MONEY management executive

The Premier News Source for Asset Management Leaders

March 2020 | Volume 28 • Number 3 | mmexecutive.com

EXECUTIVES TO WATCH

OPERATIONS: What's driving the industry's top leaders?

By Andrew Shilling and Rebecca Stropoli

How did today's top asset management executives get where they are, and where do they think the industry is headed?

This year, *Money Management Executive* recognizes five talented industry leaders who share their stories and their takes on issues that matter to the industry.

Sonal Desai, CIO of fixed income, Franklin Templeton Investments

Jeffrey Baccash, director, global head of ETF solutions, BNP Paribas

The execs discuss the products they're developing and the projects they're leading, how they give back to their communities, where asset management might be in 10 years, and the rewards and challenges they've experienced.

Jeffrey Baccash, global head of ETF solutions at BNP Paribas, tells us about the new app his team is developing, and how he shares his enthusiasm with ambitious industry newcomers.

"Explaining the benefits and different styles of a full-time versus part-time versus executive pro-

SPECIAL REPORT, on page 6

STRATEGY: Does Schwab's growth threaten Vanguard?

By Allan S. Roth

Imagine it's 2030 and Charles Schwab dominates the retail investing industry. It's more than twice the size of its nearest competitor, Vanguard. Old-fashioned index mutual funds and ETFs also stagnate, with essentially no net asset inflows.

While this picture is far from a certainty, it could happen. Here's why it could, and what it means to you and your clients.

Vanguard has been sucking up assets, but today the $6 trillion company has a real threat in Schwab. Schwab is poised to upend the industry with no fees, higher-quality service and better products that could make traditional index funds and ETFs obsolete.

Schwab made three big announcements recently. Together, they indicate what could be a brilliant strategy.

First we need to understand that Schwab, the original discount broker, is no longer in the brokerage business. In fact, it appears the asset management business is merely a side business, and a money loser at that: They are charging less than their costs. Approximately 61% of Schwab's

SCHWAB, on page 11

OPERATIONS: These 5 hedge fund execs made over $1B in '19

By Tom Maloney and Hema Parmar

Twelve billion dollars.

It's more than JPMorgan Chase paid all 56,000 of its investment bank employees, and almost twice as much as gamblers lost in Las Vegas last year.

It's also what 15 hedge fund managers collectively earned in 2019.

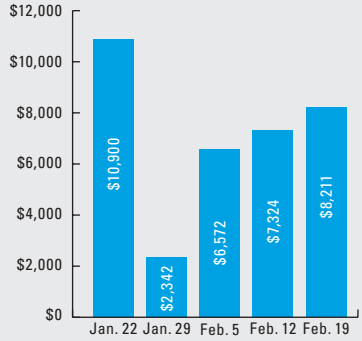
Five of them — Chris Hohn, Jim Simons, Ken Griffin, Steve Cohen and Chase Coleman —reaped more than $1 billion each, according to estimates by the Bloomberg Billionaires Index.

The rewards for the men — and they're all men — are notable, especially given only a third of the 15 managers on the list beat the S&P 500's 29% gain last year. It also comes as the hedge fund industry has been grappling with closures and mediocre returns.

Hedge fund advocates say they're

HEDGE, on page 10

Long-term mutual fund inflows were $8.21 billion for the week ending Feb. 19 (millions)



Source: Investment Company Institute

INDUSTRY HIGHLIGHTS

FRANKLIN TEMPLETON ACQUIRES LEGG MASON

Franklin Templeton entered into a definitive agreement to acquire Legg Mason for $50 per share of common stock in an all-cash transaction, according to the firm. The firm will also assume approximately $2 billion of Legg Mason's debt outstanding.

The acquisition of Legg Mason and its multiple investment affiliates, which collectively manage over $806 billion in assets, will establish Franklin as one of the world's largest independent global investment managers, with a combined $1.5 trillion in assets under management, according to the firm.

"This is a landmark acquisition for our organization that unlocks substantial value and growth opportunities driven by greater scale, diversity and balance across investment strategies, distribution channels and geographies," says Greg Johnson, executive chairman of the board of Franklin Resources.

VANGUARD CHARITABLE CELEBRATES $10B CHARITY DONATIONS

Vanguard Charitable, a nonprofit who sponsors donor-advised funds, announced that the organization issued $10 billion in grants since launching in 1997.

Roughly two-thirds of the $1.2 billion contributions to Vanguard Charitable in 2019 came from appreciated assets, allowing donors to strategically leverage their investment portfolio to maximize the amount they give to charity, according to the firm. Among the most popular causes supported throughout the past year were organizations in human services, religiously affiliated charities, education, health, and arts and culture, according to the firm.

VANGUARD AND HARBOURVEST LAUNCH PRIVATE EQUITY PARTNERSHIP

Vanguard has partnered with HarbourVest to provide investors with access to private equity offerings, according to the firm. Initially, the new strategy will be provided by Vanguard's institutional advisory services to pensions, endowments and foundations, the firms says.

"Private equity will complement our leading index and actively managed funds, as we seek to broaden access to this asset class and improve client outcomes," says Vanguard CEO Tim Buckley. "While this strategy will be initially available to institutional advised clients, we aim to expand access to investors in additional channels over time. For individual investors in particular, this partnership will present an incredible opportunity."

RESEARCH

HEDGE FUND MANAGERS ARE AVOIDING SUSTAINABLE INVESTING

Hedge funds, many of which have been slow to adopt environmental and social strategies, are faulting inconsistent data and a shortage of expertise for their hesitation, according to a new report in Bloomberg News.

About 63% of hedge fund managers cited a lack of quality and consistent sustainability data as the biggest challenge in making such decisions, according to a report from an in-

ETF estimated net issuance ($ millions)

	2/19/2020	2/12/2020	2/5/2020	1/29/2020	1/22/2020
Equity	2,990	11,114	14,520	396	4,989
Domestic	1,927	9,283	11,912	-44	1,600
World	1,063	1,831	2,608	440	3,389
Hybrid	248	297	282	188	135
Bond	3,917	8,384	5,605	1,298	2,829
Taxable	3,631	8,018	5,340	1,043	2,664
Municipal	286	366	265	255	165
Commodity	841	541	832	696	1,348
Total	7,997	20,336	21,238	2,578	9,301

Source: Investment Company Institute

MONEY management executive

1 State Street Plaza, 27th Floor
New York, NY 10004
(212) 803-8200
financial-planning.com/money-management-executive

Andrew Shilling - Associate Editor

Rebecca Stropoli - Contributing Editor

Paola Peralta - Reporter

Scott Wenger - Group Editorial Director, Financial Planning and Employee Benefits Groups

Michael Chu - Executive Director, Content Operations and Creative Services

Louis Fugazy, Associate Publisher
louis.fugazy@arizent.com
(212) 803-8773

Jamie Billington - Senior Marketing Manager
(212) 803-6099

Customer Service
(212) 803-8500
help@arizent.com

Gemma Postlethwaite Chief Executive Officer
Debra Mason Chief Financial Officer
Jeff Mancini Chief Strategy Officer
Dave Colford Chief Customer Officer
David Evans Chief Content Officer
Lee Gavin VP, People & Culture

Subscriptions: Domestic rates: Annual $1,750; 2-year $3,500. Foreign rates: Annual $1,750; 2-year $3,500. Multiple subscription rates available.
POSTMASTER: Please send all address changes to **Money Management Executive**/One State Street Plaza, New York, NY 10004. For subscriptions, renewals, address changes and delivery service issues contact our Customer Service department at (212) 803-8500 or email: help@arizent.com.

dustry consortium. Just 15% of hedge funds have incorporated ESG matters in their investment strategies, according to the article.

Hedge fund investors are pushing for ESG-focused offerings, but according to the report, they fear "greenwashing" — the use of misleading labels or advertising to create just an illusion of environmental responsibility.

PRODUCTS

NEW VANECK ETF TO TAP DEMAND FOR MUNI DEBT WITH SOCIAL INVESTING

VanEck filed to register an actively run sustainable muni ETF focused on investment-grade state and local government debt from "issuers with operations or projects helping to promote progress towards sustainable development," according to Bloomberg.

The fund will use the United Nations' sustainable development goals, which aim to encourage sustainable cities and promote responsible consumption to help make investment decisions, the filing says.

FRANKLIN TEMPLETON LAUNCHES GROWTH FUND

Franklin Templeton announced the introduction of Franklin Focused Growth Fund, which seeks to invest predominantly in equity securities of companies the investment manager believes offer compelling growth opportunities, according to the firm.

The fund is managed by Matthew Moberg, per the firm.

"We consider many factors when selecting investments, including a company's strategic positioning in its industry, its historical and potential growth in free cash flow, and an assessment of the strength and quality of management," says Moberg, senior vice president and portfolio manager with Franklin Equity Group.

HARTFORD FUNDS EXPANDS FIXED-INCOME OFFERING

Hartford Funds launched Hartford Core Bond ETF (HCRB), an ETF sub-advised by Wellington Management, which seeks to provide long-term total return by investing primarily in investment-grade fixed-income securities, according to the firm.

The fund, which has an expense ratio of 0.29%, provides investors with high-quality fixed-income exposure from diversified sources of return across multiple perspectives, investment styles and time horizons.

"Hartford Core Bond ETF is designed to satisfy an increasing investor appetite for high-quality core bond offerings, especially in ETF vehicles," says Ted Lucas, head of investment strategies and solutions at Hartford Funds.

T. ROWE AIMS TO IMPROVE RETIREMENT OUTCOME WITH NEW PRODUCTS

T. Rowe Price announced the expansion of its target-date retirement product lineup.

The additions, the firms says, are designed to help improve retirement outcomes and address the headwinds investors face in achieving retirement security.

Over a two-year period, T. Rowe Price will gradually increase equity exposure in the retirement and target portfolios' glide paths early in the accumulation years and post-retirement, and add emerging markets and U.S. large-cap core equity strategies to further diversify investments, the firm says.

FRANKLIN TEMPLETON ADDS 3 THEMATIC FUNDS FOCUSED ON DYNAMIC INNOVATION

Franklin Templeton expanded its active ETF lineup with the addition of three thematic funds: the Franklin Disruptive Commerce ETF (BUYZ), the Franklin Genomic Advancements ETF (HELX) and Franklin Intelligent Machines ETF (IQM), the firm says.

Each of the funds seek long-term capital appreciation by investing primarily in equity securities of companies that are relevant to the fund's respective investment theme, the firm says.

"We are thrilled to bring our first thematic ETFs to market. BUYZ, HELX and IQM are focused on investing in innovative companies within each theme — e-commerce, genomics and intelligent machines," says Patrick O'Connor, global head of ETFs for Franklin Templeton.

ARRIVALS

INVESCO APPOINTS DEPUTY CFO

Allison Dukes, the former chief financial officer for SunTrust, joined Invesco as deputy chief financial officer, with transition plans to assume senior managing director, the firm says.

Upon taking the position, Dukes will take the position of deputy CFO at Invesco through Aug. 1, at which time she will assume her new role as senior managing director and CFO following the retirement of Loren Starr, who currently holds that position, according to the firm.

Allison Dukes

Dukes will report to Starr, senior managing director and chief financial officer at Invesco.

"Allison's experience as CFO and, as importantly, her deep experience overseeing key parts of SunTrust's business, will be invaluable as we work to further strengthen and scale our business for the benefit of clients and shareholders," says Marty Flanagan, president and CEO of Invesco.

T. ROWE NAMES SUCCESSOR TO HEAD ITS INTERNATIONAL EQUITY DIVISION

Justin Thomson, chief investment officer of international equity and lead portfolio manager of the International Small-Cap Equity Strategy at T. Rowe Price, will succeed Chris Alderson as head of the firm's international equity division, according to the firm.

Thomson will join the T. Rowe's management committee and report to Robert Sharps, head of investments.

As a result, Ben Griffiths will become co-portfolio manager of the International Small-Cap Equity Strategy, joining Thomson until he relinquishes his portfolio manager responsibilities following the transition period, according to the firm.

"The international equity division is in a strong place, and the firm has become an ever more global business," says Chris Alderson, head of international equity at T. Rowe Price. "I have huge confidence that Justin Thomson will do an outstanding job in my place." MME

News Scan by Paola Peralta

CONTINUED
from page 1

gram can help people figure out what type of program will help them best achieve their goals," Baccash says.

IndexIQ research director Kelly Ye says firms in the next decade will shift from providing products to solutions. "Products claiming to provide similar investment strategies could diverge in performance, even when they are passive in nature," she says.

Sonal Desai, CIO of Franklin Templeton's fixed-income group, notes concerns she has about the direction of asset management: "Asset managers need to be faster and smarter to make the right bets in a fast-changing external environment, while understanding and leveraging disruptive change."

TrimTabs CEO Bob Shea says, when considering the challenges he's faced throughout his years in the industry, he remembers the lessons he learned from the 2008 financial crisis when he was managing partner of Asia-Source Capital, a multi-strategy hedge fund focused on investments in China.

"Raising money in Europe and the U.S. and investing in China was an incredible experience, and our longer-term goal was to add to our team and diversify our investments throughout Asia," he recalls. "However, 2008 delivered a massive redemption blow to the still emerging Greater China hedge fund space, with 80% of assets under management leaving the market that year. Returns since inception were positive. However, I made the difficult decision to return capital to investors."

In the end, he says, he learned a valuable lesson that, while investment risk can be managed, the business risk associated with concentrated exposure to a single emerging market is too large.

Read on for more on these executive's stories and their thoughts on the state, and future, of asset management.

"Asset managers need to be faster and smarter to make the right bets in a fast-changing external environment, while understanding and leveraging disruptive change in our own industry."

Sonal Desai, CIO of fixed income, Franklin Templeton Investments

Director, Global Head of ETF Solutions, BNP Paribas

Jeffrey Baccash

In his role as global head of ETF solutions at BNP Paribas, Jeffrey Baccash heads up the firm's smart passive initiative, and has been developing a new global servicing app for fund managers.

He and his team spent a year researching and designing the app. While in the development stage, they saw three key factors as driving the space: ensuring global coverage, including transparency and allowing for digital connection. In the prototype phase, they took feedback he says allowed them to better mold the platform from an asset manager's point of view.

"Our goal is to create a consistent global user experience that allows our clients to easily access their data and quickly analyze what is occurring with their funds," he says.

Baccash has been with BNP Paribas for 15 years, and in that time has been able to observe what kind of strategies work for a variety of teams. The strong teamwork involved in the app creation and other firm projects has been one of the more fulfilling aspects of his job, Baccash says.

"We have members in four different time zones, so being able to work together has to be properly planned for and monitored," he notes. "The thing that gives me the most satisfaction is when the team is performing well and you can see the high level of enthusiasm from each of the individual members who are finding ways to share their experiences and maximizing their talent."

Outside of the firm, Baccash enjoys educating and mentoring young people with an interest in the industry.

"It is important to keep bringing new individuals into financial services, so I enjoy helping people getting started in their careers," he says. "This is more than just helping someone find a position. It is about asking the right questions and sharing your experiences so they can determine what part of the industry is best for them."

Principal, Head of Product Management, Vanguard

Kaitlyn Caughlin

Kaitlyn Caughlin has been with Vanguard since taking an internship at the firm in 2006. More than a decade later, she is a principal in charge of monitoring the health of the manager's $5.7 trillion product lineup.

As head of product management in Vanguard's portfolio review department, Caughlin spends her workdays engaging with sophisticated clients, driving the research behind the firm's fund development and leading its talent oversight committee. "We're responsible for being the steward of our lineup; and with Vanguard at $6.2 trillion in AUM. We take that reasonability really seriously," Caughlin says. "It's our clients' money and it represents their retirement dreams, their dreams to send their kids to college, their emergency savings … so we really want to make sure we have the right focus."

Without mentors, she says she would not be where she is today. "I had a certain path in mind and a principal at Vanguard told me I could do more," Caughlin says of her mentor Sarah Houston, a 28-year veteran of the firm. If not for the help from Houston, whom she refers to as her "fairy godmother," Caughlin says she would not have thought it possible to attend MIT Sloan or apply for a senior leadership position. "I am trying to pay that back by finding talented individuals with diverse backgrounds, with high potential, and be there in the right moments for them to help them realize and want to strive for more so they can reach their ultimate potential."

Over the past decade at Vanguard, Caughlin has held roles in product strategy, flagship services, corporate strategy — where she was a key advocate for the launch of the firm's retail direct offering in the U.K. — business development and at Vanguard's center for excellence. Today, Caughlin is studying for the CFA Level II Exam and says she is more excited than ever about the future of the industry. "I don't think there's ever been a better time to be an investor than right now," she says. "Whether you take the cost compression that's occurring or the increased transparency, investors are getting a better deal."

CIO of Fixed Income, Franklin Templeton Investments

Sonal Desai

After nearly a decade of working in various roles at Franklin Templeton, Sonal Desai was named CIO of the fixed-income group. In this role, she oversees areas including corporate credit, emerging markets debt, and municipal and local fixed-income strategies and teams.

Desai drives the fixed-income group's adoption of an active quant approach, which aims to combine quantitative and data science insights with macroeconomic research and fundamental security analysis.

"The active fundamental versus quant debate is a false dichotomy," she says. "At Franklin Templeton fixed income, we bring the two approaches together. This collaboration between economists, analysts, data scientists and portfolio managers — pushing and challenging each other and creating a virtuous loop between quantitative and fundamental analysis — is the future of fixed-income investing, and what I am most excited about."

Within the firm, Desai belongs to Women@FTI, an employee-led group with a focus on networking, recruiting and mentoring. She works to promote gender diversity in the industry, and participated in a Morningstar roundtable on the topic in 2017.

As for challenges she has faced in her career, she says taking over the fixed-income group meant working hard to gain her new team's trust and confidence.

"I reorganized the platform and worked at bringing fundamental analysis and data science together," she says. "I focused on being totally transparent and direct with the team, explaining what I wanted to change and why, what I thought we could and should do better. I encouraged everyone to speak up and I listened.

"Our transformation is now well under way, and I am extremely proud of how the fixed-income group has risen to the challenge," she adds.

CONTINUED on page 9

CONTINUED
from page 7

CEO, TrimTabs Asset Management

Bob Shea

Bob Shea kicked off 2020 by starting a new job as CEO of TrimTabs Asset Management. He came from J.A. Forlines Group, which he co-founded in 2009 and for which he was most recently president and co-chief CIO.

Since joining TrimTabs, Shea has focused on internal and external communications initiatives to help the marketplace understand the firm's free-cash-flow investing strategy, which underpins their two actively managed ETFs. He also aims to educate the public on the impact of applying a quantamental approach to portfolio management.

"As early adopters of this process, we've employed this methodology into our products since 2011," he says, "showing how combining technology and data with experienced forward-looking portfolio managers can together add value to sector allocation and stock selection."

Educating others on his areas of expertise has long been a focus for Shea, as he has mentored many young industry professionals over the years,. He also spent 10 years on Nasdaq's Quality of Markets committee, which focuses on market transparency and efficiency.

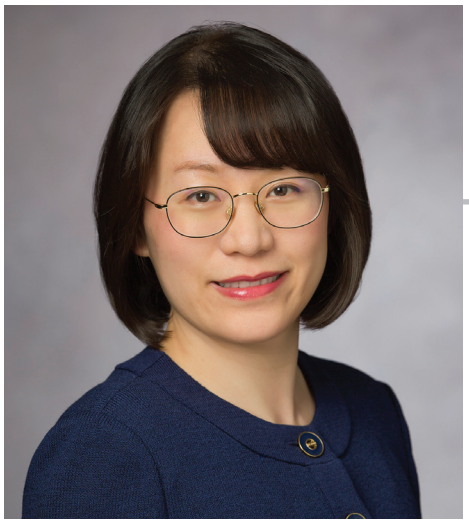
Looking ahead, one of his larger concerns is that too many people in the industry believe active management strategies will soon be dead.

While he concedes that many active managers have spent years underperforming or "hugging benchmarks" and inviting the current disruption, he says, "I firmly believe there is room for innovative active strategies that generate alpha at a competitive price."

He also sees ESG as an important focus for managers and investors. "The coming decade is when many years of talk and abstract theorizing about climate change will turn into action" he notes, "and investors who dismiss ESG as a box-ticking exercise will find themselves blindsided."

Director of Research, IndexIQ

Kelly Ye



When Kelly Ye joined IndexIQ in 2015, the firm was transitioning from a standalone operation to a New York Life subsidiary. Her quantitative background, which includes a role as head quant on the credit investment team at Goldman Sachs, has propelled her research of new fund ideas and identification of unique approaches to ETF strategies.

"I'm excited about the ways in which proven approaches from the hedge fund-style liquid alternative category are being refined and ported to other alternative investment categories," she says.

Ye also focuses on educating investors on diversification, and how to incorporate different investment strategies.

"Retail investors still lack the tools necessary to allow them to access diversified sources of returns comparable to those that are available to institutional and high-net-worth investors," she says. "This is something we work to solve."

Along with working to help investors understand diversification, she aims to promote diversity in asset management.

"Growing up in China and being a woman in this industry provides me with a perspective that I would not have otherwise, and a chance to use my voice to help spur advancement in the space," she notes.

She's a member of two New York Life employee resource groups: the Asian Network Group and the Women's Initiative–Investments. She is also part of the Speakers' Bureau with Women in ETFs. Additionally, she serves on the board of CFA Society New York, and aims to recruit female members and speakers. As of today, 50% of the board members are women.

"I'm fortunate to work for a company that embraces diversity among its core values," Ye says. "I'm also very fortunate to have a number of senior leaders coming from similarly diverse backgrounds to look up to and learn from." MME

HEDGE
from page 1

supposed to profit regardless of whether the market goes up or down and performance shouldn't only be compared with equity indexes. Still, many were boosted by soaring stocks as central banks, including the Fed, kept monetary policy loose.

Many of the firms made money betting on the same stocks, typically tech names. More than on Bloomberg's list counted Alibaba Group Holdings and Facebook among their top 10 contributors to equity returns, according to an analysis of regulatory filings.

"If that's where the opportunity is, it's where it is," said Darren Wolf, head of alternative investment strategies for the Americas at Aberdeen Asset Management, which invests in hedge funds on behalf of its clients. "But it creates challenges for us," he said, because Aberdeen's clients are already invested in indexes heavily weighted with tech stocks.

Most of the managers on this year's list charge fees of at least 20% on gains, even as the industry is slashing fees amid pressure from investors disappointed with years of lackluster performance. Representatives for the firms on the list declined to comment.

Marcus Frampton, chief investment officer for Alaska Permanent Fund, said his firm, which oversees $68 billion, is "happy to pay 20% in fees" as long as a manager consistently produces benchmark-beating returns. "That represents skill not market exposure."

Hohn, 53, topped the rankings after his TCI Fund Management gained 41%.

The London-based activist was lifted by concentrated bets on stocks, including Alphabet, Microsoft and Canadian rail companies.

Griffin, 51, made $1.5 billion through his multistrategy funds. That doesn't even take into account his market-making operation, Citadel Securities, which generates billions more in revenue.

Simons, 81, features prominently on the list even though he retired from Renaissance Technologies a decade ago. His ownership stake in the firm, which now manages $75 billion — plus his investment in the secretive Medallion Fund — almost guarantees that he'll continue to be among the highest-paid managers for years to come.

Bridgewater Associates founder Ray Dalio collected $480 million, down from $1.3 billion in 2018, after his flagship fund Pure Alpha II lost money for the first time in two decades. Dalio's All Weather strategy fared better, gaining almost 17% last year, while he continues to have a sizable ownership interest in the $160 billion Connecticut-based firm.

The list excludes those who no longer manage external capital, such as Michael Platt and Stanley Druckenmiller, but is notable for featuring so many Tiger Management alumni.

These are the so-called Tiger Cubs, who worked for legendary investor Julian Robertson, and Tiger grandcubs. Lone Pine's Stephen Mandel and Tiger Global's Coleman each gained more than 30% in their main funds. Andreas Halvorsen of Viking Global returned 18%. His former chief investment officer, Dan Sundheim, returned 22% at his relatively new firm D1 Capital Partners.

"They all had good years because they tend to be net long," Alaska's Frampton said of the Tiger complex.

HOW THEIR INCOME WAS CALCULATED

Bloomberg used SEC filings, company websites and news reporting to determine assets under management. Those figures are for the start of 2019 and don't include asset inflows and outflows during last year. Fee details were taken from SEC filings and reporting. Where there was no disclosure, Bloomberg assumed a 2% management fee and 20% performance fee. Management fees aren't included as part of the profits.

Some firms run dozens of individual funds and strategies.

In general, Bloomberg's analysis only includes the largest and most material funds within the investment firms.

Some hedge fund managers hold significant assets outside of traditional activities, including venture capital or low-fee strategies, which also aren't included in the analysis.

The information on how much each hedge fund owner had invested in their own funds comes from SEC filings and calculations done previously for the Bloomberg Billionaires Index. Ownership percentages of firms are based on regulatory filings and reporting, and phantom equity interests in firms may mean ownership is overstated.

Gross performance fee figures are calculated using annual return data for funds in the analysis. In most cases, Bloomberg assumes half of the performance fees were distributed to employees and reinvested in the firm, with the owners collecting the other half.

Losses recouped from previous years are excluded when calculating returns on managers' personal investments, and performance fees are calculated to take into account estimated high-water marks.

Several of the year's best performing hedge funds don't appear on the list because they have yet to recoup losses incurred in previous years. There are also large hedge fund firms where no return data is available.

Hedge funds must manage funds for external clients to be included on the list.

Additional reporting by Michelle Davis, Nishant Kumar and Pierre Paulden

— Bloomberg News MME

Top 5 highest-paid hedge fund managers all made more than $1B in 2019

Rank	Owner	Firm	Main fund return (%)	Income ($ million)
1	Chris Hohn	TCI Fund Management	41	1,845
2	Jim Simons	Renaissance Technologies	14	1,730
3	Ken Griffin	Citadel	19	1,500
4	Steve Cohen	Poin72 Asset Management	16	1,260
5	Chase Coleman	Tiger Global Management	33	1,105

Source: Bloomberg News

SCHWAB
from page 1

2019 revenue comes from net interest income, with most of the rest coming from asset management fees, per Schwab's 2019 earnings release.

But what's less widely known is that Schwab makes more than 100% of its income and cash flow from net interest income. I estimate that, without net interest income, Schwab's 2019 pretax income would have been a $1.7 billion loss rather than the $4.8 billion income it reported. A Schwab spokesman declined to comment on my estimate.

Schwab's expenses are nearly all related to its legacy businesses of asset management and trading. The marginal costs of paying clients little on their cash and investing in investment-grade securities is next to nothing.

According to Schwab's 2019 earnings, it has paid clients an average of 0.33% annually on $212.6 billion of bank deposits while earning about 2.8% on those assets.

Schwab has about $24.3 billion of other funding sources that bring average costs up to 0.42% annually. The spread, or net interest revenue, has been increasing over the past few years.

What this means is that more than 100% of their profit comes from paying clients little on their cash and safely investing it in investment-grade securities in a nearly riskless arbitrage-like manner. Its asset management business is thus a money loser designed to attract more cash in order to create more profit.

This business model allows Schwab to smash two paradigms often taught in business schools. The first paradigm is that a business needs to compete on either price or quality but not both. Schwab has unseated Vanguard as No. 1 in satisfaction, according to J.D. Power, while having lower or no fees for trading — and a zero-cost robo platform, the Intelligent Portfolio.

I have found Vanguard's website to be complex and unintuitive, and have had several clients complain about service. For example, in my own account, some groupings total multiple account holdings while leaving some holdings out. Several clients have told me they have given trying to transfer trust accounts to Vanguard.

By contrast, Schwab's website is very simple and intuitive and has 24/7 telephone customer service. Schwab is the clear winner in quality and low price.

The second paradigm: It's okay to have a loss leader and sell a product below cost to build a pipeline of revenue elsewhere.

Schwab is actually now in the cash business, meaning it can sell asset management or brokerage services below cost. Yet it smashed this paradigm by not only giving product away, but actually offering to pay clients to move money over to Schwab with a $2,500 acquisition award for over $1 million. Schwab has gone far past selling product below cost.

While still awaiting regulatory approval, Schwab agreed to pay $26 billion for TD Ameritrade. Though that purchase price represented a 17% premium over its stock price, TD Ameritrade stock had previously dropped by 26% in one day after Schwab's announcement that it was eliminating commissions.

TD Ameritrade stock plunged more than Schwab's after eliminating commissions, because TD Ameritrade didn't have the same opportunity when it came to cash.

That's because TD Ameritrade has a greater percentage of revenue from commissions and has a contract with its largest shareholder, Toronto Dominion Bank, limiting its earnings from cash.

But as part of the acquisition, Schwab renegotiated the insured deposit account sweep program for more favorable terms. And TD Ameritrade has a slightly higher percentage of client assets in cash than Schwab (11.7% vs. 11.4%), according to a Schwab document dated Nov. 25, 2019, announcing the acquisition.

Schwab estimates $3.5 to $4 billion in annual synergies, with roughly half coming from cost savings. Presumably, most of the rest of the other half will be coming from increasing spreads on cash as a result of renegotiating the cash agreement with Toronto Dominion Bank, which will own roughly 13% of the combined entity, with $5.1 trillion of client assets. That's nearly as large as Vanguard.

The announcement that got the least publicity may be the most brilliant of all. Schwab stated they would be launching a platform to give more people access to stocks by allowing the purchase of fractional shares in a bid to attract younger investors. They have said they will launch this in the coming months.

While I think this offering will expand equity access to younger people, I suspect Schwab has a different goal in mind — one that could make traditional indexing obsolete.

This goal is free to low-cost automated direct index investing, which happens to fit perfectly with its cash spread model.

Direct indexing refers to buying all the stocks of a certain index such as the S&P 500 or Wilshire 5000.

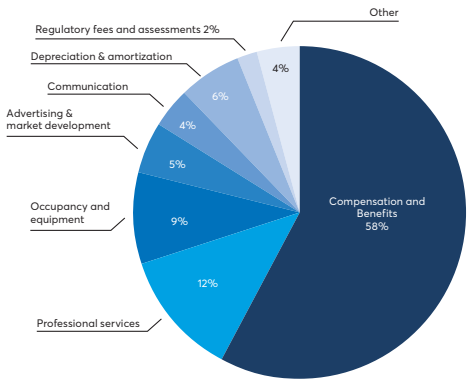
This allows for tax-loss harvesting at an individual stock level, rather than at a fund-only level. This equates to even more tax efficiency (though not tax alpha, as taxes will likely eventually have to be paid). It automates selling shares at losses and buying similar companies to avoid the wash-rule sale disallowing the loss unless waiting 31 days or more to buy them back.

Some robo advisors such as Wealthfront offer this service, but at higher fees. They don't allow fractional shares so they require larger client deposits to mimic a broad index.

CONTINUED on page 12

Schwab expenses

100% = $4.38 billion



Source: Charles Schwab 10-Q (Q3 2019)

CONTINUED
from page 11

If Schwab launches direct indexing with smaller amounts of money using fractional shares, traditional index funds could become outmoded as far more tax efficiency is gained with potentially even lower or no costs.

But the brilliance comes from two sources. First, unlike whole shares of stocks, fractional shares cannot currently be transferred, so switching costs are extremely high. One would have to liquidate those shares with capital gain implications. Second, dividends may not automatically be invested in fractional shares, so Schwab will have created a spigot of cash flow into their low-paying, high-profit, very low-risk deposit account program.

The fact that they announced fractional shares on stocks but not ETFs supports the theory of doing this for direct indexing. When I asked a Schwab spokeswoman about my hypothesis, she declined to comment.

The combined Schwab and TD Ameritrade entity would be almost the size of Vanguard. While other firms such as Fidelity and E-Trade can also make these huge profits from clients' cash, it's not in Vanguard's DNA to capture client cash and profit obscenely, because its clients are also the owners. Vanguard differentiates from Schwab and notes its money market funds (including sweep accounts) yield much more.

A Vanguard spokesperson responded that "Vanguard has always put our investors' financial outcomes first by sweeping brokerage account cash balances into higher-yielding money market funds with a low expense ratio. We will continue to take this client-first approach to cash sweeps, regardless of what others in the industry choose to do."

Regarding the possibility of Schwab offering ultralow-cost direct indexing with fractional shares, Vanguard responded, "If we believe that there is an enduring investment case for the addition of an investment strategy, and a cost-effective way to implement it, we will consider it."

Vanguard appears to be concentrating on the advice model consistent with a McKinsey & Company paper on The Virtual Financial Advisor. (Disclosure: I worked for McKinsey almost 30 years ago.) The report details the advantage of virtual advisor contact over the branch model of meeting face to face. That's a perfect match for Vanguard without branches. Not only can Vanguard get new clients, it can convert existing clients to its Vanguard Personal Advisory Services platform, which charges as much as 30 bps annually.

Vanguard likely has the lowest cost structure, but if the brick-and-mortar branches are used to attract cash, Schwab's disadvantage becomes a distinct advantage in that they can suck up more assets on which to profit more on cash. Vanguard is concentrating on asset management, while Schwab is increasingly betting all its marbles on cash.

I'm not predicting the demise of Vanguard. Vanguard has very loyal clients and I'd count myself as one. Certainly people won't sell their funds to move to a direct indexing platform if it comes with a large tax bill from capital gains. Yet it could mean the continents have started to shift — and Schwab may be the next great big asset- sucking machine.

What could go wrong with Schwab's strategy? I thought the Fed lowering the discount rate would drastically reduce the spread on the cash, but Schwab was still able to generate a healthy spread in 2013 and 2014 when the Fed funds rate was below 0.10%.

It appears Schwab was going out to intermediate-term bonds, taking some interest rate risk. Now if we enter a European type of environment with zero to negative intermediate-term yields, that would be an issue.

Another possibility is the SEC takes action to limit profit from client cash. Next, retail investors and advisors might wise up and realize how much they are losing on their cash. But this has been going on for years and is no different from a banking model where I typically see people losing out on thousands of dollars of interest annually.

And, in my view, Vanguard wins the day on trust, as Vanguard shareholders and clients are one and the same. As just one example, Schwab brought its clients the ultrashort bond fund marketed as a safe alternative to a money market account, until it lost half of its value during the global financial crisis.

In a Wall Street Journal article, journalist Jason Zweig asked, "How does Schwab reconcile forcing its clients to invest in its own bank at below-market rates with its duty to put clients' interests ahead of its own?" Schwab answered in a statement, "We take our fiduciary duty very seriously. Our clients who invest through Schwab Intelligent Portfolios understand the cash that will be in their portfolio before they decide to invest."

Schwab badly confused the term disclosure with fiduciary.

"Schwab is poised to upend the industry with no fees, higher-quality service and better products that could make traditional index funds and ETFs obsolete."

WHAT THIS MEANS FOR CLIENTS

Advisors should minimize the amount of cash clients have earning below market returns in sweep accounts.

Schwab does have some money market accounts that are earning far more, although it typically pays less than Vanguard. Additionally, owning hundreds or thousands of individual stocks with fractional shares will create more switching costs for clients, which could benefit advisors.

Expect others to follow as they did when Schwab eliminated commissions. But understand how any custodian makes money, and ensure your clients aren't unnecessarily losing out on returns. Will my 2030 prediction of Schwab's domination come true? It's a plausible possibility. MME

Allan S. Roth is founder of the planning firm Wealth Logic in Colorado Springs, Colorado.

Index funds with the biggest gains of the decade

By Andrew Shilling

Market-beating returns and low fees are just some of the characteristics associated with the decade's top-performing index funds.

The 20 index funds with the largest gains of the past decade recorded an average return of more than 19%, data show. While equity markets had big gains of their own, the average return from the winners beats the S&P 500's 14.01% return, as tracked by SPDR S&P 500 ETF Trust (SPY), as well as the 13.53% gain by the Dow, as measured by the SPDR Dow Jones Industrial Average ETF Trust (DIA), data show.

"The past decade saw huge shifts in the fund industry. It all began in the wake of the 2007-2009 credit crisis," Morningstar senior manager-research analyst Kevin McDevitt and associate manager-research analyst Nick Watson wrote in a recent paper. "The decade saw the Federal Reserve's most-stimulative monetary policy in U.S. history. There was the longest ongoing equity bull market in history, in which the S&P 500 Index gained an annualized 13.6% over the past 10 years. Finally, the decade saw a massive demographic shift as baby boomers began to retire en masse."

At 0.48%, the funds carried a net expense ratio that matched the broader industry average, according to Morningstar's most recent annual fee survey, which reviewed the asset-weighted average expense ratios of all U.S. open-end mutual funds and ETFs.

"There are nonperformance reasons for preferring index funds, such as transparency, ease of selection, and less need for monitoring," John Rekenthaler, vice president of research for Morningstar, wrote in a recent paper on the impact of fees on index fund investing. "There is no question that the practice of indexing confers many benefits. But higher total returns are not among them, if the active fund dares to match the indexer's costs." MME

	Ticker	5-Yr. % Annualized Returns	10-Yr. % Annualized Returns	Expense Ratio	Net Assets (millions)
iShares PHLX Semiconductor ETF	SOXX	24.32	20.71	0.46%	$2,595.35
First Trust Dow Jones Internet ETF	FDN	18.78	20.64	0.52%	$8,538.55
Invesco NASDAQ Internet ETF	PNQI	17.36	20.30	0.62%	$559.67
Invesco Dynamic Semiconductors ETF	PSI	23.32	19.89	0.58%	$270.66
iShares Expanded Tech-Software Sect ETF	IGV	22.46	19.81	0.46%	$3,540.22
Invesco QQQ Trust	QQQ	18.05	19.46	0.20%	$97,077.96
First Trust NASDAQ-100-Tech Sector ETF	QTEC	20.84	19.38	0.57%	$3,165.88
Vanguard Information Technology ETF	VGT	21.62	19.29	0.10%	$30,296.69
VALIC Company I NASDAQ-100 Index	VCNIX	17.68	19.10	0.53%	$630.61
Shelton Nasdaq-100 Index Direct	NASDX	17.24	19.06	0.50%	$768.25
USAA NASDAQ-100 Index	USNQX	17.72	18.99	0.48%	$2,771.11
iShares Expanded Tech Sector ETF	IGM	21.34	18.88	0.46%	$2,136.38
Technology Select Sector SPDR ETF	XLK	20.82	18.80	0.13%	$28,606.98
Aberdeen Standard Phys PalladiumShrs ETF	PALL	24.39	18.50	0.60%	$385.86
iShares US Medical Devices ETF	IHI	19.07	18.36	0.43%	$5,074.55
Invesco S&P 500 Equal Weight Tech ETF	RYT	19.01	18.30	0.40%	$1,896.67
iShares US Aerospace & Defense ETF	ITA	15.87	18.22	0.42%	$5,844.76
Rydex NASDAQ-100 Inv	RYOCX	16.78	18.21	1.36%	$1,440.38
SPDR S&P Biotech ETF	XBI	7.70	18.10	0.35%	$4,388.57
SPDR S&P Semiconductor ETF	XSD	21.76	18.06	0.35%	$514.63

Note: Funds with less than $100 million in AUM, institutional and leveraged funds are excluded. Data shows each fund's primary share class. Data as of 2/13/2020.
Source: Morningstar Direct

Mutual fund flows

($ millions)

		Equity									
		Domestic							World		
Date	Total long-term	Total equity	Total domestic	Large-cap	Mid-cap	Small-cap	Multi-cap	Other	Total world	Developed markets	Emerging markets
Estimated weekly net new cash flow											
2/19/2020	8,211	-2,714	-5,183	-2,611	-623	-633	-1,377	60	2,469	2,268	201
2/12/2020	7,324	-3,517	-4,926	-1,429	-973	-676	-1,530	-318	1,409	858	551
2/5/2020	6,572	-1,617	-6,037	-1,665	-786	-1,060	-1,821	-705	4,420	2,951	1,469
1/29/2020	2,342	-9,550	-12,527	-7,098	-1,036	-636	-3,460	-297	2,976	1,489	1,487
1/22/2020	10,900	-2,657	-5,049	-2,673	-580	-365	-1,251	-181	2,392	1,202	1,190
1/15/2020	1,253	-9,341	-8,943	-4,085	-736	-1,370	-2,735	-18	-397	-818	421
1/8/2020	-5,263	-24,453	-22,114	-7,640	-1,364	-3,031	-9,531	-548	-2,339	-2,078	-261
Monthly net new cash flow											
12/31/2019	-28,607	-60,154	-51,281	-17,688	-5,046	-4,886	-19,846	-3,815	-8,874	-9,068	195
11/30/2019	-4,969	-37,567	-33,996	-14,853	-2,696	-3,329	-10,887	-2,232	-3,571	-4,416	845
10/31/2019	-17,641	-43,294	-31,181	-12,675	-4,884	-3,604	-7,704	-2,313	-12,113	-10,323	-1,790
9/30/2019	-23,053	-41,931	-34,404	-18,057	-3,276	-2,968	-8,050	-2,053	-7,526	-6,901	-625
8/31/2019	-20,955	-22,271	-23,348	-3,614	-2,397	-3,535	-9,568	-4,235	1,078	1,696	-618
7/31/2019	-7,555	-41,214	-34,710	-14,212	-2,776	-2,648	-12,056	-3,019	-6,503	-5,733	-770
6/30/2019	-27,040	-36,633	-27,572	-10,782	-3,378	-2,379	-7,817	-3,217	-9,061	-7,801	-1,260
5/31/2019	1,609	-8,777	-12,279	443	-3,177	-1,522	-5,243	-2,779	3,501	3,087	414
4/30/2019	-12,778	-42,400	-26,785	-14,016	-2,734	-2,424	-4,628	-2,983	-15,615	-16,651	1,036
3/31/2019	-1,797	-24,629	-19,424	-6,907	-3,065	-3,305	-5,093	-1,053	-5,205	-5,894	688
2/28/2019	20,699	-12,577	-10,832	-4,790	-1,382	-520	-3,883	-258	-1,745	-2,617	871
1/31/2019	22,899	9,475	3,646	3,363	-450	950	-1	-215	5,829	3,218	2,611
12/31/2018	-183,171	-89,350	-43,885	-1,216	-9,459	-8,793	-15,057	-9,360	-45,464	-39,180	-6,285
11/30/2018	-64,290	-25,770	-17,982	-3,433	-2,959	-3,194	-4,991	-3,405	-7,787	-7,976	189
10/31/2018	-57,446	-15,146	-12,738	453	-3,683	-3,064	-3,863	-2,581	-2,408	-2,313	-95
9/30/2018	-22,657	-27,927	-25,447	-12,282	-1,816	-995	-8,218	-2,136	-2,480	-2,619	139
8/31/2018	-17,792	-24,453	-23,101	-12,831	-2,013	1,179	-8,147	-1,288	-1,352	-1,476	124
7/31/2018	-9,804	-20,871	-18,866	-9,740	-2,169	1,572	-6,639	-1,890	-2,005	-2,238	233
6/30/2018	-16,215	-19,894	-24,287	-15,433	-2,707	1,453	-6,302	-1,298	4,392	4,805	-413
5/31/2018	-5,525	-8,734	-15,718	-5,557	-4,417	544	-5,219	-1,068	6,984	5,790	1,194
4/30/2018	-6,629	-9,290	-12,662	-641	-1,123	-104	-4,022	-6,771	3,372	1,616	1,756
3/31/2018	9,863	266	-12,007	447	-2,819	-1,600	-6,676	-1,358	12,273	11,226	1,047
2/28/2018	-11,900	-8,367	-19,556	-1,574	-2,853	-2,634	-9,492	-3,003	11,189	9,450	1,739
1/31/2018	39,998	-7,072	-24,523	-6,847	-5,281	-2,117	-9,993	-286	17,451	13,251	4,201
12/31/2017	-28,550	-38,337	-43,086	-18,680	-4,735	-3,202	-12,491	-3,979	4,749	4,286	463
11/30/2017	-4,734	-16,434	-24,047	-5,862	-3,752	-3,439	-7,115	-3,879	7,613	6,289	1,324
10/31/2017	11,599	-15,969	-22,083	-7,213	-2,402	-2,109	-8,512	-1,847	6,114	4,945	1,169
9/30/2017	872	-21,997	-22,603	-7,504	-2,715	-2,046	-9,370	-968	606	1,360	-754
8/31/2017	-81	-16,476	-24,534	-7,190	-3,503	-2,555	-8,229	-3,057	8,058	6,633	1,425
7/31/2017	4,319	-13,777	-25,525	-10,232	-4,484	-2,243	-7,379	-1,188	11,748	11,022	726
6/30/2017	7,696	-9,412	-18,478	-12,645	-3,137	-2,344	1,393	-1,746	9,067	7,490	1,576
5/31/2017	27,705	3,144	-9,228	2,845	-2,369	-2,170	-5,305	-2,227	12,372	8,811	3,561
4/30/2017	756	-12,498	-19,535	-5,027	-4,055	-2,007	-7,071	-1,375	7,037	5,176	1,861
3/31/2017	12,983	-14,101	-13,391	-1,450	-824	-829	-7,873	-2,415	-710	-590	-121
2/28/2017	28,017	4,405	-2,680	-1,172	525	712	-2,118	-626	7,085	6,179	906
01/31/2017	11,641	-7,754	-10,919	785	-791	998	-10,597	-1,314	3,165	2,106	1,058

Note: Weekly cash flows are estimates are based on reporting covering 98% of industry assets.

Source: Investment Company Institute

ETF flows

($ millions)

Date	Total equity	Domestic equity	World equity	Hybrid	Total bond	Taxable bond	Municipal bond	Commodity	Total LT MF and ETF flows
Estimated weekly net new cash flow									
02/19/2020	276	-3,256	3,532	202	14,889	12,246	2,643	841	16,208
02/12/2020	7,597	4,357	3,240	409	19,113	15,859	3,253	541	27,659
02/05/2020	12,902	5,875	7,028	406	13,670	10,681	2,989	832	27,810
01/29/2020	-9,154	-12,571	3,416	24	13,355	10,166	3,189	696	4,920
01/22/2020	2,332	-3,449	5,781	474	16,047	12,958	3,089	1,348	20,201
01/15/2020	-1,222	-4,523	3,301	28	16,948	13,674	3,275	104	15,858
01/08/2020	-12,698	-13,129	432	-961	24,748	21,215	3,533	92	11,182
Monthly net new cash flow									
12/31/2019	-21,676	-27,520	5,844	-4,892	50,738	40,611	10,127	-545	23,625
11/30/2019	-813	-11,679	10,866	-1,919	44,480	34,403	10,077	-1,032	40,716
10/31/2019	-30,601	-24,646	-5,955	-1,922	43,187	34,801	8,386	304	10,968
09/30/2019	-10,885	-4,650	-6,235	-5,068	38,482	33,080	5,402	3,332	25,860
08/31/2019	-41,828	-29,909	-11,919	-6,950	22,304	13,258	9,046	3,747	-22,727
07/31/2019	-14,872	-7,889	-6,983	-2,046	44,811	34,660	10,150	2,247	30,139
06/30/2019	-20,709	-11,997	-8,712	-4,293	39,771	32,774	6,996	2,984	17,752
05/31/2019	-25,913	-24,652	-1,261	-3,837	21,332	12,778	8,554	-1,166	-9,583
04/30/2019	-15,606	-5,307	-10,298	-4,065	40,565	33,277	7,288	-1,829	19,066
03/31/2019	-7,586	-3,654	-3,931	-5,733	38,412	29,301	9,112	-353	24,741
02/28/2019	2,232	3,632	-1,400	-2,434	45,138	34,183	10,955	-1,493	43,443
01/31/2019	-11,223	-21,195	9,972	-895	29,308	21,722	7,585	2,169	19,359
12/31/2018	-57,435	-28,946	-28,489	-28,178	-49,388	-49,500	111	1,173	-133,829
11/30/2018	6,966	2,770	4,196	-12,380	-11,233	-7,443	-3,790	117	-16,529
10/31/2018	-6,658	-9,656	2,998	-11,252	-31,939	-27,692	-4,247	336	-49,512
09/30/2018	-1,051	891	-1,942	-6,087	18,090	18,521	-431	-36	10,916
08/31/2018	-3,953	-6,653	2,700	-6,195	19,556	17,218	2,338	-2,322	7,085
07/31/2018	-302	1,017	-1,319	-6,013	25,923	22,494	3,429	-599	19,008
06/30/2018	-26,523	-20,999	-5,525	-7,091	19,608	16,995	2,612	-2,450	-16,457
05/31/2018	13,743	10,072	3,671	-3,634	13,042	11,749	1,294	-133	23,019
04/30/2018	-24	-7,395	7,371	-3,763	22,416	24,175	-1,759	2,310	20,939
03/31/2018	-6,740	-22,146	15,407	-1,717	15,898	14,146	1,752	554	7,995
02/28/2018	-19,500	-41,438	21,938	-3,439	1,704	2,705	-1,001	1,026	-20,209
01/31/2018	54,206	10,793	43,413	356	56,756	46,287	10,469	1,724	113,042
12/31/2017	8,932	-9,054	17,987	-3,348	19,167	19,490	-323	-528	24,223
11/30/2017	13,729	-4,405	18,134	-3,179	21,608	19,789	1,819	-444	31,715
10/31/2017	23,930	3,174	20,756	-1,827	38,718	36,109	2,609	-747	60,073
09/30/2017	655	-9,768	10,423	-2,120	36,443	33,439	3,004	1,733	36,712
08/31/2017	-6,132	-22,746	16,613	-3,698	29,551	25,077	4,474	2,393	22,115
07/31/2017	7,407	-12,505	19,912	-2,013	31,710	29,138	2,572	-3,532	33,572
06/30/2017	21,927	-7,938	29,865	-2,567	32,644	29,371	3,273	1,528	53,532
05/31/2017	23,363	-10,719	34,082	-1,566	36,385	33,069	3,316	-449	57,733
04/30/2017	12,335	-8,259	20,594	-1,576	25,199	22,063	3,136	948	36,905
03/31/2017	24,562	9,417	15,145	-1,924	37,809	36,560	1,250	-531	59,917
02/28/2017	35,179	17,617	17,562	44	36,004	33,989	2,015	1,867	73,095
01/31/2017	20,678	5,102	15,576	-1,976	35,544	31,036	4,508	-637	53,609

Note: Weekly cash flows are estimates are based on reporting covering 98% of industry assets.

Source: Investment Company Institute