Part I: Is the era of the monolithic RIA custodian coming to an end?

by Lisa Shidler and Brooke Southall

Brooke's Note: It used to be that the downtown of the RIA business was the RIA custodian — spiritually, intellectually and, more tangibly, as a general store of services. Today, custodians are still skyscrapers on the RIA landscape but the border between exurbia and inside the beltway is blurring. The ancillary services of custodians are being usurped and sold at a profit by a new raft of companies. Will the custodians fight to regain their dominance or will they cede ground strategically? And if they do, what then will the custodial landscape look like? This report shows a long-static picture morphing rapidly with much up for grabs.

Part II has since been published: See: Part II: RIA custodians' answer to challenges to their monolithic control: We still have big-time scale advantages.*

What a difference a few years make.

When RIABiz began publication in 2009, the RIA business was still in its waning epoch of being a somewhat bizarrely bifurcated business.

First there were the 28,000 firm state- or SEC-registered mom-and-pops who made up the then $2 trillion — now $3 trillion — of retail assets managed in this format for mostly high-net-worth investors. See: What advisors should know about the next sweeping change: the switch from SEC oversight to state regulation.

And then, there were the four major RIA custody players, in order of assets, Schwab Advisor Services, Fidelity Institutional Wealth Services, TD Ameritrade Institutional and Pershing Advisor Solutions LLC..

The still-mighty four

In retrospect it was the era of the large custodian and the classic RIA, a barbell-shaped affair composed of big semi-commoditized service bureaus on one side and tens of thousands of advisory laboratories with customized offerings — replete with the business inefficiencies that often come in cottage industries — on the other.

The RIA custodians have been a giant force for good for RIAs and they remain so. The mighty four cumulatively hold assets for a combined $1.35 trillion to $1.75 trillion (depending on how many of the $630 billion FIWS assets you count as RIA assets) of assets, an amount that has grown steadily from $475 billion a decade ago. They service 28,000 RIAs employing 100,000. See: How to choose between the bewildering custody choices.

While RIA custody per se is really just the arguably dull act of serving as a vast electronic parking lot for the assets of RIAs, most advisors know these companies for the more exciting services that they typically provide — including conference-organizing, consulting, compliance help, M&A help and juggling between fees and commissions.

IBDs of unusual size

What is most notable about the past four years has been the emergence of a third mezzanine layer formed of providers that fill niches that just don't get adequately served — or have been abdicated — by the large custodians. These include a number of new RIA custodians who serve advisors either unwanted or unloved by big custodians. For a complete list, click here.

The biggest such categories are the smaller, startup-type RIAs who seem to thrive at effective, if wonkily named, companies such as Equity Advisor Solutions, Trade-PMR, National Advisors Trust Co., Shareholders Service Group Inc., Folio Institutional and Scottrade. See: A peek inside the rising RIA custodians fighting to overtake the Big Four.

The other constituency that has several new custodial homes from which to choose consists of two-hatted hybrid RIAs that are steadfastly determined to remain on IBD support as they ply their trade both as brokers and fiduciary advisors, depending on the time of day. See: Commonwealth and Securities America get into the RIA custody business and Wells Fargo is right behind them.

LPL Financial has made the most noise in this regard, but virtually every independent broker-dealer of size is making these moves. One indecisive broker in this regard seems now more resolute: RBC. See: After a head-fake, Royal Bank of Canada shows it's back (or never left) in the RIA game with two NextGen hires.

(Step) father figures

But perhaps the more dynamic players comprising the RIA third layer are the roll-ups, co-ops, OSJs TAMPs, M&A firms (thinkDeVoe & Co., compliance (think MarketCounsel, NCS and RIA-in-a-Box) and technology firms that offer services to RIAs.

Then there are the hybrids of these oddballs, such as Fortigent, LLC, Envestnet Inc. and Dynasty Financial Partners, that are almost better undescribed == as a generic description confuses the issue. But certainly these fast-emerging firms aid advisors in outsourcing investment management and technology in cogent fashion. See: How Fortigent got $50 billion on its platform by treating an RIA pain-point.

In recent years, these firms have begun to build up their empire of advisor clients and are standing in with the paternal presence custodians would provide. Some of these firms are now the first place breakaways go before they even meet with RIA custodians. For instance, OSJs and roll-ups are now instrumental in luring breakaway teams, helping them set up shop and even negotiate prime deals with the custodians. See: Why exactly LPL Financial nixed NestWise and how OSJs, once again, may be wagging the big dog.

Tyler Cloherty: All of these really strong companies are competing against one another, and it's hard to differentiate against your competitor except for price.

The third layer

"The services you'd normally think of getting from a custodian are now being done by other parties," says **John Furey**, founder of **Advisor Growth Strategies LLC**, a financial advisor practice management consulting firm based in Phoenix.

"If these roll-up firms like HighTower are doing the things a custodian used to do, it's putting price pressure on the custodians. Ten years ago, the custodian was the single-most-important provider by a mile and it probably still is, but right now there are just so many other companies providing valuable services too." See: HighTower grabs sought-after $650 million Merrill Lynch 'life sciences' team and shrugs off recent deal slowdown.

Furey's own company, incidentally, is a perfect example of a specialized firm in the third layer. Neither a lawyer nor a recruiter, he nonetheless has found a big niche serving breakaways who need a chief-operating-officer kind of expertise in executing their transition. See: How, strangely, money gets downplayed in RIA deal making and why it helps explain an anemic flow.

Givebacks under the gun

Another exacerbating factor for RIA custodians is the continuing profit margin pressure they feel not only from each other's competition, but from a chronically low-interest rate environment. Much of their profits previously derived from money market fees that have been waived or have shrunk. See: Fidelity's annual $10,000 custody fee will attach to a wider swath of small RIAs.

Telltale signs that these margin pressures affect custodians can be seen in how they occasionally find new fees to charge. Industry leaders point to the rare but recent practice of Fidelity Institutional Wealth Services' and Schwab Advisor Services' giving RIAs payments after they've invested in clients' money in certain mutual funds. While this practice was mystifying initially, many industry leaders say it's a symptom of these pressures and RIA custodians feel they must give revenue back to RIAs or they could lose the business. See: Industry leaders puzzled by RIAs' being paid by Schwab and Fidelity for investing in funds.

"Based on the firms' actions, it appears they've got margin pressure," says Tyler Cloherty, associate director of Cerulli Associates Inc. in Boston. "They're now passing through revenue to some of their larger firms and there's all of these new entrants from LPL and Raymond James. There's more competition to the exiting custodians within the RIA space. It shows the industry is maturing. All of these really strong companies are competing against one another, and it's hard to differentiate against your competitor except for price."

RIA custodians are clearly trying to undercut one another by giving out freebies to advisors. For instance, earlier this year TD Ameritrade Institutional announced it is launching a web-based version of iRebal advisors at no cost. See: TD Ameritrade will make iRebal software available free to all its RIA clients.

John Furey: Ten years ago, the custodian was the single-most-important provider by a mile and it probably still is, but right now there are just so many other companies providing valuable services too.

Extreme outsourcing

Outsourcing firms have the potential to be just as damaging to the custodians' prominence. Chicago-based Envestnet has a roster of 23,000 advisors who use its services as a back office, and now the firm is intending to turn into a living, breathing warehouse of intelligence with its new initiative. "Envestnet Intelligence" gives RIAs real-time access to thousands of advisors, allowing them to compare and benchmark many other aspects of the business, including advisory fees and portfolio trends. See: Having won advisor assets, Envestnet's next — more Google-like — play is for their smarts.

Similarly, Dynasty Financial Partners has built itself up rapidly in less than three years as an outsourcer wooing elite teams out of wirehouses and selling itself as the engine behind the breakaway to help provide services to teams.

The firm now has a network of 17 firms across the country advising more than $16 billion in client assets. Recently, Dynasty signed a partnering pack with GMP, a big Toronto-based wealth manager that has many characteristics of Chicago-based HighTower. See: A $15-

billion roll-up-like venture in Canada gets a US foothold with a Dynasty Financial deal — and vice-versa.

Big plays

Another part of the third layer is the companies trying to do something about the big RIA deficit to wirehouses — a lack of brand recognition.

When we started this custody project, Advizent fit into this category — pooling cash to buy ads to build a giant RIA brand. It subsequently closed in face of the enormity of the task. See: Advizent will close its doors after a final flurry of negotiations.

Other entrepreneurs tried to take age-old brands such as E.F. Hutton and Robertson Stephens and rehabilitate them. The E.F. Hutton venture is mostly over. See: Why Frank Campanale put his E.F. Hutton dream aside to join an OSJ.

But keep a watch on Joe Piazza at Robertson Stephens. See: With big LPL backing, the Robertson Stephens brand revives to roll up advisors to the suddenly wealthy.

Other brand plays have met an unkind fate, including NestWise and BloombergBlack. More-organic brand growth plays are faring better, including The Mutual Fund Store and Edelman Financial. See: Ric Edelman is looking to add a $1-billion RIA elephant even as he unveils an online consumer strategy aimed at the chipmunks.

Muscular aggregators

The roll-ups are also “brand” plays to a degree, and Joe Duran at United Capital Financial Advisers is perhaps most vocal on this point. He is working to establish a consistent quality and process to sell with his brand. See: United Capital’s Joe Duran throttles back on deals as he opens an RIA version of Hamburger University.

HighTower Advisors LLC, one the nation’s most voracious aggregator of wirehouse teams, is quite clear that part of its brand is its ability to play custodians off each other to get the best services and lowest prices. In the summer of 2012, HighTower CEO Elliot Weissbluth made a decision that means many more advisors will fall under the firm’s umbrella, making it a further threat to the custodians’ margins.

The Chicago-based firm predicts that in three years more than half of its business will be with non-partner firms that will take advantage of HighTower’s scale and the enticing deals it has reached with custodians and vendors. See: It won’t be long before HighTower’s fee-for-service channel revenues draw even with its partner firm revenues.

Another roll-up-like firm, New York-based Focus Financial Partners LLC, with its $55 billion in assets under advisement, wields similar muscle among such firms with its ability to steal margins from custodians. Focus Financial has traditionally gone after giant RIAs but recently said few firms are off-limits. Now, Focus is recruiting wirehouse breakaway teams with as little as $100 million in assets. These are the types of advisors that used to find homes only with the custodians. See: Focus Financial goes after $100-million wirehouse brokers after hiring five employees suited to the task.

Focus has recently hired Rob Freedman from HighTower to concentrate on really building up the brand.

Too big to…

And in this regard, the custodians remain the ones with the bigger, better brands. The most recent big breakaway we interviewed, Ajay Gupta, said he chose Schwab as the primary custodian for his $540-million practice because he believed the brand represented stability, technology and service.

But Gupta added that he liked it that the company never accepted a TARP payment.
See: Schwab wins giant UBS breakaway in San Diego.

In the second, upcoming, half of this article we'll hear much more from the heads of custodians themselves — especially Mike Durbin and Mark Tibergien who gave generously of their time. The custody chiefs are quick to acknowledge a loss of power and some creeping commoditization. But they are hardly putting themselves out to pasture — and may have some unexpected tricks up their sleeves.