Crash test: How RIAs can survive the next recession

by Ian Wenik for Citywire

Be careful…things might get rough out there! Here's what you need to do to protect your business.

1 GET OUT WHILE YOU STILL CAN

Valuations for RIAs are approaching their pre-financial crisis highs, according to David DeVoe, managing partner at RIA M&A consultancy DeVoe & Company. RIAs looking to sell can command between 4x and 6x cash flow for a $100 million firm, 5.5x to 7x for a $500 million firm, and as much as 9.5x cash flow for a $1 billion firm, DeVoe said.

But the good times won't last forever. 'When 2008 hit, the profits of these firms got hammered. You suddenly have this massive decline in your asset-based revenue, but no expenses coming out of the system,' he added.

Compressed margins and shrinking revenues can hurt valuations – and the looming possibility of a market pullback may set alarm bells ringing for advisors. A 20% dip in the market could cause RIA businesses to decline in value by as much as 70%, explained RIA consultant Tim Welsh of Nexus Strategy. 'If you're thinking of selling your business, now is the time to do it,' he said.

For prospective buyers – especially the private equity firms who have been taking particular interest in the RIA industry of late – a slide in valuations could open up some opportunities for strategic purchases.

'I don't think [private equity] would necessarily retreat. But RIAs might be reticent to sell at a discount,' DeVoe added.

2 AVOID RISK

Advisors won't necessarily need to make wholesale changes to their portfolios in a recession, but it might not hurt to de-risk to some extent.

For Peter Lazaroff, co-CIO of $4 billion RIA Plancorp, it is important to accept the fact that there's no such thing as a portfolio that is immune to a market slowdown. Advisors simply need to communicate that to clients.

'There isn't a perfect portfolio – there's just the portfolio that you can get people to stick with longest. We know the portfolio's going to lose money. We don't have a magic bullet,' he said.

While avoiding wholesale changes to allocations, Lazaroff said he would look to rebalance more frequently and make some shifts at the sub-asset class level toward less volatile markets.

'We generally look at rebalancing monthly. But if the market falls 10% in a week, we're not going to wait a month to look at your portfolio,' he said. 'We're probably going for tax-loss harvests.'

Advisors looking to change their allocations in advance of a recession need to understand that 'safe' asset classes or sectors don't always remain that way, said David Lieberman, managing director at Advisors Capital Management, which oversees around $2.4 billion in client assets.

'In a normal recession, you may not get a massive correlation between every asset class, but in a severe recession, they certainly will all be increasingly correlated,' Lieberman said. 'You can mute the impact of that by owning more high quality debt. When volatility spiked recently, that debt was bid higher and the spreads have really fallen.'

His firm has purchased more preferred securities and floating rate debt in recent months but is still overweight equities relative to fixed income.

3 HUNT FOR NEW BUSINESS

In a recession, advisors won't be able to rely as much on their existing client base to keep their businesses afloat. Although asset-based fees are a nice source of recurring revenue, they are tied to market outcomes and inevitably fall in a downturn.

Investing in public relations and marketing as a way of attracting new clients and assets could help, Nexus Strategy's Welsh said.

'If the markets are going down, then everybody's hurting,' he explained. 'That can be a great opportunity to say: "You know what, we focus more on the long-term financial planning approach. We don't hang our hats on performance in the markets – we're a different kind of firm." That messaging can bring in some good business.'

4 DON'T PANIC

Markets go up in the long run, but that doesn't make recessions any less scary for investors.

Upfront disclosure plays a critical role in managing client expectations, Plancorp's Lazaroff said. When new clients open an account at Plancorp and are placed in a model, they get the full picture of how that portfolio has performed in the past – including during downturns.

The firm also runs safety net analyses for clients nearing retirement, to make sure that they have enough money to live on even if they withdraw their money in a bear market.

'Once you have lived through that first bear market in retirement, the sequence of return risk is dramatically reduced,' Lazaroff said. 'It's not eliminated, but it's reduced.'

Of course, advisors aren't immune to panic either. For example, Lieberman's firm has one advisor who persistently sells out in market declines and buys back in when things recover.

'It happens on such a routine basis that we actually use him as a signal. When he says, "Oh guys, I just want to go to cash," we know that it's time for us to be investing in a big way again, because he's basically timing it in the opposite way,' Lieberman said.

5 PRESERVE RATIONS

Advisors don't necessarily need to cut back aggressively when a market slide hits, but keeping an eye on fixed costs can help. For many RIAs, the only truly fixed cost is the price they pay to keep a roof over their heads, said John Furey, a consultant at Advisor Growth Strategies. Everything else – including compensation – is flexible.

'Firms with compensation costs that are high, fixed in nature and have little variable components tend to do better as markets expand, but they get hit harder as they pull back,' Furey noted. 'Firms that have incentive plans that are flexible tend to do better when markets go down.'

He added that advisors with a low base salary and a high percentage of pay based on revenue would also be incentivized to bring in new clients, which would help in a downturn.

For Shirl Penney, chief executive of Dynasty Financial Partners, the firms that tend to thrive in a downturn are those that have managed their balance sheets carefully ahead of any crisis.

'Don't overhire, and be disciplined with the margins. Make smart investments in the business and give yourself the mental space to work *on* the business, not just *in* the business,' he said. 'If RIAs do this, they will be in a position to win disproportionately versus competitors when the markets pull back.'