

# STRATEGIES OF ONLINE BROKERAGE FIRMS TO REMAIN VIABLE AND COMPETITIVE IN THE PRESENT DAY MARKET ENVIRONMENT

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## Abstract

The online brokerage industry has boomed since the mid nineties. Initially dominated by the pure online brokerage firms, they snapped up market share with relative ease. Markets evolved quickly and electronic trading gained widespread popularity and acceptance. In time, true to Joseph Schumpeter's concept of "creative destruction", conventional brokerages realized the importance of having an online presence to retain market share, and began implementing E-Business models to their existing ones. Pure online firms burdened with the knowledge of growing competition from the traditional, well resourced heavy weight brokerages, poor market conditions and declining investor confidence have to face up and adapt to

the changing environment or risk extinction. The purpose of this article is to shed some light for the reader on the strategies used by pure online firms to retain and expand their market share in this highly competitive sector of the brokerage industry.

## INTRODUCTION

The online brokerage industry has seen a boom during the initial years when pure online firms dominated the scenario. Initially discarded as another fad by the more established conventional brokerage firms like Merrill Lynch, etc., pure online firms began to attack and gain market share with unbelievable speed and ease. This was largely due to the access to mass markets previously untapped by

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conventional firms, developments in the Internet and communication technology, lower commission structures per trade and smaller account minimums. This effectively meant that more individual investors could open and operate accounts, and during the bull market the online firms began seeing profits from high trading volumes. Conventional brokerages began to slowly realize that the E-business model was more than just a momentary fad and with the strength and widespread applications of the Internet, it was not only going to stay but also become the new frontier in the brokerage segment, if not the whole of the financial industry. In time, these firms began incorporating the E-business models to their existing structure to take advantage of this profitable online phenomenon. These conventional heavy weight brokerages having the resources and experience in the industry could afford a late entry into the online scenario and yet have a good chance to capture a sizeable chunk of the online brokerage market. Burdened with that knowledge, pure online firms began to see other threats like newer online brokerage firms spring up – leading to more intense competition, slumping world economy, depressed markets, lower investor confidence in the stock markets (not only due to a depressed economy but also from corporate scandals like Enron, World Com, brokerage scandals involving Merrill Lynch, Salomon Smith Barney, etc.) – which in turn meant reduced trading activity and

lower commission revenue and a new generation of investors that demanded more for their money when compared to their predecessors. Like any competitive environment, the online firms have come up with a variety of strategies to retain and gain market share and realistically find newer avenues for revenue generation, in the face of new competition from the already established conventional brokerage firms, from newer online brokerage firms, the bearish market environment and the more knowledgeable ever demanding investor.

#### **Strategies for Pure Online Brokerage firms to gain market share:**

In this section, the feasible methods and strategies (excluding cost cutting through job cuts and decrease in advertisement spending) for online firms to retain market share, to find concomitant ways to generate revenues and be competitive are scrutinized. These strategies are those that are currently being employed or are premeditated for implementation by those online brokerages that are still successful at what they do.

#### **1. Diversification of services provided by pure online firms:**

Firms have become conscious to the need for diversification as a means for both survival and profitability in the fast paced picture of the new economy.

Knowing that gaming on cheap commissions for revenues is risky, it is of the essence that pure online firms must incline towards creating an “integrated financial services platforms” so as to offer services such as financial planning, mortgages and other loans, insurance and other savings facilities, options dealing, retirement services, bonds, treasuries, mutual funds, IPO’s (Initial Public Offering) and banking services as the solution to creating added value for the customer thus opening supplementary avenues for revenue and gaining market share. This enables the firm to be flexible to the diverse investor types found in the market<sup>(1,2)</sup>. This trend should be seen as a process of adapting to the newer environments differing from the bullish markets seen earlier. On the broader perspective, it helps the firm to provide products and services over a wider horizon. This would keep avenues for revenue open even if trading volumes fall as in bear markets<sup>(3)</sup>. Take for example E\*Trade that started off as a discount broker and added other financial services like mortgage, deposit savings, ATM services, tax and advisory services, consumer lending, etc., this helped boost its share price in spite of drops in online trading during 2001<sup>(4)</sup>. Diversification as we shall see later is achieved through mergers, acquisitions, alliances or joint ventures. By involving itself in underwriting, online brokerages can use its existing customer base to boost trading of the underwritten stock and also secure new accounts, which in turn open more

means for revenue<sup>(5)</sup>. Furthermore, online brokerages, which initially catered to the individual investor, are now moving towards catering to institutional investors<sup>(6)</sup>.

## 2. Alliances and Acquisitions

Brokerage firms are now teaming up with other firms to augment and diversify their product range, consumer support and market access. This in turn creates added value for the consumer. A synergy of off line distribution and online distribution of financial products and services is achieved. When in an alliance, brokerages gain access to distribution avenues with no additional costs, for the partner firms, the alliance provides their client base with competitive financial packages – thus increasing the value added to the customer. For example, TD Waterhouse through its joint venture with Singapore's DBS (Development Bank of Singapore), has gained it access to over five million DBS customers and DBS has provided its clients with an investment portal with a range of global investment services that will be distributed via the Internet, call centers and kiosks. Alliances are formed even in the field of market research. Leading brokerages like Fidelity offers access to Salomon Smith Barney daily research, etc. to attract and retain customers<sup>(1)</sup>.

Acquisitions serve to streamline operations, create cost synergies, cross selling of products, strengthen

resources, diversify and expand both client base and market presence. E\*Trade's acquisition of Telebank in 2000 has made it a strong contender in online banking and the deposit saving segment of the financial services industry. Ameritrade's acquisition of Datek has made it the largest brokerage in terms of trading volume per day<sup>(7)</sup>. Furthermore acquisitions help bring about consolidation i.e., bring down the number of online firms – this rationale has been strengthened by considerable evidence showing decline in the usage of multiple brokerages by the individual investor<sup>(8)</sup>.

### **3. e-Advice and Full wealth management**

“e-Advisory services will build the business of e-brokerages and e-banks,”

*Rocco Pellegrinelli,  
CEO and Founder of Brainpower.*

Full wealth management is an interactive blend of consultative, financial planning, customized financial products and execution facilities. Typically, this type of service was available to high net worth clients of private banks with account sizes of US\$ 1 million or more. Online firms like Charles Schwab are now offering the same service to customers with accounts of \$ 100,000 or more. Online e-advisory or full wealth management tool is fundamental to creating added value for consumers, facilitating them

to make the most of online investing. Pure online firms believe E-advisory is going to be an advantage in the clash for the online brokerage market dominance. Online investors are becoming more challenging as they become smarter. They entail personalized tools such as stock picking, analysis and asset allocation, which acts like a supportive means for decision – making<sup>(9)</sup>. In fact, the online investing scenario has seen financial advice start up firms gaining more investor attention<sup>(10)</sup>.

The analogy behind E-advisory is that with brokerages providing sound counsel, clients become more proactive to market actions, and so participate more while trying to take gain from market fluctuations. This leads to increased trading volume, leading to amplified commission revenue. The customer clearly is seeking added value for their money and the online firms know they have to oblige in order to stay competitive. By capitalizing on the knowledge of such consumer needs, and becoming a well-rounded reliable provider for products and services and charging a small premium for this, online brokerages are striving to create a win-win opportunity for both the firm and the investor<sup>(11)</sup>. Although this strategy was thought of before the markets plunged, the bearish markets, led to a more aggressive pursuit of full wealth management concepts. The financial industry on the whole has witnessed a shift in trend, from just managing assets to distribution of

products and services, from just high trading accounts to attracting and retaining long term clients. This is essentially achieved by a multi channel approach, which calls for a blend of virtual and real presence. This in time has changed the way the market has viewed online brokerages – from just a brokerage firm to a financial service portal <sup>(12)</sup>. From mere customer service, information resources have become the new driver for overall customer satisfaction now <sup>(8)</sup>. Furthermore, information resources are now being demanded and sought out as a prerequisite for opening trading accounts, by the present day newer generation, more knowledgeable customers <sup>(9)</sup>.

#### 4. eLearning

With the diverse range of products and services, colossal amounts of investment information, total comprehension becomes a very baffling and hard task. Online brokerages have become conscious to the fact that presentation of educational material should be effortless, understandable and specific, for knotty websites can confuse a potential consumer, thus driving away his investment, commissions, et al.

Traditional eLearning systems take the user from the prologue to the conclusion through a linear learning course which is prolonged, time consuming, non user friendly and doesn't distinctively cater to the

investors learning needs. Online brokerages are moving away from this to interactive, sequential multimedia display of blocks of information on diverse investment topics. A further development is to tailor make the learning blocks to the clear-cut financial sketch of each investor. Thus, the investor is supplied with information considered necessary, and most suitable goods, products and services. Such innovative eLearning approaches are analogous to the “just-in-time solutions” giving exactly what's required – nothing more, nothing less. Education firms have conjured up interactive games that mimics stock market behavior, generating trial simulations of various investment vehicles like stocks, mutual funds, etc so as to school novice investors confidence, the benefits and the risks involved in investing.

For example, the “E\*TRADE Knowledge Center” is an online site dedicated to helping investors to invest wisely through information and education. It uses ultra-modern technology to supply pertinent information so that investors can formulate sound investment decisions. It offers educational information tailor made to an individual's investment needs and goals, together with personal financial management, retirement planning, etc. Being simple and user-friendly, the Knowledge Center helps users to concentrate on what they need to know, and hence save time and effort by allowing them access information

pertinent to their interests and level of financial expertise<sup>(13)</sup>.

## **5. Online Mutual Funds and Fund Supermarkets**

Charles Schwab first coined the model of a fund supermarket<sup>(14)</sup>. In the drive to make available more diverse products and services, online brokerages have not forgotten about the \$ 5 trillion industry segment - Mutual funds. With the quantity of funds available, investors require guidance to pick and choose the precise fund that matches their financial circumstances simply because financial planning fundamentally is a human process. Online brokerages are offering quotes, research and historical data about the assortment of funds they offer. For example, E\*Trade through its mutual fund “power search” and Schwab through its “Mutual Fund OneSource”, helps investors single out funds from their fund supermarkets according to their criteria<sup>(15)</sup>. Furthermore Schwab has catered to the market down turn by creating a “hedged” equity fund, which follows the principle of shorting – in other words this fund makes its money on the depreciation of various stocks. This fund would target overpriced stocks, which in time would depreciate in value. This is in exactly opposite to buying undervalued stocks to sell out at a higher price – usually seen in bullish market conditions. The reader should see this as a part of Schwab’s strategy to modify and adapt to the changed

market environment. Usually a strategy seen in hedge funds that cater to more sophisticated investors; Schwab is offering this to mainstream investors<sup>(16)</sup>.

## **6. Physical Presence**

“The finance industry is learning a lesson that’s becoming apparent in many consumer industries: The Web alone may not be a big enough channel for mass – market success.”

George, T. (2000)

Striving for competitive effectiveness, experts believe it is wise to coalesce online subsistence with a physical presence. This would help attract the clients that feel alleviated with a physical meeting, providing them a reassurance of sorts when opening an account. In the inevitability of technical problems, the best way to sustain a client rapport, to attend to the clients immediate needs, etc. is a physical meeting. For example, E\*Trade is opening up physical locations for customers who need more than just a web based interactive investing experience<sup>(17, 18)</sup>. During the bear period, pure online firms lost twice as much online site traffic when compared to the conventional firms that had an online presence as well<sup>(19)</sup>. This in turn lends substantial evidence to the productivity of having both offline and online presence.

## **7. Hassle free trading, margin provision, low costs, and quality execution**

Active traders encompass a good portion of the investment population. They are usually knowledgeable investors with a good if not a profound financial and market familiarity. They do not have need for investment advice or physical outlets; rather they entail low commission structure per trade and excellent trade execution<sup>(20)</sup>. Allowing investors to trade on margin – in other words, margin lending, boosts not only the investment opportunity for the investor, but also adds revenue to the brokerage. Brokerages offering this service use the investor's shares as collateral. Furthermore to cater to the convenience of the investor's needs, they have reduced the collateral required for margin trading. The rationale behind this move is two fold – one being the fact that margin trading volume hasn't decreased when compared to spot trading volumes. Secondly upon analysis of customer base showed that over eighty percent of the firm's profits could come from active traders that trade on margin<sup>(3)</sup>.

This does raise the point of how low is low. Price cutting has boosted the quantity of active accounts overall and many of the cheap online brokers gained market share at the expense of higher-priced competitors. With free trades coming into play, the ensuing price war between online brokerages has pushed down the profit margins.

Now brokerages are striving to compete on reliability and quality of services provided to the customer.

## **CONCLUSION**

This article revolves around the online brokerage phenomenon. Keeping in mind the devastating effects of the global economic slump, depressed markets, and low investor confidence due to both the market scenario and the various corporate scandals that have been exposed – online trading has slowed down. Together with a drop in new accounts, low trading volumes have shown the online brokerages a drop in commission-generated revenues. With dwindling revenues, another threat dawned the horizon – conventional brokerages which once shunned the Internet effect, began to go online. A price war would only serve to reduce the already shrinking revenues. Keeping the clientele effect in mind – whereby customers would eventually cluster around a broker that suited their needs, online brokerages had to review strategy, see the market needs, evolve and adapt to the changing market landscape. Besides cutting costs, these firms embarked on innovative methods from diversification to acquisition, from concentrating on niche consumer segments to maintaining a physical presence. This has paid off in terms that online brokerages have faced the winter of extinction and have carved for itself permanence in the financial services industry.

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