Ric Edelman's secret recipe

By Lynnley Browning for FinancialPlanning

On June 3, Ric Edelman sat down in his home office in Great Falls, Virginia, to log on to an unusual Zoom with his inner circle. For years, he had routinely chatted with the two dozen senior financial planners at his successful investment advisory firm, all loyal, long-term employees spread out from West Palm Beach to Los Angeles. Over time, he had rewarded them with fancy "executive director" titles and company stock. More than half a dozen of them had joined him on a sweaty, "guys-only" road trip through the Australian Outback in early March 2020, right before the pandemic surged. "We are a close-knit, tight family," Edelman, 63, says. He and Jean don't have kids, "so these guys are our children. They're our babies."

He knew he was about to rock the foundation of the special relationship he'd developed with them over decades.

Edelman began the meeting by recapping recent triumphs. In March, a new investor, private equity firm Warburg Pincus, bought a minority stake in Edelman Financial Engines, giving the firm a $7.3 billion value — more than double its $3 billion value in 2018. At the same time, the firm refinanced its debt and tacked on new borrowings, to bankroll more than $1 billion in special dividends to its shareholders. All told, Edelman intoned slowly, the moves made his namesake firm, the largest independent advisory in the country, "well positioned for its next chapter of growth." He took a breath, then dropped his bombshell.

He was leaving.

"I told them that Jean and I will not be joining them on that journey," he recalls. The advisors froze in stunned silence. Many began weeping. More than a few blubbered. "This was a shock to everybody," he says. Because he and his planners "have a very close relationship, I was blunt and to the point," he says. Normally with a composed, radio voice, he burst into tears on the Zoom — then readied himself to drop the same bomb on the rest of the firm.

An hour later, more than 550 other advisors and another 900 employees got the shocking news in a company-wide Zoom that Edelman led with CEO Larry Raffone and Jason Van de Loo, the retail and marketing head. While they were in the loop on the secret, other senior managers were stunned — "they did not know," Edelman recalls in a series of interviews with *Financial Planning*.

Employees watched a video that included Edelman reading a five-page, deeply personal farewell letter he'd penned to clients and employees but not yet sent out. There were other videos, too. Those came from Warburg Pincus and Hellman & Friedman, another private equity firm that has a majority stake in Edelman Financial Engines. They were sleek, corporate productions.

Four days later, on June 7, Edelman Financial Engines announced that Edelman would step down as chairman at the end of the year. While he would continue as a "strategic advisor" and remain on the board of directors, he was shifting his focus to cryptocurrencies. The letter went out to 1.3 million customers that day, including nearly 450,000 individual clients (the rest are in company 401(k) plans the firm advises.) And the $5.7 trillion independent advisory industry began asking: What does this mean for the future of financial advisors?

Lessons for the industry

With $260 billion in assets under management, Edelman Financial Engines is a bellwether. What the firm does can impact how legions of consumers will get financial advice on everything from retirement to wealth building. But Edelman's "transition" out of the firm he and Jean started 35 years ago brought to the fore a burning question: What ultimately happens to a successful, award-winning RIA and its clients when private equity investors — known for buying up everything from hospitals and housing complexes to Staples and Taylor Swift's music catalog — increasingly call the shots?

Can a firm that rewarded employees with front-row tickets to Wolf Trap Performing Arts concerts, family trips to Disney World and, after 10 years, a Rolex, keep its culture — its recipe for success — under professional investors?

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"It's a big move for the industry, as most advisors and owners are looking at long-term succession and continuity," says Brandon Kawal, a principal at Advisor Growth Strategies, a consulting and transactions advisory firm in Phoenix. "There will be a lot of lessons there for advisors around the country."

And a lot of questions. Hellman & Friedman and Warburg Pincus scored a big payday in March when they squeezed $1.25 billion in cash out of the firm in a so-called dividend recapitalization. Will they seek to cash in further by flipping Edelman Financial Engines to the likes of a Fidelity or a Bank of America (or "could be Apple or Amazon, if they ever get in the game," Edelman laughs)? Will the firm do an initial public offering on Wall Street —or sell to a SPAC?

With independent advisors centered on the best interests of their clients, how can the business that Edelman and his wife started from scratch in 1986 survive the cost-cutting and "profits first" culture of its private equity masters — or the earnings pressure of being publicly traded? Edelman Financial Engines' calling card is conflict-free advice — it's been Barron's #1 ranked independent advisor for the last three years. But what if it's courted by a firm with proprietary products to push and sales quotas to meet?

"If EFE can maintain Ric's combined loving spirit, client orientation, yet toughness for the nonsense the world throws at every business, it will do just fine," says Ken Fisher, the founder, executive chairman and co-CIO of Fisher Investments, a $169 billion RIA th at has shunned private equity ownership. Then he adds another thought: "Ric's biggest error, in my view, was surely too many involvements over time with varied private equity firms; they're usually deadly over time to most" SEC-regulated advisory firms "that get sucked in by them."

Dancing with Wall Street

Edelman has tangoed with Wall Street for decades. "This latest transaction was the sixth time I've sold the company," he says. "There will be a seventh." One big takeaway of all the deals, he says: "Your lawyer is probably the contract that's going to matter at least as much as the financial terms the investment bank negotiates on your behalf." Each time, he says, he has negotiated blocking rights on major issues like acquisitions, hiring and compensation.

“I still have the ones that matter the most,” he adds, including the right to block the sale of the firm if he doesn’t like the bidder.

But for giant advisors, private equity is increasingly calling the shots. The industry typically aims to scale up a portfolio company over five to seven years before flipping it to a new buyer at several times what they paid, or, less commonly, taking it public. Either way, the focus becomes maximizing profit margins, adding clients and cutting costs. “Above all, Ric got ‘client first’ as a guiding star when precious few did,” Fisher says. Can the firm’s original culture — its recipe for outsize success — avoid being diluted by Wall Street?

The often-quirky Edelman is known for his fast-talking, self-assured demeanor — honed through his 10 personal finance books (some New York Times bestsellers on his own or with Jean, including “The Squirrel Manifesto” for children), 1,500 episodes of his weekly radio program “The Ric Edelman Show” and podcasts. That’s not to mention Youtube videos, paid speaking gigs as a “celebrity” financial planner (at one agency his fee starts at $100,000) and Congressional testimony on retirement and wealth building.

And presentations at high-profile investment conferences, freewheeling interviews and talking-head gigs on CNBC and CNN. An electic collector, one of his prized possessions is an original copy of Johannes Kepler’s Rudolphine Tables from 1627, a catalog of stars and planets (astronomy is an obsession of his). “I’ve become the most highly acclaimed financial advisor in the country,” his letter said. Was the brash star nudged out by his main shareholder?

“The rumor mill was always a little bit that he was more of a front man than a manager, and for whatever reason, in the current composition of that business, they don’t feel like they need him involved at the level he was,” says Matthew Crow, the president of Mercer Capital, a valuation and advisory firm.

Pandemic Zooms, Satoshi the Weimaraner and Edelman’s net worth
Edelman says that since 2015, he and Hellman & Friedman partner Allen Thorpe, who is on the board of Edelman Financial Engines, “always talked extensively about the need for the company to prosper and grow without dependence on me.” Still, he says, citing the pandemic and his age, those conversations “accelerated” around the start of this year on regular Zooms. “This wasn’t an adversarial situation,” he says. “This was a collaborative effor t to recognize what [Jean and I] built and respectfully acknowledge the economic value we provide to the firm, and what would be appropriate for our continued involvement.”

By noon on May 25, after months of ironing out details on Warburg’s stake and his “transition,” he signed the final documents. He and Jean, 62, sat in their kitchen, amid custom exotic hardwood cabinets, a quirky sculpture of a crazed chef and a pandemic rescue Weimaraner named Satoshi, after the reputed inventor of Bitcoin. Neither Edelman nor his wife said a word for a long time.

“Ric is really all about himself, so I‘m sure he left on his own terms,” says Tim Welsh, the president, CEO and founder of Nexus Strategy, a consulting firm for wealth managers. Hellman & Friedman and Warburg Pincus didn’t respond to emails requesting comment.

Edelman won’t say how much of his eponymous firm he owns, or what he’s worth. While Hellman & Friedman is the majority institutional owner, and Warburg owns close to one fifth of the company, he's the single largest individual shareholder. The firm's ADV disclosure doesn't identify him as a shareholder, instead listing several Delaware entities that he controls that own stakes. "I own through both my name and through one of my corporations, a predecessor company to the current holder," Edelman says. Welsh says that combined with his media earnings, Edelman's net worth "should be north of nine figures, easily. I would expect it's very significant."

Dividend recapitalization
Largely unnoticed in the March transaction was that Warburg quickly got some of its $1 billion to $1.4 billion back. So did Hellman & Friedman.

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That's because the private equity firms had Edelman Financial Engines make a sometimes-controversial financial move. A dividend recapitalization involves private equity saddling portfolio companies with debt in order togive themselves cash payouts from the borrowed money. Critics say the move squeezes cash out of a company, potentially weakening it by pinning it under new debt.

Each time Edelman made a deal with investors in his advisory firm, he carved out a strategic payout for himself and a profit stake in the new entity.

Here's how it worked, according to a note by S&P Global on March 15. First, Edelman Financial Engines borrowed $900 million, tacking the amounts on to its existing $1.9 billion bank loans. It also extended the payback period of the loans and of a $150 million line of credit by several years. The moves gave the company $2.8 billion in debt — close to 50% more than before, making it highly leveraged. A "key risk" to the firm, Moody's wrote in March, was that it's "sponsor-owned, which could result in aggressive financial policy decisions."

Moody's said Edelman Financial Engines "plans to use net proceeds from the debt issuance plus cash on the balance sheet to fund a dividend distribution of up to $1.25 billion to private equity funds affiliated with Hellm an & Friedman, the company's private equity sponsor." How much excess cash? Anywhere from $240 million to $300 million, not including the $150 million credit line, S&P Global wrote. Edelman says a tiny piece of the payouts, made last month, also went to employees, including advisors. "We kind of have a philosophy of pushing it down," Raffone says. But the professional investors reaped the lion's share.

Private equity's signature move wasn't immediately obvious in announcements of the firm's "recapitalization." Raffone downplays the payout, saying that because low interest rates make borrowing less costly, "this is just good business hygiene." He compared it to refinancing a house, adding that the firm's debt is "very manageable and reasonable ... we wanted to leave some room for acquisitions, so you don't want to leave yourself tapped out." (In a rare deal, the firm bought Viridian Advisors, a $846 million RIA, in May.)

The special payout wasn't Edelman Financial Engines' first time at the dividend recap rodeo. In October 2017, nearly two years after Hellman & Friedman first acquired a majority stake, it borrowed money that was used to send $225 million to the private equity shop.

Kawal argues that private equity owners “can professionalise the firm and add strategic value.“ The downside: “These are professional investors, so you have to know what you’re signing up for. A lot of owners in the space are not going to have the appetite.”

Private equity muscles into RIAs

With the fragmented advisor industry nots sixth frenzied year of mergers and acquisitions, private equity increasingly sits at the head of the consolidation dinner table. Its preferred dish: RIAs with $1 billion or more in client assets. Data from Echelon Partners, an investment bank for wealth managers, shows private equity firms fuel the industry’s biggest deals, with five out of the 10 biggest transactions in the first quarter of this year involving direct investments by private equity firms or acquisitions by firms that are partially backed by a private equity partner. “We’re seeing the emergence of 24 or 25 ‘META’ RIAs that are going to be shaping the industry,” says David Devoe, the founder and CEO of Devoe & Company, a consulting and valuation firm for wealth managers. The acronym, from the world of Minecraft and other online games, means “most effective tactics available.” But Devoe says that the trend "isn’t the death knell for the rest of the RIA space.”

Most firms get flipped to a buyer. But CEO Raffone says that for Edelman Financial Engines, “you gotta assume the next transaction will be a public transaction. We’re more likely to take it public than remain independent.” He adds that “it’s a multi-year exercise. I don’t want to go public now, because we’re hiring a bunch of planners and we need to get the technoloy right” — a reference to the firm's push into AI and Big Data to find clients. Steven Levitt, the founder and managing director of Park Sutton Advisors, a boutique investment bank for financial firms, says he thinks Edelman’s firm could be worth $25 billion to $30 billion if it goes public in a few years.

Conflicts of interest

When Edelman merged with Financial Engines in 2018, it added a giant robo-advisor for company 401(k) plans. The deal meant a new revenue stream from the latter’s $169 billion in managed assets, but it also created a potential problem. Edelman advisors are fiduciaries, but they now had a financial incentive to recommend that clients roll over their 401(k)s to advisor-managed IRAs or other investment accounts. After all, a huge chunk of the firm’s total AUM, or around $200 billion, are in those 401(k)s. The firm acknowledges in its ADV that “a conflict of interest may exist for Edelman Financial Engines planners as they have an economic incentive to
offer certain advisory services, including recommending rollovers, to clients.”

The firm "does not solicit rollovers from 401(k) plans” and has “strict safeguards” to ensure that any rollover is in the client’s best interest,” the filing says. But the market reality is that as aging Boomers retire, rollovers are where the money is. In 2018, investors rolled over $534 billion from company-sponsored retirement plans to IRAs, according to IRS data cited by the Investment Company Institute.

“You have to ask about what happens at the nexus between the drive for profitability and meeting the best interests of clients,” says Leila Shaver, a securities lawyer who works with investment firms. Citing RIAs whose private equity masters impose sales quotas, she says she’s “surprised we haven’t seen more from our regulators about it.”

Edelman has often traveled with his closest financial advisors — racing dune buggies with Porsche engines in Baja (“like being in a plane crash for 24 hours,” he laughs), and whitewater rafting the Futaleufu River in Chile’s northern Patagonia days before a nearby volcano erupted. He relies “heavily on the counsel of colleagues” for personal financial advice. “Success is entirely dependent on our planners and staff,” he wrote in his letter, a copy of which *Financial Planning* obtained from a client. “To my fellow financial planners within the firm, keep doing what you’re doing.”

But he’s well aware of the terms of his latest deal — and the bargains he’s made over the last half-dozen transactions he’s done. “Your private equity partners are likely to have a very different array of emphases than you have,” he tells *Financial Planning* emphatically. “Their priority list trumps yours. You are going from being the owner of your business to being an employee for someone else.”