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Where the Wealth Is

By Kerry Pechter *Wed, Mar 13, 2013*

Do you build and wholesale financial products? Cerulli reports that the giant wirehouse channel shrank slightly last year, to the benefit of the fast-growing RIA and dually-registered advisor channels.

Despite the fines they've paid, their high fees and their resistance to a fiduciary standard, the so-called wirehouses—Merrill Lynch, Morgan Stanley, Wells Fargo, UBS, etc.—still control the lion's share of professionally managed wealth in the U.S.

While employing only about 16.3% of all advisers and brokers, the wirehouses direct the investment of about 41.1% of the $27.3 trillion that's "addressable" by advisors in the U.S. according to the latest report from Boston-based Cerulli Associates.

Asset managers—including mutual fund manufacturers—must therefore include wirehouses in their distribution strategies, even though, as Cerulli notes, they "have raised the cost of doing business through higher platform placement fees and more expensive revenue sharing agreements."

That situation is changing, but only at the margins, said the proprietary report, titled, "The State of U.S. Retail and Institutional Asset Management 2012." Wirehouse assets shrank by 0.3% from 2011 to 2012, as many advisors fled or got laid off in the wake of the financial crisis, taking some of their clients along.

Components of U.S. Asset Market
(Investment vehicles with the most assets, with highest dollar amount at the top)
Institutional separate accounts
Open-end mutual funds
Money markets
Hedge funds
Collective trust funds
ETFs
Subadvisory: Mutual funds
Fixed annuities
Variable insurance trusts
Subadvisory: Retail separate accounts
Closed-end mutual funds
Open program retail separate accounts
Non-traded REITs
Model retail separate accounts
ETNs
Source: Cerulli Quantitative Update: *The State of U.S. Retail and Institutional Asset Management 2012.*

Where are they going? The advisor-distribution channels that grew the most in 2012 were the RIA (Registered Investment Advisor) channel (assets up 14.7%) and the overlapping “dually registered” channel (up 19.1%), whose advisors are both FINRA-registered brokers and SEC-registered investment advisors. But those two channels combined handle only about 20.1% of total AUM and 14.9% of advisors, according to Cerulli, and they’re highly fragmented.

State the financial union

The main point of the Cerulli report is to show the size and strength of the various advisor-led distribution channels. “The report is meant to be a ‘state of the union’ of domestic markets,” its author, Cerulli associate director Tyler Cloherty told *RIJ* this week.

“Asset managers are asking, ‘What are our distribution options? How large are they? Are they growing or shrinking?’ We’ve seen that the RIA and the dually-registered advisor channel are growing faster than any other part of the market,” he said. “So asset managers might want to tailor their products to the needs of those two segments of the distribution marketplace,” he added.

But the proprietary report—RIJ saw only excerpts—offers a detailed snapshot of the institutions and the products where most of America’s investments are held. (Cerulli estimates that U.S. invested assets may be worth as much as $36 trillion, with only about three-quarters of that “addressable” by asset managers and advisors.)

According to the Flow of Funds Accounts of the U.S., March 7, 2013, personal financial assets in the U.S. at the end of 2012 was $50.13 trillion, and “household net worth—the difference between the value of households’ assets and liabilities—was about $66.0 trillion at the end of the fourth quarter of 2012, $1.1 trillion more than at the end of the third quarter.”

That wealth isn’t evenly distributed. According to “An Analysis of the Distribution of Wealth Across Households,” a July 17, 2012 report by the Congressional Research Service, 34% is in the hands of the richest one percent of Americans and the richest 10% hold almost three-quarters of it.

“The share of wealth held by the top 10% of wealth owners grew from 67.2% in 1989 to 74.5% in 2010. Declines occurred in the remaining 90% of households. The share of total net worth owned by households in the 50th to 90th percentile of the wealth distribution fell from 29.9% in 1989 to 24.3% in 2010, and the share of households in the bottom half fell from 3.0% to 1.1%,” the report said.

The Cerulli report also looked at how U.S. financial wealth is divided among different investment products. Institutional separate accounts and open-end mutual funds are the by far two biggest categories, with about $13.8 trillion between them. Both saw minor asset shrinkage in 2012 after three years of double-digit growth.

The two fastest-growing categories in 2012 were “model retail separate accounts” and “open program separate accounts, but both started from a very low base compared with open-end mutual funds and institutional separate accounts.

One of the main takeaways from the Cerulli report: Asset managers need to fine-tune their sales approach if they want to shift some of their resources from the wirehouse advisors to the RIAs and dually-registered advisors.

“These advisors operate their own independent practices,” Cloherty told RIJ. “They don’t have as much institutional support as an advisor at a wirehouse like UBS or Merrill Lynch. To get that kind of technology or research support they have to buy it themselves. Consequently, they may need more support from their asset manager partners in terms of macroeconomic research or marketing support.”

A change in pitch

The shift from wirehouse to RIAs and dually-registered advisors also involves a shift from the suitability standard to the fiduciary standard, and that has an impact on how asset managers and their wholesalers make their pitches.

“The asset managers are all moving toward the consultant approach, where they frame the macroeconomic environment and show try to show their customers where their product fits into their strategic outlook. It’s distinct from the commission-based formula where you say, ‘Here’s the product, buy our product,’” Cloherty said.

“In the fee-based arena, the salesperson or wholesaler needs more quantitative ability. He or she needs to move away from the mindset of, ‘I need to create sale activity.’ Now that intermediary is an advisor and a fiduciary.”

Despite their bad publicity and high fees, the wirehouses still have a grip on investors because of their strong brands and long-term relationships with clients, Cloherty pointed out. The wirehouses also benefit from the fact that most clients don’t understand how advisors get paid or what ethical standards they observe.

“Clients tend to separate their relationships with their advisors from their opinions about the firm. A client might say, ‘I’ve read about XYZ wirehouse acting in ethically dubious ways. But I know my advisor down at the local office would never do anything that wasn’t in my interest,’” he told RIJ.

“People don’t understand the difference between a fiduciary or a suitability standard. Clients have no idea how their advisors are compensated. They don’t understand how the firm’s proprietary products might harm them, and they don’t understand the pressure on wirehouse advisors to push the products that the wirehouse underwrites.

The link between underwriting and the suitability standard is strong. “That’s why you see so much lobbying against the fiduciary standard. It would blow up the way [the wirehouses] do business,” Cloherty said.

“The wirehouses still have brand recognition, but they are under pressure. Some of the clients are drifting away because they see the firms’ names in the paper every day. A bigger factor is that advisors are leaving the wirehouses because they don’t like forcing products down people’s throats.”

But the confusion about ethical standards apparently doesn’t end there, Cloherty added. “As advisors leave the wirehouses and move to the independent channel, they tell their client, I’m a fiduciary now. The client says, ‘I thought you were always a fiduciary.’”