

# **The Self-Directed Investment Market: A Focus on Active Investors**

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A CELENT REPORT PREPARED FOR:



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# The Online Brokerage Industry

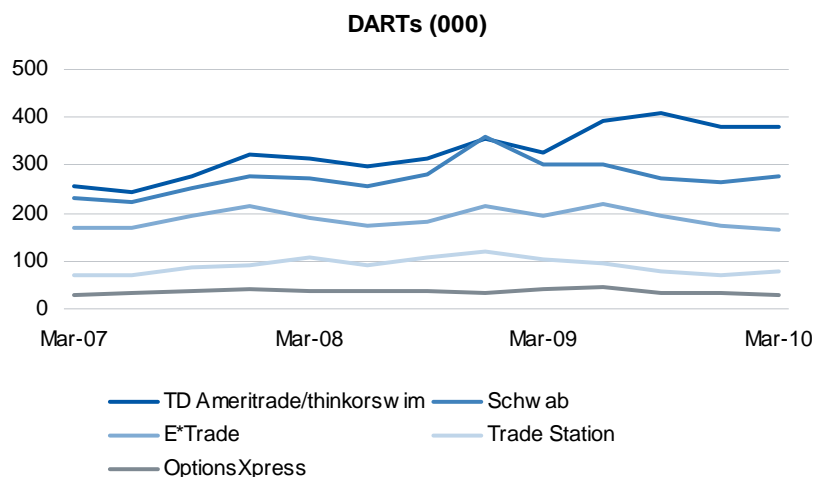
During the past two months, Celent conducted a study of the online brokerage industry in the US market, identifying major trends and developments for trading activity, product preferences, and brokerage technology. For this research Celent interviewed a broad range of firms including online brokerage firms, asset management firms, banks, and brokerage providers. The study focused on the self-directed market and in particular on the active investor customer category. This research note provides a summary of the main findings.

## Developments and Trends

Celent highlights a number of key trends in the evolution of the online brokerage industry:

- Despite the economic downturn the financial services industry has faced in the past 18 to 24 months, investors are slowly regaining confidence in the markets and therefore increasing their trading activity. Daily average revenue trades (DARTs) at the major online brokerages have shown signs of recovery after a difficult market environment in 2009 and a slowing in DARTs between late 2008 and mid-2009, as shown in Figure 1.

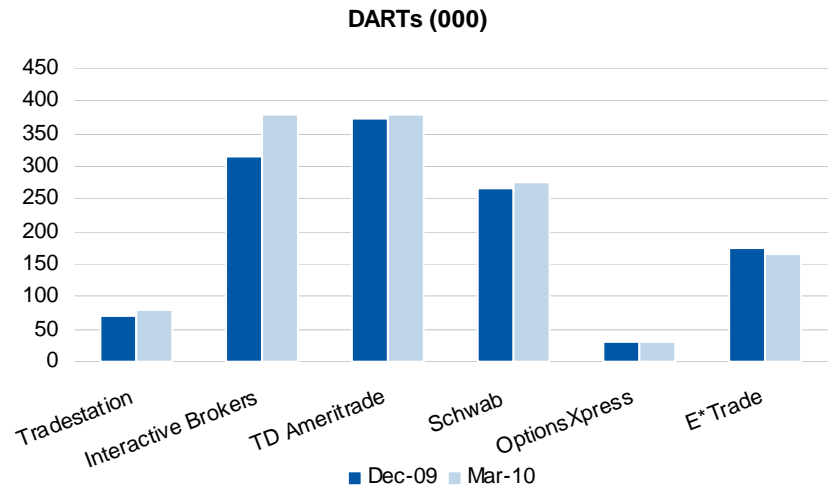
**Figure 1: DARTs**



Source: Company reports

After a slow 2009, during first quarter 2010 we have seen improvements in DARTs across types of firms, as shown in Figure 2.

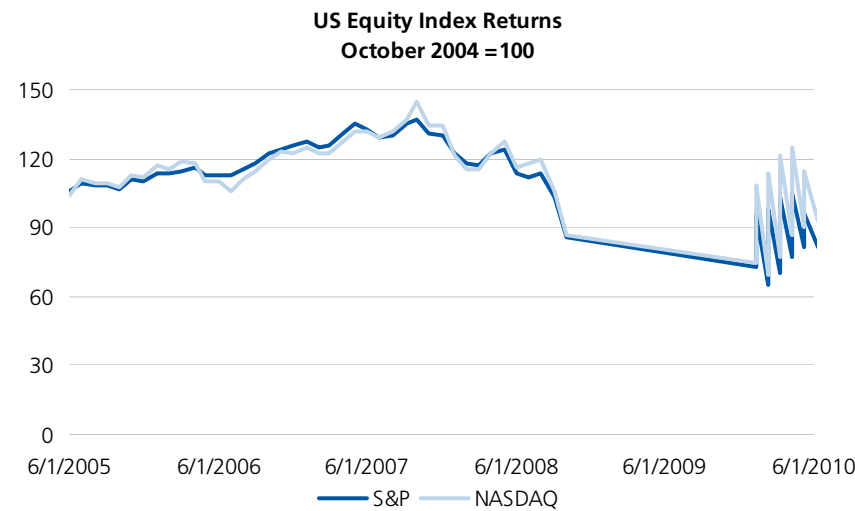
**Figure 2: DARTs Improvement Q1 2010**



Source: Company reports

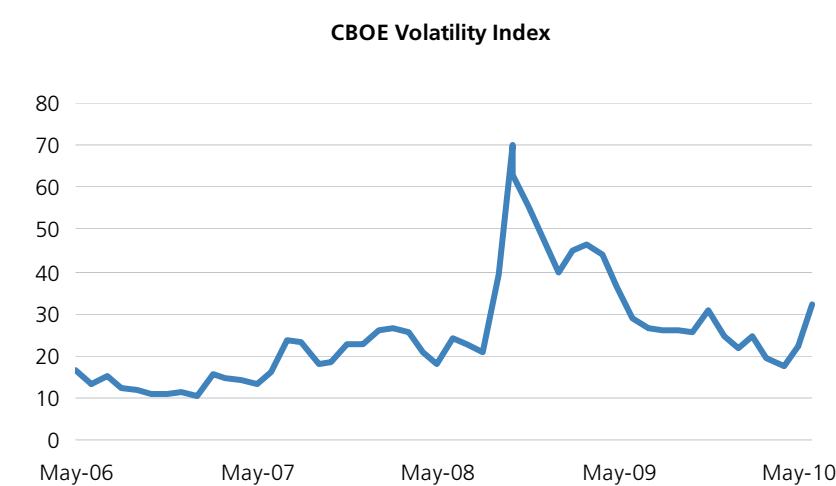
- The slight increase in trading volumes coincides with improved yet volatile S&P and NASDAQ indices, as shown in Figure 3. High market volatility (Figure 4) has benefited firms because it creates more profit for both the trader and the firm. Active traders take advantage of market volatility to make short-term investment returns. This trend has also been supported by the increase in trading products available, including options and futures.

Figure 3: Equity Markets' Slight Improvement



Source: Yahoo Finance

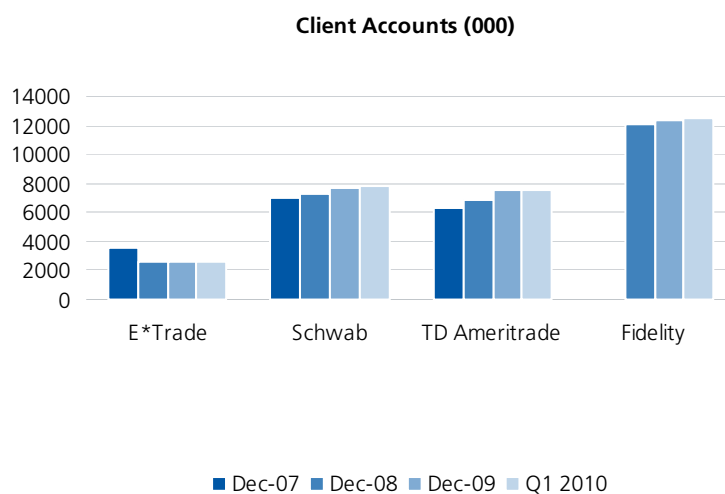
Figure 4: Increased Market Volatility



Source: CBOE

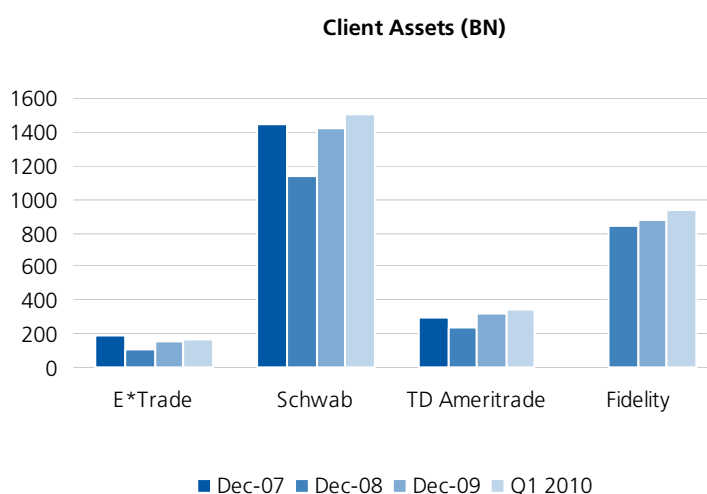
- Brokerage accounts and client assets continue to grow at major online brokerage firms, as depicted in Figure 5 and Figure 6.

**Figure 5: Brokerage Accounts**



Source: Company reports

**Figure 6: Client Assets**



Source: Company reports

- Investor migration to the self-directed model. The improved market conditions have led investors to opt for the self-directed model. While this has gone on throughout much of the market downturn, we have seen an acceleration of investors moving away from managed brokerage relationships to self-directed investments in order to have more control of their financial decisions.
- An increased focus on the active investor and active trader markets. The active investor market has traditionally been underserved by online brokerages. Retail brokerage firms have been quick to react through a combination of innovative trading tools, increased product offerings, and improved customer service. Today the US is one of the most developed markets for active investors and active traders because of a good combination of clients, products, markets, and brokerage firms.
- Technology drives active trader market growth. The role of online trading platforms and associated tools is key for active investor involvement. Online tools allow trading when and where the trader wants.
- Reduced and flat models for commissions. In the race to keep and attract investors, traditional brokerage firms like Fidelity, E\*Trade, and Schwab have lowered commission rates and even offered commission-free trades for certain securities. In general, simplicity and transparency in pricing encourage traditional investors as well as more active investors to trade with a firm. High volume traders get even more benefits from this model, because firms have introduced commission-free trades for some securities such as ETFs or options or for higher volume trading.
- Better guidance at a better price. Investors that left traditional brokerages for more self-directed models are seeking better guidance at a lower cost. Online brokerage firms have had to simplify their pricing structure and provide increased clarity about commissions and broker fees.
- Innovative platform services. Firms have focused on improving their trading platform offerings. Some of the latest additions include advanced trading functionalities, increased product coverage, direct international trading, access to research, and mobile trading.
- Rise in knowledge-building features for all investors. Providing a comprehensive set of educational and decision support resources designed specifically for advisors and brokers and



end clients. These include investor resource centers, web seminars, webcasts, research, and educational videos. Training and educational tools have become the differentiators in the value proposition.

- Diversification of business offerings. In addition to trading functionalities, some firms have expanded their offerings to include related banking and investment solutions including checking, money market, and savings accounts. A special focus has been placed on retirement planning including individual and small business 401(k) and IRA accounts to help investors meet their retirement goals.

## Product Preferences

Market volatility since 2008 has led to greater demand for a more diverse set of products. Despite slower growth rates in 2009, during the past year we have seen an uptake in fixed income trading, options, and foreign exchange. Meanwhile mutual funds and equities continue to be traded at lower levels than their 2007 peaks.

From 2003 to 2007 retail investors increased holdings in mutual funds and equities. Retail holdings of mutual funds increased by almost US\$2 trillion over this period, peaking at just over \$5 trillion, and investors turned to products that allowed them to hold equities indirectly. However, in 2008 retail holdings of mutual funds dropped over 30% and just under \$2 trillion in one year, and investors fled the equity market, leading to a 40% drop in indirect equity holdings and a 25% drop in direct holdings. While mutual fund and equity holdings have rebounded since the 2008 lows, both remain over \$1 trillion lower than the 2007 highs.

US retail investors continue to prefer putting their money in fixed income securities over US equity funds. Fixed income products remain popular for retail investors. During this period of ongoing equity market volatility, retail investors see bonds as a safe and predictable source of income. Retail holdings of fixed income products are likely to continue growing as baby boomers moving towards retirement change to a more conservative investment strategy. As more exchanges move to electronic trading platforms, online brokerages will be able to link to these markets directly. In response to market trends and increased access to fixed income markets, online brokerages are expanding their bond trading capabilities.

Both options and foreign exchange trading volumes increased rapidly from 2003 through 2008 and leveled off in 2009. However, data from 2010 indicates that trading in these products is increasing. The price volatility of options and foreign exchange products is a benefit in current market conditions, and the more sophisticated investors who prefer products with price volatility view trading in these products as a way to maximize profits and minimize losses during the current market conditions. As the active investor and active trader customer segments grow, their preference for products that allow more advanced trading strategies with multi-leg positions will continue to drive retail investor trading in options higher.

The online brokerage industry has benefited from and fed the growth in options trading in a variety of ways. Firstly, technology enhancements have made it easier to offer options trading through online brokerages. Also, brokerages have embraced options trading because it remains profitable due to high commissions and complex strategies that require multiple leg positions. Online brokerages offer educational resources in options trading so as to prevent investors from losing money in complex products, but also to drive traditional investors towards greater familiarity with more profitable products. As a result of overall investor familiarity, of market volatility favoring products with price volatility, and of a strategic push from online brokerage firms, the majority of online brokerage firms now offer options trading to both traditional and active traders. This continued growth has made options investors an important segment for online brokers. While foreign exchange firms still capture the majority of online trading volumes, interest from primarily the active trader segment is influencing online brokerage firms to enter this market.

# Client Segmentation

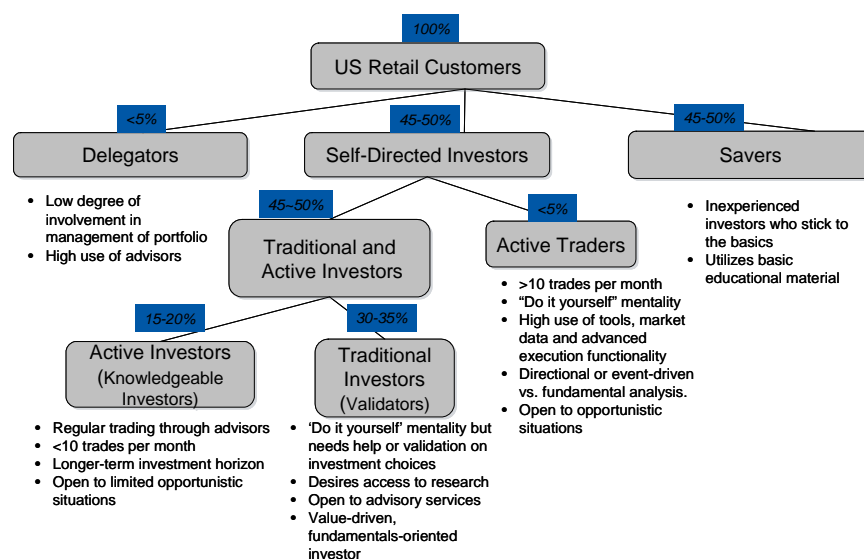
Celent defines investors in the following three categories:

- Traditional investors. Long-term investors with sporadic trading activity.
- Active investors. Investors trading between 3 and 10 trades per month. The majority of firms group traditional investors and active investors under one category, offering similar trading services and tools.
- Active traders. Investors trading over 10 trades per month. This group of investors tends to be more self-directed and is less interested in advice.

Active investors and active traders share similar characteristics in that they tend to be more sophisticated and demand enhanced tools. However, their trade frequency differences necessarily affects each segment's preferences. Active investors and active traders both demand advanced trading capabilities, integrated charting features, and real-time market information, however, active traders are more sensitive to commission rates, execution speed, and availability of streaming information. Active investors, however, put more weight in availability of services such as education and networking.

Celent's view on the US retail customer taxonomy is presented in Figure 7.

Figure 7: US Retail Investor Taxonomy



Source: Celent

Celent has placed online brokers in a taxonomy that groups brokerage firms by client segmentation, as shown in Table 1. Firms are categorized according to the characteristics of their typical users, focusing on either traditional investors or active investors.

Within the active investor segment, firms target either quasiprofessional traders or nonprofessional traders. The quasiprofessional designation is based on the types of tools and information used by the client set, and includes such things as sophisticated charting and back-testing of investment strategies and the ability to build complex trading strategies across asset classes.

Within the traditional investor segment, firms are classified by business model as publicly traded stand-alone firms, private stand-alone firms, wirehouses, bank broker-dealers, independent broker-dealers, or asset managers.

**Table 1: Celent's Online Brokerage Taxonomy**

Client Segment	Predominant Products	Business Model	Representative Firms
Active Traders	Options Futures FX	Active Traders	Lightspeed
			Just2trade
			TradeStation
			Interactive Brokers
			thinkorswim
Traditional investors and	Equities Mutual funds ETFs	Larger publicly traded stand-alones	E*Trade
			Charles Schwab
Active investors (<10 trades per month)	Increased trading in options	Stand-alone players	TD Ameritrade
			optionsXpress
			Scottrade
			Sogotrade
			TradeKing
			Zecco
		Bank broker-dealers (partially advisor- dependent)	Bank of America (its online brokerage ser- vice is known as Merrill Edge)
			Wells Fargo
		Asset managers	Fidelity
			Vanguard
		Wirehouses and independent broker- dealers (fully advisor- dependent)	Merrill Lynch
			Citi/Smith Barney
			LPL

Source: Celent

## The Active Investor Market—An Attractive Segment

The biggest segment of the active investor and active trader market is the traditional 35–45-year-old males. In addition to trading activity, these investors are differentiated from more traditional investors by the following characteristics:

- Tend to be more self-directed, with less reliance on advice.
- Favor sophisticated products, such as options, futures, and currencies, that exhibit a large degree of short-term price volatility.

- Their knowledge of the market requires advanced tools and execution platforms.
- Comfortable using leverage to enhance returns.
- Can be very sensitive to commissions and trading fees due to high trading volume.

Then there is a newer segment of 55–65-year-old retirees. This group is characterized by:

- Activity and profit-driven, but more risk-averse than the traditional segment.
- Primarily male, but has the most women of any segment.
- Sparse users of technical tools.
- Prefer simple products.
- Less comfortable with leverage.

Active investor and active trader product preferences are for products that feature price volatility, quick profit/loss resolution, tax advantages, and leverage. In terms of product preference, there has been a strong move to options, futures, and commodities, and less of a focus on equities. Foreign exchange is also of interest, and most firms targeting the active trader segment are supporting it. The active investor segment has not shown as much interest in foreign exchange products, though we believe this will change over time.

Active investors and active traders have multiple online brokerage accounts at different firms. Active investor and active trader brokerage firm preferences are for firms that charge lower commission rates, offer premium features, and provide educational tools. As stated previously, active traders tend to be more price sensitive than active investors, however, both perceive their more frequent trading patterns as compared to traditional investors as reason to receive lower commission rates. Tools, as opposed to commission rates differentiate firms for the active investor. Firms serving this segment are relatively small compared to those focused on traditional investors when measured in terms of value of assets and number of customer accounts. However, due to the frequent trading activity of their customers, these brokers account for a large proportion of US online trading volumes.

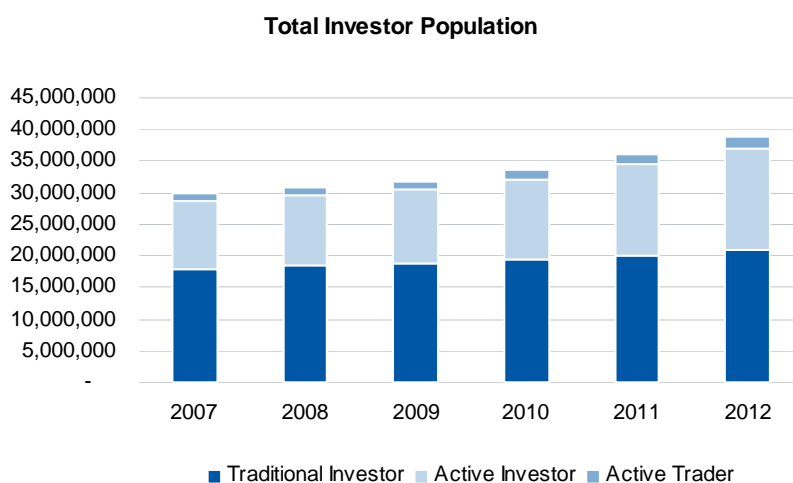
Within the active trader segment, traders are highly sophisticated individuals or paid investor trading groups executing complex and opportunistic strategies requiring advanced trading technology. Trading strategies are developed, back-tested, and executed on the online platform. Firms serving the active trader market offer real time news

and data, superior execution speed, direct market access with multiple routing choices, customizable platforms, and advanced automation capabilities. These firms tend to have lower round-trip commissions, a more monoline product structure, and a greater reliance on commission revenue than their counterparts serving traditional investors.

## Sizing the Active Investor Market

The retail investor population has been affected greatly by the financial crisis of the past couple of years. However, despite market conditions, the self-directed market showed signs of moderate growth of 3% in the past year. Traditional investors make up the bulk of investors (58%), while active traders will remain a small subset of the overall retail market, accounting for 4% of investors. Both active investors and active traders present a significant opportunity for firms, with growth rates of 9% and 8%, respectively, by end of 2010. By 2012, the active investor market will reach 16 million investors, making up 40% of the self-directed market. Figure 8 shows the investor population breakdown and growth potential.

**Figure 8: US Retail Investor Market Size and Growth**



Source: Celent estimates

# Recent Developments in Online Brokerage Technology

No matter if a firm is buying or building an online brokerage platform, it will need to have the bells and whistles to attract and retain customers. During the past year, firms have been adding a number of new technology enhancements to remain the online brokerage provider of choice. Those firms that are willing to invest and adapt to client demands will be future industry winners.

**Product expansion.** Early developments in online brokerage technology focused on trading pipes and connections. The majority of firms have offered clients the ability to trade equities, mutual funds, and ETFs for several years. Over the past two years, options have now become more common products to online brokerages. Some firms seek to differentiate themselves by offering access to fixed income, foreign exchange, and foreign equities.

**Different platforms for different types of customers.** Online brokerages have expanded their capabilities to offer different trading platforms for different types of customers. The majority of firms offer a standard online platform that features standard trading of equities, mutual funds, ETFs, and sometimes options. These firms then offer a more sophisticated downloadable platform with more complex tools for the active trader, or a different platform based on the type of product being traded. Firms such as Zecco and Lightspeed offer separate platforms for foreign exchange products; Scottrade offers an options trading platform, whereas E\*Trade offers TT Trader for futures trading. Firms that target mainly active traders offer scaled-down web-based platforms. These lighter platforms often lack the streaming data and advanced charting that high-end active trader platforms offer.

**Software as a service.** The SaaS model allows firms to use software modules as needed, reducing maintenance and administrative costs for the firms. Firms offering real time account opening for investors provides a specific example in which the SaaS model has allowed online brokerage firms to provide a new feature at a reduced cost.

**Social networking and client education tools.** Online brokerage firms offer a variety of expanded education tools that take advantage of new technologies. Many firms have taken advantage of recent web 2.0 developments to offer clients access to expanded video libraries, chat rooms, discussion forums, client blogs, member tracking, and rating



member suggestions. These tools appeal to both active traders and traditional investors for different reasons. Online brokerages use these tools so that the traditional investor may become more loyal to the brokerage firm brand. These tools also help the traditional investor upgrade to the more lucrative active investor. For the active investor, these tools provide advice and feedback for advanced strategies and market news. Social networking tools allow firms to create client-driven educational content, and eventually may help reduce costs associated with other educational tools provided by the firm such as videos and research.

**Mobile delivery.** While providing mobile online trading was more for the traditional brokerage firm and only offered basic capabilities, nowadays this channel has expanded its reach throughout all types of brokerage providers. In addition, web-based mobile platforms now have many capabilities that software-based platforms offer, including access to streaming quotes and other market data. The most serious trader still uses the software platforms, but they are interested in being able to follow the market and conduct trades on their mobile device.

As mobile devices such as the Blackberry and iPhone continue to improve their hardware, there are greater opportunities for online brokerages to offer advanced applications for PDAs. The first applications for mobile devices provided balance information and basic trade capabilities. Currently firms offer applications so that users can make standard trades, view account balances, transfer funds, and provide access to market information. As mobile devices continue to gain popularity and the networks continue to improve, more online brokerage firms will offer streaming market data and advanced charting capabilities.

**Improved usability.** Web services enable innovation for front-end solutions in the online brokerage industry. They are implemented by combining standard and existing technologies such as HTTP, XML, SOAP, and WSDL. These well-defined protocol interfaces enable automation of operational processes, to provide access to existing internet content, and to publish and use innovative services. The use of web services has enabled online brokerages to improve usability in a variety of manners. Online brokerages have improved trading functionality and usability of their platforms for all customer segments. Since many brokerages offer similar products to trade, online brokerages must differentiate themselves by improving usability and navigation.

Improved usability also starts with organization and aesthetic. By organizing tools into intuitive headings, brokerage firms have been able to make the layouts less cluttered and the tools easier to find. One impor-

tant feature enhancement of trading platforms is the increased customizability of the trader dashboard. Investors can manage their viewing screens and dashboards in a wholly personalized manner, giving investors the freedom to choose what is key to their needs. Online brokerages have made it easier to manage watchlists and alerts, and orders have become easier to execute via point-and-click entry order and auto-trade features. In addition to standard trading orders, all customer segments have greater access to more advanced trading orders such as stop orders, complex options, and automated trading. Lastly, investors have more access to technical analysis tools, access to their accounts, and tax management tools.

## Trading Functionality for the Active Investor

As more products are being offered to all customer segments, online brokerage firms must find new ways to appeal to the active investor market. Table 2 shows that online brokerage firms offer many of the same product types and tools for the active investor as they do for the traditional investor category. As such, online brokerage firms must differentiate themselves by: the analysis and market research tools they offer, the sophistication of the educational sources and social networking capabilities, and the usability of trading platforms they provide.

**Table 2: Active Investor Comparative Products and Services**

	Charles Schwab	E*Trade	Fidelity	Just2trade	OptionsXpress	Scottrade	SogoTrade	TD Ameritrade	TradeKing	Zecco	Bank of America (Merrill Edge)	Wells Fargo	Interactive Brokers	Lightspeed	thinkorswim	TradeStation
Stocks	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■
US equities	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■
International equities		■													■	
Mutual funds	■	■	■	■	■	■		■	■	■	■	■			■	
Fixed income	■				■	■		■	■		■				■	
Options	■	■	■*	■	■	■	■	■	■	■	■	■	■	■	■	■*
Futures		■			■								■		■	■*
FX		■	■*							■			■	■	■	■*
ETFs	■	■	■	■		■	■	■	■	■	■	■	■	■	■	■
Banking	■	■						■			■	■				
Advice	■	■	■					■			■	■				
Education	■	■	■	■	■	■		■	■	■	■	■	■	■	■	■

Source: Company responses to Celent questionnaires and company websites  
Key: ■ Supported; ■\* Supported for active investors and active traders only.

**Table 2: Active Investor Comparative Products and Services**

	Charles Schwab	E*Trade	Fidelity	Just2trade	OptionsXpress	Scottrade	SogoTrade	TD Ameritrade	TradeKing	Zecco	Bank of America (Merrill Edge)	Wells Fargo	Interactive Brokers	Lightspeed	thinkorswim	TradeStation
Social networking	■	■	■		■	■		■	■	■		■	■	■	■	■

Source: Company responses to Celent questionnaires and company websites

Key: ■ Supported; ■ Supported for active investors and active traders only.

As noted previously, platforms are differentiated by the type of customer segment they serve. As such, the active investor and active trader has access to more sophisticated platforms, offering the most complete set of market data, trading options, charting tools, and speed. Some of these more advanced platforms still maintain some of the basic functionalities for standard trading in equities, options, mutual funds, and ETFs, as well as offering alerts, watchlists, keyboard short-cuts, real time account information, screeners, and a variety of charting tools. Furthermore, online brokerages have worked on making their basic platforms more customizable for each user. Firms such as Schwab and TD Ameritrade that offer intermediate platforms, often designed for more sophisticated traditional investors to semi-active traders that feature greater integration, more sophisticated charting tools, and often streaming data. While tools have greatly improved over the past five years, the active trader platforms continue to offer greater customizability and sophistication.

Platforms for the active investors and active traders are fast, complex, and often intimidating to the traditional investor. Table 3 demonstrates many of the trading functionalities offered by different firms on the more sophisticated platforms. The customizability of these platforms make them flexible enough to appeal to both the active trader and to the active investor, despite different trade patterns and objectives. Market data and research are important to both active trader and active investors, however, the speed at which this can be obtained is particularly relevant to active traders. Active traders require the most up-to-date market and portfolio data, and require enhanced execution speed. To that end, the fully customizable dashboard features streaming news, RSS feeds, and streaming charts with integrated trading functions. In addition to these tools, the platforms offer real time account transfers, portfolio rebalancing, multiple routing orders for execution speed, and calculation of margin and back-testing. Users have access to a variety of short-cut keys to enter trades, automated trading tools such as point-and-click order entry, auto-invest, auto-trade, and auto-trade review. Though speed is important to the active

investor, availability of information, advanced trading orders and charting capabilities to execute complex trades will take precedence. On these platforms, investors have access to stop orders, conditional orders, complex options trading, level II quotes, and virtual/paper trading. Active traders and active investors benefit from more advanced real time charting tools such as historical options charts, volatility views, and risk/reward analysis. One of the latest tools for investors is the ability to enter a trade from related websites such as Yahoo Finance, basically allowing trading while browsing.

**Table 3: Active Investor/Active Trader Trading Functionalities**

	Bank of America (Merrill Edge)	Charles Schwab	E*Trade	Fidelity	Interactive Brokers	Just2Trade	Lightspeed	OptionsXpress	Scottrade	TD Ameritrade	thinkorswim	TradeKing	TradeStation	Wells Fargo	Zecco
Auto-invest	■		■										■		
Auto-trade	■		■	■							■	■	■		
Automated trade review	■	■	■	■	■	■	■	■		■	■	■			■
Block trade	■		■		■		■				■	■			
Stop orders		■	■	■	■	■	■	■	■	■	■	■	■		
Point-and-click entry		■	■	■	■	■	■	■	■	■	■	■	■	■	
Complex options	■	■	■	■	■	■	■	■	■	■	■	■	■		
Conditional orders		■	■		■				■	■	■	■	■		■
Back-testing		■	■						■	■	■	■	■		
Advanced charting (volatility view, etc.)	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■
Portfolio rebalancing			■	■	■			■				■			■
Portfolio monitoring		■		■	■	■	■	■	■	■	■	■	■	■	■
Tax management			■	■	■	■					■	■		■	■
Streaming market data	■	■	■	■	■		■	■	■	■	■	■	■		■
Real time access to balance and positions	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■

Company responses to Celent questionnaire and company websites  
Key: ■ Supported

Education, research, and social networking tools are often open to all customer segments. Active investors are likely to use these tools to learn more complex strategies, to get advice about portfolio recommendations, or to confirm existing strategies. Most firms offer free

analyst independent research from Thomson Reuters or S&P to all their customers; however, firms will often offer active investors premium access to research from companies such as Goldman Sachs. In addition to this research, online brokerages appeal to active investors with webinars, videos, and Q&A discussion forums that feature complex strategies and options trading.

The active investor requires a stable platform that is able to execute fast trades under any market circumstance and requires up-to-date market data and charting tools to make an informed trade. As more real time tools and complex analysis features become available to the traditional investor, online brokerages will enable the active investor to have access to more sophisticated trading platforms, up-to-date market data, and other perks in order to court this profitable client segment.

## Looking Forward

Market volatility has led to changes in the self-directed market behavior since 2007. While the traditional “buy and hold” investor segment has grown little over the past three years, active investors and active traders who are looking to maximize profits in volatile markets have increased their relative size significantly. Based on our research, we can make the following conclusions about the US self-directed market:

- Growth rates in the self-directed investor market will improve over the next three years.
- Access to sophisticated investment products as well as market volatility will encourage the active trader and active investor segments to grow at a faster rate than the traditional investor segment.
- Retail investors will demand access to a more diverse set of products including fixed income, options trading, and foreign exchange.
- The online brokerage sector will face more consolidation.
- High trading volume and use of complex trading strategies make the active investor and active trader a very profitable segment for online brokerages. As these segments continue to grow and make up a good proportion of the self-directed investor market, online brokerages will need to enhance their platforms to remain competitive. The most important additions will include: access to additional products, more sophisticated trading tools, enhanced education materials, more social features, improved mobile access, and improved navigation and design.

Self-service has never been a more attractive alternative to full service brokerages than it is today. The active trader and active investor will thus play an increasingly important part in profitability for the online brokerage as their relative size continues to grow. As online brokerage firms continue to expand capabilities and investor sentiment turns away from professional advice towards peer-driven content, the future of online brokerage will remain bright.



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