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Recruit or Reboot?

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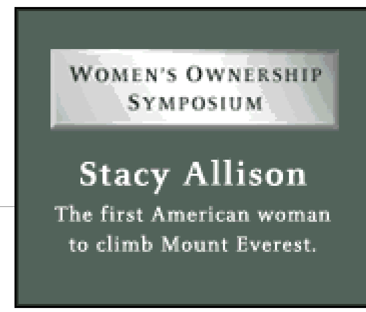
As the stock market is recovering, sales force growth is returning to the top of the management agenda in retail securities firms and life insurance companies.

Excluding acquisitions, there are two fundamental sales force growth strategies — training new producers or recruiting experienced producers from competitors.



Either approach can make sense, depending on the nature of the firm and its current circumstances, and often they are complementary. However, neither strategy will maximize its economic attractiveness without careful analysis of its pros and cons.

The Economics of Training

Training has many advantages. It enables the firm to be selective and pick precisely the types of trainees it wants. It provides the opportunity to shape trainees into the kind of producers the firm wants. "Home-trained" producers also tend to be more loyal to the firm and more disciplined — more likely to respond to management direction regarding products to be sold, selling approaches and compliance.

Training, however, is a very expensive proposition.

There are obvious "direct cost" elements that are associated with every trainee, including:

- Selection and hiring costs.
- Training for licensing and orientation.
- Preproduction subsidies in the form of an initial salary and/or an enhanced payout, special supervision and coaching costs.
- Normal producer support costs — office space, IT and telecommunications, sales assistants, compliance, office management, etc.
- "Overrides" paid to branch managers, sales managers etc.

The biggest cost contributor in a training program is indirect. It is the cost of mistakes, i.e., trainee attrition, which is unavoidable and enormous. In our experience, only one in four trainees survive a typical three- or four-year training program. The attrition rate is highest in the early years, and it decreases until it reaches a steady state. When trainees leave, the embedded costs they absorbed, from the inception of training to the time of termination, simply go down the drain.

We have analyzed the economics of training programs in detail for several securities firms, life insurance companies and financial planner organizations. We invariably have found that the "all-in" cost of training per graduate (defined as a producer who successfully survives the three- or four-year training program) is in the range of $200,000-$300,000, depending on the firm and the length of the training period. We have also estimated the likely return on training investment and found internal rates of return of around 10 percent. This is below the 15 percent or so return that firms usually seek to meet their cost of capital hurdles.

This translates into a payback period of around 11 years for most training investments, which suggests that training makes the most sense for large firms — those with enough profits to subsidize training.

The CBM Group has worked with several clients on the optimization of training programs, and we have found that the rate of return on training can be substantially improved by:

- Being highly selective about the trainees.
- Weeding out underperformers as early as possible.
- Making sure that supervisors and sales trainers really contribute.
- Managing costs tightly throughout the training process.

Recruiting Economics

Recruiting experienced producers from the competition has been a well-established practice in the securities industry for at least 20 years. This approach has the advantage of providing instant production growth, since good producers often bring their best clients with them. They also tend to energetically seek new accounts.

In our experience, recruits tend to bring some 70 percent to 80 percent of their business with them and to recover their previous production level in approximately two to three years.

Of course, poaching producers also has its drawbacks: Many brokers have become chronic switchers who will periodically jump from firm to firm in a quest for the sign-on bonus. Sometimes, the switching producers decide to jump ship when they have a burned book, i.e., clients who have lost money and are upset. Furthermore, an influx of mercenaries who join a firm in exchange for an upfront bonus is not a good example to home-grown brokers already on board.

Retail brokerage firms typically recruit producers by paying upfront sign-on bonuses and/or enhanced payouts. The recruits sign a promissory note, which is forgiven over a number of years. Should the producer leave before the contractual term, he is saddled with a significant debt. This tends to guarantee loyalty.

A typical deal is a sign-on bonus of 70 percent of the preceding 12 months' gross production for a seven-year commitment.

Sign-on deals have evolved over the years, with lengthening terms. In the 1980s, typical sign-on bonuses were 30 percent of gross for three years' tie-up. More recently, they have evolved to the current 70 percent for seven.

A simple rule of thumb (ignoring the time value of money, as a first approximation) is that firms are willing to pay upfront about 10 percent of the previous gross production for every future year of guaranteed loyalty on the part of the producer.

Does this make economic sense for the firm? Brokerage firms on average tend to have a profit margin of around 10 percent to 15 percent of revenues. So, at first blush, firms seem to be taking a bath — but not if you view it on an incremental or marginal basis.

At the margin, many of the costs in a brokerage firm office are fixed or semi-fixed. Most of the time, the firm has some empty desks and as long as there is spare capacity in the system, the firm can add an experienced producer with little or no incremental cost. The marginal contribution of an experienced hire is thus likely to be fairly high, around 40 percent of gross production (i.e., 100 percent less 40 percent payout, less 10 percent sign-on bonus per year, less cost of financing less real incremental costs, such as overrides, ticket processing, etc.).

It is important, however, to be highly selective about the producers being hired. Specifically firms need to make sure they you don't get producers with “burned books of business” or decaying customer bases.

Training vs. Recruiting

To sum up, training and recruiting are complementary strategies for growing the sales force. Both have their place.

Training makes sense for larger firms that have the resources to make the massive investments it entails. It requires patience since it takes years to recover the investment made. It also makes more economic sense in a bull market, which improves trainee retention and production. For firms that decide to have a training program, it is important to avoid brutal swings in trainee numbers as a function of markets. It is better to have a smaller, steadier and more selective approach to training.

Recruiting experienced producers is an appropriate strategy to add producers on an incremental basis. Firms however need to make sure they pay economically rational sign-on bonuses and enhanced payouts.

The economic results of both training and recruiting, which for many firms are mediocre, can be significantly improved through the disciplined use of analytics and metrics.

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