Trends

Brokerage House Blues

Joshua Lipton 10.20.08, 6:30 PM ET

On Sept. 15, the day Bank of America announced that it would snap up Wall Street brokerage house Merrill Lynch at less than half the price it was worth only a few months prior, CEO Ken Lewis made a point of telling reporters the object of his firm's desire was Merrill's 16,850 retail brokerage sales force.

Unlike the ivy-league-educated, lavishly compensated investment bankers at the firm, Merrill Lynch's financial consultants work the front lines with clients and have continued to provide liquidity for the firm's bankers, even as institutional credit flows have come to a halt. Indeed, Merrill's army, known as its GWM or Global Wealth Management division, now controls nearly $1.5 trillion in client assets. Lewis called the division the "heart" of Merrill.

But Bank of America's $50 billion price for once-mighty Merrill may not turn out to be the bargain Lewis hoped for. Reports from the rank-and-file brokers indicate that the "heart" of Merrill could soon be in need of a defibrillating shock.

Says one recent Merrill Lynch broker who left to go independent, "When you're young, the name is everything. But now, the name is tainted, and I can't see myself calling up people asking them to entrust their assets to Merrill."

Indeed, as the financial services industry reels from its "do-or-die" restructuring, and too-big-to fail institutions like Bank of America, Citigroup and Wells Fargo gobble up smaller, weaker competitors, the large brokerage sales forces at these banks are facing a crisis of confidence of their own.

"What used to be a positive, a real privilege--having Merrill Lynch or UBS on your business card--is as tainted as tainted can be," says Mindy Diamond, president of Diamond Consultants, an executive search firm specializing in the placement of financial advisers. "Brokers now spend all day defending against actions they have nothing to do with. Wirehouses have become a detriment, a real negative."

In Pictures: Top Five Brokerage Armies

In brokerage jargon, a wirehouse refers to large retail brokerage operations like Merrill Lynch, UBS (formerly PaineWebber), Smith Barney (now part of Citigroup) and Morgan Stanley. As nearly 80 million baby boomers approach retirement, these large brokerage sales forces and the lucrative asset management businesses they feed are the most promising parts of most major financial institutions.

And for many years, national brand names plus the lure of deferred compensation in company stock or options has kept most wirehouse brokers happy. But given the collapse of financial stocks and the new reality of lower leverage ratios and the lower returns associated with them, being associated with a big publicly traded firms isn't as desirable as it once was.

Moreover, thanks to cheap technology, easy access to top-shelf financial products and back office technology systems, being a part of a national firm is no longer a necessity for running a successful financial advisory business. Take, for example, David Armstrong, 41, a former Merrill Lynch broker who defected less than a year ago with four other Merrill brokers to start his own firm, Monument Wealth Management based in Alexandria, Va.

"I just had my four-month anniversary as an independent, " he says. "And it's been great. I would never go back. I get such a sense of pride of ownership, which I never had at Merrill."

Armstrong isn't alone. In April 2007, Citigroup's Paul Tramontano and Sam Katzman left Smith Barney to start Constellation Wealth Advisors, an independent advisory firm, in New York City. They now manage more than $3 billion for 100 clients, most of whom came over from Smith Barney. More recently, a team of top brokers defected from Merrill to start Los Angeles-based Luminous Capital, taking more than $1.8 billion in assets with them.

Indeed, there has been a steady bleed of advisers out of the wirehouses, like Citigroup's Smith Barney, UBS and Morgan Stanley. According to Cerulli Associates, the number of advisers at wirehouses has been dropping at a rate of 1.1% per year since 2004. Experts think the number of defectors will accelerate. Meanwhile, over the same period, the ranks of registered investment advisers are increasing at a rate of 2.4% per year.

Unlike brokers working at firms like Smith Barney and Merrill Lynch, so-called RIAs, or registered investment advisers, have a fiduciary duty to act in the best interest of their clients. They typically earn their fees based on client assets under management, rather than on product commissions.

Even more troubling than statistics showing the growth of RIAs has been the increase of dually registered advisers--advisers who maintain the licenses required for brokerages as well as those required for investment advisories. This group has swelled at a rate of 22.1% per year. Being dually registered often means that the financial representative is transitioning out of a commission-based business and into a fee-based investment advisory business. For big brokerage houses, it usually means that brokers are planning to go independent.

Why would a broker with Merrill, UBS or Wachovia leave these bigger firms to go independent?

Because independents often keep more of the fees or commissions they generate. According to analysis by consulting firm Moss Adams, a wirehouse rep generating in $1 million of production or commissions will earn a median payout of 45%.

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By contrast, a broker working for a lesser-known independent broker/dealer like Cambridge Investment Research or the Investment Center nets, on average, about 51%. If the adviser goes a step further and becomes a licensed RIA or fiduciary, earning fee-based income on assets under management, he would net 61% after overhead expenses.

Given big brokers' fall from grace, it's no wonder then that the RIA model is attracting more fans. Last year, there were 13,841 registered investment advisory firms managing $1.7 trillion compared with 12,450 managing $1.3 trillion in 2005, says Cerulli. Expect the number of RIA firms to grow.

Ultimately, the big winners of the current financial firm meltdown could be the firms like Charles Schwab, Pershing, Fidelity and TD Waterhouse. These firms act as custodians for independent RIAs. They help independent advisers build and run their businesses and give them access to the kind of technology and products available to reps from big national firms.

"The custodians are getting the assets when the brokers break away," says Julie Cooling, founder and president of RIA Database. "They take care of everything when advisers go independent."

Indeed, Pershing Advisor Solutions claims that it is now engaged in conversations with 94 wirehouse teams representing $24 billion of assets under management. That's triple what it was at this time last year, says CEO Mark Tibergien.

Schwab Institutional, another custodian for registered investment advisers, is also signing up new advisers at a record pace. In 2007, the firm brought in more than $9.2 billion of net new assets from 114 brokers turning independent. In the first half alone, Schwab Institutional brought in $9.4 billion in new net assets.

So, before Bank of America's Ken Lewis and Wells Fargo's Dick Kovacevich break out the champagne to celebrate their fire-sale acquisitions, they should be mindful of the flight risk they face among their vast brokerage troops and the assets they control.

Merrill Lynch declined to comment for this article, and Smith Barney spokesman Alex Samuelson dismisses the idea that there will be a flight of advisers out of the wirehouses. However, according to recruiters, some wirehouses are already offering top producing brokers "retention" packages amounting to one year's compensation, payable over nine years. But for some firms it may not be enough.

Says one fed up Smith Barney broker with more than $1 billion in client assets, "Our business has been very nice, actually. But we are tucked under this behemoth Citi that consistently screws up. They stumble and kill whatever contributions we make."

Adds another broker who became an employee of Wachovia after it bought AG Edwards in May 2007, "People hate Wachovia. As far as I'm concerned, the name's a curse word now."

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