The Next DIGITAL DIVIDE

The Role of NextGen in Valuing Advisory Practices

APEX Clearing™

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Most asset managers with the temerity to break away from a major institution are driven by wanting to choose the clients they work with, employing their own investment management approach, and a desire to control their own destiny. And long term, that includes selling it for an attractive profit—a multiple of earnings that becomes the basis for the discounted cash flow analysis used to arrive at the practice's value. That's how it's done. Or is it? A Fidelity Investments study of 600 registered investment advisors surveyed in 2015 raises doubt: Only 38% of RIAs believe they understand what drives their business valuation.[1] This statistic may not bode well for advisors whose long-term goal is to monetize their practice at the highest price possible.

In today's competitive environment, the traditional valuation model is not sustainable. Instead, buyers are paying attention to the composition of the client base, and assessing value based on comparable sales. That means advisors need a multigenerational strategy, because, to put it bluntly, some clients are more valuable than others. It's such a pervasive issue that if advisors don't change their approach, the potential consequences in five years may be shocking.

PRACTICE VALUATION

	NO GROWTH	GROWTH WITHIN SAME DEMOGRAPHIC	GROWTH WITH NEXTGEN CLIENTS
5 YEARS	-3 % to -7 %	+5 % to +8 %	+14 % to +17 %
10 YEARS	-14 % to -17 %	+8 % to +12 %	+42 % to +52 %

This has less to do with assets under management and much more to do with the long-term value they deliver over time. Younger clients (often referred to as NextGen), whose assets grow and who stay with the firm for many years, deliver more revenue. This makes sense, because an aging client base can result in a sharp fall-off in assets upon their demise, unless their heirs remain with the firm.

But oftentimes, heirs do not stay. In fact, as much as two-thirds of heirs' assets can evaporate. How many advisors are prepared to withstand that kind of hit? Even longer term, most children will not stay with their parents' advisory firm, according to the data. The groups known as GenX (born in the 1960s and 1970s)[2] and Millennials (born in the 1980s and 1990s) exhibit the most significant fall-off in assets. Why does this happen?

The answer is twofold: Advisors make little attempt to connect with, market to, and deliver services to younger clients, starting with their current clients' children. The other part of the answer is failing to build a digital service component. Therefore, advisors who hope not only to stem the asset flow but also position their firms to command a top-dollar price upon sale must make a concerted effort to cement and sustain a younger client base. Developing relationships with their existing clients' children, and then deepening those relationships before the asset transfer occurs, is a good place to start. They also must attract new, younger clients by designing a service model that appeals to them, one that extends beyond mere investment management. That model must include a digital interface—it's the advisors' path to building long-term value for their firm.

[1] Value traps: overlooked opportunities to help maximize your firm's value. Findings from The 2015 Fidelity RIA Benchmarking Study.
[2] Michael Dimock, *Defining generations: Where Millennials end and Generation Z begins*, Pew Research Center, January 17, 2019.

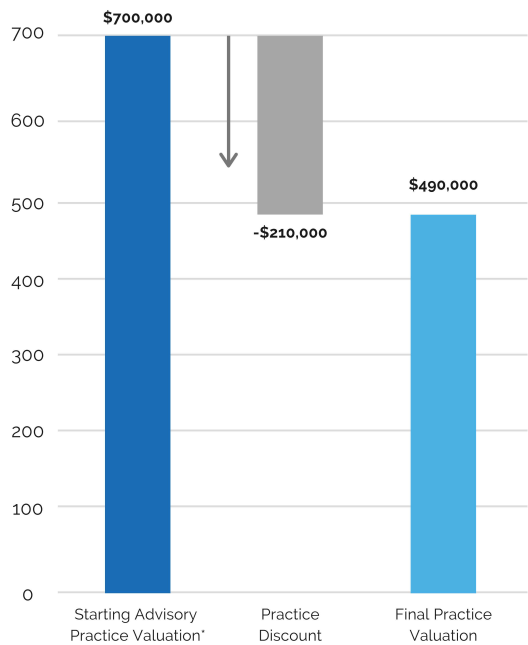
How big is the problem?

This age wave is on the horizon; and it will hit advisory practices as soon as five years, crashing down on those who are unprepared and have failed to deliver a multigenerational strategy.

Annually recurring revenue and 95% retention rates position advisory firms to capitalize on the business they've built, according to a 2017 report entitled, *FP Transitions And The Kelley Blue Book Valuation Of An Advisory Firm*, by Michael Kitces, a Partner and Director of Wealth Management for Pinnacle Advisory Group.[3] However, more recently, valuation is determined based on surveying the prices at which similar practices actually sold, akin to how real estate brokers price houses in a neighborhood that a potential buyer may be considering. This alternative valuation model is further refined by metrics such as transition risk, cash flow quality, and payment terms (all-cash transactions are typically more valuable than installment payments.) Advisors expecting to monetize their practice based on the traditional multiple-of-cash-flow method may be shocked to learn its value to a prospective buyer is less than that. Given that one-third of advisors plan to retire within the next ten years,[4] not having a strategy in place that actively seeks to attract NextGen can have painful financial outcomes, as illustrated in the chart below.

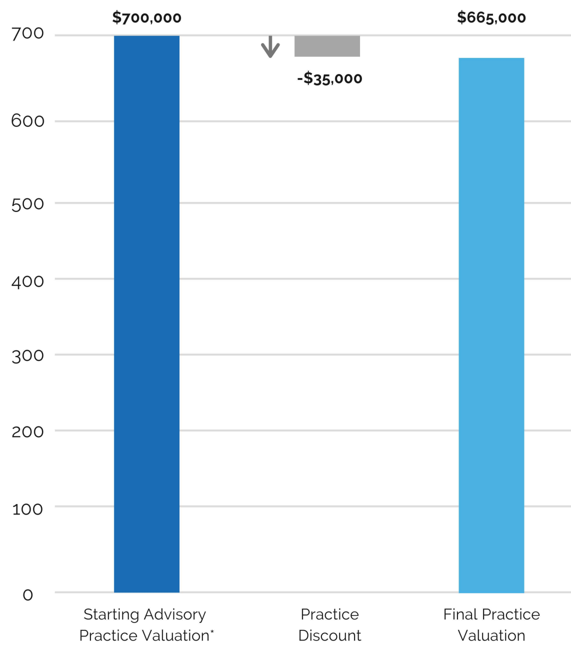
PRACTICE A

100% of clients older than 65
30% retention discount



PRACTICE B

75% of clients older than 65
25% of clients age 30 - 64
5% retention discount



NET BENEFIT FOR PRACTICE B +$175,000

*Starting valuation = 1.4x $500K trailing 12 month revenue

[3] Michael Kitces, FP Transitions And The Kelley Blue Book Valuation Of An Advisory Firm, *Nerd'sEyeView@kitces.com*, February 20, 2017.
[4] Michael Kitces, Competition For Talent And The Rising Shortage Of Next-Generation Financial Advisors, *Nerd'sEyeView@kitces.com*, September 17, 2018.

The crux of the analysis in valuing a firm this way lies in the estimated retention rate, an element of transition risk. If clients don't stick around after the sale occurs, the buyer's ongoing revenue is at risk. Although advisory firm owners are generally optimistic that their success in building and serving a client base will be amply rewarded, buyers want the reassurance of hard numbers. To protect themselves, they are examining the composition of the client base to make more realistic assumptions on the quality of the cash flow that governs the revenue stream they can expect. For example, an aging client base drawing down assets to fund living expenses is much different from a practice with a high proportion of younger clients who are still working, contributing to savings and retirement accounts, and having little or no need to tap these funds for living expenses for many years.

And assets of older clients, who may be loyal to the firm, may not necessarily transition when their heirs inherit them. Research indicates that 70% of estates run into problems, including children suing one another, resigning from trustee positions rather than being sued, or losing assets, according to a 2010 article penned by Vic Preisser and Roy Williams, lauded experts in the field of estate planning.[5] The authors explain that over time, this can erode as much as 90% - 95% of advisors' client assets.

A more recent statistic reveals that 66% of children actually fire their parents' advisor once they inherit their parents' wealth,[6] according to Liz Skinner, summarizing a survey of 544 advisors conducted by Investment News in 2015. Yet another source puts the figure at a staggering 98%.[7]

A deeper data dive may explain why. More than half the advisors surveyed by Investment News met with their clients' children less than once a year; 18% never bothered to meet with them at all, and only 1% held meetings with them more than four times a year. Nor are advisors making much effort to improve those statistics—only 20% are focused on their clients' younger family members, and only 21% express a desire to work with them at all.

An aging client base drawing down assets to fund living expenses is much different from a practice with a high proportion of younger clients who are still working.

[5] Vic Preisser and Roy Williams, The Future of Estate Planning, *Trusts and Estates*, June 2010.
[6] Liz Skinner, The Great Wealth Transfer is coming, putting advisers at risk, *Investment News*, July 13, 2015.
[7] Vic Preisser and Roy Williams, The Future of Estate Planning, *Trusts and Estates*, June 2010.

Some of this disconnect may be explained by the age gap between advisors and NextGen clients. Advisors, whose average age is 55+ (and rising)[8], with one-fifth aged 65 or older,[9] may be more comfortable working with clients closer to their own age. That advisor group's typical client is a Baby Boomer, aged 64, according to data from global consultants Simon-Kucher & Partners.[10] With only 22% of advisors younger than age 40, and only 5% of them younger than age 30, it is easy to understand the challenge advisory firms face in attracting the client base necessary to position them for maximum value.

Ongoing fees are part of the equation, but not nearly as important as the higher price an advisory practice can command when it comes time to sell because of the higher quality of cash flow. "Experts factor in the age of its clients and discount businesses whose clients are predominantly in their 70s and above," said John Furey, owner of consulting firm Advisor Growth Strategies. "Firm valuations will be higher if the adviser can show the business has a relationship with the children of their older clients, such as the younger generation having accounts with the adviser," he said. Experts also will look at the adviser's track record of retaining assets after clients die, confirmed by Tom Nally, President of TD Ameritrade Institutional, noting, "There can be a precipitous drop in revenue if suddenly clients are 72 and advisers aren't doing a good job retaining the assets or bringing in new clients."[11]

Advisors may not be targeting younger clients, but they should be. Baby Boomers (born between 1944 and 1964) now represent 30% of the population, versus 32% for Millennials.[12] The math is straightforward: Assuming an average age of 35, and a lifespan that extends to age 90, a Millennial can drive significant asset growth (and fees) for 55 years. Compare that to an average-aged Baby Boomer, who at age 64 may have just 26 years to live, and soon will be using those assets to live on. Another driver is that more than half of affluent clients expect their children will either inherit or amass at least $1 million in investable assets, and will need an advisor to help manage them. Millennials themselves state unequivocally (80%) that they wish they had "access to trustworthy retirement investment guidance."[13] That is a powerful incentive for advisors to expand their business model to include ways to attract and serve this potentially lucrative group.

[8] Liz Skinner, The Great Wealth Transfer is coming, putting advisers at risk, Investment News, July 13, 2015.
[9] Kristin Woznar, What You Need to Know About The Children of Your Wealthy Clients, *Mutualfunds.com*, April 15, 2019.
[10] Amanda Schiavo, Advisors should change fee structures to attract next-gen clients, *Financial Planning*, January 7, 2019.
[11] *Investment News*.
[12] Matt Oechsli, Why Financial Advisors Should Have Millennials as Clients, *Wealthmanagement.com*, May 6, 2015.
[13] Philip Van Dorn, "Millennials don't trust investment advisers — here's a solution," *Marketwatch.com*, May 3, 2017.

Understand the NextGen mindset

What makes NextGen (GenX and Millennials) tick? Advisors may be operating under some basic assumptions. First, that when it comes to investing, Millennials witnessed their parents lose close to half their assets in the 2008 Financial Crisis, causing them to view mainstream brands (and Wall Street in general) with suspicion. And because of that, they may shy away from investing, or limit the amount of dollars they are willing to commit to risker assets such as equities.

But the reality may be entirely different. Although 82% of Millennials say their investment decisions are influenced by the events surrounding the Financial Crisis,[14] nearly 80% plan to take on more risk, with 66% interested in equity investments. They not only are interested in equities, but data compiled on Millennials' holdings show 11.6% are invested in Amazon, 10.9% in Apple, 5.8% in Tesla, and 5.1% in Facebook.[15] GenX and Millennials combined will accumulate nearly $46 trillion in assets by the end of 2020[16], and by 2030, according to a study conducted by the Pew Research Center, Millennials themselves will account for approximately $20 trillion.[17] Nearly 40% of these combined assets will come from their Baby Boomer parents. That may make the younger clients more open to alternative ways to approach investing, and digital functionality is at the top of the list if advisors hope to retain them.

All things digital—customer-driven technology

How can advisors capitalize on customer-driven technology to build a multigenerational strategy that emphasizes attracting younger clients? Digital is more than having a smartphone, although NextGeners conduct more and more business on theirs every day. From purchasing products for instant delivery to dining options to rideshare apps (and Yelp, to pore over peer reviews and rate purveyors all in a nanosecond), digital functionality has exploded. NextGeners were weaned on technology, and they prize instant accessibility. Many of them trust technology more than humans and demand engagement and content that is simple to understand and execute. The equity-holdings data cited above is proof that NextGen relies on technology and is open to solutions from companies that include Amazon, Apple, and Facebook, among others. If a need exists, an app is available to fill it. Or soon will be. Advisors who do not recognize this need, and adjust their practices to meet it, face a severe risk in diminished practice value.

[14] Ryan Vlastelic, "Millennials are finally warming up to the stock market," *Marketwatch.com*, June 6, 2017.
[15] Apex, Next Investor Outlook, 2019, https://go.apexclearing.com/apex-next-investor-outlook-q22019-top100stocks
[16] E&Y Report 2016.
[17] Monica Melton, "By 2030 Millennials Will Have $20 Trillion In Wealth. Here's What They Want In Robo-Advisors," *Bank Innovation*, July 27, 2018.

When we think about digital solutions, we generally conjure up automated investment advice and applications. But digital is much more broad-based, going beyond selecting risk-based models and making on-line trades (although nearly $500 billion of digital investments assets is expected by 2020).[18]

The basic services clients expect to receive from a digital experience range from receiving information, including portfolio updates and research, to executing transactions, transferring money, and holding meetings with their advisors. In today's 24/7 world, clients (of almost any age) won't stand for staying on hold to get an answer to a question. They want it now.

NextGeners take advantage of digital functions for a plethora of uses: They schedule meetings, update their balance sheet, track their spending, read blog posts when stuck in traffic, view video recordings of market conditions, attend webinars, trade digital currency, invest in fractional shares, and track their progress in reaching goals. They use a myriad of applications, with more being introduced all the time.

A growing group of younger clients won't transact business any other way. They want access anytime, anywhere, via their smartphone or tablet, with engaging, interactive, user-friendly, and navigable toolsets to deliver the information and functionality they need. If Bitcoin, for example, makes a major move, they're on it—they don't have time to make a call to a brokerage firm. And if they are financially constrained in purchasing one of the FANG stocks, they may view buying fractional shares for $5 or $10 as a solution. If they lean green, or wish to align their values with their investments to benefit society or the environment, they want the most up-to-date analysis of environmental, social, and governance (ESG) investment opportunities at their disposal. If they need to meet with their advisor, they want an app that lets them schedule a convenient time. If they cannot attend a conference, they want the ability to view it afterward on a smartphone or tablet. If they are applying for a loan or mortgage, they want the paperwork delivered electronically and to be able to complete it on line. And if they are a new client, they demand a streamlined onboarding process, including e-signing functionality, bypassing the archaic slow, manual process at all costs. In short, they want speed, efficiency, engagement, and flexibility.

> **In today's 24/7 world, clients (of almost any age) won't stand for staying on hold to get an answer to a question. They want it now.**

Digital by the numbers

Taking a step back, it's astounding how much life has changed in the 12 years since smartphones burst upon the technology scene in 2007, bringing heightened demand for digital solutions for different age groups, wealth levels, and geographies. Even savvy Baby Boomers see the wisdom of paying bills through a banking app. Ordering products, making dining reservations, and ensuring a ride is at the ready are all functions we've come to expect and use almost on a daily basis, and woe is the company that fails to deliver a quality customer-facing experience. Financial advisors are among the most-often cited as being deficient in that regard, offering less-than-stellar mobile and online capabilities that may stymie NextGen client satisfaction.[19] A mere 11% of clients say they are 'very satisfied' with their advisors' mobile offerings, and their website satisfaction rates just 14%. But those statistics, poor as they are, tell only part of the story. Advisors appear not to understand just how vital these issues are to clients: Of 500 advisors surveyed, only 27% said their firm's mobile platform was either 'very' or 'extremely' important to clients.

[18] Fidelity.
[19] Corporate Insight.

Their clients beg to differ—57% of Millennials think it is vital to access their account on a mobile platform, and 80% of those under age 40 would consider leaving their advisory firm if a digital interface were not available. High-net-worth clients are demanding digital solutions, too, according to a 2014 report issued by CapGemini and RBC.[20] Of those with at least $10 million in investable assets, 74% expect to have a primarily digital relationship with their advisor in five years (meaning now), and two-thirds of all high-net-worth clients would view the lack of a digital solution as justification for leaving their advisory firm. And 57% of those aged 40 and above would consider seeking advice elsewhere if they do not receive it.

Savvy advisory firms know that a digital capability is not optional—it's mandatory if they are to both retain existing clients and attract the NextGen client base that will drive the highest monetary value for their firm when it's time to sell. A 2017 study of 1,000 investors conducted by AMG Funds appears to confirm just how important a digital-advised solution is. First, Millennials are much more aware of digital solutions (66%) versus Baby Boomers and older investors, of whom only 4% are familiar with the concept. Second, 71% of Millennials are intrigued by the idea of digital advice options, contrasting with the older group, 82% of whom find it not at all appealing. Finally, Millennials constitute 68% of those who use digital investment advice, versus only 2% of the older group.

Different uses for different users

A digital solution set won't be the same for every client. For example, some clients may embrace digital for most or all of their needs, including depositing checks on their smartphones, executing investment (and fractional share) transactions, trading cryptocurrency, and obtaining the latest market data. They need an interface that is intuitive, thoughtful, and responsive, running the gamut from basic budgeting to video conferencing. Others will prefer a hybrid option, performing the basics on a digital interface, but still wanting a 'live body' at the other end of the phone to bounce ideas off of, measure their progress in achieving goals, or discuss an alternative investment strategy. A third group may insist on the traditional, hands-on approach, using basic digital functions to conduct only the most basic transactions, if they use digital at all.

Although the users vary in how they use digital, the benefits appear to be widespread: The AMG Funds study recounts a few: 67% cited cost savings, 58% like the unbiased advice offered, and 57% appreciated the flexibility to engage at a time of their choosing, rather than being dependent on an advisor's calendar and office hours.

[20] *World Wealth Report 2014*, CapGemini and RBC Wealth Management, June 18, 2014.

However, digital advice also has some drawbacks among users. The AMG Funds study shows that 81% of respondents thought the advice was more of a cookie-cutter approach; 80% expressed skepticism that the information generated may not be of the highest quality; and 78% saw the lack of a dedicated contact to be a serious shortfall. Even so, respondents are embracing digital solutions, so advisors must tailor an approach that does more than deliver investment advice. For example, it can be broadened to curate client-specific, timely content such as a checklist for students heading back to school, with roommate-finding options or local dining and entertainment choices. It could be a newsletter with geographically germane communication, like information on ski trips for clients with an active lifestyle, or entertainment-focused, if the client is a jazz enthusiast, or regular blogs to foster deeper client/advisor engagement. The content doesn't need to be original, but it should be thoughtful and relevant to specific client issues and interests. According to Vanguard, clients who feel "engaged" with their advisor tend to invest twice as much and refer new clients twice as often, another vital step on the ladder to increasing advisory practice value.[21]

A service model for NextGen

No smart advisor believes that plying younger clients with a digital toolbox, no matter how compelling, is the entire solution set. Instead, advisors may want to take a couple of steps back to do some basic preparation by having discussions with parents about wealth transfer. If advisors haven't yet met the heirs, they can schedule family meetings to help everyone understand the process and the role children may be expected to play, and observe the family dynamics. Explain how the estate settlement process works, and how an executor, trustee, and the beneficiaries interrelate. Ask the children what topics concern them, and include their values, philanthropic goals, and education plans for future progeny. Observe what may be below the surface in sibling relationships. If there is unrest, advisors can bring in a family coach to help resolve tension. In most cases, these problems surface as a result of a breakdown in trust and communication, according to Amy Castoro, CEO of The Williams Group.[22]

If they are at a loss as to how to move forward, advisors can take advantage of training, such as a workshop offered by the Institute for Preparing Heirs.[23],[24] Advisors who demonstrate empathy for each child's needs and target follow up accordingly are doing the important spade work in preparing for a seamless asset transition, sowing the seeds to ensure both the heirs and the assets they bring will stay with the firm.

Another strategy to retaining younger clients is to hire advisors close to their age. For one thing, junior advisors speak the NextGen lingo and are in a good position to understand how they think. Not only do younger advisors tend to develop a closer rapport with clients of a similar age, but their use of and preference for social media and digital tools mean they can have greater outreach. For example, posting on Facebook ensures exposure to their clients' friends and contacts. Second, a younger advisor, positioned for the long term, inspires confidence that a stable relationship is in place to meet the client's current and future needs, versus working with a seasoned advisor who may have retirement in his sights. All of this accrues benefits to the advisory practice's valuation, because it puts a succession plan in place that can help ensure a long and lucrative revenue stream.

[21] Driving Engagement, Driving Growth, AdvisorImpact.co.uk, https://www.vanguard.co.uk/documents/adv/literature/practice_management/adviser-impact-driving-engagement.pdf.
[22] Carol A. Sherman, "The Great Wealth Transfer," Wealthmanagement.com, April 12, 2019.
[23] https://www.preparingheirs.com/
[24] https://www.phase3.biz/core/uploads/heirs/images/3HalfHrWorkshopBrochure2192019.pdf

Advisors reap other benefits, too

A digital-based service model, attuned to the needs of clients at all age levels, positions the practice to generate the higher valuation needed to attract a potential buyer. But advisors also benefit in other ways.

One issue advisors face is fee compression. The proliferation of ETFs and exploding digital technology makes it easier for advisors to provide low-cost investment advice. Whereas as recently as ten years ago it was fairly common to command a 1.25% all-in fee, those days are gone, supplanted by fees that are a fraction of that amount. In spite of that decline, investors queried on their top three complaints about their advisor cited 'fees are too high' at the top of the list, according to a 2015 study conducted by Corporate Insight.[25]

Digital solutions help to keep fees manageable. Digital functionality lowers the cost of doing business, by reducing transaction costs and generating operating efficiencies which can be a counterweight to the ongoing downward pressure on fees. One example is video conferencing. In-person meetings consume a lot of time, and even more so if travel is involved. Apple's FaceTime app and Skype permit face-to-face interaction at a fraction of the cost. Millennials appear to prefer meeting this way, with 63% saying they would either probably or definitely use it if their advisor offered it.[26]

Finally, tailored communications help advisors deepen relationships by engaging with their clients. At the same time, communications create a digital footprint when clients share content with another family member or a friend, paving the way to a potential new prospect. When clients post content on their social media sites, it can result in even wider distribution, looping back to the advisory firm's digital presence and website.

[25] "The Changing Face of Financial Advice: 2015 and Beyond," Corporate Insight, 2015.
[26] Corporate Insight.

The path forward

Advisors who fail to implement a multigenerational strategy may discover the value of their practice is at risk. The landscape has evolved to a valuation model based on comparable advisory practice sales, similar to how real estate sales are priced. Research shows that advisors' income could suffer from attrition if they fail to create and implement strategies to attract and engage the NextGen, maintain a service model that reflects an understanding of their needs, and communicates in a way that is comfortable for them. Digital solutions are key to that model: They build a bridge to younger clients, offer support to existing ones, and help perpetuate a longer, dependable, and more valuable revenue stream.

Building a digital capability demands an upfront investment in technology and tech-savvy staff, but it will pay attractive dividends. Not only can advisors handle more clients and probably spend less time doing so, but their practice will benefit from greater operational efficiencies. For example, compliance and other back-office chores can be standardized, with pop-up reminders when updated paperwork or action is due. And advisors can customize and tailor targeted communications such as blogs and educational messaging to keep their clients informed, and videos that resonate with their touchpoints. Most important, customized digital functions can attract and retain a loyal NextGen client base that will drive higher practice value.

Advisors should begin by creating a timeline to implement a digital capability, based on the firm's growth strategy. It includes defining goals that focus on what their clients need, and the technology required to serve them.

Advisors should then select a provider with a record of building innovative and integrated solutions that have helped advisory firms transition to digital efficiently and profitably. That way, advisors can not only give their clients the experience they want now, but keep them (and the higher-value revenue they generate) for years to come. And when it comes time to sell their practice, the investment they made in building a digital experience will pay handsome rewards and ensure a lasting legacy.

Compliance and other back-office chores can be standardized, with pop-up reminders when updated paperwork or action is due.

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Ron also had senior product management and development roles at Fidelity Investments where he was responsible for investment products at both National Financial and Institutional Wealth Services, and at Pershing, where he also started and ran Pershing INSITE, one of the largest conferences of its type in the industry.

Ron earned a Bachelor of Arts degree in History from Columbia University and a Master of Business Administration degree in Finance and Accounting from Cornell University. He holds FINRA licenses 4, 7, 8, 24, 53 and 63.

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Hannah Shaw Grove has held leadership positions across financial services and financial technology, focusing on growth, strategy and transformation while publishing prolifically on topics relating to private wealth creation and management, advisory best practices and alternative investments. In her role as Chief Revenue Officer at Apex Clearing, Hannah is responsible for overseeing all marketing, sales, business development, and revenue operations functions. She is focused on driving new client acquisition while accelerating growth and reinforcing Apex's position as a leader in digital wealth.

Before joining the firm, Hannah was CMO at iCapital Network, a financial technology platform that simplifies access to alternative investments. Prior to that, she spent eight years consulting private clients and family offices while conducting and publishing seminal research on the high-net-worth markets.

Hannah is the author of 11 books such as, *The Sky's the Limit: Marketing Luxury to the New Jet Set* and *Fame & Fortune: Maximizing Celebrity Wealth.* She is a founder of *Private Wealth* magazine and has been a regular contributor to Forbes.com, *The Robb Report, Worth,* and other well-known publications. Previously, Hannah was Managing Director and Chief Marketing Officer of Merrill Lynch Investment Managers (acquired by BlackRock) and held strategic management roles at Prudential Financial and Fidelity Investments.

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About Apex Clearing Corporation

Apex Clearing is a custody and clearing engine that's powering the future of digital wealth management. Our proprietary enterprise-grade technology delivers speed, efficiency and flexibility to firms ranging from innovative start-ups to blue-chip brands focused on transformation to capture a new generation of investors. We help our clients provide the seamless digital experiences today's consumers expect with the throughput and scalability needed by fast-growing, high-volume financial service businesses. Founded in 2012, Apex Clearing is registered with the SEC, a member of FINRA and a participant in SPIC.

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