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Quarterly Commentary
Orbis Global Equity

31 MARCH 2023

As discussed in last quarter's commentary, our Global Equity Strategy has meaningful exposure to selected banks that we believe offer compelling value. For reasons discussed in Our Thinking, we continue to believe that the Strategy's bank holdings are attractively valued and more resilient than many of their global peers. Although not a bank, Interactive Brokers is another business in the financial sector that we find attractive. We initially established the position in November 2021 and have added in recent weeks. Interactive Brokers is now the Strategy's 6th-largest holding at 3% of the portfolio.

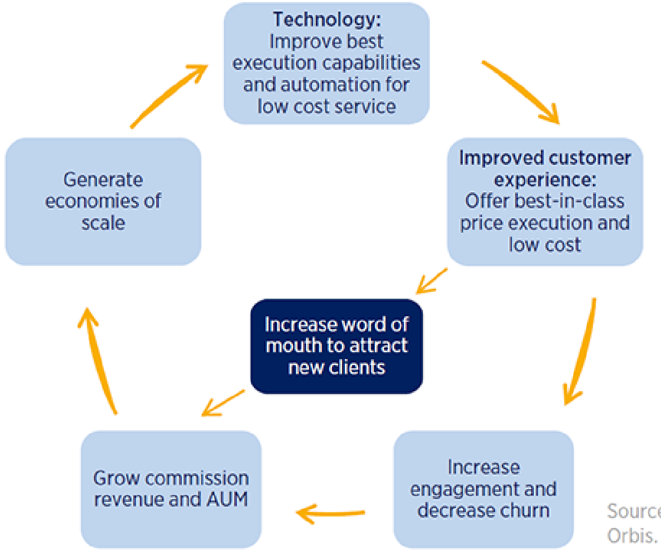
At first glance, Interactive Brokers might seem similar to many of its competitors. It offers online trading in stocks, bonds, futures, options and other securities. It makes money through a mix of commissions and interest income, and its client base includes both individuals as well as institutions such as financial advisors and hedge funds.

Taking a closer look, a picture of a far more differentiated business begins to emerge. Interactive Brokers occupies a unique niche as the go-to platform of choice for active and sophisticated traders. Its core customer trades 300 times a year, while the majority of retail investors trade less than 50 times a year. This makes Interactive Brokers very different from the likes of Robinhood, which is geared to novice investors, or other online brokerages like Schwab that cater to clients who need "high touch" services. Interactive Brokers delivers on what its core customer desires: low costs, best execution, a high degree of automation, and global market access. Its intense focus on customer value is reminiscent of what investors Nick Sleep and Qais Zakaria once called "scale economics shared". Here is how they described it using Costco as an example in their Nomad Investment Partnership letters (1).

"Most companies pursue scale efficiencies, but few share them. It's the sharing that makes the model so powerful. But in the center of the model is a paradox: the company grows through giving more back. We often ask companies what they would do with windfall profits, and most spend it on something or other, or return the cash to shareholders. Almost no one replies give it back to customers – how would that go down with Wall Street? That is why competing with Costco is so hard to do. The firm is not interested in today's static assessment of performance. It is managing the business as if to raise the probability of long-term success."

Scale economics shared

Interactive Brokers' "flywheel" is a formidable competitive edge



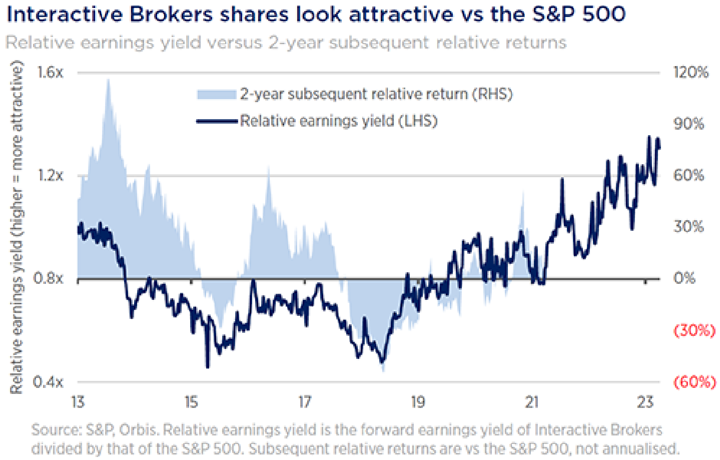
Source: Orbis.

In some ways, Interactive Brokers is like the "Costco of brokers". It doesn't try to be all things to all investors, but it provides exactly what its core customer wants. A key differentiator is its technology. The company's founder and chairman, Thomas Peterffy, was an early pioneer in developing electronic market-making systems for professional traders in the 1980s. As Interactive Brokers grew its online brokerage business over the ensuing decades, Interactive Brokers "gave back" to customers by investing into its technology to improve the customer value proposition. Its investments in technology have allowed the company to automate to drive customer fees lower, expand global access, and improve products and capabilities. This fuelled growth as customers became more loyal and recommended the product to friends and family. This further propelled growth, and Interactive Brokers kept the flywheel spinning by reinvesting further in its technology.

As a result, Interactive Brokers has created a customer value proposition that is extremely difficult to replicate. It offers best price execution, extensive market access, and low margin rates and foreign exchange fees. Despite charging customers such low fees, Interactive Brokers has remarkably attractive profitability. The company routinely earns operating margins in the 60% range versus a comparable figure of about 40% for Schwab. We believe Interactive Brokers' "scale economics shared" advantage will compound over time, because the company continues to re-invest in these value-added features for customers as the business grows.

What's most exciting to us is that Interactive Brokers still has a long runway of future growth ahead. With just two million clients, it is still a relatively small player in a very large industry. Particularly outside the US, where about two-thirds of its existing customers are based, Interactive Brokers does not have meaningful competition. Historically, the number of accounts has grown at an average of 30% per annum over the past seven years and half of this growth came from word-of-mouth. Additional opportunities for future growth include "white labelling" its platform for financial institutions looking to offer their clients international access. For example, a local bank might offer online brokerage services under its own brand and manage the customer relationship, but would use Interactive Brokers for the trading platform. Interactive Brokers is onboarding two large institutions this year onto its platform, which is expected to add 400,000 accounts. If more financial institutions seek to provide a similar offering for their clients, Interactive Brokers will be well positioned to capture this opportunity and drive further growth.

At current prices, Interactive Brokers trades at 14 times our estimate of 2024 earnings. We believe this is compelling for a high-quality company with a durable competitive advantage and exciting long-term growth prospects. The valuation also compares favourably to the S&P 500, which trades at 19 times earnings. As shown by the dark blue line in the chart, Interactive Brokers' relative valuation versus the US market stands out as particularly attractive— comparable or better than other periods that have produced attractive relative returns.



That said, we are mindful that Interactive Brokers—while not a bank itself—currently finds itself in a "bad neighbourhood" from a market sentiment perspective. To the extent that investor concerns about banks spill over into the broader financial services sector, it would not be surprising to see downward pressure on the stock price in the near term.

While we can't predict what the future holds, we can take comfort in the strength of the balance sheet and management's conservative approach to risk control. Since Interactive Brokers is not a bank, the majority of the firm's investments are in short-term Treasurys and other risk-free instruments that are marked-to-market every quarter. This includes customer deposits as well as the firm's sizable equity of $12bn. The company offers high interest rates on cash balances (benchmark rate less 50 basis points), which puts them at low risk of customers pulling cash out to invest in money market funds. In comparison, other banks provide customers low interest on cash and make income by investing client cash into long duration assets. Interactive Brokers runs a very different business model and does not carry the same risk as these banks.

We often say that our greatest concern is the risk of permanent capital loss—as opposed to short-term volatility or underperformance—and we like to find management teams whose interests are well-aligned in this regard. With the vast majority of his $20bn fortune invested alongside us, it would be hard to find a better example than Thomas Peterffy at Interactive Brokers.

Commentary contributed by John Christy, Orbis Investments (Canada) Ltd., Vancouver and Sharada Tangirala, Orbis Investment Management (U.S.), L.P., San Francisco.

(1) https://igyfoundation.org.uk/nomad-partnership-letters/