

*Creating Value:
The Best Management Practices
of Independent Investment Advisory Firms*

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Introduction

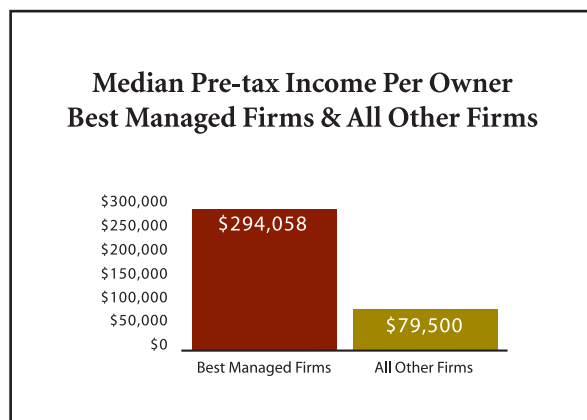
Independent investment advisors today face a wide range of opportunities and challenges. One critical aspect of their future success will be their ability to adapt to the ever-changing and increasingly competitive investment advice marketplace. Those advisors that adopt successful business management practices, target the right clients, attract and retain high-quality staff and institutionalize their businesses will be well-positioned to succeed. Indeed, these issues increasingly will affect all aspects of the financial advisory firm—from current profitability to the creation of value over the long-term.

The purpose of this white paper is to define a standard of excellence for firm management in the independent, fee-based advisory industry, and offer steps that advisors can take to help ensure their future success. This paper examines the managerial practices of the top 10% of independent, fee-based advisory firms selected from the participants in the *2002 FPA Financial Performance Study Of Financial Advisory Practices*. These firms have been identified as **Best Managed Firms** based on a composite score consisting of:

- Ranking by pre-tax profit per owner
- Ranking by revenue per professional
- Ranking by revenue per client
- Firm growth
- Professional leverage
- Career path

These Best Managed Firms are more profitable and produce a higher income for their owners than the other firms considered in this study. Best Managed Firms have a pre-tax income per owner (including salaries, owner's bonuses and share of firm profit) of \$294,058 compared with \$79,500 for all other firms. In percentage terms, the Best Managed Firms have an average operating margin of 19.4% compared to 10.8% for the other firms.

Notice, however, that these criteria also address the enhanced value of the owners' investment in their firms. When defining success, both current income and the creation of



value in a firm must be considered. An evaluation based solely on current income of the owners can potentially ignore the return on the owners' investment in building a professional reputation over the years, paying for firm infrastructure and establishing market position. A firm generating high current income but failing to create transferable value merely amortizes this investment—and as a result, does not produce an adequate long-term return on investment for its owners.

Criteria such as professional leverage and productivity, depth of talent in the firm, and career track for staff ultimately translate to four drivers of value in an advisory firm:

- Improved cash flow
- Transferability of the business to the younger generation in the firm or to an external buyer
- Sustained growth of revenue and earnings
- Lower operational risk

Key Management Lessons Of Best Managed Firms

In order to identify key management practices that make the Best Managed Firms successful, the principals of firms in this category were extensively interviewed about how they manage their organizations. The approaches, philosophies, techniques and methodologies presented below provide a framework that independent, fee-based advisory firms can consider using to strengthen their overall position in the industry.

The research reveals that Best Managed Firms employ a variety of business strategies and tactics, but share four overall management directives:

- **Institutionalization.** Best Managed Firms place a high priority on institutionalizing every aspect of their businesses, i.e., they operate as firms rather than collections of individual professionals.
- **Proactivity.** Best Managed Firms are proactive: They set goals, design specific steps to achieve them, consistently measure their progress and adjust their strategies as necessary.
- **People focused.** Best Managed Firms are proud of their staff. They enjoy working with employees, coaching them and helping them develop into better professionals.
- **Delegation.** Best Managed Firms understand the value of delegating—both inside their firms and to external providers. They focus on what they do best and delegate other functions, such as client work and firm operations, to other experts.

The interviews with Best Managed Firms covered the following aspects of firm management: business development, client selection, organizational design, compensation, recruiting, financial management and succession planning. The following summarizes how these “best in class” firms have incorporated the above management directives into their businesses.

Business Development

Best Managed Firms do not achieve success by accident. They construct and implement carefully developed plans for their practices in an effort to generate as much value as possible for themselves and their clients—both now and over the long-term. What’s more, the changes affecting the financial services industry (such as new business models, technologies and fee structures) mean that it’s more important than ever for advisors to focus on the business development process.

Best Managed Firms surveyed focus on three key business development initiatives:

- Proactively developing new leads
- Carefully managing relationships with referral sources
- Institutionalizing their brand

Proactive Marketing and Business Development

Most advisors develop new business through referrals from existing clients or other service providers. However, many advisors tend to be passive in their marketing strategies—they wait for these referrals to come through their doors. Best Managed Firms, by contrast, have succeeded in taking a proactive approach to the new business development process. As a result, Best Managed Firms added on average close to \$29 million in new client assets in 2001. Consider the following proactive methods employed by highly successful firms.

Advertising

The Arkansas Financial Group (AFG) and **Maul Capital Management**, two Best Managed Firms, have effectively used print advertisements in targeted magazines and newsletters to generate new clients.

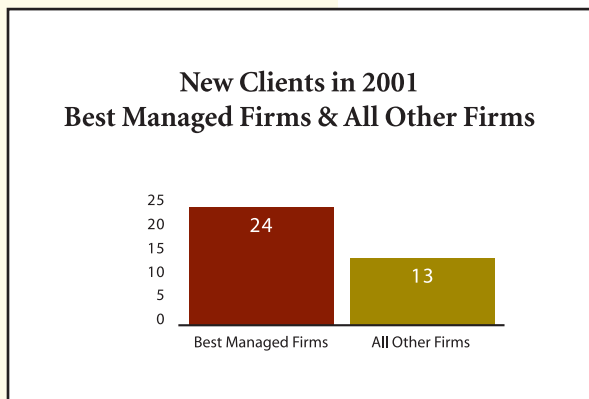
The key to their success: A clear understanding of the appropriate types of clients to target and the utilization of efficient channels to reach them. AFG has developed substantial expertise in serving doctors and continues to strengthen its focus on that market niche through advertising in the Arkansas Medical Society Journal. According to AFG, approximately 35% of the firm’s new clients have come from such advertising. Likewise, Maul Capital Management develops one of its target niches—airline pilots—through advertising in an industry journal.



With a clear target in mind, these two firms have found what they consider to be the ideal forums for their marketing messages. The advertising initiatives have been successful in increasing awareness of the firms' names and services to the intended target markets. These firms counsel that advertising expense should be measured only after a period of consistent messaging, and such advertising should not be expected to generate immediate responses to a one-time ad.

Seeking Existing Client Referrals

Best Managed Firms estimate that, on average, one-third of their new business comes from referrals through existing clients. Again, Best Managed Firms approach clients proactively. For example, **Pinnacle Advisory Group** has procedures in place to remind existing clients about the solutions it can provide and reinforce the message that the firm will be honored to serve any new clients the existing client knows. Pinnacle has made it a policy to give clients such reminders at regular review meetings and by a formal referral letter campaign.



Industry Involvement

Many of the principals interviewed are involved in industry associations and forums. They sit on the CFP Board, actively participate in industry associations, teach classes to other financial advisors on technical and practice management issues, and often appear in industry publications to express their visions of the profession's future. Involvement in the financial services industry helps build awareness among other professionals of a firm's particular expertise, and often leads to referrals from other advisors needing that expertise for their clients.

Presence In The Community

Every principal interviewed, without exception, is heavily involved in his or her community. Most of these advisors view these commitments as a way to contribute back to their communities rather than as a conscious business development initiative. Nevertheless, community involvement makes them known and introduces them to potential clients.

Tracking Prospects and Data Mining

Qualified prospects are not easy to find, and ensuring that appropriate investors don't "slip through the cracks" is **Weil Capital Management's** focus. The firm previously had a white board tracking its activities related to new clients and prospects in an effort to ensure that every task was completed. Now the firm has automated this process by using a Customer Relationship Management (CRM) system. Weil believes that investing in this technology will increase its effectiveness in converting prospects into clients. **Plancorp** has

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—Woodside Asset Management

created several custom databases to track prospects and uncover opportunities with existing clients. **Emerson Investment Management** also uses a separate database to track new prospects and generate periodic reports of new business development activity and progress. The firm is in the process of integrating the CRM system with its main portfolio management system in an effort to become even more effective and efficient in converting such opportunities.

Best Managed Firms also are looking at client relationship management information systems as a place where they can uncover more opportunities. Knowing when clients are about to retire, send their children to college, sell their businesses or exercise their options, for example, will allow firms to help anticipate needs and offer solutions well in advance of the event. The information is already in advisors’ systems, and several firms are looking at ways they can leverage it.

Client Retention As Business Development

All Best Managed Firms agree that the most effective business development tool is providing superior service to their existing clients. As a result, Best Managed Firms feel they typically have 240 emissaries in the local community marketing for them.

Managing Relationships With Referral Sources

Best Managed Firms generate approximately one-third of their business from referrals from CPA and law firms. The following best practices can help advisors make the most of those outside relationships.

Send a Clear Message To Referral Sources

Too often, advisors simply ask an outside source for referrals without providing important details. **Woodside Asset Management** identified that the key to a successful relationship with a referral source is to let that source know exactly which types of clients it is targeting. “If you tell a CPA firm you want clients with \$1 million in assets, they will send you \$1 million clients. If you don’t tell them what clients you want, they’ll send you any client they come across, or no clients at all.”

Encourage Reciprocity With Referral Sources

The relationship between advisor and referral source must be beneficial to both parties. Consider **Gemmer Asset Management**, which receives many of its referrals from CPA firms and financial planning firms. Gemmer focuses on its core investment management capability, and in turn, refers its clients back to the CPA or financial planning firms for services it does not provide, such as preparing a financial plan or tax planning. This type of reciprocal referral relationship is especially important to specialty firms that focus on a particular service. Resisting the temptation to offer “non-core” services ensures both parties that the clients are served by the best provider and maintains the vital referral relationship.

Furthermore, **SVA Planners** emphasizes the importance of giving the referral source credit for the work performed. SVA operates as the RIA arm of an accounting firm, and derives nearly all of its business from the CPA clients. By recognizing the efforts of the referring partners—for example, by including the other professional in a thank you note sent to a client—both the advisor and the referral source enhance their value in their client’s eyes.

Institutionalizing the Firm’s Brand

Best Managed Firms actively leverage the personal reputation of their principals into firm brands that will endure and continue beyond the principals’ personal involvement in the business. This process of “institutionalizing the brand” is crucial to building a firm’s value and successfully transitioning a practice to a future generation of owners.

Strategies that Best Managed Firms use to achieve this goal include:

- Involving the younger generation of professionals in the marketing process. The firm works actively to introduce its younger professionals to all referral sources.

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- Making efforts to promote younger staff—first to existing clients, then to external referral sources and community forums.
- Using the firm’s name, rather than the name of any one professional, on all marketing communications.

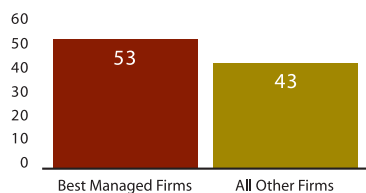
The typical Best Managed Firm is built as a result of the principal’s twenty or more years of tenure in the industry and his or her reputation and visibility. The principals interviewed have achieved critical mass and are at the peak of their careers. The reputation they have built by providing superior client service over many years is paying off through a stable stream of new prospective clients.

A critical part of institutionalizing the firm and helping to ensure its continuity is the coaching of younger professionals to become good business developers. *Tyee Asset Strategies* has made referrals from existing clients the responsibility of the client managers, not the principals. The firm recognizes that client managers have more contact with existing clients, and as a result, believes that they are best positioned to ensure that current clients refer new clients. This method has been very successful: Client managers have energetically embraced their responsibility and generated many new referrals.

Client Selection

Working with the right clients is a critical factor to a financial advisory firm's profitability. As much as they'd like to, advisors simply cannot be all things to all investors—not if they want to become and remain successful. That's why industry experts strongly emphasize the need for advisors today to focus exclusively on the particular type or types of clients that will generate strong revenue and profit growth as well as healthy margins.

**Median Clients Per Professional
Best Managed Firms & All Other Firms**



Most firms recognize that advisors can only serve a certain number of clients without compromising the quality of service. Best Managed Firms estimate that limit to be between 30 and 80 clients per professional, depending on the types of services they provide. For example, pure investment management firms typically have more clients per professional compared with wealth management firms that deliver a “higher touch” service level.

Best Managed Firms have constructed methods that help ensure they target and serve only the most appropriate clients. They also use many internal checks to discipline

themselves in the painful process of turning away potential business. The practices these top-performing firms employ include:

- Establishing minimum client asset or fee requirements
- Letting clients self-select
- Ensuring a philosophical fit
- “Cleaning up” the client base
- Implementing multiple levels of service

Establish and Enforce Client Minimums

Best Managed Firms generally demand that prospects meet certain financial requirements in order to become clients. These requirements help ensure that only the investors who are most appropriate for a particular firm are served. Typically, the requirements are focused on minimum fees and minimum assets. For Best Managed Firms, the median minimum fee is \$6,250 and the median minimum asset requirement is \$500,000.

Establishing such minimums is relatively easy. But enforcing them is often more difficult for advisors, who find that saying “no” to a prospective client is one of their

most difficult jobs. Indeed, the culture of client service found in the advisory industry makes it painful for most advisors to turn anyone away.

However, Best Managed Firms strictly adhere to their client selection criteria because they realize that they do non-conforming prospects a disservice by accepting their business. As clients, such investors most likely will not receive the highest level of service possible and will eventually become unhappy with their advisors. Rather than compromise the quality of their service, Best Managed Firms regularly turn these investors away and instead refer them to other more appropriate professionals. Despite tough market conditions, **Bingham, Osborn & Scarborough** has been able to attract a significant number of new clients without lowering its client requirements.

Surprisingly, Best Managed Firms and other practices do not differ significantly in their use of minimum client requirements: 76.5% of Best Managed Firms use a minimum requirement versus 78.7% of all other firms. The crucial difference comes from the degree to which Best Managed Firms enforce such requirements. Consider **Tyee Asset Strategies**. When the firm first started, it had few clients and was running losses that were being financed by the principals' own checking accounts. Despite these hardships, Tyee continued to refer out clients that it believed did not fit the desired profile. Tyee points to this discipline as a key reason why the firm has been successful over the years.

Let Clients Self-Select

The self-selection process puts the decision to work with an advisor squarely in the hands of the prospect. One common way to implement a self-selection strategy is to charge an upfront fee for financial planning. For example, a \$2,000 financial plan required by the advisory firm lets prospects decide if their financial situations are complex enough to justify such an expense. This effective method is especially appealing to some advisors because it does not require them to explain why a prospect is a poor fit for the firm.

Ensure a Philosophical Fit

Explaining upfront to prospects the philosophy of the firm and the firm's investment strategy allows them to decide if their philosophies about money, investment styles and the like fit well with the firm's approach. Best Managed Firms agree that a client who is not a good philosophical match eventually becomes dissatisfied and unprofitable. To assess the match between firm and prospect, **Polstra & Dardaman** has developed a unique test for determining the client fit. The test evaluates investment

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resources, desire and ability to delegate, client expectations and personality, and chemistry. The four areas produce a composite score between 0-100, and the firm considers those under 70 to be unacceptable.

“Clean Up” The Client Base

Many Best Managed Firms regularly revisit their client selection criteria, making any necessary adjustments as their firms evolve and their strategies and target clients change. Many of the advisors interviewed periodically “counsel out” clients who are no longer meeting their client selection criteria or can receive better service from another advisor.

Implement Multiple Levels Of Service

Advisors find it difficult to differentiate the level of service they provide based on the fees paid by their clients. In fact, most firms do not even look at how much a client is paying before setting up a meeting with him or her. This type of differentiation can be especially difficult for comprehensive wealth management firms. As a result, a \$3,000 client usually receives the same level of service (if not more) as a \$10,000 client.

However, differentiating the level of service is becoming an emerging trend.

Woodside Asset Management, for example, uses two investment partnerships, each managed as a single balanced portfolio, to service smaller accounts. The accounts are aggregated, making it feasible for the firm to be involved in managing them. These two limited partnerships allow Woodside to service smaller accounts that cannot be managed efficiently under its full-service offering.

Institutionalizing the Client Relationship

Identifying and attracting the proper client base clearly is necessary to build superior relationships with clients and strengthen an advisory practice. However, advisors must constantly foster client satisfaction and loyalty in order to turn a new client into one that stays with the firm throughout his or her lifetime.

Best Managed Firms build such loyalty by institutionalizing their relationships with clients—in other words, client needs become the responsibility of the entire firm, not just a single individual or group. Clients appreciate the depth of a firm using this approach, and feel confident that a complete team—rather than a single individual—is looking out for their best interests.

Taking ownership of the client relationship at the firm level can help ensure that it will continue beyond the involvement of a particular individual at the firm. This issue will become increasingly important to many advisors as they start to consider retirement and decreasing their personal involvement with clients. The institutionalization process allows these advisors to transfer the client service to the firm's younger professionals in a seamless manner.

Team Approach

Institutionalizing relationships also builds a team environment at a firm, which helps to further the goal of providing comprehensive services to clients. Many Best Managed Firms are adopting wealth management strategies, and a team approach is one of the most effective ways a wealth management firm can seek to ensure that the appropriate specialists serve each client.

Best Managed Firms institutionalize the client relationship by providing each client with multiple contacts inside the firm, thereby encouraging the development of the relationship with the firm rather than with an individual. Best Managed Firms build

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a team around their clients. They introduce all of the professionals to every client by rotating professionals for the scheduled client meetings, or inviting colleagues to sit in on some of those meetings. The four principals of *Budros and Ruhlin*, for example, rotate participation in every meeting so that the client is exposed to the entire depth of expertise at the firm.

One challenge to implementing a team approach to client service is overcoming the resistance of clients who may be used to personal attention from a senior advisor. To manage this challenge, Best Managed Firms have implemented this type of service model slowly—first by introducing junior advisors to these relationships, then building the clients' trust in those advisors' abilities and actively promoting them in front of clients. When the clients have become comfortable with the junior advisors, the senior advisor steps out of the active day-to-day management.

Another key strategy is to provide clients with a list of a firm's staff and who should be contacted with specific questions. This not only achieves institutionalization, but also increases efficiency: The client knows who to call right from the start. Finally, Best Managed Firms use their marketing materials to further the client institutionalization process. For example, some practices profile their professionals in newsletters sent to clients, who thereby gain a better understanding of all of a firm's various areas of expertise.

Recruiting and Staffing

The ability to recruit, retain, train and motivate staff may be the single most valuable management skill of Best Managed Firms. *The 2001 FPA Staffing and Compensation Study* found that most financial advisory firms struggle to recruit and retain staff, and that turnover is high. The study also found that the majority of firms in the industry were unstructured, with no clarity of responsibilities or deliberate human resource practices.

Best Managed Firms, however, avoid these and other staffing pitfalls by building teams that, in their words, “pull together” in one direction. In fact, principals of Best Managed Firms cite the team of people they work with as a key factor in their success. To create such unified teams, Best Managed Firms:

- Focus on effective recruitment techniques
- Develop professional leverage and depth of talent
- Define clear responsibilities for their staff

Effective Recruitment Techniques

While the sources of prospective employees for Best Managed Firms were no different than the standard industry practices, their processes of prospective employee evaluations are especially thorough:

- Several firms use tests to determine if the prospective employee is a good fit with the culture of the firm and the characteristics of the position.
- Several firms also have everyone in the firm interview each new candidate.
- Others use a probation period of six months for new employees, during which their performance is monitored especially closely.
- Many firms have successfully located new employees through college internship programs, particularly for entry-level professional positions.

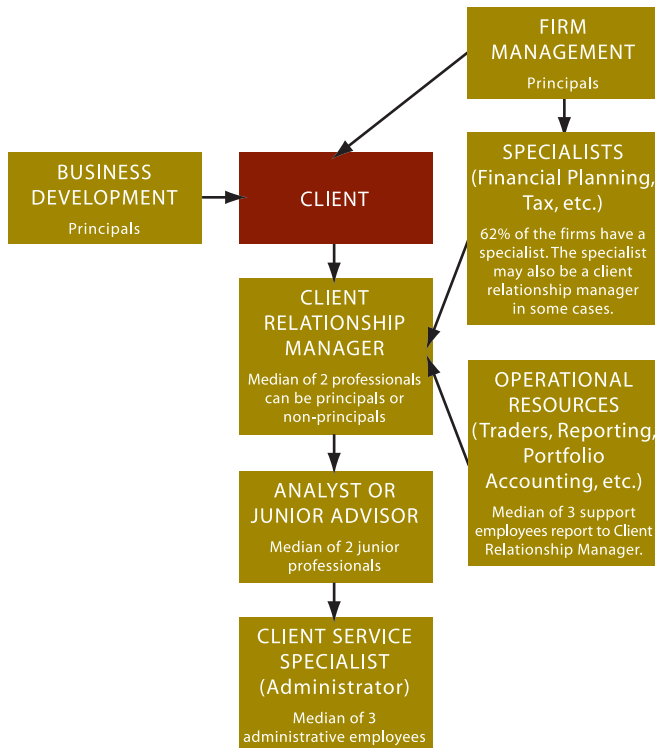
The Importance of Professional Leverage

Many of the advisors interviewed were solo professionals at one point in their careers. These advisors recognized early on the need to leverage themselves by delegating tasks to others. Understandably, many of these advisors found it difficult initially to pass off work to other professionals and feared that service quality would suffer. However, they accepted the fact that they couldn't grow their businesses without involving other people. Now, these advisors firmly believe in concentrating on

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The Organizational Chart

The staff of a Best Managed Firm is typically organized around the client team.



The team is led by a client relationship or portfolio manager who has the primary responsibility for all client deliverables. The client manager is not always a principal. In fact, the principals at many firms are seldom involved in the later stages of the client process, leaving implementation and maintenance of the accounts entirely to the other professionals. The client relationship manager is usually complemented by an analyst or a junior advisor who provides analysis and research. Finally, the team includes a client service administrator who is responsible for correspondence, communications, administrative aspects of the relationship and timely delivery of the client reports.

The composition of the client service team in Best Managed Firms clearly demonstrates the concept of leverage. By using people on multiple levels, Best Managed Firms achieve higher gross profitability and create more capacity.

the jobs they do best—and leaving non-core competencies to their staff.

The typical composition of the client service team at Best Managed Firms clearly demonstrates this concept of leverage (see the chart to the left). By integrating people on multiple levels, these firms achieve higher profitability and create more capacity.

For instance, a client relationship or portfolio manager has the primary responsibility for all client deliverables and leads the team. The client manager is not necessarily a principal. In fact, principals often introduce the client to the firm and perform the strategy development work, and then bring in junior professionals to implement and maintain the client strategy. Principals of many firms are uninvolved in the later stages of the client process.

An analyst or a junior advisor who provides analysis and research usually complements the client relationship manager. The team also includes a client service administrator who is responsible for correspondence, communications, administrative aspects of the relationship and timely delivery of client reports. This type of leveraged, delegated approach to client services allows principals at **Accredited Investors** to maintain up to 100 client relationships—approximately twice as many clients as the typical advisor can manage working alone.

Clearly Defined Responsibilities

Best Managed Firms are highly structured. Each staff position has clearly defined roles and responsibilities. This promotes consistent levels of client service and helps ensure that crucial operational or client-oriented functions do not slip through the cracks. Consider the defined roles and functions at a typical Best Managed Firm.

Principal

The principals of Best Managed Firms typically are involved in the following four functions. The first three usually are divided between the principals. In firms with fewer than three principals, the “rainmaker” and investment officer functions are often shared.

- **Business Development**—The principals are the primary drivers of business growth. While junior staff is trained for business development, the principals typically continue to be the “rainmakers.”
- **Business Management**—One of the principals usually takes on the role of managing partner and assumes the primary responsibility for implementing the firm’s business plan, monitoring the firm’s performance and finances, making personnel decisions and handling some of the business’s operational functions.
- **Investment Officer**—Most investment management firms have a chief investment officer (usually a principal) who defines and guides the firm’s investment style.
- **Personnel Development**—Principals take responsibility for coaching, training and developing their younger professional staff.

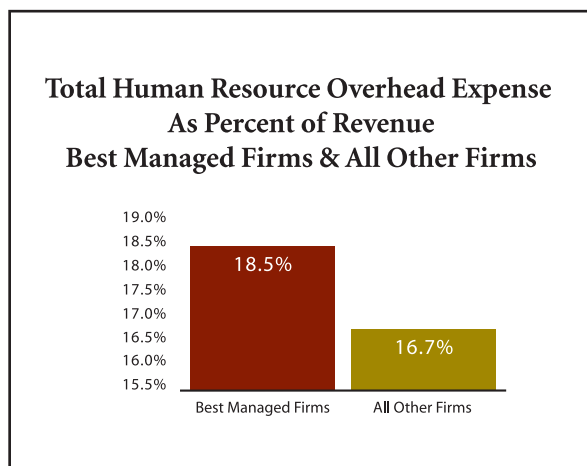
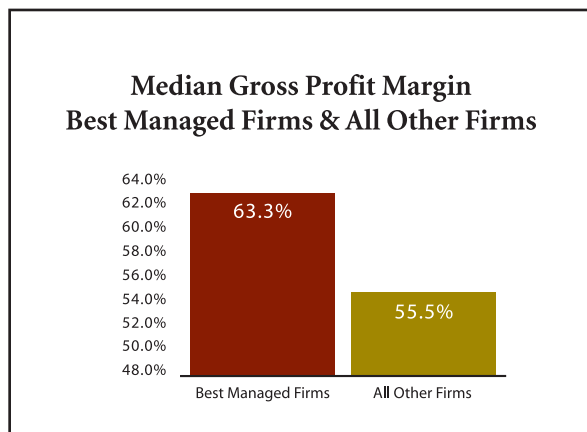
Non-Owner Professionals

All Best Managed Firms have non-owner professionals who are primarily responsible for client service. These professionals meet regularly with clients, implement strategies, prepare financial plans and address most of the clients’ questions and concerns. This high level of responsibility and trust regarding the client relationship may be what differentiates non-owner professionals inside Best Managed Firms from those at other types of practices.

There is a clear expectation at most firms for some of these non-owner professionals to step up to the next level at some point in the future. *Balasa Dinverno Foltz & Hoffman* have implemented a four-step career path while allowing professionals to customize that path based on area of expertise. That said, firms are being very cautious about feeding this expectation: Most do not have formal criteria or processes for when and how a professional may become a principal.

Support Functions

Support functions inside Best Managed Firms are much more specialized than in the rest of the industry, and include job descriptions such as trader, paraplanner, financial analyst, etc.



Administrative Functions

Best Managed Firms also maintain a variety of administrative functions, usually including:

- **Office Manager**—The principals of Best Managed Firms delegate virtually all of the operational responsibilities to the office manager, who effectively serves as the “general” of all administrative staff and the master of all administrative tasks.
- **The IT or data team**—Best Managed Firms make these employees responsible for maintaining the firm’s main investment system and producing periodic account reporting and statements.
- **Client Service Specialists**—These staff members answer client requests, schedule meetings, produce statements and reports, and work with the client relationship managers.
- **Receptionist**

Compensation

The most important issue when developing a compensation system is that the rewards must reinforce the business strategy. Compensation systems should do what they are designed to do—reward behavior. It is important, therefore, to consider carefully the type of behavior the firm is trying to reinforce and develop a system that promotes the “right” behavior.

The compensation practices of Best Managed Firms are:

- A base salary compensation for all staff, including the principals
- A performance bonus based on measurable achievements and performance evaluation
- Selective use of equity compensation

Base Pay

Without exception, all employees of Best Managed Firms are paid a salary. The firms’ general compensation philosophy is to pay a higher rate than the industry average or the regional average. These firms expect superior credentials and above-average performance from their employees in return for that salary.

The common factors these firms often look at when determining base pay compensation: education, experience in the industry and overall experience, and degrees and designations. Many firms then adjust their base salary structure according to how a new employee compares in these terms to existing employees in similar positions. By contrast, *Bedel Financial Consulting* and *Briaud Financial Planning* engage HR specialists to perform salary surveys for particular positions.

Structured Bonus Packages

All Best Managed Firms also have a bonus program for their employees. Nearly half

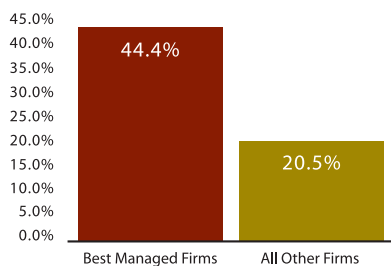
Without exception, all employees of Best Managed Firms are paid a salary. The firms’ general compensation philosophy is to pay a higher rate than the industry average or the regional average. These firms expect superior credentials and above-average performance from their employees in return for that salary.

Performance evaluation is one of the single most useful tools in developing staff, and one of the most misused. Best Managed Firms think carefully about what factors drive the success of each individual job, and involve staff in the goal-setting process.

of these firms use formula-based incentive compensation—employees know exactly when to expect a bonus and how much the bonus will be. The other firms still determine bonuses on a discretionary basis, although most expressed a desire to move to a more structured bonus system.

The incentive formulas used by Best Managed Firms are most commonly based on the performance of the employee. The performance evaluation process is typically developed by the principals and administered by the office managers. The principals usually deliver the evaluation and coaching to the client relationship managers; the managers then coach the analysts and other support staff. The office manager most often delivers administrative staff evaluations.

**Percentage of Firms Who Use
A Performance-Based Incentive Plan
Best Managed Firms & All Other Firms**



Performance evaluation is one of the most useful tools in developing staff, and one of the most misused. Best Managed Firms think carefully about what factors drive the success of each individual job, and involve staff in the goal-setting process. They also evaluate specific areas of performance that impact business strategy as well as areas of personal development.

While most of the firms interviewed use some type of performance evaluation process, *Tyee Asset Strategies* has made an effort to make its process extremely objective and formal. Every employee in the firm receives a “360 degree” evaluation: The employee evaluates him/herself; the team evaluates each member; then the owners or direct supervisor evaluates the employee.

Other factors used to develop structured bonus packages include the profitability of the firm, new clients and new asset development, maintenance of existing client relationships, specific goals for the position (e.g. all reports being mailed on time) and professional achievements of the individual employees (e.g. degree or certification).

Equity Compensation

Equity compensation is perhaps the next step Best Managed Firms will take as they grow and evolve. Most of the firms currently do not have a formal stock option or stock purchase plan in place, but most principals are considering making such a plan available in the future.

Best Managed Firms typically have gone through the process of bringing in a new partner, and therefore, realize the need to expand the ownership of their firms in order to attract talented people, grow the business and successfully transition to the next generation. Still, most prefer to “hand-pick” successors rather than use equity as compensation. Psychologically, giving up control to a broad base of people is a difficult decision for the principals of Best Managed Firms.

Hutchinson/Ifrac Financial Services is one of the few firms that has implemented a restricted stock purchase plan and an employee stock plan. Restricted stock is offered to employees for substantial and extraordinary contributions, and is reserved mostly for the upper echelon of professionals. The stock purchase plan is open to all employees, and is based on a valuation formula that is updated quarterly.

This type of arrangement allows employees to experience ownership and share in the firm’s growth. Hutchinson/Ifrac does not “make a market” for existing shareholders but has a buy-sell agreement that provides liquidity to all shareholders who leave the firm. This agreement also prevents ownership from becoming “scattered.”

Business Planning and Performance Management

Advisors looking to improve their business practices, manage costs and boost their overall level of success need to take a disciplined approach. Careful business planning is necessary to determine where you are now, where you want to be in the future and how you are going to get there.

Best Managed Firms recognize the importance of business planning, and have created a structured process that allows them to collect information, make decisions and monitor performance. The process relies on:

- A business plan that defines a firm's actions and strategic direction
- A budget and forecast that translates the business plan into financial goals
- Monthly monitoring of key measures
- Frequent benchmarking and comparison to the industry

Developing a Business Plan

Best Managed Firms follow a step-by-step process for business planning by:

1. Developing a comprehensive picture of the enterprise as it stands currently.
2. Understanding the firm's financial situation—revenues, expenses, profitability and productivity.
3. Articulating a vision and defining goals.
4. Building a five-year forecast that incorporates the vision and the goals or objectives that are to be achieved in the coming months and years.
5. Implementing and updating the plan.

Budgeting and Forecasting

Best Managed Firms have a disciplined approach to budgeting and expense management. They prepare detailed budgets—sometimes on a monthly basis but most often annually—and monitor them closely. The budget reports can be used to produce variance reports between intended budgets and actual spending. This allows management to detect problems early and take appropriate steps before spending spirals out of control. Two of the firms interviewed use budgets as a cost control measure by requiring each professional to stay within their budget or seek principal approval if expenses exceed the planned amount.

Monitor Key Measures

Best Managed Firms regularly monitor key performance metrics to confirm that their business planning efforts are paying off. At *Balasa Dinverno Foltz & Hoffman*,

for example, profitability is tracked by client and team. Typically, a firm's managing principal reviews these metrics every month. Measures that Best Managed Firms use to track their performance include:

- Total assets under management
- Revenue
- New assets and new clients
- Revenue per professional
- Clients per professional
- Average client size (in terms of assets or client fees)

Tracking Hours

Twenty-eight percent of Best Managed Firms also track staff hours in order to measure the profitability of the client relationships and assess employee workloads. Most firms still associate the practice of time tracking with “nickel-and-diming” the client; however, the firms that use this process find it valuable for understanding how they are deploying resources even if they do not charge clients on an hourly basis.

Benchmark versus the Industry

Advisors should examine their own internal practices when they conduct business planning. However, Best Managed Firms also recognize that they can learn much from their peers, and they look to adopt the best ideas of other advisors. Consider **Boone Financial Advisors** which believes that small businesses tend to isolate themselves from their environments. To break this isolation and to compare its progress to that of the overall industry, Boone carefully follows industry developments, participates in two groups of financial advisors who share business practices and speaks to other advisors on practice management issues.

Business Planning: Building a Road Map

The business planning process helps enable advisors to understand their current levels of profitability and productivity, and identify areas of strength and weakness in their practices. A business plan may also serve as a road map that shows a firm how to achieve its most important objectives, such as increasing assets under management, boosting efficiencies, reducing costs and ultimately increasing profitability.

To help you construct an effective business plan, Schwab Institutional has published *Business Planning: Building a Road Map for a Profitable Future*. This report provides detailed business planning information as well as actionable steps, and is available through the MKT—Market Knowledge Tools series on www.schwabinstitutional.com.



Financial Software Modeling Tool

Moss Adams LLP has created an Excel-based tool for Schwab Institutional to assist you in developing a business plan. This tool (available on CD-ROM for ordering via www.schwabinstitutional.com) helps you to evaluate your firm's historical performance versus a series of benchmarks drawn from other fee-based investment advisory firms by size as well as by Best Managed Firms. It also helps you develop your own firm-specific financial forecasts.



To run the model, you will need two years of historical data and up to five years of forecasting assumptions. The resulting forecast will give you an income statement and will outline key firm productivity measures on a year-by-year basis.

Succession Planning

Most of the principals of Best Managed Firms are in the prime of their careers and are not feeling the pressure to confront succession issues. Nevertheless, 50% of these principals have already named a successor, and 86% have prepared a formal management succession plan.

Such advanced planning indicates that the best advisors realize an important fact: Succession planning is not a one-time project that occurs near retirement. It is, in fact, an issue that is integrated with the other steps that advisors take to improve their businesses. For example, as advisors address key issues that affect them in the present—such as client selection, staffing and compensation—they should also consider the longer term implications and effectively build solid succession plans, because the decisions they make today will enhance or erode their firms' value over the decades to come. Enhanced value will eventually make the process of “cashing out” much easier.

Research shows that Best Managed Firms concern themselves with three key succession planning initiatives:

- Recruiting potential successors early
- Building a pool of talented younger professionals rather than an “heir apparent”
- Preparing the successors to be successful professionals and managers

Recruit Successors Early

The same processes that drive leverage and institutionalization in Best Managed

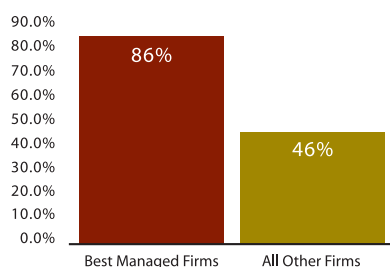
Firms also create a natural mechanism for bringing in potential successors. Through the use of junior professionals, principals have an opportunity early on to observe and evaluate individuals who may become future owners.

Likewise, those younger professionals have an opportunity to evaluate the firm and decide early in their careers if they are willing to commit to being a future owner.

Build a Pool of Successors

Best Managed Firms have taken steps to institutionalize their firms by developing generational “layers” of owners and future owners. These firms are reluctant to rely on any single individual to become the successor of a particular retiring principal.

**Percentage of Firms Who Have A Management Succession Plan
Best Managed Firms & All Other Firms**



Provide Younger Professionals Management Experience

Many Best Managed Firms delegate staff management responsibilities to their younger professionals. In several firms, younger professionals perform employee evaluations and supervise and train analysts and paraplanners. This exposure to management duties gives a firm another opportunity to evaluate potential successors on an important metric—people skills. Furthermore, early involvement allows a firm to gradually build the managerial abilities of its future principals over time.

It is interesting to note that most Best Managed Firms (82.4%) have not considered the possibility of selling, despite the fact that they are well-positioned to do so. Indeed, these firms are attractive acquisition candidates and could likely command high valuations given their size, institutionalized business practices and low reliance on a single person. Clearly, the principals of Best Managed Firms are proud of their businesses and prefer to ensure the businesses' continuity through internal succession rather than sale.

Conclusion

Independent investment advisors have enjoyed considerable success during the past decade. However, their continued success is far from assured. Heightened levels of competition, new entrants to the financial advisory business and rising investor demand for new products and services are creating an environment in which advisors will need to work harder than ever to attract and retain the best clients—as well as the top professionals needed to serve those investors effectively.

By adopting the practices of Best Managed Firms, advisors can help strengthen all aspects of their businesses, from the profiles of the clients they serve to the employees they hire. Implementing these management strategies can result in greater efficiencies, more revenues, happier clients and staff, and increased profitability. Advisors should adapt these ideas to their firms' specific strategies for business management by taking a methodical approach, looking for incremental improvements and maintaining a long-term view. The advisors who will realize these benefits are those who take action now, and get to work building the type of business that will realize success in the months and years ahead.

Best Managed Firms

Alphabetically by firm name

Accredited Investors, Inc.	Edina, MN
Balasa Dinverno Foltz & Hoffman, LLC	Schaumburg, IL
Bedel Financial Consulting, Inc.	Indianapolis, IN
Briaud Financial Planning, Inc.	Bryan, TX
Bingham, Osborn & Scarborough LLC	San Francisco, CA
Boone Financial Advisors	San Francisco, CA
Budros & Ruhlin, Inc.	Columbus, OH
Emerson Investment Management, Inc.	Boston, MA
Friedman & Associates	Novato, CA
Gemmer Asset Management LLC	Walnut Creek, CA
Hutchinson/Ifrac Financial Services, Inc.	Little Rock, AR
Maul Capital Management, Inc.	Las Vegas, NV
Pinnacle Advisory Group	Columbia, MD
Plancorp, Inc.	Chesterfield, MO
Polstra & Dardaman, LLC	Norcross, GA
SVA Planners Inc.	Madison, WI
TFC Financial Management	Boston, MA
The Arkansas Financial Group, Inc.	Little Rock, AR
Tyee Asset Strategies, LLC	Seattle, WA
Weil Capital Management, LLC	Palo Alto, CA
Woodside Asset Management, Inc.	Menlo Park, CA

The Optimal Practice

A Composite of the Best Management Practices

Best Management Practice		Benefits
Advertising	Targeted ads aimed at ideal clients	High visibility
Advisory Board	Include prominent community members	Corporate discipline; visibility in community; more referrals
Prospect Tracking	CRM system provides follow-through	Maximizes effectiveness of business development
Communicating with Referral Sources	Clearly define your target client's characteristics to sources	Referrals who are more likely to become clients; saves time
Crediting Referral Sources	Acknowledge referral source that sends you a new client	More referrals; enhances value of both firms
Client Selection	Use disciplined process to screen prospects	Minimizes inappropriate/unprofitable clients
Institutionalize the Client Relationship	All partners meet with each new client	Client sees depth of talent at the practice; builds client loyalty
Role of the Principals	Clearly define each principal's role (CIO, CFO, HR, etc.)	Creates clear decision-making process; promotes consistency
Training Professional Staff	Portfolio managers work with different partners on different accounts	Staff learns more skills and methods to approach client service
Processes	Build well-defined processes around internal operations; automated by technology	Decisions and results are standardized; smaller administrative staff may be needed
Career Track	Build a structured "promotion path;" make senior planners mentors	Makes career decisions more structured/transparent; increases staff loyalty
Determining Base Compensation	Use a multi-factor process to determine base pay of new employee relative to existing staff	Clear, easily explained method
Performance-Based Incentive Plan	Plan combines firm goals, individual goals and employee evaluation	Clear expectations of responsibilities/goals; incents the right behaviors
Performance Evaluation	6-month review based on self evaluation; team evaluation, supervisor evaluation	More objective, formal process; multiple perspectives on performance
Recruiting	Everyone in the firm interviews potential hire; employee tests	Builds consensus; personality conflicts identified early; less turnover
Succession Planning	Broad-based ownership (include outside investors)	Enhances firm value through greater stability and discipline
Benchmarking	Identify weaknesses; formulate specific goals	Understand drivers of profitability and areas for improvement
Business Planning	Formal, structured process	Facilitates decision making; identifies strategic direction

Median Productivity and Profitability Ratios

Best Managed Firms¹ and Fee-Based Firms²

	Best Managed Firms	All Other Firms
Assets Under Management	\$224,522,514	\$40,000,000
Revenue	\$1,755,354	\$385,035
Clients	242	98
Median Gross Margin	63.3%	55.5%
Median Operating Profit Margin	15.5%	7.5%
Pretax Income Per Owner	\$294,058	\$79,500
Staff Headcount		
Principals ³	2.0	1.0
Professionals ⁴	2.0	0.0
Support Staff ⁵	3.0	1.0
Administrative Staff ⁶	3.0	1.0
Total Headcount (sum of above)	10.0	3.0
Clients Per Professional	53	43
Clients Per Professional and Support	35	27
Revenue Per Professional	\$344,820	\$181,390
Revenue Per Professional and Support	\$244,718	\$112,000
AUM Per Professional	\$47,223,818	\$24,753,038
AUM Per Professional and Support	\$29,230,113	\$15,000,000
Infrastructure Expenses Per Client	\$1,243	\$715
Infrastructure Expenses Per Staff	\$29,838	\$17,287
Advertising/PR/Marketing Expenses Per Client	\$72	\$40
Travel and Entertainment Per Client	\$63	\$44
Client Appreciation Expense Per Client	\$21	\$14
Revenue Per Client	\$5,515	\$3,159
AUM Per Client	\$909,262	\$445,833
Operating Profit Per Client	\$846	\$203

1 Best Managed Firms—Top 10% Performing Firms based on composite criteria ranking of profitability, productivity, growth and professional leverage.

2 Based on 210 firms that are primarily or solely fee-based.

3 Principals—Principals/Owners with practice management and client responsibility.

4 Professionals—investment advisors, financial planners, portfolio managers and business development specialists.

5 Support Staff—paraplanners, tax preparers, research analysts, client service administrators.

6 Administrative Staff—office managers, bookkeepers, internal accountants, information system specialists and receptionists.

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Median Productivity and Profitability Ratios

Fee-Based Firms¹ by AUM Size and Best Managed Firms²

	Under \$50 MM	\$50 MM– \$100 MM	Over \$100 MM	Best Managed Firms
Assets Under Management	\$17,000,000	\$70,000,000	\$192,500,000	\$224,522,514
Revenue	\$166,000	\$535,612	\$1,327,470	\$1,755,354
Active Clients	55	116	220	220
Median Gross Margin	60.8%	54.8%	53.2%	63.3%
Median Operating Profit Margin	9.6%	3.8%	8.2%	15.5%
Median Pretax Income Per Owner	\$42,137	\$122,627	\$160,543	\$294,058
Staff Headcount				
Principals ³	1.0	1.0	2.0	2.0
Professionals ⁴	0.0	1.0	2.0	2.0
Support Staff ⁵	0.0	1.0	2.0	3.0
Administrative Staff ⁶	1.0	1.0	2.0	3.0
Total Headcount (sum of above)	2.0	4.0	8.0	10.0
Clients Per Professional	34	54	52	53
Clients Per Professional and Support	25	34	32	35
Revenue Per Professional	\$111,464	\$274,343	\$287,428	\$344,820
Revenue Per Professional and Support	\$79,212	\$142,083	\$169,069	\$224,718
AUM Per Professional	\$12,054,167	\$31,000,000	\$42,841,567	\$47,223,818
AUM Per Professional and Support	\$9,225,000	\$19,351,542	\$27,125,000	\$29,230,113
Infrastructure Expenses Per Client	\$621	\$816	\$972	\$1,243
Infrastructure Expenses Per Staff	\$14,850	\$19,306	\$23,207	\$29,838
Advertising/PR/Marketing Expenses Per Client	\$31	\$50	\$66	\$72
Travel and Entertainment Per Client	\$36	\$40	\$49	\$63
Client Appreciation Expense Per Client	\$13	\$15	\$18	\$21
Revenue Per Client	\$2,834	\$4,222	\$5,437	\$6,060
AUM Per Client	\$313,846	\$539,130	\$844,417	\$909,262
Operating Profit Per Client	\$214	\$90	\$252	\$846

1 Based on 210 firms that are primarily or solely fee-based.

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Average Common Sized Income Statement*

Best Managed¹ and All Other Firms²

	Best Managed Firms	All Other Firms
Asset Management Fees	90.9%	79.7%
Planning and Consulting Fees	7.4%	15.0%
Insurance Commissions and Renewals	0.6%	0.7%
Other Fees	0.6%	1.7%
TOTAL REVENUE	100.00%	100.00%
Professional Salaries and Bonuses ³	18.2%	28.7%
Commissions Paid	3.2%	2.1%
Owners' Draws or Base Compensation ⁴	17.5%	16.3%
Total Direct Expense	38.9%	47.1%
Gross Profit	61.1%	52.9%
OVERHEAD EXPENSES		
Administrative Salaries ^{5,6}	11.3%	9.7%
Employee Benefits	3.8%	3.6%
Payroll Taxes	2.9%	2.8%
Training and Continuing Education	0.6%	0.6%
Total HR Expense	18.5%	16.7%
Rent	6.3%	4.9%
Utilities/Phone/Fax/On-line service	1.2%	1.3%
Professional Services	1.6%	4.0%
Depreciation/Amortization	1.1%	1.2%
Software/Hardware Expense	2.3%	1.7%
Equipment Leases/Purchases	0.9%	0.7%
Auto Expense	0.5%	0.7%
Insurance	1.3%	1.4%
Office Expense	2.3%	2.0%
Repairs and Maintenance	0.2%	0.4%
Taxes and Licenses	0.4%	0.5%
Dues—Clubs	0.0%	0.2%
Dues—Professional	0.3%	0.5%
Total Infrastructure Expense	18.4%	19.4%
Advertising/Public Relations/Marketing	1.6%	1.7%
Travel and Entertainment	1.3%	1.2%
Client Appreciation	0.2%	0.3%
Total Business Development Expense	3.1%	3.3%
Charitable Contributions	0.3%	0.2%
All Other Expenses	1.4%	2.6%
TOTAL OVERHEAD EXPENSES	41.7%	42.1%
OPERATING INCOME	19.4%	10.8%
Other Income	0.3%	0.6%
Other Expenses (-)	-0.6%	-1.6%
Owner's Bonus (-)	-5.9%	-2.7%
TOTAL OTHER INC/EXP	-6.2%	-3.8%
PROFIT BEFORE TAX	13.2%	7.0%
Income Taxes (-)	-0.3%	-1.0%
NET PROFIT AFTER TAX	12.9%	6.1%
Pretax Income Per Owner	14.9%	16.1%

* Totals may not add up due to rounding.

1 Best Managed Firms—Top 10% Performing Firms based on composite criteria ranking of profitability, productivity, growth and professional leverage.

2 Based on 210 firms who are primarily or solely fee-based.

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Average Common Sized Income Statement*

Fee-Based Firms¹ by AUM and Best Managed Firms²

	Under \$50 MM	\$50 MM–\$100 MM	Over \$100 MM	Best Managed Firms
Asset Management Fees	81.9%	81.7%	86.9%	90.9%
Planning and Consulting Fees	12.9%	12.4%	8.8%	7.4%
Securities Commissions and Trails	1.7%	2.6%	1.4%	0.6%
Insurance Commissions and Renewals	1.8%	1.1%	1.5%	0.5%
Other Fees	1.6%	2.2%	1.4%	0.6%
TOTAL REVENUE	100.00%	100.00%	100.0%	100.0%
Professional Salaries and Bonuses ³	20.1%	24.2%	28.6%	18.2%
Commissions Paid	1.5%	0.3%	2.1%	3.2%
Owners' Draws or Base Compensation ⁴	22.6%	21.5%	14.7%	17.5%
TOTAL DIRECT EXPENSES	44.1%	45.9%	45.4%	38.9%
GROSS PROFIT	55.9%	54.1%	54.6%	61.1%
OVERHEAD EXPENSES				
Administrative Salaries ^{5,6}	5.2%	12.8%	11.0%	11.3%
Employee Benefits	2.6%	4.2%	3.7%	3.8%
Payroll Taxes	2.9%	3.0%	2.8%	2.9%
Training and Continuing Education	1.1%	0.6%	0.6%	0.6%
Total HR Expense	11.7%	20.5%	18.1%	18.5%
Rent	6.2%	5.9%	4.8%	6.3%
Utilities/Phone/Fax/On-line service	2.0%	1.6%	1.1%	1.2%
Professional Services	2.8%	2.4%	4.0%	1.6%
Depreciation/Amortization	1.3%	1.3%	1.2%	1.1%
Software/Hardware Expense	1.9%	2.7%	1.6%	2.3%
Equipment Leases/Purchases	1.0%	0.9%	0.7%	0.9%
Auto Expenses	1.4%	0.9%	0.5%	0.5%
Insurance	1.5%	1.6%	1.3%	1.3%
Office Expense	2.1%	2.3%	2.1%	2.3%
Repairs and Maintenance	0.5%	0.5%	0.3%	0.2%
Taxes and Licenses	0.7%	0.4%	0.5%	0.4%
Dues—Clubs	0.2%	0.2%	0.1%	0.0%
Dues—Professional	0.6%	0.5%	0.4%	0.3%
Total Infrastructure Expense	22.1%	20.9%	18.6%	18.4%
Advertising/Public Relations/Marketing	2.0%	2.0%	1.6%	1.6%
Travel and Entertainment	2.0%	1.2%	1.1%	1.3%
Client Appreciation	0.5%	0.4%	0.2%	0.2%
Total Business Development Expense	4.5%	3.5%	2.9%	3.1%
Charitable Contributions	0.3%	0.2%	0.2%	0.3%
All Other Expenses	2.1%	1.8%	1.9%	1.4%
TOTAL OVERHEAD EXPENSES	40.8%	47.0%	41.6%	41.7%
OPERATING INCOME	15.1%	7.1%	13.0%	19.4%
Other Income	0.5%	0.3%	0.6%	0.3%
Other Expense (-)	-0.8%	-1.5%	-1.6%	-0.6%
Owner's Bonus (-)	-3.6%	-1.1%	-4.1%	-5.9%
TOTAL OTHER INC/EXP	-4.0%	-2.3%	-5.1%	-6.2%
PROFIT BEFORE TAX	11.1%	4.8%	7.9%	13.2%
Income Taxes (-)	-1.3%	0.0%	-0.6%	-0.3%
NET PROFIT AFTER TAX	9.8%	4.7%	7.3%	12.9%
Average Pretax Income Per Owner	30.6%	20.2%	11.3%	14.9%

* Totals may not add up due to rounding.

1 Based on 210 firms that are primarily or solely fee-based.

2 Best Managed Firms—Top 10% Performing Firms based on composite criteria ranking of profitability, productivity, growth and professional leverage.

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