Measuring the Quality of an Advisory Firm

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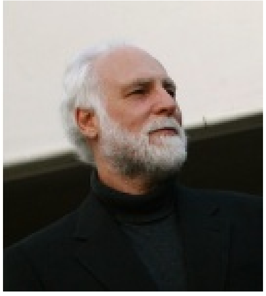

We've all gritted our teeth whenever one of the trade magazines comes out with a list of the "top" wealth management firms, ranked from "top" to "bottom" based on the absolute least meaningful way to measure the quality of an advisory business: the amount of client assets they manage. The goal of such lists should be to identify those firms that are best at serving their clients and are managed in a healthy and sustainable way.

Does anyone seriously believe that measuring firms by their AUM serves that goal?

The firm with the most assets is the "top" firm, and the firm that provides really terrific financial planning service, but happens to have "just" $150 million in AUM, falls way down toward the bottom of the list? And the firms that don't actually charge by AUM are, of course, nowhere to be found in the rankings.

Add to that, many of the "top" firms are not actually wealth management firms at all. And more generally, what do we know about each firm's culture and the quality of their internal management structure?

Nothing.

So how *would* you rank financial advisory firms based on a more comprehensive set of metrics, to determine their ability to service clients and the quality of their management and metrics? By what criteria would a firm with $150 million under management be ranked higher than the one with multiple billions of client assets, where firms that don't charge by AUM at all would rank appropriately on the list?

Until Brent Weiss showed me his RIA Health Index outline, I hadn't seen anybody give serious thought to this problem. Weiss has created a first step toward something that is long overdue in our profession: a breakdown of quality metrics for a wealth management or advisory business.

Weiss is co-founder and "chief evangelist" of Facet Wealth in Baltimore, MD. Facet is an unusual firm in the wealth management space because it serves the middle-income people that most advisory firms would put in their "C" client segmentation, and offers them comprehensive financial planning on a flat retainer basis. Bigger picture, Weiss is one of a coterie of younger advisor thought leaders who believe it's time to rethink the revenue and business models of the emerging planning profession, and the RIA Health Index is his first attempt to define "quality" in an advisory firm in a systematic and comprehensive way.

As you'll see, it might be difficult for an outsider to rank some of these elements of quality on a scale of 1 to 100 and apply the Index to create a more meaningful list of "top" advisory firms. But any senior executive at any advisory or wealth management firm could use this Index as a framework for self-assessment: *how strong are we in each of these areas, and how can we improve?*

Let's take a walk through the various components that contribute to firm excellence, and see for yourself if you could apply this tool in your own firm. (Fair warning: I've adapted the outline a bit after a conversation with Weiss, so this is slightly different from what he originally sent me.)

1. Quantitative metrics

Growth
Productivity
Profitability
Customer Satisfaction

Weiss starts the Index with the metrics that are easiest to measure, but he stops short of prescribing what is right for each firm. Every firm's principals can decide how fast they want to grow, and their desired profitability level. The point here is that growth rates, productivity metrics and profitability need to be meeting expectations for the firm to be healthy.

You know what growth is, but what about productivity? “I got the idea from Mark Tibergien’s book, *Practice Made More Perfect*,” says Weiss. “He said that the top firms have a financial management discipline, where, every quarter or semi-annually, they’re looking at things like cost of goods sold, gross margin and employee costs.” The book also includes metrics like the number of clients served per advisor, revenues per advisor and revenues or AUM per staff member.

The firm can evaluate and track progress in customer satisfaction by giving its clients an annual survey.

From there, the Index becomes more subjective.

2. Qualitative vitals

Vision, values and strategy
Mission
Capital aligned with strategy

“I’m not sure how you would quantify values, vision and strategy,” says Weiss, “but I’m sure that if you did a study of firms that have clear vision and values statements, that actually have them written down, and have a clear strategy for the firm going forward, that you’ll find that they are more successful. Not just in terms of assets under management or revenue,” he adds, “but they are probably doing better work for their clients. They will have a better sense of: *here’s who we are as a firm. Here is how we drive real value.”*

”Mission” refers to clarity around who the firm serves. This might mean having an “avatar” of the ideal client, and a certain stated discipline about taking on relationships with people who fit those criteria, who the firm can best serve. “You define: these are the people we serve, and here are the services that we provide them,” says Weiss. Some firms go so far as to give their hypothetical client avatar a name, so they can ask questions like: *“how would this new service benefit Betsy or John?”*

What about, ”capital aligned with strategy?” Weiss defines “capital” somewhat broadly, as human capital, technological capital and financial capital. Human capital is: have we defined who we need to provide the services for our ideal client? Do the existing staff members fit that profile? Are they compensated for the things that we want them to accomplish? “A lot of the compensation in this business,” says Weiss, “is driven around sales and business development: *did you bring in $20 million of new assets this year?* Not: *are you delivering excellent financial planning to your clients.* Not: *are your clients happy?”*

Technological capital is having the technology in place that most closely fits your mission. “Many advisors make technology decisions with kind of a whack-a-mole process,” says Weiss. “A problem shows up, and they go out and try to find the hot fintech thing that will solve it. And then all of a sudden they have nine systems that don’t talk to one another. That,” he says, “is not a strategy.”

A firm looking at this part of the Index gets a high mark if, after deciding who it serves and how, it also identifies the technology that can be put together in an integrated way to drive success of the firm’s mission. “Which five of the 400 different solutions out there would work best, in an integrated and efficient way, to serve this particular group of clients?” says Weiss.

3. Equity management/equity index

Financial management
Cash flow quality
Managing the client portfolio
Annual valuation
Equity management
Transferability
Culture

These can be defined as how well the firm is tracking, monitoring and managing to the goals that were outlined in the first two parts of the outline: the metrics and vitals. Are there procedures in place to stay on course in each of these areas and make incremental improvements?

Thus ”financial management” (*“managing and tracking financials”* is how Weiss labeled it in the original outline) can be defined by the question: Is the firm giving ongoing attention to the quantitative metrics that define the health of the firm? Is it staying aware of the financial vitals of the firm that were defined earlier? “In *Practice Made More Perfect*, Mark Tibergien talked about how the top firms have a financial management discipline, where they are aware of their financial health,” says Weiss.

”Cash flow quality” has to do with the decisions that a firm makes regarding new business. “A lot of advisors talk about their ‘small account problem,’ which is a term that I really hate,” says Weiss. It relates to an advisory firm taking on a less wealthy client, saying, *hey, that’s $2,000 of revenue. Fine; I’ll take it.*But if it costs you, internally, $3,000 to service that client, then the revenue is not the same quality as maybe a client who costs the same amount to service, but is paying you $5,000 a year. Or somebody who fits your ideal client profile, so you can service them more efficiently, where your internal costs are lower, and you can service them profitably.

“You find yourself over-servicing clients, and that is not quality revenue,” Weiss continues, “because it doesn’t equate to profitability and the bottom line.”

The question that the advisory firm should ask when pondering this part of the Index is:*Am I taking on unprofitable clients simply to raise the top-line revenues? Do I know if and when I’m doing this?*

”Managing the client portfolio” is the discipline around the firm’s mission: to service a certain kind of client and deliver a certain kind of service. “You look at: are we attracting the right clients?” says Weiss. “Are the clients we are taking on the people we defined as our ideal clients, or have we moved toward accepting clients who don’t fit that profile?”

Some firms may be falling into the trap of tending an increasingly aging client base, and won’t realize that their business is deteriorating until the clients start dying off or decumulating. Managing the client portfolio means constantly refreshing your client base.

”Annual valuation” is self-explanatory. Is the firm assessing its business value each year and tracking the growth? This is also important for the next category.

”Equity management,” Weiss says, is using equity to appropriately reward the key contributors to your firm. “It is giving your team the opportunity to buy shares in the firm,” he says. “It is: How do you use direct equity or phantom stock to incentivize and reward your team for the value they bring to the organization?”

To earn high marks on this issue, the firm’s leadership team must ask itself:*do we have a strategy in place for utilizing this valuable resource? Is it working effectively?*

”Transferability” simply means: is the company sustainable, so that an outside buyer (or internal successors) could step in and run the business? “This has to do with the ability to transition your firm, whether it is an external sale or internal succession,” says Weiss. “If you have a high cost structure, poor procedures and low client loyalty or an aging client base, then I would argue that that is not as transferable as if you had profitable clients and a tight management system.”

And ”culture?” Earlier in the Index, under "Vitals,” the firm should have already solidified its core mission, vision, values and strategy. The issue here is: how well are those core values communicated to the staff, and how often? This is about the maintenance of the culture that was established earlier in the Index.

How does this work? “At Facet,” says Weiss, “we hired another set of CFPs last week, and one of the first things I did was get in front of them and talk about why we started this company. I talked about our culture, and our values.” Those advisors work virtually from various locations around the country, and every quarter there is a group videoconference, where Weiss reiterates the core values of the culture. “It is part of who we are, vs. something in the background, vs. something you kind of think you need to have as an organization,” says Weiss.

4. Sustainability

Operating leverage and capacity
Human capital
Leadership and culture
Continuity planning
Succession planning

Here you monitor and track the advisory firm’s long-term viability. For the Index, Weiss identified several components that all need to be maintained in order for the firm to “live” beyond its founder and continue to succeed in the marketplace.

“Operating leverage and capacity” is about having a series of metrics where you understand when you need to add staff and where, in order to carry out the mission of servicing your clients. Earlier, Weiss defined the key productivity metrics of the firm, but I think we all understand that when productivity gets beyond a certain point, the staff members are overextended and client service issues might start falling through the cracks. Monitoring capacity is a key to the sustainability of the firm’s ongoing quality of service.

”Human capital” is related to capacity, in that it is the process by which new talent is acquired and trained. “I still hear G1 advisors saying they cannot find G2 talent,” says Weiss. “The truth is, G2 doesn’t just leave one firm and come to you. You have to have systems in place to be constantly identifying and attracting the next generation of talent.” In addition, he says, the firm would ideally have systematic processes that will invest in the staff members – – to develop, coach and train them so that they become more valuable to themselves and the firm. The firm gets a higher grade if the key staff members are constantly advancing their knowledge and skill levels.

And of course the grade is higher for firms that have a defined career path, where all the various members of the various teams know the actual steps in their career. “For the younger individual, if you have defined goals that you can achieve and be rewarded for that, then it benefits both the employer and employee,” says Weiss.”

In ”leadership and culture,” I’ve conflated two different categories in the original index into one, and this is a tricky category to locate in the Index, because it could be placed in a number of different places. Leadership is, of course, the process of managing the firm to the vitals mentioned earlier: the mission, and the vision, values and strategy. Are the leaders walking the talk? Are they communicating these important values to the team, and managing to them?

But leadership also includes tending the culture; hence the conflation of the two. But Weiss says that leadership IS part of the culture, from top to bottom. “When I talk with new hires,” he says, “I say: leadership happens at all levels. It is not confined to the top of the organization. You are a leader in this firm when you do your job in the right way every single day. You are a leader if you bring innovative new ideas to the business because you want to make it better. Leadership lives in every part of the organization,” he adds. “It does not just sit with the management team.”

Later, he adds that leadership from the top is embracing innovation and giving people permission to lead at all levels of the organization.

”Continuity planning” is making sure your business can increasingly, over time, operate without its founder, and succession planning is also somewhat self-evident. A firm would get high marks if it is building a team which can eventually, sooner rather than later, do all the things necessary to run the firm without the founder being involved, and if the successors are being given responsibility and groomed to make key business decisions.

5. Digital index

Technology
Cybersecurity
Data security

Most readers know that in this day and age, staying abreast of technology is kind of important, given all the new advances that are constantly coming to market. The ‘technology’ category, as Weiss sees it, is the process of constantly staying aware of new developments which might represent improvements to the current tech stack. Earlier in the Index, the firm may have defined the five solutions that are optimally suited to delivering, in an efficient way, the services that most benefit its ideal clients. You get a high grade in the technology area if you have procedures to stay aware of solutions that might be better than what you’re currently using.

Another component to the technology grade is staff training in your existing technology, which also addresses your utilization rate. Most software companies complain that their customers use, at most, about 20% of the features that their software offers. If you’re investing in training your staff, you can bring that up closer to 80%, perhaps higher, which earns you a higher mark in this category.

“I think if you’re only investing 2% of top line revenues in staff training and upgrades, you’re probably not thinking about technology in the right way,” says Weiss. “For staff people, the half-life of their skills is decreasing rapidly as we move forward. We need to develop new skills or we will become, as professionals, outdated. We have to train and coach properly,” he adds, “not just for existing technology but to stay on top of new developments and innovations.”

”Cybersecurity” is easy to explain: Does the firm have in-house expertise in protecting itself from hackers, and if not, has it brought in outside experts in this area? “Finding an industry-standard protocol, and a firm that can provide you with cybersecurity support, will be critical for the safety of your data," says Weiss.

How is "data security" different from "cybersecurity?" "Data security is making sure you are aware of privacy issues," says Weiss. The firm earns a higher mark if it has strong policies and procedures for ensuring the privacy of client information, which are reinforced with the staff quarterly or semi-annually.

6. Risk index

Confidentiality
Business risk
Legal and compliance
Credit
Innovation

This category looks at how well the firm is protecting itself against risks to its reputation and brand. A firm earns high marks in the "confidentiality" area if it takes seriously the fact that clients are trusting that you won't divulge the personal and financial information that they're providing you. "If clients can't trust you, then I would argue that your reputation is going to suffer," says Weiss.

"Business risk" has to do with the constant risk that you will make a serious mistake that will cost you credibility with a client or with the community. What if you make a recommendation that turns out to have been disastrously wrong, like modeling a client's future net worth where a number was accidentally transposed? A firm would earn higher marks in this category if it has internal systems to check for errors before plans or recommendations are presented to clients.

Most of you are familiar with the "legal and compliance" obligations that fall on advisory firms. A firm gets high marks if its documents and agreements have been reviewed by a reputable attorney, if the ADV is kept updated, and if there are compliance systems in place in the firm's normal workflow that make it easy to handle the annual visit from the state auditors or the SEC.

The "credit" category is how the firm addresses its financial risk. "We've always had a business line of credit, even if we didn't really need it," says Weiss. "In the event that there's a recession, having access to capital means that we can continue operations without hurting the business."

"Innovation" is another tricky category to define, but Weiss argues that there is a potentially huge risk to firms that are not constantly looking for ways to do everything better – and/or paying attention to new practice management and service developments that are arising in the marketplace at large. (He also admits that this could be a leadership issue and belong elsewhere in the Index. What do you think?)

7. Client Index

Unique value proposition
Client satisfaction
Quality of planning
Breadth of services

The client index category focuses on the actual services provided to a client. This gets closer to my first complaint about the "top" advisor surveys: they don't make any attempt to evaluate the quality of advice, or breadth of advice, that clients receive. The "top" firms with the most AUM may be providing the least advice and service, while some of the firms way down the list might be offering terrific value to their clients.

An advisory firm earns a high grade under the "unique value proposition" category if it has differentiated itself in the marketplace, and is providing a customized, tailored service to its target clients. Most firms say they provide "comprehensive financial planning." A firm with a unique value proposition might say that it walks doctors in residency through the process of restructuring their college debt and helping them negotiate employment agreements in their first post-residency job.

"Client satisfaction" is the process of monitoring the figures that were defined in the first "quantitative" section of the index. What procedures are in place to track improvements in client satisfaction, and how can the firm make these more relevant and actionable?

"Quality of planning" is crucially important to any advisory firm, but how often does the firm actually evaluate it? An advisory firm earns high marks if it is constantly rethinking and improving the quality of its advice and looking for ways to raise the level of the service goals that were defined in the "mission" part of the Index.

"Breadth of service" basically means defining all the services that the client avatar would need, and either being able to provide those services in-house, or having outside experts who can be brought in to provide expertise in those areas.

"This about real financial planning," says Weiss. "There should be a standard: *this is what we should be providing as professionals, and this is the value that we deliver*."

A firm earns low markets in this category if it is only providing asset management services to its clients.

8. Responsibility

Advancing the profession
Diversity and inclusion
Community engagement

This last category relates to the quality of a firm's "citizenship" – in the profession, and in the community that it serves, be that a physical location or a defined community of existing and potential clients.

Start with "advancing the profession." "I believe that we all have a responsibility to drive this profession in the right direction," says Weiss. "It is up to us to invest our time and energy in the things that bring us closer to a true profession." That may include joining the membership organizations and perhaps having staff members taking an active role in them, either locally, nationally or both.

"Diversity and inclusion" is fairly self-explanatory. "If your firm is more diverse, there are tangible benefits," says Weiss. You can look at the website of a larger firm and see if it's committed to hiring a diverse staff and giving opportunities to minority talent. (In the original outline, Weiss also included "developing next gen. talent," which is certainly another way to advance the profession. But this seemed to fit better under "human capital.")

"Community engagement" could be teaching a financial literacy course for local citizens, or creating a charitable foundation that serves the local community in some tangible way, or setting aside a day or two a year for the entire staff to participate in community activities. Pro bono work would fall under this category.

"It's hard to measure this," Weiss admits, "but it's in the Index as something for the people at the firm to consider. How active are we in the profession and in the community, and are there ways that we could, or should, be more engaged? This is intended to start the conversation, not prescribe how much each firm should be doing."

As I read over Weiss's RIA Health Index, I was, first, impressed at how much better this instrument would be at defining the "top" advisory firms. Compared with this evaluation, any list that uses AUM as its sole definition is laughably incomplete.

But there are way too many subjective elements, and too many moving parts, for any outside entity (particularly a magazine editor who is not in the business) to do a thorough evaluation of 11,000 RIA firms and a comparable number of IARs.

This instrument, as it evolves, will initially be used internally. The management team of any firm can look at the Index and ponder each of the subcategories, one at a time, and see more clearly whether there are possibilities for improvement. In fact, I'm hoping that this article will be shared and saved among the leadership teams at advisory firms around the U.S. and abroad, functioning as a blueprint for organizational improvement.

Weiss' RIA Health Index will continue to evolve, but he's already given us a profoundly useful tool. One thing I know: If you feel like your firm earned high marks in all of these different categories, then you are working at (or managing) one of the profession's "top" advisory firms, regardless of how much or how few client assets you happen to have under management.

What do you think? Is this a tool that you could use when evaluating your own business operations from the inside? Are you thinking about forwarding it to key staff members for further discussion? Are you (like me) disinclined to hold your breath that the magazines will adopt a broader metric than AUM?

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