Executive Summary

The U.S. wealth management industry is caught in choppy waters. To navigate toward long-term competitive advantage, banks need to fundamentally alter their value proposition and strategy. The tidal waves of changing demographics, new technologies and more rigid regulation are sweeping away entrenched practices like never before. Having seen the global economic downturn claim some of the industry’s marquee names, wealth management has emerged from its most challenging period. Nonetheless, it remains a sector in transition and under pressure.

Loss of trust, relentless regulatory scrutiny, increasing client demands, shrinking assets and profitability and a ballooning cost base are the principal concerns confronting this sector. Across the industry, competition has intensified, consolidation is underway at a fast clip, and new technology adoption is high on the executive agenda. It is against this backdrop that industry players need to reset their compasses to address ongoing turbulence. The emergence of a new order in U.S. wealth management industry is inevitable. The winners will be those firms that adapt their traditional business and operating models to meet the multi-dimensional demands of the new order.

In our view, the strategic imperatives for wealth management firms will include the following:

1. Bridge the trust deficit by serving clients in a transparent and cost-efficient manner.
2. Rein in expenses by building a flexible, scalable business with a variable cost base.
3. Strengthen long-term competitive advantage based on a business model led by service excellence.
4. Maintain integrity and reputation of the highest order through a world-class compliance system.

The Market Landscape

The $12.4 trillion U.S. wealth management market is in flux. One indication of this: Wirehouse firms are losing share to other market participants. By the close of 2009, the U.S. wealth management market was served by 450,000 financial advisors representing multiple players with distinct formats, namely wirehouses, independent registered investment advisors (RIA), online brokers, fully disclosed retail brokerage firms and self-clearing retail brokerage firms (see Figure 1).

The sharp 2009 S&P 500 Index rally of 60% saw overall assets under management improve from 2008’s lows of $10.8 trillion to $12.4 trillion. Market size analysis from 2007 to 2009 reveals that with the exception of the wirehouse firms, all other segments of the market improved their assets under management to the pre-crisis 2007 levels (see Figure 2). An Aite Group study shows that in the case of fully-disclosed retail brokerage,
The decline in assets under management from 2008 to 2009 was due to acquisition of these firms by the self-clearing retail brokerages and was not the result of an ability to grow assets under management. The implication (adjusted for the market-induced increase in assets under management): The wirehouse firms lost market share to other market segments.

Forces Shaping the Industry
Fundamental forces are reshaping the contours of the wealth management business. The ability to seize and execute the strategic implications arising from these forces will underpin the long-term competitive advantages of winning firms.

Client Assets Across Wealth Management Industry Segments

<table>
<thead>
<tr>
<th>U.S. Wealth Market Segment</th>
<th>Key Players</th>
<th>Assets Under Management</th>
<th>Characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Wirehouse</strong></td>
<td>Merrill Lynch, Morgan Stanley Smith Barney, Wells Fargo Advisors/ Wachovia Securities, UBS Financial Services, Inc.</td>
<td>National footprint with 55,000 financial advisors. USD $7.4 trillion in assets under management.</td>
<td>Full-service retail brokerage organization. Highest advisor productivity in the industry. Average advisor oversees USD $83 million in client assets. Ability to offer structured products with strong in-house investment banking capability.</td>
</tr>
<tr>
<td><strong>Fully-Disclosed Retail Brokerage</strong></td>
<td>Pershing LLC, National Financial</td>
<td>Includes 2,000 broker/dealers with 290,000 financial advisors. USD $2.1 trillion in assets under management.</td>
<td>Key fully disclosed firms are involved in mergers and acquisitions with self-clearing entities for cost and control purposes.</td>
</tr>
<tr>
<td><strong>Self-Clearing Retail Brokerage</strong></td>
<td>Edward Jones, Ameriprise Financial, Inc., LPL Financial, Raymond James, RBC Wealth Management</td>
<td>51,000 financial advisors. USD $1.8 trillion in assets under management in 2009; exceeds pre-crisis 2007 levels.</td>
<td>These firms have captured a significant number of breakaway brokers and their assets from the wirehouse firms over the past two years. USD $1.8 trillion in assets under management in 2009; exceeds pre-crisis 2007 levels.</td>
</tr>
<tr>
<td><strong>Independent Registered Investment Advisors (RIA)</strong></td>
<td>Charles Schwab, Fidelity Investments, State Street, TD Ameritrade, Pershing</td>
<td>53,000 financial advisors. Average RIA firm employs slightly more than three financial advisors. USD $1.3 trillion in assets under management.</td>
<td>RIA firms work with custodians in the areas of custody service, investment products and technology platforms.</td>
</tr>
<tr>
<td><strong>Online Brokerage</strong></td>
<td>Fidelity Investments, Charles Schwab, TD Ameritrade, E*Trade</td>
<td>USD $2.1 trillion in assets under management.</td>
<td>Services self-directed investors. Two leaders, Fidelity and Charles Schwab, control 68% of the total assets under management.</td>
</tr>
</tbody>
</table>

Source: Cognizant Research Center Analysis

Figure 1

the decline in assets under management from 2008 to 2009 was due to acquisition of these firms by the self-clearing retail brokerages and was not the result of an ability to grow assets under management. The implication (adjusted for the market-induced increase in assets under management): The wirehouse firms lost market share to other market segments.

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<table>
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<tr>
<th></th>
<th>Change Since the End of 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wirehouse</td>
<td>38% (0.9%)</td>
</tr>
<tr>
<td>Fully-Disclosed Retail Brokerage</td>
<td>19% (1.8%)</td>
</tr>
<tr>
<td>Self-Clearing Retail Brokerage (Beyond Wirehouse)</td>
<td>15% 0.5%</td>
</tr>
<tr>
<td>Registered Investment Advisors</td>
<td>12% 1.5%</td>
</tr>
<tr>
<td>Online Brokerage</td>
<td>17% 0.8%</td>
</tr>
</tbody>
</table>

Total client assets = US$12.4 trillion, as of end of 2009

Source: Company reports, Aite Group

Figure 2
We see four distinct forces — demographics, regulations, consolidation and changing client preference — that, over time, will recast the U.S. wealth management business (see Figure 3).

Demographics
Research shows that over the next decade, U.S. wealth management firms will see material change in their core franchise’s composition as Generation X and the millennial population (also known as Gen Y) assume a greater share of overall wealth (see Figure 4). This rapidly growing constituency is more technology savvy and more proactive with investment management, and it demands greater transparency in managing wealth management accounts than previous generations. We believe these emerging constituencies will exert a powerful influence and reshape existing client acquisition, advisory and engagement practices.

Regulation
The wealth management business, built on the premise of shielding client assets from taxes through offshore banking, is under intense scrutiny. Spurred

Shift in Market Share in U.S. Wealth Management

Source: Cognizant Research Center Analysis
Figure 3

Source: Deloitte, Lab49 analysis
Figure 4

cognizant reports 3
by soaring deficits, many governments are taking a tough line with tax evasion. UBS’s settlement with the U.S. Department of Justice for allegedly helping U.S. citizens evade taxes underscores the determination of regulators to close loopholes.

As part of the settlement, UBS paid $780 million in fines and handed over the account details of more than 4,000 U.S. clients to the Department of Justice, in a landmark decision that undermined Switzerland’s famed banking secrecy. This move prompted 14,700 individuals to voluntarily disclose their secret offshore bank accounts to the Internal Revenue Service (IRS) last year to avoid possible criminal prosecution. Invigorated by this success, we anticipate governments around the world to tighten the screws on tax evasion.

Consolidation
Increasing regulatory costs, falling margins, increased customer demands and declining profitability has created an enabling environment for consolidation. The fallout from the 2008 crisis included Merrill Lynch’s acquisition by Bank of America Corp.; Morgan Stanley’s purchase of a majority interest in Citigroup’s Smith Barney; and Wells Fargo Co.’s buy-out of Wachovia and its wealth business. These deals have created a more concentrated wealth management industry and shifted more than $3 trillion of client assets to the control of these three players.

Profit margins continue to shrink (see Figure 5) as banks continued to invest in emerging Asian markets and experienced increasing difficulty selling complex and profitable structured products to their clients. European private banks have seen profitability fall for the last three years running, from 35 basis points of assets under management in 2007 to 20 basis points in 2009. Also, research estimates peg the median cost to income ratio of private banks at 78% in 2009 vs. 63% in 2006. With profitability unlikely to return to pre-crisis levels soon, many small- and medium-sized private banks may look to reduce their cost base through mergers.

Changing Client Preferences
The recent financial crisis has reset client risk/return expectations across the wealth spectrum. The “animal spirits” that drove pre-crisis investment behavior toward complex, structured products stands finely tempered today, with clients eschewing these costly, illiquid products in favor of more traditional, transparent, liquidity-oriented products that offer steady — if low — returns. However, as interest rates remain near zero across the world, yield-hungry, high-net-worth individuals are looking at structured products in their quest for alpha. This time around, though, they are demanding transparency and a level of client service that was neglected during the credit boom of the last decade. While the obituaries for structured products are unfounded and a bit overstated, wealth managers need to take a deep profitability haircut, with material decline in this high-margin revenue stream.

U.S. Wealth Manager Financials

<table>
<thead>
<tr>
<th>Wealth Manager</th>
<th>U.S. Private Client Assets (in $ billion)</th>
<th>Private Client Managers</th>
<th>2010</th>
<th>2009</th>
<th>Cost/Income Ratio</th>
<th>Profit Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank Of America Global Wealth &amp; Investment Management</td>
<td>$644</td>
<td>20,010</td>
<td>82%</td>
<td>77%</td>
<td>15%</td>
<td>17%</td>
</tr>
<tr>
<td>Morgan Stanley Smith Barney</td>
<td>$1,669</td>
<td>18,043</td>
<td>91%</td>
<td>94%</td>
<td>9%</td>
<td>6%</td>
</tr>
<tr>
<td>JPMorgan</td>
<td>$284</td>
<td>2,245</td>
<td>68%</td>
<td>69%</td>
<td>31%</td>
<td>29%</td>
</tr>
<tr>
<td>Wells Fargo Advisors/ Wachovia Securities</td>
<td>$1,300</td>
<td>16,370</td>
<td>83%</td>
<td>88%</td>
<td>14%</td>
<td>8%</td>
</tr>
<tr>
<td>UBS Financial Services, Inc.</td>
<td>$689</td>
<td>6,796</td>
<td>102%</td>
<td>100%</td>
<td>n/a</td>
<td>1%</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>$200</td>
<td>380</td>
<td>78%</td>
<td>62%</td>
<td>22%</td>
<td>38%</td>
</tr>
<tr>
<td>BNY Mellon Wealth Mgmt</td>
<td>$166</td>
<td>874</td>
<td>70%</td>
<td>69%</td>
<td>25%</td>
<td>25%</td>
</tr>
<tr>
<td>Northern Trust</td>
<td>$154</td>
<td>NA</td>
<td>68%</td>
<td>61%</td>
<td>27%</td>
<td>33%</td>
</tr>
</tbody>
</table>

Source: Cognizant Research Center Analysis
Figure 5
Strategies to Bolster Long-Run Competitive Advantage

In response to the fundamental forces at play, winning wealth managers will need to focus on strategic imperatives to bolster their long-term competitive advantage. The elements that will differentiate leaders from laggards include the ability to build a flexible and scalable business model with a variable cost base; shift from product to process innovation and service excellence; engrain risk management as an operating discipline; and offer a differentiated client service and experience to regain trust.

Choosing Partners

Tasking partners with key business processes offers wealth managers a key strategic lever to address the fundamental imperative to build a cost-efficient, scalable business with a flexible and variable cost base.

We see the demand for outsourcing increasing as players recognize tangible value-creation opportunities (see Figure 6). While the labor-arbitrage cost-driven initiatives are a given, most firms now want to realize the strategic benefits achieved by outsourcing non-core operations to free up scarce internal resources for core business activities and to variabilize their cost structure (see Figure 7). While the major financial institutions count over 2.5% of total headcount offshore, industry leaders operate with over 10% of total headcount in lower cost locations. This provides wealth managers with a tremendous

Top Reasons Wealth Managers Outsource Business Processes

<table>
<thead>
<tr>
<th>Reason</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Improve focus on expertise</td>
<td>67%</td>
</tr>
<tr>
<td>Reduce risk</td>
<td>47%</td>
</tr>
<tr>
<td>Improve client service</td>
<td>41%</td>
</tr>
<tr>
<td>Control costs</td>
<td>37%</td>
</tr>
<tr>
<td>Promote compliance</td>
<td>26%</td>
</tr>
<tr>
<td>Promote asset growth</td>
<td>9%</td>
</tr>
<tr>
<td>Other</td>
<td>4%</td>
</tr>
</tbody>
</table>

Total client assets = US $12.4 trillion, as of end of 2009
Results based on 220 respondents as of September 19, 2009 from family offices, wealth management firms, private client services firms and RIA firms.
Source: Trust & Estates Magazine
Figure 7
opportunity to realize the benefits of outsourcing across the service spectrum (see Figure 8).

The managed services market is maturing as third-party service providers expand their offerings of platform-based business, applications and infrastructure services delivered with optimal cost-efficiency and operational flexibility. We foresee many wealth managers tapping into these emerging opportunities to power more cost-efficient operating models.

Growth Led by Process and Service Excellence

To achieve sustainable growth, successful wealth managers will opt for process innovation and service excellence over product innovation.

Like other retail businesses, the ability to identify and execute process innovation and service excellence will widen the competitive moat of wealth managers. A growth model led by process and service excellence will deliver revenue in mature markets and be a source of critical strategic advantage. Many wealth managers realize the material opportunity to contain cost and bolster revenues through product optimization. During the previous credit boom, wealth managers adopted a model for margin expansion and revenue growth led by product innovation; however, this strategy led to a vicious cycle of cost spikes driven by indiscriminate customization, heightened sales support and the need for a complex support infrastructure that reinforced itself with a negative feedback loop of anemic incremental revenues and poor sales effectiveness.

In contrast, the focus of process and service excellence emphasizes the way service is delivered — simpler, faster, cheaper and better. This approach nudges wealth managers to adopt an “open architecture” platform in which best-in-class products, both proprietary and third-party, are sourced and offered to clients to fulfill their needs. Studies have identified several service innovation opportunities across the wealth management value chain (see Figure 9). We foresee the industry embracing the principles of Six Sigma and Lean to industrialize wealth management services and create sustainable longer-term competitive advantage.

World-Class Compliance and Controls

Benjamin Franklin was known to point out two certainties of this world: death and taxes. To that, we can add a third: compliance.

To keep their reputations intact, successful wealth managers will engrain the compliance culture as part of their organizational DNA. Governments and tax hungry treasuries around the world are leading the charge on fraud, tax evasion and money laundering. The rationale is three-fold: political (banks are a reform hot potato); economic (treasuries are flexing their muscles to make up for lost revenue); and, legal (in some cases judiciaries are acting unilaterally, which pressures governments to act).
The elusive nature of money laundering and tax evasion makes it difficult to accurately calculate the cost of financial crimes. The Financial Action Task Force — the main body charged with combating money laundering and terrorist financing — pegs money laundering between $600 billion and $1.5 trillion annually. Two recent cases, The Hongkong and Shanghai Banking Corporation (HSBC) and Royal Bank of Scotland (RBS), offer significant evidence of the state of affairs in the world of compliance. HSBC was ordered to overhaul internal controls by U.S. regulators for failing to monitor and report suspicious activity of bulk cash purchases and international fund transfers. The UK Financial Services Authority (FSA) fined RBS $8.9 million for failing to prevent its private banking arm from complicity in a money laundering scheme.

We see banks investing in technology solutions to bolster Know Your Customer (KYC) and Anti-Money Laundering (AML) programs to maintain their integrity and reputation. At RBS Coutts, a series of systems were put in place to identify abnormal activity in any account. We see demand for IT product companies offering highly flexible and yet fully integrated systems to address evolving compliance and regulatory needs growing at a fast clip.

### Changing Bank Interactions

Percent of respondents who interact with bank frequently or occasionally in the following ways:

- In-person at the bank branch: 82% (Boomers), 77% (Millennials)
- ATM: 85% (Boomers), 77% (Millennials)
- Phone by mobile or home phone, talking to an agent: 48% (Boomers), 51% (Millennials)
- Web banking by using a PC or phone browser: 43% (Boomers), 43% (Millennials)
- Through the U.S. mail: 35% (Boomers), 39% (Millennials)
- Interactive voice response via mobile or home phone: 36% (Boomers), 36% (Millennials)
- E-mail on a PC: 4% (Boomers), 13% (Millennials)
- Using a mobile phone to text your bank: 14% (Boomers), 13% (Millennials)
- Social and new media on a PC: 6% (Boomers), 13% (Millennials)
- Instant messaging with an agent on a PC: 6% (Boomers), 13% (Millennials)


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### Service Innovation Opportunities

<table>
<thead>
<tr>
<th>Value Chain Activity</th>
<th>Main Activities</th>
<th>Outsourcing Potential Imperatives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Front Office/Client Relationship Management</td>
<td>• A more standardized approach regarding customer acquisition, customer service and customer retention will increase customer contacts (CC) and assets under management (AuM), as well as reduce customer losses (CL). This is supported by a range of related analytic and research tools.</td>
<td>• R&lt;br&gt;• I&lt;br&gt;• I</td>
</tr>
<tr>
<td>Middle Office/Client Relationship Management</td>
<td>• More effective availability of relevant customer, trade product as well as research information could reduce sales planning time.&lt;br&gt;• This time savings could be adopted for relationship management (advisory and sales). Consequently, IT infrastructure must be adapted accordingly.</td>
<td>• R&lt;br&gt;• I</td>
</tr>
<tr>
<td>Back-Office Services</td>
<td>• A stronger customer orientation and clearly defined processes of back-office services in the area of administration of securities and investment funds reduce processing time and error rates significantly. This is supported by a sophisticated IT infrastructure.</td>
<td>• R&lt;br&gt;• R</td>
</tr>
</tbody>
</table>

Benefit index: R = Reduce / I = Increase  
Source: Deloitte Research

Figure 9
Technology for Delivering a Superior, Differentiated Client Experience

Driven by changing client demographics and consumer behavior, successful wealth managers will invest in cutting-edge technology tools and platforms to add heft to their competitive advantage.

Confronted with loss of trust, stagnant or falling market share, larger wealth managers are exploiting their scale and investing in technology capabilities that enhance their service offerings and increase operational efficiency. Two specific areas where these firms can bolster their competitive advantage through technology are in client portals and advisor productivity tools.

We believe wealth management firms are lagging other financial services firms in terms of technological innovation. This becomes obvious when contrasting their use of technology with the more modern systems used in investment banking. Online portals and portal customization underpin the next generation of client-facing technology, and the cornerstones of advisor technology include the automation of low-value tasks, enhanced research and knowledge management tools, integration of portfolio management systems and enhanced internal collaboration tools.

The younger generations of high-net-worth individuals are highly technology savvy. They demand transparency and want access to online tools to track portfolios and run scenarios to take proactive asset allocation calls. Research studies indicate that millennials are more likely to use online channels for banking transactions (see Figure 10).

We see wealth managers investing heavily in automation to drive efficiency and transparency and moving forward to offer a differentiated client experience (see Figure 11).

The Road Ahead

As new forces reshape the contours of the U.S. wealth management industry, we see successful wealth managers embracing the following:

1. Fundamentally altering their value proposition and strategy by shifting to a business model led by service excellence.
2. Making material investments in client-facing IT platforms and advisor tools and offering a differentiated client experience.
3. Partnering with IT product vendors and specialist global services firms with business process capabilities to offer market-leading solutions.
Bibliography

Footnotes
1 “Animal spirits” is the term John Maynard Keynes used in his 1936 book, The General Theory of Employment, Interest and Money, to describe the emotion that influences human behavior and can be measured in terms of consumer confidence.
2 Alpha is a risk-adjusted measure of the so-called active return on an investment. It is the return, in excess of the compensation, for the risk borne, and thus commonly used to assess active manager performance. Often, the return of a benchmark is subtracted to consider relative performance, which yields Jensen's alpha.

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