BARRON'S COVER

Inside Schwab

In his six years as head of brokerage Charles Schwab, Bettinger has doubled client assets to $2.4 trillion. He's only getting started.

By DYAN MACHAN
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A lifelong Baltimore Orioles fan, Walter Bettinger II loves Cal Ripken Jr., who famously played 2,632 consecutive games over 16 seasons with the Os. But Bettinger stresses that people forget that the third baseman also had 3,184 hits and 431 home runs, and that's what earned him a plaque at the Baseball Hall of Fame. "He was just a humble, hard-working man who never brought attention to himself," says the CEO of Charles Schwab.

You could almost say the same about Bettinger, 53. Born and raised in a small farm community in northwestern Ohio, he epitomizes the modest, Midwestern approach. "To me, leadership is all about serving other people, and the leader should be in the background, but yet strong and stable and consistent," he says.

Bettinger, a team player, says, "If I wasn't the CEO of Schwab, I might have been a basketball coach."
Photo: Andy Freeberg for Barron's

Bettinger is happy to let chairman and founder Chuck Schwab, 77, be the company's public face in ads. "He's not a grandstander," says Schwab of Bettinger, "even though grandstanding can be useful." Accordingly, it's easy to overlook the sweeping change that Bettinger has spearheaded as Schwab's exacting, behind-the-scenes boss.

In his six years as CEO, total client assets at Schwab (ticker: SCHW) have doubled to $2.4 trillion, surpassing Merrill Lynch Wealth Management, once the world's largest retail broker. And he has steered the San Francisco–based company from itstransactional roots as a discount broker to offering fee-based financial advice and wealth management. Ironically, in Schwab's early years, offering customers financial advice was a dismissible offense.

Transactional fees constitute just 13% of revenue today, down from 24% in 2009. That's lower than rivals TD Ameritrade (AMTD) and E*Trade Financial (ETFC), and even full-service firms such as UBS (UBS) and Edward Jones. Bettinger now sees Schwab's main competitors as the Morgan Stanleys, BlackRocks, and Well Fargos of the world—the mega asset handlers—in his mission to bring affordable investing to the mass affluent.

The company, which boasts 9.2 million brokerage accounts, believes that it has built the platform—both in product offerings and an expanding footprint of 325 retail offices—to push a lower-cost model. Typically earnest and precise, Bettinger turns into a flamethrower when he talks about the financial-services industry. Raising his voice a little, he says, "The business models of so many financial-services firms revolve around getting people to do what's worst for them."

AFTER ONE BOTCHED succession a decade ago, Schwab seems to be getting it right. Former CEO David Pottruck was fired in 2004 after 18 months on the job. Chuck Schwab, who started the company in 1973, returned to the helm. With remarkable timing, Schwab handed the keys to Bettinger in October 2008, when the financial world seemed headed off a cliff. But he kept a steady hand.

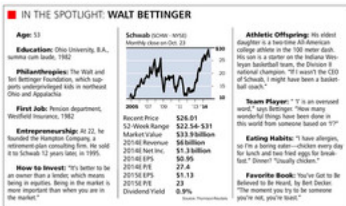
Schwab, which operates in two key segments—investor services, catering to individual investors, and advisor services, focused on registered investment advisors and employee retirement plans—didn't suffer losses from exposure to mortgage-backed securities. Although some of its clients lost money through its short-term bond funds (it paid $319 million in total settlements), it increased client assets throughout. Postcrisis, from 2009 through 2013, Schwab grew net client assets by $826 billion—the same amount as E*Trade, TD Ameritrade, Bank of America Merrill Lynch, and Morgan Stanley Global Wealth Management combined.

Schwab has a long history of disrupting the securities industry. In 1974, when Wall Street was still charging investors hundreds of dollars per trade, Chuck Schwab placed a three-inch ad in The Wall Street Journal offering discounts of 70%. A year later, the brokerage industry deregulated commissions at the behest of the Securities and Exchange Commission, and the discount-brokerage industry was off to the races.

In 1984, the firm launched the first mutual fund supermarket, allowing its investors to buy and sell different mutual funds from one account instead of opening separate accounts at various mutual fund companies, a tedious process. The industry had no choice but to follow. Eight years later, Schwab eliminated transaction fees for mutual funds, and the brokerage industry again followed suit. “We were not making friends on Wall Street,” says Chuck Schwab, “We never have.”

Soon after, Schwab took on the big wire houses again, courting financial advisors at full-commission firms by offering clearing, custody, cash management, trading, and reporting. The firm now has 7,000 advisors on its platform managing $1.08 trillion, or 26% of the $4 trillion registered investment-advisor market, it says.

Advisors are leaving the big brokerages to gain control of a larger share of their clients’ 1% to 2% annual fees. And as they find the exit door, Schwab is adding $60 billion to $70 billion a year in net new money, Bettinger says.



Schwab doesn’t share in their fees, but benefits in other ways from managers using its platform for trading. It also earns a tiny spread on its clients’ cash balances.

NOT ALL INDEPENDENT financial advisors like Schwab’s platform. Art Cohen, of A.M. Cohen & Co., a Chicago-based investment advisor with more than $500 million under management, uses Schwab’s platform for trading and administration for just a few of his clients and prefers it that way. “I don’t want a custodian that’s going to try to lure my clients away,” he says, referring to Schwab’s aggressive campaign to give new customers $2,500 in cash for opening an account with more than $1 million. “It’s disturbing.”

Cohen keeps most of his clients at Pershing, owned by BNY Mellon (BK), which doesn’t seek retail clients.

Now Schwab is pushing to expand its presence in the 401(k) market. The company has some work to do. Rival Fidelity Investments is the leader with $1.1 trillion in 401(k) assets under management, followed by AON Hewitt with $328 billion, and Vanguard with $305 billion. Schwab is a distant No. 13, with $115 billion in assets.

After the great migration from defined-benefit to defined-contribution plans ushered in by 401(k) plans, corporate plan sponsors left employees holding the bag, Bettinger says. “The 401(k) system works well for everyone—employers, service providers, money managers—everyone but investors,” he says.

When corporations were responsible for pension plans, they hired armies of actuaries and investment experts, he says. When the investment responsibility shifted to the plan participants, the corporations gave them an hour-long lecture, a flimsy cardboard retirement calculator, and a pat on the back.

BETTINGER IS INCENSED that 84% of the $3.7 trillion of defined-contribution assets are in actively managed mutual funds, which charge substantially higher fees than index funds. Statistically, he says, actively managed funds are unlikely to beat or even keep pace with lower-cost index funds over the long term. “This idea of beating the market does not need to be a part of 401(k) plans,” he says, though he’s quick to note that he’s not against actively managed funds—Schwab holds $770 billion of them on the books for its clients—just their overuse in retirement accounts.

Investment Company Institute economist Sarah Holden counters, “Plan sponsors want a broad lineup of funds for their participants.”

Says Bob Benish, executive director at the Plan Sponsor Council of America: “The problem is that many investors are too passive about their active funds. They are appropriate for the right person who pays attention.”

But Bettinger, who began his career 32 years ago calculating pension benefits, thinks Schwab has a better way. He says he anguished over a 2009 award he received from Plansponsor magazine at a dinner for his “contribution to the retirement security of working Americans,” as was inscribed on a crystal trophy. He felt the award was undeserved.

Riding in a taxi after the award ceremony, he says he felt sick and knew it wasn’t the chicken. The following day, Bettinger started changing the way Schwab managed companies’ 401(k) plans, leading to the 2012 introduction of what it calls the Schwab Index Advantage, which includes third-party advice from researchers Morningstar and GuidedChoice, giving plan participants objective advice and lower-cost investment choices like index and exchange-traded-fund portfolios.

The youngest of four children, Bettinger, the son of a college chemistry professor and a stay-at-home mom, grew up in Ada, Ohio. After a year at Delta State University, in Cleveland, Miss., on a golf scholarship, he returned to the Buckeye State to finish his studies at Ohio University. Graduating at the top of his class in 1982 with a degree in business administration, he went to work for nearby Westfield Insurance, which provided pension-plan administration to companies as a means to sell investment products. Eighteen months into it, he saw an opportunity to decouple the plan-servicing from the investing, and offer objective investing advice.

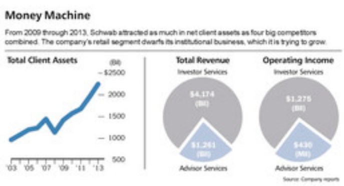
At 22, Bettinger founded the Hampton Company, dedicated to selling companies’ retirement-plan servicing along with objective investment advice. He called it Hampton because he thought potential clients would naturally picture a seasoned guy at the helm, not the still-boyish looking CEO who shaved once a week.

Starting out in 1983, he spent his life savings—a couple of thousand dollars—printing and hand-addressing brochures. He made cold calls relentlessly for more than a year without a single hit. “I knew I was failing,” Bettinger recalls. As a last resort, he attended night school to become a certified actuary, and that qualified him to start offering free investment seminars to accounting and law firms that would have him. Referrals rolled in. By early 1995, he had been vindicated and then some—having amassed nearly $1 billion in retirement-plan assets.

Schwab, which hired Hampton to handle record-keeping for its fledgling 401(k) business, bought the company that same year.

As a part of Schwab, its assets doubled to $2 billion in the first year. Chuck Schwab says he liked Bettinger's Midwestern, straight-shooting ways. "He was an entrepreneurial guy, and I liked the tempo of his personality," Schwab recalls. "We were compatible."

He also notes that Bettinger merged his company seamlessly into Schwab's businesses, something Schwab especially appreciates today, after the firm's $2.73 billion acquisition of U.S. Trust in 2000. A painful culture clash ensued, leading to an eventual divorce and the sale of U.S. Trust to Bank of America (BAC) seven years later.



SCHWAB COULD DO no wrong in the mid-to-late 1990s, helped by a rising stock market. Then the tech bubble burst in 2000, and Schwab, the company, could do no right. Competitors were offering $10 trades, beating Schwab's $29 trades. Clients bolted, and by 2001, Schwab was laying off thousands of employees. By 2004, Bettinger's corporate retirement unit, run out of Akron, was the only bright light, so he was called to headquarters in San Francisco. Bettinger said OK, but rather than uproot his family, he commuted.

As head of the retail group, his first job was to stop the bleeding. In his first 100 days, he interviewed 50 clients and 50 employees, who left of their own will, and visited 120 branches. "It's a little hard to even explain how dire things felt," he says.

Meanwhile, Schwab had lost more than 80% of its stock market value, equivalent to $40 billion, as its shares plummeted to $7 from a split-adjusted 2000 high of $36. The stock recently traded at $26.01.

On one of his cross-continental flights, Bettinger wrote a white paper on what he saw was wrong, and what the company should do about it. He sent it to Chuck Schwab. Committed from his Hampton days to putting customers first, Bettinger perceived that they felt betrayed when zinged with nuisance fees, such as an extra $3 handling charge for equity trades, minimum-balance charges, and a $1 fee for ATM withdrawals. He also argued that the company had no future living off transactions, which were in decline and appealed to only a portion of the larger investment community. The firm had to broaden its appeal, he wrote, and become a full-service wealth manager, and yet still stand apart from the crowd.

Within 24 hours, Chuck Schwab called Bettinger and said, "Implement it all." Chuck Schwab realized that Bettinger "had the skill level to be my partner." Around the same time, David Pottruck, who had been named CEO in 2003, was caught having unauthorized discussions about divesting a securities firm that Schwab had bought the year before. Pottruck was out; Chuck Schwab rejoined as CEO; and Bettinger, he says, "was now a part of the team."

Soon after, the company lowered commissions from $29 to $10, axed nickel-and-dime nuisance fees, and showed the door to six presidents in the retail group. It also started providing advice to individuals.

Schwab had taken baby steps toward managing assets in 2002, with its managed-portfolio initiative, a set portfolio of mutual funds. But Bettinger gave it a big push. Anyone with an account of more than $250,000 received a dedicated consultant, a fundamental shift for the firm. "He made it happen," Chuck Schwab says.

Earnings began to return, and assets rolled in from other firms. Chuck Schwab named Bettinger CEO in 2008, even though the committed family man informed the board he wouldn't move to headquarters until the youngest of his school-age kids graduated from high school in 2011. "I needed him to be close by," says Schwab, "but I was willing to wait."

TARGET-DATE RETIREMENT funds, which construct an asset-allocation mix based on an investor's age, become more conservative as the targeted retirement date approaches. The target-date industry took off after the Pension Protection Act of 2006 allowed companies to automatically enroll employees in 401(k) plans and encouraged the use of target-date funds as the default option. They have amassed $670 billion, according to Morningstar.

Ask Bettinger about them, and he'll set your hair on fire. "It's a fascinating product developed to capture money in proprietary funds," he says. "They may have been the best way at one time to get advice on a 401(k), but they're not the right answer for today." Schwab offers target-date funds, but it should be noted that so far they've attracted just $12.4 billion in assets, less than 2% of the total.

Bettinger illustrates: "Two people walk in to get advice. They're both 40. One is single, no children, the other one's married with five kids. The first individual has $1 million in liquid assets, the second has none. And what advice do we give them about a target-date fund? Buy the exact same thing. I mean, it makes no sense."

Schwab's mission for the retirement market, he says, is to offer third-party advice with low-cost index-fund and ETF portfolios. Schwab is offering its advice for 40 basis points (0.4% of assets), plus a 10 basis-point fee for an ETF index portfolio. That's cheaper than 90% of all 401(k) plans that don't include advice, Bettinger says.

But it's a difficult sell getting corporate buyers to shake off a huge 401(k) provider such as Fidelity. And often there's another layer of consultants such as Mercer managing the relationship, as well. Whether Schwab will succeed here is the hundred- billion-dollar question.

LOW INTEREST RATES have been devastating for the financial-services industry, and Schwab is no exception. The firm currently garners 35% to 40% of its revenue strictly from investing its balance sheet. Historically, it has also earned a fee on its money-market, or cash reserves. But with rates so low, it currently waives the fee that amounts to $750 million a year.

If the Federal Reserve raises the overnight-lending rate, which is close to zero now, by 50 to 75 basis points, Jefferies analyst Daniel Fannon calculates that Schwab's revenue would jump by $1.6 billion—half from the higher spread and half from lifting the fee waiver. That could boost earnings by $700 million, or 50 cents a share—not an insignificant sum, given that Schwab is expected to earn $1.3 billion, or 95 cents per share, on revenue of $6 billion this year, rising 19%, to $1.13 a share in 2015.

Fannon, who has a price target of $35 on the shares, notes that even in a sluggish economy, Bettinger has turned Schwab into an asset-gathering machine. He sees ongoing growth from new customers as well as a greater share of existing clients' wallets. Among independent investment advisors, 80% of growth typically comes from existing clients. But getting to his price target, he says, will take a rate increase.

Within the next few weeks, Bettinger says Schwab will offer a Web-based advice platform for the general investing public, followed by a version for its independent investment advisors. This robo-investing product will design custom portfolios based on what will likely be at least a dozen variables, and at a bargain price of around 0.25% of assets, or less. Bettinger says the cost could go still lower with scale and technology improvements. The company hopes to get the word out on all its products by encouraging money managers to open Schwab franchises, a less expensive means of expanding its retail presence.

It is a bold plan, and it might be a long shot. But given Schwab's history of disrupting the financial industry, it might not be something you want to bet against.

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