

INSIDE INFORMATION

The newsletter for serious financial advisors. (www.bobveres.com)

Special to this issue:

Client Services: *Can one person really "fix" the insurance industry? If not, he might be able to fix some problems in your clients' coverage.page 7*

Practice Management: *How study groups are helping their advisors address succession planning and issues.page 11*

Parting Thoughts: *Here's a single (potential) solution for our financial illiteracy rate, and a lot of other costly social problems as well.page 15*

THE ONCE AND FUTURE CHALLENGES

Synopsis: *As the advisory business changes and evolves, it will create new operational challenges. Here's a preview, and some advice on how to address them.*

Takeaways: *We may have a lot to learn from the independent broker-dealer and wirehouse brokerage business models.*

Mark Tibergien is the acknowledged godfather of practice management advice in the financial planning space--a consistent advocate for planners running their practices like businesses. So when the Future of the Profession white paper predicted that we've entered an era when planning practices are evolving into planning businesses, it simply echoes something he's been working to bring about for more than 20 years. "It is pretty clear that the industry will shift from being 70% solo practitioners to a lot of firms that are pretty complex entities," he says.

But as we (finally) enter this new era of professional management,

this done? As it happens, there is: For \$99, you can buy a narrative ADV Template developed straight from the SEC guidelines from ProTracker Software (<http://www.protracker.com/Products/ADV2Template/product.aspx>). It comes in the form of a Word file with suggested text that covers the requirements; you customize it to fit your firm's compensation structures, clients, methods of investment analysis, etc., and the table of contents can be created automatically.

Tibergien suggests that advisors start thinking about the new challenges that this transition will create for them.

For instance? Fee-compensated advisors will tell you that they've moved safely beyond the broker-dealer business model, away from all of its messy branch office supervision and constant recruiting activity. Others look disparagingly at the wirehouse/brokerage model, where branch office managers ride close herd

Continued on page 2

EARLY WARNING

●All SEC-registered advisors, and also those who are state-registered, will be required to create a new Narrative ADV Part II by March 31, 2011. The SEC has published fairly strict guidelines (find them here: <http://www.sec.gov/rules/final/2010/ia-3060.pdf>) including a table of contents and 19 different areas of discussion--in plain, narrative English.

Isn't there some easier way to get

The Once and Future Challenges

Continued from page 1

on the brokers who work with clients. But, Tibergien says, as independent firms get larger, they may suddenly find themselves wrestling with some of the same managerial issues that these other businesses have struggled with for decades.

To see how this can happen, consider one of the central predictions of the white paper: the emergence of larger advisory practices. The white paper predicts that one- or two-principal shops will merge to form two-to-four principal firms, and a percentage of those larger entities will continue merging, seeking greater economies of scale--particularly the ability to hire persons dedicated to compliance issues and managing the office.

But the white paper is entirely silent on precisely what those models will look like. Tibergien believes that two very distinct types of multi-principal RIA firm will emerge, and each will present its own set of challenges.

Pieces of the puzzle

To make sense out of the two models, start by grouping all the work you do with and for clients into three distinct units.

The **front office** provides the actual face-to-face interaction with the client--what you probably view as the core of your service. Broadly speaking, your advisory activities are the front office.

The **back office** encompasses the custodial clearing activities,

executing your trades and custodial client securities. Examples: Pershing (which does custody and clearing for both BDs and RIAs), Schwab and TD Ameritrade (for fee-compensated advisors) and Merrill Lynch (for its brokers).

The **middle office** represents everything that happens in between the advisor and the custodian. The middle office activities include all the downloading, reconciliation and performance reporting, plus the various tasks related to paperwork and new account forms, compliance, data entry and management, and (depending on where you draw the boundaries between front and middle office) even operating the planning software that generates the financial plan.

Generally speaking, advisory firms own and operate their own front offices, and "rent" their custodial activities. The real operational question that advisors face as they grow into larger firms is: will they own, or rent, that middle office part of their practice?

This "rent or own" choice defines the key distinction between the two business models that Tibergien expects to emerge in the consolidated future of the profession. Each of them will raise new and interesting operational issues that will look depressingly familiar to advisors who think they've escaped the challenges of the BD or wirehouse world.

Ensemble mergers

Consider the first model that

Tibergien talks about: the familiar ensemble firm. Here, the merging advisors decide that all of their clients will be clients of the overall firm. In the merger, they would receive ownership shares roughly in proportion to the number of clients (or revenues) they initially contribute to the merged entity, with the opportunity to expand or shrink their ownership interests. Operationally, this expanded firm would pool employees into departments, which would handle investments, compliance, marketing, etc.

The ensemble firm is building its middle office in-house, which represents a significant ongoing expense until the firm achieves a certain scale and the construction is largely completed--at which point (hopefully) the in-house systems will be less expensive to maintain and operate than a rented alternative. The firm will also have more control over its middle office.

As the ensemble firm grows, Tibergien points out that its operational issues begin to resemble issues that the brokerage firms and their reps have been dealing with since the turn of the century. The ensemble firm grows by recruiting new advisors, who have to be supervised and trained so they all provide a uniform service package. As more advisors are added, you have to have stricter operational controls, to make sure none of these advisors goes "rogue" on you, and this danger increases as the firm's reputation and presence in the community becomes an increasingly valuable asset.

Those who supervise these advisor employees will also be responsible for making sure they generate profits on their client-facing activities, which means there may be constraints on how much service they offer, and on what they recommend.

And, finally, since the firm itself does the marketing and brings in the clients, it expects to "own" those relationships even though the individual advisor employee is providing the actual hands-on service.

Most RIAs would agree that brokerage firms have pushed this relationship too far away from service and towards maximum profitability, and the existence of in-house proprietary products complicates the picture. But in the future, larger ensemble RIA firms are going to have to figure out how to balance the needs of the client, the employee advisor's creativity and instincts for providing great service, and the needs of the firm. And it will have to figure out how to ensure that the client views

the firm as a whole as the key to the relationship, rather than any individual advisor. Individual employee advisors, meanwhile, may have a different view of the relationship, which means both sides will need to address issues that breakaway brokers have faced, but which independent RIAs probably thought would never arise in their own careers.

Silo mergers

The other model that Tibergien envisions in the consolidating future is a siloed business. Here, a number of advisors come under one roof and share rent, the services of a receptionist and other support staff. They might also share software. But the key difference between the silo and the ensemble firm is that in a silo arrangement, the advisors will continue to run their own practices as standalone profit centers within the larger firm. This, of course, will be a very attractive option for advisors who want to become part of a larger entity that supports their business, but who still want to maintain their independence--including the freedom to deal with clients the way they want, to pursue their own unique strategy--and who also want to keep the revenues they're personally generating. "This," Tibergien adds, "will also allow them to leverage staff without dedicating time to business management."

The advisor who joins (or merges into) a silo is effectively renting the middle office from the umbrella firm--paying

a proportionate share of the expenses. As the firm becomes larger, the middle office gradually becomes the center of gravity for the firm and the advisors become somewhat interchangeable pieces that plug into the services it provides.

Tibergien notes that there isn't any real requirement that the advisor who joins a silo actually work in the central office; in this age of connectivity, that office can be anywhere and still receive middle-office support.

The closer you look at this silo firm model, the more it looks, operationally, like a broker-dealer middle office servicing its reps. "If you are a super-advisory firm with a bunch of silos, then your client is the advisor, not the end client," Tibergien points out. "As those pods or silos become more detachable, you have to work harder, in the central office, to keep them in the fold." Does that not sound like the BD business model all over again?

The challenge here, of course, is for the middle office to maintain the same focus on the end client as the middle office, plus the ancient broker-dealer industry challenge of being constantly responsive to the needs of the siloed advisory practices. Both sides will need to understand that it may not be possible for the middle office to meet all the demands of the front office, and the firm will need to understand that its evolving service level is the key to maintaining the loyalty of its various front offices. Silo practices might do well to

Continued on page 4

Inside Information is published monthly by Robert N. Veres.

©2010, Robert N. Veres. All rights are reserved. *Inside Information* may not be reproduced in whole or in part, and particularly not without the use of medieval scribes, without the permission of the publisher, who is certainly approachable on the subject and has proved to be an easy mark in the past.

Editorial offices:

1804 Garnet Avenue
Suite 510
San Diego, CA 92109.
E-Mail: bob@bobveres.com

The Once and Future Challenges

Continued from page 3

study how the most successful independent broker-dealers have navigated these issues.

Of course, dually-registered advisors--those who are affiliated with a broker-dealer--are also renting much of their middle office from the BD. Seen in this way, it isn't hard to notice that some BDs provide more of these services than others. Tibergien's three-office model can be useful for FINRA-regulated advisors who want to evaluate broker-dealers; what middle-office work does the BD handle in return for its payout?

IBD opportunities

In fact, as growing/merging/expanding advisory firms of the future decide whether to own or rent their middle offices, independent broker-dealers will expand their market, offering to rent their middle offices to fee-compensated silo or ensemble RIA firms who are currently affiliated with an institutional custodian. To help them compete in that space, Pershing created a program call RIA Complete. "We're showing [broker-dealers] how to enter the fee for service business," says Tibergien. "It is not a big leap," he adds, "for a number of IBDs to be heading in that direction." (Currently, 46 broker-dealers are participating in the RIA Complete initiative.)

This future could come faster than we expect; Tibergien points out that the BD community is about to experience a once-in-

a-career opportunity to provide these services to advisors who might suddenly require a lot of compliance help in a hurry.

"When the SEC minimum goes up to \$100 million," he points out, "it increases by thousands the number of advisors who have to register in the 12 states where they have clients. They suddenly fit into that category of needing best practices and scaled compliance and advice. The broker-dealer can say to them, I can provide you with compliance consulting as part of my offer, along with practice management support, seminars, conferences, workshops, lead generation if that were part of the offer."

The real fundamental difference, Tibergien adds, is how they enter into an economic relationship with their advisors, and what assumptions they are making about their role as supervisors and compliance providers. Broker-dealers currently operate in an "override" model, where the revenue comes out of the advisor's gross revenue. In the custodial model, the custodian's revenues are generated directly from the end clients.

Supervision may also be an issue. Later in the interview, Tibergien speculates that the BDs probably will feel like they have to have a tighter rein over the actions of the advisor. He also points out that dually-registered RIA firms could become part of the broker-dealer's corporate RIA, and bypass the state registration issue by leveraging the larger entity.

Stepping back to see the big picture, it is not hard to envision how this additional competition could change the economics of the advisory business in interesting ways. With three or four major institutional custodians competing for the advisor's middle office business, there is little incentive for pricing to come down. But if the competition suddenly increased to 20, 40 or 60 players, all of them trying to offer better service at a lower price, middle- and back-office services could become less expensive than they are today. Couple that with larger advisory firms--Tibergien says that you can achieve more negotiating leverage at \$100 million in assets, with additional breakpoints of \$300 million, \$500 million and \$1 billion--and the economics could become even more attractive.

The white paper talks about a technological arms race among institutions, broker-dealers and other back offices, and speculates that these leapfrogging improvements in platform integration and efficiency will help advisors manage their practices more effectively. But Tibergien says that the middle office enhancements (and competition) will create efficiencies in other ways as well. "Whenever we do a workflow analysis on advisory firms, there are five to seven areas where you are going to be able to find improvements in productivity," he says. "The biggest one is around the investment process"--potentially outsourcing the

download/reconciliation activities, and consolidating a lot of individualized portfolios into variations on core model asset mixes.

"The second biggest area is probably around financial planning, which can be centralized to some extent," says Tibergien. "And the third may be around the whole account opening and data gathering process"--which, he says, can be systematized, streamlined and facilitated by an efficient middle office. "The best solution in most cases is outsourcing the crap," he says; "the things that are not adding value directly to the client relationship."

In fact, in the future, the middle office could expand to include a lot of activities that are handled by the front office currently. "There is a large population of advisors who are purely interested in managing the relationship," says Tibergien. "They may not even be experts in investments; they have a financial planning orientation and relationship management strength."

Growth and constraints

As all of these changes take place, Tibergien thinks that we'll start to see advisory firms grow larger than any RIA firm in today's marketplace. "I can easily envision firms with \$5 billion, maybe even \$10 billion under management," he says. "If we use a rough rule of thumb and say that a \$1 billion firm is



*"We tried saving for our retirement.
But it was just too damned expensive."*

a \$10 million revenue firm, that is still a small business. At \$20 million of revenue, you are still a small business. I can envision the billion dollar firms merging with other billion-dollar firms. I don't think we'll see hundreds, but I wouldn't be surprised to see 50 super-regional firms."

However, Tibergien isn't expecting to see any national brand RIA firms emerge in the foreseeable future. "One of the biggest challenges in creating multi-state or multi-region offices is they are constructed like the Maginot Line," he says; "there are big holes in between each fort, so you never really create brand coverage the way you would like to."

Tibergien points out that some national study groups have talked about consolidating their firms and creating a single national brand. "But," he says, "if you are creating a national firm from scratch, what is the likelihood that you would have said: the seven markets that I want to be in are Dubuque, Orlando, Rockford, IL, Stockton, California and Quincy, MA?" For a true national brand to emerge, he says, it will have to move into larger markets strategically and systematically, as Starbucks or Nordstrom have.

Dangers in paradise

With all these new operational

Continued on page 6

The Once and Future Challenges

Continued from page 5

complexities, Tibergien predicts that consolidation will be accompanied by a darker trend that is not discussed in the white paper: a rise in firms that fail. Some of the consolidated firms, he says, will not be up to the managerial challenges they are creating--in fact, they might not even realize there ARE different managerial challenges until their firm has suffered a fatal wound.

"If you don't have somebody paying attention to how the business gets managed and how the clients get served, and it is all random and done individually by the professional staff, then the wheels will come off," he says. "Suddenly, we could start to see compliance problems, or oversight problems, or quality control problems, or pricing problems--and any of those could get out in the community and affect your reputation and the reputation of the profession. In other types of industries, more companies go bankrupt in the growth cycle than in any other phase. They outrun their logistics, their ability to supply their needs."

"When we look at the future of this business," says Tibergien, we have to realize that you can get away with a lot when you are a small practice and you don't have to be accountable to anybody. But the more moving parts you have, the more your weaknesses get revealed: an unwillingness to delegate, a lack of coherent vision, not enough attention paid to professional management and operational efficiencies and all

the other reasons why good firms never grow to become great ones."

Meanwhile, some of those advisors who DO manage to survive the complexities of building a larger firm will run into a wall in their growth, either because the advisor chooses to manage client relationships rather than the business, or insists on making all the managerial decisions, but doesn't have the time or energy to implement them, or some other flaw that is allowed to flourish. "A lot of weaknesses could get exposed during the phase transition," says Tibergien.

And the best way to move through or around the wall? "Know when it is time to take a breath," Tibergien advises. "Slow your growth a little bit and decide what type of person is going to be complementary to what you are doing, and what roles you would want them to perform, and how accountable you want make them for a certain outcome."

Navigating change

As advisory firms get larger, the best way to manage the growth process is to hire professional management--somebody whose sole function is to run the company, preferably somebody who has done it before. You could start with a consultant, or a part-time general manager, but eventually somebody will have to serve as a general manager or COO of the business.

Where do you find these people? Tibergien recommends that you consider the operations

manager who is currently managing a local law firm, an engineering firm or a medical practice--somebody running a service business that has gone through rapid growth. "See if they are looking for a new challenge," he says.

At the end of the conversation, Tibergien raises a new issue, maybe the biggest challenge to the profession over the next ten years. "We project a need for 9,000 more financial professionals just within RIA firms," he says. "There is an age gap between principals and the next tier of some 25 to 30 years, so this is a training issue as well as a recruiting challenge. For those who remain in the business, there is going to be great demand for financial planning services that they may not be able to respond to."

Tibergien's observations fill in some of the blanks in the Future of the Profession white paper. They offer a glimpse of the potential downside hidden in what has to be considered a positive trend: more size, scale and professionalism throughout the planning landscape. It may be inevitable that growth and evolution create challenges, and where there are challenges, there is an increased risk of failure. Here, Tibergien has helped us understand the nature of the challenges, and how to address them--a potentially healthy antidote to the various risks and challenges that will emerge in the new, consolidated future of the planning profession. ■

Fixing the Monolith

Synopsis: *By filling in the financial disclosures that insurance companies have always resisted, an economist/life insurance agent hopes--no, PLANS--to revolutionize the industry.*

Takeaways: *Just by deconstructing the policy illustration, you can see that the cost of insurance rises as the policyholder gets older. The marketing expenses are even more interesting.*

Brian Fechtel, of Breadwinners' Insurance in Larchmont, NY, is not your normal insurance agent. For one thing, he has a degree in economics from Georgetown University and the CFA designation, which helps you understand why he happens to be orders of magnitude more analytical about his insurance recommendations than the guy who's been persistently cold-calling your clients about equity-indexed annuities.

For another, Fechtel talks--with apparent sincerity--about "fixing" the life insurance industry in a matter of weeks.

"My approach is two-fold," he explains: "to provide the information that insurance carriers have always refused to disclose, and then to publicize it. My belief," he adds, "is that publicity of good information will prevail."

"Fixing" life insurance means helping consumers and advisors understand how products are structured and priced, making

it possible for them to comparison shop. Fechtel starts by explaining what you probably already know: that term and cash value life insurance are essentially the same thing: cash value products all have a lifetime term policy embedded inside them. "Cash value policies are nothing other than term with a tax-advantaged side fund," says Fechtel.

However, he says, the side fund of cash value policies offers certain tax privileges that are not available in term. This includes tax-deferred growth that can be borrowed out of the policy. In addition, the money that is paid each year for insurance coverage becomes part of the investment account's cost basis.

In Fechtel's view, these tax benefits make cash value life coverage worth considering for a certain number of clients. "I recommend a lot of term coverage," says Fechtel, "so I'm far from anti-term. But with term, one foregoes the ability to use the insurance

expense as a part of one's cost basis to shield investment earnings."

With term, you know what you're paying for your mortality expenses each year. With cash value policies, the investment account is paying the premium on the embedded term policy on the other side of a closed door. And Fechtel says that a lot can go on behind that closed door, including the insurance company raising the cost of coverage.

Understanding these basic principles is a good start, but it's only a start; the problem with the life insurance marketplace, in Fechtel's view, is that consumers never have enough information to comparison shop or know exactly what they're buying. You can walk into a hardware store and buy a hammer, and it's not hard to compare prices and evaluate the quality of the various products. But what if you paid for the hammer based on a 30-year projection of scheduled payments, and part of the transaction was giving the hardware store additional money that it would manage on your behalf and deduct a proportional cost to pay for the hammer every year?

"Capitalism only works when people have all the information to make an informed decision," Fechtel argues. As evidence that capitalism isn't working in the insurance marketplace, he points out that it is common for consumers to pay 55% or more of their first-year premium for cash value coverage, when the same agent could (but forgets to mention

Fixing the Monolith

Continued from page 7

it) offer a blended policy with the same coverage and same investment account for a small fraction of that commission. "If this was a truly a competitive market, with good information," says Fechtel, "you wouldn't see people paying 55% of the first year premium for the privilege of buying that policy."

If the life insurance industry is ever fixed, he adds, consumers won't be willing to pay out excessive loads or unknown costs of coverage.

Where can an advisor or life insurance customer get this information? Go to Fechtel's web site (<http://www.breadwinnersinsurance.com>) and you'll find something called the Illustration Analyzer. To get your own analysis of a policy, you take the policy illustration that the agent has given you (or two or three different policy illustrations from different agents, or the most recent in-force illustration on an already-purchased policy), and enter some information straight off of the printed page: the annual premiums, the cash surrender value each year, the death benefit, and the illustration interest rate (the assumed rate of return on investments in the illustration), the crediting rate or the dividend rate. "The current dividend rate is generally shown in the in-force illustrations, although you may have to ask the agent what you're being shown," says Fechtel. "The assumed rate of return is shown on most universal life illustrations, and a lot of whole life shows it

now."

The Illustration Analyzer gobbles up this information and spits out a present value cost of the policy. Fechtel readily admits that this information is subject to fairly severe limitations if you're using information from a policy illustration, which is made up of a lot of hypotheticals, including, prominently, the assumed rate of return. But even this limited information allows him to probe the underlying costs. In an article also posted on Fechtel's web site (look on the left side for "Policy Disclosure - press release" under the headline "Current Popular Articles"), you'll find a side-by-side comparison of a variety of different policy types offered by a variety of well-known insurance companies: Allstate, AXA/Equitable, Guardian, John Hancock, Mass Mutual, MetLife, NY Life, Northwestern Mutual, Pacific Life, Penn Mutual, Prudential, SunLife and TIAA-CREF. He compares their total cost (premium minus the money that goes into the investment account) in years one, five, ten and 20 with a generic 20-year level-premium term policy for a 40-year-old male in the best health class.

The results, based purely on the policy illustrations, shows costs in year one ranging from eight times the term cost to seventeen times; from a little more than three times the cost in year five to more than seven times. The lowest-cost cash value coverage, as you might expect, is offered by TIAA-CREF's no-commission policy, but even there--again, using the company's

own policy illustrations--the yearly price is comparable with term until the later years, when it balloons to nearly twice the term policy's cost in year 20.

Breaking out the numbers year-by-year for one Prudential universal life policy (Table 4 in the article) and a New York Life whole life policy (Table 5) shows something interesting. In spreadsheet format, you see the policyholder's age (increasing from age 40 each year) and death benefit (\$100,000 every year down the next vertical column), the cash surrender value each year. You also see the year-by-year at-risk amount--the death benefit of the term policy hidden inside the contract (\$100,000) minus the cash surrender value that fluctuates each year as new money comes in from the next premium and the investment markets bounce around. Whenever the policyholder dies with a contract in force, the insurance company pockets the cash surrender value and pays out the death benefit, so the ever-fluctuating difference between the two is the amount that is actually being insured in a given year.

What's interesting about that? When you know the at-risk amount, and you know the cost, you can calculate how much the insurance company is planning to charge you per thousand dollars of coverage, year-by-year. In the first couple of years of the illustration, this cost is pretty high--seven to fourteen times as high as a term policy, almost certainly due to the front-end commissions paid

to the agent. After those first two years, the costs drop to something pretty close to term rates, and then, gradually, they begin to creep back up. By the time the policyholder in the Northwestern Mutual contract has reached age 59, the cost of insurance--again, calculated from the policy illustration itself--has reached three times the cost that had been imposed in years 7-14 of the policy. By age 59, the policyholder in the NY Life whole life policy is paying even more: seven times the cost of earlier years.

"This," says Fechtel, "belies what sales agents will often tell their customers: that a whole life product avoids the increasing costs of term insurance. You can plainly see the costs going up in the later years, and if you ran the illustration out for more years, you would see it there as well."

All we've done so far is take a peek at the mechanics of the contract, based on the numbers that the life insurance company has projected in its sales illustration. "The question the consumer needs to ask next is: Why are you showing me an illustration run at 6.14%?" says Fechtel. "Is that realistic? What has your company done over the last 20 years?"

So step two in the analysis is to collect the actual performance of different policies--real-world information which Fechtel says has not been available to the public in the past. In fact, it may not be easy to get even if you're an owner of a policy. "When they report that cash value grew by \$3,000 on a whole life product," says Fechtel,

"you have to know to go back and ask, well, how did that happen? They might say, the net from your premium after the expenses was \$1,500, and the investment return you had on the account was another \$1,500. Only then could you go in and calculate the rate of return for that year."

The annual report on a universal life policy might make this figure easier to decipher. Fechtel says that you'll often get a month-by-month summary of expenses and sum of interested credited, which can be transposed straight to the investment earnings field in the Analyzer on Fechtel's web site.

Fechtel has collected some data on how well different insurance company accounts have performed over various periods of time, some of which is shared in the article I referenced earlier (see Tables 2 and 3, plus Table 13 for a Penn Mutual policy), but what I found interesting is not the dramatic differences, but the fact that most insurance companies are getting mostly market rates (UL products get bond market rates, whole life policies get conservative portfolio returns, VA accounts capture whatever market gyrations the underlying asset class is experiencing) minus fairly significant annual expenses which are not disclosed. Think: investing in mutual funds with 2% (or more) annual expense ratios, and you can get a sense of the expected crediting rates. A better analogy might be a closet index fund with a hedge fund's expense structure.

Step three is understanding

how much the policyholder is paying for the privilege of being sold the policy. Fechtel is a big advocate of blended contracts, which basically dial down the front-end commission without changing the essential nature of the policy. More typically, an agent will show the customer something like the Northwestern Mutual 90 Life policy, issued 20 years ago (Fechtel is a former Northwestern Mutual agent), which is deconstructed in Table 2 and Table 3 of the aforementioned article. Of the \$5,815 initial premium, \$3,722 is paid to the insurance agent, another \$930 is paid out as other sales field management costs, and an additional \$466 is taken out to cover administrative and operating costs.

The agent receives \$696 out of the premium in each of the following two years, then \$464 a year for the next three, decreasing to \$232 over the next four years and \$116 a year thereafter. Field force fees drop to \$145 a year for years two through eight, although it's not easy to see why the policy should support sales activities which have already successfully netted this particular policyholder. But you can see the policy becoming more profitable for the insurance company; the cost per thousand dollars of coverage gradually rises from about year 12, more than doubling by the policy's 20th year.

What the consumer didn't know is that the agent could just as easily have sold a virtually identical product with significantly fewer sales costs. Later, in Table

Continued on page 10

Fixing the Monolith

Continued from page 9

10 of the same article, Fechtel shows two different Northwestern Mutual products; one of them blended, the other traditional. Both have a \$17,750 annual premium for a 40-year-old male in best health. The traditional product has first year (primarily sales) costs of \$16,500 (!). The blended product assesses just \$3,000 for exactly the same sales effort.

These sales load figures are not calculated according to any formula or extracted by reverse engineering the contract numbers; they are the result of Fechtel's own experience, and he says that, as a former agent, he knows those numbers down to the penny. And he says that while the market is highly inefficient to life insurance consumers, it is still remarkably efficient with agents. "The compensation structures of the traditional companies are all very similar, aside from little tweaks here and there," he says. What you see here is probably pretty close to the commissions you're paying elsewhere.

There are three reasons to know all of this--and Fechtel is a resource in all three areas. First: when your best client plays golf with an insurance agent who tells terrific jokes, and brings back a policy illustration, you have a way to analyze what is actually being offered. The chances are overwhelming that even if you stick with the same agent, there are far less costly (blended) versions of the same coverage that he won't show his new golfing buddy

without some ungentle prodding.

Second, if you have clients who already bought a cash value policy from that agent, Fechtel (and his web site) can help you figure out what the client has and maybe make some decisions on what can be done about it.

This can be especially interesting information if your clients happen to own cash value policies that are in danger of blowing up--that is, one of those allegedly paid-up policies where the investment account has quietly diminished to the point where it is no longer large enough to cover the cost of insurance out of investment returns. The money starts coming out of the account, depleting it, causing it to generate less investment returns, which means the next premium depletes it even more in a spiral not unlike the dynamic you see whenever you flush the toilet. The client could be surprised at, say, age 87 with enormous and unexpected premiums, every year, in order to keep the allegedly paid-up policy paid-up.

This happens more often with some companies than others. On Fechtel's web site, you find an article on Penn Mutual's older life insurance policies. "I'm not a replacement artist," he says, "but when you see that Penn Mutual is presently crediting five percent, and has mortality costs three times what some other carriers have on a 65-year-old, there may be very good reasons to switch your cash value from Penn Mutual to another carrier."

Third, and perhaps most

importantly, Fechtel believes that the more people who understand what cash value insurance is (a term policy with undisclosed costs attached to an investment account with undisclosed costs and poorly-disclosed performance), and the more people learn how to identify and compare costs and performance, the closer the insurance industry will come to a true capitalist model, where consumers know what they're buying before they make that first premium payment. He's trying to give people the disclosure that the insurance industry is resisting.

Yes, this up-front information on cash value policies may be immaterial for most financial planning clients. Fechtel says that a term policy is usually the best option for protecting against the death of a breadwinner. But he says that for some clients, the tax advantages of a cash value policy could be interesting--and here, a better understanding of the products, and good data on pricing, could be an advantage.

Fechtel is licensed with a variety of companies, and although he no longer works with Northwestern Mutual, he sometimes recommends that his clients buy blended policies from them--at greatly reduced commissions. He prefers to work for fees rather than commissions. "I think ultimately, this has to be a fee business," he says. "When somebody retains me, I get paid a retainer, and that covers the cost of prodding them occasionally to get them through the process of buying," he adds. "If the commissions come to more

Study Group Succession Planning

Synopsis: *How your study group can help you transition and protect your practice--with more data, or with hands-on assistance.*

Takeaways: *The valuations you've read about for advisory firms may be orders of magnitude too high. Also: If you're hit by a bus, who will watch out for the interests of your heirs and keep your firm alive?*

than the retainer or hourly fee, then the client or advisor can specify the charity they want me to donate the excess to."

After talking with him and playing around with his web site, I think Fechtel could be a terrific resource for independent advisors, especially if you're scratching your head about a policy your client already owns, or looking for a permanent life insurance solution in case the estate tax reappears in its old draconian form.

We can also help Fechtel do what seemed impossible a few weeks ago: fix the life insurance business--or at least set the fixing process in motion. How? By spreading the word about his analyses--and telling your press contacts about his web site.

I have to confess that I think it might take more than a few weeks to reform the monolithic life insurance industry. But I do believe that most consumers would be appropriately horrified if they ever truly understood the difference in costs between different versions of the same product. And (who knows?) insurance executives might respond to that horrified reaction, especially if it spreads and gets significant publicity.

"If we can ever get to real openness," Fechtel says, "the life insurance industry would enter a golden age. This should be a product that people feel good about owning, the only product in the insurance world where there are no claims hassles. We have a terrible sales problem, but that," he says, "can be fixed with better disclosure." ■

This may be a trend; it may not. But suddenly I've been hearing about study groups around the country who are exploring how they can become a resource to help their members deal with succession planning issues. If you're a member of a study group, this article might give you some ideas. If you're not, it might offer you and like-minded professionals an incentive to create one.

Let's start with the 20/20 Group, which currently includes ten members who are all pretty high-profile in the financial planning community. "We meet twice a year, and each meeting is organized around a theme, mostly having to do with human capital, leadership, team building, that sort of thing," says Roy Ballentine, of Ballentine Partners in Wolfeboro, NH. "I volunteered to take charge of our Fall meeting coming up in September, and we agreed that the theme would be succession

planning."

Why would the owner of a planning firm want to participate in a group discussion on this issue? "Number one: It is a spur to action," says Ballentine. "Succession planning is really important but not always urgent, so you can keep putting it off until it's too late." To get the 20/20 Group members started thinking through their own issues before the meeting, Ballentine sent out a fairly detailed questionnaire for each member of the group to fill out. At subsequent meetings, the members will report on their progress and be held accountable for making some.

Of course, members also should be able to learn from one another's successes and mistakes via the group discussion, and the group as a whole might be able to bring in experts who would be too costly for any one firm to afford.

For this upcoming meeting,

Continued on page 12

Study Group Succession

Continued from page 11

Ballentine has lined up three speakers, including two attorneys with expertise in the valuation of wealth management firms, shareholder agreements and dispute resolution processes. After discussing with them what they're going to say, Ballentine has arrived at some insights which might startle you.

For example?

Your shareholder agreements contain an arbitration clause, right? "I was under the impression that the purpose of that clause was to streamline dispute resolution and minimize legal costs," says Ballentine. "But I've learned that sometimes it can have the opposite effect."

How? "It turns out there are two kinds of arbitration clauses," Ballentine explains. "If you don't specify that you want the speedy low-cost variety of arbitration, or if you are less specific, you could wind up with a process that might be more expensive and more time-consuming than going to court. You have to specify which one you want, and before we talked, I didn't know that."

Even more surprising is what he's learning about the way advisory practices are valued in today's marketplace. "Much of the valuation information that has been put out in various publications has come primarily from the investment banking world," says Ballentine. The difference between their numbers, he says, and the valuation you might get from a specialty consultant can be

orders of magnitude different; the investment banker might give you a figure three or four times as high as the valuation consultant.

The difference comes from variations in assumptions about the future. For instance, the investment banker might assume a high level of revenue growth forever into the future, when in the real world there are inevitable setbacks like the Great Recession and market downturn, or those times when a sudden loss of key staff members forces the firm to go into a temporary holding pattern. "In our case," says Ballentine, "if I believed the projections of an investment banker, we should start looking for office space in some other galaxy."

Another assumption is scalability; if the firm is growing, then it will become more efficient--right? But Ballentine points out that advisory firms tend to go through various awkward stages where they're having to reinvest profits back into staff and systems--and even when they come out the other end of one of these periods, the amount of business leverage you can achieve is limited. In addition, the investment banker may assume no competitive changes, when in fact the planning world seems to require constant adaptation, and there's always the chance that somebody will challenge you for your market niche or position in the community.

"I think the news about firm valuations is going to be a shock to people," says Ballentine. "I now believe that most of what people like me are reading in the press

about the value of our firms is just plain wrong."

This, of course, has huge implications in the planning world. Consider, for example, the next generation advisor who is buying into her boss's firm based on a price that is later determined to be considerably inflated. The incentives are all skewed in one direction; the investment banking firm knows that the founding owner is going to be paying its fee, and it also knows that the founding owner benefits from a higher valuation number. If there is an outside transaction, the investment banking firm will receive a higher fee if the outside buyer pays a higher price. You can search this paragraph for days, and not find a single incentive for the firm owner to seek out a more realistic assessment, or the investment bank to provide one.

After spending time with the experts who will speak to the 20/20 Group, Ballentine has come to believe that most advisors are asking the wrong questions about their own succession planning activities. "Instead of trying to determine what the firm would be worth to a hypothetical outside buyer, I think the right approach is to think first about values," he says. "What's important to you? What do you want your legacy, as the founder of the firm, to look like? If making a lot of money happens to be number one on your values list, then so be it," he adds. "But there might be other things that you feel more strongly about."

Once you've decided what you really care about, then look

at how to execute the transaction that you want. Ballentine says that the usual talk about the theoretical value of the firm--as if there was a liquid marketplace where the firm could be sold like a Treasury bond--can be very unhelpful if you're pursuing an internal transfer.

"I would discard the term "market value" altogether," he says, "and just talk about practicalities. The practical issue is that with an internal succession, the purchase of the interest is going to be done with whatever cash flows the business can generate, plus some portion of the employee's earnings. If that financial equation closes," he continues, "then you can reach agreement. Understand that the value of the firm is limited by the employee's ability to pay for it, and since that ability depends entirely on the firm's profitability and cash flows, everything comes back to that."

If the advisor gets an appraisal figure that is substantially more than the successor can pay, all sides are stuck. "You can resolve the internal succession dilemma by rephrasing the question," says Ballentine. "Instead of asking, what is the theoretical maximum market value of the company, ask instead: given that from a value perspective, and client service perspective and so forth, that we have decided that the best thing to do is sell to employees, what valuation will THAT kind of transaction support?"

Practice/heir protection

The SAGE study group in

the San Francisco Bay area is also looking at succession planning issues, but from a completely different perspective. Here, the members are talking about how they could help the family of a deceased or incapacitated study group member negotiate the transition of his or her firm.

How does this work? "Let's imagine that I suddenly die," says Peggy Cabaniss, of HC Financial Advisors in Lafayette, CA. "My family would be upset, and probably would not have any idea how to proceed with keeping my business running, getting it immediately ready for sale or transition. Our group's plan," she says, "would be that my family would know to immediately contact members in my study group. Three people would be assigned to help my family, and there would be instructions from me, written before my death, as to what my priorities are, ideas for a sale/transition, names and phone numbers of important advisors to contact, etc. The study group members would assist my family in quickly taking over my business and implementing a transition plan. One of our primary goals would be to preserve the business and client base instead of having the clients scatter to the winds."

Randy Manley, at Lodestar Private Asset Management in Alamo, CA, has become the group leader in this project, and he thinks that this may actually be a logical extension of the study group concept. "If the study group has become successful," he says, "then you arrive at a good sense of respect

for the members. It becomes more likely that you'll look to each other for help in difficult times--like disability and death."

In his case, Lodestar was forced to be unusually proactive about succession planning issues when one of the three principals decided to move out of state. "That left two of us, Scott Miller and myself, and one of the first things we did," says Manley, "is decide what our succession structure would look like." They worked with David Goad, perhaps the leading consultant in the succession planning space, and created a buyout arrangement with workable formulas that would value the business interests.

"The problem," Manley continues, "is that with a small firm, you're not sure if it is all going to go the way you'd like it to in the event of death or disability. If I get hit by a bus, I would like somebody to step in and help my heirs determine if everything is being handled the way it's supposed to. For instance, are the clients going to stay with us? A lot of the value of the business is going to depend on how well a lot of things are handled."

Notice that this is NOT a succession plan; the members of the study group are not forming a single business entity or selling to each other. In fact, before they can use the study group as a resource for their family and the survival of their firm, each member is required to put their own a succession plan in place. "None of us want to step into a situation where the study group members are responsible

Continued on page 14

Study Group Succession

Continued from page 13

for managing somebody else's firm directly," says Manley. "We want there to already be a plan created and implemented, so we could step in in an advisory role."

In the case of Lodestar, if Manley is hit by a bus tomorrow, his partner would be required to orchestrate a buyback of his shares--facilitated by a life insurance policy. Losing one of the principal client-facing advisors would leave a significant void; some already-identified members of the staff would know that they have to take on a senior planner role with clients. "I would look for the SAGE members to step in and help my daughters decide whether or not all of the various provisions are being implemented properly," Manley explains. "Is Scott doing all the right things to retain the clients? Are the heirs and the clients both being treated fairly?"

Notice that these can be competing interests; the heirs might want to maximize the value of the firm or liquidate it, while Manley's partner wants to hang onto cash flow during a very rough transition period. Also note that there is an imbalance of power once one of the principals dies; the heirs are almost certainly not going to be familiar with the client accounts, the books, records and revenues, the stability of certain client relationships, the best way to maximize the value of the firm and handle the transition. "I would look for the SAGE group to help make these decisions," says Manley. "And I have told my daughters to listen to them

very seriously. It will ultimately be my daughters' decision, but the input from these people is very important, and it will be hard for them to have that level of judgment on their own."

How many SAGE members will be involved in this process? Each member of the study group has a minimum of three persons assigned to him/her, although the entire group might get involved in any given situation. The plan calls for hourly compensation for the work involved.

Defining these roles would be easier if all of the members of SAGE had identical firms, but in fact the group seems to have an unusual amount of diversity. One member is a partner with a larger multi-partner firm; at the other end of the spectrum, another member is currently trying to identify/hire/groom a successor for a solo-principal company. Two members have broker-dealer relationships.

Is there any talk of merging all the members into a consolidated firm? Not at this point, though Manley says there have been discussions about sharing compliance responsibilities. "The thing is," he says, "all of us really like our independence."

As I said at the beginning, I don't know if SAGE and 20-20 are part of a larger trend, but I do know that succession planning has moved much higher on everybody's priority list these last few years. It makes sense to talk over this very complicated issue with peers you respect, and to pool resources so you can get the benefit of outside

expertise--at a fraction of the cost for any one firm. It also makes sense that advisors would turn to their study group peers--the people they know best and trust the most--to step up on their behalf in an emergency.

Until I talked with Manley, it hadn't occurred to me that an advisor's heirs are not really in a position of strength regarding their inherited share of the company, or that they would need somebody to protect their interests. Until I talked with Ballentine, I had no idea that younger advisors might be purchasing shares of their companies at inflated multiples, or that the incentives in the succession planning universe are all in favor of choosing the assumptions that will result in high valuations.

I've heard rumors that other study groups are in the very early stages of exploring the possibility of merging, transforming themselves from a group that meets two or three times a year into a multi-office firm. Anybody who has ever participated in a study group will have already, as a normal part of your meetings, done some of the qualitative due diligence on each other. It puts you in a better position to address the most difficult compatibility and personal values issues that make it so hard for advisors to join with others.

I suspect you'll see more study groups popping up, and more of them finding ways to help their members address a variety of issues around succession planning. With luck, this article will help them move a step further in that direction. ■

MANY BIRDS, ONE STONE

I think most of us realize that there are a lot of things wrong with the intersection between investors and our financial markets, and the problems are costing our society a lot of money. Consumers are never taught personal finance in grade school, high school or college, and therefore often enter the work world with only a hazy idea of what a stock or bond is--and sometimes limited understanding of a home mortgage and how to set up a checkbook. Tragically few get into good savings and investment habits early in life, and the large financial institutions have a stranglehold on our political and regulatory system, allowing them to siphon money out of retirement portfolios through hidden fees, self-serving advice and sometimes abusive sales practices.

The cost? Studies show that a majority of Americans have not saved enough for retirement, which will eventually place a considerable burden on our government social services systems. Our low savings rate puts the U.S. economy at a disadvantage when it comes to capital formation for commerce and industry, and the recent mortgage meltdown tells us that millions of people thought that taking out a mortgage with a two-year teaser rate and astronomically high rates thereafter was a great idea--one contributor to nearly bankrupting our financial system. When our legislators in Congress tried to create a consumer protection bill, the result was lobbied into virtual irrelevance--which means we'll probably get more scandals and financial fiascos to clean up.

Beyond all that, the low financial literacy rate is painfully visible in the way that the government and Congress are able to avoid serious debate about how to balance our federal and state fiscal budgets.

Until recently, I had heard no serious proposal that would address all of these issues--much less in a way that was likely to get results. But after talking with Harry Scheyer, of Pinnacle Financial Advisors in Marlton, NJ, I'm beginning to think that the solution is actually not very complicated.

His proposal is to create a National Institute of Wealth, modeled on the National Institutes of Health. Yes, that plural was not a typo; the NIH now consists of 27 separate institutes and offices, which conduct research into diseases and disabilities, collect medical science information into a centralized library and even develops the core of a computational infrastructure for biomedical computing in the U.S.

The NIH's mission is to promote better health, educate the public on health issues so that they better understand how to foster their own wellness, research better ways to treat disorders, and provide quality assurance in the

healthcare field. Scheyer's point is that all of these missions could be applied to the world of personal finance, portfolio management design and investments.

The NIW, as he envisions it, would be an independent agency that would study our personal spending and wealth creation processes and decisions. It would conduct research into the best financial wellness habits, and promote them publicly, and give advice to Congress on the best legal/tax structures to bring about more savings, investment and retirement self-sufficiency. It would create high school personal finance and financial literacy curricula. Different divisions might study the science of portfolio design, and recommend new investment products that would simplify portfolio management for consumers.

As he describes this new government/public policy agency, Scheyer takes a firmly conservative approach; you shouldn't create more government until you know how you're going to pay for it--which sounds a lot like what the policy wonks at his NIW would tell Congress at every opportunity. He says that the organization should be fiscally justified so that every dollar spent on it would have the effect of raising the country's savings rate, reducing poverty and increasing mental health, not saving the taxpayers dollar-for-dollar, but generating fiscal benefits to the country visibly in excess of the NIW's costs.

As a side benefit, the NIW's voice might offset the self-serving lobbyists who raise unlimited funds from the brokerage industry. "Our current well-meaning consumer

Parting Thoughts

Continued from page 15

advocates and professional planning associations are no match for those special interests," he says, "and may never be an effective counterbalance."

The more I hear about this idea, the more I think about it, the more sense it makes. It parallels a program that has, by most accounts, been extremely successful in the medical

world, so we have a working model already. Just like the medical world, the financial world sees a lot of social costs arise from unhealthy lifestyles, ignorance and poor advice--and I think most of us can agree that the social costs are no longer affordable in this day and time.

Where do we start? I would consider talking this over at chapter meetings and industry conferences, try the idea on for size, and then let

our associations know if we think this is something worth spending a little political capital on. It positions the planning profession as an unbiased advocate for better financial health in the U.S., which is not a bad way to be seen whenever the subject inevitably gets back to the things that affect the profession directly. I think the NIW may be the best idea I've heard this year.

What do you think? ■