THE WALL STREET JOURNAL.

EXCHANGE --- Weekend Investor -- The Intelligent Investor: The E*Trade Deal Reveals the New Rules of the Investing Game --- Brokerages don't want to be your 'financial supermarket.' They want to grab your cash.

By Jason Zweig
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Morgan Stanley 's takeover of E*Trade Financial Corp . for $13 billion shows how drastically the brokerage industry's business model has changed.

Firms no longer want to offer investment products from all sources. Instead, they want to milk their customers' cash and manage all of the assets themselves. Investors need to understand the rules of the new game.

For decades, big banks and brokers aspired to become "financial supermarkets" where consumers could open bank accounts and buy stocks and bonds, mutual funds, insurance and the like.

In the 1980s, Prudential Financial Inc . sold securities alongside insurance. American Express Co . pushed brokerage services and financial advice to credit-card customers. In the 1990s, Citigroup Inc . flogged stocks and mutual funds in its bank branches. Even the retailer then known as Sears, Roebuck & Co . sold securities in its department stores, earning the nickname "Socks 'n' Stocks."

Some outfits -- especially Charles Schwab Corp . and Fidelity Investments -- made one-stop-shopping work, managing money themselves while offering funds from other firms as well.

But most flailed. Prudential paid more than $1.5 billion in regulatory fines over sales of risky partnerships. American Express , Citigroup and Sears sold their brokerage and fund units.

Nowadays, the name of the game isn't to offer all things from all sources to all investors. It's to offer only what keeps the fees in-house.

Much as the Plains Indians used every part of the buffalo, from flesh to skin to horn to sinew and hooves, Wall Street excels at creating strategies with fees that can be harvested from every component. In practice, that means investment firms want to grab as much of your money as they can and farm out as little of it as possible.

Wall Street can't make oodles of money off your trades anymore; **technology** has driven commissions to near zero. And it can't make the windfall it once did off managing portfolios; there, too, market-tracking index funds and exchange-traded funds have become cheap as dirt.

Where are the remaining profits for brokerage firms?

They can take your cash and, instead of investing it for your benefit in the highest-yielding money fund or deposit account, they can put it in their own bank and pay you peanuts. Then they lend it out and keep the profit for themselves.

Morgan Stanley , E*Trade and Schwab all own banks to which they route much of their customers' cash. E*Trade pays its customers 0.01% to 0.25% on their uninvested cash; Morgan Stanley , 0.03% to 0.2%; Schwab, 0.06% to 0.3%.

Brokerages have been pocketing 2% and up on that money (and you can do almost as well, if you pull the cash from your brokerage account and park it in a certificate of deposit or savings account at the right online bank).

Schwab, which has hoovered up $220 billion in bank deposits, earned 61% of its total net revenues in 2019 from the interest it captured on those balances.

Financial firms can also invest your money in funds they run themselves. That way, they capture fees you would otherwise pay to somebody else.

By my estimate, 57% of the $16.5 billion in total assets of the FlexShares ETFs, managed by an affiliate of Northern Trust Corp ., are held by Northern Trust clients. The firm "adheres to an open-architecture investment platform, applying the same objective and rigorous selection process to third-party and proprietary investment products," says a spokesman.

Even Vanguard Group , the investment giant owned by its fund shareholders, is freezing out other firms. In its $161 billion Personal Advisor Services program, which manages money for individual clients, Vanguard won't recommend mutual funds or ETFs from any other companies. Clients aren't compelled to sell their non-Vanguard investments, says a company spokesman.

The house brand isn't always bad, of course. A firm's own funds can be cheaper or better than the alternatives. But investors need to be on their guard: Under federal rules, a firm can recommend its store-brand investments whether they are ideal or not, so long as they are a "reasonable" choice.

Finally, complexity pays -- for investment firms, if not their clients. Take "structured notes." The return on these short-term debt instruments is pegged -- often in complex ways -- to the performance of other assets, often stocks or market indexes.

You can lose money, but issuance is booming; in less than one hour on Thursday, banks and brokers filed nine prospectuses with the Securities and Exchange Commission . Here again, firms often hawk them to their own clients.

Structured notes are a fee bonanza. Firms rake in upfront charges of 1% to 4.5%. They earn more fees for calculating the value of the notes. They also can make money by trading against the assets the structured products are linked to. There's generally no market, so if you need to sell before maturity, the firm will buy your note at a price it sets -- including a "spread," or trading cost to you.

The best questions to ask on the new Wall Street, then, are these: What are my financial advisers doing in-house that someone elsewhere could do cheaper or more safely? Where do my brokers put their own cash? Do my advisers buy structured products for themselves? Above all, should I diversify not just my portfolio -- but my financial advice?

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Heard on the Street

Morgan Stanley Didn't Get a Discount --- There is sound logic to the purchase of E*Trade , but the rich price sets a high bar for creating value for investors in the near term

By Telis Demos
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There is a lot to like about Morgan Stanley 's most ambitious foray beyond Wall Street, but there isn't yet a lot to bank on.

Morgan Stanley paid a hefty price for growth and stability. By acquiring E*Trade Financial for $13 billion in stock -- about $3 billion above where the discount broker closed on Wednesday -- Morgan Stanley will likely dilute its tangible book value by roughly 10%.

The question is whether the firm can earn it back. From an overall strategic standpoint, the deal is fairly straightforward: Morgan Stanley for years has been moving more heavily into wealth management, and the notable piece it was missing was a truly mass-market retail program. E*Trade , known for its online-trading platform, brings that. It has over five million individual-investor accounts and a brand that isn't out of place in a roster of Super Bowl commercials.

Like other wealth-management businesses, its revenue isn't nearly as volatile as investment banking and trading, and it can grow steadily in a wider array of market conditions. That latter feature is especially important when Morgan Stanley is being put through the annual Federal Reserve stress tests.

Still, given the premium paid and the dilution, the deal merits further scrutiny. E*Trade may no longer generate as much in juicy trading commissions in the era of zero pricing, but it still brings loads of customer cash: $39 billion of deposits in its own bank and $18 billion swept off-balance-sheet. By using those off-balance-sheet deposits to replace wholesale funding at Morgan Stanley , this can help reduce funding costs by $150 million by year two.

Unfortunately, the bulk of E*Trade 's deposits aren't so readily available to be redeployed. For one thing, Morgan Stanley says it has only so much business that can be deposit-funded, though it is rapidly expanding its lending book. Also, E*Trade 's own core business needs to fund margin loans, an intimate part of why people trade with it. So further funding-cost arbitrage gains will take time.

Overall, considering both the funding gains and an additional $400 million in expense savings by year three, Morgan Stanley forecasts an improvement to its return on tangible common equity of 1 percentage point or more. That additional earnings power will most likely cover the dilutive outcome of the stock deal.

Whether there is significantly more upside to the stock is something investors will have to figure out on their own. A few possibilities stand out: The biggest is that E*Trade brings a workplace stock-plan business that will complement Morgan Stanley 's Shareworks, which it built up by acquiring Solium last year. Morgan Stanley has said it could add another million active clients through this channel. Now that number gets even bigger.

E*Trade also is building its independent adviser custody business, a big growth area for its online-brokerage rivals. Morgan Stanley 's own adviser-driven business has tools to accelerate that effort. E*Trade and Morgan Stanley can also now jointly build out a digital retail-banking offering to compete with the likes of Goldman Sachs Group 's Marcus and **fintech** upstarts such as Betterment.

There is one additional possibility: If the deal succeeds in greatly expanding the firm's steady fee-generation capabilities across its wealth business, book value might just not matter as much any more to investors, shifting the valuation conversation to a forward price/earnings ratio. On that basis, Morgan Stanley sits at about 10 times, well short of Charles Schwab 's more than 18 times.

An outcome like that is hardly assured. But with this deal at least it is in the realm of the possible.

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