case nine

Online Broking Strategies: Surviving the Downturn at Merrill Lynch, Charles Schwab, and E*Trade

Teaching Note

Synopsis

The Internet has had a major impact on the financial services industry. In no market sector has the effect been arguably so profound as within broking. The latest stock market boom coincided with the early days of Internet-based share dealing. New online entrants, including both start-ups and traditional brokers, took advantage of the period of rising stock markets and helped to grow the retail customer segment by attracting new customers to the online channel. By May 2000, the boom ended abruptly and, along with it, share dealing volumes. The market downturn continued and has now (early 2003) lasted more than 3 years.

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This case examines the impact that online broking had on the industry during the stock market boom and subsequent downturn. It describes how three widely disparate companies – Merrill Lynch (a traditional full service brokerage firm with over a century's history), Charles Schwab (a company that came to prominence in the 1970s by pioneering the discount broking service) and E*Trade (considered to be the first mover in online broking in the 1990s) – responded to the promise of the Internet for their own broking business and how they subsequently survived the downturn.

The case starts with a description of the impact of the Internet on the broking industry. It outlines the key characteristics of the broking industry and the changes that have occurred to traditional business models. It identifies the major events of the downturn that had the most profound effect on the industry. The experience of each of the three case companies is described for the two periods of market growth and decline. Each has survived so far, and the differing strategies that each took is described in some detail.

TEACHING OBJECTIVES AND TARGET AUDIENCE

This case can be used with MBA and undergraduate classes. Its description of the key features of the broking industry allows students, unfamiliar with this sector, to be able to analyze the case successfully without further research into the industry. It is appropriate for both strategy and e-business courses.

The introduction of Internet technologies was a major event for the broking industry. In general, existing companies have successfully exploited this new technology, although new firms have also entered to take advantage of the potential of new markets. This case offers the following key learning points: (i) the impact of the Internet on the broking industry and, hence, parallels to the other information-based sectors with similar characteristics to broking; (ii) the role of technology within new online business models; and (iii) the strategies pursued by new and existing firms within evolving online markets.

TEACHING APPROACH

The five questions asked on the case have been placed in an order that allows the students to build up a picture of the sector and each company's position within it. The order has been found to be important as answers to earlier questions throw light on later ones.

It is suggested that this case is suitable for a class session of between 2 and 3 hours. Students would be expected to come to class having read the case and questions, and ready to apply ideas and frameworks developed in basic strategy theory and e-business.

The case questions could also be used as the basis for a written assignment.

QUESTIONS

1. What has been the impact of the Internet on the broking industry?

Micro level

Figure 9.1 (in the Casebook) shows how the online business model fits alongside existing business models, emphasizing that online broking is an extension of the execution-only or discount broker model. It is now possible to choose from a wide range of service levels, from pure online transactions (execution-only and no advice) through to the full service (advice and execution). It seems clear that new market segments have been created, expanding the number of clients significantly. At least four main customer segments can be identified in the case:

- High net worth
- Mass affluent
- Day traders or "active traders"
- Customers new to broking (encompassing the mass affluent segment).

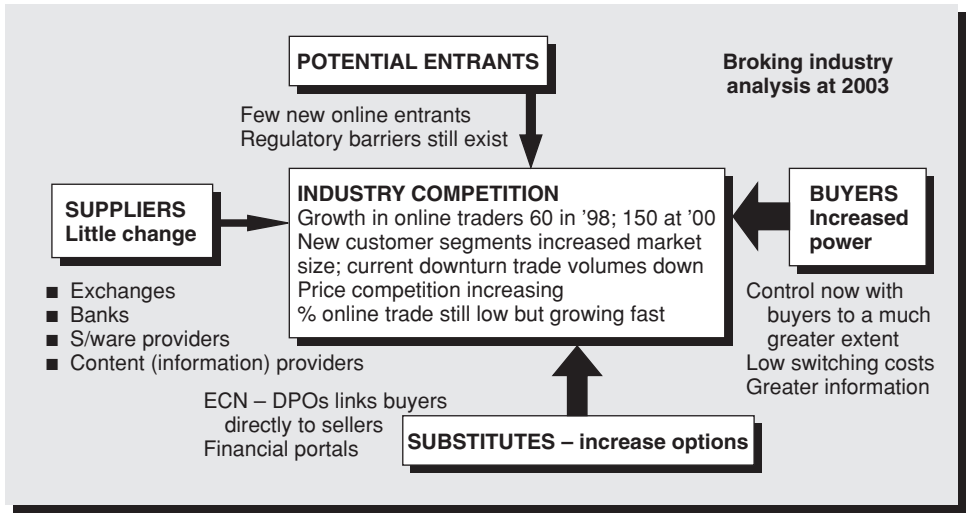
Delivering reach, real-time service and convenience has become more important. Note also the change in the *key success factors* (KSF) for broking from "quality of advice" to "quality of information" in the online model.

In summary, the Internet has created a new online market with the concomitant expansion of the customer base; online broking has expanded existing customer segments as well as having attracted new types of customers. The nature of the service offering has changed: while online customers have direct access via the web to new services, including access to research and detailed share and market data, the emphasis is on a DIY (do-it-yourself) service. Customers have access to more information, although the trade-off is lower price and more convenience in exchange for less advice.

Macro level

Porter's Five-Forces model is useful here as a format for discussion.

- Increased power of customers through lower information asymmetries and increased rivalry.
- Many online entrants but few new firms and, hence, new entrants have been less of a threat – representing a low proportion of firms in total.
- Substitutes may offer the potential to be a significant threat, with emergence of *direct access trading* (DAT) and *electronic communication networks* (ECNs) to radically restructure the industry business model.
- Competitive pressures high given large number of firms and a downturn in the number of trades.



2. During the period of market growth, how did each of the three brokers compete?

This question requires an examination of the business models for each of the three brokers, including consideration of both service provision and pricing.

COMPANY	CUSTOMERS	KSF	STRATEGY
Merrill	High net worth clients	Unchanged (reputation for quality of advice)	Largely unchanged; late mover in online market
Schwab	Existing and new retail segment	Expanded (good value for existing market and quality of information for new market)	There is increased commoditization of offering, given that the KSF changed from quality of advice to quality of information To avoid price competition, entrants are increasingly pursuing value-added strategies
E*Trade	New retail segment	New (quality of information)	

This refers to the business models in the introductory phase of online broking and to the period of market growth. It could be argued that during this period there has been increased convergence between the strategies of all entrants:

- Different types of entrant have entered the online broking market to capture growth in the retail customer segment as well as to retain existing customers (in the case of established firms);
- Value-added strategies;
- Diversifying product range;

- Service differentiation through software tools and client education;
- Online offerings increasingly targeted at capturing the growing mass affluent customer segment;
- Bricks-and-clicks strategy pursued (including E*Trade with Target).

3. E*Trade can be considered to be an Internet-based e-commerce business. Identify the type of e-business model that it has developed over the growth period. Is this a viable model?

There are several well-known classifications of e-commerce business models (e.g. Timmers (1998), Rappa (quoted in Afuah and Tucci, 2001)) as well as explanations of key value drivers in online business models (Amit and Zott, 2001).

Rappa lists the following:

Brokerage	Market makers (e.g. financial brokers, auctions, hubs);
Advertising	Content provider selling adverts – similar to mass broadcasting model (e.g. portals like Yahoo);
Infomediary	Collector of user information and site assessments (e.g. Gomez);
Merchant	E-tailers (e.g. Amazon, eToys, Lastminute);
Manufacturing	Direct to consumers (e.g. Dell, Apple);
Affiliate	Collects customers and passes to partners;
Community	Provides a service to an identifiable common, committed group of users;
Subscription	Users pay for access (e.g. consultants) – successful ventures include gambling sites;
Utility	Pay as you go.

Some of these models have proved more viable in the long term than others. E*Trade is clearly the brokerage model, where this model can generally be considered to have proved more durable than, for example, the advertising model.

Mahadevan (2000) offers a framework for e-business models which gives a far better basis for assessing longer term viability. He comments that the various models identified by authors like Rappa and Timmers are all too narrow. They describe some of the possible models but generally fail to cover the whole range. Nor do these authors offer much insight into the viability of business models.

Mahadevan categorizes Internet-based businesses into three distinct types – portals, market makers, and product/service providers. All of these have to provide value to their customers to survive. A business model, whatever its type, is a unique blend of three streams – value stream for business partners and buyers (value proposition), revenue stream (revenue from the short-term value), and the logistics stream (design of the supply chain). Online brokers fall mainly into the second type: market maker. (Definition: market makers are builders of communities of suppliers and/or buyers and facilitators of transactions between the two groups. They usually have considerable knowledge of the domain.)

*How does the business model of E*Trade operate for each of the three streams?*

Stream 1: Value proposition for business partners

This is the value to suppliers and buyers. With respect to E*Trade, buyers are their customers who wish to trade in shares, suppliers are the financial markets and service providers, like producers of software tools, financial products, and market information providers.

SOURCE OF VALUE	VALUE TO E*TRADE, ITS CUSTOMERS, AND SUPPLIERS
Virtual communities	Specialist financial chat rooms indirectly created by clients of E*Trade offer support, education, and help to new customers and generate value for customers
Low-cost business model	Lower cost business model from lower cost of operations through automation of transaction processing. Cost savings passed on to consumer in form of lower transaction fees. Lower transaction costs for customers in form of lower costs of search
Lower information asymmetries	Customers have greater access to information, including research and market/share data. Increase in volume and quality of information provided. In return, customers are responsible for their own investment decisions without the benefit of advisory service
Value-added market-making process	Developing best-of-breed technology solutions, such as sponsoring new tools and developing new ways of customer support, like payment methods, easier access channels

*Stream 2: Revenues for E*Trade*

These are in addition to conventional revenue streams.

SOURCE	E*TRADE
Potential for increased margins over bricks-and-mortar rivals as result of reduced operating costs and increased volume of trades	Question remains: how much of this cost reduction is passed on to the consumer – seems that most value is appropriated by consumers. However, increased volume of trades attracted to lower price of online transacting could increase revenues overall
Revenue from online seller communities (e.g. matching community of buyers and suppliers at lower cost)	New large market of buyers through E*Trade creates demand for suppliers of tools, market information, etc. not available prior to online market being formed
Advertising	Potential for revenue from affiliate marketing schemes – although this is not discussed in the case
Variable pricing strategies – dynamic pricing	Price discounts for high-frequency traders (e.g. lower fees for day traders vs. standard fees)
Free offerings giving up today's revenues for future revenues	Price competition and reducing prices for frequent traders to capture market share. Aim to reduce marginal costs and increase margin later (critical mass argument)

Stream 3: Logistics stream

This refers to the possibilities of maximizing value for customers through positioning in the supply chain. E*Trade as a market maker can operate most efficiently as a meta-mediary. "Meta-mediation is the process that goes beyond aggregating vendors and products and includes additional services required for facilitating transactions" (Mahadevan, 2000). All the value added services (e.g. the tools for analyzing portfolios, market information, increasing range of access channels) developed by E*Trade fits this description very well. The firm's focus is on obtaining "best-of-breed" technology solutions from other suppliers.

Summary

Using Mahadevan's framework, online broking as epitomized by E*Trade has a viable business model that looks robust enough to last for some time, although it is important to note the firm's dependence on volume transacting (see table 9.4 in the Casebook for operating losses in 1999–2001). A point for discussion could be that E*Trade, in common with many other online businesses, has passed many of the cost benefits gained from a low-cost business model on to the consumer. (Relate further to increased power of buyers in Porter's Five-Forces model in question 1). A further point for discussion could be the advantages and disadvantages of E*Trade's strategy of developing technology through alliances.

4. How well has each company performed during the downturn?

While Merrill and Schwab have lost revenues, both have managed positive net incomes. E*Trade, in contrast, has reported losses. Class discussion could focus on reasons for this. For instance, Merrill has a lower dependence on broking and, in particular, online broking revenues given its investment banking operations. Merrill and Schwab have consolidated through reducing employee numbers, while E*Trade has maintained its number of employees and emphasized cross-selling across business areas. Discuss the nature of the broking revenue model (i.e. high fixed costs with need for economies of scale).

5. How have each of the three brokers responded to the market downturn? Do you think they will be successful in surviving the downturn and why?

This question could be answered with respect to assessing whether the firms' business models meet the KSF of their respective target customer segments. It is during the market downturn when it becomes apparent that Merrill's strategy begins to diverge from that of Schwab and E*Trade. The divergence of Merrill's strategy seems to suggest that the KSF of high net worth investors are not being met with the online model. The segment of the mass affluent presents an interesting case: what

level of service do they want and are they willing to pay for? It could be that successful companies will be those that find the best match of service and price for this group. (Also, this could include discussion of the threat to online brokers from new developments such as DAT and the emergence of ECNs.)

Merrill	Overall strategy focus is on exiting unprofitable businesses. Merrill's online service relatively less important as a source of revenue to overall business. (Note closure of joint venture with HSBC well before the end of the anticipated breakeven period)
	Market downturn illustrated that high net worth investors more resilient than other customer segments. However, Merrill's reputation with high net worth investors may have been tarnished by the recent scandals – along with that of many other investment banks. Increased competition from other online brokers in mass affluent (even high net worth) segments
Schwab	Overall strategy to consolidate, which is achieved through reduction in capacity both with respect to its retail business and technology units. Overall, 35% employees were laid off by the end of 2002. Marketing budget maintained
	Continued commitment to multichannel strategy, including online broking
	Ongoing emphasis on targeting wealthier customer segments, such as mass affluent and even new private client service for high net worth clients. Development of online tools, such as stock rating system, aims to emulate the role of an advisor and hence replicate the advisory service expected from more affluent investors. Schwab risks alienating its investment advisor client base. In fact, Schwab seems to be targeting all key customer segments. Discuss whether this is possible and, in particular, whether Schwab risks alienating its traditional retail customer base
E*Trade	Market downturn has implications for pure-play entrant like E*Trade with its reliance on gaining volume. E*Trade has sought to diversify its revenues. It has developed its online broking operations in new markets overseas. It has also diversified into other financial services markets, such as online banking with E*Trade Bank – emphasis on cross-selling across product categories. Include discussion of E*Trade's ability to gain economies of scale vs. economies of scope

A case for the survival of all three online brokers could be made. What is interesting is that each broker is now aiming to exploit existing resources more effectively as well as adjusting capacity to what is considered to be lower ongoing levels of demand. They are also aiming to maximize revenues from their existing customer bases (i.e. Merrill is refocusing on high net worth investors; Schwab is targeting fees rather than volumes through focusing on its wealthier customers; and E*Trade is trying to maximize the revenues from existing customers through cross-selling products).

USEFUL REFERENCES

Earlier case material on the three companies:

Bakhru, A. and A. Brown, 2003. "On-line broking strategies: The Response of Merrill Lynch, Charles Schwab, and E*Trade," in Grant, R. M. and K. Neupert (eds), *Cases in Contemporary Strategy Analysis*, 3rd edn. Oxford: Blackwell.

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"Charles Schwab: a category of one," 1999, Harvard Business School Case No. 9-700-043.

There are many books and papers on the Internet and e-commerce, of which the following offer a good introduction:

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Timmers, P., 1998. "Business models for electronic markets," *Electronic Markets*, vol. 8, no. 2, 3–8.
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