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Small custodians compete for advisers with niche needs

Though dwarfed in size by their bigger competitors, small custodians serve thousands of loyal RIA clients

Feb 17, 2017 @ 2:26 pm
By Jeff Benjamin

When Tim Sobolewski started shopping for a custodian for his $100-million asset advisory firm, The Financial Planning Center in Amherst, N.Y., he knew what he didn't want: an experience "that felt like I was calling into a cable company."

That was more than six years ago, and Mr. Sobolewski is still happy he decided to work with Scottrade, a 12-year-old custodian with $10 billion in assets and more than 1,000 RIA firm relationships.

"They were the least expensive platform, and everything they said they were going to do they've done," he said. "I have looked at other custodians, but it's a pain to switch, and the bigger firms keep moving the goal posts by penalizing smaller advisers with higher fees."

While the four largest custodians, with more than $2 trillion in combined custody assets, vastly overshadow the raft of smaller competitors, the glitzy brand name effect of Schwab, Fidelity, TD Ameritrade or Pershing isn't always what registered investment advisers want.

"The smaller custodians fill in niches and gaps in the landscape that aren't served well by the large players," said Michael Kitces, a partner at Pinnacle Advisory Group, which custodies its $1.8 billion in client assets with Schwab, Fidelity and TD Ameritrade.

Across an industry made up of more than 12,000 RIAs, niches and gaps might be more of a rule than the exception, which helps explain the existence of more than a dozen second-tier custodians, each responsible for between $10 billion and $20 billion.

MEETING SPECIAL DEMANDS

Whether they specialize in offering fractional shares like Folio Institutional, or alternative and exotic investments like Millennium Trust Co., or target start-up RIAs like Shareholders Service Group, the smaller custodians are meeting special demands in the marketplace.

While assets are miniscule compared with their much larger competitors, small custodians serve thousands of clients.In essence, the smaller players will never be able to compete head-to-head with the big-box custodians when it comes to spending on technology and the myriad other back office and practice management services RIAs have come to expect. But that doesn't mean the two distinct tiers of custodians can't continue to co-exist, and even compete with each other on some levels.

While the big-box custodians have become hyper-competitive with RIAs, smaller custodians don't compete with advisors for clients and typically provide a higher level of more personal service.

RETAIL INVESTOR BUSINESS

For example, one thing most smaller custodians and many of their RIA clients are eager to discuss is the fact that the second-tier players don't compete for retail investor business.

Joshua Pace, CEO of Trust Company of America, a $15 billion custodian, is relishing the way the larger custodians have migrated deeper into the retail space with various forms of advice and digital-platform services.

"For those of us outside the big four, it's really a good place to be because this subset is growing rapidly," he said. "The big -box custodians have become hypercompetitive with the RIA marketplace. Your custodian could have a robo-platform beating you down on price, while also offering financial planning and packaged portfolio solutions."

"What we're seeing is almost a violent reaction to the paradigm shift of custodians going after end clients," Mr. Pace said. "If an end client calls into us, we direct them back to the adviser, because our wagon is hitched to the adviser and there is no home here for the end client."

"I could cut a deal with any custodian and probably save a few bucks on transaction costs, but it's just not worth it to me," said Carl von dem Bussche, owner of Financial Guidance Group Inc.

Continued on the reverse

Second-tier Sampler

Name	Year Founded	Assets	No. of Clients
National Advisors Trust Co.	2001	$10 billion	170
Trust Company of America	1990	$15 billion	250
Scottrade	2005	$10 billion	1,000
Millennium Trust Co.	2000	$20 billion	1,000
Shareholders Service Group	2002	$5 billion - $10 billion	1,500
Folio Institutional	2002	n/a	424

Mr. von dem Bussche, who has $94 million under management, has custodied with both Schwab and TD in the past, but since 2003 he has worked exclusively with Shareholders Service Group.

"They're small enough where you get good service, and I really like the culture of the firm," he said. "When we went fee-only in 1995, Schwab was my first custodian, but they're basically in the retail business now. You never have to worry about that with Shareholders Service."

In response to that kind of criticism, Schwab spokesman Rob Farmer suggested the competitive factor can be blown out of proportion.

"When considering the merits of the best custody platform for their clients, we believe most advisers make their decisions based on which custodian offers the depth and breadth of services that will best enable them to run their businesses," he said.

Along those same lines, TD Ameritrade spokesman Joseph Giannone stressed an almost collegial relationship between custodians and RIAs, despite the competition.

"For those investors who want the ongoing, personalized advice of a professional adviser, we refer them to an independent RIA," he said. He added that TD refers between $25 billion and $30 billion in client assets annually to its RIAs.

"I don't think the big custodians worry about the second-tier firms at all," Mr. Kitces added. "The reality is that they're literally one to two orders of magnitude smaller. Schwab literally has more than 100 times the adviser asset base of any of the second-tier custodians, and grows more in a single year than some others have in total cumulative assets."

There's no doubt that Schwab Advisor Services' industry-leading $1.3 trillion in custody assets represents an impressive advantage over the average $15-billion second-tier custodian, but size doesn't always seal the deal when it comes to RIAs.

A LOT OF BELLS AND WHISTLES

In the custodial space, fees are rarely advertised and no custodian tries to market itself first and foremost as the discount provider. More often, the big-box firms will promote their size and scale as an advantage for being able to provide more service, better technology and practice management support.

But even that claim is a matter of perspective.

"There can be a lot of redundant services, and advisers don't really need everything that is offered," said Barry Boyte, executive vice president of Shareholder Services. "Some advisers don't take full advantage of everything a technology provider offers."

Alois Pirker, research director at Aite Group, sees the opportunity for smaller custodians to thrive, but he also realizes they are up against entrenched competition from giant businesses that can throw a lot of bells and whistles at RIAs to keep them in the fold.

"The top four custodians are doing heavy investments in technology and services, which is expensive, so if you're a small custodian you need to be positioned accordingly," he said. "I think there will be some consolidation, and more players with massive scale that will become the backbone of the wealth management business."

That kind of outlook is generally scoffed at by the gritty second-tier players, who believe they are filling a legitimate function, and not just scavenging for scraps.

"At the big-box custodians you have to fit into a certain mold, and advisers can all look similar from 30,000 feet," said Mr. Pace of Trust Company of America. "You're just a number at those big custodians, and if your number is big enough you get more love."

While it is easy to separate the four major players from the rest of the hungry pack, some melding is to be expected, as is illustrated by TD Ameritrade's pending acquisition of Scottrade.

Scottrade made its mark by focusing on state-registered advisers with less than $200 million under advisement, according to Brian Stimpfl, senior vice president of adviser services.

"When you look at state-registered advisers, they're looking for three things: competitive pricing, service and a solid technology platform," he said. "That's really been Scottrade's core value proposition."

Going forward, as Scottrade becomes part of TD Ameritrade's $300 billion custodian operation, Mr. Stimpfl would only say that, "We're committed to the best possible service, but there is not a lot of detail that can be shared at this point. Our expectation is that our advisers will move over to the TD platform and get the advantages of being on that platform."