Money Management Institute

MMI Perspectives Series

A CONVERSATION WITH

Leonard Reinhart

Executive Chairman, Wealthcare Capital Management

In this interview, Len Reinhart takes us on a 38-year journey from his presence literally at the birth of fee-based advisory accounts through the current industry drive towards what may be the ultimate steps in the development of goals-based wealth management. Along the way, he touches on how institutional investment consulting was introduced into a retail investor framework, the "visible wealth" illusion, the importance of investing at the household level, and the need for changes in the advisor skill set.

It is difficult to imagine anyone more qualified to trace the evolution of investment advisory solutions. An MMI Advisory Solutions Pioneer Award recipient, Mr. Reinhart has spent the better part of four decades crafting and delivering investment advice for the Baby Boomer generation. In addition to serving on the Board of Directors of Wealthcare, Wheelhouse Analytics, and LifeYield LLC, he founded in 1995 the Lockwood family of companies which introduced the first open-architecture advisory account platform for independent advisors. When Lockwood joined forces with Pershing in 2003, it became one of the largest providers of turnkey and private-labeled advisory account solutions, and he served as Managing Director and member of the Executive Committee of Pershing LLC. He started his career in financial services at E.F. Hutton, eventually rising to President of its Consulting Group, which through various corporate events, evolved to the Consulting Group of Smith Barney, the predecessor to the Morgan Stanley Consulting Group. He is credited with developing the first advisory programs to offer institutional-level professional investment services to the individual investor marketplace. Passionate about bringing young advisors into the business, he serves on the board of the Business School at the University of Rhode Island.

Leonard Reinhart
Executive Chairman, Wealthcare Capital Management

MMI: Let's begin with an overview of the evolution of managed accounts.

Len Reinhart: Much of the evolution in our business has been driven by regulatory change. What was perhaps the industry's biggest single event happened right before I got into the business, and that was May Day in 1974 when commissions became negotiable. Until then, the brokerage industry was a commission-based business—there were no such things as fees.

I started working in 1977, and the next year I moved over to E.F. Hutton to be a financial analyst working with Jim Lockwood. Before joining E.F. Hutton, Jim had been the highest paid person at Dean Witter. As a commission broker, he was making more than the chairman of the firm, and he was based in St. Louis, Michigan, of all places. He recognized early that the state of Michigan retirement system should be in the equity markets. So he made the rounds recommending equities to them, telling them they could either buy a mutual fund or he would introduce a money manager who would manage the equities, and he, of course, got the commission business. Trades were done at standard rates, and he was making a fortune—over a million dollars a year.

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But when May Day came, it was evident the days of the golden goose were over. Jim was a very bright guy, an Annapolis graduate, and he recognized that, if you can negotiate commissions, you can negotiate them to zero, making fees the way to go. He told me around that time, "The best advice I ever gave my clients over the years was not to sell, but I didn't get paid to do that. But if I can collect a fee and charge no commissions, then for the first time I am going to be on the same side of the desk as my clients. If their assets increase, I make more money. If they go down, I make less."

MMI: How did he put that into practice?

Len Reinhart: He showed that concept to Dean Witter, but they didn't want anything to do with it. So he then took it to George Ball, the president of E.F. Hutton, who agreed to let him start up a fee-based program. Jim got together with Hutton's head of research, Alan Miller, and they created a program under which the research department would manage a portfolio of securities for an investor and charge a 3% fee—which was lower than the going commission rate—and the minimum account size was $25,000. That's how it all got started.

The next major event that moved the industry was the publication of FASB 87. It stipulated that the unfunded liability of all the large defined benefit pension plans had to carried on corporate balance sheets. FASB 87 was the death knell for the large corporate DB plans, and all of a sudden IRAs and 401(k)s appeared, and the Baby Boomers found themselves funding their own retirement.

MMI: Clearly a turning point.

Len Reinhart: We may not have realized it then, but it was huge, and it led to our next step at Hutton. While 90% of our revenues at the time was coming from state retirement plans, we had been gradually building a small program of fee-based plans for individual investors. What we did was take the institutional product and deliver it in a retail framework. We began working with money managers who normally had $10 million minimums and convinced them to manage accounts at the $100,000 level. We would put three or four managers together for a client with, say, $2 million to manage his or her money, and that was the beginning of what we called the Consulting Group, which essentially took what we learned on the institutional side and brought it to the retail investor.

So E.F. Hutton was the very beginning of managed advisory accounts, and it was absolutely Jim Lockwood's idea to take this route—to get out of the commission-based structure and all the bad things that can happen there. Why? It was simply a better way to do business. It made the advisor a fiduciary, something I find fascinating in the light of what's going on today with the DOL rule. My reaction to that has been, "Come on, what's the big deal? We have been doing it that way for over 35 years. It's the right way to do business."

Next, we began to experience significant success, and it was part of our job within Hutton to build on that success. While the Consulting Group approach and the fact that it worked became well known among Hutton brokers, it still wasn't easy to convince them to do fee-based business. We'd go into a branch where the brokers were doing well and tell them we had a new and better way for them to operate. The response was, "Yeah, right—you guys are crazy."

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The strategy we eventually adopted was to find relatively young brokers in the branches and over-service them. We helped them do presentations and whatever else was needed. We were in there every week, and before long their businesses began to grow. Then the other brokers in the branch would be looking at a young broker saying, "Wait a minute. It's January, he already has $100,000 in production, and he is only in the office two days a week." That was because they were out visiting clients—not tied to their desks doing trades. These spheres of influence that we created grew their businesses significantly, took over regions, and, eventually they were hired away, and today you will find members of the original Hutton Consulting Group scattered across the industry in leadership positions. If you look at the list of MMI Pioneer Award winners, many of them have their roots at E.F. Hutton.

MMI: What happened to the Consulting Group after E.F. Hutton went under?

Len Reinhart: Hutton went out of business after the market crash of 1987. Jamie Dimon and Sandy Weill saw the value in the Consulting Group—it ended up at American Express and later at Smith Barney, where I worked directly for Jamie Dimon. The managed money unit was a tremendously profitable area that never got sued by a client because we were doing it the right way. We were asking clients how much risk they wanted to take, what their goals were, we came up with a diversified strategy with professional money managers, and we charged fees which were fully disclosed.

"The big change is that Baby Boomers, as they prepare to retire…are asking whether they have enough money... No one knows the answer to that—what we have built doesn't give the answer."

MMI: That, of course, brings us to a question I'm sure you have heard over and over—what is so new about goals-based wealth management?

Len Reinhart: For 30 years, we saw the Baby Boomers—of which I am one—accumulating wealth on their own in IRAs and 401(k)s, and they needed someone to manage it. The managed money industry stepped up with a very clean, safe service to grow their assets. We were not going to hit home runs—it would be singles and doubles—a great product at the right time in wealth accumulation. It was really about how much risk they were willing to take.

Now, flash forward to goals-based and what is going on now. If you look at the evolution of products, we started with SMA accounts and used them for bigger clients. Schwab came out with OneSource for mutual funds, and we started to get a lot of competition from independent advisors with mutual fund wraps. So we began working with mutual fund wraps—we created the TRAK program for smaller accounts. By this time, there had been a huge shift among advisors, moving from a transaction orientation to risk questionnaires, consulting strategies, and asset allocation modeling—all the while building significant assets in fee-based accounts.

Now we have the robos coming in saying that they can do all that and do it for next to nothing. In reaction to that, we see the industry asking itself what is next, how do we add more value? It is a situation similar to what happened when discount brokerage appeared on the scene. The industry had to find a way to up the ante on its value-added proposition.

The big change is that Baby Boomers, as they prepare to retire and move out of the wealth accumulation stage of their financial lives, are asking whether they have enough money. "Am I going to make it?" No one knows the answer to that—what we have built doesn't give the answer. We asked them how much risk they wanted to take, and we gave them strategies that provided the risk levels they sought, but that didn't assure them they would have enough money for the kind of retirement they wanted. In the accumulation stage, we were looking for as much money as we could amass, but no one ever asked whether the pile would be big enough, and financial planning software didn't really answer it either.

MMI: Where does that lead us?

Len Reinhart: So this is where the goals-driven process comes in. At Wealthcare, we ask questions that seek to learn what is "ideal" and what is "acceptable." It is a hard question if I ask when a client wants to retire—which year? Similarly, if I ask the client how much money does he or she need each year, that's also a hard question. Better to ask, "When would you like to retire?" and "When do you feel you have to retire?" Ideal and acceptable. Income-wise, what's ideal, what's acceptable? What do you want to leave your kids? The answers provide a range. You compile a list of goals and provide ideal and acceptable levels for each. Next, you try to determine how much money is needed for the ideal and acceptable outcomes for each goal on the list.

Then you look at the probability of having enough money to meet each goal. Let's say the probability is low, you need to go back. Say you wanted to leave each child $500,000—what if you left them $250,000? You said you want to retire at 63. Can you wait two more years? You try to get to a point where there is a 90% or better probability of them hitting their acceptable levels of expenditure, and they are at 75% or better on hitting their ideal levels. We call the area between those points the Comfort Zone. Then we come up with strategies to maximize that zone by minimizing taxes and fees.

So the goals-driven process is for the first time quantifying a person's life goals and dreams in an ideal/acceptable format and determining the probability of what they have accumulated being enough. If it is enough, great. If not, change your ideal and acceptable parameters or find a way to earn some more money. For most Baby Boomers, however, the big earning years are over, and it becomes a matter of adjusting what is acceptable and ideal.

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MMI: You mentioned "visible wealth" earlier.

Len Reinhart: Visible wealth is a problem for the Baby Boomers. You take a Boomer with $1.5 million in savings, and the attitude is "Hey, I'm a millionaire, and I'm joining another country club and buying the big Mercedes." No, not really. In terms of visible wealth, they are, indeed, millionaires, but they are not rich because they have to live off that $1.5 million for the next 30 years. So visible wealth has misled the Baby Boomer. Goals-based brings it back to reality.

The other thing we have learned is that if you manage money at the household level rather than the account level, you can add a substantial amount of value. Most of our clients have five legal accounts. The husband and wife might each have a 401(k) and an IRA, there are joint checking and savings accounts, and they were all set up for different reasons. In the traditional brokerage approach, investment objectives were set up for each account independent of each other, and those objectives were based on how much risk a client wanted to take.

When clients came to set objectives for the retirement account in that process, the invariable reaction was, “I don’t want to lose that. I don’t want to take much risk there.” That’s the wrong response. Household management starts at the top, and we come up with an asset allocation that gives you the best probability of achieving the ideal and acceptable as if all the client’s money is in one bucket. We might say, for example, that given the fairly substantial commitment to small cap equities which will be fairly actively traded, we will put them in the IRA, the most tax-effective location. Similarly, you put the other sleeves at the household level where they will get the best tax treatment. Morningstar estimates that by managing at the household level, you can add 181 basis points of return.

When it comes to taking the money out of those five accounts, we have some fairly sophisticated software that determines the most tax-effective withdrawal method. Even if all the accounts are not under an advisor’s management, we have data aggregation tools which enable an advisor to still see, for example, a 401(k) account located somewhere else. So technology is helping.

This has been a bit of a long-winded answer, but I think we are at a point where our industry is saying that our next value-added proposition is goals-driven investing at the household level. Because of my work at Wealthcare, I’ve been able to talk to virtually every major brokerage firm, and this is what they are trying to figure out. They don’t have all the pieces yet, but they are moving in the right direction.

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MMI: What do advisors like most about the goals-driven process?

Len Reinhart: Advisors are telling us that the goals-driven process changes the client conversation. Clients really no longer care about what the market is doing. Instead they start to care about where they are in their respective comfort zones, and what the advisor is doing in managing the comfort zone—and it works. The market may go down 300 points without the client leaving the comfort zone—so no problem. But when 2008 came along and many clients dropped out of the comfort zone, the fascinating thing was that we had investors increasing their equity exposure when the market went off 50%, and that is, of course, exactly the right thing to do.

The goals-driven process makes risk just another variable you can play with because goals-driven looks forward rather than backwards. A risk-based questionnaire looks backward at risk while a goals-driven process is looking at the probability of future success. The reward for taking more risk is moving back up in the comfort zone.

MMI: It's sort of automatic behavioral finance.

Len Reinhart: Yes, exactly. Two quick stories: a wife calls her advisor and says she wants to remodel her kitchen at a cost of $125,000—does that put her and her husband out of the comfort zone? Turns out it didn't, and she moved ahead on the project without even telling her husband. When the market is booming, another investor is above the upper boundary of the comfort zone, which means he is saving too much money. The system stores initial goals and the advisor recalled that one goal was to buy a Ferrari, but that didn't make the first cut. The advisor informs the client that—after four years—it is now OK to buy the Ferrari, and he does.

So, it's not a 60-page one-and-done financial plan. It's a conversation. Life is going to change, and decisions will be made on how best to alter course. You keep adjusting to keep clients in the comfort zone, and you may also find you have to change goals along the way if that's what it takes for them to know they won't end up living in their kid's basement.

MMI: We see advisors being under tremendous time pressure—too many tasks, too little time. Does this portend more use of advisor teams?

Len Reinhart: Absolutely, and it helps address another problem in that the advisor base has gotten too old. The industry hasn't done a good job of bringing on new young advisors. The teaming allows you to bring in a younger person, and it may also play a part in transitioning an older advisor out of his or her practice.

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It is also clear that the advisor skill set needs to change. How do you do that? Can you do it with a 55-year-old advisor? Or do you work with someone who is 25? Put him or her on the team and teach them the new skills. Changing someone who has been successful and is in his or her mid-fifties—that is hard change. You have to go younger.

Once the client is well into the decumulation mode, it becomes a very administrative process. How much money do you need each month and where do you want it sent? As clients move into their seventies, I think we reach a crisis point of sorts. My worst fear relates to the fact that in our industry most advisors are the same age as the client base. Suppose that a surviving wife in a client relationship becomes incapacitated and can no longer make decisions on her own, has no family support, relies on her advisor, and that advisor retires.

What happens to her account? Do they give it to someone else in the branch who doesn't know her? A better situation would be one where a younger advisor teaming with the retiring advisor could step in and take over. Since the tasks are largely administrative at this point, another solution is for the firm to reduce the client's fee and service it from a home-office phone bank.

MMI: Healthcare administration and costs are the big bump in the road at that point.

Len Reinhart: Yes, someone on the advisory team should be knowledgeable about elder care and be able to help guide clients through the process.

MMI: How big is the advisor training challenge?

Len Reinhart: It is huge because for 30 years we've taught these advisors alphas, betas, r-squareds—all this jargon that makes them sound incredibly intelligent but that really doesn't make much difference. If I were hiring advisors out of college right now, I'd be hiring a psych major with a minor in finance.

MMI: Understanding human behavior has become a key part of the skill set?

Len Reinhart: Yes. That is tremendously important. People don't want to talk about alphas, betas, and gammas—they want to talk about their dreams and goals. When we have them list their goals for us, they do it independently, and then we merge them. The results are invariably surprising, the husband or wife saying, "I had no idea you wanted to do that!"

When it comes to Millennials—and I have four of them—they are not motivated in the same way I was. They are more about funding the lifestyle—travel and so forth—rather than funding the house and the country club, and the goals-driven approach works very well for them. Looking back at past investor behavior, the male Boomers invested for sport, pounded their chests, and the cocktail chatter was about big winners and hitting home runs. Women, on the other hand, typically invest for very specific needs—there's a reason for every investment.

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MMI: Do you ascribe to the view that the more important financial decisions are increasingly being made by women?

Len Reinhart: Absolutely. They are more practical in their thought processes. "We saved this money for these four things, and you want to buy a boat? That's not one of the four things—it doesn't fit."

MMI: What's coming down the pike that might surprise people?

Len Reinhart: Well, for one thing, I wouldn't want to be a sleeve manager anymore, meaning I wouldn't want to have a fund with expertise in just one thing. When you look at managing wealth at the household level, what are the two biggest impediments to accumulating the assets you need? They are taxes and fees. Betting on hitting a homerun with your product rather than singles and doubles isn't going to work. If I were starting a business, I would not start it based on the concept of actively managed sleeves. If you could short businesses, I'd short that one.

I'm not saying active management is going away by any stretch because the more passive you get, the more attractive active management becomes. You have to always be balanced, but being a sleeve manager is going to be a very risky business. If you don't perform, you are going to be out.

MMI: The benefits of technology to financial services?

Len Reinhart: Overall, I think it's beneficial. It helps the process become friendlier, less mystifying, and more predictable. Still, we have yet to get our arms around technology. Technology is great, but I always kid that mankind has been around for 60,000 years, and we still haven't mastered fire—every night homes burn and people die. We are not close to mastering technology, and it rears up to bite us periodically—flash crashes, scandals—Bernie Madoff couldn't have happened without technology.

What might be the biggest negative surprise for our industry? It will be something to do with technology that takes us down some path that blows up on us. It will be something so complex that we cannot comprehend the end result until it's too late.

That said, when I look across industry in general, I get excited about the impact of evolving technology. Consider Tesla—not the stock, but the concept of the Tesla not using fossil fuels. Similarly, think of the ripple effect of automated self-driving cars—fuel and personal time savings, fewer accidents, and lower insurance costs. That's tremendously exciting.

MMI: So, as you look ahead, what will, in your opinion, be the most important change for the investment advisory business?

Len Reinhart: We have already touched on it. I think the industry—through the influence of technology and a changing advisor mindset—is going to become a much more goals-oriented as opposed to a performance-oriented business. If you look at the past 40 years, it's all been about performance. I think that is fading, and it hasn't really worked exceedingly well.

When I look at the longer term trends, I see the conversation changing. It's going to be more about future needs and really looking at an investor the way you would look at a business. What will be the liabilities of this person for the rest of his or her life, and how are we going to fund them? The investment strategies we deliver will be designed to fund specific future goals.

You are also going to see a difference in the way the client is approached. The advisor is going to be something like a psychiatrist in helping an investor determine what are reasonable goals and coming up with strategies that have a probability of achieving them. That is really a big change from where we are in the business today.

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Historically, specific goals were rarely part of the conversation—it was all about how much risk an investor wanted to take. That is beginning to change, and the transition will, I believe, be seen as pivotal. An outcomes-based—or, if you will, aspirational—approach to investment planning works for the Baby Boomers, and it also works for Millennials. In adopting this approach, we are finding people are taking less risk than in the past. When you think about it, a good deal is being explained about past behavior—how people took on a lot of risk, and when the market began to fall, they panicked and sold. The reality was that they couldn't really assume the level of risk they had indicated to their advisors.

"When you start looking at goals rather than investment returns and risk, what has to be funded opens up the need to offer a much broader array of services."

Another thing that is likely to change is the way advisors are compensated. I think you are going to see more fixed-rate as opposed to asset-based pricing. Fees will be set in a way that relates to the needs of an investor at various points in the client relationship life cycle. When an investor, for example, is starting to draw money down, that's when the fees as a percentage of assets begin to drop. But that's also the point at which an advisor is doing more work than ever before. So pricing will, I think, be set in relation to brackets or buckets of services needed rather than how much money the client has. Take a husband and wife who have $700,000 to $800,000 in an IRA, that's one level of service for which you would charge a set amount. Then, consider someone with $10 million, assets in multiple buckets, and a handicapped child who needs lifetime care—that's a far different level of service.

MMI: Essentially you are talking about a retainer fee that is set until some material change occurs?

Len Reinhart: Right. You might need advice on planning for college education, there are four or five other things to be handled in addition to taking care of the investment portfolio. Our annual fee for that would be, say, $5,000. For the 25-year-old who just wants advice on his or her 401(k), the annual fee might be $250.

MMI: There's a lot of talk about mid-sized firms being badly squeezed by rising compliance costs and fee compression.

Len Reinhart: There is some truth to that. The regulatory burden has really put a lot of pressure on smaller firms because they cannot do it themselves, and they have to outsource those functions, which are getting more expensive. But if you look past that, there will be a point where the big clearing firms become more cost-competitive in helping them, making compliance less burdensome.

Just looking at the role of the advisor, it will without question be tough for the one-person firms to survive. In smaller firms, you are going to see more of a "general practitioner" approach with a broader range of services—one where a service package might include accounting fees and estate planning along with other services. Rather than four advisors who all know investments, I think we will see four advisors with different specialties—more of a team approach, and one specialist may be all about health insurance and care for elderly parents. When you start looking at goals rather than investment returns and risk, what has to be funded opens up the need to offer a much broader array of services. For example, care for the elderly is a daunting task, and being able to offer the services of a specialist who knows the long-term care facilities in the community, how the pricing structure works, and what Medicare will cover would be an extremely valuable capability.

MMI: What advice would you offer college graduates contemplating a career as a financial advisor?

Len Reinhart: Coming out of school and trying to develop your own advisory business is very hard to do. I would suggest starting by going for the Certified Financial Planner certificate and really digging into the goals-driven, aspirational approach to investing. They should try to team up with senior advisors in their fifties and work with them to support their practices and help transition them to a goals-based approach, if that's what is needed. And, if the relationship works out well, eventually there may be the opportunity to take over the book of business.

MMI: A final question—do you see the SEC moving in the same direction as the DOL rule?

Len Reinhart: I think the SEC should. It represents a full commitment to putting clients' interests first, an integral aspect of the industry's moving towards higher professional standards.

MMI: Thank you for your time.

MMI Perspectives Series

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