

# Schwab Fundamental Index\* Mutual Funds and ETFs

Schwab Fundamental Index mutual funds and ETFs provide investors with access to an innovative indexing approach that offers a complement to traditional market cap indexing and active management, helping to create the potential for more attractive risk-adjusted portfolios.

## An Innovative Approach to Index Investing

Following more than 50 years of finance theory and indexing convention, the vast majority of stock indexes determine a company's weight based on the market value of its stock—its "market capitalization." Market cap indexes rely on market sentiment which can drive stock valuations to excessive levels in either direction, leading indexes to overweight stocks that the market has overvalued and underweight those it has undervalued, resulting in portfolios that can be vulnerable to pricing bubbles and subsequent corrections.

Fundamental Index® strategies attempt to address these aspects of traditional market cap indexes while offering the opportunity for attractive risk-adjusted returns over longer periods of time. Instead of selecting and weighting companies based on their market capitalization, Fundamental Index strategies weight companies based on **objective** financial

measures of company size, essentially breaking the link with stock price. This methodology employs a disciplined approach that counters the constantly shifting sentiments of the broader market while preserving many of the chief benefits of traditional cap-weighting: investment capacity, liquidity, diversification and broad market participation. During periods of strong market performance, however, Fundamental Index strategies may lag their market cap counterparts.

As a pioneer in Fundamental Index strategies, Charles Schwab Investment Management, Inc. (CSIM) established a relationship with Fundamental Index creator Research Affiliates, LLC (RAFI™) and was the first to launch index mutual funds following a RAFI methodology in 2007. CSIM subsequently launched a series of exchange traded funds (ETFs) in 2013. Both the Schwab Fundamental Index mutual funds and ETFs passively track certain indexes within the Russell RAFI Index® Series, which is based on RAFI's methodology.

## A complement to traditional market cap indexing and active management

Fundamental Index strategies fall along a continuum spanning index and active strategies by focusing on fundamental measures similar to many active stock-picking strategies.



## Three Industry Leaders; One Strategic Alliance

### Research Affiliates, LLC

*Developing the methodology*

Research Affiliates LLC is the pioneer of the Fundamental Index methodology. Founded by Rob Arnott in 2002, Research Affiliates is a leader in asset allocation and indexing strategies, with approximately \$214 billion in assets managed using its investment strategies (\$171 billion of which are in Fundamental Index-based strategies).<sup>1</sup>

### Frank Russell Company

*Creating the indexes*

With more than four decades of experience, Frank Russell Company is a premier institutional index provider whose indexes are used to benchmark more than \$9 trillion in investor assets.<sup>2</sup> Russell indexes combine the firm's rigorous index construction methodology with best-of-class thinking to serve as a trusted source of index intelligence.

### Charles Schwab Investment Management

*Providing access via mutual funds and ETFs*

With \$360 billion in assets under management, Charles Schwab Investment Management (CSIM), a subsidiary of The Charles Schwab Corporation, is one of the nation's largest asset management companies and the third largest provider of index mutual funds and fifth largest provider of ETFs<sup>3</sup>. Since 1991, CSIM has delivered passive, core strategies to investors, providing convenient access across key categories of market cap and alternative index strategies through both mutual funds and ETFs.

## What's Behind the RAFI Fundamental Index Strategies?

Market cap indexes that select and weight their constituents according to market-determined prices are inherently momentum-driven, assigning the largest weights to companies whose stocks the market has rewarded. By overweighting overvalued stocks and underweighting undervalued ones, traditional market cap indexes tend to favor companies trading at high multiples and exclude those trading at distressed, deep-discount prices.

In seeking to avoid such biases, Rob Arnott and his company, Research Affiliates, created a transparent approach to investing that seeks to break the link between price and portfolio weight, focusing instead on financial measures that objectively anchor a stock's weighting in a broad-based index. Constituents in Fundamental Index strategies are selected and weighted according to fundamental metrics of company size, such as adjusted sales, retained operating cash flow and dividends plus buybacks to determine index weights. These weights, which can often differ significantly from a company's market capitalization, tend to be relatively stable over time.

Additionally, the Fundamental Index strategies rebalance periodically to reset the preceding period's price drift, trimming exposure to stocks that have performed best and adding to positions that have lagged, and bringing sector, country and individual companies back to their objectively derived anchor weights. This periodic rebalancing exercise enables the Fundamental Index strategies to take advantage of the theory of "mean reversion"—a theory that has been observed in the returns of investment securities since the beginning of markets—that prices eventually return to their mean, or average. In the context of the Fundamental Index strategies, prices would move away from inflated or deflated market expectations and toward their inherent value based on objective, quantifiable metrics, minimizing the impact of ever-shifting market forces. Fundamental Index strategies offer many of the advantages of index investing, while helping to create the potential opportunity, over time, for more attractive risk-adjusted returns when paired with traditional market cap index and actively managed strategies.

### Two Views on Markets

Traditional market cap indexes are based on the premise that markets are efficient and that stock prices reflect all relevant information and, thus, that stocks are fairly priced. Fundamental Index strategies have roots in the Graham & Dodd<sup>4</sup> economy-centric premise that prices are fluid, so overpricing and underpricing are possible.

	Market-centric (market cap)	Economy-centric (Graham & Dodd)
Premise	<ul style="list-style-type: none"> <li>Markets are efficient; prices reflect true valuations</li> <li>Departures from cap-weights are active bets; inherently a zero-sum game</li> </ul>	<ul style="list-style-type: none"> <li>Markets are constantly seeking fair value, but prices are rarely right</li> <li>Some companies can get over-priced; some underpriced</li> <li>The market itself makes active bets</li> </ul>
Beliefs	<ul style="list-style-type: none"> <li>It's difficult to beat a market cap index</li> </ul>	<ul style="list-style-type: none"> <li>Market cap indexes overweight overpriced stocks and underweight underpriced ones; the result is a return drag relative to its opportunity set</li> </ul>
Tactics	<ul style="list-style-type: none"> <li>Invest in companies proportional to market valuation</li> <li>Seek equity-risk premium<sup>5</sup>, not alpha<sup>6</sup></li> </ul>	<ul style="list-style-type: none"> <li>Create valuation models of companies and invest in those that offer the best rate of return</li> </ul>

## The Russell RAFI Index Series

In constructing the Russell RAFI Index Series, Frank Russell Company starts by developing a list of potential securities from a large, global investment universe. Research Affiliates then scores those companies based on three fundamental measures: adjusted sales, retained operating cash flow, and dividends plus buybacks. The metrics are widely accepted and consistently derived; they are not intended to be predictive of future size or value; and are uncorrelated with stock prices. The data is easily accessible and broadly available across countries. Research Affiliates then equally weights the three factors to produce an aggregate score for each company. From this data, Frank Russell Company creates multiple Fundamental sub-indexes along such dimensions as geography, size and state of market development. The Russell RAFI Indexes are recalculated annually. The subsequent changes to the indexes are then implemented on a quarterly basis.

Fundamental Index strategies weight each company's economic footprint using a company's **fundamental measures**.\*\*



\*\*Fundamental measures listed are specific to Russell RAFI Index® Series.

## Russell RAFI Index Ranking Factors

	Adjusted Sales		Retained Operating Cash Flow		Dividends Plus Buybacks		Fundamental Weight
	Weight	Rank	Weight	Rank	Weight	Rank	
Company A	5.4%	1	2.6%	2	7.2%	1	5.1%
Company B	3.5%	2	2.1%	4	1.9%	7	2.5%
Company C	1.9%	3	1.7%	9	1.8%	8	1.8%
Company D	0.9%	16	0.5%	35	3.6%	2	1.7%
Company E	0.3%	70	2.9%	1	1.7%	9	1.6%

Source: Research Affiliates LLC. Actual company names have been concealed. For illustrative purposes only.

## Implementing the Strategy

Schwab Fundamental Index mutual funds and ETFs are designed to serve either as standalone core investments within a portfolio or as complements to existing equity index holdings and/or active strategies. They are transparent, offer broad diversification and have competitive expenses.

Since market cap indexes are the broadly accepted measure of the overall market, the addition of incremental holdings of Schwab Fundamental Index mutual funds and ETFs may help improve portfolio diversification.

### Why Schwab Fundamental Index Mutual Funds and ETFs

- When used in **combination** with traditional market cap index and actively managed strategies, Fundamental Index offers the potential for more attractive risk-adjusted returns over time
- Uses **multiple fundamental measures** of company size which may provide greater investment opportunity than single-metric methodologies, such as those that focus only on dividends or earnings
- Broad offering of 12 ETFs and mutual funds across **various asset classes**
- Preserves many of the **benefits of index investing**: lower expenses, lower turnover, liquidity, full market participation, broad diversification across sectors and a high level of investment capacity as compared to many actively managed products

## The Lineup

Schwab Fundamental Index ETFs	Ticker	Expense Ratio
Schwab Fundamental U.S. Broad Market Index ETF	FNDB	0.25%
Schwab Fundamental U.S. Large Company Index ETF	FNDX	0.25%
Schwab Fundamental U.S. Small Company Index ETF	FNDA	0.25%
Schwab Fundamental International Large Company Index ETF	FNDF	0.25%
Schwab Fundamental International Small Company Index ETF	FNDC	0.39%
Schwab Fundamental Emerging Markets Large Company Index ETF	FNDE	0.39%
Schwab Fundamental Index Mutual Funds	Ticker	Expense Ratio
Schwab Fundamental US Large Company Index Fund	SFLNX	0.25%
Schwab Fundamental US Small Company Index Fund	SFSNX	0.25%
Schwab Fundamental International Large Company Index Fund	SFNNX	0.25%
Schwab Fundamental International Small Company Index Fund	SFILX	0.39%
Schwab Fundamental Emerging Markets Large Company Index Fund	SFENX	0.39%
Schwab Fundamental Global Real Estate Index Fund	SFREX	0.39%

## For more information

**Visit:** [www.schwabfunds.com](http://www.schwabfunds.com)

**Call:** 1-877-824-5615

\* Schwab is a registered trademark of Charles Schwab & Co., Inc. Fundamental Index is a registered trademark of Research Affiliates LLC.

<sup>1</sup> As of 12/31/17; based on estimates. Includes asset managed or subadvised by Research Affiliates or licenses using RAFI, Enhanced RAFI<sup>®</sup> or GTAA strategies.

<sup>2</sup> Data as of December 31, 2017, as reported on April 2, 2018 by eVestment for institutional assets, Morningstar for retail mutual funds, insurance products, and ETFs, and additional passive assets directly collected by FTSE Russell. AUM data includes blended benchmarks and excludes futures and options. Passive assets directly collected by FTSE Russell have been removed from third party sources to prevent double counting. No assurances are given by FTSE Russell as to the accuracy of the data.

<sup>3</sup> As of 12/31/17, Charles Schwab Investment Management managed approximately \$345.5 billion on a discretionary basis and approximately \$15.2 billion on a non-discretionary basis. Source Charles Schwab Investment Management, Inc.

Rankings based on assets under management from iMoneyNet and Strategic Insight as of December 31, 2017.

<sup>4</sup> In their 1934 book, *Security Analysis*, Benjamin Graham and David Dodd laid the intellectual foundation for what became known as "value investing," criticizing investment analysts for their myopic focus on earnings and identifying alternate metrics for valuing stocks.

<sup>5</sup> The excess return that an individual stock or the overall stock market provides over a risk-free rate. This excess return compensates investors for taking on the relatively higher risk of the equity market.

<sup>6</sup> The abnormal rate of return on a security or portfolio in excess of what would be predicted by an equilibrium model.

**Investors should consider carefully information contained in the prospectus, or if available, the summary prospectus, including investment objectives, risks, charges and expenses. You can request a prospectus at [www.schwabfunds.com](http://www.schwabfunds.com) or by calling 1-877-824-5615. Please read the prospectus carefully before investing.**

**There can be no assurance that the Fundamental Index methodologies will achieve their desired outcomes. Each investing strategy brings with it its own set of unique risks and benefits. Past performance does not guarantee future results.**

The Schwab Fundamental Index Funds and ETFs are not in any way sponsored, endorsed, sold or promoted by Frank Russell Company (Russell), by the London Stock Exchange Group companies (LSEG), or by Research Affiliates LLC (RA) (collectively the Licensor Parties), and none of the Licensor Parties make any warranty or representation whatsoever, expressly or impliedly, either as to the results to be obtained from the use of the Russell RAFI Index Series (the Indexes) or otherwise. The Indexes are compiled and calculated by Russell in conjunction with RA. None of the Licensor Parties shall be liable (whether in negligence or otherwise) to any person for any error in the Indexes and none of the Licensor Parties shall be under any obligation to advise any person of any error therein. "Russell<sup>®</sup>" is a trademark of Russell. The trade names "Research Affiliates<sup>®</sup>", "Fundamental Index<sup>®</sup>" and "RAFI<sup>®</sup>" are registered trademarks of RA. Charles Schwab Investment Management, Inc. has obtained full license from Russell to use the Indexes. For full disclaimer please see the funds' statements of additional information.

Investment returns will fluctuate and are subject to market volatility, so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost. Unlike mutual funds, shares of ETFs are not individually redeemable directly with the ETF. Shares of ETFs are bought and sold at market price, which may be higher or lower than the net asset value (NAV).

Diversification does not eliminate the risks of investment losses.

Charles Schwab Investment Management, Inc. (CSIM) is the investment advisor for Schwab Funds and Schwab ETFs. Schwab Funds are distributed by Charles Schwab & Co., Inc. (Schwab), Member SIPC. Schwab ETFs are distributed by SEI Investments Distribution Co. (SIDCO). CSIM and Schwab, are separate but affiliated companies and subsidiaries of The Charles Schwab Corporation, and are not affiliated with SIDCO.