FOUR HABITS OF HIGHLY SUCCESSFUL ADVISORS: PART ONE

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My colleague Ryan Krystopowicz and I recently co-wrote a white paper "think piece" entitled, "Four Habits of Highly Successful Advisors."[1] Over the course of a four-part blog series, we will break down that longer white paper into shorter chunks, focusing on a different habit in each post. For the first installment, we look into habit number one: focus on value.

The wealth management industry is in a constant state of evolution, and the next five to seven years will see a pace of change that will make Moore's Law proud.[2]

As a starting point to address taking advantage of this accelerating change, it is worthwhile examining some of the trends within the wealth management industry since the global financial crisis and the Covid Era.

At a macro level, one tectonic shift facing advisors is that the growth and evolution of disintermediated information, social media and online "advice" continues to be a disruptive force on the wealth management industry. The next generation of investors is technologically savvy, more collaborative, less trusting of tradition and more socially conscious.

Other trends include:

- End clients view professional investment management as table stakes—it is viewed increasingly as a commodity
- End clients are more cost/value/tax sensitive
- End clients increasingly are interested in and open to more non-traditional investment approaches and solutions
- Advisors seek to build enterprise value in their firms through scale and efficiency
- Advisors want to deliver institutional-quality investment portfolios while being able to focus on holistic wealth management advice—the services end clients increasingly are willing to pay for
- Advisors increasingly are open to outsourcing as a means of driving scale and efficiency in their practices

What this means for wealth managers and advisory professionals, who frequently define themselves primarily as *investors*, is the need to recognize that what future clients will want from them is *simplicity* in their interactions and *solutions* to their financial problems and concerns. Those solutions extend well beyond just investment solutions. Issues like wealth transfer, tax optimization, philanthropy, impact investing, family governance, inter-generational cooperation, personal counseling and estate planning will be of critical importance.

How then should advisors be building portfolios and running their businesses? How can

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they help clients achieve evolving goals and objectives, and/or take advantage of industry trends? Are there best practices among successful, profitable and fast-growing advisors that can be identified, analyzed and adopted?

We believe the answer is yes.

We are privileged to work with some of the most successful and sophisticated advisors and financial institutions in the country. These firms are winning business in a highly competitive marketplace. They are building and managing differentiated investment portfolios and running their enterprises efficiently and profitably. We are in a position to observe them and see what they are doing to set themselves apart.

Here is the first of the four habits we see being employed by successful advisors in addressing the sophisticated demands of HNW investors.

Habit One: To increase enterprise value, focus on scale, efficiency and profitability, not AUM or AUA

Many advisors believe their "enterprise value"—the value of their practice—is measured in terms of a multiple of their assets under management or advisement. It certainly is true that, if you sell your practice for a certain dollar amount, you can translate that into a multiple of your assets.

But that is not what the buyer is actually paying for.

According to research done by *Investment News*,[3] what buyers pay for is *scale, efficiency and profitability*.

As a simple example, a firm with $1 billion in AUA that breaks even from a profitability perspective is probably worth less than a profitable firm with $500 million in AUA.

According to *Investment News*, some of the more commonly used metrics for evaluating enterprise value include:

- **Revenue per professional:** This simple metric captures the amount of revenue generated per client-facing professional at the firm. This is a measure of enterprise *productivity and efficiency*.

- **Earnings before owner compensation (EBOC) as a percentage of revenue:** This is a profitability metric somewhat unique to RIAs. Most financial professionals are familiar with the concept of EBITDA—earnings before interest, taxes, depreciation and amortization. This is a commonly used metric for evaluating the actual "working earnings" of a company derived by carving out extraneous and non-recurring expenses.

  EBOC is a similar metric used to evaluate the working earnings of an owner-operated enterprise like an RIA (and of course there may be multiple owners). Consider the example of an owner-operated RIA where the owner is considering monetizing the value of their firm three to five years into the future. There is nothing to prevent that owner from cutting or even eliminating their compensation in order to "goose" the net profitability number and increase the perceived value of the enterprise.

  This is not to suggest that owners are nefarious and looking to game the system. But by removing owners' compensation from the profitability evaluation, you simply remove even the temptation to do so.

  Alternatively, an owner may be maximizing their current income by taking home most of the profitability each year. But that expense will be eliminated (or managed) once the firm sells, so it makes sense to remove it from consideration.

- **Compound annual revenue growth rate:** This is a *scalability* metric and is just what it sounds like—a measure over time (typically three or five years) of the compound annual revenue growth rate of the enterprise.

What do these metrics have in common? The all focus on the scale, efficiency and profitability of the firm, not the level of assets.

Now, here comes a couple of paragraphs that may rub some advisors the wrong way.

Many, if not most, advisors get into the wealth management business because they love or are interested in investing—they like managing client portfolios and view that as one of their primary value propositions.

But here is the dirty little secret—*very few firms get paid for their research capabilities*. There are exceptions, of course. But in most cases, the potential buyer already has an investment solution in place (either internal or outsourced). The buyer may retain some of the research professionals of the acquired firm, *but that is not what they are paying for*.

What this means is that if you operate an RIA that has less than $1–$2 billion in assets, and your goal is to maximize your enterprise value for a potential buyer, you are better off driving scale, efficiency and profitability by outsourcing all or some of your portfolio management function (including middle and back-office functions).

WisdomTree conducted extensive research in 2019–2020 into the biases and preferences of both financial advisors and their end clients—we surveyed and interviewed thousands of end clients and hundreds of financial advisors.[4]

Some of our key findings included:

- 90% of end-client investors welcome third-party models into their portfolios
- 70% of end-client investors believe third-party models will improve their portfolio performance
- 75% fewer investors would consider leaving their current advisor if they knew that advisor was using third-party models

We will examine more research on the topic of outsourcing later in this blog series. For now, the key point is that if you want to optimize the enterprise the value of your firm for an eventual monetization, succession or liquidity event, your focus should be on driving scale, efficiency, productivity and profitability, not just gathering assets and managing portfolios.

For those interested in learning about the rest of the habits, please keep an eye out for the next three blog posts and make sure to read the entire white paper: "Four Habits of Highly Successful Advisors."

[1] With respect to Dr. Stephen Covey for his The Seven Habits of Highly Successful People, Simon & Schuster, Anniversary Edition, May 2020.

[2] Moore's Law, named after Intel Co-Founder Gordon E. Moore, states that computer processor speeds, or the overall processing power of computers, will approximately double every two years. When referenced outside of technology, it generally is taken to mean a state of accelerating change.

[3] See Matt Sirindes, "Three ways top-performing firms stand out," Investment News, 10/8/14.

[4] Source: WisdomTree's Models Research Initiative. Interviews conducted 10/16/19–7/21/20. WisdomTree's Models Research Initiative maintained a +/- 2.3% margin of error among consumer investors across generations and a +/- 6.2% error rate among financial advisors. A mixed methodology was applied that included a robust base of more than 2,000 constituents in the Models' value chain, as well as dozens of in-depth interviews that were conducted on the topic

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DEFINITIONS

Moore's Law : The observation that the number of transistors in a dense integrated circuit doubles about every two years.

The Global Financial Crisis : Refers to the period of extreme stress in global financial markets and banking systems between mid 2007 and early 2009.

Macro : Focused on issues impacting the overall economic landscape as opposed to those only impacting individual companies.

High net worth individual : Refers to an individual with a net worth of a minimum of $1,000,000 in highly liquid assets, such as cash and investible assets.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset’s price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.