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# **Charles Schwab Investment Advisory, Inc. Disclosure Brochure**

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This brochure provides information about the qualifications and business practices of Charles Schwab Investment Advisory, Inc. ("CSIA"). If you have any questions about the contents of this brochure, please contact us at the phone number above. The information in this brochure has not been approved or verified by the United States Securities and Exchange Commission or by any state securities authority. CSIA's description of itself in this brochure as a registered investment advisor does not imply a certain level of skill or training on the part of CSIA or its representatives.

Additional information about CSIA is also available on the SEC's website at [www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov).

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## Advisory Business

Charles Schwab Investment Advisory, Inc. ("CSIA") is a wholly owned subsidiary of The Charles Schwab Corporation ("CSCorp"), a Delaware corporation that is publicly traded and listed on the NASDAQ (symbol: SCHW). CSIA has been registered as an investment advisor since November 5, 2009.

CSIA provides portfolio management services for the Schwab Managed Portfolios™ wrap fee program ("SMP" or the "Program") that is sponsored by its affiliate Charles Schwab & Co., Inc. ("Schwab"). The Program consists of various investment strategies, selected by clients, and consisting of either mutual funds ("SMP-MF") or exchange-traded funds, also known as ETFs ("SMP-ETF"), bought and sold for clients on a discretionary basis. The investment strategies employed in each Program account are also governed by the client's agreement with Schwab and by any reasonable restrictions a client places on the management of the account.

As of December 31, 2011, CSIA managed \$13,631,166,992 in assets in the Program. CSIA does not manage any assets on a non-discretionary basis. More information about the Program is available in the *Schwab Managed Portfolios Disclosure Brochure* provided to Program clients.

## Fees and Compensation

Pursuant to an agreement between CSIA and Schwab, Schwab pays all costs and expenses incurred by CSIA in connection with the Program and other services provided by CSIA to Schwab, plus an additional amount up to 10% of all such costs and expenses. Schwab also provides CSIA with human resources, legal, compliance, and other administrative and technological support services. The portion of the costs and expenses paid by Schwab for the work done by CSIA in connection with the Program is expected to range from \$2.5 to \$3.0 million per year and may be adjusted by Schwab and CSIA from time to time as more or fewer resources are required to support the Program. CSIA does not enter into agreements directly with Program clients and accordingly does not receive direct compensation from or negotiate fees with them.

## Performance-Based Fees and Side-by-Side Management

CSIA does not receive performance-based fees in connection with the Program.

## Types of Clients

Clients of the Program may include individuals, trusts, charitable organizations, investment clubs, corporations and other business organizations. Certain accounts subject to the Employee Retirement Income Security Act of 1974 ("ERISA"), as well as charitable remainder trusts, are not eligible for this Program.

The minimum investment required to open an account in SMP-MF and SMP-ETF is \$25,000 for all account types. If the market value of your account falls below these specified minimums due to your withdrawal of assets from the account, Schwab may require you to deposit additional money or securities to bring the account up to the required minimum, and CSIA reserves the right to discontinue management of the account.

## Methods of Analysis, Investment Strategies and Risk of Loss

Using asset allocations and mutual fund and ETF selection parameters designed by Schwab, CSIA creates diversified portfolios of mutual funds or ETFs combined with a cash investment in a single account. Each portfolio is designed to be consistent with a certain combination of investment objectives and risk tolerance. Certain portfolios are intended for taxable accounts and others for tax-deferred accounts. Certain portfolios are intended for clients who are looking for some level of income generation. Each SMP-MF portfolio consists of approximately 10–30 mutual funds. Each SMP-ETF portfolio consists of approximately 7–25 ETFs.

CSIA may use written reports prepared by recognized analysts who are specialists in the industry and may use computer-based models to assist in portfolio management. CSIA may also use include statistical and other information published by third-party data providers, industry and government, meetings of professionals within the industry and research of investment trends.

Investments in securities, including mutual funds and ETFs and the securities that they in turn invest in involve various risks, including those summarized below. In addition, each mutual fund and ETF has its own investment style, which may involve risks different from those described below.

## Schwab ETFs™ Risk

The ETFs managed by CSIA's affiliate Charles Schwab Investment Management, Inc. ("CSIM") and included in the Program were launched beginning in November 2009, and some of them even more recently. Accordingly, there is limited data available for CSIA to rely upon when assessing investment risk associated with these ETFs. As a result, one or more of the following may occur: (1) poor liquidity in or limited availability of the ETFs, or (2) lack of market depth causing the ETFs to trade at excessive premiums or discounts.

## Equities Risk

The prices of equity securities, and thus the value of funds that invest in them, rise and fall daily. These price movements may result from factors affecting individual companies, industries or the securities market as a whole. Individual companies may report poor results or be negatively affected by industry and/or economic trends and developments. The prices of securities issued by such companies may suffer a decline in response. In addition, the equity market tends to move in cycles, which may cause stock prices to fall over short or extended periods of time.

## Affiliated Mutual Funds Risk

The value of mutual funds can be impacted by the movement of large positions in and out of a particular fund. Because of the limited universe of mutual funds available, Program clients may also collectively account for a large portion of the assets in certain Schwab-affiliated mutual funds. A decision by CSIA to buy or sell some or all of a particular Schwab-affiliated fund where Program clients hold a significant portion of that fund may negatively impact the value of that fund.

## Schwab Equity Ratings® Risk

Some of the Schwab affiliate mutual funds in SMP-MF accounts use Schwab Equity Ratings as a principal means of selecting individual equities. Schwab Equity Ratings is Schwab's proprietary stock evaluation system and evaluates securities on the basis of four primary factors: fundamentals, valuation, momentum and risk.

Certain Schwab affiliate equity mutual funds have limitations arising from their use of the Schwab Equity Ratings. Given that systematic stock evaluation approaches cannot capture all the dynamics that affect individual stock returns, Schwab Equity Ratings may not capture more subjective, qualitative influences on return and risk such as management changes and pending lawsuits. Furthermore, the ratings may not reflect the possible impact of late-breaking news. The quality of the ratings depends on the accuracy of financial data provided by third parties, including the companies rated through the approach.

## Large- and Mid-Cap Risk

Mutual funds and ETFs that focus on large- and/or mid-cap segments of the stock market bear the risk that these types of stocks tend to go in and out of favor based on market and economic conditions. However, stocks of mid-cap companies tend to be more volatile than those of large-cap companies because mid-cap companies tend to be more susceptible to adverse business or economic events than larger, more established companies. During a period when large- and mid-cap U.S. stocks fall behind other types of investments—bonds or small-cap stocks, for instance—the performance of investment strategies focused on large- and/or mid-cap stocks will lag the performance of these other investments.

### **Small-Cap and International Risk**

Historically, small-cap and international stocks have been riskier than large- and mid-cap stocks. Stock prices of smaller companies may be based in substantial part on future expectations rather than current achievements and may move sharply, especially during market upturns and downturns. Small-cap companies themselves may be more vulnerable to adverse business or economic events than larger, more established companies. International investments involve additional risks, including differences in financial accounting standards, currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets. International companies may be more vulnerable to geopolitical factors than U.S. companies. During a period when small-cap and/or international stocks fall behind other types of investments—bonds or large-cap stocks, for instance—the performance of investment strategies focused on small-cap or international stocks will lag the performance of these other investments.

### **Commodities Risk**

Commodities involve unique risks that may be distinct from those that affect stocks and bonds, including worldwide supply and demand factors, weather conditions, currency movements, and international government policies regarding commodity reserves and choice of currency for commodity pricing.

### **Mutual Fund Management Risk**

Mutual fund managers may base investment decisions for funds using historical information. There is no guarantee that a strategy based on historical information will produce the desired results in the future. In addition, if market dynamics change, the effectiveness of that kind of strategy may be limited. Either of these risks may cause the investment strategy of a particular fund to underperform its benchmark or similar funds.

### **Fixed Income Risks**

#### **General**

Bond markets rise and fall daily, and fixed income investments are subject to various risks. As with any investment whose performance is tied to bond markets, the value of a fixed income mutual fund or ETF will fluctuate, which means that you could lose money.

#### **Interest Rate Risk**

When interest rates rise, bond prices usually fall, and with them the value of a mutual fund or ETF holding the bonds. A decline in interest rates generally raises bond prices, and with them potentially the value of a bond fund, but could also hurt the performance of a mutual fund or ETF by lowering its yield.

#### **State and Regional Factors**

To the extent that a mutual fund or ETF is invested in securities from a given state or geographic region, its value and performance could be affected by local, state and regional factors, including erosion of the tax base and changes in the economic climate. National governmental actions, such as the elimination of tax-exempt status, also could affect performance. In addition, a mutual fund or ETF may be more sensitive to adverse economic, business or political developments if a substantial portion of it is invested in municipal securities that are financing similar projects.

#### **Credit Risk**

A decline in the credit quality of a fixed income investment could cause the value of a fixed income mutual fund or ETF to fall. The mutual fund or ETF could lose value if the issuer or guarantor of a portfolio investment fails to make timely principal or interest payments or otherwise honor its obligations. The emphasis of a fixed income strategy on quality and preservation of capital also could cause a mutual fund or ETF to underperform certain other types of bond investments, particularly those that take greater maturity and credit risks.

### **Disciplinary Information**

CSIA has no legal or disciplinary events that it is required to report.

### **Other Financial Industry Activities and Affiliations**

In its role as sponsor of the Program, CSIA's affiliate, Schwab, sets the target asset allocations for each Program portfolio and creates the parameters that determine mutual fund and ETF eligibility for the Program. Although CSIA does not favor any Schwab affiliate mutual fund or ETF, or disfavor any third-party mutual fund or ETF, in its selection of investments or allocation among investments for Program portfolios, the parameters and eligibility criteria created by Schwab are designed, in part, to favor certain Schwab affiliate mutual funds and ETFs and to disfavor certain third-party mutual funds and ETFs. This results in higher overall compensation to Schwab and CSIM, though not to CSIA.

### **Code of Ethics, Participation or Interest in Client Transactions and Personal Trading**

#### **Code of Ethics**

CSIA has a code of ethics adopted pursuant to SEC Rule 204A-1 under the Investment Advisers Act of 1940 (the "Code"). The Code reflects the fiduciary principles that govern the conduct of CSIA and its employees when acting as investment advisor. The Code requires that CSIA's covered employees comply with applicable federal securities laws and report violations of the Code. Covered employees who are deemed "access persons" by virtue of providing investment advice or having access to certain related information must report their personal transactions and holdings in, and obtain clearance before buying, ETFs used in Program portfolios. The Code prohibits access persons from disclosing Program transactions or any other non-public information to anyone except certain designated employees of CSIA and Schwab. The Code also prohibits access persons from using the information for personal profit or the profit of others. Access persons may not engage in deceptive conduct in connection with the purchase or sale of securities for client accounts. The Code is subject to change as necessary to remain current with regulatory requirements and internal business policies and procedures.

You can get a copy of the Code by asking your Schwab representative or calling Schwab at (877) 316-6400.

#### **Participation or Interest in Client Transactions**

CSIA's affiliate, Schwab, sponsors the Program and receives compensation from mutual funds held in Program accounts. This compensation is in addition to the explicit asset-based fee that Program clients pay to Schwab. CSIM, another CSIA affiliate, earns compensation from affiliated mutual funds and ETFs held in the Program. Program clients receive detailed disclosures about Schwab's and CSIM's Program-related compensation in the *Schwab Managed Portfolios Disclosure Brochure*.

#### **Personal Trading**

As described above, the Code is designed to detect and prevent conflicts of interest and unlawful practices that may arise in connection with an access person's personal securities transactions. Accordingly, the Code requires access persons to obtain prior approval before purchasing ETFs used in Program portfolios.

### **Brokerage Practices**

Clients with accounts under the Program agree in writing with Schwab that all brokerage transactions for equity securities will be executed by Schwab, which may not always obtain as favorable a price as another broker or dealer. Schwab receives a portion of the fee paid by Program clients as disclosed in Schwab's Disclosure Brochure.

CSIA may use a trade rotation process among client accounts. This trade rotation process is designed for trades that need to be executed over more than one trading day. CSIA's trade rotation process is designed to treat clients equitably and, over time, to avoid unfairly advantaging one client account over another client account. Client accounts traded on different days may receive different prices. Each client account traded on a particular trading day will receive the same trading price.

CSIA may aggregate securities sales or purchases among two or more clients. CSIA will not aggregate trades unless it believes that aggregation is consistent with its duty to seek best execution for each affected client and consistent with the terms of the client's investment advisory agreement with Schwab.

In managing the Program, CSIA aggregates trades within a single model and, where possible, like trades across models. CSIA excludes from aggregation those SMP client accounts that have relevant investment restrictions or client activity (e.g., withdrawals pending) and, therefore, should not participate in the aggregated trade.

CSIA reserves the right not to aggregate transactions when to do so would be: (i) unfair under the circumstances; (ii) impractical; or (iii) otherwise inappropriate. Once a trade is executed, the trade is allocated back pro-rata to each account that participated in the order. CSIA's procedure is designed to ensure that trade allocations are timely, that no set of trade allocations unfairly advantages one client over another and that over time, client accounts are treated equitably, even though a specific trade may have the effect of benefiting one account over another when viewed in isolation.

CSIA will review their aggregation procedures at least annually to ensure that they are adequate to prevent any client from being systematically disadvantaged as a result of the aggregated transactions, and, if CSIA discovers that the procedures are not being followed or that the procedures do not have the intended results, it will take whatever corrective measures are necessary, including revising the procedures.

### Review of Accounts

CSIA's portfolio managers review, at least quarterly, the performance of SMP against its applicable benchmarks. Schwab contacts clients participating in the Program at least annually to determine whether there have been any changes in their financial situation or investment objectives and whether clients wish to impose any reasonable restrictions on the management of their accounts or reasonably modify existing restrictions. Schwab communicates the information obtained from clients to CSIA as necessary for the management of the account.

### Client Referrals and Other Compensation

As explained in "Fees and Compensation" beginning on page 3, Schwab compensates CSIA for providing portfolio management services in the Program.

### Custody

Schwab has custody of client assets in Program accounts and, at least quarterly, sends Program clients account statements detailing account positions and activities during the preceding period. Account statements include a summary of all transactions made on behalf of the account, all deposits and withdrawals made to or from the account, all fees and expenses charged to the account, and the value of the account at the beginning and end of the period. You should review these statements carefully.

### Investment Discretion

CSIA has discretionary authority to manage accounts enrolled in the Program, subject to the reasonable restrictions imposed by Program clients. Clients invested in SMP-MF may restrict up to three mutual funds in each Program account. Clients invested in SMP-ETF may restrict up to three ETFs in each Program account. Mutual funds and ETFs designated for restriction by clients will be replaced with alternatives selected by CSIA. Clients who enrolled in SMP-MF prior to July 23, 2010, may also restrict third-party mutual fund families, but not mutual fund families affiliated with CSIA.

### Voting Client Securities

CSIA has adopted written proxy voting policies and procedures (the "Procedures"). For proxies voted by CSIA on behalf of each client who delegates voting authority to CSIA ("Delegating Clients"), procedures may be changed as necessary to comply with regulatory requirements and internal policies and procedures, and are designed to maximize the economic benefit to Delegating Clients. CSIA has retained a third-party vendor to manage this process and reviews the vendor's own written policies no less than annually to ensure consistency with the Procedures and CSIA's fiduciary duty to Delegating Clients.

For proxy issues deemed by CSIA portfolio management staff to raise significant concerns, CSIA reviews the analysis and recommendation of the vendor. Examples of factors that could cause a matter to raise significant concerns include, but are not limited to: issues whose outcome have the potential to materially affect a company's industry, or regional or national economy, and matters which involve broad public policy developments which may similarly materially affect the environment in which the company operates. After evaluating all such recommendations, CSIA decides how to vote the shares and will instruct the vendor to vote consistent with its decision.

To address any potential conflicts of interest, CSIA votes proxies of affiliated mutual funds and ETFs in the same proportion as the vote of all other shareholders of the mutual fund or ETF (i.e., "echo vote"), unless otherwise required by law. When required by law, CSIA also "echo votes" proxies of unaffiliated mutual funds and ETFs. When not required to "echo vote," CSIA delegates to the vendor responsibility for voting proxies of an unaffiliated mutual fund in accordance with the vendor's procedures.

Program clients can get a copy of the Procedures and information about how CSIA has voted their securities in a particular proxy vote by asking their Schwab representative or calling CSIA at (415) 667-1910.

### Financial Information

CSIA does not require or solicit prepayment of Program fees and is therefore not required to include a balance sheet for its most recent fiscal year. CSIA is not the subject of any financial condition that is reasonably likely to impair its ability to meet its contractual obligations to its clients. CSIA is not the subject of any bankruptcy petition, nor has it been the subject of any bankruptcy petition at any time during the past 10 years.