

Level III of the CFA® Exam

Study Notes - Private Wealth Pathway – Volume 1

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Reading 29: The Private Wealth Management Industry

LOS 29a. Discuss the typical business models of private wealth management service providers and their segment-based strategies

Private Wealth Management

Private Wealth Management (PWM) is a specialized branch of finance that caters to the complex needs of affluent individuals and families. The evolution of PWM has been shaped by various factors, including global economic and regulatory changes.

Evolution of Private Wealth Management

- Post World War II, private banks like **HSBC** and **Credit Suisse** expanded their operations globally, establishing their presence in major financial hubs such as London and New York. This expansion was fueled by the growth in international trade and the emergence of offshore financial centers (OFCs) like the Cayman Islands and Switzerland.
- The late 20th century witnessed economic growth due to globalization and emerging markets like China and India, leading to further expansion of the wealth management industry.
- During this period, there was also an improvement in the quality of services and ethical standards in wealth management, with the introduction of fiduciary duties and stricter compliance measures.

Regulatory Reforms and Transparency

- Regulatory reforms such as the Sarbanes-Oxley Act (2002) and Markets in Financial Instruments Directive (MiFID, 2004) were introduced to increase transparency standards. Similar changes were implemented globally, including the revision of Hong Kong's Banking (Capital) Rules in 2007.

- The 2008 Global Financial Crisis triggered many significant reforms that impacted wealth management. These include the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010) in the United States, the Markets in Financial Instruments Directive II (MiFID II, 2014) in the European Union, and other global efforts coordinated by the Financial Stability Board to promote expanded supervision, oversight, and transparency for bank and non-bank entities.
- Today, transparency is the industry standard, driven by global regulatory bodies like the Financial Action Task Force (FATF).

The wealth management industry continues to evolve, providing numerous legitimate opportunities for wealth management professionals. For instance, the rise of robo-advisors like **Betterment** and **Wealthfront** has revolutionized the industry by offering automated, algorithm-based portfolio management services.

Wealth Management Industry

The wealth management industry is a complex and diverse sector, influenced by a myriad of factors such as historical events, demographic shifts, geographical location, cultural norms, and capital market trends. Additionally, the social infrastructure of a country, encompassing aspects like health care, unemployment, and retirement benefits, also significantly shapes the services offered in the wealth management industry.

Impact of Retirement Schemes and Capital Markets

Government-provided defined benefit (DB) and defined contribution (DC) retirement schemes, along with individual savings plans, are common features in many countries. For instance, in the United States, the wealth management industry is characterized by a wide range of services including investment products, personal saving plans, insurance products, and support for employer-sponsored DC plans. On the contrary, in countries like France, Italy, and Spain, the industry leans towards an oligopoly, dominated by a few large universal and local banks. These countries place more emphasis on defined benefit retirement plans, which often provide better post-retirement income replacement coverage than DC plans.

Global Variation in Wealth Management Industry

The structure of the wealth management industry varies significantly across the globe. In regions like the United Kingdom and many Asian countries, a diverse array of banks and financial advisers offer wealth-management-related services. Despite these differences, the wealth management industry is typically fragmented and non-uniform across the globe, with certain dominant players with Swiss heritage or who are well established among the locals.

Onshore and Offshore Financial Services

The terms "onshore" and "offshore" are used to describe the location of financial services in relation to a client's home country. Onshore services are provided within the client's primary country of residence, typically where they are considered a tax resident. Conversely, offshore services are offered outside of the client's primary country of residence or prevailing regulatory authority.

High-net-worth individuals may opt for one or both of these services, depending on their specific needs. Offshore services can be attractive due to factors such as political stability, legal advantages, tax incentives, and access to investment products not available locally. For example, Singapore has become a leading offshore wealth management hub in Asia, due to its political stability and financial robustness.

Cross-Border and Offshore Centers

The terms offshore center and cross-border financial center are often used interchangeably. Cross-border financial centers, like the United States, United Kingdom, and Switzerland, serve both domestic and international investors. Offshore centers, like the Isle of Man, predominantly cater to foreign investors.

Different jurisdictions offer distinct advantages tailored to client needs. For instance, Switzerland is known for traditional private banking, while Monaco and Dubai attract residents with tax-free environments. Portugal's golden visas offer initial 10-year tax exemptions. Specialized centers include Luxembourg, known for its fund and insurance industries, and the

US state of Delaware, a hub for company formation.

Key Players in Wealth Management

The wealth management industry is a complex ecosystem with a variety of participants offering a range of services. These participants include universal banks, local banks and trust departments, private banks and trusts, investment banks, digital and direct banks, brokerage firms, asset managers and fund managers, independent advisers, and family offices. Each of these entities plays a unique role in the wealth management landscape.

- **Universal Banks:** Offer wealth management alongside other services under different brand names; global presence.
- **Local Banks and Trust Departments:** Offer retail banking or wealth management services; include local, state, regional, and private banks.
- **Private Banks and Trusts:** Primarily offer wealth management; some larger firms may offer additional services.
- **Investment Banks:** Provide services for mergers and acquisitions, capital raising for UHNWIs; exclusive investment opportunities.
- **Digital and Direct Banks:** Focus on smaller clients with automated investment advice; minimal physical presence.
- **Brokerage Firms:** Facilitate market transactions; offer wide range of investment options with low fees.
- **Asset Managers and Fund Managers:** Emphasize asset management through dedicated products; essential building blocks for portfolios.
- **Independent Advisers:** Operate independently, managing assets with their own strategies; some affiliations for additional resources.
- **Family Offices:** Entities like Rockefeller Capital Management handling various financial aspects such as administration, investments, tax planning, and philanthropy.

They can be single-family (for one family) or multi-family (for ultra-high-net-worth clients), managing portfolios directly or through banks and fund manager.

Competitive and Strategic drivers

- **Porter's Analysis:** An analysis of Porter's five forces (Porter, 1980) supports an understanding of the industry.
- **Threat of New Entrants:** The financial industry faces high regulatory barriers and values trust and reputation, making entry challenging. Established firms like **Goldman Sachs** and **J.P. Morgan** leverage economies of scale and strong reputations to maintain dominance.
- **Emergence of Specialized Wealth Management Firms:** Family offices and multi-family offices have emerged, catering to the financial needs of single or multiple families. They've gained market share in ultra-high-net worth (UHNW) and high-net-worth (HNW) segments due to personalized service offerings.
- **Rise of Robo-Advisers:** The rise of robo-advisers, automated platforms using algorithms for financial planning and investments, is notable. They've attracted customers from the mass affluent segment due to their lower costs. In conclusion, these trends shape the competitive landscape of the wealth management industry.
- **Bargaining Power in the Wealth Management Industry:** Buyers such as mass affluent, HNWI, and UHNWIs hold significant bargaining power due to their wealth and available alternatives. Suppliers generally have limited bargaining power, except when dealing with large banks or possessing specialized expertise.
- **Threat of Substitutes in the Wealth Management Industry:** Various alternatives like self-directed platforms, robo-advisers, and family offices serve as substitutes. Multi-family offices offer personalized services appealing to UHNWIs, impacting traditional wealth management firms.
- **Intensity of Competitive Rivalry:** Competition is high in the wealth management industry. Firms with diverse products, expertise, and specialized services hold a

competitive edge.

Strategic Decisions in Wealth Management

The strategic decisions of a wealth management firm are influenced by a variety of factors. These include the unique in-house expertise that sets the firm apart from its competitors, the reputation of the firm which can act as an asset or a liability, the financial capacity of the firm to invest in technology, the firm's positioning for either a mass market or niche market, the target market segments, the sophistication of markets and clients in operational regions, the extent of regulation in operational regions, the presence or absence of an established distribution network, and the presence or absence of physical branches or offices.

Location Considerations

When considering location, wealth management firms must decide between offering onshore and offshore services, as well as whether to establish a local presence. This decision is complex and must take into account various local requirements. For instance, a firm planning to operate in multiple countries will need to navigate disparate regulatory landscapes, understand cultural preferences in client-adviser relationships, meet professional norms that may differ significantly, and offer services that address the unique needs of clients in each location.

To illustrate, if a US-based firm like Goldman Sachs is contemplating an expansion into Switzerland, it must consider Swiss banking secrecy laws, the local appetite for risk, and even the types of assets that Swiss investors commonly hold. The firm will also have to decide whether to open a local branch or operate remotely, keeping in mind the high value that Swiss clients place on privacy and face-to-face interactions. Therefore, deep knowledge of local requirements such as licensing, cultural nuances, professional norms, and specific client needs is essential for a successful international strategy.

Legal, Licensing, and Technology

Understanding the role of a firm's license in shaping its strategic planning process is crucial. For instance, a multinational corporation like Apple Inc. identifies its target markets, such as China

or India, based on the opportunities available and ensures compliance with local regulations. Legal advice, readily available from firms like Baker McKenzie, is vital for navigating the regulatory landscapes in different markets.

Technology's role in client acquisition and management is universal, yet varies in specifics. Traditional methods like personal connections and referrals, akin to LinkedIn's networking model, continue to be important. However, technology is becoming increasingly integral in managing these relationships. The extent of a firm's reliance on automation and technological resources can vary, often depending on the firm's focus and the wealth level of its clients, similar to how robo-advisors are used in wealth management firms.

Client Acquisition and Retention in Wealth Management Firms

For wealth management firms, understanding the dynamics of client retention, acquisition, and development is crucial for establishing a sustainable business model. These firms operate in three primary stages: client acquisition, development, and retention, similar to other service providers.

Client Acquisition

The first stage in the client lifecycle is client acquisition. The goal here is to attract new clients cost-effectively. This is often achieved through referrals and collaborations with professionals such as lawyers and accountants. Marketing strategies, including digital outreach and events, are also instrumental in this phase. For instance, a firm might collaborate with a law firm to offer estate planning services to its clients.

Client Development

The second stage is client development. The firm's goal is to deepen the relationships with the clients. This is accomplished by cross-selling various offerings and persuading clients to allocate a larger share of their investable assets to the firm. For example, a firm might offer tax planning services to an existing client who initially only invested in a mutual fund.

Client Retention

The final stage is client retention. The focus in this phase is on maintaining profitable, growth-oriented relationships. The firm stays attuned to changes in client circumstances and proactively adjusts its services. Trust-building, open communication, and problem-solving are key elements in this phase, along with expertise that adds value and encourages long-term engagement. For instance, a firm might adjust a client's portfolio in response to a significant life event, such as retirement or the birth of a child.

Porter's Strategies in Wealth Management

In the field of wealth management, implementation strategies often hinge on Porter's three core approaches for gaining a competitive edge. These include cost leadership, differentiation, and focus/niche strategies. These strategies can be employed individually or in combination to create a robust approach to market competition.

- **Cost Leadership:** The cost leadership strategy targets a broad customer base, emphasizing economies of scale and operational efficiency. For instance, companies like Vanguard and Charles Schwab offer low-cost index funds and robo-advisors to attract a wide range of investors. Both universal banks and specialized services compete in this segment.
- **Differentiation:** The differentiation strategy is tailored towards High Net Worth Individuals (HNWIs) and the mass affluent. This strategy aims to provide unique offerings that are valued by clients. For example, firms like Goldman Sachs and J.P. Morgan offer comprehensive wealth planning and exclusive investment opportunities not readily available to retail investors, thereby achieving higher margins.
- **Focus/Niche:** The focus or niche strategy targets a specific segment of HNWIs or Ultra High Net Worth Individuals (UHNWIs) in specialized markets or regions. For instance, firms like UBS and Credit Suisse offer personalized services and face-to-face interactions that warrant premium pricing.

By understanding and leveraging these approaches, wealth managers can create a competitive

advantage tailored to their operational markets and client base. For instance, a hypothetical firm, Pi R-Squared Investors (PRS), leverages long-standing industry relationships and specialized investment opportunities to meet the complex needs of HNWI and UHNWIs.

Services and Product Range in Wealth Management Firms

Wealth management firms provide a comprehensive range of services to cater to the diverse needs of their clients. These services, which can be either in-house or outsourced, vary based on the firm and the client's specific requirements.

Core Services

These are the fundamental services offered by wealth management firms.

- **Deposit management:**
- **Liquidity and payment oversight:**
- **Client reporting (statutory, tax, and on-demand):**
- **Account administration:**

Lending Services

These services involve providing loans and credit facilities to clients.

- **Mortgages (private or commercial):**
- **Credit cards (usually via separate issuers):**
- **Lombard loans (secured by investment assets):**
- **Specialized lending (e.g., for aircraft, artwork):**

These services involve trading in securities and other financial instruments on behalf of the client. They include: Trade execution for securities, currencies, funds, and structured products:

For example, buying or selling stocks, bonds, or currencies for the client.

Asset Management Services

These services involve managing the client's investment portfolio. They include:

- **Portfolio management:** This involves managing the client's investments to achieve specific financial goals.
- **Discretionary and advisory mandates:** Providing investment advice and making investment decisions on behalf of the client.
- **Asset allocation advice:** Advising the client on how to distribute their investments across different asset classes.
- **Investment products (in-house or third-party):** Offering investment products either developed in-house or sourced from third parties.

Wealth Planning and Advice

These services involve providing financial planning and advice to the client.

- **Wealth structuring:**
- **Legal and tax guidance:**
- **Estate planning:**
- **Financial planning:**
- **Retirement and pension optimization:**
- **Philanthropy advice:**

Insurance and Wealth Protection Services

- **Life insurance:**

- **Trusts and global fiduciary services:**

Private Client Segmentation

Wealth management firms segment their client base to tailor these services effectively. Most wealth management firms cater to clients that fall into one or more wealth-based segments determined by client assets.

Wealth-Based Segmentation

In the private wealth sector, wealth-based segmentation is a common method used to categorize clients according to their asset ranges. This segmentation typically includes four categories: retail, affluent, high net worth (HNW), and ultra-high net worth (UHNW). The asset range can consist of deposits, investable, or liquid assets.

- **Retail:** Retail clients, for instance, those with a modest savings account at a local bank, receive minimal dedicated servicing. The focus is primarily on savings accounts and product-driven solutions such as inexpensive passive vehicles like ETFs and in-house investment funds.
- **Affluent:** Affluent clients, like a successful small business owner, may receive services that include basic financial planning and tax considerations. Technology and digital tools often play a significant role in servicing these clients, and standard in-house products dominate the offerings.
- **High Net Worth (HNW):** High net worth clients, such as a multi-millionaire entrepreneur, generally have a longer investment time horizon and may require wealth-transfer assistance. The focus for these clients shifts to tailor-made investment solutions, and the range of investment products becomes more exclusive.
- **Ultra-High-Net Worth (UHNW):** Ultra-high-net worth clients, like a billionaire business tycoon, are a subset of HNWI and their needs are often highly complex. They may require a network of both internal and external advisers. The asset mix for these clients is diverse, often including both liquid and non-liquid investments. Senior

management and even the board of directors of the wealth management firm may be involved in client relationships.

Practice Questions

Question 1: The size and diversity of a country's capital markets also impact the wealth management industry. In countries with large and diverse capital markets, the volume of transactional activity supports a wide range and depth of financial services and products. Which of the following statements is correct?

- A. Countries with small and less diverse capital markets support a wide range and depth of financial services and products.
- B. The size and diversity of a country's capital markets have no impact on the wealth management industry.
- C. Countries with large and diverse capital markets support a wide range and depth of financial services and products.

Answer: **Choice C is correct.**

Countries with large and diverse capital markets indeed support a wide range and depth of financial services and products. The size and diversity of a country's capital markets are directly proportional to the volume of transactional activity, which in turn supports a wide range of financial services and products. Large and diverse capital markets provide a variety of investment opportunities, which is beneficial for wealth management. They offer a wide range of financial instruments, such as stocks, bonds, derivatives, and other securities, which can be used to diversify investment portfolios and manage risk. Furthermore, large and diverse capital markets also attract a large number of participants, which increases liquidity and makes the market more efficient. This is beneficial for wealth management as it allows for quick and easy transactions, and it also provides more accurate pricing information.

Choice A is incorrect. Countries with small and less diverse capital markets do not support a wide range and depth of financial services and products. The lack of diversity and size limits the range of investment opportunities and financial services available. This can hinder the development of the wealth management industry as it

restricts the ability to diversify investment portfolios and manage risk effectively.

Choice B is incorrect. The size and diversity of a country's capital markets do have an impact on the wealth management industry. As explained above, large and diverse capital markets support a wide range of financial services and products, which is beneficial for wealth management. Therefore, the statement that the size and diversity of a country's capital markets have no impact on the wealth management industry is incorrect.

Question 2: A private wealth client is looking for a jurisdiction that specializes in a specific financial service. They are interested in jurisdictions that cater to specific needs and offer unique advantages. Which of the following jurisdictions would be most suitable if the client is specifically interested in setting up a trust for wealth management purposes?

- A. Monaco, due to its tax-free environment attracting residents.
- B. The Isle of Man, due to its specialization in trusts.
- C. Delaware, United States, due to its status as a hub for company formation.

Answer: **Choice B is correct.**

The Isle of Man is a jurisdiction that specializes in trusts and would be the most suitable choice for a client interested in setting up a trust for wealth management purposes. The Isle of Man has a robust legal framework for trusts and a long history of providing trust services. It is known for its strong regulatory environment, political stability, and high level of professional expertise in trust management. The Isle of Man offers a variety of trust structures to cater to different needs, including discretionary trusts, purpose trusts, and asset protection trusts. The jurisdiction also provides a high level of confidentiality and asset protection, which are important considerations for wealth management. Therefore, the Isle of Man would be the most suitable jurisdiction for a client looking to set up a trust for wealth management purposes.

Choice A is incorrect. While Monaco is known for its tax-free environment that

attracts wealthy residents, it does not specialize in trusts. Monaco's financial services sector is more focused on banking and investment management. While it is possible to set up a trust in Monaco, the jurisdiction does not offer the same level of specialization and expertise in trust services as the Isle of Man.

Choice C is incorrect. Delaware in the United States is known as a hub for company formation, particularly for corporations and limited liability companies. While Delaware does offer trust services, its primary focus is on corporate services. Therefore, it may not be the most suitable jurisdiction for a client specifically interested in setting up a trust for wealth management purposes.

Glossary

- **Defined Benefit (DB):** A type of pension plan in which an employer/sponsor promises a specified pension payment on retirement that is predetermined by a formula based on the employee's earnings history, tenure of service and age.
- **Defined Contribution (DC):** A type of retirement plan in which the employer, employee or both make contributions on a regular basis. Future benefits fluctuate on the basis of investment earnings.
- **Ultra-High-Net-Worth Individuals (UHNWIs):** Individuals with investable assets of at least \$30 million, excluding personal assets and property such as a primary residence, collectibles and consumer durables.
- **Robo-advisers:** Digital platforms that provide automated, algorithm-driven financial planning services with little to no human supervision.

LOS LOS 29b. Discuss typical fee, revenue, and compensation structures prevalent in the private wealth management industry

Private Wealth Management: Fee and Compensation Models

The private wealth management sector, known for its higher fees compared to retail banking, is a lucrative field for professionals. It's essential for advisers to understand the regulatory mandates requiring detailed and regular disclosure of all fees to clients, especially considering the reporting rules in the countries where their clients reside.

A transparency shift is currently underway in the wealth management industry, led by new online wealth management firms that prioritize clear fee structures. This contrasts with traditional institutions, which may offer personalized services at higher fees but with less transparency.

Business Models and Industry Drivers

Understanding the revenue-generation capacity of a wealth management firm requires a comprehensive analysis of various factors. These factors extend beyond the current market conditions and include the firm's business model, operating licenses, company size, geographical presence, and the efficiency and experience of its staff.

Revenue Categories

Revenues in a wealth management firm can be broadly divided into:

- **Recurring:** These are revenues generated from regular activities such as portfolio management, investment funds, custody, tax planning, and other service-related activities. For instance, a firm like Vanguard Group generates recurring revenue through its portfolio management services.
- **Non-recurring:** These are revenues that arise from life events or "one-off" events such as death, divorce, sale of business, etc. Special projects like bespoke analysis and reports requested by clients can also result in fees. For example, a firm like Goldman Sachs may charge for a bespoke investment strategy report.

Revenue Types

Revenues can also be classified as:

- **Fixed Revenue:** These include service fees charged on a periodic basis, like a monthly account maintenance fee.
- **Variable Revenue:** These typically include transaction fees or assets under management (AUM)-based fees. For example, a firm like BlackRock may charge a variable fee based on the AUM.

External Drivers Impacting Revenues: Industry Trends

- **Global Capital Markets Connectivity:** With the advent of globalization, capital markets worldwide are becoming increasingly interconnected. This has led to heightened market sensitivity to macroeconomic and geopolitical events. For instance, the Brexit vote in the UK had ripple effects on global markets. While this connectivity offers benefits like access to global opportunities, it also comes with costs such as increased asset sensitivity to geopolitical risks.
- **Private Markets Investments:** There's a rising trend towards private markets investments like private equity, debt, real estate, or venture capital as alternative investments. These investments, like investing in a startup through venture capital, can provide diversification and a return premium due to their low liquidity. However, the impact of lower liquidity is a topic of debate. Some argue that infrequent valuations and low turnover make alternatives lower volatility choices, while others believe that less frequent valuation leads to less pricing information and unreliable volatility measurement.
- **Technology adoption:** such as robo-advisers and low-cost trading platforms, is on the rise. This could lead to lower client costs but also lower industry revenues. However, technology could also create opportunities for small investors to use wealth management firms for the first time, potentially raising industry revenues.

- **ESG awareness:** is becoming a crucial factor in portfolio management. However, ESG-related services are not costless to advisory firms. If costs related to providing the service cannot be passed to clients, they will compress net revenue.

The trends mentioned above, along with other factors, reflect the increasing intensity of competition in wealth management. Additional initiatives could further compress industry revenues.

Internal Drivers impacting revenues: Growth Strategies

Wealth management is a crucial aspect of financial planning that involves providing suitable investment products and services to clients while ensuring the firm's profitability. There are four primary strategies that wealth management firms employ to increase their revenue.

- **Increasing Returns on Client Portfolios:** The first strategy involves enhancing the returns on client portfolios. Since a significant portion of fees in this industry is based on **Assets Under Management (AUM)**, higher asset returns lead to increased assets and revenue. However, this strategy is subject to market fluctuations and may not be reliable in a competitive market.
- **Increasing Fees:** The second strategy is to increase fees. However, this is challenging in a competitive and transparent industry. Advisors with unique products or services may have more pricing power. For instance, advisors who specialize in managing discretionary accounts, which are less cost-sensitive, may have a higher ability to raise fees.
- **Soliciting New Clients:** The third strategy is to attract new clients. If the growth in clients leads to an increase in net assets, this should raise the firm's revenue. However, it's not feasible for most small to mid-sized firms to cater to all market segments. Therefore, it's crucial for wealth management firms to focus on the relevant client segment and monitor the efficiency of their efforts.
- **Client Retention:** The fourth strategy is client retention. A strong focus on client retention can minimize AUM and revenue losses. This is a defensive strategy, but it's

good business practice as satisfied clients are more likely to stay with the firm and refer new business. Some firms use scorecards to monitor advisors' effectiveness in adding and retaining clients, as well as success across products and market segments.

- **Revenue Management Metrics:** Two common metrics related to revenue management are **Net New Money (NNM)** and **Net New Business Volume (NNBV)**. NNM focuses on bringing new client money to the firm, while NNBV captures the volume of new business across new and existing clients.

Pricing Strategies and Characteristics in Wealth Management

Understanding the pricing strategies and characteristics in wealth management is crucial for both wealth management firms and their clients. This involves understanding the types of fees, how they are applied, and the importance of transparency and updates.

For instance, a firm like **Morgan Stanley** aligns its pricing strategies with the price sensitivities of its clients. The pricing strategies revolve around fees which can be recurring like annual management fees or non-recurring like setup fees. These fees can be fixed or variable and can be bundled together or charged separately. For example, a firm may charge a fixed annual fee for managing a portfolio, but also charge a variable fee for any transactions made. Pricing consistency should be the norm at the firm level, with special pricing as occasional exceptions rather than a standard practice. In most markets, firms are legally bound to provide clients with transparency on how fees are assessed.

Types of Fees

Fees can be levied on most activities undertaken by a wealth management firm. While fees are often described as advisory fees or management fees, direct fees often take one of these forms:

- asset-based
- transaction-based
- interest- and margin-based

- service- and maintenance-based
- additional or supplementary

Certain indirect or hidden fees are applicable to each of those categories. For example, a firm like **Goldman Sachs** may charge an asset-based fee for managing a client's portfolio, but also charge a transaction fee for any trades made on behalf of the client.

Transparency and Updates

Because no client likes to be surprised by unexpected fees, best practice requires active transparency and updating clients on changes to both direct and indirect fees. A fee schedule should be presented at the beginning of the client relationship and updated periodically, or when fees change. This is mandatory in many jurisdictions. Major costs associated with each service should be outlined clearly, either in a pricing brochure or in a formal agreement or both.

Asset-Based Fees

Asset-based fees are a common form of charges in the financial industry, particularly in wealth management and investment services. They are recurring fees calculated as a percentage of the total market value of a client's assets. These fees are variable, provisioned daily, and typically invoiced on a quarterly basis.

Calculation of Asset-Based Fees

Asset-based fees are calculated using a fee rate, expressed in basis points, which is multiplied by the period-end value or the average value of client assets. The fee rate is often degressive, implying that as the value of the assets increases, the marginal fee for additional assets decreases. For instance, if a wealth management firm charges 1% (100 basis points) on a \$1 million portfolio, the fee would be \$10,000.

Types of Asset-Based Fees

- **Custody Fees:** These are charges for holding securities. Despite the administrative costs, these fees are significantly lower than asset management fees. For example, a bank may charge a small percentage for holding a client's stock portfolio.
- **Investment Mandate Fees:** These are fees for managing a client's investments. These fees are typically three to five times higher than custody fees. For instance, a financial advisor may charge a higher fee for actively managing a client's investments.

Asset-Based Fees and Investment Funds

Asset-based fees are also applicable at the level of the underlying investment funds used in clients' portfolios. These fees are sometimes expressed as the total expense ratio (TER), which reduces a fund's return by the costs of running it. Firms may offer discounts at the investment mandate level to incentivize clients to use their proprietary products.

Role of Wealth Managers

Wealth managers play a crucial role in considering embedded costs in mutual funds/ETFs when constructing portfolios. The goal is to minimize the overall cost for the clients while maintaining returns. Many wealth managers are shifting to constructing portfolios using less ETFs instead of more expensive mutual funds if the performance is similar, especially in large liquid markets.

Transaction-Based Fees

Transaction-based fees are charges applied to client account transactions, often as a fixed amount or a percentage of the transaction value. These fees are common for securities, funds, structured products, fiduciary deposits, money market instruments, and securities delivery.

For example, buying shares of a company like Apple Inc. through a brokerage incurs transaction fees based on the shares' total value. Similarly, investing in mutual funds may lead to fees based on the invested amount.

These fees often adjust based on transaction size and asset class, typically disclosed upfront by firms. While equity securities trading fees are usually transparent, fees related to other

securities, like secondary market bonds, may require clearer communication to clients.

Investment funds may also entail additional fees such as management fees, subscription and redemption costs, or distributor fees. Alternative funds, like real estate funds, may incorporate premium or discount fees based on market demand.

Interest and Margin-Based Fees

Interest and margin-based fees are charges associated with lending programs. These fees are typically applied by financial intermediaries who possess a banking license or an equivalent, such as the ability to accept client deposits. The fees or margins are applied to various financial transactions including negative cash balances, mortgages, Lombard loans, and securities lending. For instance, a bank might charge a margin fee on a mortgage loan to a homebuyer.

Factors Influencing Margins

Several factors can influence the margins applied to financial transactions. These include:

- The size of the transaction: For example, a larger mortgage loan may have a different margin compared to a smaller one.
- The length of the engagement: A long-term loan may have a different margin compared to a short-term one.
- Prevailing interest rates: The current market interest rates can influence the margins. For instance, higher interest rates may lead to higher margins.
- Associated risks: The level of risk associated with the transaction can affect the margins. For example, a loan to a borrower with a poor credit history may have a higher margin.

Financial Intermediary's Ability and Willingness to Lend

The ability of a financial intermediary to lend is directly linked to its financial strength, as indicated by the robustness of its balance sheet (capital requirements), and its risk appetite.

Without a banking or equivalent license, wealth management firms cannot directly earn income from lending.

Client's Borrowing Capacity and Lending Ratio

Before lending, substantial preliminary work is required to evaluate the client's borrowing capacity, especially for mortgages. Lombard loans require an assessment of pledged portfolios and underlying securities to establish a suitable lending ratio. Lending activities can significantly boost revenues, potentially matching or even surpassing those from investment mandates.

Service and Maintenance Fees

Service and maintenance fees are fixed charges that are either recurring or one-time, associated with the upkeep and functionalities of an account. These fees encompass a range of costs such as administrative fees, charges for payments and transfers, fees for initiating new services like loans or mortgages, and costs for mail, checks, and safe deposit boxes.

Unlike asset management fees, these charges are not tied to the size of the asset but are instead based on the volume of transactions or the number of payments made. Minimum fees may be applied to client accounts, and these can either have a cap or be uncapped.

In specific scenarios, such as account closure, wealth management firms may levy substantial closing fees and high charges for transferring stock market securities. These fees are occasionally waived by the client's new bank as a gesture of goodwill.

Additional Fees and Client Acquisition

In the realm of private wealth management, additional fees often arise from services that are not directly related to portfolio management. These can include services such as accounting, taxation, legal support, or operational and technological support like the distribution of portfolio data. For instance, a client may require legal advice for estate planning, which would involve hiring a lawyer whose fees are not part of the traditional wealth management offering.

Additional fees also apply for held-away assets that are not directly custodied and related assets

under advisory. These assets can be diversified across different financial intermediaries, digital platforms, or even non-liquid assets like art collections. Dedicated providers offer both consolidation services and overall portfolio analysis for these assets, which can also incur additional costs.

These additional fees can generate remarkably high expenses for clients, particularly when specialists with significant hourly rates are involved. For instance, lawyers' fees can escalate in the face of complex, lengthy succession planning.

New clients can be obtained via digital channels, or thanks to the public recognizing the expertise of a specific wealth manager, or in response to the outstanding reputation of a wealth management firm. They can also be brought in by introducers, who can be remunerated based on either new Assets Under Management (AUM) or the revenue generated.

Compensation Structure for Wealth Managers

The compensation structure for wealth managers is a complex system influenced by a multitude of factors. These factors include the firm's structure, which could be either public or private ownership, the size of the firm, its global presence, the complexity of its business model, and its annual financial performance. For instance, a wealth manager at a large, publicly traded firm like J.P. Morgan might have a different compensation structure than a wealth manager at a smaller, privately owned firm.

While the compensation structure is influenced by various factors, the primary determinant is the net revenue generated by the manager for the firm. This emphasizes the importance of the wealth manager's role in contributing to the firm's financial performance. For example, if a wealth manager at Goldman Sachs generates a high net revenue, their compensation would likely be higher.

Key Performance Indicators (KPIs) and Key Risk Indicators (KRIs)

The final remuneration package of a wealth manager is also determined by adherence to criteria

around key risk indicators (KRIs) and key performance indicators (KPIs). These are important metrics that measure the performance and risk associated with the wealth manager's activities.

Wealth Manager Remuneration Models

The compensation structure for wealth managers is crucial as it often begins even before the start of employment, typically in the form of a welcome bonus. This bonus can be part of the manager's remuneration package or it can serve as compensation for a bonus forfeited from the previous employer.

Components of Remuneration

The remuneration of a wealth manager usually consists of four elements:

- **Fixed Salary:** This is a base salary that is paid throughout the year. For example, a wealth manager at a top-tier bank might have a fixed salary of \$100,000 per year.
- **Variable Remuneration:** This is often performance-based and is commonly referred to as "the bonus". For instance, if a wealth manager exceeds their targets, they might receive a bonus of 20% of their base salary.
- **Long-term Incentives:** These could be deferred payments that vest and are payable over a period of one to five years. Continuation of employment with the firm is typically a requirement for these incentives.
- **Deferred Pay or Equity Participation:** A portion of the deferred amount may be in the form of stock shares, especially for publicly traded firms. For example, a wealth manager might receive \$10,000 worth of company shares as part of their remuneration package.
- **Fringe Benefits:** These are additional benefits provided by the employer, such as health insurance or a company car.

The combination of these benefits can vary significantly from one firm to another and even within the same firm, depending on the employee's role and experience. Many firms focus on

total compensation when recruiting new employees or communicating annual amounts to employees.

Fixed Remuneration

Fixed remuneration, also known as a fixed salary, is a crucial aspect of employee compensation. It is determined by a combination of employee-specific and firm-specific factors. For instance, an employee's role, experience, and network, along with their educational background and industry tenure, significantly influence their fixed salary. Similarly, the size and compensation structure of the firm also play a vital role.

Traditional firms that prioritize client retention may structure their compensation with a larger fixed component and a smaller variable component. The effectiveness of in-person interaction and the perceived ability of wealth managers to retain and attract clients also impact fixed remuneration. In partnership firms, the fixed compensation may be minimal, with variable pay linked to the firm's financial performance.

Variable Remuneration in Wealth Management

Variable remuneration is a crucial aspect of compensation for wealth managers, typically comprising an annual bonus. This bonus is a recognition of the contributions made to the earnings of the previous year. While bonuses are usually paid in full, a portion might be held back for future distribution. Variable compensation, including bonuses, can be risk-adjusted, particularly for senior roles or in response to local regulations. Claw-back provisions can be invoked to withhold or rescind variable compensation in cases of misconduct.

Levels of Determining Variable Remuneration

Variable remuneration is determined at three distinct levels: the firm, the department, and the individual. At the firm level, remuneration is influenced by the overall financial performance, taking into account both profitable and challenging years. The firm's culture around growth and risk appetite can also have a significant impact. For instance, a company like Goldman Sachs might have a different approach to variable remuneration compared to a smaller, more

conservative firm.

At the department level, remuneration is linked to the team's performance, efficiency, and growth in the respective region or client type. For example, the financial results of the Latin American team at JP Morgan may differ significantly from the Middle East and North Africa team at Citigroup.

At the individual level, the performance of the wealth manager greatly affects variable remuneration. Their results can be based on the number of accounts under a discretionary or advisory mandate, along with the associated profitability, the net new business volume acquired over the calendar year, and how well margins on client relationships are maintained.

Profit-Sharing Remuneration Models

Profit-sharing remuneration models show relationship managers retaining up to a third of the income produced from their clients' portfolios. This proportion could be higher in smaller structures with less overhead and fixed costs, reaching up to two-thirds of the generated income.

Legal Requirements for Variable Compensation

Variable compensation must comply with internal and external legal requirements. In some jurisdictions or at some firms, there may be a limit on the ratio of fixed-to-variable compensation in order to balance incentives for advisers to perform core duties well, with creating incentives to expand business and revenues. In the European Union and the United Kingdom, the pay of those who are in senior roles and are deemed to be material risk takers (MRTs) may be subject to additional regulation.

Long-Term Incentives, Deferred Pay, or Equity Participation

Senior relationship managers, such as those at multinational corporations like Apple or Google, often receive equity or stock ownership as part of their compensation. This strategy is designed to retain key personnel and foster loyalty. Long-term incentive plans (LTIPs) are commonly used for this purpose. These plans typically include vesting periods, requiring the manager to remain

with the company to fully benefit. After three to five years, a portion of the accrued benefits are distributed as registered shares or cash payments.

Fringe Benefits

Compensation models in wealth management, such as those at firms like Goldman Sachs or J.P. Morgan, vary due to differences in growth models and risk appetite. However, portfolio size and profitability often indicate the total compensation package. Fringe benefits can include insurance packages and retirement perks. Special pension categories for senior managers and preferential terms like reduced mortgage rates may be offered. Other non-financial benefits may include access to exclusive training and recognition programs.

Professional Conduct

Regardless of the compensation model, wealth management firms and relationship managers, like those at Merrill Lynch or Morgan Stanley, must serve clients impartially. They must adhere to transparency and disclosure requirements, and apply the relevant sections of the CFA Code of Ethics and Standards of Professional Conduct.