How Your Brokers Can Make 10 Times More on Your Cash Than You Do

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Photo: Alex Nabaum

By
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When some investment firms say they will treat your money as if it were their own, they mean it — all too well.

If the Securities and Exchange Commission wants to make good on its promise to compel brokers to act in their customers' best interest, it should shine a klieg light on how brokers treat investors' cash.

Investors invest, but of course they leave billions in cash in brokerage accounts, too.

At Morgan Stanley, $6.3 billion of that cash is in a money-market mutual fund yielding 1.8%. On Aug. 13, the firm will shut that fund and sweep its clients' idle cash into bank accounts that, after a transition period, could yield much less.

As Charles Schwab also did earlier this year, most major brokerages have shoved clients out of money-market funds and into lower yielding bank sweeps, thereby capturing much of the return on customers' cash for themselves.

In a bank sweep, your brokerage automatically rakes together and deposits your spare cash in one or more banks. Banks hand the brokerage a hefty fee, and the brokerage hands you some crumbs. For any given investor, a few dollars from dividends or interest income don't amount to much. Rolled together with idle cash from thousands of other investors, they can add up to millions.

Even as short-term interest rates have risen to roughly 1.9% from 1.1% over the past year, brokerage firms have barely budged how much they pay on their customers' cash.

Is This Your 'Best Interest'?
Even as short-term interest rates have risen sharply, brokerage firms are paying next-to-nothing on their customers' cash.

These firms often describe cash sweeps as "a low-cost source of funding." They're not kidding. You've probably never realized how badly you could be getting stiffed: Sweeps often affect only a few dollars at a time, and the disclosures are hard to find, understand and compare.

All this is perfectly legal. Regulations don't require brokers to pay you anything on your cash, says Paul Clark, a partner in banking and securities law at Seward & Kissel in Washington, D.C.

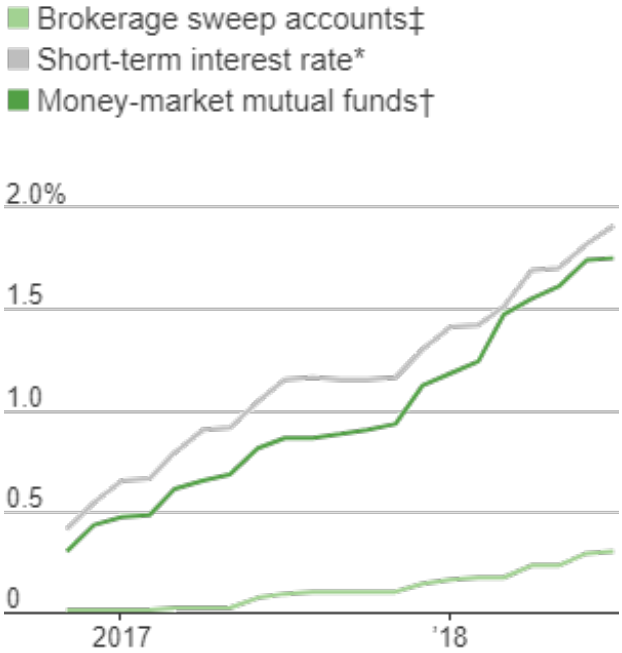
Most firms declined to comment. Others said most clients keep only a small portion of their portfolios in cash, and all clients are free to select money-market funds or other choices.

*Effective federal funds rate †Crane 100 Money Fun Index ‡Crane Brokerage Sweep Index
Sources: Crane Data (sweep, money-market funds); Federal Reserve Board (interest rate)

Bank sweeps have considerable benefits: federal deposit insurance, instant access to your money, checkwriting, a debit card, online bill payment and the like, all with no fees. A broker's profits on sweeps may subsidize other services — lowering commissions, for example. What's more, if you just put your money in a bank instead, the bank would also make a fat spread off you — with even less disclosure of how much profit it is earning.

The foregone gains aren't huge. If you hold $10,000 in cash, you could earn about $200 over the next year, at current yields, in a money-market mutual fund. In the average brokerage bank-sweep account, you would make $19, according to Crane Data, a firm in Westboro, Mass., that tracks cash rates.

Yet brokers talk constantly these days about acting in your best interest. Pushing you into sweep accounts that are far more lucrative for them than for you seems inconsistent with that noble goal.



And sweeps are rife with conflicts.

Many brokerage firms sweep your cash into banks their parent company owns. Charles Schwab's brokerage now deposits all its bank-sweep balances at siblings Schwab Bank and Schwab Signature Bank. "In setting interest rates, the affiliated banks may seek to pay as low a rate as possible," says a Schwab disclosure.

Some firms, including Wells Fargo Advisors, disclose that the adviser assigned to your account may get paid an incentive fee for steering your cash into a sweep at a sister bank rather than encouraging you to shop elsewhere for better rates.

At Ameriprise Financial, which has $24 billion in cash from clients, revenue from sweeps was up 56% in the first half of 2018 over the same period last year, Chief Executive James Cracchiolo said in a call with analysts on July 25.

According to a recent disclosure from Ameriprise, a bank-deposit account earning 1.9% would cost the firm about 0.1% in service fees. Ameriprise pays its customers 0.13% to 0.14% on balances of less than $250,000. The firm keeps the difference, roughly 1.6%. Ameriprise — like many brokerages — makes more than 10 times as much on its customers' cash as they do.

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The sweep business is so lucrative that Ameriprise expects to launch its own bank next year, partly to capture the spread for itself, the company's management confirmed on the July call.

Brokerage customers at E*Trade Financial Corp. averaged $37.9 billion in sweep deposits in the first half of 2018, according to the company's latest earnings release. The firm lists 29 banks where it may deposit cash sweeps, and its disclosures say it relies on an outside

provider's "allocation algorithm" and "objective process" to distribute cash among those banks. Yet E*Trade has deposited 92% of its customers' sweeps at siblings E*Trade Bank and E*Trade Savings Bank, according to its latest earnings release.

For the full year 2017, at the 0.01% yield E*Trade was then paying on cash, it paid all its customers combined only $4 million in interest on sweep deposits, according to the firm's annual report.

In March, E*Trade began raising the yield on its sweeps. Customers are now earning 0.15% on cash balances between $100,000 and $499,999.

Investors with sweep accounts at the brokerage division of LPL Financial Holdings earn 0.16% on a $250,000 balance. LPL, meanwhile, is making roughly 1.85% on its customers' cash, Chief Financial Officer Matthew Audette said on a call with analysts and investors on July 26.

Cash sweeps contributed 25% of LPL's total gross profit in the second quarter, nearly as much as LPL's commission and advisory fees combined, according to a financial presentation by the firm.

At Raymond James Financial, clients have $41 billion in bank sweep accounts, of which 46% resides at Raymond James Bank — up from 37% a year ago. "More and more of the client sweep cash has been directed to our bank as opposed to outside banks," Chief Financial Officer Jeffrey Julien said in a conference call on July 26.

Part of the problem is inconsistent and incomplete disclosure. Some brokerages say how much they are taking in fees; some disclose the maximum they could take. Some disclose they will sweep all your cash to banking affiliates; some don't clearly state that their sibling banks get first dibs on your dough. Regulators could do more to make these disclosures informative.

The bottom line: Brokerages are getting rich on your money. You have the right to change how they handle your cash, and you should.

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