CERULLI ASSOCIATES

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THE CERULLI EDGE

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*Cerulli Associates is pleased to present the inaugural issue of* The Cerulli Edge—Australian Edition. *This fifth publication in* The Cerulli Edge *series focuses on providing global research relevant to our Australian client base. Each quarterly issue will provide intelligence and perspective on the Australian managed funds industry, as well as provide our Australian clients insight into the U.S., U.K., and Asian asset management marketplaces.* The Cerulli Edge—Australian Edition *continues our tradition of providing quality research.*

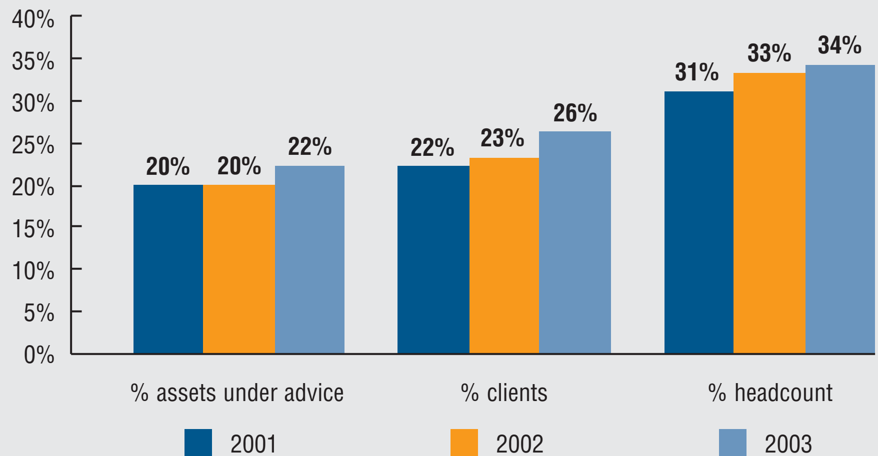
# More Boutiques Around the Corner

## *Meritum could reignite the breakaway dynamic*

Despite dire predictions that implementing the Financial Services Reform (FSR) Act would—in the words of some—lead to administrative death by a thousand paper cuts, there are no reports of financial planners found bleeding to death over their reams of paperwork. But many are still sweating from the boiler-room deadline pressure emanating from the Australian Securities and Investment Commission, which has spent more than two years putting the staged pieces of its stringent new, and supposedly level, playing field into place.

Now—with the March 2004 deadlines long behind them, and FSR a reality—what's next for Australia's financial planners? Those who have met their obligations are getting on with the flood of business that follows the end of the fiscal year on June 30. In their elusive spare time, however, FPs are likely pondering what the new financial year will hold for them. Because despite the new regulatory regime, which came at no small cost to the institutional owners of financial planning groups, the distribution market is currently in a state of flux—even, in some quarters, experiencing mild panic.

Why? Events of the past year have led to a dramatic realization that the cycle for distribution-led businesses has turned to the detriment of the industry's large players. A prominent case in point: the April walkout of some 25 big-hitting FPs from national dealership Financial Wisdom.




*Note: Recalibrates previous statistics includes effects of 2004 Meritum breakaway.*
Sources: Cerulli Associates, based on original data from Money Management and Look Research

Known colloquially as "Fin Wis," the planning group is one of the original brands in financial planning in Australia, a name that over the years has belonged to several bigger parents thanks to serial acquisitions: British life insurer Prudential; *allfinanz* specialist Colonial and its diversified asset management and platform businesses; and ultimately—after a A$9.6 billion deal to buy Colonial—the Commonwealth Bank of Australia (CBA).

But the 25 defectors instead elected to establish their own brand name, Meritum, in the form of a boutique planning operation in Melbourne. Within four months they have grown to 92 advisors overseeing A$1.5 billion. Their success raises a question that may shake some banks to their core: is the recent experiment in institutional ownership of financial planning enterprises failing? The most recent data from *Money Management* and Look Research—the basis for Cerulli Associates' annual estimates on independent FPs' collective marketshare in Australia—indicate it has. Independent dealer groups now represent one-third of collective headcount.

### *Defects and defections*

This has happened despite fund managers and investment service providers spending billions of dollars buying up financial planning networks. Australia's five high-street banks alone still control about one-third of the nation's advisorforce, thanks to aggressive acquisition campaigns. Challenger Financial Services, the financial conglomerate ultimately backed by media magnate Kerry Packer, already owns Garrisons and in May offered A$100 million for Associated Planners. CountWealth Accountants and Professional Investment Services, two of the largest remaining dealer groups, are now targets, if one believes the rumor mill. Buyers and analysts have argued that the increased compliance burden under the FSR coupled with difficulties securing affordable professional indemnity insurance (see article on page 13), are driving

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***The Cerulli Edge™—Australian Edition*** is a quarterly periodical designed to update the firm's clients about the most recent Cerulli research initiatives regarding Australia and the 19 other asset management marketplaces the firm covers worldwide. Articles each month outline various trends in the Australian managed funds marketplace and provide relevant global context for analysis.

The annual subscription fee is A$6,000 per client firm. The publication is available only in electronic format and includes copies sent to as many as 15 key executives. We suggest including heads of business units, CEOs, and directors of marketing, strategy, product development, and sales.

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## Hard Line Against Soft Dollars

### *ASIC cracks down on sales perks*

As if planner defections and dwindling inflows weren't enough to keep banks and other institutional owners of FP dealerships on their toes, in June umbrella regulator ASIC announced its intent to investigate some 40 companies as part of a crackdown on sales incentives and other soft-dollar perks, used to reward intermediaries for recommending house products, including regular managed funds, through portfolio administration systems—platforms such as master trusts and custodial wraps. Such soft-dollar incentives can include the exotic overseas holiday, educational "conferences," gifts, movie tickets, hospitality events, free office space—the list is long, varied, and certainly more difficult to track than hard-dollar cash rewarded through volume bonuses, commissions, and the like.

Calls in the financial media to ban certain forms of commissions have been met by the industry with its much-used rejoinder: commissions are not the issue so long as they are transparent and disclosed. Adequate disclosure is a point the Financial Planning Association of Australia has been trying to resolve (without satisfaction) for almost a decade. Now, with ASIC taking a keen interest, this will certainly prove another testing point for the rapidly evolving financial advice industry as it strives for professional status.

FPs toward better capitalized and better branded parents.

Meritum rips a hole in this conventional wisdom, with the defecting Fin Wis planners representing a no-confidence vote in CBA's ownership model. CommBank isn't alone, either. National Australia Bank continues to grapple with grumbling among top producers at Godfrey Pembroke, a high-end FP unit attached to the bank through serial acquisitions and already the victim of a noisy departure: the Berkeley Group, in 2000. And after it decided to restructure and consolidate several of the dealer groups it acquired, ING Australia watched scores of its planners, disgruntled by the result, head for the door.

In their defense, Australia's banks have tried to be good parents, mindful of the challenges that the softer issues of integration present any new dealership owner. In late 2003, CBA introduced generous incentives to all its planners, encouraging them to further grow their businesses. The bank also expanded the selection within its recommended investment menu and invested more money in back-office support for its advisorforce. Nice in theory, but in hindsight, these moves by CBA—which was also seeking to boost its planner numbers—look awkward, rushed, and ultimately unsuccessful.

#### *The competitive response*

CBA's stopgap solution foundered because it failed to recognize the primary reason advisors break away to establish boutique firms—a desire to meet client demand for independent, objective advice. One of the few common threads connecting asset management industries worldwide is growing investor desire for unbiased advice—or, at least, advice that looks unbiased. Recent product-pushing scandals, particularly in the U.S. mutual fund industry, are further strengthening this shift.

Independence, Cerulli Associates argues, allows dealerships to claim such objectivity. It also allows them to execute more targeted business plans. Bank parents often pressure their dealerships to serve as many people as possible—their core clients, after all, are mass-market. And in Australia, one of the world's most complicated tax and superannuation regimes raises the need for mass-market advice beyond levels required for servicing clients in the United States or

Europe. Consequently, planners that would rather focus their attention on higher-net-worth clients sometimes find it easier to break away, allowing them to sell more services to a smaller number of richer customers. This is why our estimates often indicate that independent FPs control a faster-growing component of overall assets under advice in Australia.

It is likely that Meritum's apparent initial success will spur other top producers to establish their own shops, potentially reawakening a breakaway dynamic that seemed stunted by the bear market in Australia. And the continued growth of platforms provides breakaways with necessary turnkey solutions for product and administration. We caution, however, that growth will be more sedate than some would expect, and likely to occur more in terms of assets (again, reflecting the affluent orientation of many boutique groups) rather than headcount. Regulatory and professional indemnity (PI) cover burdens remain difficult to surmount.

Most importantly, perhaps, banks could stem breakaways by acting like them. This has occurred in the United States, where national brokerages battled defections by increasing their sales of third-party products, providing strong internal platform support to their advisor groups, and retooling compensation to favor steadier fee-based income that, in the long run, planners find more attractive (see article on page 10). The result: while U.S. independent financial advisors continue to grow in terms of assets, the number of practices and practitioners has plateaued. Banks will only beat Meritum by mimicking it. ◆

FINANCIAL PLANNERS

# Playing Freebird

## *FPs struggle to balance scale with independence*

Independence may attract customers, but it's a frustratingly elusive commodity for many of the nation's financial planners. Put aside the two-thirds—a shrinking but still sizable proportion—of Australian FPs tied to banks, life offices, or fund managers, and the remaining planners still face a struggle, thanks to the fact that the majority of their revenue still comes from trailing commissions. This makes it difficult to defend any independent label that advisors slap on the facade of their practices. Like their British colleagues, Australia's advisors share a life-office background, and grew up on a steady diet of commissions. Even though Australia rightfully prides itself on offering leading-edge back-office technology, planning groups have not yet found efficient means (or motivation) to unbundle the myriad of fees, soft- and hard-dollar commissions from fund managers and other institutional owners on whom most planners still rely.

No surprise, then, that ASIC's strict regulations limit use of the words "independent," "impartial," and "unbiased," as they relate to dispensing financial advice. Australian Financial Services Licensees—which most financial planners now need to be under FSR—are well versed with Section 923A of the Corporations Law, which prohibits advisors from using such terms unless they reject commissions from product manufacturers or rebate any commissions back to their clients. The restrictions prohibit most dealerships,

even boutiques, from calling themselves truly independent. (The United Kingdom's regulators considered similar regulations as part of their recent navel-gazing over the depolarization initiative—see article on page 8; it was, however, ultimately rejected in favor of rules mandating greater transparency.) They have not kept more enterprising (*i.e.*, sneakier) FPs from resorting to thesauruses for synonyms such as "nonaligned" or even "non-institutionally owned."

### *Objectivity, for sale or rent*

Others are trying to buy independence. Challenger Financial Services Group provides the most egregious example, with its A$100 million offer (expected to be accepted as this issue went to press)—an eyepopping 671 times annual profits—for "nonaligned" dealership Associated Planners. (Some argue that Associated Planners is more aligned than it appears, pointing to Zurich Financial's 30% stake.) Challenger clearly recognizes the value of an unsullied brand, reportedly incorporating a "charter of independence" in its offer documents that ostensibly precludes the fund manager, with A$10 billion under management, from influencing product selection decisions of Associated advisors. And Challenger's current compensation structure rewards existing planners with stock after hitting certain volume targets—regardless of their proprietary content.

The road to hell, however, is always paved with good intentions. Skeptics argue that hard-headed businessmen such as Challenger owner Kerry Packer and wealth management chief Chris Cuffe—the exec often credited with transforming Colonial First State Investment Management from a sleepy life office subsidiary into a global asset management firm—are not known for their corporate altruism. Neither is likely to be satisfied with Associated's currently slim profit margins and would probably demand a higher return on investment—possible if Associated planners were "encouraged" to sell more Challenger product. If backed into a financial corner, Challenger's execs may be

**AUSTRALIAN BANKS AND THEIR WEALTH MANAGEMENT STRATEGIES**

Increasing reliance on captive distribution.

| | National Australia Bank | Commonwealth Bank | Westpac | ANZ | St. George |
|---|---|---|---|---|---|
| Retail marketshare* December 2003 | 12.2% | 14.3% | 7.5% | 9.4% | 4.1% |
| Fund managers | MLC (multimanager) | Colonial First State | BT Funds Management<br>Sagitta Asset Management<br>Hastings Fund Management | JV with ING | Advance Fund Management (multimanager) |
| Administration platforms | Flexiplan | L&G/Pru<br>FirstChoice<br>Avanteos | BT Portfolio Services | JV with ING | Asgard (Sealcorp) |
| Distribution (FPs outside branch) | Godfrey Pembroke<br>Garvan Financial Planning<br>Apogee Financial Planning<br>Deutsche Financial Planning | Financial Wisdom | Hartleys | ProTax,<br>AustAccount | Securitor,<br>Pact (Sealcorp) |

**Reflects marketshare of retail-oriented managed fund offers under management by bank's proprietary manager or manager-of-managers program.*
Sources: Plan for Life, Cerulli Associates

sorely tempted to turn up the nozzle on proprietary funds.

***Paragem's paradigm***

Reasons such as these lead some to argue that half-measures can neither yield true autonomy nor align client and planner interests. One such advocate is Ian Knox, former Sealcorp exec and now founder of Paragem, which bills itself as a "dealer support services business" for independent FPs and dealerships. Paragem apparently will operate somewhat as a collective, bundling the various demands of its clients together for scale. The firm hopes to alleviate back-office concerns for advisors by providing systems that support FP access to multiple distribution platforms in Australia—reducing advisor dependence on any single platform. Knox also has declared support for unbundled pricing, separating the fees for advice, administration, and asset management.

The Paragem story is powerful: not only does it play directly to consumers' demands for unbiased advice—Knox argues that 80% of Australia's advice industry belongs to conflicted parties that encourage or pay planners to cross-sell—but it also shines a harsh spotlight on the bundled fees platforms charge, potentially applying some pressure by juxtaposing them with one another. (The irony is rich in that Knox's last job involved building one of the largest platforms in Australia, the Asgard master trust.) It is also a very tall order. Mammoth Fidelity Investments has attempted something similar in the United States, letting some of its financial advisor clients mix and match various administrative modules—including due diligence, portfolio accounting and trading systems, client profiling modules, and advisor workstations—from third-party vendors. By several accounts even Fidelity is straining to administer such choice, in a marketplace with far fewer platforms and service agents than Australia possesses. ◆

RESEARCH HOUSES

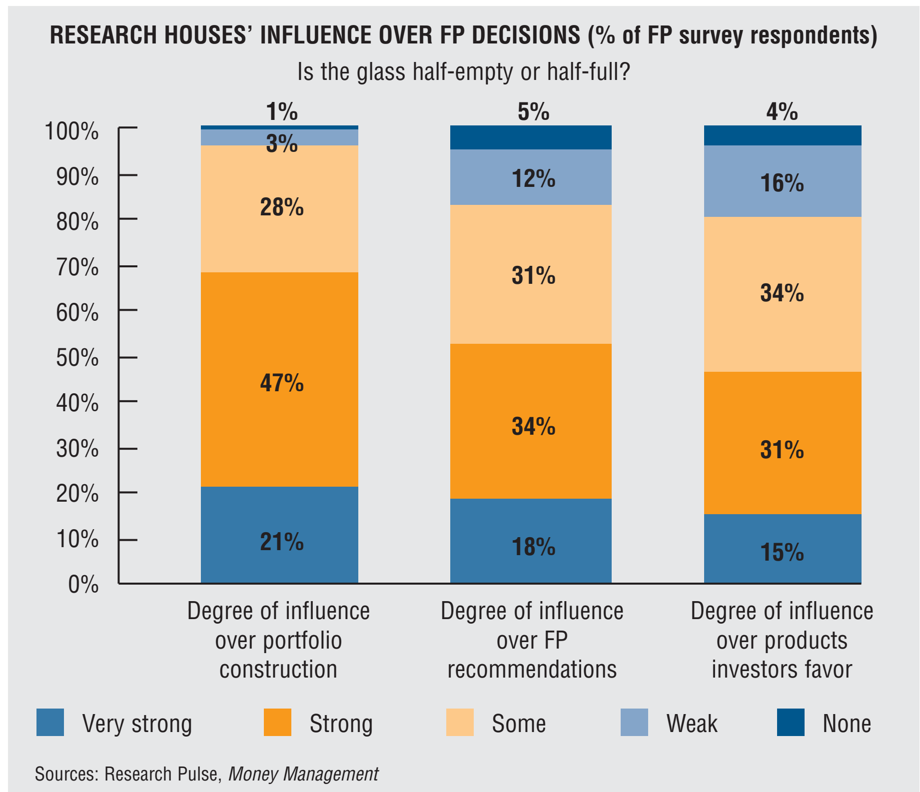
# Watching the Detectives

## *Should someone rate the ratings agencies?*

Financial planners bristle about many things, but research firms often receive the brunt of their ire. Australia prides itself on being one of the world's more sophisticated advice markets, yet many advisors have less ability to offer their clients access to new investment products than their counterparts overseas.

Much of this is due to the influence of the research houses. As in most asset management marketplaces, new investment funds—or even fund managers—roll out to take advantage of immediate opportunities. But the research and rating process in Australia, particularly for independent research houses, often means these products only become available two or three years down the track. Buying at this point, of course, may involve forfeiting the opportunities awarded to early investors in a product.

It's a conundrum in many countries, where true ratings fail to take hold until a product has been on the market for three years. Even U.S. funds rated by Morningstar need a three-year track record to receive their stars. And relations between ratings agencies and fund man-




agers are always contentious. European fund managers and ratings groups continually squabble over the composition of product peer groups, and the former have even formed a liaison delegation to address such issues with the research houses.

### *Feds on the case*

But such issues are particularly thorny in Australia, where demonstrating proper research is part of the obligatory compliance demanded of Australian FPs—even if, as some argue, it can provide a suboptimal result for investors. And the research houses' recent efforts to diversify their revenue streams by adding business further complicates matters: there are complaints that research houses cannot rate product manufacturers whilst simultaneously competing with them for the same investment dollar. One of those making such an argument is Senator John Watson, who has asked the Federal Parliament to require ratings houses to apply for a full license under the FSR legislation—a complicated process that asks a firm to outline its intent in business. Watson has also asked ASIC, the regulator, to more actively monitor research houses—particularly those that manufacture, or subadvise, managed investment products.

FPs increasingly agree with Watson. A Research Pulse survey in May 2004, commissioned by the trade magazine *IFA*, found that 40% of 331 industry participants (including 177 financial advisors) felt research houses should be subject to greater regulation. Of that 40%, 92% further argued that independent research houses are not sufficiently accountable for the quality of their research.

Another survey admininstered by rival trade paper *Money Management* tapped similar discontent by asking a different question: "Do you believe ratings produced are used to leverage other arms of the [researcher's] business?" Between one-third and two-thirds of respondents agreed with the suggestion regarding most of the nation's research houses; Standard & Poor's and Zenith were the only firms to escape widespread cynicism. And an astounding 83% believe fee payments to researchers compromise their ratings.

### *More flash than bang*

Despite such complaints, FPs realize the research houses remain full of clout. They rated local houses such as van Eyk, Assirt, and Mercer in the top rank, with Lonsdale Securities (Lonsec) a close second. The international houses—Morningstar and Standard & Poor's—received poor responses, with FPs arguing that neither

has established itself successfully in Australia. Understanding the rating process is as important as gauging influence, and in this area of "transparency" the ratings were uniformly spread over the "average" to "good" bands—but Assirt was the only house where more than 80% of the respondents felt the transparency of their process was "good" to "excellent."

And while financial advisors the world over are quick to dispense sour grapes, when pushed most Australian FPs seem to agree that researchers are not out to get them. Understanding "influence" and "transparency" is important when seeking product distribution; relying on researchers to have an objective opinion is the final piece in the puzzle. Pleasingly, all of the research houses surveyed scored well, with most responses in the "somewhat objective" or "highly objective" bands—but few felt their evaluators were "totally objective." Will that change even if the regulators get involved? Watch this space. ◆

UNITED KINGDOM

# Turn Southward, Poms

## *British IFAs require an Australian solution*

Custodial wrap platforms, a fixture in Australia's managed funds industry, are not yet a widespread reality at all in the United Kingdom. The only successful custodial wrap platform operating in Britain as of March 2004 was Australian: a platform called Transact, a subsidiary of Melbourne's ObjectMastery. Transact offers British advisors a range of investment products (inside and outside tax wrappers), has links with some 900 IFAs, and at last measure held about £600 million (A$1.5 billion) in assets, 60% of which resided in managed funds. While several potential competitors have labeled it rather basic, Transact has shown that a wrap platform can operate in the United Kingdom, and probably has provided a basic roadmap to those who are likely to follow.

That group includes everybody and their sister. Britain's regulators are in the final stages of dismantling the nation's polarization regime—rules similar to those in place ages ago in Australia, forcing tied agents to sell only proprietary product. The Financial Services Authority (FSA), Britain's regulator, hopes that new rules requiring greater transparency in advisor charges will spur British IFAs to adopt a greater degree of fee-based compensation. Fee-based advisors will need distribution systems that are product-neutral: holding cash, equities, and managed funds, as well as other products, in a single account across which they can apply asset-based advice charges. Custodial wraps provide such a platform. They also, at least in theory, make it easier to dispense *holistic* financial advice across a client's entire portfolio—not simply focus on a single product set. This, some IFAs argue, is the competitive advantage they require to match advice quality with large banks and insurers, all of whom are likely to start selling nonproprietary product from 2005.

Britain already maintains three dominant *service agents*, platforms that offer a wide range of managed funds bundled with adminstration technology and advice tools—similar to master trusts. But at least a couple dozen firms (including the service agents) have announced their hopes to

**WRAP PLATFORMS IN THE U.K.: RUNNERS AND RIDERS**

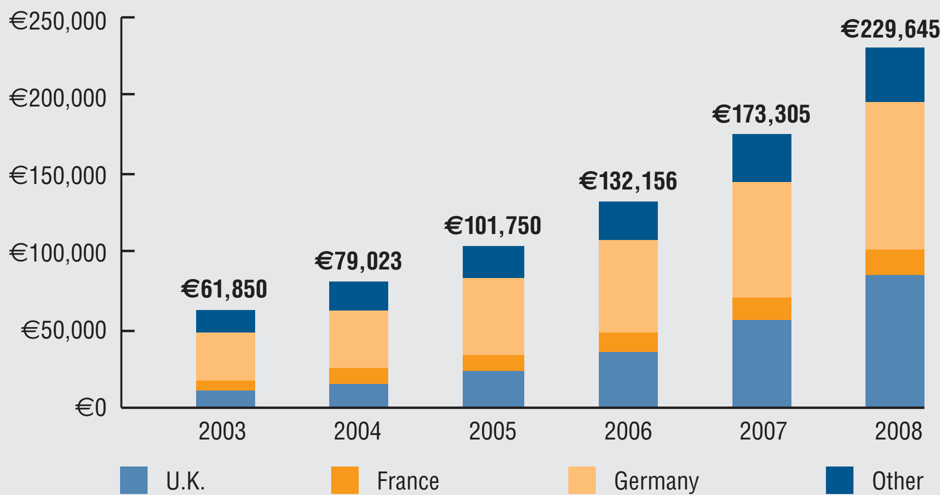
| Platform Name | Primary Sponsors | Product Offerings | Distribution and AUA | CA Comments |
|---|---|---|---|---|
| Transact | Integrated Financial Arrangements plc, a subsidiary of Australia's ObjectMastery, an e-commerce and software developer | Non-tax and tax wrappers (incl ISAs, PEPs, pension products, and offshore bonds). Also offers products sourced through external providers. | Has links to 900 IFAs and assets of £600 million. | A pioneer of the wrap concept in the UK, using its Australian links, Transact is going to have to face up to stiffer competition from the big financial insitutions, several of which have been eyeing the wrap market for the past couple of years. |
| Abbey Wrap | Offered through Abbey for Intermediaries, which is the primary IFA distribution channel for The Abbey | SIPPs, ISAs (funds, shares, cash), TESSAs, PEPs, and nonqualified protected investment portfolios, which include equities, cash and collectives. | The wrap offering is being started from scratch and being road tested with over 100 IFAs. | An early adapter of wrap amongst U.K. financial institutions of some scale, the platform has had a hard time attracting IFAs and has come in for a fair amount of criticism from industry observers. The Abbey has invested heavily in this platform, which coincides with its more broad-based initiative to move from manufacturer to distributor in the U.K. |
| Skandia Wrap | Skandia UK | Skandia has one of the largest investment platforms in the U.K., and has offered the various wrap components in a disaggregated fashion for some time now. It is currently working on an integrated solution which will cover the gamut of products and present a more holistic wrap offering. | £3 billion on existing (disaggregated) platform. | Skandia has lost some ground in the perception game, first with fund supermarkets and now with wrap, given that in both cases it has been a leader rather than a follower — though this is not something that is immediately appreciated. |
| FundsDirect's Adviser Platform | FundsDirect is 85% owned up Egg plc, and the rest by Prudential plc (now sold to MBNA) | Plans are for a summer launch: as part of the first phase the platform will offer ISAs, PEPs, and life wrappers as well as a SIPP offering from PPML, the third party pension administrator from Credit Suisse's Winterthur Group. | A full launch is expected towards the end of the year. The platform is currently being tested with a handful of medium to large IFAs. Legacy assets on the platform are negligible and represents FundsDirect's initial foray into the B2C market. | A very well articulated strategy, but one that may be derailed following MBNA's bid. |
| Cofunds | Prudential M&G, AmEx Threadneedle, Commerzbank Jupiter, Nationwide Gartmore, and IFDS | One of the three largest mutual fund platforms in the U.K., Cofunds offers IFAs over 650 funds from 50 investment management firms. | Estimated £1.8 billion on platform. | Cofunds is not a wrap platform in its current form, but recognises that the market in the U.K. is moving in that direction. That said, the plan is to adopt a "wrap by stealth" strategy, adding one component at a time, rather than trying to provide a full-service wrap solution at one go. |
| Lifetime | Lifetime Group, Millfield plc, Norwich Union | A phased launch is expected to commence this summer, with the initial offering to include a pension and ISA strategy. | None yet. | Norwich Union has looked at the issue of wrap platforms before, and now it owns almost 50% of Lifetime. Norwich controls Navigator, a large Australian platform (but one that lacks significant wrap features). |
| Ample | Back with Tomas Carruthers who set up Interactive Investor, which became Ample after he sold it to the AMP Group | Will require a root and branch restructuring to convert it from a trading platform for investors to a wrap platform for IFAs. | Currently has 1.4 million registered users. | Too early to comment, but the landscape is rather different to the one Carruthers first operated in when he set up Interactive Investor. Funding will be crucial. |

Source: Cerulli Associates

launch custodial wrap platforms for British IFAs, although some of these amount to little more than vaporware. Cerulli Associates expects the first and most common British wrap platforms to include not only investment products, but also pension products, offshore bonds, equities, insurance, structured products, and some cash management facilities. A few of the larger systems will also include mortgages, gearing, and full-out banking services.

***Runners and riders***

This said, the pace of change relies on a number of factors (regulatory, financial, and technological, to name but a few), but in almost every case it will be slower than first anticipated. Discussion of wrap platforms began almost two years ago, and it likely will be at least another two years




legacy assets, particularly of the more intractable variety (*e.g.*, life and pensions). Even the more sophisticated Australia market's custodial wrap solutions have yet to devise a way in which to smoothly migrate legacy assets onto wrap platforms without creating a technical nightmare or a taxable event. In the United Kingdom, this single issue could be the difference between wrap accounts being simply another distribution system—or a whole-of-market solution.

Cerulli Associates believes fund distribution platforms in the United Kingdom already hold nearly A$20 billion in assets, most of which lies in managed funds. By 2008 we expect this number to jump to A$140 billion—with wraps comprising a significant component of the inflow. Further information can be found in a new **Cerulli Report, *European Advisor Distribution***, which pays particular attention to custodial wraps in the United Kingdom. ◆

before more British wrap platforms are fully operational—and several more after that before they begin to break even.

Scale will help. Inefficiencies in the U.K. marketplace always will ensure a degree of fragmentation, but ultimately the very purpose of wrap accounts is aggregation and consolidation, something where bigger is better. Expect several entrants to be out of business in the next five years, although—if Australia provides any example to the British—being the first mover is not always a sure bet.

And finally, the British will face the same problem dogging the Australian custodial wrap marketplace: dealing with

UNITED STATES

# Should I Stay or Should I Go?

## *America's breakaway dynamic is cooling off*

While the global financial landscape has changed drastically in recent years, U.S. advisors—a group of nearly 300,000 intermediaries including brokers, bank reps, and insurance agents, as well as independent practitioners—are still driven to independence by many of the same factors that their Australian counterparts

face. But U.S. advisors increasingly find themselves with more options where they are—and less reason to break away and become independent. Today, roughly 10% of American advisors function as independent financial advisors; another 30% share revenues with the home offices of franchising dealerships (so-called *independent broker/dealers*, or IBDs) that usually lack proprietary product.

Lifestyle—including a desire for autonomy, flexibility, and control—always has been a primary reason that U.S. advisors choose independence. This, combined with supporting motivators such as the desire for product freedom, increased payouts, fee-based pricing, and financial planning enabled the independent sector of the marketplace to grow rapidly during the 1990s. In addition, early in that decade, a backlash against traditional firms' bias toward proprietary products served as a catalyst for the growth of the independent sector. Many advisors pursued independence to sell a greater variety of products.

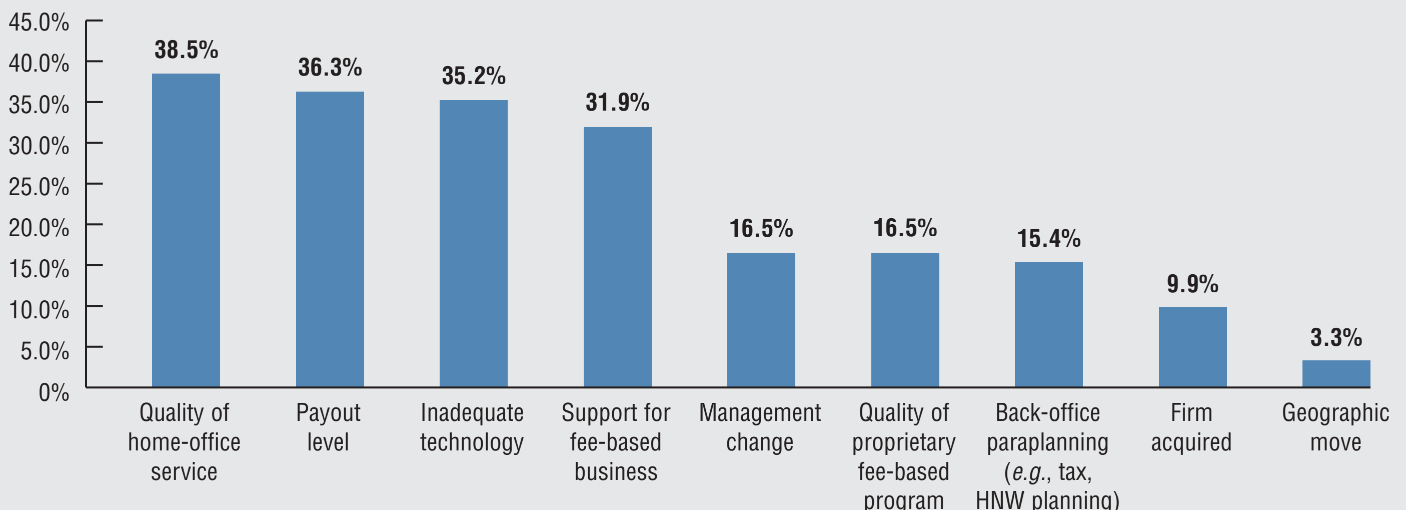
They also left traditional firms in search of higher payouts. IFAs enjoy 100% payouts, as they are their own home office; IBD representatives typically receive 70% to 95% of commissions. Those employed by national full-service brokerages, conversely, receive payouts of between 30% and 50%.

Still other advisors left traditional firms in an effort to employ fee-based pricing. Enticed by the promise of stable revenue, asset retention, wealthier clients, and larger account sizes, many advisors sought to break away.

Finally, increased advisor awareness of investor demand for advice drove other advisors to embrace financial planning. Eager to incorporate planning and the relationship-based approach it provides, adivsors became increasingly frustrated with the lack of home-office support for planning at traditional firms, and many found an outlet for their passion in the independent channel.

### *That was then, this is now*

It remains true that more advisors are driven out of their firms by frustration than wooed into the independent arena through recruitment. And today, some advisors plan for independence earlier in their careers, aiming to take their books of business and hang out their own shingles once they achieve certain goals.




Source: Cerulli Associates

But Cerulli Associates contends that the majority of these advisors will find that they can meet those goals by staying at their current post, something impossible to do 10 years ago. Today, third-party funds are commonplace, the payout differentials are starting to diminish, and access to fee-based pricing and financial planning is widespread, even within national brokerages. Wary of increased regulatory scrutiny and concerned about investor distrust, traditional firms have moved away from proprietary product. This provides advisors at such firms with access to a wide array of product, enabling them to maintain their objectivity.

At the same time, the ability of IBD advisors to stay objective has come into question, as scores of firms have been acquired by product managers, usually insurers. These affiliations force IBD agents to grapple with the stigma of being associated with proprietary products. IBD firms, facing very thin profit margins (such as Associated Planners; see page 3), realize high payouts are increasingly dangerous—and many home offices are beginning to rethink their payout policies.

Finally, and perhaps most importantly, recognizing the benefits of fee-based pricing and financial planning, traditional firms have been changing their business models in an effort to accommodate increased advisor independence. Brokerages have been supporting such compensation systems by rolling out managed account programs and fee-based brokerage, paying advisors more for using such systems. They also typically have access to more specialist services—such as high-net-worth products, estate planning, and wealth transfer advice—that smaller independent firms may find difficult to secure.

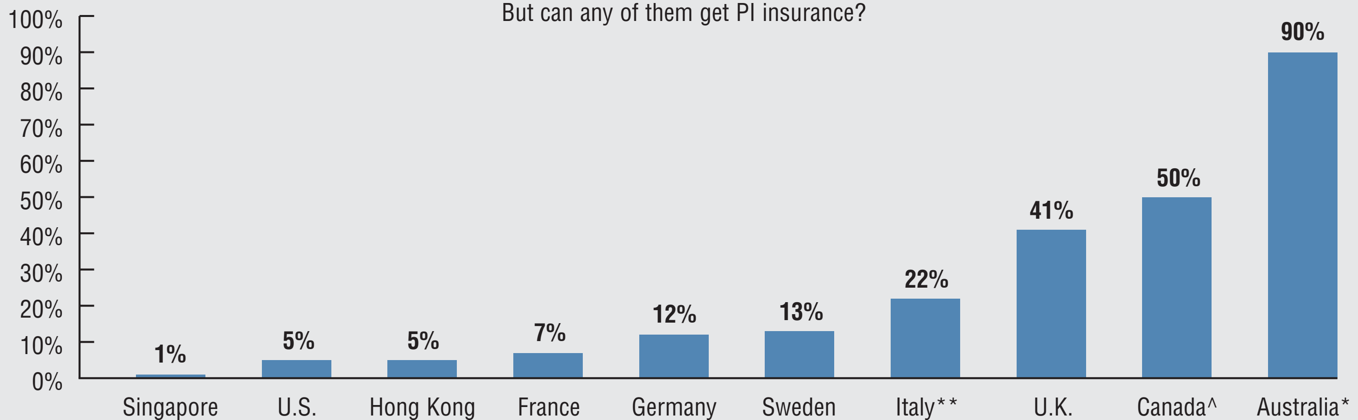
Many advisors remain drawn to independence—but industry changes are providing a number of alternatives. Advisors among the more traditional distributors who require more independence may be just as likely to find it at other traditional firms—or even with their own employer—as they will by setting out on their own. It is also likely that a growing number of financial advisors will seek greater degrees of autonomy while retaining home-office support and structure that would be unavailable to them if they became fully independent. Some firms, such as American Express and Wachovia Financial, are even experimenting with *multiple-affiliation models*: inviting advisors either to join as employees or more as independent contractors with greater payouts and autonomy—in return for fewer benefits from headquarters. In short, advisors no longer need to equate their dissatisfaction with their current firm with a need for independence. ◆

PROFESSIONAL INDEMNITY

# Playing Hard to Get

## *Good PI cover continues to act coy*

"There are worse things in life than death," Woody Allen once quipped. "Have you ever spent an evening with an insurance salesman?" Worldwide, however, a growing number of financial planners would jump through hoops to do so, particularly if that agent had a professional indemnity (PI) policy tucked away




*Notes: *Includes bank-owned advisors; truly independent advisors = 22% at last measure **SIMs ^Largely grouped into major networks*
Sources: Cerulli Associates (Investor Economics for Canadian data)

in the briefcase. Across the globe, regulators are forcing intermediaries to stock up on PI coverage—essentially malpractice insurance for financial planners. But the number of insurers willing to sell PI coverage to advisors is shrinking dramatically, and the consequent scarcity premiums are the largest threat independent financial advisors (IFAs) in many countries face.

Australia is already familiar with this problem. The number of insurers willing to cover financial planners has shrunk from 23 to no more than four, and the remaining underwriters have riddled their policies with loopholes that exclude high-risk products (*e.g.*, margin lending and gearing products, currently in high demand among Australian individual investors). Premiums have shot through the roof: local press reports describe brokers who saw their annual payments rise from A$1,800 to A$80,000. Tenfold increases in yearly costs are common.

For Australia's largest financial planner groups—those within, or controlled by, the nation's banks—this is annoying but solvable, especially as the groups are large enough to mollify insurers' concerns about risk, giving them the ability to negotiate more favorable rates. But ASIC reports that of the 1,500 organizations seeking new licenses under the reform act—many of them financial planning groups—at least 75% of the applicants employ less than 15 people. For them, the costs of ballooning PI coverage—if they can even get it—are crippling.

### *Bad news from Brussels*

Australia is not alone. Similar problems are bound to plague Europeans. It appears that when the insurance mediation directive (IMD)—a European Commission ruling designed to harmonize regulation for financial intermediaries across the European Union—takes effect in January 2005, all financial advisors will have to maintain at least €1.5 million (A$2.6 million) of PI coverage, with the capability to handle a €1 million claim should it arise. While in past years member states have "selectively implemented" directives from Brussels, the Commission's newly muscular enforcement (*e.g.*, sanctions against Germany for unfair tax discrimination against cross-border funds, a practice Berlin quickly dismantled) leaves little doubt that the Union will look unkindly upon countries that fail to observe the IMD's new rules.

This spells trouble for Britain, home to 4,500 independent financial advisory firms,

representing the largest and strongest community of IFAs in Europe. Westminster used to require PI cover, but gave up after an ever-fewer number of insurers agreed to provide such policies. The Financial Services Authority (FSA), the umbrella regulator, has allowed nearly 200 IFA firms to opt out of PI coverage because they can prove they have "enough" cash on hand to settle claims for compensation should they arise. This failed to provide enough relief: in 2003, at least 360 collapsed IFA firms blamed their demise on a lack of affordable PI coverage, and another 825 failed to confirm that they had purchased any insurance (a figure that has recently dropped to around 200).

***What, me worry?***

IFAs, particularly the British ones, are complaining, but the FSA is offering little but tea and sympathy, indicating that they will follow orders from Brussels. The regulator is holding out some hope: Brussels must review the PI coverage requirement in April 2006, providing an opportunity to talk Eurocrats into replacing the blanket minimums with a more flexible coverage requirement. It raises an interesting, if yet unanswered, question about how the FSA will handle British IFAs that refuse to comply with the IMD between now and then.

The PI problem has yet to arise in the United States, where such coverage is more voluntary. A few insurance companies, notably Chubb Corp., specialize in insuring advisors from claims, usually through "errors and omissions" (E&O) coverage. But the primary maxim in the U.S. securities market remains *caveat emptor*, and case law makes it more difficult to blame advisors for poor advice. Some argue that the recent mutual fund trading scandals—and a resulting increased emphasis on consumer protection—could change that. This could spark a powderkeg. While Moss Adams, an accounting firm servicing financial advisors, does indicate the "average" IFA practice annually spends US$7,000 (A$9,800) on non-benefits insurance such as E&O policies, most industry observers believe that few advisors carry adequate policies. Don't tell Mr. Spitzer. ◆

MULTIMANAGER

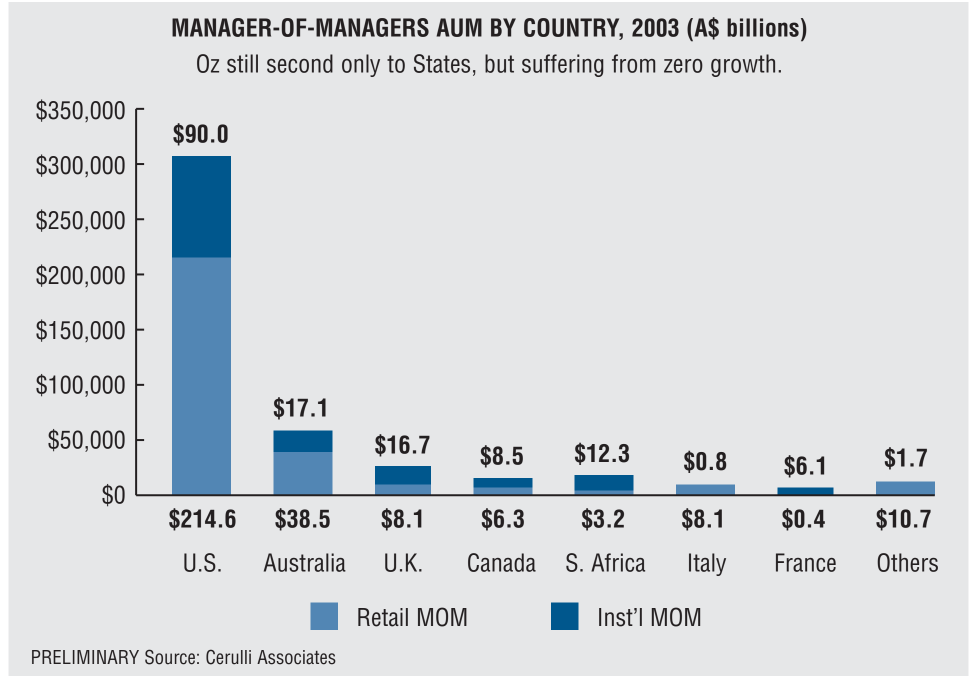
# Idling Engine

## *Managers of managers need to shake off their recent slump*

Australia remains the world's second-largest marketplace for multimanagement products: retail and institutional portfolios that divide assets among multiple subadvisors or asset management products. We include two sets of products in our multimanagement universe. *Manager-of-managers vehicles* are vehicles, be they managed funds or institutional portfolios, that subcontract assets to third-party subadvisors in the form of segregated accounts. *Funds of funds* are managed funds that invest in other existing fund offers in the marketplace—affiliated or unaffiliated.

Drawing a boundary around these products in Australia is difficult, given that the marketplace is highly sophisticated and already supporting a wide degree of open architecture. While many argue that portfolio administration services such as master

trusts and custodial wraps are multi-manager vehicles—they boast long lists of managed funds—we define these as platforms, not products, as advisors and investors can pick and choose various funds. True multi-manager product sponsors hardwire their manager selections and asset allocations into their products—*embedding* advice into their portfolios.



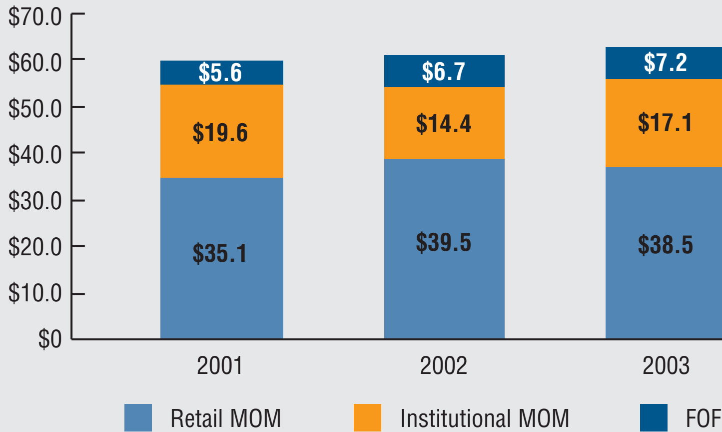

Multimanager product vendors ar-gue their products include embedded advice and better manage risk, key considerations for both retail and institutional investors still licking their wounds from the bear market. During the past three years assets in manager-of-managers products and funds of funds grew 10% compounded per year, faster than the expansion clip of the overall industry. In 2003 alone global multimanager assets leapt 28% to hit the A$900 billion mark, fueled by nearly A$90 billion of net new business. Manager-of-managers products alone expanded 24% in terms of assets, one of the strongest instances of annual growth on record. (Funds of funds increased more in size, but largely due to U.S. lifecycle products.)

### *Like an outback plateau*

Much of the multimanager activity in 2003, however, centered on the United States and the United Kingdom. Far fewer sparks have flown in Australia. The current A$63 billion multimanager marketplace has grown a total of 4% during the past two years, slow growth in comparison to global norms. New business in multimanager products was nearly nonexistent, with the products realizing net redemptions in the neighborhood of A$500 million.

Several reasons lie behind this recent malaise. Australia's overall retail fund universe has suffered from a slump as mums and dads raid all repositories of household savings—including managed funds—to throw money into a property market that arguably has ballooned into a bubble (one that will likely pop if the Reserve Bank of Australia makes money any more expensive). Plan for Life says retail fund management products only recorded net new inflow of A$5 billion during 2003: barely one-third of 2002's net sales and one of the worst years on record. Despite a continued fascination with implemented consulting—a subindustry continuing to expand by most accounts—nearly two-thirds of multimanager assets come from retail-oriented products.

Growth in funds of funds has stalled, with the fillip of growth in 2003 largely attributable to Australian Skandia, a relatively new market entrant. Many Australian funds of funds are actually nondiscretionary master trusts (NDMTs)—last




year's model of portfolio administration systems that provided advisors preset, nonmodifiable models as investment choices. New portfolio administration systems that allow advisors to build customized solutions for clients are now the norm, outmoding the NDMTs. Despite the advantages of multimanager products—leveraging an investment committee, access to institutional fund managers worldwide, and the benefits of buying in scale—most advisors want to build their own portfolios in order to justify advisors fees charged to customers made increasingly skeptical by miserable secret-shopper reports.

### *Mainstream multimanagement*

Such slower growth may be temporary. Australia is still home to the world's fourth-largest manager of managers, National Australia Bank's MLC. Ipac Asset Management, a firm Cerulli Associates has recently reclassified as a manager of managers, has offered multimanagement solutions for years; it has taken over all the multimanager options offered by new parent Axa Asia-Pacific, and we speculate it has the potential to play a greater role in the French insurer's worldwide multimanagement operations. Russell, the world's largest manager of managers, was an early entrant to Australia (years ago, it taught MLC how to select managers) and continues to make inroads as an implemented consultant with large and small superannuation plans.

More importantly, most of Australia's other large fund managers now offer some form of multimanager option. Commonwealth Bank's Colonial First State, by most measures Australia's largest retail fund manager, offers some manager-of-managers solutions, as does AMP Asset Management, following its noisy demerger with Henderson. Westpac's asset management groups increasingly depend on large subadvisory relationships, such as the ones maintained with Putnam Investments and BlackRock Financial; such arrangements are only a half-step away from full-bore multimanagement options. And St. George's Advance Asset Management announced plans in late 2003 to convert its entire operation to a multimanager format, scaling down or eliminating most proprietary asset management operations. ◆

**Related Research from Cerulli Associates**

## Cerulli Quantitative Update: *Global Multimanager Products*

This annual report examines the key trends shaping the multimanager product marketplaces in 10 core countries, as well as emerging multimanager industries in Asia and Latin America. More than 100 exhibits — populated by our proprietary multimanager survey — provide key quantitative metrics regarding funds of funds and manager-of-manager products, both retail and institutional. This year's report also provides additional information regarding funds of hedge funds and expands CA's viewpoint on the multimanager marketplace.

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