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The 1987 EPA Mileage Estimates

Camcorders

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Discount Brokers

CAFE Standards

The Gray Market

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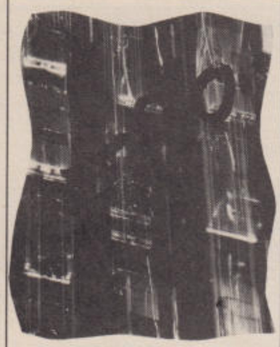

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DEPARTMENTS

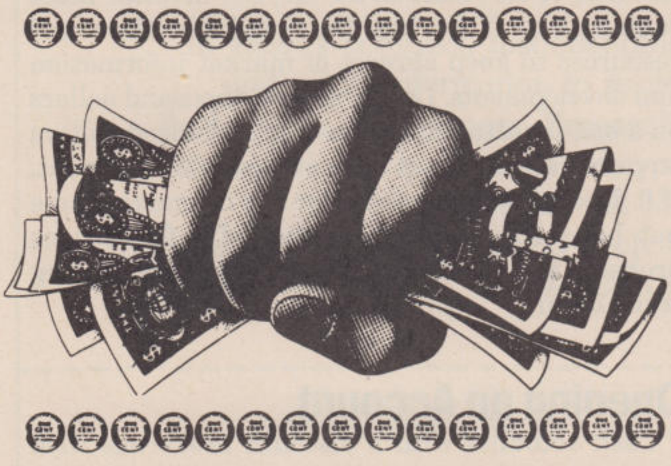
CONTENTS

How to Use A Discount Broker

Bradford Boyle

A relatively new option for investors, discount stock brokerages account for 20% of retail securities traded in 1985, up from 12% two years earlier. The characteristic features of discount brokerages are the buying and selling of securities. The savings can be great because discounters' commission fees are usually substantially lower than those at full-service brokerage firms.

Discount brokerages came into being as a result of a decision by the Securities and Exchange Commission (SEC) on May 1, 1975, abolishing a long-standing Wall Street tradition of a fixed commission schedule on security trades. Prior to the ruling, the New York Stock Exchange (NYSE) controlled the amounts that could be charged, and members of the Exchange (which included most of the large brokerage firms) were prohibited from accepting orders off the Exchange. Thus, shopping for the best price was useless: the only differences between competing firms were the services they offered. The fixed schedule did not allow for discounts on large orders and, because it cost the brokerage firm about the same for a small transaction as a



large one, large trades were the major source of profit.

With the arrival of the SEC's 1975 decision, however, competition entered and rates fell. Discounters appeared shortly thereafter and, although some dismissed them as "fly-by-night" operations, well over 100 firms are in evidence today.

How They Work

A discount brokerage differs from a full-service brokerage mainly in that it offers very few, if any, research services or underwriting departments. The discounter takes little or no interest in your account, and gives limited or no investment advice. By not employing a research staff, discounters are able to keep overhead costs down, and thus can offer lower commissions.

In full-service firms, most employees work on a commission based on the volume they generate, while employees at a discounter are usually salaried and interested only in taking your order. Some discounters act as their own clearing houses, meaning they handle their own trades, securities registration, billing and other responsibilities. However, most discounters contract with other firms to handle these duties.

While discount brokers won't give you investment advice, many provide a diverse range of other services. Discounters now offer such extras as the safekeeping of securities, the collection of dividends and interest, money-market funds, bond trading, extended hours, self-directed IRAs, mutual funds, and more. A few offer computer software so that you can place orders or monitor the markets with a personal computer. Many will provide, on request, free material from independent research sources such as Valueline or Standard and Poor's.

More often than not, discounters belong to the NYSE, which enforces conduct standards and arbitrates disagreements between customers and firms, along with other obligations. Discount brokerages offer securities protection of up to

$500,000 (limited to $100,000 for cash claims) through the Securities Investors Protection Corporation (SIPC). Many carry independent protection for up to several million dollars as well. The insurance covers losses from firm failures, not stock fluctuations.

The major advantage of using a discounter is cost. You can save up to 70% off the price of a full service broker on large-volume stock purchases. A full-service broker, for instance, might charge a commission fee of as much as $399 for a $20,000 investment, while the discounter's fee might be as low as $98 (see chart). The money saved by using a discounter can be used to subscribe to an investment newsletter to help in trading decisions, and the subscription costs are tax-deductible.

Discount vs. Full Service*

	100 shares at $40	300 shares at $30	1000 shares at $20
Discount brokerages			
Quick and Reilly	$41	$75	$ 98
Olde Discount	45	80	105
Charles Schwab & Co.	49	89	122
Full-service brokerages			
Merrill Lynch	86	193	357
E.F. Hutton	84	180	399
Smith Barney	77	169	369

*Prices as of October 1, 1986.

Various methods are used by discount brokers to calculate commission fees. Among the most common:

1. A percentage discount from the old fixed-commission schedule.
2. A set fee, with an additional charge of a few cents per share.
3. A set fee, with an additional charge based on the dollar value of the transaction.

Because discounters can use any of these methods, you should consider your investment plans and match those with the commission method that will cost the least.

If, for instance, you are buying a large number of low-priced stocks, a broker using the third method will charge a smaller fee than a broker using the second. If you are buying a small number of high-priced stocks, then the third method will result in a higher commission fee. An investor should investigate several firms to determine which commission schedule best suits him.

However, if your trades are small and involve low-priced stocks, a full-service broker will probably be cheaper because most discounters levy a minimum commission charge, usually about $35.

But there are disadvantages and dangers when trading with a discounter as well. Because they offer little or no research advice, the investor must contemplate if he has the available time and resources to keep abreast of market information and developments. Losing several thousand dollars on a bad investment but saving a hundred dollars on commission costs is not a successful investment. If it does happen, the investor has no one to blame but himself. One of the duties of a full-service broker is to face unhappy customers when a losing trade occurs.

Opening an Account

Cash accounts with a discount brokerage firm can be opened over the phone or with a short application. Other types of accounts that require equity, such as margin or option accounts, require a deposit of cash or "marginal securities" (stocks that can be borrowed on). Current regulatory rules for these accounts demand a minimum $2,000 deposit. For the more complex (and dangerous) short account, maintenance requirements vary as a percentage of the short market value.

If you open an account, you are under no obligation to make any trades, but the broker will request that you supply and certify your tax-identification number. This is the result of a 1983 Internal

Revenue Service regulation that states that if no tax number is given, the account will be subject to a back-up withholding tax of 20% of the sale proceeds from "sell" transactions.

Shop around to determine which discounter offers the best services and commissions for your investment needs—most discounters have toll-free numbers. Discounters rely heavily on word-of-mouth advertising, as well as print, so ask around, or check *The Wall Street Journal* for information on various brokers in your area. An increasing number of firms are using television to promote themselves as well. Opening an account is free, so you can have several if you wish.

Since 1983, bank holding companies can also provide discount services: you might check to see if your bank does so. Trading through a bank adds still another option—the withdrawal or deposit of needed funds or sale proceeds directly into your savings or checking accounts. Banks that offer such services are often listed in the Yellow Pages under "stocks."

To trade with a discounter after you have opened an account, all you have to do is call your broker, give your account number, the security and number of shares you want to buy or sell, along with the type of order you want transacted. Most discounters offer a full-range of order executions, including market, limit and stop orders, as well as option and short orders (see "How to Invest in the Stock Market," *CR*, May 1986). Your broker will discuss the various order types if you need clarification.

When your trade has been completed, the broker will mail a confirmation, and many will call you when the trade has been executed. Some firms even offer confirmation of your order within 20 seconds, while you're still on the phone.

A Final Word

Discount brokerages are not for everybody. Using one can result in a disaster for the uninformed or novice investor. But for the confident investor who doesn't need the advice of an expert, a discount brokerage can add profit to an already profitable investment. CR

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