

Tips And Traps Of Starting A Portfolio Management Or Dealer Firm

Plutus, the God of Wealth in ancient Greek Mythology was dissatisfied with the performance of his investment portfolio so he asked his underlings to summon three top ranked financial professionals to his office - a portfolio manager ranked in the top quartile, a financial planner to ultra wealthy families, and the CEO for a national integrated dealer.

As the three approached the Investment Division of heaven, they saw Plutus seated on an ornate throne. He looked at them and said, "I'm going to ask each of you a very important question and depending on how you answer, we'll decide where you sit."

He then turned to the portfolio manager and asked, "What do you believe?"

"Well," said the portfolio manager "I believe there are no short cuts in portfolio management. One has to do the hard work to uncover good opportunities. Before taking on a position, one should also consider one's exit strategy. Never let emotions or panic get in the way of sound decision making."

Plutus was impressed and directed the portfolio manager to sit beside him to the left. He then asked the financial planner the same question.

"I believe that when a client chooses you to be their financial planner, they are placing their financial security in your hands. That means you have to fully appreciate the client's economic needs and emotional state and carefully offer insurance, investment and tax planning solutions."

Plutus was even more impressed and directed the financial planner to sit to his right.

Finally He turned to the CEO and asked, "What do you believe?"

"Well," said the CEO, "I believe you're sitting my chair".

In this article, we would like to offer some observations on what we believe it takes to transition from being an experienced and high value professional, to an experienced and high value professional that runs his or her own portfolio management or dealer firm.

Over the last several years, Ara has worked with a number of start-up firms. Some have developed into successful ongoing businesses and others have not. We would like to share our observations.

The First Step - Clients

Though it is difficult to determine what types of businesses will successfully generate a sustainable level of revenues, we've observed that the probability of success is greatly enhanced if:

1. The business starts with a solid client base from day one. These can be existing customers or an employer who may be willing to engage the firm on an outsourced basis. Contributions from friends, family and others who are investing for love, but not money, do not count;

2. The owners' experience and profile in the industry are so exceptional that if they were a classic rock band, they would be Aerosmith; or
3. The business has a financial offering that can solve an urgent problem, and it is recognized as being able to credibly follow through.

In other words, unless you already have clients or are a rock star, your business' ability to attract a sustainable level of revenue is dependent on your ability to address important client needs.

However, there is often a fundamental obstacle to the sales process. The average adult mind typically retains only 20% of what it hears.

To break through, a financial offering should ideally address issues that appear to the client to be like raging fires rather than simply a general concern about the business. In other words, while your potential clients' homes are engulfed in flames, ideally you want to be the person driving a giant water truck and asking, "How can I help"?

For example, consider the situation of a vast number of mutual fund dealers that are presently sitting on large assets under administration, accumulated over the past several decades. These owners and branch managers are in a declining industry with aggressive regulation, a restricted offering, obscene levels of office administration and the ongoing threat that other types registrants who can offer better and lower cost investment solutions can swoop in and poach their best clients.

Consider how stock market volatility has impacted retail investor sentiment and the compensation of retail representatives that care for them. What impact would this have on the receptivity for alternative assets that can provide for steady returns with no market volatility?

Put yourself in the position of a well-healed family office in the Middle East. When compared to volatility in their home markets, the euro crisis in Europe and stagnant growth in the US, Canada's stable banking system, resource-based industries, and stable currency must appear like a dream to them.

Job number one is to find, thoroughly research and design a financial offering that puts out fires. Please recognize that its not common for clients or potential investors to express their need in elegant terms like, "I'm on fire for a sound portfolio overlay strategy that will smartly reposition my risk using low cost and effective..." "I don't want my life's work of 25 years going down the drain", is probably a better expression of need.

Operational Support

Several years ago as was I reviewing the operations of a smaller high growth hedge fund, I noticed that the firm's admin assistant was tasked with verifying each client account statement that the fund administrator produced before mailing it out.

I thought this was unusual. Portfolios Managers are expected to supervise the activities of third party service providers. However they aren't expected to review each piece of paper that the fund administrator generates. So, I asked her what she was looking for. "Sometimes there is a mistake with the number of units; sometimes the address is wrong, and sometimes even the name of the client isn't right...so we have to check before it goes out". I was amazed. I imagined a client's private statement being sent to the wrong address, the visceral anger of a well healed client for having their privacy violated and the ensuing yelling, apologies, embarrassment, etc.

This fund administrator had been selected because they were cheap and had a lot of other clients in the funds industry. However, it appeared that management was unable to trust them to do something as simple as maintaining an accurate name and address file.

Working with poor operational support is like running a marathon with a pebble in your shoe. You notice the hurt at first, but after a while you don't mind checking every client statement, and then you're confused as to why your firm always seems to be in some type of operational crisis. For a start-up business, poor operational support can be very expensive and even fatal.

The availability of inexpensive third party operational support through correspondent brokers, custodians, fund administrators, technology providers, etc., allow new firms to get up and running with minimal staff.

However, if hiring third party support removes the barrier of hiring teams of operational staff, it follows that these third party providers effectively become your firm's virtual employees.

The thought process for hiring operational support should not be too different than for hiring staff. The hire has to have some basic level of ability and knowledge. However, beyond that, the most important criteria are that they "fit" with your business and operations and can work well with your team. Effective firms do not simply hire the candidate that is willing to work for the lowest salary. They find the best candidate that can be found in a range they can afford and sometimes even pay higher if they find someone who is an excellent fit.

It's also important to recognize that there is no bronze, silver or gold in operational support. It's either pass or fail. For example, either your custodian settles the trade or doesn't. Furthermore, every provider, no matter how competent, will make an occasional mistake.

The more relevant question is, what happens when things go wrong. If there is a problem, you need to be able to speak to someone who knows what he or she is talking about, and get the matter solved quickly. Service providers that take on more business than they can reasonably handle, have poor operational systems, have high staff turnover or unhappy or unmotivated staff, may have difficulty helping you when your business needs help the most. Unfortunately, these firms are also typically lowest cost providers that attract inexperienced start-ups (and a fair number of experienced ones as well).

Compliance

In our view, compliance can be a significant industry barrier to entry. National and major regional firms have the luxury of hiring teams of experienced staff to participate in the rule making process and -analyze new rules. Smaller and mid-size firms do not.

Unlike legal matters, compliance is about taking rules, requirements and concepts and making them live in your business. To navigate effectively, one needs to understand the underlying concepts of each regulatory requirement as well as the environment in which these concepts will operate. This includes the firm's technology, its operations, the fundamental characteristics of the financial products and services offered, and the reasonable (or unreasonable) expectations of clients and regulators.

At Ara, we recognized this gap several years ago and built a support program that applies proprietary methodologies and processes to replicate the "head office compliance experience". Like a head office compliance department, we distill new and ongoing regulatory requirements into specific policies and procedures that are appropriate for the firm's circumstances. We conduct periodic on-site compliance reviews and educational training, and serve as an ongoing resource for any compliance questions or concerns.

Of course, there are other solutions as well. Firms can rely on legal counsel to some extent, hire compliance staff, or consult with colleagues that run similar firms. It's important however, to not lose sight of the role that compliance matters will play in your start up business.

Final Thoughts

Professionals who are well regarded and highly compensated at national and large regional firms are like tennis players with a killer forearm but incredibly weak backhand. Unlike the CEO, many of these folks have never been required to think too deeply about matters such as operations, technology, compliance, general marketing, creating a corporate profile, engaging service providers...etc.

The first step is to accept that you may be blind to important parts of your proposed business (embrace it). Secondly, find an offering that can put out fires. Ideally, it should be something that the investor client will grab from your hands and quietly swear at you for not giving them sooner. Thirdly, assemble a strong internal and external team that allows you to deliver. It's important to spend time understanding exactly what each team member (i.e. service provider) does. Pick the right team members with top quality customer service, not just the cheapest ones or the ones everyone else is using. Fourthly, glow in the praise and adulation of your colleagues on what a brilliant entrepreneur you are.

Ara Compliance Support

Ara Compliance Support is a boutique firm that provides compliance support to firms in the securities, investment management and insurance industries. Our focus is to help small and mid-size firms reduce their compliance risk, and apply their time more efficiently. We offer a full range of services including ongoing compliance support, and compliance consulting on a project basis.

If you are thinking about starting a new Portfolio Management Firm or Exempt Market Dealer, we can also help assemble your thoughts and help create an implementation plan.

To discuss further please contact us at 416-941-1263 or info@aracompliance.com.