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Wall Street -- The Need for Long-Range Planning

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Back office clutter, the traditional explanation for the chaos afflicting the securities industry, is only a symptom of a much more critical problem, the lack of a coherent development plan—

WALL STREET – THE NEED FOR LONG-RANGE PLANNING

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OVER THE past several years, conditions on Wall Street have at times approached chaos. Terms such as "Back Office Log Jam," "Inability to Deliver," "Error Costs" all made the headlines. And, finally, the logs did indeed jam, and the securities industry achieved the unique distinction of becoming the first industry forced to shut down operations during a period of peak demand.

It is ironic indeed that Wall Street—which in its research departments evaluates the performance of companies whose shares it sells and which places a market value on these shares based on projected profit—has until very recently not used any advanced managerial accounting techniques to measure and evaluate its own operations. One of the reasons for this neglect was that profits were usually so high in good times (periods of high volume) that costs were ignored and the narrowing of the profit margin was not readily apparent. During such periods of economic prosperity, the problems requiring solution were solved on an ad hoc basis. Back office facilities were expanded and little attention was paid to their impact on profitability in the future. On the other hand, when volume contracted, costs were slashed without any regard to the effect on the longer term.

Interestingly enough, many articles have been written prescribing quick solutions to the problems besetting the securities industry. These solutions, for the most part, are based on greater use of computers, increased mechanization, techniques such as "locked-in trade," etc. One article even goes so far as to state that "standardized and coordinated data processing operations could wipe out the paper backlog that has long stifled Wall Street. Member firms and investors alike have suffered several years from back office blunders and it's time the securities industry equalized their systems with the technology that surrounds them."[1]

We submit that the approach that looks to mechanization or computerization as a cure-all for the problems of Wall Street is fraught

[1] Munch, Marilyn, "Wall Street's Back Office Blunder," *Data Systems News,* May, 1970.

with danger because of the false sense of security it creates. With such an approach, targets are set, activity abounds, and everybody proceeds on the assumption that once this or that application "is on the computer" the problems will disappear. This approach has the same inherent danger as treating a very sore throat by taking a lozenge, when professional diagnosis would recognize a streptococcus infection. What the securities industry needs are not palliatives or quick solutions to cure specific symptoms, but an overall, comprehensive method for defining, analyzing, and then solving the industry's problems. The technique to accomplish this has been accepted and implemented successfully in many other industries. It is called, quite simply, Long-Range Planning (LRP).

The lack of LRP in the securities industry has been amply documented by the events of recent years:

- The inability of the industry to handle the volume of business during 1968
- The almost hysterical reaction during the recent period of declining prices and low volume
- The reported financial difficulties of respected firms, causing the merger of several of them
- The actual failure of a number of brokerage houses.

Only recently, however, has Wall Street begun to recognize the need for LRP. Robert W. Haack, president of the New York Stock Exchange, stated in the Exchange's 1969 Annual Report: "Our success in dealing with the difficult issues on our immediate and long-range agendas will determine in large measure whether or not we emerge from the new decade as a stable, prosperous industry. . . . Indeed, with nothing less than the future of our industry at stake, there is no room for failure."

In its *Perspectives on Planning* No. 4, dated September 2, 1969, the New York Stock Exchange reported the results of its survey of LRP activity undertaken by member firms. It stated that "management and operational difficulties are often symptoms of a lack of long-range planning—a situation not unique to the investment community. Consequently, the problems that have surfaced during the recent years of rapid growth and change in the securities industry have stimulated a growing interest in long-range planning." The Exchange publication further stated that 53 per cent of the firms responding to its inquiry about LRP activities indicated that no such activity existed, that the overall percentage of non-planning brokerage firms was probably much greater, and that even those firms which were engaged in LRP activities had relatively little experience with planning and frequently took a rather limited approach.

Based on this New York Stock Exchange study, it would appear that a great need exists among member firms (and undoubtedly also among non-member securities businesses) for LRP. But planning, especially for the longer term, involves a paradox: No one can foretell the future, and, if one cannot predict what is going to happen, how can one plan? The obvious answer is that precisely because it is impossible to foretell the future, it is essential that one plan. Economist Kenneth E. Boulding summed up this idea:

"I think the difficulty with predictions in the social sciences, on which much business planning is based, is that we are faced with systems which have strong discontinuities in them. . . . I would say that planning is not really prediction of the future, because 'prediction' is nonsense. You can't predict the future. There may not be any future. What I think you can plan for is change itself. If you can think of planning in terms of an organization's flexibility in preparing for the unknown and anticipating possible crises and systems changes, this really seems to me to be the essence of it."[2]

Planning thus involves the identification of the range of possibilities and the preparation of the business to cope with them. Proper planning does not only consider changes, innovations, and new developments; it must be equally aware of the many stable elements of the business.

Speaking in general terms, business plans can be identified as covering three timing parameters:

(1) Plans for today's business
(2) Plans for remaining in business
(3) Plans for the growth and development of the business.

Long-Range Planning concerns itself with business plans covered in (2) and (3) above. It is the process of making current decisions based on an anticipated future and can be defined as a firm's overall strategy for profit. As such, it touches upon every activity of a company and, subject to financial and managerial constraints, considers such areas as:

- Analysis of the economy
- Analysis of the industry
- Organization structure of the company
- Operating and information systems
- New business programs
- Acquisitions and mergers.

In LRP, the "future" covered by the plan may be only one year, though usually objectives are set two, five, or even ten years ahead. Frequently, the planning activity covers a span of five years, with annual and semiannual reviews when the accomplishments are reviewed and measured against the objectives. At the time of review the plan may be adjusted. It is essential, therefore, that the long-range plan be more than a vague, or even precise, statement of hopes; the

[2] Thompson, Stewart, *How Companies Plan*, American Management Association, 1962.

plan must stipulate courses of action to produce measurable results.

How do these generalities about the LRP process relate specifically to Wall Street and the securities industry? The way in which the general lack of planning has resulted in the current near-crisis condition in the securities industry has already been discussed. Managements of Wall Street firms have traditionally maintained that the extreme fluctuations in trading volume do not permit meaningful long-range planning. The explosive growth in volume during late 1967 and 1968 and the depressed volume of the first eight months of 1970 are examples of such extreme fluctuations affecting the securities industry. This is not what a rational planner would anticipate. It is precisely because of this unpredictability that managements of Wall Street firms must give consideration in their planning to the instability in volume. Dr. Boulding's comments cited earlier have great pertinence to the problems facing the securities industry: "You *can't* predict the future. . . . you can plan for . . . change itself" (emphasis supplied). Managements must provide for alternate, or contingency, plans in addition to the main, or preferred, long-range plans.

But more than mere planning is needed if the securities industry is to survive. It is necessary to consider the projected economic and political climate, to determine the type of business the firm wants to engage in, and to decide on the expansion or contraction of the business and/or geographic area covered by the firm. It is also necessary to consider the growing economy as a whole to understand the estimated requirements which the securities industry will be expected to meet. In its *Perspectives on Planning* No. 1 (May, 1968) and No. 2 (October, 1968) the Office of the Economist of the New York Stock Exchange projects that by 1980:

- Real Gross National Product (or output in dollars unaffected by inflation) will rise by 75 per cent over 1967 to $1.4 trillion.
- Shares listed on the NYSE will total 38 billion (vs. 11.6 billion in 1967).
- Average daily round-lot transactions will increase to 68,000 (vs. 39,000 in 1967). This is equivalent to an increase in the daily average number of shares traded to 27,000,000 shares per day in 1980 from the 10,000,000 shares per day averaged in 1967.
- High day's volumes in 1980 will range from 32,000,000 to 63,000,000 shares.

Questions to be asked

Given these economic parameters as a start, the Long-Range Planning process for a firm in the securities industry begins with the answering of the following questions:

- Where does the firm want to be five (or ten) years from now?
- What significant assumptions must be made on which to base the long-range plan?
- What are the steps that have to be taken and what are the targets that have to be reached each year to achieve the overall objective?

As a first step in the LRP process a decision has to be made as to what a given securities firm

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wants to be five years or ten years hence. This planning cannot be based on the economic predictions alone. After all the predictions and forecasts have been made, the senior management of the firm must decide what kind of business it wants to create in the future. It is this total and absolute commitment of management to LRP which is essential to its success.

Three ways to go

Generally speaking, any firm in the securities industry today can consider three basic approaches to the direction it wants to move over the next five or ten years. One approach, simply stated, foresees no change in the firm over this period. This means that a firm which is a regional firm now would plan to arrive at 1975 as substantially the same firm. It might have a few more branch offices, possibly have an improved research department, but basically it would still be a regional firm. A second approach places such a pessimistic outlook on the future that the management plans the discontinuance of the firm or its merger into, or acquisition by, another, larger firm. The third approach, and the one that requires LRP, plans for and pursues a strategy of growth and increased profitability.

If growth is chosen

Many factors are considered in the plans for growth of a firm. These include (1) the projected growth in the share volume traded, (2) an increase in the firm's market share of the business, and (3) the entry of the firm into activities where it is not now participating.

The planning to capitalize on the increase in trading volume includes a determination of the overall complement of account executives (customer men), the optimum branch office size, and the composition and size of the back office.

The plan for an increase in the firm's market share of the business considers:

- Expansion of the branch office system by either opening additional offices or acquisition or merger with local or regional firms
- Improvement in service to the firm's clientele
- Better penetration of the potential market through advertising, sales promotion campaigns, etc.
- Establishment of research preeminence.

The development and execution of such plans includes studies and analyses of the growth potential of those local markets where the firm's branch offices are now located, studies and analyses of possible geographic areas where the firm is not now represented, an analysis of the effect of advertising and sales promotion campaigns, and a study of the relationship of costs to increased business created by improved client services and research preeminence.

The third factor affecting the plans for growth is a program of expansion of the firm's activities into related fields. For instance, if the firm is now primarily a retail house (a firm dealing with individual rather than institutional clients), such plans might include the entry into the institutional market. Other activities which should be looked at if they are not now a part of the firm's business are underwriting, the U.S. Government bond market, venture participation capital, investment banking, the option (put and call) market, asset management, commodities, real estate, insurance, mutual funds, etc. This is in line with the trend in the industry of providing comprehensive, one-stop financial service to clients. The plans for the entry into related activities should consider the availability of capital for these new ventures, the priorities for the use of available capital, the return on the capital invested, and the potential impact of such broadening of activities on other areas of the firm.

Improving profits

In addition to planning for the growth of the firm, the Long-Range-Planning activity is concerned also with planning for an increase in the rate of profitability. This is accomplished by reducing operating costs through better controls, improved systems, and, above all, reduction in errors. Other areas which have an impact on the rate of profit are improvement in money management (speedier collection of outstanding balances, utilization of "free credit" balances, use of drafts rather than checks to pay amounts due, greater utilization of available securities for stock loans, etc.) and a marketing emphasis on "higher-profit" items such as larger orders, minimum commission charges, and mutual fund sales.

But a firm's strategy for growth and increased profitability does not assume operation in a vacuum. The securities industry is affected not only by general economic and political conditions but also by the impact of changes within the industry such as the proposed new commission rate, public ownership of firms, increased institutionalization of the market, new services to institutional investors, Central Certificate Service, and technological advances such as machine-readable certificates and the "locked-in trade."

It has been the aim of this discussion to point out the lack of Long-Range Planning in the securities industry, to demonstrate the need for LRP, and to indicate the economic, timing, and business plan parameters which should be considered in the LRP process. These plans, however, have to be translated into reality, and while an entire article, or possibly even several articles, could be written to discuss the actual implementation of a LRP activity, a brief outline of a pragmatic approach to LRP in the securities industry should have application for individual firms.

LRP is integrated planning or, to put it another way, planning by objective. Answers to the questions which should be asked at the inception of a LRP project (Where do we want to go, what are the assumptions, and what are the logical steps to reach our objective?) clarify the objectives, identify the resources needed to achieve them, and permit the construction of a comprehensive plan. In every instance, once the "business" aspects have been planned, the concomitant development of clerical and service activities should be considered. Included in this area are the definition of organizational development and responsibility, personnel planning (including recruitment, training, and management development), and the design of an integrated Management Information System (MIS). The MIS, in turn, should provide timely and error-free service to clients, act as a sensitive and *current* indicator of the economics of the business, and continually measure actual accomplishments against projections.

Organizational handicaps

The definition of organizational development and responsibility is one of the prime requisites for the creation of a management environment in which a long-range planning project can succeed. Traditionally, Wall Street firms have been small, family-type operations, and until recently even most of the larger firms have been operated in a proprietary, club-like manner. The introduction of a long-range planning activity must be accompanied by a sound organization plan clearly defining duties and responsibilities and by a willingness of management to operate on a professional basis.

The entire discussion of the need for, and the development of, long-range planning becomes academic, however, if Wall Street does not solve promptly the one overriding problem facing it. This problem is the critical need not only for an increase in the capital available to a given firm but also for the assurance of permanency of that capital. New York Stock Exchange member firms operate under a rule which limits total liabilities to 20 times net capital (non-member firms operate under similar rules enforced by the Securities and Exchange Commission). But this capital may be highly vulnerable to shrinkage in falling markets. Besides the investment of partners, such capital frequently includes large quantities of speculative securities and large amounts of so-called "subordinated capital." The latter are the proceeds of loans made to securities firms by lenders who subordinate their claims to other creditors. Subordinated capital as well as partners' capital is also often subject to withdrawal on relatively short notice, usually 90 or 180 days.

While trading volume, and therefore gross revenue, are highly volatile, operating expenses remain relatively fixed and do not respond quickly to changed business conditions. Furthermore, periods of lower volume are frequently associated with security markets with declining prices. Thus at the precise moment when capital requirements increase, capital decreases. Additionally, capital is required to finance the expansion of the securities business which is projected for the future.

The "capital" problem

The "capital" problem of the securities industry is not the subject of this discussion, but it must be solved before any long-range plan can be projected. The solutions which have been proposed consist, among others, of the following suggestions:

- Reduction in the ratio which now permits total liabilities to amount to as much as 2,000 per cent of net capital
- Elimination (or at least a drastic reduction in the value allowed for capital purposes) of capital in the form of securities
- Lengthening of the term for which subordinated loans must be available to a firm before they may be allowed as capital
- Extension of the length of notice required before partners can withdraw personal capital
- Incorporation, with the subsequent ability to sell shares to the public.

The maturity of an industry is recognized to some extent by its acceptance of the need to plan. The recognition of the need for planning acknowledges that there are major problems that confront the business and that may ultimately threaten its very survival. An indication of the effectiveness of planning is the degree to which the major problems are specified and defined.

Long-Range Planning in the securities industry can be successful only if each firm's senior management recognizes its need and makes a wholehearted commitment of the entire firm, its resources, and its leadership to the planning process. The major task which confronts top management in planning the survival and growth of the business is the definition and continuous redefinition of the direction and limits of company growth. This task requires the making of choices and therefore acts as a restriction on the work to be performed and on the resources to be used.

During the period of high trading volume in 1968, the securities business had to close down; during the current period of low volume, marginal firms are forced to go out of business, and the entire industry is caught in a severe profit squeeze and is fighting for its very survival. Only through proper planning can the securities industry hope to avoid the periodic recurrence of these extreme situations at the expanded levels of activity projected for its future.