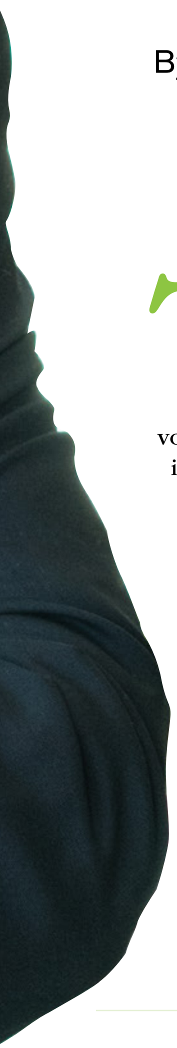
‘DISRUPTION is Just Part of the Way We Live Today’

Dealing with it is not optional, former Vanguard CEO Jack Brennan tells BISA Annual Convention Attendees

By Andrew Singer



These are challenging times in the investment business. The global economy is fragile, markets are volatile and competitive upheaval is the norm.

“Disruption is just part of the way we live today,” observed Jack Brennan, chairman emeritus and senior advisor, The Vanguard Group, in a keynote session at BISA’s recent Annual Convention in Hollywood, Florida. “Dealing with it is not optional.”

Whether it be Stanford University “disrupting” Harvard University (Stanford has become America’s new “it” school, the *New York Times* recently noted), Uber disrupting the taxi industry (“Uber is not a taxi company. It’s an information company,” said Brennan) or GoFundMe, a crowdfunding company, disrupting the United Way charity (GoFundMe last year attracted more than 11 million donors and $1 billion in donations), change is in the air, Brennan said.

The stakes are high and the consequences are grave. “We don’t do do-overs in our business,” Brennan told the audience.

Where does this leave banks? More specifically, where does this leave bank *investments* programs, relative newcomers to the investment world?

Actually, banks are pretty well positioned for the new investment world, said Brennan, the son of a banker, whose first job after college was in a thrift institution. “The banking gene is in me,” he told *BISA Magazine* in a one-on-one interview prior to his keynote address.

It shouldn’t be a surprise that banks are in this business, he said. After all, in other parts of the world, “banks are dominant” when it comes to distributing investment products. But the United States has faced structural impediments like the Glass-Steagall Act, Brennan explained. Banks moved into the investment business eventually — although slowly. But banks are here to stay for one primary reason — people trust them.

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A Two-edged Sword

This trust was evident to him as a youth, growing up in Winchester, Massachusetts, when he sat in his dad's bank office during his school vacations. His father, Frank Brennan, was chief executive of Union Warren Savings Bank in Boston and taught his son how much trust mattered in the business world.

And financial institutions have another advantage — they already hold many investors' savings, and sometimes their mortgages and loans as well.

Brennan's point seems to be that disruption is a two-edged sword. Yes, it can be destructive, but it can also offer opportunities. And it isn't just destruction, but "creative destruction," in the oft-quoted words of economist and political scientist Joseph Schumpeter. After all, it wasn't that long ago that The Leuthold Group published a report that declared index mutual funds like Vanguard's were "un-American." Or as one of Vanguard's major competitors stated: "I never think about Vanguard. They're a curiosity, not a competitor." Vanguard is a curiosity, by the way, that managed $3.1 trillion in global assets at the beginning of 2015, making it the United States' second largest mutual fund family, second only to BlackRock, according to *Forbes*. Brennan was the firm's chief executive officer from 1996 to 2008.

Comments like those from Schumpeter are instructive with regard to banks becoming a force in the investment business, as well as the rise of third-party marketing (TPM) firms, like LPL Financial, which supported the expansion of bank investment programs. (Brennan serves on LPL's board, and LPL sponsored Brennan's appearance at the BISA annual convention).

Twenty years ago, wirehouses and regional brokerage firms did, in fact, regard bank investment programs and TPMs like LPL as a curiosity, Brennan observed. Why in the world would their clients ever go to a deposit-taking institution for investment advice? Sure, maybe a few trust clients would sequester their funds with a bank. But retail investors who had discretionary assets that were ripe for securities investment? Never.

Those naysayers were wrong. Today, banks are a core part of the financial marketplace, Brennan noted.

Perils remain, of course — and not just from the Department of Labor's (DOL) challenging new fiduciary language. Complacency is always a danger.

"How are you challenging your own precepts?" Brennan asked the convention audience. You have to find ways to disrupt your own thinking before others force you to do it.

When Brennan was CEO of Vanguard, he hired an academic on a part-time basis to do exactly that — to challenge his own dogmas. He gave this individual the title of devil's advocate (really). His job was to ask all the questions that Brennan's subordinates couldn't or wouldn't ask. The advocate attended key executive meetings, often not saying a word. But over the next few days, Brennan received a four-page, tightly reasoned report about everything that *wasn't* great with the company.

Brennan could never quite decide if he liked the advocate — or hated him — but in retrospect, hiring a devil's advocate was one of the best things he ever did, he admitted.

Aside from the perils of corporate complacency, there are more specific disrupters on the horizon, of course. Will banks' investment business, heavily weighted toward live advice, be disrupted by robo-advisors? Robo-advisors, or digital advisor platforms, are expected to be one of the winners if and when the DOL's fiduciary-duty rule takes hold.[1]

Robo-advisors Versus Face-to-Face Advice

What is Brennan's take on robo versus human advisors? Consumers really need both, Brennan answers: Robo advisors (for younger investors, especially), but also live, full-service advisors. "Most people need a [live] advisor," and they should buy their investments on an advised basis, he said.

(Ironically, Vanguard built its business almost entirely on the do-it-yourself investor, but the world is populated by both types, Brennan insisted.)

Brennan recalled the observation of a Merrill Lynch asset manager: As people get old and accumulate assets, they want and need financial advice.

As for the DOL's fiduciary duty rule: Regulations are a natural part of doing business, Brennan said. Banks will have to adapt.

That said, "Choice matters," he added. Not everything belongs on an advisory platform. A commission structure might be more appropriate for some clients. Brennan prefers dual platforms — a broker/dealer (B/D) and a registered investment advisor (RIA), side by side — and he said that is probably how things will evolve. One size doesn't fit all.

There has "never been a better time to be in the [investment] business," Brennan concluded in his convention address. The demographics are great. Many baby boomers are retiring, and they will need financial advice to manage assets for what could be a very long final stage of their lives.

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"Don't eliminate choice." If the market says, "All I want is fee-based," that's where things will end up. But don't pre-judge the issue, Brennan cautioned.

In response to a pointed question from the convention audience as to whether the Financial Industry Regulatory Authority (FINRA) is really serving its members (some critics charge that the regulator has not been forceful in fighting the DOL's proposed fiduciary rule), Brennan, who serves on FINRA's Board of Governors and is its lead governor, answered that the regulatory agency is serving its members "all the time," while acknowledging that may require "a challenging balancing act" at times, as in the case of the DOL rule.

Sometimes, we overlook the positive contribution of regulators. We require regulators. "We need cops on the beat," Brennan said. We need laws and regulations as the guardrails of economic activity, but then we ought to "let the market determine what goes on within the guardrails."

A Great Time to be in Investments

Overall, there has "never been a better time to be in the [investment] business," Brennan concluded in his convention address. The demographics are great. Many baby boomers are retiring, and they will need financial advice to manage assets for what could be a very long final stage of their lives.

Finally, in response to a question from the audience about reconciling the need to be skeptical, even cynical (Brennan had approvingly quoted former Intel CEO Andrew Grove's book, "Only the Paranoid Survive"), with his professed "Churchillian" optimism, Brennan answered: "You have to be skeptical, cynical, but *not* let it overwhelm your optimism. You want to be an optimist, but not a naïve optimist." ▲

Reference

1. According to a Cerulli report, "digital advisor platforms may provide a solution for broker-dealers to work with low balances in individual retirement accounts. Robo-advisors offer scalable trading technology, algorithmic portfolio construction and heavy use of low-cost exchange-traded funds." See www.thinkadvisor.com/2016/03/16/dol-rule-will-mean-cheaper-annuities-more-robo-adv

Andrew Singer is editor-in-chief of BISA Magazine. He has been writing about the financial services industry since 1985 and is the managing director of Singer Publications based in New York City. He can be reached at asinger@bisanet.org.