



The 2011 FA Insight
Study of Advisory Firms:
People and Pay



Where Financial Advisors Turn for Advice

Acknowledgments

The FA Insight team would like to acknowledge the hundreds of firms that responded to *The 2011 FA Insight Study of Advisory Firms: People and Pay*. We appreciate the time and effort that you put forth to share detailed information on your firms and look forward to your participation in the 2012 FA Insight Study. We also thank our media partner, *Investment Advisor* magazine, for promoting the study to its readers.

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Executive Summary

Endangered Supply of Critical Ingredient

Recovery continues for financial advisory firms. Driven predominantly by sustained appreciation in security markets, virtually all performance indicators for advisory firms trended upward in 2010. As firms grew again, so did their need for people. Always an important part of a firm's budget, people-related costs increased from 77 cents of every dollar in average expenses in 2008 to 80 cents in 2010. People will continue to be a priority in 2011, with the typical firm projecting to expand from 6.1 to 7.4 full-time equivalents (FTEs).

For advisory firms, people represent the critical ingredient for growth as well as building value and effective succession planning. Achieving these objectives, however, will require firms to shore up weaknesses with regard to how they deploy and develop staff. Reflective of growing labor scarcity, compensation levels are on the rise again, retention is at risk, and the source of the next generation of firm leaders is unclear.

With *The 2011 FA Insight Study of Advisory Firms: People and Pay*, FA Insight endeavors to support advisory firms in confronting these challenges. *People and Pay*, our third annual industry study, is the second FA Insight study released with a special focus on human capital. A primary intention of the 2011 *People and Pay* study is to assist firms to not only attract and retain the right individuals but to map a path that progresses people toward ownership and management responsibility.

Upward Trends and New Challenges

While the industry is yet to return to pre-recession growth rates, recovering security markets fueled a healthy rise in advisory firm assets under management (AUM) during 2010, which in turn supported strong revenue growth for the year. Typical firm revenue jumped 18% in 2010. Despite increasing rates of client growth, the pace of revenue growth is expected to slow to a 13% rate in 2011 as AUM growth cools.

Profit margins expanded in 2010 as revenues outpaced growth in expenses. The median operating profit margin in 2010, at 19%, represented an eight-percentage-point improvement over 2009. Owner income, including profits and owner compensation, also showed strong improvement over the year. Median owner income as a share of revenue rose to 50% in 2010 from 44% the previous year. Median income per owner, at \$261,000, was up 14% in 2010 relative to 2009.

Improved firm performance has put owners in the mood to hire again, which is beginning to put upward pressure on wages. Firms are most interested in beefing

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up support personnel, with a 16% average increase expected in 2011. Hiring is also expected to be strong for professional positions. In the past two years, compensation growth for advisor positions has surpassed national all-industry averages as the advisor labor market tightens.

Median compensation for Associate Advisors jumped most sharply in the two years since 2009, increasing 17%. This mid-level advisory position, above a Support Advisor but below a Lead Advisor, is clearly in demand as firms seek to plug the gap between their most experienced advisors and their support personnel. By nature of their experience level and mix of responsibilities, Associate Advisors represent a critical transition step for firms to progress team members and for owners to broaden their options for succession solutions. While just 45% of firms had an Associate Advisor on staff in 2009, by 2011 60% of firms had at least one team member in the position. Despite the growth, just two Associate Advisors exist on average to replace every three Lead Advisors.

The imbalance highlights the challenges most firms will face to ensure that a new generation of advisors is in place to better build, sustain, and transfer firm value over time. As firms struggle to simply replace exiting advisors, labor costs will continue to rise and pressure owners to increase revenues at a pace that can preserve profitability.

Looking to Standout Firms

Despite clear signs of recovery, firm owners cannot afford to relax. Unless the development of personnel can be strengthened, quality talent becomes scarcer, firm growth is restrained, and succession options for owners narrow.

One source for guidance on these issues is the industry's best-performing firms, which we have designated Standout firms. Standout firms represent the top 25% of firms at each stage of development in terms of two key performance indicators: revenue growth and owner income as a percentage of revenue. Depending on firm stage, Standouts showed 9% to 33% higher revenue growth than other firms in their stage, and produced 11 to 20 cents more owner income per dollar of revenue.

With regard to use of personnel, people-related expenditures tend to account for a greater share of total Standout expenses. This greater allocation pays off for Standouts, whose team members are more productive, managing more clients and more revenue per FTE. Standout pay practices also help to support this productivity advantage. While compensation levels are similar between Standouts and other firms, Standouts more frequently use performance-based incentive programs and use them more effectively than other firms, linking pay to a wider range of individualized objectives.

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Providing more team members with further incentive to perform, Standouts show a broader distribution of firm ownership. Owners account for a greater share of total FTEs in Standout firms compared with other firms. A more open approach to ownership, combined with greater internal career opportunities brought about by growth, also contributes to generally better staff retention among Standouts.

Although Standouts clearly outperform other firms in important areas, with certain personnel practices there is no apparent superiority. One area of weakness for Standouts, as well as other firms, is the lack of a clearly defined organizational structure that can support firm growth and progress team members. Standouts are also comparatively lax in offering formal training programs and conducting routine performance evaluations.

These deficiencies in developing personnel may be affecting the ability of Standouts to move toward effective succession planning. Despite proportionately more widely spread ownership, only a minority of Standouts feel they are adequately prepared for succession. This is especially true among the largest Standouts, of which just 25% report having an adequate plan in place.

The Challenge of Succession Planning

Without a proper succession plan, even Standout firm owners will have only limited success in extracting liquidity from their firms upon exit. Lack of succession planning is of concern across all firms. As the business ages and grows and founding owners prepare to retire, shares become increasingly valuable and less affordable to a new generation of owners, causing ownership to become increasingly concentrated.

In 2010, fewer than one in six staff members were primary owners (holding 5% or more ownership), with the ratio falling to one in 10 for the largest firms. Additionally, over half of primary owners (51%) are within 12 years of retirement, and almost 18% expect to retire within seven years. Despite the need for urgency, the level of succession preparedness is largely unchanged in recent years. Two-thirds of firms do not have an adequate succession plan, and more than half of these indicate having no plan at all. For smaller firms, only about one-quarter feel that they are adequately prepared.

The most effective plans will support the transfer of equity shares as well as a smooth transition of responsibilities for client relationships, business development, and management oversight. Striking differences exist between firms that do and do not have an adequate succession plan. It is not surprising that these differences primarily relate to the ability of better prepared firms to develop and advance people, thereby creating a fertile environment for grooming qualified succession candidates.

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Firms most ready for succession have a clear organizational structure that defines future firm growth and needs for personnel. Not only are current roles and responsibilities clear, but the structural plan provides guidance for adding positions, the advancement of current team members, and the hiring of new talent. To further increase their pool of potential successors, properly prepared firms tend to develop their people more proactively by maintaining structured career paths, individual development plans, and formal training programs.

Progressing People Is Paramount

Good people practices tightly correlate with succession preparedness, but effective use of people can also be an important solution for controlling costs, improving efficiency, preserving culture, and building sustainable value in the firm over the long term. Although expenditures on people far and away dominate a firm's expenses, even the best firms appear challenged to properly progress their personnel in order to maximize their return on this investment.

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Organizational structure can provide a vital road map for a firm in advancing people upward through its ranks of responsibility but is a relative weakness for firms of all sizes. Although more than two-thirds of firms have documented their current organizational structure, just 14% have a plan for how their structure should change as they grow. An effective organizational plan offers a framework that helps move current team members along a career path. A clearly documented organizational structure will also include detailed position descriptions, supporting productivity by clarifying accountability. Despite the benefits, only 38% of firms have documented position descriptions.

Career path planning combines a structure of more progressively advanced positions with an intentional focus on how personnel develop the skills and experience necessary for advancement. Formal planning is limited; fewer than one-quarter of firms have structured paths for all roles, and more than 30% have no career paths in place. Having three levels of advisory roles—Support, Associate, and Lead Advisors—offers a primary path for progressing professional staff, but fewer than one-quarter of firms have at least one of each of these roles. Even among the industry's largest firms, fewer than half have personnel in all three positions.

Retention is a key factor in a firm's ability to progress personnel along a career path, with good hiring practices being a prerequisite for limited turnover. As well as current qualifications, the longer-term potential of a recruit is an important consideration in hiring. The leading reason for terminating staff was an individual's job performance, cited by 49% of firms that had terminations. This indicates that the skills and experience of the recruit were a poor match or that the firm may have

failed to adequately orient the new team member. The next most frequent reason was poor cultural fit between the firm and the staff member, an area which should be probed deeply during the hiring process.

Retaining talent long-term and progressing team members internally through a career path is a struggle without a program to purposefully enhance the capabilities of staff. Firms spend a surprisingly small percentage of revenue (less than 1% on average) on personnel development, with almost 30% of firms providing no formal staff training.

Creation of individual development plans and effective performance evaluations are practices with great potential to increase a firm's success. Nearly half of surveyed firms create individual development plans, and about three-quarters of firms conduct performance evaluations for employees at least once a year. However, of these, only 29% felt these reviews were "very effective," indicating a need for improvement in technique and frequency.

Transitioning Equity to Build and Realize Value

Developing and retaining good talent is vital for continuing the growth of a firm and upholding its value. Experienced employees are a valuable commodity on the job market, and retaining them will typically be difficult unless there is an opportunity for equity. Without an ability and willingness to share equity, however, staff retention is put at risk and succession options are obviously limited.

As ownership in advisory firms becomes increasingly concentrated and shares become more valuable, finding creative ways to transition equity is a challenge but increasingly critical. Just 13% of firms added a primary owner in the past two years. The addition of new owners has not kept pace with rates of departure of owners or of acquisition of employees, resulting in a shrinking proportion of owners to total firm personnel.

Many complex decisions must be made regarding an equity transition, a typical one being how to select potential new owners. Half of firms considered a prospective owner's character and values to be among the most important criteria. Leadership and management abilities ranked closely behind as highly desirable characteristics.

Affordability of shares for a new generation of owners is an increasing challenge. Despite the need for creative solutions, at present most buy-ins are through upfront cash or personal financing. If current owners are truly serious about creating succession solutions, they will need to get more involved in exploring other viable ways to facilitate funding an acquisition that will support the succession plan.

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The question of sharing control is another common hurdle preventing owners from more broadly sharing equity. Some firms (16%) sidestep this concern by not granting voting rights to certain ownership share classes. A complete succession solution, however, depends on transitioning full voting rights with ownership at least in proportion to ownership share. A proper evaluation and admission process for new owners will provide original owners the confidence to grant new owners their rightful input on strategic decisions.

Sustaining Success

Advisory firms weathered very tough times in 2008 and 2009. A better business climate has tenuously emerged since 2010 albeit with uncertainty. New areas of focus arise for advisory firm owners who are anxious to continue building and realizing business value irrespective of market conditions.

To sustain firm performance over time requires that firms not only attract and retain the right individuals but also map a path that progresses people toward greater responsibility and ownership. Firms would also be well-served to more clearly define organizational structure, especially as it relates to how the firm will grow and advance team members over time.

The greatest vulnerability for all firms, however, is a lack of preparedness for succession. Building long-term firm value and ultimately realizing this value will require a wholesale shift to more active and comprehensive succession planning, including creative financing and a transition plan for equity, client relationships, and firm management responsibilities.

While people are imperative to successful advisory firms, the supply of good people is becoming increasingly scarce. Unless addressed, this situation will threaten growth and limit succession options. The good news is that there are practical solutions that can be applied to ensure that a firm gets the most from its team members and that team members get the most from their firm.

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