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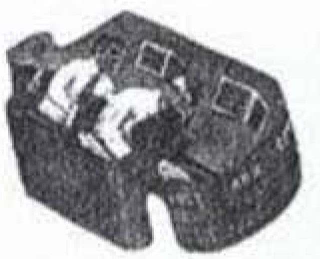
Survival depends on adapting to new market users

How midsized brokerage firms aim for industry niches

By Susan Abbott, senior editor



Contrary to what large brokerage firms might like to think, midsize and small futures commission merchants (FCMs) are not ready to concede defeat in the battle for new customers.

Large firms argue that the future of the brokerage business lies in serving institutional customers. Those customers require a cross section of financial services and like the protection of a well-capitalized firm — requirements that point to a large firm, they say (see "Why Big Brokerage Firms See Brighter Days Ahead," *Futures*, October 1985).

"That the future growth lies in institutional business and that those firms will go to the better-capitalized (brokers) is correct," agrees Leo Melamed, chairman of Dellsher Investment Co. in Chicago. "The new business will be harder to get for the medium or small firm."

However, that doesn't mean firms like his or others, which have customer equity up to $40 million and capital typically less than $10 million, are ready to give up trying to attract the institutional business.

They admit that capital is a major hurdle to overcome with institutions, but not an impossible one.

Frank Franiak, chief executive officer of Anspacher & Associates in Chicago, thinks the question of a firm's capital, intensified by the collapse of Volume Investors Corp. in March, will soon die down.

"It's pretty clear that some form of insurance will be in place before too long, and that ought to alleviate some of those concerns," Franiak says.

Trading through an exchange clearing member provides several levels of protection, says Chicago Mercantile Exchange (CME) Chairman Brian Monieson, who also is chairman of GNP Commodities. In addition to a firm's assets, customers who trade through CME clearing members have a $30 million trust fund as a second tier of defense against a firm's bankruptcy. A third protection is the clearing members' obligation to meet the deficit of a failed fellow member.

"Capital is a perception problem, not a real problem," he says.

Instead, words such as "niche," "specialized service" and "personalization" are on the tongues of many of the smaller firms' leaders.

"The medium-sized firm can maintain its niche by providing specialized service," Melamed says.

For example, a brokerage firm might "tailor-make" a process for the institution to attract a segment of its business.

Flexibility a key

That's the approach Monieson's firm advocates. He says a medium-sized firm's strengths in attracting institutional customers are its flexibility to respond to requests and a more personal relationship with the FCM's staff and management.

His firm intends to compete with the large houses for institutional business by analyzing customers' needs and putting together programs that can help their year-end yield.

Says Monieson, "We have to prepare to become product oriented, not execution oriented."

"You have to recognize where the niche is," he adds. "You have to have the ability to use the relationships that exist in all markets — futures, options and securities — the ability to recognize you're not just futures."

That kind of service requires the help of computers and very knowledgeable people who understand relationships between markets and how a customer could use those to his advantage. Attracting those kind of people is another advantage for the smaller firm, Monieson says. For example, his firm has formed more than half a dozen divisions in which the employees have a direct interest.

Franiak agrees, saying, "It may be true that business is moving toward the institutions. But the commodity business typically is controlled by brokers, not the brokerage firm. The small and medium-sized firms can induce the entrepreneurial broker."

Those kind of people are needed at smaller firms because customers who send only a portion of their business to those firms expect specialization.

"The 'Buy 1,000 at the market' order goes to their own firm," Monieson says.

David Ganis, president of Northern Futures Corp., the brokerage firm owned by Northern Trust Bank in Chicago, sees the entire FCM community focusing on specialized business.

"The futures world today is more and more oriented to specialization and niching strategies," he says. "Large brokers are pursuing institutional business. Others are into managed accounts. But there still are the grain specialty firms and the discount firms that cater to the individual."

He predicts bank FCMs will remain small and not threaten to take institu-

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tional business away from large wirehouses because of the niching strategy that has developed.

"We're mainly going after other banks and some broker-dealers," Ganis says. "A year ago I would have said we were going after all institutional business."

The impetus for Northern to enter the futures brokerage business was twofold, Ganis says. First was the increasing cost of commissions the bank was paying for trading its own account. Second was an increased interest in futures from other banks with which Northern did business.

Eighteen months into the business, Ganis reports the FCM has passed break-even and holds the promise of being a profitable business.

"But if it were freestanding, I doubt we'd be in it," he adds, because commission rates tumbled just as the bank entered the brokerage business.

"Early estimates by Northern were based on competitive rates at the time," Ganis says. "Now rates half that much are freely available."

Not everyone wants institutional business, however. Take, for instance, Les Rosenthal, managing partner of Leslie Rosenthal & Co. in Chicago.

"Institutional business cuts you to the bone as far as rates go," he says. "I'm happy letting the larger firms do the institutional-type business."

Instead, Rosenthal has his eye on the 40 million individuals who trade stocks and will want the flexibility to trade stock indexes, particularly foreign indexes. (Not coincidentally, Rosenthal is a former chairman of the Chicago Board of Trade, which is planning a foreign stock index complex and has two such contracts pending before the Commodity Futures Trading Commission.)

He believes a more sophisticated trader is emerging who will enjoy the ease of trading foreign stock indexes as opposed to trading individual stocks on foreign exchanges.

"It won't be a ball of fire, but it will whet their appetite to trade the other stock indexes, too," he says.

Other advantages Rosenthal sees in sticking with retail business include the back-office system he has set up —

Smaller FCMs aren't conceding defeat in the battle for customers.

geared toward large numbers of small accounts — and the risk that comes from errors and customer disagreements that potentially lead to lawsuits.

Says Rosenthal, "I'd rather chase 10 accounts for \$10,000 apiece than one for \$100,000."

The big question Franiak asks when a firm decides to take on institutional business along with retail is, "Which business is more profitable?"

For example, just a one-tick error on a 100-lot T-bond order priced at \$8.50 would cost nearly four times the commission earned. Meanwhile, a one-tick error on a one-lot cattle trade priced at \$50 would still leave the house with \$46.

The future for medium-size and small brokerage firms lies in profitability — mainly tied to commission rates. Melamed and Franiak say the bulk of consolidation by brokerage firms is over. Melamed thinks commission rates have bottomed, and Franiak says the pickup in markets has helped boost revenues.

Monieson, too, sees great industry growth coming from stock players who have yet to discover futures.

"The business is going to enter a dynamic growth phase over the next five years; it's going to be far bigger than it is today," he says. "And the main reason is because you have not tapped the securities aspect of the business that really is going to learn how to use these markets."

But that doesn't mean every brokerage firm in business today will survive, he says. Monieson, who also runs a data-processing firm, compares it with the consolidation of small computer firms that needed bigger names and more marketing expertise as the industry grew.

"I think the industry can consolidate by another 50% over the next five years," he says. "But that doesn't mean there will be 50% fewer firms. There will be bigger firms coming in who realize they have a hole in their services." □