

Charles Schwab's Big Challenge

He founded the firm that changed investing. But the market went sour, and so did his succession plan.

By Betsy Morris

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(FORTUNE Magazine) – Charles Schwab was doing what semiretired billionaires do--rolling through the first flight of the Stock Farm golf tournament in the Bitterroot Valley of Montana--when his directors began to call. They were not happy. It was July 15, 2004, and just eight months earlier they had approved the \$322 million acquisition of the investment firm Soundview Technology after CEO David Pottruck had given an elaborate and impassioned explanation of how it fit his plan to turn around the struggling discount brokerage that bears Schwab's name. Now, they had learned, Pottruck was trying to sell it. And how had they found out about his abrupt change of heart? By reading about it in the New York Post. The company appeared to have lost its mind.

Pottruck had been Chuck Schwab's hard-driving No. 2, at his side as the company rocketed from upstart discount broker to red-hot growth stock. For five years the men had been co-CEOs. Schwab had coached Pottruck, and Pottruck had become increasingly restless to strut his stuff. In May 2003, Schwab finally let go of his half of the CEO job, retaining the role of chairman and giving Pottruck his chance to shine.

But along the way a strange thing happened. Just as the stock market underwent a personality change, so, it seemed, did Pottruck. After the bubble burst the company was adrift in a storm, and Pottruck seemed to have no compass. Once gung-ho and decisive to a fault, now he seemed unsure of himself, tactically all over the map. Desperate for growth, Pottruck made acquisitions, some of which, like Soundview, took the company deep into unfamiliar territory like institutional investing. He deployed his marketing team to design a mind-blowing array of new offerings, targeted to so many groups that they hardly seemed targeted at all. He raised prices on some services, figuring the Schwab brand would command a premium. In truth, Schwab's pricey commissions had made the environment ripe for the brokerage price war that had erupted after the bubble burst. Fidelity had it in a chokehold. And now this--an embarrassing reversal on Soundview.

Chuck Schwab continued to field calls during the three-day tournament. Realizing that this matter could not be resolved long-distance, he cut out early on Saturday to catch a plane home to San Francisco. The following day he met with all but one of his directors in his apartment. The board members, Schwab says, "really wanted Dave to leave. The

question was, Would I return? I didn't hesitate a second because I definitely had it in my own mind that we had lost our way."

On Monday morning, July 19, the board met as it usually did, but this time Pottruck was asked to leave the boardroom. He wasn't summoned back. An hour later Schwab called him into his office and gave him the news: Pottruck's run was over, and Schwab, then 66, would be returning as CEO.

So ended one of the stranger succession sagas in recent memory--not the all-too-common kind in which a founder can't let go and sabotages his protégé, but rather a case in which everybody tried to do the right thing but somehow got it all wrong. So, too, began the latest chapter in the death-defying story of Charles Schwab, the man and the company.

In short order Schwab has put the company back in fighting shape. He sold Soundview and the company's capital markets group for \$265 million, not flinching at the loss. (Soundview, it turned out, was worth practically nothing.) He reduced the workforce by 2,400 employees. He cut \$600 million in annualized costs. That allowed him to slash commissions by 45%, take market share from Ameritrade and E*Trade, and still post a first-quarter revenue decline of just 4% (to \$1.06 billion) and a 3% rise in operating net (to \$164 million). He will try to boost assets under management (\$1.1 trillion) by attracting new clients and capitalizing on the relationships that the company already has to provide investment advice, home-equity loans, mortgages, and banking services. He has bolstered the balance sheet by buying back \$617 million of the company's stock. He has surprised a lot of people. "In a short period of time he's made significant progress in making the firm more competitive and a better long-term investment," says Ken Worthington, an analyst with CIBC World Markets.

In fact, Schwab's renewed vigor has probably been one catalyst for the latest moves toward industry consolidation (see box). In a continued weak market, Schwab's increased muscle has raised the pressure on online brokerage firms and may be part of what's driving E*Trade's latest play for Ameritrade. Schwab says he doesn't plan to enter that fray, though. "I won't say never, but it is unlikely that we will be an active bidder for any of these consolidation plays," he says. "Trading has been commoditized. The future is really about competing for [client] relationships." Besides, Schwab has plenty of work to do at his own company. The stock, of which he owns 20%, is trading at around \$11, way off its peak of \$50 a share in April 1999. It'll take a lot more top-line growth to make the company a darling of Wall Street again. That is Chuck Schwab's next challenge.

"Why am I doing this when I could be out playing golf?" In a recent interview, Schwab doesn't even wait for the question. He asks it himself. He's obviously grappled with it

plenty. "I'm really doing this for, one could say, the fulfillment of my original ambitions--to do what I started out doing."

Schwab launched his company with a single contrarian idea--that there just might be a business in selling stock to the middle class. On May 1, 1975, the day the SEC deregulated brokerage commissions, Merrill Lynch and the rest of the pack raised fees for individual investors. Schwab lowered its commissions by more than 50%. The company was a maverick West Coast brokerage business--a ragtag bunch of anti-MBAs in a bullpen on Montgomery Street in San Francisco--and for a long time nobody on the East Coast took it too seriously. But it grew fast, long before the dot-com bubble. Schwab was the first to bundle mutual funds together, one of the first to force the funds (not the clients) to absorb trading fees, the first discount broker to add a branch network.

Charles Schwab's company would become the biggest, most successful discount brokerage firm in the industry, and he would become a multibillionaire, even a household name. In television advertisements he promoted ownership of stock, seeding the notion that anybody could get rich in the market. That would change the investing landscape forever. That would lead to active investing, to day trading, and you know the rest of the story. Some people who never dreamed it possible would get rich; some would go broke. Either way, nothing would be the same.

Pottruck, a marketing guy who had worked at Shearson American Express, joined Schwab in 1984 and within a decade became the CEO's indispensable No. 2. An expansive man, Pottruck had a personality so overbearing that it took him lots of coaching to learn to collaborate. (One of his favorite stories was how, after a second failed marriage, he'd sought counseling for what he thought was a "wife selection problem" only to be told he had a "husband behavior problem" and needed to learn how to compromise.) He wore his heart on his sleeve and could engender great loyalty and team spirit, in contrast to Schwab, who was private and aloof. The two made an interesting contrast in other ways. Schwab was a golfer at Stanford, where a part of the business school is named after him; Pottruck was a wrestler at Penn, where a gymnasium is named after him. Schwab collects modern art; Pottruck had a Remington sculpture in his office of a frontiersman on a bronco.

Their relationship grew into one of those mysterious corporate marriages, a highly effective partnership that was, it is clear from conversations with both men, laced with deep affection and sometimes great annoyance. Pottruck was competitive and openly ambitious. He made it no secret that he wanted to be CEO, and of course Schwab didn't want to give up the role. That dance began in earnest in 1998, when the two became co-CEOs. They created a division of labor to suit their strengths and personalities, and that may well have created the conditions for problems that erupted later. Schwab isn't a

touchy-feely kind of guy, and Pottruck wasn't really inclined toward the visionary, blue-sky stuff. Schwab looked outward, focusing on the customer, and Pottruck looked inward, carrying out the tactics, doing all the hiring and firing, and making operating and administrative decisions. Schwab wrote books on investing (four in all, with titles like *How to Be Your Own Stockbroker* and *Charles Schwab's New Guide to Financial Independence*). Pottruck wrote a book called *Clicks and Mortar*, about how passion drives growth in the Internet world.

Schwab says that he tried to give Pottruck plenty of authority and responsibility; sometimes he overruled him. What's clear, though, is that Pottruck never really got the hang of looking outward. Whether it was because Schwab didn't quite trust Pottruck with the job, or whether he just couldn't quite let go--maybe a little of both--the arrangement lasted five years. On May 10, 2003, Pottruck became CEO. The timing couldn't have been worse. He would get 14 rocky months.

By spawning a new investor class, Charles Schwab was not only one of the great progenitors of the retail-driven bull market of the 1990s, he was one of its great beneficiaries as well. His company's revenues more than quadrupled, to \$5.69 billion, from 1993 to 2000 as millions of people graduated from active investors to hyperactive ones. As the first company to figure out Internet trading, Schwab accommodated and spurred the frenzy and became the unofficial capital of Trader Nation.

When the bubble burst, Schwab's customers went into shock, and to its shame, so did the company. It had remained too dependent on trading, which had soared from a daily average of 28,000 trades in 1993 to 242,000 at the end of 2000 and then plunged the following February by half. In 2001, Schwab's revenue fell 25%, to \$4.3 billion; its net income dropped 72%, to \$199 million, after a \$400 million restructuring charge.

By the time Pottruck took over as CEO, the company was caught in the middle--it was neither a discounter nor a full-fledged brokerage firm, but because of Schwab's brand, Pottruck thought it could walk that line. He was counting on acquisitions to generate new revenue, like wealth-management fees from U.S. Trust, which Schwab had acquired in 2000 when he was co-CEO. Soundview would build Schwab's presence in its capital-markets business, boosting trading profits by adding Soundview's impeccable investment research. The research could also be bundled and sold to individual investors in its retail business. Pottruck also hired a marketing hotshot from Verizon and put her to work developing a complex new menu of investing services, called Personal Choice, to expand Schwab's reach with investors.

But by early July 2004 it was clear the strategy was in trouble. The market had weakened. Personal Choice was a dud. Schwab's revenue was under tremendous pressure. Fidelity

had cut its prices the prior September (to \$8 a trade from \$14 for active investors). Schwab, feeling the pinch, cut its prices in February (to \$9.95 from \$29.95). On top of it all, Soundview was not only way below plan but also a drag on the rest of operations. Schwab CFO Chris Dodds, preparing second-quarter results, was dismayed to find that the after-tax profit margin had fallen to barely 10%, from the 12% to 13% range. Pottruck was in a Catch-22. He could not afford the fat salaries Soundview analysts were used to making, but if he didn't pay them, they could walk out the door. Yet he couldn't afford to wait for the unit to turn around either. "This is it, man," Dodds recalls thinking. "We'd intended to create an interrelated business with premium returns due to synergy. What we ended up with was an interrelated business with discounted returns due to complexity. Dave knew it, and I knew it."

Pottruck says that Soundview "was a mistake, a horrible mistake, there is no question about it. I blame myself more than anybody for what happened. Not the board. Not Chuck. I blame myself." More generally, he says, "Reducing costs and taking apart and unwinding when the bubble burst, I came at that with reluctance when I should have come at that role with a lot more energy. If I had it to do over again ... I would be so much tougher."

Schwab, looking back on that time, says, "My personal hope was that Dave would emerge as the guy who could lead this thing for the next ten or 15 years. I lay down on the tracks for him many times. He had the potential, the mental capabilities, the passion for the business. I would go to the ends of the earth to make this thing work. But when it becomes an obvious dead end, I won't do things that are really stupid."

Charles Schwab would be getting no hero's welcome on his return as CEO, and he knew it. For most of the company's history he had been respected, if not revered, by its employees, many of whom were attracted to the firm because of the anti--Wall Street culture he had cultivated. But by last summer revenue had fallen 28% over three years, to \$4.1 billion. Trading volume had plunged 40% and showed no signs of recovery. New accounts, a key growth measure, were plummeting. The stock had skidded to a low of \$9 in June. The firm's workforce, which had stood at 15,100 in 1998, had swollen to 26,300 in 2000 and then shrunk to 16,300 by the end of 2003. Schwab wasn't yet financially crippled, but it soon might be. Here it was, three full years into the downturn, and Pottruck was still floundering while Schwab was little more than a bystander. On Vault.com, a website where Schwab employees frequently vent their frustrations on a message board, Chuck Schwab had become "the emperor who has no clothes" or "Chuckie Cheese." Pottruck was "Potluck." The prior August a briefcase found at the foot of Schwab's driveway in Pebble Beach contained a device that so resembled a bomb that police blew it up to get rid of it. (They never did figure out who left it there.)

Even some of Schwab's own board members weren't sure he was up to the job. "I had a big question about whether Chuck was really ready to do this," recalls Frank Herringer, chairman of Transamerica and a Schwab board member since 1996. "Was he willing to change his lifestyle? He said he was. I said, 'Okay, Chuck, that's great. Let's go.' In my mind, I thought, 'Yeah, sure, Chuck. But in three months or six months, you're going to get tired of this real fast.' There's the nice part and the nitty-gritty part. And the nitty-gritty part can get old in a hurry. Particularly when you're 67 years old."

A marathon two-day meeting of the executive team and outside consultants from Bain, who had been looking for more ways to cut costs, had been scheduled for the week Schwab returned as CEO. Schwab seized the opportunity to restructure the company. It was awkward business. This wasn't his executive team, it was Pottruck's. "We saw Chuck when he was playing the chairman role or the icon role," says Jan Hier-King, executive vice president of human resources. "It's weird to face off with the icon in a one-on-one."

Schwab asked the group to help him redraw the organizational chart on a dry-erase board at the front of the room. As Schwab pushed for input, the executives were reluctant to speak, so he began to call on them by name. "You had to answer," recalls Hier-King. Over and over, he added his own thoughts: We need to simplify, decentralize, to refocus on the customer. Our pricing has gotten out of whack. We need to fix this. Fast. By the time the group broke for dinner, everybody was exhausted.

And by the end of the meeting with Bain, the company had a new plan. A new organizational chart covered the dry-erase board. It was nameless and impersonal, but nearly everybody who walked out of the room that day knew whether he had a place in it. Within months, Jody Bilney, head of marketing, and Lon Gorman, head of capital markets, would leave. Dawn Lepore, head of technology, would take a job as CEO of Drugstore.com. What had looked so complicated now looked very clear. Before the week was out, executives would have clear lines of responsibility. Anything that didn't have to do directly with serving the customer and making a profit was considered "junk that got in the way." It was gone. "I don't want to say it became a mantra, but you began to get a sense that yeah, we'd kind of lost our way," says Hier-King.

One major new focus was Charles Schwab's bank. Schwab had insisted on founding it in 2002, but it had been a low priority for Pottruck. Now Schwab wanted to make the company a single source for banking, brokerage, and credit card services--one that would give Schwab customers something of value: a personal relationship they could trust. That would lessen Schwab's dependence on trading and give it a more reliable earnings stream, increased revenue, and a deeper relationship with clients to counter the defections that become such a problem in, say, a price war.

While his new executive team tackled costs, he began to do damage control with customers. Last fall he traversed the country, meeting with clients, visiting branches in Phoenix, Indianapolis, and New York City. He redesigned Schwab's branch network. In November he spent two days in Philadelphia, hosting an annual conference for more than 1,000 independent investment advisors who serve Schwab clients. He intends to build revenue by taking the company back to its roots, focusing on individual investors and their advisors, not just doing their trading (now the low-margin part of the business) but providing all their financial needs. While E*Trade, Ameritrade, and TD Waterhouse scrap over the low end of the business, he plans to focus on households with assets all the way from \$50,000 up to \$1 million. Earlier this month he dispelled any doubt that he intends to hang on to U.S. Trust by installing Peter S. Scaturro as its new CEO (replacing Alan Weber, a Pottruck recruit, who is retiring). The betting is that Scaturro, a 45-year-old former CEO of Citigroup's Global Private Bank, is a possible succession candidate, along with Bill Atwell, head of the individual investor business, and several other insiders.

Schwab is up to his elbows in details and meetings. He is impatient and entrepreneurial, says Atwell, the closest thing Schwab has right now to a No. 2. "He doesn't overintellectualize. He wants to make a decision and move on." When Fidelity announced another price cut this past February, Schwab gave his executives the rest of the day to figure out what to do. He opened the next day's meeting, Atwell recalls, by saying, "We're here to make a decision. Chuck was very specific." Two days later Schwab, too, cut prices.

Schwab is fiddling with the website, figuring out how to integrate the banking services and the brokerage business and link them in the minds of clients. "I'm focused frankly on integrating the part between the brokerage and the banking. Cash, cash products, balance sheet kinds of things," he says. You can do a whole lot more than just trade on the Schwab website now. You can open a bank account or find out about a home-equity line. Schwab sees a day--he acknowledges he has a way to go--when a Schwab account will send automatic messages that tell clients they need to tweak their asset allocations, or redeploy the cash that's sitting idle in their checking accounts, or unload their stock and buy real estate.

On a recent afternoon in New York, he crisscrossed the city to visit his branches, drinking lemonade with his brokers, posing for snapshots, fielding questions from clients about what he thinks will happen to oil prices and whether it's a good idea to be in REITs. Every chance he gets, he pushes Schwab's advisory services. On the Upper West Side he chats for an hour with a group of clients, and empathizes with a pianist from Juilliard who was all but wiped out in the dot-com bubble. "I'm frightened," she says. "I have just really given up." He gives her the same analogy he has used all day. People feel like a rowboat bobbing in the ocean, but they could be more of an ocean liner if they would diversify

their assets, make a plan, and follow it, he says. He is driven to save his company, yes, but he is also obsessed with teaching middle-class investors how to increase their wealth.

This from a guy who is a billionaire twice over. "My dad was a struggling businessman for all my childhood," says his daughter, Carrie Schwab Pomerantz, senior vice president, who went to work at the company when she was 16 and it was a startup. By then Schwab was a serial entrepreneur with several business failures under his belt, divorced, in debt, and well into his 30s. "In his mind, he had a lot of failures. He sees himself as the underdog," says his daughter.

Schwab has given himself a deadline--he will remain CEO until January 2007. The market may give him an earlier one. "It's hard to put up revenue growth when we're cutting prices like we are," says board member Herringer. "The growth will come when our value proposition to the individual investor starts to get traction. That's going to be a matter of a year or so, and the numbers will be there or they won't." There are two possible outcomes: Go it alone or sell the firm, says Herringer. "Chuck has said many times he just wouldn't sell it, and as long as the board is convinced that's the best outcome for shareholders, that will remain true."

Of course, Schwab did have to sell it once before--and then he saved it in the clutch. In 1983, in need of capital to finance rapid growth, Schwab sold his company to Bank of America. Then, in 1987, as the bank ran into trouble, he managed to regain control by buying it back in a \$280 million management-led leveraged buyout. That September, one month before the October stock market crash, he took Schwab public in order to raise the money to pare down what could have been a fatal \$200 million debt load.

This is just the kind of setting Charles Schwab thrives in. He has studied how the modern artists whose work he collects develop as they get older. "As some of these guys move into their 60s and 70s, they have unbelievable periods of greatness," he says. "They give me a lot of inspiration." He's no Picasso, he says, but the company is his canvas, and he's not finished yet.

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