SHIFTING BUSINESS MODELS WITHIN THE BROKERAGE INDUSTRY

NEW IMPERATIVES FOR THE ZERO TRADING COMMISSIONS WORLD

The race to zero trading commissions that we are witnessing today in the brokerage industry is not new. We have seen it manifest itself in the form of declining trading commissions and advisory fees over the years. However, there has been an acceleration in this trend recently, wherein major brokerage firms in the U.S. dropped their equity and ETFs trading commissions down to zero. The tipping point was industry incumbents' reactionary move to match the commission-free trading offered by the new entrants, further compounding trends in the margin compression at these established brokers and custodians. Schwab and E-Trade, two of the largest brokerage platforms in the industry, expected to lose about seven to ten percent in annual revenue over the past year because of commission-free trading on their platforms[22 23 24]. That expected revenue loss is still far less than their competitors' TD-Ameritrade and Interactive Broker. The two firms collected about a third of their revenues in the form of trading fees in 2019. Brokerage firms will have to adapt to the structural change driven by the commoditization of the brokerage model by re-evaluating their business models, the backbone of value creation, and ensuring that they are in line with the new market realities. In this paper, we explore how firms can address the challenges of the commoditized brokerage model, navigate the result of the race to zero transaction fees, evaluate platforms for alternate sources of revenue, and avoid the pitfalls of delayed response to competitive pressure from new entrants.

A COMMODITIZED BROKERAGE MODEL

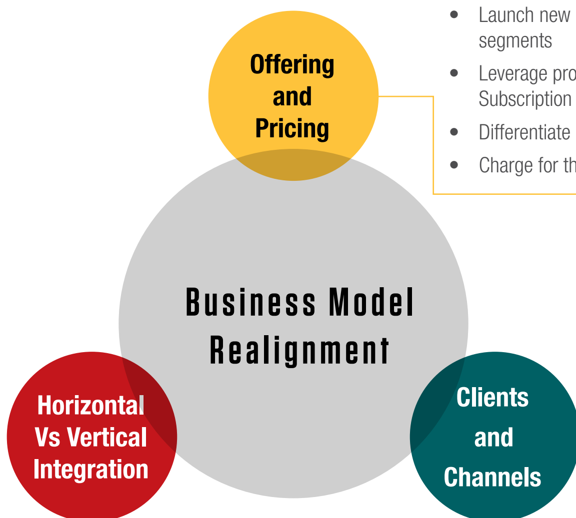
PRIMED FOR DISRUPTION

The present-day brokerage business model's genesis lies in the commissions deregulation of 1975 that allowed trade commissions to be driven by market forces instead of a fixed flat rate[20]. Prior to 1975, brokers charged a fixed rate for services irrespective of the trade lot size that favored large institutional investors over smaller investors due to their sheer economies of scale. With the commission deregulations, brokerage firms were free to differentiate their service offering levels and charge lower fees for lesser services, which leveled the playing field for smaller retail investors. Firms led by Charles Schwab that recognized these shifting market dynamics early on quickly adjusted their business models to cater to the retail investor segment by offering discounted trading services based on tiered service levels, including trade size and advisory. This business model's massive success led to the establishment of the discount brokerage industry with more firms leveraging the same strategy of lower transaction fees. However, the brokerage business model was disrupted in 2013, albeit by free-market forces this time, with Robinhood's emergence, an app-based free trading platform. Robinhood - with its mission to democratize finance - effectively exploited a commoditized business model, thereby expediting the race to zero commissions. The established industry incumbents with trillions of dollars in AUM were slow to act on the disruption this time until the scale started to tilt towards the new entrants, and clients, including millennials, started to flock to the new Fintech apps. As incumbents have recently followed suit, they are now confronted with revenue threats and need to recalibrate their business models once again.

BROKERAGE MODEL REALIGNMENT

CHART NEW PATHS TO GROWTH

Brokerage firms still possess some valuable levers that can be pulled to adapt to these structural changes and offset declining revenue, ultimately paving a path to growth. We see business model realignment primarily driven by the monetization of data and services instead of direct compensation for execution cost. This includes leveraging technology and harvesting data to enable the personalization and customization of services to previously underserved market segments and demographics.



Offering and Pricing

- Launch new products and services to cater to target customer segments
- Leverage proven pricing models from other industries e.g. Subscription based pricing
- Differentiate pricing across product features and tiers
- Charge for the parts of the platform that are less commoditized

Horizontal Vs Vertical Integration

- Integrate horizontally to increase in size, achieve economies of scale, diversify product & service offerings, reduce competition, and expand into new markets
- Integrate vertically to capture upstream or downstream profits and get immediate access to clients through new distribution channels

Clients and Channels

- Use data to identify customer needs
- Leverage technology at lower cost base to cater to new client segments
- Double down on digital strategy to integrate services

INNOVATE AND INTEGRATE SERVICE OFFERINGS

The established business model of the brokerage industry is geared towards providing trading services to investors at the lowest possible price point. To that end, brokerage firms have conventionally leveraged technology and data as tools to improve operations efficiencies and reduce trade execution costs through economies of scale, while catering to retail investors as a large monolithic market segment. However, the new zero commission trading model calls for enhancing a firm's digital strategy to harvest data more effectively. This will in turn help increase its market penetration by offering more personalized products and services that cater to the financial needs of previously underserved segments while supporting new revenue streams. For example, this past June, amidst the ongoing pandemic, Schwab launched an innovative new offering – fractional stock trades – which allowed investors on its platform to own slices of individual stocks for a fraction of the full stock price at zero trading commissions[3]. This strategy pursued a targeted customer segment and attracted many risk-averse new retail investors to Schwab's trading platform, bringing the industry giant face to face with new entrants like Robinhood and Stash that have similar offerings. The influx of new brokerage assets generated an increase in interest income on essential features of its business.

Firms that successfully attract market share in a new segment or client base can then benefit from expanding their digital - first strategy leveraging holistic client data to deepen client relationships by providing adjacent products such as advisory, banking and cash management services. Additionally, these firms explore untapped opportunities to convert core affluent customers affiliated with their institutional business into wealth management clients, while expanding banking capabilities to service this segment. This benefits from diversifying revenue from mature market segments and mitigating the effects of lost compensation for trade execution. For example, Fidelity Investments is an established player in the brokerage industry that also offers full-service wealth management and robo-advisory services to its existing and newly acquired retail brokerage clients. Last year, the brokerage firm focused on building its retail advisory offerings and integrated financial planning tools, which continue to be in high demand amongst retail investors during the pandemic. In the third quarter of 2020, the company reported a jump of 34 percent in the households using its financial planning services compared to the same period over the previous year and 164 percent year over year growth in customer accounts seeking financial advice[21]. This boost in new customer accounts has helped the firm ease the burden of reduced commission revenue. Both Morgan Stanley and Goldman Sachs have made multiple acquisitions and investments to expand into new segments, starting with workplace wealth clients targeting deposit growth and new retail investors. Even the new player in the brokerage industry Robinhood, which started as the commission-free trading app, partnered with banks such as Goldman Sachs, HSBC Bank, Wells Fargo, among others, to expand into new services by offering high-yield cash management accounts to its customers. As firms continue to evolve their strategy to align with this new paradigm, they leverage data to have a more holistic view of their existing clients to provide a broader set of product and service offerings while exploring ways to acquire new customers more effectively.

ADOPT SILICON VALLEY PRICING MODELS FOR TARGET CUSTOMER SEGMENTS

While subscription-based pricing is common in the entertainment platform industry, brokerage firms can imitate the pricing model to be the Netflix of the wealth management industry. This pricing model has proven itself to bring in a predictable revenue stream from customers and help win customer loyalty with a familiar payment system that is easy to understand and transparent. In 2019, Charles Schwab started to explore a similar innovative pricing model for its robo-advisory service, Schwab Intelligent Portfolios Premium. Schwab Intelligent Portfolios provides automated investing with unlimited guidance from human professionals, all for a one-time charge of $300 for financial planning and a flat monthly advisory fee of $30[2 25]. Within four months of launching its service, the company reported an increase of 25 percent in new account opens and a 40 percent increase in average household assets enrolled. Charles Schwab does not report revenue by services. Still, this past June, it reported a year over year increase in advisory fee-based revenue by about 10 percent over the same six-month period and the highest average administration fee of 0.48 percent[5].

Players in the niche corners of the brokerage industry can also leverage tiered pricing models for their advanced product features geared towards their target customer segments. This pricing strategy will allow firms to remain competitive for the masses through their general product offerings while still maintaining a fee-based revenue from their niche market customers who value their unique product features. For example, Tradestation, a wholly-owned subsidiary of Japan's Monex Group, is known for its statistical modeling, portfolio back testing and stress testing tools utilized by its sophisticated day-trading clients[11]. The company launched a new commission-free trading platform called TSgo that allows its low trading volume clients access to trade stocks and ETFs for no fee. However, the service is free only for the first 10,000 stocks in the order. Stocks over 10,000 incur a $0.005 per stock fee. Tradestation's other pricing plans similarly offer per-stock or per contract fees that are tiered depending on the trading frequency (or in-frequency) in each asset class. This pricing strategy has allowed Tradestation to offer zero commission trading to its low trade investors, just like its brokerage competitors, while still maintaining the fee-based revenue from frequent day-traders who value the platform's advanced analytics tools.

CONCLUSION

As commission-free trading continues to take hold throughout the brokerage industry, we now expect to see this race to zero extend to robo-advisory services. This was evident in July, when Fidelity Investments announced it would drop its robo-advisory fee to zero on accounts less than $10,000[6]. Schwab had already reduced its robo-solution, Intelligent Portfolio, fee to zero for investments of at least $5000[6]. Hence, with mounting pressure on profitability, we expect industry consolidation to continue focusing on driving expense savings and enhancing platform capabilities to grow revenue. For example, Charles Schwab recently closed its acquisition of TD-Ameritrade, a transaction recognizing the market's new realities and the power of a more vertically integrated business model with less reliance on trading commissions[26]. The combined entity is well positioned to offset the decline in revenue, having a larger client base post-acquisition, a new distribution channel for Schwab’s proprietary products and an enhanced platform capable of generating revenues from other services.

We believe it is increasingly imperative for firms to re-evaluate their platforms to identify less commoditized parts and add value to existing clients while attracting underserved market segments to generate alternative sources of revenue. By defining and adapting to the market's structural changes, brokerage firms can avoid the pitfalls of delayed response to the competitive pressures in the industry and make growth a reality in this zero-brokerage commission world.

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