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Money Management: Success Is in the Details

by Edward McCarthy, CFP

It's easy to understand the lure of investment management. Just offer to handle clients' portfolios, pull in a quick $100 million or so in assets, and let the fees roll in every quarter. Admittedly, you have to do some work: send out reports occasionally, meet with anxious clients to soothe them when the markets get choppy, and so on. Still, it beats the heck out of trying to make a living as a financial planner.

Portfolio management has become a most profitable business activity for many planners. In some firms, asset management fees generate 80 to 90 percent of annual revenues. Advocates argue that it is a win-win scenario for clients and planners. Clients receive a reasonably priced service that frequently includes financial planning as part of the arrangement. Planners earn more predictable incomes, ensuring the viability of their businesses and their ability to service clients for the long term.

There's one catch, though: successfully incorporating portfolio management into a financial planning practice is much more difficult than it might appear to the casual observer. Those planners who have made the transition point to a number of challenges, including

- Selecting service providers such as broker/dealers and custodians
- Deciding which securities and services to offer clients
- Integrating portfolio management technology into current operations
- Finding and training staff
- Adding perceived value

This article examines these issues and shares insights from industry consultants and planners who have made the transition to portfolio management.

Selecting Service Providers

Although it seems nearly every planner has migrated to asset management, it's not necessarily the right move for everyone. Larry Howes, CFP, a principal with Sharkey, Howes, Wagner & Javer in Denver, frequently consults with planners on this issue. He believes that the first decision should relate to the planner's goals for the practice.

"The first question to ask is, do I want to get any bigger?" Howes says. "Do I want to have income generated by means other than my own efforts? The answer for a lot of people is no, which is fine. There are many sole practitioners out there who make a fairly good living and they just want to keep it real simple and efficient. They sell variable annuities, loaded funds and life insurance. But when the answer to that question is 'I do want to get bigger and have other sources of income,' the next place to go is assets under management."

Planners can choose from several methods for offering asset management. For some, signing on with a broker/dealer is the easiest way to get established. Another approach is to serve as an "asset gatherer" and place clients' funds with a management firm.

Howes believes these methods have inherent limits. "If you are going to keep a broker/dealer, then you are limited in the services you can offer your clients. By that I mean what kind of quarterly reports you can provide, how they look, how hard they are to download. You're creating a logistical problem that eventually has to be solved by either starting your own broker/dealer or dumping them entirely.

"Asset gathering is a more sophisticated route than a broker/dealer but it's still fundamentally a start-up. We manage money for other planners through Prism Advisors where we split the fees with the planner. It gets them started in the asset management business, but once they get $10 to $20 million, they're at a point where they need to start doing things internally. It is a long-term solution for somebody like a life insurance agent for whom managing money is a sideline, but for anybody in the planning business, something like Prism is just to get you going."

What to Offer?

Another important decision is the range of securities to use with clients' assets. Will you stick with mutual funds or should you use direct investments in stocks and bonds? Should you manage stock and bond investments internally or affiliate with outside managers? Greg Friedman, CFP, of Friedman & Associates in San Rafael, California, sees problems with an individual's attempt to master the financial planning and investment universes. "You have to do your homework and decide what your investment philosophy will be," Friedman points out. "Are you going to advise on stocks and bonds or just mutual funds? It also depends on your ability to do research. I've yet to find someone who can do comprehensive planning, asset management including stocks, bonds and mutual funds, and do all of it well without significant help. We have almost 100 clients with an average account of roughly $500,000 and I know I can't do all that."

Mutual funds have been the most widely used vehicle among planners, due at least partially to the emergence of the fund supermarkets and their support operations. But some planners believe that funds are not the solution for wealthier clients. They argue that fund distributions cause clients unwelcome income tax and cash flow problems, and on an emotional level, mutual funds lack sex appeal.

For these clients, separately managed accounts might be the solution. "When people get to a certain amount of net worth, the tax efficiency becomes very important and the issue of name brands kicks in," says Judy Shine, CFP, of Shine Investment Advisory Services, Inc. in Denver. "If you've got $5 million, you want J.P. Morgan—you don't want Fidelity Magellan and Twentieth Century. You want the names that the big boys use. So separate accounts are the perfect product for multi-million dollar accounts."

Shine stresses that name-brand appeal is not the only reason she offers the separate account option to clients. The decision is also based on the perception of her firm's strengths and weaknesses. "I am not a money manager. A person who does mutual funds and laddered municipal bonds and a few large cap stocks is not an active money manager. But once you start getting into huge amounts of money, things change. You can't just buy 10 stocks—you've got to buy 40 stocks. And since you're buying larger amounts of bonds, you can't afford to have anything go wrong, because it goes wrong with a big number. Sometimes you just have to step back and say that you're not as good as these people. And it's in your client's best interest, when you know there are people out there who are better at this than you are, to put them in touch with each other."

Len Reinhart of Lockwood Financial in Malvern, Pennsylvania, a money management firm that focuses on separate accounts, shares Shine's observations on the need to offer separate accounts as an alternative to funds. He believes that the lower capital gains tax rates, combined with growing investor wealth as a result of the bull market, create demand for this service among clients. "Investors are getting more sophisticated and their accounts are getting bigger. Million-dollar accounts are all over the place and investors are demanding more customized services than mutual funds. They're saying, 'I can get mutual funds anyplace; mutual funds don't do anything for me after taxes.' These investors are asking more sophisticated questions, and with that you need a more sophisticated product line."

Not all planners see the need to work with separate account managers, however. Deena Katz, CFP, of Evensky, Brown & Katz in Coral Gables, Florida, has not added this option to her firm's offerings. "We've talked about working with separate account managers but we're not doing it," Katz says. "It's strictly an ego trip for clients. These are expensive mutual funds. When you have a separate account manager, they're not really managing for your client. It's part of a larger group—you're not dealing with the top principals. If I'm going to use a separate account manager, how much money do I need for that manager to pay attention?"

Technological Requirements

Offering asset management services puts new demands on a planning practice. Greg Friedman believes that, at a minimum, the advisor needs an asset management program, such as Centerpiece, dbCAMS or Advent—to track assets and transactions and create reports. To track communications with clients, the practitioner should use some type of contact management software. In addition, Friedman sees a need for a spreadsheet, word processor, graphics and optimization program. On the research side, he suggests that planners using funds should have a research package such as Morningstar or Value Line.

An important consideration with portfolio management software is the ability to download client data electronically from a broker/dealer or custodian. As Hugh Bowman of E-Z Data in Pasadena, California, notes, it's a question of efficiency. "One issue that may eliminate some programs from consideration is the inability to retrieve client data electronically from a broker/dealer or custodian. If you have a large customer base or extensive activities in client accounts, it's not cost effective to type data in manually when a lot of it is available electronically. That feature saves a lot of time and effort and allows you to provide that level of service to a customer. So a software program might fit the bill for everything you need, but might not have the particular interface needed for managing a pool of money."

Technology doesn't solve all problems, though. Peggy Ruhlin, CPA, CFP, of Budros & Ruhlin in Columbus, Ohio, found that her portfolio optimizer often generated skewed portfolios. "We thought it would be cutting edge to buy portfolio optimization software, but if you let the software run wild, it would recommend things like equipment leasing," Ruhlin reports. "A colleague told me that her optimizer once came up with a two-asset portfolio: real estate investment trusts and real estate. I like playing with optimizers—sometimes just to test a theory—but we definitely learned the garbage in, garbage out lesson. It's just not the way to do asset allocation with a client."

Staffing for Growth

Many of the account management and reporting processes required to manage investments can be automated, but as the number of client accounts grows, so do the demands on the planner. At some point, it becomes necessary to add new staff. But finding good employees can be a major obstacle. According to Greg Friedman, whose area (north of San Francisco) has very low unemployment, the shortage of qualified job seekers is the biggest problem his practice currently faces. He has several executive recruiters searching for him, but they report far more local positions than applicants.

A CFP practitioner (who requested anonymity) on the East Coast reports a similar problem. "The degree of computer competency that we've found among applicants is relatively low—they want to come work with you to learn," he says. "People with strong computer skills frequently have no interest obtaining a CFP license or anything like that. We've tried working with interns and paraplanners, but we still wind up spending a significant amount of time training these people and overseeing the quality and accuracy of the work. Another option is to have an employee who would do that work and other things for us. But with a high net worth clientele, you can't put less experienced, younger people in contact with those clients."

Keeping Clients Happy

Assuming you put all the required elements into place and have success in attracting assets, you still face a major hurdle that you must constantly clear: How do you retain clients and keep them convinced that your services are worth their cost? Consider the clients' perspective for a moment. They are paying you a significant amount each year—probably thousands of dollars—to help them manage their wealth. They don't see and probably don't care about your investments in technology and staff that allow you to service their accounts.

Perhaps you can convince them that your investment expertise is worth the fee. But that's a risky approach, because one sub-par year could reduce your asset base substantially. Greg Friedman believes that the asset management business is really about communication, not performance results. "What I didn't realize about the asset management business when I started is that the biggest thing we do has nothing to do with performance," he says. "It's how well you communicate to clients and track and measure and help clients make investment decisions on an ongoing basis. If you think that you will sign people up, park money, charge on it, and not do a whole lot —you're in for a rude awakening. You will lose those clients to firms that provide more service or you'll lose them when they're upset because they're wondering why they are paying you when you don't do anything."

For Deena Katz, financial planning is the glue that keeps the planner-client relationship. Katz, whose book, Managing to Grow, will be published by Bloomberg Press in the spring, urges financial planners to maintain planning relationships with clients. "We all started out as comprehensive planners," she points out. "Then we figured out that nobody wanted to pay for that service. So we decided to do focused planning. Then we decided that what people really want to know is what to do with their money, so we said we would manage their money. The problem is that investment management is a commoditized business—everybody is in it. So what are you offering of value? I say stick to your financial planning roots: Provide planning in addition to your asset management and extraordinary service that people can't find anywhere else."

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