Registered Rep. The Source for Investment Professionals

Unbundling the Financial Supermarket

By André Cappon

Mar 1, 2005 12:00 PM

Once upon a time — some 20 years ago — securities and insurance firms were dens of incest, with product manufacturing married closely to sales. Securities firms developed proprietary research ideas, launched new issues of stocks (including IPOs) and bonds and managed mutual funds — and all these functions were supported by the efforts of the firms' sales staffs.

Similarly, life insurers created their own proprietary life insurance and annuity products and used their sales forces as the primary distribution channels. In both industries there was some distribution of third-party products and services, but these almost always took a backseat to the in-house options.

Producers typically were trained in-house and remained loyal to the firms where they grew up. They were supervised by the firms' office and regional managers who, to a large extent, dictated what the producers should sell. This "bundled" business model was comfortable for firms. They could earn money both coming and going, profiting from both manufacturing and distribution. They could also subsidize one or the other as business strategy or market conditions required.

But nothing lasts forever, and the recent shift away from this under-one-roof climate has significant consequences for advisors and those who manage them.

Disturbing Factors

Several factors disturbed this in-house business model:

The bull market in the early 1980s, which came after some 15 years of stagnating stock markets, caught brokerage firms unprepared. During the lean years, firms had reduced costs and cut back training programs. Suddenly there was strong demand for brokers, and firms began massive efforts to poach experienced producers from competitors. A few firms, in particular those in a hurry to grow and/or those who did not have effective training programs, started this trend. They attracted experienced producers from competition by offering significant sign-on bonuses, forgiven over a period of several years, which guaranteed retention for the period of the deal. Over time, "mercenary" behavior among producers became accepted. Many producers became chronic switchers, jumping from firm to firm every few years in search for ever higher sign-on bonuses. The upshot: The fierce loyalty to firms that helped bolster the all-in-house model gave way.

The rise of "packaged products" was another key factor. The mutual fund revolution began in earnest in the mid 1980s, stimulated in 1983 by the first bull market in 15 years. Load mutual funds were a great product for producers, who transformed themselves into "asset gatherers" and shifted the responsibility for investment performance to third-party asset management firms. When funds' performance flagged, the broker could blame the fund managers and replace them with others, sometimes from third parties. This helped him — at least in theory — preserve his customer relationship, the firm's revenue stream and his own payout.

The rise of nonproprietary product was both a logical consequence and driver of this change. Regardless of how good the in-house product manufacturing capabilities were, there always were some third-party asset managers with better performance. This created pressure for firms to open up their distribution systems to third-party, "nonprop" products. "Manufacturers," i.e., asset management firms, thrived, since they could now distribute their products through many sales forces that were eager to embrace third-party products. By now, we have about as many domestic equity funds (5,110) as domestic stocks (5,295) in the U.S. The same is quickly happening in other markets. Because of the intense competitive nature of their markets, manufacturers have to compete hard for "shelf space." This has spawned an entire business system, with manufacturer-sponsored wholesale sales forces, "visible" (sales loads and trailers) and "invisible" payments for distribution ("distribution allowances," reciprocal business), as well as "wholesaler" and "aggregator" firms.

Increased regulatory scrutiny has also contributed. Initially, firms opened their distribution systems to third-party manufacturers reluctantly, under pressure from customers and producers. For a long time they favored their own proprietary products, offering producers higher commissions and enhanced support for selling the products. They gave more “shelf space” to proprietary product and made it difficult or expensive for customers to buy nonprop product. However, in the last few years, regulatory scrutiny has forced firms to create a level playing field for proprietary and nonproprietary product. Open architecture has become the norm in most U.S. retail brokerage firms and life insurance companies.

The rise of “independents” was another key trend beginning in the 1990s. Independent broker/dealers that offer minimal, low-cost support to their producers, an open architecture product suite and high payout (80 percent-plus instead of the traditional 40 percent to 50 percent) have thrived. At an indie firm, the producer is responsible for his own support structure (office space, sales assistants) and pays for it out of his own pocket. These firms offer a convenient platform to the independent advisor or financial planner: They provide access to product, a technology platform, back-office execution and a regulatory framework. Independents have grown faster than traditional firms in recent years by taking large numbers of experienced producers away from the brokerage firms or life insurance companies where they had been trained. Independents never offer training programs (which are costly and can only be financed by traditional firms that pay the producer a lower payout, thus subsidizing the training effort).

Eliot Spitzer's investigation into the real and potential conflicts of interest in the industry is a force unto itself. Post-Spitzer, firms have had to become much more transparent and to ask themselves — at every step — whose interests they are serving. To serve the retail investors interests effectively, firms must become customer-centric and treat all product vendors, including in-house ones, at arms' length.

Management Implications

The above evolution has several effects on the way managers must approach their jobs.

Distribution has become a stand-alone business. In the retail brokerage industry, this fact was already clear in the late 1980s. In the life insurance industry, distribution traditionally was (and still is in many cases) viewed as a cost center. This viewpoint led to cross-subsidization and suboptimization in both manufacturing and distribution.

Since life insurance distribution systems now compete against a variety of pure distributors — other life insurance companies, stockbrokers and financial planner networks — it is crucial to measure its performance on a stand-alone basis and judge it against relevant benchmarks.

Manufacturing has become a stand-alone business. Asset managers — manufacturers of mutual funds have obviously long recognized this fact. Once again, the life insurance industry was behind and it began to recognize it as it developed third-party distribution channels, notably through wire houses and financial planner networks.

Wholesaling is also emerging as a stand-alone business. In recent years, wholesale intermediaries, or “product aggregators,” have also emerged. They are middlemen between distributors (especially smaller distributors who do not have sufficient purchasing clout) and the manufacturers, in particular life insurance carriers and major mutual fund firms. These firms aggregate demand from several smaller distributors and use their resulting purchasing power to negotiate higher dealer concessions and distribution allowances from the manufacturers. They make their money by taking a cut.

Each of the above “lines of business” must learn to compete on their own strengths, facing efficient competitors in their own area. Each line of business has its own “key success factors” and management imperatives.

When distribution, for example, has to stand on its own, a number of new imperatives emerge. For one, it becomes difficult to justify large training programs, since training programs are often subsidized by large manufacturing margins and lower payouts for experienced producers. Also, since proprietary products are no longer the core of customer relationships, distributors must provide a new value proposition to attract and tie customers to the firm; financial planning is often that key proposition. Payout grids must reflect the true economics of producers. As a result they become highly skewed in the favor of large producers.

To sum up, the unbundling of manufacturing from distribution forces firms to become much more efficient, much better at what they do. They must restructure themselves to capitalize on their strengths and abandon cross subsidies that allowed inefficient operations to survive. They must pick their spots: Experience suggests that the most successful players are those that focused on strengths.

Writer's BIO: Andre Cappon is president of The CBM Group, a New York-based financial services management consultancy specializing in retail investment product distribution economics. www.thecbmgroup.com