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Investment ADVISOR

War Room

How the most successful advisory firms are mitigating risk on two fronts: for their clients, and for their own businesses

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By [Maya Ivanova](#)

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Maybe it was the bailout of investment bank giant Bear Stearns or the government takeover of Fannie and Freddie. Perhaps it was the steep decline in home prices combined with tumultuous energy costs. Whether it was a single debacle or the entire chain of events that dominated headlines for the better part of the year, Wall Street's bad news has changed the mood on Main Street. Risk management is now top of mind for individual investors—some who may be in or near retirement—as well as those who are simply striving to make ends meet in an ever-challenging economy. Advisors, too, have felt the market's woes and are looking to ease clients' fears while buffering their practices against declining profit margins and other business risks.

The 2008 annual Rydex AdvisorBenchmarking study, which examines practice management trends in the registered investment advisor (RIA) space—including financial performance and operations, investment and organizational management, marketing and client relations—reveals some surprising truths about the industry. The study showcases the best practices of the most successful firms in the business, highlighting opportunities for planners looking to step up their risk management efforts.

Everyone Shares the Pain

Regardless of whether or not you believe there's light at the end of this bear market, there's no denying the hefty burden that some families and individual investors still carry. In fact, many are reeling from the continuing decline in value of their often largest and most important asset: their homes. Nearly a quarter of advisors say the housing slump has impacted their clients' ability to sell their homes or get their anticipated asking price.

“The American consumer accounts for two-thirds of economic spending...With no credit, property values falling, incomes stagnant, job security a thing of the past, and higher fuel, utilities, and food costs sucking up every dime of disposable income, the American consumer is tapped out,” says George Cheatham, founder and president of American Financial Consultants, Inc. of Columbus, Kentucky.

For some clients, a bit of budgetary consulting or asset shifting may be enough to ease the pain. But those who are approaching retirement or who have already retired are likely unable to stomach extreme market volatility. Tightening the belt will only go so far and for these clients especially, advisors will need to take a closer look at how they approach investment management risk.

A Flight Toward Safety and Alternatives

While the majority of advisors (50%) consider themselves strategic or “buy and hold” investors, more than one-third (35%) take a tactical approach to managing money—which some feel offers the ability to be more reflexive to market conditions.

“It is extremely important to stress absolute returns in a negative relative returns environment; in other words, tactical asset allocation should provide a shield for clients from the full brunt of market downturns,” says Paul

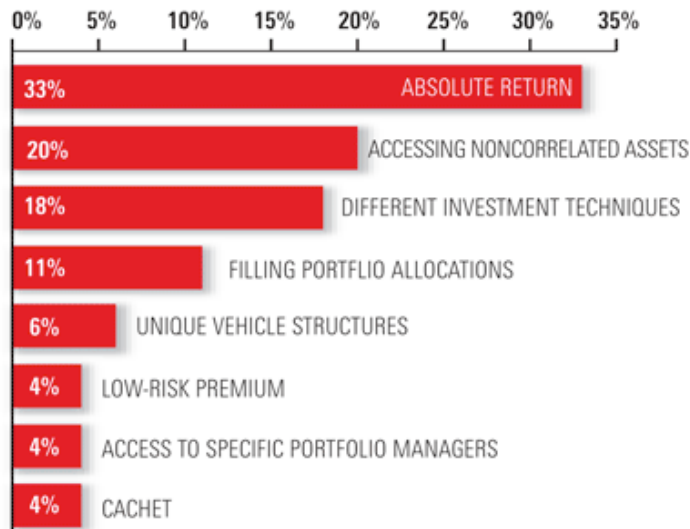
Bennett of C5 Wealth Management in Great Falls, Virginia, who moved clients to cash, short mutual funds, Treasury inflation-indexed securities (TIPs), and gold. “These moves have dampened volatility and preserved capital for our clients,” he adds.

Not only are planners shifting clients’ assets to areas they consider safe havens, but they’re also adding exposure to nontraditional investments to reduce portfolio volatility. Driven by a demand for absolute returns and access to assets that don’t necessarily correlate with stocks and bonds, advisors are increasingly turning to alternative investments to help diversify clients’ portfolios and mitigate downside risk. Alternative or nontraditional investments—defined as those assets other than stocks, bonds, or cash—can include asset classes like commodities, currency, and real estate. They also encompass absolute return, long/short, leveraged, and managed futures strategies.

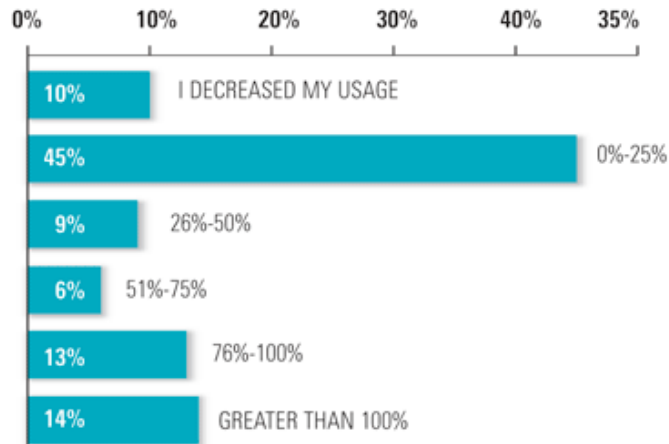
AdvisorBenchmarking findings indicate that 80% of advisors have increased their use of alternatives over the past six years, with 18% increasing their use of these investments by more than 100%.

In addition to achieving portfolio diversification, some advisors are seeking to generate alpha for their clients by keeping costs at a minimum. Considering exchange traded funds’ reputation for being cost-effective investment vehicles, perhaps it comes as no surprise that ETF usage has risen substantially. Ninety percent of advisors report that they have increased their use of ETFs in the last five years, with nearly half (42%) increasing their use by more than 25%. For the first time ever, ETFs surpass individual stocks in advisor portfolios. What’s more, it looks as if this trend is here to stay. Half of advisors (49%) believe that ETFs will become as important, if not much more important, than stocks and mutual funds.

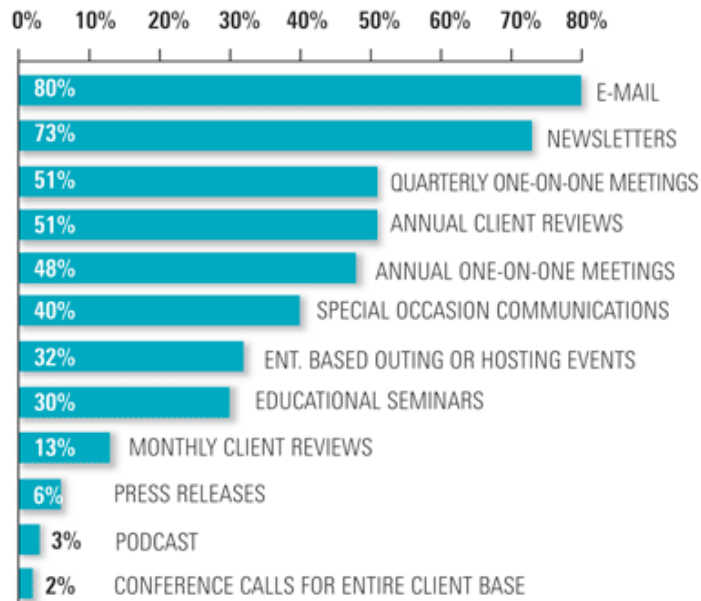
WHAT'S DRIVING CLIENT DEMAND FOR ALTERNATIVES?



CHANGE IN THE USAGE OF ETFS SINCE 2002



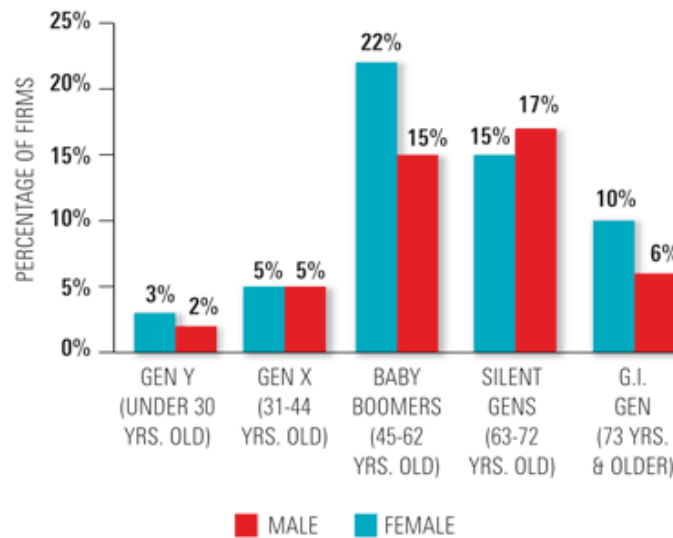
HOW ADVISORS COMMUNICATE WITH CLIENTS (2007)



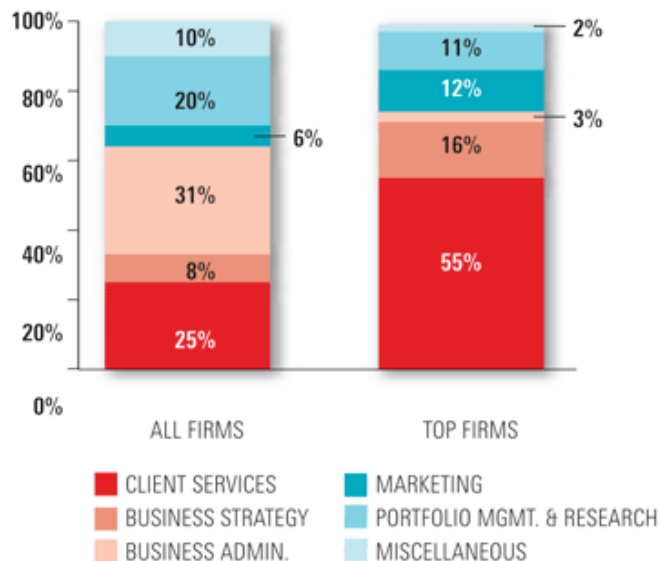
Keeping the Lines Buzzing

Regardless of the investment techniques advisors employ, managing client expectations is essential, particularly during challenging market environments such as these. In fact, 42% of advisors consider managing client expectations to be the biggest challenge in their business. Open and frequent communication with clients can go a long way towards reducing the risk that clients are surprised and/or dissatisfied with investment management results. While the great majority of advisors communicate with clients via email (80%) or newsletters (73%), a smaller majority (51%) report they are staying even closer through one-on-one quarterly meetings and annual client reviews. The most successful advisors realize that there's no substitute for face time with clients. Top firms spend the majority of their time (55%) with clients compared to average advisors who spend only 25% of their time with clients. Moreover, past Rydex AdvisorBenchmarking research, and the most recent study, has found that advisors who spend 60% or more of their time in client-facing situations are up to eight times more profitable.

WHO ARE YOUR CLIENTS?



HOW PRINCIPALS SPEND THEIR TIME



Meanwhile, on the Eastern Front . . .

Reducing investment risk for clients is only half the battle for advisors hoping to grow their practices in a tough economy. As the RIA industry becomes increasingly competitive, advisors must take a hard look inside their firms to address business risks that could threaten future profitability.

First, the good news: Assets under management increased 9% from 2006 to 2007, to a median of \$155 million for those advisors who participated in the AdvisorBenchmarking survey. Here's some even better news: Overall revenues increased 7% in 2007 to a median of \$1.67 million. The average number of clients per firm also climbed—up 6% to 356 from 336 in 2006.

Business Risk #1: Rising expenses

Although the industry continues to grow, advisory firms suffered declining profit margins for the second year in a row in 2007. Profit margins dipped to 24% from 28% in 2006 (down from 29% in 2005). The median profit per firm fell to \$408,000 from \$433,000.

Rising costs are primarily to blame for the profit margin squeeze, highlighting an opportunity for advisors to fortify their practices by getting a better handle on expenses. Operating expenses increased an average of 12% in 2007, due in large part to higher compensation for principals. In many instances adding clients and assets can require infrastructure enhancements, such as technology upgrades and new staff. Top advisors, however, seem to avoid ratcheting costs by focusing on steady and sustainable growth. The most successful firms enjoyed a 40% profit margin—nearly double that of average firms.

Business Risk #2: Operating without a game plan

Despite the decline in net profits, a significant 44% of advisors expect to dramatically grow their businesses at a 30% clip over the next five years. However, for 63% of advisors, finding new clients poses the biggest threat to their business. Moreover, more than half (54%) do not have a marketing plan in place to help them reach new client acquisition goals. Along these same lines, the majority of planners (74%) consider “wealth range” to be the primary qualifier in targeting potential clients. Advisors who want to take their practices to the next level realize the necessity of running their firms like a disciplined business, including adhering to a formal marketing plan and targeting a defined market niche. Rather than focusing solely on “wealth range,” successful firms tend to cater to clients based on other considerations that often involve a “transfer of wealth.” Advisors who can position themselves as experts or specialists concerning life events such as retirement, college planning, or divorce have more success attracting new clients.

Business Risk #3: Overlooking potential client segments

When defining a market niche, advisors may consider looking beyond Baby Boomers (ages 45-62) and the Silent Generation (ages 63-72). These two segments represent 69% of advisors' clientele, with very few planners focusing on Generation X (ages 31-44) and even Generation Y (under 30 years of age). These generations provide fertile ground for growing a client base, and making these groups a priority can help differentiate one's practice, making it a savvy business strategy that pays off down the road.

Another under-recognized audience advisors are now finding favor with is other financial advisors. A growing percentage (36%) of advisors now provide investment management services to advisory firms, broker/dealers, 401(k) administrators, insurance companies, and hedge funds. By leveraging their investment management prowess to a different type of professional client, advisors can increase revenue without necessarily increasing staff or adding infrastructure.

Business Risk #4: Poor time management

The expression ‘time is money’ has never been more true for the advisory business. As previously mentioned, the most profitable advisors spend the majority of their time with clients. They also spend twice as much time on business strategy (16%) compared to their peers who spend only 8% of their time on this function. Top planners focus their energy on marketing and business planning activities and spend far less time on administrative tasks. In some cases, this may mean outsourcing select business functions such as tax filings, bookkeeping or compliance. Likewise, the most successful advisors tend to enlist their employees' help by delegating client relationships and meetings.

Business Risk #5: Finding and retaining quality talent

In addition to freeing up time for business strategy, delegating important client meetings and relationships can help provide career opportunities that keep employees engaged and committed to the firm. While AdvisorBenchmarking findings indicate that more advisors are placing greater emphasis on staff education and training, nearly one-third still consider staff development and retention to be an area ripe for improvement. Fifty-eight percent of advisors rank finding qualified staff as a top business priority, yet half do not currently have any type of incentive plan in place to reward and motivate employees. In stark contrast, the best practices allocate more

of their expenses (37% versus 20%) to staff compensation. They're also more likely to tie employee incentives to revenue, which tends to lead to higher individual compensation and increased employee retention rates. Bonuses predicated on increased revenue are more likely to create a collegial, team environment in which all share in the reward for contributions to overall firm growth.

To sum up, it's critical that advisors not let the challenges of today's market climate and unprecedented competition in the RIA space overshadow the opportunities that could ensure the long-term success of their practices. The most successful firms are open to new ideas, willing to change old habits, and always aware of what the competition is trying. By keeping risk management top of mind, the best practices, and their clients, can win the two-front battle and capitalize on emerging alternative investments, shifting demographics, and untapped employee resources.

Maya Ivanova is the research manager for AdvisorBenchmarking, a Rydex Investments' affiliate and free practice management program designed to help RIAs grow their firms. E-mail her at mivanova@advisorbenchmarking.com. Results are from the 2008 online AdvisorBenchmarking annual survey of more than 1,000 registered investment advisors.



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