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Stock Jocks Get Their Knocks at BDs

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While reminiscing about the early 1990s and my brokering days at Prudential Securities, I was reminded how much has changed in our industry. Back in the day, my branch manager in Pasadena, California was a wealth of wisdom. I took advantage of his open door policy, frequenting his office with the many questions that come with being a newer representative.

By today's standards some of what he shared would be shocking, such as, "If a rep doesn't have a couple of dings on his compliance record he's probably not aggressive enough," or "Reps that have cocaine problems are usually substantial producers because they are insecure and driven," or one of my favorites, "You want to pass your Series 7, but not score too high." Sometimes jaw dropping and controversial, my former manager's comments provide an interesting contrast to current thinking.

The Truth About Test Scores

Today, FINRA wants to make advisors' test scores available on their public website. They should take note that wirehouses have for decades sliced and diced data on advisors because they ultimately need to put their money where their mouth is, which is in direct opposition to the regulators, who put other people's money where their mouth is.

Regarding test scores, wirehouse data has concluded that reps that passed in the 70% to 80% range were far more likely to be successful advisors than reps that tested at 90% or above. Those that scored unusually high generally lacked the social skills necessary to build and maintain a book, and were better suited to becoming CFAs working in more technical roles that require less social interaction.

Those that tested in the 70% to 80% range had the best social skills. If FINRA wonders why people with lower test scores have more marks, they need to realize the likely answer is they have larger books on average and with more business volume comes greater risk of compliance issues.

Transaction Stock Traders: Gain or Loss?

Also in the early 90s, transactional stock traders were the norm. Having $100,000 of production with $1 million to $3 million of client assets was quite common. My focus was the larger portion on the investment pyramid, targeting income for retirees, so bonds and preferred stocks were more on my radar. But I always enjoyed listening to the active traders strategize stock purchases, often coupled with options trades.

Our branch manager, who was gifted in complex options strategies replied after a pregnant pause, "probably break-even" when I asked him, "If you took all of the options trades you've done over the years, would you be at a gain or loss?"

In today's world of the fee-based model, making $100,000 on $1 million of client assets raises an immediate red flag. FINRA prefers the one percent mark, so $10 million of client assets should produce $100,000 of revenue. Those that record earnings well above the one percent threshold are in the regulatory crosshairs of both broker-dealers and FINRA, and potentially face accusations of churning, inappropriate investments, inappropriate risk levels—the list goes on.

The other type of stock trader that I witnessed in the 90s was the "stock farmer." These traders purchased stocks and, based on fundamentals rather than charts, gave the stocks ample time to grow. Then they harvested the stock, planting new stocks in their place.

It is increasingly rare that I come across advisors that farm stocks, but I consulted with one earlier this year that had $100 million of client assets and was producing $1 million of GDC. Most of those that farm stocks have moved to transacting stocks in an advisory platform because what they earn is similar but carries far less risk of compliance issues.

Alive But Not Well

The transactional "active stock trader" is still alive but not faring well. Far fewer firms are open to churn-prone models and many firms that did cater to these models are now either closed or sold. John Thomas, Merrimac, Brookstone Securities and JHS Capital are but a few of the many firms that are no longer around. Surprisingly, there are still a fair number of firms in and around New York City, Long Island and Southern Florida that cater to the active trader, but their days are numbered.

David Alsup of Fishbowl Strategies explains that over-regulation has been killing equities-focused firms since 2008, and the pace has remained high since Dodd/Frank passed in 2010.

Equities Firm Losses Since 2012

Year	New Firms	Firms Closed	Net Loss
2012	32	164	132
2013	34	145	111
2014	44	104	60
Rolling 12 Months	30	125	95

Alsup further explains that many of those shuttering firms are flocking to investment banking and merger and acquisitions to escape retail regulations.

Of new firms opening, half have been private placement firms, with 12 Reg D filings per day five years ago. Today, that average is up to 250 per day. Securities attorneys see easy billable hours when transactional stock trader customer complaints pop up.

Securities attorney Jim Eccleston of Eccleston Law argues that "Firms catering to stock jocks are like buggy whip companies catering to horse and buggy drivers; nearly extinct. The name of the game is spending time to gather assets for someone else to manage, not wasting time on active stock picking. Add to that the regulatory and customer complaint risks, and there is no doubt that such stock jock firms are going the way of the dinosaur."

A recent consultation I had with a regional firm regarding an active stock trader that was dismissed for not converting to advisory business fast enough brings to light the regulatory pressures broker-dealers in all channels are feeling—get away from transactional stock trading or get heightened scrutiny during FINRA audits.

In another recent conversation, this one with the president of a smaller independent broker-dealer, he explained he was getting rid of reps who were doing lots of transactional stock trades because he felt overwhelmed by the number of questions he had to field during their FINRA audit.

The Model Must Serve the Client

Ultimately, the investment model has to serve the client. If you ask the transactional stock traders the same thing I asked my branch manager, "If you took all the stock trades you did with your clients, would it be a gain or a loss?" You would very rarely hear, "A gain in value." Transactional active stock traders, despite all the forces working against them still persist. However, their numbers will continue to shrink as the risk versus reward no longer supports their model.

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