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July 2025

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Tenon Financial Happenings

Moose's hat and new Tenon Financial clients

This is completely random, but it made me giggle so I thought I'd share it.

Someone gave us a little foam visor for our dog, Moose. So of course I had to get a picture of him wearing it. But he didn't seem as enthused about it as I was:

Dog hats aside, we have some fun staff happening this month with us here at Tenon Financial. Michelle and her family are going to be doing a vacation in the Netherlands. Brad and his family will be going up to Boston for his daughter's freshman college orientation. My family and I will be in Atlantic City for a few days for my kids' dance competition. And, as mentioned last month, Michelle and Brad will be in Chicago for a few days for the Ed Slott tax planning training. Busy month!

For those who've reached out to find out more about potentially working with Tenon Financial, thank you for your consideration! Brad is actively in the process of having intro calls with people and going through the "onboarding" process (for lack of a better word) with folks who've decided to formally engage Tenon Financial in an advisory relationship.

Given the amount of folks reaching out and moving forward, we're having to space out the official start dates of some of the relationships. But we're trying to keep it such that it's not more than a couple of months between when people decide they want to work with us and when the relationship formally begins (i.e. when we officially execute the advisory agreement).

If you're considering ongoing advisory services and would like to know more about our services to see if we might be a fit for what you're looking for, check out our **Services & Fees** page.

And if you'd like to know more about Brad, check out the **Get to know Brad Flood** video he and I did, where I had him in the hot seat asking him all sorts of questions about himself.

I hope you're all having a great summer so far, and we'll see you in August!

-Andy

Retirement Planning Happenings

How brokerage custodians make money (even when you're not *directly* paying them anything)

Chances are many of you reading this have your brokerage accounts, IRAs and/or Roth IRAs held at Vanguard, Fidelity or Schwab. This is especially true if you are a DIY'er with your investments, as these three custodians are the elephants in the room for retail investment accounts.

And if you work with an advisor, particularly an independent "fee only" advisor (i.e. one that isn't able to sell products for commissions), there is a good chance your accounts are at Fidelity or Schwab. Vanguard doesn't have a custodial platform for independent advisors.

And if your accounts aren't at one of the three already mentioned, they may be at the likes of Merrill Lynch, Wells Fargo, JP Morgan Chase, UBS, Edward Jones, LPL, Raymond James, etc.

Regardless where you hold your investment accounts and whether you're a DIY investor or work with an advisor who manages your accounts, it's likely you're not paying any outright fees to the custodian to open or maintain your accounts, to trade in your accounts, to transfer money in or out of your accounts, etc.

This begs the question; if you aren't directly paying anything to the custodian of your investment accounts, how do they make money? Especially since 2019 when all of the major custodians stopped charging fees/commissions for stock and Exchange Traded Fund ("ETF") trades.

There's an old saying along the lines of "if something is free, you're the product." That means that if you're getting a product or service for "free," chances are the company is somehow making money off you without you knowing it. In other words, YOU'RE the product they're monetizing.

This is largely true with how custodians make money. They don't necessarily get revenue directly from you. But that doesn't mean they're not making money *off of* you as a customer of theirs.

With that said, if you know the ways in which custodians are making money, you can potentially act in certain ways, avoid certain things, etc. to minimize how they monetize you. Or, more specifically, you can help keep for yourself more of what they'd otherwise make off you.

And I'll add that at Tenon Financial, part of how we manage clients' accounts at Schwab is to help ensure we keep indirect custodial costs as low as possible, to do what's in clients' best interests. I'll explain more about that at the end, where I'll mention what you could do (or what your advisor could/should do) to help make sure you're doing what's best for you which, in turn, could mean the custodian is making less off of you.

In explaining the typical ways in which custodians make money, I'll use Schwab as an example, since they're a publicly traded company and therefore have rather thorough public disclosure of their financial operations. This way, I can put some numbers to how big each source of revenue is for them.

Unfortunately, neither Fidelity nor Vanguard are publicly owned, so the same level of financial disclosure is not available for them, hence I can't compare and contrast them vs Schwab.

All of the figures referenced below for Schwab are as of 2024, as reported in the company's annual 10-K filing with the Securities and Exchange Commission.

And I should add that the info and figures below aren't purely in reference to Schwab's custodial business. Schwab also has a banking division and an investment management division. Therefore, it's not really possible to isolate the sources of revenue from just their custodial business (i.e. holding clients' investable accounts).

Additionally, different custodial firms will have different compositions of revenue. As such, don't assume that Schwab's amount and proportion of revenue from A, B and C is similar to Fidelity or Vanguard's amount and proportion of revenue from those same things.

Okay, enough background, let's get to the ways in which custodians make money!

Net interest on cash balances

The approach here is pretty simple; custodians pay clients X% interest on the cash in their accounts, and then turn around and use/invest that cash to make more than X%. The difference is called interest rate "spread" or "net interest."

This is the way in which banks make most of their money. And many investment custodians follow suit. For Schwab, the net interest spread is by far the firm's largest source of revenue.

Specifically, for 2024, Schwab had total net revenue of $19.6 billion. $9.1 billion, or 47%, of the firm's total net revenue was from interest rate spread. For all of 2024, Schwab paid total interest of $6.4 billion to clients, and received $15.5 billion of interest on using clients' cash. Hence, $9.1 billion of *net* interest revenue.

If you have idle uninvested cash sitting in your Schwab brokerage account, they are currently paying you only 0.05% per year interest on it. But Schwab will use your cash (along with all other clients' cash) to put to work earning higher interest. The cash may be invested in higher yielding instruments like Treasury Bills, it may be lent out to other clients who want to take margin loans against their brokerage accounts, etc.

While I don't know the exact level of interest Schwab gets on making use of clients' idle cash, it's safe to say it's well in excess of 0.05%, as evidenced by its $9.1 billion of net interest revenue for 2024.

While net interest revenue is the largest single source of revenue for Schwab, it doesn't necessarily mean it's the largest source of revenue for other major custodians.

As I mentioned before, in addition to providing investment account custodial services, Schwab also has a traditional banking division, offering clients checking accounts, savings accounts etc. And I frankly didn't look in detail to see how much of the company's total 2024 net interest revenue was from banking vs custodial operations. But it's safe to say not *all* of the firm's net interest was purely from custodial operations.

Trading commissions

You may not realize this, but when you open investment accounts somewhere such as Schwab, you're inherently agreeing to not only hold your investable assets in their custody, but also execute your trades through them.

In theory, you can separate out the two services and use Schwab just as the custodian/holder of your assets, and then separately use another firm to do the actual execution (or buying and selling) of your positions.

For example, you could shop around which brokers can give you the best price quote for buying however many shares of stock XYZ you want to buy. And then when you find the broker you want to use to buy those shares, you'd execute and buy the shares through them. You'd then instruct that broker to "settle" your shares at Schwab by delivering/depositing the shares into your account at Schwab.

This is how many large institutional investment firms do it. For many hedge funds, for example, it's not uncommon for them to execute trades through dozens of different brokers. But then use one or a few separate custodians to actually hold all of the fund's positions.

For retail accounts though, it's not really practical or feasible to split apart the trading/execution functions vs the custodial functions. Therefore, when you read through the few dozen pages of account opening paperwork at Fidelity, Vanguard or Schwab, it says in there that you're agreeing to use them not just for custody of your positions, but also for trading.

Anyway, I felt the need to give that backstory because doing your trading through your custodian technically is a different function than just using that firm as a custodian. As such, any fees or commissions the firm gets for executing your trades isn't technically part of their custodial operations. But practically and realistically speaking for purposes of this article, I'm lumping in trading as part of custodial services.

Trading commissions are fees paid to the custodian for executing trades for clients. As I mentioned earlier, since 2019, none of the major custodians charge trading commissions for most stock or ETF trades. But they still charge fees for some other trades, such as certain mutual funds, certain individual bonds, trades for stocks that aren't traded on an exchange, etc.

For 2024, Schwab received $1.6 billion in trading commissions. This represented 8% of the firm's total net revenue for the year.

Payment for order flow

This one is a bit more difficult to grasp, but I'll try my best to explain it, using Schwab as an example. But most (all?) custodians operate in a similar way.

When you place a trade at Schwab, it might not technically be Schwab who executes it in the market. Often times, Schwab will route your trade request to another firm who will then go and execute that trade in the market.

As far as you're aware, it will look and feel like Schwab was the one to do the trade; there will be no mention on your transaction summary or trade confirmation that the trade was sent off and executed by another firm.

But, behind the scenes, there will likely be an intermediary organization doing the actual execution of the trade. Those intermediary organizations pay Schwab to route client trades through them. The trades that get routed through the intermediate are called “order flow.” And the intermediaries pay custodians for that order flow.

I frankly don’t know the exact amount the intermediaries pay for the order flow, or what it equates to on an average trade. But it’s a relatively miniscule amount per trade. However, over the course of thousands or millions of trades, the total dollar amount of payments for order flow can add up.

In 2024, Schwab received a total of $1.5 billion in payments for order flow. This represented about 7% of the firm’s net revenue for the year.

On the surface, you might think that you’d have to get less favorable execution prices on your trades through an intermediary than if Schwab executed the trades itself (because when going through an intermediary, the intermediary has to cover the cost of the order flow payments it’s giving to Schwab). However, there are regularly “best execution” studies and data gathering done throughout the industry to confirm if routing trades through intermediaries is actually in clients’ best interests.

While it may seem counterintuitive, this process does appear to consistently get clients better execution prices. The logic is that the intermediaries specialize in trading and can do it better, faster and cheaper than the custodians themselves.

And since the intermediaries are getting order flow from multiple custodians, they can see more of what’s going on in the market.

Also, the intermediaries can trade in larger volumes than the custodians could by themselves (again because the intermediaries are batching up and aggregating multiple blocks of trades from multiple custodians).

Platform fees

While rare, some custodians do charge an outright fee to have assets held in custody there. This is more commonly something custodians charge to advisors who use them. It’s rare for custodians to charge retail clients any sort of platform fee.

For example, Fidelity will typically charge independent advisors a platform fee. And I previously looked into using Fidelity as a custodian for clients of Tenon Financial. Specifically, I talked with Fidelity’s advisor services team in the Summer of 2023 to get a quote.

Fidelity has a complicated and opaque pricing matrix to determine what platform fee, as a percentage of assets in custody there, they will charge. And the advisor has the option of passing the fee through to clients or paying it itself.

Fidelity said the platform fee can vary, depending on how the advisor runs their business, and how profitable the advisor’s (and their clients’) activity will be for Fidelity. All else equal, the less profitable the advisor’s business, the higher the platform fee they’ll charge.

In case you’re wondering, when I talked with Fidelity a couple of years ago, they said our business wouldn’t be very profitable for them. That’s because we don’t actively trade, we don’t keep a lot of idle cash in client accounts, we don’t have clients take out margin loans in their accounts, we don’t use mutual funds that charge clients trading commissions, etc. As such, they’d charge us a 0.05% platform fee. I decided the additional expense of moving to Fidelity (vs the zero platform fee at TD/Schwab) wasn’t worth it; neither for clients nor for us.

Anyway, Schwab doesn’t charge a platform fee, so there is nothing of the sort reported on its 2024 financial statements. But, some other custodians make a sizable portion of their revenue from such fees.

Asset management fees

This one isn’t specific to firms acting as a custodian. Instead, it’s the fees firms get for managing investments, such as acting as fund manager of an ETF or a mutual fund, or for providing customized investment advisory solutions.

However, many of the major custodians also have an investment management division. Specifically, Vanguard, Fidelity and Schwab do. So, while providing asset management isn’t technically a custodial function, per se, it’s nonetheless a common additional activity of many custodial firms. And it’s often a sizable portion of revenue. Hence, I feel the need to consider it a common source of revenue for custodians.

For example, when you buy a Vanguard S&P 500 index fund (whether you hold the fund in an account at Vanguard, Fidelity or Schwab), Vanguard is the investment manager behind it. And the fund expense ratio that all holders of that fund pay goes to Vanguard to compensate their investment management division for managing the fund.

Same thing with Fidelity and its hundreds of various Fidelity-branded ETFs and mutual funds. And same for Schwab.

As an example, when our clients hold one of Schwab's money market funds in their accounts as a place to get better interest on cash than just the 0.05% they'd otherwise get, Schwab's asset management division receives the revenue from the fund's built-in expense ratio.

Another area of revenue within Schwab's asset management group is receiving payments from certain other non-Schwab mutual fund managers for offering their funds to Schwab's clients without any trading fees or commissions.

Not to make it sound dirty, but this is basically a pay-to-play arrangement where non-Schwab fund managers pay Schwab for the benefit of Schwab giving "shelf space" for the funds. Specifically, by Schwab waiving the trading commission it would otherwise charge on clients buying and selling the other manager's funds.

For example, Schwab typically charges a fee to clients every time they buy or sell mutual funds. I believe the current fee to buy or sell a Vanguard mutual fund, for example, in a Schwab account is $45 per trade for retail accounts. For our clients, it's a lower negotiated rate of $35 per trade for Vanguard mutual funds.

Some fund managers want to incentivize Schwab clients to buy their funds, and therefore want Schwab to waive the trading fee they'd other charge. However, there needs to be something in it for Schwab to waive the trading fee and give up the revenue they'd otherwise get. So, the other fund manager will pay Schwab to waive the trading fee and put the fund on Schwab's list of "No Transaction Fee" or "NTF" funds.

This revenue from waiving transaction fees on non-Schwab mutual funds is included in Schwab's reported mutual fund asset management fees.

For 2024, Schwab received a total of $3.2 billion of fees for managing and administering its various Schwab funds, and for including non-Schwab mutual funds on its NTF list. This represented 16% of the firm's total revenue for the year.

Additionally, Schwab also provides investment advisory solutions direct to clients or through advisors. Basically, clients can pay Schwab to create, implement and rebalance pre-canned models of funds. And there can also be other advisory offerings above and beyond just managing "model" portfolios for clients. Schwab calls these other investment advisory activity, "managed investing solutions."

For 2024, Schwab's combined managed investing solutions generated $2.1 billion of revenue. This accounted for 11% of the firm's total 2024 net revenue.

Other sources of revenue

While all custodians are a bit different, they may nonetheless have additional sources of revenue above and beyond what's thus far been mentioned.

For Schwab, for example, they also have miscellaneous fees charged on some of their bank account products. Such as typical account overdraft fees, wire fees, etc.

Additionally, there are "exchange processing fees" that most custodians pass through to clients from stock exchanges.

Specifically, every time you sell shares of a listed stock or ETF, the stock exchange may charge a small fee. That fee is charged to the custodian. The custodians generally turn around and pass that fee on to the client who did the trade.

The fees can vary over time, as they're occasionally revised by the exchanges. In recent years, the exchange processing fees have ranged from zero to upwards of $30 per $1,000,000 of securities sold.

Also, while most custodians don't charge you anything to open or maintain account with them, they often charge you a fee when you close accounts or transfer accounts away from them. Such account closure or transfer fees typically range from $100 to $200 per account.

<u>What you can do to maximize what you get (and minimize what custodians get off of you…)</u>

With the above knowledge in hand, here are some ways you try to maximize your economics at your custodians. By making some relatively minor changes in what you trade, how you trade it, etc., you can ultimately squeeze out a bit more return and/or a bit less expenses for yourself. And I'll add these are all things we do for our clients at Tenon Financial.

Minimize how much idle cash you hold – Some custodians like Vanguard and Fidelity will automatically "sweep" any idle cash in your accounts into one of their money market mutual funds. Idle cash pays next to nothing in interest, whereas money market mutual funds (at least currently) are paying around 4% interest.

Schwab is unfortunately one of the few custodians that doesn't automatically sweep idle cash into money market funds.

But we don't let too much idle cash build up in client's accounts and will consciously deploy cash to either reinvest into stock or bond positions, or put into a money market fund.

While I'm a bit frustrated that Schwab doesn't automatically sweep cash into higher yielding options, I suppose I can't blame them, considering how much money they make on the cash net interest spread!

Invest in ETFs instead of mutual funds, where possible – Since most custodians charge you to buy or sell mutual funds that aren't their own (e.g. Schwab charges a trading commission when clients buy or sell Vanguard mutual funds, but they don't charge anything when clients buy or sell Schwab mutual funds), try to avoid trading in such funds where possible.

A simple solution could be trading in an ETF instead of a mutual fund, since ETFs trade like stocks and therefore don't have any trading commission to buy or sell. As an example, if you want to invest in an S&P 500 index product from Vanguard, use Vanguard's ETF instead of its mutual fund, as there is no trading fee to buy or sell the ETF but there is a trading fee to buy or sell the mutual fund.

Consider avoiding funds that pay for shelf space – Like I mentioned above, some non-Schwab fund managers pay Schwab in order to have their mutual funds on Schwab's No Transaction Fee fund list. The non-Schwab fund manager needs to make up for the cost of paying Schwab for the shelf space. What commonly happens in this case is the non-Schwab fund will have a slightly higher expense ratio than it otherwise would, and that higher expense revenue is what's used to pay places like Schwab for the shelf space. And since fundholders are the ones who pay the expense ratios, fund holders are indirectly also paying for the privilege of the fund being on Schwab's NTF list…

Try to avoid additional services and their fees – While most stock and ETF trading is free, there could at times be a cost for certain trades. For example, if you place a stock or ETF trade online yourself through your custodian's website, there likely won't be any trading commission. But if you instead call up the custodian's trading team and verbally instruct them to do the trade for you, they will likely charge you a trading commission for the service of placing the trade through a live person. Try to avoid using such extra fee services where possible.

That's it, I hope you found this helpful. Custodians need to make money and stay profitable to remain in business. But with some basic knowledge, you can help tip things a bit in your favor and get or keep more from your custodian!