

Chuck Schwab's search for the next paradigm

His firm invented discount brokerage and mutual fund supermarkets, prospering mightily. Now what? A whole batch of new businesses.

By Alyssa A. Lappen

Smart businessmen in most industries profit from their competitors' mistakes. Uniquely, in money management they can also profit from their rivals' successes.

Consider Fidelity Investments' canny chairman, Edward C. Johnson III. During last year's bull market, his fund managers loaded up on the stocks of several financial services giants. One was Charles Schwab & Co., the Boston fund company's archrival and the biggest campaigner on the brutal battlefields of discount brokerage and mutual fund supermarkets. As of

last June Fidelity held 16.5 million Schwab shares — nearly 10 percent of the \$4.5 billion-in-market-cap San Francisco firm. Only Charles Schwab himself owns a bigger chunk: 23 percent. According to fund tracker CDA/Spectrum, Fidelity had cashed in most of its Schwab chips by December, presumably having made a tidy profit.

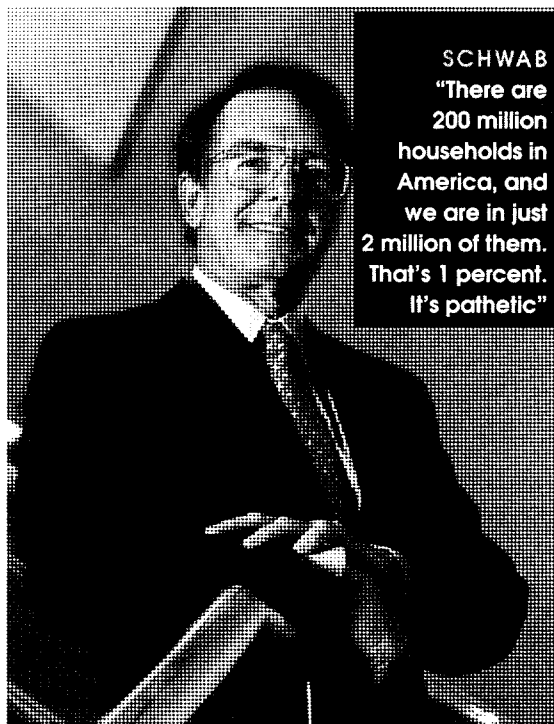
Chuck Schwab wasn't altogether flattered by the attention. "Fidelity was not trying to screw around with our stock," allows the Schwab chairman graciously. Yet, with a slight edge to his voice, he adds, "We're not happy with anyone buying more than 5 percent." And for Ned Johnson the gain on Schwab shares must have been as bittersweet as Boston baked beans with vinegar: The very factors that made the stock an attractive buy also make the firm an ever-more-formidable competitor of Fidelity's, especially in mutual funds.

Charles Schwab & Co. has been profitably rubbing rivals the wrong way for nearly three decades. The firm's audacious foray into the discount brokerage business in the early 1970s (even before the official deregulation of stock commissions) rattled Wall Street and forced the wire houses to adapt grudgingly to a whole new trading regime. Then, starting in 1990, Schwab began offering its own name-brand mutual funds; that effort has

so far picked the big fund companies' pockets of some \$34 billion in might-have-been assets. And it added an estimated \$57 million pretax to Schwab's coffers in 1995, or roughly 20 percent of the firm's total pretax earnings of \$277 million.

But Schwab's boldest, in-your-face threat to Fidelity, Vanguard Group and the other outsize fund families is the permanent change the upstart firm has wrought in the fund game by offering its customers the no-load funds of other companies. Schwab & Co.'s Mutual Fund Marketplace, including funds in its "no-fee" OneSource program, has ballooned to \$58.3 billion in assets and is growing at a startling 61 percent-a-year clip. Counting the \$19 billion in new assets raked in last year, Schwab now ranks as the third-largest direct distributor of mutual funds, after Fidelity and Vanguard, according to New York City consulting firm Strategic Insight. And with total securities and mutual fund assets of \$200 billion, Schwab & Co. is today more than one third as large as Fidelity and a tad larger than Vanguard (see chart).

But not all the knockoff artists work on Seventh Avenue. Fidelity, Vanguard, Merrill Lynch & Co. and Smith Barney have all mounted attacks on Schwab's Mutual Fund Marketplace by



SCHWAB
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Richard Morgenstern

launching or planning their own one-stop-shopping supermarkets. "Schwab is just a utility," says T. Rowe Price Associates managing director and marketing chief Edward Bernard, with a sniff. "It is eminently copyable." Schwab's discount brokerage business, meanwhile, already abounds with aggressive competitors, on Wall Street and off, even as individual stock investors become an increasingly endangered species (at least for the time being).

Great successes beget great expectations, of course, and the pressure is mounting on Chuck Schwab to dazzle and confound the financial community with yet another, third-wave strategic breakthrough. Comments one observer, posing a common question: "Schwab has changed the rules in the industry twice before. What's the next trick?"

Actually, it may be a whole bag of tricks. Chuck Schwab and his chief operating officer, David Pottruck, insist that they have no particular new paradigm, no third revolution in mind. "We don't have the secret Coca-Cola formula in the safe," confides former college wrestler, football star and Wharton School MBA Pottruck with a shrug of his wide shoulders. "There's no patent that runs for 17 years. There's nothing we do that can't be [easily] emulated by someone else."

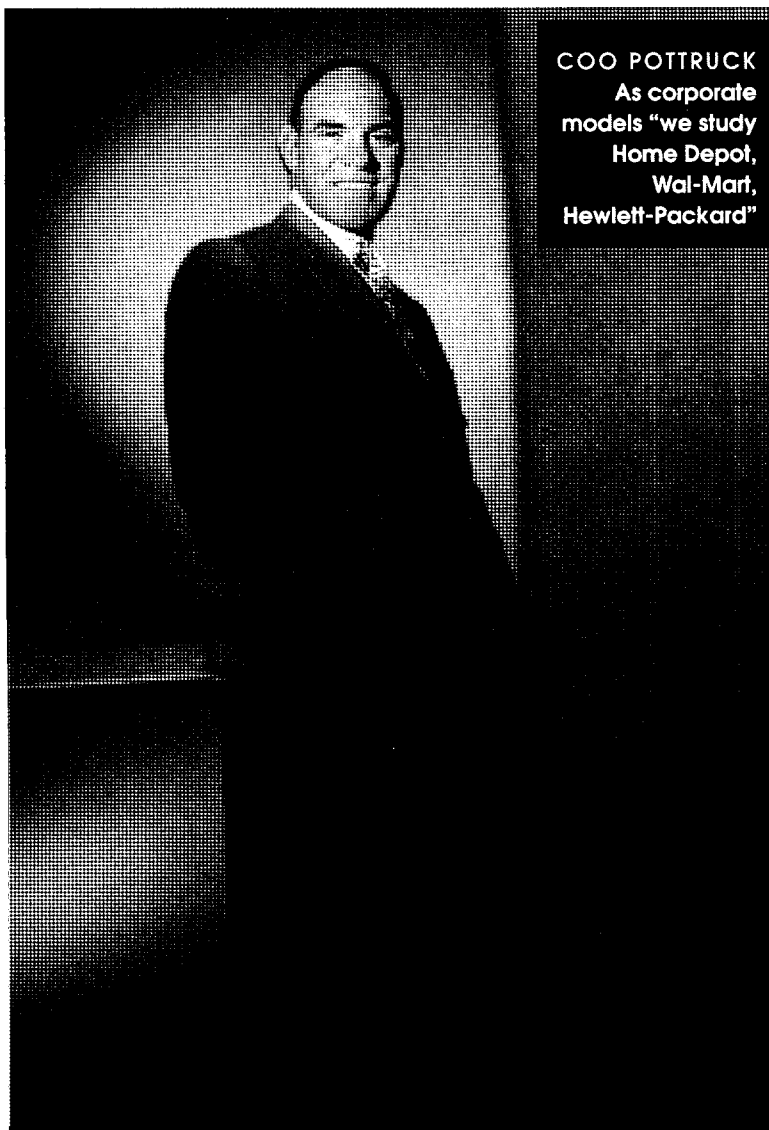
Just the same, Schwab and his colleagues are not suited by temperament to smugly standing pat — as if that were possible in this frenetic financial services era. The restless spirit of the firm derives more from the creative turmoil of nearby Silicon Valley than from the stuffy precincts of traditional Wall Street. Ideas are percolating out in Baghdad by the Bay.

For a start, Chuck Schwab is window-shopping for a mutual fund family he can put under his own label. "My dream boat would be an index group," he muses, noting that he looked at Dreyfus Corp. and bid aggressively on the Standard & Poor's 500 index fund that IBM Corp. sold in 1994 to Fleet Financial Group. "I'd love to buy Vanguard, [and] Dimensional Fund Advisors would be a very nice fit," he adds wistfully. But with money managers fetching a stiff premium (*Institutional Investor*, December 1995), and Schwab being a frugal type, it's unlikely he'll turn up the right family soon.

Plenty of other plays, though, are scribbled in Schwab's strategy book. "There are 200 million households in America," he points out, ever the mutual fund missionary, "and we are in just 2 million of them. That's 1 percent. It's pathetic." Pottruck is driving his troops on several fronts to help — and profit from — this savings-short populace. Among other things, Schwab & Co. intends to: further extend its Mutual Fund Marketplace into financial advisers' portfolios; push into the top five 401(k) providers by 2001 — no mean feat, since Schwab came late and largely empty-handed to this particular party (see technology box); broaden the offerings and flexibility within the Schwab-label variable annuity; increase Schwab & Co.'s No. 1 market share in financial service sales by way of PCs and other electronic channels; and export the mutual fund supermarket idea to Europe. (Last year Schwab

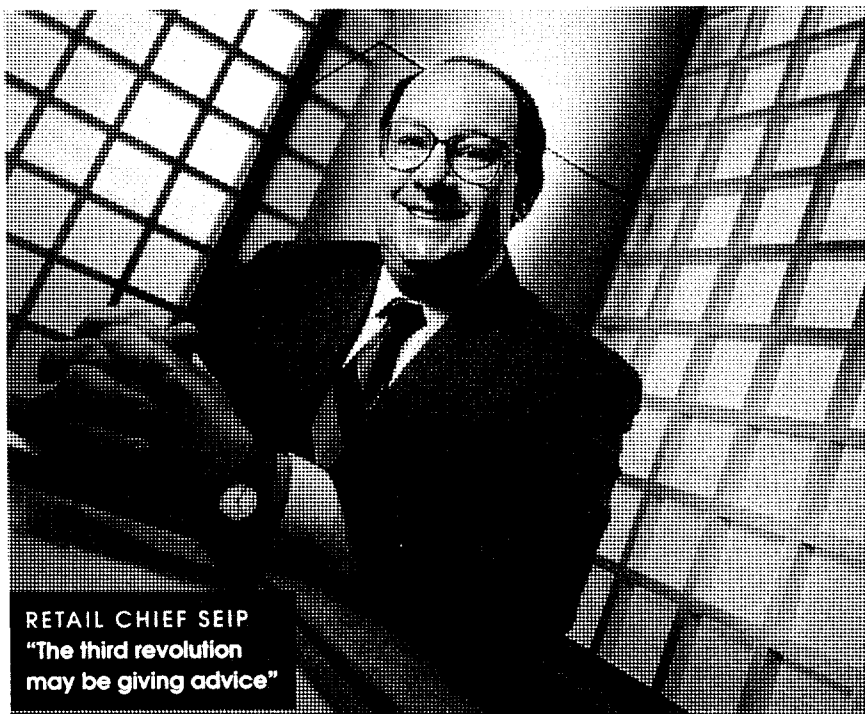
bought Britain's biggest discount broker, ShareLink.) Schwab is also spending serious money to maintain its technological edge (see 401[k] box).

Consolidation of gains may never supplant innovation of new products at Schwab, but it has ascendancy at the moment, particularly in the mutual fund segment of the business. This shouldn't be any great consolation to competitors. "Internally, we look at our Mutual Fund Marketplace assets, including the Schwab OneSource [no-transaction-fee fund program] plus the Schwab [money market and index] funds, to see where we fall on the Investment Company Institute list of families," says Pottruck. "It's not apples to apples, but it is a way for us to look



consistently at what we do. When we started [OneSource], we were in 15th place. Now we are No. 6, with \$88 billion, [after Franklin Templeton Group]. Our goal is to keep knocking them off."

In that cause Schwab has enlisted a small army of fee-only financial advisers who peddle its funds. So-called Schwab Institutional has pulled in \$52 billion in assets (nearly one third of Schwab's total client assets) through 5,600 planners. The firm has amassed a staggering 82 percent of the assets available



RETAIL CHIEF SEIP
"The third revolution
may be giving advice"

from fee-based advisers using outside firms for their back-office and administrative support, according to a recent report by Cerulli Associates and Lipper Analytical Services. "We expect to grow 30 percent a year among investment advisers," says institutional division chief John Coghlan. Given that Schwab intends to target registered securities brokers who want to leave the wire houses, along with money managers who don't often call themselves financial advisers, that target is not unrealistic.

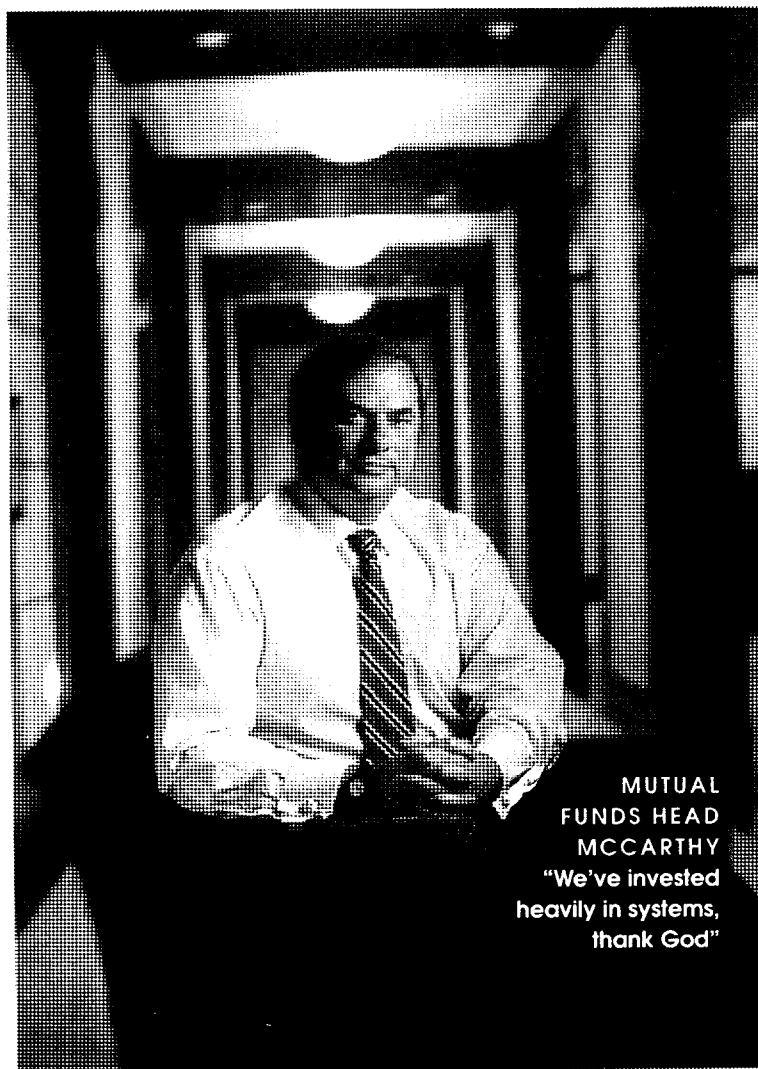
Simple demographics is behind the effort. "The third revolution may be giving advice," suggests Thomas Seip, the executive vice president who heads Schwab's retail business. "The baby boomers are entering their peak earning years, many of them have seen their approaching mortality, they have to put their kids through college, and they must plan for their own retirement. They have parents to support.

And when they get restructured out of a job or come into an inheritance, they get fat distributions. But they'd rather be out sailing than planning for all this."

One engine that powers the Schwab machine sweeping up adviser-controlled assets is the groundbreaking no-transaction-fee program OneSource. "We realized that if we couldn't get [assets in the program] to \$50 billion in five years, it was a loser," says Pottruck, who had trouble getting fund companies to sign up when OneSource was started in 1992. "I did a lot of begging with Tom Bailey at Janus [Funds]. I wore out the knees on at least two or three suits." The bended-knee routine eventually won over eight fund companies, including Janus, Dreyfus and Neuberger & Berman, which agreed to pay Schwab 25 basis points annually on the assets in their funds purchased and held through Schwab. Their reasoning was that this was money they wouldn't attract otherwise.

"In 1992 we were very small, only about \$6 billion," says Janus chief marketing officer Mark Whiston. "A lot of firms like us were wrestling with the decision to invest in back-office systems, telephones, imaging for shareholder accounts. We decided to do both [invest and also go with Schwab], to see if combining forces would give us a strong package." Today 10 percent of Janus's \$31 billion in assets come through OneSource, making Schwab the fund company's largest fund partner.

Midsized and small firms later joined the program for 35 basis points annually, which was still less than what it could have cost them in marketing expenses to accumulate equivalent assets. "We pestered Schwab to get in," says Ron Baron, whose Baron Asset Fund had stagnated at \$50 million for four years until he joined OneSource in 1993. Now Baron



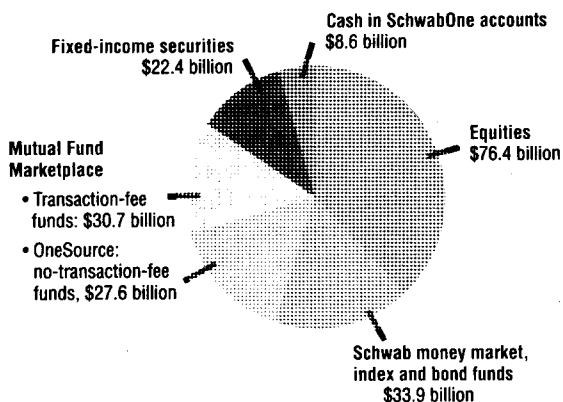
MUTUAL FUNDS HEAD MCCARTHY
"We've invested
heavily in systems,
thank God"

photos by Richard Morgenstein

Schwab: A statistical snapshot

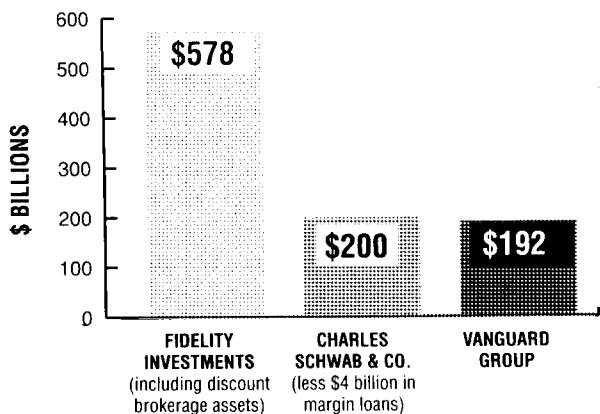
Where Schwab gets its assets

Here's how Schwab's \$200 billion in client assets break down by product category. (The firm also has \$4 billion in margin loans outstanding.)



How Schwab stacks up against its chief rivals

Total client assets at Schwab have been growing at a phenomenal pace, but Fidelity Investments is still way ahead.

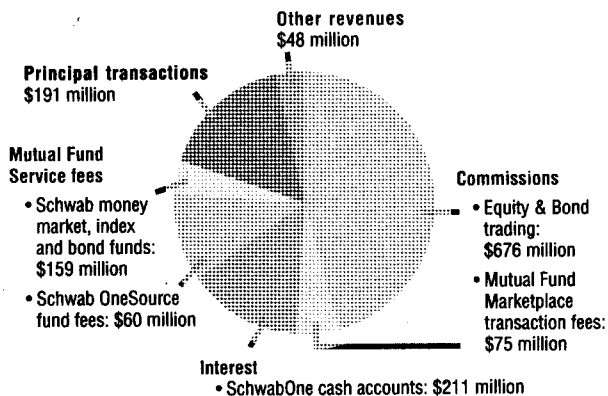


Capital Management has two funds with a combined \$600 million in assets, nearly half of that courtesy of Schwab. (Baron is such a believer in the firm that his own funds hold more than 3 million shares of Schwab.)

To date Schwab has easily spent more than \$150 million on the Mutual Fund Marketplace. "We invested heavily in the systems and process, thank God," says Timothy McCarthy, executive vice president of Schwab's burgeoning mutual fund enterprise. "We are in effect a transfer agency that is open to the public." Every one of the 43 fund families providing 350 funds in the retail OneSource program has a direct, Schwab-supplied computer linkup, at \$30,000 a pop. Ditto for an additional 40 families with 200 funds available (with no transaction fee) only to fee-only advisers and retirement plans

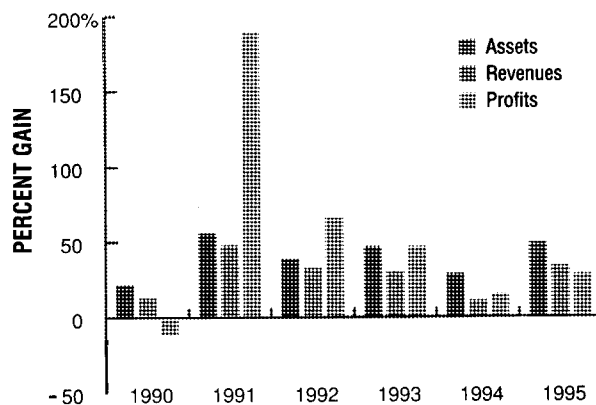
Where Schwab earns its revenues

Schwab does not publicly break out revenues by product lines. Here *Institutional Investor* offers its own estimate of how the firm generated its \$1.4 billion in gross sales last year.



The pattern of Schwab growth

Schwab is a mighty growth engine. Shown are average annual growth rates in assets, revenues and profits.



Source: Charles Schwab & Co.

and 174 families with 650 transaction-fee funds that have custody agreements with Schwab.

Schwab has also had to design or buy technology to handle millions of individual fund accounts as well as shell out for marketing and educational material. McCarthy describes the purport of such bumph as "guided discovery" — quarterly fund performance rankings, asset allocation software and a "select list" of 30 funds that goes out quarterly to clients that ask for it.

The no-fee funds now pay Schwab an average of 30 basis points annually on some \$28 billion in assets, giving the firm more than \$75 million in annual revenues, or more than 5 percent of its total sales. Schwab probably earns pretax margins of 20 to 30 percent on OneSource, netting perhaps 15 percent. That may not be a sparkling return by money management's

exaggerated standards. But dozens of funds are clamoring to get in, which would bolster margins.

Schwab has been so successful in attracting assets to OneSource that even front-end load families, such as Govett & Co., Global Asset Management, Société Générale and Morgan Stanley & Co., have come around reluctantly, offering shares for no load and no fee through the Schwab adviser program. "The fee-only advisers will be the death of people like us," shudders the head of one front-end-load family. "Dealers used to sell us, but now they can draw from whatever [inventory] is appropriate."

The add-on earnings are nothing to sneer at, either. Says Sanford C. Bernstein & Co. analyst Guy Moszkowski, "This is very lucrative: OneSource has unquestionably fed [Schwab's] money market funds, which have roughly tripled in a period when there has been little growth in money market funds." OneSource, he adds, has also had spillover benefits for Schwab's discount brokerage business. Its equities in custody grew 54 percent last year, a far faster rate than for that market

as a whole. OneSource has also fed cash balances that are *not* invested in money market funds: at present an \$8.6 billion pool off which Schwab creams a fat 300 basis points each year. And transaction fees paid on the other half of the Mutual Fund Marketplace assets — another beneficiary of the OneSource idea — probably accounted for at least 10 percent of Schwab's \$751 million in commission revenues last year.

Indeed, the conspicuous success of OneSource has now attracted the scrutiny of the Securities and Exchange Commission. "We have been trying to find out more about how the program works, about the kind of services provided and about how the funds report the fees [they pay]," says Barry Barbash, the head of the SEC's enforcement division. "It's a matter of disclosure. The Investment Company Act doesn't prohibit service arrangements, so long as investors understand what they are buying. But here you are told there is 'no transaction fee,' [when in fact] the funds pay fees for distribution and other related services." New rules are undoubtedly in the offing.

Schwab & Co. seems unfazed. "We have said publicly

On technology's 'leading, not bleeding,' edge

Chuck Schwab can't exactly be called a closet nerd. Only now, in the second decade of the PC revolution, is he making a concerted effort to become computer-literate. Still, Schwab is probably more akin to Bill Gates than to Charlie Merrill.

In 1977, when Charles Schwab & Co. had a relative handful of customers and scant data to process, Chuck Schwab invested millions of dollars in a mainframe computer. Even then he sensed that computers were the way of the future for financial services firms.

As a tentative techie but savvy businessman, Schwab has made an enormous commitment to the computer era. "Schwab has always been willing to invest heavily in technology, to reinvest nine figures a year and not talk about it," says one former Schwab & Co. information officer. Adds veteran independent brokerage analyst Perrin Long, "Chuck Schwab's back office is more sophisticated than that of anyone on Wall Street." Schwab & Co., Long notes, spends the highest proportion of its revenues on technology of any brokerage firm.

Schwab technology chief Dawn Lepore, an executive vice president and the current chief information officer of the parent company, reports that her budget runs from 11 to 15 percent of the firm's

annual revenues, which were \$1.4 billion in 1995. Brags Chuck Schwab, "We reinvest about 95 percent of our cash flow every year" in the company. Last year the firm devoted at least 64 percent of its \$241 million in cash flow to technology alone. That kind of spending has halved Schwab's cost per customer transaction over the past three years, according to Baron Capital Management chief Ron Baron.

In contrast with the technology splurges at some companies, this is money that's not spent in scattershot fashion. Sanford C. Bernstein & Co. Wall Street analyst Guy Moszkowski figures that fully half of Schwab's technology outlay between 1990 and 1993 went into its no-transaction-fee OneSource mutual fund program alone (story). "Technology is strategic," points out tech chief Lepore, "but we have to be careful. As a public company, we prefer to be on the leading edge, not the bleeding edge."

Schwab & Co. has long counted on computer paraphernalia to give it a distinct marketing advantage. In 1991 the firm was asking the fee-only advisers who invest their clients' assets through Schwab to try out SchwabLink software: Still in use in upgraded form, it gives advisers everything from real-time access to their clients' accounts at Schwab to

on-line trading and confirmations. Agents even get access to external research and such tools as prewritten letters to answer clients' queries.

In 1990, the year Schwab introduced its name-brand mutual funds, the firm had already begun overhauling its integrated mainframe computers and introducing networked client servers. The idea was to enlarge the system as well as to give it more flexibility and backup-processing capability. "Before, we had batch-oriented processing with central mainframes and dumb terminals on people's desks," explains Lepore.

Then in 1993 the company began moving critical applications to client servers, well ahead of the competition, a process it will presumably continue as new applications arise. "Now we are going to intelligent workstations, Pentium PCs, with processing on mainframes or client servers," says Lepore.

Today the Schwab technology system includes IBM, Sun Microsystems and Compaq client servers, networked to more than 5,000 IBM and Compaq workstations equipped with Windows NT software. This year brokers' workstations in four regional calling centers, as well as at branch offices, will be equipped with the custom-designed system called IWIN, for I Want Information Now.

from the beginning how the program works and never kept the fees a secret," says spokesman Glen Mathison. "We will be happy to comply with any new disclosure rules the SEC deems necessary."

Competition may prove to be a bigger headache for Schwab than whatever rule changes the SEC promulgates. OneSource is no longer the sole source of such fancy fund services. Fidelity is pushing its Funds Network, Jack White & Co. has been expanding its own \$4.1 billion Mutual Fund Network, Vanguard is adding funds to the brokerage service it first offered big clients in 1986, T. Rowe Price is doing something similar, and Kansas City recordkeeping giant DST Systems is adding more services to its FanMail electronic mail to protect its huge franchise in mutual fund recordkeeping.

Even the wire houses are venturing into no-load mutual funds. Merrill Lynch is reportedly working on a no-load product for its 13,000 financial consultants, although the broker insists that no decision has been made; Prudential Securities and Dean Witter are looking into the business. Smith Barney isn't

announcing its plans just yet either, but it reportedly plans to provide no-load funds to clients for an annual asset-based fee of perhaps 1.5 percent. (The firm will argue that its vast database on money manager performance gives it an edge). Schwab's competitors are also pressuring brokerage-distributed load families to pay for distribution out of management fees as well — Nationwide Insurance Group is reportedly asking funds for 16 basis points; Merrill Lynch, 30 basis points; and Smith Barney, 25 basis points.

Schwab's splashy successes, however, belie some surprising weaknesses that can no longer be dismissed as growing pains. The 401(k) shortfall is the most dramatic, but there have been other setbacks. One vulnerability has been a dangerous inattention to what's brewing at close competitors. "I am running scared, absolutely," insists Pottruck, tacitly admitting to a newfound awareness of the intensifying market pressure.

Yet until recently Schwab didn't systematically study any of its fund marketplace competitors except Fidelity, according to



Ever since 1989, well before most rivals, Schwab has been allowing customers to place "telebroker" trades simply by punching buttons on their phones. The firm has four regional computerized phone centers, in Denver, Phoenix, Indianapolis and Orlando, which handled 60 percent of the firm's 82 million calls last year. The remainder went through telephone reps.

Like other firms, Schwab has made computerized electronic trading systems a priority, but it didn't just draw up a shopping list and hand it to some consultant. In 1985 Schwab pioneered its own computer trading software, called Equalizer. Eight years later the firm issued a first-generation on-line trading program on the Windows platform and dubbed it StreetSmart. It fol-

lowed up the next year with a version for Macintosh computers and, in 1995, with a second-generation version for Windows.

Then last year, after only six months of development, the firm launched "e.Schwab," a still-more-advanced electronic trading program. Like StreetSmart, e.Schwab works on-line, but users get reduced telephone-service options, though more electronic-library services for research on stocks or mutual funds. And they pay dramatically lower commissions than with StreetSmart (only \$39 for trading up to 1,000 shares).

In March the company launched its e.Schwab software on CD-ROM discs. On this front, too, Schwab remains years ahead of the competition. By the

Tech chief Lepore: A growing proportion of electronic trades

end of last year, 15 percent of Schwab's more than 15 million annual transactions were coming in by personal computer — more than double the volume of a year before.

Schwab has suffered some technology flubs. The company invested tens of millions of dollars in Unix software for its desktop operating systems, only to switch later to Windows NT, and it similarly wound up swapping Sun workstations for Compaq and IBM PCs. Schwab is also reconsidering its applications-development tools, according to a new report by Cambridge Technology Group. Overall, however, Cambridge gives Schwab high marks for technological leadership in the brokerage industry.

Tech chief Lepore expects Schwab's proportion of electronic trades to swell steadily in future years. What else is being scrolled up on the Schwab technology screen? Says Lepore: The firm is working to develop trading on the Internet and will be the exclusive stockbroker for CompuServe's WOW! on-line venture. The company is also embracing other forms of electronic trading (installing a World Wide Web site, for instance) and working with Intuit to provide an electronic bridge from the software firm's Quicken financial management program to Schwab. Stay on-line.

Fumbling on 401(k)s

For Charles Schwab & Co., the 401(k) market has been one thin paradigm. The phenomenal proliferation of defined-contribution plans could conceivably have provided the firm with its third great market breakthrough, after discount brokerage and the fund supermarket (story).

But instead of being the smartest and the fastest firm moving into this burgeoning marketplace — 401(k) assets have been growing about 15 percent a year and have now reached some \$600 billion — Schwab bumbled in disastrously late and with a slapdash approach. “We are late, yes,” concedes senior vice president Hugo Quackenbush. “We tried earlier and couldn’t do it.” Now Schwab must play determined catch-up.

The firm first tackled the then-9-year-old market in 1990 with a prototype that was apparently the first offering of multiple funds and families. Former Schwab strategic planner and corporate services vice president David Krimm developed the firm’s first no-transaction-fee fund offerings for the retirement market but left in 1992 and is now at Intuit. He elaborates on that first effort: “The product we went in with was unique. We had multiple funds, the best of their class, with daily valuation.

We did well with small and medium-size third-party administrators.”

But the effort was scrapped after 20 months. “We worked with Seafirst Corp. [the Washington State bank] as trustee and SEI [Corp.] as the record-keeper, and the product was very expensive,” admits John Coghlan, executive vice president of Schwab’s otherwise booming institutional division.

Schwab tried again in late 1992, this time working with such firms as Coopers & Lybrand, Milliman & Robertson and Hampton Pension Services. At that point, Fidelity Investments had already been active in the market for eight years. But critics say that Schwab, being a public company, did not have the patience to sell directly to corporations or to stick with investments that had a payback of more than one year. The company counters that it had the patience but lacked the in-house record-keeping to make a go of the venture.

The upshot has been that the growth of Schwab’s defined-contribution business has been far less spectacular than that of the market’s biggest players. Last year it pulled in \$2 billion in new 401(k) assets, versus \$33 billion for Fidelity and \$10 billion for Vanguard Group. More than 14 percent of Schwab’s share came through

big plans, such as those of the United Airlines Pilots’ Association and Adobe Systems.

They were attracted to the “personal choice” retirement account Schwab introduced in 1995, which enables plan participants to trade individual stocks and bonds. This new wrinkle promises to generate a lot more interest.

The 1995 gain was Schwab’s best-ever showing. Yet the firm still has only \$6 billion in 401(k) assets — less than 6 percent of Fidelity’s \$105 billion, 14 percent of Vanguard’s \$42 billion and only 1 percent of the total 401(k) market. Schwab has yet to rank among the top 25 providers of 401(k)s, a dismal showing for a firm of its size and reputation.

Acknowledging its 401(k) failings, Schwab last year bought Hampton Pension Services, a private pension consulting firm in Akron, Ohio, and TrustMark, a North Carolina record-keeping software firm, for undisclosed sums. Schwab hopes the two acquisitions can pull in a lot of small 401(k) plan business and is rolling out its bundled effort this month.

Fee-only advisers are also helping Schwab get into small 401(k) plans, although this strategy may prove a bit tricky: The fee-only advisers take retire-

one of Schwab’s internal market researchers, who has been looking for details on the expanded T. Rowe Price brokerage business. Officially, Schwab insists that it has always watched competitors closely and has in fact stepped up that effort as the competition has grown. Pottruck, however, implies that researching rivals is still somewhat beside the point for Schwab. “We don’t study the brokerage industry,” he says. “We study Home Depot, Wal-Mart, Hewlett-Packard — companies in incredibly competitive environments, and with no patents, that have somehow year after year, over decades, regenerated their competitive advantage and grown.”

Schwab’s fix on exactly who its retail clients are and what they want may also be a bit hazy. This is a firm that has been so good at flying by the seat of its pants that it apparently never bothered to switch on the market research radar. “Fidelity used to know more about Schwab’s customers than Schwab,” says one industry veteran who knows insiders at both firms. Adds another mutual fund guru: “What they had built were transaction systems. What they need is customer information.”

Schwab strategic marketing head William Baughman, a onetime Fidelity marketing analyst and planner, was shocked

to learn how little Schwab knew about its own customer base when he joined the firm from Bankers Trust Co. in late 1994. “Both Fidelity and Schwab have invested a lot in understanding their customers,” Baughman says now, “and if it was ever true that Fidelity knew more about Schwab’s customers than Schwab, it is no longer. We have made a significant commitment to customer satisfaction, going back one decade to find out on every single trade how customers think we did. We have also become very sophisticated about understanding customer needs and expectations.” Schwab sent out 750,000 customer-satisfaction surveys last year. (Purported overall satisfaction levels: more than 95 percent.) The firm’s new client-server network, which lets phone reps pull up real-time updates on demand and then stores that data, is also helping to upgrade Schwab’s intelligence on customers.

Schwab’s compensation scheme has had its singular shortcomings: It tended to pay people either too much or too little. Top-level executives were rewarded mostly with stock options. The result: As Schwab thrived, many got rich — and retired early. Foot soldiers, meanwhile, were not so well taken care of, sometimes making it difficult for Schwab to recruit first-rate



Seth Affumado

Institutional head Coghlan: Late out of the gate

dous amount of [potential] market share, and companies want to go with a provider that can build employee confidence and help them to invest." (Only 11 percent of the nearly 2 million companies with fewer than 100 employees have 401(k) plans; of the 24,000 companies with 100 to 500 employees, just 32 percent have the plans, according to Access Research.)

Schwab will find the going tough. Fidelity, Cigna Retirement and Investment Services, Vanguard and T. Rowe Price Associates are also marching

have to give up to get business. But it is a way of life." The pot of gold, he notes, is the rollover market at the end of the 401(k) rainbow, when employees retire.

Patience — not the outstanding trait of the antsy folk at Schwab — is imperative for penetrating this market. Already it takes big providers three to six years just to break even on small plans, and that horizon is likely to recede into the distance as competition drives down the price of small-plan service. Indeed, some see the potential for a repeat of the kind of pricing war that so riled the institutional money-fund market in the early 1990s, when Fidelity unseated PNC as the No. 1 supplier by slashing its management fee from 25 to 18 basis points. "Make no mistake," says one big player, "the people who control the investment management business will control the [small-plan] market by lowering fees and costs."

Schwab has one 401(k) priority more immediate even than conquering small-plan market: putting its new defined-contribution chief into high gear. Richard Tinervin, a former Fidelity bank services man and NationsBank trust specialist, will lead the charge under Coghlan. Patience — but not too much of it — will be his best friend.

ment plans away from small and midsize regional bank trust departments, which are among TrustMark's key customers. Schwab denies that this creates any real conflict.

"We want to be in the top five players in this business by 2001," vows executive vice president Coghlan. Can Schwab do it? "Fidelity is way ahead," admits Schwab chief operating officer David Pottruck. "But there is a tremen-

small-and-midsize-401(k) terrain. All likewise offer multiple fund families. "The larger players are not going to let Schwab monopolize the small market," contends a senior marketer at one of Schwab's big rivals. "We want to see all those 2 million [small] plans get 401(k)s, and [those that have plans with our competitors] we will set about taking away. First sales are expensive. Take-away is costly, too, because of what you

talent in the ranks. Now base pay is better, though Schwab still tends to offer lower salaries than competitors, if higher bonuses and a heap of stock. Officers and directors together own nearly 7 percent of Schwab, and employees in the company's stock ownership plan hold a further 9 percent. These days a Schwab executive vice president (there are eight of them out of 9,200 employees) can expect a base of up to \$400,000, plus a bonus of perhaps 200 percent — and those splendid stock options, which last year ranged from 150,000 shares to more than 500,000 shares for the firm's top officers.

Chuck Schwab has been willing to commit more resources to bolting down good people. "We don't make cups," he declares. Our product "is intangible, it's pure service, delivered with people." Pottruck elaborates on this Schwabian theme: "The next great product does not give us the competitive edge. It's recruitment of terrific people that creates the ability to innovate."

Schwab & Co. has been sluggish about trying to cash in on the semicraze for no-load variable annuities. A joint venture with Transamerica Corp. flopped (because of inadequate systems and the insurance carrier's inability to add new fund port-

folios to the offering). But Schwab plans to relaunch the product soon with a new insurance underwriter.

The firm is once again reorganizing its troubled trust business. The purchase of recordkeeper Hampton Pension Services and a daily recordkeeping software provider, TrustMark, will allow Schwab to refocus the trust effort on employee benefits and 401(k) plans.

Some things Schwab does just plain superbly, suggesting that it may know its customers pretty well after all. It lavishes attention on the all-important fee-only advisers through dedicated account representatives who have the authority and the expertise to handle every question or problem promptly. "We have been working with Schwab since 1989, and they remain the best in the field," says Michael Davis of Resource Consulting Group in Orlando, which handles virtually all \$140 million of its clients' funds through Schwab. Despite rapid growth in assets and client accounts at his firm, Davis says, he's been able to hold his own back-office support staff to five.

Litman/Gregory & Co. in Larkspur, California, manages

\$300 million for about 120 clients exclusively through Schwab. "We could not operate this way without Schwab," says partner Craig Litman. "Every day, every week, every month, [Schwab provides us] with pricing and other updates. Execution is reliable, and one-stop shopping is invaluable. Schwab has a price, but it is worth it." Besides, Litman adds, rivals like Fidelity are not really any cheaper, and their services are not compelling enough to warrant a change.

Schwab & Co. hopes to fuel growth in the adviser segment by building this kind of loyalty among the thousands of small and midsize advisers that trade primarily in stocks and bonds rather than in mutual funds. One such is Gregory Lathrop of Lathrop Investment Management in Little Rock, who has lodged \$40 million of his clients' \$140 million in assets at Schwab. He avoids stiff bank custody fees, at least halves retail commissions and can even trade away from Schwab as necessary (for a small fee). "We will take more business to Schwab as we can," vows Lathrop.

To cultivate the Lathrops-of-Little-Rock nationwide, Schwab has launched an adviser referral service — AdvisorSource — for individual customers who ask for help with investments. Since it was set up last June, the service has signed up 320 prescreened advisers in 30 states (who must have been registered as investment advisers with the SEC for at least two years and meet nine other stringent criteria). Though the advisers aren't obligated to place new assets with Schwab, most do anyway — adding nicely to OneSource assets, transaction fees and commissions. Even better, the advisers have agreed to fork over

30 percent of their fees in the first year, 25 percent in the second and 20 percent in the third (zip in the fourth) on all accounts that Schwab refers to them. That alone is purportedly enough to offset most of the program's marketing and start-up costs.

Schwab is coy about how many new individual accounts it has gleaned from AdvisorSource, but the company is moving up its schedule for rolling out the program nationally by six months, a sign that the new idea is probably another winner. Indeed, Schwab senior vice president James Hackley, who still runs the adviser business he originally researched in 1985, believes that by 2000 the firm's assets will be dominated by advisers.

That is, if the competition is willing, which it may not be. Fee-only advisers appear to be skeptical of Fidelity's new Investment Advisor Group, a would-be rival to Schwab's fee-only planner business and AdvisorSource. Launched in 1992, it has roughly the same \$5 billion in fee-only assets it had last year, Cerulli reports. Others say that more than half of those assets are tucked in Fidelity funds. "Transfer agency is not Fidelity's real, core business, and we aren't confident that they will stay in that line," says a wary Litman. Adds adviser Lathrop, "I'm not familiar with Fidelity's brokerage product — I don't need additional custody choices — and Fidelity is a major competitor [of mine]." Investment Advisor Group has reportedly suffered a raft of resignations lately. (Fidelity spokespeople would not respond to questions on this point.) Nevertheless, if Fidelity ever does train its powerful cannons on

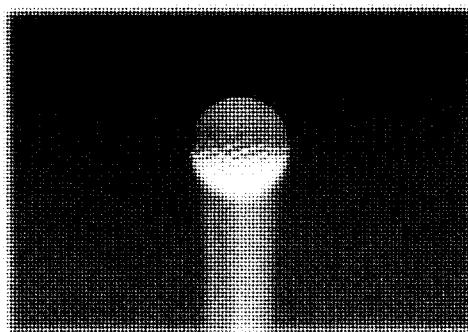
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this elusive target, Schwab could find itself in the line of fire.

Now a frisky 23, Charles Schwab & Co. is imbued with an entrepreneurial youthfulness that somehow promotes teamwork and, for want of a more apt term, sheer good feeling. "Teamwork is the only way we can accomplish anything," sermonizes chairman Schwab, sounding not-uncharacteristically preacherish on this close-to-home subject. "We are not built like a traditional brokerage house. We are not about out-selling everyone else but about growing the company, which will create jobs and allow people to grow their careers."

Just about everyone at the company, from office clerks on up, seems to buy into this notion. Turnover is low. And employees seem to genuinely adore the place. "This is the best company I have ever worked for," says Joan Joyner, assistant manager of the Schwab branch on San Francisco's Montgomery Street, who counts two traditional brokerage houses among her former employers.

As Pottruck can attest from personal experience, Chuck Schwab's commitment to teamwork is no mere sloganeering. The COO, whose ego is not noticeably malnourished, remembers having to swallow his pride, or rather be force-fed it by his boss, in 1989. At the time, Schwab vice chairman Lawrence Stupski was president and COO of Charles Schwab & Co.; Pottruck was president and COO of the brokerage arm. "We were tripping all over one another," Pottruck recalls. "I assumed I had been handed the baton, and it created two camps, which was not healthy. My first instinct was to leave. I had been pursued by Fidelity, and I interviewed with Ned Johnson. But Chuck found out about it. He sat down with Larry and me and said, 'I don't want to lose either one of you.' He was kind of a marriage broker. I had to put my ego in my pocket and become Larry's chief supporter, not his chief competitor." From that moment, until Stupski was sidelined by a heart attack in 1992 (he's still vice chairman and a member of the board but is chiefly responsible for the company's considerable charitable efforts), the pair worked well together, Pottruck says.

A sizable body of skeptics, which includes some former Schwab employees, maintains that Chuck Schwab's latest grand designs are as ephemeral as Bay Area morning fog. "He is a great salesman," says one mutual fund marketing maven, "but he is not Mr. Strategic." Yet those who consider

Schwab's string of successes in discount broking and mutual funds (and, for that matter, the firm's 1987 public offering — two weeks before the crash) to be happy mistakes should think again. This is a firm that, sometimes impulsively, sometimes deliberately, has consistently sought to break out of the molds of the industries in which it operates, revolutionizing them in the process.

"Our advantage is in our ability to innovate faster — to make the discontinuous leap," proclaims Pottruck. For the time being, Schwab appears to be content to make small leaps. But competitors would probably be wise to stand back a safe distance. **■**

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