What to Make of Mark Hurley's Latest Prophecy

Originally Published By Brook Southall, RIABiz

Brooke's introduction: Mark Hurley burst onto the report-writing scene in 1999 with a report that even he refers to as "unwelcome". The Undiscovered Managers principal predicted that the structure of the wealth management industry would change from being a highly fragmented one made up of competitors of all sizes to a small group (40 to 50 organizations) of dominant competitors. These large highly profitable firms would "look like multi-user family offices for the semi-affluent" and would have at least $15 billion — $20 billion in assets under management and some would be much larger.

Needless to say, this did not occur.

In 2005, Hurley wrote [on behalf of JPMorgan which acquired Undiscovered Managers in 2003] a similar 120-page report, titled Back to the Future: The Continuing Evolution of the Financial Advisory Business that predicted that about half of the top 1,100 financial advisory practices would consolidate into 25 to 50 "scale competitors," with the other half continuing as profitable niche players.

Hurley's conclusions are often provocative, drawing firestorms of controversy – and as these two examples illustrate, his sweeping conclusions can be quite wrong. Yet, the depth of his research and the insights in his reports make him an influential thinker in the business. He has a knack for making people think about what they already know in new ways – and as the president & CEO of Fiduciary Network, LLC — he has produced a no-less-provocative 117-page report titled: "Creating, measuring and unlocking enterprise value in a wealth manager."

On the surface, fee-only advisory practices are positioned well for establishing salable value. After all they have stable revenue, a customer turnover rate of only 1% or 2%, and an average term of an account that is 33 years to 99 years, according to the report by Mark Hurley and his firm. Yet, it also concludes that only a tiny handful of firms, only about 2% of the total 18,000-19,000 in the industry, have any potential for enterprise value whatsoever.

Prognosis is pain for Baby Booming RIAs

The implication is that the thousands of Baby Boomers preparing to sell their practices in the next decade or two are in for a rude awakening. They'll be forced to retire with nothing or sell out to other RIAs in deals with little cash down, low prices and high risk. Selling their businesses as standalone units is all but out of the question — unless they take drastic steps now. Hurley believes few advisors have the will to make such wrenching changes because of how difficult and expensive it can be.

Hurley has an interest in how RIAs sell their practices. In 2006, he co-founded Fiduciary Network, a specialty finance firm that invests in fee-only wealth management firms and helps current owners transition their businesses to their successor professionals. Yet, his report, which focuses on the obstacles to developing enterprise value, is already creating buzz among the experts, who are dissecting his ideas even if they don't agree with his conclusions.

Prior to starting his current company, Hurley was chairman and CEO of Undiscovered Managers, LLC, a mutual fund company he launched in 1998 and sold to J.P. Morgan/Chase in 2003 when it had six funds with about $600 million in assets. Before Undiscovered Managers, Hurley was a managing director at Merrill Lynch and Co. and a vice president at Goldman Sachs & Co.

According to the report, most RIAs can't be sold for material amounts as standalone businesses. By standalone business, the authors are referring to what is left of a company once the principals remove themselves and pay someone a salary to fulfill their duties.

One major reason wealth management firms have no value once the owners depart is that the "vast preponderance" of these practices rely heavily on commissions generated by transactions rather than fees based on asset levels. The wealth management industry is loaded with banks and rollups looking to acquire fee-only practices, because the aggregate fee stream over the life of a single relationship is staggeringly large. It can be $1.28 million over the course of 30 years if it starts at $20,000 and assets increase (along with the fee) by 6.5% during the first 10 years, even if assets subsequently decline by 5% with withdrawals later on, according to the report. Hybrid [fee and commission-based] practices, on the other hand, rely heavily on transactions for their revenues.

The problem with the model is that it effectively front-ends the compensation paid by the client.

No evidence that successors can sell additional products

Though one generation of employees at a firm successfully sells products, there's no evidence that its successors will sell additional products to that same group, the study says. "Rather the ability of the individual involved is the key determinant of such success and not the pre-existing relationship," writes Hurley in the report. The "individual" is the person who actually made the sale.

The Fiduciary Network report also raises significant doubts that fee-only practices will be able to establish enterprise value because they face steep challenges in passing on value to successors. Clients will only stay – and continue to pay – if the service levels and quality of relationships hold steady.

This proves difficult for firms managing less than $300 million of assets and generating less than $3 million of revenues if they get sold. The problem: "The fee-only economic model relies heavily on one input – professional labor. That is in short supply. The Achilles heel of every wealth manager is that it has limited scalability and ultimately its ability to grow is dependent on recruiting and retaining professional staff."

Dan Seivert, CEO of Manhattan Beach, Calif.-based **ECHELON Partners**, believes that Hurley is too quick to generalize based on what may happen in certain cases.

Questionable extrapolation

"He takes a situation and takes a very specific example and extrapolate it as if that the way it always unfolds," Seivert says.

Yet the Hurley report suggests that the labor problem is a general problem across the industry.

There is a chronic shortage of quality wealth management professionals, and it is driving up the cost of labor, it says. The report has a graph that shows that revenues of wealth management firms rose less than 20% between 2004 and 2008 but non-owner compensation jumped by about 60% during the same time period. With labor costs so high, it takes significantly more revenues to earn the same profits. "A firm with $1 billion of client assets is viewed much the same way that one with $100 million to $200 million" was formerly, the report says.

The labor squeeze is a product of the age distribution among financial advisors, says the report. Less than 25% of industry professionals fall between the ages of 35 and 50 and only 16% are 35 or younger. 'A chronic shortage of quality wealth management professionals is driving up the cost of labor – a threat to operating margins and future profitability of every firm,' the report says.

Seivert disagrees that a labor shortage has erased the value of wealth management practices. There are four layers of staff with varying levels of skill that a wealth manager hires and there was temporarily a shortage of some of the more skilled practitioners, he explains. But this scarcity abated in the economic downturn making data from 2008 is no longer relevant. "That was the story then; it's not the story now,' he says.

Ways to generate enterprise value

Despite significant challenges relating to labor shortages, it is possible for firm principals to overcome them by taking a number of steps to lessen reliance on the rainmaking capabilities of the firm's big producer, the Fiduciary Network report reads. These steps can include: bringing on outside professionals to handle the day-today duties, creating a strict compliance atmosphere, institutionalizing the brand and diversifying the customer base so the firm isn't reliant on a handful of big relationships. To make all this happen significant cash needs to be plowed into the business – either by going to outside investors or forgoing current profits.

Wealth management principals are unlikely to take these steps to build enterprise value because it is "unattractive and fraught with risk," the report says. It adds: Building enterprise value will require that a wealth manager undergo a complex and emotionally-wrenching evolution – new management, new roles.

"It's a gross oversimplification," Seivert says. A wealth management firm is actually among the most transferable in the professional realm. "It's way more transferable than physicians, law firms and accounting firts," he adds.

Brooke's Postscript: Mark Hurley presented the findings of this report at TD's Elite Advisor Summit in Laguna Beach last week. As a reporter, I was not invited to that session, but I was present as advisors and industry experts filed out. I spoke with Dan Seivert, CEO of ECHELON Partners, who had taken on Hurley and he was *quite passionate that the study's findings do not bear out in reality. I sat next to Hurley at dinner that night and he was equally passionate about the correctness of his views. He cited his conversations with several advisors he had debriefed about deals and just how little the sellers had received from buyers when the smoke cleared.*

My article really only summarizes the overarching views of the study. That probably doesn't do justice to the study. It contains detailed information about the proposition of selling a practice to a wide variety of buyers. You don't need to agree with Hurley's conclusions to find rich material. When I talked to Hurley on Saturday and asked him for an overarching quote that would summarize his controversial conclusions, he demurred. Instead, he said: "The real reason we did this was to give people a tool to realize what's going on," he said. Hurley added that such a report is also a door-opener to talking to many wealth managers.

I looked for overlap the study had with his previous ones. The common theme seems to be that there are a very small handful of wealth managers that have their act together and that the rest are really what some consultants

like to call 'lifestyle practices.' Each report suggests that this vast discrepancy between these two varieties of wealth manager will have significant consequences down the road — with the smaller advisors treading on a sort of quasi-lucrative road to nowhere and a few barons heading big well-oiled organizations reaping true riches. This is an interesting theme, and I very much look forward to hearing how other people react to it this time.

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