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# The Brokerage World Is Changing, Who Will Survive?



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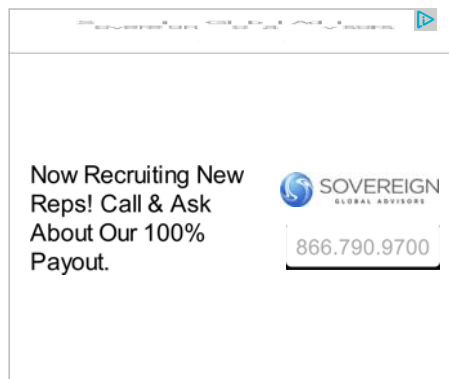
Once upon a time, being a stockbroker was comfortable, genteel and lucrative.

In the “old world,” brokers, as members and owners, controlled the exchanges. Exchanges were run as quasi-non-profit clubs or utilities to support their members. Exchanges had monopoly on liquidity and brokers controlled access. By providing investors access to markets, brokers earned commissions and also received trading fee rebates from the exchange. A long time ago, brokerage commissions were even fixed (remember?). Brokers thus competed on the basis of service and relationships, rather than price.

The introduction of negotiated commissions in the U.S. in 1975 (eventually followed by most other markets in the world) marked the beginning of constantly increasing competition and challenges for brokers. In the last 10-15 years, this process accelerated.

Capital markets experienced a revolution driven by technology and radical change in market structure.

Electronic trading dramatically increased trading volumes and liquidity and slashed the cost of intermediation and broadened access to markets. Exchange demutualization led to a dilution of the



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status of exchange member. Access to liquidity was “democratized”. Liquidity became fragmented among exchanges, alternative trading platforms, lit and dark pools and so on. Exchange “specialists” (market-makers) disappeared.

In many ways, brokers and exchanges now compete with each other: brokers may internalize order execution, they may use alternative exchanges or dark pools; established exchanges offer “direct market access” (DMA) and are occupying increasing space in the investment process, both pre-trade and post-trade.

Life has become very tough for brokers.

Evolution of the securities industry

The US and UK markets – New York, Chicago, London – are pretty much the “laboratory” for the securities industry worldwide. We shall draw on their experience to illustrate the evolution of the securities industry and extrapolate to other geographies.

The “sell-side” securities industry (i.e. the brokers), has been experiencing deteriorating economics, due to pricing pressures, increasingly stringent regulation, and changes in market structure.

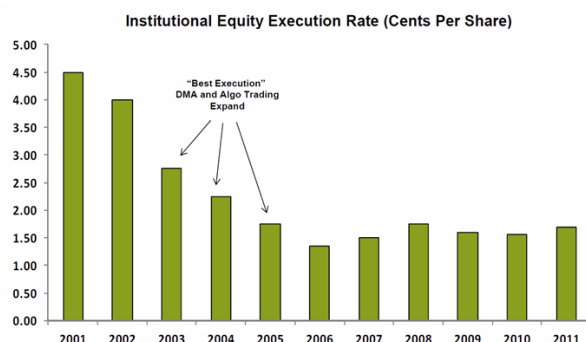
Their clients – the asset managers – the “buy-side” – drive demand. The buy-side itself has been experiencing increasing pressure due to a changing business mix.

Traditional, active asset managers, who charge investors significant fees (~1% of assets under management), and could thus afford to pay brokers full commissions for full service, i.e. execution and fundamental equity research, have steadily lost market share to low-cost passive managers.

Passive management – index funds and exchange-traded funds – has been growing very fast: in the U.S. passive has already captured around 20% of mutual fund outstanding assets; by now, new asset inflows into passive funds outstrip those into active funds. Relative to active funds, which is “1% business”, passive funds charge much smaller asset management fees (0.1% basis of assets for a large cap ETF) and clearly cannot afford to spend as much on brokerage services. They choose low-cost

execution, such as “direct market access” (DMA) and do not use traditional research. The consequence is pricing pressure for the sell-side, as illustrated by the declining commission rate on institutional equity trades. At the beginning of the century, institutional commissions were around 5 cents/share. They are now around 1.5 cents / share, a 70% decline in about a decade...

### Erosion of institutional commission rates



Source: Bernstein analysis

A historical perspective reveals that the securities industry, which was a growth industry in the 1980's and 1990s, has become, since 2000, a highly volatile business with no clear growth trend. Industry revenue cycles reflect overall market conditions, as tracked by the S&P500 index.

### Revenues of the securities industry



Source: SIFMA, Bernstein analysis

Not surprisingly, the securities industry has been undergoing major consolidation. Since 2000, the number of brokerage firms in the US has fallen by almost 25%.

So, in view of these difficult conditions, what can brokers do?

How did US brokers' adapt their business models? What lessons can brokers in other countries extract from US experience?

### Institutional Brokerage Business Models

Institutional brokerage business models may be classified into several broad categories.

- “Traditional” brokers are defined as those that offer full service intermediation, including investment banking, research, trading and sales and asset management.
- Execution and “quant” brokers: they offer low-cost, high – speed, high-tech execution platforms.

This type of broker serves passive investors seeking low-cost execution and/or highly sophisticated, high-tech players.

- Research firms: produce analysis and investment ideas. They may get paid via commissions or hard dollars.
- Service providers: These firms provide services or technology to the investment process and get paid via commissions
- “Disintermediators”: new business models, such as Liquidnet, which dis-intermediate the buy-side and the exchanges

The table below (click to expand) provides a more detailed description of this typology of institutional brokerage business models and examples of successful firms in each category:

SEGMENT		DEFINITION	EXAMPLES
TRADITIONAL BROKERS	Full-service global securities firms	Global firms, active in all areas of the securities business: investment banking, research, brokerage, sales and trading and asset management	Goldman Sachs, JP Morgan, Bank of America Merrill Lynch, Barclays, Citi, UBS, Credit Suisse, Jefferies
	US “regional” securities firms	Firms focused on a geographical region. Typically serve small and medium cap issuers and regional investors	Raymond James, Baird, William Blair, Piper Jaffray
	Sector specialists	Firms focused on an industry or sector e.g. high tech, health care, financials	Sandler O’Neill (financials), Cowen (health care and tech), FBR (financials)
	Global investment specialists	Firms focused on serving global investors by providing “local research”	Auerbach Grayson
EXECUTION / QUANTS	Quantitative traders/liquidity providers/market makers/High Frequency Traders	Firms focused on trading. Usually driven by “quants” using high-tech trading software and algorithms	Interactive Brokers, Investment Technology Group (ITG), GETCO/Knight, Susquehanna
RESEARCH	Research firms	Firms focused on producing high quality, “high touch” investment research; usually staffed by top analysts, with access to company managements	Bernstein, International Strategy and Investment (ISI)
	Expert networks	Securities firms focused on collecting expert-based information on companies and industries – typically serve hedge funds	Subscription Model: Coleman, GLG, VistaBroker Model: De Matteo Monness,
	“Neutral”, “quant”, research firms	Securities firms focused on producing investment research based on quantitative models	Value Line, Argus, Ford, Factset
SERVICE PROVIDERS	Clearing firms	Securities firms focused on offering clearing and settlement services to other securities firms (typically smaller firms)	Pershing (BNY)
	Trading services providers	Securities firms provide trading support for asset managers (typically small)	CF Global, Bank of New York Mellon (BNY), State Street Bank
	Soft dollar firms	Firms that provide services paid via soft \$	FinTech, Instinet
	Technology providers	Firms that provide trading room technology (Order Management Systems, Execution Management Systems, Transaction Cost Analysis, etc.)	Sungard, Blackrock (Aladdin), Charles River
“Disintermediator”		Firms that disintermediate the “sell-side” by providing the buy-side various services: Anonymous trade-matching services, Buy-side research pooling	Liquidnet

It is clear the institutional brokerage business requires specialization. Successful firms have each found a unique combination of customer focus and products/services that match the needs of the targeted customers.

On the issuer side, firms may pursue large caps, mid-caps or small cap firms, or they may focus on certain industry sectors such as technology, health care, financials etc. or other niches.

On the investor side, firms may focus on traditional active asset managers, on hedge funds, on “quants” or “indexers”.

Regarding products/services firms also need to specialize: while some have remained traditional full-service, many have become narrowly focused on areas such as research e.g. Bernstein Research or execution for professional traders e.g. Interactive Brokers.

Following the 2008 financial crisis, it has become clear that minimizing risk-taking and proprietary trading is a very good idea. Successful forms have learned to focus on customer flow earned by offering superior service, rather than by taking risk

An interesting category in the typology is “Disintermediators” with one prominent example: Liquidnet.

While Liquidnet is technically a broker, in some ways it performs the functions of an exchange.

“Liquidnet is the global institutional trading network. We connect more than 700 of the world’s top 4 asset managers to large-scale equity trading opportunities in 42 markets across the globe.<sup>1</sup> Asset managers rely on Liquidnet to enter and exit their investments more efficiently”.

Liquidnet accesses “latent liquidity” - it matches buyers and sellers anonymously, based on their intention to trade large blocks of shares (typically around \$15 million per trade) and executes the matched trade on the exchange without market impact. Obviously, execution in these conditions is little more than “printing the trade” to meet regulatory requirements.

To sum up, institutional brokerage as a business is under pressure – the industry is likely to continue consolidating. The winners will be those

firms that specialize and innovate.

## **Retail Brokerage Business Models**

In both developed and emerging economies, populations are rapidly aging. This demographic change requires steady growth in retirement savings, since “pay-as-you-go”, or “social security” retirement are under pressure everywhere. The need for retirement savings drives increasing demand for investment services and financial advice. Thus, retail brokerage promises to be a growth business overall.

The nature of retail brokerage has changed a lot in the last 20 years or so: the business has “democratized” and evolved from “transactional” towards holistic financial advice.

We will first address the “advisory channel”, i.e. firms that deliver investment services through brokers or financial advisors.

Traditionally, brokerage clients were either wealthy people and/or people with a passion for the stock market or speculative streak (most people saved at the bank....). Brokerage clients usually expected the broker to give them “stock tips”, help them “pick stocks” (and bonds) and make money fast. Savvier clients asked the broker to help them manage their portfolio, seeking diversification and the right asset allocation (e.g. stocks vs. bonds). In this business model the broker earns commissions on trades. This compensation model may lead to excessively active trading – “churning the account” which is obviously against the client’s interest.

In the 1980s, starting in the US, the industry changed: brokers became primarily “asset gatherers” while

the investment responsibility (picking securities) migrated to professional asset managers. This drove the rapid growth of mutual funds. Basically brokers understood that stock picking for their clients could be a risky game – a client who lost money may blame the broker and leave. It became much more attractive for the broker to collect client assets, offer asset allocation and diversification advice and then farm out the money management to several external asset managers and mutual funds in the so-called “open architecture”. The broker’s value proposition thus became: customer relationship

management, asset allocation (based on customer age, income and risk profile), selection of mutual funds/asset managers. In this business model, broker compensation is a combination of sales commissions and “retrocessions” paid by the “manufacturers”, the asset managers to the distributors, the brokers. The retrocessions are typically about half of the asset management fee.

By now this business model has become common in Europe and elsewhere. A number of issues have surfaced:

- Is the broker an “advisor” for the client or a salesman for the manufacturer?
- To what standards should the broker be held by regulators : a “fiduciary standard” – i.e. do the best for the client, in particular minimize the expenses of investing, or a simple “suitability standard” – i.e. as long as the broker sells products suitable for the client’s profile (e.g. selling penny stocks or futures to an unsophisticated client would be “unsuitable”)?
- Does broker compensation via retrocessions from asset managers create a conflict of interest and the risk that brokers will push products with high fees (and retrocessions) rather than the products that are best for the client?

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## The Top 50 Wealth Managers

The annual Top 50 Wealth Managers list is proof the industry continues to boom. This year’s Top 50 Wealth Managers oversee a combined \$224 billion in assets. That’s roughly 15% of the entire RIA market. To address these problems, brokerage firms have introduced “wrap programs”, in which the client pays a single comprehensive fee, a % of assets under management. This fee is meant to pay for all of the advice, transactions and asset management fees. Note that manufacturers retrocessions continue, which still creates a conflict of interest and the suspicion that brokers will select those funds that pay the distributor most. Typically retrocession rates are highly confidential. This entire debate is being complicated (or perhaps radically simplified) by the rapid growth of exchange-traded funds (ETF). In an ETF, the management fee is very small, ranging from around 0.75% for exotic products to as little as 0.05%. ETFs are exchange-traded, like a stock. Brokers still earn a commission but commissions have become very small as a result of discounting. So, there is no way to pay for the distribution of an ETF.

Many clients opt for portfolios of ETFs. So, the only way to pay for a broker's advice is by charging explicit fees.

What about financial advice?

Clients want and appreciate advice, but have often resisted paying for it explicitly. Strangely enough, they have preferred to pay for it indirectly, through higher asset management fees

Increasingly, regulators in Europe and North America are forcing transparency and explicit fees. They are also demanding higher professional standards for advisors (e.g. UK Retail Distribution Review)

These pressures will force advisors to deliver more value to their clients. There is plenty of evidence that advisors can deliver value. The value is not in "stock picking", since by now, most people understand that markets are efficient. Rather the value of the advisor is more holistic, more planning-oriented: helping the client plan his financial life, setting goals, sticking to a discipline of saving money, investing in a disciplined manner, through careful diversification, asset allocation that reflects stage-in-life, income and risk profile, using methods such as dollar-cost averaging and avoiding "market-timing". In addition, the advisor must help the client take advantage of all tax incentives and show him how to manage financial risk, through life insurance and long-term care insurance.

Another important issue is the organizational affiliation of the advisor. Brokers or advisors may be "employee" or independent financial advisors.

Employee advisors usually work exclusively for their firm and follow the instructions of their supervisors.

Employees get significant support from their firms, including training (very important), supervision, regulatory compliance, office space, marketing support, sales assistants etc. The firm must pay the cost of this support. As a result advisor compensation or payout tends to be in the range of 30-50% of the production, i.e. the



revenue they generate for the firm. The profit margin of the firm might be in the 15% of revenue range.

Independents are pretty much on their own. Their firms only offer a regulatory and technology platform and access to products. The advisor typically pays for his/her own office and infrastructure. Advisor payout is much higher, typically 80-90% of production. The producer is the “brand”

The independent model can be very attractive to an advisor who has completed his training (usually as an employee of a wirehouse), has already built a book of business and wants to go on his own.

The independent model however cannot finance training programs, since these firms make a very skinny profit margin, typically around 5% (or less) of revenues. So, the independent channel “feeds off” the employee channel and attracts advisors who are either pushed out or seek a different lifestyle or simply a higher payout.

Today the US brokerage industry accommodates multiple types of firms, as illustrated in the table below

Retail Firms US business models and headcount:

SEGMENT	DEFINITION	EXAMPLES
<b>Full-service firms (“wirehouses”)</b>	National firms; large branch networks. Wealthy clients ( \$ 0.5-1 mill.). Fee-based managed accounts, payout 30-50%/50,000 advisors, AuM \$4,500 bill, ~\$90mill/FA	Merrill Lynch, Morgan Stanley, Wells Fargo, UBS, Edward Jones
<b>Regional firms</b>	Regional focus. Fee-based. Payout 40-60%/37,000 advisors AuM \$1,800 bill, ~\$50mill/FA	Raymond James, Piper Jaffray, Stifel
<b>Registered Investment Advisors (RIA)</b>	Small firms ; Wealthy clients; Fiduciaries. 34,000 advisors AuM \$2,000 billion ~60mill/FA	Small firms (000's), supported by a few giant platforms (Schwab, Fidelity, Ameritrade, Pershing)
<b>Independent broker dealers</b>	Platforms for self-employed independent financial advisors. Payout 70-100%/113,000 advisors AuM \$2,000 billion ~18mill/FA	LEL, Cetera
<b>Financial planners</b>	“Mass affluent” clients (<\$100K) Financial planning; mutual funds, retirement solutions, insurance, credit	Investors Group (Canada), Ameriprise, Mediolanum (Italy), MLP (Germany)
<b>Online brokers, fund supermarkets</b>	Low cost online execution, “do-it-yourself” retail investors	Schwab, TD Ameritrade, E Trade, Scottrade
<b>Asset Managers (with retail distribution)</b>	Asset management firms; retail focus; direct distribution	Vanguard, Fidelity, Schwab

The traditional firms, wire houses and regional firms, have consolidated over the past 20 years. Today only 5 giant wire house firms dominate the business. There are still a few regional brokerage firms, which probably will consolidate further. All this consolidation has created turmoil and many advisors have left and moved to Regional

Investment Advisors, often boutique firms, or to Independent Broker-Dealers or Financial Planning firms.

With the overall pressure on fees, smaller accounts cannot afford an advisor.

The direct channel offers all types of investment products, but without the benefit of an advisor. It is suitable for smaller investors or “do-it-yourself” types. Some firms in this channel offer very sophisticated online interfaces, which can replicate some of what an advisor does. Others offer products which incorporate some light “advice-like” features: for instance target-date funds. Very likely, technology will help the direct channel expand and offer more to the client.

Nevertheless, we believe that many clients will continue to seek a human advisor, be it for the “hand-holding” value, the “trust factor” or simply convenience.

We have focused on the US retail brokerage industry, which is considered as a model and trendsetter around the world. We believe other countries are likely to evolve in similar directions, with one key difference – banks. Continental European systems and Latin American systems tend to be dominated by banks. Banks usually try to thwart open architecture, because they would prefer to distribute the products of their captive managers and make money in both manufacturing and distribution. This bank resistance is formidable but it will erode over time under pressure from clients and competitors.

To sum up our forecast is simple: retail brokerage will be a growth business for the foreseeable future. We are likely to see the types of business models outlined above emerge and develop in most countries, as the need to retirement savings continues to create demand.

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