INVESTMENT BANKS & BROKERS
In the Battle for New Brokerage Accounts, Who’s Winning Between Industry Incumbents and Startups? It’s Complicated

INDUSTRY OVERVIEW

• In the battle for new brokerage accounts, who’s winning between industry incumbents and startups? It’s complicated. As we discussed in our recent industry study "2018 Digital Wealth Management & Personal Finance Innovators," the wealth management space is evolving at an accelerated pace, a trend we think will only continue. In the following report, we take a closer look at account growth over the past year at some of the leading discount brokerage firms and at a group of leading startups, where data can be harder to come by and is generally not aggregated well, in our view. While the established industry players have been enjoying healthy account and asset growth, and are currently leveraging macro tailwinds to invest in their platforms, improving their competitive positioning in many areas, in our opinion, our analysis also highlights the success at some of the leading startups. We believe the incumbents should be monitoring this closely at risk of losing future growth potential as many of the startups have been making inroads with smaller accounts today that could ultimately become more meaningful down the road.

• Several of our high-level observations include:
  ○ The established industry incumbents we analyzed experienced healthy account growth over the past year (~5% on average), and these accounts tend to be at sizable asset levels.
  ○ The startups we analyzed nearly doubled their account base, in aggregate, over the past year, and while we estimate with relatively small account balances on average, the absolute account growth was also well above that of the incumbents.
  ○ While some of the accounts targeted by startups might not be attractive to the incumbents today and comparisons are also not all apples-to-apples, we think the established players should be watching closely as a small account today has the potential to become more meaningful down the road.
  ○ Startups are operating with significantly fewer employees and marketing budgets, potentially positioning them for profitability at lower revenues and adding to their agility and innovation cycles, in our view.
  ○ We believe incumbents are more focused on millennials than many realize and are having better success recently than broadly appreciated. Thus, we do not expect startups to dominate this market unchallenged and we think the younger generation will gravitate toward brands that provide the best user experience, the best value, and, ultimately, can help them reach their financial goals.
Organic account growth in the retail brokerage & digital wealth space has been elevated over the past year; industry leaders enjoyed success (including strong new assets), although notably, startups added more accounts, in aggregate (albeit, at smaller asset levels). The industry has been experiencing strong account growth within self-directed trading, digital wealth management (including robo and hybrid robo platforms), and full-service financial advisors in the RIA channel (benefiting the leading custodians). As we highlighted in our industry study "2018 Digital Wealth Management & Personal Finance Innovators," many incumbents are evolving their platforms at an unprecedented pace, adding new capabilities and expanding their client focus, while a number of startups have also been experiencing noticeable momentum as their models continue to mature.

In Figure 1, the group of established brokerage firms highlighted added an estimated ~4.6M accounts organically over the past year, an impressive 5% growth rate. That being said, while not all apples-to-apples comparisons (different account focus, dramatically different account size, etc.), we estimate that the group of leading startups added over 7.0M accounts over the past year, nearly 100% growth.

**FIGURE 1. Retail Brokerage & Wealth Organic Account Growth Comparison**

<table>
<thead>
<tr>
<th>Customer Accounts</th>
<th>Accounts Added</th>
<th>YOY % Chg</th>
<th>Avg. Assets per Account</th>
<th># of Employees</th>
<th>Startups</th>
</tr>
</thead>
<tbody>
<tr>
<td>Incumbents</td>
<td>Mid-'17</td>
<td>Mid-'18</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fidelity (JMP est.)</td>
<td>~67.0M</td>
<td>~69.5M</td>
<td>~2.5M</td>
<td>4%</td>
<td>~$100k</td>
</tr>
<tr>
<td>Charles Schwab</td>
<td>13.2M</td>
<td>14.1M</td>
<td>~0.9M</td>
<td>7%</td>
<td>~$240k</td>
</tr>
<tr>
<td>TD Ameritrade</td>
<td>10.9M</td>
<td>11.4M</td>
<td>~0.5M</td>
<td>5%</td>
<td>~$110k</td>
</tr>
<tr>
<td>E*TRADE</td>
<td>5.5M</td>
<td>5.8M</td>
<td>~0.3M</td>
<td>6%</td>
<td>~$75k</td>
</tr>
<tr>
<td>Merrill Edge</td>
<td>2.3M</td>
<td>2.5M</td>
<td>~0.2M</td>
<td>9%</td>
<td>~$75k</td>
</tr>
<tr>
<td>Interactive Brokers</td>
<td>0.4M</td>
<td>0.5M</td>
<td>~0.1M</td>
<td>27%</td>
<td>~$250k</td>
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<tr>
<td>Ally Invest</td>
<td>0.2M</td>
<td>0.3M</td>
<td>0.05M</td>
<td>16%</td>
<td>~$20k</td>
</tr>
<tr>
<td>Total</td>
<td>~99.5M</td>
<td>~104.1M</td>
<td>~4.6M</td>
<td>5%</td>
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</table>

<table>
<thead>
<tr>
<th>Customer Accounts</th>
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</thead>
<tbody>
<tr>
<td>Incumbents</td>
<td>Mid-'17</td>
<td>Mid-'18</td>
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<td></td>
</tr>
<tr>
<td>Fidelity (JMP est.)</td>
<td>~7.8M+</td>
<td>~15.1M+</td>
<td>~7.3M</td>
<td>95%</td>
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</table>

1) Fidelity reflects JMP’s estimate for customer accounts and employees, assets reflect total customers assets under administration
2) Schwab reflects all accounts and assets
3) TD Ameritrade "Mid-2017" includes ~3.5M accounts related to the Scottrade acquisition to reflect core account growth
4) E*TRADE reflects all accounts and assets. "Mid-2017" includes 146k accounts related to the TCA acquisition to reflect core account growth
5) Figures on the “Startups” reflect recent news articles, company disclosures, management commentary, and JMP estimates

Source: Company reports, company disclosures, company websites, & JMP Securities LLC estimates

**Incumbents are benefiting from the current operating environment...** The leading incumbents are all performing quite well currently with strong growth, revenue tailwinds from increasing equity markets and higher interest rates, and elevated operating margins (many in the 40-50% range currently) despite significant investment back into the business. This is creating a virtuous cycle as the current favorable backdrop is allowing the scale players to increase advertising & marketing budgets and to offer more services, roll out new products, and improve pricing (i.e., lower or zero trading commissions in some instances, lower or zero investment management fees, more tools and investment features), all in effort to create a better customer experience and drive new account growth. After what we view as a noticeable shift in the cadence of these types of competitive announcements on product innovation and pricing, which we believe the favorable backdrop is supporting, we see competitive behavior amongst the scale players only intensifying further so long as the operating backdrop remains as favorable.

The retail brokerage and digital wealth space continues to experience elevated organic account growth, though we highlight that the less well tracked startups have actually been outpacing growth at the industry incumbents (both rate and in the absolute).
...but many startups are also faring well, arguably taking some share of the targeted growth from incumbents (or pulling forward future growth). The startups highlighted in Figure 1 are growing at a faster pace from a smaller base, but also in aggregate new account additions. The question we are often asked is “how much is eating into the growth potential of the industry leaders?” It is difficult to say precisely since each platform is nuanced and not all accounts are equally targeted. For example, micro-investment firms such as Acorns and Stash, which are expanding exponentially, have much smaller account sizes and average transactions than the leading incumbents, therefore, not a perfect comparison. However, as these accounts mature and scale, we think they have the potential to become more productive, and establishing a customer relationship early is likely an advantage. Importantly, we continue to expect a number of startups to further broaden their suite of financial services and capabilities (or partner with others) as we believe the industry is gravitating toward more holistic, customized, and goals-based relationships (see “2018 Digital Wealth Management & Personal Finance Innovators” for more details). If these firms can effectively evolve with their customers’ needs, we believe the long-term relationships could become quite sticky, something the incumbents must be attune to as these smaller accounts today could represent some of their future potential customers.

Startups are growing with significantly fewer employees and small marketing budgets, better positioning for profitability as they reach appropriate scale, while leaner infrastructures are supporting agility and rapid innovation, in our view. Profitability per account is currently going to be meaningfully higher at incumbents given larger average account sizes and existing monetization models. That being said, we think an element often missed is how much growth the startups are enjoying with far less fixed infrastructure (branches, employees, etc.) and advertising & marketing spending. We believe this dynamic positions some of the startups well if they can continue to scale quickly as we estimate the economics, even off smaller account sizes, can be attractive at a greater level of scale given the lower fixed infrastructure required to service these accounts. Furthermore, we have been impressed by the product innovation cycles at many of the leading startups and believe their smaller organizations and disruptive cultures has supported innovation, agility, and to some degree, risk taking, and we think the established players are beginning to take note of how quickly some of these firms are evolving and expanding.

Incumbents are also having notable success with millennials despite some misconceptions otherwise. With a historic generational wealth transfer just commencing, most firms, from long-established to new startups, understand that today’s millennials will increasingly hold the wealth in the upcoming decades. Accordingly, firms must focus on serving their existing customers (many of which include baby boomers for the established firms), but also create a platform that is attractive to the next generation in order to sustain long-term growth. While many of the startups have been explicitly targeting millennials, with some also attempting to move upstream to wealthier individuals, we would highlight that the established firms have been increasing targeting, and seeing success, with a younger clientele. For example, Schwab noted on its Summer Business Update in July that ~20% of its retail clients are under the age of 40 today, but over half of new clients to the firm are under the age of 40. Similarly, Ameritrade highlighted on its earnings call in January that growth among customers under the age of 35 is up “considerably” from the prior year (a 72% increase). Thus, we generally disagree with the perception we often hear that the established brands will not resonate with a younger audience. While brand does matter and perceptions are important, many surveys suggest that today’s consumers are looking for the best platform and experience to fit their needs. As a result, consumers have less absolute brand affinity and are willing to switch to another brand that better aligns with their goals and values. This can cut both ways, but we believe established firms are much more focused on younger clients today than in the past.
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<th>Regulatory Equivalent</th>
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<th># Co's Receiving IB Services in Past 12 Months</th>
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<td>60.54%</td>
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<td>441</td>
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<td>99</td>
<td>22.45%</td>
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Stock Price Chart of Rating and Target Price Changes:
Note: First annotation denotes initiation of coverage or 3 years, whichever is shorter. If no target price is listed, then the target price is N/A. In accordance with FINRA Rule 2241, the chart(s) below reflect(s) price range and any changes to the rating or price target as of the end of the most recent calendar quarter. The action reflected in this note is not annotated in the stock price chart. Source: JMP Securities.

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