

Options for Independence[®]: content, coverage, and investment access

Introduction

Meeting the financial needs of today's high-net-worth individuals often requires use of a range of investment products and services outside more traditional mutual funds and individual securities. As clients look to their financial advisors to find the most appropriate solutions, with an emphasis on risk-adjusted performance, having access to high-quality research and money management capabilities that span the investment spectrum is paramount.

Many brokers with full-service firms are attracted to the independent advisory model, which promises more autonomy and control and the ability to build a valuable asset that can potentially be monetized. At the same time, however, some worry about losing access to the resources needed to support their clients' investment demands should they break away. This may be especially true for larger teams that use an array of more sophisticated products.

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Interviewees

RIA FIRMS

Constellation Wealth Advisors LLC

Launched in 2007
~\$4.5 billion AUM

HighTower

Launched in 2008
~\$20 billion AUM in total for RIA practices that are part of the firm

Luminous Capital, LLC

Launched in 2008
~\$4.4 billion AUM

INVESTMENT PROVIDERS

Goldman Sachs Asset Management

Provides mutual funds, separate accounts, and access to hedge funds, private equity products, economic and market insights

Kohlberg Kravis Roberts & Co.

Provides private equity products, energy and infrastructure opportunities, credit strategies, a newly launched hedge fund, access to initial public offerings (IPOs)

SumRidge Partners, LLC

Provides content, coverage, and execution for fixed-income products

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But is this concern warranted? Will access to investment capabilities be more restricted in the independent channel? Will advisors' ability to service their affluent clients and grow their business be hindered?

The purpose of this paper is to help address this concern by looking at the breadth and depth of investment content and coverage that can be accessed by independent registered investment advisor (RIA) firms, including the range of investment vehicles, research capabilities, consultative services, and ongoing support available in this channel.

The content presented in this document is based on the experiences of Constellation Wealth Advisors¹ and Luminous Capital, RIA firms formed by advisors previously with full-service firms, and HighTower, a strategic acquirer enabling experienced advisor teams to join a national advisor-owned firm where they enjoy autonomy over investment decision making and all aspects of client relationships while having their infrastructure and support needs handled by a central organization.

The content is also based on interviews with three third-party firms focused on the RIA space: Goldman Sachs Asset Management (GSAM), Kohlberg Kravis Roberts & Co. (KKR),² and SumRidge Partners. Together, they provide access to investment management products, hedge funds, private equity offerings, structured products, IPOs, fixed-income products, investment research, execution services, and more. While many other players cover the RIA market, these three serve as examples of the range of capabilities that are available. These firms are

not affiliated with Fidelity Investments (Fidelity) and mentioning them does not constitute an endorsement.

I. Growth drives interest in independents

COMPETITION HEATS UP TO MEET RIA DEMANDS

According to Cerulli Associates, the RIA and dually registered channels experienced the greatest growth over the past five years.³ This growth has captured the interest of many product and service providers, resulting in the creation of a wide range of RIA-specific offerings—from compliance tools to portfolio reporting software, investment solutions, and more.

“There is increasing competition in the market to serve independent advisors on many fronts given the growth of this segment,” says Kevin Morano, co-founder of SumRidge Partners. This growth was one of the driving forces behind he and his partner, Tom O'Brien, leaving a full-service firm in 2010 to form a wealth management focused fixed-income firm. “We thought many RIA firms would be looking to lean on fixed-income experts for this portion of their asset allocation strategies,” explains Morano. SumRidge provides tactical ideas, access to inventory, support to review or construct a portfolio, and execution services.

¹The third-party firms mentioned in this document are not affiliated with Fidelity Investments. Listing them does not constitute an endorsement. Both HighTower and Luminous Capital are Fidelity clients. The experiences of these two firms and of Constellation may not be representative of your experience.

²Fidelity has a relationship with KKR that allows Fidelity's retail and institutional brokerage customers the opportunity to participate in IPOs and follow-on offerings of KKR companies, while providing KKR's capital markets business with a new retail distribution channel.

³*Cerulli Quantitative Update: Advisor Metrics 2011*, Cerulli Associates.

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“We are bringing institutional coverage to wealth advisors.”

*– Kevin Morano, Co-founder,
SumRidge Partners, LLC*

Many others are also focused on providing RIA firms with the content and coverage they need. For example, GSAM made a strategic decision to significantly expand its presence in the area. “It was clear that independents were a growing segment,” says Steve DeAngelis, who runs this channel of business for GSAM. “Our group can meet their demands for both traditional and alternative offerings, as well as serve as a conduit to other parts of our company for more sophisticated products and services.”

KKR is in the independent space as well. Jim Burns, head of the high-net-worth business at the firm, came from a wirehouse specifically to execute a strategy to deliver their products to a wider audience. “I’m looking to expand upon our current programs,” Burns says, “by providing RIA firms access to our global private equity vehicles, energy and infrastructure opportunities, real estate products, credit strategies, and hedge fund business.”

“Competition results in better service and economics and, ultimately, better offerings,” says Mike LaMena, Chief Operating Officer at HighTower. “That plays out across a range of capabilities for advisors, including investment solutions, research, and consulting.”

II. Ready access to investment vehicles

A BROAD SPECTRUM OF NEEDS

While most advisors hold the majority of their client assets in mutual funds and individual securities,⁴ having access to a wider range of capabilities is particularly important for larger breakaway teams, according to the interviewees.

Typically serving an affluent client base, their asset allocation strategies may include domestic and international equities and fixed-income products, mutual funds, exchange-traded funds (ETFs) and notes (ETNs), separately managed accounts (SMAs), hedge funds, private equity vehicles, structured notes, options, and commodities. For example, Luminous Capital looks across all asset classes to identify opportunities with an asymmetrical risk-reward profile. “Our clients are wealthy already, so we strive to preserve their wealth,” says Kim Ip, Partner.

“As an independent, the entire investment industry is our platform.”

*– Paul Tramontano, Co-Chief Executive Officer,
Constellation Wealth Advisors*

The sections that follow look at the availability of a selection of products for RIA firms.

⁴Cerulli Quantitative Update: Advisor Metrics 2010, Cerulli Associates.

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A VAST OFFERING FOR RIA FIRMS

According to the interviewees, both traditional and alternative investment products can be accessed from many different sources. These include:

- Forming relationships directly with money managers.
- Using third-party platform providers that have conducted their own research on money managers and created a consolidated offering.
- Tapping into capabilities of custodians, which may include access to mutual funds, equities, fixed-income products, SMAs, alternative investment funds, options, and more.

Many RIA firms use a combination of the three. “We help our advisors leverage all the different access points,” says LaMena. “We typically start with our custodians and then see how we can supplement that to find the best solutions for the end client.”

According to Cerulli Associates,⁴ when choosing a “service agent,”⁵ 67% of RIA firms with AUM of \$1 billion or more say the product platform was an important decision factor. Of these firms, 73% use their service agents for trade clearing and settlement, 27% for access to separate account managers, and 9% for access to structured products, IPOs, and banking capabilities.

EXTENSIVE COVERAGE AND LIQUIDITY FOR EQUITIES

Many RIA firms use their custodial platforms when they need to trade equities. This offering includes access to domestic and international securities, block trading, and an extensive liquidity pool.

“HighTower advisors connected to Fidelity have absolute confidence in the breadth and depth of capabilities Fidelity brings to bear managing best execution,” says LaMena. Fidelity Capital Markets (FCM)⁶ monitors execution quality against competitive benchmarks that include execution speed, price improvement, and percentage of shares executed at or better than National Best Bid and Offer (NBBO). The sole purpose of the order flow management team within FCM is to direct order flow to the best-performing market centers.

⁴Custodians like Fidelity Institutional Wealth Services that specifically serve the RIA space and provide a range of products and services in addition to clearing and custody.

⁵Fidelity Capital Markets (FCM) is the institutional trading arm of Fidelity Investments, providing trading, products, and services to a wide array of clients and Fidelity businesses.

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Advisors also have the option to trade with their broker of choice and can obtain institutional-level coverage from numerous firms, according to the interviewees. For Fidelity clients, prime brokerage services enable advisors to execute block trades for equities and fixed-income securities using another broker-dealer, while settling the trade through allocations into individual investor accounts custodied at Fidelity.

Securities lending services are also available with 27% of RIA firms with AUM of \$1 billion or more using their service agents for this capability.⁴ A fully paid lending program is available through Fidelity⁷ that enables users to loan to Fidelity certain fully paid or excess-margin securities that Fidelity desires to borrow. In return, users gain the opportunity to earn incremental income on their portfolio through the securities lending market.⁸

COMPETITIVE PRICING FOR FIXED-INCOME PRODUCTS

When looking for fixed-income opportunities for clients who want to hold bonds directly versus through a fund, the Luminous team typically contacts three to five dealers to get competitive bids. This opens up many more choices than they had at a wirehouse, helping the firm obtain attractive pricing. “At the wirehouses, you can only go through their trading desk,” says Ip. “If they have the bonds in inventory, you may or may not be getting the best bid.”

“A lot of wealth advisors think they won’t get best execution if they leave a wirehouse. I think they will get better execution as there will now be additional competition for their trade flows.”

*– Kevin Morano, Co-founder,
SumRidge Partners, LLC*

Constellation is both an RIA firm and a broker-dealer and, as such, has access to the range of fixed-income products on the street. “Not only are we not captive to a desk, but in most cases we are talking directly to the internal traders that the big firms are talking to,” says Paul Tramontano, Co-Chief Executive Officer.

“HighTower is also a hybrid firm,” says LaMena, “that created a Capital Markets Service Team to support the complex trading needs of advisor partners. The desk does not take balance sheet risk or hold inventory, and is aligned with the interests of the advisor and their end client to seek out best execution, value-add services, and investment solutions by engaging numerous counterparty relationships, including the specialists inside Fidelity Capital Markets.”

⁷This reference to Fidelity includes National Financial Services LLC (“NFS”) and Fidelity Brokerage Services LLC (“FBS”), Members NYSE, SIPC.

⁸Securities on loan are not covered under the provisions of the Securities Investor Protection Act of 1970 (SIPC).

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“Fidelity also has a vast Capital Markets area and a large balance sheet of its own holdings that we can leverage with our advisors,” says LaMena. The dedicated fixed-income trading desk of FCM is a principal trading desk that takes market risk and carries positions in order to facilitate client needs. It trades all types of fixed-income products in the secondary market and underwrites many in the primary markets, providing access to a range of new issues. It has its own inventory, traders, and sales professionals, plus an electronic portal.

SUPPORT FOR STRUCTURED PRODUCTS

There are numerous solutions for advisors working with clients who hold large concentrations of stock, or who are looking to gain customized exposure to various asset classes. Many Wall Street firms support advisor demand for structured products. FCM also offers a multi-issuer platform that provides users with access to a complete suite of structured products. In addition, for structured equity strategies, FCM provides a range of equity hedging and monetization solutions, including equity option collars, and variable prepaid forward contracts.

In addition to using their custodians and several full-service firms that have large structured product groups, HighTower works with a number of aggregators. “Aggregation points have been fantastic for us for accessing prepackaged solutions when we want to pull something right off the shelf,” says LaMena. In addition, many of the firm’s advisors are looking to diversify by guarantor of the debt, not just by basket. “With the broad access they have available in the independent space,” says LaMena, “they can diversify their exposure across numerous issuers to help safeguard their portfolios.”

“Our study shows that access to hedge fund managers in the independent space is an improvement for wirehouse advisors.”

*– Mike LaMena, Chief Operating Officer,
HighTower*

ACCESS TO MANY HEDGE FUND MANAGERS

RIA firms can tap into a large number of hedge funds, according to an in-depth analysis recently completed by HighTower.⁹ The comprehensive study was initiated to show brokers with full-service firms they could still choose from a selection of top managers if they went independent.

Based on its research, HighTower was able to confirm that independent advisors have significant access to the same hedge fund managers available at full-service firms, and to many more as well.

“On average, full-service firms offer access to 15 to 20 hedge fund managers, while independents can choose from potentially 50,” says Matthias Kuhlmeier, head of Group Investment Solutions at HighTower. “And asset managers are ramping up their efforts to work with RIA firms. Asset managers were putting their primary focus on independents 73% of the time in 2010, compared to 46% in 2008, and it is one of the few channels where asset manager efforts increased rather than decreased.”

The Luminous team feels this flexibility to choose from a wide array of managers and styles helps them deliver highly effective investment solutions for their clients. “When we choose hedge funds, we can either take a rifle shot approach, accessing a manager who focuses on a very narrow set of the market we believe is dislocated, or we can choose one with a broader mandate,” says Ip.

⁹“Redefining the Horizon: Shedding Light on Independent Advisor Access to Hedge Funds,” by Matthias Paul Kuhlmeier and Colin Healy, www.hightoweradvisors.com.

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“We often use boutique fund managers that have a focus on generating alpha versus raising assets.”

*– Kim Ip, Partner,
Luminous Capital*

ACCESS TO MANY PRIVATE EQUITY FUNDS

There are also many private equity choices available, with offerings that span numerous countries, sectors, and industries. Strategies may include leveraged buyouts, growth financings, venture capital, distressed securities, and more. Again, HighTower uses an aggregator to tap into certain private equity vehicles.

A RANGE OF OTHER INVESTMENT VEHICLES

From plain-vanilla investment products to more sophisticated offerings, there is ample choice in the independent space, according to the interviewees. “The offerings are vast,” says LaMena. “We even have providers that are interested in collaborating with us to define the investment solution sets.” On the alternative front, one firm is re-creating the feeder fund structure of the wirehouses for the independent space and is working with HighTower to identify the managers their advisors want to see included. “They look for best-of-breed providers to put on their platform rather than managers who may be willing to discount their pricing,” explains LaMena.

CONSULTATIVE SERVICES

Many money managers also leverage their internal think tanks and their ongoing work with large institutional clients to support advisors in a highly consultative fashion to help construct portfolios or handle other investment issues. SumRidge is seeing demand from advisors looking for a review of their fixed-income portfolios to identify any potential concerns with their allocations. Heightened fiscal problems in the municipal market have been one recent driver of this trend. GSAM has a dedicated Portfolio Construction Services team that helps it fulfill a need in the RIA market for providing customized analysis of RIA investment models and the sharing of its insights on concepts such as including alternative allocations in portfolios or managing portfolio volatility through advanced diversification strategies.

Constellation often forms relationships with specialists in the alternative space. “We work with a firm that is a large hedge fund of funds, for example,” says Tramontano. “They help us with sourcing new ideas and thinking about exposure in the funds we have invested in, which is very helpful.”

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III. Flexibility to choose

INDEPENDENTS CAN SCOUR THE MARKET

According to the interviewees, being independent provides the freedom to try and find the most appropriate investment solutions to meet client needs. “It’s not people working in isolation to create and deliver a product, hoping it works for advisors,” says LaMena. “HighTower advisors collaborate with our middle office to craft solutions for our clients.”

“HighTower advisors actively innovate with our teams to design and implement investment solutions for our clients.”

*– Mike LaMena, Chief Operating Officer,
HighTower*

Ip agrees. “Our ability to build partnerships with leading managers we couldn’t access when we were at a wirehouse is a key differentiator,” she adds. It is also something the Luminous team clearly points out in prospect meetings. Because many of the managers they work with are boutiques, they wouldn’t generate the flows needed for a wirehouse to put them on their platform. Yet these smaller managers may be very astute in their area of expertise.

“At wirehouses, advisors are captive to whatever third-party managers the firm decides to put on its platform,” adds Burns. “As a result, many world-class managers are not offered.”

SUPPORT FOR DUE DILIGENCE

Of course, choosing the appropriate manager(s) for an investment strategy from the wide array of available options requires a thoughtful selection process. HighTower has taken the vetting process of investment content offered to clients to a different level, utilizing independent providers for in-depth operational and investment due-diligence—providers that usually were only available to institutional investors. In addition, all investments receive a final review in-house. “Solutions and products are sourced and introduced by HighTower partners using active committees,” says LaMena. “Rather than relying on a forced distribution network, our partners are involved in sourcing what we believe is good for our clients.”

Both Constellation and Luminous handle due diligence internally. For Luminous this includes having conversations with managers to assess their holdings, investment approach, and performance, in addition to more operational issues. “We were a large team when we left the wirehouse, so we had the infrastructure to handle manager due diligence on our own,” says Ip. “You can outsource your due diligence, however, and there are a number of well-established firms focused on working with advisors in this capacity.” In addition, many platform providers incorporate a due diligence process that can be used to supplement internal efforts.

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IV. A multitude of investment research

EXTENSIVE COVERAGE

While brokers at full-service firms are used to having access to a lot of investment research, there may be even more available in the independent channel. This can include sell-side research obtained through relationships with brokerage houses, buy-side research obtained through relationships with money managers or purchased from a variety of third-party firms, or a combination of offerings provided by custodians.

“Our goal is to help advisors make sense of the markets by offering access to the insights from economists, market strategists, portfolio managers, and other specialists inside Goldman, Sachs & Co.”

*– Steve DeAngelis, Managing Director,
Independent Advisor Channel,
Goldman Sachs Asset Management*

RIA FIRMS USE MULTIPLE OFFERINGS

For example, HighTower offers a comprehensive research pool which consists of sourcing investment content from the major players on the sell-side, well-known independent providers for global, macro, and technical content, as well as idea-sharing among HighTower partners. “The myth that advisors with full-service firms have the only or best access to research is simply untrue. At HighTower, our advisors joining us from the traditional brokerage firms are blown away at the breadth and depth of content they have access to. In many cases, this includes the exact same research content they utilized at their former firm,” says LaMena.

Constellation uses a research consolidator and also subscribes to several economic research firms. “With the proliferation of information on the Web today,” says Tramontano, “finding research on the areas of interest to our firm is not an issue at all.”

The Luminous team focuses on buy-side research, and they feel they get good institutional coverage given their size. When it comes to thought leadership, however, they say the real competitive edge comes from the ability to reach out to the managers they invest with to discuss market developments and how these managers are reacting and adjusting their investment strategies in response. “This is a big advantage we have over wirehouses,” says Ip. “Our entire portfolio benefits from these in-depth discussions.”

“We have access to many money managers who are thought leaders. At the wirehouse, we only had the house’s views.”

*– Kim Ip, Partner,
Luminous Capital*

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V. Dedicated support

IT'S A RELATIONSHIP BUSINESS

According to the three third-party providers interviewed for this paper, delivering high-quality support to RIA clients is a top priority. “It’s very important,” says Morano. “Large wirehouse teams are used to picking up the phone and speaking to someone knowledgeable.”

The RIA firms interviewed for this paper see this in action. “We have a relationship with our managers,” says Ip. “There is a point of contact and frequent interactions.” HighTower agrees. Providers—be they managers, platform providers, or custodians—are looking to establish long-term partnerships and strong, ongoing support is essential.

VI. Additional benefits of independence

ASSETS CAN BE POOLED

While many money managers have large minimums, they typically treat the RIA firm itself as the client. This enables firms to pool assets in increments that make sense for each of their individual investors to take advantage of the offering.

OPPORTUNITIES TO BE CREATIVE

At an RIA firm, there is also much more flexibility to make tactical moves that would be more difficult to do at a full-service firm, according to the interviewees. In a difficult economy, advisors may choose to reallocate their model portfolios, moving a large portion of client assets into cash. Strategists at the full-service firms tend to make minor changes in asset allocations, the interviewees say.

In addition, there are often creative things that can be done with pricing when an advisor has a direct relationship with a manager.

ABILITY TO BE NIMBLE

The interviewees point out the ability to be much more nimble in the independent space because RIA firms typically aren’t bound by legacy architecture that can impede their progress. According to Luminous, one important area where this is very evident is with performance reporting. “When we were at a wirehouse, the reporting was very limited,” says Ip. Her team spent many hours customizing formats and doing manual entry. When they went independent, they began using advisor-based software that fully automated the process, saving an enormous amount of time that can now be devoted to client and prospect interactions.

“We are also nimble in looking into the marketplace for opportunities,” adds LaMena. “Having experienced the bigness of the large wirehouses, I’ve seen us being able to move faster to take advantage of providers and integrate them into our business.”

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VII. Summary

Should large teams at full-service firms looking at the independent channel have concerns about the availability of investment content and coverage to service their clients? The interviewees think not.

“As an independent, we have the ability to look across the entire investment spectrum on behalf of our clients.”

*– Paul Tramontano, Co-Chief Executive Officer,
Constellation Wealth Advisors*

There are many myths in the marketplace about what is or is not available in the independent channel. Yet RIA firms have the freedom and flexibility to look beyond more captive solutions and work directly with managers, third-party platform providers, and custodians to help meet their clients' needs.

“After having shown promising growth over the last several years, the RIA channel has become the apple of many a product manufacturer’s eye,” according to Cerulli Associates.⁴ From investment vehicles to research, support, and execution services, the independent channel offers many choices for today’s advisors looking for a vast array of products and services to support client relationships and help grow AUM and revenues.

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