Aite PARTNER. ADVISOR. CATALYST.

Blurring the Lines: The Impact and Importance of Self-Directed Investing in Wealth Management

AUGUST 2011

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AN AITE GROUP REPORT PREPARED FOR:

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IMPACT POINTS

- Following significant portfolio losses realized in 2008 and 2009, investors have become more cautious with their investment dollars and now seek greater control over their financial lives; this behavioral change has led to a growing demand for self-directed solutions from investors across wealth segments and geographies.
- Online brokers have gained a 3% market share from full-service firms in both 2009 and 2010 in the United States, while most types of full-service firms either lost or maintained market share.
- Despite the gains of online brokerage firms, the adoption of self-directed solutions by full-service firms remains low; more than half of U.S. financial advisors surveyed state that their firm does not offer a self-directed channel.
- The prevailing attitude among full-service firms has been to differentiate their offer from those of online brokers with face-to-face service delivered through a dedicated financial advisor.
- But this attitude is changing as several leading wealth management firms (mostly bank-owned) have recently introduced or are currently developing self-directed platforms. These organizations have recognized the following opportunities:
  - Better addressing the investment needs of mass-affluent bank customers, only a minority of which currently has an investment relationship with their bank (approximately 20%)
  - Meeting the needs of younger generations that have grown accustomed to accessing and purchasing products and services, both offline and online
  - Capturing or re-capturing the self-directed assets of existing wealth management customers currently held at external online brokerage firms
  - Helping the wealth management organization service low-balance clients more efficiently and cost-effectively
- Once wealth management firms offer a self-directed solution, financial advisors' fear of the service diminishes; an Aite Group survey of more than 400 financial advisors conducted in Q1 2011 revealed that financial advisors who work for firms that offer a self-directed platform tend to view the self-directed channel as an opportunity, rather than a threat to their business.
- Over the next decade, Aite Group anticipates that leading wealth management firms will provide investors with several multi-channel offers to appeal to investors' growing appetite for online access to information and tools; firms that provide a self-directed investing solution will hold an advantage over firms that do not, as they will be better positioned to capitalize on the latest consumer technologies and online investing innovations.

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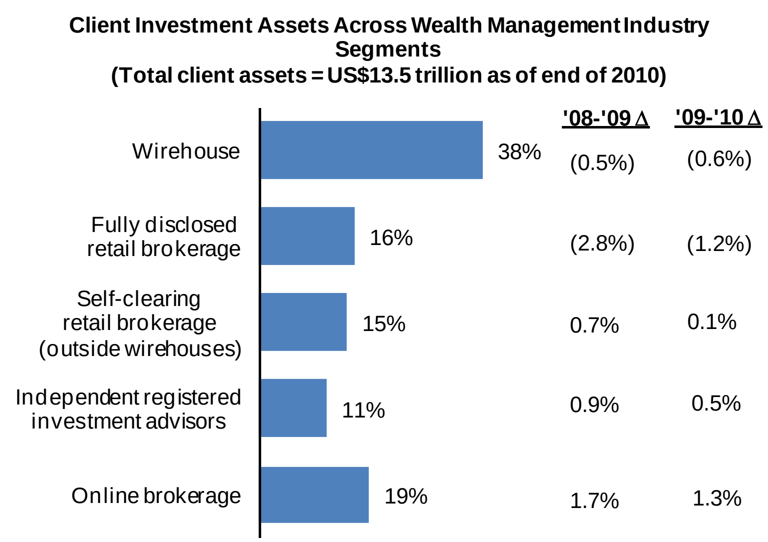
THE WEALTH MANAGEMENT INDUSTRY POST-CRISIS

This paper explores the growing appeal of self-directed platforms among U.S. investors across wealth segments. Following significant portfolio losses realized in 2008 and 2009, investors have become more cautious with their investment dollars and increasingly sensitive to the cost of working with a financial advisor. Many clients have shifted assets to online brokerage firms in search of lower fees, greater control over their investments, and the latest investing tools (e.g., mobile access to brokerage accounts, social networking). These behaviors explain why online brokerage firms have been gaining assets at the expense of financial advisors over the last few years. Given this important shift in investor preferences, Aite Group believes that now is the time for wealth management firms to make self-directed solutions available to their clients, alongside full-service offers.

This approach will help firms retain assets and meet the changed needs of clients across wealth segments. Figure 1 illustrates the success that online brokerage firms have had in recent years, expressed in market share changes. In 2009 and 2010, 3% of the overall market shifted to online brokerage players. Today, these firms manage 19% of U.S. retail investment dollars, or US$1 in every US$6, and have surpassed their pre-crisis asset levels by approximately 12%. Strong net inflows to online brokerage firms have more than compensated for market action in recent years. By contrast, many full-service firms either lost or maintained market share over the last two years, with the exception of RIA firms.

Figure 1: U.S. Wealth Management Industry Market Share Changes



Source: Company financials and Aite Group estimates

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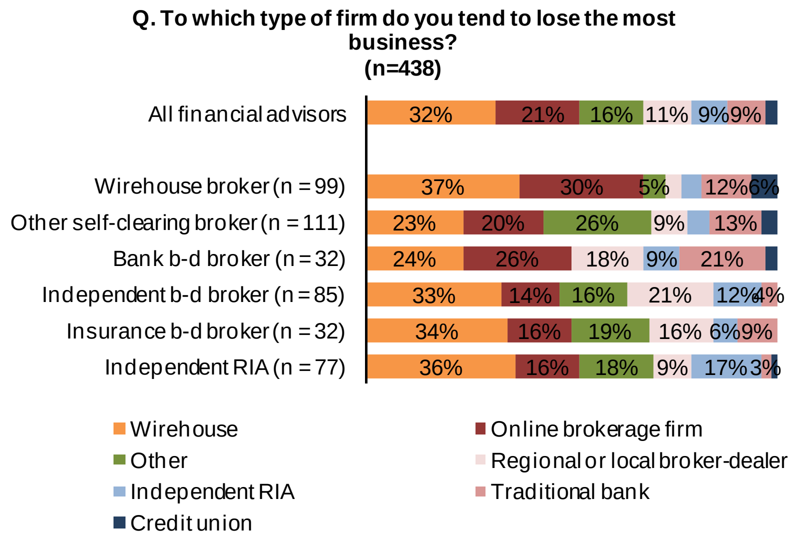
Financial advisors confirm the consumer trend towards self-directed investing. Online brokerage firms were cited as the second most important recipients of lost business by 438 financial advisors sampled in a Q1 2011 Aite Group survey (Figure 2).

Figure 2: Financial Advisors' Competitive Landscape



Source: Aite Group survey of 400 U.S. financial advisors, Q1 2011

CHANGES IN INVESTOR BEHAVIOR

There are many reasons behind wealthy individuals' interest in online brokerage offerings. For one, the online players have continuously built out their platforms, going well beyond their initial scope of providing online trading capabilities. Especially when it comes to self-directed advice tools, many of the online platforms offer a rich feature set that might include a multitude of financial-planning calculators (e.g., for retirement savings) and portfolio-review capabilities and services.

The recent advances in consumer-oriented technologies have further played into the hands of online brokers. While full-service brokerage firms struggle with how to leverage online capabilities, including access to client portfolios via mobile phones or social media, their online rivals are well prepared to take advantage of the latest consumer cravings for gadgetry by integrating the latest technologies into their platforms, thereby capturing these consumers' assets. The fact that recent technology innovations (e.g., the iPhone and iPad, and social networks such as Facebook) appeal to a broad consumer base, attracting consumers of all ages and wealth brackets, has helped firms that leverage these technologies increase their appeal—not only with the younger, tech-savvy consumers, but also with a wide range of older, more wealthy individuals. In sum, the technological innovations of the last 10-plus years have forever changed the way that consumers want to do business with their financial services firms.

Traditionally, online brokerage platforms have been perceived as solid solutions for investors in lower wealth segments. The thinking went that these investors would not be able or willing to

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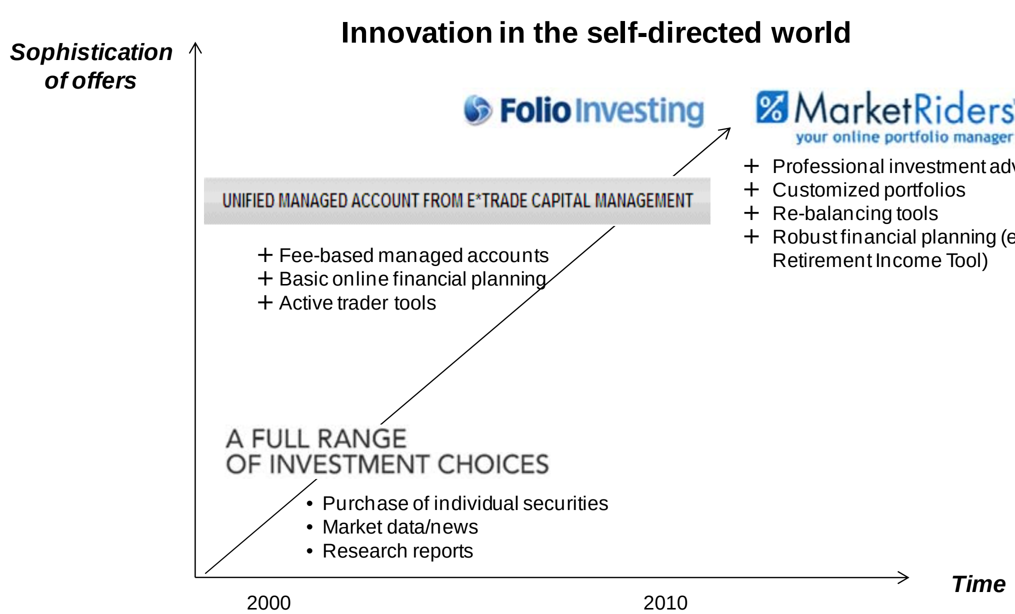
pay for advice. Investors with a half-million dollars to invest, on the other hand, would be willing to pay for advice in order to receive higher returns. According to the results of Aite Group's Q4 2009 financial advisor survey, this conventional wisdom no longer applies. Financial advisors to high-net-worth investors estimate that approximately 25% of their clients have a self-directed account as well as a financial advisor. Consumers' increasing desire for control over their financial lives has led to a growing demand for self-directed solutions from investors in higher wealth segments. In addition, online brokerage firms have started to offer more sophisticated investment solutions, such as Unified Management Accounts (Figure 3), which have traditionally been reserved for the full-service channel. Startup online investing firms are emerging every day to provide even more sophisticated tools directly to the investor (for example, self-service portfolio construction and rebalancing tools). Firms that can learn to leverage a self-directed investment platform today will be at an advantage when these more sophisticated offers gain traction among high-net-worth investors.

Figure 3: Self-Directed Investment Offers Moving Up in Sophistication



Source: Aite Group

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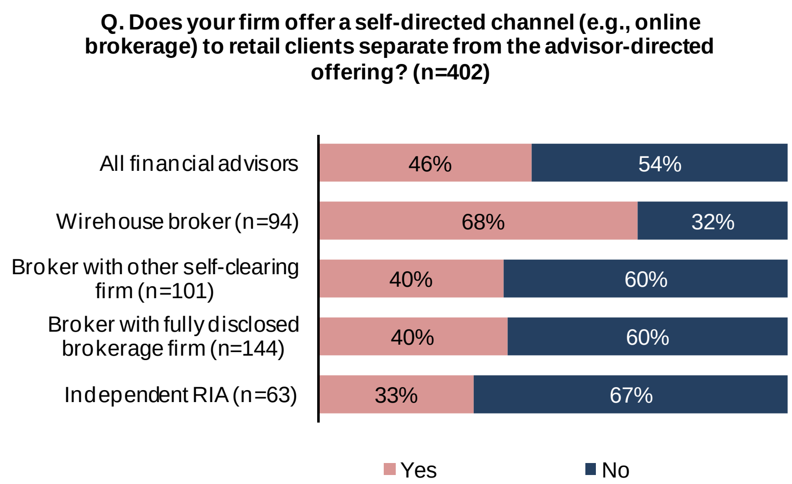
ADVISOR/FIRM ADOPTION OF SELF-DIRECTED INVESTING

More than half of U.S. financial advisors surveyed through Aite Group's latest annual survey of 400 advisors stated that their firm does not offer a self-directed channel (Figure 4). The advisor segment with the lowest adoption is independent RIAs. These advisors are part of small firms that are typically selected by clients for their investment management/advice expertise. In other words, RIAs do not currently see a need to offer self-directed services in order to attract assets.

Figure 4: Advisor Awareness and Self-Directed Adoption Among Full-Service Firms



Source: Aite Group survey of 400 U.S. financial advisors, Q1 2011

Only 40% of financial advisors at self-clearing firms (e.g., Ameriprise, Edward Jones, LPL, etc.) and fully disclosed firms (bank, insurance, and independent broker-dealers that outsource their clearing operations) state that they offer self-directed investing. Rather than embrace this channel, these wealth management firms seek to differentiate themselves from online brokerage offers with face-to-face service through a dedicated financial advisor. Based on an Aite Group survey of more than 20 executives in charge of mass-affluent programs, Figure 5 shows the common products and services that characterize North American banks' mass-affluent offers. Almost all participants described the mass-affluent offer as one based on providing in-person service and advice through a dedicated financial advisor or relationship manger. Only four banks mentioned their self-directed offer as a key service for their mass-affluent client base. Two of these banks position the self-directed offer for clients in the lower-tier mass-affluent segment (less than US$250,000), and the other two have made their self-directed offer the primary one for clients that do not meet their Private-Bank's minimum balance requirement.

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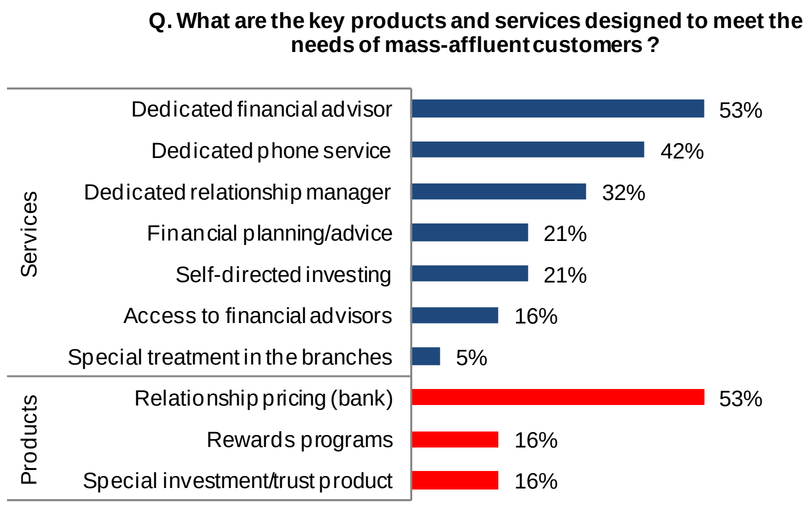
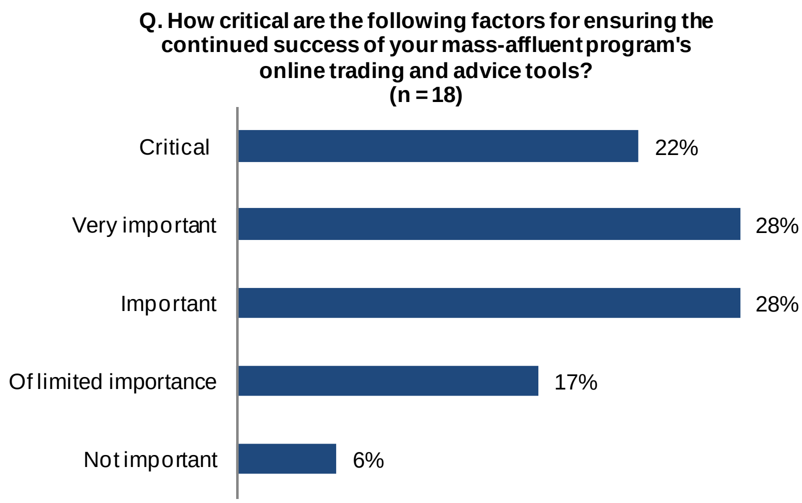
Figure 5: Mass-Affluent Offers at Large U.S. Banks—Key Products and Services



Source: Aite Group survey of 19 top 50 North American banks

While banks do not yet lead with self-directed investing in the mass-affluent segment, many do view the delivery of online trading and/or advice services as "important" or "critical" for successfully capturing the investment assets of the mass-affluent (Figure 6). Of the banks surveyed that currently lack a self-directed offering, approximately half have plans to introduce such a service in the near future. More generally, half of the 19 North American banks surveyed are enhancing their online channel in various capacities (access to consolidated information, self-service capabilities, etc.).

Figure 6: Importance of Online Trading and Advice Tools to Banks



Source: Aite Group survey of 400 U.S. financial advisors, Q1 2011

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The U.S. wealth management industry has begun to recognize the importance of offering online brokerage and self-service tools to investors since the crisis years. The pioneers in this space among full-service firms have been the larger banks that have recently acquired or invested in wealth management businesses. These players have recognized the importance of providing robust online, mobile, and self-directed trading capabilities for a number of reasons:

- Banks have yet to capture their mass-affluent clients' investment assets, for example:
    - 13 million of Bank of America's affluent customers (emerging-affluent and mass-affluent) do not have an investment relationship with the bank
    - Based on Aite Group interviews with 16 of the top 50 U.S. banks, only 20% of banks' mass-affluent customers also have a brokerage account with the bank-affiliated broker-dealer
- Younger generations, including the children of high-net-worth and ultra-high-net-worth clients, favor online tools for account information, education, communication, and investing:
    - US$40 trillion is expected to transition from one generation to another in the United State by 2050[1]
    - If institutions hope to retain these assets, they will need to provide a multi-channel offer (phone, branch, and online), as younger investors have grown accustomed to accessing and purchasing products and services both offline and online (for shopping and, increasingly, for educational services)
- A significant percentage of high-net-worth investors have self-directed accounts in addition to their full-service accounts; offering a robust self-directed platform gives financial advisors a better opportunity to re-capture some of these assets held outside the firm

We anticipate seeing more wealth management firms invest in a direct business model to cater to the needs of customers in a way that is scalable and cost-effective. One platform can serve the needs of many different types of customers. The platform also offers the potential for firms to offer more choice in products and services, particularly to mass-affluent customers. Adding new products and services to the direct channel is likely to be more cost effective than distributing new offerings through full-service advisors who need to be trained and who need to take additional time to profile customers for these new offerings. This effort may be too costly an undertaking for firms working with mass-affluent customers.

In addition to better meet the needs of mass-affluent customers, a self-direct platform allows firms to more generally satisfy the needs of high-net-worth investors for self-directed trading and/or self-service tools (Figure 7). Firms that can leverage one platform across their lines of business and client segments will be able to realize the economies of scale necessary to justify ongoing investments in a self-directed platform.

1. Boston College Center for Wealth and Philanthropy, 2003.

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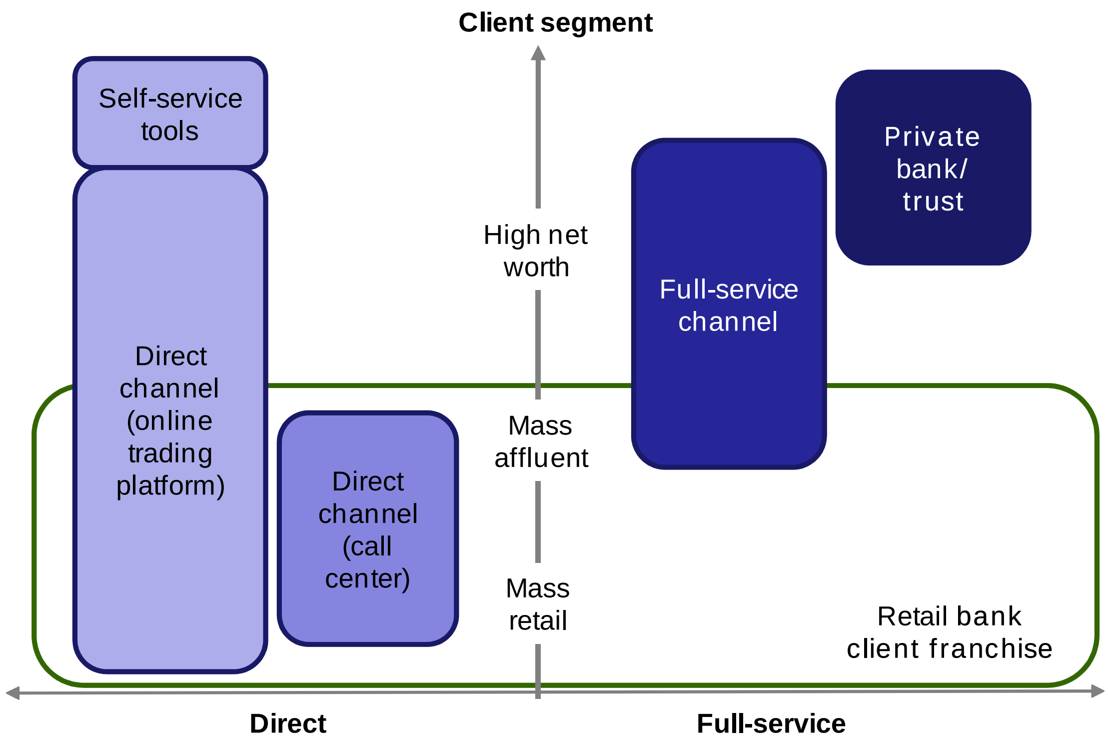
Figure 7: Post-Crisis Wealth Management Business Model



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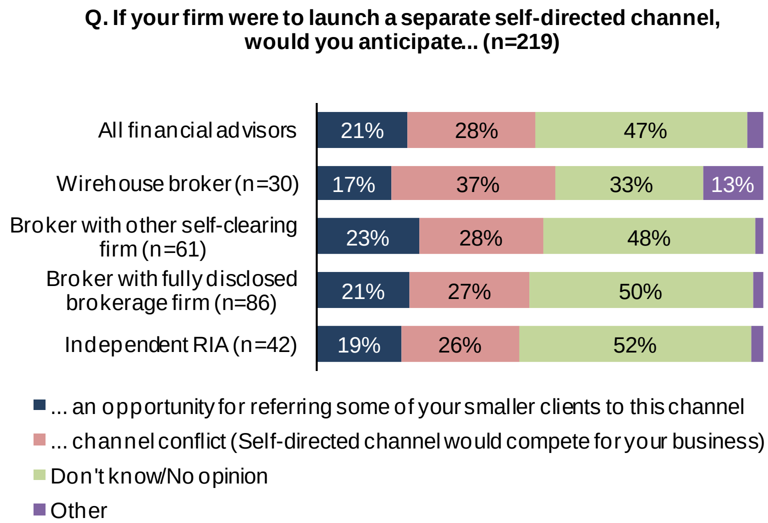
ADVISOR PERCEPTIONS OF THE DIRECT CHANNEL

Advisors whose firms currently do not offer a self-directed channel are more likely to view a potential self-directed offer as a channel conflict rather than as an opportunity to refer small clients and focus on clients with higher balances (Figure 8). Interestingly, more advisors state that they are "not able to estimate the impact of a self-directed channel on their business," which indicates that advisors are not naturally opposed to a self-directed offer.

Figure 8: Financial Advisors' Expectations for a Self-Directed Channel (Firms Without the Service)



Source: Aite Group survey of 400 U.S. financial advisors, Q1 2011

While fear of channel conflict dominates with advisors whose firm does not offer a self-directed channel, this fear is greatly reduced once firms implement a self-directed solution. Figure 9 shows that the percentage of financial advisors recognizing the opportunity presented by this channel grows significantly once firms acquire a self-directed capability, while the percentage of financial advisors who view the self-directed channel as a conflicting offer begins to diminish.

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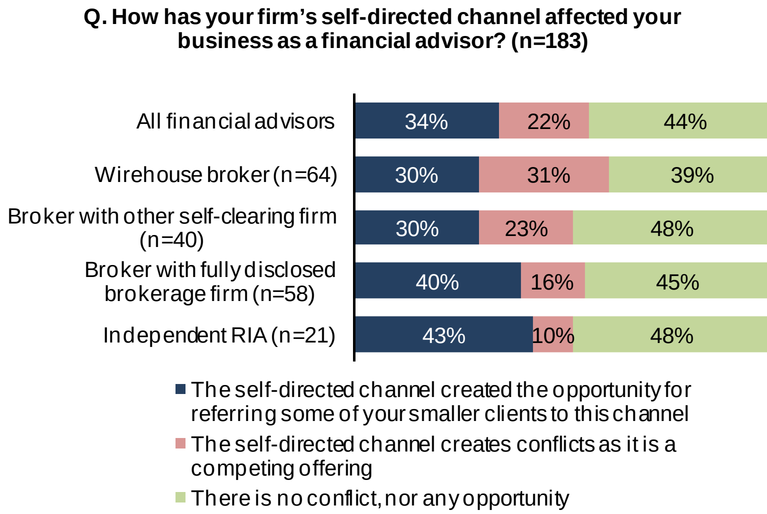
Figure 9: Financial Advisors' Acceptance of the Self-Directed Channel (Firms with Service)



Source: Aite Group survey of 400 U.S. financial advisors, Q1 2011

The charts above also show that firms have a long way to go in convincing all advisors of the value of the self-directed offer. In time, however, we believe that wealth management firms will identify how to offer complementary full-service and a self-directed offerings. Aite Group estimates that more firms will introduce hybrid self-directed/full-service offers to provide investors with the best of both worlds: convenience, control, and lower-cost service for basic investment products coupled with sophisticated advice and access to more complex products at a higher price point. Wealth management firms already see the value of leveraging the self-directed channel to better manage client needs across the lifecycle, from the time that clients first start investing through to retirement. A self-directed platform allows firms to profitably address the needs of mass-market and lower-tier mass-affluent firms.

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IMPLICATIONS FOR THE WEALTH MANAGEMENT INDUSTRY

The success of online brokerage firms has led full-service brokerage firms to face:

- Greater competition for emerging- and mass-affluent clients
- Increased pressure to offer:
  - Online capabilities to support the full-service channel for "hands-on" clients
  - Self-directed trading capabilities and self-service tools for high-net-worth and ultra-high-net-worth clients
- The risk of losing advisors to firms that offer self-directed investing to focus advisor capacity on the most affluent/profitable clients

Full-service firms that offer online brokerage services can compete with pure play online brokerage providers by:

- Leveraging internal partners (investment bank, retail bank) to provide valuable content (e.g., research reports) and non-investment products to online customers
- Offering competitive rates on online trades due to the high volume of trades generated by the full-service firm
- Providing relationship pricing that takes into account the customers' relationship with other firm businesses

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SELF-DIRECTED CHANNEL BENEFITS

FOR THE FIRM

By providing a self-directed offer, full-service wealth management firms are better able to address the needs of clients across wealth and technographic segments. For banks in particular, coupling their banking offer with a self-directed investing offer will position them well to capture the investment assets of their large existing mass-market and emerging-affluent bank customers. The online channel is particularly well suited to customers in these segments who require standard products and advice; by offering a self-directed service to clients with lower balances, advisors can spend more time delivering the customized advice and solutions that their most profitable and affluent clients often require. In addition, wealth management firms can leverage their self-directed investments to better meet the needs of their wealthier client base for Web-based access to portfolio information. These Web capabilities are increasingly sought after by high-net-worth and ultra-high-net-worth investors.

FOR ADVISORS

Advisors across the industry struggle with how to handle clients that do not officially qualify for their services. By offering a self-directed service, firms provide financial advisors with a platform that they can feel good about offering to their small clients. Migrating unprofitable clients to the self-directed channel frees up advisors' time to focus on profitable clients, which should lead to deeper and even more profitable client relationships.

Adding a self-directed service also allows advisors to attract or retain clients' self-directed dollars. Capturing these assets presents the following benefits:

- **Decreases client attrition:** As clients transfer a larger share of their assets to the full-service firm, the client is less tempted to move to a competitor
- **Increases the stickiness of these assets**: If advisors provide an additional service to clients by including the self-directed portion of their assets in the planning process

FOR CLIENTS

Clients that previously could not receive investment solutions from a full-service wealth management provider are now able to access a full set of products and advice tools/content through a self-directed platform. For existing full-service clients, the addition of a self-directed offer enhances the value provided by the firm in the following ways:

- Allowing investors to gain more control over their investments and financial lives by consolidating assets (self-directed, full-service, and potentially banking through Personal Financial Management capabilities)
- Enhancing the value of financial advisors, which are better able to provide advice on a larger share of their clients' assets

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CONCLUSIONS

Full-service wealth management firms will need to determine whether they want to play in the mass-affluent space or whether they should abandon this segment altogether. In the latter scenario, the need for a self-directed platform is less urgent. But, as self-directed offers grow in sophistication over time and baby boomers retire and transition their assets over to their children, firms without a self-directed platform may see a significant erosion of market share.

Full-service firms are no doubt likely to enhance their website and add mobile capabilities in order to deliver better and more frequent information and statements to investors. For a percentage of high-net-worth and ultra-high-net-worth investors, these Web capabilities will suffice. But these self-service capabilities will have trouble keeping up with the latest innovations in consumer technology, which are not subject to the same level of competition as are self-directed investing platforms; self-service tools are not revenue generators, but are instead part of the cost of servicing clients. Firms that enter the business of providing online brokerage services directly to investors will be technology innovators and better able to offer their high-net-worth investors the latest tools designed to improve their financial lives.

For firms that cater to the mass-affluent through an in-person-only offering, we recommend adding a self-directed solution and building a multi-channel offering to cater to the needs of this diverse segment. As part of this exercise, we recommend that wealth management firms do the following:

- Review their client segments and related service models in order to determine which clients are best served in the self-directed channel and how this channel can enhance advisor profitability
- Define the role of the online channel for the business:
  - Will it be a standalone service?
  - Will it be part of the full-service business, as an accommodative service?
- Define product and service offerings for each channel :
  - Clarify the advisor proposition in light of the new regulatory environment and corresponding higher costs to service clients
  - Define the product and pricing strategy for a separate online channel (in addition to paying for commissions, some investors may be willing to pay for access to premium tools and content)
- Continue to experiment with the latest technological advances to
  - Keep up with changing client expectations
  - Develop innovative services
  - Increase advisor productivity and firm attractiveness to advisors

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