth, culture gets stretched and redefined. We will see, however, that firms who espouse change as part of their strategy find it is a useful tool to fuel even faster growth.

## Become an Advisor of the Future

Growth will happen. The change induced by this growth will be significant, and its impact on your firm's organizational structure and culture will likewise be significant. It is up to you not only to manage it, but to capitalize on it. We summarize the action items in this report below.

### 1) Make bold organizational changes.

- What would it take to triple the size of your firm? How many new employees can you envision hiring?
- Re-examine your staffing structure to take advantage of leverage, create new positions in the following job families: dedicated management, technical specialists, client service, and administrative.
- Adapt the role of advisor to reflect the realities of changing client expectations and needs.
- Position yourself for healthy growth by examining productivity and growth projections in order to hire intelligently, craft the right organizational structure, and recruit, and retain great people.
- Create a path to ownership in order to ensure succession, boost retention, extend the span of control, and reenergize your firm.

### 2) Create and maintain capacity.

- Capture the “big years” by responding to periods of dramatic growth immediately and productively.
- Create capacity early in order to take full advantage of opportunities as they arise.
- Leverage the critical advisor positions, using operations and other staff more effectively to increase productivity.

### 3) Foster a culture that supports strategy.

- Preserve the “family” culture. Even if you cannot see everything that happens in your firm, take care to adapt your culture as firm goals change.
- Manage cultural change, lead by example, define success appropriately, articulate and communicate a set of shared values, and accept and embrace new employees.

We hope that our historical examination gives you the practical tools you need to meet this industry's extraordinarily promising future head-on, making it a fruitful time for you, your employees, and your clients.

## Ideas Without Limits

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