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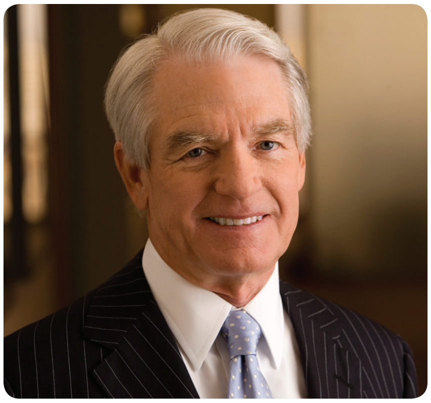
THE ETF INVESTOR
2010 IN REVIEW BY CHARLES SCHWAB

A LETTER FROM CHUCK SCHWAB



It's no secret that I'm a big believer in the benefits that exchange-traded funds (ETFs) can offer, and I know my enthusiasm is shared by a rapidly growing number of investors. With their low expense ratios and exposure to hundreds of asset classes, sectors and subsectors of the markets, ETFs can provide a cost-effective way to diversify and gain exposure to market segments that previously had been difficult for the average investor to access.

ETFs can be powerful tools, but like any investment vehicle, understanding what they are and how to use them is vitally important. *The ETF Investor: 2010 in Review* by Charles Schwab, a collection of research and commentary by Charles Schwab Investment Advisory managing director Michael Iachini, is a resource for reporters, industry analysts and others looking to better understand and explain the roles ETFs can play for investors today. Michael has been making his institutional-level insights on the evolving ETF industry accessible to Schwab investors, and I'm excited we're able to present them to you here as one reference guide.

My hope is that The *ETF Investor* will leave you with a greater understanding for how ETFs can work for investors today, and that you'll be able to share this perspective more broadly.

Chuck Schwab
Founder and Chairman
The Charles Schwab Corporation

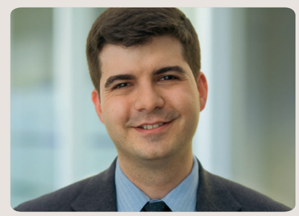
INTRODUCTION

While ETFs have become more popular with Schwab clients and the financial services industry, understanding who is using them and why has been an enigma. Schwab clients—individual investors as well as advisors—have adopted ETFs as a part of their investment tool kit at different times and in different ways.

This report looks at ETF usage trends in 2010 among different Schwab clients. It was developed for use by industry participants and advisors, those in a position to educate investors about ETFs and how they are being used. For each theme discussed, data and trends are provided on Schwab investor and advisor usage as well as educational commentary from Michael Iachini, Schwab's Director of Investment Manager Research, from Charles Schwab Investment Advisory, Inc.

The educational commentary included are excerpts of full articles available on Schwab.com. There, you will find many ETF resources, such as:

- **Articles:** Access the full library from Michael Iachini and Charles Schwab Investment Advisory, Inc.
- **ETF Select List:** Review the list of pre-screened, low cost ETFs across 48 asset allocation categories, designed for investors looking to fill a gap in their portfolio with an ETF.
- **ETF Screener:** Search for ETFs that offer the exposure within various markets, industries, sectors and asset indexes to fit your investing needs.
- **ETF Compare Tool:** Compare ETFs' diversification and risk to find investments that can help you balance your portfolio.



Michael Iachini

CFA, CFP®, Director, Investment Manager Research, Charles Schwab Investment Advisory, Inc.

Michael Iachini oversees quantitative research into mutual funds, managed accounts and exchange-traded funds for Charles Schwab Investment Advisory, Inc. In addition, he is responsible for risk management and trade oversight for Schwab Managed Portfolios. Michael also contributes exchange-traded fund articles for Schwab's newsletters and websites.

Prior to joining Schwab in 2004, Michael was a domestic equities analyst for the State Board of Administration of Florida. He earned a bachelor's degree in international affairs and a master's degree in economics from Florida State University. He holds both the Chartered Financial Analyst designation and the CERTIFIED FINANCIAL PLANNER™ certification.

Charles Schwab Investment Advisory, Inc., is an affiliate of Charles Schwab & Co., Inc.

Read more: **Go to Schwab.com to read the full articles listed at the bottom of each page.**

IMPORTANT INFORMATION ABOUT THIS REPORT

Terminology

The report looks at the following client segments who custody assets at Schwab:

1. **RIA Clients:** RIA stands for "Registered Investment Advisor." Schwab Advisor Services™ supports independent, third-party RIAs whose clients open accounts at Schwab and use Schwab for custodial, operational, and trading support. In this report, "RIA Clients" pertains to the end clients served by RIAs unless specifically noted otherwise.

2. **Retail Clients:** Schwab customers who maintain brokerage accounts at Schwab and either trade on their own or with some help and guidance from Schwab. For the purposes of this Report, the Retail population is generally split into two groups:

   a. **Retail Traders:** Retail Clients who trade at least 36 times a year (including ETFs and stocks) and have $150,000 or more in investable assets with Schwab.

   b. **Retail Investors:** Retail Clients, except Retail Traders, plus Schwab Corporate and Retirement Services end clients (which includes corporate brokerage accounts and employee retirement and stock option plans). These have been grouped with Retail Investors for simplicity.

"Schwab" means Charles Schwab & Co., Inc., an SEC-registered broker-dealer and investment advisor.

"Households" means an individual or family with at least one open account. An "open" account is an account that has received a statement in the past eight months and does not have a Closed restriction code.

"ETF Ownership" If any account in the household has at least one ETF at the end of the month, including Schwab ETFs™ and third-party ETFs.

Data sources

All data is as of December 31, 2010 unless stated otherwise. Industry growth information from Strategic Insight (SI), an Asset International company. All other data and information from Charles Schwab & Co., Inc.

Schwab Independent Advisor Outlook Study: An online study conducted for Schwab by Koski Research. The study has a 2.74% margin of error. Koski Research is neither affiliated with, nor employed by, Schwab.

ETF Qualitative Study: 2010 focus group on ETF usage among Retail Clients. As with any qualitative assessment, this research should be viewed as exploratory in nature. Due to the small sample size, results should be viewed as informational only.

Schwab and its affiliates

Charles Schwab Investment Advisory, Inc., a registered investment advisor, is an affiliate of Charles Schwab & Co., Inc.

Schwab Advisor Services™ provides custody, trading and support services to RIAs. Charles Schwab Investment Advisory, Inc. and Charles Schwab & Co., Inc. are subsidiaries of The Charles Schwab Corporation.

Schwab ETFs™

Online trades of Schwab ETFs™ are commission-free at Schwab, while trades of 3rd-party ETFs are subject to commissions. Broker-Assisted and Automated Phone trades are subject to service charges. Minimum $1,000 deposit is required to open most Schwab brokerage accounts. Waivers may apply. See the Charles Schwab Pricing Guide for more details. All ETFs are subject to management fees and expenses. Commission-free trades are available through the broker/dealer subsidiary of The Charles Schwab Corporation, Charles Schwab & Co., Inc., member SIPC.

Charles Schwab Investment Management, Inc., ("CSIM") the investment advisor for the Schwab ETFs and an affiliate of Schwab, receives fees from the Schwab ETFs for investment advisory services.

Schwab ETFs are distributed by SEI Investments Distribution Co. (SIDCO). SIDCO is not affiliated with The Charles Schwab Corporation or any of its affiliates.

Exchange-Traded Funds

Before purchasing an ETF, investors should consider carefully information contained in the prospectus, including investment objectives, risks, charges and expenses. You can request a prospectus by calling Schwab at 800-435-4000. Please read the prospectus carefully before investing.

No mention of particular funds or fund families here should be construed as a recommendation or considered an offer to sell or a solicitation of an offer to buy any securities. This information provided here is for general informational purposes only and should not be considered an individualized recommendation or personalized investment advice. The securities listed may not be suitable for everyone. Each investor needs to review a securities transaction for his or her own particular situation. Schwab or its employees may sometimes hold positions in the securities listed here. Data contained here is obtained from what are considered reliable sources; however, its accuracy, completeness or reliability cannot be guaranteed.

Some specialized exchange-traded funds can be subject to additional market risks. Investment returns will fluctuate and are subject to market volatility, so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost. Unlike mutual funds, shares of ETFs are not individually redeemable directly with the ETF.

Since a sector fund is typically not diversified and focuses its investments on companies involved in a specific sector, the fund may involve a greater degree of risk than an investment in other mutual funds with greater diversification.

Using this report

To be approved for use, analysis and data herein must be attributed to: Charles Schwab & Co. If reprinted, all pages of this ETF Report must be included.

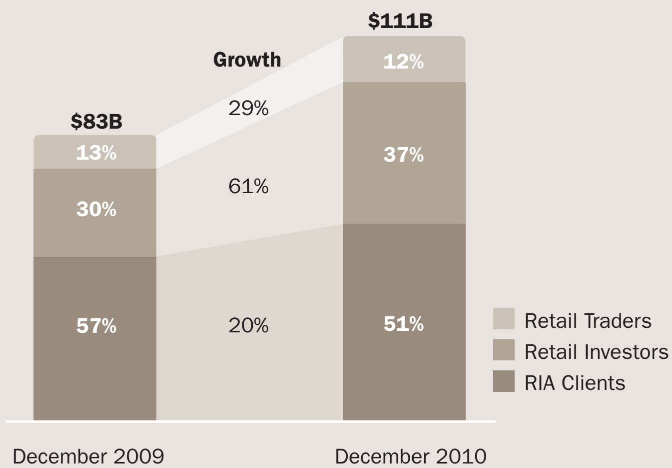
RETAIL INVESTOR GROWTH

Retail ETF assets grew tremendously in 2010, accounting for the majority of ETF flows at Schwab.

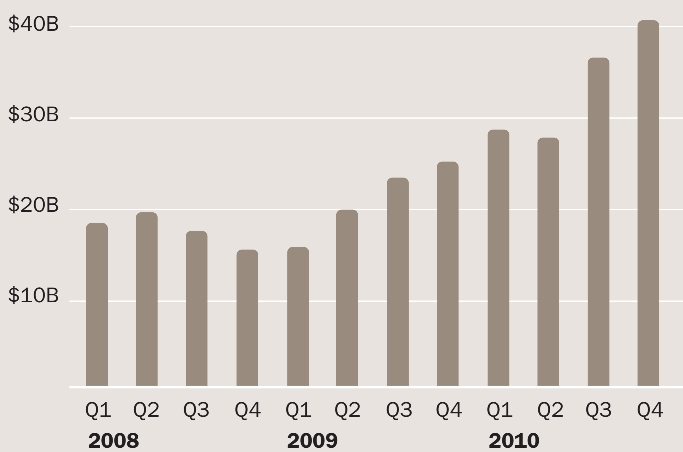
Schwab Trends

- Retail Investor ETF assets grew 61% in 2010, compared to ETF industry growth of 28%, accounting for 37% of the total ETF assets at Schwab.
- 15% of Retail Investors owned ETFs at Schwab in 2010.
- 12-month Retail Client flows outpaced RIA Client flows at 54% and 46% of total flows, respectively.
- 45% of Retail Investor flows went into Equity ETFs in 2010, followed by Fixed Income ETFs (21% of flows).
- Nearly a quarter of Retail Clients with ETFs at Schwab are Retail Traders.

ETF Assets at Schwab by Client Segment



Retail Investor ETF Asset Growth at Schwab



Commentary

Exploring ETFs

Although ETFs are all over the financial press, they are relatively new for individual investors. Though most ETFs are essentially index funds that trade like stocks, there are differences in how they work compared to mutual funds and stocks. Additionally, not all ETFs are alike, and they're not right for every portfolio, so it's important for investors to understand what they are buying before diving in.

How do investors use them?

ETFs can be useful investments, particularly if the investor is seeking to:

- Get market returns (i.e., not seeking to outperform) in a diversified, low-cost product
- Access intra-day trading and price transparency (including placing limit orders on trades)
- Gain exposure to previously hard-to-access asset classes like commodities or currencies
- Invest in a sector or region without betting on a specific security
- Put excess cash to work—typically in a broad market ETF—until they've made their next long-term investment decision.

How to choose the right ETF?

With all the hype around ETFs and new ones being launched every day, picking the right one can be challenging. Investors should consider the following factors as they research investment options.

- What vehicles can help me meet my investment goal? An ETF may not be the only, or best, solution.
- Does the ETF's index fit the market exposure I'm looking for? Some may be too narrow or too broad.
- Does the ETF have a good track record? Look at things like trading history, assets in the fund and tracking error.
- Am I comfortable with the ETF structure? Some ETFs are structured as trusts or limited partnerships rather than open-end funds, which might have different tax implications.
- What is the best total-cost option? Cost is not just the expense ratio of the fund. Investors should also consider the trade commission charged and the average bid-ask spread. These too add to the total cost of investing.

Trading tips

Invariably, the market prices of ETFs fluctuate around their NAVs to some extent. Placing a limit order allows for choosing the price at which the investor wants to buy or sell an ETF and can be a smart way to take advantage of intra-day pricing (although placing a limit order does not guarantee execution).

Learn more: "Invest Intelligently in ETFs", "ETFs: Beyond the Hype"

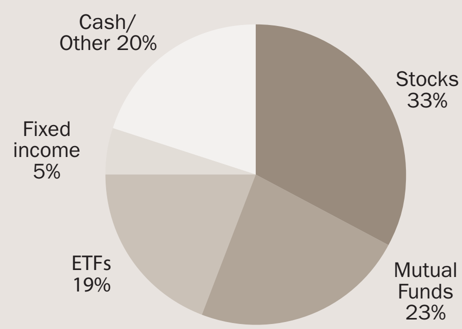
PORTFOLIO USAGE OF ETFS

Advisors and Retail Investors are using ETFs in a variety of ways.

Schwab Trends

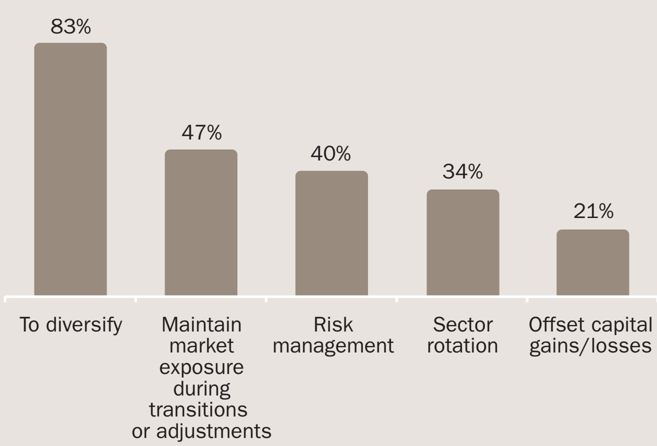
- On average the typical Retail Client that held at least one ETF had 19% of assets in ETFs.
- A recent qualitative study by Schwab found that Retail Clients were initially attracted to ETFs by satellite opportunities such as sector, foreign country and commodity funds.
- 85% of RIAs and 38% of their clients (by household) owned ETFs at Schwab in 2010.
- 31% of RIAs that participated in the recent Schwab Independent Advisor Outlook Study reported they will invest more in ETFs in the next six months. Of RIAs who use ETFs, 83% say they use ETFs to diversify clients' portfolios.

Retail ETF Clients' Average Balances*



*Includes both Retail Investors and Retail Traders.

**Independent Advisor Outlook Study:
How ETFs are Used in RIA Client Portfolios**



Learn more: **"3 Ways to Build an All-ETF Portfolio"**

Commentary

Key use of ETFs: Diversification

ETFs have a number of tactical uses—RIAs and Institutional investors often use them to "equitize" cash, or maintain market exposure during portfolio transitions or adjustments. Retail Investors have cited the ability to access niche areas of the market as one of the things that attracted them to ETFs initially. ETFs also offer convenient ways to fill specific gaps in a portfolio.

However, the main reason that ETFs are gaining popularity is their ability to provide excellent diversification at low ongoing expenses. How to use them to diversify comes down to personal taste. Some investors may use ETFs to invest in narrow slices of the market to help diversify their overall portfolio (and it may be that these ETFs are not themselves diversified). Others may choose to invest in one or more ETFs to cover an entire asset class, and use individual securities or mutual funds for the remainder of their portfolio. Some investors—and increasingly, advisors—even choose to build their portfolios entirely of ETFs.

The all-ETF portfolio

With the range of ETFs available today, it is possible to build a complete portfolio out of nothing but ETFs. If an investor is looking for diversification at low cost, and is seeking visibility into what stocks, bonds or other investments the ETF holds each day, owning nothing but ETFs may be a straightforward yet flexible solution worth a closer look. Here are three ways to build an all-ETF portfolio ranging from maximum simplicity to maximum customizability:

Keep it simple: A balanced, diversified portfolio of stocks and bonds can be built with just two trades—a total world stock market ETF and a total bond market ETF.

Middle-of-the-road: An intermediate approach to an all-ETF portfolio would consist of about 10 ETFs. For stocks, consider a large-cap U.S. ETF, a small-cap U.S. ETF, an international developed market ETF and an emerging-market ETF. For bonds, start with a core lineup including treasuries, government-agencies, mortgage-backed bonds, investment-grade corporate bonds and some dollar-denominated international bonds. Further diversification could be added through ETFs that invest in TIPS, high-yield "junk" bonds, and international bonds. Another layer of diversification can be added with a broad commodity ETF or a real estate ETF to get returns not typically as highly correlated with stocks and bonds.

Fine-tuning: This portfolio may have 20 or more ETFs and can make sense for engaged investors who like to allocate their accounts toward exactly the parts of the market they expect to perform best. This portfolio begins with the Middle-of-the-road ETF portfolio but then divides the various parts into thinner slices. For example, large-cap can be divided into sectors or equity into cap weighting or style. A broad commodities basket can be traded in for the individual commodities or smaller categories like oil or agriculture.

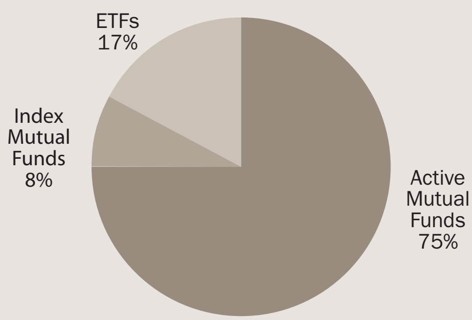
ETFS AND MUTUAL FUNDS

Mutual funds continue to be the choice for accessing active management while ETFs are growing in popularity for index investing.

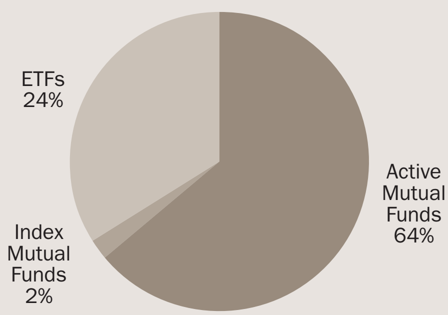
Schwab Trends

- While ETF assets only accounted for 17% of all fund (ETF and mutual fund) assets at Schwab, ETF flows accounted for 34% of all fund flows in 2010.
- 2010 ETF flows at Schwab were driven by both Retail Investors and RIA Clients, particularly into Equity ETFs.
- Mutual fund flows decreased each quarter in 2010 in both of those client segments, mostly due to outflows in Fixed Income mutual funds.

Mutual Fund and ETF Assets at Schwab (December 2010)



Mutual Fund and ETF 2010 Flows at Schwab



Commentary

ETFs and mutual funds explained

While Schwab clients continue to invest in mutual funds, ETFs are increasing in popularity. ETFs are similar to index mutual funds, but they trade like stocks. There are times when either an ETF, an index mutual fund, or an actively managed mutual fund might suit an investor's needs.

When might one have the advantage?

Investor Situation	ETF	Mutual Fund	Rationale
Plans to trade actively	●		Intra-day trading and the ability to set limit orders, as well as some advanced trading features.
Wants niche exposure	●		Today, ETFs cover more niche areas of the market than index mutual funds, though some active mutual funds are available. Niche ETFs expose the investor to higher risk, however.
Seeks tax efficiency	●		ETFs have the potential edge over index mutual funds due to their structure. Actively managed funds tend to be the least tax efficient.
Primary concern is low cost	●	●	Often, ETFs have the lowest expense ratios, but index mutual fund expenses have come down. It's also important to factor in trading costs, though some ETFs and many mutual funds trade commission-free.
Making small, regular investments	●	●	ETF trade commissions may make them more expensive than a no-load, no-transaction-fee mutual fund, though some ETFs are available commission-free.
Looking to beat the market		●	Active management gives investors the opportunity to beat the market, although many funds do not outperform their benchmarks.
Seeking broadest fund choice		●	Today there are about six times more mutual funds than ETFs, most are actively managed.

Ultimately, ETFs, index mutual funds and actively managed mutual funds can meet investors' needs in a variety of cases, but the details matter. The points above can help clarify these three options when it comes time to invest.

Learn more: "Choosing Between ETFs and Mutual Funds"

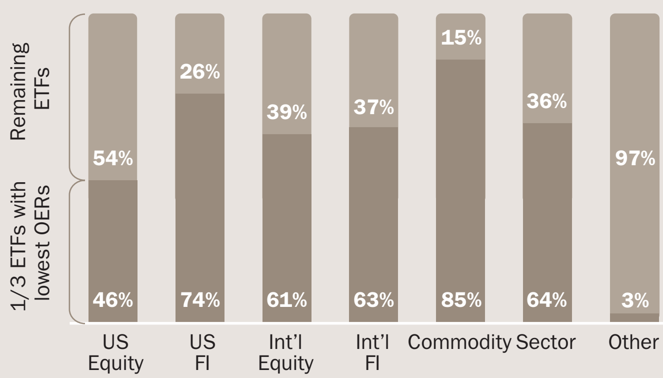
ETF OPERATING EXPENSES

Investors showed a preference for ETFs with lower operating expenses for most asset classes.

Schwab Trends

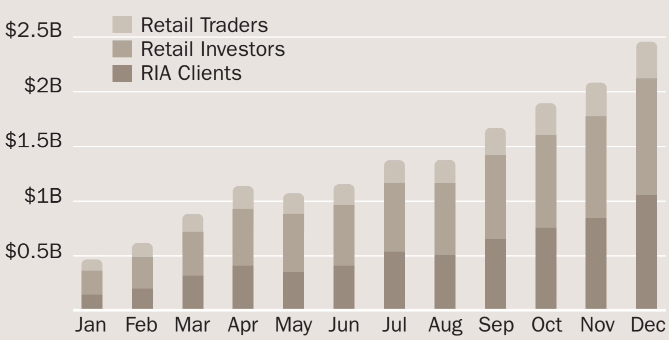
- For this analysis, ETFs were separated by their operating expense ratios (OERs)* and the lowest 1/3 were compared to the rest of the ETFs per asset class.
- Investors chose ETFs with lower OERs over comparable ETFs in most categories in 2010. Investor flows into US Fixed Income and Commodity ETFs particularly favored ETFs with lower OERs.
- While investors disproportionately chose U.S. Equity ETFs with lower OERs, they also chose ETFs in that category that brought specific qualities but had higher OERs, such as Value or Income Equity ETFs.
- ETFs not fitting within the traditional asset classes (the “Other” category) saw the reverse affect—investors chose ETFs for their exposure and fit, such as Currency and Multi-Asset ETFs, rather than for their OERs.
- Both RIA Clients and Retail Clients invested in Schwab ETFs™ in 2010 when seeking lower-priced portfolio solutions.

2010 ETF Asset Class Flows at Schwab by OERs*



*Reported Operating Expenses Ratios (OERs) by ETF provider. Does not take into account any fee waivers or breakpoints, as well as trade commissions.

Schwab ETFs™ Asset Growth 2010 by Client Segment



Commentary

Understand the “total cost” of ETFs

Even though ETFs are relatively inexpensive, investing in them does include certain costs, and low OERs do not necessarily equate to low total cost. The three main components are commissions to trade ETFs, the fund’s OERs incurred while holding them, and bid/ask spreads.

In general, brokers charge a **commission** for trading an ETF (although some ETFs may trade commission-free). In cases where clients pay commissions for ETF trades, they can play a more significant role in the total cost of ownership if the individual trades frequently or in small dollar amounts. This means that active traders should pay more attention to commission costs than long-term, buy-and-hold investors. It also means that ETFs may not be the best choice for individuals who frequently invest small amounts of money over long periods of time, unless choosing commission-free ETFs.

ETF **fund expenses** are usually stated in terms of a fund’s operating expense ratio (sometimes abbreviated as OER). The expense ratio is an annual rate the fund (not a broker) charges on the total assets it holds to pay for portfolio management, administration and other costs. Since the expense ratio represents recurring fees, it’s particularly relevant for long-term, buy-and-hold investors.

The **bid/ask spread** is the difference between the “ask” (or “offer”)—the market price at which an ETF can be bought, and the “bid”—the market price at which the same ETF can be sold. It is similar to a transaction cost built into the market price and paid (to market participants, not your broker) on each roundtrip purchase and sale. So, the larger the spread and the more frequently the investor trades, the more relevant this cost becomes. In general, a smaller or “narrower” bid/ask spread is more cost efficient. Investors should look for three main factors that drive narrow bid/ask spreads:
1) strong market maker competition, 2) low inventory management costs, and 3) liquid ETFs.

Hypothetical $10,000 trade

This scenario developed by the Schwab Center for Financial Research assumes both ETFs trade commission free. It demonstrates that the impact of the bid/ask spread can outweigh a lower expense ratio.

Annual Costs	ETF A	ETF B
OERs	0.72% ($72)	0.49% ($49)
Bid/ask spread	0.03% ($3)	1.32% ($132)
Total cost (roundtrip cost after one year)	0.75% ($75)	1.81% ($181)

Learn more: **“ETFs: How Much Do They Really Cost?”**

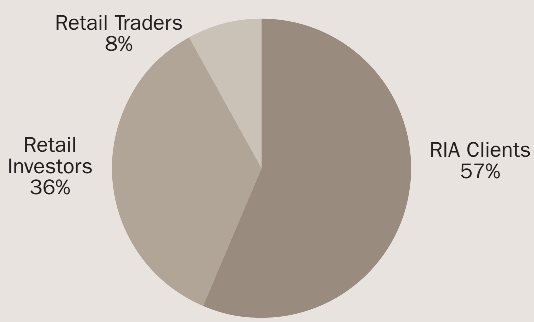
FIXED INCOME ETFS

Investor flows into Fixed Income ETFs were mixed in 2010.

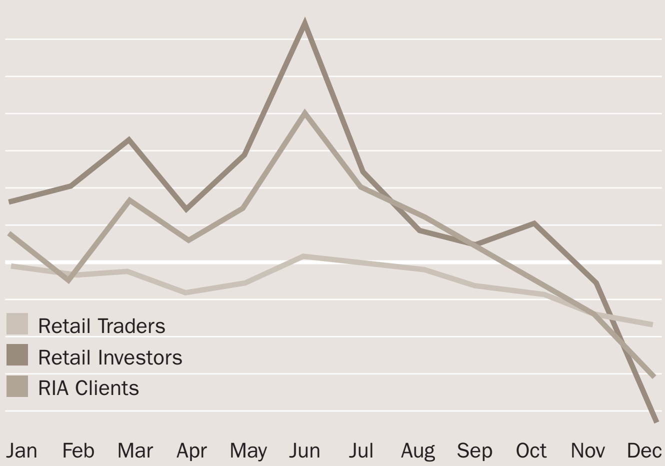
Schwab Trends

- Investors flocked to Fixed Income ETFs at Schwab in Q2 2010 when most Equity ETF asset classes saw outflows. In Q4 Fixed Income ETFs saw large outflows as Equity ETF inflows gained more momentum.
- Retail Investors saw the highest inflows and outflows in any given month, as well as the highest net flows for 2010.
- RIA Clients held a disproportionate share of Fixed Income ETFs; they accounted for 57% of the Fixed Income ETF assets even though they only held 51% of all ETF assets at Schwab. Retail Traders held only 8% of Fixed Income ETF assets, proportionally smaller than their share of 12% of total ETF assets at Schwab.
- 16% of RIA Client assets in ETFs were allocated to Fixed Income ETFs.

% Share of Fixed Income ETF Assets at Schwab (December 2010)



2010 Fixed Income Flows at Schwab by Client Segment



Commentary

Investing in bond ETFs

Individual bonds feature a set stream of interest payments and a set value at maturity (assuming they don't default). But they can be expensive to trade and it can be difficult to spread risk around. Bond mutual funds have long been an option for investors who want to sidestep some of the drawbacks of owning individual bonds. However, Bond ETFs have recently come onto the scene, with low OERs and ease of trading. When choosing a bond ETF, however, it is important to understand that they are not like equity ETFs, and come with a different set of risks.

Risks

The two most basic risks involved with Fixed Income securities in which Bond ETFs may invest are credit risk and interest rate risk.

Credit risk, also known as default risk, is the risk that a bond issuer will not pay the interest and principal that it owes to bondholders. If the issuer defaults, it's possible bondholders could get nothing at all. High-quality bonds like Treasury bonds might have little to no credit risk, while high-yield bonds from low-rated companies would have a great deal of credit risk.

Interest rate risk, also known as duration risk, is the risk that a bond might lose value if interest rates in the market rise. If you own a bond with 10 years until maturity that's paying 4% interest, but new 10-year bonds from the same issuer are coming out with 6% interest, no one would be willing to pay full price for your 4% bond if you tried to sell it today. The longer a bond has until maturity, the more its value will be sensitive to changes in market interest rates. Bonds with only a few months until maturity have very little interest rate risk.

Types of bonds

When choosing a Fixed Income ETF, it is important to understand the types of bonds in which the ETF might invest and how much credit and interest rate risk is generally associated with each.

Type of Bond	Credit risk	Interest rate risk
Government/ Treasury bond	Nearly none	Moderate
Short-term Treasury bond	Nearly none	Low
Long-term Treasury bond	Nearly none	High
Investment-grade corporate bond	Moderate	Moderate
High-yield bond	High	Moderate
International government bond	Low	Moderate
Treasury Inflation Protected Securities (TIPS)	Nearly none	Moderate
Agency/mortgage-backed bonds	Low	Moderate

Learn more: **"Bond ETFs: What You Need to Know"**

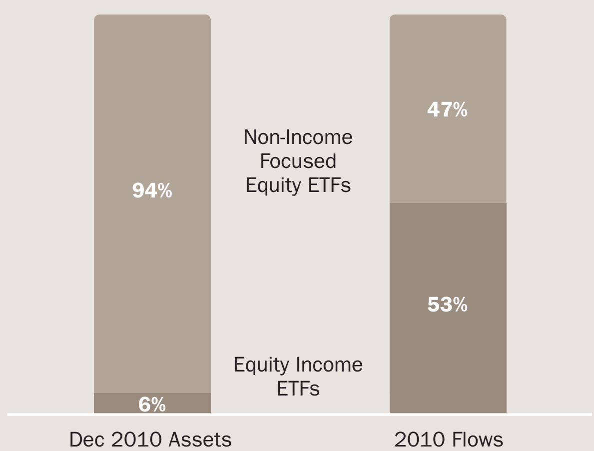
EQUITY INCOME ETFS

Income ETFs have gathered relatively more flows in 2010 as investors looked to generate cash flow.

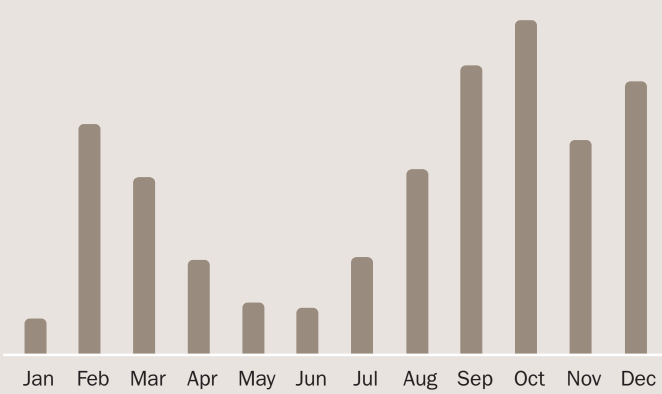
Schwab Trends

- For this analysis, Equity Income ETFs are defined as Equity ETFs that are income or dividend-focused. At Schwab, assets in these ETFs grew 129% in 2010, compared to overall Equity ETF asset growth of 27%.
- While only 6% of all Equity ETF assets, Equity Income ETFs gathered more than half of the flows in 2010 into Equity ETFs. RIA Clients accounted for 49% of the assets and 63% of the flows in 2010.
- Although there were ETF asset classes with outflows in Q2 2010, US and International Equity ETFs combined had positive inflows largely driven by Equity Income ETFs (which accounted for 68% of the Equity ETF inflows that quarter).

% Equity Income and Equity ETFs at Schwab



Equity Income ETF 2010 Flows at Schwab



Commentary

Finding income with equity ETFs

Income doesn't stop with fixed income and real estate—it can also come from stock dividends. Not every stock pays a dividend of course, but many do. Given the low yields on so many investments in 2010, income-focused investors explored every tool at their disposal to generate cash flow. This includes ETFs designed to track indexes of stocks that pay healthy dividends, although dividends are not guaranteed and can be reduced in times of financial stress. Each index is constructed a little differently, but the general idea is to include stocks with a history of paying steady and, in many cases, increasing dividends over time.

Both U.S. and international dividend stock ETFs can play a role in a well-diversified portfolio, but keep in mind that international ETFs will provide exposure to non-U.S. dollar currencies.

Keep in mind, though, that stocks are inherently more volatile than bonds and have more risk of falling in value (though they also offer more potential for appreciation).

Selecting an income ETF

When looking for ETFs that provide income, take these factors into account.

- **Yield**. Obviously, search for a fund that pays a good yield, but be cautious if the yield is exceptionally high relative to similar ETFs—as the fund could be exposed to some non-obvious risks.
- **Assets**. Look for a fund with at least $20 million under management (smaller ETFs may eventually be closed by their managers).
- **Trading volume**. Look for at least 50,000 shares per day. While not a perfect measure of liquidity, a higher trading volume may indicate confidence that the fund won't be overly expensive to trade.
- **Bid-ask spread**. Check the difference between the prices at which market makers are willing to buy the ETF (the lower "bid" price) and to sell the ETF (the higher "ask" or "offer" price). This is essentially the cost of trading the ETF, and it should be no more than 0.25% of the ETF's price.
- **Commissions**. Add any commissions to the overall cost.

Income vs. total return

Income investing means focusing on investments that provide regular income, such as interest payments from bonds and dividend payments from stocks. Whether the investment itself rises or falls in value is at best a secondary consideration. However, too often an income investor will gravitate to an investment with a high yield even if that investment has less growth potential than a similar investment (or perhaps is even likely to fall in value). Investors should be careful not to chase yield at the expense of growth, and remember that high yield usually means high risk.

Learn more: "Finding Income With ETFs"

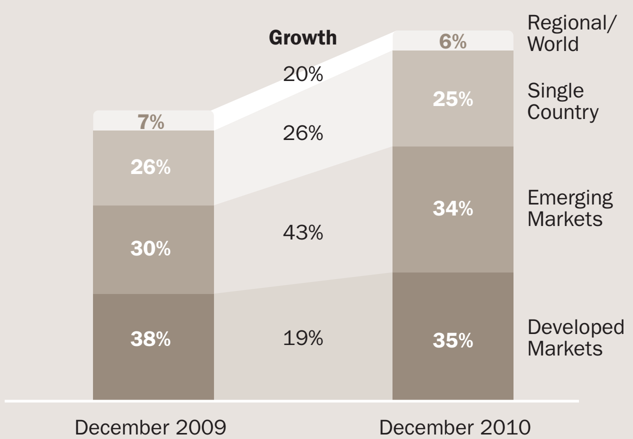
INTERNATIONAL EQUITY ETFS

Investors used International ETFs as a way to gain exposure to developing markets.

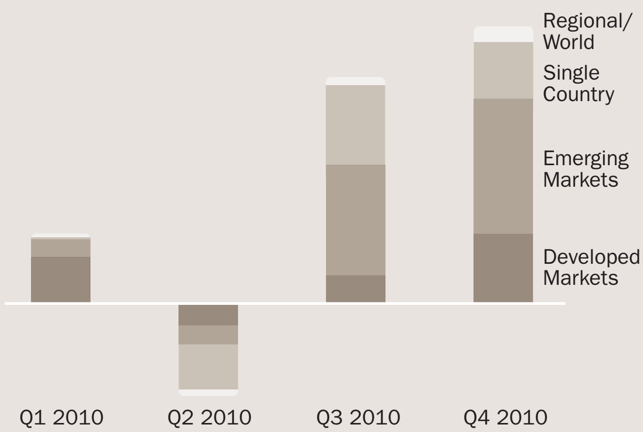
Schwab Trends

- International Equity ETF assets at Schwab grew 28% over the past year, in line with industry ETF asset growth and slightly slower than total ETF asset growth at Schwab (34%). Retail Investors and RIA Clients evenly led flows into this ETF asset class.
- Emerging Markets Equity ETFs led asset growth in International Equity ETFs in 2010, up 43% over the past year. Emerging Markets ETFs also accounted for more than half of net flows into International Equity ETFs at Schwab.
- International Equity ETF flows at Schwab followed a similar trend to U.S. Equity ETFs in 2010, where there were large outflows in Q2 followed by strong inflows in the last half of the year. Net flows for the year in all International Equity ETF sub-classes were strong despite the Q2 outflows.

International Equity ETF Asset Growth 2009–2010



International Equity ETF Flows at Schwab



Learn more: "Around the World with International Stock ETFs"

Commentary

Why use international ETFs?

International stock ETFs can help diversify across world markets easily and inexpensively. These ETFs come in different flavors—from broad ETFs focused on stocks in well-established countries, to up-and-coming countries in Asia and Latin America. Still others focus on a single country or a subset of broader international markets. Each of these could have a role in a well-diversified portfolio, but it's based on individual investor needs.

Types of international stock ETFs

Developed market ETFs are very broad, focusing on stocks in countries seen to have the most stable economies in the world. The list typically includes the Western European nations, Israel, Japan, Singapore, Australia and sometimes Canada. These investments often form the core of a global equity portfolio.

Emerging markets are countries with economies and financial systems seen as having greater growth potential than developed-market countries, but with greater risk as well (including political risk). Examples include China, Brazil, India and Eastern European countries. To be well-diversified, a growth-oriented stock portfolio should include both emerging markets and developed markets. A good rule of thumb is to have 20–25% of the international stock allocation in emerging markets and the rest in developed, non-US markets.

Niche ETFs. Many ETFs focus on a subset of the international markets. Some track a single country, some focus on a region or group such as Europe or the BRIC nations. Others focus on a particular part of a broader market, such as the stocks of smaller companies within developed-market countries. These niche ETFs, provide less diversification than developed-market or emerging-market ETFs, and are likely to see more volatility in performance.

A note on international ETF prices

It's important to compare a fund's market price to its net asset value (NAV). NAV is based on the stocks within its portfolio, and the price of an ETF should usually be close to its NAV. However, some international ETFs may swing from trading below NAV one day to trading above NAV the next, and back again.

This is due to the timing of the NAV calculation. NAV is officially calculated once per day based on the closing prices of all of the stocks in the ETF's portfolio. International ETFs hold stocks that trade on foreign exchanges so by the time the ETF calculates its NAV at the U.S. market close, the prices of the foreign stocks in the portfolio may be stale by many hours because those markets are no longer open.

Don't be too concerned about differences between the price of an international stock ETF and its NAV—they're just out of sync by half a day. If the difference persists in one direction over time, however, it warrants a harder look at what's driving the discrepancy.

International investing involves special risks such as currency fluctuation and political instability. Investing in emerging markets may accentuate these risks.

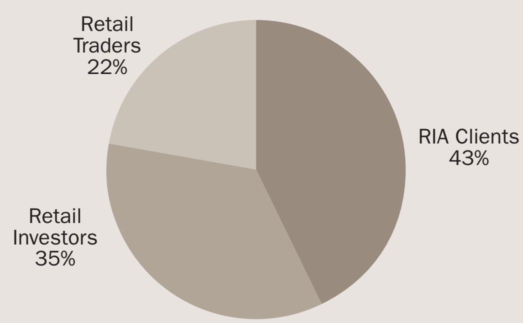
COMMODITY ETFS

Investors flocked to Commodity ETFs in 2010 as a possible hedge in an uncertain market.

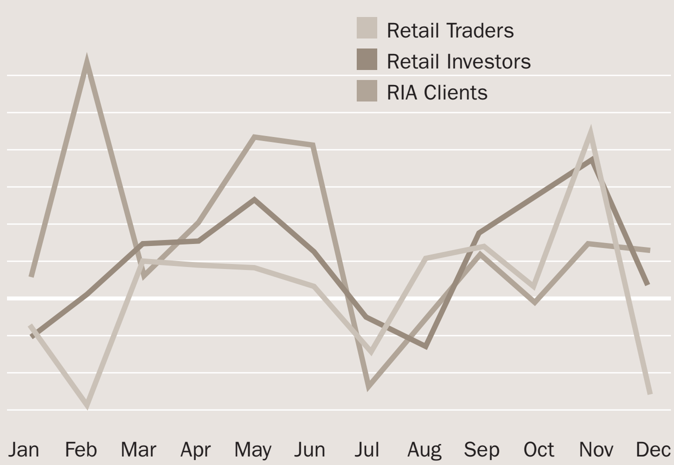
Schwab Trends

- Schwab clients held a total of $9.6B in commodity ETFs at the end of 2010, 9% of all ETF assets at Schwab.
- Commodity ETF assets at Schwab grew 53% over the past year, fastest among Retail Investors (78% 12-month growth). This exceeded the ETF asset growth rates of 34% at Schwab and 28% for the industry.
- While Retail Traders only held 12% of all ETF assets at Schwab, they accounted for 22% of the Commodity ETF assets.
- RIA Clients accounted for 51% of 12-month net flows into Commodity ETFs. Flows in general were strong, particularly in Q2. July saw the most outflows from Commodity ETFs, when most ETF asset classes had weaker than normal flows at Schwab.

Commodity ETF Assets at Schwab (December 2010)



2010 Commodity ETF Flows at Schwab



Commentary

Why investors choose commodity ETFs

One feature of ETFs that many investors find attractive is relatively low-cost access to asset classes that are otherwise difficult to invest in. The poster child is commodities—physical goods such as precious metals, oil and agricultural products. While it can be tough for a typical investor to buy and store these goods, an ETF can grant access with relative ease.

Some investors turn to commodities for diversification and some protection against inflation. While commodities can be useful as a hedge against inflation, they generally shouldn't make up a large portion of a portfolio—no more than 5% to 10% for most investors. More than that may reduce the diversification benefits.

Before investing in a commodity ETF, it is important to understand what makes them different from other ETFs.

Access to different types of commodities

Unlike stock ETFs which typically track an index of equity securities, commodity ETFs can track single products such as oil or gold. A popular choice is a diversified commodity index ETF, which is designed to offer exposure to a wide variety of commodities in a single investment. Investors can also access the main commodity sectors—energy such as natural gas, metals (i.e., gold) and agriculture (i.e., corn).

Structures of commodity ETFs

The structure of commodity ETFs is different from a stock ETF. It is critical that investors understand the different commodity ETF structures and their unique implications.

The first and simplest structure buys and stores the physical commodity itself. These are technically trusts, and use their assets to buy the commodity to store in bank vaults. The value of these ETFs will move with the spot price of the commodity.

The second common structure is a fund that holds futures contracts, an agreement to deliver the commodity at a certain future date for a price paid today. Futures contracts trade on exchanges and don't require storage like a physical commodity. When a futures contract approaches the delivery date, the holder will typically "roll" that contract in exchange for another contract on the same commodity to be delivered further in the future. The impact on the ETF's returns from the continuous process of selling expiring contracts and buying longer-dated ones is called roll yield; investors should be aware that roll yield can potentially erode returns.

Commodity-related products, including futures, carry a high level of risk and are not suitable for all investors. Commodity-related products may be extremely volatile, illiquid and can be significantly affected by underlying commodity prices, world events, import controls, worldwide competition, government regulations, and economic conditions, regardless of the length of time shares are held. Investments in commodity-related products may subject the fund to significantly greater volatility than investments in traditional securities and involve substantial risks, including risk of loss of a significant portion of their principal value.

For tax reporting purposes, keep in mind that commodity ETFs typically generate schedule K-1 instead of a 1099 tax form.

Learn more: "Getting Started with Commodity ETFs", "Commodity ETFs: Spot and Futures Prices", "Commodity ETFs and Schedule K-1"

NOTES

IAN (0311-1655) MKT61093 (03/11)

charles SCHWAB