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BROKERAGE VS CUSTODY: EVERYTHING YOU NEED TO KNOW

PILOTAGE PRIVATE WEALTH AG

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Gain an improved understanding of how your investment account works.

A high net worth individual can be faced with something that the majority of the population never has to worry about when it comes to financial assets: too much choice. Everywhere you look there will be a different group of people ready and waiting to declare themselves the experts you've been waiting for.

Much of the focus of financial experts is on the client's risk tolerance, life goals, expectations, behaviors and various important factors to determine the ideal investments and corresponding risks and return. Rightly so, however, a fundamental subject that is often overlooked is the issue of the **safety of the client's assets**, in other words, brokerage vs. custody accounts.

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What is a Brokerage Account?

A financial institution called a broker offers a brokerage account which is also commonly known as a trading account, securities account or investment account. In short, an investor deposits funds in an account that allows the broker/dealer to act on the investor's behalf to buy and sell securities, such as a share in a company. Essentially, a broker will be a middleman the moment you decide you want to invest your assets in the market.

This may sound like something you could readily do yourself, but when you factor in the complicated mechanism of financial markets - for example settling trades, collecting dividends/interest, vote proxies, reporting - you would likely prefer to rely on a broker to handle these necessary steps of investing. As you can imagine, with millions of investors, brokers simply cannot do so on an individual basis. In fact, they need to commingle all the investor's assets and trade **in the broker's name** to make this mechanism work. This is where the term 'street name' emerges - where all securities and cash are held in the name of the broker and not under the name of investor. In order to achieve this, we need to go back to the initial step of an investor depositing funds with a broker. Effectively, the investor is depositing funds that will belong to the broker for purposes of accessing the market that will be for the benefit of the investor. But what happens when the broker gets in trouble whether it be bankruptcy, fines, regulation, fraud and so on?

What is a Custodian?

This is where things get interesting, because 'custodian' is not a term you will have heard very often. People talk about hedge funds, investment banks, and visiting their broker. What they don't tend to mention is the way their account is set up and structured to protect their assets.

A custodian is responsible for the safekeeping of your assets. This is in contrast to the broker who is primarily focused on accessing the financial markets on your behalf. This critical difference can be easily identified by the simple fact that custodians do not commingle client assets whereas brokers do. Client assets that are with custodians are held in 'nominee name' which is to say that investment securities are held **in the name of the client**.

Given the additional layer of security many high net worth individuals and institutions choose a different approach that involves having a separate custodian relationship which makes the custody of the assets independent of the broker. In this case you would need to hire a custodian and an investment manager, and allow the manager to trade through a broker of choice on your behalf.

What are the costs of Brokerage vs Custodians?

Evaluating the costs of each setup provides more clarity on the differences between Brokerage and Custodians.

With a brokerage account, it is very likely that you will not have any account, administration or operation fees, and probably minimal transaction fees. Remember, with a brokerage account, your assets are held in the name of the broker, so your assets sit on their balance sheet. This is how brokers make their profits — by using their balance sheet as collateral for leverage. The main source of revenue comes from charging interest on loans, margin, stock shorts, share lending or any form of leverage.

Since client assets are held in their own name with a custody account, the assets do not sit on the custodian's balance sheet. The custodian does not have the ability to pledge their client's assets for leverage purposes.

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Therefore, custodians make their profits by charging a fee to service, maintain and safeguard the account. There may be a transaction fee in the event that a client wishes to trade.

In 2008 a number of brokers went bankrupt and others had to be acquired to survive. In bankruptcy, the broker's entire balance sheet is considered, which of course includes the client's assets. At this point, we learn about insurance policies brokers are required to have through industry sanctioned companies. However, digging into the details we've noticed that either the insurance companies are not solvent enough for the risk they cover, there is a very narrow definition of what an investor can claim and finally the coverage is often too low for high net worth individuals

Contrarily, with a custody account, the client's assets are not on the balance sheet so if the custodian were to go bankrupt, the client's assets are segregated from bankruptcy proceedings. This means that the account continues to be serviced and the investment manager can quickly and easily redirect any transactions to other financial institutions.

Unfortunately, there isn't a free lunch. With a brokerage account you pay for it with counter party risk whereas with a custody safekeeping account you pay for it through fees and charges.

How Do You Know Which One to Choose?

It's the question we always get asked once we've laid out the fundamental definitions, and it's one which really doesn't have a one-size-fits-all answer. Both brokerages and custodians have their merits, so let's take a look at each of them in turn so you can see where the balance lies. If we keep things simple and avoid any in-depth case studies, you should be able to determine which approach is right for you.

Let's start with the brokerage approach. Here the key selling point you will always be told by anyone who is in favor of it is the chance of higher returns. Since custody accounts incur fees, the lack of fees with a brokerage account allow assets to grow at a slightly higher rate. In addition, should a client want standard loans, margin or any form of debt themselves then a brokerage account might offer better terms since their business is based on debt. All this comes at a cost of counter party risk through leverage.

Now let's turn our attention to the idea of a custodian. Here the key selling point is the safety of the account in the event of a financial crisis. Should you want to withdraw, transfer or change your investments, your assets are always there. If a client wishes to have loans or margin, custodians can offer these services as bespoke solutions. This comes at a cost of having fees which may have an impact on performance.

On the face of it the custodian seems to be a far tamer approach which isn't going to pay off in a big way, but to think that is to miss the whole point of the exercise. In times of normal market operation there's likely to be no appreciable difference between either approach with regards to risk, but this all changes when there's a sudden change in the markets.

What are the benefits and can have you have both?

There are investment strategies that will employ a form of leverage such as with options, forward contracts and margin. Due to the inherent risk of these strategies it might make more sense to use a brokerage account if leverage is an integral part of the investment strategy. A brokerage account could also be more appropriate if the goal is to make calculated aggressive returns with aggressive risk. In addition, there are some accounts which are only offered through brokerage.

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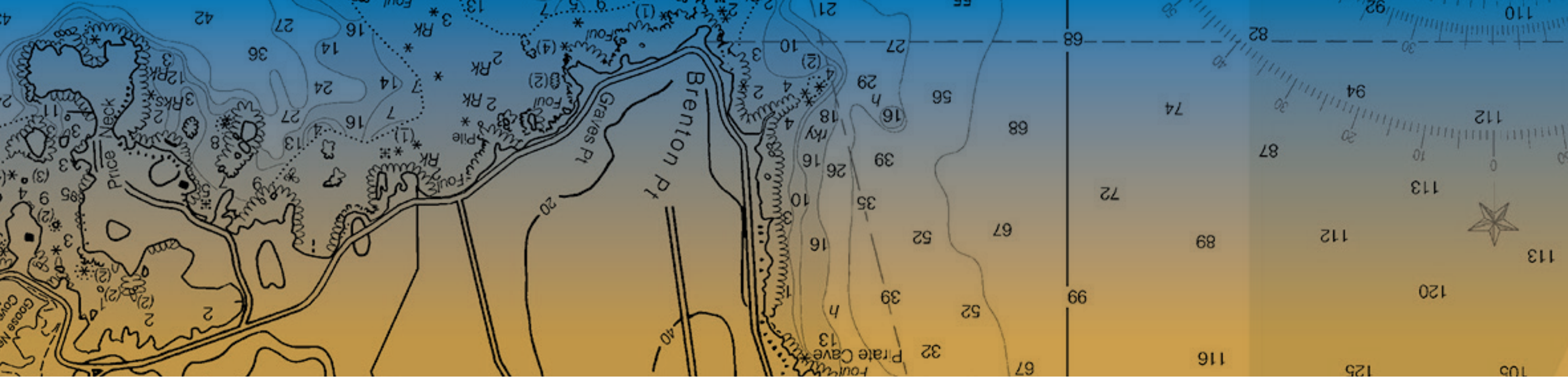
On the other side, investment strategies that are meant to be prudent, long-term and fiduciary-like usually favor a custody account. Investors who are more stewardship-oriented focus more on what can be lost more so that what can be gained. In addition, custody accounts are typically fitting for sophisticated, international, multi-jurisdictional investments which require complex tax reporting, global risk attribution and other functions.

Yet you can have both. An independent advisor with financial acumen can deploy a comprehensive investment strategy across various financial institutions in a synchronized and consolidated manner.

In part two of our series we're going to take a closer look at the world of custodians by looking into Swiss vs US custodians.



For any questions, clarifications, or comments please contact the team at Pilotage:
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Pilotage Private Wealth AG is a Swiss based, SEC registered, independent wealth and asset management practice that partners with US clients to deliver bespoke global investment strategies. In an increasingly complex world, we guide our clients through US cross border challenges to provide a transparent and consolidated approach to multi custody, multi jurisdiction and multi asset strategies.

From generational wealth preservation to asset diversification to philanthropy, PILOTAGE delivers a unique global perspective to capital allocation and risk management in a tax-efficient framework. Our team of experts come together to continuously refine our client's experience to ensure their values are preserved.

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