Is Bigger Better In The Broker-Dealer Space?

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Most large broker-dealers hope to lure advisors into their ranks (or hold onto them) by boasting about their size. They warn reps that there are perils to going to a small B-D—that smaller firms lack scale and will likely be run out of the business, and that even midsize firms are finding their viability challenged.

But big broker-dealers come with their own disadvantages. One of those is that they must appeal to the masses. That makes it hard for them to support hyper-focused practices, especially when it comes to compliance issues. Broker -dealers with expanded ranks must often paint with a broad brush to curb reps' wrongdoings or missteps, and that can hamper many advisors' flexibility. If the environment is too rigid, the advisors there may find it hard to build a niche business.

At our recruiting firm, we encounter advisors who are drawn to the idea of greater independence and better financial opportunities—and they also may shy away from onerous compliance and inflexible support. That's one of the reasons the RIA channel is growing, as are the number of "fiduciary acting" broker-dealers who have added RIA businesses.

Still, the largest-broker dealers push myths to frighten their advisors about the impracticality of joining smaller firms. Here are some that ought to be debunked.

Myth 1: Advisors Need Advantages Of Scale

Large broker-dealers say their scale helps them charge advisors lower fees while offering inclusive practice management support and other resources. They say that size is essential for survival, and that being small is impractical these days. Yet most of the large companies are not sharing cost benefits in a way that deserves advisors' loyalty.

The big companies have big cost centers—what they pay to service debt (perhaps after expensive acquisitions), to hire staff, to cover legal fees and to build. When they do pursue expensive acquisitions, it can force transitions on advisors, and the high-risk debt they sometimes incur can make them more vulnerable.

Small shops, on the other hand, can be nimbler and bootstrap in a way that empowers their advisors—cutting costs where possible, for instance, or operating with lower margins and helping their advisors capture revenue sources beyond asset management to better meet clients' changing needs.

Indeed, advisors are flourishing at smaller broker-dealers and independent RIAs with the help of custodians such as Fidelity Institutional and Schwab, which have lowered their fees and helped smaller advisors with their profit margins.

Moreover, the extra flexibility lets advisors conduct more business, provide additional client solutions, grow their client base faster and be more competitive overall.

A company achieves scale, of course, when its revenue increases faster than its costs. But even smaller broker-dealers have advantages. For instance, they can negotiate favorable institutional custodial pricing contracts that reduce the disadvantages of their size. Moreover, there are other ways for smaller firms to save money—by outsourcing technology and support to third parties. That helps make them more efficient.

Is scale a critical factor for financial practices? Yes, advisors benefit from it, but maybe not as much as you think. In smaller broker-dealer relationships, advisors can retain much more practice net revenue. Advisory fee billing and performance reporting costs are often paid by advisors at large B-Ds (10 to 15 basis points is a common range for advisor managed client assets. Advisors may pay a B-D around 5 to 10 basis points to directly access (with a broker-dealer's approval) Schwab or Fidelity Institutional. These two fees can wipe out 20% of rep-managed advisory revenue. Furthermore, advisors have the flexibility to pay for what they want and need with smaller firms.

It's à la carte versus bundled pricing—choose what you want instead of having it chosen for you (including services you may never use). Clients can benefit too, from lower administrative account-related costs, including better cash management pricing, for example.

Myth 2: Merger And Acquisition Activity Is Wreaking Havoc On Smaller B-Ds

M&A is normal in most business environments, but broker-dealers have been more aggressively looking to capture advisory assets in a fight for lucrative advisory fees and head count retention as fewer advisors join the industry. By buying a competitor, they can replace lost revenue and increase the advisor count. But big B-Ds frequently overextend their back office by lumping hundreds of new advisors, via acquisitions, into service troughs, which means the advisors' service can suffer, sometimes for years.

RIAs, meanwhile, are enjoying the wide and expanding bandwidths of investment and insurance products in fee-based formats, which have helped them grow. Although the big broker-dealers now have corporate RIAs, they are often expensive for both advisors and clients.

Myth 3: A Big Broker-Dealer Is More Like A Wealth Manager

Big broker-dealers have begun to position themselves as wealth managers—companies that, like fee-only RIAs, provide tax-friendly solutions to maximize financial results for their clients, especially high-net-worth clients. But is it the companies themselves, the advisors, the technology, or some combination of the three that embodies wealth management?

Accounting, tax planning and estate planning services are increasingly software-driven. A broker-dealer can indeed help advisors in these tech spaces by providing support like education, training and general guidance. But what advisors really need in this space is the help of third-party providers, which can help them with specific advice. And broker-dealers are famous for limiting how much advisors work with third parties, given that they come with legal liabilities the B-Ds would prefer to avoid.

The upshot is that innovative and broader client investment solutions require flexible working environments.

We find that smaller broker-dealers can give advisors more product choices. Take, for example, Delaware statutory trusts, entities that allow "like-kind" real estate swaps for 1031 exchange purposes (such exchanges allow you to swap similar investments without taking capital gains for the sale of one). This entity is designed to allow clients to defer taxes while getting price appreciation for their property and enjoying investment diversification at the same time. In our experience, such offerings at big broker-dealers can pale in comparison to those offered by small ones (where it's a specialty). We've seen a common range of 15 to 25 offerings recently from smaller alts-friendly broker-dealers, while several of our alts-focused partners say the big broker-dealers' offerings are smaller. This may seem counterintuitive, but it's because big broker-dealers are bigger legal targets (they have deeper pockets), so they have limited product availability, and when the subscription windows are shorter and you have more clients trying to get into a nuanced product (as you would at a larger broker-dealer) you might find there are more challenges and they might be less suitable than they would be at a smaller firm where the more complicated products would get more care.

We believe smaller, specialized B-Ds can better accommodate investors by considering their entire financial profile. Conversely, the compliance departments at larger firms may take a harder line, likely because of their firms' past regulatory missteps (a problem that typically increases when they have more advisors). That crimps their flexibility to offer new investment opportunities.

Be Nimble

The *Titanic* was a big ship, some may say too big to get out of its own way. Smaller broker-dealers, like smaller ships, can change direction faster than big ones. That's important at a time when the big broker-dealers are facing a near-term challenge—to find the right balance between the fees they are charging to advisors and clients and the services they are offering. They may wind up encouraging advisor activity that's better for the broker-dealer than the advisors and clients. And if they don't materially share the financial benefits of their scale with advisors, that could prompt advisors to leave.

If scale is the golden goose, how are smaller broker-dealers and RIAs succeeding? By catering to advisors' needs, building on relationships and adding new ones in the effort to continually simplify business processes for the advisors and themselves. That makes them more efficient, too.