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Outfront

OMAHA'S OTHER ORACLE

What Mortgage Mess?

The big brokerage firms skewered themselves on fancy mortgage derivatives. JOE MOGLIA'S TD AMERITRADE sticks to stocks and bonds | By Neil Weinberg

A YEAR AGO THE GUYS AT TD AMERITRADE were catching a load of grief on Wall Street. Analysts took them to task for not expanding the discount brokerage into red-hot retail markets like mortgages and boat loans. Hedge funds SAC Capital and Jana Partners bought 8% of the firm and then slammed it for squandering a chance to merge with rival E-Trade Financial Corp.

These days it's the chief executive, Joseph Moglia, and his low-key staff who look like the sly ones. As E-Trade struggles to recover from a near-death brush with the mortgage meltdown, and big wirehouses oust their bosses for losing billions, TD AMERITRADE is basking in the glow of a share price up 14% over the past year.

"We haven't had to dodge any bullets because we didn't get in front of them to begin with," says Moglia, a brusque 58-year-old Bronx native with an unwavering faith in his unadorned game plan.

TD AMERITRADE'S financial results would make Goldman Sachs proud. Revenue (net of interest expense) rose 20% from a year earlier in the December quarter to $642 million. The $357 million pretax net gave TD AMERITRADE an industry-leading profit margin of 56% and a return on equity of 42%. The company has a solid balance sheet with $1.5 billion in low-interest debt and a half-billion dollars in cash, which could come in handy for acquisitions—perhaps even of E-Trade's brokerage business. Analysts at Credit Suisse expect TD AMERITRADE to earn $1.5 billion before interest and taxes this year.

Client balances recently topped $300 billion, thanks in part to $9 billion in inflows last quarter. That included $2 billion the firm lured from E-Trade with cheeky ads stating, "The markets may be volatile. Your brokerage doesn't need to be."

TD AMERITRADE is a well-oiled machine for a simple reason: Trading is a game of scale in which the company is now the online leader, handling 346,000 transactions a day in January. Often that includes processing 100 trades a minute in Apple Computer. Once TD AMERITRADE covers its fixed costs, it pays only pennies to handle additional orders, which bring in $12.84 each. The other, fee-based side of its business involves managing long-term investor assets in exchange-traded funds, mutual funds and money market accounts. This lucrative business throws in 58% of revenues.

Rather than launch risky or far-flung ventures, management has used its excess cash to reward shareholders with a special $6 dividend and share buybacks. "We're not willing to let a small group leverage our balance sheet or take big proprietary risks that can blow up the franchise," says Moglia. "We're happy to make a reasonable spread."

Moglia and his staff wear their midwestern persona as a source of pride and competitive advantage. Their headquarters are on the outskirts of Omaha, sandwiched between a nursery and a Kellogg's cereal factory that permeates the area with the aroma of Cocoa Krispies. A few miles away 1,000 people work at a call center in a former Younkers store inside a shuttered mall. At $5 per square foot annually, the rent is one-sixth of what such space fetches in costlier cities.

The name of the company's founder, J. Joseph Ricketts, shows up in this issue on page 156. The native Nebraskan founded Ameritrade in Omaha in 1971 and began offering discount trades a few years later when commissions were deregulated. He launched online trading two decades later, took his firm public in 1997 and built a national name during the dot-com boom by offering cut rates, bare-bones service and Stuart, a ponytailed spokesman who taught his boss how cool it was to trade online.

ANDREY MIKITYUK FOR FORBES

As investors fled e-brokerages amid the tech bust, trading volumes evaporated, along with 87% of Ameritrade's market value. Ricketts recruited Moglia in early 2001, at a time when the company was losing money and many analysts figured it would go the way of Etoys. Moglia had grown up a son of a shopkeeper in an Italian section of the Bronx before spending 16 years coaching college football, ending his career as Dartmouth's defensive coordinator. In 1984 he joined a Merrill Lynch training program (25 M.B.A.s and one coach), became the most successful rookie salesman in the firm's history and rose to run its investment products, insurance and 401(k) businesses.

At TD AMERITRADE Moglia began by cutting 450 jobs and shutting losing operations in Korea, Germany and elsewhere. He also began scavenging the bombed-out landscape for acquisitions that would add trading volume. The first big one came four months after he arrived, when Moglia agreed to pay $154 million in stock for National Discount Brokers, an outfit Deutsche Bank had paid $823 million for 80% of eight months earlier.

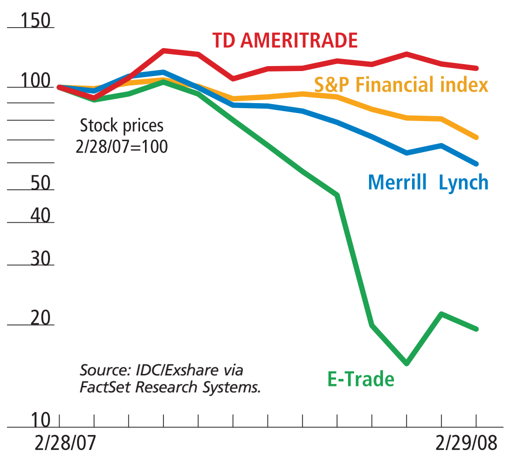
The following spring he won a bidding war for Datek, raising fears that he'd overpaid. As the stock market began to recover later that year, however, Datek's software for active traders began to garner a new following with its streaming data, the same bleeps and bongs as on institutional trading screens and best-execution order-routing software.

After spurning a hostile bid from E-Trade in 2005, Moglia did his biggest deal yet, agreeing to buy online brokerage TD Waterhouse. The deal left former parent Toronto-Dominion Bank with a 33% stake (it has since increased that to a predetermined maximum of 39.9%).

It didn't all go smoothly. TD AMERITRADE'S most moneyed clients are the 4,300 registered investment advisers who control $76 billion and clear millions of dollars of their clients' trades at a pop through the firm. Following the TD merger, the advisers' clients began receiving TD AMERITRADE statements showing zero balances. Swamped with calls, the company's phone reps left many advisers waiting hours to get through and clear up the mess.

Trading Out of Trouble

Swaths of the financial industry have been clobbered by bad housing debt. TD AMERITRADE has steered clear, benefiting investors.



Source: IDC/Exshare via FactSet Research Systems.

"They stumbled during the merger, but they've done everything they could since to make it right," says Michael Mers, who has run his fee-based Boise, Idaho firm, Aspen Capital Management, on TD AMERITRADE'S platform for six years. Moglia himself stood up at an Orlando conference for investment advisers earlier this year and accepted blame.

These days the boss is big on beefing up account sizes and wallet share. TD AMERITRADE'S own clients entrust a mere 12% of their investable assets to the firm, versus 60% claimed by Schwab. The average $50,000 account balance among TD AMERITRADE'S 6.5 million accounts compares with Schwab's roughly $300,000. "Eighteen months ago we didn't ask customers, 'Are you okay with your retirement plan? Your fixed income?' Now we ask those questions," he says.

Moglia, who shares the occasional steak dinner or poker game with fellow Omahan Warren Buffett, is rolling out investment tools like WealthRuler for retirement planning. He is also making a bigger push into the adviser market. He paid $225 million in February for a Fiserv unit that brought in $25 billion in assets held by investment advisers and retirement plan administrators.

So what could go wrong? A plunge in the stock market that drove down trading volume. Or an acquisition gone bad. With its solid performance and middling market cap of $11 billion, TD AMERITRADE could also become buyout bait one day. But given how things might have turned out that's not a bad problem to have. F