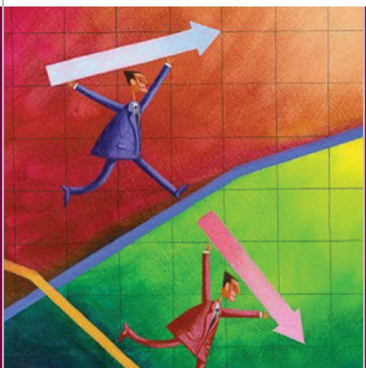

Trends in the Rep as Portfolio Manager Business

Opportunities and Challenges for Investment Managers

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EXECUTIVE SUMMARY

The Rep as Portfolio Manager ("RPM") business is growing rapidly and is quickly evolving from a niche to a mainstream strategy. The catalyst for the recent ascent of the RPM business was the market downturn, when FAs came to fully appreciate the need to manage client accounts more nimbly. This could be solved with discretionary relationships that also provided practice scalability, greater efficiencies, and control and tactical flexibility. Fortunately, the technology and tools curve has trended sharply upward over the past five years, which has facilitated the conversion to discretionary practices by providing greater efficiencies in the operation of the business.

This research paper focuses on the burgeoning RPM segment of the managed solutions business. Among the topics we examine are the evolution of the RPM segment, the drivers of the recent rapid expansion, best practices for investment management firms (product manufacturers) to effectively tap into this growth, and future trends.

In preparing this research paper, we conducted primary and secondary source industry research, sponsored an on-line survey with industry leaders, and interviewed the heads of RPM business units at wirehouses and regional and independent broker/dealers.[1] Observations that were persuasive and deserved a 'call out' are included under the caption Insights or are annotated with bold type. We also had the opportunity to speak with several leading financial advisors, including the head of a high net worth ("HNW") RPM practice. His perspective, which is found at the end of this research paper, also is instructive about the steps an investment management firm should take to be more effective with these practitioners.

INTRODUCTION

We all know that advice is a growth business as investors seek more counsel, holistic solutions, a broader service array and personalized portfolio recommendations. The growth of the fee-based advice business has been nothing short of spectacular, and has fundamentally changed the broker/dealer business model. Attendant to that growth has been a realignment of the distribution approach of investment managers.

According to the MMI's **Central** report for 2Q 2011, for the one-year period ending March 31, 2011 advised assets grew by 23.7%, and five of the six defined *advice* segments[2] recorded one-year growth rates ranging from 9.9% to 87.7%.

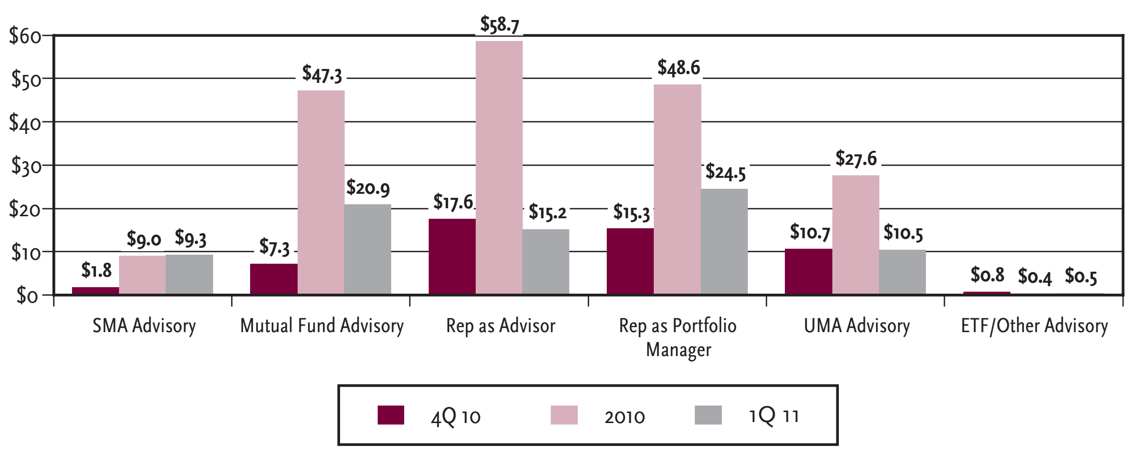
Advisory Program Assets by Market Segment ($ billions)

Advisory Program	1Q 10	4Q 10	1Q 11	1Q 10 vs 1Q 11 ($)	11 vs 10 %
SMA Advisory	$531.6	$556.8	$584.2	$52.6	9.9%
Mutual Fund Advisory	$532.6	$611.5	$657.8	$125.2	23.5%
Rep as Advisor	$399.0	$458.8	$490.7	$91.7	23.0%
Rep as Portfolio Manager	$297.1	$360.3	$402.7	$105.6	35.5%
UMA Advisory	$72.6	$123.7	$136.2	$63.6	87.7%
ETF/Other Advisory	$10.5	$8.0	$9.2	-$1.3	-12.0%
	$1,843.4	**$2,119.1**	**$2,280.8**	**$437.4**	**23.7%**

Sources: Money Management Institute, Dover Financial Research

The UMA Advisory managed solutions segment notched an extraordinary 87.7% growth during that period, but it was from a relatively small base. The segments with the strongest growth were Mutual Fund Advisory, RPM and Rep as Advisor.

Advisory Program Net Sales by Major Segment ($ billions)



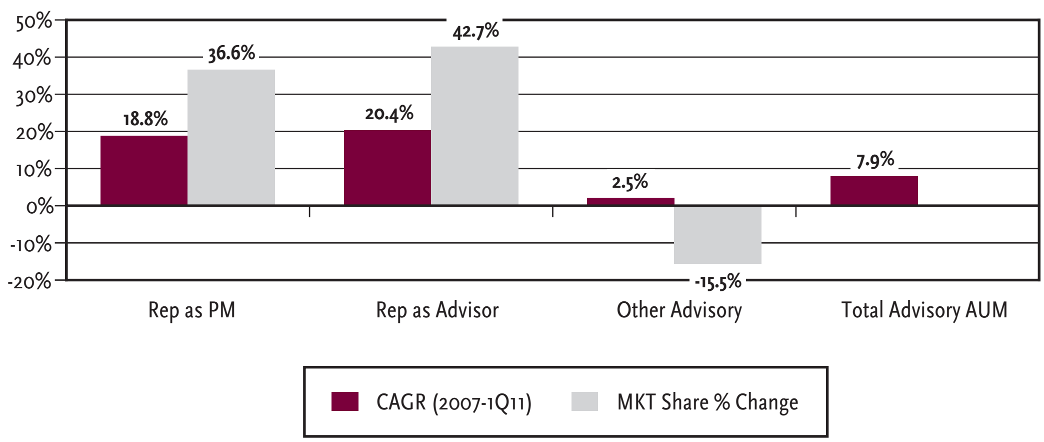
Sources: Money Management Institute, Dover Financial Research

The exhibit above, which shows net sales in various managed solution segments, demonstrates the increasing popularity of the RPM cohort. Consider fourth quarter 2010 sales against total year 2010 volumes. On this basis, Mutual Fund Advisory, RPM and UMA programs garnered a disproportionate percent of the year's total sales volume in the fourth quarter. Moving to the first quarter of 2011, only two segments were able to meaningfully continue that upward trajectory – RPM and Mutual Fund Advisory, and net sales into RPM programs were $3.6 billion greater. These recent trends, viewed in concert with the longer-term CAGR rates (described below), indicate likely meaningful future growth.

The following table takes an historic view of compound annual growth in AUM among the various advice segments since 2007 – *Rep as PM* ("RPM"), *Rep as Advisor*, and *Other Advisory*, which combines the four other advice segments.[3]

Advisory Program Growth Rates

Period End AUM	Rep as PM	Rep as Advisor	Other Advisory	Total Advisory AUM
2007	$230	$268	$1,281	$1,779
2008	$182	$218	$878	$1,278
2009	$291	$334	$1,087	$1,712
2010	$360	$459	$1,300	$2,119
1Q 2011	$403	$490	$1,387	$2,280



Source: Money Management Institute, Dover Financial Research

Although the *Other Advisory* segment includes the fast-growing Mutual Fund Advisory business, its CAGR has been flat over the three plus year period, and its market share has slipped by 15%. Nevertheless, this segment still accounts for more than 60% of advisory assets. Contrast this with the 19% and 20% CAGRs of the RPM and Rep as Advisor[4] segments, and the measurable upticks in market share. (Source: Money Management Institute) While the focus of this research paper is on the RPM segment, we caution the reader not to discount the outstanding growth in the Rep as Advisor sector.

Depending on their business model, skill set, and value proposition (and subject to the program options of their parent broker/dealer), financial advisors[5] ("FAs") have the flexibility to choose among several types of advisory programs. As financial advisors have been transitioning their practices to consultative business models, they may be able to delegate all or a portion of the investment management activities, or establish and retain complete control of investment management. **In a constantly evolving business, more customized solutions, flexibility, efficiency, and choice are powerful facilitators.**

Definitions are in order for two of the fastest growing segments of the advisory fee-based business – RPM and Rep as Advisor. The principal difference is the party who has discretion over the client's account.

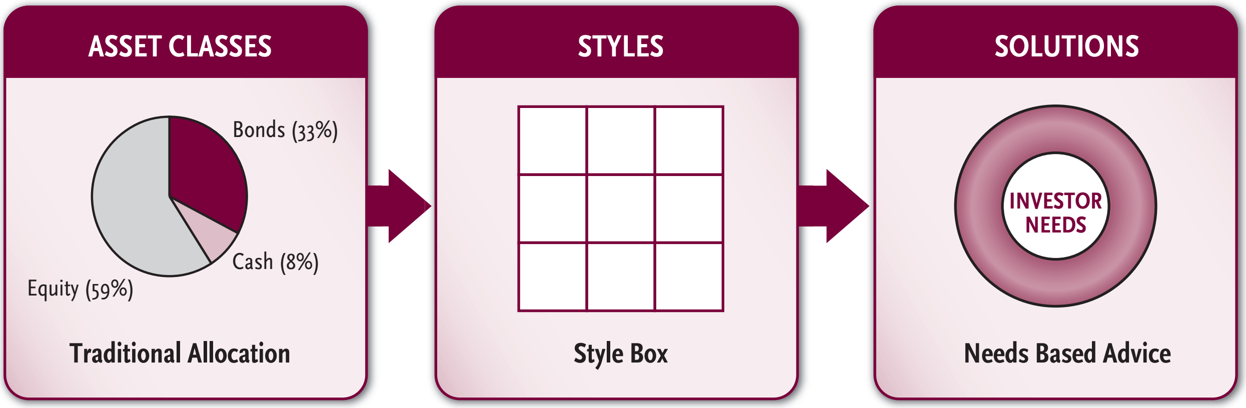
> ***RPM*** – These are *FA-discretionary programs* where the FA acts as the portfolio manager for his/her clients. The FA takes full responsibility for selecting a customized portfolio of products that may include some combination of cash, stocks, bonds, open- and closed-end mutual funds, option strategies, ETFs, and other investment products. (As discussed later, currently most FAs are utilizing pooled vehicles.) FAs who operate under the RPM umbrella must have significant experience and advanced training, and must pass stringent industry examinations.
>
> **Rep as Advisor** –The FA operates under a fee-based arrangement, *but does not have discretion and must obtain client consent for every investment recommendation*. While the financial advisor provides a greater level of guidance and resources for his/her clients than a traditional commission-based broker, the investor effectively acts as his own de facto portfolio manager. Only the investor can make the final investment decisions on asset allocation and specific security/vehicle selection.

EVOLUTION OF RPM BUSINESS

Notwithstanding the recent rapid growth in the RPM business, it has a long heritage. Its roots reach back to the EF Hutton days, when the firm rolled out its Portfolio Management Program in 1979. Since its launch, the population of RPM FAs has been constantly expanding.

In the early years, RPM FAs typically approached this business as a specialty within their practices. Discretionary portfolios generally consisted only of stocks and bonds -- much like a traditional SMA, but managed by the FA. Over time the *early adopters* model evolved to reflect the influence of style boxes and eventually to greater needs-based advice using multiple products. This latter trend began to gain significant traction about five years ago, as a result of rapidly improving trading technologies and the expansion of product options. At this point, RPM adopters included FAs who had already embraced RPM and leveraged their unique competency, such as US small cap equity. They would differentiate themselves by taking a broader portfolio approach and hiring other managers to supplement their specialty.

Evolution of Portfolio Construction



Source: Lord Abbett

Over the last decade, concurrent with the addition of mutual funds and ETFs to the platforms, more FAs became discretionary asset allocators. They either built their own models or followed other asset allocation advice and guidance. Largely as a result of the 2008 – 2009 market break and heightened market volatility, the trend to RPM FAs accelerated further. Many FAs and FA teams started to migrate substantial portions of their books of business to the RPM model.

In some cases, entire practices were restructured to the RPM model. The team might include one or more client relationship managers, analysts, portfolio managers and client services personnel. **In fact, the largest (and perhaps the most sophisticated) teams are effectively operating much like registered investment advisor ("RIA") practices, but with one distinction – they are operating under the umbrella of a wirehouse, regional or independent firm.**

Through our industry research, it was acknowledged that the trend to the RPM model is not universal. Not all broker/dealers even offer this advisory fee-based model, and not all FAs are demanding this capability. Furthermore, there was skepticism among some firms about an FA successfully serving in a *dual-hatted* role of providing superb client service and being an effective portfolio manager.

Notwithstanding these cautions, the following insights from due diligence leaders may provide underpinnings to the future growth of the RPM business model.

Insights

- While some of these recent growth trends may be in reaction to cyclical events (i.e., the 2008-2009 market break), the secular trend toward the RPM model is likely to be sustainable.
- FAs like to organize their practices in this manner. FAs who effectively articulate their 'value add' are better able to demonstrate the worth of their services, which is often more crucial to the long-term durability of the relationship than performance. Fees become a secondary factor.
- Clients of RPM FAs prefer that their FAs operate under a discretionary relationship, particularly in the high net worth ("HNW") space.
- There is the perception that when the client gives discretion to the FA (or the home office), the client is better served.

MOTIVATIONS TO BECOME RPM FA

We identified several principal motivators for an FA to migrate to an RPM business model – scalability, total control and flexibility, and technology. These factors are closely intertwined.

One interviewee described another motivator, so-called FA chatter, where one RPM FA promotes the worth of, and his success with, the business model to others at the broker/dealer. FA chatter in and of itself is a potent instigator.

Scalability

As advice became increasingly central to the client relationship over the past several years, non-discretionary relationships became onerous to administer, and a manually intensive process became far less appealing. An FA operating a non-discretionary book of business is unable to unilaterally shift an allocation or holding in a client's portfolio without first obtaining client consent. Given that the typical FA may have several hundred client relationships, contacting each of them is an enormously cumbersome, time-consuming process. As a result, it precludes effecting a portfolio shift en masse and in a timely manner. By the time all consents are received, the market may have moved against the FA, thereby impacting portfolio performance. The RPM model eliminates this burdensome process, empowers the FA to complete the realignment in a timely manner, and thereby provides more optimal portfolio management. With scalability comes efficiency in the FA's management of his/her practice.

Our research unearthed another nuance to the term scalability. Sophisticated RPM teams with broad capabilities and sufficient size and staffing find that it is often more economical to hire specialized portfolio management staff and internalize additional asset management activities rather than hiring outside money managers.

Control and Tactical Flexibility

As our introduction to the topic of control, we paraphrase several interviewees' comments, two of which were focused on the consequences of the market break.

> *When the markets were struggling, some FAs who may have put their faith in either the home office or a third party manager often were disappointed in the outcomes, and risked the loss of valuable client relationships as a result of lagging performance. In addition, the importance of 'brand image and cachet' could not be ignored. During those turbulent times, broker/dealers with 'headline issues' may have unintentionally foisted a negative halo effect on their FAs. Under these circumstances, it was not surprising that some FAs wanted to regain control of their practices.*
>
> *If an FA had a non-discretionary or manually intensive practice, the market break demonstrated the need for greater control and tactical flexibility. The RPM model enabled the FA to take greater control over the relationship and gain the flexibility for fast decision-making, thus avoiding client laments such as "Why aren't you raising cash in my account?"*
>
> *The FA's value proposition is centered on his/her investment process. FAs operating under the RPM model garner greater discretion and control over how client asset are invested. With account discretion comes additional responsibility and accountability – to the client and the home office.*

Yet, beyond the above explanations there was no consensus around the benefits of control (which might more appropriately be described as the benefits of discretion). For example, on the one hand, the home office of the RPM FA could cede too much control over the relationship. On the other hand, relying exclusively on the home office for research advice potentially could result in a lack of diversification around an FA's capital markets and/or intellectual research. (Examples might be the use of portfolio hedging or more 'exotic' strategies such as alternative investments.) In addition, several interviewees noted that a few FAs are shifting away from the RPM model. The commitment to managing client portfolios under a discretionary structure takes away from the opportunity to cross-sell other financial solutions, such as lending, which suggests that, without a well-orchestrated team approach the RPM model is not for everyone.

Technology

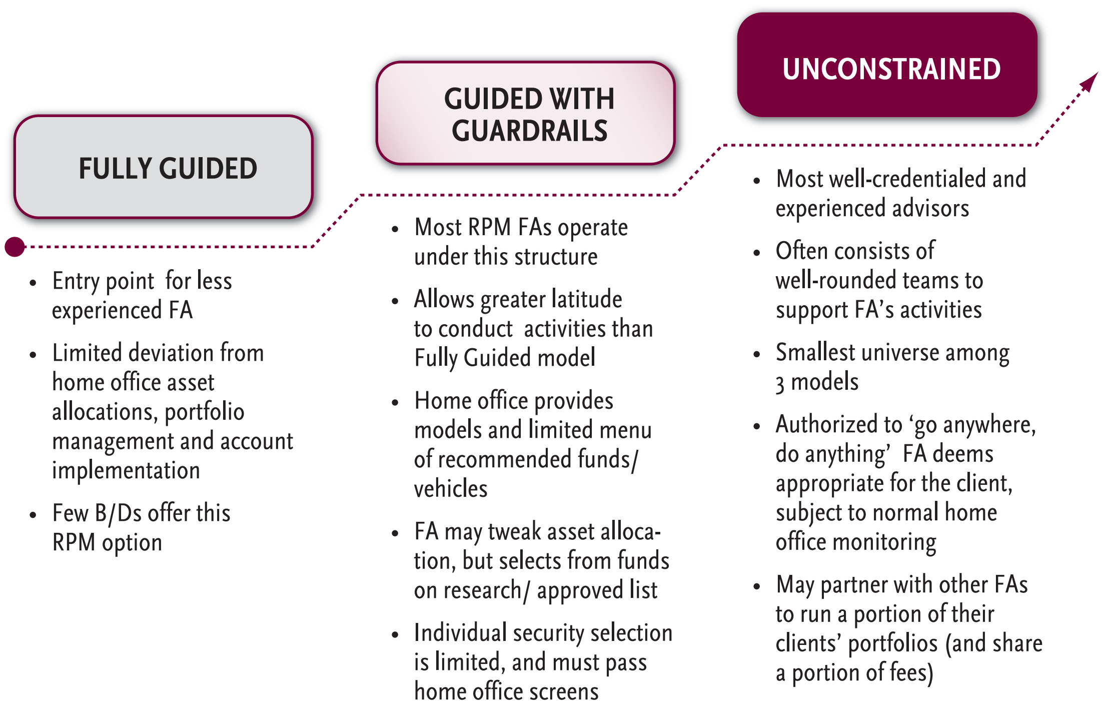
Technology has fueled the growth of the advisory business over the past decade. At the outset, the fee-based business model was paper-based, with less mature technology options, while commission-based business was easy to administer. With technology, this trend has reversed and the advantages of a commission-based book have largely been eliminated. The so-called aggravation factor of a fee-based portfolio has diminished so much that operating a commission-based practice was viewed as being more burdensome.

The technology and 'tools' curve, which has trended sharply upward, has led to greater efficiencies in the operation of the business. Examples include improved trading systems, easier account establishment and account administration, better performance reporting, greater customization, auto rebalancing, and integration of a wider product swath. To quote one interviewee, "It makes the RPM advisory business much more FA friendly."

REP AS PM BUSINESS MODELS

There are typically three fundamental models for the RPM business. We use the following nomenclature to define these models — *fully guided*, *guided approach with guard rails*, and *unconstrained*. The differentiator is the degree to which the FA's activities are 'chaperoned.'

Basic RPM Models



Source: FUSE Research

The *fully guided* model generally may be viewed as the entry segment. The FA does not deviate in any material way from home office asset allocations, portfolio management or account implementation. This model is particularly fitting for the less experienced FA, or the FA who does not want to do individual security selection. *Home office discretionary advi-*

sory programs are fundamentally analogous to the fully guided model; variances are at the firm level and focus on the degree of required home office shadowing/implementation.

The *guided approach with guardrails* offers the FA greater latitude to conduct his/her activities. The home office provides models and a limited menu of recommended funds/vehicles to use in a particular asset allocation strategy. The FA may be able to modestly tweak the asset allocation, but selects from the various funds that are on the broker/dealer's research/approved list. Depending on the firm, the FA may be able to do some individual security selection, but those securities must pass home office screens. The preponderance of RPM FAs operates under this mandate.

The *unconstrained* model is appropriate for the most well-credentialed and experienced advisors.[6] These FAs are authorized to 'go anywhere, do anything' they deem appropriate for the client, subject to the caveat that they still are subject to ongoing home office monitoring, approach validation, risk management and performance measurement (to name a few metrics). As measured by the percent of FAs operating under this model, this is by far the smallest cohort. These FAs may have well-rounded teams to support their activities. In addition, in another emerging trend they may partner with other FAs to run a portion of their clients' portfolios (and share a portion of their fees). We expect that this model is most apropos for more sophisticated practices and/or those focused on the top tiers of the HNW space.

There was broad consensus that the *guided approach with guardrails* will continue to gain the greatest traction among the three RPM business models. (More on this in subsequent sections of this research paper)

A number of broker/dealers offer only two models, the *guided approach with guardrails* and *unconstrained*. Newer FAs would enter the RPM program under a guided approach with guardrails mandate.

Business Model Qualifications

As expected, there is a correlation between the various business models discussed in the prior section and FA qualifications. Those models determine the degree to which the activities of the RPM FA can be conducted independently. Predictably, each progressive model has higher entry hurdles, whether measured by length of service, size of book, test credentials, training, or a myriad of other factors, such as due diligence around investment style, strategy, philosophy and research methods. Regardless of model, ongoing training is required and might include topics such as ethics or advanced portfolio management.

The criteria for entry into an RPM program were considered to be more stringent than other advisory programs. It was acknowledged that only a small subset of FAs should be unconstrained RPM FAs because of the inherent risks to the broker/dealer. The guided approaches enable the home office to more effectively manage risks associated with the RPM advisory program.

Regardless of model, all FA activity is closely tracked. Typically, this is likely to be accomplished via centralized compliance and oversight tools that monitor such factors as performance, risk, concentration limits, and securities quality ratings (to name a few measures). All FA accounts are reviewed on a pre-determined frequency.

Team Composition

Particularly at the top tier, the trend is toward RPM teams. While there was no consensus around the exact team structure, some key roles were identified, which would depend on the size of the practice. Firms that are restructuring their practices along these lines are operating similar to RIAs/wealth managers. Under this team structure, one rep specializes as the PM; other roles may include (but are not limited to) asset allocator/portfolio manager, client relationship manager, trader, and CFA/research analyst.

OTHER CURRENT TRENDS

Portfolio Construction

The investment mix in RPM accounts generally has shifted toward pooled investment structures, such as mutual funds and ETFs. Many FAs understand that they do not have 'single stock' (or bond) insights; instead they prefer to delegate underlying securities decisions in a particular asset allocation to a professional manager and then 'manage the managers.' More recent adopters to the RPM model, who generally had been utilizing pooled investment structures prior to 2008, have continued to use those structures-but under a discretionary relationship.

Whereas nearly ten years ago, a majority of RPM FAs used individual securities, the percentage has reversed. The drivers fueling the growth in mutual funds are variety, the increasing availability of reasonably priced institutional/advisory share classes, superior diversification, efficiency of exposure to many asset classes (such as alternatives investments in a '40 Act wrapper), the array of international/emerging market options, and flexible global strategies. The examples abound. The key explanation for the growth in ETFs was that they give the FA the ability to generate portfolio level beta in a relatively cost efficient way while the FA actively manages the asset allocation exposure. While this was described as a 'huge development,' it was not universal.

Our research and interviews identified several portfolio construction trends:

- Tactical asset allocation strategies – This is being driven at both the portfolio and product level. The RPM platform is very efficient for tactical asset allocation because an FA can scale portfolio changes across all clients in a few minutes.
- Alternative investment vehicles and absolute return strategies, ideally delivered in '40 Act packaging.[7]
- Increasing interest in using hedging and currency strategies for a small portion of the portfolio.

It was suggested that, by the nature of their processes, home office models (and strategists) are less nimble and are not being adapted to a changing market outlook quickly enough. This is driving the addition of broader asset classes (such as alternatives), recognition of the deficiencies in the style box methodology for strategic asset allocation, and/or increased flexibility to allow a tactical reallocation into cash or other asset classes.

Total Portfolio Management

Total portfolio management ("TPM," also known as holistic asset management) is the fastest growing segment of the RPM business. The FA acts as the *overlay manager*, that is, the asset allocator. He/she employs a series of models to provide complete asset management and broad portfolio solutions, and principally employs mutual funds and ETFs as the investment vehicles. The models may be firm-based, developed by the FA, originated through external strategists or a combination of all. The FA then selects the funds as a part of the implementation strategy. Under this structure, the FA acts more in a planner capacity, by providing overlay management and employing professionally managed solutions for the underlying portfolio pieces.

Models/Asset Allocation

Generally asset allocation advice can come from three sources: the home office, an external overlay manager, or the FA himself, subject to the standard home office oversight. The extent to which any of these approaches is used depends on the FA's experience and the business model under which he operates. Not surprisingly, less-experienced FAs are often encouraged or required to use pre-established, home office dictated models.

As a rule, broker/dealers have exceptional proprietary intellectual capital in areas such as asset allocation, portfolio construction, and security and fund selection. FAs are increasingly looking to internal or non-proprietary models either as standalone solutions, to complement their own portfolios, or as a foundation from which to build their own solutions. The FA then may tweak or augment those models with his own ideas.

It was suggested that some FAs will increasingly look to third parties for alternative viewpoints and/or models to be included alongside their own. As addressed in the *Future Opportunities* section of this research report, if home offices move to open architecture for models, the challenges will be twofold – technology and compensation. The external investment manager will provide the model electronically, which would need to be set up on the firm's systems. The third-party manager providing the models will likely want to be compensated. This is in contrast to proprietary models, which typically are provided without additional cost to the clients.

Pricing

The term *pricing* has two connotations – at the account and product levels. FAs want to use the lowest cost share class in portfolios, which typically is an institutional class. Price should not necessarily be a driver at the account level, and it appears that there is price elasticity as long as the FA can effectively demonstrate his value-add to the relationship. If the FA is unsuccessful in distinguishing himself, an expected price compression logically follows.

MAKING AN IMPACT AS AN INVESTMENT MANAGER

Overview

Before elaborating on the ways an investment manager can make an impact in the RPM space, we offer the following tenet. ***The distribution business is becoming more fractured and less homogeneous, with more narrow markets for manufacturers to segment and focus on.*** The RPM constituency is an excellent example of a fast growing segment that requires a thoughtful strategy from manufacturers. A 'one size fits all' approach will not be effective, and the investment manager's distribution team may require a fundamental realignment.

We share several *insights* from our broker/dealer interviewees. While the following bullet points may seem obvious to the reader, the interviewees were blunt in their views about the investment managers' apparent lack of strategy.

Insights

- It is critical for the investment manager to establish a well thought-out value proposition, product and distribution strategy to capture assets in RPM programs, as well as in the firm's other advisory programs. The business plan must support the business, and reflect the investment manager's comprehension of the broker/dealer's overall retail strategy.
- Personnel in the distribution arms of investment managers need to be trained specifically on the broker/dealer's RPM model and its limitations. Know all other advisory offerings of the broker/dealer where the investment manager's strategies may work, as well as their internal research views, models, and the central messaging being driven throughout the organization.
- Segment the FAs at the broker/dealer for greater effectiveness. (more on this later)
- The FA's decision-making is influenced by home office advice; however, they are seeking increasingly more diverse sources of information, including their own research and external resources (providing an opportunity for asset managers to add value).
- Partner with the home office; help take home office initiatives to the field. This improves the relationship and ultimately facilitates the investment manager's ability to *tell their story*.
- Do not bypass channel level managers; work with the appropriate liaisons in the field. Offer to be an extension of home office training, and partner with the firm's regional specialists to execute in the field.

In the following sections, we describe other areas for improved investment manager effectiveness as it relates to RPM programs.

Understand How Investment Managers are Selected

Understanding – and influencing – the manager selection process is a two-pronged approach. Consistent with the various business models for the RPM programs, **the investment manager must consider both the home office and those RPM FAs who are able to govern (at least to some extent) their own portfolio construction.**

Investment managers should understand how the home office research (manager selection) groups influence the FAs. For example, many provide guidance through models and themes. The (obvious) first step – which is pursued by investment managers – is to gain placement on research lists. If the investment manager's offering is selected by the research group, that offering should be positioned as a complement to the views of the research group, convey the manager's rationale for this approach, and elaborate on long-term performance consistency (a so-called repeatable solution). If a fund is not selected by the research group, it was suggested that investment managers identify their 2 or 3 funds/products that complement – or augment – the FA's strategy.

The portfolio solutions employed by the FAs reflect their views of the market and risk/return trade-offs, to name just a few considerations. Investment managers have an opportunity to collaborate with the home office and explain the benefits of leveraging the broker/dealer's 'intellectual content' when constructing their portfolios because the firm's portfolio construction capabilities provide perspective, scale, and efficiency to the FA's models. As one interviewee suggested, ***"Firm solutions are leverageable building blocks toward the final discretionary portfolio constructed by the FA."***

Segmenting RPM FAs

There is a strong **perception that most investment management firms have not done enough to either segment, differentiate and/or tier their RPM FA support, or train their sales forces on trading tools.**

RPM FAs are not a homogeneous group, whether measured by experience level, use of home office research or fund recommendations, types of securities employed, practice structure, or use of tactical management techniques (to name just a few differentiators). Precisely because of the different FA practice types, it is imperative that investment managers identify and segment FAs. For example, that segmentation may be based on the sophistication of the FA's business, practice orientation or tier. As a part of this process, investment managers also should identify and include the FA's points of influence, such as regional managers, branch managers and regional field specialists.

The imperative of partnering at various levels within the broker/dealer's organization was stressed. A broker/dealer may not necessarily provide its investment management partners with data that would identify certain FAs and/or transactions as being part of the RPM program. Through their relationships with a broker/dealer's field specialists, the investment manager may be able to understand the firm at the local level and thereby gain those crucial insights. Those partnerships might also include regional managers and branch managers. Since branch managers must supervise their RPM FAs, they will be in an excellent position to provide guidance on more effective service practices for the targeted FAs.

Optimizing FA Interactions

Segmenting RPM FA practices takes us directly to the optimal structures for interactions. For example, if the RPM FA is running a total portfolio practice, it was suggested **that investment managers should develop a team of field specialists to work with these sophisticated practices by offering assistance with portfolio management and investment implementation. Those field oriented specialists would have topflight credentials and experience. To quote an interviewee, *"No one is doing this well yet."***

Along those same lines, the FA's role can vary, particularly for those operating in a hybrid manner, that is, as advisor/RIA. Such a practice may include a CFA or research team, who would be disinclined to speak with a traditional wholesaler. A portfolio specialist (or the field specialist described in the preceding paragraph) would facilitate access to the practice. This is particularly apropos for the premier teams that have devoted many years in building highly sophisticated investment management capabilities. **Investment managers need to support these practices *at their level.*** Resources such as transparency around investment processes, composite reporting, custom investment guidelines, risk management and portfolio modeling analytics, or customized market materials should be considered table stakes. One interviewee noted that ETF manufacturers are doing particularly well with this cohort by providing value added content in the area of portfolio construction.

An effective face-off to the FA is via a team model from the manufacturer. The investment manager that utilizes a field wholesaler or specialist coverage supported by internal and/or hybrid wholesalers projects a solid coverage team. An ancillary benefit is that the investment manager's coverage team is able to create effective partnerships with the broker/dealer. That team should be responsible for identifying the gatekeeper for the practice; he/she may not be managing client assets.

The foregoing may require investment managers or specialists to **upgrade field talent to more effectively respond to the distinct needs of the RPM FA constituency.** Investment managers may already have specialist teams in place for target RIA practices; similar *face-off* strategies now must be extended to the RPM business.

Product Education and Training

Product education and training was a distant second to the caliber and effectiveness of field personnel. Even so, several important themes emerged from our research. **The overarching conclusion is *'help the FA become a better PM,'* by strengthening his portfolio management acumen and ability to manage/control risk.** Specifically,

- Train FAs on what it takes to be a more effective portfolio manager and to manage risk in portfolio construction.
- Product education must be more institutional in focus and quality.
- Offer solution-based education for the FA and his clients. This may be focused on (but is not limited to) client needs such as retirement income, risk management or capital preservation.
- FAs need more information about management of the investment manager's suggested fund(s) and the most effective deployment in an overall portfolio/strategy. Topics such as investment process, attribution, correlation and performance drivers were considered key.

Marketing

In our research, the term *marketing* had a more nuanced meaning than the expected connotation. **Marketing advice revolved around knowledge-share and tools.** To wit, under the banner of understanding the FA's *due diligence process* it was suggested that more well-prepared, "finals-like due diligence materials" would facilitate the FA's review. Particularly for the total portfolio management practices, tools addressing portfolio construction and fitting an investment manager's offerings into the FA's models were considered to be particularly worthwhile. Going one step further, FAs are seeking more effective and attractive ways to share this investment and intellectual capital with their clients.

Marketing should be extended to helping promote to FAs the home office or strategist-designed models, and where appropriate, the mutual fund research recommended list.

Finally, the adjective *more* needs to precede each of the following words/phrases in describing the goals of marketing materials: (a) customized, (b) institutional in content, and (c) focused on investment related topics. Investment management firms that focus on the RIA distribution channel will immediately recognize the commonalities in marketing approach.

Management Resources

Similar to the findings in the *Marketing* section, practice management resources can be summed up in one phrase, ***tools to run, grow and market the FA's business.*** While the suggestions did not provide great specificity, they nevertheless provide some helpful guidance. In no particular order, they include:

- The best value investment manager partners can provide is in supporting new client acquisition, which is best accomplished through **seminar support**. High caliber, relevant content from partner firms is welcomed.
- Under the aegis of helping FAs market themselves are tools to facilitate that marketing and **practice management best practices.**

- Provide assistance with value-added topics such as **client communications.** One area mentioned was improved client communications around the topic of the cost of FA services and the fees charged, which circles back to helping the RPM FA demonstrate his *value-add*.

- **Portfolio analysis tools** are helpful to the FA's practice.

Product Considerations

Given the sharply increased interest in investments other than stocks and bonds (whether standalone, in models or packaged offerings), our interviewees stressed the **need for investment managers to get more progressive strategies/structures on the platforms. Complementing expanded product choices with manufacturers offering increased granularity around their investment process is a powerful combination.** While we have cited many examples of an FA's product needs, we reiterate several of them in the following bullets:

- More tactical solutions

- Flexibly managed funds with broad, go-anywhere mandates

- Greater use of passive investment strategies

- Alternatives and non-traditional products that extend beyond the style boxes (which were described as "so 2000s" for many FAs) and fit a discrete need in a portfolio. Examples of such non-traditional products are real estate, fee-based VAs, and structured products.

This section would not be complete without a comment on the growing role of ETFs and passive investing in portfolios. As discussed earlier, RPM FAs are using ETFs to provide cheap beta. In fact, research conducted by Strategic Insight showed that the typical RPM FA uses ETFs for almost double the portfolio assets than a Rep as Advisor.

Concurrent with the offering of these 'non-traditional' solutions and changing market demands, there is an appetite for additional guidance and education – both for the FAs and the home offices of broker-dealers.

Financial Considerations

The RPM model was aptly described as, ***"It's less about buying your way in."*** For example, investment managers should expect that there will be demand for a greater number and a higher caliber of due diligence meetings; however, with that will still come both wins and losses. It is incumbent on investment managers to focus on **building long-term relationships because as was told to us consistently, manufacturers should be prepared for greater velocity of assets – both in and out.** While there is the potential for these assets to be less sticky, being a part of a core asset allocation model can make these assets more persistent (especially as RPMs gain a deeper understanding of those products and the underlying investment processes).

Finally, if an investment manager is asked for marketing support, **the firm should ensure that the results of that support are measurable in order to effectively assess 'the worth of the spend.'** This means developing the appropriate analytics to measure the profitability of this business; if possible, this profitability analysis would be at the most granular, RPM level. For example, products with too much velocity may not be sufficiently profitable for the type of fee-based advisory business targeted by the investment manager. As has been the experience of many investment managers in the RIA space, large volumes of assets may flow in and then out in a reasonably short period of time; after the costs of distribution are factored in, this can be an economic loser.

FUTURE OPPORTUNITIES FOR, AND CHALLENGES OF, THE RPM BUSINESS MODEL

Continued Growth

The findings from our research, survey and interviews were unanimous that **RPM growth will continue.** RPM assets still comprise a relatively small percent of a broker/dealer's AUM, suggesting that there is significant upside. To this point we reinforce conclusions from earlier in this research paper; **FAs like organizing their practice this way, and clients prefer that their FAs operate with discretion, especially in the HNW space. Given their inherent flexibility, scalability, product/portfolio dexterity, and opportunity for practice differentiation, the trend toward FA discretionary relationships should continue.**

The Use of Models

A potential trend that is only *buzz* today would be to allow outside manager(s) to supply models to home office trading systems for implementation by the FA, whether with or without some input from the home office and/or model tweaking by the FA. With enhanced platform capabilities, the home office could include these external models on their trading systems so that the FA can easily implement these strategies. This would also necessitate resolution of fee sharing challenges, that is, the willingness of the FA to give up a part of his wrap fee. Thus, we expect that **next generation models will move to an open architecture environment.**

The nature of the models also is likely to change, in that **models may become even more client-centered solutions designed to solve for needs such as tax minimization, income, downside protection, and/or social investing.** In addition, it was suggested that more home office guided models will be implemented over the next 3-5 years. A guided model would include both pre-set allocations and individual securities selection.

Investment Manager Focus

By dint of absolute size and growth prospects, the most potentially lucrative space for investment managers will be to focus on the middle business model — *Guided Approach with Guardrails*. Efforts should be centered on both the top down and the bottom-up, meaning on both the home office research teams and within the investment manager's targeted FA segment. For top tier FAs (a niche market in absolute numbers of FAs), a true institutional approach must be utilized.

Segment Differentiation

We anticipate that there will be further differentiation between advisor segments based on skills and experience levels. The best RPM practices will be treated more like RIAs, which suggests a more comprehensive suite of professional portfolio management tools and greater investment flexibility.

Platform Improvements

The challenge is squarely on broker/dealers to provide their FAs with additional tools to run their practices more efficiently and in a more scalable manner. Tools that enable these efficiencies without a sharp increase in staffing become a driver in managing practice (and relationship) profitability. On the flip side, broker/dealers need to determine if their RPM FAs are using the models, block trading capabilities and supporting technology to their full extent. Education must be conjoined with technology implementations, which represents another opportunity for asset managers to partner with the home office. These comments quickly take us to the need for a single combined account – the UMA – from which the FA will be able to oversee/manage the client relationship.[8]

The term *discretion* will take on different dimensions, and it goes hand-in-hand with deployment of comprehensive UMA technology. Looking ahead, the UMA will be able to aggregate multiple advisory accounts (including those of SMA or other managers supporting the relationship), support the delivery of multiple products, and provide the ability/flexibility to manage an investor's portfolio in an all-encompassing manner.

Whereas RPM platforms historically were focused on mutual funds and ETFs, the future RPM advisor will have discretionary authority across a much wider swath of investment strategies and vehicles (alternatives, SMA managers, strategist models, and so forth). The FA will have overlay/asset allocation capabilities and responsibilities, will be able to manage/oversee a combination of underlying relationships, such as SMA portfolio managers, rep as advisor accounts, and RPM accounts, and may also have direct portfolio management of a sleeve. The FA also would supervise rebalancing, tax sales and manager oversight activities. The FA will be able to deploy individual accounts for each SMA manager.[9] Outside models may also be incorporated, but the trading systems would need to be able to incorporate that additional functionality. Rolling these various strategies and structures into a combined account reverts to the need for more capable UMA and trading platforms that ultimately deliver all the relevant information and metrics in one combined account.

Other Considerations

Final regulations resulting from Dodd-Frank are clouded in sufficient uncertainty that we are reluctant to make any prognostications. Nevertheless, it has been suggested that as RPM business models continue on their growth trajectory, a byproduct may be **increased regulatory scrutiny** in areas such as suitability, risk management, performance reporting and/or acceptable marketing materials.

As the RPM business continues its maturation process, it is likely that there will be a greater emphasis on **professional development and advanced training and certifications.** Organizations such as the Academy of Portfolio Managers (ACPM) and IMCA and other emerging firms are likely to play a role in the credentialing of RPM FAs.

Some Insights on Third Party Training and Certification/Credentialing

For many years, the gold standard of the industry from a third-party credentialing perspective has been the CFA designation. Earning this designation is difficult and time consuming.

In the 1980s and 1990s, other titles have sprung up that tend to acknowledge levels of competency in specific niches, beginning with the Certified Financial Planner® title, and extending to Certified Investment Management Analyst®, Certified Private Wealth Adviser® and others. None of these newer credentials, however, address directly the core competencies specific to discretionary portfolio management.

In 2006 a group of Smith Barney RPMs began developing a credentialing program for discretionary portfolio managers. This group of RPM FAs established a partnership with Columbia University to develop a RPM designation known as Certified Portfolio Manager®, or CPM®. The intention was to have a structure similar to the popular CIMA program, but focus the curriculum on asset valuation, portfolio construction, risk management, and asset allocation from a portfolio manager's perspective. The first class graduated from the program in 2009.

We also cannot predict future **market direction**. It is reasonable to expect difficult market dislocations in the future, which are not likely to mirror 2007-2009. Particularly FAs new to RPM may decide to (1) transition away from a discretionary practice, (2) migrate to home-office controlled models, or (3) partner with a deeply experienced RPM FA. Yet, as detailed in the Final Thoughts section, the increased scrutiny and risk management controls may surmount such a transition.

Case Study

While researching this research paper, we had the opportunity to speak with a wirehouse senior PM/wealth advisor. His insights reinforce the various findings in this research paper.

Our advisor's profile is not atypical – 30 years' industry experience, starting in the then-popular operating style – selling stocks and municipal bonds. Our FA's focus has always been on stocks. As the cost of buying and selling individual securities became less economical for clients, his practice migrated to fee-based accounts. The FA was confident that his portfolio performance was at least equal to separate account managers, while providing more individual portfolio customization. In the mid-90s, this FA transitioned his practice to RPM. The drivers were full client discretion and the ability to continue running two specific equity style portfolios. Today the practice team totals 5: portfolio manager, co-partner/financial planner, 2 support personnel, and a trust officer-equivalent. One additional staffer will be added to build out the investment capabilities.

As his practice matured, its capabilities were expanded to provide asset allocation solutions across multiple asset classes and total portfolio management. This practice now runs 16 diversified portfolios, which largely are offshoots of the original two styles. 80% of portfolio assets are invested in individual stocks and bonds. Mutual funds and some ETFs are used for international allocations or specialized areas. ETFs are used for precious metals and hedging strategies. Alternative investments offer big growth opportunities, and will be the only other outsourced strategy.

Our FA made the shift to RPM FA for scale and leverage, and with the right team and a willingness to understand this business model, it offers "real power." If something goes awry in the markets, "I can push a button and address the issue." Our FA has a well-defined value proposition:

- Value is added through the team's stock picking skills.
- Active management beats passive management.
- Tactical allocation strategies can serve as both offensive and defensive strategies.
- Use mutual funds to garner the expertise of the most talented professional managers.

Suggestions for Investment Management Firms in Dealing with RPM Practices

- Tell us (the practice) who are the sharpest portfolio managers at the investment management firm. How do their funds complement my models — particularly in non-traditional categories (i.e., convertible bonds)? **The practice does not need more style box funds.**
- What funds is your firm offering with broad mandates, tactical asset allocation strategies, or go-anywhere mandates? **Your best managers should have more latitude.**
- Have your wholesalers tell us what is really hot right now, so we can **avoid the "crowded trade."**

FINAL THOUGHTS

To protect the firm (and its investors) from likely additional regulatory scrutiny, we expect that firms will build and institute increased controls to more effectively manage risk. If growth projections and regulatory scrutiny prospects are correct, broker/dealers will need to make significant systems investments to bring their risk management tools current.

We anticipate that even more close monitoring of diversification requirements, position limits, eligible securities and prudent man rules will be integrated into the platform. Interestingly, as the platforms are strengthened, it was suggested that regulatory changes and/or increased regulatory scrutiny could drive more business to the RPM model because it will become *industry best practice*. Some FAs not currently using the RPM model might migrate to that structure – and firms may encourage it – precisely because of the controls that will be in place.

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Footnotes

1. *The terms* broker/dealer *or* firm *are used throughout this research paper to encompass any type of distributor (i.e., wirehouse, regional, or independent broker/dealer).*
2. *SMA Advisory, MF Advisory, Rep as Advisor, Rep as Portfolio Manager, UMA Advisory, and ETF/Other Advisory*
3. *SMA Advisory, MF Advisory, UMA Advisory and ETF/Other Advisory.*
4. *Where appropriate, we address the rep as advisor segment throughout this research paper.*
5. *To avoid a particular firm's nomenclature for its advisors, we use the term* financial advisor *or* FA *generically throughout this research paper.*
6. *There is a shrinking subset of the* unconstrained *model, under which the FA would directly manage a sleeve of the client's assets according to his specialty, akin to a privately managed SMA, while all other assets are managed using other investment strategies. This contraction is primarily driven by the declining focus on FA stock picking expertise and the concurrent increase in the tools that allow broader investment solutions.*
7. *A repercussion to using alternatives in portfolios is the need for additional education and/or accreditation.*
8. *Today the UMA principally is an aggregation tool that enables the FA to have an 'overall look.'*
9. *This assumes that SMAs are treated as eligible investments in RPM programs.*

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research network

About FUSE Research Network LLC

FUSE Research Network was launched with the view that research and consulting support for asset managers has failed to evolve with the changing needs of the client. The future competitive environment will demand that clients make important business decisions within shorter and shorter timeframes.

In order to support clients in this setting, FUSE provides a dynamic research platform that covers our clients' current and future decision areas (strategic and tactical). Our goal is to become an invaluable business partner through the delivery of highly informed and forward-looking recommendations that are among the critical inputs our clients need to optimize results.

INNER WORKINGS OF FUSE

It is the goal of FUSE to develop a level of partnership with each client that transcends traditional vendor relationships. In order to achieve this, the day-to-day activities of FUSE are guided by the following principles:

- Ardent Client Advocacy
- Absolute Candor and Objectivity
- Incisive and Tangible Guidance

Our ability to adhere to these principles is supported by our commitment to constantly be looking for ways to improve our support offerings through ongoing feedback and innovation. In addition, we will take steps to insure that FUSE staff members are among the best informed in the business so as to achieve a thought-leadership position on the behalf of clients. Finally, we will provide a superior level of client service that sets FUSE apart from all other decision support firms. It is important to note that the FUSE service model accepts the fact that we do not have all of the answers in-house, but our network of contacts, which is one of the best in the industry, helps to insure that we will always know someone who does.

Other Differentiators:

- Formal evaluation of client needs to initiate relationship
- Customized service offering
- Dynamic research support...not static annual updates
- Proactive advice, guidance, and recommendations
- Formal periodic review of service and support

Keith Sloane has been with leading organizations on both the broker-dealer and the asset management sides of the business for over 25 years. He has held a variety of senior investment products roles including: sales, marketing, relationship management, strategic planning, product management, and business integration.

Most recently, he served as Senior Vice President and Head of Mutual Funds/529 Savings Plans at The Hartford, with over $100 billion in assets under management. He was primarily responsible for corporate strategy, financial management, and leading new business initiatives across multiple distribution channels. This included retail and institutional distribution, product development, product management, financial results, and Board of Directors initiatives.

Prior to The Hartford, Mr. Sloane was Managing Director, at Wachovia Securities, where he headed Marketing and Relationship Management for the advisory fee-based business, mutual funds, ETFs, retirement plans, alternative investments, unit investment trusts, insurance, fixed income and equities, and personal trusts. Before that, Sloane was responsible for overseeing all aspects of domestic and offshore mutual funds, 529 plans, and UITs across Wachovia's broker-dealer, bank, independent rep, offshore, direct, and clearing channels.

He has also held several positions at UBS/PaineWebber where he served as a sales and marketing manager for a variety of financial products including mutual funds, separately managed accounts, variable annuities, alternative investments, and closed-end funds.

Sloane earned a bachelor's degree in business administration, with a major in accounting, from the University of Richmond. He has been a member of the Board of Governors for the Money Management Institute and Co-Chairman of the Forum for Investor Advice.