

## FUND OF INFORMATION

by Lawrence C. Strauss

# The Value Proposition Returns

*Schwab post-election confab features one united group: investment advisers*

**T**HE COUNTRY IS DIVIDED OVER THE WAR in Iraq, gay marriage and abortion rights, among other issues, President Bush's solid recent re-election victory notwithstanding. But at the Schwab Impact 2004 conference last week, the mood was rather upbeat—and hardly divided.

Not even the appearance of Bill Clinton dampened the harmony. The former president, the keynote speaker, received a warm, if not overly enthusiastic, reception. Clearly, however, he wasn't preaching to the converted. Of the 262 financial advisers surveyed at the conference, 68% said they believed the re-election of Bush would help the economy.

The gathering's cheerful demeanor fit the surroundings quite well. After all, the annual confab for independent investment advisers, a key Schwab constituency, was held in Philadelphia, the City of Brotherly Love. "In the past, it's been almost adversarial-type discussions, and I've seen none of that this year," said one attendee, referring to the various panels and presentations at the conference.

Among the advisers that Barron's spoke with, there was a palpable sense of relief that the presidential election had come to a quick conclusion. "A lot of it has to do with having the fog of the election behind us," says Richard J. Bloom, who runs Bloom Asset Management in Farmington Hills, Mich.

What's more, many of these advisers find themselves in strong, lucrative niches in a business with good growth prospects. As the baby boomers age and with the recent stock-market meltdown still fresh in many investors' minds, the notion of financial advice has more resonance these days. And for Charles Schwab, whose shares have taken a beating this year, thanks to missteps that T. Rowe Price financial-services analyst Jeff Arricale sums up as "trying to be too many things to too many types of investors," the independent adviser market is crucial.

The firm's founder and chief executive, Charles Schwab, who returned to the top job in July (replacing the ousted David Pottruck), acknowledged the recent stumbles. Addressing a large audience, he said the company "got so complicated" that it ran into problems. On the retail end, he commented, "we'd lost, in many respects, our value proposition."

To turn the company around, Schwab has cut costs (it aims to slash \$270 million in expenses

this year) and lowered rates, among other moves. Arricale asserts that Schwab has "been undermanaged for a long time," adding that "Somebody's going to manage that asset and earn an appropriate return. If the current team is successful, great. If not, it will be somebody else. I don't think Chuck Schwab is going to wait around for results at this point."

Trading around 10 late last week, Schwab shares were down more than 25% since January.

However, Schwab Institutional, a division that provides custody, trading and other back-office support to independent advisers and that sponsored the Impact conference, is a bright light. Schwab Institutional works with about 5,000 fee-based adviser firms that oversee about \$316 billion—about 20% of the \$1.5 trillion in customer assets handled by independent advisers.

It's been a good growth engine for the company. In a recent research note, analyst Scott Patrick of Morgan Stanley noted that Schwab Institutional generated a 30.2% pre-tax margin in the first half of 2004. He characterized the unit as "the crown jewel of the company." To continue that growth, the division needs to do a better job tapping the larger investment advisers, typically those with at least \$1 billion in assets under management, Patrick asserts.

"It's a very, very fragmented market," says Joshua Rymer, senior vice president at Schwab Institutional and head of strategy. A key part of the unit's strategy, he says, is to get more business, notably trading and custody of assets, from firms with whom Schwab already has relationships.

One part of this initiative is to add more alternative investments, namely hedge funds. That includes the SPhinX Fund, a fund of hedge funds operated by Rydex Capital Partners.

There was plenty of interest in hedge funds at the conference. A session on the basics of hedge funds, run by HFR Asset Management Chairman and Chief Executive Joseph G. Nicholas, was well-attended. But not every adviser is jumping on the bandwagon. "I don't see anything in a hedge fund that you can't get in a mutual fund," says Tim Medley, president of Medley & Brown Financial Advisors in Jackson, Miss. In fact, compared with hedge funds, Medley observes, mutual funds offer more liquidity, better transparency and lower fees.

That's not the case for David E. Lees, national director, wealth-advisory services, at Ernst & Young in Philadelphia. With interest rates relatively low, investors are looking for alternatives to bonds. "We see a lot of interest in the long-short funds," he says, referring to a popular hedge-fund investing strategy in which portfolios hold both long and short positions.

Nevertheless, Lees maintains, investors' expectations for 2005 are too frothy. "We think rising rates and energy costs will be a head wind," he says.

Lees had plenty of company. The sunny outlook at the conference was tempered by fairly modest investment expectations for 2005. Although about 90% of the advisers surveyed expect stocks to rise next year, 79% predict returns in the 5% to 10% range—hardly a blazing bull market.

In addressing the conference, former President Clinton discussed big-picture items like national security, not small-cap securities. He did recognize that independent investment advisers run small businesses. "Most new jobs in America are created by people like you," he observed.

Although concerned about the divisions in the country, Clinton said he remains optimistic. "For 200-plus years, we have had a system that was flexible enough to allow us to argue and work together," he told an overflowing lunchtime audience.

Analyzing President Bush's re-election, Clinton said that 4% of the voters made up their minds in the campaign's last 24 hours. And most of them voted for Bush, mainly supporting him on the security issue, Clinton said. He credited Bush with running "a brilliant campaign." However, he lamented that the election had "turned into a theology contest."

Globalization cuts both ways, the downside being that it makes the U.S. more vulnerable to terrorism, he said. An upside is the economic lift that foreign trade can give to the U.S. economy.

Clinton wasn't pleased with the state of affairs in Iraq, although he said, "we have to make this thing work." As for a foreign-policy framework, the former president, clearly at odds with his successor, said the U.S. should "cooperate when we can, and act alone when we must." ■