

## 2012 First Quarter Performance Commentary Strong First Quarter for Equities Fueled by Economic Optimism

The improving investor sentiment we experienced at the end of 2011 continued into the first quarter of 2012. With fears of a euro zone collapse dissipating, the U.S. economy showing continued signs of strength, and central banks extending efforts to support economic growth, investor optimism strengthened. Markets responded positively to this favorable backdrop with strong equity returns and substantially lower price volatility.

Equity index returns for the first quarter were tightly bunched across market capitalization. The large cap S&P 500 Index increased 12.6% while the small cap Russell 2000 Index returned 12.4%. Growth stocks outperformed value stocks, with the Russell 3000 Growth Index increasing 13.3% while the Russell 3000 Value Index gained 11.6% in large part due to the Growth Index having more exposure to Technology and less to Commodities. According to Lipper, the average U.S. equity mutual fund increased 12.3% for the quarter.

One dramatic change in the equity market this quarter was the degree to which stocks moved together. This degree of co-movements among stocks, as measured by stock return correlations, was close to 100% for most of last year. Macro effects like the euro crisis and concerns about the global economy led investors to move in and out of the equity market en masse – ignoring fundamental differences among stocks. A more benign macroeconomic and political environment this quarter resulted in close to a 50% reduction in stock correlations as a renewed focus on more traditional drivers of individual stock performance (like profitability and valuation) emerged.

Against this backdrop, Schwab Equity Ratings performed well. A-rated stocks outperformed the average Schwab-rated stock by 0.9% while F-rated stocks underperformed by 2.4%.

Contributing most to this success was the model's ability to identify attractively valued companies with improving cash flow, profitability and sentiment. Also, the market's renewed focus on stock fundamentals, rather than macro effects, added to our model's strong performance this quarter.

Schwab Equity Ratings® and the general buy/hold/sell guidance are not personal recommendations for any particular investor or client and do not take into account the financial, investment, or other objectives or needs of, and may not be suitable for, any particular investor or client. Investors and clients should consider Schwab Equity Ratings as only a single factor in making their investment decision while taking into account the current market environment.

For the quarter, Schwab Equity Ratings continue to be a useful surprise anticipation tool, as 71% of A-rated stocks reported earnings above consensus forecasts while only 49% of F-rated stocks reported positive earnings surprises. These numbers compared favorably to the overall total number of surprises for the quarter of 61%. 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.

The news improves even more for Schwab Equity Ratings performance as we shift our focus to the last year. On a twelve-month buy-and-hold basis, the model's performance has been exceptional in discriminating relative performance. A-rated stocks have outperformed the average Schwab-rated stock by 2.2% while F-rated stocks have significantly underperformed the average Schwab-rated stock by a large 18.5%, reinforcing the Rating's usefulness as a sell discipline.

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 5.4% annually, while F-rated stocks have lagged by an even larger margin of 7.6% annually. 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.