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Brokerage Commissions and Odd Lot Trading

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Stock brokers charge commissions the calculation of which typically considers the absolute dollar amount and the number of shares among other factors. Specifically, the rate of commission charged is magnified when the number of shares traded is not evenly divisible by 100. With respect to stocks, commissions are typically charged for both their acquisition and purchase.

Not all brokerage houses charge the same commission rates. Brokerage houses may also charge differing rates to customers whose trades are identical.

These commissions are not typically disclosed on the face of the monthly statements. Rather, they are included in the total amount listed as the purchase price or reduction in cash balances associated with the acquisition of the stock. The commission and fees are disclosed as separate items on what is known as the "broker's advice" associated with the purchase of each security. The broker's advice is remitted to the client separately from the monthly statement.

The following analyses are based upon information obtained from a large global broker.[1] The information provided to us was based upon their standard commission and fee schedules. The stocks used to illustrate the economics of investing were selected in an arbitrary manner and are not intended to be recommendations or endorsements.

One of the more controllable factors in managing the cost of acquiring and disposing of stocks is a fundamental principle of avoiding trading in "odd lots". Odd lots of stock are the purchase or sale of a quantity of shares not evenly divisible by 100. For example, the purchase of 99 or fewer shares of a stock is

[1] This broker which provided the hypothetical information in this memo handles certain of my personal and business financial affairs. I also own stock in the parent of the broker.

not evenly divisible by 100 and results in an odd lot. Purchase of 250 shares results in two even lots and one odd lot.

The following is a comparison of the commissions and costs which would have been charged by a large full service brokerage firm on four hypothetical transactions the only difference being one set of calculations assumes 100 shares are involved and the other assumes 50 shares are involved:

Transaction/ Company	Commissions and Costs: 100 Shares Total	100 Shares Per Share	50 Shares Total	50 Shares Per Share	Percent of Share Cost of 50 Share Lot in Excess of 100 Share Lot
Buy General Electric Co.	$79.60	$.80	$51.09	$1.02	22%
Sell Pfizer PLC	87.98	.88	77.49	1.55	43
Buy Exxon Mobil Corp.	92.08	.92	60.57	1.21	25
Sell Intel Corp.	74.76	.75	58.55	1.71	27

In each case the absolute dollar amount is higher when 100 shares are purchased. However, in each case the amount of commissions and costs on a *per share basis* is significantly higher by 22% to 43% where the number of shares is 50 rather than 100.

The following chart shows the percentage of commissions and fees of each transaction assuming 100 shares are either purchased or sold:

Transaction/ Company	Assumed Per Share Cost	Assumed Total Value	Commissions and Fees	Percent Gain to Recover Cost
Buy General Electric Co.	$31	$3,100	$79.60	2.6%
Sell Pfizer PLC	37	3,700	87.98	2.4
Buy Exxon Mobil Corp.	42	4,200	92.08	2.2
Sell Intel Corp.	29	2,900	74.76	2.6

In these circumstances, the stocks would have had to appreciate on average about 2.5% before the owner of the stocks breaks even.

The following chart is identical to the one immediately above except it assumes 50 shares are either purchased or sold:

Transaction/ Company	Assumed Per Share Cost	Assumed Total Value	Commissions and Fees	Percent Gain to Recover Cost
Buy General Electric Co.	$31	$1,550	$51.09	3.3%
Sell Pfizer PLC	37	1,850	77.49	4.2
Buy Exxon Mobil Corp.	42	2,100	60.57	2.9
Sell Intel Corp.	29	1,450	58.55	4.0

The change is dramatic. By changing only the number of shares involved in the transaction, the average appreciation needed for the owner to break even jumps from 2.5% to 3.6%.

When you consider that commissions and fees are typically charged for both the purchase and sale of stock, the realty is the increase in value of an investment in stocks necessary to break even is really about two times the percentage calculated above. *I.e.*, in the illustration in this memo, about 5% in the case of even 100 share lots and about 7.2% in odd lots not divisible by 100.

Reference points are helpful. Many economists and analysts suggest that a reasonable annual rate of return from stocks over a period of decades is 7% to 8% per year. This means it is reasonable to expect the average stock position in lots of 100 to take about three quarters of a year of ownership for the owner to break even. Odd lots (not divisible by 100) would, on average, take a little over 12 months to break even.

These commissions and fees are effectively assessed on the portfolio each time it trades. Thus, if the average holding period of each individual stock in a portfolio is less than one year, all profit on the entire portfolio is lost in commissions and fees even though there is an historically typical gain in the overall market and the individual stocks.

The foregoing does not consider the impact of dividends typically paid quarterly. The rate of dividends paid by corporate enterprises varies. Many pay none. It is unusual for publicly traded enterprises to pay more than 2% annually of the value of their common stock in dividends. Dividends do impact the recovery of an investor's costs. Indeed, they have a meaningful impact on the total return an investor in stock receives.

These factors are some which work to greatly reduce the chances of success of an investor in stocks who trades frequently. This is exasperated for the small investor trading in small odd lots.

There are strategies which investors use to mitigate the adverse affects of the costs of investing in stocks. Three come to mind:

1. Buy and hold

2. Buy directly from the issuing company and dividend reinvestment plans sometimes referred to by the acronym DRIPs.

3. Mutual funds

Buy and Hold

This strategy involves nothing more than following a general principle of buying a stock and not selling it for an extended period of time typically measured in years.[2] The goal is simply to allow sufficient time for an investment to recoup the costs and provide a return on the total dollar invested including the costs of sale. It also, by its nature over time, reduces the total commissions and fees incurred within a portfolio as a whole.

Some using a buy and hold strategy also reduce the number of companies in their portfolio. This enables the purchase of fewer companies in even lots reducing the commissions and fees paid. This process has the corresponding impact of reducing diversification.

Buying Directly from the Issuing Company

Some publicly traded companies have a mechanism for investors to purchase stock directly from the company and, if elected, reinvest the dividends in additional shares. These plans typically have either reduced or no commissions associated with the purchase and sale of their stock.

The benefit lost is the investment advice of the broker and the single source custodial function.[3] This method of investing requires much more personal involvement on the part of the investor.

[2] The number of years can vary. One investment advisor has suggested three. Other people would suggest at least five years. We have clients who view this as decades.

[3] When buying stock directly from the company, the investor may actually have to take delivery of the stock certificate rather than having a broker hold the certificates. In some cases, the company or its agent will act as custodian. However, this results in multiple custodians and a greater record keeping burden on the part of the investor.

Mutual Funds

Mutual funds are really nothing more than the pooling of multiple investors funds. These larger pools of investable money allow for the negotiation of reduced commissions in connection with the purchase and sale of individual stocks. There is also the benefit of professional investment management of the portfolio. By their nature, most mutual funds result in a diversified portfolio.

Mutual funds are not without costs in addition to the commissions and fees inherent in the trading of individual stocks within the fund. The fund manager is compensated through a fee which the fund pays. Further, some, but not all, mutual funds carry a commission for the purchase of their shares. Some funds also charge a commission upon their redemption or sale. These commissions are typically called “front and back loads”.

For small investors[4] without the inclination to actively manage their portfolios, buying and holding mutual funds are often the most efficient choice.

[4] The definition of small varies. It is often reflected in the minimum required investment necessary for an investment advisor or institution. In today’s world, I most frequently hear a threshold of $250,000 used with respect to a younger person with growth potentional and $500,000 with respect to portfolios which are not expected to have meaningful additions to principle. These “rules of thumb” are intended to estimate when the additional costs of individual management are cost efficient for both the manager and the client.