INVESTMENTS & WEALTH MONITOR

A reprinted article from May/June 2018

FUTURE ADVICE

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By Paul Schaeffer and Steven Unzicker

INVESTMENTS & WEALTH INSTITUTE®
formerly IMCA

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Some Californians swear that you can tell when an earthquake is about to strike. Temblors, they say, are foreshadowed by certain atmospheric conditions. That hazy air and eerie calm you feel before the earth lurches under your feet? That's "earthquake weather."

Earthquake weather falls into the category of pseudoscientific hokum, but it is easy to see how someone in the financial advisory industry might describe the current business climate as similarly calm before a shake-up. You may ask, how is that even possible when advisors are largely confident and clients are mostly satisfied? Indeed, the sector is healthy, exhibiting solid growth and enviable margins. It is in many ways a calm and benign environment.

As long-time industry consultants, we've made our living sensing upcoming disruptions and helping our clients either get out of the way or capitalize on changing circumstances. Make no mistake: There is a very real series of shocks about to rock the industry, as surely as the earth will shake beneath those who live on the west coast of North America (whether or not they believe in earthquake weather).

A TASTE OF THINGS TO COME

Financial advisors have had the wind at their backs for quite some time now. Market growth has propelled assets upward since the 1980s. Many advisors also rode the demographic wave, cultivating relationships with baby boomers as they accumulated wealth and needed help managing it. The flood of Employee Retirement Income Security Act of 1974 assets hasn't hurt either.

There have been some bumps along the way. The collapse of the dot-com bubble, the financial crisis less than a decade later, and a spate of scandals spurred a variety of changes. These included greater focus on risk management, a proliferation of alternative investment products, and tighter regulations for everyone. Some of the forces that will shape the industry in coming years are continuations of trends rooted in these earlier events, such as the following:

Transparency. Transparency has been a growing theme in the retail investment business since performance and risk data started becoming widely available in the 1990s. The transparency trend accelerated with each jolt to the system, and savvy investors now expect reasonably easy access to all kinds of information. It is virtually impossible to envision a scenario where the industry reverts to being more opaque. In fact, expectations are more likely to rise further, with investors looking for real-time access via mobile apps that give them intuitive and unparalleled insight to their portfolios and portfolio advisors. Advisors of all types will need to cater to this demand if they wish to stay competitive.

Cost sensitivity. Cost sensitivity is nothing new, but it also shows no sign of abating. A growing number of investors are coming to understand the full impact of fees on the value of their portfolios, but their reaction is generally more nuanced than a simple demand for lower fees. That approach has been working in recent years for large institutional investors, but it is less likely to be effective for retail investors. Their main option has been to vote with their browsers or apps, moving their assets to more automated forms of advice (more on that below). Such moves have been limited among most investors with any significant assets, underscoring the fact that they are less interested in low costs per se and more keen on getting good value for their money.

Asset allocation over security selection. The stress on value has reinforced the growing emphasis on asset allocation over security selection as the cornerstone of effective financial planning. This, in turn, has been one of the driving forces behind the mass migration to fee-based advice. Whatever the reality, the perception of non-fiduciary brokers is generally growing less favorable and they are headed toward extinction. New rules may even be irrelevant, because the industry has largely shifted to a fiduciary approach anyway.

Exchange-traded funds (ETFs). Any talk of asset allocation would not be complete without the mention of ETFs. Record asset flows to ETFs in 2017 highlight the popularity of these products and the central role they play in the financial lives of investors ranging from the largest institutions to individuals of modest means. All major and minor asset classes are already accessible with ETFs, and a growing array of factor-based and actively managed strategies now offer the potential for even more customization. There really is no excuse for cookie-cutter client strategies anymore.

Solutions, not products. Some advisors have been reluctant to use ETFs because they fear ETFs make it harder to justify an advisor's existence. Such fears are largely unfounded, because investors appreciate lower underlying costs but ultimately want solutions, not products. The value lies in the consultative process, effective planning, and dependable execution. If anything, the simplicity of ETFs allows for a better advice delivery process. (Advisors who can't figure out how to leverage one of the most useful investment vehicles ever devised may need to reconsider their career choice.) This is not to say that advisors should limit their offerings to a semi-automated allocation among inexpensive building blocks. Advisors have the potential to add value in other ways. Social investing, for example, continues to become more important, and it is increasingly easy to apply customized screens. Previously inaccessible asset classes such as private equity also are viable tools for more advisors, for whom the effective application of relatively illiquid strategies with scant information available might prove to be a key differentiator. More holistic financial planning also seems to be making a comeback. As asset management becomes more commoditized, the best advisors may engage increasingly with their clients on financial decisions such as whether they should lease or buy a car. This shift could in turn spark a move away from asset-based pricing to a different model. Unbundled pricing seems unlikely, but some advisors may move to retainers, consulting fees, or variable pricing based on advice being delivered as it is needed.

Individualized risk management. Individualized portfolio construction is all fine and well, but it isn't much use without individualized risk management. Until very recently, the vast majority of retail investors only had access to risk management as part of a larger pool of risk (aka other people superficially like them). Resource intensiveness and high costs meant individualized risk analysis was available only to large institutions and wealthy investors. Technological advances now make it accessible to a much wider array of investors. In truth, much of it is really mass customized advice (something we've been talking about since the mid-1990s) with such a huge number of choices that it effectively produces the same result as a bespoke portfolio. More precise management of portfolio risk is the major benefit to both investors and their advisors, who have a growing number of ways to locate and invest in non-correlated strategies as well as to hedge certain positions and even implement versions of liability matching for their retail clients. Given the many tools and partners at their disposal, advisors also have the opportunity to be more thoughtful about overall operational risk and to lock down specific risks such as cybersecurity.

TECHNOLOGY: STALEMATE OR SALVATION?

None of this would be possible without technology's relentless march forward. Advances have been remarkable, but they have come at a cost. One industry study reported, "Technology and ops spending continues to rise inexorably as new priorities like cybersecurity join older initiatives like disaster recovery."[1] There may not be consensus on whether specific initiatives are transformational or dead ends. But most would agree that the promise and potential of technology is vast, and smart advisors will at least take the time to carefully consider their options.

We are currently tracking the following six areas of rapid innovation that are likely to have profound implications for financial advisors.

Big data. One of the reasons big data has been such a buzz word over the past few years is because it captures the imagination. The scale of data being produced daily is almost incomprehensible (2.5 quintillion bytes!). But so much of it is cast aside and neglected. So much value wasted—if only it could be tapped. Big organizations such as Google lead the way, but tools inevitably will become available to smaller businesses, including advisory firms. There is an almost infinite array of potential applications for financial advisors, who sit at the nexus of vast data pools from external as well as internal sources. Drawing insights from market movements, investor behavior, government filings, demographic information, and other datasets could provide advisors with a serious competitive edge. Decision-making would improve, market efforts would be more successful, and employees would be more content. Meanwhile, clean data remains a major challenge, as does the legacy software that so often is called upon to generate data in ways for which it may have never been designed.

Artificial intelligence (AI). Rapid strides and more applications are found for AI every day. IBM's AI platform called Watson is kept busy as a medical diagnostician. Even self-driving cars are suddenly close to being a reality. Can self-driving portfolios be far behind? Portfolio management (particularly among hedge funds) so far has been the primary area of application and experimentation for cognitive computing in the investment world. As this approach inevitably migrates downstream into retail investments, advisors will need to understand and be able to articulate its proper use. Furthermore, cognitive computing could be used to improve client communications, make operations more efficient, and manage risk more effectively. A key question will be whether the machines should support the people or the other way around.

Distributed capabilities. Typifying what is colloquially known as the "gig economy," a growing number of companies rely on nonproprietary resources to function, undercutting traditionally structured organizations in the process. The move from proprietary funds to open architecture in the money management industry is actually an early example of this disaggregating of the value chain. We've now moved far beyond that to a point where a manager or advisor theoretically could contract with an outside party to run every aspect of a business, including portfolio management. In the future we expect to see even more turnkey solutions for advisors that do everything from publishing expertise to launching products. Most advisors are looking for ways to leverage technology, but not all of them take stock of the human capital that suddenly has become available to them. Instead of trying to locate and recruit people with rare skill sets in the suburbs of the local metropolis, they can tap into a worldwide talent pool.

Democratization of media. Technology has transformed how businesses communicate with—and learn from—their customers. The communication revolution may not have been televised, but it has certainly been tweeted. Social media has played a starring role, but it has yet to be embraced wholeheartedly by many in the financial services business. Those that move on despite compliance challenges and resource intensiveness find a different way of doing business. Traditional marketing approaches are upended and brand building is replaced by conversations. The guesswork is taken out of client experiences, which now can be fine-tuned based on customer feedback. Clients can even be roped into crowdsourcing initiatives, voting for new ideas or features. Collaboration is possible in ways that were unthinkable a short time ago. The irony is that although everybody now owns their own channel, nobody is fully in charge of telling their own story. You'd better place yourself in a position to help shape the narrative, or it could have an ending you never imagined.

Mobile interfaces. Mobile computing is so ubiquitous that it can be difficult to conjure up that magical time when people didn't walk around with their faces in their phones. Is the iPhone really only 10 years old? Smartphone use can be annoying, but it is also incredibly powerful. Now that most people are comfortable with the idea of financial apps, watch as these apps flourish and evolve before our eyes. There is no reason to think that users will be limited by the presence of a small glass rectangle in their hands. People are increasingly interacting with smart homes, smart appliances, smart cars, and personal assistants that live in stylishly designed speakers. Mobility and voice recognition increasingly will be joined by augmented reality environments featuring interactive data and graphics. Gimmicky? Maybe. But possibly a game changer as well.

One key outcome is likely to be a wider array of investment strategies available to advisors, with exchange platforms providing greater access to asset classes ranging from alternative lending to private equity.

Platformization. Online platforms are disrupting supply chains in many industries, empowering consumers with unprecedented levels of transparency and feedback. Platforms already have played a major role in the financial advisory world for decades, but the role of platforms will continue to evolve and their impact will continue to grow. We may even come to see the advisor landscape dominated by a small number of mega platforms. One key outcome is likely to be a wider array of investment strategies available to advisors, with exchange platforms providing greater access to asset classes ranging from alternative lending to private equity. Advisor platforms themselves may be a mixed blessing, enriching advisors with tools and expertise, but also exposing advisors to more comparison shopping and unsolicited public feedback. Most importantly, platformization lowers the barriers to entry and simultaneously raises standards. This means advisors need to prepare themselves for new market entrants with the potential to disrupt the status quo.

THE ROBOTS ARE COMING

All these trends are helping drive frenetic activity in the fintech sector, which includes alternative lenders, crowdfunding sites, insurers, cryptocurrencies, digital banks, and payment firms. In the advisory world, it is the rise of robo-advisors that caught everyone's attention, thanks in part to their catchy moniker.

It is easy to forget that until very recently most people's experience with robots consisted of either watching a vacuum cleaner chase dust bunnies or cursing at automated answering systems. But people are adjusting quickly and becoming increasingly comfortable interacting with machines as bots get smarter, better, and faster. Even if we assume that the wealthiest investors continue to retain human advisors, at least some investors will think of advisors the way they think of bank tellers or travel agents, i.e., people they seldom if at all do business with. This doesn't mean that advisors will necessarily disappear. Their roles will simply change.

We may even move quickly from robo-advice to virtual advisors. Digital assistants such as Alexa and Siri have been one of the hottest technology trends in recent years. They are still far from perfect, but there is no denying that many people increasingly are at ease interacting with them. They also are steadily becoming more useful. They already can assist with account balances and transaction histories. How big a leap is it to having a digital assistant keep an eye on your portfolio? We're on the cusp of letting cars make life or death decisions for us, so it doesn't seem like such a stretch. This behavior would have significant implications for asset managers and financial advisors behind the scenes.

At a minimum, running a technology-enhanced practice should mean considerable changes to time management. It may mean advisors actually are able to meet with clients or prospects more often than they were able to in the past. We expect to see success stories among all permutations along the human-to-computer continuum. Fully automated models will meet the needs of some investors, but others will insist on regular and meaningful interactions with another human being, even if that human is being guided by algorithms behind the scenes.

A.C.T.

Because there always will be a role for at least some advisors who do things the "old school" way, this is an easy business in which to get complacent. Advisors resist change at their peril. Some inevitably will see the market move right by them. For those who plan on being more proactive in order to be relevant and competitive, here are three themes to keep in mind:

Automate. You don't have to be a robo to embrace efficiency. Process automation is a powerful tool that is much more accessible than it used to be. Simplify your workflow, sideline distractions, and differentiate your practice in more meaningful ways.

Customize. Give your clients what they want, when they want it. Your services are increasingly fungible, so don't get too used to your clients being loyal. Use every tool at your disposal to differentiate your services from competitors offering more mundane choices.

Transform. Machines can't offer that emotional connection that is so important to relationships. But they can be used to fundamentally change the way you do business. Use them to your advantage, and you can devote extra time and resources to crafting a great client experience and attracting new assets.

FAKE NEWS OR REAL CHANGE?

Prescribing change is easy. Implementing change is hard. It is even harder when so many variables are involved.

Service levels, for example, always have corresponded to wealth. New technologies have the potential to dramatically lower the cost of some services, meaning lower-end investors suddenly may develop higher expectations and advisors servicing the top end of the market will need to work harder to differentiate their services. Advisors planning on geographic expansion also may find that attitudes toward brands, relationships, and banks can differ significantly from place to place. Variations also can be found across generational cohorts, particularly when it comes to the affinity for technology.

It is also possible that entirely unexpected developments could shift investor behavior in unforeseen ways and force advisors to respond. A tech giant such as Google, Amazon, or Alibaba deciding to enter the fray as either a direct competitor or industry platform would send shockwaves through the business.

Furthermore, we find ourselves in an unusual and uncertain political environment that has the potential to quickly change the business climate in unexpected ways. It isn't hard to imagine the fake news phenomenon becoming more entrenched and problematic than we would like to think is possible. Growing distrust of all information could have drastic consequences for investors and advisors alike.

Ironically, those with the fewest assets may be the ones to lead the way forward. Millennials may not be wealthy yet, but the sheer size of their generation makes them an attractive target. They are also style and culture leaders, giving them outsized roles in a marketing environment dominated by so-called influencers. Millennials are already the most surveyed generation in history, and their attitudes and preferences are well-documented. They are famously skeptical of marketing and demand authenticity. We know, in other words, what they want. The quid pro quo, of course, is that they get to complain if they don't get what they want.

As anyone who has lived near a fault line can tell you, there's no point in worrying about earthquakes. The more sensible approach is to plan and prepare. So automate, customize, and transform your advisory business to meet the needs of people born in the 1980s and 90s. They are likely to be some of your most demanding clients, and any changes based on their preferences are likely to serve you well into the future. Older clients who are your current bread and butter won't mind, as long as their experience improves as well.

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ENDNOTE

1. AUG, the Exchange. Survey of the Asset Management Industry: Operations and Compensation Metrics and Best Practices (June 2017), http://augtheexchange.org/?page=OpsCompSurvey.

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