

# **Interactive Brokers Group's (IBKR)**

## **Q1 2018 Results - Earnings Call Transcript**

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### **Executives**

**Thomas Peterffy - Chairman and CEO**

**Paul J. Brody - CFO**

**Nancy Stuebe - Director, IR**

### **Analysts**

**Chris Harris** *Wells Fargo Securities*

**Conor Fitzgerald** *Goldman Sachs*

**Doug Mewhirter** *SunTrust Robinson Humphrey*

**Kyle Voigt** *Keefe, Bruyette, & Woods*

**Mac Sykes** *G. Research*

**Rich Repetto** *Sandler O'Neill*

**Peter Binas** *Schooner Capital*

**Cullen Breen** *Dutch Asset Corp*

### **Operator**

Good day, ladies and gentlemen, and welcome to the Interactive Brokers Group first quarter financial results conference call. (Operator Instructions) As a reminder, this conference call is being recorded. I would now like to introduce your host for today's conference, Director of Investor Relations, Ms. Nancy Stuebe. Ms. Stuebe, you may begin.

### **Nancy Stuebe**

Thank you, operator, and welcome, everyone, to our first quarter earnings call. Our earnings were released today after the market closed and are also available on our website.

Our speakers today are Thomas Peterffy, our Chairman and CEO; and Paul Brody, our group CFO.

As a reminder, today's call may include forward-looking statements which represent the company's belief regarding future events, which by their nature are not certain and are outside of the company's control. Our actual results and financial condition may differ, possibly materially, from what is indicated in these forward-looking statements. We ask that you refer to the disclaimers in our press release. You should also review a description of risk factors contained in our financial reports filed with the SEC.

I'd now like to turn the call over to Thomas Peterffy. Thomas?

**Thomas Peterffy**

Good afternoon, and thank you for your attention today. Even though I know it is hard to follow the accent and on every occasion, it takes a long time for us to correct the record. Therefore, to make this process easier on you, starting this quarter, we are going to do something new. My script, which is the result of a joint effort between myself and our able representative for Investor Relations, Nancy Stuebe, I am asking Nancy to read the script. As in the past, I will remain on the call and attempt to answer any questions addressed to me. Nancy?

**Nancy Stuebe**

Good afternoon, and thank you for joining us for our first quarter 2018 earnings conference call.

This quarter saw the long-awaited return of volatility to world markets. We have said for several quarters that our strategy has been to grow our business in all segments, to get as many accounts on our platform as possible, so we could take advantage of volatility when it returned. And this quarter, it did.

The VIX volatility index rose to an average of 17.2 this quarter, up from 11.7 last year. Volume in our brokerage business rose 48% in options and 53% in futures over the last year. This compares with overall Options Clearing Corporation volume growth of 33%. Our stock share volume rose 28%.

The strength and scale of our platform, which we designed to handle trading volumes many multiples of what we have currently, helped us take advantage of this activity. This also explains why, while many of our peers had service interruptions during the busiest times in February, our customers had no such issues on our platform.

Our cleared DARTs rose to a record 876,000 this quarter, up 44% over last year. DARTs per account were also up to the highest levels in 2 years.

Yes, the market started moving again. The absolute numbers reminded us of the '87 and '08 crashes. But percentage-wise, of course, these daily changes in market prices were much closer to the long-term norm than anything unusual.

Towards the latter part of 2017, the higher the market climbed - even though we thought this was a well justified move in view of the prospects for economic revival - and the lower the volatility and the VIX trended, the more concerned we became about a sudden potential explosion of volatility.

As opposed to other folks, we tend to expect sudden large moves when things become very calm, and always in the opposite direction from what is currently taking place. This is also a good time to try to cajole people to rein in positions because they are liquidating large winners rather than large losers.

For this reason, we increased margin requirements above exchange minimums and increased the exposure fees we charge to those accounts that carry short volatility positions that, under certain scenarios, would suffer losses substantially above the amount of equity in those accounts. We calculate these exposures continuously, and we provide our customers the means to view them and to study hypothetical positions, with the trades that they could potentially enter into to diminish such exposures, and thereby reduce or eliminate the exposure fees. We also provide a mechanism to study various what if scenarios.

By imposing these so-called exposure fees, our goal is not to collect the fees, but rather to

incentivize our customers to minimize their - and, indirectly, our - exposure to potential market moves.

This strategy paid off for us during the first quarter. Our customers' losses were smaller than they otherwise would have been and, in spite of our large margin loans, our losses were limited to \$3 million across 15 accounts due to the wild market gyrations.

As expected, with the high volatility, volumes spiked up. In February, our DARTs exceeded 1 million per day, which is a new record for us.

On last quarter's call, we said the big question for 2018 would be if we can keep our accounts and customer equity growing at the rate we did in the fourth quarter. So far, the answer appears to be yes. Our accounts grew 27% to 517,000 and customer equity grew 33% to \$129 billion. And Interactive Brokers' growth comes from signing up new customers in addition to existing customers adding additional assets - and not from acquiring other brokers.

We attract new customers for several reasons: our superior technology, our low costs, the interest we pay to our customers on their cash, and positive word of mouth. We are also introducing new products and services such as IBot, which is our resident order desk robot to whom you can ask questions and give orders. We believe all this will increase the ease and attraction of our customer interface, and the number and kinds of transactions customers can do on our platform.

You can see our business' scalability in our margins. Compared to last year's first quarter, our reported pretax income for brokerage this quarter was \$291 million, up 57%, raising our pretax margin in brokerage from 59% to 63%. The factors driving brokerage were commissions of \$220 million, up 43%; and net interest income of \$210 million, up 56%.

Interest rates rose again in March. For those of you who pay attention to what interest you earn on the cash in your brokerage account, and you should, Interactive Brokers now pays 1.19% on customer cash in U.S. dollars. That is interest on the cash sitting in your brokerage account that you can access immediately, not cash you have to move to another account, or cash you have to use to buy a money market fund and spend several hours or days to free up in case you want to

buy a stock or a car.

Net interest income rose on increased assets and higher average benchmark rates. In addition to credit balances moving higher, our customers' average margin loans for the quarter reached a high of over \$29 billion as our customers capitalized on our lower margin rates. By paying the highest rates we know of on customer cash, and charging the lowest rates we know of from margins loans, we are attracting more takers on both sides.

Finally, our total equity reached \$6.7 billion in the first quarter, our highest to date. As we grow larger, our equity capital helps us attract larger customers.

We saw growth in all 5 of the client types that we service. I'll now go over our 5 client segments.

1. We saw particular strength once again in our introducing broker segment, which had first quarter account growth of 64%, client equity growth of 69% and commission growth of 48%. Operating and regulatory costs of running a brokerage firm go up every year as regulation grows worldwide. Smaller and mid-size brokers eventually reach a point where it is difficult, if not impossible, to justify maintaining their own technology. So they come to us to white label our platform, which gives them the benefit of Interactive Brokers' low cost while also giving their customers access to our state-of-the-art technology.

The introducing broker is charged our lowest commission rates, which they can then mark up. Every account, no matter what the size, is charged on the same commission schedule. A benefit for us is that many of these accounts are below IBKR's \$100,000 equity threshold for interest payments, and we can therefore capture that net interest revenue ,while providing the lowest commissions and best execution.

The introducing broker handles the customer service for, and manages the relationship with, its clients. We provide the execution and back office - the trading, reporting, clearing, custody and regulatory tasks. This symbiotic relationship works well for both sides. There is something for everybody.

2. We continue to see good growth in the hedge fund customer segment. For the first quarter, we saw 15% hedge fund account growth, 40% customer equity growth and 30% commission growth. As our word-of-mouth grows, more potential hedge fund clients try Interactive Brokers and see the quality of our platform and the strength of our balance sheet. Because hedge funds like and trade on volatility, commission growth was particularly strong in the quarter for this segment.

3. Individual customers, which make up 51% of our accounts, 35% of our client equity and 49% of our commissions, had account growth of 18% for the quarter while client equity grew 31% and commissions were up 15%. The more active trading environment meant that commissions for this segment finally started to keep pace with account growth.

4. Proprietary trading firms are 3% of our accounts, 10% of client equity and 17% of commissions. For the quarter, this group grew by 10% on accounts, 6% in customer equity and 18% in commissions. Like hedge funds, prop trading firms are sensitive to volatility and trade more when volatility rises.

5. Our final category is financial advisers. They are 17% of our accounts, 23% of our customer equity and 17% of our commissions. This group grew accounts by 16%, customer equity by 24% and commissions by 15%.

As was the case with individual customers, a better trading environment meant that commissions kept up with account growth. Also, Greenwich Compliance, our in-house team that assists advisers with the legal and regulatory process of setting up their own RIA business, has been very helpful to this segment's growth. Greenwich Compliance is our group of legal experts that take an RIA through state or SEC registration, get them set up in business, and onto our platform. By leveraging our expertise and ability to provide services and technology, RIAs can focus on their business in their start-up phase and on through their operational phase.

In addition to the constant improvement of our trading platform, you will see us continue to introduce new initiatives, like the FDIC-insured bank sweep program and Interactive Brokers debit Mastercard in the fourth quarter of 2017. We will also offer a bill pay function and payroll direct deposit, both of which are being rolled out shortly. These features are designed to give our

customers the most flexibility in their Interactive Brokers account and, not coincidentally, to give them little reason to leave our platform.

There are many of you on this call who are investors in our company but not customers. We prefer investors who are customers, with whom we are happy to share our success. Our success depends on feedback from and working with our users. We believe that we may not be the right investment for those who are not willing to use our platform. We ask that you join us, seriously explore and experiment with what we provide and give your suggestions to help us get even better.

With that, I will turn the call over to our CFO, Paul Brody, who will go through the numbers for the quarter.

**Paul Brody**

Thank you, Nancy. Welcome, everyone, to the call. As usual, I'll first review our summary results and then give segment highlights, including some additional color on the winding down of our market maker, before opening it up to questions.

First quarter operating results reflected a solid performance in brokerage, led by gains in net interest income and commission revenue. These were supplemented by currency translation gains and a continued low level of Trading Gains produced in the Market Making segment.

Operating metrics reflected a stronger trading environment with greater volatility as measured by the average VIX. Volatility rose 47% from the year ago quarter to 17.2% this quarter. Higher volatility typically gives rise to more trading opportunities for our customers worldwide. And, with the added tailwind from new account growth, our quarterly total DARTs were up 43% year-over-year and our cleared DARTs per account rose 14% and our average net revenue per cleared account grew 19%.

We continued to see strength this quarter in asset gathering and margin balances in brokerage, as I will describe further in my comments on the segment's performance.

First quarter reported net revenues for the company rose 41% against the lukewarm low volatility quarter last year. Pretax income was up 60% for a pretax margin of 65%, excluding extraordinary items like our Treasury marks, currency translation effects and market maker exit costs from last year. Consolidated net revenues were up 51% versus last year while pretax income rose 85% for a pretax margin of 62%.

And for the brokerage segment, excluding treasury marks, pretax income was up 58% for a pretax margin of 63%. Discussing the main factors, stronger market environment, firstly, the average VIX, as I said, rose 47% year-over-year and volatility rose steadily beginning in February after a years-long period of historically low readings.

Generally, a higher VIX enhances trading volume and therefore, brokerage revenues. Next, the U.S. dollar weakened versus other major currencies. As a result, the currency basket in which we keep our equity, which we call the GLOBAL, rose 0.7% against the dollar for the quarter, resulting in a gain of \$46 million. This includes a gain of \$38 million reported in Other Income and a gain of \$8 million in Other Comprehensive Income or OCI.

We estimate the total impact to comprehensive earnings per share from the GLOBAL to be a gain of \$0.09 for the quarter with \$0.07 reported as Other Income and \$0.02 as OCI.

Finally, short- to medium-term interest rates rose again in the quarter as the Federal Reserve continued to raise its target rate with another 25-basis point increase. As a result of our short duration portfolio, which we manage to reduce our yield curve exposure, we recorded a modest mark-to-market loss of \$3 million on our holdings of U.S. Treasuries. Although we plan to hold these securities to maturity, we must, as brokers, unlike banks, mark them to market in our financial reporting.

I'll summarize the quarter's revenues, adjustments and pretax results as follows.

Reported net revenues for the quarter were \$527 million, deducting the \$38 million gain on our currency strategy and adding back the \$3 million loss from marking our Treasury portfolio to



market results in adjusted net revenues of \$492 million for the quarter. That's an increase of 51% from adjusted net revenues of \$326 million in the year ago quarter.

Reported pretax income was \$340 million. And adjusted for these factors, pretax income was \$305 million. That's an increase of 85% over adjusted pretax income of \$165 million in the year ago quarter. Pretax margin in the latest quarter was 65% as reported and 62% as adjusted.

Turning to the income statement line items. Commissions and execution fees were \$220 million, up 43%, driven by increased volume across product types. Net interest income was \$217 million, up 53%. Brokerage produced \$210 million; Market Making, \$6 million; and Corporate, the remainder. While the December Federal Reserve rate hike helped us this quarter, the benefit of the March hike will be reflected in our numbers going forward.

Trading Gains were \$13 million, up from \$2 million in the year ago quarter. The increased volatility has helped the small remaining Market Making operations. Other income, which, as I described earlier, included the effects of our currency diversification strategy and also Treasury portfolio marks, was a gain of \$77 million, about even with the prior year quarter.

Noninterest expenses were \$187 million for the quarter, up 16% from the same quarter last year. The rise in expenses reflects higher execution and clearing costs on strong trading volume as well as higher compensation and benefit and G&A expenses. At March 31, 2018, our total headcount stood at 1,252, an increase of 3% over the year ago quarter.

As the modest increase shows, we have been moderating the pace of hiring while transferring some employees, mostly software developers, from Market Making to Brokerage operations. We continue to build our customer service and legal and compliance capabilities. Compensation and benefits expenses somewhat outpace the increase in headcount this quarter, reflecting primarily accruals for higher bonuses.

Comprehensive diluted earnings per share were \$0.65 for the quarter as compared to \$0.40 for the first quarter of 2017. On a noncomprehensive basis, which excludes the OCI, diluted earnings per

share and net income were \$0.63 for the quarter as compared to \$0.34 for the same period in 2017. Excluding the impact of noncore items, comprehensive diluted earnings per share were \$0.57 for the current quarter versus \$0.27 for the year ago quarter on the same basis.

Now to help investors better understand our earnings, the split between the public shareholders and the noncontrolling interests is as follows. Starting with income before income taxes of \$340 million. We deduct \$10 million for income taxes paid by our operating companies, which are predominantly foreign taxes. That leaves us with \$330 million, of which 82.6% or that \$273 million reported on our income statement, is attributable to the noncontrolling interest. 17.4%, the remainder, or \$57 million is available to the public company stockholders. GAAP accounting prevents us from putting this \$57 million number on our income statement because the public company results are reported after taxes.

After we expense the remaining taxes of \$11 million owed on that \$57 million on top of the company's net income is the \$46 million reported on our income statement. In total, income tax expense of \$21 million consists of this \$11 million plus the \$10 million paid by the operating companies.

Turning to the balance sheet. It remains highly liquid with low leverage. As a general practice, we hold an amount of cash on hand that provides us with a buffer should we need immediately available funds for any reason. We are extremely well capitalized from a regulatory standpoint and continue to deploy our capital within our growing brokerage business. We elect to hold excess capital to take advantage of opportunities as well as to convey the strength and depth of our balance sheet.

We continue to carry no long-term debt. And our consolidated equity capital at March 31, 2018, reached \$6.7 billion, of which approximately \$5.1 billion was held in Brokerage, \$1.3 billion in Market Making and the remainder in the Corporate segment.

As the market maker is wound down, capital is being used to support our brokerage business. It bolsters the broker's financial credibility, facilitates customer orders and products, such as CFDs and ETFs, and also allows us to take advantage of greater customer financing opportunities.

In addition, we're evaluating our policy of funding quarterly dividends from the subsidiaries that have accumulated Market Making earnings over the years, and we expect to begin sourcing these funds from accumulated brokerage earnings over the coming quarters.

Turning to the segments, beginning with Electronic Brokerage. This quarter, we saw a rise in trading volume largely driven by increased volatility, which has long been absent in world, and especially U.S., markets. Customer trade volumes rose 28% in stocks, 48% in options, and 53% in futures. Foreign exchange dollar volume was also up.

Commission revenue rose 43% on a product mix that featured smaller average trade sizes in stocks and futures and larger in options and ForEx. This mix resulted in an overall average cleared commission per DART of \$4.04 for the quarter, up 1% from the year ago quarter. Customer equity grew to \$129.2 billion, up 33% from last year and 4% sequentially. The source of this growth continues to be a strong inflow of new accounts and customer assets.

We continue to have success in attracting increasingly larger customers, including hedge funds as well as financial advisers and introducing brokers that, while large overall, manage groups of smaller accounts. In particular, large introducing brokers who bring their business to us on either an Omnibus or fully disclosed basis, continue to sign up with greater frequency.

Our average account equity rose 5% year-on-year to \$250,000. In addition to the larger accounts that we attract with financing and short sale support, we hope to persuade customers of all sizes to deposit more of their cash with us by offering an expanded suite of cash management tools such as our Interactive Brokers Debit Mastercard, our FDIC-insured bank deposit sweep program, bill pay and payroll direct deposit services and our strong mobile offerings.

Margin debits rose 40% year-over-year, reaching \$29.3 billion. Our compelling margin lending rates, especially in a rising interest rate environment, along with customers' appetite for increased risk and our expanded prime broker financing, drove increases in margin lending across large and

small accounts. Customer credit balances continued their steady growth, rising 7% over the year ago quarter.

Net interest income rose to \$210 million, up 56% from the first quarter of 2017, and our net interest margin widened to 1.55% from 1.12% in the year ago quarter. The Federal Reserve's four increases in the Fed funds target rate since March of 2017, together with increased customer balances, generated more net interest income on cash balances. Our continued success in asset gathering should lead to larger revenue contributions from interest-sensitive assets going forward. Our bank sweep program introduced last year has seen increased acceptance, though, it's not yet contributing meaningfully to net interest margin. And finally, our Stock Yield Enhancement Program where we share revenue from lending out fully paid securities with our customers continues to expand providing an additional source of interest revenue on securities assets. Margin lending and our segregated cash management were the largest contributors to the improvement in net interest margin.

Given the opportunities presented by the market, our new product introductions, and a growing customer asset base, we continue to believe we are well positioned to maximize our net interest income. In this environment, expectations over further rate increases are baked into the yields on instruments in which we invest. Isolated from these expectations and based on current balances, we estimate that an unanticipated single rise in overnight interest rates of 25 basis point would produce an additional \$9 million in net interest income over the immediately-following 4 quarters and \$15 million as the yearly run rate, which includes reinvestment of all current holdings at higher rates. Further increases in rates will be reflected to a lesser degree in our net interest margin. We would realize part of any increase in the interest we earn on our segregated cash and our margin lending, offset somewhat by the interest we paid to our customers, which is pegged the benchmark rate less a narrow spread.

Fixed expenses in brokerage were \$103 million, up 30% over the year ago quarter. The primary component of this increase was higher general and administrative costs, driven by the expected transfer of staff from Market Making and increased legal and compliance expenses and reserves. Customer bad debt expense was \$3 million, higher than in prior quarters but a reflection of the success of our robust risk management systems and limiting customer defaults during highly

volatile periods.

Our Risk Committee continues to enhance our scenario-based risk models in order to reduce exposures to world events. Pretax income from Electronic Brokerage was \$291 million, up 57% from the prior year quarter, for a 63% pretax margin. Excluding Treasury marks, core pretax income was \$294 million, up 58% from the prior year quarter on the same basis.

I'll now give a few brief remarks here about the Market Making business, as we have wound the majority of it down.

This segment today consists of the customer facilitation business we will retain in products such as CFDs, ETFs and single stock futures, as well as a few profitable international markets that we will continue to operate and evaluate for a period of time.

Earnings from these operations have and are expected to continue to defray the \$25 million of exit costs we incurred in 2017. As expected, Market Making trade volume generally declined year-over-year. Options and futures contract volumes fell 75% and 63%, respectively, while stock share volume was up. That stock volume reflects an increase in market activity in Hong Kong, and our ongoing customer facilitation activity. Trading gains for Market Making for the first quarter were \$13 million, up from \$2 million in the low volatility quarter last year, and about even with the \$14 million reported for the fourth quarter. Pretax income was \$9 million in the quarter, up from a pretax loss of \$22 million in the year ago quarter. And on the cost side, execution and clearing fees expenses were down 62% on lower trading volumes, fixed expenses decreased \$7 million, down 59% from a year ago quarter, as the majority of Market Making employees who are staying with us have been transferred to brokerage.

As we had said, we expect our brokerage operations to absorb approximately \$40 million of expenses or about \$0.08 per share annually going forward. The added costs consist primarily of personnel and certain technology infrastructure.

On a run rate basis, the brokerage business has now absorbed about 95% of that \$40 million annual amount, and we expect the migration of these expenses to continue over the coming

quarters until the full amount is absorbed some time in 2018.

Finally, the earnings reported for the Corporate segment reflect the effects of our currency diversification strategy. Our overall equity, as measured in U.S. dollars, increased as the U.S. dollar weakened against most other major currencies. We estimate the overall gains from our strategy of carrying our equity in proportion to the GLOBAL to be about \$46 million for the first quarter of 2018. As I described earlier, because \$8 million of a GLOBAL gain is reported as Other Comprehensive Income. This leads a gain of \$38 million to be included in reported earnings.

Now I'd like to turn the call back over to the moderator, and we can take some questions.

## **Question-and-Answer Session**

### **Operator**

(Operator Instructions) And our first question comes from Rich Repetto with Sandler O'Neill.

### **Rich Repetto**

And the first thing I want to say is I enjoy listening to you, Thomas, so I'm going to ask questions of you. Anyway, so the first question for you, Thomas, is congrats on the Brokerage growing tremendously, both trading and net interest. And I'm just trying to get a feel for how it looks. I know we're only a little bit past half of April. But you got high volatility, or volatility that's still comparable to 1Q, but you see volumes a lot lower as far as industry volumes go. And I'm just trying to see, just get a feel, what's overall more of an impact, the volatility or the lower volume so far?

### **Thomas Peterffy**

You see it correctly. People get used to the higher volatility, they adjust their positions accordingly and feverish trading subsides. So what we see is what you see industry-wide.

**Rich Repetto**

Okay. And then the other thing was on the overall environment with a much -- with higher volatility in 1Q. And you've gone through -- Nancy did the different customer segments. Did anything jump out of you as different as -- did the higher volatility give more opportunities in certain customer segments than others? Or was it pretty hard to decipher or any comments that you might have on...

**Thomas Peterffy**

It's obvious that the people who are engaged in volatility selling had to substantially retract their positions. And that activity did not come back to the extent that it was there before. So that is basically the big change that has happened.

**Rich Repetto**

Got it, okay. And the very last thing. I will ask Paul a question. The constant questions on taxes. So when you actually look at your tax rate for IBG Inc., it looked like it was a little bit below the 22.5%, sort of like 19% -- in the low 19%. Is that -- are you -- not that it's a big amount overall to the bottom line but is that a better number, the 19% range, than the 22.5% you talked about before?

**Paul Brody**

Right. So the way to think about it is, the 22 and change that we talked about is kind of a statutory rate, absent any other factors, if we just had a standard amount of income flowing through that gets taxed to the public company. So the effective rate this quarter was in the high 19%, a little bit under 20%, actually. And that comes about because in any particular quarter, we may be able to take advantage of some foreign tax credits. It depends where the income is earned. There might be certain deductions, R&D. Whatever they are that do vary quarter-to-quarter. Those factors tend to reduce that statutory rate to something lower. This time, they reduce it to a little bit under 20%.

**Operator**

And our next question comes from Kyle Voigt with KBW.

**Kyle Voigt**

Just a first question on the introducing brokers segment. The 64% account growth looks really strong. I'm just wondering if you could talk to the pipeline here in terms of potential brokers looking to outsource their technology to IB, maybe compared to a year ago? And then the second part of that second question, Thomas, I'm just wondering, is there a way to help us frame the potential runway that's left in that segment specifically in terms of framing the aggregate side of these smaller brokers you think that could look to partner with IB?

**Thomas Peterffy**

I do not see this revenue stream as that it will be ever exhausted because new brokerage firms pop up all the time. Especially since our platform is there, it takes very little effort to enter into the business. So I think that this line of business will continue to expand for a very long time. As far as the pipeline, yes, it takes some existing brokerage firms, especially if they are larger, a long time to make up their minds. And once they do make up their minds and decide to come over, it takes them 3 to 6 months to get their pipes together. So we do have several ones that we are waiting to onboard, and that's all I can tell you about it.

**Kyle Voigt**

Okay, fair enough. And the second question will be on the duration of the securities book. I think from the beginning of 2016 through the middle of 2017, you kind of significantly shortened the duration of the securities book. And from the disclosures that we have, it looks like during the back half of 2017, specifically in the fourth quarter, you began to re-extend that duration slightly. I was just wondering if you could help us understand how we should think about IB's investment decisions in terms of that duration over the next maybe 12 months?

**Thomas Peterffy**

You're talking about Treasuries specifically, yes?

**Kyle Voigt**

Yes, yes. Yes.



**Thomas Peterffy**

So yes, we have to maintain a position in Treasury bills because the futures exchanges, mainly the CME, will take original margin only in the form of cash or Treasury bills. And so to that extent, we have about \$4 billion in Treasuries that we tend to roll over whenever they come due for about a 2-year period so that the weighted maturity of that is about a year forward. Otherwise, we keep our customers' funds in repos, and the repos are within 3 months.

**Kyle Voigt**

Okay. So the increase in the U.S. government securities is from \$3.5 billion to \$4.5 billion in the fourth quarter. That wasn't -- that was mostly to do with activity levels at futures exchanges? Or was that an investment decision to invest those?

**Thomas Peterffy**

It's an investment decision. We actively manage these positions.

**Kyle Voigt**

Yes, okay. All right, fair enough. Last one for me is just really on the other income. I think we back out the FX impact and the Treasury marks in the Other Income line. The kind of core Other Income numbers have been growing quite strongly. Just wondering if you could help us understand what's driving that growth.

**Thomas Peterffy**

So it's -- you have heard, we talked a little bit about exposure fees we charge to accounts, who in certain scenarios, appear to potentially lose more money than they had with us and we try to discourage them, to try to rein in their positions. We ask them to and it's -- and if they don't want to, we charge them this fee. And that amounted to, I believe, \$8 million for the quarter.

**Operator**

And our next question comes from Doug Mewhirter with SunTrust.

**Doug Mewhirter**

A question about your introducing broker business, which is growing quite nicely. Give me an idea of the new customers, IB customers, either banks or brokerage affiliates of banks or brokers that you signed, what's the average accounts per brokerage client that you signed up? Just to get an idea of how big a bite you take every time you sign up one of these Introducing Broker clients.

**Thomas Peterffy**

By account, you mean how many accounts they have?

**Doug Mewhirter**

Correct. That would be move over to your platform once you sign the agreement.

**Thomas Peterffy**

On average, they have a few thousand.

**Doug Mewhirter**

A few thousand. Okay, that's helpful. And Paul, on the expenses, you alluded to some bonus accruals, which certainly would be well-deserved with your performance. Can you give me an idea of maybe how much that was above the trend this quarter or what the dollar amount -- absolute dollar amount was?

**Paul Brody**

Yes. I can't be too specific. I can tell you that -- I mean, what you're after, I guess, is trying to estimate a better run rate. And the run rate is closer to this quarter than the last year's quarter because of some additional accruals. I can also tell you that there was some adjusting in the fourth quarter, because it was -- that number was a little lower than normal because we did the best we could, accruing bonuses towards the end of the year with all that was going on with Market Making and moving employees and you have a lot of unknowns. So we were slightly over-accrued going into the fourth quarter. So that, if you're comparing on a sequential basis, that number was slightly depressed. Other than that, I can tell you we're close to run rate, probably a little bit over because of period-to-period, you have certain adjustments that are always going in.

**Thomas Peterffy**

If I just may correct the record a bit. On average, the introducing brokers do have a few thousand but we have 2 large ones, one of them has over 40,000 and the other one has nearly 20,000. Otherwise, they have a few thousand.

**Doug Mewhirter**

Great. That's very helpful. And my last question, Thomas, could you characterize how the growth rates in either accounts or equity or however you want to define it, was different between international versus United States-based clients or segments?

**Thomas Peterffy**

Well, obviously, in Asia, it's the highest and Europe is the second highest and the United States is the lowest.

**Doug Mewhirter**

Okay. And I guess, that makes sense given the definite increase in activity over in Asia and your franchise there and especially in Hong Kong.

**Operator**

And our next question comes from Mac Sykes with Gabelli & Company.

**Mac Sykes**

Just had two. First, I would just highlight again what a terrific job you've done with growth but given the last quarter in terms of volatility, are there any areas where you may want to increase resources more dramatically to support that growth in terms of client support, data centers, et cetera?

**Thomas Peterffy**

Well, we are piping quite a few resources into Asia. Yes, that's where we're growing the fastest, yes.

**Mac Sykes**

Okay. And then the margin balance costs, or the rates around 1.9% to 2% the last quarter. And it's been a while since we've seen materially higher rates. Is there a point where that level of cost to the consumer may slow down demand for margin balances?

**Thomas Peterffy** Could you rephrase the question, please?

**Mac Sykes**

So if I take out a margin balance, the cost is almost 2% at this point. Is there an absolute level of rates where there will be pressure to reduce margin balances just simply because of the cost of carry?

**Thomas Peterffy**

Well, it's hard for me to tell, because I've never been in this business at the time when margin -- when interest rates are very high, but you see, I think that most of the accounts we get, we get from other brokers. And as long as all their margin loans are so much less expensive than our brokerage margin loans, I think that we do not have to worry about that.

**Operator**

And our next question comes from Conor Fitzgerald with Goldman Sachs.

**Conor Fitzgerald**

Just wanted to ask one on deposit cost, which I think were up 6 basis points quarter-over-quarter. Meaning, you passed through roughly 6 basis points, I think, versus the 25 basis points you saw the Fed funds rate rise. So 2 questions on that. Can you just give us a little more color of how much of your deposits are tied to U.S. dollar? And then of the deposits that are tied to the U.S. dollar, can you help us understand what the pass-through rate on future Fed increases should be on those balances?

**Thomas Peterffy**

It's mostly U.S. dollars, roughly around 90%. And the pass-through rates are one for one for roughly 95% of the money.

**Conor Fitzgerald**

Okay, that's helpful. I guess, my question is if it's a one for one pass-through on the majority of your deposits, just trying to understand why that cost would be only up 6 basis points quarter-over-quarter. And just the reason I'm asking is just trying to think about the go-forward, how sustainable the lower pass-through rates are.

**Thomas Peterffy**

That's a tough question. I -- well, when was the rate increase? The rate increase was?

**Conor Fitzgerald**

Mid-December.

**Thomas Peterffy**

Mid-December. Paul, you have any idea why that would be the case?

**Paul Brody**

Conor, repeat the last question coming from...

**Thomas Peterffy**

He says the Fed increased the rates by 25 basis points. Our customer interest expense went up only by about 6 basis points.

**Conor Fitzgerald**

And just to further clarify. Just looking at the customer credit balances, 42 basis points this quarter. Just trying to understand how to think about that number tracking going forward.

**Paul Brody**

Right. Well, there is a -- there's actually a more significant portion of the credit balances. I think

Thomas was referring to invested cash but understand that credit balances fund debit balances. And then they attract interest on their own to the extent that -- of the gross amount of the credit balance. So approximately, I want to say, 20% of the credit balances are not earning interest to the customer, meaning that we are capturing any rate increases there. And so if you're looking at increased expense paid on credit balances, they're only paid on the remainder, right? They're paid on the larger balances, balances on equity -- accounts with equity more than \$100,000, on cash balances more than \$10,000, et cetera. So that's not the total, right? That's 70% to 80% of the total.

**Thomas Peterffy**

Yes, 80% of the total. So if the Fed rate is 25, it should go up 20, right?

**Conor Fitzgerald**

Right, right. And just fair to think about the 6-basis point increase this quarter as a good proxy for what we could expect with future hikes.

**Thomas Peterffy**

Are you sure you're right about the 6 basis points?

**Conor Fitzgerald**

And just from a GAAP income perspective, Thomas. I understand the dynamics of what you're actually passing on. The customers are higher. Just want to understand from a go-forward modeling perspective on that line if it's not...

**Thomas Peterffy**

I think you should use 80%.

**Conor Fitzgerald**

Got it. Okay, that's helpful. And then just last question from me on the margin balances. I know you had increased pricing to try and slow down some of the growth in January. Just wondering what you learned from that experience and if it gave you any indication of how price-sensitive

some of your customers are and maybe if you do you have pricing power in these parts of your businesses.

**Thomas Peterffy**

So to tell you frankly, I did not follow this very closely. I expect that there are some loans we did not make. But generally, we are so much lower for large amounts of money than anybody else that we do not believe that there are many other outlets that compete with us.

**Operator**

And our next question comes from Chris Harris with Wells Fargo.

**Chris Harris**

As a follow-up to those last series of questions. The credit balances that are not paying any interest to customers. Why is that? And is it a certain type of customer, certain type of account?

**Thomas Peterffy**

So we do not pay interest on cash in accounts where the total assets amount to less than \$100,000, number one. Number two, the interest we pay on cash for other accounts, we do not pay interest on the first \$10,000 of cash.

**Chris Harris**

Okay, got it. And then in terms of your expenses, any thoughts that you guys might want to share on the trajectory of these expenses maybe throughout the course of this year?

**Thomas Peterffy**

We're trying to expand as fast as we can, and we do not expect that expense growth will moderate.

**Operator**

(Operator Instructions) Our next question comes from Peter Binas with Schooner Capital.

**Peter Binas**

Just a brief question on our Asia performance and exposure. Given concerns around possible adjustment coming from debt levels in China, I'm wondering how you think about the exposure of the business to that part of the world and how a major correction or exchange rate correction in that part of the world would affect the business overall.

**Thomas Peterffy**

Well, these accounts are not very huge. So I do not really think that they would be substantially impacted by any of those forces that you mentioned.

**Peter Binas**

Meaning that they make up a smaller part of the total than I would suspect or because they're small in the...

**Thomas Peterffy**

No, the accounts themselves are not very large. So I wouldn't think that they will be very sensitive.

**Peter Binas**

Got it. And they're, for the most part -- if I understand correctly, they are dollar-denominated?

**Thomas Peterffy**

Mostly, yes.

**Operator**

And our next question comes from Cullen Breen with Dutch Asset.

**Cullen Breen**

Thomas, I had a question specifically about the minority interest and if you saw any potential to change that in the future to consolidate that with the public interest?



**Thomas Peterffy**

That's a question that I have -- basically have already been looking at, so I can't answer that question right now, but I do not think that from the point of -- the current public interest that would make any difference. In other words, if our shares were -- if my shares were registered but I kept on sitting on them, I don't think it would make any difference for the public shareholders.

**Cullen Breen**

Well, currently, it's an S&P 400 component, correct? And the...

**Thomas Peterffy**

It would remain such, because closely - our shares do not figure into the S&P weighting. I did look at that. I did look at that one. That's the answer.

**Operator**

And I'm not showing any further questions at this time. I would now like to turn the call back over to Nancy Stuebe for any closing remarks.

**Nancy Stuebe**

Thank you, everyone, for participating today. As a reminder, this call will be available for replay on our website. We will also be posting a clean version of our transcript on our site tomorrow. Thank you again, and we will talk to you next quarter end.

**Operator**

Ladies and gentlemen, thank you for participating in today's conference. This does conclude today's program. You may all disconnect. Everyone, have a wonderful day.