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Fido Attacks!

By Kristen French

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Patrick Horan, CEO of Horan Capital Management in Towson, Md., ran some numbers on the referrals he gets from custodian Charles Schwab today versus three years ago. He didn't like what he found. "Not only has the percentage of leads steered to us dropped by half. The total number of leads is down by a quarter, and the quality of leads is about half as good," says Horan. A weak equity market hasn't helped, but Horan says Schwab is also to blame: Schwab is competing more directly with its own advisors, Horan says, and steering more of those branch-network leads in-house. Schwab has been fielding such complaints for years and denies they have merit. But Horan isn't convinced. Now he's considering moving his assets to Fidelity.

Welcome to the battle between Goliaths, if you will, that is now intensifying. Long a distant second to Charles Schwab in the lucrative business of serving financial advisors, Fidelity is making an aggressive push to close that gap. And some advisors are taking notice. Over the past year, Fidelity's Registered Investment Advisor Group (FRIAG) has restructured the team that sells custody services to advisors, adding 20 new sales people, which brings the total up to 70. It also hired additional relationship managers, who provide consulting to advisors once they are on board. In addition, the company spent millions to install new platform technology and opened 10 new branch offices (six of them within a half-mile of a Schwab office). Additional technology investments and six more branch offices are planned for this year. The company also cut electronic equity-trading commissions for advisors by almost 70 percent, to $8.

It's part of a larger restructuring taking place at Fidelity. In early May, the company made a number of high-level management changes in its investment management and distribution operations. And then there's the ongoing effort to overhaul Fidelity's brokerage unit, which includes FRIAG, the online retail brokerage and Fidelity's institutional services. Since Ellyn McColgan came on as president of Fidelity's brokerage unit in late 2002, she has slashed prices for online trades, cut costs and spent $700 million on technology. During that time, the firm has added more than 1 million retail accounts, bringing total brokerage assets up to $1.13 trillion. That's just a hair ahead of Schwab's $1.08 trillion, and a little short of Merrill Lynch's $1.36 trillion.

Focus on Advisors

Now McColgan is focusing on the advisor services unit. At the firm's annual conference in Palm Beach, Fla., this April, she told advisors that she wants to displace Schwab as the No. 1 custodian for advisors. That goal has a deadline of 2008, says Scott Dell'Orfano, who was hired away from SEI Investments in October of last year to head up the custody sales group for FRIAG. Bigger investments and hires are on the way, Fidelity says, including a replacement for Jay Lanigan, the longtime leader of the advisory business who stepped down at the beginning of the year. Lanigan managed to double FRIAG's assets over the past two years, but apparently that wasn't enough.

The firm is looking for someone with the "authority and vision to take [FRIAG] to the next level," explains Harold Evensky, who custodies with both Fidelity and Schwab and is a principal at wealth management firm Evensky & Katz in Coral Gables, Fla. "That's what they told advisors." Evensky attended a Fidelity Executive Forum this spring where he had a chance to meet with senior management.

Fidelity has a long way to go to get to the top. Today, Fidelity custodies some $132 billion in assets for around 2,700 advisors, versus Schwab's $352 billion in advised assets and 5,000 advisors. And Schwab doesn't intend to give up its lead. “We certainly are not resting on our laurels,” says Michelle Swenson, senior vice president of Schwab's advisory brokerage unit. Schwab recently hired Charles Goldman as chief operating officer to enable Debby McWhinney, president of Schwab Institutional, to focus on long-term strategy for continuing the unit's growth, says Swenson. The company has also invested in new technology to speed the delivery of client reports and simplify complex mutual fund trades. In the second quarter, it will begin offering advisor clients a pledged asset line of credit from Schwab Bank, and it recently designed a compliance information center for advisors on the Web. Last May, Schwab also slashed trading fees for advised clients by 20 percent, to $19.95.

“We continue to make very significant commitments to our platforms, our systems, our service teams, our sales force,” Swenson says. “Certainly our size and scale we think is a real differentiator, and coupled with that is our 18 years in the business.” The first to offer custody services to advisors in 1987, Schwab has been the leader ever since. T. Rowe Price and Vanguard began to nibble at it shortly afterwards, but Fidelity didn't begin to offer custody services until 1993. Schwab, which has a vast mutual fund and managed account supermarket, is known for having the highest-quality service in the business.

Trading Places?

Still, analysts think Fidelity stands a chance at swiping the crown. “Historically, Schwab had a better offering — they had scale and dedication,” says Matt Snowling, an analyst at Friedman Billings Ramsey Group. “But Fidelity is quickly ramping their offer up to be competitive. And they're getting there.” Snowling continues, “[Fidelity's] got deep pockets, and with their mutual fund base, it's in their best interests to be a winner in this part of the space.” Meanwhile, Schwab has been struggling financially and cutting costs, says Snowling. “So they have an incentive to move [assets] to relationship advisors, internal advisors, over the independents that use them as a platform. If you push too hard in that direction, you may end up upsetting your core customer base.”

Horan Capital's Horan, who manages $217 million and has used Schwab exclusively for the past 10 years, has heard only that Fidelity's referral program is vastly improved, that it is gaining ground on Schwab in terms of technology and “that their back office has really taken some quantum leaps.” He has already set up an appointment with a Fidelity salesperson, and is hoping to find out more, he says. “At this point we are seriously considering taking a considerable chunk of assets to Fidelity, trying them out for a six-to-nine month period, and if everything works out well, making the switch,” he says.

Early this year Fidelity rolled out a new referral program targeted at a small subset of advisors. It aligned 50 firms with its retail branches to get referrals on accounts with over $1 million. “We are seeing an acceleration in the number of referrals, the close rate and the average account size,” Dell'Orfano says. The close rate is up to 60 percent, he says, and the average referral account size is $1.8 million. That compares with a 40 percent conversion rate and an average referral account size of $750,000 at Schwab. Meanwhile, Fidelity doesn't charge a cent for advisors to participate in its referral program, whereas advisors have to pay Schwab (and TD Waterhouse) 15% of the fees they earn on referred assets, or a minimum annual fee of $10,000.

Schwab's program still has far greater reach. Schwab has 280 branches, versus Fidelity's 100; there are 330 advisors in its program, versus a total of 150 in Fidelity's; and it converted $6.4 billion in referrals in 2004, versus just $800 million at Fidelity. On the other hand, Fidelity has a vast treasure chest of potential referrals in its 401(k) business, says Chip Roame, managing principal of Tiburon Strategic Advisors in Tiburon, Calif. “That retirement business is a home run if they learn to leverage it. If they were able to capture those rollovers, and hand them to advisors, that could be a much bigger source of assets than any branch-based referral program,” he says. Fidelity, which manages $479 billion in retirement plan assets for 19 million employees in the U.S, says it is considering giving advisors access to those accounts, but it's taking it one step at a time. First it wants to roll out the right tools, according to Dell'Orfano.

One advisor said that was a big point in Fidelity's favor when he decided to go independent. “I saw that as time went on there would be great opportunities there, especially with retirement plans,” says J. Patrick Collins, president of J.P. Collins & Associates in Towson, Md. “I expect they may open that up to their advisors,” says Collins, who left Merrill Lynch to custody with Fidelity last year.

On the technology front, Fidelity rolled out Integrated Decision Systems (IDS) for its advisors last year, which essentially “integrates” advisors' various portfolio management and trading tools. And this year it plans to integrate IDS with its NaviPlan financial planning software and the Advisor CHANNEL platform. By early 2006, the platform will also include contact management, account servicing and practice management support.

“What Fidelity has done is integrate its software, which makes processing a lot easier,” says Roame. “Schwab has that with Centerpiece, but most people see it as a relatively low-end product. So essentially what Fidelity did is to integrate with a much more sophisticated product.”

Other services that Fidelity has added in the past year include trust accounting and asset management systems, a comprehensive annuity and insurance program that is integrated with Fidelity's brokerage platform, a number of Best Practices regional workshops, and operational administration and management outsourcing services.

The Wirehouse Challenge

No matter how competitive Fidelity's service is, or how worrisome Schwab's in-house advice, it's unlikely that many advisors will actually move clients off of Schwab's platform, both advisors and analysts say. In that sense, Patrick Horan's case may be somewhat unique. Moving assets from one custodian to another is usually a colossal hassle requiring thousands of pages of paperwork. But Fidelity could capture new assets from advisors already custodied with Schwab as they grow their businesses. A lot of advisors are using more than one custodian these days, in part because it gives them greater bargaining power, say advisors.

Ultimately, whether Fidelity can leapfrog into first place may depend on whether it can capitalize on the growing interest among wirehouse brokers in switching to the independent channel. According to preliminary data, the Securities Industry Association estimates that the ranks of registered reps were stagnant in 2004, versus a 20 percent increase in the number of registered investment advisors (RIAs), and that trend is expected to continue.

Schwab is making a concerted effort to attract wirehouse advisors with a new ad campaign and Web cast. Last year, Schwab wooed 30 brokers to the firm, and this year it plans to double that number, Swenson says. "While we have always won business from brokers turning independent, we really saw a pickup in that flow last year. And now we have an organized program around that and are feeling very excited about it."

Still, in some ways, for brokers making the switch from commissions to fees, Fidelity is the ideal place to get a start. Unlike most of its competitors, it has both custody and clearing business, as well as a big institutional trading capability. This means that an advisor who does both commission and fee business can manage all his accounts in one place. "The combination of those things should allow them to serve large RIAs who are hedge fund managers or combined RIAs and broker/dealers," says Roame.

Frank Martin, a former Merrill broker who moved $500 million in assets to Fidelity last fall, says Schwab was a close second, but what he most liked about Fidelity was its salesmanship. "They have a consultative sales approach," says Martin, who works out of Northern Indiana. "They surprised us in the beginning. They wanted to know about our business and what our needs were, instead of the typical sales approach, which is to show us all the bells and whistles. All I remember is I was so impressed with the Fidelity people, so it stuck out. It was conspicuous in its presence."

No matter the outcome, for many advisors, a growing rivalry between Schwab and Fidelity is a great thing. "I'm glad that the competition is intense because it means both of them are going to do a better job of serving clients," says Martin.

BY THE NUMBERS: FIDELITY VS. SCHWAB

Fidelity's Registered Investment Advisor Group:	Schwab Institutional:
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Advisors: 2,713	**Advisors:** 5,000
Assets under management: $132 billion	**Assets under management:** $352 billion
Number of branch offices: 101	**Number of branch offices:** 280
Number of mutual funds available on platform: 11,900 share class alternatives from over 390 fund companies	**Number of mutual funds available on platform:** 5,273
Number of separate account managers available on platform: 220 separate account managers offering 600 product types.	**Number of separate account managers available on platform:** 756 with more than 2000 different account management styles.
Total sales/recruiting personnel: 102	**Total sales/recruiting personnel:** 212
Total back-office personnel: N/A	**Total back-office personnel:** 1,092
Number of advisors with more than $100 million in assets custodied at Fidelity: N/A	**Number of advisors with more than $100 million in assets custodied at Schwab:** 862
Number of years in business: 12	**Number of years in business:** 18

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