Preparing for an age of declining revenues

For independent wealth management firms, inaction is not an option

Rising costs, changes in consumer behavior and shrinking margins do not make a good recipe for success. Yet this is the combination independent wealth management firms face in the wake of the global financial crisis.

Fueled by the boom times of recent years, many companies saw their fixed and variable costs for back office management, technology and people rise. While assets under management and assets under administration rose concurrently, the additional revenue balanced out the cost increases. However, when the bottom fell out of the market, declining asset values drove many investors to scale back their market exposure – leaving wealth management firms with high costs unsupported by sufficient revenues.

On its own, this revenue-cost mismatch is game changing. However, it is not the only factor affecting the industry. As the population ages, investors are looking for personal advice and for products that support asset de-accumulation. Unwilling to pay high fees for sub-optimal performance, retail and institutional investors are pushing wealth management firms to lower their fees. Thanks to a new regulatory regime, compliance expenses also are on the rise. As a result of these combined forces, both manufacturers and distributors are being squeezed as never before.

There is no question that independent wealth management firms fill an important role in Canada's financial landscape. In addition to providing more choice and regional diversity, they often provide niche and current market-driven products unmatched by their larger rivals who have higher internal risk management hurdles to deal with. However, to compete in this altered landscape, independent players must revisit their business models. In some cases, this may require a fundamental reconsideration of their operating environment. In other cases, it may suggest the need to position for either a sale or acquisition. In all cases, one thing is clear: the time for inaction has passed.

Three drivers of change

To compete effectively in an age of declining revenues, wealth management firms need to understand the primary trends driving industry change. While many factors contribute to the current challenges, there are three main issues to consider.

1. Shifting demographics

As of the end of 2005, financial assets controlled by households for the purpose of accumulating wealth totaled $2.1 trillion. Long-term projections, however, tell a more cautionary tale. While the Canadian wealth market is expected to exceed $4 trillion in a decade from now, almost 70% of those assets will be controlled by retirees and near retirees. As of the end of 2005, financial assets controlled by households for the purpose of accumulating wealth totaled $2.1 trillion. Long-term projections, however, tell a more cautionary tale. While the Canadian wealth market is expected to exceed $4 trillion in a decade from now, almost 70% of those assets will be controlled by retirees and near retirees.

As the population ages, investors will require products that will help them meet their cash flow needs and manage risk – rather than simply accumulating assets. This will drive an increased demand for products that deliver reliable streams of income and provide principal protection and tax efficiency. It will also lead investors to expect improved advice on how they can manage their finances through their life-cycle. The result? Independent wealth management firms will find themselves facing formidable competition from both insurance companies (with their risk management expertise), global wealth management firms (with their marketing and financial resources) and investment banks (with their structuring expertise).

2. Changing investor behaviour

The huge market correction in the latter part of 2008 and the early part of 2009 resulted in a complete wipe-out of all the market gains of the last decade. This event in itself spooked investors who were getting accustomed to double digit annual gains from the market and were oblivious to the risks. Furthermore when the Reserve Primary Fund's price dipped below $1 per share in September 2008, investors learned the hard way that money market funds were not 100% secure and could, in fact, lose money. These events were a few in a series of crises that has badly shaken investor confidence. Investor behaviour is now shifting as a result of these mega market events.

The huge market correction and the declining faith in their advisors' ability to beat market indexes caused many investors to take matters into their own hands and this was evidenced in the following survey. According to J.D. Power's inaugural survey of Canadian discount broker customers, one-third of existing discount brokerage customers in Canada opened their accounts in the past year. At the same time, net flows into equities dropped into the negative as investors flocked to yield-oriented investments. Investors are also showing a proclivity towards Exchange Traded Funds (ETFs) over actively-managed mutual funds. These changes are putting pressure on wealth management firms to lower retail MERs and commissions – and the pressure will only mount if the SEC decides to curtail trailer fees in the U.S.

According to J.D. Power's inaugural survey of Canadian discount broker customers, one-third of existing discount brokerage customers in Canada opened their accounts in the past year.

3. Rising regulatory burden

The financial industry is already one of the most regulated in Canada, and recent market events are contributing to even higher regulatory burdens. In September 2009, National Instrument 31-103 came into force, imposing risk-adjusted capital requirements on asset managers, mutual fund dealers and exempt market dealers. Additionally, rather than simply reviewing the structure of financial products, new regulations increasingly require greater transparency around fees, commissions, disclosure of conflicts, complaint handling and performance reporting. The proposed shift towards a fiduciary standard for all investment advice in both the U.S. and the UK has raised concerns that Canada may be next.

This tightening regulatory environment comes as a blow to an industry that already spends billions of dollars each year in compliance, risk management and supervision. For independent wealth management firms, these mounting obligations may prove to be too much to bear.

How do you plan to respond?

In an environment of shifting pricing dynamics, declining consumer confidence and rising regulatory mandates, it is imperative for independent wealth management firms to develop a clear response strategy. Depending on your assessment of the market, there are three ways to respond:

Build scale through acquisition

By engaging in strategic acquisitions, wealth management firms with strong balance sheets and robust business models can gain the scale they need to navigate through the new market conditions. By developing a strategy that identifies your opportunities to reduce cost and increase revenues, you may be able to narrow down the landscape to identify a good fit with your business model. Before engaging in an acquisition, however, it is essential to identify your potential targets, conduct sufficient due diligence, source the financing you require and develop a solid plan for post-merger integration.

Divest

If your company is facing potentially insurmountable financial challenges, or your owner/managers are nearing retirement, it may be time to consider a partial or complete divestiture. To fully capitalize on the current favourable environment for consolidation, however, it is important to maximize your value drivers and provide a compelling story which focuses on your business model to attract the highest possible valuation.

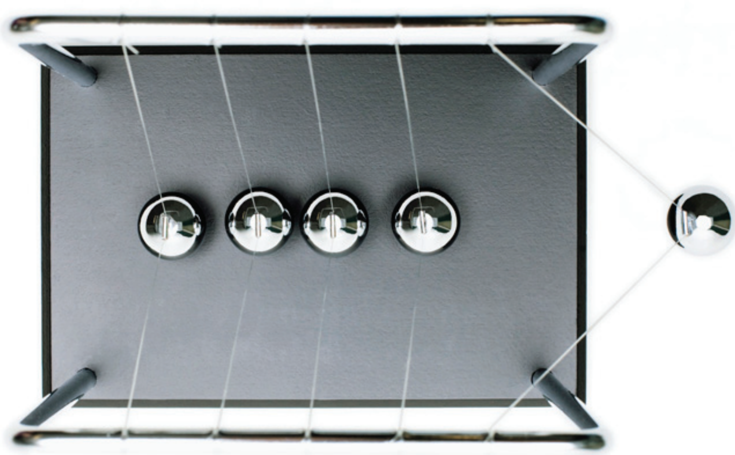
Enhance your business model

If you are prepared to make the strategic investments necessary to enhance your business model, you may be able to avoid a purchase or sale. Bear in mind, however, that this route may require you to fundamentally alter your products, services, fee model, marketing strategy and/or operating processes. At the very least, this effort will position you to enhance business value upon a sale. On the flip side, it also allows you to build a foundation for future growth.

> If you are prepared to make the strategic investments necessary to enhance your business model, you may be able to avoid a purchase or sale.

As the year wears on, independent wealth management firms are bound to face a range of difficult decisions. To ensure your choices ultimately benefit your customers, staff and other stakeholders, you must understand the factors influencing industry shifts and develop a response strategy well in advance.

> It is essential to identify your potential targets, conduct sufficient due diligence, source the financing you require and develop a solid plan for post-merger integration.



Contacts

To find out how Deloitte can help you prepare for an age of declining assets under management, please contact:

Mervyn Ramos
merramos@deloitte.ca
416-601-6621

Paul Gibbons
pagibbons@deloitte.ca
416-601-6232

Rob Galaski
rgalaski@deloitte.ca
416-601-4594

Milan Roy
miroy@deloitte.ca
604-640-3239