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IBKR.OQ - Interactive Brokers Group Inc at Goldman Sachs Financial Services Conference (Virtual)

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PRESENTATION

William Alfred Nance - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Okay. So joining us today, we're pleased to have Thomas Peterffy, Chairman of Interactive Brokers. Thomas founded Interactive Brokers in 1977, and it was one of the pioneers of the financial services industry, especially in its automation.

Thomas, thanks for joining us again for the conference for the fifth straight year, even in virtual form this year. Before we begin with today's presentation, which will be fireside chat, I wanted to remind the audience that they can send their questions via the webcast. And time permitting, we will take some of the audience questions at the end.

QUESTIONS AND ANSWERS

William Alfred Nance - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

But Thomas, maybe we can just start off high level on Interactive Brokers' unique position in the industry. So you have the most global reach of all the publicly traded brokerages, the most active client base, the highest return on client assets. And you've massively expanded the customer base this year by, I think, 52% account growth year-over-year as of November.

So can you talk about what positioned the company to take advantage of the market environment and the opportunity this year and how you're looking forward to serving this much larger account base over the next 3 to 5 years?

Thomas Pechy Peterffy - *Interactive Brokers Group, Inc. - Founder & Chairman*

Well, as you know, Interactive Brokers grew out of our fully automated option market (inaudible) in the early '90s. Timber Hill launched Interactive Brokers with the mission of serving the roughly 6,000 individual floor traders in the -- on the various exchange floors. They needed electronic tools to be able to continue their business as the exchanges were going electronic.

According to -- accordingly, the platform we build had to be suitable for professional traders and the execution quality, commission, margin and borrow and sub-borrow rates have to be low enough for them to be able to continue to produce regular daily income. That is still our focus today. But once we build the platform, we saw nothing wrong with making it available to our commerce.

Over the years, many floor trader customers, they are gradually replaced by proprietary trading with hedge funds and their employees. But we still maintain the attitude that anything we build should be available for anyone to use if they bother to learn it, and many people enthusiastically do so. Automation, low pricing and tools that enable professionals to invest and trade profitably still remains our primary focus today.

William Alfred Nance - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Got it. So I think investors devote a lot of attention and time focusing on your competitive position in the U.S. And I think time and time again, you've emphasized the strong international growth in recent years. What do you hear from customers abroad about why they choose IBKR? And how do you differentiate your comp -- yourself from the competition in international markets?

Thomas Pechy Peterffy - *Interactive Brokers Group, Inc. - Founder & Chairman*

It's true. We aim to be a global broker. You can come to us from practically any country with any of most currencies and buy any publicly traded product anywhere in the world practically. The brokerage business is not as well-developed in most other places outside of the U.S. as it is here. And we have less competition, especially for financially sophisticated investors and traders. Although for these folks, the financially sophisticated traders, our investors have no -- sorry, our platform has no competition within the United States either.

Outside the U.S., people are more open and eager to learn about stocks, options, futures without preconceived ideas of what a brokerage platform should look like. We find that many people in the U.S. are a lot into a mindset of using their obsolete and less capable platform due to sheer inertia and reluctance to learn new things. This is much less of a problem for us outside of the country. People are more willing to learn our way of looking at markets, our way of looking at trading and investing. We don't just give them an online order ticket to fill out, we give them live markets to interact with using our very large tools.

William Alfred Nance - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Got it. And just one more on the international growth. I mean with so much of the growth coming from international, can you just help us understand which geographies do you expect to drive the most growth outside of the U.S. from here? And where you see the biggest opportunities to expand the reach?

Thomas Pechy Peterffy - *Interactive Brokers Group, Inc. - Founder & Chairman*

Sure. Well, our growth over the last 12 months has been about 60 -- 36% in America. It's been about 61% in Europe and 63% in Asia, especially rapid growth is coming from Hong Kong, Singapore and Malaysia, Eastern Europe and the Middle East, and Canada and South America.

William Alfred Nance - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Got you. And then just more broadly on the different customer segments. I think for several years, the introducing broker segment was what drove a lot of the growth in accounts, but this year the story has really been about the individual client base and just the rapid influx of new investors into the market during lockdowns and stay-at-home orders.

So as the world waits the vaccine and various forms of lockdowns are kind of ongoing throughout the world, do you think this sort of growth can persist in the very near term? And then as the world and the environment normalizes, what do you think the growth profile of the company looks like longer term?

Thomas Pechy Peterffy - *Interactive Brokers Group, Inc. - Founder & Chairman*

Yes, so -- yes, individual customers' accounts have grown by 72%, which is especially high over the last 12 months. Much of this is due to many of our tools that are very accessible to individual investors to do their own research and also better advertising that we targeted to this segment. This is my favorite customer segment because 32% of our new customers come to us by recommendation of existing customers. The more of them we get, the more new ones will come.

While the COVID lockdown certainly enticed some customers to open accounts and try their hands at trading, I think that the rapid growth of the individual customer is also due to a more fundamental global trend in the growth of capitalism, private ownership and widely spread appreciation and acceptance of capital markets around the world. I believe this to be a long-term trend, and this growth will continue in the foreseeable future.

So while going forward it's unlikely that we will keep -- be able to keep up the 52% growth rate or especially the 72% for individual customers, I think it may -- after the vaccine, it may level off around in the high 20s or around 30% maybe.

William Alfred Nance - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Got it. That makes sense. So maybe digging in a little bit more into what we've seen year to date, it hasn't -- the environment hasn't really just manifested itself in elevated account growth numbers, you've also seen it in the volumes. Activity rates have been 50% to 75% elevated per account.

And -- that being said, a lot of the volume has been smaller notional sizes, maybe a little bit less derivatives than you'd run previously. So what is the makeup of the higher volumes and the incoming accounts? How are you about the types of new customers that are attracting -- that you're attracting right now? And kind of how do you assess the quality of these accounts versus, kind of, the legacy customers that you have?

Thomas Pechy Peterffy - *Interactive Brokers Group, Inc. - Founder & Chairman*

So I look at it this way. Last 12 months to November, account growth -- overall account growth 52%, client acquisition 61%, commission income 50%. But since about 20% of the client equity growth is due to the appreciation in market prices, we can conclude that new accounts have somewhat less money and tend to trade smaller order sizes than older ones, and that is okay with us.

We like the idea of many young people, who do not necessarily have the amounts of money their parents may have, come to us to learn about investing and trading. Eventually, many of these accounts will become much larger.

William Alfred Nance - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Got it. That's a good segue into the next question on just like younger accounts and smaller account sizes. I think people understand that Interactive Brokers is a platform for sophisticated traders, and you aren't always attracting the same sort of client that maybe like Schwab or Fidelity attracts.

More recently, however, there's been a lot of focus on the competition for active traders and the success of fintech platforms at attracting large amounts of new investors that are very highly active. So how do you compete or do you compete with these fintech platforms? And is there anything to be learned from the rapid growth that you've seen among younger investors?

Thomas Pechy Peterffy - *Interactive Brokers Group, Inc. - Founder & Chairman*

So I need to take this question in 2 parts. Schwab and Fidelity, they have many of our target customers. They are both well stablished, very credible and well-run firms. We compete with them by providing better execution, lower margin rates and easier accessible shortable inventory. It is those few percent of the Schwab and Fidelity customers who care about these kinds of things. That is our target customer. And we got some of them every now and then. It's not easy because people suffer from this disease or inertia. But every now and then we succeed with a few.

Robinhood, on the other hand, we do not compete. They are a platform for young novice investors, and we prefer that these people cut their teeth on other platforms. Some of these folks become good traders and investors. And at some point, they realize that they need to upgrade to a more sophisticated platform and then they come to us. We indeed get, on the average, about 8 accounts a day from Robinhood, but I do not recall ever having seen one going in the opposite direction.

William Alfred Nance - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Understood. So -- I know the rollout of IBKR Lite has had some unintended consequences over the past year as all the competitors rushed to move to 0. And I think after a year, after rollout, the adoption has still been just 1% of the account base, which I think validates the focus that you've always had on execution quality, but do you have any color on what you've learned from running the 2 models side-by-side in terms of the quality or the value of the order routing at IBKR Pro?

Thomas Pechy Peterffy - *Interactive Brokers Group, Inc. - Founder & Chairman*

So the numbers are slightly larger than that. Today, 4.8% of our customers are Lite accounts. And in the last quarter, they accounted for 2.7% of our trades. So clearly, it indicates that customers who trade more often want to have a professional quality execution and are happy to pay a small commission. On the other hand, less frequently trading customers like Lite, which is exactly what we expected and we're happy with this outcome.

William Alfred Nance - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Got it. So maybe keeping with this idea of highly active versus less active clients, much of the online brokerage industry relies on generating net interest income from client cash balances in order to generate revenues because the commissions are low and their accounts trade so infrequently that -- and they use less margin that trading revenues just don't fully pay the bills. And you've managed to create this cash machine that still derives the majority of the revenues from active traders and enjoys a little bit strong profitability.

So my question here is, will IBKR ever be the right platform for buy-and-hold oriented investors to invest? And do you need to broaden the funnel in order to get to that 80 million accounts over the next 20 years that you spoke on, on the most recent earnings call?

Thomas Pechy Peterffy - *Interactive Brokers Group, Inc. - Founder & Chairman*

Yes, definitely. So it is true that buy-and-hold customers are less concerned about execution quality. If they do not use leverage, they do not care about margin. But since Schwab, Fidelity and E*TRADE have done away with stock commissions and option commissions are not enough to make up for the lost revenue, they are now focusing on various fees, and more significant one of these is a custody fee.

Interactive Brokers does not charge a custody fee. So 10% or 30% -- or 10 or 30 basis points of custody fee may not be noticeable in a year when markets are up 10% to 20%. But in slower years, customers will refocus on broker costs, and at that time, the buy-and-hold customer will become more attracted to Interactive Brokers free custody offering.

Our recent purchase of 70,000 portfolio -- Folio customers is going to give us -- from your firm -- is going to give us the opportunity to understand how to work with the buy-and-hold customer and how we can make an acceptable return on housing them without a custody. We also expect that some of these folks, once they get familiar with our platform and all the research and trading tools that are available for free, may become more active customers.

William Alfred Nance - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Got it. Maybe switching gears a bit. Trading in single name option has been a big part of the increase in retail volumes over the past year. Just a high-level question about the industry more broadly. Do you think the industry is striking the right balance between making it easy to trade derivatives versus making sure that investors have the right amount of education and sophistication required to trade these instruments?

Thomas Pechy Peterffy - *Interactive Brokers Group, Inc. - Founder & Chairman*

So I -- to be honest, I never look at other platforms. So I don't really know what other brokers do. We require our customers to either have previous options trading experience or they have to take an online study course and pass a test.

Having started in business as an options trader, this is a very important issue for me. And we have spent years to create option-oriented analytical tools to help our option trading customers. We have fantastic tools like Probability Lab is one of my favorite tool that really everybody should understand to -- everybody should experience if they want to understand my way of looking at options.

So options are all about probability of future events. They are wonderful tool for people who like to analyze things. But otherwise, they are risky. So if you're unwilling to really learn about it, I don't think you should get into it.

William Alfred Nance - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Makes sense. Maybe switching gears to the regulatory environment. Four years ago, you sat on stage in person, not over Zoom, and shared some views on what the incoming administration might mean for the industry, for the economy. Four years later, you've got a different administration coming in. Do you expect there to be any major changes in the regulatory environment that's relevant for your business?

Thomas Pechy Peterffy - *Interactive Brokers Group, Inc. - Founder & Chairman*

I do. I think that regulations will increase and get tighter. Regulators will build up more examination and enforcement staff and compliance costs will increase even further.

On the brighter side, competition will diminish because it will be even more difficult for smaller newcomers to basically build out all that what the regulators expect them to build out. So if you were -- there would be a larger (inaudible) larger online brokers.

William Alfred Nance - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Got it. Just a reminder for the audience to submit questions via the webcast, if you have them, and we will -- we'll see if we can get to some of them towards the end here.

But, Thomas, maybe sticking with kind of more regulatory developments or jurisdictional developments. I wanted to see if we could get an update on the Brexit issue that you discussed on the earnings call. I think you mentioned you'd applied for several licenses in Europe in order to continue to remain operational for new customers.

Do you expect this to be -- do you still expect this to be an issue post year end? And are you anticipating any material impacts as you kind of work to dissolve the licensing issue?

Thomas Pechy Peterffy - *Interactive Brokers Group, Inc. - Founder & Chairman*

So in preparation for the Brexit, we secured the brokerage license in Luxembourg because we used to serve our European customers from Interactive Brokers U.K. and after Brexit that will no longer be allowed. So we got this license in Luxembourg only to find out that the regulators would not allow us to accommodate all of our 200,000 customers in the EU because the EU's SIPC coverage guarantees each account for up to $20,000 and Luxembourg could not undertake a potential $40 billion obligation. So they told us that we can only house 10,000 of our 200,000 customers.

So upon receiving this terrible news, we immediately applied for licenses in Ireland and Hungary. Each of these license applications are currently pending. And we are very, very optimistic that we will get at least one of them, certainly before the end of the month.

In the future, our EU customer base will be segmented into Western Europe and Central Europe or Eastern Europe. So we'll have Interactive Brokers Ireland, we'll have Luxembourg and we'll have Interactive Brokers Central Europe.

William Alfred Nance - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Got it. That makes sense. So similar topic, different continent, different license, but you had applied for a U.S. bank charter about a year ago. And I think you recently mentioned the time line had been pushed out a couple of quarters. But can you maybe talk about timing and maybe hit on some of the -- what do you think the primary benefits of a bank charter for Interactive would be?

Thomas Pechy Peterffy - *Interactive Brokers Group, Inc. - Founder & Chairman*

So the opportunities that -- wait, no, no. So -- the primary benefit would be for our customers to have a seamless experience in funding and withdrawing money through our own bank, right? Owning a bank would give us all the freedom we would need to build the software that we would make a banking and brokerage platform fully integrated and adding other banking services in the future. However, due to the original Brexit-related tasks, this project has moved to the (inaudible).

William Alfred Nance - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Got it. Okay. Let's see, I think recently, you made a few comments that you expect to see some opportunities on the investment advisor platform to win new business from fallout from the merger between Ameritrade and Schwab. Are there any initiatives that you have internally to target that business or make investments in the platform to attract those potential customers?

Thomas Pechy Peterffy - *Interactive Brokers Group, Inc. - Founder & Chairman*

The opportunities that many financial advisors had accounts with each Schwab and Ameritrade in order to -- for one account to serve as a backup for the other. We now see a number of such RIAs coming to us and kicking the tires, looking to establish another backup.

When they come, they are pleasantly surprised by our newly extended portfolio builder where they can filter stocks by a huge number of criteria, combine them in a portfolio and back test the portfolio, not only for returns but also the variability of these returns and other performance statistics.

From here, they can move these portfolios into an updated portfolio allocation and rebalancing tools, namely, they can put several of our model portfolios that they constructed in the portfolio builder together and combine them according to different ways -- weights and continue back testing them.

The other thing, they -- these RIAs would be extremely attractive to is the flexible report that they can, in fact, design on our platform to look in any way they like because they love their own. The reports they used to receive, that they want to continue to receive, so we enable them to build that very simply.

William Alfred Nance - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Got it. You talked a little bit before about the difficulty in competing in terms of investment spending versus the large U.S. players with very large technology budgets, particularly after some of the consolidation in the industry that we've seen. Can you talk about the ways that you would approach investment spending to get the most bang for your buck?

Thomas Pechy Peterffy - *Interactive Brokers Group, Inc. - Founder & Chairman*

So it isn't so much about the bang for the buck for us. Technology budget has never been an issue for us. We would be willing to spend a great deal more if we could do that productively. We always have a large number of projects that we would like to do and a limited amount of resources to do that. But the resources are not limited by money, but they are -- but by rather a sufficient number of talented people who are good at building applications and are familiar with the business so that what they build makes practical sense.

Our CEO, Milan Galik, is a software engineer and has been with us for 3 decades, during which he learned our business and our culture and our relentless focus on automation. Over the years, he has become a much better manager than I was. And I have no doubt that he will be able to continue to hire and train more talented people to build more applications even faster than we did in the past so that we can continue to fulfill long-term goals and, at the same time, be reactive enough to suddenly changing circumstance in the industry.

From our point of view, this is a competition on technology and development, and developers are our most important assets. We must build things and capabilities to our platform that our competitors do not have, which can be well-described by very few words in an ad or by our salespeople because we only get very short attention time and only [infrequently].

We think that we do this quite well. We come from behind in the United States, but very few customers who decide to take a chance on us ever seem to regret it. And we keep on growing faster and faster. Milan is extremely good at directing all these large multitude of projects to fruition so that we will find new capabilities on our platform (inaudible).

William Alfred Nance - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Got it. Maybe sticking with that theme of new capabilities, the last 2 years have been very active in rolling out new products, markets, features onto the platform. I think more recently, you rolled out the Impact Dashboard, which is focused on ESG investing. You've also expanded the mutual fund marketplace. As you look out into next year, how does the pipeline of customer-facing products compare to the past few years? I know you won't tell us what they are.

Thomas Pechy Peterffy - *Interactive Brokers Group, Inc. - Founder & Chairman*

So the Impact Dashboard is a new and unique tool in the industry. It is a brain child of my son, William. He's 31. And along with many people his age, he is more focused on ESG and related issues.

We think that this tool and its evolution into future versions will be extremely attractive, especially for financially sophisticated younger people who will continue to come to us in greater numbers. 43 is the average age of our customers at this time. We would like to keep near that number, and the ESG impact app will help us do that.

Please stay tuned on this tool. You'll see other tools coming soon and lots of young customers to follow. The last 2 years were bountiful with digital tools, the next 2 years will be even more so.

William Alfred Nance - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Understood. Looking forward to that. The long-term guidance on the expense base has been 10% to 15%. It's been in place for a really long time now. Expense growth is at the high end of the range in 2020, but that's obviously in the backdrop of a 50% increase in accounts. And I think on your call, you also indicated that some of that was certainly compliance-related issues and investing in strengthening your controls. And maybe there are even some more onetime and major costs in the run rate this year.

It sounded like the bulk of the work on the compliance front was nearly complete at the end of the third quarter. Can you maybe help investors understand what the increased costs have been? What's kind of more onetime in nature? And as you look out, how do you think about cost increases in this elevated account growth environment?

Thomas Pechy Peterffy - *Interactive Brokers Group, Inc. - Founder & Chairman*

So expenses will continue to grow with increased compliance. As I said, we keep looking for and hiring more developers. We have no limits here. We will hire as many good people as we can get.

Expanding around the world with more and more offices and more and more customer service will add to expenses. So we'll continuously increase in marketing and sales expenses. Unfortunately, our legal fees keep also rise.

So to sum it up, we hope that we will be able to exceed that 15% because we want to grow as fast as we can. So we hope that we'll exceed the 15% rate expense growth, but with controlled growth. The emphasis is on the word "controlled."

William Alfred Nance - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Understood. And I understand you have a hard stop at 11:55. I'm going to squeeze one more question in here. Thomas, the business generates a significant amount of capital over time. The dividend only absorbs a small amount of those earnings. Can you tell us about significant capital base that you have and what you intend to do with it over time?

Thomas Pechy Peterffy - *Interactive Brokers Group, Inc. - Founder & Chairman*

So we hope to break the $10 billion mark in equity capital sometime around the end of the coming year. We intend to grow and continue to use the capital to find new subsidiaries, finance various customer needs, but most importantly, to convince more potential customers of our credibility and trustworthiness. That's what it's all about.

William Alfred Nance - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Got it. Well, on that note, Thomas, on behalf of the investors on the call, myself, the firm, thank you so much for joining us yet again, even if it was virtual. We're hoping very much to have you again next year in person, and hope you have a wonderful rest of the year.

Thomas Pechy Peterffy - *Interactive Brokers Group, Inc. - Founder & Chairman*

It was a great pleasure, and thank you very much for listening to me.

William Alfred Nance - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

All right. Bye bye.

Thomas Pechy Peterffy - *Interactive Brokers Group, Inc. - Founder & Chairman*

Bye.

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