As featured in the October 29, 2021
issue of Financial Advisor

FINANCIAL ADVISOR

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Price's Law And Large Broker-Dealers

It was Derek Price, a British physicist and information scientist, who discovered that it was often a small percentage of subject matter experts among his peers who dominated the publication of academic papers. From him we get Price's law, which says half the publications on a subject are written by the square root of all the contributors (in other words, that five people out of 25 will get half the work done).

Let's adapt that rule to corporate cultures. Jordan Peterson, a best-selling author and professor of psychology, says Price's law suggests that as a company grows, the incompetence grows exponentially and competence grows linearly. It means that if a company has 10 people, three people (30%) are doing half the work, and at a 100-person company, 10% of people are doing half the work. By the time we get to a corporation with 10,000 people, we have 100 people, or only 1%, doing half the work.

That makes growth a mixed blessing. The profit growth is a blessing, while the back-office disconnect is a curse.

Take the independent broker-dealer industry. Our firm, Henschen & Associates, works as a recruiter for several midsize B-Ds. These firms want to work with high-production financial advisor reps who are seeking a relationship with staff and management but, more important, a high service level. For that reason, the firms have no intention of growing large, and they have capped their growth to prevent losing the culture and service they have cultivated.

Now let's turn to another rule, one Malcolm Gladwell talks about in his book *The Tipping Point*. It's called the "Rule of 150," and it expands on the problems companies face when they have too many employees. The rule says that the size of any group of people is a subtle contextual factor that can make a big difference in that group's behavior. Gladwell tells the story of W.L. Gore & Associates, the maker of Gore-Tex fabric, Glide dental floss and more than 1,000 other products. Gore's late founder, Bill Gore, told a reporter, "We found again and again that things get clumsy at 150, so 150 employees per plant became our goal." The company made a plan to put only 150 parking places in the parking lot at one of its locations, and whenever employees started parking on the grass, the company knew it would be time to build a new plant.

Gore manufactures products. But how do these concepts relate to service companies like broker-dealers?

Consider a broker-dealer's two primary functions: supervision and business processing. Our firm has been observing and hearing feedback from advisors at B-Ds for years, and we've made two important observations:

1. As firms grow to more than 3,000 advisors, they are less able to properly track and monitor advisors for compliance. This is why the bigger firms face more frequent litigation involving larger amounts. The Financial Industry Regulatory Authority has no issue with this because it knows larger broker-dealers can afford to pay its fines.

2. When firms have more than 3,000 advisors, they will likely have 500 back-office employees (using a six-to-one ratio of advisors to staff). At that size, the firm's ability to service advisors and process business becomes more difficult. That's when we see more advisors prompted to switch broker-dealers entirely, pushed out by the deterioration in service, relationships, commissions and business processing as well as a compliance effort that caters to the lowest common denominator.

Again, Price's law suggests that an increasingly smaller percentage of employees will be doing most of the work at these large companies, and as the employee pool expands, we also have the rule of 150 to "make things wonky," as the Brits would say. Price's rule also suggests that companies must know who its "square rooters" are, because in difficult times those people are more likely to jump ship first (they know their worth in the marketplace, after all). Yet, as companies grow, it becomes increasingly difficult to identify that handful of people the company's survival may depend on.

Large firms also rely increasingly on layers of management, while the upper management at a smaller firm is still working in close contact with the people they are overseeing in their day-to-day activity.

As broker-dealers grow (and incompetency grows exponentially), patterns develop, and our firm has tried to identify some of them. For instance, there's a relationship disconnect between advisors and staff or management.

We recently worked with an advisor at a large broker-dealer who wanted to join an RIA. His reason: "There is no connection between me and management nor connection between me and staff. I don't know anyone, and they don't know me, so now that a large percent of my business is advisory, cutting the cord with my broker-dealer is a no brainer."

Advisors most often complain about their B-D's automated phone menus, where they experience trade approval difficulties, as well as the amount of paperwork they have to do, the accuracy of the payments and poor business processing. In their complaints about the phone menu, they often express sentiments like these:

- "I'm on hold for long periods of time."
- "I get different answers from different people, so I don't know what to believe."
- "The quality of back-office service staff is something we have to tolerate."

- "There appears to be high turnover of back-office staff, so we are frequently talking to people that aren't knowledgeable."
- "They said they would get back with me with answers to my question(s), but it can take a week or more."

Small and midsize firms have a clear service advantage, since their advisors don't have to go through phone trees like these. The reps have key contacts to reach out to for quick answers, and have relationships not only with the staff but also with management. Turnover is typically low at small and midsize firms, so the staff members the advisors call on have been employed longer and thus know the answers to many of the day-to-day questions that come up. The staff at firms with higher turnover appear inept by contrast, because they are frequently on learning curves. Upper management at small and midsize broker-dealers know their employees well, and (as we've seen in Price's law), the square rooters represent a larger percentage of the employees at smaller firms, so management knows who they are.

Since smaller firms have those advantages, what can larger broker-dealers do to counter? Here are some suggestions:

1. Companies must hire only "A" players. Management has to focus on hiring the best in order to skew the number of "square rooters" within a firm.

2. People should only do what they excel at. Employees are much more productive when performing those tasks they're good at. That makes them more productive, and they find more meaning in what they are doing.

3. Companies should pay their square rooters more: Despite recent arguments to the contrary, merit-based society doesn't treat everyone equally. The best gets more of everything.

4. Consider Frederick Reichheld's words in his book *Loyalty Effect*. "Companies with profits in the upper quartile pay their employees in the upper quartile for their industry, and the inverse holds true with companies in the bottom quartile paying employees in the bottom quartile for their industry. If you pay in the upper quartile for your industry, you'll see your retention of employees rise dramatically." Reichheld adds, "Pay cuts and price increases can boost earnings, but they have a negative effect on employee and customer loyalty and so shorten the duration and worth of those assets. Since the only way a business can retain customer and employee loyalty is by delivering superior value, high loyalty is a certain sign of solid value creation. Be aware that getting your employees to stay with the company longer won't necessarily produce superior economics. A lot of firms are loaded with dead wood."

5. It is essential that larger broker-dealers offer a premier service level for higher producing advisors. The top 20% of producers (which account for 80% of revenue, according to the Pareto principle) have little tolerance for mediocre service and will leave a broker-dealer that can't deliver a high level of service. We've seen some firms set the bar too high, giving the advisors access to higher tier service only after they've reached $1.5 million in gross dealer concession. Other firms spread themselves too thin, offering top tier service at low thresholds like $500,000 and including too many advisors in the offering. Giving access to premier service just to the top 20% will raise retention of the advisors who matter most. You could be creative on this as well so that advisors on a fast growth trajectory could also be included, even though their production currently falls under the threshold for a higher service level.

6. If your broker-dealer has 500 employees (meaning 22 employees are doing half the work), realize that you have accumulated a large number of inefficient people. Jack Welch, the former CEO of General Electric, would do an annual purge of 10% of his bottom-ranking employees. Perhaps companies that need to do this are tacitly admitting that there's something wrong with their hiring in the first place. But because larger firms have a propensity to be less efficient in any case, it's still prudent to purge some bottom performers.

7. Upper management needs to escape the ivory tower and connect with advisors through phone calls, zoom calls and meetings with advisors in their home cities for lunch or dinner. The leaders of large producer groups need these connections, as do the top 10% of individual producers. At these meetings, advisors get updated on company business, but more important, they get heard and appreciated. It naturally gets harder logistically to meet everybody when a firm is getting bigger, but if managers don't make the effort, their advisors will feel alienated.

8. Broker-dealers must focus on growing their larger producer groups. Also known as "Super OSJs," these groups often have their own staffs helping advisors with service. They sometimes act like small firms within large ones, and thus offer the same small-culture qualities. At the same time, these OSJs can give their advisors access to the premier service of the parent broker-dealer, meaning the reps are getting two levels of service.

Economist Thomas Sowell said, "There are no solutions, there are only trade-offs; you try to get the best trade-off you can get, that's all you can hope for." There are trade-offs advisors make when choosing among small, midsize and large broker-dealers. Each size has strengths and weaknesses. Smaller firms don't have the benefit of scale, so they focus on service, relationships and specialization. Large firms, on the other hand, have to battle with their propensity to inefficiency and questionable service, so instead they highlight their technology or depth and breadth of services, offering to help advisors grow and run their practices more efficiently. Large firms also have a major recruiting advantage in their ability to write large upfront checks to the advisors they want to entice.

But remember: For some of these advisors, by year two, the forgivable note has become a seven-year prison sentence.

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