January 2000, Vol. 3, No. 1

SENIOR CONSULTANT

The Voice of the Investment Management Consultant

Converging Events Changing Our Industry:
People, Firms, Honors and Ideas

Stephen C. Winks

Bond Market Moves Toward Electronic Trading and Distribution

With the city of Pittsburgh directly auctioning $55 million of municipal bonds to institutional investors via the Internet, a new era has emerged in municipal finance and bond underwriting. Pittsburgh has effectively cut out the middleman, eliminating steep underwriting fees and cut the City's cost of issuing bonds by paying a lower yield. According to the Tower Group, a technology research firm, 37% of all U.S. bonds will be traded electronically in 2001, up from 5% in 1998 and 0.6% in 1995. Fifty-five percent (55%) of U.S. government bonds will be traded via the Internet in 2001 as compared to 6.5% in 1998.

Much of today's bond market is inefficient, not having changed materially since the 19th century when investors had to get quotes by calling broker to broker. A tight oligarchy of Wall Street brokers and dealers controls prices and the spreads, between bid-and-ask prices, can be huge. Last year dealers collected some $25 billion spread revenue.

The Internet and its electronic communications networks is allowing buyers and sellers to bypass the middleman and has already narrowed the spread by as much as 25%. The Internet will provide investors with more offerings, more information and better pricing than ever before. Hamid Biglari, The McKinsey & Company partner in charge of its global banking and financial services practice said, "Every investment bank must reinvent how they think about their business." While dealers will lose a lot in the spread, there should be an explosion in secondary training. This would create more liquidity in the market, making it less volatile. Though the U.S. faces increased competition across the Atlantic from the growing market of Euro-denominated debt, the E-bond revolution will help keep the U.S. bond market the world's best place to raise money."

Conflicts of Interest A Major Issue in 401(k) Plans

The biggest and most respected names in consulting are not necessarily always models of how business should be done. The $1.5 trillion 401(k) market offers a good example. Brian Ternoey, a consultant whose pension consulting firm had been acquired by consulting giant, William M. Mercer, found he had to, in good conscience, resign because of conflicts of interest between his new firm and his clients. His concern was that he was instructed not to conduct an independent search for money managers and plan administrators until Mercer and its parent Marsh McLennan's strategic partner, Automated Data Processing, Inc., decided they wanted to bid on the business.

Objectivity is central to the integrity of a consultant's work, and often there are no checks and balances in place for plan fiduciaries to know if there is self-dealing or its implications. Propriety not only requires full disclosure of potential conflicts but the avoidance of any unnecessarily conflicts of interest. Though Mercer insists it did nothing wrong, the seldom discussed issue of disclosure is raised.

William McNabb of The Vanguard Group in Valley Forge, Pennsylvania, testified at a Department of Labor hearing in 1997 that paying a yearly 401(k) fee of 1.5% instead of 0.8% could mean 25% less in retirement. David Huntley of H. R. Investment Consultants in Baltimore, Maryland, said, "When he asks during his presentations at Pension conferences, 'how many plan sponsors know what their plan costs are,' only 10 out of 100 will raise their hands." The opportunity for abuse is particularly strong in 401(k) plans where employees mistakenly think they are in control. Smaller 401(k) plans do not go out and shop for a plan as much as they are sold a plan. Thus, the need for engaging an objective third-party investment management consultant is even more imperative as plans get smaller and the level of discernment is not as great. Fees as high as 3.5% are not uncommon in the 401(k) market, and the opportunity for consultants to be of value is great. Consultants and plan service providers must become most sensitive to the plan and investment cost structure, as required under ERISA, in addressing and managing the needs of plan participants and plan sponsors. Aggressively managing cost is becoming a hallmark of leading consultant and financial services firms.

70% of Schwab's New Accounts Are Opened In Person

If you don't think a bricks-and-mortar branch presence is important, consider this. Seventy percent (70%) of Charles Schwab's new accounts are open in person with a Schwab representative. This is why Schwab's average account balance is $200,000 compared to E*Trade's $30,000 account balance. Even though DLJdirect, E*Trade, Datek, Waterhouse and Discover all offer cheaper trades, clients like dealing with real people. Schwab's 3,000 representatives in 310 branches in 47 states is a very important element of its success and is the reason why Schwab has a relatively low customer acquisition cost of $130 per customer as compared to its Internet competitors like E*Trade at $250 per customer.

Schwab's branch offices are integral to their Internet strategy. Schwab's strategist, Dan Leemon, said, "Even before we knew of Merrill's plans, we saw that all the customers and all the assets are with full-service brokers, and we said, 'that's where we've got to go.' The whole strategy of help and advice, of segmented offerings for customers with more complex needs, of continuing to build our branch network – it's a concentrated strategy to blur those lines between us and Merrill. This is about reinventing full-service brokerage."

The strategy is that Schwab will embody full-service on the Internet the same way as Merrill embodies full-service off-line. Schwab's unique value proposition is that it is a full-service, Internet-centric broker with huge cost advantages. The strategy seems to be working. ■

Notes

SENIOR CONSULTANT

THE VOICE OF THE INVESTMENT MANAGEMENT CONSULTANT

SENIOR CONSULTANT

1457 Crystal Springs Lane
Richmond, Virginia 23231
Ph 804-795-1642 ■ Fax 804-795-7703
www.SrConsultant.com