ENGINEERING A SOFT LANDING
Responding to the Rising Cost of Doing Business

WISE

November 2023

THE HIGH STAKES OF HIGH COST

As firms plan for 2024, there is no shortage of headlines that seem to demand a response. The application of artificial intelligence, competition for deposits, and upheaval in commercial real estate are a few, not to mention generational transitions that have implications for wealth, retirement, and the way Americans work. **Although there are many things that firms 'could' prioritize in 2024, one that warrants attention is the rising cost of doing business.** For the past three years, total wealth management expenses have gone up about 6% annually. Firms need to plan for the possibility of substantial expense increases in 2024 and beyond.

Our View

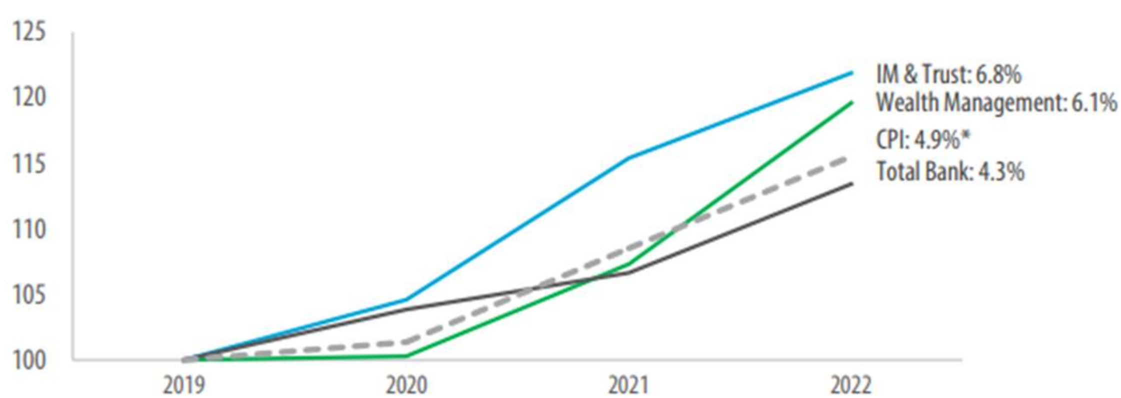
Sustained rising costs in a challenging revenue environment could meaningfully impact margin and growth goals in 2024. Firms have at least three ways to mitigate the implications of higher costs:

1. Free up capacity in existing teams for sales and high-value servicing
2. Adopt more flexible hiring strategies
3. Use pricing to offset expense increases

Compensation increases are the main driver of changes in total expenses and will likely remain elevated. In the investment management and trust business, compensation and benefits expenses grew 6.8% per year for 2019-2022, an acceleration from a 2.5% growth rate in the previous three years.[1] For comparison, compensation expenses across the banking industry grew at a 4.3% rate in the past three years.[2] Preliminary data from firms specializing in ultra-high-net-worth clients also indicate compensation expense growth above 7% for 2023.[3] High growth rates reflect a mismatch between supply and demand for talent. Across wealth management channels, McKinsey estimates that the total pool of advisors is shrinking,[4] and demand for talent will remain high as advisors retire. Absent greater supply of talent, many firms will face growth and profitability risks if they do not take swift action.

Compensation and Benefits Expense (Wealth Management, IM & Trust, and Total Bank)

Indexed to 2019 Average Expenses

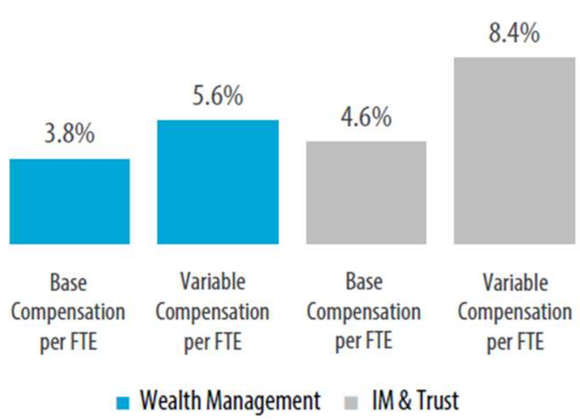


[1] WISE samples for wealth management and investment management and trust expenses only include firms that provided a non-zero answer each year between 2019 and 2022. Growth rates are compound annual growth rates.
[2] Total Bank data is from the Federal Financial Institutions Examination Council (FFIEC) and includes companies that file a Consolidated Report of Condition and Income (call report).
[3] WISE 2024 Ultra-High-Net-Worth Compensation Study preliminary finding from 500 employee records across firms.
[4] McKinsey Wealth & Asset Management practice, Cerulli Advisors. *Consumer Price Index (CPI), Bureau of Labor Statistics.

RAISING THE STAKES

The driver of high firm compensation expenses is twofold: an uptick in headcount and increases in compensation per FTE. Variable compensation, in particular, has increased at rates exceeding most other expense categories over the past five years.

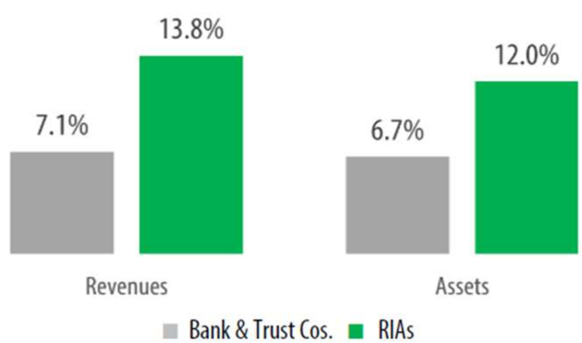
Base and Variable Compensation per FTE, 2017-2022 (CAGR)



As we have observed for the past few years, firms are investing in their sales organizations to improve revenue outcomes. Organic growth rates have been modest, and banks and trust companies routinely lag other competitors such as RIAs (below).

Bank and Trust vs. RIA Growth Rates, 2017–2022 (Median)*

Firms with $2.5B to $10B in AUM



As many RIAs can offer equity to top producers, they have become a magnet for advisor talent, which puts upward pressure on compensation plans. Additionally, bank brokers pay more than twice as much variable compensation as bank wealth and trusts and grow revenues 2-3 percentage points faster per year. More bank wealth managers and trust companies may be tempted to follow a similar path. As we have written elsewhere, surging variable compensation has also been fueled by expensive sales team programs and inefficiencies in how firms design incentive plans.[5]

Along with the competition for talent is another uncontrollable factor in rising costs—retirement. Per Cerulli, advisors who plan to retire in the next decade control about 40% of total industry assets, the equivalent of more than $10 trillion. The talent and compensation risks related to an aging workforce are significant. For example:

- Older, well-compensated advisors may exit their role later than expected, limiting career advancement opportunities for younger workers and creating employee retention risks.
- A retirement wave may exacerbate existing talent shortages.

The financial implications of labor scarcity, cross-channel competition for top talent, new hiring, and retirements loom large. The early warning signs for margins are already manifesting in our data. These dynamics may eventually impair firms' revenue outcomes absent remedial action (next page).

[5]WISE, "It's Payday! Responding to Rising Compensation Expenses," April 2023. *WISE; Charles Schwab 2023 RIA Benchmarking Study.
Note: wealth management includes all services typically found in a bank wealth manager excluding brokerage. These data are more representative of a large private bank. Investment management and trust is abbreviated IM&T. It excludes net interest income from loan and deposits as well as brokerage revenue.

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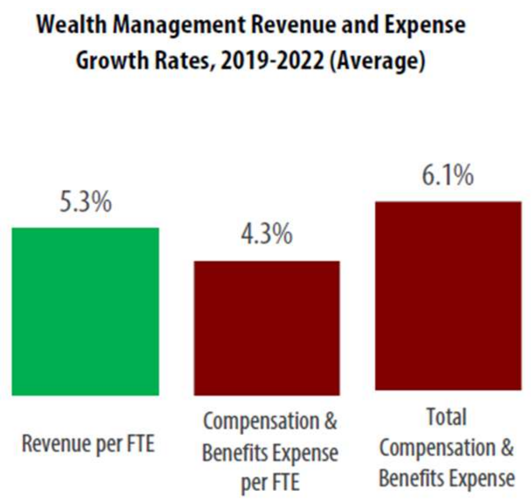
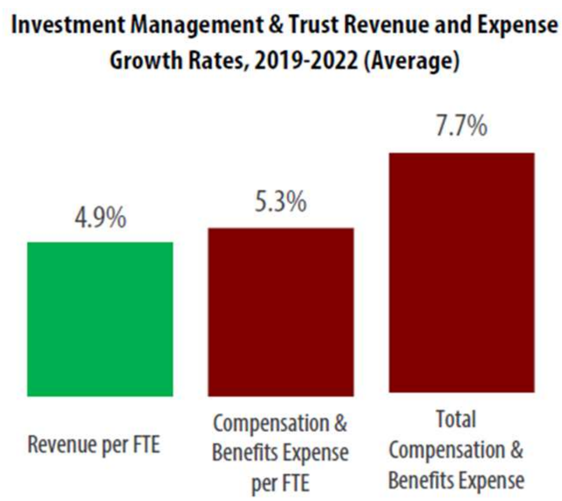
PROFITABILITY AND GROWTH RISKS





Profitability Risks

Rising expenses will put pressure on firms' margins which, in recent years, have been buoyed by productivity gains and increases in revenue per employee (top, green). Worryingly, firms are giving back most of these gains due to similar or even faster increases in compensation (top, red). Margins may decrease if growth rates decline in a challenging revenue environment and if compensation trends continue.

Growth Risks

Arguably, banks should grow faster than they do given their intrinsic strengths such as access to bank clients and service breadth. However, bank leadership often holds their wealth management businesses to high margin expectations. As a result, underwhelming revenue outcomes may reflect short-term profitability prioritization at the expense of long-term growth. Put simply, if banks are unable to pay for top talent in a competitive environment, then average compensation will result in average sales outcomes.

Choosing a Path

Given rising compensation expenses, firms may need to reduce margin expectations to compete for top sales talent and improve growth outcomes. To alleviate the tension between growth and profitability, we advise firms to focus on three strategies:

1. Free up capacity in existing teams for sales
2. Adopt more flexible hiring strategies
3. Use pricing to offset expense increases

A Big Reallocation?

A sustained period of steep expense increases might motivate significant resource reallocations that favor sales and relationship management resources. For consideration, firms may increasingly choose to:

- Concentrate their compensation and incentive dollars with employees who have high-demand skillsets (e.g., who can source new business).
- Seek greater leverage from centralized resources (e.g., investment teams, planning resources, centers of excellence) and support resources such as client service officers.
- Outsource or partner with third-parties to free up back-office dollars for reinvestment in front offices. The bank brokerage world has already started down this path: compensation, compliance, and technology costs are driving more rapid adoption of the Third-Party Marketing (TPM) model among midsize and large private banks. It may seem far-fetched today, but sustained IM&T cost increases may motivate banks to consider outsourcing trust administration.

#1 FREE UP CAPACITY IN TEAMS FOR SALES

To help grow the topline in 2024, firms need to bring renewed discipline to three known strategies. First, rising labor costs make it urgent for firms to free up capacity for their teams to sell and serve high-value clients.

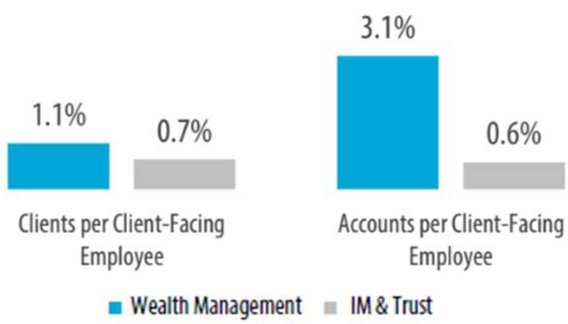
Our view is that administrative and support resources are highly leveraged and create opportunities for new talent growth and development, a win-win. Also foundational is continuous streamlining and centralization of essential but routine sales and service processes, such as account opening.

One way firms are getting leverage is through small and steady workload increases. Even though firms report increased productivity with clients and accounts (right), likely, there are still abundant efficiency opportunities in their books of business. Consider prioritizing two:

- **Limit the intake and servicing of small accounts and households.** About 36% of industry households have less than $500K. These households average only about 1.3 accounts versus more than two for households above $500K. Firms often bring on non-target clients with the hope that they will grow. Most do not, and in many cases only constrain capacity. The cost of providing the service to these clients often exceeds the revenue they generate.[6]

- **Expand existing single-service relationships.** Rather than hunting new, start by deepening existing relationships. More than two-thirds of private banking clients do not have a trust or investment management relationship with their firm.

Clients and Accounts per Client-Facing Employee, 2019-2022 (CAGR)



Technology and innovation are enabling firms to free up capacity for sales in new ways, faster than ever before. CRM and workflow engines pay capacity dividends and are just the beginning. For example, robotic process automation using bots is saving "thousands of man-hours and increasing employee engagement". One firm automated Reg 9 reviews and reporting. This firm also solicits employee ideas for automation; grades them on effort, impact, and investment; and recognizes and celebrates innovation.

Five Ideas to Free up Sales Capacity

Examples of how our members are doing it:

1. **Teaming** – bolster administrative support for maximum officer leverage and to offer more entry points for younger and nontraditional hires
2. **Development** – place junior employees on small accounts teams. A rule of thumb: 2x the typical account load, 2/3 the compensation, and opportunities to advance into more senior roles
3. **Scorecards** – use tools to align officers based on client account complexity, not assets alone
4. **Outsourcing** – offload back-office tasks (e.g., collections, corporate actions processing)
5. **Pricing** – use a la carte fees to limit high-cost service demands

[6]WISE Price Insights database. Most small accounts are not trust accounts in drawdown mode, and about 1 in 5 represent the full relationship.

#2 ADOPT MORE FLEXIBLE HIRING STRATEGIES

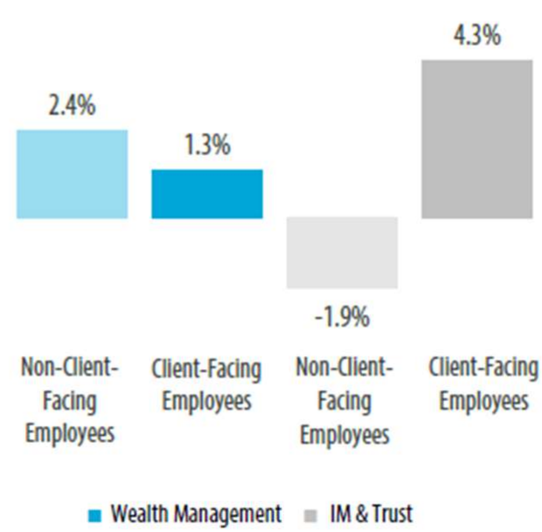
Firms' preferences for hiring experienced industry professionals has exacerbated talent shortages. This habit is increasingly unsustainable and is driving renewed interest in more flexible hiring strategies to meet the expanding needs for employees (right). More firms are embracing alternative – often less expensive – talent pools such as:

- **Nontraditional hires**. Some firms are increasing the talent pipeline by expanding the parameters for new client-facing staff, from limited profiles to a broader array of candidate characteristics and skills. They are employing CPAs, teachers, veterans, nonprofit workers, commercial bankers, and nurses, among other experienced workers.

- **Next generation hires**. Firms are improving efficiency and the client service experience by hiring and training a new generation of younger workers. One firm reduced compensation and benefits as a share of revenue ten percentage points by championing a "youth movement" along with rolling out new technology. Others have transitioned one or more retiring relationship managers into new full-time training roles to coach/educate new hires.

A talent imperative for all firms is to market the appeal of wealth management to a future advisor workforce. Fewer than one in three CFP holders are under the age of 40 today, a figure that also points to a 'missing middle' between new workers and tenured staff.*

Employee Growth Rates for IM & Trust and Wealth Management, 2019-2022 (Average)



At a firm level, an employee value proposition is integral to flexible hiring and retention strategies. Firms can differentiate employment on factors beyond their competitive compensation and benefits. These include:

- **Employee experience**. To attract and retain best-fit talent, articulate and deliver on specific, compelling nonmonetary benefits, such as supporting technology, employee connection, well-being, and growth potential.

- **Career paths**. Communicate growth opportunities, not only immediate job needs. For instance, one firm created a pipeline for a tier of bank-sourced trust specialists to fill officer ranks after mentorship and advancement in their roles. Another firm added new, senior levels to existing paths to create additional financial rewards and job opportunities for high-value, tenured employees and candidates.

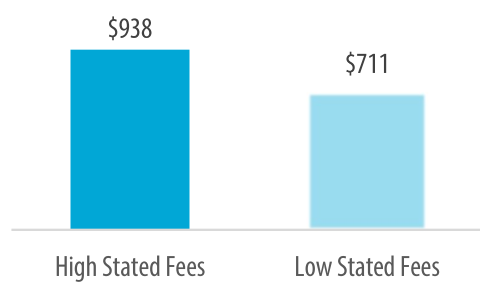
[7]CFP Board.

#3 USE PRICING TO OFFSET EXPENSE INCREASES

Pricing is a powerful and controllable source of margin relief to fund growth. Wealth management is no different than many other industries that change pricing practices to reflect higher costs of doing business. We have advised member firms to adjust pricing, discounting, and other fee realization practices to reflect the fact that the key input for their business is more expensive.

- Our 2023 research continues to affirm past lessons about the impact of pricing. For instance, we find that the typical 'high stated fee' firm generates 32% more revenue per client-facing employee than low-fee firms (right), despite a similar number of clients and accounts.[8]
- Fee realization for existing business also has a significant incremental revenue impact. Realization rates vary by household size and across firms, offices, as well as RMs. Our research finds a 35 basis point difference for the typical $1M asset household at the 25th and 75th percentile in realized fees (below). That represents a 39% 'lift' in revenue from low to high. Limit discounts and exceptions to capture this incremental revenue.

Revenue per Client-facing Employee (Medians in $000), 2022*



Six Pricing & Discounting Best Practices

1. Actively manage price
2. Maintain fee integrity
3. Limit pricing discretion
4. Price with pride
5. Measure pricing performance
6. Debunk pricing myths

New in 2024

Our pricing research will dive deeper on fee realization, including how to improve realization rates and efficiency by appropriately defining and serving different types of client households within your firm's ecosystem. Firms have many specific incremental revenue opportunities to go after to offset expenses.

Realized Revenue Per Household, by Household Assets
In Basis Points (BPs), 2022

[8] WISE Benchmarking and Pricing database. Note: Low-fee firms have stated fees at or below the industry 25th percentile. Middle-fee firms have stated fees between the 25th and 75th industry percentile. High-fee firms have stated fees at or above the industry 75th percentile.

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EXTEND THE RUNWAY IN 2024

In the near term, we expect wealth management and trust compensation expenses to continue to rise within an increasingly challenging revenue environment. Bank executives may put more pressure on their wealth businesses to reel in costs while still contributing to growth—a difficult needle to thread. Trendlines point to significant headwinds firms will need to navigate to achieve their growth and profitability goals.

However, turbulence and headwinds are not the only thing we see on the horizon. Firms have powerful levers within their grasp to engineer a soft landing from high compensation expenses and to meet or even exceed their performance goals.

Our advice for leaders is to take immediate action on three proven responses: free up capacity for sales, adopt flexible hiring, and use pricing to offset expenses.

Underpinning each of these three responses is a single imperative: elevate and defend a strong wealth management value proposition this year. Sell to and serve more high-value target clients, price with pride, and attract nontraditional and next-generation talent to do it. These are ways to 'add runway' in your business.

By prioritizing and defending value, firms will bend the curve on rising expenses, avoid a growth and profitability tradeoff, and land in a stronger position in 2024 and beyond.

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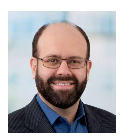

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ABOUT WISE

WISE is a boutique analytics and advisory firm founded on the belief that wealth managers and trust companies deserve the same high-quality data analysis that is increasingly common in other industries. We apply rigor to analyzing firms' performance, including growth, sales, pricing, productivity, and profitability. Our network of members shares data and insights with us, enabling our team to identify and promote best practices.

WISE members are the largest firms in wealth management, as well as innovative midsize and small firms in every region of the country. Members include bank wealth managers, independent trust companies, and trust companies affiliated with brokerage and insurance firms. For member firms, our team provides comparative data and insight about their firm's performance, peer networking opportunities, industry insight, and stakeholder education. Our service model specializes in private banks, registered investment advisors, brokers, independent trust companies, and single and multi-family offices. We are experts in the high-net-worth and ultra-high-net-worth spaces.