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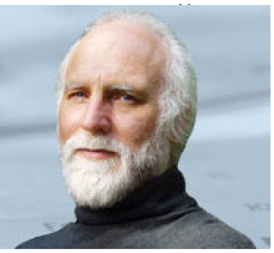
inside information



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## Special to this issue:



# Feedback Loop

**Synopsis:** ***How do you create a culture of continuous improvement in your service model? Here's the formula created by one of the major custodians.***

**Takeaways:** ***Let the staff participate in the process, and tie their compensation to measurable improvements. Meanwhile, the profession has yet to evolve a way to compare service levels among its primary service providers.***

At the TD Ameritrade Institutional conference in Orlando last February, you heard a lot about the importance of service in the welcoming speeches and host messages, from the top executives to the customer service staff at the booth. Yet when I asked the attendees what they thought of this, it was clear that many of them were tuning it out. After all, doesn't EVERY service organization pay lip service to service?

Since then, after taking an informal poll at different conference venues, I've realized that the profession really doesn't have a consistent way to evaluate or measure the service quality of its custodians. Advisors will tell you that this or that firm provides better service, but in answer to the next question, you discover that they've never worked with one or another of the firms being compared. The opinions are sometimes contradictory, and they always seem to be based on a small handful of anecdotal incidents.

This is remarkable. Imagine if we heard mutual funds tout their superior performance, but advisors had no clear way of determining whether their managers had beaten their benchmarks or given their clients a lot of tax loss harvesting

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## EARLY WARNING

• Five years after the the U.S. District Court of Appeals for the D.C. Circuit ruled that the SEC could not exempt brokers who held themselves out as advisors from RIA registration and fiduciary responsibilities, the SEC has continued to do just that. Two years after passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act required the SEC to normalize regulation between brokers and RIAs up to at least the standards of RIAs, the SEC has continued to "study" the issue.

This September, the Institute for the Fiduciary Standard, plus Jack Bogle, Arthur Levitt and Paul Volker, will once again ask the SEC to take action. Don't count on it. But word on the street is that Mary Schapiro is in her last months as SEC chairperson. Let's hope her replacement finally decides to follow the guidance of the courts and the law of the land.

## Feedback Loop

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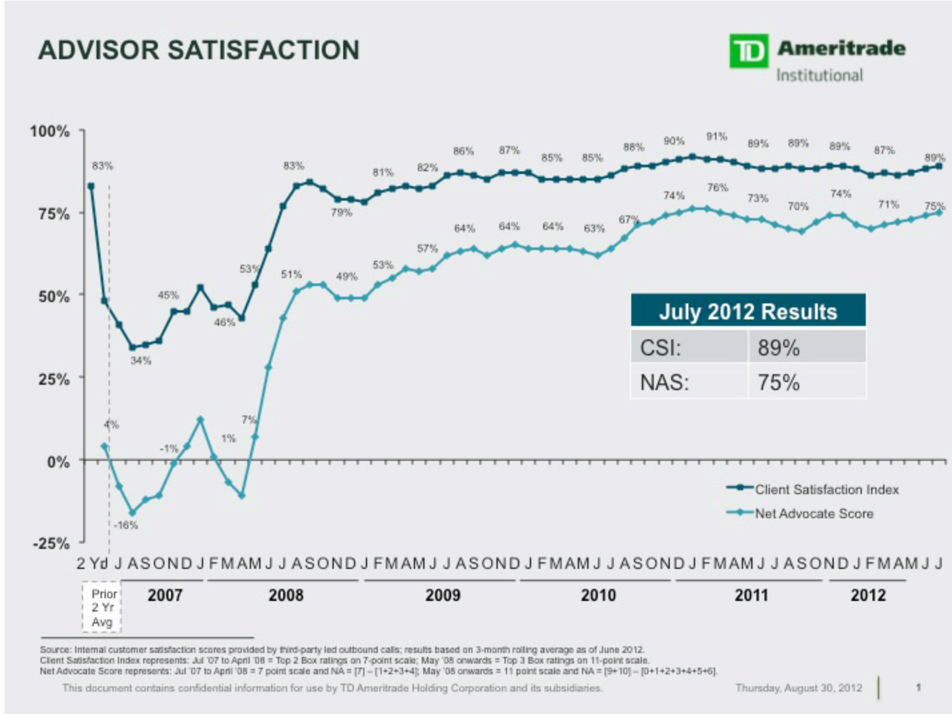
opportunities.

So I turned the question around, and asked TD Ameritrade Institutional executives whether they, who had brought up the subject, could show me an actual methodology for measuring something as fuzzy as customer service.

As it turns out, not only did they have one; they've been using it to reinvent their advisor-facing processes and procedures. TDA has data going back to the most difficult customer service experience in the company's history--the transition of millions of customer accounts from the Waterhouse to the Ameritrade back office back in 2007, when every advisor client went through one of the biggest repapering projects in the history of the profession. It's all on a graph whose updated version is posted on office walls and cubicle workspaces for 1,000 TDA Institutional employees.

Naturally, I asked for my own copy, and you can see it here. The dark blue line represents a customer satisfaction score--the number of advisors who give the company high marks for its responsiveness and customer service--going back to early 2007. The lighter blue line is a bit more complicated. It represents the percentage of advisors who describe themselves as advocates (who would go out of their way to recommend TD Ameritrade Institutional to other advisors) minus "detractors"--advisors whose views are not quite as




positive. These numbers are updated each month by a third-party polling firm that calls a random selection of 500 different advisory firms, asking not only about satisfaction and advocacy (or not), but also qualitative questions that are included in a separate part of the report.

The graph tells a pretty clear story. When Ameritrade took over the institutional division from Waterhouse, the firm had pretty high satisfaction numbers but advocacy was not something to brag about. Then the repapering began, and I think it's fair to conclude that most advisors were not raving fans of the massive account transfer process. Zohar Swaine, TDA's Managing Director of Institutional Strategy and Product, acknowledges that the company had some work to do to overcome memories of this time when clients were getting confusing account statements that reflected not-yet-completed transfers of assets.

After the repapering experience was completed in early 2008, as the investment markets were testing service models everywhere in the industry, the numbers suggest that advisor satisfaction levels improved dramatically, and the advocacy score has been testing new heights ever since.

I asked Swaine whether advisors could apply these numbers in some standardized way when comparing platforms, and his answer was interesting. First, he says, the net advocate score is something that many service firms track internally, and the chances are high that most of the other custodians are keeping score in a similar way. If you can get the numbers, and if you feel comfortable trusting them, this is the closest thing you are likely to find to an apples-to-apples comparison. If there was a company like Morningstar collecting these scores independently, it might be able to produce something comparable to the mutual fund rankings.

But Swaine also points out that TDA doesn't collect this data for marketing purposes--which may be why you haven't ever seen it before this article. "The key is not the measurements themselves," he says. "It's what you do with that information that truly matters."

Such as? John Tovar, TDA Institutional's Managing Director of Brokerage Services, says that the company has tried to create an identity of interest between the people who do the work and their customers--not unlike the idea that when fund managers invest their own money in their portfolios, they take better care of it. Every employee who works in the Institutional division, including the people who answer the phone and rip open envelopes in the mailroom have their bonus compensation based on these client service scores. It gives everybody an incentive to build a great working relationship with advisors," says Tovar.

At this point, you start to realize that many of the service challenges and client satisfaction issues that the custodians face are very similar to what advisors face in their own offices. And the solutions might be applied to advisor offices as well.

For instance? One traditional problem with tying compensation to satisfaction scores is that the rank and file employees may not feel like they have much influence over how those scores are achieved. You collect client satisfaction scores and pay out bonuses to your staff, but how do you connect it to what your staff does every day? How could that mail room employee possibly move that needle and earn a higher bonus next year?

The answer that TDA came up with was to create a systematic opportunity for the employees themselves to suggest efficiency improvements. The theory is that the employees are the experts in whatever obstacles that they face in getting things done quickly and efficiently. "The service teams meet every morning in small groups to identify if there was some inhibitor in their ability to be able to provide great service," says Tovar. "Is there an outdated policy? A misstep in a process? The associates are empowered to bring up suggestions as a team--and more importantly," he adds, "they are empowered to resolve problems on the fly, so that tomorrow they can provide better service."

***A "culture of continuous improvement" can become unsettling when the staff questions your basic organizational structure.***

The advisor who tries this at home should be warned that a real commitment to a "culture of continuous improvement" (as it is referred to internally at TDA) can be a little unsettling. For instance? The teams asked for more autonomy, so that somebody on the phone could make a problem-resolving decision without checking first with somebody in management.

Then the staff questioned the basic organizational structure of the service teams. "They pointed out that there were a lot of handoffs going on between one department and another, which was slowing things down," Tovar explains. "The handoffs were wasting time, rather than adding value."

Slowing down how? "Think of customer service as a factory," Swaine explains. You have different departments making different pieces of the finished

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## Feedback Loop

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item, and another department assembles the pieces for the end customer. Each of these departments is operating at great efficiency, and that efficiency is closely tracked. But the end result is that sometimes the people in one silo might not fully understand what the people in the other silo were asking for. All those small inefficiencies get multiplied, and the efficiency of the overall process--which the service teams are talking about daily--falls short of the goals.

Is there a better way? "Rather than having an account opening team, and a principal review team, and a check-cashing team," Swaine says, "we created the equivalent of mini-factories, which are assigned to a discrete set of clients." Each team is now made up of people with training and expertise in each of of the different areas. "When you need something done while you have somebody on the phone," Swaine adds, "instead of sending it out to a different department, you swivel your chair and get the answer right then and there."

As Tovar puts it: "We think that advisors want us to become an extension of their office."

This transition is still going on as more mini factories are set up, as more advisors get their own teams and move away from the silo service arrangement, as the service teams continue to look for improvements. Inevitably, eliminating the frictional challenges created new challenges of their own. Suppose the advisors working with one service team needed a lot of one kind of service and not much of another, while the opposite happened with another service team? The service team members--many of them formerly specialists--had to be cross-trained in different tasks, to handle a variety of requests and be able to distribute work more flexibly. Would the staff buy into that? "As it turned out," says Tovar, "this created a lot of job enrichment for our associates."

To move the needles that drive their bonuses, the service teams needed better feedback than the dots on that graph on page 2. So the company empowered them to call their advisors and get direct feedback on what they were doing and how they could do it better. "Four times a year," says Tovar, "each service team's relationship manager is calling the advisors who are served by that team, asking for very specific feedback on what went well and what didn't."

I think there are some lessons here for advisory firms who want to start evolving their own "culture of continuous improvement." Routinely measuring client satisfaction scores--or, if you want to be in step with the larger service-oriented companies, net advocate scores--helps you measure how clients view your services. You can tie staff compensation to those metrics, and then allow your staff members to brainstorm ways to move them--and (gulp) give them the opportunity to change your office organization and processes.

But has this answered the original question, about how advisors can measure the service of their custodial platforms? What it suggests, to me, is that there are three components to any eventual ranking or scoring system. The first is your subjective experience--the satisfaction rating you give that outside polling agency when they call your office. The second is the net advocate score, which, if it could be standardized (and I suspect that it can) would be equivalent to a mutual fund's performance ranking. And finally, there's a qualitative score, not unlike the new Morningstar Qualitative Rating, which would take into account things like how the staff is compensated, what kinds of processes and systems the company has, whether there is a discernible process in place that could plausibly deliver above-average service.

At the moment, the profession is relying on anecdotal information to evaluate what may be an advisor's most important relationship. A more precise measure might come from looking at whether you're getting those calls from an outside auditor of customer satisfaction, and/or a call from your service team.

Meanwhile, it would be nice if the custodians would share their data in some kind of consistent format. Before I started writing this article, I put out a feeler with one of TDA Institutional's rivals, asking basically the same questions I asked here. The response was enthusiastic. ■

Practice Management

# Integrated Compliance

**Synopsis:** ***Gary Davis, Jr. thinks that you can eliminate a lot of hassles if your compliance activities could become a component part of your office procedures.***

**Takeaways:** ***Replace the traditional mock audit with a practice management audit, and build new efficiencies into office routines. Meanwhile, the SEC may finally be moving toward genuinely relevant oversight of advisors.***

Gary Davis, Jr., vice president of practice management at the MarketCounsel legal and compliance firm, thinks that mock audits--one of the stock-in-trades of compliance attorneys--may be an exercise in futility. "As a practice management consultant, I never saw their value," he says, "and I said so pretty much as soon as I walked in the door here."

Why? "Anybody who has been through the examination process knows that it's extremely subjective," says Davis. "So if I walk in the client's door pretending to be an examiner, I will be as subjective as the regulator is, and I'll write them up based on what I, personally, think they're doing wrong. At the end of the day, we'll just scare our clients, and provide them with no real guidance on how to correct what the actual examiner might think are problems."

So what should advisors--or compliance attorneys--do in place of the traditional mock audit? Davis says that after more than 50 years, both the advisory profession and the SEC seem to have gradually forgotten the original purpose of the regulatory framework. Both sides now use the examination exercise to make sure that certain pieces of paper match up with certain other pieces of paper in a certain way, that certain disclosures and wordings have been carefully managed, and that certain kinds of information are documented on a particular schedule. "For a lot of advisory firms, compliance is regarded as a headache and a hassle," he says; "a big necessary hassle to be managed in a reactionary manner off to the side, as an afterthought that is irrelevant to the actual day-to-day business of servicing clients."

That, of course, could not have been the original intention. Looking at the compliance process through the prism of more than a decade of practice management consulting experience, Davis is able to reconstruct some of those original intentions. In the deep shadow of the Great Depression, these various busywork requirements might have represented something more meaningful, the routine work product of a firm whose daily systems and procedures advocate for the best interests of its advisory clients.

Could it function that way again? Davis's mission at MarketCounsel is to reverse 60 years of drift from relevance to busywork. He helps advisory firms reintegrate the basic compliance concepts that are suggested by the paperwork back into the operational side of their business. Fiduciary advisors, he says, will embrace the practice management journey from compliance hassle to compliance integration when they see how the integrations protect their clients from preventable accidents and missteps. At the same time, he says, the integrated compliance/office procedures framework also has to directly benefit the advisor, by making his/her firm more efficient, less prone to a variety of problems and risks, less distracted by paperwork chores, and ultimately more valuable.

How do you transform busywork and form-filling into greater practice management efficiency? Davis starts with a simple example: trading processes.

"When the examiners walk in the door, they're going to want to see your order memos and post-trade followup," he says. "Did you make the trade that you intended to make, and was the execution good, and were the fees associated with those trades what they should have been? Was there reconciliation followup to make sure the trade happened and the securities went

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**Integrated Compliance**
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to the right place?"

Notice first that these are all things that the advisory firm wants to ensure as well. Nobody wants to risk making the wrong trade, or having the money show up in the wrong place. Davis recommends, for your own peace of mind and with an eye on that future audit, that your firm do something simple. Create an email template, so that whenever an advisor sends a trade through the operations staff, he or she gets in the habit of pulling up the order memo template, filling it in and sending it. At the same time, you should create a consistent, familiar, repeatable process for generating a trade blotter from Advent, PortfolioCenter or the custodian. You should have these things filed electronically as a matter of business routine.

Not only does this automatically capture what you need to make the SEC examiners happy, it streamlines, automates and does a better job of making sure nothing potentially harmful happens to the client. And, as Davis points out, it isn't particularly hard to implement--MUCH easier than having somebody reconstruct all this information at the end of the year.

The same trading process would be followed for held-away accounts, whenever you're moving money around while managing a client's 401(k) account. Meanwhile, whenever you do investment research on the funds and ETFs that are placed in client portfolios, there is an office procedure to create files that capture whatever you've learned. Every advisor evaluates what kind of portfolio is right for each client, which is great information to have when the markets go sour and the client is asking why you took so much risk in her portfolio. You can satisfy the examiners and also stay on top of the rationale behind your portfolio recommendations if, as a matter of routine, you include a note in the CRM about the client meeting and what was discussed, and how you arrived at the recommendations you made.

> ***The key purpose of these little systematizations is to boost efficiency and reduce errors.***

The key purpose of these little systematizations is to boost efficiency, reduce errors and give you the information you need to provide consistent service--which may have been what the people who wrote the regulations envisioned seven decades ago. If it also makes the SEC examiners happy, so much the better. Better still, you are moving closer to eliminating some of the redundancies of having the compliance officer (or team) laboriously reassemble compliance information.

As these integrations take place, MarketCounsel's mock audit becomes something much more beneficial to your practice's bottom line: a practice management audit, which looks at how efficiently these checks and balances are being integrated into your daily routine, and provides advice on how to streamline your workflows.

It will also check whether any new integrated compliance procedures are being followed in a reliable way. You might, for example, discover that one of the staff advisors is not using the new trading forms to record personal securities transactions when they're made. Or an advisor may never get around to using the pre-created order memos whenever he changes a client portfolio. Not uncommonly, the whole staff may have never quite gotten in the habit of using them. "Whenever the staff reverts back to the old way of doing things, where they just told somebody to make the trades," says Davis, "then you don't try to convince them of the importance of busywork regulation or the paperwork. Instead, you go back to the business reason why you wanted that system in the first place. How is this the best way to protect clients from our own inevitable mistakes? What improvements need to be made so these procedures are followed in the future?"

The practice management audit might also look at something extremely practical, like billing. You want your clients to be billed accurately, according to what they agreed to--right? "In the audit, we'll take a sampling of the client files for the last quarter," says Davis, "and compare that to the fee schedule in the client agreement. Then we can look at the billing system in Quickbooks or Black Diamond or PortfolioCenter to make sure they match up. Finally, you go out to the custodial statements and check the fee that you intended to take out against the actual amount that came out of the account."

If this random sample comes through clean, you document the process and feel comfortable that the SEC examiner won't find any discrepancies the next time she knocks on the door. If it doesn't, if there are discrepancies, then the examiner is the last thing on your mind; you want to get the problem corrected and reconciled before the client notices. Again, the compliance reason for the audit is secondary to the more important business justification. Davis makes the point with each example: integrated compliance takes you out of busywork and filling in the blanks. It's all about making sure there are no potentially embarrassing mistakes building themselves into your client relationships.

Whenever you do the review, of course, you should create a documented description of what you did and what you found. If there were errors in the random sample, you'll want to pull more client files and see if this is a bigger problem--and having that documented addresses the most frustrating, hard-to-understand compliance requirements. "The examiners want to see that you're self-policing," says Davis. "But a lot of advisors aren't sure what that means."

At this point, we're starting to get closer to what I think most of us assumed was an empty SEC phrase: a "culture of compliance." The compliance culture is not, as we might have generously interpreted it, genuinely caring about clients when you meet with them and give advice. It can be interpreted as having business processes in place that systematize and cross-check your level of care for your clients, and protect them from the inevitable errors that will slip through the cracks.

As an ancillary benefit, integrated compliance takes away the tiresome chore of locking the chief compliance officer in a room in late December, so he can create the forms that would have to be given to an SEC examiner. "That is a very reactionary way to do things," Davis observers. "Not only is it very inefficient and labor-intensive, but there is a high likelihood that you are not going to capture everything you need."

**_The "culture of compliance" can be interpreted as having business processes in place that systematize your level of care for your clients, and protect them from errors that will slip through the cracks._**

The SEC also requires you to conduct compliance training with your staff, which I suspect many advisors view as an empty exercise in make-work. Yes, your staff should know that it's against firm policy to steal from clients, commit fraud, or leave account documents on your desk when you go home in the evening. But now, with these integrated compliance/workflow procedures in place, your compliance training program becomes a systems and procedures training program, and addresses directly things like office efficiency and proactively checking for errors. "What some people regarded as a waste of time is turned into valuable business training," says Davis. "At the same time, you can get feedback from your staff on how to do things better. For the staff, it doesn't feel like wasted time any more."

Davis argues that advisors who want to monetize their practices can get three boosts at once from integrated compliance procedures. First, the company becomes more valuable. An outside firm or internal buyer will have more confidence that he/she/it is not buying a lawsuit waiting to happen. Second, the more smoothly the office operates, the easier it is for somebody to step in and take over. Finally, the more efficient the firm is, the more profitable it will be, which raises the value all by itself.

The interesting thing about all of this is that it looks, to Davis, like the SEC is starting to rediscover some of its original purpose. The audits are starting to look at whether a firm has built-in processes that make visits less necessary. Even the term "culture

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## Integrated Compliance

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of compliance" suggests a different mindset.

Even so, would an examiner understand an integrated compliance culture if he saw one? Davis thinks that many examiners are not yet "getting" this new thinking that has been trickling down from the highest levels of the SEC; they still regard their job as making sure the busywork has been handled, and many of them still don't have a good understanding of the operational side of a planning business. However, they do have to follow the newer procedures, and those procedures are increasingly looking for this integrated approach to compliance that Davis is recommending--even if the actual examiners may not realize it.


*"Save and invest. Save and invest. Don't you financial advisors ever have any fun?"*

"When you say you are doing a best execution review, or tracking the accuracy of trades," he says, "then increasingly, the SEC examiner's position is that if you don't have good documentation, then you didn't actually do it. You can no longer just hand them a piece of paper with names and signatures on it; that doesn't tell them that you did a review."

There's an irony here as well. As the SEC starts to encourage advisors to do more than just handle a lot of busywork, the monarchs of busywork--the FINRA examiners--are poised to take over regulation of the profession. "People complain to me that they wish the SEC would just tell us what we have to do and standardize all of this," says Davis. "I tell them: be careful what you wish for, because that's how FINRA works. We live in a very nonstandardized industry, where companies operate very differently from each other and are generally free to create their own best practices and procedures," he adds. "We would like to keep that individualism alive, that ability for creativeness and developing new solutions and new technology."

Beyond that, he says (and this is one of the best arguments I've ever heard against FINRA taking over RIA regulation): why did Congress establish two different industries in the first place--broker-dealers and registered investment advisors--if they intend to put everybody into the same regulatory box?

I think Davis is one of the very first people in our profession to sense a major change in the regulatory winds, and he's offering a prescription. It is not a precise one; Davis freely admits that a culture of integrated compliance is going to be different at every single firm. But the next time you look out a few years with a sigh and project that compliance burdens are going to be heavier in the future than they are today, you might realize that meeting those future requirements might not be as hard as you thought.

All you have to do is make your firm more efficient, and build in procedures that ensure that you're doing the right things for your clients. You can enhance the value of your practice while you're at it, and the paperwork starts to take care of itself.■

Practice Management

# The Outsource CIO

**Synopsis:** ***Should you consider bringing in an outside professional to help you create and manage client portfolios?***

**Takeaways:** ***The upside: you can get far more research on the markets and your portfolios than you can possibly do by yourself. Meanwhile, does the current trend toward top-down strategic management and alternatives make sense for clients?***

Ask four practice management consultants a question, and you'll get five different answers. But most of them agree that it's crazy for an advisory firm with less than $500 million under management to be doing your own portfolio software downloads, reconciliation and performance reporting. Outsource providers will do those things for less money than it costs you in staff, with a lot more expertise and precision. That's why several sessions at the Business & Wealth Management Forum will explore your outsource options--including one panel discussion where advisors talk about how they've outsourced most of their middle office work and gained scale and powerful new portfolio management tools in the process.

As back office outsourcing starts to catch on, you might consider a more interesting way to get some of that work off your desk: hiring an outside firm to serve as your chief investment officer. We're not talking about a TAMP here, where you're locked into a particular technology and have to choose among predetermined portfolios. Your new CIO would broaden and deepen your investment research and due diligence, identify and research alternative investments that you may be interested in, provide you (and your clients) with economic reports and forecasts, and generally make it easier for you to create appropriate client portfolios.

Where do you find a company like that? Let me introduce you to Barry Mendelson.

Mendelson is CEO of a company called Capital Market Consultants, in Milwaukee, WI (http://cmark.com), which he founded back in 2002 after having set up the investment division for a regional brokerage firm. "You can divide my career into thirds," he says. "For ten years, I worked as an advisor, and the next third, I was a manager of advisory fee-based businesses for financial services firms."

In the shadow of the tech wreck, Mendelson spotted an opportunity. Many bank trust departments, credit unions, law firms and insurance companies were casting about for better, safer investment models and more due diligence to put in the files in case their clients decided to use the court system to recoup portfolio losses. Mendelson offered them an experienced investment team--currently ten professionals with CFA designations or masters degrees in finance, plus the chairperson of the economics department at Marquette University--who would provide more research depth than they could plausibly build in-house. "From day one, we were doing extensive research on investment managers, separate account managers for UMA and wrap programs, mutual funds, ETFs, any and all of those," says Mendelson. "We also explore the capital markets, and valuation and spread information, trying to decide and document which managers do what, and when we think the economic environment favors their style."

What does this have to do with you? As he was working with these larger firms, Mendelson never forgot his experience as an advisor. He knows that advisors running midsized RIA firms have way too much work on their plates, and a significant number of them are less interested in the portfolio management side of the business than in planning work and direct client interactions. These advisors are reluctant to hand over their clients' investments to a TAMP or outsource provider, but they also can't afford to hire an investment specialist on staff.

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## The Outsource CIO

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So Mendelson decided to leverage the research and institutional due diligence that CMC was already doing, and offer it to these firms as well.

Today, a lot of advisors rely on CMC's model portfolios, due diligence or research without realizing it. CMC does a lot of the background work for the investment platforms at Adhesion Wealth Advisor Solutions and TradePMR, and the firm provides services to advisors through Fidelity, Pershing Advisor Solutions and Schwab Advisor Services. The company makes its research and model portfolios available to advisors affiliated with TD Ameritrade.

More recently, the company has begun working directly with independent advisory firms. These come in all shapes and sizes. "Our newest client does a lot of insurance business but not much AUM yet," says Mendelson. "They realized that they need to spend more of their time with clients, so they wanted someone else to do the research, portfolio modeling and asset allocation, and to create their newsletter for them. They're not really analysts, and don't have a research capability, so they want someone to do that independent work for them. Since it's all private-labeled," he adds, "the clients don't even know we exist, and we're fine with that."

For advisors, as with institutions, CMC's service might best be described as having your own investment research staff--at a cost, all in, comparable to the salary of a part-time receptionist (somewhere in the low five figures a year, depending on the level of service). The base package includes a client newsletter, research and due diligence on the investment firms in client portfolios (for your SEC files), plus news alerts and economic updates from, among others, Dr. Abdur Chowdhury, dean of the economics department at Marquette University, former member of the Chicago Fed.

***A lot of advisors rely on CMC's model portfolios, due diligence and research without realizing it.***

In other words, CMC will give you everything you need to put together the client portfolios--and if you decide to outsource that last function, CMC will create model portfolios that you can mix and match for clients. "We want it to feel like we are an extension of your staff," Mendelson explains. "It should be as seamless as possible. They're not buying a product; they're buying a research service from experienced people who have knowledge and software and experience and versatility that they can leverage off of."

What do those models look like? CMC portfolios tend to be globally-diversified, and Mendelson believes in making tactical adjustments to accomplish what he calls fundamental tilting. That process starts by comparing the valuations of different asset classes with historical norms. For stocks, it means looking at price to sales, price to book and PE ratios. For fixed income securities, it means looking at the spread information between different grade bonds and between different maturities. "Then we look at the global macro economy," says Mendelson. "We try to determine where the headwinds and tail winds are going to be. We want to tilt the strategic portfolios slightly, to take a bit more advantage of the tail winds and minimize headwinds."

In real terms, CMC's recommended portfolios have been overweighted in domestic large cap and growth stocks for several years. "Given the environment we're in, with all the headline risk, we want to have the defensive characteristics of large caps," says Mendelson. "We get their lower beta vs. mid and small, plus the fact that many of these companies generate a significant percentage of their sales and profits from overseas. They have the opportunity to participate in high-growth emerging economies, and give us exposure to those volatile markets without necessarily exposing us to the volatility. But," he adds, "when we first started tilting in that direction, it wasn't nearly that complicated. At the time, we thought large cap valuations were far more attractive than mid or small."

Other decisions might include whether to be in TIPS or not (the negative yield on recent issues might be a discouraging factor), and how much to allocate to commodities or managed futures. In these less-well-traveled alternative markets, CMC's value proposition is having the staff and expertise to do research/due diligence at a level that most midsized advisory firms couldn't match.

That said, CMC is not a hedge fund aggregator. All of the investments on CMC's alternatives platform are either 1940-Act funds or separate accounts that trade ETFs. "I think you have to stick with firms that have been around for a while," he says. Nor, he says, is he convinced that you have to pay outrageous fees to get a really smart manager working for you.

Years of research has made Mendelson somewhat skeptical about the profession's recent rush to all things that have the word "alternative" in their names. "Just because products are available doesn't mean they should be used," he says. "If you look in the rear-view mirror and see that somebody had a positive return in 2008, is that, by itself, an argument for investing with them going forward?"

Meanwhile, despite the economic forecasting that goes into CMC portfolios, Mendelson is even more skeptical about advisors trying to add value with tactical shifts. "Do I think we've added value with our fundamental tilting?" he asks rhetorically. "Certainly not every quarter, or every decision, but over time, collectively, we certainly have. But I have to say it's very difficult, and you can hurt yourself with too many short-term movements." He's concerned that many advisors are responding not to opportunities to add value, but to client anxiety, and perhaps their own anxiety about losing clients if they don't implicitly promise to save them from another 2008-like downdraft.


*"Doctor, if I don't die by the end of this year, it's going to cost me a fortune in estate taxes."*

Where does he draw the line? "Our fundamental tilting does address what I call the 'nervous investor syndrome,'" says Mendelson. "We want to avoid bad weather and try to take advantage of tail winds. But," he adds, "we tend to rely on primarily on low correlations, only using the tactical strategies at the margins."

Although Mendelson sees danger in recent investment trends, he thinks that the outsourcing trend will be generally positive for the profession. Bringing in outside expertise might be evidence of a fiduciary-level of concern for the safety of clients' investment portfolios. "We have ten people doing this, soon to be twelve," Mendelson says. "We talk to a couple of hundred investment firms a quarter. Even if a very smart advisor is looking at Morningstar pages full-time, do you think he can do what we do? If nothing else, we're likely to make fewer mistakes."

In this environment, Mendelson thinks advisory firms have to find ways to focus harder on the oft-neglected areas of business management and client service. "If advisors are approaching their practice from a business person's point of view," says Mendelson, "instead of putting the weight of the world on their shoulders, trying to be everything to everybody, they'll find companies to serve as extensions of their office." Otherwise, they will run out of personal capacity and run into a wall right when they experience the greatest growth opportunities.

"From my own experience,"

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## The Outsource CIO

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he says, "I believe there are four things that advisors have to do to run their practices. They have to create new opportunities for business; they have to convert those opportunities into paying clients; they have to service those clients, and they have to keep track of their businesses. The most labor-intensive, expensive, difficult part of the whole operation," he adds, "is servicing clients. You have all the planning work, all the client-facing work, the service experience, and then on top of all that, which is more than a full-time job, you have all the research and analysis that goes into the portfolios you recommend for them. Which of those other things," he asks rhetorically, "are you going to cut back on in order to spend time researching the markets and building portfolios?"

As the middle office outsource trend starts to pick up, as more advisors suddenly take the paperwork and downloading chores off their desks, they may decide that they want even more time to focus directly on working for their clients. If you're one of those advisors who enjoys sitting down with a cup of coffee and the Morningstar investment database every morning, CMC may not be the best outsource opportunity for you. But if you want the capacity to build a business ten times as large as it is now without going on a hiring binge, or if you're adding most of your value with your planning services, then an outsource CIO might be the next step in your practice evolution. ■

Client Services

# Holistic Monetizing

**Synopsis:** ***What's the next Big Thing in the planning profession? It could be integrated strategies to help clients cash in their concentrated investment holdings.***

**Takeaways:** ***Advisors play the crucial role in the process, by identifying and clarifying client goals. The most effective, customized strategies could require coordinating very different specialties. The article introduces Intelligent Edge Advisors as a possible resource.***

Ask Tom Boczar about the value of a financial planning relationship, and he tells a story that has very little to do with managing assets or even running the numbers in a financial plan. "We recently got a call from a financial advisor who was managing a small business client's $3 million portfolio," says the CEO of New York-based Intelligent Edge. "His client had just found out that after working for ten years at the firm, his son no longer wanted to take over his business. The father's succession plan--his whole life, really--was built around selling the business to his son for a note."

Intelligent Edge might be the country's only firm that specializes in handling client liquidity events, working primarily with financial planners. Its stock-in-trade is tax-efficiently monetizing the small business, real estate or the low-basis concentrated stock positions that often make up the bulk of a client's total wealth. In this case, the advisor called Intelligent Edge because the client decided to sell the business. "He wanted us to find a buyer," Boczar says, and on the surface that made sense. "An outright sale would have completely eliminated his stock concentration risk. He had no particular desire to pass the company on to favored management or the employees, so an ESOP or management buyout were not in the cards. Thank goodness," Boczar adds, "we had the advisor in the room as we were discussing these things."

The advisor knew the client well enough to understand that his identity was tied up in the company, and that he would be at loose ends in retirement. And he realized that the client was deeply worried about the potential demise of his life's work if the buying company were to mismanage his firm.

"The most important thing," says Boczar, "was that this guy was 61 years old at the time, still in good health, and the business he was in was very fragmented. He saw the opportunity to grow, and for years he had wanted to make acquisitions, but he could never come up with the capital. The advisor knew this, and as we were talking about the sale, he asked me if I could think of any alternatives."

Boczar could. He suggested that the business owner consider a recapitalization instead of a sale, and eventually facilitated the transaction with a private equity firm. "The idea," he explains, "is that the owner works in partnership with the private equity group. They allowed the owner to cash out up to 80% of the value of the company--so in this case, they wrote a check for $40 million on a company that would have been worth $50 million in an outright sale."

Instantly, the client was able to take out the majority of his wealth at long-term capital gains rates--which, Boczar points out, are attractive right now. The advisor put those assets into a diversified portfolio, eliminating the huge concentration risk that something might go wrong with the company.

Going forward, the client retained a 20% ownership stake in his business, and stayed on as CEO with the private equity firm as his deep-pocketed partner. "Now he can finally start to make those acquisitions," says Boczar. "His firm has become the platform that the private equity firm is using to acquire other firms. The client is realizing his dream of growing," Boczar adds; "he is still building his company, and it's up to him to make the enterprise worth a lot more than it was when he started this journey."

If the client succeeds, in three to five years, when the private equity firm has its next liquidity event, the client could potentially take home more than he initially did with that 80%.

The point is that without the advisor in the room, the business almost certainly would have been sold. The client would have had an unsatisfying end to his life as an entrepreneur, paid more in taxes and ended up with far less wealth. "The advisor's role is to dig deep and really understand what the client wants and needs," says Boczar. "If nobody takes on that role, the investment banker and attorney and accountant will come up with terrific strategies that make no sense for the person they're working for."

From his perspective as an investment banker, real estate strategist and concentrated stock specialist, Boczar has an interesting view of where the advisory profession is going, and where its next client service breakthrough will come from. An attorney by training, he started his career at a large Wall Street law firm. "Because I worked for Touche Ross while I was in law school," he says, "the first thing the law firm had me do was figure out ways their small business clients could get their money out of the company without paying it all back in taxes. It was amazing how much wealth there was in those businesses, and how these business owners could have all their net worth tied up in one place."

In many cases, he adds, these business owners also owned the company's headquarters building, and that, too, had to be addressed in a tax-efficient way. "A lot of time, the best advice was to keep the real estate and lease it to the business," says Boczar.

Later, Boczar took a job with a boutique brokerage firm and helped corporate executives tax-efficiently monetize another form of concentrated wealth: the stock and options in their employer's company. "It was the same story," he says, "except that this time it was people who had worked for a startup that went public, or who had worked at GE their entire life, and their net worth was tied up in low basis stock of one company."

These experiences gave Boczar insight into some things that financial planners should understand. First, a huge number of Baby Boomers are entering what he calls the pre-retirement "monetization" phase of their lives, where they cash out their concentrated assets--and for many, it will be, emotionally and procedurally, the most complicated challenge they will ever face.

The second insight, the point of the small business owner's story, is that nobody is asking them the right questions--not even, in many cases, their own financial planner. "There is an incredible opportunity here," says Boczar. "But most advisors are providing advice only on the liquid, investible part of their wealth. Somebody has to talk to them about their objectives. Is liquidity of the utmost importance? Or the survival of the company? Are they worried about risk?"

Finally, when those goals and

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## Holistic Monetizing

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objectives have been uncovered, where do advisors look to for tax-efficient, goal-specific monetization strategies? "How many companies," Boczar asks, "are familiar with cashless collars, prepaid variable forwards, completion portfolios, recapitalization, ESOPs or how to negotiate a loan against private company shares?"

The staff of Intelligent Edge Advisors combines experience in investment banking for small businesses, business valuation and raising capital, and real estate sales and transfer strategies. Advisors can access its services through any of the major custodians, whenever they need to facilitate sophisticated monetization strategies.

For example, imagine that you have an 85-year-old client who put up some of the early seed capital for Facebook, and now she has $25 million in paper wealth tied up in a company whose future (let's say this delicately) may hold more downside than upside. She'd like to avoid losing money on the stock. At the same time, she wants to pass on this strange windfall to her heirs, and also give them the step-up in tax basis.

"If you go to Goldman or Merrill," says Boczar, they're going to offer you a product. If you want to monetize, they'll sell you a prepaid forward contract. Want to hedge the position? They'll do a cashless collar."

The alternative? "We would tell you, yes, that a prepaid variable forward contract will achieve some of the objectives that you want: hedge, monetize and hopefully defer taxes," says Boczar. "But we'd also mention that the IRS has taken an inconsistent position on this strategy--and in one tax court case, a prepaid forward was deemed to be a taxable event. The strategy was originally introduced as a way to get around the margin rules, where you call the transaction a sale for margin rules purposes, but not a sale for tax purposes. I would call that a shaky foundation that the IRS can attack any time."

> ***"the advisor is the one who digs deep and really understands what the client wants and needs. We can't meet the clients' needs until somebody has taken the time to understand them fully."***

Boczar says that the new portfolio margin rules provide a simpler way to achieve the same result. "If you have a $100 stock, and you have a put on that that is worth $100, and if you do it in a portfolio margin account," he says, "you can borrow up to 100% of whatever protection level you chose, and defer the taxes until the sale. If you're fully protected, they will release $100 to you that you can put into a diversified portfolio. You get rid of the concentration risk, you get the same tax result with less audit risk."

Yes, there's a borrowing cost to factor in here--typically the Fed Funds rate plus 75 basis points, which can add up over time. What if that same client, with the same fact pattern, happened to be 40 years old? "At that age," says Boczar, "we would probably tell them that it's best to take advantage of the current tax rates, and sell whatever they think is appropriate." The fancy strategy, he explains, is appropriate whenever the present value of the step-up in basis is high and the client wants to own the stock until death--where the tax isn't just deferred; it is eliminated.

One of the points that Boczar makes over and over again is that his firm's role is limited. Intelligent Edge provides follows the lead of the professional who has the close relationship with the client. "The advisor is the one who digs deep and really understands what the client wants and needs," he says. "That is not our role. We can't meet the clients' needs until somebody has taken the time to understand them fully."

Another point is that, in many cases, the expertise that is needed to solve the problem is spread out among a variety of firms who aren't accustomed to working together. "Investment bankers typically think like investment bankers, and the people who sit on a stock concentration desk have a certain mindset," says Boczar. "Real estate brokers sit in their office with other real estate brokers. They don't realize that these three disciplines can all be combined to create very intriguing results for the owners of these assets. That is not being done by anybody right now."

Let's see how investment banking and concentrated stock expertise can be married into one solution. The owner of a private company has received an offer from a large publicly-traded technology company. "The owner was really excited," says Boczar. "There were only a few big companies where there was a natural fit, and this was one of the key firms that could be a strategic buyer of his company."

The owner and the CFO entered negotiations with no investment bankers involved, and things were going well right up until the negotiations stalled. "The owner wanted $350 million in cash, and had a reasonable appraisal to back up his position," says Boczar. "The publicly-traded acquirer drew the line at $300 million. The owner felt that they were lowballing him, and he became upset."

The financial advisor found out about all this when he got a call from the angry client, and he called Intelligent Edge. "When we sat down with the client," says Boczar, "the first question the advisor asked was: have you considered taking stock for some of the purchase price? In this case," he says, "the client was adamant: I don't want to hold stock. I'm 75 years old. I just want cash.

"We showed him the combined federal and state tax on an all-cash transaction," says Boczar, "and he said, I know, I know, but why should I take the risk of holding that much stock?"

Boczar suggested that if the client would at least consider taking back stock, and a deal could be worked out, he would find a way to liquify the assets. When he went back to the acquiring company with a more flexible position, the negotiations proceeded much more smoothly. "They said absolutely; the company was worth every penny," says Boczar. "The problem, as they explained it to me, is that they were tight for cash. They had lines of credit that were running out, so a stock purchase would help them out enormously."

***The tax advisor said: you guys just made $120 million come out of the blue. It shows how much of a difference you can make.***

Boczar helped structure the sale as a tax-free reorganization, where the advisor's client swapped the shares in his private company for $350 million worth of shares in the publicly-traded acquirer, so that his basis would carry over and the stock would be registered immediately. "This wasn't tax-free," cautions Boczar; "it just meant that no tax was triggered on that date."

Before the deal was consummated, Boczar had the client short $350 million worth of the acquiring company's stock, so that when the stock was received and registered, the former business owner had, in effect, a classic short against the box position in the stock he had received.

He had what??? "Many people will say: you can't do that!" says Boczar. "They'll tell you that you can't do a short against the box anymore under the constructive rule, but that isn't always true. If you put your short position on like we did, at a time when there is still considerable deal risk, the shares are not substantially identical for tax purposes. His tax counsel was comfortable writing an opinion to that effect."

The bottom line is that the client received his asking price. If he keeps his hedge position for the remainder of his life, the tax on the gain would be eliminated. Meanwhile, borrowing against the fully-hedged position, the client was able to take 99% of the value of the stock and invest it in a diversified portfolio. "If the client would have sold and taken $300 million in cash," says Boczar, "his after-tax take-home would have been $225 million. This way, it was over $345 million--a difference of $120 million in the client's pocket. When the client called to thank us," Boczar adds, "his tax advisor was on the phone, and he said, you guys just made $120 million come out of the blue. Of course, that's not true, but it shows how much of a difference you can make if you understand these different disciplines."

I asked for one more story, this time involving a real estate transaction. Today, Boczar says, Intelligent Edge is running into a common situation, where an investment property's appraised value fell dramatically during the 2008 crash. But, of course, the owners have been depreciating

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## Holistic Monetizing

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these properties. If they want to sell and reduce any further risk, if they want to redeploy that capital into something a little more diversified, they'd have to take a loss and at the same time pay taxes at ordinary income rates. "They're in this messy tax situation and not sure how to get out," says Boczar.

The solution? "In these situations, we'll do a tax-free exchange for a very specific type of replacement property," says Boczar. "We look for a commercial property that is leased by an investment-grade corporation under a long-term triple-net-lease arrangement. In effect, they swap their original property for a bond-like stream of income."

Boczar says that the capital markets view this arrangement very differently than a typical piece of real estate. To a lender, the new investment looks like a bond-like income stream for the next 15 years. "That stream of income," he says, "can be monetized up to about 90% on a non-recourse basis."

Come again? "They borrow against the property," Boczar explains. "We can negotiate a good long-term rate. Economically, it's as if they've struck a put at 90% and fully monetized it. They retain all of the upside potential on the new property, so that if, five to ten years from now the property has gone up in value, they receive the appreciation. If they hold the property to death, they're eligible for that stepped-up basis. And it's a very cheap cost to borrow, because the income coming off the property will offset the loan payments. Meanwhile, more than 90% of the equity can be re-deployed by the client's financial advisor into a diversified portfolio.

"At the end of the day," Boczar says, ticking off the original goals, "the client now has only 10% of the risk in real estate, they've generated liquidity and they did it tax-efficiently. And they can potentially eliminate the capital gains at death."

What is interesting to Boczar is how often the client goals will be essentially the same (reduction of risk, reduced concentration, the liquidity to diversify and tax-efficiency) even if the tools and techniques can be very different (forwards and portfolio margining with stocks; dealing with nonrecourse loans and 1031 exchanges with real estate; recapitalizations, ESOPs and sales to strategic buyers when working with businesses). "The tax roadmap and tools and techniques are different, but you tend to see a commonality in the primary objectives," he says.

So what, exactly, does all this cost? "In each of the disciplines, there is a standard pricing structure," says Boczar. In investment banking work, he says, a $20 million deal might involve a 3-4% fee, whereas it might be 1% for a $100 million transaction. When you get down to $5 million, the fee is negotiable, and could run as high as 5%. A $1 million real estate property might involve a 4% commission. In cases involved in prime brokerage activities, the brokerage firm lending the money will split the interest payments with Intelligent Edge. "It doesn't get marked up for the client," says Boczar, "but we'll participate in the Fed Funds rate plus 75 basis points, or Libor plus 100."

Boczar expects the advisory profession to begin recognizing the opportunity to help clients monetize their less liquid assets. If they embrace the challenge, they will play the primary role in the process.

> ***Boczar expects the advisory profession to begin recognizing the opportunity to help clients monetize their less-liquid assets.***

"The advisor is the person who asks: what are your spending needs and desires?" he says. "What do you want to do the rest of your life? Let's bring that down to a present value number. Once we understand the answers to these questions," Boczar adds, "then we can look at strategies that generate the money they need on an after-tax basis. The critical thing is to create this benchmark, and to have somebody help the client grapple with the personal and emotional issues surrounding that business or that piece of real estate. Compared to that," he says, "our part is not that complicated." ■

Parting Thoughts

# Goodbye to Marv

I'm sure by now you've heard the news: Marv Tuttle has unexpectedly announced his retirement as CEO of the Financial Planning Association, effective in October. Several people contacted me, including a member of the press, to remind me of what I have no trouble remembering: that I had recommended that the FPA look for new leadership. Was I pleased by the news?

Pleased? No. Whatever our differences, it has always been clear that Marv Tuttle is a good man, a good citizen of the financial planning community, a champion of what's right and a stalwart opponent of what's wrong. More than that, he is one of the few people in this business who has a clear idea about what the planning community needs to do in order to become a true profession.

I became increasingly critical because the results at the FPA are not good. Membership is falling, services are less robust than they had been, and more than that, I saw instances where Marv would identify a service initiative for the FPA to implement, and then, somehow, the staff would veto the idea and the organization would go back to business as usual. In our last meeting, I urged Marv to take firmer control of the organization, but I have a feeling that he was never quite able to overrule the internal decisions or impose his vision on the staff's work activities.

In the end, I think the truest thing I can say about Marv as a leader and manager is that he was too nice a guy.

So, first of all, I'm sorry to see one of the profession's best friends and allies retire to the sideline. Second of all, I'm wondering why the FPA decided, suddenly, to cancel the idea of doing a full-scale job search. There's nothing wrong with deciding to promote from inside, but why not explore your options first? The way it is now, the very people who felt empowered to overrule Marv's ideas and initiatives are now running the organization.

How did the resignation come about, more than 18 months in advance of the date when Marv had expected to retire? I have no inside information here and haven't asked for any, but the timing is certainly interesting, coming right as the FPA Board was meeting. What matters going forward is whether the FPA staff can resurrect the vitality that the organization carried with it when the ICFP and IAFP--both strong, viable organizations--gave it birth. How? I think new FPA CEO Lauren Schadle was on the right track when she suggested that the FPA will become more CFP-centric. She ran into immediate flak from the American College, whose agenda is to make sure insurance agents have a seat at the table, but I think this actually highlighted the problem. Currently, a lot of salespeople are able to quietly tout their FPA membership, while the credentialed professionals have been leaving the fold. You can see this in the simple chart I've created here, which divides the total number of FPA members by the total number of CFP designees each year since the FPA's formation through the end of last year. This probably understates the case, because I strongly suspect that the percentage of FPA members with

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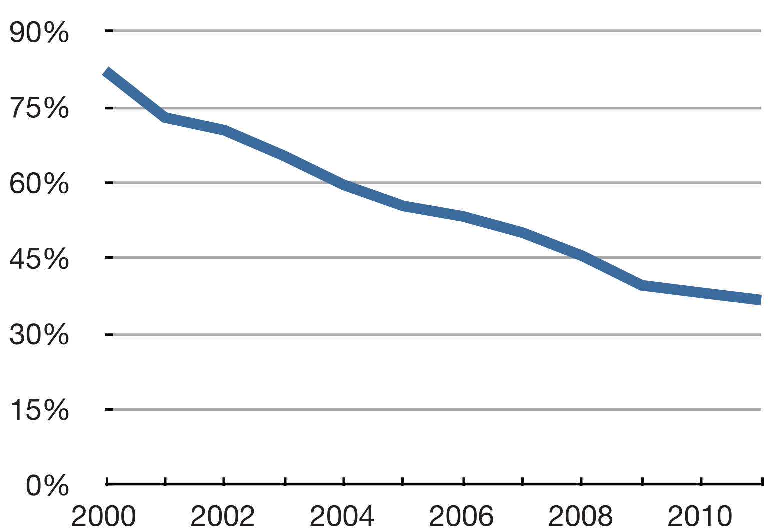
FPA Membership as % of Total CFP Population



## Parting Thoughts

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the CFP designation has been declining. If we were talking purely about CFP advisors, the graph would actually look steeper than what you see here.

The American College rifted from its own alumni organization when NAIFA decided to become less insurance sales-oriented. Now the American College is clearly alarmed that the FPA might follow the same course. I hope Schadle decides to face this criticism head-on, and make the FPA stand for professionalism, and find ways to serve professionals with a richer, expanded, more sophisticated member benefits package. The FPA has long been concerned that this might cost it members--and, of course, it will. But the chart shows us that there is a lot of growth opportunity right there in the CFP world, among advisors who--like the ICFP members--want to belong to an organization that stands for the same things they do.

Meanwhile, I hope that Marv Tuttle remains involved in the planning community, to help steer us toward increased professionalism. ■