

2009 Second Quarter Performance Commentary

Q2: EQUITY MARKETS IMPROVE AND SCHWAB EQUITY RATINGS PERFORMANCE DEMONSTRATES THE SUCCESS OF SCHWAB'S APPROACH

The equity market posted strong gains for the second quarter of 2009 as investors became more comfortable holding riskier assets. Also, the financial data began to point to a stabilization of the economic freefall that gripped the market late last year and the beginning of this year. For the quarter, the large cap S&P 500 Index climbed 15.9%, its largest quarterly increase since 1998. Small cap stocks provided even better returns as the Russell 2000 small cap index gaining 20.7%. Growth and value stocks performed comparably. According to Lipper Inc., the average U.S. equity mutual fund returned 18% for the quarter. Small cap funds performed best, averaging close to 22%, followed by mid cap funds, averaging 18%, and then large cap funds with an average return of 16%. The average Value mutual fund outperformed the average Growth fund by between 1% and 3% depending on the market cap segment.

Within this strong market environment, Schwab Equity Ratings performed well. A and B-rated stocks dramatically outperformed the average Schwab-rated stock, while F-rated stocks slightly underperformed. Contributing most to this success was the performance of the model in the smaller cap segment of the market. For the quarter, we found that Schwab Equity Ratings continues to be a useful surprise anticipation tool, as 69% of A-rated stocks reported earnings above consensus forecasts while only 45% of F-rated stocks reported positive earnings surprises. "Surprise anticipation" is an important aspect of Schwab Equity Ratings' underlying strategy, as earnings surprises are generally (though not always) strongly correlated with stock returns.

On a buy-and-hold basis over the last year, Schwab Equity Ratings performance has been mixed. On the plus side, F-rated stocks have significantly underperformed the average Schwab-rated stock. Unfortunately, the A-rated stocks also underperformed, largely due to the market's performance variability over the last year. The A-rated cohort from June 30, 2008 contained stocks of companies that had performed well in the initial stages of the bear market. These defensive stocks held up relatively well as the bear market steepened over the next three quarters (Q3 2008 through Q1 2009). But when the market rebounded in March, the defensive A-rated cohort from 1 year ago didn't bounce as strongly off the bottom as the average stock, leading to underperformance over the twelve month period. The good news is that the A-rated stock cohort has rotated into more aggressive stocks in recent months. As a result of Schwab Equity Ratings' adaptive nature, model performance has been strong during the recent rally off the March 9th bottom, as we highlighted above.

Since inception in May 2002, Schwab Equity Rating performance has been excellent. On average, A-rated stocks have outperformed B's, B's have outperformed C's, C's have outperformed D's, and D's have outperformed F's on a 52-week buy-and-hold basis. A-rated stocks have outperformed the average rated stock by 3.05% annually, while F-rated stocks have lagged by an even larger margin of 6.8% annually. To put this performance edge into perspective, if the stock market appreciated 8% annually over the next ten years, \$10,000 invested in a hypothetical stock portfolio that outperformed by 3.05% annually would grow to \$28,522 versus only \$21,589 for a similar investment in a market index portfolio (assuming no fees, expenses, or taxes). While past performance doesn't ensure future results and performance will inevitably vary over shorter evaluation periods, Schwab Equity Ratings' long-term track record strongly suggests that they can be useful tool for helping investors decide which stocks to buy and which to sell or avoid.