The Personal CFO: An Alternative Model for Financial Advice

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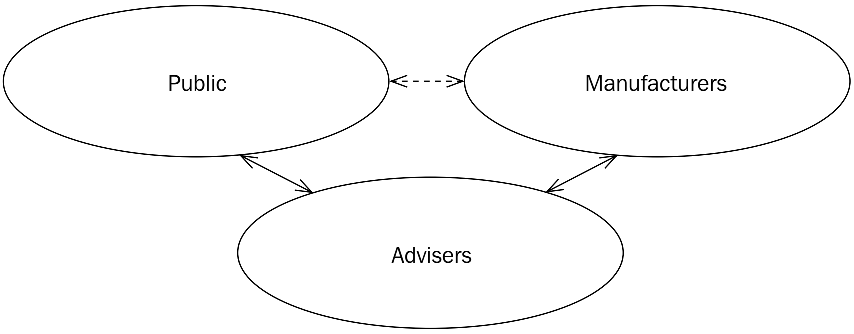
Martin left BT/Westpac at the end of 2005 to embark on a career in training, facilitation and business advice.

Martin is currently enjoying a portfolio of activities. He presents training programs for financial advisers, including coaching of new skills, on behalf of Strategic Consulting and Training. He also acts as a business adviser to a number of companies, including Macquarie Life where he is a member of the Board.

The catalyst for this paper was 'The Value of Advice', presented by Richard Cornwell at the 2006 Institute of Actuaries Financial Services Forum.[1] That paper provided a valuable summary of the typical financial adviser proposition, as well as a basis for quantifying the value of financial advice.

The purpose of this paper is to explore an alternative model that is being adopted by a small but growing minority of advisers.

My aim is to create some discussion about the implications of viewing the financial adviser as a professional rather than as an optional intermediary. Richard's simple diagram is a telling one:



If advisers are perceived only as a 'distribution option', an intermediary between the client and the product manufacturers, then there are profound implications for their role, their pricing power and their value to the client. At its most basic, some financial commentators generalise that commissions are paid by manufacturers, and fees are paid by clients.

A suitable analogy could be drawn with the medical General Practitioner (GP). What if the role of a GP was regarded primarily as an intermediary between the client and the pharmaceutical companies? How might their standing in the community be impacted? How might the quality of their advice be perceived? How might we expect them to be remunerated? And most importantly, how might the client assess the value of the GP?

1 Richard Cornwell, 'The Value of Advice', 3rd Financial Services Forum, Institute of Actuaries of Australia, May 2006.

THE CURRENT MODEL FOR PROVIDING FINANCIAL ADVICE

EXISTING CLIENT VALUE PROPOSITIONS

There is a very wide range of financial advisers currently operating in Australia. However, one could categorise each adviser's core value proposition under one of the following headings:

1. *Product Specialists*

These are advisers who have positioned themselves as experts in a specific product-related field. Examples include: retirement incomes, life insurance, gearing and Self Managed Superannuation Funds (SMSFs). The Product Specialist's appeal to the client is problem-solving in a particular field, and their value proposition can be summarised as:

> "*I can solve all of your (SMSF) needs as I am an expert in (SMSFs).*"

The target market for these advisers is defined by their product and they rely on marketing and branding that supports the specific positioning they have selected. They may have formed alliances with advisers in one of the other two categories listed below, or with accountants, lawyers or bankers.

Advisers in the other two categories are happy to refer clients to these product specialists, rather than obtain or acquire that product-related expertise.

2. *Investment Specialists*

These are advisers who have positioned themselves as experts in providing investment advice. Their specific expertise may vary but can include asset allocation, fund manager selection, stock selection or access to special offers. Their appeal to the client is 'outperforming' in terms of investment returns and their value proposition can be summarised as:

> "*I will produce great investment returns for you as I am an expert in helping you make smart investment decisions.*"

The target market for these advisers is people who have money to invest. There are plenty of Australians with superannuation, redundancy, inheritance or Lotto cheques who are looking for investment advice. The investment advisers have generally been satisfied with a supply-driven model and have been very passive in their marketing.

Many advisers in this category are relaxed about the future when, for example, superannuation assets have been predicted to quadruple to over $4 trillion by 2021.[2]

3. *Wealth Managers*

These are advisers who have positioned themselves as experts in providing holistic financial advice. Their primary delivery mechanism is a 'financial plan' that sets out a road map, including specific strategies. Their appeal to the client is the ability to address most of the client's current financial needs and their value proposition can be summarised as:

> "*I will produce a great financial plan for you as I am an expert in helping you make smart decisions about your money.*"

The target market for these advisers is people who have recognised that they have some financial complexity that is not necessarily being well managed or co-ordinated. Not many of these advisers have been successful in developing strong individual profiles, nor have they been focused with their marketing efforts. Instead, these advisers are generally happy to rely on referrals from clients, accountants, or even from elsewhere in the organisation to which the adviser belongs.

EXISTING PRICING PHILOSOPHY

For the purpose of this paper, I would like to define the term 'pricing' as the determination of the adviser's remuneration. I would also like to differentiate between 'pricing' and the collection mechanism. For example, an adviser may unilaterally determine (and quote) a fee of 1 per cent of the client's Funds Under Management (FUM). This paper is not concerned with whether the fee is paid by a single cheque from the client, by monthly direct debit from the client's cash account, or by way of trail commission deducted from a platform. In short, my focus is on the means by which the adviser arrives at his/her remuneration.

Remuneration for financial advisers has not necessarily been aligned with their value proposition but has been primarily driven by the product design. The history of the financial advice industry in Australia has been characterised by advisers adopting the role of 'price-taker' rather than 'price-maker'.

For the price-taker, price is calculated xand aligned to the product delivered. Hence, price-takers are rarely remunerated for their services where no products are provided. Their prices are totally dependent on their ability to select the appropriate brokerage for the product supplied. It follows that price-takers are totally reliant on the product designers to build remuneration options into the product. This also leaves price-takers vulnerable to potential reduction in the embedded pricing, as they have developed little in the way of pricing muscles.

For the price-maker, price is calculated and aligned to the work performed, regardless of whether product is provided. Price-makers determine their prices with reference to their target revenue, the concept of standard job rates and their

2 Trowbridge Deloitte, Superannuation Model Press Release, August 2007.

understanding of the costs incurred in delivery. Price-makers have developed pricing muscles.

Consider the pricing practices for each of the three value propositions outlined above:

1. *Product Specialists*

   These advisers are genuine intermediaries who have happily accepted the fee (i.e. commission) that is embedded in their specific product-related field. They are price-takers almost by definition. For example, the life insurance specialist is happy to rely on the commission from placement of life insurance policies and the form (e.g. upfront versus level) is, in reality, a question of payment terms, independent of effort or any concept of 'value'.

   The introduction of various disclosure regimes has had limited impact on remuneration to date, but many observers predict that trail commissions will be subject to downward pressure in the near future as consumer attention, coupled with government attention, brings more light to bear.

2. *Investment Specialists*

   Interestingly, these advisers do not usually structure their remuneration in terms of the 'investment outperformance' but generally adopt a product specialist mentality. Hence, they are also price-takers in that they are satisfied with accepting the margin that is embedded in the products or funds that they recommend.

   These advisers tend to define their remuneration as an upfront percentage of the assets placed, and an ongoing percentage trail thereafter, as per the product design.

   This approach has resulted in some criticism – mainly, that these advisers may have an inherent bias towards investment advice; they favour solutions with embedded fees (e.g. managed funds) rather than solutions without embedded fees (e.g. investment properties and direct shares).

   In the absence of any proven capability to charge fees, how would an investment adviser be rewarded for a valuable property recommendation?

3. *Wealth Managers*

   Interestingly, again, these advisers do not generally align their fees with their proposition. Historically, the financial plan has been given away, or been subject only to a nominal fee, because these advisers have also been happy to rely on the product-related remuneration. There has been minimal price-making activity, and revenue has again been dependent on commission, both upfront and trail.

   These advisers have not exercised pricing muscle and have almost given away their most valuable property; the financial plan or financial strategy.

   Advisers realise the value of their professional advice needs to be protected when they learn that clients have taken their financial plans and implemented the recommendations themselves. Advisers currently attempt to prevent such sabotage by insisting on execution of the plan, or by charging a more significant fee for the plan. It is interesting to speculate on the driver for this behaviour. Perhaps Ric Battellino, Deputy Governor of the Reserve Bank, offers a clue when he stated, at the 20th Australasian Finance and Banking Conference, in December 2007:

   > "*This reluctance to pay for advice upfront appears to be a form of money illusion, whereby investors may feel that they are somehow paying less for financial advice if the cost is buried in reduced earnings in the future*."

IMPLICATIONS FOR PRODUCT DESIGN

Historically, financial institutions have clearly regarded advisers as intermediaries and have explicitly factored the adviser's remuneration into the product design. The result has been that financial advisers have not developed any pricing power and have left themselves exposed to criticism of bias in their recommendations. They have also left themselves exposed to reduced revenue if (when?) the manufacturer reduces the margins in the products, either as a result of market or legislative pressure.

OVERVIEW OF AN ALTERNATIVE MODEL

A NEW CLIENT VALUE PROPOSITION – THE PERSONAL CHIEF FINANCIAL OFFICER (CFO)

Let's imagine that a subset of the Wealth Managers described above take their value proposition to another level. The focus is still holistic, attempting to resolve the financial complexity in their clients' lives, but instead of addressing only current needs they are positioned to work with their clients over a long period of time.

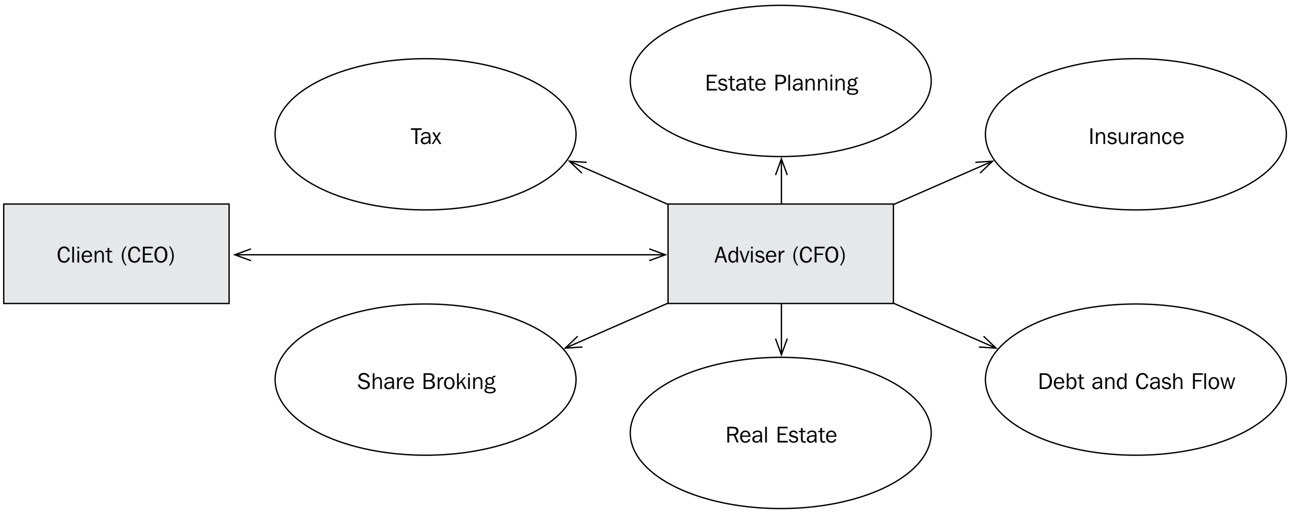
The proposition is no longer based just on a financial plan (an input) but is based on outcomes. Their generic client value proposition takes the form:

> "*I am an expert at helping you achieve your financial goals and aspirations.*"

This represents a fundamental shift in emphasis from the plan (and subsequent transactions) to a trusted long term relationship. One term for this positioning is 'the principal wealth adviser'. The expression used by CEG Worldwide is the 'personal CFO'.[3]

3 CEG Worldwide, 'Cultivating Advice', Strategy One, 2007.

The client can be thought of as the CEO of the family, and he/she will turn to the CFO for financial advice before making any material decision. The analogy goes further. In a corporate environment, the CFO will have a team of experts supporting him/her. Similarly, the financial adviser, acting as personal CFO, will develop a network of trusted specialists to resolve all of the client's financial challenges. The role could be presented diagrammatically as:



It becomes apparent that the core skills of the adviser must incorporate:

- ➜ relationship management for the client; and
- ➜ project management for the network of specialists.

This represents both a challenge and an opportunity for advisers who wish to establish such relationships!

TARGET MARKET

As the target market comprises clients with significant financial complexity (both now and in the future), this proposition is not currently viable for the majority of Australians. Examples of complex financial situations affecting this client demographic are outlined in the 'Case Studies' section later in this paper.

Target clients must be willing to take advice and be prepared (and have capacity) to pay for that advice. So, how large is the target market?

It is very difficult to obtain any research that would accurately indicate the number of Australians that might meet this demographic criterion. Assets are a very blunt indicator but may provide some insight into the size of the market.

The Australian Bureau of Statistics (ABS) study of Household Wealth[4] produced the following distribution of net worth in 2003-04:

Australian Households by Net Worth*

Range $m	Number of Households ('000)	Percentage of Households
Less than 0	56.6	0.7
0.0-0.5	5,405.6	69.9
0.5-1.0	1,516.3	19.6
1.0-2.0	542.7	7.0
2.0-5.0	180.3	2.3
5.0-10.0	28.5	0.4
Over 10.0	5.9	0.1
Total	**7,735.9**	

* Net worth represents the difference between the value of household assets (financial and non-financial) and the value of household liabilities.

If, for illustrative purposes, we drew a line at $2 million in net worth (in 2003-04 dollars) and speculated that only 10 per cent of those households would be considered the target market, then around 20,000 Australian households may require a personal CFO.

Industry research by Strategic Consulting and Training would suggest the optimal number of 'CFO clients' that a financial adviser should manage is around 50 clients, so there is scope (in very rough terms) for 400 advisers to adopt this proposition.

4 Australian Bureau of Statistics, 'Wealth and Wealth Distribution 2003-04', 6554.0, April 2006.

PRICING PHILOSOPHY

If the fee charged by the adviser is to be consistent with the proposition, and for the adviser to become a price-maker, then certain principles should be adopted. The fee should:

➜ be expressed in dollar terms for the full year;

➜ be requoted in each subsequent year as part of the annual review/planning meeting;

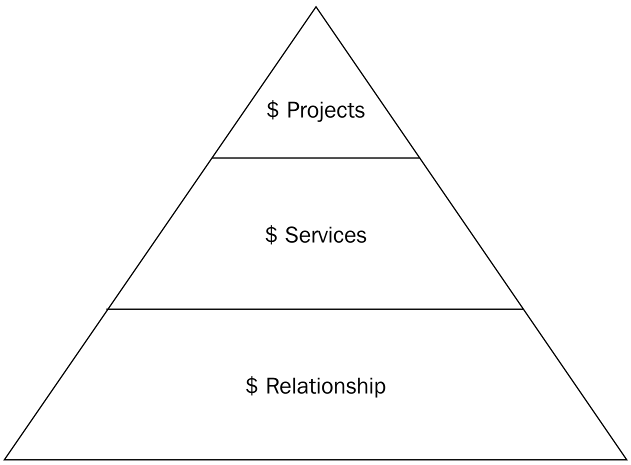
➜ be independent of product recommendations;

➜ include the cost of the specialists likely to be utilised by the adviser; and

➜ be quoted as a range, not as a 'fixed price quote'.

Furthermore, no material work should be undertaken until the client has accepted the quote.

One way to think about the composition of the annual fee is in three components:



i. The Relationship Component can be considered the annual retainer or the minimum fee. What is the basic price for guiding the client towards his/her financial aspirations?

ii. The Services Component is the variable component as it will depend upon the activities being performed for the client. This will vary over time as challenges arise and are resolved.

iii. The Projects Component is also variable and may not be required for every client. The adviser may choose to charge the complex client for managing the network of specialists required to assist with the advice. This project management cost may be in excess of the fee for the individual services delivered.

The fundamental principle is that, as a price-maker, the adviser is determining his/her own pricing model and is in control of the decisions. In practice, this should not be the prerogative of an individual as the pricing policy for the advice business should be managed by a Pricing Committee.

CASE STUDIES

To bring the model to life, let's consider three very different clients.

CASE STUDY 1: A COMPLEX CLIENT

Dan and Lauren are married with 8 year old twins, Jordan and Jessica. Dan also has a 14 year old son, Michael, from an earlier marriage and a 77 year-old mother. Lauren's parents both died last year and she is anticipating a significant inheritance.

Dan runs a small consulting engineering business with annual income of $700,000 and Lauren is a hospital administrator with annual income of $85,000.

Current assets include:

➜ the family home;

➜ a holiday cottage;

➜ superannuation funds;

➜ a direct share portfolio; and

➜ a fund set aside for education purposes.

Dan currently obtains advice from:

➜ an accountant (in connection with his business);

➜ a lawyer (in connection with Lauren's parents' estate);

➜ a stockbroker (in connection with his direct shares); and

➜ an insurance broker (in connection with the business - and who is also willing to introduce him to a life insurance specialist to review Dan's life cover).

Dan's main driver is financial security for his family, including Michael and his mother. He also seeks financial independence and would like to enjoy the fruits of his labour when he retires. He is worried that he can't find time to stay on top of his finances and is frustrated with the narrow mindset that each of his current advisers adopts. He is also concerned about how to realise the value of his business at some point in the future.

Lauren shares Dan's concern for the family and is re-thinking her own career path. She is considering using the inheritance to purchase an investment property, as her Dad had strong views on the importance of real estate.

How might a traditional financial adviser approach Dan and Lauren? How might a personal CFO proposition be more effective? What would the scope of work look like? How might a traditional pricing approach lead to neglect of some of their concerns or be mismatched with the activity required? What would Dan and Lauren be prepared to pay if all of their concerns were resolved?

CASE STUDY 2: A YOUNG PROFESSIONAL SPORTSMAN

Simon signed a contract with Cricket Australia two years ago when he was 23 and he has recently been contracted to the Indian Premier League. He is also hoping to play cricket in England this winter. His agent has been successful in securing a lucrative deal with a new sponsor but refrains from providing any advice on Simon's income.

Simon's father is keen for Simon to invest his accelerating income. Simon's mother is worried that Simon may be led astray by dubious advisers and his older team-mates. Simon is not going to be in Australia for much of 2009. He feels that he should take his parents' advice but is worried about leaving all of the decisions to his father. His current assets are limited to an interest-bearing cash account and a new Porsche.

How might a traditional financial adviser approach Simon and his parents? How might a personal CFO proposition be more effective? What would the scope of work look like? How might a fee be determined when there are currently limited assets to invest?

CASE STUDY 3: A WIDOW

Ann is 55 years old and her husband Greg passed away late last year. She has two children, Ben and Belinda. Ben, aged 28, is living and working in London. Belinda, aged 25, shares a Sydney unit with one of her friends and works in the travel industry. Greg was a senior finance executive. Ann enjoyed a healthy social life, including golf and international holidays with Greg. Greg looked after all of the financial decisions for the family.

Ann has been told by her lawyer that she has been left a large estate, but she is very worried about the future. She has never been interested in financial matters and, in fact, the thought of having to deal with the estate is causing her some stress. She has been invited to go to Europe with some of her friends in August but doesn't know whether she can afford it or whether it is the right thing to do. She is concerned that the golf membership may be a luxury she can no longer afford and can't make up her mind about whether to keep Greg's BMW.

How might a traditional financial adviser approach Ann? How might a personal CFO proposition be more effective? What would the scope of work look like? How might a suitable fee be determined when the fundamental proposition is providing peace of mind?

IMPLICATIONS OF THE ALTERNATIVE MODEL

FOR THE FINANCIAL ADVISER'S BUSINESS

There are many significant implications for the financial adviser's business if he or she embarks upon a personal CFO model.

i. *Increased Skills in Relationship and Project Management*

The first implication, as already noted, is that the future core skills are based on relationship management and project management. This may be foreign to advisers currently in the business, if their core skill lies in identifying tax and investment solutions.

ii. *Selective Marketing*

The second implication is that the business must be far more selective in its choice of clients. The discipline of saying "no" does not come readily to advisers with a tradition of saying "yes". More importantly, significant work is required to hone the positioning of the business and a new approach to marketing is required.

iii. *Regular Client Engagement*

The third implication is that the service proposition must evolve from an annual review to a far more regular program of engagement with the client. The challenging aspect of the new service proposition is the capability to tailor the style of the engagement to match the style and values of the client.

iv. *Pricing Committee*

The fourth implication is the introduction of a pricing committee to deliver rigour, consistency and profitability in the fee determination. This must be associated with a new mindset, if advisers are to avoid the semi-automatic tendency to link the fee to the FUM.

v. *New Valuation Approach*

The final implication involves the value of the adviser's business. The current valuation approach is generally expressed as a multiple of trail (or renewal) revenue. When there is no 'trail', as such, a new valuation approach is required.

The emphasis in the new model must evolve to a multiple of Net Profit After Tax (NPAT), and this in turn highlights the critical realisation that the business must not be dependent on a single adviser if it is to achieve an attractive market value.

FOR THE FINANCIAL ADVISER'S CLIENTS

The proposition for the new clients will vary from client to client because their values and goals will be very different. (Consider what the 'value' is for each of the clients discussed in the earlier Case Studies). However, there are some common themes that emerge when a personal CFO asks his/her client what they value most highly in the relationship. The clients generally feel more confident about their financial future and the major gain for them is time. This is a markedly different response to that received by the product specialist or the investment specialist.

Perhaps the most interesting implication for the client is that they fully understand and appreciate that they now have 'one throat to choke' if something does go wrong in their financial lives. (And this has repercussions for the adviser's accountability!)