

Five International Managers in One Fund

Jeffrey Mortimer's job isn't stock picking. Instead, he picks managers, and more importantly, he picks how much capital is allocated to each manager. The goal is to achieve a broadly diversified international fund that can have a value tilt or a growth tilt depending on the macroeconomic environment. A key aspect of the fund's strategy is the focus on future, not past performance, and that is achieved through a proprietary mean reversion model.

Q: What is the investment philosophy of your fund?

A: Ten years ago we started with the premise that there is more than one way to beat an international benchmark. You could pick a mutual fund or a manager to do that for you, but we decided that we could combine several managers to achieve something that's greater than the sum of the parts. The premise was that we could not only take the stock-picking expertise of the underlying managers, but we could also tilt the overall portfolio depending on our macroeconomic view of the marketplace. We could allocate more assets to the managers expected to do well going forward, while under-allocating assets to the managers whose style may be struggling in the near term.

That philosophy allows us to potentially add value at two levels, while most mutual funds only add value at the stock-selection level. I came to Schwab about ten years ago to put in place an investment process for searching and selecting those managers, and the end result is a portfolio that's broadly diversified across

sectors, market caps, and regions. The fund has more than 400 names in total, ranging from the smallest emerging market stocks to names like BMW. You typically don't find that range in other products.

Q: What is your strategy for selecting and combining those managers?

A: As we interview potential sub-advisors, we start with the four "P"s, or performance, philosophy, process, and people. But while the industry usually stops there, that's just our starting point. Then we add proprietary research, or mean reversion research, as well as top-down research. We do both on-site visits and have visits in our office; we do due diligence at both the qualitative and the quantitative levels.

The goal is to find managers with patterns of performance that can be a forecaster for performance going forward. Traditional screening processes are wonderful for finding past top performers, that's what they are designed to do, while ours is designed to find future

FUND FACTS

Symbol	SWOIX (Investor Shares)
Website	www.schwab.com/laudusfunds
Address	Charles Schwab Investment Mgt Inc. 101 Montgomery Street San Francisco, CA 94104
Tel. No.	877 252 8387
Inception	10/16/1996

PORTFOLIO

Total Net Assets *	\$1,674
Avg Mkt Cap (\$ Weighted) *	\$11,421
Average Price/Earnings Ratio	20.30
Average Price/Book Ratio	3.32
Turnover Ratio	53%

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$2,500
Min Subsequent Investment	\$0
Min Initial IRA Investment	\$1,000

RISK (AGAINST MSCI EAFE ND IX - 3 YEARS)

Alpha	0.04
Beta	0.99
R-Squared	0.91
Ann Std Deviation	10.94
Sharpe Ratio	1.88

RETURNS VS. LIPPER INTERNATIONAL FD INDEX

	SWOIX	Index
1 Year (Cum.)	26.33%	27.26%
3 Year (Ann.)	25.30%	23.15%
5 Year (Ann.)	10.98%	10.14%

RETURNS VS. MSCI EAFE ND IX

	SWOIX	Index
1 Year (Cum.)	26.33%	26.56%
3 Year (Ann.)	25.30%	23.94%
5 Year (Ann.)	10.98%	10.02%

FEES AND EXPENSES

Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee **	2.00%
Total Expense Ratio	1.65%

PORTFOLIO MANAGER

Jeff Mortimer - Lead PM	6/30/2004
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* millions ** within 1 month after purchase

Data through: 6/30/2006

Source: Company Documents; Lipper



strong performers. There isn't a lot of value in finding the best past performing fund.

The overall strategy is hiring sub-advisors to pick the stocks for us, so our work actually is allocating money appropriately to those sub-advisors. In essence, they are our stocks, and although there are five of them in the portfolio, we're giving more weight to the ones who we believe will do best going forward. We have a macro-economic outlook into styles, sectors, and industries, and we try to determine future performance based on that outlook. Right now we have a growth tilt; we are about 62% growth and 38% value.

The shifts in the focus tend to be long-term, so this is not a growth fund one day and a value fund on the next. It is a long-term tortoise that slowly drifts around in the core space slightly into growth or into value. And although most rankings position us in the growth space, I would argue that we are in the far left of that space. It is a broad core holding within the international space.

As an example of our process, in late 2002 and early 2003 we did mean reversion work by screening the entire international mutual fund database. That screening alerted us that small-caps had high probability of outperforming the MSCI EAFE, or a broad peer group of international managers. So we were able to allocate a lot of money towards American Century Small-Cap, which plays a small-cap role in our fund. Traditional screening would have never pointed the move to small-caps because they'd been a very poor performer during the correction that started in 2000.

Another example is early 2000, when we determined that value would potentially be the right place going forward. This was the time when, if you looked in the rear view mirror, you would think that the more growth in the portfolio, the better. At that point we were able to sell off growth holdings and to allocate money towards very conservative managers. So this fund performed very much

like a growth fund in 1999, but like a blended fund in 2000. It didn't go down like the traditional growth funds in that period of severe correction.

The fund will do 5% to 15% moves within its allocation, so it's not shifting overnight. It's trying to take advantage of the major turning points and to position itself ahead of them through our manager screening process. That subtle shifting allows us to participate in up markets and to protect shareholders in down markets.

Q: So you seek out funds with mandates that fit your expectations, and then you let them manage their portion. Is that correct?

A: Yes. We screen both the mutual fund and the institutional universe for the right mandate. Once the manager is chosen, we put together investment policy guidelines for that separate account. These guidelines are similar to the guidelines of their general mandate, but are still specific to us. We may have some restrictions, but we usually give the managers as much freedom as possible because we want them to manage money to the best of their ability. When Sparky Anderson, the baseball manager, was asked about his key to success, he said "I don't trip my players when they run onto the field." I think that's a wonderful analogy because if we've found wonderful sub-advisors, we really want to let them work. We evaluate them formally on a quarterly basis, communicate regularly with them, but they have the freedom to do what they do best, which is pick stocks and regions.

Q: How do you avoid becoming overweight in a certain region or sector? Is that part of your guidelines?

A: It is not part of our guidelines, but the managers are chosen because of their diversifying effect to the fund, so there isn't a lot of overlap. We have a value manager, opportunistic growth manager, multi-cap growth manager, small-cap value manager, small/mid-

cap growth manager, so they don't play in similar ponds. But because we own 420 names, even if they were all picking the same name, it would reach only 3% or 4% of the portfolio. That still isn't a heavy weighting by typical mutual fund standards.

The largest holding in the fund currently is about 1.2% of the assets. Even the largest ten positions make up only about 10% of the fund. So we would certainly become aware of an overweight, but we tend not to stand in the way as long as it doesn't get to an extreme level. But based upon mathematics, it really couldn't reach an extreme level.

Q: Could you explain in more detail the mean reversion method? Why do you believe that approach helps you achieve better selection of sub-advisors?

A: It's proprietary work that I cannot discuss in great detail, but basically, we've found that the managers at the top, who have continuous great performance, may mean revert down to the bottom. So we study the other side of the coin with the idea of finding managers with poor near-term performance, but with the potential for strong performance going forward. We believe that the managers at the top for long periods of time are probably quite talented, but the managers at the bottom may be facing a style that's out of favor. That's where we're getting at sub-styles through our mean reversion.

The rating agencies divide the world, at least domestically, into three large buckets - value, core, and growth, while we can come up with ten sub-styles. If you can understand a manager to a great degree, you can really understand what his sub-style is. Then, depending on the economic background, this sub-style either thrives or suffers. And by looking at mean reversion, you can pick the sub-style with the greatest potential for strong performance going forward as the economic background changes.

That's the reasoning behind the mean reversion process. People often choose

the best performing five-year manager and then all of sudden that manager underperforms. I've done that too in younger periods of my career. The problem is that past performance isn't a good predictor for future performance.

Our role is to look at a return series and decipher whether this is luck or skill. By looking at mean reversion, you can select skill with bad luck, which pays you off double. When the style comes into favor, the manager comes into favor and it's almost like the P/E expansion. When you buy a low P/E stock, not only the earnings come up, but the P/E expands, so you win twice. When we picked the small-cap manager in early 2003, we didn't only get a great manager, but also the style that was coming in vogue.

Q: Does that mean that a manager with strong performance wouldn't stand a chance in your model? What about managers who have consistently done well for ten years or longer? Would they be excluded by your manager-selection process?

A: No. If a manager is good, he'll tend to be good. There are factors that can signal if the best days are behind that manager or if he or she has a wonderful philosophy and process that will continue to produce strong results. We're not turning over advisors and we're not timing advisors; we tend to be long-term holders of both the sub-advisors and the strategies. This is a fund that moves like a tortoise and we're trying to get the major turning points right and let the trend play itself out. So we're just trying to find the sub-styles and the strategies that give us signals of upcoming strength, and get there before the crowd.

For example, in 2002 nobody would want to invest in international small-caps except for us. That gives us contrarian flair, but we have a methodology that allows us to see these trends. We're not contrarian for contrarian sake; it's the methodology that points in that direction. That does not go against a great manager still being great, and we still

kept William Blair. We just allocated new cash flow to American Century.

Q: When you have multiple managers, what kind of risks do you perceive and how do you monitor and control them?

A: The risks are typical of any mutual fund. They include over-concentration in the same region, sector, industry, or style, and we've mitigated this risk almost by design. The fund plays in five separate areas and represents five funds in one. Many risks can never go away, but

we believe that we mitigate a lot of them through diversification. The growth tilt is mitigated by the value portion, large-cap by small-caps; emerging markets by developed markets, so most risks are controlled through diversification.

But while the structure does most of the heavy lifting for us, there's the risk of that structure breaking down if a growth manager wanders over into value, or if large-cap wanders into small. So we are constantly evaluating manager's holdings formally on quarterly basis and informally on individual basis. We do style maps of each sub-advisor to make sure that they are adhering to their style. We are looking at our squares relative to the benchmarks, at the upside and downside capture of each sub-advisor and the overall fund as we want it to behave in the right way in various market conditions.

Q: What benchmarks do you follow?

A: The fairest benchmark for this fund would be the MSCI EAFE, which is the broadest benchmark in that space. The fund is a core international holding, although it's temporarily in the growth base of the agencies. For many of our investors, this fund is their only international holding because it represents five funds into one. Others use this as a core holding and they combine it with other mutual funds to supplement the return, but those are the two manners in which this fund is utilized by investors. [T](#)

Ticker

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JEFF MORTIMER, Schwab Senior Vice President, is chief investment officer of equities and head of equity portfolio management at Charles Schwab Investment Management, Inc. (CSIM). He is responsible for Schwab and Laudus Funds™ actively managed equity funds, Schwab's index funds and separate accounts.

Before joining CSIM in October 1997, Mortimer was chief investment officer at Higgins Associates, Inc. Prior to joining Higgins, he was employed by Gannett, Welsh & Kotler, a money management firm in Boston.

Mortimer earned a Master of Business Administration degree with an emphasis in finance from the University of Chicago Graduate School of Business and a Bachelor of Science degree from Babson College. He is a CFA charterholder and a member of the Security Analyst Society of San Francisco.