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GUEST ARTICLE: You Can't Judge A Book (Of Business) By Its Cover

Allan Starkie, May 15, 2017

Buying a book of business should not be regarded as a panacea, or as a substitute for developing a functional sales force, the author of this article argues.

Here is a guest article by Allan Starkie PhD, a partner at Knightsbridge Advisors. He writes about the kind of considerations that need to be held in mind when assessing advisors, including in the process of M&A deals where wealth management firms are in play. Allan has written for this news service on previous occasions (see here for an example) and the editors are pleased to share these insights with readers. As always, this publication doesn't necessarily endorse all views of guest contributors. Email tom.burroughes@wealthbriefing.com if you wish to respond.

Starkie specializes in executive recruiting in wealth management, and also provides management consulting and merger and acquisition support for clients. Prior to joining Knightsbridge Advisors, he served as a partner at the executive search firm Riotto-Jones, where he led CEO and high net worth sales searches. Starkie is a graduate of West Point and Harvard Business School. He has also worked in the intelligence services.

"I really want an advisor with a book." This is a request I hear almost daily. Usually it is delivered in a tone one might associate with an Alpine climber, trapped by an avalanche, breathing his hopes for help to a speck in the distance, which he fervently hopes to be a St Bernard, carrying a flask of brandy- followed by a team of rescuers.

"I would like a minimum of $250 million in AuM" adds the prospective client with a piercing, hopeful gaze suggestive of what I imagine to have been the look in the eyes of General Custer, as they scanned the horizon, searching for a troop of non-existent reinforcements large enough to defeat Sitting Bull.

Before we can even begin to satisfy such hopes, a great deal of analysis must be accomplished. In my earlier career as an intelligence officer, I was taught that the definition of intelligence was "the analysis and processing on raw information". Information itself is not intelligence, and is a dangerous basis for decisions. Let us, then, describe a systematic approach for analyzing the components of information associated with a book of business, and using that analysis to make more realistic predictions around portability.

The following is a list of categories/questions which need to be addressed, to make such a determination:

1. Is the book a work of fiction or non-fiction?
2. What is the exact composition of the book?
3. How was it created, and at what pace does it grow?
4. In what ways is it encumbered, entrenched and institutionalized?
5. What is the exact role of the advisor, and who else is involved in tending the book?
6. Is the advisor's firm a member of the "Broker Protocol" (this does not only pertain to brokerages)?
7. What agreements have the advisor signed: non-solicitation, non-compete, garden leave?
8. What are the differences between the advisor's current platform and yours?
9. What is the fee structure at the advisor's current firm versus yours?
10. How much are you willing to pay for the portable assets, and when are you willing to pay?

Is the book fiction or non-fiction

It was once said that "the closest a person gets to perfection is when writing one's own resume". In that vein: the oral description of one's book of business, the self-sourced, Herculean method of its creation, and the blind, eternal devotion of one's clients, somehow loses some of its hyperbole when translated into Excel spreadsheets.

The creation of a clear, definitive spreadsheet, combined with a statement early in the process that financial enrichment for portable assets will follow delivery of those assets (as opposed to paying upfront based on hope and good wishes), are the two surest methods of stripping away the fiction.

Describe the composition of the book

In many firms, advisors are provided surprisingly limited information about their own books of business. But to the extent that they are able, ask them to create a table that lists each client (never by name), and describe each relationship as follows:

- Total net worth
- Current AUM with advisor
- Portfolio construction of these assets, to understand whether your platform can accommodate the product mix, or even individual positions that might be important to the

client. If it cannot, and you require the client to liquidate securities at a low cost basis, the resultant tax liability might greatly inhibit portability
- Fiduciary relationships associated with the assets
- Credit relationships each client might have with the current institution, and if any of the AUM are used to secure them
- Corporate relationships the client may have with the institutions Commercial Bank
- How was the relationship initially sourced
- Did the relationship follow the advisor from his/her proceeding firm (this becomes especially important in the event of existing non-solicitation agreements)
- How long has the client been with the advisor

Sourcing and growth
In analyzing the referenced spreadsheet, the first question to ask yourself is whether the clients were primarily self-sourced by the advisor, through a network of referral sources that would be accessible when he/she joins your firm. If it appears that most clients came from internal bank referrals, or intermediaries loyal to the current institution, it is a pretty good guess that portability will be low, and even worse, that the advisor will have little success at building new client relationships, in the absence of those intra-bank referral networks.

Study the annual growth of the book, again focusing on the source of those leads. Hiring an advisor that is generating above $50 million, in new self-sourced AUM each year, (but offering limited portability) is a better hire than an advisor purporting 85 per cent portability on a $200 million book that has stagnated for a decade.

Institutionalization of client-base and the role of the advisor
An “advisor” can mean many things in an industry with creative job titles. It could mean a quarterback directing a large team of specialists, to include: portfolio manager, trust officer, credit officer, financial planner, and the more esoteric personnel associated with ultra-high net worth clients. They could also be portfolio managers in a firm that does not use relationship managers, or they can even be the primary trusted advisor to their clients, in an environment in which there is little support or institutionalization. To understand the actual role your candidate plays at his/her current institution, it is imperative to determine how many people surround the client-base, what services do they offer, and to whom has each client bonded.

International money centers, and super-regional banks are notorious for surrounding each client with scores of specialists that make the notion of severing each of these relationships an ordeal that many clients will not consider. In such cases, the greatest success we have had in achieving exemplary portability, has been by lifting-out entire client-facing teams from these banks, and moving them intact to the new firm.

In addition to the possibility that a client is too well-ensconced within a team of professionals, there is the added complication of the significance of existing credit relationships, both personal and in some cases corporate. Even if the assets are not being used to secure a particular credit facility, there is a strong chance that a client will fear losing that source of credit if he/she moves their assets. Additionally, the nature of complex (even irrevocable) trust relationships associated with the assets must be clearly understood to gauge its impact on portability.

The broker protocol and non-solicitation agreements

It astonishes me how few firms are even aware of The Protocol, and the profound implications it offers in the way of portability. In 2004 three wirehouses, exhausted by litigation and restraining orders against departing brokers signed an agreement known as the "Broker Protocol". It created a "cease fire" allowing departing FA's to move their clients to the other members of the Protocol without sanctions. It superseded any restrictions that might have been associated with their employment contracts such as non-solicitation clauses. The Protocol only works when both the departing and hiring firms are members. Since 2004 hundreds of RIA's have joined The Protocol raising its ranks from the founding three firms to 650 members!

My first question to a prospective client interested in "buying a book", is whether they would be willing to join The Protocol. If they agree, membership is free and very swift. The downside is that their current advisors/employees now become more vulnerable, as their existing employment restrictions no longer apply to them regarding soliciting their clients, were they to leave.

Other than that, it creates an entirely new environment for recruiting. Clearly, for most of the smaller firms, poaching brokers from wirehouses is not feasible, due to cost and often cultural differences. But the majority of Protocol members are other RIA's as well as breakaway brokers. Hiring a candidate from a Protocol firm means immediate portability with very few restrictions. These restrictions are more centered on what pieces of client information one can bring, rather than preventing clients from following immediately. Typically the departing advisor is permitted to bring the following information:

- Client name
- Address
- Phone number
- Email
- Account title

Firms well-versed in onboarding Protocol-advisors will have a transition team waiting to turn this information into immediate account opening forms. Portability between Protocol firms is estimated to be between 50 per cent and 85 per cent, while our own survey of portability between non-protocol firms estimates between 15 per cent and 20 per cent. Our last experience with moving an advisor between two RIA's registered in the Protocol (moved three weeks ago) was 72 per cent in the first three weeks, with an additional 23 per cent in transit. A good source of additional information is an article by The Law Offices of Patrick J. Burns, Jr. PC, entitled *Opening the Floodgates to Independence.* I cannot emphasize enough the advantages of considering Protocol membership, if one is truly committed to purchasing books of business.

In the absence of Protocol membership, extreme care must be utilized in understanding the exact terms of the agreements an advisor may have signed with his/her current company. Non-solicitation agreements are standard, and usually restrict an advisor from directly or indirectly soliciting their clients for one year. They are usually enforced. Non-compete agreements are rarer, but do exist as well. They restrict an advisor from working for a competitor for a period of time (usually one year), within a specific geographic area (usually a radius of miles from their former employer). These are often harder to enforce, as they restrict a person from earning a living. Large banks often have “garden leave” periods of sixty to ninety days, in which the advisor remains on the payroll of his/her old employer and simply is not allowed to start work at the new firm. The idea, of course, is that during that period the book of business will be turned over to a new advisor and firmly entrenched within the nurturing bosom of the former institution.

There are some twists to these standard agreements, perhaps the most odd, is the “non-accept clause” in which the new institution is prohibited from accepting a client from the advisor’s old firm, for a specific period of time. One often finds this clause among Boston-based firms. Its enforceability has been called into question, as it restricts clients from doing what they wish. As a result, clients are not prohibited from following, but there is usually a penalty that the new firm must pay to the old one- often some percentage of the realized first year fee.

Legal precedent is key in assessing the enforceability of any of these documents, and great care must be exercised in deciding how to proceed with contacting clients. Recent precedent seems to favor advisors soliciting clients that had followed them to their last firm, from previous affiliation at a previous firm. That is why we ask candidates to define how long and from where they began their relationship with each client.

Social media, such as resetting one’s *LinkedIn* profile, offers means of notifying clients, without the old and sometimes dangerous practice of sending out announcements. The legal issues surrounding solicitation are some of the most complex and tenuous questions one needs to dissect before moving forward with an offer. I strongly recommend that regardless of the talents of your in-house legal team, an outside attorney specializing in The Protocol, and one that is kept current on legal precedents regarding solicitation should be engaged, fairly early in the process.

Platform compatibility
Sometimes when I am asked to help fledgling or damaged firms acquire assets, an image comes to mind of a castle on a hill, populated by wealthy, happy, well-fed people and their minions. At the bottom of the hill is a trailer park from which emerges a disgruntled, disheveled, hungry person who looks up at the castle and wonders why none of the occupants have moved into his trailer.

Books of business are only comprised of numbers when you look at a spreadsheet- their real occupants are human beings, who have committed their life-savings and hopes for retirement in the hands of the advisor and the firm he/she represents. As human-beings and not lemmings, they cannot be expected to mindlessly follow an advisor, regardless of how charming, to an institution incapable of servicing their needs. It is delusional to assume that a popular advisor will overcome client objections to an inferior offering, or even an offering that might be philosophically add odds with the client’s disposition. A profound example of this is the attempt to move assets from an open architecture platform to a proprietary one. Although I am far from convinced that open architecture is superior to the accountability associated with a proprietary offering, it is clear that many clients have been force-fed substantial quantities of Kool-Aid, and believe that large mark-ups on indexed managers is the only way to go. In situations like this, where a potential philosophical re-education is required, it is very difficult to be sure of any meaningful portability.

In such a case one needs to examine the client-base on a truly case-by-case basis, to make any estimate at all.

The fee structure of both firms must also be examined. Few clients will gleefully follow their advisors simply to pay higher fees for similar products. Of course, discounts can be made initially, but what will be the effect when fees are later raised to conform to the new firm's fee schedules? Have you positioned yourself with "claw-back" clauses to recoup monies you have paid for those assets in the event that many of them leave later on, for reasons such as this?

What will it cost?
Not so long ago, wirehouses were paying deals that topped-out at 350 per cent of the advisor's trailing twelve month of revenues. To put this absurd overpayment into perspective- it is about 175 per cent the franchise value of a typical RIA, based upon top-line valuation metrics. The money was paid in a combination of upfront sign-on bonuses and "back-end" bonuses, triggered by achieving asset and revenue bogies over a period of time. For the most part, the bonuses were given as self-amortizing employee forgivable loans, acting as "golden handcuffs," until they were repaid.

Outside of brokerages, this form and magnitude of compensation for portability does not exist. We have designed a multitude of models for various RIA's and each is slightly different, using a combination of cash and equity, triggered by performance, not expectations. The optimal model will invariably utilize equity as a major form of compensation for portable assets, with some form of cash payment, as well. Equity needs to be introduced in a manner that makes defection of the new advisor costly for him/her, but also allows for access to the value of the equity, in times of need. A good example would be to allow the advisor to borrow against some percentage of the value of vested equity.

Conclusion
Buying a book of business should not be regarded as a panacea, or as a substitute for developing a functional sales force. It can be a fine augmentation to a firm's organic growth, when executed with care and structure. The assets themselves should not tantalize and blind the new employer to the fundamental question: would you hire this person, and would they succeed even without portable assets? If the answer is yes, then utilize the steps I have outlined above then understand exactly what lies between the covers of that particular book.