Welcome to the Jungle

The Next Phase of the Evolution of the Wealth Management Industry

Presentation to:

South Dakota Trust Association

by

Mark P. Hurley
Digital Privacy & Protection, LLC

DIGITAL PRIVACY & PROTECTION

www.dpripro.com

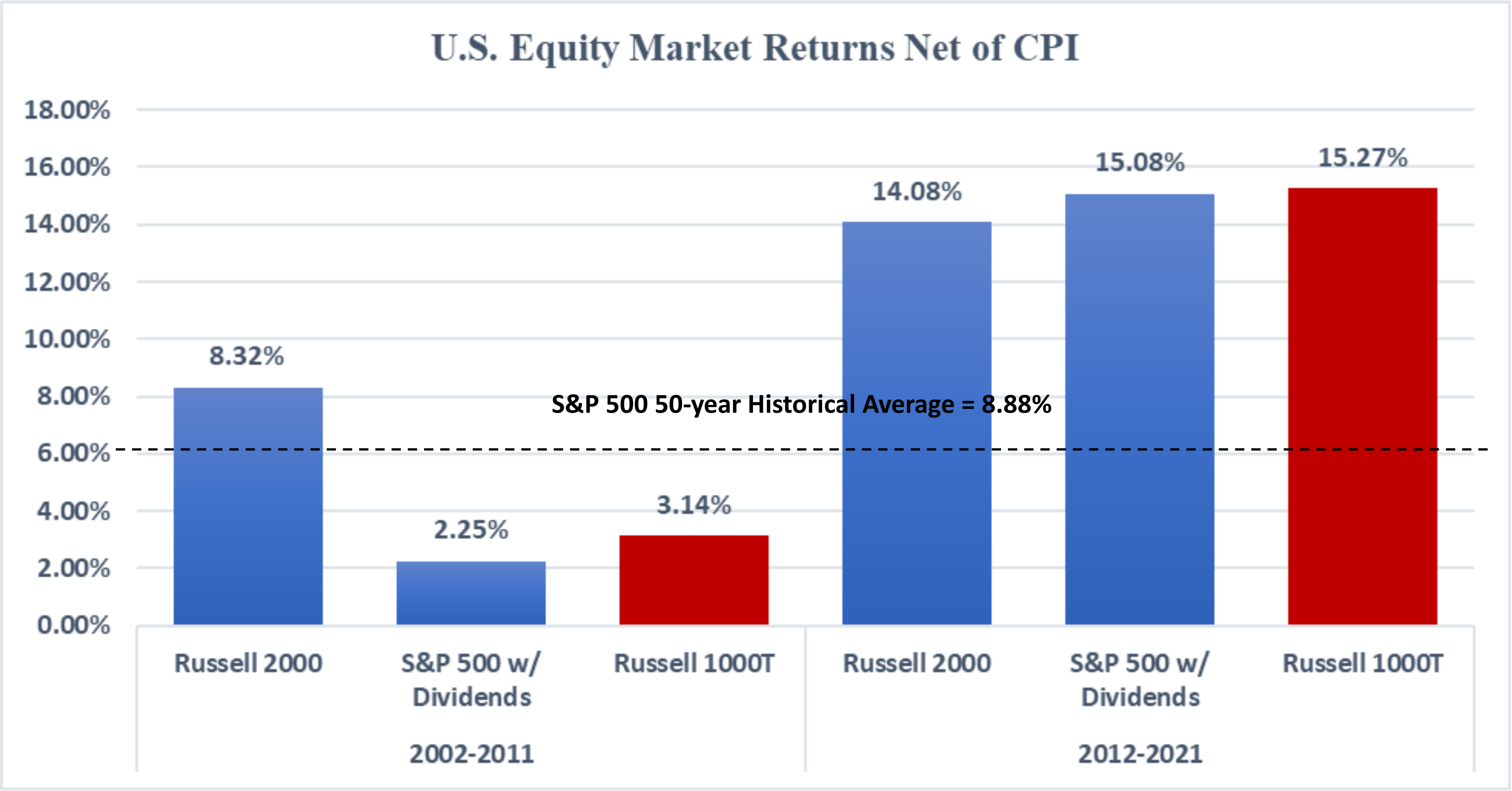
Background

- CEO of Digital Privacy & Protection
  - Provides cyber privacy/security services to wealth management clients
  - Bundled packaged of “best of breed” existing technologies and services
  - Designed by former military cyber-warfare officers
  - Can only get through financial adviser
- Comprehensive, painless & attractively-priced
  - $35 per month for 1st three devices; $5 month for up to each additional three devices
  - Includes everything, set up/installed & regularly updated for the client
- Previously co-authored multiple studies on wealth management industry
  - First one in 1999 – predicted consolidation of industry
  - Controversial – triggered immense debate & consternation
- This report
  - Twelve-month project
  - Collection of best ideas from multiple industry thought leaders

Industry Waking Up From Financial Bacchanalia

- Soaring US equity markets + low interest rates + low inflation
  - 2012-2021: S&P 500 up 425%; Wilshire 5000 up 350%
  - 1 Month LIBOR 20% of historical average; 10-year CMT about 40%
  - CPI half of historical averages
- Wealth manager AUM, fees & profitability exploded
  - Operationally leveraged investment in financial markets
  - EBITDA compounded at 15% to 20% per year
  - 4x to 6x increase in profitability ***w/o adding new clients***
- M&A feeding frenzy
  - Oceans of PE money + cheap, plentiful debt
  - 100+ buyers & 1600 transactions
- Prices went stratospheric
  - “Adjusted EBITDA”
  - Many at 20x EBITDA; some at 30x EBITDA
  - *Betting heavy on a rising tide*

U.S. Equity Returns Net of CPI ≈ 170% of 50-Year Historical Averages

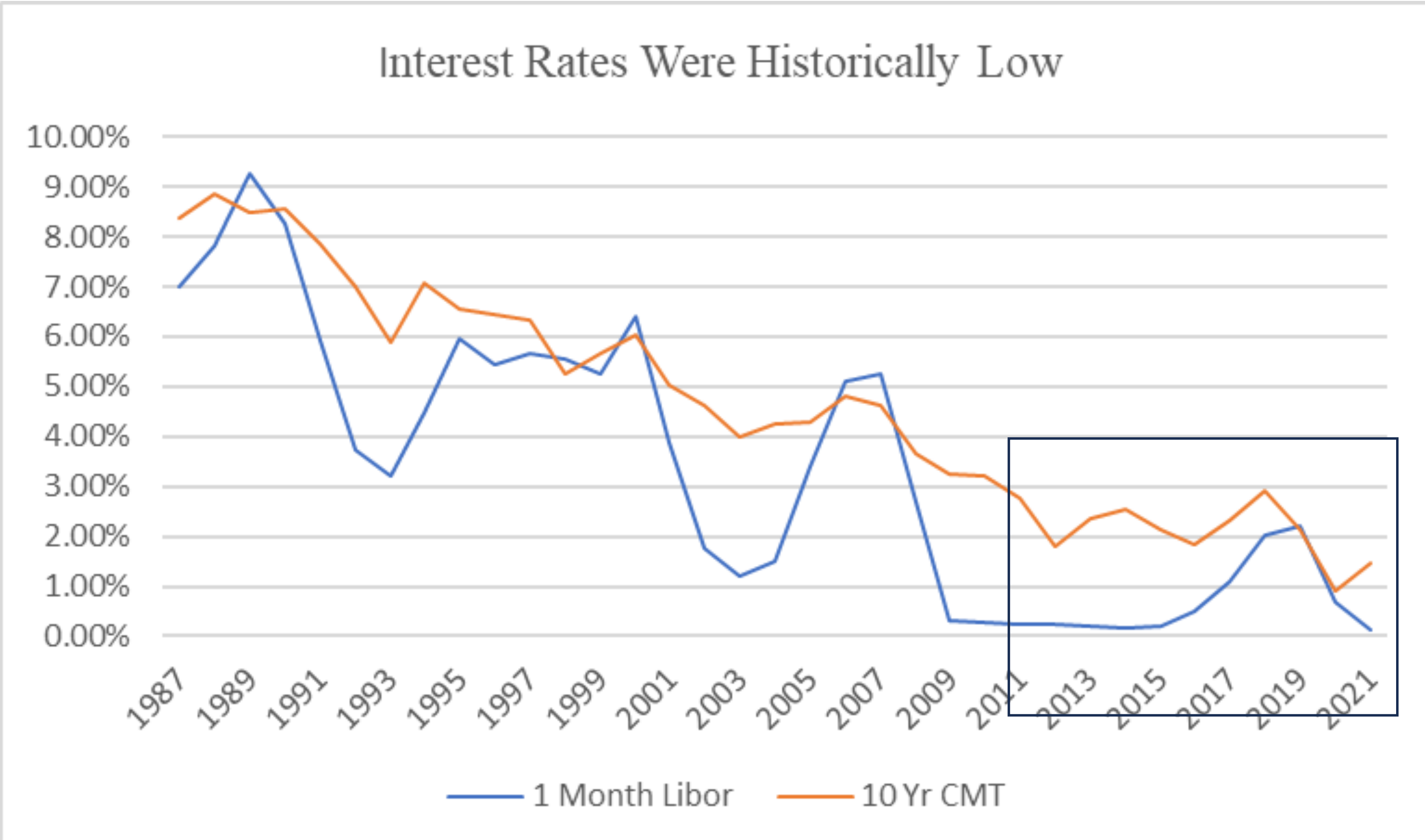


Sources: https://www.1stock1.com/1stock1_785.htm; https://www.1stock1.com/1stock1_784.htm; S&P 500 Price Return, Dividend Return, and Total Return (slickcharts.com); https://www.usinflationcalculator.com/inflation/consumer-price-index-and-annual-percent-changes-from-1913-to-2008/

DIGITAL PRIVACY & PROTECTION

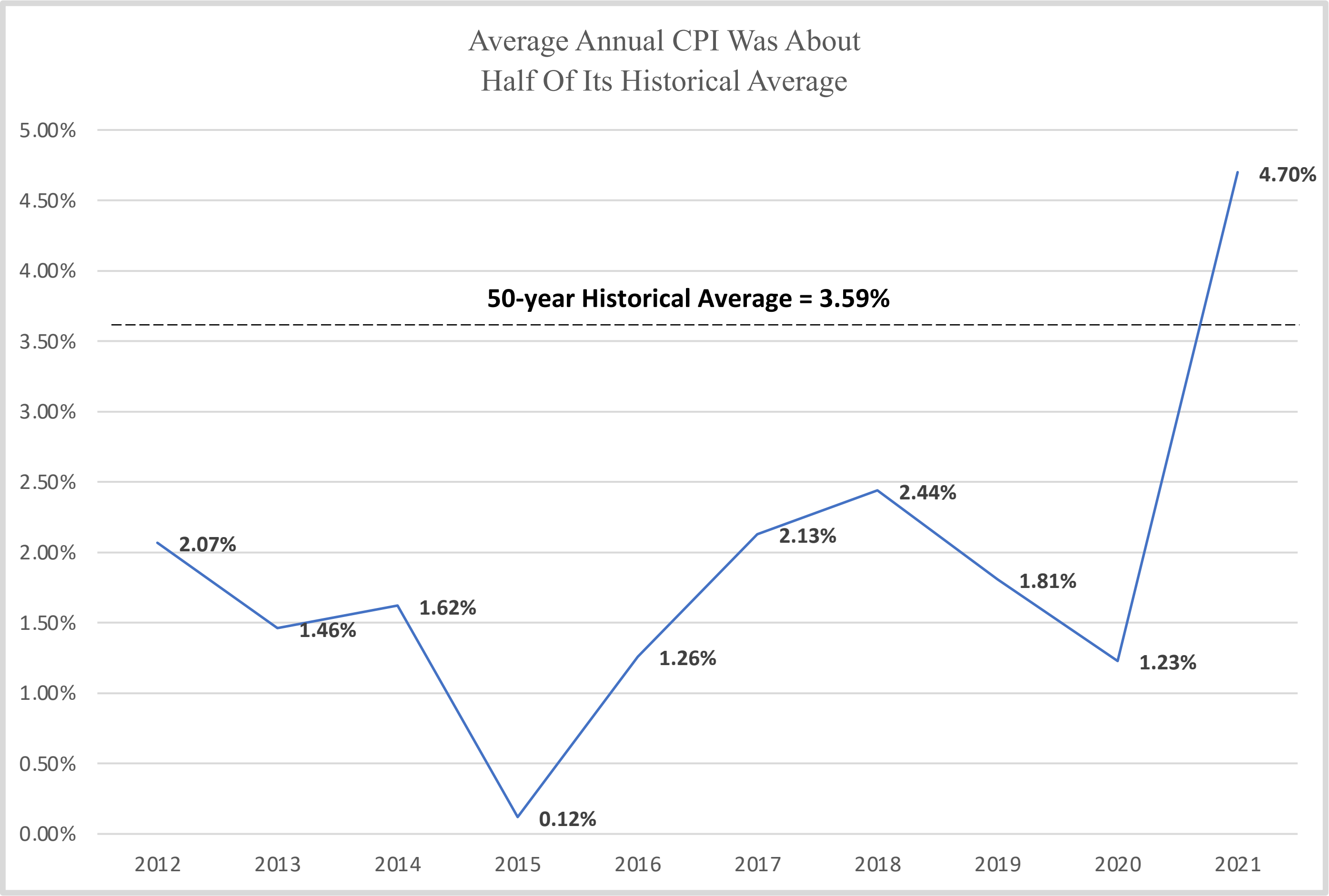
www.dpripro.com

Debt Was Cheap and Plentiful



Sources: LIBOR Rates - 30 Year Historical Chart | MacroTrends ; https://www.macrotrends.net/2016/10-year-treasury-bond-rate-yield-chart

Accompanied By Historically Low Inflation



Source: https://www.usinflationcalculator.com/inflation/consumer-price-index-and-annual-percent-changes-from-1913-to-2008/

Industry Participants Were Lulled to Sleep

- Most firms largely stopped marketing
  - 70% of all growth from market appreciation
  - Erstwhile existing client referral
  - 70% of all firms *shrinking* but for market appreciation
- Little effort made to distinguish offerings
  - No differentiation regardless of size
  - Not what they do but how well they do it
- Also stopped adding staff
  - Revenues grew 2x the rate of staffing
- *Less* value for *higher* fees
  - > 50% effectively devolved into "investment-only" wealth managers
- Ignored cybersecurity threats
  - 75% at T3: "Done nothing"
  - Acting like its 1993 instead of 2023

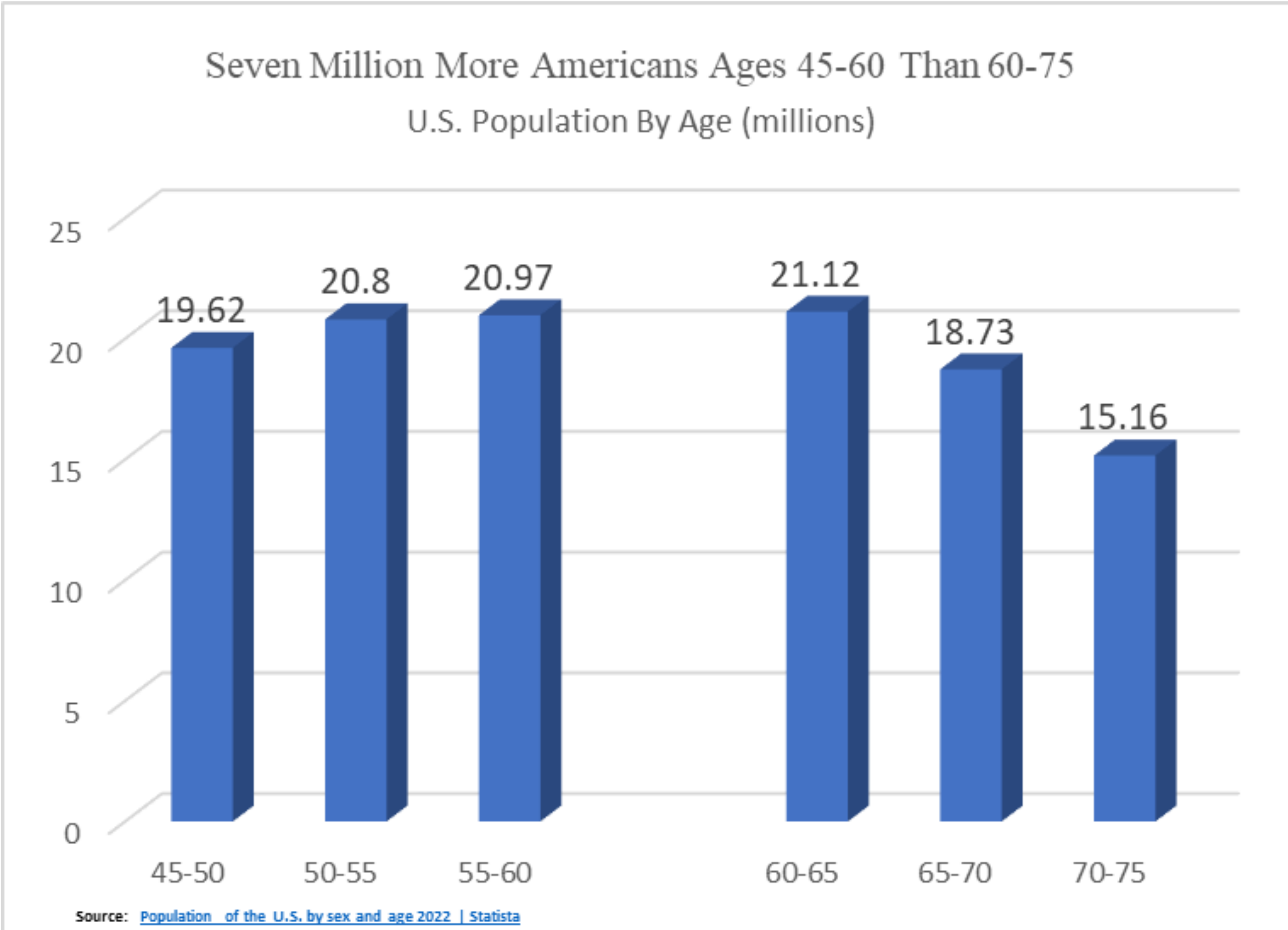
Party Ended In March 2022

- Fed tightened & markets corrected
- Debt now expensive & much less plentiful
  - 1 Month LIBOR > 5% higher
  - 40% of all banks tightened lending standards
  - Aggregators scrambling to refinance
- No more easy money from M&A
  - Competition + higher debt costs
  - Nearly all value created depends on what happens post closing
- Industry remains fragmented
  - 15,000 RIAs w/ median $412 million AUM
  - Most aggregators confederations of small firms
- And looks like a shrinking geriatric ward
  - Nearly 1/3 CFPs > 60; more than 50% > 50; only 5.6% <30
  - Projected 37% of industry participants retiring in 10 years

Massive Opportunity Ahead But Few Prepared to Capitalize

- Seven million more 45 to 60-year-olds vs 60 to 75
  - Hundreds of thousands of potential new clients
- Mammoth challenge to restart proprietary marketing
  - Founders retired
  - Comfortable employees incapable of client recruitment
  - COI networks takes years to build
- Addiction to custodial referrals unsustainable
  - Custodians decide participation & pricing
  - Recently threw out many long-time participants
  - Recent economics inflated by U.S. equity bull market
  - Aggregators evolving into competitors
- Industry-wide dependence on operating model that inhibits scaling
  - Athlete vs specialization-by-function
  - Best marketers disincentivized to recruit new clients

Tidal Wave of Potential New Clients Coming



DIGITAL PRIVACY & PROTECTION

www.dpripro.com

All Industry Forecasts Dependent On Financial Market Returns

- Normal economic rules suspended from 2012-2021
  - Everyone prospered regardless
- Report assumes reversion to historical averages
  - Negative or minimal returns = accelerated evolution
  - Inflated returns delay evolution
- Change will be gradual
  - Wealth management moves much slower than other financial services industries
  - Client acquisition, M&A, employee recruitment, etc.
- Also will be non-linear
  - Handful of first movers
  - Followed by sudden, industry-wide adoption

Eight Ways Future Operating Environment Will Be Different

1. All about organic growth
   - Billions of potential enterprise value up for grabs
   - Either add clients or own shrinking business with old clients
   - Current PV of new clients immense
2. Industry will become more of jungle & less of a club
   - Intense competition for clients and employees
   - Industry norms discarded
   - Less polite & genteel
3. Big firms will act like big competitors
   - Do much more for same fees
   - Family office-like services for high-net-worth clients
   - Squeeze smaller competitor margins / lessen their ability to compete
4. All-out battle for talent
   - No pool of unhired trained professionals
   - Wave of retirements of seasoned staff
   - Much higher labor costs

Future Operating Environment Different In Eight Ways

5. Cyber will raise costs, lower productivity & aggravate everyone
    - Existential threat to every participant
    - New SEC rules: cybersecurity = meeting fiduciary duties
    - Cyber counterparty risk disclosure to clients
    - “Face tattoo” if breached
6. AI-software will impact wealth managers but not for some time.
    - Too expensive + paucity of data for near term
    - Ultimately improve client onboarding
7. Smaller average M&A transactions
    - Middle of industry hollowed out
    - Aggregator transactions unlikely prior to rationalization
    - PE firm incentives
    - No incremental value & only bigger problems without transformation
8. Prices fulsome but quality will now matter
    - 100 buyers + market recognizes stability of WM revenues
    - Aggregator management already up to its eyeballs

Ten Traits Common To Most Successful Future Firms

1. Decisive owners w/ very long investment horizons
   - Massive reinvestment & patience required
   - Decisions today will decide outcomes in 15 years
   - Challenging for both PE firms & most firm owners
2. Take advantage of new client land grab as quickly as possible
   - Before acquisition costs soar
   - Proprietary COI networks and not custodial referrals
3. Specialization-by-function operating models
   - Compensation follows value created
   - Marketers market full time & can build great wealth
   - No more books of business
   - Very challenging to implement – may require dual systems
4. Reset cultures
   - Recruiting new clients brutally hard
   - Most firms currently, low stress "lifestyle" practices
   - Organizational obsession + accountability = stress

Ten Traits Common To Most Successful Future Firms

5. Do whatever is necessary to quickly get & retain talent
   - Run up the Jolly Roger
   - Poach competitors' best people
   - Take preemptive steps to retain best employees
6. Build powerful, cost-effective brands
   - Pull rather than push large numbers of prospects to organization
   - Communicate organization's expertise in certain client problems
   - Small firm brands focus on complicated problems of narrow groups of targeted clients
7. Embrace rather than endure necessary cyber changes
   - Upgrade quickly to meet/exceed industry best practices
   - Accompany mandatory disclosures w/ solution for client cybersecurity risks
   - Use to differentiate offering
8. First movers using value proposition to change terms of business
   - More value for same dollars first
   - Differentiate offering to prospects & clients of other firms
   - Force competitors to respond

Ten Traits Common To Most Successful Future Firms

9. More sophisticated buyers & sellers
   - Buyers:
     - Narrower targeted groups of potential acquisitions
     - Understand seller firm internal dynamics
     - Build relationship with sellers well in advance of transaction
     - Create compelling value proposition beyond just price
   - Sellers:
     - Knowledgeable about prospective buyers
     - Prepare firms long before coming to market
     - Address potential buyer concerns
     - Demand much more from bankers

10. Run by business operators who are a cross between Mary Poppins & Attila the Hun
    - Fundamentally different forward operating environment
    - Ferociously challenging transitions required
    - Requires passion for day-to-day details of business
    - And a deft hand and decisiveness
    - Not all current management capable of building enterprise value

Future Structure of Wealth Management Industry

- Industry in early stages of consolidation
  - $57T market > 10,000 participants
  - Largest firms have de minimis market share
- In 10 to 15 years will look like investment management does today .
  - Eerily similar evolution
- Three primary groups of participants will emerge
  - Mega-firms
  - Specialist wealth managers
  - Generalists

Current Structure of Investment Management Industry

Mega Firms	51 firms	\$200B - \$1T+ AUM
Specialist Investment Managers	250 firms	\$5B - \$200B AUM
Generalists	≈5000 firms	< \$5B AUM

Sources: Largest Money Managers 2023 - Full List | Pensions & Investments (pionline.com); https://investmentadviser.org/wp-content/uploads/2022/06/Snapshot2022.pdf

Mega-Firms

- Thirty to fifty firms w/ $500B to $1T of AUM
  - Diversified financial services companies
  - Direct competitors with Schwab and Fidelity
- Winners far from decided
  - Unlikely to be de novo aggregator - but current size irrelevant
  - Backer investment horizons paramount
  - At some point mergers between aggregators
- Organic growth rates most determinant of success
  - Alternative is old, shrinking client asset bases
  - M&A will create scale but not value
  - Mature market too efficient for financial engineering
- Eventually directly owed by sovereign funds
  - Already owners through PE funds
  - Will use co-investment rights, disintermediate PE firms & create intergenerational asset
- Public company models recipe for destroying value in wealth managers
  - Insufficiently long investment horizon

Specialist Wealth Managers

- 200 to 500 firms with $5B to $100B of AUM
  - Emerge from ranks of current generalists
  - Extraordinary expertise in complicated problems of small groups of people
- Few true specialist wealth managers currently exist
  - Expertise too shallow; targeted client base too broad
- Experts in helping clients create and build wealth
  - Understand careers as well as executive recruiters
  - Client businesses as well as industry consultants
  - Far more sophisticated tax advice
  - Comprehensive service similar to big firms
- Very profitable and valuable businesses
  - Brands will pull clients & reduce acquisition costs
  - Much larger than today + able to charge premium price
- M&A between specialist firms
  - Both similar and other specialties

Generalists

- Thousands of firms
  - Relatively unchanged from today
- Less profitable & little enterprise value
  - Forced to do more for same fees
  - Gradually make less over time
  - Nothing to sell
- Local bookkeepers