BUSINESS BUSINESS ESSENTIALS

Markup

By JAKE FRANKENFIELD Updated March 31, 2021
Reviewed by JULIUS MANSA

What Is a Markup?

A markup is the difference between an investment's lowest current offering price among broker-dealers and the price charged to the customer for said investment. Markups occur when brokers act as principals, buying and selling securities from their own accounts at their own risk rather than receiving a fee for facilitating a transaction. Most dealers are brokers, and vice versa, and so the term broker-dealer is common.

Markups also appear in retail settings, where retailers mark-up the selling price of merchandise by a certain amount or percentage in order to earn a profit. A pricing method whereby a retailer establishes a selling price by adding a markup to total variable costs is called the variable cost-plus pricing method.

KEY TAKEAWAYS

- A markup is the difference between the market price of a security personally held by a broker-dealer and the price paid by a customer.
- Markups are a legitimate way for broker-dealers to make a profit on the sale of securities.
- Dealers, however, are not always required to disclose the markup to customers.
- In retail settings, markups occur when retailers increase the selling price of merchandise by a certain amount or percentage in order to earn a profit.

Understanding Markups

Markups occur when certain marketable securities are available for purchase by retail investors from dealers who sell the securities directly from their own accounts. The dealer's only compensation comes in the form of the markup, the difference between the

security's purchase price and the price the dealer charges to the retail investor. The dealer assumes some risk as the market price of the security could drop before being sold to investors.

In business, the markup is the price spread between the cost to produce a good or service and its selling price. In order to ensure a profit and recover the costs to create a product or service, producers must add a markup to their total costs. They will express the markup as either a fixed amount or a percentage over the cost.

Markups vs. Markdowns

A markdown, on the other hand, occurs when a broker purchases a security from a customer at a price lower than its market value. Markdowns also occur when a dealer charges a customer a lower price for a security than the current bid price among dealers. Dealers might offer lower prices to customers in order to stimulate additional buying, which will offset their initial losses by earning them extra commissions.

For retailers, a price markdown is a deliberate reduction in the selling price of a good. There are several reasons why a retailer may decide to markdown its goods. For seasonal merchandise, the retailer may be eager to clear the shelves of old merchandise to make room for the next season's goods. They may slash prices to do so, even if it means they take a loss on the sale. Some manufacturers may come out with new models of products each year or every few years, in which case they will offer markdowns on older products rather than risk being stuck with obsolete inventory.

Benefits of Markups

Markups are a legitimate way for broker-dealers to make a profit on the sale of securities. Securities, such as bonds, bought or sold on the market are offered with a spread. The spread is determined by the bid price, what someone is willing to pay for the bonds, and the ask price, which is what someone is willing to accept for the bonds.

When a dealer acts a principal in the transaction, he can mark up the bid price, which creates a wider bid-ask spread. The difference between the market spread and the dealer’s marked-up spread is the profit.

> In lieu of charging a flat fee, brokers acting as principals can be compensated from the markup (gross profits) of securities held and later sold to customers.

Special Considerations for Markups

The dealer is only required to disclose the transaction fee, which is typically a nominal cost. In doing so, the buyer isn’t privy to the dealer’s original transaction or the markup. From the buyer’s perspective, the only cost for the bond purchase is the small transaction fee. Should bond buyers try to immediately sell the bonds on the open market, they would

have to make up the dealer's markup on the spread or incur a loss. The lack of transparency places the burden on the bond buyers to determine whether they are receiving a fair deal.

Dealers compete with each other by reducing the amount of their markups. It is possible for bond buyers to compare the price the dealer paid for the bond with its actual price. Bond buyers can have access to bond transaction details through various sources, such as Investinginbonds.com, which reports all information related to bond transactions daily.