LATITUDE
INVESTMENT MANAGEMENT

Dear Shareholder,

A company can outperform rivals if it can establish a difference which it is able to preserve.

It must deliver greater value to customers, or create comparable value at lower cost, or do both. The arithmetic of superior profitability then follows: delivering greater value allows a company to charge higher unit prices; greater efficiency results in lower unit costs.

Such competitive advantages are frequently sought by financial analysts. Sought with such vigour that, often, these accolades are frequently misallocated to companies with nothing more than a short-term tailwind.

Nothing is more dangerous than buying shares in a *clearly* competitively advantaged company, only to realise it is not quite so.

Likewise, nothing is as exciting (in our line of work, anyway) as finding a company with concurrent competitive advantages which are yet to be recognised by the wider market.

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Interactive Brokers (IBKR) is a financial technology company, listed in America and operating globally. Fifty years ago, it was the first firm to use computer generated share price sheets and the first to introduce handheld computers on the American Stock Exchange, and this spirit of technological innovation has catapulted them to the market leading position they have today.

Today the business is an online trading platform, used by sophisticated individual investors as well as hedge funds, wealth managers, and other brokers.

Their history of successful innovation has rewarded the company with three concurrent competitive advantages:

- Lower prices for customers
- Lower operating costs
- Better service

The company has been rated lowest cost broker every year since 2002 by Barrons. Looking at their margin loans and deposit rates[1] below we can see why.

Margin Loan Rates %	$25k	$300k	$1.5M	$3.5M
Interactive Brokers	**6.83%**	**6.50%**	**6.28%**	**6.17%**
E-Trade	13.70%	12.20%	N/A	N/A
Fidelity	13.08%	11.83%	9.25%	9.25%
Schwab	13.08%	11.83%	N/A	N/A
Vanguard	13.25%	11.75%	N/A	N/A

[1] As disclosed in https://investors.interactivebrokers.com/download/investors/3Q23_Investor_Presentation_GS.pdf

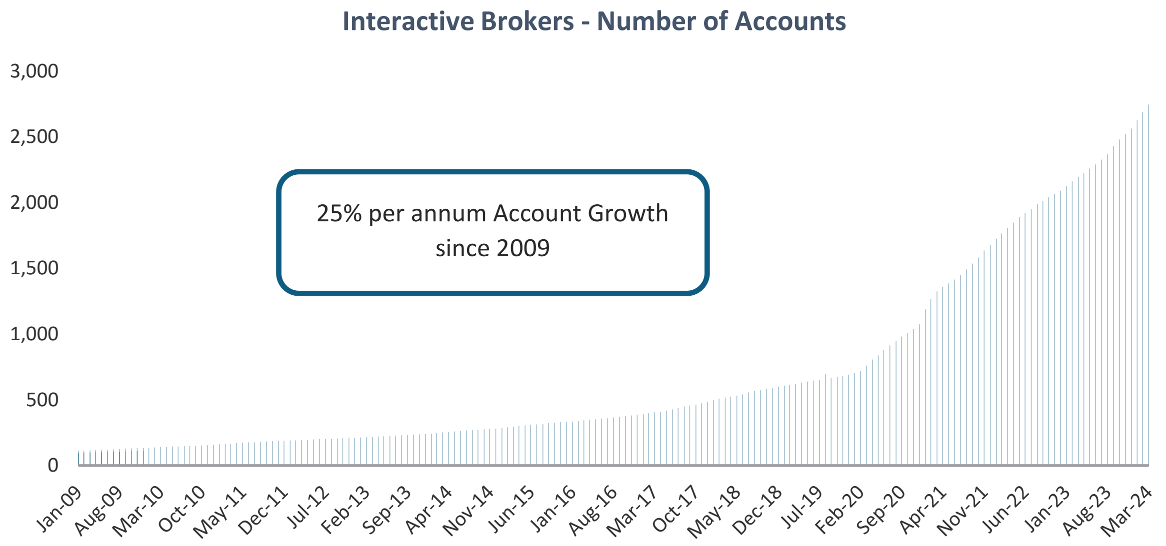
Interest Paid on Customer Deposits (USD)	
Interactive Brokers	**4.83%**
Bank of America	0.04%
Citi	0.12%
E-Trade	0.01%
JP Morgan	0.02%
Schwab	0.45%
Wells Fargo	1.00%

Customers of IBKR benefit from a multitude of enhancements which are unavailable on rival platforms. Advanced trading tools include one hundred different order types, Application Programming Interfaces (APIs) and smart routing technology to ensure best execution.

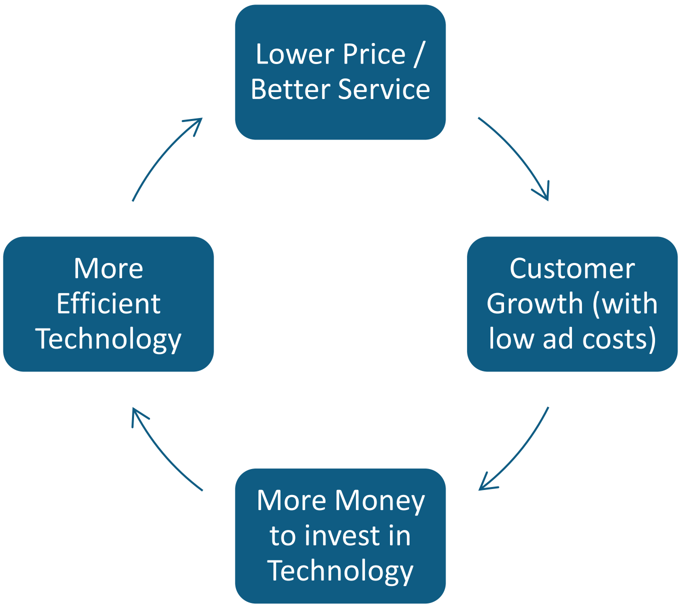
This is in stark contrast to other firms like Charles Schwab or Robinhood who receive "payment for order flow" by sending their customers' orders to others to execute, presumably at a worse price given the profits of these intermediaries. IBKR have even invested in tools which allow customer orders to be matched against each other at mid-prices, saving both buyer and seller the cost of a bid / offer spread.

It achieves all this at a fraction of the cost that rivals incur, meaning IBKR earns higher margins than peers, while offering greater service and functionality, at lower costs to the customers. Cash costs per account have fallen from $5 to $0.50 over the past fifteen years, and today IBKR's operating margin is 70% while Charles Schwab and others earn margins in the range of 20-40%.

The optimal distribution strategy is one where the proposition is so appealing it acts like a force of gravity pulling in customers towards it in an exponential way. This is what has been happening at IBKR where advertising costs are a fraction of competitors, leaving more internal resources in the business to reinvest in better technology and even lower prices.



The IBKR Flywheel of Customer Value Creation



The distribution strategy for the business has revolved around building out the technology to cater for a wider groups of clients. Having previously focused on sophisticated individuals, in 2012 they introduced a platform for wealth managers, fund manager groups, and investment advisers. In the same way that **Visa** has benefitted from the start-up banking revolution, IBKR has also been selling their technology to other online platforms who cannot compete with their efficiency and scale. They now have 6% of the global prime broking market up from just 1% in 2016.[2] Individuals now make up less than half of the client assets across the business.

Strategically the business is incredibly well-positioned to continue to grow customer accounts. They currently have 2.5m accounts, up 270% since 2019, and have a target to reach 20m over the medium term (for context Charles Schwab have 40m accounts) and 80m over the very long term. We have high confidence that this is achievable, and over time their competitive advantages could even lead to them surpassing this figure, provided their rollout of IBKR Lite[3] is successful.

There are two primary sources of revenue at IBKR, the first of which is **trading revenue**. Across their 2.5m accounts, customers place around 200 trades per year, at an average cost of $3 per trade, giving $1.5bn in trading revenue. Trades per account have been falling gradually over time due to the mix of customers, although this is dwarfed by account growth. Commission levels fluctuate depending on the securities being traded (shares, options, futures etc) and we estimate that they will stay broadly flat over time.

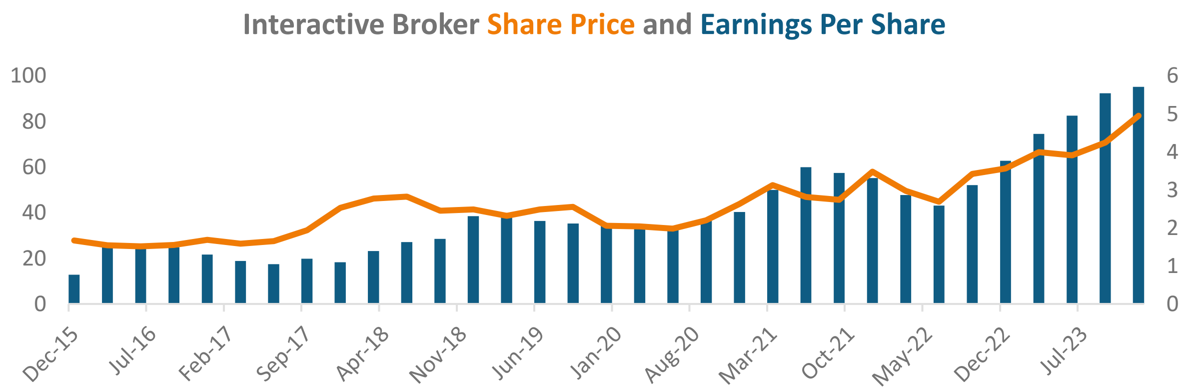
The company also earns a **net interest margin (NIM)** on customer deposits and margin loans.

[2] Goldman Sachs Investment Research
[3] IBKR Lite is an online platform with far simpler user interface, more similar to Charles Schwab, aimed at regular investors.

They have interest-earning assets of around $119bn which earn around the Fed Funds rate +0.5%, and interest-bearing liabilities of $106bn which cost around 70% of the Fed Funds rate -0.5%. At current interest rates this yields around 2.5% NIM or $2.75bn of NIM.

Clearly there is sensitivity around the level of interest rates, although interest-earning assets have doubled since 2019 and are likely to move in tandem with account growth over time. Likewise, demand for margin loans increases as rates fall, creating a partial offset to this risk. Given the business pays market leading levels of interest on customer accounts, they do not see the level of switching experienced at peers.

This resulted in record profits for the firm of $2.8bn or $5.72 per share.



Supporting these profits, and the continued strategic investments, is a fortress balance sheet which is 99% invested in short-term liquid assets, no long-term debt, and equity of $13bn which is multiples of the regulatory requirements.

IBKR has the best-in-class product allowing them to grow and take market share in an industry which grows at 7-10% per year[4]. If you have the best product or service, customers find their way to you. Not as smoothly as other businesses but, importantly, in one direction. Why would you leave if the product and service is better and cheaper?

This fly trap creates a flywheel of value creation which can continue for a decade or more. Over the past ten years the company has grown it's comparable EPS at 18% per year[5], and we believe the future is brighter than the past due to the current scale of the franchise.

We invested in shares of Interactive Brokers in January this year.

As ever, please get in touch with anyone in the team if you have any questions.

Best wishes from all of us at Latitude,

Freddie Lait

[4] Redburn Atlantic Research
[5] LIM Internal Estimates