5 critical areas for RIAs to watch

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Summary

The model for operating a successful RIA business is rapidly changing along with the financial services industry as a whole. Philip Chao, founder and CIO of RIA firm Chao & Company, discusses the changes shaping the industry and five key areas to which RIAs should pay close attention.

The RIA model isn't safe from disruption, says Philip Chao, founder and chief investment officer of RIA firm Chao & Company. Based in Vienna, VA, Chao founded Chao & Company in 1990, experiencing firsthand many pivotal moments that have shaped investor psyches in modern times – including the dot-com bubble, financial crisis and the ongoing shift from active to passive.

Chao believes the RIA model is currently undergoing drastic changes that will shape the industry for years to come. According to Chao, there are five critical areas for RIAs to watch.

Fees

While the industry can't agree if it will face further pressure on fees, Chao is firmly in the camp that fee headwinds aren't going away:

"Never say never that RIAs won't face continued fee pressure. We didn't imagine seeing negative interest rates, but it happened. Fee pressures are so pronounced in the ETF market that a couple of ETFs were recently introduced with negative fees that pay investors a few basis points for their assets. To be clear – I don't expect RIAs to start paying their clients, but I expect fee headwinds will be an ongoing challenge for firms."

Advances in technology are partly to blame for fee pressure. Chao sees technology as a double-edged sword, in that it enables RIAs to reach scale, pursue new opportunities and lower costs. But the same technological proliferation often puts the pinch on fees as well.

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To mitigate pricing pressures, Chao believes clearly defined value-add and client-centric differentiations should be introduced into the equation. Whether that means tailored communication or education, help with plan design (for retirement plan advisers), or using technology to deliver intuitive and timely reports, it's clear to Chao that RIAs must figure out where their value and opportunity exist.

Services

A shift to a model where RIAs are charging separately for financial advice and asset management is likely underway, as many advisors believe they are underappreciated or spending too much time under a bundled-fee approach. Clients charged a bundled fee might also be questioning if their fee is too high since it obscures costs. Ultimately, as clients' needs get more complicated, Chao expects à la carte menus to increasingly become the norm.

In fact, Chao thinks firms are better off separating advice from portfolio management: "It gives the client some real choice and could also help them appreciate what you do more." However, Chao notes it's essential for RIA firms to remember that under a split approach, they are investment professionals when managing assets and financial planning professionals when offering advice, requiring different skill sets and resources. Each segment of their practice needs to understand its value proposition clearly.

Industry consolidation

Will the future be one where the smaller RIAs go the way of the dinosaurs? Chao thinks so:

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"The industry is in the middle of an acquisition phase right now where scale and size are competitive advantages, and the pendulum is still swinging in this direction. Plenty of private equity money is chasing RIAs and plan advisory firms. As long as the economy continues humming along and "dry powder" is aplenty, this will go on. While we might see a dissolution phase again, that is not expected to happen anytime soon."

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While Chao sees larger firms continuing to acquire practices to sustain themselves, he offers a grimmer outlook for smaller, independent firms:

"The independent model – defined as a small set of founders or family members running a wealth shop – will probably not stick around too long, especially if these firms shy away from adopting technology. Smaller, risk-averse RIAs might unfortunately wither away over time; they will shrink with their aging clients."

Technology

Many RIAs do not think of or understand artificial intelligence (AI) and machine learning (ML) as tools that can positively impact their firms. But Chao believes AI and ML can help to glean insights from clients and prospects that lead to value-add opportunities:

"AI and by extension machine learning can help to identify personalization opportunities and anticipate the needs of clients. But RIAs must first get their data scrubbed and made ready to build solutions and algorithms."

This could enable RIAs to focus on the burgeoning model of providing bespoke client experiences. With effective data mining, Chao says specialty concierge services that cater to client tastes, unique circumstances and needs can be instituted.

The role of the RIA

Chao believes the role of the RIA is in flux and being redefined:

"We went from financial planner to investment advisor, to financial advisor, and now to wealth manager. You can't be all things to all people. The complex regulatory and financial environment requires more education and specialization, and proper devotion can only be accomplished through teamwork."

He added, "Then there are the fee-only models as opposed to firms that also earn transactional commissions, implying there might be less conflict since a fee-only model is not tied to the products clients end up with."

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But Chao believes you can't eliminate conflict entirely – you can only manage it. In fact, Chao thinks a “healthy tension” should be maintained between the advisor and the client, which protects the client's own interests:

“Advisors shouldn’t be too close with their clients. Keeping a professional distance holds both parties more accountable. After all, clients are not buying a friend!”

RIA Exchange
A community for RIAs

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Philip Chao founded Chao & Company, Ltd. in 1990 to provide individuals, families and institutions with the independent and thoughtful advice that would serve as a tailored alternative to the conflicted, one-size-fits-all, bundled solutions. As the Chief Investment Officer of the firm, he designs and manages investment portfolios in the best interest of the clients. Philip also serves as an ERISA investment consultant in a co-fiduciary capacity and is a founding member of The Institute for the Fiduciary Standard. Philip earned his Certified Financial Planner (CFP) designation in 1990 from the Certified Financial Planner Board of Standards, his Accredited Investment Fiduciary Analyst (AIFA) designation in 2004 from Katz School of the University of Pittsburgh and the Center for Fiduciary Studies (Fi360) and Retirement Plan Associates (RPA) designation in 2006 from the Wharton School of the University of Pennsylvania and the International Foundation of Employee Benefit Plans.

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