Schwab Market Knowledge Tools™

Industry Report

Best Management Practices of Independent Investment Advisory Firms:

The Path to Profitable Growth

charles SCHWAB INSTITUTIONAL

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The Best Managed Firms (Alphabetically by Firm Name)

Accredited Investors, Inc.	Edina, MN	**Moler Capital Management**	Irvine, CA
Balasa, Dinverno & Foltz LLC	Itasca, IL	**Moneta Group, Inc.**	Clayton, MO
Ballentine, Finn & Company, Inc.	Wolfeboro, NH	**Parthenon LLC**	Louisville , KY
Bingham, Osborn & Scarborough, LLC	San Francisco, CA	**Pinnacle Advisory Group LLC**	Columbia, MD
Boone Financial Advisors, Inc.	San Francisco, CA	**Plancorp, Inc.**	Chesterfield, MO
Budros, Ruhlin & Roe, Inc.	Columbus, OH	**Polstra & Dardaman, LLC**	Norcross, GA
Dowling & Yahnke, Inc.	San Diego, CA	**RegentAtlantic Capital, LLC**	Chatham, NJ
Emerson Investment Management, Inc.	Boston, MA	**Rowling, Dold & Associates, LLP**	San Diego, CA
Founders Financial Network	Cupertino, CA	**Sage Financial Group**	Bala Cynwyd, PA
Friedman & Associates	Novato, CA	**Shine Investment Advisory Services, Inc.**	Lone Tree, CO
Gemmer Asset Management, LLC	Walnut Creek, CA	**The Monitor Group, Inc.**	McLean, VA
Kochis Fitz Tracy Fitzhugh & Gott	San Francisco, CA	**Trinity Wealth Advisors**	St. Louis, MO
Laird Norton Tyee	Seattle, WA	**Wade Financial Group, Inc.**	Minneapolis, MN
LBMC Investment Advisors, LLC	Brentwood, TN	**Whitegate Investment Counselors, Inc.**	Concord, NH

Introduction

There's no question that independent investment advisors have experienced tremendous growth. According to Cerulli Associates, total assets managed by Registered Investment Advisors have grown 36% since 1998, to more than $1.5 trillion.[1] What's more, a recent study by the Spectrem Group reveals that 38% of ultra-high-net-worth investors[2] now use independent advisors.[3] Clearly, the value you bring to clients' financial lives is being recognized in the marketplace.

That said, many advisors are having difficulty leveraging their growth into financial success. Consider that one out of five multi-professional practices during fiscal year 2003 saw revenues increase, but income per owner decrease, according to the *2004 FPA Financial Performance Study of Financial Advisory Practices* compiled by Moss Adams LLP. Meanwhile, nearly half of sole practitioners saw revenues rise but personal income fall during that time.

The message behind these numbers is clear: Strong revenue and market share growth does not guarantee a financially healthy practice. Often, increased growth is accompanied by higher expenses and lower levels of internal efficiency that diminish or destroy profits. In order to survive and thrive, advisors must institute optimal strategies that will drive profitability for themselves and their firms.

With that in mind, Schwab Institutional® is pleased to present the Schwab Market Knowledge Tools™ (MKT) Industry Report on the best management practices of independent investment advisory firms. This report focuses on the concept of profitable growth, and examines how the industry's most successful fee-based advisory firms—collectively known as the Best Managed Firms—are taking steps to ensure that they grow profitably. For this report, we interviewed the principals of the 28 Best Managed Firms in the industry to gain insight into the keys to their success. Advisors can learn from these strategies and can use them to help maximize their chances of building and maintaining profitable businesses, and potentially achieve a higher level of success than their peers and competitors.

Methodology

Schwab's research into successful advisory practices defines a standard of excellence, and provides guidelines for achieving that standard. The Best Managed Firms were selected from the 521 participants of the *2004 FPA Financial Performance Study of Financial Advisory Practices*. Of those participants, the 306 that generated at least 75% of their revenues in FY2003 from fees were considered. From that group, the top 10% of independent fee-based advisory firms (*shown on the opposite page*) were selected based on a composite score that consisted of:

- Profitability, as measured by pre-tax income per owner;
- Productivity, as measured by revenue per professional;
- Leverage, as measured by presence of non-owner professional and support staff;
- Depth of client relationships, as measured by revenue per client.

[1] *Cerulli Quantitative Update Intermediary Markets 2004*. Cerulli Associates.

[2] Investors worth more than $5 million in net worth.

[3] *Relationship with Advisors: 2003 High Net Worth Perspective Series*. Spectrem Group.

The Key Lessons of Best Managed Firms

Extensive interviews with the 28 Best Managed Firms revealed four key lessons that these Firms follow:

• **Pursue Ideal Opportunities Only.** Not every opportunity is as good as it may appear. The most successful advisors have instituted disciplined methods for identifying and pursuing select types of new business that fit extremely well with their overall strategy and that can contribute positively to the bottom line.

• **Structure Your Firm Around Your Strategy.** Every aspect of an advisory firm—such as the client experience, hiring and training, and operations—must be organized and targeted to effectively and profitably capitalize on the ideal opportunities that firm has identified. Best Managed Firms employ a wide range of methods for consistently aligning their decisions and practices with their overarching strategies—such as hiring a dedicated General Manager—that result in stronger profit growth.

• **Institutionalize Your Business Processes.** Best Managed Firms understand that delivering a consistent experience, both internally and externally, is crucial to maximizing efficiencies, managing costs and providing a superior level of service to clients—all of which help generate greater profitability. This consistency results from instituting systems and processes that work reliably and predictably every time.

• **Delegate to Maximize Effectiveness.** Advisors who fully leverage their limited time are able to focus on those areas of their businesses where they add the most value. Delegating and allowing specialists (both internal and external) to handle appropriate responsibilities can reduce expenses and enable owners and senior partners to concentrate on boosting profits.

Many of the Firms that have adopted these key lessons of profitable growth report tremendous forward momentum as a result of their efforts—a "snowball effect" of positive results that occurs once the right strategy and structure have been put in place and refined over time. These Firms essentially are experiencing what Jim Collins, in his landmark business management book *From Good to Great*, calls "The Flywheel Effect." Picture an advisory firm as an extremely heavy flywheel. Turning the wheel takes enormous effort at first. But with enough discipline and work, momentum eventually takes over and the flywheel accelerates without any more pushing.

Definition: *Snowball Effect*
Positive results that occur once right strategy and structure have been put in place and refined over time.

What's more, most Best Managed Firms we surveyed expect profits to at least double over the next three years with only a 10% to 20% increase in staff. Our research also indicates that operating profit margins at these top Firms average 20.5%, compared to 14% for the typical fee-based firm.[1] The upshot: While the benefits of adopting the key lessons of profitable growth do not always occur rapidly, the potential payoff can be powerful. *(See Exhibit A in the Appendix for Composite Financial Performance Data from the Best Managed Firms.)*

[1] Individual results vary and there is no assurance that these results may be duplicated in the future.

Pursue Ideal Opportunities Only

The number of opportunities facing advisors today and in the coming years is profound, thanks to the aging of the baby boomers and continued growth in the number of affluent investors. Many advisors believe that they will achieve continued success by aggressively pursuing as many of those opportunities for new business as possible. By saying "yes" to every client request and prospect they meet, these advisors expect to grow into a highly profitable practice.

The reality, however, is quite different. We see that advisors who take on too much business and too many types of clients typically end up working harder but generating little or no additional income. In their attempt to be all things to all people, these advisors find themselves bouncing from opportunity to opportunity—and never gaining the type of traction in any single area that fosters profitable growth. By taking on too much, advisors can become scattered. They lose focus and find it impossible to develop a compelling value proposition that attracts affluent investors. They also fail to manage their firms efficiently because they are stretched too thin. Those factors combined can decimate an advisory firm's bottom line.

Best Managed Firms, by contrast, take a fundamentally different approach that allows them to rapidly and profitably grow. These Firms recognize that, contrary to intuition, profitable growth results from being focused and deliberate about the types of clients they serve and the services they offer to meet those specific clients' needs. If a potential client or business venture isn't a good fit, Best Managed Firms always say "no" to the opportunity—no matter how tempting it may seem. The fact is, an opportunity that isn't ideal (such as a client who is unprofitable or extremely difficult to work with) eventually can drain a firm's time, energy, efficiency and income.

Tip: If a potential client or business venture isn't a good fit, Best Managed Firms always say "no" to the opportunity–no matter how tempting it may seem.

Accordingly, Best Managed Firms have developed a detailed profile of their ideal clients (based on factors such as age, profession, income, investable assets, revenue from the client, likability, delegation propensity, referral propensity, and financial and investment philosophy), a clear suite of services they will (and will not) provide to those ideal clients, and client selection processes that ensure only ideal clients make the cut.

As part of their strategies, these Firms have learned to say "no" in the following areas:

• **Say "no" to bad prospects.** Some advisors—especially those just starting out—will take any prospect that knocks on the door, but this practically ensures that they will have difficulty growing profitably. The key to success is to work only with ideal clients right from the beginning. That said, even established advisors must guard against prospects who don't fit their strategy. A relatively small number of non-ideal clients can quickly force a firm to divert its attention away from its established goals, wasting time and dampening profits.

• **Say "no" to a lone client who asks for something outside of your competency or philosophy**. A one-off project can sap your time and create liabilities. What's more, you risk damaging the client relationship by trying to address an isolated need that's beyond your expertise. Instead, Best Managed Firms develop relationships with trustworthy resources (CPAs, attorneys, etc.) that can address the client need.

• **Say "no" to clients and prospects who ask for a discount.** To facilitate increased profitability, Best Managed Firms work only with clients who see the value in the services they offer and who are willing to pay for them. Price your offering appropriately, then focus your time on providing a superior level of service and conveying the value you provide—not defending your pricing (or negotiating discounts) for clients who don't value what you do. Such clients will be better served by bargain shopping elsewhere, and your firm can achieve greater success over time by not cutting prices.

• **Say "no" to financially attractive prospects who don't fit your competency or philosophy.** Taking on one large but distracting client will do more harm than good, despite the big influx of revenue they represent. Chances are, such an investor won't be happy with the experience and level of service they receive from the firm, and will eventually move assets elsewhere. In the long run, it's better to wait and fill the gap with three or four (or more) clients who fit your overall approach.

Say "No"

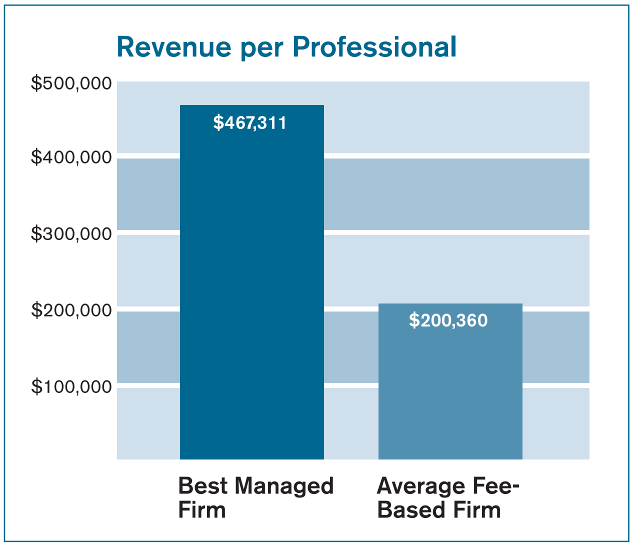
- ☑ To bad prospects
- ☑ To projects outside your competency or philosophy
- ☑ To discounts
- ☑ To financially attractive prospects who don't fit your competency or philosophy
- ☑ To bad, rich clients
- ☑ To offerings that don't match your clients' needs

• **Say "no" (and goodbye) to bad, rich clients.** Firing your largest client is a frightening prospect, but more than one of the Best Managed Firms did just that. For example, Ross Levin of **Accredited Investors** in Edina, Minnesota, actually fired his two biggest clients seven years ago. The Firm bounced back more quickly than expected. More importantly, Levin's realization that survival didn't depend on any one client, particularly a dreaded one, gave him the freedom and courage to build a business he truly enjoys.

• **Say "no" to offerings that your clients don't care about.** You must provide your ideal clients with the products, services and technology they need most to achieve their financial goals. Any new potential offering must deepen your relationships with clients, attract ideal new business or increase your own efficiency in serving ideal clients and managing your firm. If it does not, it's an unnecessary expense that will do nothing more than erode profits.

It's important to note that there is no one type of ideal client that all advisors should pursue. Ideal clients of the top Firms we surveyed include local company executives, recent medical school graduates and small business owners. Whether a prospect is good or bad depends entirely on each firm's overall business goals and focus, investment philosophy and—most importantly—the extent to which the firm can profitably deliver exceptional service to the prospect.

Saying "no" and turning away business is a scary proposition for many advisors. But this is precisely what Best Managed Firms do time and time again to attain profitable growth. These Firms are acutely aware that targeting a group of ideal clients is more effective than chasing a large number of "opportunities" that don't match up with their overall strategies.



This understanding is one reason why Best Managed Firms generate $467,311 in revenue per professional on average. By contrast, the typical fee-based practice[1] garners just $200,360 in revenue per professional—a difference of approximately $267,000. By increasing revenue per professional to the level of the Best Managed Firms, the typical advisory practice could garner $75,000 in additional before-tax profits—a 65% increase over the practice's current profits.[2]

Your financial statements often will reveal if you are being diligent in targeting and accepting ideal business. A client profitability analysis can help you identify a client or a segment of clients that are not contributing to the bottom line as much as you thought.

See Exhibit B in the Appendix for a Client Profitability analysis example.

[1] A "typical fee-based practice" is the median of the 278 other fee-based practices (Non-Best Managed Firms) that participated in the *2004 FPA Financial Performance Study of Financial Advisory Practices*.

[2] **Calculation:** $267,000 x two professionals at the typical practice x 14.0% operating profit margin at the typical practice ≈ $75,000.

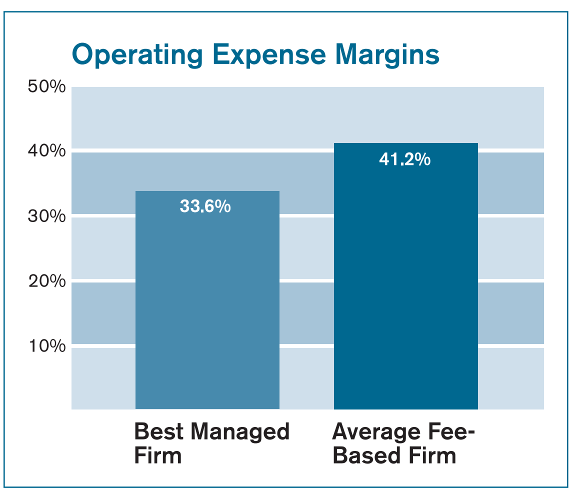
Structure Your Firm Around Your Strategy

Once Best Managed Firms have identified the specific types of clients and opportunities that are right for them, they structure their entire organizations—from service offerings to staffing—to support their pursuit of those strategic opportunities. As a result, their businesses are designed to deliver the right services effectively and efficiently—thereby ensuring that client satisfaction, client retention and referrals, business development and profits remain strong as they grow larger. "You need to identify the client you want to serve and build your business around that client," says Judy Shine of **Shine Investment Advisory Services, Inc.** in Lone Tree, Colorado.

Effectively structuring a practice around a chosen strategy typically is an evolutionary process. By taking the appropriate foundational steps, firms generate resources that can be deployed toward more advanced practice management and staffing solutions that further enhance profitability.

Foundational Steps

Make the commitment. The ability to "structure around strategy" is especially important for smaller practices and those firms just starting to develop strategic plans. Often these firms experience periods of slim or negative profit margins as they build out their business model, and it is during these challenging times when firms must maintain their commitment to their strategy in order to reach profitability. According to Greg Herman at **LBMC Investment Advisors** in Brentwood, Tennessee, the Firm is successful largely because all stakeholders agreed to wait out an unprofitable period and not succumb to the temptation to deviate from the target clients they had identified.



Likewise, Randy Moler, owner of **Moler Capital Management** in Irvine, California, has achieved success through operating by a simple rule: "Never accept a client that's not an 'A' client—no exceptions."

One result of committing to the right clients: Operating expense margins at Best Managed Firms are significantly lower than at the average fee-based practice (33.6% versus 41.2%, respectively). By decreasing its operating expenses as a percentage of revenue to the Best Managed Firms' level, a typical advisory firm could generate additional before-tax profits of $65,000 per practice—a 55% increase on current profits.[1]

[1] **Calculation:** $835,272 in revenue at a typical practice x 41.2% = $344,123; $835,272 x 33.6% = $280,651; $344,123–$280,651 ≈ $65,000.

Seek outside guidance. It's difficult to think creatively about your business without the benefit of thoughtful and challenging discourse. Chris Dardaman of **Polstra & Dardaman** in Norcross, Georgia, recommends that advisors "find people who are a step or two ahead of you, and build relationships so you can learn from them." Fellow advisors who face similar challenges as you can be an excellent resource. Consider locating such advisors at conferences and through local or regional advisor study groups. Other local business owners in your community also can provide insightful non-industry perspectives. Finally, some Best Managed Firms employ a professional coach or mentor to facilitate creative solutions and stay motivated.

Maximize any human capital. Incorporate your staff—even if it's just one person—into the process, particularly when implementing your strategy. Employees know what's working and what isn't, and often will share innovative ideas if given the chance.

Intermediate Steps

Divide responsibilities. As practices grow, the decisions they face regarding the application of their strategies become more consequential and the implementation more time-consuming. Several Best Managed Firms have met these challenges by allocating various responsibilities among the partners and other senior professionals, typically along the following lines:

- **Strategy development:** One or more individuals responsible for thinking about the future of the business beyond its current limitations, definition and identity.
- **Internal strategy implementation:** One or more individuals responsible for evaluating staffing, systems and other infrastructure against the strategy; developing plans for improvement; and monitoring their implementation.
- **External strategy implementation:** One or more individuals responsible for ensuring the strategy is reflected in client service, marketing and interactions with prospects and the public; developing plans for improvement; and monitoring their implementation.

Incorporate strategy into compensation. Compensation must be designed to incentivize and reward behavior that reflects a firm's strategy. Schwab's Market Knowledge Tools™ (MKT) Industry Report *Best Management Practices: Creating an Effective Compensation Plan* offers detailed perspectives on how Best Managed Firms institute compensation programs that drive intended results.

Prepare for a General Manager. Advisors typically enter the industry because they care about serving clients, not because they are passionate about running a firm. However, the majority of top Firms reports that "treating our business like a business" created the foundation for their success. Therefore, most top Firms eventually appoint a dedicated General Manager (G.M.) to manage operations, technology, financial reporting and human resources. The key is to prepare for a G.M. well in advance to ensure a smooth transition.

Advanced Steps

Set up communication infrastructure. At larger practices, a formal communication process is essential in making sure all staff members have the same vision, values, priorities and opportunities to contribute. Likewise, communication protocols ensure that all clients continue to receive superior service even as the firm grows and the number of employees having contact with clients increases. Best Managed Firms' communication initiatives include meetings (weekly or biweekly all-staff meetings), formal client communication processes (regular newsletters and client seminars/events) and forums for staff to develop and implement improvements to internal processes.

Hire a top-quality General Manager. While more expensive immediately, an experienced General Manager saves costs in the long run because of the chain reaction of positive effects he or she has on a practice. According to Michael Kossman of **Kochis Fitz Tracy Fitzhugh & Gott** in San Francisco, California, hiring a professional business manager four years ago was a key milestone in the Firm's development. "The efficiencies we've gained have allowed us to grow our client base by 50% with the addition of only one person to the professional staff," he says. "Also, turnover in staff has been virtually nil because someone had the mandate to develop a world-class human resources program." (*See the General Manager Preparation Checklist above for details.*)

General Manager Preparation Checklist

The time to prepare for the addition of a General Manager is before you actually need one. Strong advance work will help ensure you make the optimal choice.

1. **Define the role.** Outline the G.M.'s responsibilities at your firm in as much detail as possible. Also spell out his or her level of authority and power to make and implement decisions.
2. **Define the ideal candidate.** List the qualities you require in an effective General Manager. For example, a good G.M. should have as much passion about and expertise in staff development as you have regarding your clients' financial lives.
3. **Seek out great candidates.** Keep in mind that your future General Manager may be an existing partner at the firm who has developed the skills and passion to manage the practice.
4. **Determine compensation.** Assess the value of the G.M. position. If a current partner is being considered for the job, determine that value relative to the other roles he or she will play.
5. **Budget appropriately for the position.** The introduction of the General Manager will be costly, and it will take approximately 12 to 18 months to achieve a return on the investment.

Examine the best practices of non-industry peers. Some Firms, such as **Polstra & Dardaman**, evaluate their service models against service leaders in other industries to improve strategies, reduce costs and boost efficiency. "Our clients are comparing us to Disney, the Four Seasons, Starbucks," says Chris Dardaman. "How do we stack up against the service they are getting in other areas of their lives?"

Focus on building the next generation. The largest and most successful Firms with decades of history carefully cultivate the next generation of leaders to ensure future success and avoid a stagnating business model. "Our clients' financial lives extend well beyond the next 20 years and we need to make sure that we're going to be here to serve them," says Kaycee Krysty of **Laird Norton Tyee** in Seattle, Washington. To that end, the Firm had 15 principals and senior professionals at the end of fiscal year 2003 and plans to continue bringing up new senior professionals within the organization.

Finally, all firms regardless of size must have the discipline to set aside time devoted to strategic planning and evaluation. (*See Eight Strategic Differentiators below.*) A focused strategy requires energy and dedication. Best Managed Firms therefore typically take at least one multi-day annual strategic planning retreat, with or without the staff, followed up with monthly or quarterly meetings to assess progress. Obviously such strategic planning is important for smaller firms trying to grow aggressively. But it's also essential for the largest practices, which commonly fall into the trap of thinking they've "arrived." Given the competitive environment in the advisory industry, it's likely that even well-established firms will suffer if they stop striving and allow their business structure to deviate from their strategic goals.

See Exhibit C in the Appendix for performance metrics that advisors can use to monitor the effectiveness of their efforts to structure their businesses around their strategies.

Eight Strategic Differentiators

Independent academic research indicates that any business seeking to create a unique value proposition and develop a clear competitive advantage must adopt one of eight strategies:

Niche market: Known for serving a named market (doctors, small-business owners, etc.)

Technical specialty: Known for specific technical expertise (concentrated stock portfolios, estate planning)

Low-cost/standardized approach: Known for standardized processes, high volume, low cost (assigning clients to model portfolios)

Famous person/team: Known for identity of founder, individuals or team (name recognition via reputation, media appearances, etc.)

Dominant local firm: Known for size and presence (regional players, etc.)

Unique sales method: Known for a unique way of attracting clients (seminars, classes, etc.)

Share of wallet: Known for cross-selling of services and products (standard suite of services plus concierge/family office services)

Local presence of national brand: Known for major national consumer brand

Source: *Top Management Strategy: What It Is and How to Make It Work* by Benjamin B. Tregoe, Ph.D., and John W. Zimmerman, 1981, Simon & Schuster.

Institutionalize Your Business Processes

After aligning their practices with their overall target strategies, Best Managed Firms develop processes and systems that enable them to deliver a consistent and reliable experience time and again. "Ultimately, it is through consistency that excellence and quality are created," says Norm Boone of **Boone Financial Advisors** in San Francisco, California.

The top Best Managed Firms' profits per client averages $1,596–ten times that of the typical practice.

This process of institutionalization enables the Best Managed Firms to deliver superior client service as well as maximize their overall internal efficiency, resulting in strong revenue and income growth. By contrast, firms that fail to build such systems and processes typically find it difficult to achieve and maintain profitability. Essentially, they have to "reinvent the wheel" each time they perform a task. That's one reason why the top Firms' profits (as represented by EBITDA[1]) per client averages $1,596—ten times that of the typical practice ($167).

For institutionalization to be effective, systems must be set up to address all aspects of an advisory firm—from internal tasks to client-facing responsibilities. The Best Managed Firms have developed systematic approaches to their practices in the following areas:

Internal Processes

Portfolio management. Best Managed Firms leverage portfolio management software and other technologies to ensure that the trading, asset allocation and portfolio rebalancing process is smooth and seamless. When evaluating such technology, focus on the system's capabilities relative to your needs and not just the price tag, recommends David Gemmer of **Gemmer Asset Management, LLC** in Walnut Creek, California. Several Firms have hired a contract or permanent programmer to customize their software packages for full automation of the portfolio management process.

Client reporting and information management. The keys to efficient client reporting and management are properly using software and standardizing client reports. For example, **Dowling & Yahnke, Inc.** in San Diego, California, has cut its quarterly reporting, invoicing, accounting and billing processes to ten days after the end of the quarter (without any manual manipulation of the data required) by integrating its billing software with its accounting and portfolio management software systems. When used effectively, CRM software and wireless networks enable firms to perform tasks such as automating client communications and instantly recording client meeting notes.

[1] Earnings Before Interest, Tax, Depreciation and Amortization.

Staff training and development. Best Managed Firms understand that the better trained and educated their employees are, the more efficiently and effectively they can do their jobs and the more quickly they can move up within the organization to help it grow. For example, **Budros, Ruhlin & Roe, Inc.** in Columbus, Ohio, encourages all of its staff members to become CFP certificants. Principal Peggy Ruhlin credits the Firm's success to the ongoing "growth in expertise, competence and growth of the financial planning staff. The four principals are smart enough, but they certainly can't do and know everything." Likewise, **Moneta Group** in Clayton, Missouri, "brings in one to two new professionals each year, who go through 168 hours of training in the first six months," says Principal Joe Sheehan.

The Client Acceptance Process

Information gathering. Pointed questions about a prospect's expectations best indicate if the individual is a strong or weak fit. For example:

- "What would you expect me to do for you as your advisor?"
- "What do you hope to achieve through consulting with a financial advisor?"
- "What do you hope to be able to do with your assets and when?"
- "What is important to you?"

Process explanation. Detail how your services will—and will not—match the prospect's expectations. Unmet expectations are extremely detrimental to a client relationship, making it crucial for advisors to be honest about their perception of the likely fit between the firm and the prospect.

Philosophy explanation. Communicate your planning and investment philosophy. There are many views on financial markets and investing; many people seeking your advice will not share your philosophy.

Accept or reject. Acceptance should not be a knee-jerk reaction to the successful completion of steps 1–3 above, and, according to several of the Best Managed Firms, it should not happen during the first meeting with the prospect. At **The Monitor Group**, for example, each prospect is reviewed against an ideal client profile (including personality and financial perspectives) and given a score. The partners then decide collectively whether to accept the individual as a client.

External Processes

Business development. Several top Firms have experienced significant success using a structured approach to business development via client meetings (for example, consistently asking for referrals during meetings with top clients), client surveys (to determine client satisfaction levels and identify clients willing to make referrals) and relationships with outside professionals (formal and informal partnerships with CPAs, attorneys and other professionals serving the target client and using the same service philosophy).

Client acceptance. Because profitability hinges greatly on serving only the right types of clients, the vast majority of the Best Managed Firms have detailed and multi-meeting client acceptance processes that give them a formal framework to make a go/no-go decision on a prospect. Most share several basic steps that seek to identify a prospect's needs and expectations, and communicate how the Firm's services and investment philosophy do—or do not—match those expectations. (*See The Client Acceptance Process above.*)

Client service. Delivering a consistently strong client experience is critical in generating a steady stream of referrals from satisfied clients. The Best Managed Firms ensure consistency through a variety of measures in different areas of the client relationship. For example: kick-off meetings with clients to set up initial accounts; regularly scheduled client meetings with well-planned and well-communicated agendas; client communication tailored around each client's wishes (in terms of timing, frequency, method, etc.); and the use of well-defined teams so clients always know whom to contact with specific questions and concerns.

Recruiting and hiring. Best Managed Firms agree that employees are their most valuable assets, and all of the top Firms indicated that it is essential to hire the best person for a job regardless of the extra cost or effort involved in finding that person. "The best people may be more expensive to hire, but they are worth it because they are able to exceed the expectations of our very discriminating clients," say Roy Ballentine and Alice Finn of **Ballentine, Finn & Company, Inc.** in Wolfeboro, New Hampshire.

Best Managed Firms' hiring practices are proactive and designed to prepare for future growth, not react to current growth. This enables the Firms to avoid training new employees during busy periods, which can create staff dissatisfaction, turnover and ultimately poorer financial health for a practice. As part of this proactive approach, many Firms view any interaction as an opportunity to put a promising future candidate on file. Staff rosters include former clients, former competitors, fellow university alums and chance encounters. At **Bingham, Osborn & Scarborough, LLC** in San Francisco, California, for example, the philosophy is "always to be on the lookout for good people," says Principal Carol Benz. "That way, when the time comes to hire, you don't have to start from scratch."

"[Be] on the lookout for good people. That way, when the time comes to hire, you don't have to start from scratch."
Bingham, Osborn & Scarborough, LLC

Finally, many of the Firms have instituted thorough candidate evaluation processes that include multiple interviews with members of the existing staff, psychometric or personality testing, and technical testing to evaluate job aptitude. The result: Detailed job descriptions and minimum requirements are already written as a benchmark against which to compare the candidates.

Delegate to Maximize Effectiveness

How advisors spend their time largely determines their success. Unfortunately, some advisors fail to leverage their limited time effectively because they attempt to do everything themselves—from managing internal operations and staff to addressing client needs, managing assets and selecting and monitoring managers. This approach results in tremendous inefficiencies that, over time, dampen growth and diminish profitability. Think about it: If you're trying to do every task that is necessary to manage a practice, chances are there are at least some duties you don't perform especially well. As a result, you could be damaging the client experience, internal effectiveness and morale, and, ultimately, income.

> "We're clear in our performance reviews and our compensation that each person must focus on doing their own job, and help and allow others to do the same."
> Sage Financial Group

Once again, Best Managed Firms differentiate themselves by their ability to focus. These Firms are devoted to their core competencies, and delegate all other non-core duties to specialists (both within the Firm and third-party experts) and junior staff members. This approach frees up enormous amounts of time and energy for principals, who then can devote themselves to focusing on those areas where they add the most value for their clients and Firms. In short, the old adage "if you want something done right, do it yourself" often doesn't hold true in today's environment. A better approach: Assign the right people to the right tasks, and let them do their jobs. "We're clear in our performance reviews and our compensation that each person must focus on doing their own job, and help and allow others to do the same," says Stephen Cohn of **Sage Financial Group** in Bala Cynwyd, Pennsylvania.

Leveraging Specialists

It's tempting to maintain control over things that are familiar, including workplace responsibilities. But to achieve profitable growth, advisors cannot retain duties that specialists can do better, faster and more cheaply. Some advisors hesitate to hire or contract with outside specialists because they perceive such experts to be too expensive. However, specialists are almost always a better choice because they can complete a job more quickly and accurately, resulting in cost savings and greater productivity for the firm.

Many Best Managed Firms leverage experts and specialists—both in-house and external—in all aspects of their practices in order to reduce costs, maximize efficiency and provide a superior service offering to clients. The most important areas where these Firms typically encourage specialization include:

Investment management. Specialization in the investment management arena is extremely common among Best Managed Firms, and has been incorporated in multiple ways based on each Firm's core competency and area of focus. For example, the most common approach is to create a separate in-house department that focuses solely on investment management. Other Firms are dedicated investment managers and have developed strong referral relationships with CPAs, attorneys, financial planners, lending agencies and other service professionals to deliver additional financial services to clients. Some Firms do not perform in-house investment management at all, and instead use referral relationships with dedicated investment managers to offer investment expertise to clients. Finally, a small number of Firms employ an individual or team that evaluates and contracts with third-party investment managers.

Financial, tax and estate planning. Most Best Managed Firms have dedicated individuals or teams of financial planners on staff. Even those Firms with one or more in-house CPAs have relationships with outside CPA firms in order to ensure that clients with complex tax issues receive outstanding service. Likewise, though many Firms have one or more attorneys on staff, they also have relationships with outside law firms for the drafting of complex legal documents. **Founders Financial Network** in Cupertino, California, performs a single service—comprehensive financial planning—and uses an extensive network of investment managers, accountants, attorneys and other professionals to provide additional services their clients and their business need.

Technology. Technology is not a core competency of most advisors. Most Firms therefore have in-house technology specialists in network administration and/or software development, or they outsource these functions. They report that the efficiencies this approach delivers significantly outweigh the cost.

Compliance. Keeping up with compliance and regulatory issues has become increasingly time-consuming. Several of the Firms therefore have hired outside consultants to assist with the growing demands and complexities of compliance, and most of the Firms that have not yet hired outside consultants are looking to do so in the near future.

Strategic planning and business development. Approximately half of the Best Managed Firms have hired a coach or a business consultant to develop a strategic plan. A select few have hired outside marketing and advertising firms to help with their business development initiatives.

Leveraging Junior Staff

> "There's nothing that can reenergize a business more than a fresh young mind with a fresh perspective wanting to create success."
> Budros, Ruhlin & Roe, LLC

Junior staff are cost-effective, have more time than senior staff to devote to tasks, and need to be challenged in order to grow professionally. By delegating to junior staff, advisors start a chain reaction: Employees take on more responsibility and pass down some of their old duties to the next level. This approach generates cost savings while also giving employees a career path. Empowered employees who don't feel bored with routine tasks are more likely to be attentive, thorough and motivated to help a firm grow profitably. Junior employees who take on more responsibility also often improve existing practices. "There's nothing that can reenergize a business more than a fresh young mind with a fresh perspective wanting to create success," says Peggy Ruhlin of **Budros, Ruhlin & Roe, LLC**.

Finally, delegating allows Best Managed Firms to develop their staff toward becoming senior professionals or even principals. The faster that happens, the faster a firm can grow. "There is a risk of growing people and then watching them leave, but if you don't give them a career path they'll leave anyway," says David Bugen of **RegentAtlantic Capital, LLC** in Chatham, New Jersey. "The bigger risk is not giving staff the opportunity to grow and develop a specialty."

In the end, specialization and delegation allow advisors at top Firms to serve more clients—thereby generating more profits. Consider that the typical principal at a Best Managed Firm can serve 99 clients, while a principal at the average fee-based firm serves just 75. The bottom line: The average practice could generate $40,000 per firm in additional before-tax profits by reaching the Best Managed Firms' level of success—an increase of 35% on current profits.[1]

[1] **Calculation:** Two professionals at the typical practice x (75 to 99) clients per professional x $4,145 revenue per client at the typical practice x 20.5% operating profit margin at the Best Managed Firms ≈ $40,000.

Conclusion

It appears that fee-based investment advisors will likely continue to experience strong growth as affluent investors looking to achieve their most important financial goals increasingly demand independent advice from true professionals. Indeed, 50% of affluent investors surveyed by the Spectrem Group cited "objectivity" as the main reason they use independent advisors. Furthermore, a full 80% of investors using independent advisors reported being satisfied with the advisor-client relationship.[1] Going forward, the value that you provide puts you in a better position to capture an enormous amount of opportunities.

Focusing on growing profitably can have a profound impact not just on your business, but on your overall quality of life.

But as we've seen, the key to your success will be the strategies you use to identify and pursue those opportunities—and then parlay them into profits. A haphazard, "say yes to everything" approach may enable you to grow revenues aggressively, but revenue growth is simply not enough. You must generate strong, steady profit growth that will help ensure a thriving practice. By doing so, you also can enjoy a significantly higher level of personal success. Consider that the income per owner of the typical Best Managed Firm is $568,882—versus just $143,929 for owners of the average fee-based practice. The upshot: Focusing on growing profitably can have a profound impact not just on your business, but on your overall quality of life.

Advisors seeking to achieve profitable growth can look to the key lessons of the industry's Best Managed Firms for guidance:

Pursue Ideal Opportunities Only. Exclusively target those clients who are perfect for you—the ones you can serve exceptionally well and who, in turn, will contribute to your bottom line—and say "no" to the others.

Structure Your Firm Around Your Strategy. Design all aspects of your firm to capitalize on your chosen opportunities and execute on your strategic goals.

Institutionalize Your Business Processes. Make the most of business systems, processes and technologies that maximize efficiencies, reduce costs and enable you to deliver consistently superior service to clients at every interaction.

Delegate to Maximize Effectiveness. Don't try to do everything yourself. Focus your time and attention on what you do best, and allow junior staff members and specialists to handle the rest.

By understanding and adopting these top Firms' best practices, advisors can put themselves in the optimal position to overcome the challenges they face and enjoy what promises to be an exciting, prosperous and profitable future.

[1] *Relationship with Advisors: 2003 High Net Worth Perspective Series*, Spectrem Group.

Appendix

Exhibit A: Composite Financial Performance Data

Average Common Size Income Statement–Fee-Based Firms by Assets Under Management*

	Best Managed Firms	>$250M	$100M–$250M	$50M–$100M	<$50M
REVENUES					
Asset Management Fees	70.4%	81.5%	81.2%	81.3%	62.3%
Planning & Consulting Fees	23.7%	14.5%	11.1%	9.7%	29.4%
Securities Commissions & Trails	0.1%	1.0%	1.7%	2.9%	1.8%
Insurance Commissions & Renewals	3.5%	0.6%	2.1%	1.3%	1.6%
Other Revenue	2.3%	2.4%	3.9%	4.8%	4.8%
Total Revenue	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**
DIRECT EXPENSES					
Professional Salaries	27.6%	27.4%	19.9%	19.7%	16.3%
Owner's Draws or Base Compensation	14.8%	13.5%	19.8%	21.6%	29.5%
Other Direct Expenses	3.5%	2.7%	5.1%	2.9%	4.2%
Total Direct Expenses	**45.9%**	**43.5%**	**44.8%**	**44.2%**	**50.0%**
Gross Profit	**54.1%**	**56.5%**	**55.2%**	**55.8%**	**50.0%**
OPERATING EXPENSES					
Total HR Expenses	15.7%	13.5%	22.1%	17.5%	12.6%
Total Infrastructure Expenses	13.2%	18.5%	16.2%	19.0%	17.8%
Total Client Development Expenses	1.9%	2.5%	2.9%	3.2%	3.3%
All Other Operating Expenses	2.9%	3.6%	4.7%	5.4%	5.3%
Total Operating Expenses	**33.6%**	**38.0%**	**45.9%**	**45.1%**	**38.8%**
OPERATING INCOME	**20.5%**	**18.4%**	**9.3%**	**10.7%**	**11.2%**
Total Other Inc/Exp	-5.8%	-4.6%	-3.2%	-1.6%	-3.3%
BEFORE-TAX PROFIT	**14.6%**	**13.8%**	**6.1%**	**9.1%**	**7.9%**
Income Taxes	-1.0%	-0.1%	-0.3%	-0.3%	-0.3%
NET INCOME	**13.6%**	**13.6%**	**5.9%**	**8.8%**	**7.6%**
Pre-Tax Income Per Owner	17.7%	8.5%	20.1%	27.2%	31.0%
Count	28	32	59	69	118

Median Ratios

	Best Managed Firms	>$250M	$100M–$250M	$50M–$100M	<$50M
Average Assets Under Management	$691,610,109	$544,598,115	$159,486,659	$71,036,766	$21,163,344
Average Revenue	$3,205,562	$3,397,979	$993,294	$515,977	$247,997
Total Clients	213	359	171	117	60
# of Partners/Principals	2	3	2	1	1
# of Other Professional Staff	3	4	2	1	0
# of Admin. Support Staff	7	7	3	2	1
Total Staff	12	15	7	4	2
# of Clients per Partner/Principal	99	105	95	84	52
AUM per Partner/Principal/Prof. Staff	$81,923,333	$66,040,404	$36,950,000	$32,500,000	$16,750,000
Revenue per Partner/Principal/Prof. Staff	$467,311	$302,412	$241,012	$233,563	$134,631
AUM per Client	$1,528,030	$1,325,692	$893,734	$608,046	$362,691
Total Revenue per Client	$9,796	$6,362	$5,110	$4,428	$2,986
EBITDA per Client	$1,596	$729	$155	$272	$103

1. Information is based on 306 firms that have more than 75% of revenue from fees.
2. Best Managed Firms—top 10% performing firms based on composite criteria ranking of profitability, productivity, growth and professional leverage.
3. Principals—professionals/owners with practice management and client responsibility.
4. Professionals—investment advisors, financial planners, portfolio managers and business development specialists.
5. Support Staff—para-planners, tax preparers, research analysts and client service administrators.
6. Administrative Staff—office managers, bookkeepers, internal accountants, information system specialists and receptionists.

*All figures may not appear to sum due to rounding.

Exhibit B: Determining Profitability per Client Segment

Determining client profitability requires a clear understanding of the time and expenses needed to serve each client. Most advisory firms oppose tracking hours spent on specific clients, feeling that they should offer clients the services they need when they need them rather than "nickel and dime" them on an hourly basis. However, tracking the hours spent per client provides valuable insight into client profitability and a firm's use of its most valuable resource—the time of its professionals. Furthermore, tracking hours does not mandate that clients be billed on an hourly basis. Billing on a project or relationship basis (e.g., AUM fees) while also tracking hours for internal analysis is a common and effective practice in advertising, public relations, engineering and architecture, graphic design, accounting and other professions.

Tracking professional time as a method of allocating expenses to specific clients is grounded in the logic that professionals are the most expensive and limited resource at a given firm. A professional's time is also a good indicator of all the activity related to a client relationship: If a professional has spent 10 hours on a client, a proportionate amount of overhead activity (reporting, copies, calls, emails, etc.) can be assumed. Thus, the analysis reveals both the **direct cost** (professional time) associated with a client and the **indirect cost** (overhead).

This method of analyzing the cost of service is called **activity-based costing**, and involves the following steps:

1. **Set up a time-tracking system.** (Note: The rest of this analysis is applicable even if you do not track hours.) There are sophisticated software packages that track time, although many advisory firms use a simple spreadsheet. When tracking time, use client codes or numbers rather than client names to ensure that everyone identifies each client the same way. Such consistency will make it easier to use formulas to sum up totals later. Enter time daily rather than weekly, as details can get blurry during a busy week.

2. **Review the overall amount of professional hours available and determine the total number of hours in the pool.** Start with the expected number of compensated hours each professional will have in a year. Then subtract time needed for vacation, sick or personal time, professional education, and time spent on business development as well as administrative and firm management tasks. (*See the example at right.*)

Work Hours Available in a Year	2,080
Less	
Vacation Time	100
Sick Time	40
Personal Time	40
Professional Development	50
Business Development	400
Administrative Tasks	200
Client Service Hours	**1,250**

   Once you perform this analysis for all of your professionals, add up the pool of total available client service hours. In this example, assume three professionals with a total estimated pool of client time of 3,750 hours.

3. **Allocate the total overhead expense to the total pool of professional hours to estimate how many dollars of overhead are spent for each hour of client service.** Simply divide the total overhead (which includes all expenses other than professional compensation) by the number of hours to arrive at an overhead per hour figure. In this example, assume the firm has $375,000 in overhead expenses, and therefore spends $100 in overhead for each hour of professional time. If the firm spends 30 hours on one client, for example, we estimate that this costs $3,000 in overhead.

4. **Add the cost of professional compensation to the estimate of expenses per client.** First, take the base compensation of all professionals and convert it into an hourly rate using the total number of hours devoted to client service (not the time spent on paid time off, administrative, etc.). For example, if Jim Smith is paid $100,000 per year and is expected to have 1,250 client service hours, his hourly cost to the firm per client service hour is = $100,000/1,250 = $80/hour. Add this amount to your estimate of overhead per hour to get an estimate of total cost per client service hour:

   Cost Per Client Service Hour = $100 (Overhead per hour) + $80 (Professional Compensation per hour) = $180 per hour

Client Service Hours	1,250
Total Pool of Hours for Three Professionals	3,750
Total Firm Overhead	$375,000
Overhead per Hour = Total Overhead divided by Total Hours	**$100**
Advisor Base Compensation	$100,000
Client Service Hours	1,250
Direct Cost per Hour = Base Compensation divided by Client Hours	**$80**
Break-Even Cost per Hour	**$180**
Expected Profit Margin	**25%**
Full Hourly Rate = Cost per Hour divided by (One minus Expected Profit)	**$240**

This is your approximate cost for every hour spent with a client. This estimate may be used to determine if a client relationship is profitable for the firm. For example, if Jim Smith spends 30 hours with a client who pays the firm $5,000 in fees, the cost of the client is 30 X $180 = $5,400. Therefore, this client relationship is not breaking even.

You can perform this analysis even if you don't track time by client. Simply go through steps 2 to 4 and you will be able to at least analyze **estimated profitability** for a new client or a typical client. By performing this analysis, you will be able to answer a question such as: "If my typical low-end client demands 30 hours of Jim's time, and pays $5,000 in fees, are we breaking even on such relationships?" An example of a question that won't be answered is: "The Johnson family demands a lot of extra attention and they pay us $20,000 in fees, but given the time that we spend, is this a profitable relationship?" To answer such specific questions, time spent related to the Johnsons must be tracked.

So far we have focused only on the cost component. Most firms also incorporate an expectation of profitability into their analysis. For example, if you expect your firm to earn a 25% operating profit margin, incorporate that margin into the hourly cost by dividing the cost estimate so far by one minus the margin expectation. For example: $180 divided by (1 minus 25%) = $240. This is the "hourly rate" that will produce a 25% profit margin for your firm.

If, for example, the Johnson relationship requires 30 hours of work and the Johnsons' AUM fees amount to $7,200, the profitability of the relationship will be exactly 25% on a **fully allocated basis** (meaning all costs included). If the Johnsons pay a fee of $6,000, the relationship will still be profitable—but the profitability will be lower than the "expected" 25%.

Example Client—Johnson Family	
Revenues from Johnson relationship	**$6,000**
Time Required (in hours)	30
Full Hourly Rate	x $240
Fully Allocated Cost	**$7,200**
Time Required (in hours)	30
Break-Even Rate	x $180
Break-Even Cost	**$5,400**
Client is profitable, but not under the expected 25% margin built into the hourly rate.	

When performing this type of analysis, consider these factors:

a. Advisors may prefer to evaluate the profitability of ongoing relationships rather than a single year or single event. It is perfectly valid to have lower profitability on a client for one year if the relationship is valuable over time. The question is: How will the relationship become more profitable?

b. Not all professional hours will have the same "cost" attached to them, because the compensation component will not be the same. In the example above, Jim Smith's fully allocated cost is $180/hour ($240/hour with the profit built in). The same analysis of a junior advisor at the firm who has a compensation of $60,000 will have a rate of $148/hour ($197/hour including the profit expectation).

c. This analysis assumes that everyone will work the budgeted number of client service hours. If, at the end of the year, Jim Smith spent only 1,000 hours on clients but had the same compensation, his actual cost on an hourly basis would be higher.

d. Firms using variable base compensation (percent of revenue) will have difficulty adapting this analysis, because their direct cost is defined not by the number of hours spent, but by the compensation contract (e.g., a set percentage rather than the hourly rate we calculated).

Exhibit C: Performance Metrics to Monitor Strategy Execution

In addition to watching profit margins year by year, there are several financial performance metrics that are helpful in evaluating whether a firm's strategy is being progressively integrated into operations and procedures. In particular, monitoring the current client mix relative to the target client mix is critical. Using the specific characteristics that define your target client, break down your client base into the percentage who meet your target and those who do not.

The following data on client mix is taken from the *2004 FPA Financial Performance Study of Financial Advisory Practices*. This data illustrates that profitability is not simply a function of having larger clients, but rather is a function of having a larger percentage of target clients. It also reveals the critical nature of focus and strategy for smaller practices—and the significant financial rewards that can be reaped thereof.

The table to the right compares the target client mix to the actual client mix for ensemble firms (multiple owner/advisor) that focus on the smallest clients (less than $500,000 in investable assets) and the Fee-Based Firms included in the FPA study that were not Best Managed Firms. It shows that the typical practice (as represented by Other Fee-Based Firms) is not on target, with a majority of clients being outside the ideal AUM range, while the firm pursuing smaller clients currently is on track.

Client Segmentation

	Small Target Client		Other Fee-Based Firms	
	Target	Average % of Clients	Target	Average % of Clients
Investable Assets				
Less than $500,000	X	**50%**		8%
$500,000–$1M		35%		12%
$1M–$5M		10%		**45%**
Over $5M		5%	X	35%
Total		**100%**		**100%**

The following table shows key performance metrics of both types of firms. Note that while revenue per professional and support staff is almost equivalent, pre-tax income per owner is 2.3 times greater for those firms that are on target—even though they focus on clients with relatively few assets. These practices are characterized by several other key metrics, including:

- Higher revenue ($1M vs. $429K). A disciplined strategy makes these firms much more successful.
- Higher gross margin (67% vs. 53%). The cost of generating sales and directly serving clients is less at the firms focused on the smallest clients, and revenues are greater.
- Higher operating profits (20% vs. 6%). The gap between those firms successfully targeting ideal clients and firms that are not on target widens significantly at the operating profit level. Firms that are not on target are highly inefficient.
- More clients per professional and support staff (107 vs. 33). This is the result of greater efficiencies at the focused, on-target firms.
- Lower AUM per client ($214K vs. $604K). The Small Target Client Firms enjoy greater overall success despite having fewer AUM per client than the Other Fee-Based Firms.

Median Ratios

	Small Target	Other Firms
Assets Under Management	$160,000,000	$62,404,900
Revenue	$1,020,000	$429,629
Clients	749	115
Gross Margin	67.2%	53.1%
Operating Profit Margin	19.7%	5.8%
Pre-Tax Income per Owner	**$250,677**	**$108,100**
Staff Headcount		
Principals	1	1
Professionals	4	0
Reps/Contractors	4	1
Support Staff	2	1
Admin Staff	2	1
Total Headcount	13	4
Active Clients per Professional	250	48
Active Clients per Professional & Support	107	33
Revenue per Professional	$340,000	$200,360
Revenue per Professional & Support	$145,714	$133,240
AUM per Professional	$53,333,333	$29,922,083
AUM per Professional & Support	$22,857,143	$19,705,850
Revenue per Active Client	$1,362	$4,145
AUM per Active Client	**$213,618**	**$604,179**
Operating Profit per Client	$269	$356

Notes

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CRS 15671 (1001-01628)   MKT30566SIM (11/04)

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