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E*TRADE Financial Corp. (ETFC)

Q4 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good evening, and thank you for joining E*TRADE's Fourth Quarter 2019 Earnings Conference Call. Joining the call today are Chief Executive Officer, Michael Pizzi; and Chief Financial Officer, Chad Turner.

Today's call will include forward-looking statements. These statements reflect management's current estimates or beliefs, and are subject to risks and uncertainties that may cause actual results to differ materially.

The company will also discuss non-GAAP financial measures during the call. For a reconciliation of such non-GAAP measures to the most comparable GAAP measures and for additional discussion of risks and uncertainties that may affect future results, please refer to the company's earnings release furnished on the Form 8-K along with the risk factors described in the company's filings with the SEC. As a reminder, all of these documents are also available at about.etrade.com.

This call will present information as of December 31, 2019, and January 23, 2020. The company disclaims any duty to update forward-looking statements made during the call, except as required by law. This call is being recorded and a replay will be available via phone and webcast later this evening at about.etrade.com. No other recordings or copies of this call are authorized or may be relied upon.

With that, I will now turn the call over to Mr. Pizzi.

Michael A. Pizzi

*Chief Executive Officer & Director, E*TRADE Financial Corp.*

Good evening, and thank you for joining us on our fourth quarter and full year earnings call. The past 12 months were historic for our industry and will no doubt be remembered as one of the most significant periods of sector-wide disruption. Nonetheless, our business proved its power and we delivered solid business and financial results marked by our strongest year ever for retail trades, derivative trades, Corporate Services client wins, and customer cash growth. And we generated net new assets just shy of the firm record.

We tactically shifted capital deployment to optimize value amid a challenging interest rate backdrop, returning the greatest amount of capital to our shareholders ever with $1.2 billion in repurchases and dividends.

Throughout the year, the team raised the bar on our commitment to the customer, delivering significant enhancements across digital properties, including a fully-integrated toolset for active traders with the launch of our award-winning Power E*TRADE platform, followed by a continuous series of differentiating functionality, including increased customization, charting enhancements, dynamic alerts, comprehensive idea generation tools, and paper trading, to name a few. We also meaningfully bolstered our mobile offering with the launch of a revamped iOS app, while also diving deeper into the voice-assisted space with our integration of Google Assistant.

On the institutional side, we launched the E*TRADE Advisor Network, our RIA referral program, and brought it up to marching speed across all our branches and national sales center. We further strengthened our top-rated Corporate Services platform with first-of-its-kind technology across tax reporting, ESPP share withholding, and trade clearance automation, while also unveiling a groundbreaking alliance with an innovative ESPP start-up, Carver Edison, to help employees nationwide get the most out of company-sponsored stock plans. To cap off the year, we laid the groundwork for a comprehensive financial wellness offering that transcends stock plans through our acquisition of Gradifi, a leading student loan benefit administrator.

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Our team's laser-focused on delivering great experiences to our customers. We're seeing some well-deserved validation, earning the number one online brokerage designation by Kiplinger in August, as well as banners for number one-rated mobile, options, and web-based platform by StockBrokers.com, offering tangible proof of how our value proposition competes and wins against much larger players.

There is much to be proud of as we reflect on the year, but 2019 will also be remembered for the tectonic shifts in the competitive environment, as zero commissions became table stakes and the two largest players in our direct industry announced the intent to merge. Both of these dynamics have uncovered opportunity for E*TRADE. The former leveled the landscape for digital brokerage customers by removing prices from the equation, allowing our superior value proposition to shine bright. And the merger presents a unique opportunity to take market share, which we must seize with deliberate measures.

Huge transactions like these lead to significant assets in motion, and we will serve as the alternative for those who fear they could get lost in the shuffle in a mega company where personalized service is not a priority for all customer tiers. We will lean into this opportunity with the firepower of E*TRADE's iconic brand, our industry-leading platform, and our best-in-class service teams, to firmly plant our flag as the choice for the digitally inclined and perhaps disaffected trader, investor or advisor.

Shifting to broader market conditions, after relatively flat performance in the spring and summer, the S&P 500 roared back in the fourth quarter with a 9% increase, capping a full-year total return of 30%, which serves as the second strongest year for equities in the last two decades. While equity markets remain robust, questions around global trade, tensions in the Middle East and uncertainty heading into US election year have caused retail sentiment to begin to wane, as evidenced by record customer net buying activity in 2017 and 2018, reversing to net selling in the last six months of 2019.

Despite a more reserved retail investor, we continue to grow at a healthy pace, as the breadth of our offerings range from robo-advisory to derivative trading and managed products to fully advise solutions allows our customers to navigate markets, both good and bad. Furthermore, the diversity of our Corporate Service channel provides a healthy flow of accounts, assets and deposits across market conditions.

Moving to operating results for the quarter, we generated $6 billion of net new assets in Q4, our strongest organics quarter ever. For the full year, we generated $15 billion of net inflows, just shy of the record year from 2018. We generated DARTs of 331,000 and derivative DARTs of 111,000, both records. The increased engagement is very encouraging, particularly within derivatives. And while we no longer generate commissions on stock and ETF trades, strong customer engagement portends well for our other sources of revenue. Customer trading momentum continues to build in 2020, with both year-to-date DARTs and derivative DARTs up over 35% from last quarter's level, which is partially benefiting from smaller trade sizes on average.

Corporate Services had another stellar period, as total assets ended at $296 billion. We generated record Corporate Services proceeds of $35 billion in 2019, almost double what it was three years ago, which helped contribute to the overall strong net asset flows into retail. We expect the net new asset and deposit growth contribution for the Corporate Services to continue to accelerate, given the significant number of clients and assets we've won over the past several periods.

For the year, we implemented $24 billion in stock plan assets, a record year following $23 billion in implementations in 2018. And last, but certainly not least, we generated $6 billion of customer cash growth in Q4,

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a company record. Chad will speak to the cash dynamics in more detail, but the growth illustrates the power of our multichannel platform to generate deposits.

Looking forward, I'd like to highlight our key priorities for the new year. First, we will seize the opportunity to gain share amid the meaningful shifts in the industry, namely commission reductions and the merger of our peers. Second, we will advance our RIA offering. Third, we will broaden our Corporate Services offering to encompass financial wellness. Fourth, we will continue to enhance our industry leading digital solutions as we execute on our retail growth plan. And fifth, as always, we will balance growth opportunities with expense discipline.

To expand on each of these points and a bit more detail, we see a huge opportunity from anticipated industry consolidation. Even with the best executed combinations, all customers will not be satisfied with their experience being chosen for them, and we aim to win every dissatisfied relationship that comes out of the Ameritrade/Schwab transaction. The team is highly focused on this near-term opportunity and we are deploying incremental resources across sales and marketing. This extends across retail, where the opportunity is significant right into the institutional channel, where the potential is arguably even greater.

In Advisor Services, we are diligently working to integrate our RIA offering to connect third-party advisors to our back and middle office by summer. This channel remains critical to retaining relationships through our referral network. But even more timely, it allows us to present a custody alternative for advisors who are unhappy with the proposed merger of our peers. We see clear opportunity here, as evidenced by the number of RIAs that have reached out to us.

In Corporate Services, we are capitalizing on our industry leadership position and broadening our offering to encompass holistic financial wellness, of which Gradifi will serve as our springboard. E*TRADE serves many of the leading firms in the US, including roughly half of public technology and health care companies, many of which are hiring graduates from advanced educational programs with heavy debt burdens.

This is one of the most pressing generational problems of our time and is driving the increased necessity for employers to provide a benefit that helps their best and brightest employees position themselves for financial independence. This has been a true hot topic with both current and prospective corporate clients, and legislative proposals recommending favorable tax treatment of tuition payment and student loan pay down is only advancing the discussion. We are fortunate to add this leading provider to our platform, further enriching the value that we can deliver.

Shifting to our digital offering, we have much in store as we evolve E*TRADE into a more fully integrated provider of financial services. Over the past year, we have focused on improving ease-of-use particularly around mobile, and have created a more customizable and personalized interface. As we enter 2020, our retail goal center on deepening customer relationships, igniting customer acquisition, developing a more analytical approach to our customer interactions and offers, and expanding brand resonance beyond trading. Some of the specific initiatives include improving the integration of our brokerage and banking, streamlining our transaction capabilities, and enhancing our value proposition for digital advice.

And finally, we seek to balance growth with expense discipline. We have a highly efficient business model that is geared to operating leverage. We will remain diligent in keeping our overhead low and reaping the benefits of our digital-first platform. However, we will not constrain ourselves when it comes to investing for growth. And we recognize the opportunity created in the marketplace by the proposed Ameritrade/Schwab merger. As such, we are revising our 2020 expense guidance to at or below $1.6 billion from approximately $1.5 billion.

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Our original thinking post commission cuts was to reduce advertising and marketing development expense substantially into 2020. We now see clear opportunity for growth and anticipate marketing spend closer to last year's level. Additionally, we have accelerated the growth in our financial consultant force from approximately 410 today to a goal of more than 450 by year-end 2020 and in excess of 500 by 2021. This build-out is key to taking full advantage of the growth opportunity that is now squarely in front of us.

We've also accelerated the onboarding of sales and service personnel in our Advisor Services team to take advantage of what has become an even more present opportunity. Furthermore, we have realigned our technology prioritization to deliver more quickly for Advisor Services, while making sustained progress on our retail growth plan. Lastly, while purely environmental, we are forecasting better volumes in 2020, and therefore we'll have higher variable costs in associated expense categories. As always, we will continue to be dynamic in our spending and shift as necessary to respond to the operating and revenue environments.

In closing, 2019 was a year of twists and turns to say the least, but the results demonstrate that we navigated them deftly. As we look to 2020, we could not be more excited for what the future holds. We have the right team on the ground to further develop our industry-leading platforms, and we have a proven history of finding and integrating inorganic opportunities to evolve our company. We will leverage our strengths on both these fronts as we enter the new decade.

We could not accomplish our mission and vision and uphold our values without the hard work and dedication of our more than 4,000 associates. Core to our culture at E*TRADE is an emphasis on diversity and inclusion, and I'm exceptionally proud of the progress we have made on that front. We were recently named the Diversity Champion finalist in the InvestmentNews' Excellence in Diversity & Inclusion Awards. And just this past week, we earned a perfect score on the HRC's Corporate Equality Index, where we were highlighted for our inclusive health care benefits and deep involvement in the LGBTQ community.

I firmly believe that an emphasis on inclusion serves as a differentiator in recruiting and retaining the best and brightest talent in the industry. And when it comes to our status as an employer, I'm pleased to also note that we were named one of the Best Places to Work in 2020 by Glassdoor and the only online broker recognized within the top 80 companies.

Before passing the call to Chad, I would like to take a moment to express my gratitude to our former Chief Risk Officer, Paul Brandow, for his more than decade of service with the company. Paul built a best-in-class enterprise risk function at E*TRADE and is finally embarking on a much deserved retirement. Paul has served as both a mentor and a business partner to me over various points in my career, and we are fortunate as an organization to have benefited from his expertise.

After meeting with a number of qualified candidates, we ultimately decided to leverage our deep bench of talent and tapped our Corporate Controller and Principal Accounting Officer, Brent Simonich, to be our CRO. Brent has built a more than 20-year career at E*TRADE through diligence, integrity, and hard work, and I look forward to having him take the same approach for the risk function.

I will now turn the call over to Chad to walk through the financial results.

Chad E. Turner

*Chief Financial Officer, E*TRADE Financial Corp.*

Thanks, Mike. For the quarter, we reported net income available to common shareholders of $172 million, or $0.76 per diluted share. Included in the quarter was a $19 million pre-tax, or $0.06 per share, benefit to provision

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for loan losses. Offsetting this is a $0.14 negative impact made up of $21 million in restructuring and acquisition related expenses tied to the closure of the New York office, severance from organizational changes driven by cost containment initiatives, and expenses related to the purchase of Gradifi, as well as $8 million in impairment of certain technology assets and $11 million of higher tax expense related to the revaluation of deferred taxes.

Before walking through earnings in detail, I'll spend a moment on customer deposit trends, given the several moving pieces to modeling the impacts of cash on earnings. Q4 represented a record quarter for customer cash growth, topping off our strongest year ever for deposit growth. There were several driving forces and many should continue to contribute to strong or accelerated deposit growth over time.

First, we experienced strong traction in our premium savings banking product, which grew to $8 billion during the year, and further enables us to retain high value relationships. We have additional projects in our pipeline focused on enhancements to our retail banking experience, which should enable further growth of our banking offering.

Second, our leadership in Corporate Services and record implementations over the past few years contributed meaningfully to deposit growth, as our customers generated record proceeds in 2019. By their very nature, Corporate Services relationships serve as an evergreen pipeline of deposit growth, as all participant activity ultimately manifest itself as deposit flows into the retail channel.

Over the past three years, retail deposits sourced from Corporate Services have grown at a 9% annualized pace or more than double the growth rate of our other deposits. That pace of customer cash formation should only accelerate, considering the nearly doubling of stock plan awards over the past three years currently funneling through the Corporate Services machine.

And lastly, with respect to customer net purchase activity, with history as a guide, we assume customers will be net buyers over time, although not at the pace we experienced in 2017 and 2018. A simple moderation of net buying behavior should support strong future cash growth. Customer cash growth has continued at a strong pace in 2020, with balances already up approximately $1 billion.

Shifting to core results, net interest income decreased by $40 million sequentially, as our average interest earning assets remained relatively flat and NIM contracted by 27 basis points. Balance sheet asset levels held steady as we directed deposit growth off balance sheet, creating flexibility that allowed us to return a greater amount of capital to shareholders. The decline in NIM was driven by three Fed fund cuts in the back half of the year and normalization of securities lending revenue and growth in our relatively higher rate premium savings product.

Our blended deposit rate decreased 6 basis points to 28 basis points as we modestly lowered sweep rates on the heels of the October Fed cut and realized the full benefit of Q3 pricing changes. This was partially offset by the growth in PSA. We expect the blended deposit rate, which includes on- and off-balance sheet brokerage and bank deposits and customer payables to be around 31 basis points in Q1.

Moving to 2020 balance sheet dynamics. With the current reinvestment rate at 250 to 275 basis points and off-balance sheet rates around 180 basis points, we are right on the line between deploying capital for on-balance sheet customer deposit growth or directing deposits off-balance sheet to free capital for incremental share buybacks. Each alternative provides attractive EPS outcomes.

Accordingly, we are remaining tactically flexible in our decision making, growing assets when attractive yields are available, while remaining committed to our buyback program. Given these dynamics, we are guiding NIM for 2020 of around 300 basis points with the following assumptions.

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First, we assume Fed funds rates remain stable throughout the year. Second, we assume margin balances remain flat to current levels, which are currently in line to where they finished the year. Third, our guidance assumes a flat balance sheet throughout the year, with customer deposit growth directed off-balance sheet. This maintains some level of new asset purchases as we backfill turnover into our investment securities and the runoff of our loan book.

Finally, we expect to continue to shift premium savings deposits off balance sheet, as we began doing in the fourth quarter, and bringing lower cost brokerage sweep deposits back in their place. This rotation of moving PSA off, while bringing brokerage sweep on, will cause some geographic shifts to the model, and you should expect to see compression in the blended net fee we earn on off-balance sheet deposits from third parties with a corresponding improvement to net interest income, given the movement of relatively lower cost deposits on to our balance sheet. We assume that we shift a substantial portion of premium savings off-balance sheet by the end of Q1, but our actual distribution of deposits will depend on market conditions.

Returning to the P&L, commission revenue of $56 million was down $66 million sequentially, driven by the commission cuts, in line with the expected impact we guided to last quarter. Fees and service charges were up $18 million quarter-over-quarter, driven by an increase in off-balance sheet fee income and other volume-related revenue.

Third-party cash increased by $6.2 billion, as we essentially directed all deposit growth off-balance sheet. The average yield on third-party cash was 162 basis points net of deposit cost. This was comprised of third-party brokerage sweep deposit fees of 179 basis points, bank sweep deposit fees of 6 basis points and third-party money market fees of 53 basis points.

For Q1, we anticipate gross fees from off-balance sheet brokerage and bank sweep deposits will be around 180 basis points. After accounting for the cost of deposits, we anticipate generating net fees of approximately 165 to 170 basis points on brokerage, and 5 to 10 basis points on banking deposits swept to third parties. For the quarter, gains on securities were $14 million, well within our guidance range of around $10 million to $15 million.

Shifting to expenses, total noninterest expenses of $446 million were up $47 million sequentially, driven in part by the previously discussed one-time items. Normalizing for these items, expenses were still elevated, as we tactically invested in sales and marketing efforts. Our effective tax rate in the quarter was 32%, which was higher than our anticipated 27% rate, driven by the revaluation of state deferred taxes. This also drove our full-year rate closer to 28%. We anticipate a 27% tax rate in 2020.

Moving to capital, we executed on $176 million of share repurchases in Q4 and have utilized $586 million of our $1.5 billion share repurchase authorization. We continuously assess market conditions to use capital most efficiently and will aggressively deploy capital to grow the balance sheet if we begin to see signs of a steepening yield curve. With our assumption of holding the balance sheet flat, we would anticipate executing a minimum of $200 million of repurchases in the first quarter.

We finished the quarter with $645 million of corporate cash, reflecting $550 million in subsidiary dividends, less the $176 million used to repurchase our stock and $32 million paid in common dividends. Finally, after completing our review of the new accounting standard for current expected credit losses, also known as CECL, we anticipate that we will receive a benefit to opening retained earnings of approximately $80 million effective the beginning of Q1.

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And with that, I will turn the call back to the operator for Q&A.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question is from Rich Repetto with Piper Sandler and that line's open. Hi, Mr. Repetto, your line's open, go ahead.

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

Hey, Rich.

Operator: Okay. So we'll proceed to the next. So next question is from Steven Chubak with Wolfe Research and that line is open.

Steven Chubak
Analyst, Wolfe Research LLC

Q

Hi. Good evening.

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

Hi, Steven. How are you?

Chad E. Turner
*Chief Financial Officer, E*TRADE Financial Corp.*

A

Hey, Steven.

Steven Chubak
Analyst, Wolfe Research LLC

Q

Hey, doing well, thanks. So I want to start off with a question on NNA growth. We saw some nice acceleration in fourth quarter, in December in particular. In addition to the share gains from some of the legacy zero commission players that you – Mike, I think you had spoken to pretty recently, I'm just wondering, given the incremental investment, are you seeing any opportunity or improved NNA due to the stronger client acquisition following the merger specifically.

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

Yes, we are. I would categorize the shift in the sort of NNA from coming out of the third quarter into the fourth quarter is driven by multiple factors. One you hit is the zero commissions have improved the value proposition substantially versus a lot of the financial technology players. The merger itself has created some degree of inflows. But I'd also like to highlight that we've been more aggressive both on the marketing and sales side, and have been positioning our offering very effectively. And I've seen a broad-based lift across both our FCs, as well as what's just coming in a new customer, as well as additional assets coming in from customers that are already here.

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Steven Chubak
Analyst, Wolfe Research LLC
Q

Thanks. And just one follow-up on expenses. So based on the 2020 expense guidance, it sounds like the incremental investments are focused on, I guess as you put it, a number of select or unique growth opportunities presented by the merger. I'm just trying to reconcile, has there been any change in your commitment to deliver on the efficiencies that were maybe contemplated as part of the original $1.5 billion target? And how quickly can you dial that back or manage that spend if we do, in fact, enter a tougher environment?

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*
A

We have a portfolio of expense initiatives that we have assigned teams to and are working on. Many of those predated some of the recent work to try and take advantage of the market opportunity that's in front of us. That work is ongoing. We anticipate those expense savings will be put forward to increase our growth and to take advantage of the opportunity that's in front of us. As I highlighted in the prepared remarks, right after the commission cuts, given what the market environment felt like, it looked like we'd be pulling back substantially on advertising and market development, wouldn't want to ramp sales growth so much. The merger plus just the change in the environment, seeing the market come back and customers engage in a very, very real way with the market, has shaped that differently. And that's why we are taking the expense guidance to $1.6 billion.

Steven Chubak
Analyst, Wolfe Research LLC
Q

Helpful color, Mike. Thanks for taking my questions.

Operator: [Operator Instructions] The next question is from Will Nance with Goldman Sachs. Please go ahead.

Will Nance
Analyst, Goldman Sachs & Co. LLC
Q

Hi, guys. Good evening.

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*
A

Good evening, Will.

Will Nance
Analyst, Goldman Sachs & Co. LLC
Q

Maybe I'll start on the Corporate Services business. So, Morgan Stanley was emphasizing some of the success that they've seen on the Solium platform and their appetite to grow the business. Can you talk about the competitive environment, whether you've seen some stiffer competition in Corporate Services from them or others more recently and how you're thinking about that into next year?

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*
A

We're very happy with the progress that we've made in Corporate Services. We continue to improve the functionality of that platform. We think the acquisition of Gradifi really extends us into a new space that we think will be one of the fastest emerging benefits categories there. You see the importance of Corporate Services to us.

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We highlighted the $35 billion of proceeds. It's a record last year. We feel really good about the pipeline in terms of the companies that we're talking with. We believe our product truly makes their life easier. Companies that sign with us can actually reduce their costs around the administration of the plan because the software is so powerful. So, at this point we couldn't be happier with where we are.

Will Nance
Analyst, Goldman Sachs & Co. LLC

Q

Understood. And maybe I'll follow-up on the net new asset growth. So, this is one of the better months that we've seen in terms of flows into the Advisor Services platform. Can you just talk about the momentum there and sustainability of that flow level and just what we can kind of expect heading into next year as the referral business ramps up? Thanks.

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

Sure. As you saw in prior periods, there was some weakness coming from some of the larger advisors that came with the TCA acquisition that had some really poor performance and we're losing – the underlying advisor was losing assets. And so, those were coming through to our asset totals. We've gotten past that. We've added 20-plus new advisors to the platform, and we've sort of made that turn and we're seeing that build. So if you normalize the period for the sale of the ACS business, which is that alternative custody business, we actually had really good flows, up $300 million in the period.

So, we're happy with what we're seeing. The referral program is now up and running. It's scaling across the national sales centers, the branches, and we're going to be rolling it out soon to executive services. So we're seeing flows build there. We're seeing solid advisor interest and we're making great progress on getting the technology to where we think it needs to be.

Will Nance
Analyst, Goldman Sachs & Co. LLC

Q

Understood. Thank you for taking all of my questions.

Operator: The next question is from Rich Repetto of Piper Sandler. Please go ahead.

Richard Henry Repetto
Analyst, Piper Sandler Companies

Q

Yeah, good evening. Can you hear me, guys?

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

Yeah, Rich, we can hear you.

Richard Henry Repetto
Analyst, Piper Sandler Companies

Q

Yeah. I apologize for the technical problems here. My first question is on trading, and if you look at the reduction in commission revenue, it's less than the $75 million, plus you've had an uptick in payment for order flows, well, quarter-over-quarter. I think it's both high double digits. So the question is, is it reasonable to say that the trading activity is outpacing your expectations? And I didn't hear a January to-date number and I could have missed that.

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But just an idea how resilient you think this trading activity and do I have the right view that it is outpacing some of the initial guidance of the $75 million per quarter decline?

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

Yeah. I'll turn it over to Chad for some of the details, Rich. But the January to-date is up about 35% from where the prior quarter was, so we're off to a great start of the year. We are seeing trade sizes a little bit smaller, but overall this is a great environment. We're seeing really good volume. But I'll turn it over to Chad to give a little bit more color on payment for order flow, trade volumes, and items.

Chad E. Turner
*Chief Financial Officer, E*TRADE Financial Corp.*

A

Yeah. Rich, so the $75 million that we quoted as a quarterly number, behind the scenes we think the quarter came in pretty close to as expected around that number. But to your point, the volumes that we saw in Q4 are offsetting that a bit and that's a bit of the dynamic you're seeing there. Also note that we didn't lower commissions until the first week into the quarter, so that's giving a little bit of benefit there.

As it relates to volumes and payment for order flow, you can see that trending pretty much in line with the increased volumes we saw in Q4. To Mike's point, there is a bit of share size which may be impacting quality slightly, but still a really positive story. And in Q4, you can see derivatives up a lot, which we do still earn a commission on and [ph] payment for (00:32:40) order flow. And then that is also up 35% in January to-date. So, nice trend we're seeing there on the active trader side as well.

Richard Henry Repetto
Analyst, Piper Sandler Companies

Q

Got it. And my follow-up would be, Mike, at an industry conference, you stated that E*TRADE hadn't turned away any offers. You also changed the change of control, I guess, payouts to named executive officers. So I guess I'm just wondering like what's the message you're trying to send to investors and what should we read to on this.

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

Well, sure. The change of control payments has been in the investor dialogue for quite some time now. It has intensified in recent months. We decided we would just take the issue off the table, and that's what we did there. In terms of the comments from the conference, I have nothing to add to them here this evening. It was an attempt to set the record straight, which I believe I did.

Richard Henry Repetto
Analyst, Piper Sandler Companies

Q

Okay. Thank you.

Operator: [Operator Instructions] The next question is from Craig Siegenthaler with Credit Suisse. Please go ahead.

Craig Siegenthaler
Analyst, Credit Suisse Securities (USA) LLC

Q

Thanks. Good evening, everyone.

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Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*
A

Good evening, Craig.

Chad E. Turner
*Chief Financial Officer, E*TRADE Financial Corp.*
A

Hey, Craig.

Craig Siegenthaler
Analyst, Credit Suisse Securities (USA) LLC
Q

I have another one here on the RIA business. With the RIA technology integration completion scheduled for 2Q, what are your expectations for net new assets in the RIA channel for the second half of this year?

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*
A

Let's just start from kind of where we are today. I think we've worked through some of the problems with some of the clients that I talked about in some of the previous question. We're building quite nicely. We're signing advisors. The referral program is scaling. I think this business is on a solid trajectory to continue to accelerate.

Yes, there are some larger national advisors that are waiting for the technology is complete so that they can connect the way they want to, also so that they don't have to go through a separate conversion. I think those will start to build more materially in the second half of the year, specifically in the late Q3 and through Q4.

Craig Siegenthaler
Analyst, Credit Suisse Securities (USA) LLC
Q

And I guess you just hit on that, but you did announce it to very large RIA signed up to the platform like over a year ago. So, is the expectation that those two large RIAs will allocate business to your RIA platform in 3Q/4Q?

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*
A

They're already allocating as they're part of the referral program. So they're receiving referred assets, and so they're already on the program up and running. But when we get past the conversion, there are additional assets that will come over to our platform as well.

Craig Siegenthaler
Analyst, Credit Suisse Securities (USA) LLC
Q

Thank you, Mike.

Operator: The next question is from Devin Ryan with JMP Securities. Please go ahead.

Devin Ryan
Analyst, JMP Securities LLC
Q

Great. Good evening, guys.

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Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*
A

Good evening, Devin.

Devin Ryan
Analyst, JMP Securities LLC
Q

First one just on the competitive backdrop. So, I mean, clearly, very good flows in the quarter, and I'm sure moving forward the competition is going to fight hard to retain their customers. So I'm just curious where you're seeing people compete today. That we're, for the most part, all zero beyond commissions, is it margin lending rates or anywhere else in the model where people are fighting on price to, I guess, probably retain customers from you guys?

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*
A

Well, Devin, I mean, margin has been an area that has been very competitive for a long time. I wouldn't describe the dynamics around margin today as being any more competitive than it has been for the more sophisticated, larger balance margin customers. It has always been an area where you have to look at the complete profitability picture of the customer and decide sort of the riskiness profile of the margin account as to what you're going to award or give that customer in a negotiation if they're trying to negotiate the margin rate.

Broadly speaking, we're in a position now where most of the revenue received is indirect to the client, meaning the client earns a rate on cash, and then we earn an additional spread on it. The client's order is not a charge to the client. We're just earning a payment for that order from a market center. So as you kind of look what's directly observable in terms to the client is exactly margin rates and option commissions, and then maybe a few other fees and service charges, which are not really often charged unless a certain activity occurs. So I think it's a small set of clients that are observing that direct charge, and so I think it's getting more and more difficult to disrupt on the basis of price.

Devin Ryan
Analyst, JMP Securities LLC
Q

Got it. Okay. And then just to follow-up, it seems like you have some evidence on the strong ROI from the ramp in advertising maybe in the fourth quarter, and so that's giving some confidence with the acquisition. But I guess I'm curious on what's changing in the thinking on financial consultants and really feeling like the head count ramp there is necessary and is going to have a strong payoff. And if you can, just how you're thinking about the ROI on that as well?

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*
A

Yeah, sure. As we look at the analysis of financial consultants in terms of just the stats of what a consultant can bring in from an asset and what sort of revenue comes in, and then you look in sort of the assignment universe of clients in terms of how many clients have an active relationship, and then compare that over even into the Corporate Services world and what we can touch from there, if we can just linearly hold those production rates constant and add financial consultants, we create the opportunity to grow faster.

That opportunity was there before anything occurring this quarter, but I think getting them in place – and so growth in that number has always been part of our plan. But getting them in place sooner, getting them in the

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market today while the opportunity set is there is what we're clearly accelerating, and that's driving some of the expense build.

Devin Ryan
Analyst, JMP Securities LLC

Q

Okay, great. Thank you.

Operator: The next question is from Chris Harris with Wells Fargo. Please go ahead.

Christopher Harris
Analyst, Wells Fargo Securities LLC

Q

Thanks, guys.

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

Hey, Chris.

Christopher Harris
Analyst, Wells Fargo Securities LLC

Q

A question on the NIM guide for 2020. I thought I heard you say there's going to be some deposits moving around, some higher cost deposits going off-balance sheet, lower cost deposits on-balance sheet, and that's part of the NIM. How will that affect your off-balance sheet yield for 2020?

Chad E. Turner
*Chief Financial Officer, E*TRADE Financial Corp.*

A

Sure. As I mentioned, we're going to earn 180 basis points on a gross basis. And then just for the purposes of modeling, we gave you two different rates off. So on the brokerage side, you would expect that net rate to be in the 165 to 170 basis point range, and then the banking deposit off-balance sheet rate to be in the 5 to 10 basis point range. So that's, to your point, giving you a bit of the math of how that's going to compress the off-balance sheet number.

The assumption for the approximately 300 basis points of NIM for the year on a flat balance sheet does assume that premium savings moves off at least a significant portion of it in Q1, which is what is supporting the 300 basis point NIM while giving a bit more compression off. So, depending on how you model growth, that gives you a bit of the components of how to think about it.

Christopher Harris
Analyst, Wells Fargo Securities LLC

Q

Okay. Thanks for that. And then, with respect to Advisor, sounds like some good momentum there. However, the platform is new. There's not a really long track record there. Do you think advisors that are not happy with the Schwab-Ameritrade merger are going to be willing to kind of look past that?

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

Well, I mean, we're focusing on leveraging the platform and the technology strength of the platform, which is a completely open architecture setting that allows sort of the latest in risk management or other items to be

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connected directly, specifically modeling as a key central advantage. We're going to apply the same principles here that we applied in Corporate Services. We're going to listen to the advisors and we're going to put in place the technology that truly makes their life easier.

What do advisors want to do? They want to spend their time on client acquisition. They want to get clients in the door. They don't want to spend time on middle and back-office burden. We're going to listen to them. We're going to do the things that makes their life truly easier and keeps them out of acquiring clients. So, I do think we're going to get good resonance around the platform.

Christopher Harris
Analyst, Wells Fargo Securities LLC

Q

Thank you.

Operator: Next question is from Brennan Hawken with UBS, and your line's open.

Brennan Hawken
Analyst, UBS Securities LLC

Q

Good afternoon, guys. Thanks for taking my questions.

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

Good morning, Brennan.

Brennan Hawken
Analyst, UBS Securities LLC

Q

Hey. So, I think you referenced, Mike, in your prepared remarks about incorporating financial wellness into your Corporate Services offering, and you guys just made the acquisition of Gradifi, so that clearly fits in. Does it go beyond Gradifi or is that the expansion? And if it goes beyond, can you let us know, like what your plans are, what you need to develop in order to complete that offering?

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

Sure. The acquisition of Gradifi gives us the most capable platform in the space to manage student loan refinance and student loan pay-down benefits. And it's the pay-down benefits in particular that we're hearing most from our customers in the Corporate Services channel. It's a great opportunity for us to add that platform at a reasonable price tag that gives us something that we can scale very, very quickly in the marketplace.

There are other areas that are very important to financial wellness. Some of them we're in today in terms of products and services on our website, from retirement planning and things like that, that we can leverage from a planning and toolset. But when you get into kind of other areas, such as 401(k), they're probably best approached from an area of partnership and working actively with a larger player in the space in how to go to market together.

Other areas that are out there are going to be things like HSA accounts and items like that. Those are clearly also probably addressed through partnership, but there are also technology innovators in that space as well. So, from our standpoint, we're going to build a complete financial wellness offering. We've got a lot of this in-house in what

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we need. Gradifi gives us one missing piece. There's a couple others. And we have active plans really on addressing those, largely through partnerships, but possible acquisition as well.

Brennan Hawken
Analyst, UBS Securities LLC

Q

Cool. That really helps. Thanks. Thanks for that, Mike. And then, when you talk about ramping up salespeople and FCs, I believe you laid out a plan to ramp not only in 2020, but also in 2021. So, when we think about modeling out the expenses out to 2021, should we continue to see some further growth with the idea of expense growth be that when we go from your original plan of $1.5 billion, then it moves up to $1.6 billion, should that pace of growth then sustain into 2021? And I think it was touched on earlier, but I'm not sure I got the answer. How are you thinking about an ROI or how do you think about the revenue results from these investments and calibrating return on that investment?

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

I'll let Chad talk a little bit about expense planning in the long-term model. I think a lot of it is how we look at sort of finding productivity to fund investment growth, and what that results to in an overall expense growth rate. But I'll let Chad cover the details and then how we think about that ROI decision.

Chad E. Turner
*Chief Financial Officer, E*TRADE Financial Corp.*

A

Hey, Brennan. So, Mike hit on that well. If you look over time, first off, just on the long-term earnings, we believe that that low single-digit operating expense growth does support the upper single-digit revenue growth that we expect over time. Clearly, that can ebb and flow a bit in any given period, but that's the way to look at it as you step from 2020 all the way through 2023 and 2024.

Now to Mike's point around being efficient and harvesting additional efficiencies to invest, I would use this last quarter as a prime example of that. If you look at our metrics, you will see that our head count is down quarter-over-quarter. If you looked in more detail behind the scenes at individual areas in the business, what you would find is areas that are down significantly year-over-year, to then allow other areas to be up significantly year-over-year as we invest. That's a model that we've used historically fairly well back when we used to use the operating margin framework as a guide of how do we make sure we're harvesting efficiencies. We're a digital-only firm and so we do have an ability to do that fairly well.

So, for example, on the FC side, being able to continue to use operating leverage through technology and other efficiencies to then be able to drive revenue-generating head count growth is something built inside of our model. I would use that low single digits as an example of what that looks like over time.

Brennan Hawken
Analyst, UBS Securities LLC

Q

Awesome. Thanks for the color.

Operator: Next question is from Mike Carrier with Bank of America Merrill Lynch. Please go ahead.

Michael Carrier
Analyst, Bank of America Merrill Lynch

Q

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Great. Thanks for taking the question. You mentioned the strong deposit growth from the Corporate Services business. I think you said 9%. So just given the larger base, as well as more focus of you guys retaining those assets, can you provide any metrics, maybe either the trend in like the conversion rate or the retention rate, just to gauge like that potential over the next few years?

Chad E. Turner
*Chief Financial Officer, E*TRADE Financial Corp.*
A

Yeah. First I would highlight just that the long-term model and the way we built it does not have any sort of meaningful shift in retention rate. That 15% of retained proceeds, 12 months post-sale is the number that we still use. Seth and team added a great slide to the investor deck, page 21. I would point you there to give you a good sense of how Corporate Services contributes over time.

We've talked for a long time about the ability over time – not necessarily in any given period, because there are exogenous factors, but over time to be able to get deposit growth in that upper single-digit range. The slide does a good job of laying that out, where you can see, as I mentioned, that Corporate Services from 2016 to 2019 is growing at a CAGR of 9%, while the remaining businesses at 4%.

That's an example of how as that business has scaled and grown at an outsized pace, it contributes meaningfully to cash growth over time. Given the implementation wins we saw in 2018, as well as 2019 record levels, you could expect that that acceleration will contribute to that higher overall cash growth in the out-years.

Michael Carrier
Analyst, Bank of America Merrill Lynch
Q

Okay. And then just one more on the cash. I think you mentioned like the net on the retail side in terms of cash versus clients like buying – like that trend has balanced out versus the last couple of years. Anything that's driving that? I mean, from one standpoint, maybe it makes sense, because there's been more uncertainty. On the other hand, just given the strong markets like typically in that backdrop, you would see clients putting more like cash to work. I'm just curious if you're seeing anything within the numbers that makes you think that that trend continues.

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*
A

I think that in terms of what we've seen in 2017 and 2018 was an area where there was consistent increases in retail engagement, meaning that money coming into the market, clients coming into the market, quickly moving balances and redeploying them. With some of the ebbs and flows of volatility, the geopolitical risk, the election items, trade, you name it, we're seeing a more balanced approach. Customers are still engaged, but they're stepping a bit to the sidelines quicker and moving into cash, and that's resulting in a net selling number that's coming into year-end here.

Look, I'm sure with a 30% gain, some of the selling that we've seen was somewhat tax related. But overall, I think it's a bit of a shift into a more risk-managed or risk-balanced approach within the client set.

Michael Carrier
Analyst, Bank of America Merrill Lynch
Q

Right. Thanks a lot.

Operator: Our next question is from Kyle Voigt with KBW. Please go ahead.

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Kyle Voigt
Analyst, Keefe, Bruyette & Woods, Inc.
Q

Hi. Good evening. Maybe just a follow-up on the really strong trends in trading activity. I guess how much of that do you believe is related directly to eliminating commissions versus the market environment? And do you think there could be still upside to the activity levels even from these January levels, these strong January levels, as clients continue to kind of acclimate to this zero commission world?

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*
A

Well, I think certainly we are seeing clients trade more, and I think that falls into a couple of different categories. One is clients breaking up their trades into smaller sizes. That's not necessarily adding a whole lot of value, if any. But also, just clients trying to trade intraday more, position more, the active traders taking more advantage of the lower commission rate. That is a more sustained effect in terms of the overall volume level. I think that's probably something that's here to stay, but probably not going to grow too much from these levels, as clients have pretty much adjusted their trading styles to what's going on.

Kyle Voigt
Analyst, Keefe, Bruyette & Woods, Inc.
Q

And just another one maybe on the market disruption, kind of assets in motion potentially with the Schwab/Ameritrade merger. And with respect to the opportunity for your Advisor channel specifically, can you just give some more detail around the sales message that you're going to be going out to market with over the next year to kind of capture some of that opportunity? And any color you can give also in terms of kind of the inbound calls like that you've been fielding related directly to the deal?

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*
A

Sure. I mean, I talked a little bit in the prepared remarks, we use the word anyone as sort of disaffected. I mean, certainly we want to be a strong presence in the marketplace for that, but there's also just another effect, and I talked a little bit about this in the past. If you think of sort of three physical locations on the intersection of two street corners of three different companies that do the same thing and one closes, the natural just pickup in sort of mindshare or customer mindset that you're going to get from that over time is going to be continuous.

And it's not necessarily who's disaffected. It's just we are the branded alternative in the marketplace with one of the most iconic brands in the space. We will benefit even if no one is disaffected, just because the number of properties has been reduced. We want to be front and center. We want to have our sales personnel, our tool sets, our digital experience exactly where we want it to be to capture the entirety of that opportunity.

Kyle Voigt
Analyst, Keefe, Bruyette & Woods, Inc.
Q

Thank you.

Operator: Next question is from Brian Bedell with Deutsche Bank. Please go ahead.

Brian Bedell
Analyst, Deutsche Bank Securities, Inc.
Q

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Great. Thanks very much for taking my questions. Maybe just to continue on that theme, Mike, what are you thinking about your ambition in winning over customers from the merger over the next few years? And is it – typically we've seen attrition rates around 5% for some deals. I know Schwab has a 4% target for this. Do you think this merger could deliver attrition rate that's potentially much higher than that? And then just over – just the timeframe of that, typically we see this happen in bunches. Do you see this happening over a multiple year timeframe?

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

Yeah, look, I think 4% to 5% is a good estimate for something where it's managed very well. The best conversions, the best integrations at 4% range is probably a good number. But certainly, you can look at other ones that didn't go so well and those numbers can go quite higher. So, there's opportunity beyond that. But I think that's a reasonable size of the opportunity. But I really want to say, don't just think of it as that net finite flow. It's also just the number of large branded players in the marketplace. And we should pick up from that just from the evolution of customer mindset when they're looking for a provider in this space. And it's just an increase in the overall natural growth rate, we want to take advantage of that. So, it's both elements there.

Now, on the Advisor side, I think there's a lot more consternation in the market, if you will. You can just see it. If you take a look at any of the RIA publications that are out there, a lot of the smaller, medium-size RIAs are concerned and there's concern that there's going to be changes around referral flows and greater degrees of internalization. We want to be a place in the market that has a very strong platform, leads with technology, makes the advisor's life easier, provides excellent service to all tiers of advisors, and that's what we're building. That's our mission for our institutional channel. So, we think that's going to resonate quite well over time. We thought that was going to resonate well before this acquisition. This is just going to add to that.

Brian Bedell
Analyst, Deutsche Bank Securities, Inc.

Q

Okay. Thanks for that. And then maybe just along those lines, economically as you try to attract those customers, is that more coming from cash offers that will increase the ad marketing spend or do you see yourself competing more on things like margin rates and deposit pricing? And then, are you thinking more about targeting options customers, given strength of your options platform, or is it not so directly focused on that area?

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

Yeah. Look, I don't have a specific answer to that. I would describe it this way, cash offers are here to stay. They've become part of the industry. And I think that that's something that's just always going to be part of it or less, the larger clients, especially because they've come to expect it. And that sort of locks in an amount of that that always needs to be sort of funded and put into your advertising and market development.

We've got a great option platform. Of course, we're going to position our option platform as aggressively in the marketplace as we can. We're always out in doing education, trying to get our customers to understand the option market, to grow into option trading. We think it's an area of strong retail growth, and that it'll continue to be for a number of years.

Brian Bedell
Analyst, Deutsche Bank Securities, Inc.

Q

Thank you.

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Operator: The last question is from Michael Cyprys with Morgan Stanley. Please go ahead.

Michael J. Cyprys
Analyst, Morgan Stanley & Co. LLC

Q

Oh, hey, good afternoon. Thanks for taking the question. Just on the RIA side of the business, I think today you have over 200 RIAs, $20 billion in assets or so. I guess once you get past the conversion in the second quarter, just curious what's the asset or RIA capacity of the platform once you get through the conversion, and how much would you need to spend in order to materially increase that capacity? Say, if another $20 billion or $50 billion wanted to come online in the third quarter, how much would you need to spend to accommodate that? Just how do you think about that?

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

Yeah. That is the beauty of the integration and conversion. Once we connect to our core middle and back office systems, our scalability of the RIA business is directly in line with the scalability of our main business. We operate with significant excess capacity, obviously, for trade volumes and extremely high volume days, which come every now and then. We've got a solid amount of capacity for client accounts and items like that. We're going to scale this business in the same way. It's not something that would be – if we had to add compute power for the amount of growth, it's not a cost that I'm really worried about if we were to see growth at those levels.

Michael J. Cyprys
Analyst, Morgan Stanley & Co. LLC

Q

Okay. And just a follow-up question on the technology front. You've talked about some of the – high level at least some of the analytical approaches that you referenced earlier. Just hoping you could dig in a little bit more, flesh that out around some of the analytical approaches on customer offers that you have in the marketplace. How are you approaching that today and how might you evolve your approaches around – analytics around customers over the next couple of years?

Michael A. Pizzi
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

Oh, sure. We are investing in data and analytics across the company. We want to learn about our customers what they want, what the best product set to put in front of them is, how to customize our experience better. I'd say, we've been on this journey for a little bit, but we're really starting to ramp now much more sort of into those insights, using those insights to drive business, using it to inform our marketing strategy how and where we place offers, how and where we place our advertisements, things like that. So, it's taking a much more data and scientific approach to the problem of marketing than we have ever taken really in the past.

Michael J. Cyprys
Analyst, Morgan Stanley & Co. LLC

Q

Great. Thank you.

Operator: Okay. No further questions, so I'll turn the call back over.

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Michael A. Pizzi

*Chief Executive Officer & Director, E*TRADE Financial Corp.*

Sure. Thank you all for joining us tonight, and we'll talk to you again soon. Thank you.

Operator: So that does conclude our conference call for today. We thank you for participating and you may now disconnect.

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