BCG: Small Advisors Face Big Challenges

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by Dorothy Hinchcliff

Wealth managers face a very challenging future, particular smaller advisors that will need to deliver more personalized services while charging lower fees, according to the Boston Consulting Group (BCG).

That is a major takeaway from a report, Global Wealth 2020, recently released by BCG, a global wealth management consulting firm founded in 1963 that now has 85 offices in 48 countries. BCG has released a global wealth report every year for the last 20 years, and this year's report included predictions on how the industry will change over the next 20.

The report also includes a look at how global wealth and the number of millionaires has increased dramatically during the decade-long bull market. It also predicts that the wealthy will pay a high price as a result of the pandemic because of their greater exposure to equities and market volatility.

But what will be most interesting to financial advisors is the report's analysis of the current state of the wealth management industry and how firms will need to evolve in order to thrive from now until 2040. Most wealth managers have not done enough to position themselves to remain relevant to clients in the years to come, BCG finds.

I spoke with the report's lead author, Anna Zakrzewski, a BCG managing director and partner based in Zurich, to get more insight on the findings.

Wealth managers today

Whether the economy sees a quick rebound, slow recovery or lasting damage from the COVID-19 pandemic, wealth managers globally will face more pressure for several reasons, the BCG report says. One is that asset-based fees, which are more vulnerable to market declines, make up a higher percentage of income than in the past – 45% in 2018 versus 30% in 2013. Also, more wealth managers are operating in the red (9% when 2020 started versus 5% in 2007) and many have higher cost-to-income ratios than when the 2008 financial crisis hit (77% in 2018 versus 60% in 2007).

Zakrzewski added the return on assets globally for wealth managers is 22 basis points lower over the last 12 years, too. She expects wealth managers' cost-to-income to continue rising in the U.S. and in many other regions in the coming years.

Wealth managers weren't doing some things well before the pandemic and that now will take a greater toll, she believes. For one, they have continued with the same expensive high-touch model to serve clients without using data and technology to improve service and lower costs. Wealth managers haven't felt that much pressure to change because they were very profitable as a result of the 10-year bull market. Regulatory and compliance burdens have also ballooned, and instead of finding efficient ways to deal with them, they kept adding more people to cope with them.

"It's become quite an expensive model," Zakrzewski said. "It's a lot of unchanged ideologies and people. The environment has been way too favorable. And a lot of the things that we call the homework, in terms of the core things that protect your bottom line, have been done a little bit superficially. But firms have not yet taken the steps to fundamentally rethink where you will differentiate to create value and have a low-cost setup in terms of scalability for the future."

Most services that differentiate wealth managers today will, in the next few years, become commodities, she continued. "They need to start to think how they will differentiate in the future because a lot of the things they offer today will just not be the things that clients will be willing to pay for."

She believes the pandemic is providing a trigger –a turning point – that will result in some firms finally addressing these imperatives in a meaningful way. Those that successfully differentiate will be the ones that come out in a stronger position after the crisis is over.

Changing clients

BCG's report suggests "disruptive trends that have started to shake up the wealth management landscape over the past 20 years will gather steam, fueled by rapid digitization, a more knowledgeable and empowered client base, and far greater choice."

In particular, more wealth will be in the hands of more people, fueled by a huge handover of assets from one generation to the next. "If the prototypical wealth management client of the past 100 years was white, male, in his fifties, and Western, tomorrow's will upend that stereotype in nearly every way," the report said.

Zakrzewski calls it "a more inclusive setup." Just looking at gender, the wealth of women will actually grow faster than the wealth of men, she said.

BCG's report also predicts that Generations X, Y and Z will be more educated and economically empowered than prior generations. They will live in a more dynamic and fast-paced global environment with increased economic and geopolitical volatility where the divide between information sharing and information privacy grows increasingly gray, it added.

More and more, clients won't simply be looking for financial returns, Zakrzewski said, but will want their investments to make an impact and be more purposeful. Interest in investments that consider environmental, social and governance (ESG) factors will continue to grow, she added.

"COVID-19 definitely accelerated that interest," Zakrzewski said. "First of all, in times of crisis, sustainable and ESG investments do perform better than standard investments, which I think is quite interesting. Second, ESG funds had higher cumulative net inflows then traditional ones, also accelerated by COVID. Some investors actually believe the coronavirus is like a tipping point for ESG investments, and I actually think that that's quite an important angle, because this can also be a strategic advantage for wealth managers. It helps to protect and grow the assets. It helps to protect and grow the margin, in particular with clients thinking, 'I don't just want a return on financial performance. I want my investment performance to be good, but to also create an impact.'"

How wealth managers will help clients create impact will vary, the report notes. "For example, clients might be interested in helping an individual fund a small business that is doing important, pioneering work, or adopting the role of a disruptor by acquiring a meaningful stake in driving the next life-changing or market-making innovation."

Rising to the challenge

Trusted personal relationships with clients are not going away, but wealth managers must incorporate data and technology to provide better, more customized service, BCG said. "Next-generation machine-learning analytics will help providers make incisive connections that reveal potential client vulnerabilities or opportunities," the report says. "Visualization tools built into the models will enable advisors to walk their clients through different financial and investment choices, giving them a more visceral feel for how different scenarios might play out."

Wealth managers who can quickly integrate knowledge about their clients and events will have an advantage and be able to create value, Zakrzewski said. Consider a relationship manager who has 250 clients today and something happens in the market, she continued. The manager must determine which clients are exposed, what is the right proposition for each of them and then provide various options. Digital tools can do that analysis very quickly so that individualized ideas can be offered in a timely manner to clients based on their needs. "If you do not support that digitally and get the trigger points to clients one way or the other, the opportunity will have gone by and you wouldn't have even realized that, but you could have," she said. "You could have made something really good happen for the client's portfolio."

Some wealth managers have begun to use digital tools to quickly propose individualized action for clients, she added. "It means you get a letter that says, 'Dear Anna, your portfolio has just dropped by 15%. However, we are proposing x, y and z. Here is what these opportunities will do to your portfolio.' That's kind of it in today's world, which is pretty good."

What happens more often today, if clients do get a letter at all, it is just an acknowledgment that portfolios have dropped and it's sent a week late, with no effort to build a connection, Zakrzewski said.

And as digitization accelerates, the industry's economics will change, BCG said, with revenue margins facing enormous pressure. Fintech platforms will squeeze wealth managers on prices for transactions and custody services and offer tailored portfolio management at lower rates. Meanwhile, younger generations will want greater fee transparency, and online comparison tools will make it easier to find the most competitive providers.

“Together, these pressures could cut margins on investment services by half, with the result that wealth management providers will have to meet clients’ burgeoning demands and find new ways to drive value with just a fraction of today’s resources. That’s a tall order,” BCG said.

Instead of emphasizing product, successful wealth managers will seek to own the client relationship and source investment management components that can help clients achieve their broader wealth goals, it added. In the process, wealth managers will shift to values-based pricing, where the client is offered services she truly needs and her entire relationship with the firm across divisions is considered in setting the price she pays.

BCG believes the need for scale, specialization and choice could push the wealth management industry to converge around four models: large-scale consolidations where the biggest providers double their market share over the next 20 years; fewer boutique firms although a cadre of specialists remain; retail banks and asset managers that use technology to aggressively undercut traditional wealth managers in serving the growing numbers of mass affluent; and big tech players like Amazon, Google and Alibaba that provide wealth management services to affluent individuals and those in the lower HNW segment.

With all these pressures, will smaller RIAs survive?

They will “if they're able to deliver on personalization and differentiation, and they have a lean model,” Zakrzewski said. “Their offering will potentially be a bit different. They need to think about not offering everything, but differentiating with a very specific angle.”

Dorothy Hinchcliff is the editor at Advisor Perspectives.