FP50 2018: Independent Broker-Dealers Adapt to Survive

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IBDs began the movement to independence. Now they risk being overtaken by it. The headwinds shaking the industry haven't relented, even after independent broker-dealers produced their strongest revenue growth in three years.

Serious pressures face the top IBDs analyzed by Financial Planning for the 33rd annual FP50. Shrinking margins and bulked-up regulatory oversight, and growing competition and consolidation, are just a few.

"The value proposition of an IBD from 20 years ago has to change. There's little demand left for only processing transactions," says Cambridge Investment Research CEO Amy Webber. "It's a relationship business. It's a consulting business. If they don't transform, survival will be difficult."

BY THE NUMBERS

The nation's largest IBDs showed positive steps on that front in 2017. After a slight contraction in revenue in 2015 and an even larger drop in 2016, total revenue at the top 50 firms rose 8.6% to $25.7 billion in 2017.

While the list of the 50 largest IBDs changes slightly from year to year based on their level of business and mergers and acquisitions, the past year marked the highest growth among the FP50 since their revenue expanded by 12.7% in 2014. All but three firms reported increases in revenue, with 24 of the top 50 firms producing double- or triple-digit percentage gains.

The record high in combined revenue amounts to nearly double the firms' $13.2 billion in 2007, but it obscures the notable disparity between fees and commissions. In 2017, fee-based revenue overtook commission-based revenue for the first time.

Fees of a little more than $11 billion at the top 50 firms were $112.2 million higher than their commissions. Fee revenue has more than tripled in the past 10 years, while commissions have gone up only 21%.

The rise in fee-based business is a switch "from commission-based to recurring revenue," says John Anderson, managing director of SEI Advisor Network's practice management solutions team.

"You're having better financial performance at these IBDs today because more and more of their clients have moved to this recurring revenue model," he says.

REGULATORY BURDEN

The U.S. Department of Labor's fiduciary rule accelerated the change, says John Rooney, a managing principal with Commonwealth Financial Network.

Even though the rule is most likely dead after an appeals court vacated it, compliance efforts that had already been put in motion and are now mostly solidified — coupled with strong stock market returns and rising interest rates — paid off for IBDs in 2017.

The Securities and Exchange Commission's proposed Regulation Best Interest may force IBDs to make further adjustments to get into compliance as the agency gathers public comments. Rooney, who is also the chairman of the Financial Services Institute's political action committee, sees enhanced oversight, in part, as an opportunity for IBDs, though.

"Ironically, what we're seeing is that the increasing regulatory scrutiny being extended to the RIA channel, either from the SEC or the state agencies, is working in our favor," Rooney says. "A number of large RIAs are concerned that they'll encounter regulatory issues which could become existential and appreciate having a full-time compliance staff to support them."

Nevertheless, the enhanced regulatory burden and the rise of low-cost, passive strategies in asset management have also cut into the margins of IBDs, says Kenton Shirk, who is director of the intermediary practice at Cerulli Associates.

Thirteen of the top 25 companies generated double-digit growth in 2017 as rivals close in on the perennial No. 1 firm.

For example, the average asset-linked fee on mutual funds and ETFs dropped roughly 8% to 52 cents per $100 invested in 2017, according to Morningstar, which notes it as the largest decline since 2000.

The long-term downward trend in asset-management fees, which accelerated ahead of the partial implementation of the fiduciary rule, has cut into the revenue shared by IBDs and asset managers. The lost revenue came with extra regulatory burdens and expenses ahead of the rule's partial implementation a year ago.

At the same time, Shirk says, firms need to attract and retain advisors by improving services. Tools like planning software, practice management coaching and upgraded customer relationship management systems will help IBDs compete against the fully independent RIA model, he says.

"Without scale, it's hard to stay competitive and it's getting harder," Shirk says. "Being able to offer that fully integrated and comprehensive suite of services and ensuring advisors are using it is going to be key for independent broker-dealers reinforcing that value proposition."

WINNERS AND LOSERS

Many IBDs have failed to crack the formula of lower margins with better services or have given up trying to do so as the number of RIAs increases each year.

The count of IBDs has fallen by 28% since 2007, to 847 firms, as operating margins at IBDs declined to 3% from 11%, according to **ECHELON Partners**. At the same time, the number of SEC-registered RIAs has jumped 57% to 14,957 firms.

The margins will get even smaller in a business that is "getting more complex and will continue to get more complex," says Bill Morrissey, president of LPL Financial's business development unit.

"For our financial advisors to maintain their same quality of life, they're going to be forced to work with more clients and solve for a broader, more complex set of needs," Morrissey says. "As their partner, we need to help them with that."

Morrissey's firm, a pioneer of the independent space and its longtime giant, faces growing competition. LPL has been the largest IBD for 17 years, but the No. 2 firm, Ameriprise, closed to within $21.5 million of LPL's $4.28 billion in revenue in 2017, narrowing the gap from $32 million a year earlier.

MOVING UPWARD

Ameriprise's emergence was inevitable because the firm has "always had that legacy of planning, and planning always leads to managed money," says Tim Welsh, CEO of Nexus Strategy. LPL's offerings of research, technology and other broker-dealer services also may no longer hold as much appeal, Welsh adds.

"There are lots of other places for advisors to go get that stuff in an open architecture environment," Welsh says. "So they should be on red alert."

Indeed, other big firms are also moving upward. Cambridge, Commonwealth and Raymond James each saw double-digit revenue growth in 2017. Cetera Financial Group, Advisor Group and Ladenburg Thalmann — the three largest networks — and their 15 subsidiary IBDs also reported increases for the year.

At No. 35, the midsize firm Independent Financial Group increased its year-over-year revenue by 13% to $139.3 million. The IBD opened in 2003 after its three managing directors met at SunAmerica Securities, a forerunner of SagePoint Financial, says David Fischer, the firm's head of recruiting and marketing.

The San Diego-based firm set an internal record for recruiting in 2017 by adding 97 advisors with $25 million in production, Fischer says. Independent Financial eschews the big upfront bonuses, call centers and proprietary technology and products of the giants and instead offers flexible open architecture, family-friendly conferences and personal services for advisors, Fischer says.

"They've served their time at those large organizations, and they want to get back to a partnership," he says. "We're really not making deals, we're making promises that we're living up to."

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COMPETITION AND CONSOLIDATION

LPL rivals like Independent Financial, Cetera, Ladenburg's Securities America and Advisor Group's Woodbury Financial Services tapped the 3,200 advisors of National Planning Holdings' four IBDs for recruits after the No. 1 IBD acquired their assets in August. LPL has retained about 70% of National Planning's business, though.

Like LPL's deal with Jackson National Life Insurance, other major M&A deals revolved around insurance firms. So-called product manufacturer IBDs remain a significant and, in some cases, growing presence in the space.

Carolyn Clancy is the head of the broker-dealer segment at Fidelity Clearing & Custody Solutions.

In December, the private equity-backed No. 14 IBD, Kestra Financial, purchased H. Beck, the No. 38 firm, from Securian Financial Services, the No. 20 IBD. Securian, whose parent firm also has an insurance firm, picked up a minority stake in Kestra while retaining its existing IBD with more than 1,100 advisors.

M&A deals have trimmed Fidelity Clearing & Custody Solutions' fleet of client IBDs to around 200 over the past four years even as the custodian's overall client assets have more than doubled, according to Carolyn Clancy, head of the broker-dealer segment.

"It's just massive consolidation, and our client concentrations are getting larger," Clancy said in an interview in late January, citing Fidelity client MassMutual's acquisition of a MetLife unit. "So our big [IBDs] are getting bigger and our smaller are kind of staying the same."

MassMutual's MML Investors Services fully absorbed the advisors and assets of MetLife's MSI Financial Services in March 2017, and in the process rose to the ranks of the top 10 IBDs. After the deal, MML joined only four other IBDs and three networks with more than $1 billion in annual revenue.

Lincoln Financial Network maintained a spot in the top 10 at No. 9 even though its revenue ticked down 1% to $740.2 million in 2017. But the firm has launched a multiyear technology upgrade and is "aggressively looking to grow our base of advisors," says LFN President David Berkowitz.

Mid-tier and smaller IBDs face uncertain futures, especially if the double-digit stock gains of 2017 do not continue in future years, according to Berkowitz. LFN's parent firm, Lincoln Financial Group, equips the firm to deal with the "Darwinian aspects of the industry," he adds.

"If you look back at the last 200-plus years in our country, there are a lot of examples where size and scale and financial strength really mattered," Berkowitz says, describing Lincoln as having "the financial wherewithal to play in this space and do it well."

The consolidation has shown no signs of letting up, though.

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Cetera — the largest IBD network with six firms and $1.8 billion in revenue last year — and its parent firm, Aretec, have retained Goldman Sachs for a capital structure review. A sale looms as one possible outcome of the review.

The consolidation, pressure on margins, bulked-up regulations and advanced average age of advisors will continue roiling a space still divided among insurance-owned firms, private equity-backed firms, privately held firms and publicly traded ones, says LPL's Morrissey.

"I think the NPH acquisition is representative of a number of the trends that are manifesting themselves in the marketplace today," he says. "The industry is at an inflection point."