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What Are Low-Cost Leader Schwab's ETF Milestones, Goals?

SCHWAB

Jonathan de St. Paer explains why Schwab has become such a disruptive force in the ETF field.

BY NANCY GONDO

Though Charles Schwab Corp. (SCHW) didn't begin offering exchange traded funds until 2009, it's made a big impact on the industry.

It launched its first four ETFs in November 2009 with some of the lowest operating expense ratios at the time, ranging from 0.09% to 0.15%. That challenged rival ETF providers to lower their fees.

What's more, Schwab offered its ETFs with commission-free online trading to Schwab account holders.

The San Francisco-based brokerage continues to live up to its reputation as a low-cost disrupter. When it launched, Schwab U.S. Broad Market (SCHB) carried a 0.08% expense ratio. Today, the cost is even lower, at 0.03%.

Schwab is now the fifth-largest provider of ETFs, with nearly $80 billion in assets under management. Its proprietary ETF offerings have grown from four to 21.

IBD caught up with Jonathan de St. Paer, Senior Vice President and Head of Strategy & Product for Schwab, to discuss how the investment giant became such a disruptive force in the industry and offer tips on ETF investing.

The full interview with de St. Paer follows:

IBD: Tell me about the strategy for Schwab ETFs, and why have ETFs become an increasingly important part of Schwab's business?

de St. Paer: Charles Schwab Investment Management is driven by a desire to serve our clients' largest needs, and a belief that price and simplicity matter. We are focused on building a limited number of products that can serve as the foundation of a portfolio for a wide variety of clients. Our focused set of 21 ETFs are a great example of this strategy's success, as we've grown to become the fifth-largest ETF manager and are ranked third in terms of inflows. We're pleased to see the results that we've achieved by sticking to that long-term strategy.

In Q2, we achieved the largest asset flows in our history and had the highest quarter-over-quarter assets under management growth rate amongst the top 10 ETF providers. This was

the second time in Schwab ETF history that we surpassed $6 billion in quarterly flows. These strong flows helped us reach record assets under management of nearly $80 billion.

We know that investors and advisors are embracing ETFs overall and we expect adoption to continue to grow. Their low costs, tax efficiency and intraday tradability drive their continued popularity. In a 2016 study of ETF consumers, 52% of RIAs and 44% of individual investors increased their investments in ETFs. Our products also have exposure in nine out of 16 robo models.

IBD: What are your most significant achievements/innovations since launching Schwab ETFs in 2009? What sets your products apart?

de St. Paer: We think our straightforward approach to building high quality products at a great price — without unnecessary complexity — sets us apart. In today's world of product proliferation and competing sound bites, it's important to remember that having a strong, low-cost portfolio core is vital for all investors. I was here when we launched our first ETFs in 2009, and like a proud parent, I'm thrilled to see how well our offering has grown in just eight years. Schwab ETFs have gone from 0 to nearly $80 billion in assets under management, and we are now the fifth-largest provider of ETFs.

I should also mention that over the past three years (2014-16), not a single Schwab ETF saw outflows. No other top 10 ETF issuer can make this claim! And, no Schwab ETF has had to distribute capital gains yet.

IBD: If your focus is on foundational products, why offer smart beta strategies?

de St. Paer: We offer investors traditional market-cap weighted and Fundamental Index strategies because we believe that both can be part of a strong portfolio foundation and work well together. Each of these strategies can play an important role in a portfolio, and combining them can provide better diversification and potential for more attractive risk-adjusted returns across various market cycles.

Retail investors and RIAs are embracing Fundamental Index strategies — both on their own and as a complement to market cap indexes. In fact, our Fundamental Index offering is now over $20 billion, and our Fundamental Index ETF assets under management reached $10 billion in Q2. Five of six Fundamental Index ETFs have over $1 billion in assets.

IBD: Schwab entered the ETF business relatively late but has been a disruptive force in the industry. How have you managed to compete with the biggest players that have been entrenched longer than Schwab?

de St. Paer: I started at Schwab almost 14 years ago, and very soon realized that this company is different. Schwab strives to challenge the status quo and looks for ways to offer clients more value and a better experience. And our scale makes that possible.

Today, we compete with the biggest players in the industry because of our simple goal — we want every investor, regardless of their size, to have access to great products and pay the lowest possible costs for them. One way we do that is by remaining focused. We offer a carefully designed offering of ETFs, each of which can reach large scale. That allows us to pass the benefits of that scale back to investors through great pricing. We were the first to offer commission-free ETFs, and we did that right out of the gate with the launch of our first products. Our market cap index ETFs have been recognized for having some of the lowest operating expense ratios in the industry. The results speak for themselves, and I feel like we're just getting started.

Schwab ETFs are no longer the new kids on the block. They have been established as one of the largest and fastest growing managers in the U.S., and have compelled the entire industry to rethink costs. At the end of the day, investors are the big winners here, and that's how it should be.

IBD: What's the next big thing in ETFs? And for Schwab?

de St. Paer: I don't have a crystal ball, but we certainly see a continued appetite for low-cost, transparent ETFs. And in a post-DOL (Dept. Of Labor fiduciary rule) world, we expect that demand to accelerate.

Investors don't need innovation in the form of more complex products that generate extra fees for managers. The proliferation of complex products has led to a lot of confusion among investors, from beginners to professionals. Providers need to focus on investors' needs, and take a hard look at products that don't work. There are too many ETFs out there that are sub-scale, complex, expensive or confusing to investors.

Our goal is to have every investor, regardless of their size, pay the lowest possible costs for high-quality products that form the core of a portfolio

IBD: How is demand shaping up so far in 2017, and what key trends did you see in the first half of this year?

de St. Paer: Demand for Schwab ETFs has been extremely strong so far in 2017. Schwab ETFs have pulled in $13.2 billion year-to-date in flows, ranking us third in the industry. Schwab ETFs ended the second quarter with $78 billion in assets under management, up from $59.8 billion at the end of 2016. That amounts to more than 30% asset growth in six months, the largest growth of any top 10 issuer.

The bulk of flows continue to go into our low-cost cap-weighted strategies. Notably, international equities, both developed and emerging markets, pulled in more assets than U.S. equities year-to-date. This is a trend we've seen across the industry as the U.S. market rally shows signs of fatigue and investors are moving to increase their international exposure. In fact, our own Schwab International Equity ETF (SCHF) has surpassed $10 billion in total net assets, the first Schwab ETF to cross this milestone.

IBD: What are your most popular ETFs by total assets and flows so far this year?

de St. Paer: Our most popular ETFs by flows year-to-date are SCHF, Schwab U.S. Large Cap ETF (SCHX), and Schwab Emerging Markets Equity ETF (SCHE). Combined, these three ETFs have grown by $6.9 billion, or 42%, in the first 6 months of 2017.

Our most popular ETFs by assets under management are SCHF, Schwab U.S. Broad Market ETF and SCHX. Combined, these three ETFs have $28.7 billion in assets under management.

IBD: Recent industry flow data shows just how dramatically investors are favoring low-cost index products over active management. Can you talk about that trend?

de St. Paer: We know that cost and value matters to investors and even a few basis points can make a big difference over time. And as I mentioned earlier, as firms absorb the impact of the DOL rule, we expect this focus on value to continue. The fact that prices are coming down across the industry is great news for investors.

Much of the asset management industry still relies on a model that's based on high-cost funds. As fee awareness and fiduciary expectations rise, downward pressure on costs will continue, and some of these managers will need to evolve. Here at Schwab, we'll remain focused on delivering foundational, transparent and straightforward ETFs — at very low cost.

IBD: People are comparing you to Vanguard more; how do you feel about that?

de St. Paer: We are like-minded in many respects, such as keeping costs low. However, there are many differences between our businesses — from our pricing to our service model to our use of smart beta strategies. But I think we have a more compelling value proposition — from pricing to product focus to service.

IBD: How will CSIM continue to disrupt — in the next three years, five years and 10 years?

de St. Paer: Schwab has a heritage of democratizing investing for 'Main Street' investors — and disrupting the industry while we're doing it. That's in our DNA and I don't expect that to change.

We'll continue to disrupt by putting the client first. No matter what! It sounds simple, but if you're genuinely committed to that idea as we are, disruption will naturally follow. You can look at the last 40+ years from Schwab as proof.

IBD: How can people learn to invest in ETFs — and what are the most important things to know before starting to invest in ETFs?

de St. Paer: At Schwab, we encourage everyone to take ownership of their financial lives by asking questions and doing their homework. A good place to start is by talking to a professional who encourages your questions about investing in ETFs. If you prefer to do your own research, there are a number of ETF education resources and tools on schwab.com and schwabfunds.com.

Saving and staying diversified are paramount. Don't get caught up in the latest pitch you've heard or ad you've seen. Before investing in an ETF, it's important to know what you're looking for and make sure the ETF you're buying provides the exposure you want. When you're confident in that, you'll want to examine costs, consider the structure and the sponsor, and review how the ETF has tracked its index over time.

IBD: Will ETFs ever be a major choice in 401(k)s?

de St. Paer: This is the biggest question the ETF industry has faced for many years. We believe that index products, with their low costs and broad diversification benefits, will continue to play a very important and growing role in 401(k)s, but today's retirement plans often provide index exposure through other products, like mutual funds and collective trusts. This is because of operational challenges many retirement platforms have in supporting ETF trading. That being said, we are seeing some adoption of ETFs by plan sponsors looking for low cost solutions, often coupled with personalized managed accounts, and by those who like the wide array of ETF strategies that are available. ETFs are also gaining adoption in 401(k)s as underlying investments in target date funds, and they remain a very popular choice for 401(k) participants that use self-directed brokerage accounts.

IBD: What's the biggest mistake investors make in ETFs?

de St. Paer: Not paying close enough attention to costs. Although low expenses are one of the big draws of ETFs, there are several costs investors have to keep an eye on. The most obvious costs are trading commissions and operating expenses. Two other misunderstood, and often overlooked, elements of cost are bid/ask spreads, and the difference between market price and net asset value.

It's important for investors to understand and account for expenses when evaluating ETFs. Although total costs of ownership have been trending downward, costs still matter!

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**De St. Paer is an employee of Charles Schwab & Co. Inc.

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