WHITE PAPER NO. 38

OPEN ARCHITECTURE AS A DISRUPTIVE BUSINESS MODEL

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White Paper No. 38 – *Open Architecture as a Disruptive Business Model*[1]

Open architecture financial advisors offer institutional and other investors objective, unconflicted advice because they have separated the business of giving advice from the business of selling proprietary investment products. This advisory platform has powerful appeal to investors. But in this article I will focus not on the impact of open architecture directly on investors, but rather on its impact on the financial services industry—in other words, on open architecture as a disruptive business model. Investors searching for advisors today will find that the open architecture revolution has had a profound effect on the way that even the most traditional financial advisors now do business. Understanding the impact of open architecture can help investors make more informed decisions as they navigate their way through the financial services minefield.

A "disruptive business model" is one that blindsides existing competitors in an industry so completely that they are largely unable to defend against it, essentially ceding industry leadership to a new generation of firms. Disruptive business models were first identified by J. L. Bower and Clayton M. Christensen in their classic 1995 Harvard Business Review article, "Disruptive Technologies: Catching the Wave" (1995). The theory of disruptive innovation has been described by Christensen, who has become the dean of disruption theory, like this:

> *"We view disruptive innovation as a dynamic form of industry change that unlocks tremendous gains in economic and social welfare. Disruption is the mechanism that ignites the true power of capitalism in two ways. First, it is the engine behind creative destruction. . . . Disruption allows relatively efficient producers to blossom and forces relatively inefficient producers to wither. This destruction, and the subsequent reallocation of resources, allows for the cycle of construction and destruction to begin anew, enhancing productivity, lowering consumer prices, and greatly increasing economic welfare." [From Clayton M. Christensen, Sally Aaron, and William Clark, "Disruption in Education."]*

Examples of disruptive business models obsolescing existing competitors, even huge, powerful ones, are legion. Looking at the past, for example, consider Henry Ford's

[1] This paper originally appeared in *The NMS Exchange*, August 2006, Vol. 7, No. 1, page 7

introduction of the assembly line into the auto industry, which eliminated dozens of competitors in one fell swoop; the introduction of the telephone, which nearly eliminated the telegraph (and marginalized then-powerful Western Union); the introduction of the tabletop copier not by Xerox, IBM or Kodak, but by Canon and Ricoh; the introduction of the personal computer, not by IBM or Digital (who had pioneered the minicomputer), but by dozens of theretofore unknown companies; the introduction of discount brokerage, not by the giant full-service firms but by Schwab and others (causing most of the full-service wirehouses to disappear).

Open architecture is a disruptive business model that began to appear in the financial services industry in the mid-1990s. As is usually the case with disruptive models, open architecture was invented and launched not by the traditional competitors in the business — pension consultants, investment banks, traditional banks and trust companies — but by theretofore unknown start-up boutiques. The existing firms had known since at least the mid-1970s that conflicted advisory models, in which conflicts of interest were endemic, were harmful to investors and needed to be replaced with a new model. Yet, like the dominant firms in other industries that had been brought to grief by earlier disruptive models, the dominant firms did nothing (or, as we will see, very little) while the aggressive new firms ate their lunch.

Why didn't the traditional financial advisors immediately embrace open architecture? There are numerous reasons, of course, but let's focus on the most important of them, using examples provided by Christensen.

Reason #1 – Big firms can't do small things. When a disruptive business model is introduced, it is often a "stealth" model, introduced on such a small scale that even though existing competitors are well aware of it, its footprint is too small to be of interest. By the time it has become clear that the market for the new model is huge, it is too late for the existing competitors—the new firms own the business.

This situation has prevailed in the open architecture world from the beginning—the global market for open architecture services was simply too small to be appealing to the huge financial powerhouses that then dominated the advisory business. These firms weren't unaware of open architecture; they simply saw no reason to enter a business that couldn't possibly have a significant effect on their gross revenues or bottom lines. Meanwhile, the open architecture business has been "branded" by a group of still-boutique-sized firms that will likely own the market by the time the big firms have taken a serious interest.

Reason #2 – Existing competitors often have outmoded cost structures. Sometimes a new business model simply can't be adopted by existing competitors because their cost structures are too high. Sears Roebuck & Co. was an American retailing icon, for example, but its position was undercut by Wal-Mart's far lower costs.

Because profit margins had for decades been unusually high in the asset management business, cost structures in the industry also grew out of control. Enormous salaries were paid to people of very modest talents, and low-margin back-office tasks were conducted out of Class A real estate space in midtown Manhattan. Open architecture disrupted this cozy world in at least two ways. First, by controlling costs, the open architecture firms were able to operate profitably in a business the traditional firms had priced themselves out of. Second, open architecture disrupted the prevailing pricing model for asset management. In the pre-open architecture world, any firm with a brand name could charge sky-high fees and get away with it. In the post-open architecture world, only the most elite firms, those with the demonstrated ability to add value consistently across time, could hope to charge the kind of fees that used to be routine. In the post-open architecture world, everyone else is a commodity.

Reason #3 – Corporate cultures are hard to change. If a new business model requires existing firms to change their culture in radical ways, it will be unlikely to happen. When Charles Schwab and the other discount brokers launched their disruptive business model, we might imagine that the old-line wirehouses would have quickly adopted the new model. But in fact the old-line firms couldn't change, and most of them disappeared.

Open architecture firms and old-line financial advisory firms are both engaged in the financial advisory business, but their cultures could hardly be more different. The traditional model is all about asset gathering, while open architecture is all about improving client investment performance. Changing the culture of the old-line firms would require changing the personnel, starting at the top and working all the way down the line.

Reason #4 – A large installed customer base for the old products is a huge obstacle. Like firms in other industries that were undone by new, disruptive business models, traditional financial advisory firms have thousands of investors who like the product they are getting. Many traditional firms are listening to these customers and ignoring the “early adopting” customers, investors who have migrated to the open architecture model. Since the old firms aren’t actually losing clients, they have failed to notice that their businesses aren’t growing nearly as fast as they should be growing. Eventually a tipping point will be reached when the existing customers of the old firms will suddenly see the light, demand open architecture, and abandon the old-line firms.

In the face of the open architecture challenge, the traditional competitors have typically responded in one of the following ways:

Some competitors have left the business. The decisions by huge global firms like Citicorp and Merrill Lynch to exit the asset management business will seem astonishing to anyone not familiar with the open architecture revolution. But to those who understand the current dynamics in the industry, it was clear that these huge firms simply could not both compete effectively in the business and also manage their conflicts of interest.

Some competitors have adopted the new model wholesale. A few firms, especially those who were already also-rans in the asset management business, have converted themselves to true open architecture advisory firms, eliminating their proprietary products altogether.

Some competitors are still in denial. A few advisory firms still maintain that they can both advise investors effectively and also sell those investors proprietary products. This model is disappearing fast, but it is not completely gone.

Most competitors are straddling the fence. By far the most common response to the challenge presented by open architecture is to straddle the fence, that is, to continue to offer high-profit-margin proprietary products while also offering outside managers and products.

What is the impact of all this change on investors searching for new advisors? The main challenge for investors is the turmoil that is roiling the industry as a result of the introduction of open architecture. In a free-market economy, industry ferment is typically a long-term positive for customers, but in the short run confusion can reign. Here are a few suggestions for investors who may be searching for advisors in a transforming industry:

(1) Investors may find it prudent to avoid the few remaining closed architecture firms. Although some of these firms are quite competent at managing their conflicts, the model is dying out and the best professionals are fleeing. The endgame for the best of these firms is life as a pure asset manager, with no advice offered.

(2) A healthy skepticism may be appropriate for firms that have recently converted to pure open architecture platforms. Not only do most of these organizations lack experience offering investors strategic advice, manager recommendations and consolidated performance reporting, but many of them will badly underestimate the challenges of managing an open architecture business.

(3) The majority of firms—those now offering both open architecture and proprietary options—may appear to offer the best of both worlds, but in fact these firms tend to suffer from the objection articulated above (lack of experience offering open architecture products) and also to have an incentive to push higher-margin proprietary products even when superior open architecture products are on the menu. Many of these firms haven't even invested in the infrastructure required to offer an open architecture product, but have outsourced this activity.

(4) Pure open architecture advisors have great surface appeal, but many of these firms are new, small and untried. Due diligence and reference checking are required.

For investors willing to do their homework and conduct serious diligence on prospective advisors, the open architecture era offers vastly greater choice and many attractive advisory models that possess fewer conflicts of interest than traditional models. But *caveat emptor* still prevails: investors who fail to recognize the impact of open architecture on the industry are likely to come to grief.

GREYCOURT & CO., INC.
October 2006

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