

2013 First Quarter Performance Commentary

Schwab Equity Ratings® Perform Well in Market Rally Fueled by Low-Beta Stocks

MARKET ENVIRONMENT

The end of year rally we experienced in 2012 continued into the first quarter of 2013. With the U.S. economy showing continued signs of strength, progress on budgetary issues in Washington, and an accommodative Federal Reserve, investor optimism strengthened. Markets responded positively to this favorable backdrop with strong equity returns as the S&P 500 topped its 2007 recording closing high on the last trading day of the quarter.

For the quarter, small cap stocks performed better than their large-cap counterparts, with the small cap Russell 2000 Index returning 12.4% while the large cap S&P 500 gained 10.6%. Value stocks outperformed growth stocks for the fourth quarter in a row as the Russell 3000 Value Index gained 12.3% while the Russell 3000 Growth returned 9.8%. The average mutual fund returned 10.2%.

An unusual aspect of this rally has been the type of stocks leading the charge. Normally, in a strong market advance, you'd expect riskier stocks (stocks with higher betas¹) to lead the charge. However, we saw low-beta stocks (the 20% of stocks from a universe of the largest 800 with the lowest beta) outperformed high-beta stocks (the 20% of stocks with the highest beta) by 3.7% last quarter.

For some perspective, this was the only quarter since 1990 when the market has rallied at least 10% and low-beta stocks outperformed high-beta stocks. This highlights the degree to which investors sought defensiveness and safety this quarter, even in the midst of a bull market.

SCHWAB EQUITY RATINGS PERFORMANCE

Against this backdrop, Schwab Equity Ratings performed extremely well as A-rated stocks outperformed the average Schwab-rated stock by 3.4% while F-rated stocks underperformed by 3.2%. Contributing most to this success was the model's ability to identify undervalued stocks with high and growing cash flows. The model's success was also aided by stocks that had improving analyst sentiment.

The news further improves 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, on average, have outperformed the average Schwab-rated stock by 6.4% while the average F-rated stock significantly underperformed the average Schwab-rated stock by a large 17%, 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% annually, while F-rated stocks have lagged by an even larger margin of 9% 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.

1. **Beta** (Risk Level for Equities) Betas are widely used to measure the volatility of a stock's price relative to the general market. The beta relates the volatility of a single stock to the volatility of the market as a whole.

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