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THE RISK DYNAMIC

Overcoming risks that threaten an advisory firm demands new insights and focused attention.

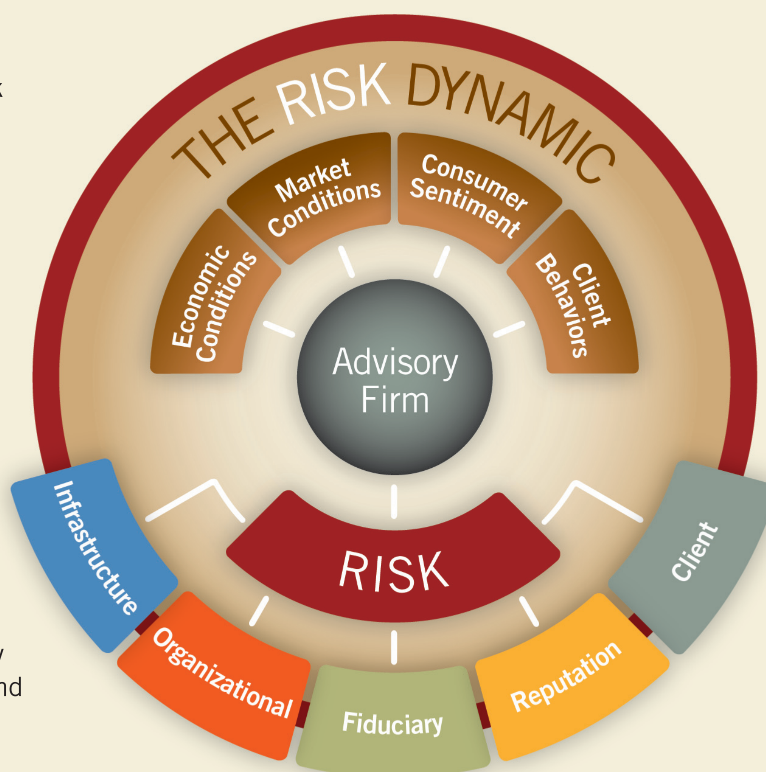
Overview

Risk management is a customary concept for nearly every financial advisor, an essential factor in an advisor's ultimate success for the client. Now, in the face of the market turmoil that began in 2008, a new dynamic of risk affecting the whole of an advisory firm has been brought to light. Aggravated by diminished operating margins and revenues, departing clients, manager scandals and the fall of long-standing name-brand institutions, this dynamic is driven by a set of closely interrelated risks. These risks have always existed, yet have been masked and more easily overlooked by market prosperity and healthier portfolio returns.

Today's market environment magnifies the exposure to these risks. For advisors whose firm prosperity depended heavily on a bullish market, this new risk dynamic proves particularly challenging. Advisors focused nearly solely on risks normally relegated to a client's portfolio and client issues, and not within their own firm, allowing vulnerabilities in other areas to gain a foothold and potentially expose the entire operation to losses.

But risks can be managed, even turned to advisors' competitive advantage, if they are identified and properly addressed. This paper will outline five fundamental types of risk that define this highly interrelated dynamic — infrastructure risk, organizational risk, fiduciary risk, reputation risk and client risk — and examine their potential effects on an advisory firm.

Further, it will discuss factors of risk and highlight best practices and steps to help protect an advisory firm, allowing advisors to sustain successful firm and client processes in all market conditions.



Defining the Risk Dynamic

Regardless of size, demography or culture, advisory firms share common business components, each with its own distinct vulnerabilities to risk. Together, these different exposures contribute in varying degrees to the risk dynamic.

Component	Definition Areas	Vulnerable to Risk
Infrastructure	Internal business processes and technologies to enable and support them.	Operational efficiency, process efficiency, technology integration, allocation of resources on the proper activities.
Organizational	Human and financial resources that drive business.	Fiscal soundness of the company, proper allocation of financial capital, business development, and sustainability of the business.
Fiduciary	Client suitability, the investment processes, and making the right decisions for clients.	Investment processes, transparency of client's assets, basis for selection of managers, stocks, or funds, alignment of client goals to investment risks, and entities holding assets or other partner firms.
Reputation	Advisory firm brand and perception in the market, marketing and communication's initiatives.	Brand management, centers of influence relationships, professional relationships, public relations, and community relations.
Client	Client needs, attitudes and behaviors, goals, and expectations.	Client relationship management, risk tolerance assessment and ongoing evaluation, understanding and exploiting behavioral finance, financial advice, client communications, and process transparency.

Infrastructure Risk

If an advisory firm is an engine, then technology and business processes are its cogs and gears. To achieve optimum performance, these elements must move together with precision and cooperation; otherwise the firm subjects itself to labor-intensive inefficiencies that continuously disrupt operations and can limit a firm's ability to scale and grow.

Research indicates that the cost of maintaining an advisory firm will continue to rise despite declines in revenues. According to the 2007 Moss Adams Compensation and Staffing Study, from 2006 to 2007 overhead expenses as a share of revenue for the average firm rose from 36.9 percent to 39.3 percent — an increase that outpaced inflation even in a positive market environment.[1] Given the current market's impact on revenues and margins, advisory firms can expect that percentage to increase, thus emphasizing the need to diminish overhead costs wherever possible without compromising service.

Integrating technology and scaling internal business processes offer opportunities for efficiencies, yet depressed revenues can prevent a firm from securing sufficient technological and staff resources. Further, a firm's development depends on scaling internal business processes with low marginal costs to ensure long-term profitable growth. Finally, because processes are only as strong as the resources that utilize them, infrastructure risk can encroach on organizational strength, and vice versa.

Organizational Risk

The organizational strategy represents the intersection of infrastructure and resource allocation. The application of both human and financial resources can be subjective, and too often, advisors default to the "squeaky wheel" approach. Back-office and administrative tasks, which quickly clutter operations, can consume time, capital, and energy that should otherwise be devoted to current and prospective clients.

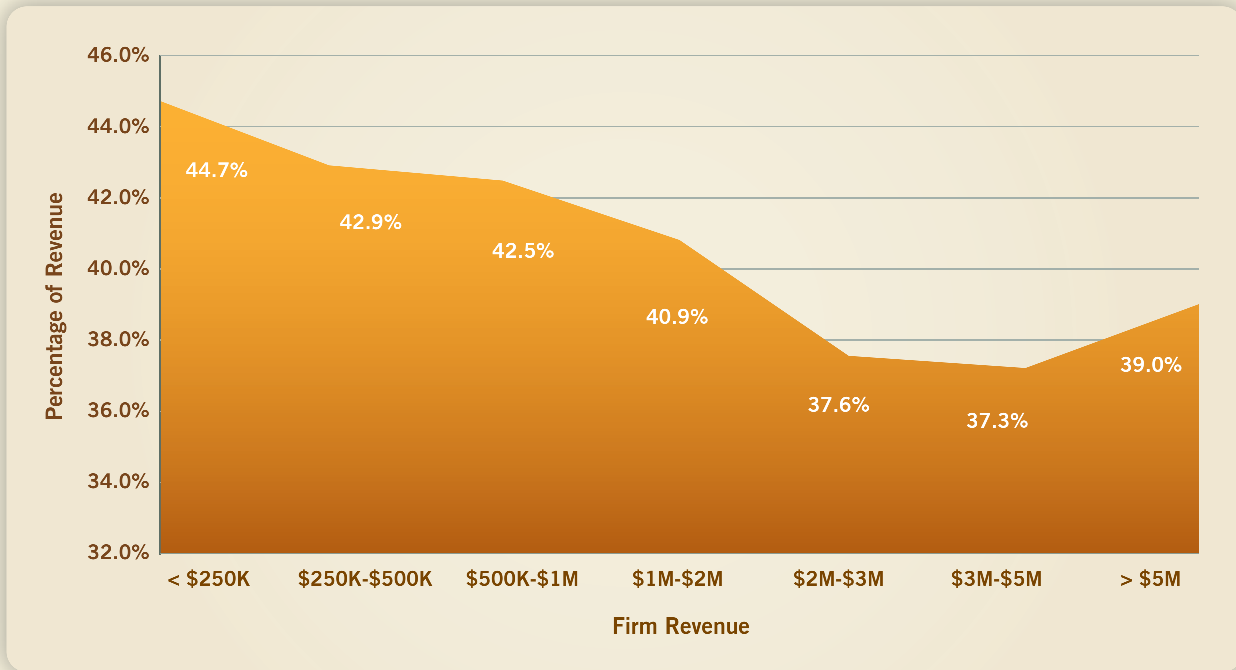
Misallocation of human and financial capital can not only dampen the firm's business viability (or financial soundness) but also the opportunity to grow longer-term. A lack of definition can lead to incongruous hiring and uneconomical compensation practices, mismanagement of roles and responsibilities and unpredictability of overhead expenses. Further, as solo or small advisory firms grow, the owner's small-business mindset lingers, resulting in a "do-it-all" approach to running the business.

[1] Source: Pershing Advisor Solutions, LLC and Moss Adams, LLP, 2009.

This lack of a scalable organizational strategy overextends the advisor and staff, compromising efficiencies and increasing infrastructure risk. The end result is limitation of much-needed client contact and service functions, thereby encroaching further on the successful development of the firm.

Costs Are Rising for Largest Advisory Firms

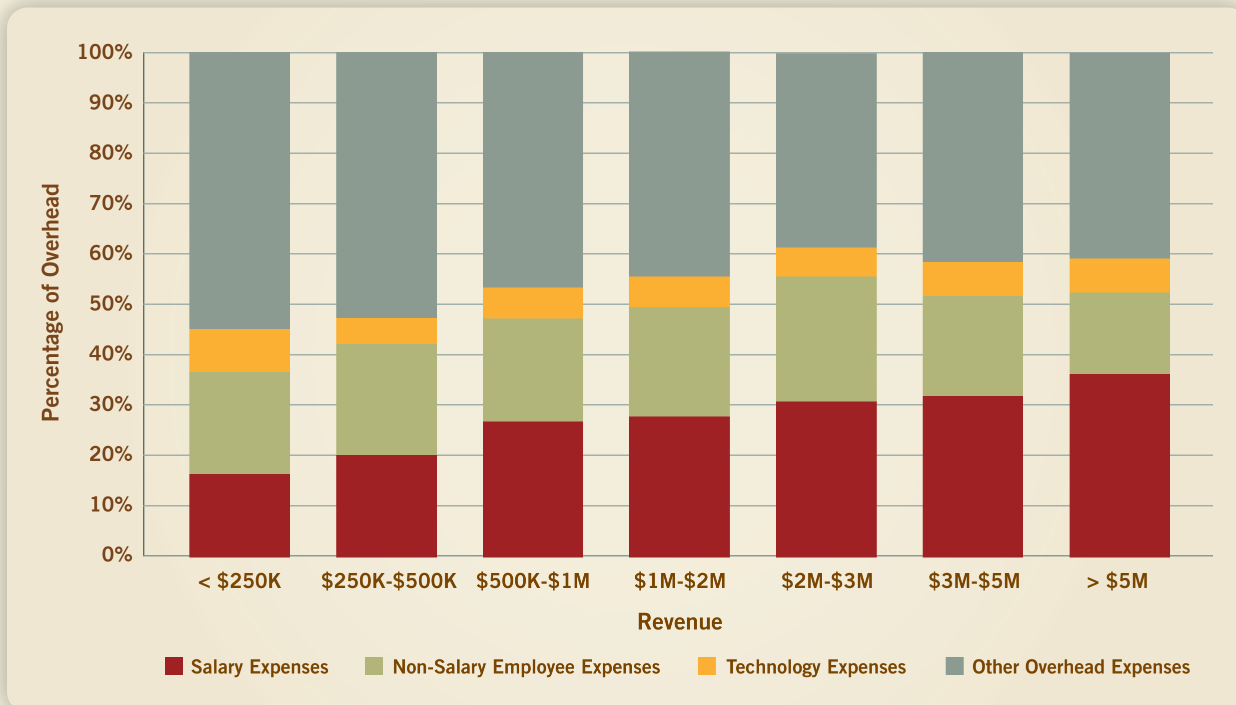
Overhead Expenses as a Percentage of Revenue, 2007



Source: 2007 Moss Adams Compensation and Staffing Study of Advisory Firms

Employee-Related Costs Grow in Share with Firm Size

Overhead Expense Distribution by Firm Size



Source: 2007 Moss Adams Compensation and Staffing Study of Advisory Firms

FOCUS RESOURCES WHERE THE YIELD WILL BE OPTIMAL

Advisors in top-performing firms spend the most time on client service and business development. The top 25 percent of mature solo firms spend 56 percent of their time on client service and business development, versus just 46 percent for other firms.

Source: 2008 Moss Adams LLP Financial Performance Study of Advisory Firms.

Fiduciary Risk

The advisor assumes certain responsibilities as fiduciary, chief among them the obligation to make decisions in the best interests of the client. Fiduciary risks can also reveal themselves through the processes, partners, and investment approach that advisors take to advise and service clients.

In addition to their own actions, advisors may be negatively impacted by the actions of other agents and advisors, such as sub-advisors and other service providers who handle clients' money. In some cases, when clients' assets are held in brokerage accounts, the assets may be listed on the broker's balance sheet. Often, trust institutions segregate client assets from their own, and hold them in each accountholder's name.

Further, with a diverse range of clients and needs, inconsistency increases the threat of oversights and miscommunication within the investment approach and process. A lack of predictability and uniformity can hinder the advisor's ability to manage expectations, damaging even the most trusted relationships and intensifying the impact of client risk.

Reputation Risk

According to a report by The Conference Board, reputation risk is viewed by the majority of executives and investors as the most significant threat facing a company's global business operations today.[2] Due to the much-maligned missteps of a few, financial services professionals collectively face a crisis of reputation. In fact, according to a 2008 BBB/Gallup poll, 20% of the respondents had "very little trust" or "no trust" of the financial services group, which included banking, financial institutions, and stock brokers – an increase of 30% from the original survey conducted in September 2007.[3]

> "It takes many good deeds to build a good reputation, and only one bad one to lose it"
>
> — Benjamin Franklin

Even in independence, advisors are inextricably linked with industry scandal and instability. Adding to these inherited burdens is an increasingly open, user-generated dialogue as social networks, blogs and online comment boards amplify uncertainties across the marketplace.

Just as negative actions can dilute an advisory firm's reputation, so too can a lack of actions. As margins sink, marketing and branding tactics that once lent support to reputation are viewed as luxuries and sacrificed for the sake of expense reduction. The failure to reinforce reputation and generate awareness about the firm, its principles and its advantages paves the way for competitors to prey on clients by filling the silent void left by their own advisors.

Client Risk

Affected by but far more personal than reputation risk, client risk can be the most subjective and hazardous risk throughout the entire risk dynamic, especially in this bear market. Each client has a specific set of needs, attitudes, insecurities, behaviors, and expectations, all of which are the responsibility of the advisor to understand and address on an ongoing basis.

Because clients lack the ability to empathize with the advisor's business obligations, they measure success only as it relates to their own experience. Compounding this complexity, research shows that clients rarely voice dissatisfaction unless prompted by events or circumstances; thus advisors are often unaware of client issues until they reach an irreparable state.

ACCORDING TO A SEPTEMBER 2008 SURVEY CONDUCTED BY PRINCE AND ASSOCIATES:

81 percent of investors with $1 million or more in investable assets plan to take money away from their current advisor.

86 percent plan to tell other investors to avoid their advisor.

Only 2 percent plan to recommend their current firm to other investors.[4]

[2] Reputation Risk: A Corporate Governance Perspective, The Conference Board, 2007.
[3] BBB/Gallup Trust in Business Index survey, August 2008
[4] September 2008 survey conducted by Prince Allen and Associates

Client risk cannot be attributed to the bear market alone, however. Miscommunication and a lack of understanding about client priorities could prove detrimental to firms. According to the 2009 World Wealth Report conducted by Merrill Lynch Global Wealth Management and Capgemini:

- 66 percent of clients categorized online access and capabilities as "very important," while only 32 percent of advisors did so — a 34-percentage-point gap;
- Statement and reporting quality had a 24-percentage-point gap; Risk management and due diligence capabilities had a 19-percentage-point gap;
- Fee structures showed an 18-percentage-point gap.[5]

Along with service disconnects, outdated or inaccurate investment risk tolerance assessment also contribute to client risk. In the development trials of one risk profiling tool, developers claim that as many as one out of six advisors drastically miscalculated the risk tolerance of a client control group.[6] Even the slightest discrepancy between a client's perceived and actual risk tolerance – whether it be under- or overestimation – can call the advisor's abilities and commitment to the client's goals into question.

Active client communications also plays a pivotal role in helping clients feel informed of not only the market conditions, but of the advisor's actions in response to them. While good communication alone cannot sustain a relationship, poor communication can almost certainly break it, especially in challenging market conditions.

"One way to help alleviate the negative market impact is to offer stellar advice and proactive and timely communication to clients," said Lubo Li, Senior Director and financial services practice leader at J.D. Power and Associates, Toronto. "By offering investors a little soothing touch of support in these tumultuous times, advisors and investment firms may differentiate their services from the competition and increase client loyalty."[7]

From service hiccups caused by organizational inefficiencies, to uncertainty in the investment process, to doubts about performance seeded by competitors, or simple lack of active client communications, client retention is the most critical yet vulnerable aspect of an advisor's practice.

Protecting the Firm from Risk

The risk dynamic is a formidable adversary, poised to expose old weaknesses or spawn daunting new challenges to an advisory firm. With proper perspective, however, advisors can pre-empt these risks through a multi-faceted yet unified approach.

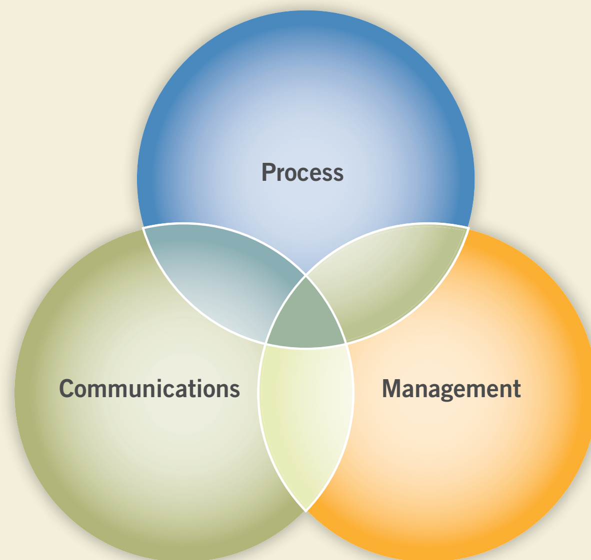
The Role of the Owner in Managing the Risk Dynamic

The success of an advisory firm hinges on the sum of its parts – no single strength can carry the entire business. Unfortunately, however, financial advice is a business predicated on time, so singular challenges that usurp time can encroach on all areas of the business. Thus, understanding the risk dynamic demands an understanding of the interrelatedness of challenges and how each impacts specific areas and the firm as a whole. The responsibility for this all encompassing perspective logically falls on the advisor firm owner, who is at once forced to act equally as chief executive officer (CEO), chief operating officer (COO), chief financial officer (CFO), chief investment officer (CIO), chief marketing officer (CMO), practitioner and even administrator.

Risk Mitigation Strategies

Because the risk dynamic dictates that certain risks can compound others, so too can the strategies mitigate them. Each solution falls into a distinct category defined by its approach and execution:

1. Process-oriented: implementation or refinement of appropriate standards, systems and technology.
2. Management-oriented: analysis and redeployment of existing practice talent, time or resources.
3. Communications-oriented: introduction of new concepts and practices related to internal/external communication, educational or new business tactics.



[5] 2009 World Wealth Report, Merrill Lynch Global Wealth Management and Capgemini
[6] FinaMetrica
[7] Economic News/Trends and Analysis — June 24, 2009, http://www.dailycommercialnews.com/nw/12705/en

1 Process-oriented Strategies

Process-oriented strategies address inefficiencies and opportunities throughout the firm on a systematic level. This includes re-examining, documenting, and standardizing all current processes, resulting in comprehensive uniformity and a quality control regimen. It not only optimizes business processes and reduces costly maintenance, it also punctuates opportunities for process reengineering and improved technology integration to reduce the risks associated with account administration and investment transactions. Process-oriented strategies counter exposure to all types of risk throughout the risk dynamic. These strategies and their benefits include:

Strategy	Risks Mitigated				
	Infrastructure	Organizational	Fiduciary	Reputation	Client
Upgrade technologies to enable straight-through processing for client acquisition. Advisors who can provide an end-to-end integrated client process that encompasses financial planning and proposal creation, portfolio construction, strategy selection, and execution of account opening transactions can avoid the risks that a typical non-straight through process exposes. These risks include duplicate client data, non-scalable creation of allocation models, customized strategy implementations, and the manual completion of multiple forms for account open instruction. All of these risks can be mitigated by stronger integrated technologies that enable the client process and enhance the overall client experience.	●		●		●
Consider third-party back-office administrators to handle day-to-day processing and technology integration to service clients. Investing cash, rebalancing, statement generation, disbursing funds in the most tax-efficient manner, and tax loss harvesting present opportunities – all take efficient and scalable processes with integrated technologies in order to accomplish. Outsourcing these elements reduces the risk of process scale, increases process efficiencies and ensures that the integration of back-office and middle-office technologies does not distract human and financial capital from your front-office needs in servicing existing clients and developing new relationships.	●	●	●		●
Understand and ensure the safety of clients' assets. In some cases, when clients' assets are held in brokerage accounts, the assets may be listed on the broker's balance sheet. Often, trust institutions segregate client assets from their own, and hold them in each accountholder's name. An advisory firm needs to ensure that the entities holding or custodying their clients' assets segregate these monies from their own, and hold them in each investor's name. For ultimate safety, an advisor should make sure the entity holding the assets does not pledge, lend or margin assets that are held in custody. Furthermore, one should ensure the entities are subject to regular audits by internal as well as independent auditors and examination by the proper federal authorities.	●		●	●	●
Apply a consistent investment approach. Some advisors have many clients with similar needs, but their assets are invested very differently. Advisors should employ a consistent approach to asset allocation and portfolio construction to ensure clients with similar risk and return objectives are treated similarly.			●		●
Follow a reasonable approach to money management. Taking investment risks to always be a top-performing advisor might work in up markets, but a more moderate style can be more effective over a full market cycle. In tough times, a more conservative style, together with stable operations, creates a client base that is less susceptible to making rash decisions to leave their advisor.			●		●
Follow a consistent client management process. Clients rely on their advisors to help them achieve their goals. When a severe bear market threatens those goals, clients are likely to hold their advisors responsible – either by leaving the advisor all together, or at worst, threatening legal action. An advisor who has a consistent, auditable, and repeatable client process, demonstrating due diligence with a client's financial plan, should be in a better position to weather any challenging client situation.		●		●	●
Develop a client documentation process. Document all communications with clients. It's not uncommon for an advisor and a client to have different recollections about the particulars of a meeting or phone call. Articulating standards for detailed note-taking of all client contact can alleviate miscommunication, conserve time and reduce potential expenses brought on by errors.		●		●	●
Contact clients regularly. Relationships with clients are strengthened by spending time listening to them, understanding them, and ultimately advising them. Clients want to know their advisor is paying attention and has their best interests at heart. They appreciate being called by advisors, especially in tough times.				●	●

Standardized protocol and metrics also provide a foundation for decision-making, and longer-range perspective on expansion. With systems in place, business transition — whether at the ownership or management level — becomes less burdensome and unclear.

❷ Management-oriented Strategies

Management-oriented strategies enable an advisory firm to properly balance the demands of the profession along with the fundamentals of running the business. While the true measure of success is client satisfaction, the prosperity of the firm depends equally on efficient allocation of resources and capitalization of growth potential. In short, the firm must be run like a business and not simply a practice.

	Risks Mitigated				
	Infrastructure	Organizational	Fiduciary	Reputation	Client
Analyze staffing structure and define roles and responsibilities. Proper allocation of human capital is essential to harnessing the firm's resources, motivating employees and enabling growth. This is particularly important during extreme market conditions — bullish and bearish. A sound staffing strategy including well-defined job descriptions will streamline time management, avoiding employee burnout and task oversight.	●	●			●
Develop an appropriate compensation strategy. There exists a fairly broad selection of compensation structures from which to choose, depending on a firm's specific needs and clientele. Careful analysis of the firm's revenue model may reveal a need to explore possible transitions to a new approach to compensation for all employees.	●		●		●
Ensure advisors' primary focus is advice. Many advisors have migrated to outsourcing the investment management process versus selecting funds, investments, and managers themselves. This has freed up time to meet with clients and advise them on the factors they can have more influence over. An advisor can't control how markets behave, but can influence the decisions clients make. Choosing a turn-key manager-of-managers investment approach allows advisors to focus their capital on client development and retention, and not on the tools or research necessary to select and monitor managers on an on-going basis.	●	●	●		●
Evaluate budget decisions rationally. The current downturn has caused many firms to make knee-jerk decisions over cutting costs in the short term without weighing the longer-term consequences. Budget decisions should be made based on actual needs versus perceived insecurities. Advisory firms should employ a consistent budget development process, keeping a close watch on expenses throughout the business cycle regardless of market conditions.		●		●	●
Maintain consistent training standards. Ongoing training for both advisors and support staff is critical to maximizing firm technology resources, as well as keeping staff abreast of developments in the industry. Further, it enables professional development and enhances the quality of service to clients.	●	●			●

3 Communications-oriented Strategies

Communications-oriented strategies pose the least amount of operational burden, yet they can ultimately have the greatest effect on a firm's bottom line. These strategies directly appeal to the personal needs of both the client and firm staff, significantly impacting client retention and employee turnover. While many aspects of these strategies seem intangible, it is critical that firms view communications-oriented initiatives as critical necessities instead of optional luxuries.

	Risks Mitigated				
	Infrastructure	Organizational	Fiduciary	Reputation	Client
Articulate your firm's "story." The foundation of firm reputation, company culture and sales message is its story – what the firm offers, what it stands for, why it is different. The story should be communicated to all employees, empowering the entire staff to generate distinct, meaningful awareness about the firm.				●	●
Enhance your visibility. Area media and community groups are often hungry for financial perspectives from local experts. Advisors who establish themselves as knowledgeable sources can improve their visibility, strengthen their reputations and encourage word-of-mouth affinity.				●	●
Build an expanding network. Advisors often get their most productive leads from centers of influence, such as attorneys and accountants. Maintaining strong relationships with centers of influence enhances your reputation and trust.		●		●	●
Understand and consider behavioral aspects of the individuals and the investments. Clients do not always react rationally, especially under stressful conditions. Expect a rise in the level of clients' anxiety and be prepared to guide clients away from making ill-considered decisions.			●	●	●
Be proactive in client relationships. Clients look to their advisors to get their financial plans back on track in any market. Proactive client management keeps the advisor attuned to the client's changing needs and circumstances — and their real risk tolerance. It further enables the advisor to realign investment strategies and make prudent portfolio changes where necessary.			●		●
Recast conversations to focus on client goals instead of merely performance. To build client relationships based on more than market performance, advisors must deliver a value proposition broader than a client's investment portfolio. Advisors should remind clients that they do more than merely manage assets by discussing their investments in the context of the goals they're trying to realize. Shift the focus away from the performance pie charts and help them see what really matters — whether they're on track to achieve their goals.					●

Conclusions

Despite the intensified threat to an advisory firm brought on by the risk dynamic, advisors remain well-positioned to overcome — and even prosper — in the face of challenges. Success, however, demands a disciplined, multi-pronged approach that considers long-term and short-term needs of the firm and its clients. Advisors must resist the temptation to recoil in the current market conditions, instead of approaching the risk dynamic as a collective effort on a number of singular fronts.

Protecting and growing an advisory firm requires objective analysis of resources, openness to new approaches to existing practices and a willingness to consider relinquishing processes that do not directly contribute to client success. By embracing this mindset, advisors not only mitigate existing risks in the current market, but they also prepare the firm to endure and develop in whatever market conditions the future holds.

About the SEI Advisor Network

Acknowledging and mitigating risks are as important to your success as your market strategy, and that's where the SEI Advisor Network can help. The SEI Advisor Network provides financial advisors with turnkey wealth management services through outsourced investment strategies; administration and technology platforms; and practice management programs. It is through these services that SEI helps advisors save time, grow revenues, reduce risk, and differentiate themselves in the market. With a history of financial strength, stability, and transparency, the SEI Advisor Network has been serving the independent financial advisor market for more than 16 years, has over 6,000 advisors who work with SEI, and more than $25 billion[8] in advisor's assets under management. The SEI Advisor Network is a strategic business unit of SEI.

[8] As of 3/31/2009

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1 Freedom Valley Drive, Oaks, PA 19456
www.seic.com/advisors
1-888-734-2679

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