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Thought Leader Series

The Illusory Recruiting Check:
What's Next For Wealth Advisors

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CHAMPION OF THE INDEPENDENT ADVISOR

The wealth advisory business model at wirehouses and big banks is broken.

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Founded by a team of former Wall Street executives and independent wealth advisors, Sanctuary serves both breakaway advisors and established wealth management firms. Sanctuary is an independent wealth advisory firm committed to delivering wealth management solutions that are always in the best interests of clients.

For breakaway wealth advisors, Sanctuary provides a complete set of investment solutions, business support services and consulting expertise that allows them to break away from an existing firm and become a more profitable, independent entity.

For established wealth management firms, Sanctuary provides a full menu of business support and back-office services, along with world-class investment solutions targeted specifically for independent wealth managers and their clients.

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THE ILLUSORY RECRUITING CHECK: WHAT'S NEXT FOR WEALTH ADVISORS

SUMMARY

Recruiting checks used to be one of Wall Street's most effective weapons in hiring top producers. Today, those lucrative incentives to switch firms are harder for advisors to earn as wirehouses and big banks apply virtually impossible terms and conditions. As a result, few will realize the full award. The illusion of the recruitment check, coupled with growing uncertainty and sometimes an unfriendly work environment at embattled firms, is prompting many advisors to consider a more profitable alternative for themselves and their clients – going independent.

PART I - **Why the check is *not* in the mail**

Is your recruiting check as big as you think?

These days, it pays for wealth advisors to look at the fine print closely before signing on the dotted line. While wirehouses and commercial banks are promising bigger and bigger recruiting checks to lure advisors, it's unlikely that advisors will ever see all of the promised bounty.

The Game Has Changed

The economics of advisor recruiting checks, which are structured as forgivable loans to advisors, have changed dramatically in the aftermath of the financial crisis.

It was once a no-brainer for both firms and advisors to play the recruiting check game because it was beneficial for everyone. For advisors, it made perfect sense to take a six- or seven-figure recruiting check and change firms every five years. For firms, ever increasing profits meant there was no need to scrutinize the large recruiting payments, even if they were a questionable economic proposition.

Now, the ground rules have changed for both firms and advisors because of profitability constraints on the industry. The daunting conditions attached to most recruiting offers strongly suggest that advisors could be making a mistake if they take the money and run to a new firm. That's especially true for advisors with a strong, loyal base of clients.

More Strings Attached

What happened? For much of the past 20 years, recruiting checks have totaled 100% to 150% of a broker's Trailing 12-month

Revenue. (TTR). In the past few years, firms have actually offered 180% to 350% of a broker's TTR to lure away top producers to grow their wealth management businesses. (see Figure 1)

Despite the apparent sweetening of the pot, the deals are structured "much differently" now, says Carol Hartman, a partner with the executive search firm Caldwell Partners. "The upfront cash is much lower these days," Hartman said. "The deals are longer and more complex. It's not just AUM or commissions that are measured. It is both. Brokers not only have to hit their current production numbers, but also exceed them by a big percentage."

Firms are hurting for a multitude of reasons. Ongoing pressure on investment management fees, the negative effect of low interest rates on money market balances, and the fact that investors are shunning away from margin accounts, have all translated to lower profitability. At the same time, recruiting expenses continue to rise. At some firms, the cost of bringing new advisors on board is growing by 20 percentage points in 2010 to more than 60% of anemic revenues.[1]

As a result, firms can't afford to write the same type of forgivable loans they did in the go-go years before the financial meltdown in 2008, nor can payouts remain at the levels that existed in the past. Over the past 20 years, industry payouts have declined from approximately 40%-45% in 1990 to approximately 30%-35% today. Sanctuary expects this trend may continue for a long time.

Nevertheless, even with less financial wherewithal, firms still need to compete for top-tier advisors. They have responded by appearing to

FIGURE 1

DEAL TERMS HAVE CHANGED

	2010	**2000**	**1990**
Avg. Total Loan (% of Production)	265%	150%	120%
Deal Term (years)	9	7	5

[1] *The Wall Street Journal*, Oct. 11, 2010, "Signing Bonuses Haunt Wall Street"

up the ante with larger checks, but have attached far more stringent conditions to earn the payment.

In the past, firms would offer as much as 100% of the loan's value up front to lure a successful advisor on board. Over the past five years, the upfront portion has been trimmed to 50 - 60%. Meanwhile, the forgivable loan term has grown from five years to seven years to nine years.

Perhaps most onerous, firms have imposed what can only be described as "unrealistic expectations" on advisors to earn the remaining back-end payments. Today, in order to receive the back-end, advisors are being asked to expand their business at a rate that was achievable in the last cycle, but is becoming nearly impossible in the current environment.

The net effect is that the probability of advisors being able to earn the entire back-end of the recruiting check has declined markedly. While the majority of advisors who elected to take the check in the 1990s and 2000s were successful in recouping the back end, Sanctuary's research indicates that only 10% of the advisors will actually earn the entire back-end. (see Figure 2)

FIGURE 2

PAYMENT STRUCTURE HAS CHANGED

	Present	**2000**	**1990**
Advertised Recruiting Check*	$2,650,000	$1,500,000	$1,200,000
Upfront Payment %	50%	80%	90%
Upfront Payment	$1,325,000	$1,200,000	$1,080,000
Back-end Payment (%)	50%	20%	10%
Back-end Payment	$1,325,000	$300,000	$120,000
% of Advisors that receive Back-end	10%	75%	95%
Realized Back-end Payment	$132,500	$225,000	$114,000
Requirement to get Back-end Pymt.	Production & Assets	Assets	Assets

** For advisors with $1 million of production*

Financial reform, decimalization and the decline of lucrative proprietary products, such as OTC derivatives and IPOs, are making it more problematic for advisors to earn as much as they have historically at a wirehouse or big bank. Now more than ever, there is real uncertainty about what advisors are going to earn from fees and commissions, and where payout levels are likely to bottom out going forward.

Viewed another way, the growing length of the loan term, along with the reduced upfront and increased back-end payments, tacitly confirm that recruiting checks typically hurt a firm's bottom line over the long-term.

"The economics of the business are going to have to change" an executive at a firm that pays large recruiting checks recently told *The Wall Street Journal*. "Many deals that look bad in hindsight were struck because asset-hungry brokerages were willing to pay 'extremely uneconomic' sums. "[2]

The bottom line is that despite the inflated headline number it is unlikely that advisors who take the check today will realize the advertised amount. That new reality, coupled with declining product margins and lower overall firm profitability, implies that the payout on advisor production will also continue to decline. (see Figure 3)

FIGURE 3

WHERE HAVE RECUITMENT CHECKS GONE?

	2010	2000	1990
Annual Loan Forgiveness	$161,944	$203,571	$238,800
Payout % on $1 M Production	35%	40%	45%
Annual Income on $1 M Production	$350,000	$400,000	$450,000
Total Annual Compensation	$511,944	$603,571	$688,800
Implied Payout	**51.19%**	**60.36%**	**68.88%**

[2] *The Wall Street Journal*, Oct. 11, 2010, "Signing Bonuses Haunt Wall Street"

Should I Stay Or Should I Go?

What does all this mean? For the big brokerage firms and especially ones owned by commercial banks, there's likely to be more payment inflation in the headline numbers to catch the attention of advisors and the media.

However, given all of the burdensome new payment conditions, firms will likely have more trouble recruiting, even with a heftier advertised incentive. According to Rick Peterson of Rick Peterson & Associates, a Houston-based search firm, recruiting is down 50% in 2010. [3] Word-of-mouth on the Street is quick and efficient. A growing number of advisors are realizing that there is less than meets the eye to this new generation of recruiting checks.

PART II – **The Case For Going Independent**

For advisors, the new financial calculus of recruiting checks and the changing landscape in the wealth management business create a stronger case than ever to go independent.

Traditionally, a big upfront check represented a generous portion of overall compensation. Advisors amortized their checks and came to view that as one part of their total annual compensation, in addition to their customary fees and commissions. Many received handsome payments more than once in their careers, with back-end terms that were short and allowed them to move to a new firm after five years.

Because the back-end portion of the check is now more difficult to achieve, the option of going independent – earning more with fewer hassles and offering clients unconflicted solutions – is looking more and more like a better alternative. That's particularly true in a progressively more hostile work environment and during a period where the advisor's individual tax rates are widely expected to increase.

Intense profitability pressure at wirehouses and big banks also has fundamentally altered the advisor/manager relationship. In years

[3] *Registered Rep*, Sept. 13, 2010, "Wirehouse Recruiting Stalls, Deals Keep Rising but Fewer Advisors Moving"

past, managers took care of advisors, but also applied bitter medicine when it was necessary. It was all part of the social compact at the office.

That dynamic no longer exists. Management turnover at big firms has been very high due to lofty new performance benchmarks and ongoing cost-cutting initiatives. Managers are now forced to routinely fire advisors for performance or obscure regulatory reasons. The clubby environment that made it great to work for one of the icons of American finance is gone, probably forever.

Loyal Advisors Subsidize Recruited Advisors

When the good times were rolling, the checks weren't an issue. Since the financial crisis, however, the checks stand out as a glaring expense because the economics don't work. Growing profit pressure on firms makes it unacceptable to pay $30 for $10 of inflated trailing revenues in today's marketplace.

So who pays for the profligacy? The firm's long-term advisors – those who have remained loyal to the company. A firm with a commission-only compensation structure has no choice but to lower the payout for all brokers to combat the twin challenges of lower revenues and larger recruiting expenses. It is the only way to lower the expense ratio to acceptable levels.

The bottom line is that a firm's existing advisors face a triple whammy – they make less in commissions; they don't benefit from a potentially big recruiting payout themselves; and they have to subsidize the recruiting package for a newcomer. This ripple effect is corrosive on brokers who have dutifully served the company.

Long View Is Attractive

Interestingly, the longer the breakaway advisor's time horizon, the less attractive the check becomes.

In the nine years it takes to earn the recruiting check in the current environment, a successful independent advisor's income can realistically exceed the deals offered today by Wall Street's biggest investment and commercial banks – especially when taxes are factored in. Income earned from a recruiting check is taxed as ordinary income, versus income earned as an independent advisor which flows through an LLC structure.

Breakaway advisors also can earn more because their payout under the independent model can range anywhere from 55% to 65% or more of their revenues. Without the Wall Street bureaucracy, breakaways have more time to grow their business and take care of clients.

Although going independent is more attractive today, it may not be right for every advisor. For professionals at large banks, there is a benefit in leveraging the institution's balance sheet to make loans, both commercial and personal. At boutiques with investment banking operations, the referrals from newly enriched business owners, benefitting from a liquidity event, can be very profitable for advisors. Yet, for those who want the freedom to serve clients and build their own franchise as they see fit, the independent model has never been more appealing.

Each advisor needs to carefully consider whether it best to go independent or augment current income through a recruiting check. For some advisors, a check may still be the ticket to financial freedom. For others, it increasingly looks like a mirage.

Read our Blog on Wealth

For market perspective and commentary by the team at Sanctuary Wealth Services, visit www.blogonwealth.com

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