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CHARLES SCHWAB

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Charles "Chuck" Schwab founded and built what is arguably America's premier discount securities brokerage company. That business began in 1974 when the federal Securities and Exchange Commission (SEC) first allowed limited discounting. A year later the SEC permitted unlimited discounting and Schwab's company began a one-quarter century period of growth and change. The era of growth came to an abrupt halt in the spring of 2000 when technology stocks led a sharp stock market decline. Schwab's trading business fell so sharply that the company had to fire almost 25 percent of its employees. In 2002 the 64-year old Schwab was engaged in trying to restart growth by means of a major change in the company's business model.

The final chapters of Chuck Schwab's business career remain to be written. But the public record is already ample enough to provide useful lessons regarding business principles, processes and philosophical issues. This article presents a stylized history of the company and highlights a few useful lessons. Readers are encouraged to learn "the rest of the story" by consulting the two substantial primary sources for this article, Joseph Nocera's *A Piece of the Action* and John Kador's *Charles Schwab.*[1] Both books deserve a permanent place in any comprehensive business history library.

THE BASIC HISTORY

1.Preparation - Youth, College and Early Business Experiences

Charles Schwab was born July 29, 1937. He spent the first 11 years of his life in the Sacramento, California area where his father worked as an attorney and served as district attorney of Yolo County in the early 1940s. In 1949 the family moved to Santa Barbara where Chuck was exposed to a culture of tolerance for different beliefs and life styles.

Even though Schwab's family was financially well-off, Chuck started two small businesses as a youth. At the age of eleven he gathered English walnuts and sold them in 100 pound sacks. A year later he began raising chickens and selling eggs, chicken droppings (used as fertilizer by the customers), and plucked fryers (Kadoor, pp. 30-33).

Then he fell in love with golf. He took a job as a caddy and made enough money to begin investing in the stock market in a small way. He became so proficient at golf that his high school golf team elected him captain and Stanford University awarded him a golf scholarship.

Schwab suffered from dyslexia and that caused problems in all school subjects that required reading. He made up for the handicap in part through working longer than his peers; in part through strong oral communication skills; and in part through off-setting strengths in math and science. His major at Stanford was economics, a subject which played to his math and science strengths.

Schwab received his undergraduate degree in 1959 and went on to earn an M.B.A. degree from Stanford. He then took a job with a firm that published an investment newsletter. Once he learned the newsletter business he left his employer and started his own financial newsletter in partnership with two partners. He was twenty-five years old.

Schwab's newsletter venture did not fare well in the beginning. The problem was ineffective marketing. The venture was saved when Schwab met an expert on direct mail marketing and hired the man to teach him how to sell subscriptions by mail.

Having salvaged the newsletter business Schwab started a no-load mutual fund targeted at California investors. But he accepted out-of-state customers and did so without bothering to register his company in any other state. Texas was the first state to discover this illegal practice and demand that he not only stop sales in Texas but also make full refunds plus 6 percent interest to all Texas investors. That action caught the attention of the U.S. Securities and Exchange Commission which ordered Schwab to stop selling fund shares anywhere. Schwab's first mutual fund was out of business.

At this critical juncture an uncle, William Schwab, offered Chuck $100,000 to start another investment company. Chuck and four partners did just that, naming their new venture the First Commander Corporation. The new venture did not have a clear business strategy and floundered so badly that both the uncle and the four partners sold their equity back to Chuck. By 1973 he was sole owner of a failing company. But an opportunity was about to present itself and First Commander would become Schwab's vehicle for seizing that opportunity.

2. Triggering Events

Schwab's opportunity was created by a major change in the regulatory environment of the American securities industry. Prior to 1975 the purchase or sale of stock listed on the New York Stock Exchange (NYSE) was done at fixed commissions. The practice dated back to 1792 and was enforced by the rules governing membership in the exchange. The members of the NYSE set the commission rate. While this price fixing practice would seem to be a violation of American antitrust law, it remained free from government prosecution. But in 1968 the Securities and Exchange Commission held hearings on fixed rates and momentum began to build for putting an end to the practice. Eventually the exchange accepted a deadline of May 1, 1975 for the complete elimination of fixed commissions[2] .

Schwab did not initially perceive this change as a business opportunity for his firm. It took a friend's advice to wake him up. Hugo Quackenbush , an investment portfolio manager in San Francisco, was that friend. Quackenbush had admired Schwab since their days at Stanford. In 1973 he realized that deregulation of commissions would create an opportunity for Schwab as a discount broker and pointed out that opportunity to Schwab.

Schwab was emotionally ready to act on the information. There were certain problems in the brokerage industry which bothered him. He could envision opening a discount brokerage firm as his personal contribution to righting those wrongs. Kadoor puts it this way (p.101):

> "When Chuck started the firm out of a deep sense of personal outrage that the brokerage industry systematically exploited its customers, he vowed eternal hostility against three things: advice, commission-based sales, and sales calls."

3. Strategy and Start-Up

Schwab's initial discount brokerage business model was fairly simple. His target market was those investors who did not rely on their brokers for advice and who were therefore likely to be attracted by lower commissions. This group represented 10 percent of investors and placed 90 percent of the volume (Nocera, p. 119). Schwab would charge commissions 30 to 80 percent below the fixed commissions then in existence. The amount of the discount would depend on the size of the trade. He would not solicit customers nor offer advice. As a result, he would not have the expense of hiring qualified brokers. Instead his staff would consist of less expensive clerical workers .He would create awareness of his business by placing small advertisements in the *Wall Street Journal.* Customers would place their orders by telephone. Finally, the business name would be changed to Charles Schwab & Co.

In April 1974 the New York Stock Exchange began to accept orders from discount brokers on a trial basis (for trades of $2,000 or less). Schwab jumped at this opportunity to test his idea. His advertisements drew an average of four orders a day that April . Schwab decided the concept was workable. Full deregulation of commissions occurred on May 1, 1975.Within a few months Schwab was handling 75 orders a day.

4. Early Challenges

From the very beginning Charles Schwab and Company was faced with several constraints on its ability to keep pace with potential demand for its services. Exacerbating the basic challenges was Chuck Schwab's somewhat weak administrative skills. Here is how one executive level early hire described the scene when he arrived in search of a job (Kador, p. 51):

> " There was paper everywhere. People were running around. I opened a desk drawer and found bank statements that hadn't been opened, much less reconciled. I found backlogs of exceptions and errors. If there were controls, I didn't see any. I saw someone taking reconciliations home in a shopping bag. I learned that she called in sick the next day. One thing that did impress me was that Chuck was in it up to his armpits. He was certainly not sitting in his office."

Offsetting the administrative shortcomings were Chuck Schwab's values and vision. The company attracted people who "bought in" to both. Thus motivated, they were willing to put in the extra effort needed to overcome the administrative "chaos" and to work with Chuck to meet the early challenges.

Technology and Productivity

One major problem was the firm's limited physical ability to handle orders. Initially the response was to hire more staff. But by the time volume reached 400 orders a day in 1977 Schwab decided to install a computer based ordering system. This was a daring move since no such system was yet in existence. Nevertheless, Schwab was able to get one up and running in 1979 . The company's volume jumped to 2,000 orders a day that year.(Nocera, p. 121).

Computerization reflected Chuck Schwab's belief that technology would be a key to the company's success, a belief that was possibly initiated and certainly amplified by one of Chuck's earliest hires --- Bill Pearson. Pearson had accumulated more than a decade of operational experience in the securities industry when he unexpectedly showed up at Schwab's office in San Francisco looking for a job (He had left his previous job in Dallas, Texas in order to be with his girl friend in San Francisco). Schwab hired him and gave him the responsibilities of a chief operating officer (COO). Pearson believed that computers were essential if Schwab were to handle the hoped for explosion of transactions and Schwab authorized him to create a computer based transactions system. The result was, in Kapor's words, " In 1979... Schwab risked $500,000 - 100 percent of its revenues that year - on a turnkey back-office settlement system, becoming the first discount broker to bring automation in-house... Schwab...had the first online order entry system in the brokerage business." (p. 54).

Convinced of the potential payoff to investment in technology research and development, Chuck established Schwab Technology Services. In order to attract top talent and remove bureaucrat barriers, Schwab made the unit a separate division. It was located in a separate building and and had its own budget. It looked and felt like an independent entrepreneurial start-up. Chuck made its mission clear, " ... to develop products and services to help individual investors make better investment decisions." (Kador, p. 64).

One of the notable accomplishments of the technology operation was the 1985 introduction of SchwabQuotes. This is reported to be the world's first automated stock quote system and that achievement was made even sweeter by the fact that a giant of the industry, Fidelity Investments, was competing against Schwab for the distinction.

In 1987 the company reorganized the technology operation, making it part of the Information Systems Division.The change was pushed by David Pottruck who believed that the independence of the unit was beginning to interefere with the ability of the technology people to work effectively with the retail side of Schwab. Pottruck wanted more cost effective research and development and a better focus on real customer needs (Kador, pp. 70-71). Most of the technology units key employees were unhappy with the decision and left for other jobs.

Capital

A second perennial problem was growth capital. Like banks, brokerage firms were required to hold a certain amount of capital in reserve to cover possible losses. The required amount was a percentage of all assets. Therefore, as the firm grew it had to acquire more capital. Schwab quickly ran into this constraint in the summer of 1975 when the Philadelphia Stock Exchange restricted Schwab's trades on the grounds of inadequate capital. In this case, Schwab was bailed out by his uncle, William Schwab, who invested $300,000 in the firm (Nocera, pp. 122-123).

In 1980 the company attempted to solve its capital problems with an initial public offering (IPO) of its stock. But planning for the offering as well as general market conditions aborted that effort. A capital constraint remained a matter of immediate concern until 1983 when Schwab allowed itself to be acquired by Bank of America. Later, when Schwab bought the firm back from Bank of America in 1987, Schwab was able to make a successful IPO thus bringing in badly needed new capital.

Competitor Response

A third potential problem was opposition from the established brokerage firms. To be sure, there were some annoyances. Schwab was denied at least one building lease due to opposition from an established firm. And the Pacific Stock Exchange seemed to go out of its way to discourage Schwab by means of what seemed like petty warnings and penalties (Nocera,p. 121). But the bigger story is what the established Wall Street competitors did NOT do. What they did not do was to respond to the discount challenge by cutting their own commissions and conceivably driving startups like Schwab out of business. Merrill Lynch was the most feared of the majors but it failed to respond. Nocera explains this failure to compete as in part as follows (Nocera, pp. 118-119):

> "Like all the big wirehouses, Merrill Lynch had a hard time taking discounting seriously. The way the discounters went about their business violated too many of the ancient truisms of the brokerage business. - Stocks are sold, not bought,' went one such axiom - meaning that most Americans still did not come easily to a decision to buy or sell a stock or bond. They had to be cajoled, prodded, convinced. Brokers activated this process by picking up the phone, planting an idea, slowly reeling in the customer."

Serendipitous Developments

In addition to startup problems, there were also some serendipitous developments which gave Schwab significant competitive advantages. One was the decision to use a picture of Chuck Schwab in the company's advertising. Here is an abbreviated version of that story as told by Nocera (pp. 124-125):

> " In late 1976 the *San Francisco Examiner* did a story about the new firm. Included with the story was a photograph of Schwab, wearing a crisp white shirt and aviator glasses, and smiling that smile that would soon become famous....
>
> When (Hugo) Quackenbush saw the smile in that picture - when he saw how perfectly it represented his image of the firm - he bought the picture...and persuaded Schwab to use it in an ad. In the ad, Schwab's picture ran alongside a headline that read: - The other brokers laughed when I cut commissions.' ....
>
> Schwab's essential shyness made him reluctant to put his own face in an ad, and it is something he would never have done without prodding. But once the results came in, his reservations evaporated. ads that used Schwab's face did better than ads that didn't...
>
> Discounting had taken an extremely personal business, revolving around a broker's relationship with his customers, and made it impersonal. By using his face in his company's ads, Schwab was making it personal again. "

Another serendipitous development was the opening of branch offices. This occurred as a direct consequence of Bill Schwab's offer to invest $300,000 in the new firm. As explained by Nocera (p. 123):

> "Uncle Bill's money came with a condition attached. He wouldn't invest unless his nephew agreed to open a branch office in his home town of Sacramento. Such an office would employ Uncle Bill's son-in-law as its manager (Perhaps no less important, it would also give Uncle Bill a place to hang around.)
>
> As much as Schwab needed the money, he resisted at first. In theory, discounters didn't need branch offices ... But Uncle Bill would not budge: it was Sacramento or nothing. So Sacramento it was. Uncle Bill rented space in an inexpensive storefront across from a state office building, and in September 1975, Charles Schwab and Co.'s first branch office opened for business.
>
> What happened next was a revelation. Schwab's volume - both the number of trades transacted each day, and the number of customers who called each day - immediately lurched upward. ...The only answer that made sense was that branches did matter after all - they mattered psychologically. It wasn't so much that people would insist on visiting the branch office every time they wanted to make a stock trade, they just needed to know it was there. There was something reassuring about seeing a real office - something that made a financial enterprise seem more solid than when it was represented merely by an ad in the *Wall Street Journal. "*

Nocera goes on to share the following colorful story indicative of the marketing value of branch offices (p. 122):

> " Die-hard investors were often stunned by Schwab's prices; part of the lore of the firm is the story of a man so bowled over by the commission Schwab planned to charge him for an options trade- $34 instead of the $ 175 his usual broker would have charged - that he brought his lawyers to the Schwab office to make sure it was all on the up and up."

5. Building the Management Team

One executive responsibility that was not adequately filled in those early years was that of the chief operating officer (COO). To be sure, in theory Chuck had hired Bill Pearson to perform that role. But in practice,Chuck continued to perform many of the roles of COO . The public record does not make it clear why Pearson could not have been given more authority. What is clear is that Chuck's abilities as a part time COO were sufficiently weak that selection of a replacement became a serious company issue in the years leading up to 1980. Kador describes the situation as follows (p.49):

> "Chuck is just not wired as a detail guy. He has the vision thing, but every manager who ever worked for him uses the same terms. Not detail-oriented. Avoids conflict. Tactically tone deaf. Detail-averse. And those are the compliments. Schwab was the least rigorous of the financial services companies, for which the SEC occasionally slapped Chuck's wrist. The company had to endure many crises to develop a mature governance structure, validating the theory that life is attracted to order but uses messes to get there."

The issue of inadequate daily management was finally addressed when Chuck asked an executive recruiting firm to find an executive to manage the branch network. Schwab ended up selecting Larry Stupski and enlarging the job title to that of chief operating officer. Stupski was a Yale Law School graduate with five years of experience as an executive at a computer services company. Schwab hired him not only for his administrative experience and demonstrated strong work ethic, but also for his, " world-class analytical mind, generosity of spirit, and scrupulous integrity" (Kador, p. 192). Kador argues that Stupski was, " ...a gifted top executive who would be the catalyst that transformed Schwab into a true financial services powerhouse" (p. 122). But Kador is quick to note that one reason for Stupski's success was that his presence allowed Chuck to focus on his main areas of executive strength , " .. advocating or customers, imagining new products, and championing inspired marketing" (p. 122).

By the end of 1987, following the company's successful public offering, it appeared that Charles Schwab & Co. had a fully staffed and well qualified top management team. The officers at that time were (Kador, pp. 148-149):

1. Charles R. Schwab - Chairman and chief executive officer
2. Lawrence J. Stupski - President, chief operating officer, chief financial officer
3. Barbara A. Wolfe - Executive vice president-administration
4. Richard W. Arnold - Executive vice president - investment banking
5. Robert W. Fivis - Executive vice president - operations and finance
6. Woodson M. Hobbs - Executive vice president - information systems
7. David S. Pottruck - Executive vice president - marketing branch management
8. Phyllis Kay Dryden - Senior vice president and general counsel
9. Hugo W. Quackenbush - Senior vice president - communications
10. Robert H. Rosseau - Senior vice president-retail service delivery
11. Elizabeth G. Sawi - Senior vice president - marketing and advertising
12. Barry G. Snowbarger - Senior vice president- trading administration/ operations
13. James F. Wiggett - Senior vice president - human resources

This list raises the question of whether or not the company was becoming too bureaucratic. If so, continued vitality would depend upon the leadership skills of Schwab and Stupski. Events would show that the two were up to the challenge. Schwab and Stupski successfully managed the business until 1994 when Stupski stepped down in the aftermath of a heart attack. His replacement as president was David Pottruck. Pottruck worked out so well that in 1997 he was named co-CEO with Chuck Schwab. It became clear at that point that Chuck Schwab was going to have a hard time letting go of the CEO position.

6. The Bank of America "acquisition" and buy-back: 1983-87

In 1981 Charles Schwab and Co. was ready for growth by merger. In that year it acquired another discounter, Kingsley, Boye and Southwood and two other securities related firms. At the same time Schwab became a member of the New York Stock Exchange.

Those growth related actions put further pressures on the firm to find substantial new capital. With the failure of the 1980 initial public offering (IPO) Chuck Schwab was emotionally receptive to a merger with or acquisition by the right kind of capital rich company. The right kind of company was one which would allow Charles Schwab & Co. to retain its freedom of action and ability to remain true to its values. Bank of America seemed to be such a potential partner. Schwab announced its intention to be acquired by Bank of America in 1981 and the actual sale occurred in 1983 with a purchase price of $ 57 million. The terms of the acquisition put Chuck Schwab on the

Bank of America board of directors and still left him with ample freedom as head of the Charles and Schwab and Co. subsidiary of the bank.

For a number of reasons the Bank of America "merger" did not live up to Chuck Schwab's expectations and in 1987 Schwab management bought the company back from Bank America for $280 million in the form of some equity and a great deal of debt. Chuck provided $9 million of the equity portion of the buyout, ending up with a 41.5 percent ownership share

Later that year Schwab completed a successful IPO , selling eight million shares at $ 16.50 a share thereby bringing in $132 million in new capital. Chuck Schwab's share of ownership dropped to 29.6 percent following that offering. The management group as a whole fared well. Officially the company they bought back from Bank America for $280 million was valued at $ 400 million by the public offering. Privately Schwab's management figured they did even better. As they saw it, they only paid Bank America $ 190 in "real money." The rest of the purchase price was accounting entries that did not represent a true cost to the buyer (Kador, pp. 142 - 147).

The timing of the IPO was fortunate. Within four weeks of the successful offering the stock market crashed. On October 19,1987 the Dow Jones Industrial Average lost 22.6 percent of its total value. Had Schwab delayed the offering, the IPO would have failed. Once again, Schwab's success was due in part to a little bit of good luck.

7. Expanding Services in the 1980s

During the 1980s Charles Schwab and Company expanded its range of services and continued to experience rapid growth. In 1982 the firm introduced an innovative money market account for small investors. Called the Schwab One Account, it wasn't the first such offering in the industry, but it was the first to be truly accessible to smaller investors. It only required a minimum of $5,000 (compared to a $20,000 minimum investment at Merrill Lynch) and there was no annual fee. Schwab One represented a significant change in the nature of the company's business. Now Schwab was not only performing transactions but also gathering customers' assets and investing them.

In 1984 the company introduced its Mutual Fund Marketplace.This service allowed Schwab customers to buy shares in one or more of 140 different no-load mutual funds. This was the beginning of a string of mutual fund service introductions. In 1991 the company started selling the Schwab 1000 Index Fund and the Schwab U..S. Government Bond Fund. In 1992 the company started offering a California Bond Fund and a National Tax-Free Bond Fund.It was also in 1992 that Schwab introduced its soon-to -be famous Mutual Fund OneSource.

In 1986 Schwab began offering a No-Annual-Fee IRA. The United States Congress had authorized individual retirement accounts (IRAs) in 1982. All financial institutions which offered them charged the customer a small annual fee (including Schwab). One of Schwab's advisors challenged Schwab to live up to its professed commitment to the customer by eliminating the fee. Chuck Schwab made the decision to eliminate it on the twin grounds that (1) it was, indeed, in the customer's best interest to do so and (2) the company would eventually more than offset the initial revenue loss through increased customer business. David Pottruck and John Kador both cite this decision as a testimony to the nature of decision-making in a value driven company. In brief the message is that a company with strong values will be more likely to incur clear short run costs or give up clear short run gains in order to be true to the company's values. But this will be done with the expectation that the short run sacrifice will pay off in the long run, even though the long run gains are less clear than the short run results (Kadoor, p. 73).

Then, in 1989 the company introduced an automated telephone service for trading and providing quotes. Named TeleBroker, this was an expanded version of the earlier telephone quotation service introduced in 1985 under the trade name SchwabQuotes.

The proliferation of financial services available from Schwab was accompanied by an impressive expansion of production facilities. The number of branches rose from 15 in 1979 to 23 in 1980 and to 111 by the end of 1989.

8.Environmental Emergencies in 1987 and 1989

Business firms operate in environments over which they have no control.Cultural environments, legal environments, economic and financial environments and natural environments are examples. On occasion one or more of those environments produces an unexpected emergency problem which puts the firm at risk of great loss or even failure. Two such environmental challenges hit Schwab in the late 1980s.

The first challenge occurred as a result of the stock market crash of 1987. Charles

Schwab & Co. had difficulty executing the huge volume of sell order on time. As a result the company had to make up any customer losses due to Schwab's failure to execute. In addition the company had some customers who speculated on options. Their losses also became Schwab losses. The worst such situation was with a Hong Kong customer whose margin calls were large enough to wipe out all of Schwab's capital if the company were forced to pay for them. Schwab hired a special agent to go to Hong Kong and attempt to get the Hong Kong customer to pay up. The agent's successful efforts to do so make fascinating reading as told by both Nocera (pp. 358-365) and Kadoor (pp.160-169). Schwab still had a large loss in 1987 and its stock price fell from $ 16.50 a share to $ 6.50. But the company avoided what could have been a terminal loss, and it used the experience to identify needed changes. One such change was for Chuck to finally turn over most of the daily management authority to the company president.

The second environmental challenge was the San Francisco earthquake of October 17, 1989. Thirteen hours before the markets were to open, the earthquake knocked out Schwab's headquarters computers making it impossible for the company to conduct business. Home office employees worked feverishly to get the facility up and running before the financial markets opened. An employee chartered a plane, flew to the Colorado site where Schwab kept backup data tapes, and then took copies of the backup tapes to a backup computer disaster recovery site in New Jersey. With minutes to spare the company was back in business when the markets opened on October 18th. While this particular emergency situation was resolved in less than 24 hours, it exercised a powerful positive effect on internal morale and Schwab's external image. The experience also motivated Schwab to make some important disaster preparedness changes. The company's primary data center was moved to Phoenix, away from the earthquake danger zone. Later additional data centers were established in Indianapolis and Denver. Each center had the capability of running the company if the others failed for any reason .

9. Independent Financial Advisors in the 1990s

In the 1980s numerous financial advisors used Schwab services to help them manage their clients' money. Chuck Schwab recognized them as a distinct market segment and the company developed additional services to meet their needs. SchwabLink was one of those services. Introduced in 1991 SchwabLink enabled financial advisors to use Schwab computers to not only trade but also have Schwab do their record keeping, including preparation of client statements. Financial advisors paid a fee to Schwab for this service but the price was right and this segment of Schwab's business grew rapidly.

In 1995 Schwab took the next step when it introduced AdvisorSource. This involved establishing a list of qualified independent financial advisors and providing names from this list to any Schwab client who wanted an advisor. There were 600 advisors on the list. Each advisor on the list paid Schwab a quarterly fee plus a variable percentage of assets under management. Perhaps more important to Schwab was the fact that the program encouraged the financial advisors to place the assets they were managing with Schwab.

A Stanford University business school case study of Schwab argued that the financial advisors became, in effect, a sales force for Schwab. Merrill Lynch supported this assessment when it stated that, " We don't compete with the discounters... We do compete with Schwab. They have essentially built a Merrill Lynch by proxy" (Kador, p. 107).

By 2001 Schwab was doing business with 5,800 independent investment advisors. Together they were managing $235 billion in assets through Schwab. Schwab, in turn, was courting and serving them through the company's division of Services for Invesment Managers. But the relationship began to sour a bit in 2000 when Schwab bought a firm that provided investment management services to millionaires (U.S. Trust). Then,in 2002, Schwab's relationship with the financial advisors was truly put at risk by Schwab's new strategy of offering advice itself. As reported by *Business Week (*Louise Lee and Emily *Thornton,* ,2002, p. 67 *):*

> " As Schwab pushes deeper into the advice business, many (independent advisers) are feeling much more threatened and blame the firm for eating into their business. - We feel Schwab's competing with us,' says Christiane Delessert, an adviser in Newton, Mass., who keeps about $150 million in client assets at Schwab."

10. OneSource Mutual Fund: 1992

In 1992 Chuck Schwab realized another of his revolutionary visions when the company introduced its Mutual Fund OneSource program. OneSource offered customers a no-load, no-transaction fee way to invest in mutual funds. The mutual funds themselves paid Schwab a fee for being included in the package. The OneSource product was intended to be sold through banks, thus adding another sales force partner to the company's network (Schifrin, 1997, p. 43). Here are some highlights of Kador's treatment of this breakthrough (pp. 184 ..185):

> " When the final history of Wall Street is written, ... OneSource...will go down as the innovation that most liberates do-it-yourself investors from the constraints imposed on them by an industry less interested in service than in exploitation. It may be Chuck's most durable legacy: OneSource changed the way people around the world bought and sold mutual funds."

> ".... Mutual Fund OneSource took the hassle out of owning funds. With one phone call, visit to a branch office, or, for the computer literate, with Schwab's brand new StreetSmart software for the PC, a customer could buy More than 200 different funds from 25 fund families, compare their performance, sell the funds, and switch between funds. Investors who diversified and bought funds from several different fund families no longer had the frustration of dealing with a confusing variety of statements, rules, and sales representatives. Investors in OneSource received one statement that consolidated the performance of each fund, individually and by family. "

11. On-line Trading: 1996

Perhaps Schwab's most impressive and instructive act of renewal was the introduction of on-line trading in 1996. Schwab was not the first to offer this service, nor were Schwab's rates the lowest (For example, E*trade charged $14.95 per $ 1,000 trade compared with Schwab's $ 29.95). But within a year of introducing it, Charles Schwab and Co. accounted for 700,000 of the 1.5 million active on-line accounts in the industry (Schifrin, 1997,p. 42).

Schwab's on-line initiative required courage in facing up to the issue of cannibalization. In the deliberations leading up to on-line trading Schwab strategists concluded that a substantial number of existing customer base would migrate to the internet service. That would reduce the commission revenue from those customers . But the company was willing to accept that short run liability in order to maintain leadership in the discount segment of the industry. Furthermore, it was hoped that over time Schwab would end up earning more per customer through on-line trading because customers would trade more often. But the most important reason for taking this plunge was the competitive factor. As David Pottruck put it (Pottruck, p. 157):

> " The decision was painful, but it wasn't hard. We knew that someone would do it, and that our business would either go to them or stay with us because we had done it better. The primary questions revolved around how to organize this new effort to give it the best chance for success."

> Other instructive and impressive parts of the story were (Nanette Byrnes,1999, p.88):

1. The CEO (Chuck Scwab) was behind the effort so that it received adequate funding.
2. The online business was set up as a separate business unit so that employees working on it were totally focused on making it work.
3. Resistance from the branch staff was lessened by frequent communications pointing out the rapid growth of online trading and raising the spector of obsolescence for any firm that did not offer online services.

4. Having the branch staff train their customers to use online services rather than having that done by the technical staff (This made the branch personnel part of the team bringing about the change).

When Schwab's online service was first introduced the company adopted a two-tier pricing system --- Existing or full service customers were charged $65 on average to use the internet service whereas net-only customers paid only $29.95. The understandable chorus of complaints by the full-service customers caused the company to eliminate the difference. Volume increased following the fee reduction and Schwab's online business became very profitable (Nanette Byrnes, 1999, p. 88).

12. Schwab Equity Rating and Private Client: 2002

On May 16, 2002 Schwab announced what may turn out to be an act of renewal as significant as any other in the company's history - entry into the business of providing individual investment advice to affluent clients (individuals who invest $500,000 or more). The new service was called Schwab Private Client. It consisted of making available to the target market a personal financial consultant. The customer will pay a fee of 0.6 percent of assets for the privilege of a face-to-face meeting with a Schwab advisor . The advisor will help the client develop an investment plan and will then help the client monitor investment performance. The advisor will not provide advice in the areas of taxes, legal matters, or estate issues. Furthermore, the advisor's stock picking advice will, in theory, be based on a stock ranking system also newly introduced by Schwab. That stock ranking system, named Schwab Equity Ratings, will provide weekly rankings of about 3,000 stocks. The rankings will be done by a computerized program with the top 10 percent rated "A" and the bottom 10 percent rated "F".

In full page ads in the *Wall Street Journal* Schwab tried to assure investors that this latest act of renewal was fully compatible with the company's founding philosophy which consisted of ("The Schwab Way," *The Wall Street Journal*,May 22, 2002, p.All):

1. The Principle of The Individual Investor

   " From day one, the individual investor has been at the center of what we do. Every investor is important to us. We're not focused on investment banking. We represent you, the individual investor."

2. The Principle of Facts, Not Hype

   " We give advice based on facts. We do not give so-called - hot stock tips.' Research and facts are the foundation of our advice. And now with our Schwab Center for Investment Research and Schwab Equity Ratings, we analyze and rate more U.S. stocks for the individual investor than any other major investment brokerage firm."

3. " The Principle of Sell as Well as Buy"

"Last year according to *First Call* , less than three percent of analysts' recommendations in the marketplace were a -sell.' And at Charles Schwab we don't believe that's the way it should be. With our Schwab Equity Ratings, we analyze stocks based on quantitative facts and give each one a simple A, B, C, D or F rating. And our research is designed to give just as many F's as we do A's. So now there's a system that helps you decide what to sell as well as what to buy."

4. " The Principle of Advice Not Driven by Commission"

" Individual broker commissions can undermine relationships. That may bias the advice you're getting. Our Investment Consultants' compensation is based on their service to you and assets at Schwab, not commissions. It has always been. And will always be."

5. " The Principle of Objectivity"

" At Schwab, we're not focused on investment banking. For example, we make IPOs available but we don't receive any compensation for their distribution. To us it's a potential conflict of interest. We always strive to avoid conflicts of interest in everything we do. This is at the heart of our values."

This particular act of renewal took place at a time when the company was suffering from a 25 percent drop in revenues, a 72 percent decline in net income and layoffs representing close to 25 percent of its work force. The immediate cause of that poor performance was the dot-com bust in the stock market that began in the spring of 2000, followed by a spate of financial reporting scandals and a resultant loss of investor confidence in the stock market. But at the top levels of Charles Schwab and Company there was concern that the problem would be more than temporary. Co-chief executive officer David Pottruck's explanation for the new services was, " Obviously, we weren't going to succeed based on online trades... (Trading levels are) not going to go back to where they were in 2000, ever." (Louise Lee and Emily Thornton, 2002, p. 67).

In addition to the concern with the level of profits it was clear that Schwab was anxious to find ways to reduce the large variations in volume that were an inevitable part of the trading side of the business. The stock market would presumably always be subject to periods of heavy trading followed by bear markets with low volume. What was needed was additional business activities that would reduce the overall fluctuations in company revenue.

Kador sees the new strategy as both a movement away from the company's founding principles and a necessary change if growth is to be sustained. With respect to the principles, here is his assessment (. Pp. 269. Kador's arguments for this view are presented on pages 269-272):

" Founded as a brokerage for the average investor, Charles Schwab & Co. prided itself on three standards: no advice, no cold calling, no commission-paid brokers. In its desire to recreate itself as a full-service brokerage, Schwab is systematically abandoning the principles on which it was established."

It is not at all certain, of course, that Schwab's Private Client service will succeed. This is a new market segment for Schwab, one which does not appear on the surface to play to Schwab's competitive advantages. The pessimistic view of the ultimate outcome would emphasize a number of barriers to success. One would be an inability of Schwab to create a reputation for high quality advising relationships. A related problem could be the creation of a fuzzy image caused by the attempt to simultaneously offer low price and high price services. That is, Schwab might end up in a situation such as occurred to Sears, Roebuck when it ceded discounting to Wal-Mart and failed to reestablish itself in fashion merchandising as originally planned. Then there is the matter of a substantial increase in operating costs caused by the higher pay required to recruit qualified financial advisors and equip them with the supporting tools which affluent customers expect. Thus, once again Schwab has shown a willingness to take risks in the hope of sustaining growth.

LEADERSHIP INSIGHTS

One of the appealing features of John Kador's book is his moving collection of vignettes. A number of them provide insight into company culture and management styles. Following are a few highlights from Kador's book:

Chuck Schwab

As reported in earlier sections of this article, Kador sees Chuck Schwab as a strong leader and weak manager. The leadership strengths include Schwab's ability to vision, to achieve employee "buy-in" to the company mission, to practice renewal, and to empower individual employees. One of those employees, David Pottruck, once described Schwab's ability to motivate others as stemming from Chuck's own, highly visible values and vision. In Pottruck's words (Pottruck, pp.8-9):

> " -Chuck' Schwab ... certainly started the firm to make money. But he believed that could be done by actually serving others, giving market access to people who wanted to manage their own accounts. He knew if he provided value to customers and paid attention to good business principles, profit would follow. He was determined to -provide customers with the most useful and ethical brokerage services in America.' Talk to Chuck for an hour and you will hear all about the things we should be doing for customers. You'll probably never even here the word -profit.' Chuck's vision reflects his personal values - fairness, empathy, responsiveness, service - and these have become the bedrock for how he expected everyone in his company to behave. I personally have never seen Chuck behave any other way. Hearing him, people respond with a resounding, -Me too!".

While the degree of employee "buy in" to the corporate culture does seem to be impressive, dissatisfaction could be an issue from time to time. A 1994 employee survey revealed that 30 percent of the employees were concerned or ignorant of the company's direction, trust in senior management and their own career prospects (Pottruck, p. 13). That particular survey caused Pottruck to get the entire company involved in producing formal statements of vision, goals and strategic vision and priorities.

Among Chuck's managerial shortcomings two common complaints seem to be that (1) he created a high stress environment and (2) he did not communicate concrete expectations very well. On the second point it is instructive to refer to Kador's explanation of Larry Stupski's role at the company (p. 198):

> "Stupski's main role was to translate Chuck to the company and, in turn, translate the company to Chuck. For example, Chuck might look at a laout of a prospective ad and grunt something undecipherable. It was left for Stupski to explain to the bewildered art director and copywriter what Chuck objected to."

It can be argued that both the stress and the ambiguity contributed, at least to some extent, to employee opportunities to feel empowered. But it does appear that first Stupski and later Pottruck brought a needed balance to the daily work environment.

Larry Stupski

Stupski, as previously reported, had the operational strengths that Schwab lacked. He was experienced, smart, hard working and ethical. His Yale Law School degree had taught him to use the case method (which he hated at the time) and that turned out to be a valuable business skill. As he put it (Kador, p. 194):

> " The heart of the problem (in business) is the concealment of the real issue. In business, things always come at you with a spin, with a view, with a partial set of facts. I came to believe that the relentless questioning effort of the case method, a kind of pounding for 3 years, really helped me better understand issues and problems in the business world."

Nevertheless, he arrived at Schwab with some managerial shortcomings that he courageously addressed. The shortcomings had to do with human relations. Stupski was prone to argue and seemed to have a need to win the arguments (although he was intellectually honest). He was a perfectionist and was quick to criticize the work of others when it did not meet his standards. As a result he tended to be respected but not liked.

After arriving at Schwab and assembling a talented management team Stupski hired Joe Cutliffe, an organizational psychologist and executive coach, to deal with the tensions within the team. It turned out that part of the problem was Stupki's personality. Once he became aware of his managerial shortcomings, Stupski learned to delegate more, to communicate better and to avoid letting his perfectionism sour relationships (Kador, pp203-204). As a result, he became liked as well as respected.

Among Kador's several assessments of Stupski's contribution the following stands out (p. 198):

> " Under Stupski's stewardship, the company prospered, transforming from a scrappy discount brokerage that succeeded in spite of itself, to an increasingly well-disciplined machine for growth. He helped the company take its present form, its organizational structure, presentation to the outside world, and its remarkable record of commitment to employees. He spent 18 years at Schwab, 13 as chief operating officer... When he joined Schwab the company had 18 branches, 400 employees and $ 30 million in Revenues. On the day of his heart attack, the company had 175 branches, 4,000 employees, and revenues of more than $ 750 million."

The heart attack to which Kador refers occurred January 10,1992. Stupski was 46 years old at the time. He recovered and went back to work. But the experience caused him to rethink his priorities and those of the company. It also caused other management employees to take a look at their work practices and some decided to relieve the stress by retiring from Schwab. Back on the job Stupski began pushing for better work life balance at the company and Schwab backed him up in principle. But in practice, Schwab was not pleased with Stupski as a more relaxed president. In 1994 the position of vice chairman was created; Stupski was moved into that position; and a new , harder working president and COO was appointed (Kador, p. 239). It appears that stress remained a fact of life at the company.

David Pottruck

David Pottruck was the new president and chief operating officer. Like Stupski, Pottruck was a hard driving executive who was respected but not always liked. Kador puts it this way (pp. 227-228):

> "David Pottruck arrived at Schwab with a lot of what Chuck diplomatically labeled - East Coast baggage.' He was brilliant, of that there was no doubt, but Pottruck's hard driving personality, molded by growing up as the eldest of three boys in New York, and a management style refined by gigs at Citibank and Shearson, irritated a lot of people at Schwab. The Schwab culture was no less intense or competitive than at Pottruck's previous employers, but it demanded that displays of testosterone be downplayed. At Schwab the aggressiveness, the ambition couldn't be announced. ... (Y)ou could have it, but you couldn't show it. At Schwab, above all, you acted nice, collegial, avoiding any hint of grandstanding. Pottruck came to Schwab with a streak of impetuousness, an Eagerness to call a spade a spade, and a strong fondness for making Wise-cracks. All three traits violated Schwab norms."

Pottruck had joined Schwab in 1984. His prior experience included earning an M.B.A. degree from the Wharton School of Management, working as a health administrator with the U.S. Department of Health, Education and Welfare, serving as a management consultant for Arthur Young & Co., working as a controller at Citibank, and serving as senior vice president of consumer marketing and advertising at Shearson/American Express. He joined Schwab to handle marketing and branch management and was being groomed to eventually succeed Stupski.

Pottruck got off to a rocky start at Schwab and, like Stupski, eventually addressed his managerial shortcomings by hiring a management coach named Terry Pearce. That strategy worked. Pottruck was able to change his leadership style and become an inspirational leader in his own right. Readers interested in the fascinating story of that transformation of Pottruck should consult Kador (pp. 232- 238) and Pottruck's own book (Pottruck and Pearce, 2000). In terms of Pottruck's job performance, let Kador have this final word (p. 241):

> " Chuck had set a high bar for Pottruck, and he outperformed in every way. He helped navigate Schwab to a dominant position on the Internet ... his fingerprints were on every part of the company, from the monumentally successful AdvisorSource program to Schwab's increasing presence in the retirement plan market. With Chuck increasingly preoccupied with visionary duties and activities such as writing his book...Pottruck had been operating in every respect like a chief executive officer."

On January 1, 1998 Pottruck's success was rewarded with a promotion to the newly created position of co-CEO.Of course, Pottruck would have preferred to be the sole CEO and Chuck's inability to grant him that wish became an issue that would remain unresolved into 2002.

Pottruck made one other contribution that warrants mention . Together with Terry Pearce he wrote a valuable book on leadership, drawing heavily on his experiences at Charles Schwab & Co. It is meant to be a guide for managers who seek to build great companies in the age of the Internet. And so it is. In the preface are the following comments which might well reflect David Pottruck's assessment of what he accomplished at Schwab (Pottruck and Pearce, p. xxiii):

> "In our experience, there are three essentials - building culture, practicing a particular brand of leadership, and using a handful of management disciplines - to igniting the fire that is necessary to generate the loyalty and commitment, the energy and the courage, that are necessary to integrate the Internet and to continue to build a great company. This book is about such organizational transformation. It is also, of necessity, a primer of personal change, of learning the difference between managing for compliance and control and leading for passion and commitment. "

Tom Steip

Tom Seip's inclusion in a short article about Schwab is merited by an inspiring decision and speech he delivered to his management peers after being passed over for a promotion. Seip was the Korn/Ferry International junior partner who recruited Larry Stupski for Schwab. Later Stupski returned the favor by hiring Steip to head up Schwab's human resources function. Seip went on to lead the development of OneSource Mutual Fund Service and Services to Investment Managers. He also served as CEO of Charles Schwab Investment Management and almost succeeded Stupski as company president.

In 1997 Seip justifiably expected to be named president of Schwab's brokerage subsidiary. Instead, Pottruck chose another person, one who had joined the company 2 years earlier to turn around Schwab's money funds operation. Kador reports that Seip's rejection was so humiliating that 9 out of 10 executives in a similar situation would resign. And Seip did indeed consider doing so. But he changed his mind and proceeded to give a speech to the senior management team --- a speech that is reproduced by both Pottruck (2000) and Kador (2002). It is a speech that might provide inspiration and direction to any executive in a similar situation and one which provides insight into the values of Schwab senior management. Highlights of that speech are presented in the following paragraphs (Kador, pp. 254-260).

> Seip begins by acknowledging the pain he felt, saying :
>
> > "I would not for one moment want you to believe that I didn't want the job ...I did. I thought a lot about it, and I was terribly disappointed when I did not get the job. I Was at first angry...and because I was raised like you were, To put tremendous value on where I was positioned in The hierarchy , it was a fairly significant blow to my self Esteem. And to the degree my identity is linked to my Job, the answer to the question, - Who am I?' comes Back very quickly. -You are not the president'.
> >
> > And So now what? And I had to deal with that; not only for myself, but for My wife and family...
> >
> > And, for me, there was the issue of how all of you would Perceive me. That, by the way was the biggest hurdle.... There was a part of me that

> just wanted to disappear.
>
> But I didn't. And I wanted you all to know why ...."

Seip next explained that he considered simply retiring. But he decided against that in part because he was trying to instill the value of hard work in his oldest son. For Seip to retire would, he thought, set a bad example for the son.

Seip then told the executives that he had to force himself to recognize that commitment to the organization carried with it the responsibility to recruit and nurture persons who might end up being one's boss. If that occurs, one can still take pride in having done one's duty and providing the organization with a better qualified leader.

Next Seip asked himself 6 questions to determine whether or not he should remain at Schwab. The questions and his answers were (Kador, p. 259):

"1. Do I believe in the mission of the company? Answer: of course.
2. How does the fact that you didn't get this job affect my commitment to the mission of the company? Answer: not at all.
3. Is there any place in the world, other than starting your own company where you could express that commitment? Answer: probably not.
4. Do I believe in the strategy? Answer: I helped fashion it.
5. Is there any group of people that you would rather be with, leading and following...with all of the foibles and all the successes? Can you imagine having the kind of long-standing and committed relationships in another environment? Answer: probably not.
6 . Do you respect the new person you are going to be working for? The answer: absolutely."

"So then, "concluded Seip, " the only reason to leave would be petulance ... because I didn't get to play the position I wanted to play. And then I asked, - How am I going to explain this to Jake, my 12-year-old son... who is a starting halfback on his middle school soccer team, but now wants to play center forward because there is more glory there? .... So I decided to stay."

Seip then told the executives that there was one last question he still had to answer. Would he still pour himself into his job at the company as he had in the past? Or would his failure to get the promotion cause him to lose the energy and feeling of excitement that he had been bringing to work every day? His pride wouldn't let him stay if he was not going to give his best effort. He concluded that he could continue to be a star and would, therefore, remain.

Unfortunately, the job became vacant a year later and once again Seip was not chosen. This time Seip did resign. Nevertheless, his speech the previous year remains a valuable part of Schwab history.

Rhet Andrews and James Losi

One final insight into leadership and culture at Schwab occurred at the time of the 1987 stock market crash. One elderly California customer had a $7 million investment in Treasury bills held by Schwab. But he had been persuaded (not by Schwab) to sell naked puts. When he stock market crashed Schwab not only had to sell he customer's Treasury bills but also to recover an additional $1.5 million from the man. There was nothing left but the man's home where the elderly gentleman and his wife had lived for 47 years. It was an expensive home overlooking the Pacific Ocean. Schwab had every right to seize the home and sell it. But the Schwab branch manager, Rhet Andrews, did not feel doing so was consistent with Schwab values. He took the matter to the vice president in charge of collecting bad debts, James Losi. Losi knew that top management was anxious to collect the money from the sale of the home. And company lawyers were insisting that he do so. But Losi also felt that seizing the home under the circumstances did not square with Schwab values. So he arranged to allow the couple stay in the home until both died. David Pottruck was watching this situation and had asked Losi to call him as soon as the property had been seized. But when Losi called Pottruck to tell him that the seizure and sale would have to wait and explained why that decision had been mad, Pottruck replied, " Jim, you did the right thing." (Kador, pp. 153-155).

CONCLUSION

The story of Charles Schwab & Co. is instructive in many ways. Perhaps most instructive is Schwab's ability to reinvent itself - to successfully practice renewal. Kador puts that history in the following perspective (pp. 5-8):

> "Schwab has reinvented itself three times. It is currently in the midst of its fourth transformation...
>
> Schwab version 1.0 was the pure discount brokerage made possible by the deregulation of brokerage commissions on May 1, 1975...
>
> Schwab version 2.0 emerged in the 1980s as it transformed itself into an asset gatherer. As the business model shifted from transaction fees to the benefits of having millions and then billions of customer dollars under management, Schwab diversified its product offerings with mutual funds and institutional services...
>
> Version 3.0 illustrates Schwab's struggle to seamlessly integrate the Web-based services it developed in the mid-1990s with the established company....By fits and starts the company figured out how to use its Web offering to cannibalize the company's bread and butter services...
>
> Schwab version 4.0 makes the company look more than ever like the full-service brokerage firms it used to scorn.... But with this newest reinvention, Schwab faces a huge risk to the franchise that has become so successful. Average investors feel abandoned. Employees feel betrayed by the increased emphasis on advice-giving and sales."

Schwab's senior management is aware of the risks involved in acts of renewal. The company is counting on the culture to win back or retain the loyalty of the average investor and employee as Scwab version 4.0 is rolled out. That culture is the focus of Pottruck's book, so let us give him the final word (Pottruck and Pearce, p. 291):

" Schwab's unprecedented growth is rooted in our customers' trust. Our values are translated into products and services that fundamentally help people help themselves...

Through the years we have often chosen radically new directions when we were at the top of our game. We have understood the desirability and the necessity of embracing change from a position of strength. Now - while we are strong - we need to again change some of our behaviors, build important new skills, and shift our structure and processes.

If we have the courage to be led by our vision, we can truly make a difference in our customers' lives. We can serve others, serve the community, and be proud of our profession and our company."

END NOTES

1 This article draws heavily from the books by Nocera (1994) and Kapor (2002) which are listed as references. The Kapor book is the more recent of the two and provides substantially more information about the company and the man. The Nocera book does an outstanding job of presenting the bigger picture of Charles Schwab and Company as one of a number of firms that democratized American financial markets. Both books are highly recommended.

2 For colorful and detailed descriptions of the process leading up to deregulation see Nocera (1994) and Kador (2002).

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