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Letter from the President

Restructuring, Regulatory Reform and Retiring Boomers: the 3 R's of U.S. Wealth Management in the Post-Crisis Period

Observations from the SIFMA Private Client Conference April 7-8, New York City

by Ian C.W. Russell

Overview: The Impact of the 2008 Financial Crisis on the Industry

How to recover from the legacy of the 2008 financial crisis? That is what most of the sessions at the SIFMA Private Client Conference focused on. Specifically, discussion revolved around:

- Restoring the trust and confidence of investors damaged by the understated risks of derivative securities, and misleading assertions of market and institutional stability that unraveled into a virtual meltdown averted only by massive taxpayer support.
- Responding to comprehensive and aggressive regulatory reform initiatives launched by Congress and securities regulators in reaction to the financial crisis and its aftermath.
- Managing changes in the retail wealth management business that began before the crisis and accelerated soon thereafter.

The institutional acquisitions and amalgamations during the crisis triggered an exodus of many broker-dealers from the wire-house firms such as Merrill Lynch, Morgan Stanley, Wachovia, et al, to independent small firms with broker-dealer and RIA registration. This shift was propelled by cultural clashes, as the large retail houses were driven together, as well as greater receptivity by clients – jaundiced by the risks associated with large financial groups – to smaller franchises.

From the conference sessions, a consensus emerged that the key objectives of the wealth management industry are to meet the increasingly complex savings-investment needs of clients, and to deliver advice, strategic planning, and an expanding array of financial products and services cost-effectively. Effective communication underpinned in many cases by a written plan supplemented with ongoing dialogue is identified as a necessary condition to deliver investment products and services tailored to the financial objectives of the client. Based on referenced surveys, the baby-boom generation, both those in pre-retirement and retirement mode, place priority on planning, asset preservation and low-risk investing to meet their investment goals, recognized as a challenge in today's near-zero interest rate environment.

Firms have adapted new technologies that facilitate on-line access to account balances and investment information and meet the product and service demands of an aging clientele as baby boomers transition from asset accumulation to distribution. For example, the industry is investing in tools to promote productive inter-active client discussions. These tools are designed to work from the client back to the advisor, by assisting the client to identify life goals and objectives and frame a financial plan to achieve investment objectives given income, wealth and lifestyle needs.

Survey results indicate the top five considerations for retirement-bound baby boomers in the United States are the value of their investments, their health, the cost of health care, inflation and the value of their pensions. This is not surprising when pre-retirees cite retirement accounts and non-retirement portfolios as their foremost concerns, followed by pension plans and lastly social security. Indeed, investors typically discount social security as a factor in pension make-up. For current retirees, company pension funds and social security are at the top of the list. The corollary is that as Canada moves to more privatized health care, the retirement savings process will be significantly impacted.

Financial Planning in a Near-Zero Rate Environment

It is recognized that a key to retirement is customized financial planning – a written plan tied to life goals, coupled with ongoing monitoring of portfolio results against objectives. The building of a credible financial plan in a near-zero interest rate environment is a challenging task. Three important aspects of a retirement strategy were identified:

a) Strategies to enhance diversification across asset classes, including commodities and emerging markets. It was noted the strategy was dual-focused between the appropriate asset category and appropriate packaging of asset classes among ETFs, limited partnerships, closed-end mutual funds, unit investment trusts, discretionary accounts, etc. to achieve cost-effective delivery of product diversification.

b) Re-orientation of fixed-income portfolios from U.S. Treasuries into a range of fixed-income products, including corporate high-yield bonds, emerging market bonds, municipal

bonds and interest rate spread products. The consensus placed more emphasis on absolute returns than indexed returns. While panelists recognized the difficult fiscal circumstances of most states and the related market risks, the general consensus is that a portfolio of municipal bonds should form the core of a retirement portfolio, but the bonds should be managed professionally.
c) Taking a holistic approach to financial planning -- including an offering of ancillary services such as banking, estate planning and trust services.

Bolstering Advisor Productivity

The second overriding objective of the wealth management industry is to enhance advisor productivity by delivering products and services cost-effectively. Approaches to boost productivity include:

1. Practice management that effectively segments advisors across different client groups measured in terms of wealth and sophistication. These segmented advisor groups offer different suites of programs and products geared to each client category in terms of service, customization and cost. While this process is not new, it is recognized as more complex given the wider array of products and services available to pre-retiree and retiree investors. Practice management also defines the advisory structure -- the vast majority of advisors are in teams, the responsibilities of these teams and the outside specializations needed and where sourced (insurance, estate planning, etc.).

2. Enhanced technology, particularly applications related to on-line accounts, access to information and products, and back-office services, such as flexibility in accessing different custodial services, and expanding the "solution set" in two ways:
i) extended products, such as banking trust services and financial planning, and
ii) global capability to access non-U.S. debt and equity securities and managed funds.

Small Firms: A Success Story

Despite the emphasis on sophisticated products and services, and the need to improve productivity, small firms have fared strikingly well in responding to client demands in the current environment, making up a thriving component of the U.S. wealth management business. The clearing firms in the U.S. market, notably leading firms such as Pershing and First Clearing (Wells Fargo), have responded effectively to the demands of financial advisors registered as broker-dealers and Registered Investment Advisors. Many advisors have migrated from the large wire-house firms. This process began in the pre-financial crisis period, but accelerated in the post-crisis period. Small firms have demanded and received from the clearing firms sophisticated product offerings, including a full suite of managed products and ancillary services such as broker recruitment and training, and cost-effective clearing and settlement. This has been supplemented by other third-party providers. Some of the smaller firms have third-party arrangements beyond the correspondent relationship to provide trust services (to avoid conflicts of interest) tax preparation, sales and capital compliance, and anti-money laundering rules.

Navigating the Thicket of Regulatory Reform

The wealth management business has been overwhelmed in the past two years with massive regulatory reform covering all aspects of the savings-investment process. In many cases, notably the uniform fiduciary standard, the rules are still not in place. SIFMA has issued over 70 comment letters on a wide range of reform initiatives to Congressional committees, the SEC, FINRA staff and other regulators to influence the rule-making process to improve investor protection without unintended consequences that might interfere with the investment process.

The imposition of a uniform fiduciary standard for broker dealers and Registered Investment Advisors is the centerpiece of the reform initiatives. SIFMA has argued that regulators must recognize the two distinct business models at play, and implement well-crafted rules that are neutral in respect of the business model, not constraining client services or influencing the payment of services in either the brokerage or advisory model. SIFMA has argued that the 1940 Investment Advisers Act cannot be imposed carte blanche on broker-dealer firms. A study by Oliver Wyman has demonstrated this approach would not be business neutral and clients would be adversely affected. The SEC is unlikely to complete its rule-making exercise on the fiduciary standard this year given that scarce SEC resources are triaged across the numerous Dodd-Frank priorities.

An added complexity for the U.S. securities industry is that the Department of Labor has proposed a fiduciary standard for individual retirement plans, including 401Ks and IRA plans. The extension of a fiduciary standard to retirement plans creates confusion about the role of financial advisors and would prevent principal transactions in these plans.

Conclusion: Keeping Up With Client Demands

The U.S. wealth management business has been dealt seismic market shocks, and massive structural change from the financial crisis, as well as growing retirement demands from an aging demographic. Clients have become more conservative in terms of investment practices; demand better communication, information and financial/estate planning; and have adapted aggressively to online technology. The securities industry has responded effectively to these client demands in the brokerage and advisory business models delivered through large and small firms, providing the communication, online account access, financial tools, advice, full range of investment products and ancillary services. The challenge will be for the industry to keep pace with financial and technological advances to meet consumer demands and shape the reform process to enhance client protection without damaging the efficiencies and flexibility of the savings-investment process.

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Yours sincerely,

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