

Equity Commission Pricing Myths and Realities

Introduction

In our last volume of PriceMetrix *Insights*, we examined fee and managed asset pricing and established that there is a significant opportunity to clarify pricing strategy and policies for accounts in fee and managed asset products. While much of the focus for growth in the wealth management industry in recent years has been on the fee and managed asset category, traditional transactional accounts continue to drive core revenue for most advisors and firms, accounting for 51%¹ of overall retail revenue compared to 37% for fee-based business.

This edition of PriceMetrix Insights reveals the most common pricing behaviors and examines the practices that are more likely to lead to success.

PriceMetrix directly measures aggregated data representing 3.2 million investors, 500 million transactions, 1 million fee-based accounts, 4 million transactional accounts, and over \$900 billion in investment assets. PriceMetrix combines its patented process for collecting and classifying data with proprietary measures of revenue, assets, and households to create the most insightful and granular retail wealth management database available today.

In this issue of *Insights* we reveal the following:

- Commission discounting remains rampant in the full service brokerage industry.
- Advisors follow their firm's commission schedule only one half the time.
- Advisors prefer prices that can be easily calculated and communicated.
- Small households get bigger discounts than medium-sized households.
- Advisors who raise their commission levels don't lose clients; they improve their businesses overall.
- Advisors who increase discounts during a market downturn don't recover their foregone production during a subsequent market upswing.
- Advisors who demonstrate consistency in the execution of their pricing strategy outperform their peers.

For the purposes of this paper we looked at over 7 million retail equity trades executed in the 3-year period ending June 2011. PriceMetrix found no statistically significant differences in the pricing behaviors of advisors from the U.S. and Canada; therefore, all results presented in this paper are combined.

PriceMetrix is the first choice in practice intelligence solutions for retail brokerages in North America. We help wealth management firms enhance revenue growth, by enabling advisors to identify and action otherwise lost revenue opportunities. By combining industry know-how with powerful aggregated market data, we help our clients increase overall firm profitability.

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Founded in 2000 and headquartered in Toronto, Ontario, we service a notable range of retail wealth management firms within the United States and Canada. To learn about why our clients love us, please visit www.pricemetrix.com or call and email us at 1-866-955-0514 and info@pricemetrix.com.

¹ Includes all transactional revenue in transactional accounts: Commissions on Equity, Options and Fixed Income Transactions and New Issues Revenue.

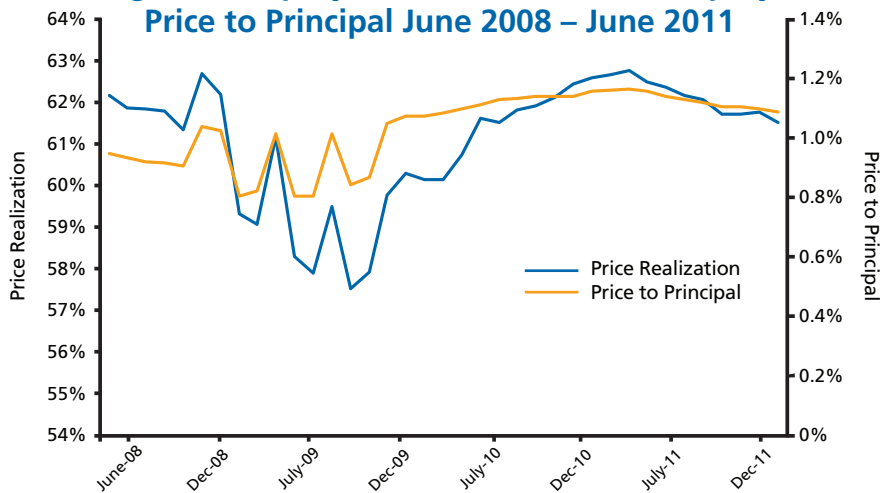
DEFINITIONS

Throughout this paper we employ two different, but related, concepts to measure an advisor's pricing effectiveness: Price Realization Ratio and Price-to-Principal Ratio. We define these concepts as follows:

Price Realization Ratio (P.R. Ratio): The percentage of the scheduled price of a trade that is charged. If a trade has a scheduled price of \$200 and the advisor charges \$160, we say that the trade has a P.R. Ratio of 80%.

Price-to-Principal Ratio (P.P. Ratio): The percentage of the trade principal that is charged. If a trade has a principal value of \$20,000 and the advisor charges \$300, we say that the trade has a P.P. Ratio of 1.5%.

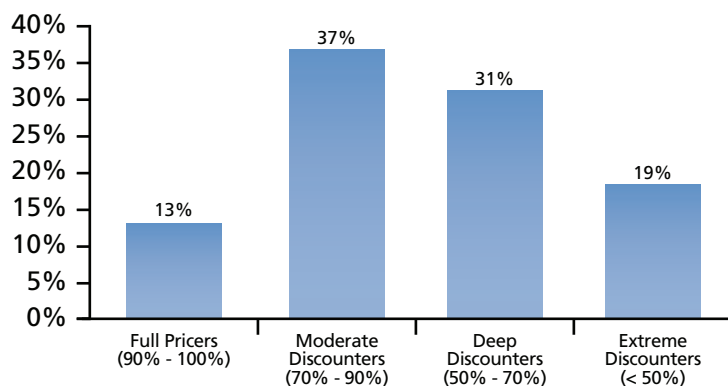
Figure 1 - Equity Price Realization and Equity Price to Principal June 2008 – June 2011



Pricing Through Market Turbulence

Figure 1 shows the volatility that pricing experienced over the past three years. It is remarkable how unstable price levels become during volatile markets. At an aggregate level, one could conclude that the message being sent to the investing public is that the value of advice declines when the market declines.

Figure 2 - Distribution of Advisors by Price Realization Ratio (June 2008 - June 2011)



Price Levels Have Recovered, But Remain Fragmented

Despite periods of instability, transactional pricing has recovered in the past year from lows seen in the market turmoil of 2008-2009. We looked at January 2009 – June 2011 and found that the average ticket size increased from \$224 to \$231, and the average percent-of-principal ratio rose from 1.02% to 1.15%.

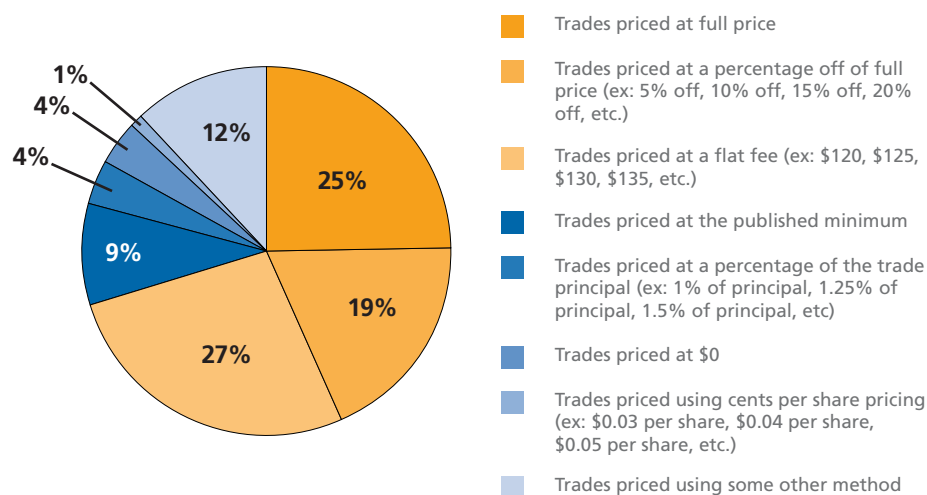
In spite of these increases, advisors continue, to leave an average of \$132 per trade on the table. Our data shows that advisors discount two-thirds of all trades and that the average discount per trade is 35% off of the scheduled price. 50% of advisors have a P.R. Ratio of less than 70% (see Figure 2). 13% of advisors discount little or nothing off of their firm's schedule.

Advisors Seek Simplicity

Pricing policies and behavior form the cornerstone of any successful business. Pricing decisions are made every day, by every advisor, for each client and transaction. Understanding the effectiveness of pricing decisions is critical for maximizing revenue and building the right kind of business.

**Figure 3 - Equity Trade Pricing Behavior
(June 2008 – June 2011)**

Retail commissionable trades only (excludes fee accounts)



Of the 7 million retail equity trades that we examined for the 3-year period ending June 2011, only half of all trades were priced according to a given firm's published price schedule (see figure 3). We consider trades priced at full price, at a percentage off of full price, or schedule minimum, to have been priced using the price schedule as guidance. That only half of all

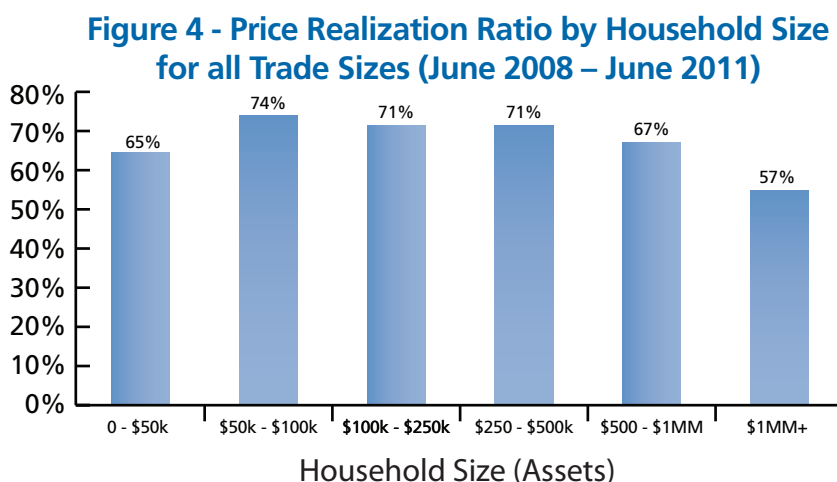
trades are priced according to a schedule indicates that a firm's schedule has only moderate influence on pricing levels. Over half of the firms tracked by PriceMetrix employ a price schedule modeled on decades-old logic that is difficult to understand and hard to explain. Complex and outdated price schedules lead to advisors developing a pricing approach of their own.

Advisors assign a price other than the scheduled price to a trade for a number of reasons: what they believe the 'right' price is; rounding up or rounding down to make a price easier to communicate; discounting to a price they believe the client is willing to pay; aligning price to compensation grid levels. Advisors not following the price 'schedule' show a preference for round numbers and for prices that can easily be calculated based on the principal value of a trade. Among the half of all trades priced using other methods, the most popular pricing behavior is to price a trade at a flat fee – a round number like \$100, \$125, \$150. More than one quarter of all trades are priced at a flat fee; the most popular price for a trade is \$100.

At the firm level, it is important to understand that simply changing your price schedule will affect only half of the trades executed by advisors. Pricing policies are a significant factor in determining advisor pricing behavior. A fair, clear, and rational price schedule, together with an appropriate minimum ticket size and penalties for excessive discounting, are critical to establishing and maintaining suitable pricing behaviors among advisors.

Small Households Get A Good Deal

Households with less than \$50,000 in assets get bigger discounts on equity trades than households that have \$50,000 to \$1 million in assets (see figure 4).



To remove the distortion that the price schedule and/or minimum ticket charges could introduce, we narrowed the above universe to trades between \$10,000 and \$25,000 of principal. Small households still receive an average discount of 32%, compared to an average discount of 28% for households with \$100,000 to \$1 million in assets (see figure 5). Small households generate, on average, only \$364

in revenue per year for an advisor and yet receive an average discount of \$116 per trade. What are these clients doing to earn such generous discounts?

Figure 5 – Pricing and Productivity of Different Household Segments (June 2008 – June 2011)

	Small Households (Less than \$100,000 in assets)	Medium Households (\$100,000 to \$1 million in assets)	High Net Worth Households (\$1 million in assets or more)
Average Household Annual Revenue	\$364	\$2,884	\$16,772
Average Number of Trades Executed per Book per Year	43	204	123
Average Price-to-Principal Ratio (Trades between \$10,000 and \$25,000 in Principal)	1.70%	1.74%	1.54%
Average Discount (Trades between \$10,000 and \$25,000 in Principal)	32%	28%	36%

It should come as no surprise that High Net Worth households (those with \$1 million or more in investable assets) realize preferential pricing across the board, on all sizes of trades. High Net Worth (HNW) households execute more trades and generate more revenue than smaller households. While this increased activity may compensate for the discounts that large households receive on the price of trades, the impact such pricing decisions have on revenue potential should not be underestimated. For the average advisor, simply raising prices for HNW households by 5% would result in a \$4,800 lift in annual revenue.

As discussed in previous volumes of *Insights*, there is increased pressure on advisors to reduce the proportion of small households in their books. With that in mind, advisors should take care not to relax pricing policies for low priority clients.

Raising Prices Is Good For Business

Advisors who raised their prices over the past three years improved their businesses and experienced less client attrition than advisors who did not raise their prices. The data shows that advisors who increased both their P.R. Ratio and their P.P. Ratio by 25% or more over a three-year period had better client retention rates than other advisors. While all advisors, on average, reduced the number of households in their books, advisors who raised their prices saw their average number of households decrease by 6.1% compared to a decrease of 9.4% for advisors who did not raise their prices (see Figure 6). Advisors who raised their prices also increased the quality and productivity of their businesses over the three year period:

- Average production for the group that raised prices grew by 12% compared to an increase of 9% for the non-raisers.
- RoA increased from 0.63% to 0.69% for the group that raised prices. RoA for the group that did not raise prices remained flat.
- Advisors who raised their prices saw a greater increase in the number of households in their books that generate \$2,500 or more in annual revenue (core households); advisors who raised prices grew their number of core households by 10% in the three-year period compared to 6% for the other advisors.
- Revenue concentration risk (the percentage of revenue generated by the top 10 households in an advisor's book) decreased by 5% for the group that raised prices; it grew by 2% for the non-raisers

Figure 6 - Growth Rates for Price Raisers vs. Control Group (June 2008 – June 2011)

	Price Raisers	Control Group
Increase in production	12%	9%
Decrease in number of households	-6	-9%
Increase in number of core households	10%	6%
Improvement in RoA	10%	0%
Change in percentage of revenue generated by top 10 households	-5%	2%

Raising prices does not result in significant client attrition, less revenue, or fewer assets. A carefully considered pricing strategy is part of the value proposition that advisors offer their clients. The facts suggest that strong advisor-client relationships can support repricing and that clients are willing to pay for trusted advice.

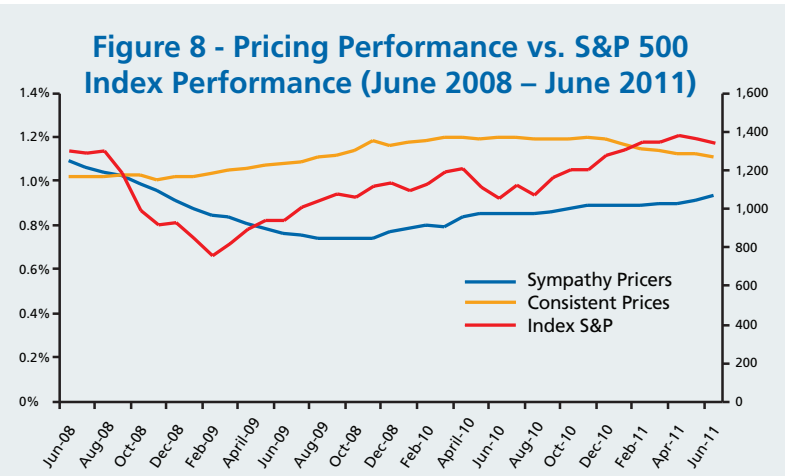
Sympathy Pricing Is Bad For Business

As the recent past has shown us, the role of the financial advisor is put to the test during volatile markets. For this analysis, we tracked a group of advisors who tend to discount more heavily when markets are down. We call them 'Sympathy Pricers.' On average, Sympathy Pricers charged less for trades, discounted trades more heavily, and have a lower overall book RoA than advisors in the 'Consistent Pricers' group (see figure 7). Sympathy Pricers also execute more trades at zero – in particular 'sell' transactions.

Figure 7 –Sympathy Pricers vs. Consistent Pricers (June 2008 – June 2011)

	Sympathy Pricers	Consistent Pricers
% of Sells at \$0	6.1%	4.1%
% of Buys at \$0	2.3%	2.6%
Average Discount	43.0%	38%
RoA	0.6%	0.7%
Length of Service	20 years	27 years

While Sympathy Pricers follow the market on the way down, it is interesting to note that they do not reset their pricing as quickly when markets trend upwards (see figure 8).



Most clients of financial advisors are invested in the market for the long term. A rational pricing strategy should hold in good times and in bad. Clients pay for the advice and experience of their advisors and shouldn't expect a discount when market performance is poor any more than they expect to pay a premium when market performance is above average.

Equity Price to Principal Ratio	Sympathy Pricers	Consistent Pricers	S&P Index
Change June 2008 - Feb 2009	-25.5%	4.3%	-37.7%
Change Feb 2009 - June 2011	16.8%	2.3%	65.5%

Consistent Pricing Pays Consistently

One of the most important and often overlooked aspects of an effective price strategy is how consistently it is applied. For the first time, we are able to measure pricing over a defined period of time to identify the relationship of consistency to advisor performance.

Advisors who priced trades consistently over a 3-year period outperformed those who didn't across a variety of measures. To determine who the Consistent Pricers are, we looked at advisors who have a P.P. Ratio within a narrow band for trades of similar size and for clients of similar size. The Consistent Pricer group charges, on average, 1.13% of the principal value of a trade, compared to 1.04% for the control group. Consistent Pricers also have slightly smaller, but more productive, books: they have an average RoA of 0.76% compared to 0.71% for the control group. Consistent Pricers are more active traders than advisors in the control group, executing more trades per year and larger trades (see figure 9).

Figure 9 – Consistent Pricers Business Performance (June 2008 – June 2011)

Consistent Pricers Control Group	Consistent Pricers	Control Group
Average Trade Size	\$23,561	\$20,763
# of Trades per Year	855	574
Average Household Assets	\$194,358	\$176,241
Median Household Revenue	\$786	\$679

Having a pricing strategy appears to be a key factor in determining an advisor's success. Advisors who price rationally and who demonstrate consistency in their pricing outperform their peers. Many clients don't ask for a discount and don't know when they have been given one. Advisors should consider the value of their advice balanced against the value of the client relationship whenever a discount is applied; any revenue lost should be returned, whether by referrals to new clients, increased activity resulting in more revenue, or an increase in share of wallet.

Conclusion

Revenue from equity transactions is important to advisors and firms alike. Understanding the drivers for pricing decisions, and the results achieved from these decisions, can only help develop better pricing policies and behaviors. We have shown in this edition of *PriceMetrix Insights* that advisors favor simple price schedules, and advisors who have clear and consistent pricing methodologies, perform better in the long run than those who give discounts to their clients haphazardly.

A set pricing strategy absolves the advisor from having to make decisions on discounts and pricing on the fly. Firms can offer guidance to their advisors in the form of rational, simple pricing policies that reinforce the value of the service advisors are providing to their clients.

As an advisor, what should you do to make better pricing decisions?

- Identify your pricing behavior and do the math: how much money are you leaving on the table because of your own bias against charging full price?
- Review your client list and their most recent equity trades: how many of them asked you for a discount? How many of them asked you what you were going to charge at all? Are your clients demanding a discount, or are you giving them one because you think that will make them happy?
- Take the time to understand your firm's pricing policies. Your firm has an interest in helping you maximize your revenue, and price schedules and discount sharing policies are tools to help you set the right price, every time.

At the firm level, what can you do to address pricing inconsistencies?

- Renovate your commission schedule and adapt it to the actual pricing behavior that you see among your advisors.
- Identify your sympathy pricers and your consistent pricers, and share information around best practices with them.
- Give your advisors the tools to measure their own pricing consistency and reward those who charge full price.

We hope that this paper has provided you with insights on customary pricing behaviors and how you can help identify and address inconsistencies. In the end, our recommendation to both firms and advisors is – be confident, be consistent.

For assistance with assessing your pricing policies, please contact Doug Trott, President and CEO of PriceMetrix at 416-955-4498 and email him at Doug.Trott@pricematrix.com

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The analysis delivered in this edition of *Insights* is made possible by our aggregated market data and is the result of a collaborative effort by Patrick Kennedy, Vice President, Product & Technology, Madeleine Cruickshank, Manager, Client Analytics & Advisory and Dylan Martz, Client Analyst.

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