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# Charles Schwab Investment Advisory, Inc. Schwab Intelligent Portfolios® Disclosure Brochure

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This brochure provides information about the qualifications and business practices of Charles Schwab Investment Advisory, Inc. (CSIA or "Adviser") as an adviser for the above mentioned strategies. 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 adviser with the SEC 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 New York Stock Exchange. CSIA is an affiliate of Charles Schwab & Co., Inc. ("Schwab"). In early 2018, Windhaven Investment Management, Inc. and ThomasPartners, Inc. merged into, and became divisions of, CSIA. In anticipation of this merger, on March 30, 2018, CSIA incorporated the existing ThomasPartners® and Windhaven® portfolio management teams to manage the respective assets and assume fiduciary responsibility for the ThomasPartners and Windhaven Strategies formerly managed by these affiliated investment advisers. CSIA has been registered as an investment adviser since November 5, 2009. Windhaven Investment Management, Inc. was founded in 2010 when CSCorp purchased the assets and intellectual property of Windward Investment Management, Inc., which had been registered as an investment adviser since April 2000 (and registered as Windward Capital Inc. since October 1994). ThomasPartners, Inc. was purchased by CSCorp in December 2012. Prior to this acquisition, ThomasPartners, Inc. traces its roots back to July 1970 under other names, including Shorey-Huntington; during a change in control in 2004, the firm adopted the ThomasPartners name.

This brochure relates to the portfolio management services that CSIA provides for the Schwab Intelligent Portfolios® program ("SIP" or the "SIP Program"). CSIA also manages portfolios for several other strategies or programs, including: Schwab Managed Portfolios™ ("SMP"), Windhaven Strategies, and ThomasPartners Strategies (collectively, "Strategies" or "Programs").

The SIP Program offers clients a diversified portfolio composed of exchange-traded funds ("ETFs"), as well as an FDIC-insured cash allocation (the "Cash Allocation") that is based on the client's stated investment objectives and risk tolerance. The portfolio of ETFs includes up to 20 asset classes across stocks, fixed income, real estate, and commodities. The SIP Program is designed to monitor a client's portfolio daily and will also automatically rebalance as needed to keep a client's portfolio consistent with their selected risk profile unless such rebalancing may not be in the best interest of the client. The SIP Program is sponsored by CSIA's affiliate, Schwab, which sets investment policy and parameters and also provides trade execution, custody, administrative and related services for the SIP Program as described below.

The SIP Program is also used to provide discretionary portfolio management in Schwab Intelligent Portfolios Premium™ sponsored by Schwab. The SIP Premium Program combines the SIP Program as described above with additional features of financial planning and guidance from Schwab planning consultants ("Planning Consultants") and access to online financial planning tools. Unless otherwise indicated, descriptions of portfolio management through SIP apply to SIP Premium, as well. This brochure, combined with the Schwab Intelligent Portfolios® Solutions disclosure brochure, contains details about the SIP Program and SIP Premium Program, including a description of the automated component ("Algorithm") of the Program.

Schwab has chosen CSIA to provide portfolio management services to the SIP Program accounts on a discretionary basis consistent with investment policy and parameters developed by Schwab and with clients' chosen investment strategy, and to direct appropriate trades in clients' accounts. Schwab acts as the qualified custodian for SIP Program accounts and provides trade routing and/or execution and related services for SIP Program accounts. Some ETFs in the investment strategies are managed by Charles Schwab

Investment Management, Inc. ("CSIM"), which is also an affiliate of Schwab and CSIA.

Schwab offers the SIP Program online through an interactive website and mobile application (collectively, the "Website"). Clients use the Website and answer questions from an online questionnaire that help determine whether the SIP Program is appropriate for them. The Website also presents a suggested SIP portfolio based on the client information for client's review and approval. Prior to enrollment, clients are asked to carefully consider whether their participation in the SIP Program and whether their selected SIP portfolio are appropriate for their investment needs and goals. Once enrolled, SIP clients can update their investment profile or monitor their accounts' allocation, activity, and performance through a customized dashboard. Clients should periodically review their existing investment risk profile and update it when their goals, risk tolerance, or other aspects of their financial situation change.

Clients agree to accept electronic delivery of contracts, disclosure documents, prospectuses, statements, and other materials. More information about the SIP Program is available in the Schwab Intelligent Portfolios Solutions disclosure brochure provided to SIP Program clients.

The Website allows prospective clients to review information about the SIP Program, including general information on the types of ETFs included, as well as information about CSIA's approach to allocating client accounts. Clients may also monitor their portfolio's allocation and activity, monitor their account's performance, and use a goal tracking tool to monitor whether their account is on target to reach their savings or income goal. Clients may also initiate deposits and withdrawals from existing SIP Program accounts or open new SIP Program accounts. The investment strategies employed in each SIP Program account are governed by a client's agreement with Schwab.

Similar to SIP, SIP Premium Program clients may complete an online questionnaire which results in the recommendation of a diversified portfolio based on clients' stated investment profile and risk tolerance. Alternatively, SIP Premium clients may receive a recommended portfolio from the Schwab Planning Consultant based on a review of the clients' stated investment profile and risk tolerance for the applicable accounts. More information about the SIP Premium Program is available in the Schwab Intelligent Portfolios Solutions disclosure brochure provided to SIP Premium Program clients.

Clients may impose reasonable restrictions on the management of their account(s) subject to acceptance by CSIA. See the "Investment Discretion" section of this document for details on potential investment restrictions.

In addition, upon the request of its affiliate Charles Schwab Trust Company ("CSTC"), CSIA may offer access to some of its Strategies or Programs to CSTC in connection with the management of trust assets.

CSIA offers several types of separately managed account strategies and manages \$70,583,747,656 on a discretionary basis as of 12/31/2018. CSIA also manages \$5,224,382 on a non-discretionary basis as of 12/31/2018.

## Fees and Compensation

Pursuant to an agreement between CSIA and Schwab, Schwab pays all costs and expenses incurred by CSIA in connection with the SIP Program and other services provided by CSIA to Schwab, plus an additional amount based on a fixed percentage of 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 may be adjusted by Schwab and CSIA from time to time as more or fewer resources are required. The SIP Portfolio Management Team serves as a portfolio manager in the SIP Program offered by Schwab. More specific information about the managed account programs appears in Schwab's Disclosure Brochures for those programs, which are provided to program clients. CSIA does not enter into agreements directly with Schwab Managed Account Program clients and so does not receive direct compensation from or negotiate fees with them. Management fees are discounted for Schwab employees.

## **Additional Costs**

As further detailed in the Schwab Intelligent Portfolios Solutions disclosure brochure, clients are not charged an annual Program Fee; however, the SIP Program is not free of charge. Clients pay the operating expense ratio ("OER") of ETFs used in the portfolios, including Schwab ETFs™, which affects the performance of SIP Program accounts. Account performance is also affected by the Cash Allocation and the Sweep Program (defined below). Schwab and its affiliates earn compensation from certain ETFs used in the portfolios and from the Cash Allocation and Sweep Program described in the Schwab disclosure brochure provided to SIP Program clients. Schwab will waive all of its trading commissions on SIP accounts managed by CSIA. Please note that Schwab's waiver does not extend to any other non-Schwab broker fees, commissions, account fees, or expenses. Information relating to CSIA's brokerage practices is included in the "Brokerage Practices" section of this document.

ETFs held in SIP portfolios are subject to operating expenses and fees as set forth in the prospectuses of the funds. These fees and expenses are paid by the funds but ultimately are borne by clients as fund shareholders. CSIA may also provide access to certain ETFs, mutual funds, or classes of funds that a client might normally not be qualified to purchase. If an account leaves, these investments may be liquidated or exchanged for the share class corresponding to the size of the client's individual investment in the ETF or fund.

## **Compensation Earned by CSIA Affiliates**

Schwab and its affiliates may receive an investment management fee for managing an affiliated ETF or mutual fund, or other forms of compensation in connection with the operation and/or sale of shares of affiliated or unaffiliated ETFs or mutual funds, to the extent permitted by applicable law. The fee arrangements are available in the applicable ETF's or fund's prospectus.

As detailed below in "Methods of Analysis, Investment Strategies, and Risk of Loss," Charles Schwab Bank ("Schwab Bank") earns income on cash balances participating in the Schwab Intelligent Portfolios Sweep Program ("Sweep Program"), which presents a conflict of interest. Additional details regarding the Sweep Program can be found in the Schwab Intelligent Portfolios Sweep Program Disclosure Statement and the Schwab Intelligent Portfolios Solutions disclosure brochure.

These conflicts of interest regarding affiliate compensation are mitigated by the fact that, subject to the Parameters defined below, the CSIA investment decision-making process is independent of and separate from Schwab, Schwab Bank, and CSIM.

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

CSIA does not receive or charge any performance-based fees.

## **Types of Clients**

Pursuant to the enrollment criteria established by Schwab, clients of the SIP Program primarily include individuals, living trusts, and individual retirement accounts ("IRAs"). Organizations, such as corporations, limited liability companies and limited partnerships, may also participate in the SIP Program as a client. These types of clients may not have the same client experience as individuals or trust clients. Government entities and accounts that are subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), are not eligible for the SIP Program.

To be initially invested in an investment strategy, clients must meet all requirements of Schwab to open an account in the SIP Program and fund it with the applicable minimums. SIP clients must establish their account with a minimum of \$5,000 in each account. There is also a minimum balance requirement to employ a tax-loss harvesting strategy, and a minimum balance requirement to maintain a tax-loss harvesting strategy.

Schwab may terminate a client from the SIP Program for failing to fund or maintain their account with the required minimum, for failure to maintain a valid email address, or for any other reason, at Schwab's sole discretion. Upon unenrollment from the SIP Program, the client's enrollment in the Schwab Intelligent Portfolios Sweep Program will terminate and the account will no longer be managed.

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

Pursuant to written investment policy and parameters provided by Schwab (the "Parameters"), CSIA has created a number of investment strategies for the SIP Program that consist of diversified portfolios of ETFs combined with the Cash Allocation in a single account. The Cash Allocation is an allocation to the Sweep Program. Each investment strategy is designed to be consistent with a certain combination of investment return objectives and risk tolerances. Certain investment strategies are intended for taxable accounts and others for tax-deferred accounts. Certain investment strategies are intended for clients who are looking for a level of income generation. Upon request from Schwab, CSIA may add, remove, or change investment strategies used in the SIP Program.

Schwab sets the Parameters for the Cash Allocation for each investment strategy. These Parameters are set based on a disciplined portfolio construction methodology designed to balance performance with risk management appropriate for a client's goal, investing time frame, and personal risk tolerance, just as with other Schwab managed products. Schwab Bank earns income on the Cash Allocation for each SIP investment strategy. The higher the Cash Allocation and the lower the interest rate paid, the more Schwab Bank earns, thereby creating a conflict of interest for Schwab and for CSIA. The Cash Allocation can affect both the risk profile and performance of a portfolio. To mitigate any conflict, Schwab instructs CSIA to construct the SIP Program strategies consistent with the Parameters. More information about the Selection of ETFs, Cash Allocation, Sweep Program, and Conflicts of Interest and How They Are Addressed can be found in the Schwab disclosure brochure, as well as the Schwab Intelligent Portfolios Sweep Program Disclosure Statement provided to SIP Program clients.

The written Parameters established by Schwab place limitations on the universe of ETFs that CSIA may select for the SIP Program.

Schwab has ETF selection parameters designed to support its philosophy of low-cost and index-based investing. In support of providing broadly diversified and risk-adjusted portfolios, eligible ETFs must represent well a particular asset class in the portfolio, meet sufficient liquidity standards and be among the lowest cost (in terms of the OER) in their asset class or category. When it comes to replacing an ETF, CSIA also considers the potential impact to clients such as additional trading costs or other costs. Eligible ETFs include Schwab ETFs, which are managed by CSIM, which is an affiliate of Schwab and CSIA. Schwab ETFs pay fees to CSIM that are described in "Participation or Interest in Client Transactions" below. Schwab has instructed CSIA to select or retain Schwab ETFs in the portfolios as long as CSIA determines that they satisfy the above factors.

CSIA will generally select both a primary and secondary ETF for each asset class in consideration of, among other things, tax-loss harvesting and requested investment restrictions. In limited circumstances, as determined by CSIA, only one ETF may be used in certain asset classes. In such cases, the tax-loss harvesting feature would not be available for execution in the affected asset class(es). To be eligible for consideration, ETFs designated as the primary ETF in an asset class must have a share price less than a cap that is necessary to enable trading in smaller balance accounts.

CSIA receives a broad range of research from a wide variety of sources that include Schwab-affiliated entities, other brokers, and independent research providers, including issuers and trading partners. 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 statistical and other information published by third-party data providers, industry, and government; information gathered at meetings of professionals within the industry; and its own research of investment trends.

CSIA creates diversified portfolios that primarily consist of ETFs in a single account for several Programs or portfolios/Strategies, such as Schwab Managed Portfolios – ETFs, Windhaven Strategies, and Schwab Intelligent Portfolios. In addition, CSIA also provides portfolio management for ThomasPartners Strategies, which invests primarily in dividend-paying stocks, and fixed income investments. Each Program or portfolio maintains a cash component which may be invested in the Sweep Program, a money market fund, an ETF, or similar cash instruments. The guidelines for asset allocations for each differ from the others. There may be times when clients in different Programs or portfolios/Strategies are investing in the same ETF; however, each Program or portfolio/Strategy has a separate portfolio management team making investment decisions.

## **General Risks**

### **Risk of Loss**

There are inherent risks to investing in Schwab Intelligent Portfolios, including, but not limited to:

### **Management Risks**

CSIA applies its investment techniques and risk analyses in making investment decisions or recommendations for its clients, but there can be no guarantee that they will produce the desired results. In addition, there is no guarantee that a strategy based on historical information will produce the desired results in the future,

and if market dynamics change, the effectiveness of the strategy may be limited. Each strategy runs the risk that investment techniques will fail to produce the desired results. There also can be no assurance that all of the key personnel will continue to be associated with the firm for any length of time.

### **Investment Risks**

Investments in securities, including ETFs and mutual funds and the securities that they in turn invest in, involve various risks, including those summarized below. In addition, each ETF and mutual fund has its own investment style, which may involve risks different from those described below. Clients and prospective clients should be aware that investing in securities involves risk of loss that clients should be prepared to bear.

### **Model Risks**

The Schwab Intelligent Portfolios may use quantitative analyses and/or models. Any imperfections, limitations, or inaccuracies in its analyses and/or models could affect its ability to implement strategies. By necessity, these tools make simplifying assumptions that may limit their effectiveness. Models that appear to explain prior market data can fail to predict future market events. Further, the data used in models may be inaccurate, and/or it may not include the most current information available.

### **Algorithm Risks**

There are limitations inherent in the use of an Algorithm to manage Program accounts; for instance, the Algorithm is designed to manage Program accounts according to the asset allocation selected for that account and is not designed to actively manage asset allocations based on short-term market fluctuations. The Algorithm is also not designed to consider certain factors such as short-term asset class volatility or individual tax circumstances such as capital gains taxes; rather, its functions consist of proposing a portfolio based on a client's answers to the online questionnaire, identifying opportunities for tax-loss harvesting and rebalancing, and initiating buy/sell orders accordingly. Investment advisory personnel of CSIA oversee the Algorithm but do not personally or directly monitor each individual Program account.

There is also a risk that the Algorithm and related software used in the Program for strategy selection, tax-loss harvesting and rebalancing, and related functions may not perform within intended parameters, which may result in a recommendation of a portfolio that may be more aggressive or conservative than necessary, and trigger or fail to initiate rebalancing and/or tax-loss harvesting trading.

### **ETF General Risks**

ETFs in which the strategy may invest involve certain inherent risks generally associated with investments in a portfolio of underlying securities, including the risk that the general level of underlying security prices may decline, thereby adversely affecting the value of each unit of the ETF. Moreover, an ETF may not fully replicate the performance of its benchmark index because of the temporary unavailability of certain securities in the secondary market or discrepancies between the ETF and the benchmark index with respect to the weighting of securities or the number of securities held. Investing in ETFs carries the risk of capital loss. ETFs are not guaranteed or insured by the FDIC or any other government agency. You can lose money investing in ETFs.

ETFs in which the strategies invest have their own fees and expenses as set forth in the ETF prospectuses. These fees and expenses lower investment returns. Although ETFs themselves are generally classified as equities, the underlying holdings of ETFs can

include a variety of asset classes, including but not limited to equities, bonds, foreign currencies, physical commodities, and derivatives. A full disclosure of the specific risks of ETFs is located in the respective prospectus of each fund.

ETFs may have exposure to derivative instruments, such as futures contracts, forward contracts, options, and swaps. There is a risk that a derivative may not perform as expected. The main risk with derivatives is that some types can amplify a gain or loss, potentially earning or losing substantially more money than the actual cost of the derivative, or that the counterparty may fail to honor its contract terms, causing a loss for the ETF. Use of these instruments may also involve certain costs and risks, such as liquidity risk, interest rate risk, market risk, credit risk, management risk, and the risk that an ETF could not close out a position when it would be most advantageous to do so.

### **Market/Systemic Risks**

Equity and fixed income and other global capital markets rise and fall daily. The performance of client investments is, to varying degrees, tied to these markets. When markets fall, the value of a client's investments will fluctuate, which means a client could lose money.

### **Asset Allocation/Strategy/Diversification Risks**

The asset allocation decisions can result in more portfolio concentration in a certain asset class or classes, which could reduce overall return if the concentrated assets underperform expectations. The more aggressive the investment strategy selected, the more likely the portfolio will contain larger weights in riskier asset classes, such as equities. The asset classes in which an investment strategy in the SIP Program seeks investment exposure can perform differently from each other at any given time (as well as over the long term), so the investment strategy will be affected by its allocation among the various asset classes. Depending on market conditions, there may be times where diversified portfolios perform worse than less diversified portfolios.

### **Geographic Concentration Risk**

Portfolios concentrated in any one geographic region can be more susceptible to that region's political and economic risk. For example, a portfolio that is concentrated in the United States will be more susceptible to the United States' political and economic risk, as compared to a more globally diversified portfolio.

### **Trading/Liquidity Risks**

A particular ETF may be difficult to purchase or sell or may become difficult to sell after being purchased for a client account. CSIA may be unable to sell ETFs on behalf of a client at an advantageous time and/or price due to then-existing trading market conditions.

### **Large Investment Risks**

Clients may collectively account for a large portion of the assets in certain ETFs. A decision by CSIA to buy or sell some or all of a particular ETF or mutual fund where clients hold a significant portion of such may negatively impact the value of that security.

### **Counterparty Risks**

There may be a risk of an executing broker failing to deliver securities, especially due to the large volume of step-out transactions for the Windhaven® and ThomasPartners® Strategies. This may result in a loss to the client. CSIA, working with Schwab, will attempt to mitigate trading counterparty risk through its broker selection program included in "Brokerage Practices."

ETFs may have some "product" or "structural" risk associated with underlying derivatives, as they will sometimes provide market exposure through indirect means, like futures, options, and forwards contracts.

### **Custodian Risks**

Schwab is a Securities Investor Protection Corporation ("SIPC") member brokerage firm and maintains SIPC protection. SIPC offers protection of up to \$500,000, including a \$250,000 limit for cash, if a member brokerage firm fails. SIPC covers most securities, such as stocks, bonds, ETFs, and mutual funds, but does not protect against market loss.

### **Tax Risks**

The Program is not designed to address specific tax objectives. There is no guarantee that the tax-loss harvesting strategy in the Program will reduce, defer or eliminate the tax liability generated by a client's investment portfolio in any given tax year. Also, gains and losses associated with some commodities may be taxed differently than standard short-term and long-term capital gains and losses. Clients should consult a professional tax advisor for help with their unique situations.

## **Underlying Securities Risks**

### **Equity-Related Risks**

#### **General Risks**

The prices of equity securities, and thus the value of ETFs or mutual funds that invest in them, will rise and fall. 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.

#### **Large- and Mid-Cap Risks**

Large- and/or mid-cap U.S. stocks, along with mutual funds and ETFs that focus on large- and/or mid-cap segments of the U.S. stock market, bear the risk that they 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/or mid-cap U.S. stocks fall behind other types of investments—bonds or small-cap stocks, for instance—the performance of the portion of the investment strategies invested in large- and/or mid-cap stocks may lag the performance of these other investments.

#### **Small-Cap and International Risks**

Historically, small-cap and international stocks have been riskier than large- and mid-cap U.S. stocks (also see the "Foreign Investment-Related Risks" section below for additional information). During a period when small-cap and/or international stocks fall behind other types of investments—U.S. large- and mid-cap stocks, for instance—the performance of the portion of the investment strategies invested in small-cap or international stocks may lag the performance of these other investments.

### **Fixed Income-Related Risks**

#### **General Risks**

Bond markets rise and fall daily, and fixed income investments, which generally also include instruments with variable or floating

rates (including cash and cash-like investments), are subject to various risks. As with any investment whose performance is tied to bond markets, the value of a fixed income investment, ETF, or mutual fund will fluctuate, which means that the client could lose money.

#### **Interest Rate Risks**

When interest rates rise, bond prices usually fall, and with them the value of an ETF or mutual fund holding the bonds. A decline in interest rates generally raises bond prices, and with them potentially the value of a bond fund or ETF share, but could also hurt the performance of an ETF or mutual fund by lowering its yield (which could increase reinvestment risk). The longer the duration of the investments held by an ETF or mutual fund, the more sensitive to interest rate movements its value is likely to be.

#### **Credit Risks**

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

#### **High-Yield Risks**

Investments in ETFs or mutual funds that hold high-yield securities and unrated securities of similar credit quality (sometimes called junk bonds) are subject to greater levels of credit and liquidity risks. High-yield securities and the ETFs or mutual funds that invest in them may be considered speculative.

#### **Government Securities Risks**

Many U.S. government securities are not backed by the full faith and credit of the United States government, which means they are neither issued nor guaranteed by the U.S. Treasury. Certain issuers of securities, such as the Federal Home Loan Banks ("FHLB"), maintain limited lines of credit with the U.S. Treasury. Securities issued by other issuers, such as the Federal Farm Credit Banks Funding Corporation, are supported solely by the credit of the issuer. There can be no assurance that the U.S. government will provide financial support to securities of its agencies and instrumentalities if it is not obligated to do so under law.

#### **Bank Loans**

Investments in ETFs or mutual funds that hold bank loans are typically below investment-grade credit quality and may be subject to more credit risk, including the risk of nonpayment of principal or interest. Most bank loans are floating rate, whose interest rates are tied to LIBOR or another short-term reference rate, so substantial increases in interest rates may make it more difficult for issuers to service their debt and cause an increase in loan defaults. Bank loans are typically secured by collateral posted by the issuer, or guarantees of its affiliates, the value of which may decline and be insufficient to cover repayment of the loan. Many loans are relatively illiquid or are subject to restrictions on resales, have delayed settlement periods and may be difficult to value, which could have an adverse impact on the ability of the ETF or mutual fund to sell loans at an advantageous time and/or price. Loans are also subject to maturity extension risk and prepayment risk.

#### **State and Regional Risks**

To the extent that a security, ETF, or mutual fund invests 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, an ETF or mutual fund 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.

#### **Foreign Risks**

Investments in ETFs or mutual funds that hold securities of foreign issuers or securities with credit or liquidity enhancements provided by foreign entities may involve certain risks such as adverse changes in foreign economic, political, regulatory, and other conditions; differing accounting, auditing, financial reporting, and legal standards and practices; differing securities market structures; and higher transaction costs. In addition, sovereign risk, or the risk that a government may become unwilling or unable to meet its loan obligations or guarantees, could increase the credit risk of financial institutions connected to that particular country.

#### **Foreign Investment–Related Risks**

##### **General Risks**

Investments in securities of foreign issuers or ETFs or mutual funds that hold securities of foreign issuers may involve certain risks that are greater than those associated with investments in securities of U.S. issuers. These include risks of adverse changes in foreign economic, political, regulatory, and other conditions; changes in currency exchange rates or exchange control regulations (including limitations on currency movements and exchanges); differing accounting, auditing, financial reporting, foreign taxes, and legal standards and practices; differing securities market structures; differing trading and settlement practices; ownership restrictions; and higher transaction costs.

##### **Emerging Markets Risks**

These and other risks (e.g., nationalization, expropriation, or other confiscation of assets of foreign issuers) are greater for those securities, ETFs, or mutual funds investing in companies tied economically to emerging countries, the economies of which tend to be more volatile than the economies of developed countries.

##### **Frontier Markets Risks**

The risks associated with investing in securities, ETFs, or mutual funds that hold foreign or emerging markets generally are magnified in frontier markets, also known as "next emerging" markets. Some frontier markets may operate in politically unstable regions of the world and may be subject to additional geopolitical/disruption-of-markets risks.

##### **Geopolitical/Disruption-of-Markets Risks**

Geopolitical events may adversely affect global economies and markets and thereby decrease the value of and/or the ease of trading those securities, ETFs, or mutual funds invested in those affected markets. Those events as well as other changes in foreign and domestic economic and political conditions could adversely affect the value of the strategy's investments.

##### **Currency Risks**

Fluctuations in exchange rates may adversely affect the value of ETFs or mutual funds that hold foreign currency holdings and investments denominated in foreign currencies.

#### **Risks Related to Other Asset Classes**

##### **Commodities Risks**

Commodities involve unique risks that may be distinct from those that affect stocks and bonds, including, but not limited to, worldwide supply and demand factors, weather conditions, currency movements, and international government policies regarding commodity reserves and choice of currency for commodity pricing. Commodities investments may also involve unique risks inherent to

investing in derivatives, which may include basis, roll, liquidity, and regulatory risks. A detailed explanation of the risks is available in the prospectus of the respective commodity fund. Commodity pools may be subject to different regulatory requirements than traditional funds governed by the Investment Company Act of 1940.

#### **Hard Asset Risks**

The production and distribution of hard assets, such as precious metals, oil and gas, real estate, and/or agricultural commodities, may be affected by geopolitical and environmental factors and are cyclical in nature. During periods of economic or financial instability, hard asset securities and other instruments may be subject to broad price fluctuations, reflecting volatility of energy and basic materials prices and possible instability of supply of various hard assets. Hard asset securities, hard asset companies, and other instruments may also experience greater price fluctuations than the relevant hard asset. Therefore, the return on hard asset securities can deviate from that of the hard asset itself.

#### **Real Estate Risks**

Real estate-related investments (and the ETFs or mutual funds that hold them) may be adversely affected by factors affecting the real estate industry, which may include changes in interest rates and social and economic trends. Real estate investment trusts ("REITs") may also be subject to the risk of fluctuations in income from underlying real estate assets, poor performance by the REITs' managers, prepayments and defaults by borrowers, adverse changes in tax laws, and, with respect to U.S. REITs, their failure to qualify for the special tax treatment granted to REITs under the Internal Revenue Code of 1986 and/or to maintain exempt status under the Investment Company Act of 1940.

#### **Limitations of Disclosure**

The foregoing list of risks does not purport to be a complete enumeration or explanation of the risks involved in CSIA's strategies. As CSIA's strategies develop and change over time, clients and investors may be subject to additional and different risk factors. No assurance can be made that profits will be achieved or that substantial losses will not be incurred.

#### **Disciplinary Information**

CSIA (including, historically, Windhaven Investment Management, Inc. and ThomasPartners, Inc.) and its (their) employees have not been involved in any legal or disciplinary events in the past 10 years that would be material to a client's evaluation of the company or its personnel.

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

As a wholly owned subsidiary of CSCorp, CSIA leverages the resources of CSCorp and Schwab, such as personnel, including, but not limited to, its Chief Compliance Officer ("CCO"), Chief Legal Officer, legal and compliance support, sales, marketing, technology, operations, finance, human resources, and risk management personnel. These relationships or arrangements may create the potential for conflicts of interest to arise. These potential conflicts of interest are governed by various policies adopted by CSIA. For example, CSIA has adopted policies and procedures reasonably designed to protect against the misuse of information (and mitigate potential conflicts of interest) whether among Schwab-affiliated entities or entities or individuals outside of Schwab. Other wholly owned subsidiaries of CSCorp are engaged in investment advisory, brokerage, trust, custody, or banking services.

Pursuant to the Parameters provided by Schwab, CSIA recommends target asset allocations subject to CS&Co. approval and chooses the ETFs for each investment strategy in the SIP Program. Eligible ETFs include Schwab ETFs, which are managed by CSIM, which is an affiliate of Schwab and CSIA. Schwab ETFs pay fees to CSIM that are described in "Participation or Interest in Client Transactions" below.

Schwab effects securities transactions for clients in the SIP Program on an agency basis.

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

#### **Code of Ethics**

CSIA has adopted a written Code of Ethics (the "Code") pursuant to SEC Rule 204A-1 under the Investment Advisers Act of 1940 (the "Advisers Act"). The Code reflects the fiduciary duty CSIA owes to its clients to avoid activities, interests, and relationships that run contrary to the best interests of CSIA's clients. All Access Persons (employees and other individuals deemed appropriate by the CCO) are required to place clients' interests ahead of their own, engage in personal investing that is in compliance with the Code, and avoid taking advantage of CSIA's position as Adviser. Access Persons are prohibited from using information for personal profit or the profit of others and from disclosing non-public information to anyone except certain designated employees of CSIA and Schwab.

The Code places restrictions on Access Persons making personal investments in securities traded on behalf of clients, in initial public offerings, and in private placements. Access Persons may not engage in deceptive conduct in connection with the purchase or sale of securities for client accounts and are required to: (1) pre-clear certain personal securities transactions; (2) report certain personal securities transactions on a quarterly basis; and (3) provide a detailed summary of certain holdings (initially and annually) that the Access Person has a direct or indirect beneficial interest in. The Code and its requirements are subject to change as necessary to remain current with regulatory requirements and internal business policies and procedures.

A copy of CSIA's Code is available upon request by calling the number located on the front of this brochure.

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

The written parameters established by Schwab place limitations on the universe of ETFs that CSIA may select for the SIP Program, as described in "Methods of Analysis, Investment Strategies, and Risk of Loss" above. Because Schwab and CSIA are affiliated companies, Schwab has an incentive to select and keep CSIA to provide portfolio management services for the Program. Similarly, CSIA has a conflict of interest in selecting Schwab ETFs, which pay compensation to CSIM, and ETFs in the Schwab ETF OneSource™ program ("ETF OneSource"), which pay compensation to Schwab. Schwab has a conflict in that it has instructed CSIA to select or retain Schwab ETFs in the portfolios, but only if Schwab ETFs meet all the criteria noted above in "Methods of Analysis, Investment Strategies, and Risk of Loss." CSIA also has a conflict of interest because it selects ETFs that it holds in other client accounts CSIA manages in other Schwab programs.

Each ETF, including a Schwab ETF, pays investment advisory, administrative, distribution, transfer agent, custodial, legal, audit, and other customary fees and expenses, as set forth in the ETF prospectus. An ETF pays these fees and expenses, which ultimately are borne by its



shareholders. Therefore, CSIM (a CSIA affiliate) will earn fees from Schwab ETFs that are held in SIP Program accounts.

Schwab has established the ETF OneSource program under which ETFs can be traded without a commission on buy and sell transactions. SIP Program accounts may include ETFs that participate in ETF OneSource. Schwab receives payments from the third-party ETF sponsors or their affiliates participating in ETF OneSource for recordkeeping, shareholder services, and other administrative services that Schwab provides to participating ETFs. In addition, Schwab promotes the ETF OneSource program to its customers, and a portion of the fees paid to Schwab offsets some or all of Schwab's costs of promoting and administering ETF OneSource. Schwab does not receive payment to promote any particular ETF to its customers.

ETF sponsors or their affiliates pay a fee to Schwab for ETFs that participate in ETF OneSource. The program fees vary, but typically range up to \$15,000 per year for each participating ETF plus an asset-based fee (that is, a fee based on ETF assets purchased by Schwab customers after the ETF was added to ETF OneSource), typically 0.04% but may range up to 0.20% annually. This fee offsets Schwab's costs of providing recordkeeping, shareholder services, and other administrative services to participating ETFs. Schwab also promotes ETF OneSource to its customers, and a portion of the fees paid to Schwab offsets some or all of Schwab's costs of promoting and administering the Program. Schwab ETFs do not pay any program fees or asset-based fees to participate in ETF OneSource.

At times, Schwab may enter into alternative fee arrangements with ETF sponsors or their affiliates for participation in ETF OneSource; these alternative fee arrangements might include a flat fee at the ETF or sponsor level. Regardless, all participating firms receive the same benefits, and the same potential conflicts exist regardless of fee structure.

Assets in SIP Program accounts are included in the calculation of the asset-based fee to be paid to Schwab by an ETF sponsor or its affiliates. Schwab may exclude other assets or other types of transactions from the asset-based fee paid by an ETF sponsor or its affiliates. Schwab's affiliate Schwab Bank receives income on cash balances in the Schwab Intelligent Portfolios Sweep Program, as detailed in the "Methods of Analysis, Investment Strategies, and Risk of Loss" section above.

Other affiliates of CSIA, as well as divisions within CSIA, may buy or sell the same securities for client accounts. These are all inherent conflicts of interest within and among CSIA, Schwab and its affiliates. CSIA mitigates these conflicts of interest through its policies and procedures and by the fact that, subject to Schwab's oversight as SIP program sponsor, the investment decision-making processes of CSIA portfolio management teams, including those of its Windhaven and ThomasPartners business divisions, are separate and independent from each other and from Schwab and its other affiliated portfolio managers.

## Brokerage Practices

CSIA's principal objective in executing client trades is to obtain best execution and to aggregate and allocate trades to achieve fair and equitable treatment of its clients. CSIA has adopted policies and procedures that are designed so that the trading practices do not unfairly or systematically favor one client or group of clients or strategies over another and that, over time, accounts are treated equitably.

## Selection of Brokers and Best Execution

CSIA seeks to obtain the best execution for clients' portfolio transactions and will evaluate the quality and cost of services received from broker-dealers/custodians on a periodic and systematic basis. Factors evaluated include execution price, transaction fees, commissions, mark-ups and mark-downs, or brokerage fees ("Brokerage Fees"), promptness and reliability of execution, accuracy of trades, ability to place trades in difficult markets, ability to source liquidity, and confidentiality. In seeking to meet its best execution goal, CSIA considers whether the transaction represents the best qualitative and quantitative execution, which may not be solely determined by the lowest brokerage fee available. Brokerage Fees are generally considered to be transaction fees, commissions, or mark-ups and mark-downs on the purchase and sale of securities.

For the SIP program, all brokerage transactions for securities will be routed to Schwab for execution, which may not always obtain as favorable a price as another broker-dealer. Program monitoring and trading are subject to systems and technology constraints and availability and, while unlikely, may not take place daily.

## Soft Dollars

CSIA does not participate in or actively seek out soft dollar arrangements. Due to its affiliation with Schwab, or participation in certain Broker/Custodian-Related Programs, and/or other brokers with whom CSIA may trade, CSIA may receive certain benefits that it would not otherwise receive, if it did not have an established relationship with these companies. These benefits may include trading, custody, reporting, research, technology, software, and related services that assist the firm in managing and administering client accounts. CSIA is not obligated to direct client transactions to broker-dealers that provide research information.

## Trading Process

Trade orders for different strategies (e.g., the SMP Program, the SIP Program, Windhaven Strategies, and ThomasPartners Strategies) are generated by different portfolio management teams, may be on different systems, and may utilize one or more trading strategies (e.g., price at the time of order arrival, market closing price, and volume-weighted average price over some specified period). Certain trading strategies place relatively greater emphasis on timing, and others on speed of execution, while others place greater emphasis on reducing market impact cost. As a result, the speed of trade order fulfillment and the prices achieved for the same security may vary in different programs or strategies. Certain strategies, which may include accounts in programs with different fee structures, may trade in advance of other trade strategies or may be completed more quickly and, as a result, may achieve different execution on the same or similar securities. In addition, market, regulatory, and/or country limitations (especially in the case of emerging markets) may contribute to differences in security prices.

For SIP Program accounts, CSIA typically performs maintenance trades and strategy trades. Maintenance trades reflect individual activity in a client account, such as initial contributions, additional account contributions, or raising cash for withdrawal ("Maintenance Trades"). Strategy trades impact nearly all client accounts within a strategy and are directed by the SIP Portfolio Management Team ("Strategy Trades").

For the SIP Program, clients direct CSIA to use Schwab to effect securities trades for their account. Large share trade orders can occur when there are large daily flows into or out of the program, CSIA reallocates/rebalances clients' accounts, or CSIA replaces

an ETF with another ETF across all applicable client accounts. For these large trade orders, Schwab may solicit bids from other broker-dealers that may act as principal in the transaction, meaning that the other broker-dealer executes the trade in an account in which the broker-dealer has a beneficial ownership interest, or may execute a riskless-principal trade where the other broker-dealer buys (sells) a security from (to) a third party (e.g., another customer or broker-dealer).

## Trade Aggregation

CSIA will not aggregate trades unless it believes that aggregation is consistent with its duty to seek best execution for affected clients in the aggregate and consistent with the terms of the client's investment advisory agreement.

CSIA may aggregate securities sales or purchases across investment strategies including Windhaven, ThomasPartners, SMP, and SIP. If trades are not aggregated, clients may pay prices for the transactions that are different from what they may have paid had the trades been aggregated. When aggregating, CSIA may, consistent with its policies and procedures and fiduciary duties, include proprietary and/or employee accounts in an aggregated order.

CSIA may exclude from aggregation those client accounts that have relevant restrictions or client activity (e.g., withdrawals pending). In addition, certain securities in client accounts may at times be executed through aggregation, but may not be aggregated at CSIA's discretion (e.g., individual bonds).

## Program Fees

For the SIP Program, in transactions where Schwab uses another broker-dealer acting as principal, the other broker-dealer typically accepts the risk of market price and liquidity fluctuations of executing the transactions. The broker-dealer adds a Brokerage Fee to compensate for this risk. Schwab does not act as principal for ETF trades in the SIP Program and does not receive the third-party's Brokerage Fee. In transactions where Schwab uses another broker-dealer acting as an agent, the other broker-dealer may charge a Brokerage Fee. Brokerage Fees for any trades where Schwab uses another broker-dealer acting as either principal or agent are not shown separately on a client's trade confirmation or account statements. Schwab does not charge a commission itself or receive the third-party broker-dealer's fee or commission.

Schwab receives remuneration, such as liquidity or order flow rebates, from a market or firm to which some orders are routed, but its trading practices are designed to achieve best execution. Clients will not be compensated or reimbursed for such third party Brokerage Fees. Instead, any Brokerage Fees will reduce the overall return of a client's account.

## Trade Rotation

CSIA has a trade rotation process for Maintenance Trades that it uses among client accounts within a single program or across programs (e.g., within or across the SMP Program, the SIP Program, Windhaven Strategies, or ThomasPartners Strategies) to prevent any client from being systematically disadvantaged. For Strategy Trades, if more than one program (e.g., the SMP Program and the Windhaven Strategies) wants to trade securities in the same direction that are similar or the same, the CSIA Trading Team will conduct an analysis and then escalate the findings for further instructions on how to proceed with the trades. Trades done on the same day or on different days are not guaranteed to receive the same trading price. CSIA will review its rotation procedures at

least annually to confirm that they are adequate to prevent any client from being systematically disadvantaged.

## Trade Allocation

Trade allocation procedures are designed to provide that trade allocations are timely, that no set of trade allocations is accomplished to the unfair advantage of one client or group of clients over another, and that over time client accounts are treated equitably, even though a specific trade may have the effect of benefiting one account or group of accounts over another when viewed in isolation.

Trading orders that can only be partially filled are generally allocated on a pro rata basis or allocated on some other basis consistent with the goal of giving all clients equitable opportunities over time. CSIA may elect to execute trades in a single aggregated trade over multiple days due to volume, liquidity, or other factors. This could include an aggregated trade that is executed over multiple days where at the end of each day whatever portion of the trade has been executed is allocated to client accounts, or it could include an aggregated trade that is executed over multiple days where the full order is held and not allocated to client accounts until fully executed on the final day. Client accounts will receive the average price for those aggregated trades allocated to their account(s), whether at the end of each day of the trade or when the trade is fully completed. There may be some variations in allocations based on account size and security price due to full share allocation methodology. In some cases, the CSIA Trading Team may execute strategy trade orders at the same time it is executing a different trade order for the same security with the same or a different broker to meet account or strategy-specific requirements, in which case the two trades may be treated as distinct trades and may not be subject to pro rata allocation.

When opportunities are limited (collectively, "limited opportunities"), CSIA will generally consider the needs of clients across programs. When it is not practicable to allocate an opportunity across all eligible accounts, CSIA uses various methods to give all accounts using the same trading strategy equitable opportunities for allocation over time. This may result in a limited opportunity being allocated to only some of the eligible accounts.

## Trade Errors

CSIA maintains policies and procedures that address the identification and correction of trade errors. On those occasions when such an error does occur, CSIA will use reasonable efforts to identify and resolve errors as promptly as possible. CSIA will address and resolve errors on a case-by-case basis, in its discretion, based on the facts and circumstances. CSIA is not obligated to follow any single method of resolving errors but will seek to treat all clients fairly in the resolution of trade errors.

## Review of Accounts

CSIA's portfolio managers review, at least quarterly, the performance of the SIP Program investment strategies. Schwab contacts clients participating in the SIP Program at least annually via electronic channels 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. Schwab Planning Consultants contact clients participating in the SIP

Premium Program generally on an annual basis, but which occur with varying frequency, depending on the client's needs. Clients may update their financial plans online at any time.

## Client Referrals and Other Compensation

As explained in "Fees and Compensation," Schwab compensates CSIA for providing portfolio management services in the Program. CSIA does not make payments to its representatives or other persons for referring clients to the Programs. Schwab makes payments to its representatives for referring clients to the SIP Program and SIP Premium Program, as detailed in the Schwab Intelligent Portfolios Solutions disclosure brochure.

## Other Broker/Custodian-Related Programs

For the ThomasPartners Strategies, CSIA participates in a number of Broker/Custodian-Related Programs sponsored by unaffiliated firms. These Broker/Custodian-Related Programs and their affiliates provide CSIA with certain economic benefits and access to products and services not typically available to retail clients as a result of CSIA's participation in their programs. Some of the products and services made available by these custodians through their program benefit program clients; some products and services may benefit CSIA but not the clients. These products or services may assist CSIA in managing and administering client accounts, including accounts not maintained at the custodian. As part of its fiduciary duties to clients, CSIA strives at all times to put the interests of its clients first.

## Custody

Clients use Schwab as custodian for their SIP account, and Schwab, on at least a quarterly basis, will send SIP Program clients account statements detailing account positions and activities during the preceding period. Clients should review these statements carefully.

## Investment Discretion

When clients choose the SIP Portfolios, they electronically sign the applicable agreements giving CSIA authorization to make trades in their accounts. This investment management discretion is limited to the purchase and sale of securities and investment of cash, and does not include discretion for distributions of cash or securities. Investments will not exceed the client's funds in the account and a margin balance will not be maintained. Clients may impose reasonable restrictions on the management of their accounts subject to the acceptance of CSIA.

Subject to meeting minimum balance requirements, a client may also direct CSIA to employ a tax-loss harvesting strategy (according to the Algorithm) in managing the client's taxable account. This means that CSIA will sell ETFs in the client's account at a loss to offset a potential capital gains tax liability (although CSIA does not monitor the type and amount of capital gains). The rebalancing and tax-loss harvesting opportunities may be affected by programming limitations and information clients make available to Schwab. For

more information about tax-loss harvesting and rebalancing strategies, please refer to the Schwab brochure, the Schwab website, and mobile applications. In addition, clients may restrict up to three ETFs (limited to one per asset class or sub-asset class) in each account. ETFs designated for restriction by clients will be replaced with alternatives selected by CSIA, in which case the client will forego the opportunity for tax-loss harvesting from this asset class.

## Voting Client Securities

CSIA has adopted written proxy voting policies and procedures (the "Policy"). 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 vote the proxies. CSIA reviews the vendor's voting guidelines no less than annually to determine consistency with the Policy and with CSIA's fiduciary duty to Delegating Clients.

For proxy issues deemed by SIP Portfolio Management to raise significant concerns and which relate to those securities that are managed through the Program, 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 outcomes have the potential to materially affect the issuer (ETF/fund) or issuer's sponsor/index provider, and matters which involve broad public policy developments which may materially affect the issuer (ETF/fund). 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, ETFs, and Schwab stock in the same proportion as the vote of all other shareholders of the mutual fund, ETF, or stock (i.e., "echo vote"), unless otherwise required by law. When required by law, CSIA also "echo votes" proxies of unaffiliated mutual funds, ETFs, or stock.

Clients can get a copy of the Policy and information about how CSIA has voted their securities in a particular proxy vote by calling CSIA at (415) 667-1910. The information will be provided at no charge.

Delegating Clients may not direct voting in a particular solicitation. Clients wishing to retain the ability to vote proxies must submit a separate form to their custodian.

## Financial Information

CSIA does not require prepayment of fees and is therefore not required to include a balance sheet for its most recent fiscal year. CSIA (and historically also Windhaven Investment Management, Inc. and ThomasPartners, Inc.) has never filed for bankruptcy and is not aware of any financial condition that is expected to affect its ability to manage client accounts.



**March 28, 2019**

# **Summary of Material Changes to the Charles Schwab Investment Advisory, Inc. Schwab Intelligent Portfolios® Disclosure Brochure (Form ADV Part 2A) Since March 30, 2018**

This brochure, which describes the role of Schwab's affiliate, Charles Schwab Investment Advisory, Inc. ("CSIA"), which provides portfolio management services to the Schwab Intelligent Portfolios program, has undergone the following material changes since March 30, 2018.

On November 30, 2018, we enhanced disclosures related to conflicts of interest and compensation to Schwab and its affiliates, including disclosures related to the cash allocation and the compensation earned by Schwab Bank.