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Stan Witkowski, Prudential Securities



THREAT FROM

THE NET

AS MAIN STREET EMBRACES THE COMPUTER, WALL STREET FINDS IT MUST ADAPT

BY JEFFREY HOFFMAN

Doug Shepard has no use for full-service brokers.

The 31-year-old computer software engineer, who manages a development team for a Redwood City, Calif., start-up called InfoGear, also has taken to managing an \$800,000 stock portfolio on his own, via the Internet. A buy-and-hold investor who favors technology companies, Shepard trades once a month using Schwab.com, the Internet service of San Francisco-based discount broker Charles Schwab Corp. The trades cost \$29.95, a fraction of what he'd pay for the same transactions using a full-service firm. But it wasn't just price that turned Shepard into a do-it-yourselfer.

"It's much easier to use the computer to get things done. It's more convenient and faster to put your account up on the screen to check on your money. With full-service brokers you have to call during business hours and talk to them. You can't always get through. I value the human interface, but it's too much of a sacrifice today."

Shepard didn't always feel that way. In fact, he was a full-service client for three years before turning to the Net. For a time he used Smith Barney, but became frustrated because his broker didn't have an answering machine, let alone e-mail, which Shepard uses for much of his day-to-day com-

munication. "If a broker had e-mail and would make things available via computer, whether it's the [World Wide] Web or some other means, there might be some value to me. But there has to be this basic information-gathering ability."

For quotes or news about his stocks and the market, Shepard turns to Yahoo! or Stockmaster to supplement Schwab's informational offerings. Is he completely confident that he can make all of his own investment decisions without expert advice? No, says Shepard, "but I don't necessarily feel confident that the broker can do that for me either." He dropped his last full-service firm after a broker advised him

to buy shares of computer networking firm Cisco Systems, a stock he'd already had in his portfolio for five years. "As soon as he started recommending things that I knew long before I met him, I felt, 'What do I need this guy for?'"

A few years ago, Shepard could have been dismissed as a fringe element in the investing world, a tech-savvy early adopter from Silicon Valley. Not anymore. In the past year, Internet investing has taken off with a vengeance to become one of the fastest-growing sectors in the financial services industry. The trend is being fueled by a PC market flooded with \$1,000 boxes, cheap Internet access and a profusion of free or cut-rate financial information — including real-time stock quotes, Wall Street analysts' reports, SEC filings and earnings estimates.

"As the online world goes from the early adopters to the mass market, and we think the Web is becoming a mass-market medium, it's not just a small group of folks who are interested," says Arthur Shaw, senior vice president at Schwab, where online accounts have more than doubled in the past year to 1.3 million and over \$91 billion in assets. "It's the investing public as a whole that's coming to us."

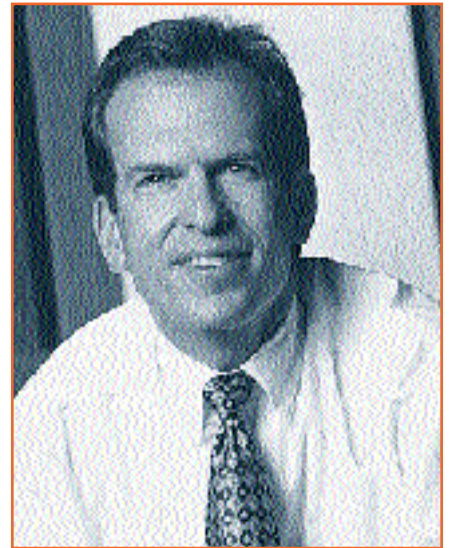
Initially, the major full-service firms downplayed online trading as a niche offering for "day traders." That's starting to change, however.

"Various media, supported by technology, are changing the whole market," says Stan Witkowski, director of Strategic Client Initiatives for Prudential Securities, which is moving quickly to beef up its presence on the Web. "People have access to information, the ability to analyze information on an interactive basis, to track markets worldwide. You can do it seven days a week, 24 hours a day and it's all supported by technology. It represents a change in the way full-service brokerages do business and in some ways it changes the relationship we have with our clients."

The number of online accounts doubled in each of the last two years, growing to around 3 million, with

\$120 billion in assets, by late 1997, according to Forrester Research, a Cambridge, Mass.-based consulting firm. While that only represented about 5 percent of all retail accounts, Forrester projects the numbers to rise to 14.4 million accounts with \$688 billion in assets in 2002. A recent study for Nasdaq by D. Heart Research Associates indicated that 58 percent of investors owned home computers, though only 7 percent had traded online. Clearly, the online brokerage business has plenty of room for growth.

With a burgeoning market and relatively low entry costs, brokerages are proliferating on the Internet. Over 50



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online brokerages operate today, versus 20 in 1996 and just 12 in 1995. Some have been set up by major industry players, such as Schwab, Fidelity, Discover Brokerage Direct (a unit of Morgan Stanley, Dean Witter & Co.) and DLJ Direct (a unit of Donaldson, Lufkin & Jenrette). But some of the most prominent online concerns are newcomers, including E*Trade, Datek and Ameritrade.

Collectively, online brokerages represent about 30 percent of the discount market, according to a study in November by Piper Jaffray. Online trading commissions jumped 129 percent to \$614 million in 1997 from \$268 million in 1996. Those commissions will grow to \$875 million this year, says Piper, which estimates that by 2001, Internet-based brokerages will account for 60 percent of the discount market and 10 percent of all retail commissions.

Should full-service brokers be worried about losing customers to these online upstarts? Right now the threat remains minimal, says Piper Jaffray senior analyst Bill Burnham.

"In the short term, online brokerages aren't going to be able to make significant inroads into the customer

bases of full-service brokerages," he says. "Many have had their customers for 20 or 30 years. These are older people who aren't interested in moving to the Internet."

Still, say Burnham and other analysts, the rise of Internet brokerages and dramatic changes in the retail investment market add up to a significant challenge over the next few years for the major wirehouses as they seek to attract the minds and assets of the next generation of affluent Americans.

"Full-service brokers are fighting the battle for the next generation of investors," says Burnham. "This segment is made up of computer literate, younger professional customers who are pressed for time and have opened a brokerage account as a matter of course. But they don't utilize all the services of the traditional broker and find an affinity to online trading."

Because online investing is so new, having started to attract significant numbers of clients only in the past year or so, it's still difficult to accurately gauge how much of the growth represents a move by self-starting investors from traditional, phone-based discount brokers to the new medium of



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the Internet, and how much is accounted for by defections from the big full-service brokerages. According to Burnham, full-service clients increasingly are testing out Internet trading. “You see customers keeping their full-service accounts and opening second online accounts. That’s masked the impact of the Internet.”

Adds Alex Stein, a principle at the Boston-based consulting firm Gomez Advisors, which helps develop Internet strategies for financial services companies: “To some degree, full-service firms have a false sense of security because there hasn’t been a huge number of outright account transfers to online brokerages. But they haven’t looked at the number of customers who are cheating — writing \$10,000 checks from their money-market accounts and opening online accounts.

“In the past, a full-service broker didn’t have to worry that clients were also customers of the competition. Merrill Lynch customers on the Internet, whether they have online brokerage accounts or not, are increasingly aware of the benefits of trading on the Internet. That becomes a liability over time.”

According to Stein, the growing ability of individual investors to do research and execute trades independent of a broker-adviser has led to an increasing fragmentation of a retail market that was until recently divided cleanly into two groups: do-it-yourselfers who patronized discount brokers, and clients

who relied on a full-service firm for everything from advice to execution of transactions. Now, he says, it makes more sense to consider three types of retail investors: “dependents,” who still want all the services and are willing to pay for them; “independents,” who can do it all without help and just want the cheapest trade; and “validators,” those who want to take more control of their financial lives but realize the value of some professional advice to provide a “sanity check.” These “validators” are the fastest growing group of retail investors and have been fertile ground for online brokerages.

Michael Gazala, senior analyst for Forrester Research, argues that full-service brokerages aren’t paying sufficient attention to the needs of this third force in the retail market and have drawn the wrong profile of the online investor.

“It’s a disaster to say the people investing online are all young, or male, or engineers or even early adopters,” he says. “These are people who like technology, enjoy using it and see the benefits of using it at home and at work. They also tend to be motivated by family concerns and have a high level of disposable income; they’re exactly the types that full-service firms need to attract. These are people with

complex financial lives and significant assets to manage. Maybe they self-manage 10 percent of their assets online. But if they’re successful at it and it works, what’s stopping them from closing down their full-service account and going 100 percent to an online broker?”

Clearly, the wirehouses have become attuned to the power of the Internet. In the past two years, Merrill, Salomon Smith Barney, PaineWebber and Prudential Securities have poured millions of dollars into building a presence on the Web. Most computer-



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HOW FULL-SERVICE FIRMS SHOULD USE THE NET

Dr. Alex Stein, principle at Gomez Advisors, a Boston-based consulting firm that advises financial services firms on technology, says full-service brokerages must embrace the Internet, using it to enhance the broker-client relationship, if they're going to thrive in the wired world of the 21st century. Stein offers some basic points on how brokerage firms should approach the Net:

1) Train your brokers. Get them comfortable with the Internet and allay their fears about technology. Make sure brokers are skilled in the most up-to-date uses of the Internet, and make sure they know how their customers use it. Then, develop programs to get the broker excited about using the Net.

2) Create World Wide Web home pages for brokers. Such pages, under the firm's main page, can serve as communication centers where brokers can interact with customers. Each customer could have a separate "account" on the page, enabling him or her to log in and view content the broker deems appropriate. That way, a client who's interested in fixed-income securities or emerging markets gets information tailored to his or her needs and doesn't have to wade through irrelevant material.

3) Use technology to automate tasks that don't add value. Clients should be able to check on their accounts and make decisions online about buying and selling assets. Whether a customer actually executes the trade online or not, there's no need for phone tag. Brokers also could send "alerts" to customers, notifying them when changes in the market mean it's a good time to buy or sell an asset.

4) Use the Internet to increase the frequency with which customers think about their broker. If once a week customers notices that the broker is looking out for their interests and assets, the relationship is enhanced and trust increases.

equipped clients of full-service firms can now go online to check their accounts, get data on markets and individual securities, and make use of automated financial planning tools.

The firms are also taking tentative steps to provide online trading to customers. In the second half of 1998, Merrill will start allowing a limited number of free trades per year to clients with Financial Advantage and Asset Power accounts, both of which charge an annual fee for asset management, according to Frank Zammataro, director of Merrill Lynch Online. Prudential is currently testing a trading system with clients and brokers, called Pru-Trade, and is experimenting with a variety of pricing systems. Prudential has not set a launch date for the service. Salomon Smith Barney declined to make executives available for this article, but brokers with the firm say some form of online trading is in the works.

But analysts say efforts to date fall short of what the major firms need to do in order to address the threat from the Internet and the changes in the market brought about by technology.

"None of the wirehouses has anything close to fulfilling their need of using the Internet to support customer relationships," says Stein of Gomez Advisors. "They're talking about it, but the unfortunate truth is that none of them are doing it yet. There's nothing more to point to than just putting printed material online."

According to Piper Jaffray's Burnham, the biggest challenge to full-service firms as they move onto the Internet, allowing customers to do self-service trading and giving them access to research and other information restricted previously to broker-advisers — is meshing customer demands for greater control with a business model in which brokers are still primarily paid on commissions.

"This is an extraordinarily delicate issue with existing brokerage forces," he says. "They see online trading as a direct threat to their livelihoods. As a result, every step a firm takes toward online trading risks alienating their existing brokers. For most firms, that

risk just isn't worth it."

Indeed, one Salomon Smith Barney broker contacted by *Research* expressed concern about the firm's plan to let clients trade online. The broker, who spoke on condition of anonymity, pointed to the ill-fated move by a former employer, American Express Financial Advisors, to let customers trade stocks on their own by calling a toll-free phone number. "It was set up in direct conflict with the advisers," the broker says. "The advisers wouldn't support it because they didn't make a dime. They irritated the advisers and didn't deliver for the client."

At Prudential, Witkowski concedes that there has been "some resistance."

"Some people feel threatened by the new agenda," he says. "For some, arming the client with the ability to trade is a danger. We really don't think so. We're not interested in the eight-dollars-a-trade market. We're a full-service firm and clients build a relationship with a broker because they get convenience, advice and service. Does that mean there's no role for technology? Absolutely not."

Ultimately, however, if firms like Prudential are going to embrace technology within the full-service model, they will have to find a way to earn a living as advisers rather than as transactors. And that's likely to mean a much greater emphasis in the industry on collecting annual fees from clients or paying brokers based on a percentage of client assets under management.

"The transaction has become a commodity," says Witkowski. "We've got to acknowledge that a lot of people view it this way and at the same time bill for the advice and service we add to the relationship."

But getting paid for advice also puts tremendous pressure on the broker-adviser to stay a step ahead of the customer in the information and analysis provided, say industry observers like Gazala of Forrester Research. "Brokers who find value by forwarding a research report or executing a trade are going to be out of luck. An Internet-empowered customer is going to be much more demanding of their broker."

Prudential's Witkowski agrees: "If a broker hasn't been giving a client any value-added, he or she hasn't been doing anything meaningful to that account. If the relationship up till now has been based on cursory platitudes and a little bit of service, it's going to be a problem."

Still, the Internet offers tremendous advantages to full-service brokers who grasp the changes in the market and take the time to learn new technology like the Internet. For one thing, they'll be able to offload many administrative tasks, such as checking account balances

and even trade execution, to the Web. After brokerage firms resolve regulatory issues like how e-mail communication with clients is monitored, they'll be able to communicate more effectively with clients. That will free up more time for the broker to learn about customer needs and provide advice, the thing that investors have come to value most.

"It's a huge opportunity for brokers who grasp that the Net is a much more efficient way to work, gather information about clients and communicate with clients across more channels,"

says Gazala. "Customers still need guidance and help. The Net should be looked at as just another way to provide that guidance. By the time the customer, who's online, comes to you, they've already done a lot of your dirty work. They've educated themselves on the options. At that point, they need help with specific choices between different mutual funds or securities. They're ready to buy. These are great leads for brokers. By the time they've come to you, they're primed!" ■

YOUR FUTURE ON

THE NET

Q&A with Murali Balasubramanian, vice president at Prudential Securities' Strategic Client Initiatives unit. He oversees technology strategies for the firm.

Research: People often refer to the Internet as the "World Wide Wait" because of frequent delays. Is the Web now up to the task of delivering a positive experience to clients?

Balasubramanian: When we give something to our clients, we try to minimize the use of bandwidth (the amount of data transmitted). Prudential took some of the graphics off its Web sites to speed up access. We're also trying to stay away from plug-ins as much as possible. Plug-ins are helper software programs that work with an Internet browser to provide graphics in a certain format, or sound or video. These programs tend to take up space on the client's computer, and if by mistake the client downloads the wrong version of the plug-in, their computer might get ruined.

Research: Most people now access the Internet with 28.8 kilobits-per-second modems. Will you be able to offer more sophisticated graphics and tools when speed increases?

Balasubramanian: When you have a high-speed modem, it's great, but not everybody has this capability. For now, you have to optimize Internet sites from a bandwidth perspective. In time, communications costs will come down and people will have high speed connections to the Internet, such as cable modems that can receive data at 40 times current speeds.

Research: What features will brokerages like Prudential be able to offer when clients have high-speed access?

Balasubramanian: Clients would have connections that are always open. They could have real-time market monitors, continuously updated. You could have real-time video that allows the clients to see their financial adviser on the screen and ask questions directly. Take the TV as an example. If you divide the TV screen into four quadrants, a financial adviser would call and appear in one quadrant. As he or she is doing this, in the other quadrants the client sees information about a particular company or stock, a briefing being given by the chairman of the company, and a buy or sell order in the last quadrant. The client would swipe a smart-card through a reader, enter a password and bingo, the trade goes through. This builds a tighter client-adviser relationship, and provides a tool to the financial adviser by which he or she can provide the customized service that a client deserves. In a cable modem world, all of this is possible and it's not that far away. The infrastructure for those kinds of services is being laid now. You can do it today, but it's very expensive. Technologically it's possible; cost-wise it's not.

Research: What about security on the Internet? Many people remain concerned about whether it's safe to conduct financial transactions on the Net.

Balasubramanian: Our Web site uses 128-bit encryption technology for anything that's transaction oriented. In addition, we can also use digital certificate technologies. E-commerce is slowly gaining momentum. People are paying bills, shopping and trading on the Internet. And the number of users doing e-commerce is growing and not diminishing. ■