FAMILY WEALTHREPORT

GUEST ARTICLE: Compensation Trends In Wealth Management: Lessons From The Wirehouses

Allan Starkie, March 24, 2015

Here is part one of a guest article by Allan Starkie, a partner at Knightsbridge Advisors, about compensation trends in the wealth management industry. His insights reflect the presentation he made earlier this month at the annual American Bankers Association, Wealth Management and Trust Conference.

Starkie specializes in executive recruiting in wealth management, and also provides management consulting and M&A support for clients. Prior to joining Knightsbridge Advisors, he was a partner at the executive search firm Riotto-Jones, where he led CEO and high net worth sales searches.

The views expressed below are those of the author's, but Family Wealth Report is grateful for the right to publish them, and welcomes reader responses.

"Can a private bank or trust company construct a compensation plan for producers that delivers, and competes with the wirehouses?" That was the question that the American Bankers Association asked me to address at their annual Wealth Management and Trust Conference last month.

As I conducted the research necessary to address this, I was able to confirm some facts about how the wealth management industry has fundamentally changed, and why the wirehouse model has begun to morph into something quite different from its traditional roots.

In developing any compensation strategy, one should avoid concentrating on simply compensation; it is essential to regard compensation in light of the "three Ps": platform, product and people.

For example, the ideal compensation plan for a business development officer selling a proprietary investment product, grossly out-performing its benchmark, would vary enormously from that of a professional garnering new AuM in a purely open-architecture platform, with strong referrals from commercial lenders and capital markets.

Product changes in the last decade have been moderate. The industry has settled around the almost predominant use of outside managers, and the effects of open-architecture have been translated into most platforms and compensation plans. Margins have been compressed, due to the cost of outside managers, and the profile of client-facing professionals has migrated from the once invaluable alpha-type sales professionals to more empathetic, credentialed purveyors of holistic, comprehensive wealth management services.

The greatest changes since the crash have been to the “platform”. Two trends have occurred simultaneously:

· The business climate in wealth management has undergone a structural change (source: Boston Consulting Group, *Global Wealth*, 2013).
· Private wealth has experienced explosive growth (Capgemini and RBC Wealth Management, *World Wealth Report*, 2014).

The major changes in the business climate have been directly or indirectly attributable to the crash itself:

- Enormous increase in back-office costs due to regulatory changes;
- Costs in facilitating the integration of corporate cultures and redundant personnel due to forced, post-crash consolidation; and
- Artificially compressed interest rates, forcing increased pressure on the growth of AuM to mitigate the loss of revenues on credit spreads.

It is interesting that the latest BCG report indicates: “because of regulatory requirements and the subsequent rise in back-office costs, cost-to-earnings ratios (CIR) have increased by 19 per cent since 2007…players posted the highest CIR around 80 per cent.” Naturally, this has had a very negative impact on compensation in general, and the burden has fallen on the front-office to subsidize the increased costs of the back-office.

Evidence of this was noted by BCG, and they point out that “CIR did not increase commensurately with revenues in 2012, indicating that wealth managers are placing an increased emphasis on cost containment.” And in further testament of the impact being borne by the front-office, BCG concluded:

“Pay and performance were not always fully aligned, but compensation ratios (measured by employee compensation as a percentage of revenues) appeared to be stabilizing at around 40 per cent...the trend is toward rising back-office costs and declining front-office costs…with many managers coping through striving for greater frontline efficiency…many RMs manage larger books…revenue per RM has increased.”

In other words, client-facing professionals are working harder, and when not formulaic, their compensation is not rising as fast as their increased workload. As a result, we must adamantly conclude that formulaic incentive compensation is critical in the current environment.

The second major trend that has resulted in a profound change in the wealth management climate is the enormous growth of private wealth since the crash.

According to Capgemini and RBC's latest *World Wealth Report*, we have just experienced a 17.7 per cent growth in HNW assets, growing US private wealth to $13.9 trillion (the fastest annual growth since Capgemini began measuring it in 1997).

This has resulted in an increase in US HNW individuals to 4 million. With a population of 320 million, this means that the "one-percenters have now proliferated into the one-and-a-quarter-percenters" (source: KBA Study, 2014). To put this in perspective, in a similar speech I delivered to the American Bankers Association in 2006, I cited that 2.7 million Americans were HNW, holding $9.3 trillion in wealth. That means that there are 1.3 million more HNW individuals since 2007, holding an addition $4.6 trillion in new wealth. This constitutes a 50 per cent increase in both potential clients, as well as newly-minted AuM.

Let us put this into a tangible perspective for the wealth management industry: $4.6 trillion in new AuM at fees of 50 BPS would generate additional annual fee revenues at $23 billion. If the average US advisor produces $350,000 of new fee revenues per year, we would have needed to have added 65,000 new advisors to the national sales force; but in actuality, the national sales force has shrunk since 2007.

Let us take a look at the national sales force, combining for the sake of analysis, business development officers, with all the other forms of revenue-bearing, client-facing professionals, to include: Private bankers, relationship managers, wealth advisors, and financial advisors.

According to Cerulli Associates' *Advisors Metrics* for July 2013, the total number of advisors has reduced from 330,909 in 2007 to 302,270 in 2013. This trend will continue and in 2017 Cerulli projects that the FA population will be 208,859. Our firm's further analysis would indicate that only 92,000 of these FAs are focused on HNW clients, while all other "senior client-facing/revenue-bearing professionals" (Includes: banks, trust companies, mutual fund companies, asset management companies and RIAs) muster an additional 78,000 professionals (source: KBA study 2014, assisted by Jamie McLaughlin of J H McLaughlin & Co).

The national sales force, long-rumored to be about half a million is, therefore, actually 380,270 - of which only 170,000 are servicing the current 4 million HNW client base holding $13.9 trillion in AuM. This same $13.9 trillion, at a 6.5 per cent annual growth rate, will reach $16.8 trillion by 2017, precipitating the need for another 40,000 client-facing professionals.

The hardest-hit and most troubled members of the wealth management community will be the brokers, for Cerulli also points out that "more than half of the advisor population is within fifteen years of expected retirement; 43 per cent of advisors are over 55, the average age of all the advisors is 51." To make matters worse, "a significant percentage of older advisors are their firms' highest performers."