Evolution of the Financial Services Industry

By Dan Sondhelm

The financial services industry is always undergoing change. Many of the big changes we have seen over the last decade were precipitated by a single, major event – the financial meltdown in 2008. The only real constant that has been introduced is that of uncertainty, which has kept the industry in a state of flux ever since. Demographic shifts, advancing technology, changing consumer preferences, a surging and sometimes volatile stock market, and increasing regulatory scrutiny are compounding elements of the uncertainty keeping many firms in a perpetual reactive mode. It is an extremely challenging time for the industry; some would say it is at a tipping point. It is more important than ever for business leaders to understand the current trends, what is driving them, and the risks they present. This article offers insight on those crucial challenges, along with various best practices firms might use to cope with them.

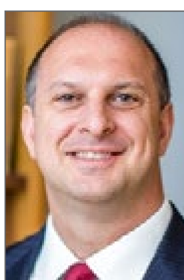
What are the most disruptive trends occurring in the financial services industry today?

There are always new trends emerging in the financial services industry that can influence decisions and force a change in strategy. However, some, such as the following, have the potential to be especially disruptive.

Passive Inflows Force Asset Managers to the Brink

In the face of a relentless bull market, investment management firms are dealing with margin compression as they continue to struggle with making the case for "alpha" (that is, their contribution over and above an indexed portfolio) and investor flight to lower-cost investment solutions. According to the Morningstar Active/Passive Barometer, active funds posted their best year since 2009, yet they their inflows are still anemic. While active funds in 2017 did report positive inflows of $25 billion through November, versus net outflows of $285 billion, most of the inflows went to taxable bond funds. Equity funds had $181 billion of outflows through November 2017. On the flip side, total passive fund inflows for the same period were $634 billion with $199 billion flowing toward passive U.S. equity funds. Another $308 billion found its way into U.S. stock ETFs.[1]

Until recently, asset management firms have benefited from the tailwind created by asset-price inflation thanks to rising stock prices. According to Goldman Sachs, more than 70 percent of the revenue generated by global asset management firms



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has come from asset inflation.[2] Meanwhile, revenue generated from flows continues to decrease. Industry experts believe that tailwind is coming to an end, which will leave firms with a shrinking revenue pool and continued downward fee pressure as they continue to lose flows to passive funds.

Increasing Industry Consolidation

The last several years have seen an increase in mergers and acquisitions among asset managers. More than 450 firms have been involved in M&A activities between 2014 and 2016 according to Sandler O'Neil.3 That level of activity can be expected to continue, especially among small to midsized managers looking for scale or specialist capabilities. As the industry continues to consolidate, the larger firms, such as BlackRock and Vanguard, continue to gain a larger share of assets managed globally.

[Millennials'] unbridled access to information has made them savvier and more empowered than previous generations, which, in turn, has also made them more skeptical and cynical.

As margin pressures mount and regulatory costs increase, scale is becoming an important consideration for smaller firms looking to compete. We are thus likely to see more of them seeking strategic partnerships or being acquired by larger firms as a way to survive.

Advice Automation Becomes Mainstream

Technology is set to transform the nature and delivery of financial advice significantly in the next few years. Automated investment platforms, or robo-advisors, have quietly moved to the forefront of industry evolution, bringing billions of investor dollars with them. Robos presently manage just a small fraction of investor assets – about $80 billion. However, according to the InvestmentNews 2017 Advisor Technology Study, they are expected to capture as much as $250 billion within the next two years.4 While that is still a small fraction of total assets under management, the trend is irrefutably clear.

Two of the more established players, Wealthfront and Betterment, manage more than $15 billion between them and they are valued at about $1 billion each.5 Dozens of smaller platforms have sprouted around them and many have become targets of larger investment firms seeking a branded platform of their own. Firms that are not buying robo-advisors are partnering with them or building their own. Within two years, every major investment house will have an automated investment platform or be well on the way to building one.

The independent robo-advisor model has yet to achieve a level of profitability that would please larger firms. So, the trend appears to be moving in the direction of a hybrid business model that combines algorithmic-based investment planning with the human touch of live financial professionals staffing call centers. Wealthfront and Betterment have introduced their hybrid versions for which they charge a higher fee, and hybrid pioneer Personal Capital has made it work so well that companies such as Wells Fargo, Merrill Lynch, Morgan Stanley, and JPMorgan are launching their own hybrid platforms targeting affluent and high net worth investors.

Smaller firms and independent advisors will be able to compete by offering off-the-shelf technologies or by latching on to platforms through Schwab, Fidelity and other robo-providers. In fact, they can win by merging their digital tools with their own unique value propositions because, as robo-advice continues to commoditize, investors will likely turn to more authentic digital advice sources.

The growth of robo-advisors in all of its forms will fuel more inflows into passive investments, putting even greater downward pressure on fees.

Increasing Regulatory Scrutiny

After a nine-year post-crisis awakening, the regulatory agencies are just beginning to hit their stride. Regulatory activities have increased substantially over the last several years, introducing greater regulatory risk for wealth management and investment management firms. While regulatory risk is not new to these firms, the stakes are much higher than ever. As firms struggle to compete in the high net worth market

by broadening their product offerings and global reach, their regulatory risks increase correspondingly. One misstep – such as a major data breach or a major regulatory fine – can destroy their reputation, and in turn, the profits of the firm. For firms of all sizes, the cost of risk relative to profits will continue to increase significantly.

In 2018, compliance will continue to take a bigger share of the operating budget for firms that must adapt their products, fee structure, and compensation to the requirements of the Department of Labor's "fiduciary rule." Although full implementation of the rule is now uncertain, firms are continuing to move forward, driven by peer and public pressure to conform to the "clients' best interests" standard under the rule. Firms may also be anticipating the SEC adopting its own uniform fiduciary standard for the industry. As a result, firms can expect to face additional downward pressure on profit margins due to fee reductions and further adoption of low-cost investments.

What changes or factors are driving those trends?

Shifting Demographics

There are several forces converging upon the industry that are accelerating current changes, the biggest of which is a historic transformation of the demographic landscape. Shifting demographics are driving changes in consumer demand and investor preferences across the entire age and wealth spectrum. At one end of the spectrum are the aging baby boomers who are entering the distribution phase of their lives. That will cause a steady drain of assets that will have to be replaced.

At the other end of the spectrum are the millennials. Not only will wealth management firms have to find a way to replace retiring advisors, they will have to find a way to narrow the generational gap between the growing affluent market of millennials and an aging advisor population that relates more with their parents and grandparents. As asset managers, wealth management firms and advisors sit at the threshold of a nearly $60 trillion intergenerational transfer of wealth that will be taking place over the next 55 years, they could either be looking at an unprecedented opportunity or facing the greatest threat to their survival.[6] Historically, only 10 percent of wealth transfers from one generation to the next have remained with the same advisor. Most firms have done an inadequate job of building multi-generational relationships with their clients and their families.

The millennial generation presents a major challenge to firms that have been laser-focused on capturing their share of baby boomer assets. It represents an entirely new segment of investors, whose expectations and preferences are being shaped by new technologies and by having watched their parents struggle through the last financial crisis. Their preferences for advisor engagement tend to be different from older segments of the population, with a greater expectation for online relationships and digital trust.

Their unbridled access to information has made them savvier and more empowered than previous generations, which, in turn, has also made them more skeptical and cynical. Their insistence on greater transparency, lower investment costs, and digital interaction will favor automated investment platforms and firms able to provide a rich, digital experience. The influence of millennial investors is beginning to spread to the older generations, which are developing the same digital acumen and the demand for greater control over their financial decisions.

Surging Stock Market

The stock market itself has been a driving force behind the popularity surge of passive investing, which has grown at the expense of investment managers whose value to investors has come into question. Hedge funds and money managers have struggled over the last nine years to outperform the benchmarks, raising the question of whether their skills and expertise warrant the higher fees they charge. According to the Morningstar Barometer, which is an objective analysis that compares the performance of actively managed funds to a composite of relevant passive index funds, over a 10-year period, equity passive funds generated an average a .65 percent higher annual return over active funds. Morningstar attributes much of the performance disparity to the higher fees charged by active funds.

On the other hand, the low-interest rate environment has made it more difficult for yield-seeking investors to generate meaningful income,

which increases the value of active managers who focus on income strategies. For the same reason, when the stock market corrects or returns to its volatile state of just a couple of years ago, investors will once again appreciate the value that active equity managers bring with their long-short and downside protection strategies. However, by that time, it may already be too late.

The next extended stock market correction will likely expose those firms that have weak fundamentals, business models and compliance systems as happened in the 2008 market correction and economic downturn.

What new risks do these trends entail for firms?

It has become a challenging environment for the financial services industry, characterized by increasing uncertainty and rising costs of risks to firms. While some firms may thrive, many will struggle to keep pace with environmental changes driven by evolving customer preferences, increasing competition, and proactive regulatory agencies. While it is important to recognize the current trends and the driving forces behind them, it is critical for firms to understand the potential impact they could have on their businesses.

Aging Advisors

The aging advisor population presents an immediate risk to firms that are not prepared for the steady attrition they will experience over the next 20 years. Nearly half of U.S. advisors are over the age of 55, one-third of whom are expected to retire in the next 10 years. According to Deloitte, the industry will need to recruit and train over 230,000 advisors just to cover the attrition.[7] The challenge is that fewer young people are entering the business than are leaving it, and those who do enter rarely stay with the firm that recruited and trained them.

At stake are the trillions of dollars in assets already passing to the younger generations. Clients want to know what will happen to their assets when their advisor is no longer able to perform his or her duties. This is particularly problematic for advisors and firms that fail to forge multi-generational relationships. Firms that struggle to attract and retain a younger generation of advisors will not be able to close the generational gap. As it is, 90 percent of generational transfers result in a change of advisors.[8] Firms that are least prepared to meet the needs and preferences of a younger generation of wealth risk extinction over the next 20 years.

Consolidation Risk

Industry consolidation is especially rampant in the independent broker-dealer channel, which has seen profit margins decline steadily since the financial crisis. New regulations, such as the DOL fiduciary rule, threaten the revenue generated from the sale of high commission products, which will compress margins even further. Larger firms, which have the advantage of scale and resources to better adapt to regulatory changes, are attractive to smaller firms looking for ways to survive in this new environment.

However, there is risk in consolidation. The merging of conflicting cultures, incompatible legacy systems, or uncoordinated compliance programs can increase the cost of a merger far beyond its deal price. There is also a greater risk of inheriting compliance nightmares, which can be costly in terms of time and resources, as well as reputation.

Last year there were five IBD mergers, of which LPL's acquisition of National Planning Holding's (NPH) network of five, smaller IBDs was by far the largest. In addition to acquiring the assets, advisors and clients of the smaller firms, LPL also acquired their compliance responsibilities. Earlier in the year, the firms paid $2.5 million in restitution and fines as a result of a FINRA investigation into excessive mutual fund fees charged by NPH firms.[9]

While LPL assumed no compliance liabilities under the terms of the purchase, it can be held liable for past conduct of NPH advisors revealed through any future investigations. LPL says it hired an additional 600 back office staffers to handle the additional compliance responsibility, which illustrates how difficult it can be to integrate different compliance systems.

Obstacles to Growth

Asset managers exist in a Darwinian environment where the larger firms have shown a greater capacity to adapt and grow to the next level. With their money, access, and resources, the dominant firms will continue to capture market share, leaving smaller firms in their wake to struggle for

existence. Under the weight of fee compression and stagnating fund flows, smaller firms cannot expect to compete at that level. Without a commitment to a real growth strategy, many small firms will cease to exist.

Small firms can no longer afford to accept the status quo. To grow or be discovered, they need to have a long-term, proactive strategy. Firms with great stories to tell but no effective strategy to tell them, might as well be invisible to their market. Many firms have no idea how little awareness their brand has due to underspending in public relations ("PR") and marketing. An effective PR and marketing strategy does not have to be expensive, but it does have to be well planned and executed. Firms that lack the internal resources or skills to develop and implement a PR and marketing strategy might be benefitted by the objective and real-world expertise of an outside consultant who can bring scale to their efforts.

Increased Regulatory Risk

The wealth management business has always been fraught with regulatory risk. However, regulatory activity has reached fever pitch in the last couple of years with a record number of fines levied against firms by the SEC and FINRA. In its Global Risk Management Survey, Deloitte found that 81 percent of investment management firms cite regulatory risk as their top challenge, with many acknowledging that regulatory readiness is becoming increasingly difficult to achieve.[10]

The constantly shifting regulatory environment is said to be the biggest contributing factor coupled with the fact that many firms are subject to the jurisdiction of multiple regulatory authorities. Increasing competition is forcing investment managers to expand their product portfolio and geographic reach, which can increase their exposure to regulatory and compliance risk exponentially.

Although the current political environment tilts toward deregulation (including a softening of Dodd-Frank), advisory firms should expect a continuing expansion of scrutiny and enforcement by the SEC and FINRA that will affect the way they do business. Particular areas of regulatory concern include:

Consumer protection: The DOL's fiduciary rule and the concept of putting clients' interests first are now a major focus for regulators, especially as it relates to retirement product recommendations and at-risk clients such as senior citizens. Regulators will be looking more closely to see if firms have the structure in place to supervise the transition from non-fiduciary to fiduciary. States and insurance regulators are also weighing in with their own rules for protecting consumers.

Investment products: Regulators will also be taking a closer look at certain investment products that present greater market, liquidity, interest rate, or operational risk. Products in the line of sight include certain retail alternative investments (including cryptocurrencies), non-traded REITs, variable annuities and other structured products.

Outsourced activities: Outsourcing is becoming a reality for an increasing number of firms. Regulators are putting pressure on firms to ensure that outsourced activities are in full compliance with all applicable securities laws and regulations and that providers are properly supervised by the firms.

Cybersecurity: With the increase of major data breaches at financial services firms, regulators are increasing their scrutiny of firms to ensure that well-conceived and compliant governance, processes, and controls are in place.

It will be more important than ever for firms to develop a true culture of compliance that influences the way they conduct business on an on-going basis and not just as a reactionary process in response to regulatory or organizational changes.

What are the immediate challenges facing firms and what are some best practices that can help them cope with it?

The challenges facing wealth and investment management firms in an increasingly competitive marketplace prompt the question: How can firms effectively balance the need to differentiate themselves and the demands of compliance?

It begins with the recognition that marketing and compliance are both vital to the overall well-being of the firm. Given the potential impact heightened regulatory risk can have on a firm's brand and bottom line, firms must make the investments in resources, processes and technologies to ensure regulatory readiness at all times. Generally, however, this need not come at the expense of an effective sales and marketing strategy that will ensure the firm's growth or survival. It is clear that both must co-exist in a firm's operating model, but it is time that they start operating with a mutual respect of the value they each bring to the organization.

Below are a few insights on what constitutes best practices for an organization seeking to balance the priorities of both sides, distilled from comments offered by a number of industry experts.

The stock market itself has been a driving force behind the popularity surge of passive investing, which has grown at the expense of investment managers whose value has come into question.

Compliance Education

It starts with education. Much of the friction that exists between compliance and marketing lies in a lack of understanding of each other's roles and responsibilities. In some firms, compliance is viewed as the "business prevention unit," using a cold-hearted approach to shut down ideas and the best of intentions. Compliance often characterizes marketing and sales staff as undisciplined hot shots, always trying to push the envelope. While those are the extreme perceptions, you will find that there is a general lack of understanding on both sides of each other's challenges.

Karen Fay Luedtke, the Senior Vice President and Director of Distribution Services for UMB Fund Services, suggests that compliance take the initiative to educate sales and marketing on what can and cannot be done, breaking down each of the components of compliance so they are understandable. When the client (sales and marketing) feels more comfortable with compliance requirements, it creates a more cooperative environment.

Ryan George, Assistant Vice President of Marketing and Communications with 1st Global Corp, a broker-dealer that caters to CPA/financial advisors, adds that education is the key to creating a compliance-minded culture. He says sales and marketing need to take an interest in the compliance side of the business. That includes understanding the rules and demonstrating they know what compliance is trying to do. Ryan suggests that mutual understanding and respect can lead to a more collaborative relationship that can turn a "no" into "let's see what we can do to make this work."

Early Collaboration

Gene Podsiadlo, a long-time industry expert and Special Advisor to the Board of Wasatch Advisors, says a big mistake sales and marketing teams make is to wait until they have fully developed their campaigns before running it by compliance, which invariably forces a "yes" or a "no." He says the tendency is to come up with a brilliant campaign and expecting everyone to love it before involving compliance.

Gene suggests that, by involving compliance in the conceptual stage, it can offer guidance that will keep the idea from going too far astray. Having an upfront conversation can drive the campaign more efficiently. In that regard, as Ryan points out, compliance can provide valuable perspective. He says that compliance staffs are generally analytical, but they like to be challenged creatively and participate in the problem-solving process.

Streamline Workflows

Karen Luedtke offers another way to create a more harmonious relationship, which is for the organization to invest in an easily accessible, online, compliance workflow system. The system should track submissions and provide marketing, sales, legal, compliance (all key stakeholders) with real time access to the state of a current marketing piece. A streamlined workflow system relieves the burden of using emails, hard copies, spreadsheets and other antiquated tracking tools and recordkeeping. Phone calls and email

to follow up on the status of an item are reduced as the current status (including notes and comments) is up to date in the system.

The system should also be SEC Rule 17a-4 compliant. The marketing materials are kept in one place electronically and there is no longer a need for paper records. The reviewed materials are easily searched in an archive and can be accompanied by backup and FINRA letters. While particularly releva nt to broker-dealer firms subject to 17a-4 and FINRA requirements, this type of workflow and recordkeeping system would be helpful for advisory, fund and other firms in meeting their regulatory requirements, even if not directly subject to 17a-4.

From firsthand experience, Karen can say that key stakeholders appreciate the efficiencies in the advertising review submission process, saving the organization time and money.

Making Compliance a Partner

In many organizations, compliance and marketing operate as different silos, each with their own objectives, responsibilities, processes, and mindsets – a delineation that precludes the development of a compliance culture. Compliance needs to be vested in the firm's growth and prosperity, without which the firm may not survive. Sales and marketing need to be proactive in gaining compliance as a partner in its success, presenting its ideas as a growth opportunity for everyone involved. Firms with a strong compliance culture have a solid story to tell, which can be a true differentiator in this highly competitive environment.

Conclusion

The four trends outlined in this paper – increasing passive inflows, industry consolidation, advice automation, and increasing regulatory scrutiny – are unmistakable and as potentially disruptive as any seen in the industry in recent years. Very powerful forces – a dramatic shift in demographics and a surging stock market – drive them. While we are likely to see a change in the direction of the stock market, the demographic transformation will continue for decades. Firms that hope to flourish or simply survive must not only recognize these trends and the forces that drive them, they need to understand the potential impact they can have on their businesses.

The costs of these risks have never been higher. It has never been more important for firms to be able to see around the corner and think strategically and proactively rather than reactively. That can be difficult due to regulatory constraints and the uncertainty that blankets the industry. Compliance needs to become a partner in that strategic thinking because it could be the edge many firms need to overcome the serious challenges they face.

ENDNOTES

1. Source: Morningstar Direct Access Commentary: November 2017
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