VAN Working Session

Q&A with Michael Kitces

Presenter

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These notes have been developed by the VAN team to share the insights and learnings from the recent VAN Working Session featuring Michael Kitces. Shared with permission.

About Michael Kitces

Michael Kitces is a Partner and the Director of Wealth Management for Pinnacle Advisory Group, a private wealth management firm located in Columbia, Maryland that oversees approximately $1.8 billion of client assets.

In addition, he is a co-founder of the XY Planning Network and New Planner Recruiting, the former Practitioner Editor of the Journal of Financial Planning, and the publisher of the popular financial planning industry blog *Nerd's Eye View* through his website Kitces.com, dedicated to advancing knowledge in financial planning.

Key insights

Key learning/s:

- **Crisis of differentiation:** As technology and robo-advice force advice firms to once again redefine how they add value on top of the products they offer, many firms are attempting to broaden their value proposition in response – creating a situation where too many firms are claiming to offer the same 'unique' value on top of the same underlying products. The result is a sea of 'sameness' in the advice space. Firms have the opportunity to carve out a reputation for deep expertise in a certain client segment or a niche area of technical skill in order to truly differentiate themselves from their competitors.
- **Opportunity of systematising investments:** Using a combination of technology, a consistent investment process and model portfolios, Pinnacle is able to execute trades and update 1,200 client households in one hour, and communicate the change the same day.
- **Fee transparency:** Those who buy online expect to be able to price services online, and clients are increasingly expecting fee transparency on firm websites. Fee transparency online can: act as a filter, reducing non-viable prospects; build trust; and increase referrals as referrers can feel confident in the fees that their friends/family will be charged.

Q&A

What do you see as the key themes and trends in the financial advice industry?

- We are at the intersection of technology and advice.
- Technology makes it easy for firms to buy and manage portfolios for a large number of clients. It frees up advisers to spend more time with clients. Ultimately, technology will replace transacting roles.
- When the internet first started to enable private individuals to trade online, financial advice firms were forced to improve their value proposition. In the US, a typical financial advisor addressed this by climbing the value chain. Their value proposition went from ‘I can sell you a stock’ to ‘I can find you a mutual fund’ to ‘I can build you a personalised portfolio’.
- The rise of technology is forcing advice firms to once again review and rebuild their value proposition. Globally, there is a shift in focus from product sales to genuine advice.

What do you see as the key challenges and opportunities in intergenerational wealth transfer?

- Michael’s XY Planning Network focuses on building advice models for GenX and GenY
- The model that they are having the most success with is a shift away from fees as a percentage of assets, to fees as a percentage of income, charged in the form of an ongoing monthly fee. GenX and GenY don’t yet have enough assets for percentage-of-assets-based fees to be a viable model.
- It’s a common misunderstanding that the planning needs of GenX and GenY are simpler than the planning needs of Baby Boomers. However:
    - Baby Boomers require intense focus during their transition to retirement phase, and then simple annual reviews for five to fifteen years, until they experience a major health event.
    - GenX and GenY are going through a significant number of life-altering events: managing student debt, buying their first home, combining their finances with their new partner, having their first children, setting up a business – and all these milestones impact their planning.
- Another common misunderstanding is that GenX and GenY want to work with technology, not an adviser. The more correct view here is that GenX and GenY don’t want to work with an adviser for things that they should be able to do online or otherwise through technology. For example, a bank transfer should be able to take place online, and if it requires a phone call, a GenX or GenY client will be dissatisfied. The client still wants advice, but on issues above and beyond just simple transactions that can be accomplished online.
- There are three types of tasks involved in financial advice:
    - Simple tasks: Clients should be able to do these online
    - Mid-range tasks: Clients currently need to talk to a customer service representative
    - Complex tasks: Clients need an adviser

  It is the mid-range tasks where people expect technology to improve to fill the gap, turning them into ‘simple’ tasks. The biggest customer service fails today take place in the middle layer, where a client is forced to contact a customer service representative for something that, in their view, they should be able to do online – and the customer service representative is not empowered to, or not skilled enough to, solve their problem.

  Mid-range tasks will slowly disappear and be replaced by technology, and employees should begin to increase their skills to be able to add value at the ‘complex’ layer.

Do you see that small firms will be able to survive in the advice industry of the future?

- As technology automates transactions and reduces the reliance on support staff, smaller firms will become increasingly more profitable – and more able to compete for clients who typically fall within the mandate of mid-tier firms.
- The main caveat here is the regulatory environment – small firms may not be able to meet capital requirements and licensing requirements.

- Mid-tier firms will, as a result, increasingly try to compete (often unsuccessfully) for the ultra-high-net-worth segment, as small and mid firms will continue to struggle to attract, and service, ultra-high net worth clients. However, ultra-high-net-worth clients will typically continue to go to private banks because private banks have the capability to service the capital requirements of the segment - e.g. $50m loans, $50m portfolios.
- Many firms, particularly in the mid-tier, are experiencing a crisis of differentiation – as more technology becomes available, advisers are broadening rather than narrowing their value proposition. In the US, up to 72 per cent of advisers are differentiating themselves by saying that they know more than other advisers and provide more holistic advice with better service than their competitors (despite this not being mathematically possible for 72 per cent of the marketplace at once).
- In order to succeed, both small and medium firms will need to make a shift towards either a niche in a tightly defined client segment, or deep expertise of technical skill in a particular area. The narrower your area of expertise, the more it's possible to build a reputation for knowing *everything* about that topic (and the audience it impacts).
- If you can position yourself as the expert in a tight niche, you'll either attract a distinct subset of clients, or build a strong referral network of professionals with clients who have a need for your expertise. For example:
    - Pinnacle has recently opened an office in Florida, specifically targeting high-net wealth expats from South America. They have hired a Spanish-speaking planner with deep technical expertise in cross-border tax provisions and property investment for non-US citizens. They have developed a reputation in Florida for being the go-to experts on this area of technical expertise, and are working to cultivate referrals from lawyers and real estate agents who work with cross-border nationals.
    - Michael is also familiar with a firm that specifically targets dentists. This means that over time they have built a significant amount of experience in the issues that dentists commonly face. This allows the firm's advisers to be proactive in their approach to helping dentist clients, and allows them to ensure they have solutions for common challenges faced by dentists. Recently, the firm worked with two young dentists who were struggling to get finance to buy out the owner of their practice, who was retiring. The firm was able to leverage its industry expertise and knowledge of lending risk to start a specialist finance company to offer succession purchase loans to dentists – including the two dentists trying to buy the practice.
- Generating referrals from other professionals in your network becomes much easier when your advice firm has a deep specialisation, because referrers can be confident they are matching the needs of the client with the firm.

In the fintech industry in Australia, a lot of systems don't integrate well with each other. What are you seeing in the US, and what do you see as resolving this challenge in the future?

- Technology integration is a pain point for everyone in the industry.
- There are two core options:
    - Buy the best-in-class solution for each sub-class of needs, and then get frustrated when they don't integrate.
    - Buy an all-in-one system that is integrated by design but is often mediocre in each category, because it's not possible to be the best at everything, all at once.
- How the future plays out depends on the number of enterprise-level firms in the marketplace. In an environment where there are a lot of independent firms, there will be a lot of independent software options. In a market where there are mainly enterprise-level players, there will be fewer independent software options because enterprise-level firms either mandate a single solution, or build their own.
- There are three waves in advisor technology revolutions:
    - FIRST WAVE: This was mostly for consumers. Then software firms learned that getting people to trust you with their money is very hard. For example, in US, the pure robos have 0.03% market share. This wave mostly fails.

- SECOND WAVE: This wave tries to pivot its consumer-focused technology to enterprises – with partial success, because their technology wasn't built for enterprise and B2B functionality from the start.
- THIRD WAVE: This wave starts with enterprise in mind, and builds to solve B2B problems from the start; this is the wave we are starting to see now, and they disrupt the second wave with a more relevant and easier-to-implement enterprise solution.

DIY are never going to seek external advice. This leaves delegators and validators as the core market for advice. What's your view on what these clients see value in?

- Delegators usually rely on results and brand, however they are getting more sophisticated and starting to ask more about costs. It comes down to whether or not you have a compelling process – a story that your team can tell to explain how your process adds value. It's important not to sell performance, but to sell process – 'this is what we do, and this is why'
- Validators are where we are seeing the biggest shift, as they can buy portfolios directly with technology and want advice on top, which drives the need to update your value proposition to align to this shift.
- In the past, each client got invested in the investments you were using at the time they came on board. Over five years, you could end up with 90+ portfolios – and each year you'd have to try and standardise them as much as you could.
- Today we're seeing a shift to models portfolios, often delivered via a managed accounts solution. Firms are deciding that they are going to have 5 + standard portfolios (aligned to different goals and risk profiles) – with the ability to standardise on a scalable level.
- Not only can you standardise your clients' portfolios with ease, but you can also market your approach more consistently, and train all of your team to bring on new clients and retain existing clients using a standard investment story.
- The ability to manage with discretion is key here. At Pinnacle, if our team makes a change to the portfolios, we decide the change at 10:30 am, it's done for 1,200 clients (and 3,000+ portfolios) by lunchtime, by one trader. We then update clients via a standard email before the market closes.

What if a client requests a different portfolio, or what if they have legacy assets?

- If they are committed to a different investment approach, ultimately, we'll choose not to do business with them (or they'll choose not to do business with us!). We communicate that we take "risk managed tactical investing with ETFs" approach, and the reasons for that. However, because you are selling the same approach, consistently and regularly, you get skilled at handling objections, and you have the opportunity to develop sophisticated marketing collateral to support your story.
- Some clients have planning-based exemptions - e.g. capital gains tax implications. We may not be able to transfer all assets at once because of the CGT - so we have to transition over time.
- We do have the ability to manage exceptions. For example, a client may be an employee of a large national firm, and they may have a large amount of company stock – here, we can use their company stock as an exception to the S&P500 ETF – so we retain their company stock, and carve it out from their S&P500 allocation.
- When clients ask 'but why isn't this more customised for me?' – I, personally, tell them that I don't have a secret list of our 'real' best investments - we consistently give all of our clients our best investment ideas!
- Ultimately, we win more and can sell more with our standardised process than we lose for those who want exceptions.

What will the adviser be doing in 10 years that is different to today?

- Demands for knowledge and expertise will continue to get higher and higher.
- Demands for specialisation will increase – either technical specialisation or target audience specialisation. For example, Pinnacle's office in Florida, targeting high-net-worth South American and Mexican immigrants who need help navigating cross-border property investment and tax implications.

- There will be a shift towards playing more of a coaching role – working with clients to understand what their goals are, and then helping them achieve those goals.
- We'll be expected to communicate with clients more often, but in more bite-sized time blocks (for example, 30 minutes per month instead of 2-3 two-hour in-person meetings per year).

At Pinnacle, how are you systematising / industrialising the personalisation process?

- We're definitely on a journey and haven't perfected it yet.
- We're trying to build towards standardising the client experience more – starting with standardised meeting agendas and client review agendas.
- We're getting our new advisers to identify a niche, where we'll work with them to upskill them in a specific area over a period of time.
- We're also increasingly matching clients to advisers – if we have a client who's quite tech-savvy, we'll pair them with a tech-savvy adviser so that needs and expectations and communication styles are aligned.

What's your view on disclosing minimum fees on your website?

- This is something I am personally very passionate about, and think it absolutely should be done, for many reasons:
    - It acts as a filter and reduces the time you spend nurturing clients unsuited to your model.
    - Those who shop online have an expectation of transparency. By being genuinely transparent, you build trust.
    - People are less likely to refer you if you're not transparent with your fees. It represents a personal risk to them if they refer you, and their friend or colleague is unable to afford you. Fee transparency reduces this risk for the referrer.
- We've tracked website visitor behaviour, and we know that listing the prices on the site drives conversions. We had to remove the prices from the site for a period of time (for regulatory reasons, during a pricing review), and we watched a significant decline in web enquiries. When we were able to put the prices back up, within a month we'd returned to our previous level of web enquiries.

What are some of the major challenges you see with internal succession in advice firms?

- Many founders feel like the younger generation successors need to "suffer" through the same struggles as they did to become equity owners. Founders need to accept times have changed and successors will have a different path to ownership than they did.
- Founders generally have a great lifestyle with a very healthy income. If they are running a practice rather than an entrepreneurial business then "dying with their boots on" is an attractive and realistic option.
- Many firms are not growing (normally these are lifestyle practices) and so for the founder it is often more financially attractive to continue to receive a long term annuity style income then to sell equity to a successor.
- It is worth noting that founders will generally find the decisions easier to sell equity to an internal successor where the following conditions are in place:
    - The business is growing
    - There is belief that the successor can drive further business growth
    - The business is of a significant size so that founder does not need to sell much equity for it to be significant and motivating for the successor

Why don't more advisers use technology more frequently when meeting face to face with clients?

- The truth is they have normally not been trained on the technology and are really scared to use it with clients. It feels like walking on a tight rope over the Grand Canyon without a safety net.
- Advisers have become accustomed to presenting a paper based report with a client and if the client asks a question which is not addressed in the report then the adviser can just say I will go away, do that analysis and come back to you. When the technology is in front of the client the client expects the answer there and then and if the adviser cannot find it then they lose credibility and trust.

What are the growth stall barriers you see for advice firms?

- In the US it is common for successful firms to hit a growth barrier around the $250 mil FUA mark. This happens because partners (usually 2 to 3) have grown the business successfully prospecting and servicing new clients but have run out of capacity to go and find new clients.
- To break through the growth barrier partners need to transition their clients across to servicing advisers and then partners can spend most of their time prospecting. In the US market good servicing planners are generally paid around $100k - $150k (plus bonus for new client growth) to look after around 100 clients with FUM of $50m - $100m.
- If firms use the model described above and break through the $250m growth barrier then another growth barrier arises around the $1bil FUA mark. Here the barrier is that the number of new clients that partners are bringing to the firm not enough to meaningfully grow the firm in percentage terms. To break through this growth barrier the partners need to coach advisers to become partners and revenue generators.
- KPIs and professional development for advisers seeking to become partners should include a people management component, existing client revenue growth component, and a new client growth component. This ensures that advisers are developing the leadership, sales, and client relationship skills required to be a competent business owner in the emerging goals-based financial advice environment.

How do you go about hiring new advisers?

- We are fortunate that we have built a strong reputation and are approached regularly by highly talented people wanting to join our firm. We have a minimum education standard of CFP certification and then want to see advisers further their education to become a specialist in a particular area (e.g. cross border tax).
- Prior to employing a new adviser, we have them sit a test that is similar but harder than the CFP exam. The CFP certification is the minimum capability an adviser should have, therefore we use a more difficult test to identify the true stand-out candidates. As part of the interview process we also ask them to complete written tasks in addition to the CFP-style test. An example might be that we give them a financial planning scenario, and ask them for a recommendation to solve the scenario, but get them to present it in the form of a letter to the client. What we're looking for here is demonstration of empathy, strong written communication skills, and an ability to articulate a clear planning strategy which shows an understanding of market conditions, relevant legislation, etc.
- If the candidate performs strongly at this stage, then we perform face to face interviews with the key stakeholders in our business.