

BENEFITS, COSTS AND LIMITATIONS OF ONLINE INVESTING TO THE INDIVIDUAL INVESTOR

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Abstract

The Internet has changed the landscape contours of the financial services industry in ways never ever anticipated. The online approach of conducting commerce has gained more and more acceptance from consumers and suppliers alike. Online Brokerages, when they first came into the scene, attacked mass markets with unbelievable ease, speed and success that it took conventional brokerages like Merrill Lynch, by surprise. In time, conventional brokerages having learnt the advantages of the Internet have moved to create an online presence for themselves. Online trades are accounting for consecutively larger

percentages of total retail trades on established exchanges like the NASDAQ and the NYSE, since its inception. Just as any application in business, online investing has its fair share of not only benefits but also costs and limitations too. The purpose of this article is to enlighten the reader on the above-mentioned aspects of online investing and aid a potential investor to reflect on these aspects before carrying out trades over the Internet.

INTRODUCTION

The online brokerage phenomenon came into being in the mid '90's. Since

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then it has radically transformed the financial services industry. It gave more weight to the notion of a virtual world being quite within reach. Investors could log on from anywhere, at anytime and appreciate market events, and carry out investment decisions over the Internet. With online brokerages offering the investor easier and cheaper ways of holding trading accounts, the online investment scenario boomed. By 2000, online trades accounted for 25 – 30% of all retail trades in the US. With the American economy in its longest expansionary state in the '90's, lower commission structures when compared to conventional brokerages, online brokerages saw more trading accounts, larger asset sizes managed, and higher transaction volumes. Towards the last quarter of 2000, the global economy was slumping. Investors saw Wall Street's hot picks plummeting and investors grew wary. A passive portfolio strategy – Buy and Hold, in other words to wear the Bear out, was gaining more acceptance to those investors that previously sought to ride the Bull. With the Internet still presenting advantageous avenues for securities trading, investors should also realize the costs and the limitations involved while investing online. Like with all goods, products and services that have gained acceptance, online investing also provides more benefits when compared to the risks involved. Nevertheless anyone from a student of finance to a truly informed and intelligent investor should be aware of the whole landscape of online investing,

not just its widely publicized advantages.

The benefits enjoyed by an individual investor due to Online Investing:

a) Independence and freedom due to access to the markets:

This is conceivably the greatest advantage of online brokerages. A novice investor with an Internet connection can know the real time stock quotes, historical stock price trends, have a handle on market events, access vast amounts of economic and market analysis, do research on firms, and interact with other investors via forums or chat rooms. This, in combination with time, can transform even the most novice investor with an active interest in investments into a knowledgeable and powerful investor. ⁽¹⁾

b) Elimination of the “middle man”:

Investing online gives the investor a sense of control over their wealth. Buying and selling of stock no longer requires another individual to carry it out. It saves the investor the added worries that come with busy phone lines; broker not being in, etc. when wanting to do an important trade. It can be done whenever and wherever by the investor themselves. ⁽¹⁾

c) Elimination of Losses on account of Brokers:

Most brokers live on commissions, hence the tactics used by them are in the favor of the broker first, the

brokerage house next and finally the client. Online brokerages pay financial advisors a fixed salary, thus eliminating the chance for an investor doing unnecessary trades for the benefit of the brokerage firm and the broker. ^(2,3)

d) Inexpensive and affordable commission charges:

Commissions per trade online are much lower than when compared to that charged by traditional brokerage houses like Merrill Lynch, etc. This is the fulcrum on which online brokerages leverage. Cheap transaction costs along with the immense amount of information accessible online are the biggest reasons for the clients to move online. Traditional brokerage houses have brokers that direct clients on trades. They charge the clients an expertise fee in the form of commissions. This in time and over a number of trades turns out to be very expensive. Online brokerages have deleted the broker from the picture thus creating a lower commission charge. Online trades can cost from as little as \$4 - \$8 a trade. Active traders at E*Trade are charged \$ 4.95 per trade from its usual \$14.95 per trade compared to a full service traditional commission of \$180 - \$250 per trade. Amex and Ameritrade offer schemes that involve commission free trades. ^(1,3)

e) Internet as an Information Superhighway:

Information related to stocks, company fundamentals, etc., which were once only available to licensed brokers, are

now at the fingertips of anyone and everyone. Online brokerages are in constant endeavor to bridge the gap between the investor and the market. ⁽⁵⁾

f) Diverse range of investment products and choices:

Online brokerages are offering more products to the consumer, so as to give the consumer a wider choice and also to accommodate consumers that have niche tastes. Investors can invest in stocks, bonds, mutual funds, mortgages, insurance, derivatives, futures, options, etc., online through a single or multiple websites from their home, which was something fictional before the online investment phenomenon. ⁽¹⁾

g) Speed of trade execution:

Keeping time in mind, online trading is much quicker – as far as accessibility and availability to investment information and execution of trades are concerned. Online brokerages have decreased the time for total completion of a trade from the regular T+3 days to a matter of minutes. ⁽²⁾

h) Security Issues:

Given all of the above, clients were skeptical to go online simply because of security reasons. Now, these fears can be rested with encryption technology at its zenith, the major brokerage sites are intrusion tested, with the highest levels of encryption. Further more all communications between the browser and the network, occurring in the “secure sockets layer”, are encrypted. ^(2,3)

The costs borne by an Individual Investor from Online Investing

a) Technical Reliability:

The greatest disadvantage of online trading is the inability of a network to be fail-safe. Computers in spite of the technological advances are by no means perfect. There are various things that could go wrong like failure to log on to the network, network blackout due to power failure, server crash resulting in site failure, traffic overload thus causing site freeze. Site freeze can happen on extremely demanding days with large amounts of orders going over the networks. This is where Bricks and Clicks have an upper hand. Online brokerages had their share of bad publicity on October 27, 1997, when the one-day crash caused trading disruptions at the NYSE ⁽²⁾. People have gained doing trades online but have stood to lose all their profits on paper by technical faults. Web site crashes have cost various investors substantial sums of money and this in turn has left a bad taste in the investor's mouth. ⁽⁴⁾

b) The investor is alone:

Another disadvantage may be the penalty of a bad investment. The do it yourself attitude that empowers the investor over his own money, can give a sense of autonomy previously not experienced when dealing with traditional brokerages. But it can also spell investment failure. Stockbrokers could possibly give a bad recommendation, nevertheless they are

professionals who would not just recommend a stock without doing their due diligence. That's why their services bear a premium in the form of higher commissions. A novice online investor with no sound financial basics is more likely to invest without proper analysis of the stock's fundamentals like the key financial ratios, etc. Online trading sites provide investors with vast amount of market information without any sort of personal advice. That's where the bricks and clicks firms have an upper hand. ^(1,6)

c) Lack of set of standards for service, etc.:

Investors' experience in online trading differs extensively. It can be from complete gratification to complete frustration. Sad but true, just like human brokers and financial advisors, online brokerages don't have a fixed set of minimum standards with which investors can benchmark these brokerages and choose the best suited to their liking. ⁽⁶⁾

The Limitations of Online Investing to an individual investor:

Besides advantages and disadvantages, there exists the possibility of limitations of what online brokerages can do for an individual investor. Though the Internet has allowed more players into the investment playing field, some investors like the institutional investors still have an advantage over the individual investors in spite of the Internet and all its advantages. It can be assertively said, "Size does matter".

Firstly, because of the sheer size of resources and contacts, institutional investors almost always get exclusive access to the hottest Initial Public Offering (IPO) deals before it goes into the markets. Individual investors usually gain access to these stocks after the initial price gain is already lost. Online brokerages do offer IPO deals – provided the trading account has between \$100,000 to \$500,000. Next, because of their large trading volumes per deal and such trades being done off-exchange, the institutional investors by and large execute transactions at prices lower than individual investors. Finally because of sheer size and resources – both financial and human, institutional investors have the capability to monitor numerous markets and thus rapidly take advantage of any positive market fluctuations.⁽⁵⁾

Conclusion

This article centered on the phenomenon of online investing. From the perspective of an individual investor, massively advertised by online brokerages, investing over the Internet provides tangible benefits of ease, control, cost effectiveness, autonomy, and a diverse product mix of investment vehicles. It is not wrong to acknowledge the fact that online investing has opened avenues for investors that didn't exist before. It is still a boon to those stock savvy individuals that never could play the markets due to the high entry

restrictions and the costly commission structures placed by conventional brokerage firms. With the online investment scenario being fiercely competitive, such entry barriers could never be erected. This has lead more and more investment savvy individuals to assume the role of an online investor. This may blind a novice investor to the potential costs involved that may not stand out, but nevertheless are as real as can be. Furthermore, being armed with the advantages of online investing, an individual investor still has to realize that in the face of larger institutional investors like pension funds, etc. the playing field of investments can never be leveled.

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