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NASHVILLE NOTES

It's not You Invest, it's rising rates

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JPMorgan Chase & Co. created a modest stir in the financial press last week when it announced a major push into online brokerage beyond what I gather has been a sub-optimal product that previously was offered. Because clients will get to execute trades for free — at least to a point — the shares of online brokers TD Ameritrade Holding Corp., E*TRADE Financial Corp. and Charles Schwab Corp. were clocked on the day the story was reported by CNBC.

The digital product offering, which will include portfolio investment options, goes by the not-so-catchy moniker You Invest.

I doubt You Invest as a stand-alone competitive product is going to have a dramatic impact on the incumbent online brokerage companies, but the move highlights two big trends for many financial service firms: Deflation is deeply embedded in many product pricing models, and the value of core deposits at banks and uninvested customer funds at brokerage firms is growing the more short-term interest rates rise.

I do not disagree with the market that revenues from executing trades for online brokers is at risk at some level due to JPMorgan's action; however, the price to trade has been falling for decades both for retail and institutional investors. JPMorgan's announcement made the market focus on the issue for the online brokerage firms, and perhaps produced a market consensus that zero-dollar or near-zero pricing will arrive sooner than expected.

It is hard to make up lower prices with volume when the price is zero, but I would not sell Wall Street short. The brokerage industry managed brilliantly after "May Day" occurred in 1975 when the SEC abolished fixed-rate commissions despite fierce industry opposition. (It is not so funny how capitalists are for government protection via regulatory fiat when it is perceived as helpful.) In the years after May Day, trading volume soared and new revenue-producing products were developed. With the end of government-directed price fixing, firms were forced to innovate to reduce costs to be profitable. Some were better than others. The result was consolidation of what was once a highly fragmented industry. Like every other industry that is not overly protected by the government, low-cost providers acquired the high-cost ones.

Another byproduct of May Day was the emergence of the discount brokerage industry. Schwab is the best known, but there were many others. Only a few have survived to the present; those that did have morphed into financial services firm that provide an array of services beyond "discount" trading.

Prior to its sale to Ameritrade, I had the opportunity to spend time with executives of Scottrade Financial Services Inc. on several occasions. Management's view was the price for customers to execute a trade inevitably would go lower even though pricing that had pierced $10 per trade felt incredibly low viewed from the vantage of falling prices over several decades. Although unwelcome, a price of zero was viewed as possible if a market leader such as Schwab adopted it.

Maybe JPMorgan as a newish market entrant will prove to be the price-setter instead. JPMorgan wowed the card industry in 2016 when it rolled out the Chase Sapphire Reserve credit card, which was introduced as an upmarket card to compete with American Express Co. and partially targeted at millennials as is the case with You Invest. The company has spent heavily to promote the card. The initial launch included 100,000 points to get the market's attention. Allegedly the company hit its one-year card acquisition target in two weeks.

JPMorgan as a new entrant that forces pricing toward the lower bound of zero is not as illogical as it seems. As a global financial services firm with a top three domestic retail banking franchise it seemingly needs a robust online brokerage offering. The surprise is that it does not have one. Maybe management was distracted by the aftermath of the financial crisis.

In rolling out You Invest, JPMorgan at a minimum in my view is protecting its retail deposit franchise, which becomes more valuable as short-term rates rise and the spread between the cost of deposits and the assets they fund widens. Funds that could be transferred to Schwab or elsewhere may not leave the bank if You Invest is well-received. If You Invest attracts a sizable flow of funds from competing firms, then it may be deemed a huge success.

What is transpiring is what the Scottrade executives predicted would happen: Rising short rates (then discussed as a possibility) would provide the means for someone in the industry to cut the benchmark price to trade to an unimaginably low level, even zero. Like a commercial bank, the value of uninvested client assets increases with rising rates because the spread widens between where the funds can be invested (usually a T-bill if invested within the broker or better if swept to an affiliate bank) and the credit rate to the customer.

Schwab is an example. Trading revenues are less than 10% of revenues. Net interest income, on the other hand, accounted for about 55% of year-to-date revenues compared to 38% in 2014. The irony is that trading, which was once central to the discount brokers revenue model, is becoming a loss leader if it is not already so.

In addition to protecting JPMorgan's retail deposit franchise, You Invest may give the company's nascent ETF business a lift. Presumably the investment options will be built around JPMorgan's ETF platform, but one might question the upside in ETFs as an asset management product line absent BlackRock-like scale when pricing has collapsed for many ETFs to near zero, too.

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