EPISODE TRANSCRIPT

Financial Advisor Economics: From Transition and Beyond.

A Special Industry Update with Louis Diamond and Jason Diamond.

Mindy Diamond:

Welcome to the latest episode of our podcast series for financial advisors. Today's episode is Financial Advisor Economics: From Transition and Beyond. It's a special industry update with Louis Diamond and Jason Diamond. I'm Mindy Diamond, and this is Mindy Diamond on Independence. This podcast is available on our website diamond-consultants.com, as well as Apple Podcasts and other major podcast platforms. If you are not already a subscriber and want to be notified of new show releases, please subscribe, right on your favorite podcast platform or on the episode page on our website. For Apple Podcast users I'd be grateful if you'd give the show a review. Your input helps us to make the series better and alerts other advisors like you who may find the content to be relevant.

And while you're at it, if you know others who are considering change or simply looking to learn more about the industry landscape, please feel free to share this episode or the series widely. When discussing advisor movement, there's a question that's often top of mind. What kind of deal did the advisor who moved get? Certainly, it's no secret that in the competitive recruiting world, advisors receive a transition deal when joining another firm. It's most common for traditional W2 models to offer lucrative and highly aggressive financial incentive, often north of 300% of trailing 12 months revenue to switch jerseys while independent models offer less if any monetary incentive for those moving into the space.

But beyond the transition deal, there were plenty of advisors who wonder how they can monetize their business over time, thinking about the short, mid, and long-term, whether they are in an employee or independent model. So in this episode, Louis and Jason talk about where recruiting deals are at. They break down the motivations around a move and how monetization plays a part in the decision-making process, and they look at the long and short-term contrasting the value of an upfront deal against the long-term potential of business ownership. Plus they offer a perspective on retire in place programs and how those monetization events compare to opting for a recruiting deal from another firm or even going independent. There's a lot to discuss, so let's get to it.

Louis Diamond:

Louis Diamond here, really excited to welcome my brother and partner, Jason Diamond to the show.

Jason Diamond:

Thanks, Louis. I appreciate you having me on. I'm excited to be here.

Louis Diamond:

Excellent. I think this is to many a basic topic, but it's one that is of fundamental importance. We've talked about private equity getting into the space. We've talked about deals on the show quite frequently, but we thought today we'd just take a step back and talk a little bit about the economics that advisors consider when thinking of a move, really the short, medium, and long-term economic considerations. So with that in mind, Jason, why don't you provide a brief update

on recruiting deals both in the traditional W2 world, but also in the independent financial advisor spaces?

Jason Diamond:

Yeah, absolutely. So I think you're right. We've obviously spoken about this topic many times before, but it continues to be a question we get asked quite frequently. So just thought it'd be good to provide a brief update on where deals stand. Every advisor I think knows that a transition deal is standard industry practice when it comes to making a move. And we certainly like to say that one's personal financial gain should not be the primary driver of a move, but it's a consideration. So with that in mind, most traditional W2 firms, so wirehouse firms, regional firms and the like are offering deals north of 300%. Those deals are structured as a forgivable loan. They're not paid all upfront. We'll get a little bit more into the structure later in the episode.

I think it's reasonable to expect an advisor with a fairly attractive business, we'll call it a million plus in revenue and largely fee-based to expect a deal north of 300% from a traditional firm. Independent firms, so this would be some RIAs, but namely the independent broker dealers, they offer some transition capital as well. It is not in the same ballpark as the traditional firms. Most independent firms, if they do offer capital, are in the ballpark of, call it 30 to 50% of an advisor's trailing 12 months production typically also structured as a forgivable loan. We have seen those creep a little bit higher where I might be comfortable even saying maybe 40 to 55% of an advisor's trailing 12, and there are a couple of outliers there as well.

Louis Diamond:

I think that's right. We've even seen some independent firms getting closer to a hundred percent of trailing 12 and above. Obviously devil's in the details. Typically, the more upfront capital firm provides either the more captive that advisor is or the more expensive the platform is. And I think what you're saying is the average deals, but certainly there's firms that will pay more. And I think that's probably a question for you. What are some notable trends you're seeing right now as it relates to recruitment deals?

Jason Diamond:

Yeah, it's interesting because I think five years ago, six years ago, if you had asked that question, we would probably talk about how deals have been slowly but surely creeping upwards, total deal packages creeping upwards. And I don't know that we're seeing that today. I think we've seen baseline deal numbers stay more or less consistent over the past year or two years, but what we are seeing is firms getting more creative and more selective and a willingness to color outside the lines, particularly for the big swings, for the right teams. Even if baseline deals haven't moved, we are seeing firms absolutely pay up for the right teams, for the biggest and most productive teams in the industry. A couple other interesting trends.

Deal structure seems to be a lever that firms are increasingly playing with, and what I mean by that is either shifting more money to upfront, which obviously advisors value more, changing the length of a deal, changing the pay structure whereby the hurdles one needs to achieve the deal

are either easier to hit or are timed differently. We're also seeing absolutely more firms shift dollars to the upfront component. As I said, that's the component that advisors value the most. So I think it was reasonable maybe five years ago, the highest upfront deal on the street in terms of upfront percentage from a traditional firm was maybe 150% of an advisor's trailing 12, and that was considered very strong. Today from a traditional firm, 150% of trailing 12 for a productive advisor would actually be considered quite low. We're seeing firms, some firms even test like 200% of an advisor's trailing 12 upfront, and then there's an additional backend component as well.

And then the last one I'd mention in terms of trends regarding deal structure would be we are seeing some firms, UBS most notably offering deals structured as where the backend is paid as a guaranteed salary instead of the traditional hurdle structure. So typically an advisor would receive a portion of the deal money upfront, and then the rest of it would be contingent upon hitting some asset or revenue-based hurdles. But this structure I'm describing instead of that kind of hurdle bonus approach, it's a more consistent, stable, predictable cashflow where the backends are just paid as a guaranteed salary over the life of the note.

Louis Diamond:

Yeah, that's a deal structure that many advisors have been interested in because to them it takes a lot of risk off the table. They can move their business over and not really have to stress about the growth hurdles attached to it. Are you surprised that more firms haven't adopted a similar structure if it's been successful?

Jason Diamond:

A little bit actually. I mean, usually, as you know, our industry is a copycat industry where a firm does something that works well and other firms are typically fairly quick to at least try it out. So I am in some ways a little bit surprised. There is no question that I think firms prefer the hurdle structure, the more traditional structure because it protects the firm from a poor transition. The hurdles are essentially, some of them are trying to achieve growth, but a lot of times they're more like firm protection hurdles where they'll say an advisor needs to move over 90% of his assets or a hundred percent of his revenue within a certain period of time to hit the hurdle.

I would however expect, especially given the success of this UBS deal structure, I would expect some additional firms to roll it out. And maybe I would ask you going the other way, so if that would obviously be a positive trend, what are some risks? Maybe if you're an advisor today contemplating a move or maybe you have a move in you five years from now, what are some risks to deals? Do you expect deals to stay where they are or improve or do you think there's things advisors need to worry about?

Louis Diamond:

It's a great question. My prediction is deals will continue to improve because we're right now still in a mode where there's a supply and demand imbalance. There's so much demand for the best advisors in the industry, even say mid-tier advisors with more firms gunning for these individuals

that you really have to be competitive on deal and keep pushing the envelope in order to attract talent. We see it often with new firms entering the industry. They want to make a splash. They have to air quotes up overpay for the first few teams, but that typically drives the market. So I think as long as we have that dynamic, which we fully expect to continue, I don't worry about deals coming down. There are though a couple of called black swan events that could happen to note a couple.

One, First Republic obviously is no longer in the business or in business is now part of JP Morgan, but for a while, First Republic was setting the market or pacing the market as far as the top deal. So whenever you have a firm who's no longer writing those deals, it does take some stress out of the market. So I think First Republic was a great thing for advisory recruitment and recruitment deals because any firm they competed against had to bring their A game. So with less firms like First Republic, that is a potential risk to deals. Another one would be looking back 2017, 2018 or so, the wirehouses pulled out of protocol, UBS and Morgan Stanley. And we also saw at the same time, Merrill along with Morgan and UBS make comments that they were kind of against recruiting experienced advisors in the same capacity and pulled back.

In the case of UBS and Morgan, it was fairly short-lived. We're seeing Merrill kind of come back in the market. But those types of firms pulling out would absolutely be an impact to deals because either it's less deals that someone has access to or they're a very viable firm that someone might consider who all of a sudden may or may not even have a deal. And then I think the last one is just, this is just common business sense. You never know what's in store for your own business. It's kind of like you don't know when to sell your house. You want to sell it top of the market, but you don't know if something's going to happen to dent the market.

So who knows what the stock market does, who knows what your firm does to make your business less portable or less valuable, maybe they pull out of a certain line of business and that makes your business less competitive. So I'd say those are the three risks. It's a kind of a black swan event, like a First Republic happening, wirehouses pulling out or something of the sort, and then just not really knowing the future of what's going to happen to your own specific business.

Jason Diamond:

Yeah, I think that's right, and I would almost just view it as basic economics, if you remember back from high school, supply and demand, right. There is right now the current dynamic in the market is such that there is a shortfall of supply of quality advisor businesses and there are plenty of firms that are trying to recruit and attract top talent, but there's no guarantee that that's the case into the future. I think we expect it to be because of how profitable and attractive a lot of these businesses are, but there's no question that more firms in the recruiting game is good for advisors. So to your point about a First Republic, for example, yeah, it's possible that has an impact on headline deal numbers because they really were pacing the market. So I think that's well said.

Louis Diamond:

So let's make our second key point here. It's that a transition deal is only a small part of the economic equation when advisors make a move or evaluate a new firm. So what we mean by that is advisors are paid to move their businesses, to take the risk for the most part, but there's other components, we'll call it the medium-term and the long-term. So I think of a transition deal as more of the short-term monetization event, but we also have the medium-term and long-term. So when I say that, can you elaborate on what we mean?

Jason Diamond:

Absolutely. So here's how I think about transition deals. If transition deals were the only way for an advisor to monetize their business, then every advisor or almost every advisor would opt for a traditional captive model because they're paying deals that start with a three handle, deals north of 300%. But obviously we're seeing plenty of advisors opt for independence or for firms that don't necessarily offer the highest transition deal, upfront transition deal on the street. So what that tells me is that advisors value more than just the short-term monetization event. The way I think about the medium-term is what are the opportunities an advisor has to make money on an ongoing basis once they're with a firm or a platform? And the most easy way to think about that is just what is an advisor's payout? So to your point earlier, you made the point about trade-offs where typically taking more transition dollars means either you're more captive and or a firm or platform is charging you more on an ongoing basis.

I think that's absolutely true. So an advisor, for example, who opts to go the independent route, while they may be receiving, call it 50% of their trailing 12 in a transition deal, their ongoing payout is likely much higher than a captive advisor of a similar size. So in the medium-term, no question, advisor payout is one of the primary levers. I think the longer term piece though is probably the most impactful. We call it long-term greedy because I think that's the right way to say it. An advisor has to be long-term greedy to be willing to forego a 300% plus transition deal from a traditional firm. So how does an advisor monetize the business in the long-term? Well, if they're with a traditional firm, the simplest way is via a retire in place program, Merrill CTP, UBS's Alpha, Morgan's FAP, a traditional retire in place program whereby essentially the firm helps to finance the sunset of the senior advisor to a junior advisor.

But what about in the independent space? This is where I think the term long-term greedy really applies because in the independent space, an advisor owns their equity, they own their book of business, and therefore they have the ability to sell that business at day's end on the open market to another independent firm, to a private equity firm as you mentioned in the episode last week. They have many options to monetize the business at day's end for a very significant multiple. And sometimes in fact, in many cases, it's well in excess of what a traditional recruiting deal might pay you. But there's no question, it requires some foresight and it requires some patience, and it requires, again, this notion of long-term greed because if you're going to go that route, you are foregoing in all likelihood, a very large substantial recruiting deal from a traditional firm.

Louis Diamond:

And I think it's worth noting that kind of going back to the medium-term, that when we're thinking of ongoing payout, usually advisors don't change firms within a similar model because payout is so superior. So I'm not going from one employee model firm to another because the payout is much better. They're usually in a fairly similar ballpark. The difference is when you look at cash payout, that can vary widely between firms. Wirehouses tend to defer a much larger proportion of their compensation than regional firms for instance. Wirehouses often change their compensation plan, move the hurdles around where regionals tend to keep the payouts in place. And we're even seeing now some firms will say innovate on traditional W2 economics by adding an independent tilt, so having payouts that mimic what someone would net as an independent, but in a W2 construct. So I think we'll continue to watch that and allowing advisors to have their cake and eat it too. And on the independent side we've talked about this before, headline payout is sometimes misleading. I get a 95% payout.

That might be true in some cases or a 90% payout, but it's really about what's the net? So after platform fees, ticket charges, program fees, administrative fees, all these different fees, what are you netting? Typically, whether it's a supported independent model or an independent broker dealer, we see advisors all else equal before their own local costs probably in around an 80% payout. And then depending upon the business, they're probably netting 60 to 65%, maybe a little bit more. So obviously that's better than what you get in a captive environment, but you have to make the trade-off. Is that extra 10, 15, 20% in payout, is that worth it to me because I'm monetizing for less? And then one other thing on the long-term side, you talked about the retire in place programs within a traditional firm. Is it reasonable to think that what I get paid through one of these retire in place deals, is it less than what I can sell my business for as an independent? And why do you think that is?

Jason Diamond:

I think yes, it's probably true that you would sell your business for less. A couple of reasons for that. One is just the tax treatment. Typically, independent businesses on the open market sell at long-term capital gains versus a retire in place program is an ordinary income transaction. But the other I think just comes down to competition or lack thereof. The beauty of an independent business is that they can sell their business on the open market, which means the pool of buyers is virtually unlimited versus a traditional firm, the pool of buyers is limited to that particular firm. Now, some advisors don't care because there's an ease associated with a sunset program within the confines of a same firm, and some advisors are plenty comfortable taking a discount in that regard. But if you're just talking about it from a purely economic perspective, setting aside ease and client service and all of that, if you're just talking about it from an economic perspective, typically deals in the independent space are much more robust than traditional sunset deals.

I mean, the other reason is just if you think about how they're structured, most wirehouse or traditional firm sunset deals are as a percentage of revenue versus a well-run independent business, probably sells more for a multiple of EBITDA. So if the business is able to run lean and keep costs under control, it will very likely exceed a revenue-based deal structure that an

advisor might get from a traditional firm. Let me ask you a question there. You just brought up something that got my wheels turning a little bit. I was thinking about this. I was on a call fairly recently with an advisor and he asked me the question, something to the effect of, so you're basically telling me you need to move, you need to make a transition. And I think that sounds like a simple question, but I think it's actually a great point. So are you saying that in order for an advisor to really maximize the value of their business, do you feel like it's imperative that an advisor makes a transition? And it sounds like yes, given how heavily economics are sometimes tied up in these transition deals.

Louis Diamond:

Yeah, I'm with you there. I think the other piece is even in the independent space, we see internal succession deals, meaning I'm selling my equity to someone on my team or to a family member or to a next generation team member at a discount to fair market value. Usually it's about 25 to even up to 40% discount to fair market value. So that's a way to think of a retire in place deal. It's you're trading the business or selling the business to someone internally, you're rewarding them for their loyalty. And because you have, like you said, lack of competition, I think it's expected that that type of trade is going to be at a discount. Yeah, very, very good question. So a concept that we created is called maximizing your career enterprise value. And what that concept states is that the way you calculate your career enterprise value is the summation of your career cash flows. It's not a secret that getting a lucrative recruiting deal is one very efficient way to bolster your career cash flow or career earnings. It also means that selling the business is the other lever to maximize your earnings.

So in our opinion, if someone is focused on maximizing their career enterprise value, and the keyword here, keywords is enterprise value, then making one or multiple well timed moves is the way to do that. So either moving and getting a big deal somewhere and then taking that firm's retire in place program, moving to independence, getting a deal or getting a higher payout, owning your business and selling the business on the open market, that is the way to really maximize the equation. But we are not advocates to move just because of that. There's plenty of advisors who have been quite well served at their firm for the long-term. They may never move because to them they're comfortable. They make plenty of money, they can do what they need to for clients, and they'd rather maximize ease and familiarity and stability rather than maximizing the dollars and cents. But the short answer is yes, I do believe that an advisor at some point in their career, when things line up, there's enough frustrations and they find a model that's better for them and their clients that a move is the best way to maximize value.

Jason Diamond:

Spot on. And some advisors just value that happiness quotient or that best business life quotient more than others. But with this conversation, I think is more geared towards the economics and in that context, no question one or more well timed moves is the way to do it.

Louis Diamond:

No doubt. So let me ask you this, lets kind of round out this concept. In your opinion, is one better than the other? Meaning is it better to prioritize the short-term, the medium-term, or the long-term? Is there a set answer or even put it another way is there a model or a type of firm that is a superior economic trade for all advisors?

Jason Diamond:

The short answer is no and if there were, you would see every advisor on the street go to that firm or model. So I know for a fact the answer is no, because we're seeing this really bifurcated landscape where a sophisticated advisor running a very profitable business is just as likely to opt for a wirehouse as he is for an independent business. So the short answer is absolutely no, one is not better than the other, it just depends what you value more. Plenty of advisors will say, a move comes with risk and a move is a hassle and a lot of work, and I deserve to be compensated for that maximally upfront.

There is absolutely nothing wrong with that point of view. Plenty of other advisors will say, I'm long-term greedy. I'm comfortable foregoing the short-term transition economics in exchange for the ability to monetize on my backend. It really just comes down to what do you as an advisor value more? But the piece that I think we're losing sight of here is that oftentimes the economic decision to the advisor is not and probably should not be the primary driver of a move. We also have to consider this from the perspective of which firm or model best enables the advisor to service his clients, to support his team, and to feel like they're really just generally well-served. That decision is often not purely an economic one. So for some advisors, it's about would it be nice to have a 350% all in transition deal? Of course it would be, but I'm comfortable foregoing that because I think I'll be able to better serve my clients in the independent space, and ultimately that's what I value most.

So one is not better than the other. Any move involves trade-offs in terms of economics and also just in terms of running your business or most moves involve selecting, do you value the stability of a brand or the autonomy of independence? So trade-offs in everything. But I think at the end of the day, the beauty of our industry is that's what makes a horse race right, is if you value the upfront economics, great, there's options for you. And if you're comfortable foregoing the upfront economics and your goal is to maximize in the long-term, great, there's options for you as well.

Louis Diamond:

I do think there are ways that advisors can have their cake and eat it too. We've seen it with some firms that offer multiple channels of affiliation, Wells Fargo, Stifel, Raymond James, LPL, Ameriprise, et cetera, where advisors can join a traditional W2 model, get one of these very attractive recruiting deals, but then migrate to independence at some point in the future and be able to sell the business for a higher multiple than that firm's captive succession planning program. So I think there's also ways that advisors can ring the bell on both ends. It's been a little bit of a shift actually in advisor mindset, but I remember even as few as three years ago, most younger teams, so teams where a lead advisor was 35, 40, 45, et cetera, would say, I'm

young enough where I can get a nine or 10 year recruitment deal from a firm, and then I can take the business independent and basically move once for money and move the second time for passion.

So that's always an option too, if you're looking to maximize the economics. But if you are bullish on yourself on independence in this example, then why put your clients through two moves? I think the point is here, there isn't one formula for success. If you value the economics, follow your heart, follow your own financial situation, follow what's most important to you. But if you follow only the economics, then oftentimes you will have buyer's remorse at some point. So I think it's balancing everything. It's balancing what are my fears, what are my pain points? What are my goals? What am I looking for? And matching that up with a very exciting slate of options for advisors. Oftentimes, economics is the only objective measure of a firm. So comparing, I can get 305% at this firm, 301% at the other firm. Okay, it makes sense, which one to go to, but that's only a tiny part of the equation as you mentioned.

Most of the time, a decision on what's the best move for an advisor is based upon the subjective, it's about culture, it's about platform, brand and all the other things that are most important to them. So I think this has been a very interesting and exciting topic. We are talking about economics, not to say that economics are the only factor, but they are of course a very important factor because advisors are at the end of the day running a business. So whether it's the short-term, the medium-term, or the long-term, advisors continue to be in the driver's seat with so much demand for their services, but also so many options for them to consider. So Jason, I want to thank you for sharing your insights today and joining us. I'm excited to talk about this topic again in the future.

Jason Diamond:

Yeah, my pleasure. Thanks for having me. I hope you'll have me on again to check in on this topic again because it is one that's constantly evolving, so I really appreciate the time and this was a pleasure. This was a lot of fun.

Mindy Diamond:

There's no doubt that advisors have choice when it comes to considering the next phase of their careers. Whether they are looking to monetize in the short-term or playing the long game, there are plenty of options for them to consider. In each and every case it's important to ensure that the decision that's made is based upon achieving your goals and ultimately what will help you to live your best business life. I thank you for listening, and I encourage you to visit our website, diamond-consultants.com and click on the tools and resources link for valuable content. You'll also find a link to subscribe for regular updates to the series. And if you're not a recipient of our weekly email, perspectives for advisors, click on the articles link to browse recent topics.

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