

2009 Third Quarter Performance Commentary

The equity market posted strong gains again for the third quarter of 2009 as investors continued to prefer to hold riskier assets. Also, the economic data continues to point to a stabilization of 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 15.6%. Small cap stocks provided even better returns as the Russell 2000 small cap index gaining 19.3%. Value stocks outperformed growth stocks, with the Russell 3000 Value Index returning 18.6% while the Russell 3000 Growth Index returning less at 14.1%. According to Lipper Inc., the average U.S. equity mutual fund returned 16.7% for the quarter with the average Value mutual fund outperformed the average Growth fund by between 2% and 4% depending on the market cap segment.

Within this strong market environment, Schwab Equity Ratings performed very well as the market reward value which one of the major components that the Schwab Equity Ratings emphasizes. A-rated stocks dramatically outperformed the average Schwab-rated stock while B-rated stocks also outperformed. On the other end, F-rated stocks significantly lagged the average Schwab-rated stock. Contributing most to this success was the performance of the Schwab Equity Ratings in the small and micro cap segments of the market. For the quarter, Schwab Equity Ratings continues to be a useful surprise anticipation tool, as 77% of A-rated stocks reported earnings above consensus forecasts while only 52% of F-rated stocks reported positive earnings surprises. These numbers compared favorable to the overall total number of surprises for the quarter of 66%. "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 solid in discriminating relative performance. A-rated and B-rated stocks have outperformed the average Schwab-rated stock while the D and F-rated stocks have significantly underperformed the average Schwab-rated stock.

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 2.8% annually, while F-rated stocks have lagged by an even larger margin of 6.6% 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 2.8% annually would grow to \$27,887 versus only \$21,589 for a similar investment in a market index portfolio (assuming no fees, expenses, or taxes). While past performance doesn't insure 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/avoid.