

2009 Fourth Quarter Performance

The equity market posted another quarter of positive gains as investors continued to be encouraged by improving economic data. Large caps led the way as quality, liquidity and lower risk (as measured by beta) became important stock selection considerations. For the quarter, the large cap S&P 500 Index climbed 6.1%. Small cap stocks provided lower returns with the Russell 2000 small cap index gaining 3.9%. Growth stocks outperformed value stocks, with the Russell 3000 Growth Index returning 5.9% while the Russell 3000 Value Index returned only 4.2%. According to Lipper Inc., the average U.S. equity mutual fund returned 5.4% for the quarter. In line with the market's return, the average Growth mutual fund outperformed the average Value fund by 2%.

Within this strong market environment, Schwab Equity Ratings performed well as the market shifted from rewarding lower quality, higher risk stocks from the March lows through September to preferring stocks with better fundamentals, stronger momentum and lower market risk in most of the fourth quarter – just the type of characteristics that the Schwab Equity Ratings emphasize. A-rated stocks significantly 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. For the quarter, Schwab Equity Ratings continue to be a useful surprise anticipation tool, as 77% of A-rated stocks reported earnings above consensus forecasts while only 57% of F-rated stocks reported positive earnings surprises. These numbers compared favorably to the overall total number of surprises for the quarter of 67%. This overall total has been relatively high historically for the past two quarters (the historical average is 59%) and helps explain the market's performance since March – investors have been more positively surprised about earnings this year than prior years. As a reminder, “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 was mixed. Most importantly, A-rated stocks significantly outperformed the average Schwab-rated stock. This was mostly due to the strong performance of the small and micro capitalization stocks over the last year, which the A-rated stocks preferred. However, the F-rated stocks also outperformed, largely due to the “junk” rally off the market lows in March. This F-rated performance is typical when the market recovers off a bear market bottom.

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 3.2% annually, while F-rated stocks have lagged by an even larger margin of 6.3% 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 3.2% annually would grow to \$28,910 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 a useful tool for helping investors decide which stocks to buy and which to sell/avoid.