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The Charles Schwab Corporation

(SCHW-NYSE)

Company Brief: Revised

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Capital Markets: Brokerages & Exchanges

Here's Why Schwab Is So Excited About Its Robo-Advisor Offering

- **Conclusion:** We now understand why Charles Schwab is so excited about the upcoming launch of Schwab Intelligent Portfolios (SIP), the firm's "robo-advisor" offering that is slated to launch at some point in 1Q15: SIP will allocate between 7% and 30% of client portfolios to cash. By holding such a large percentage of managed account assets in cash that can be swept to its bank, Schwab stands ready to generate substantial revenue from the product despite not charging any advisory fees. From the client's perspective, however, the potential performance drag from such a high cash allocation may easily exceed the management fee savings relative to competitors.

- **Two revenue streams from Schwab Intelligent Portfolios (SIP):** Although the product itself is free (no advisory fee, no commissions, no service fees), SIP will generate revenue for Schwab in two ways. First, some portion of client portfolios may be invested in Schwab ETFs, from which Schwab will earn management fees. Second, Schwab will sweep the cash allocation of client managed accounts into Schwab Bank and earn a net interest margin on this cash. We believe the second revenue source is likely to be much greater than the first and Schwab's regulatory filings indicate the same.

- **Allocation details available in regulatory filing details:** Schwab has filed its disclosure brochure with the SEC that provides detail about a number of elements about SIP. What caught our eye is the fact that the cash sweep allocation within the various managed accounts will range from 7-30%, and the customer has no discretion over this amount. This compares to the 0% cash allocation utilized by robo-advisor start-ups Betterment and Wealthfront. Schwab defended the allocation during its recent business update by arguing that cash will provide "ballast" in down markets, but the reality is that many of these clients will have cash sitting elsewhere, either in different Schwab accounts or in third-party banking or brokerage accounts. Indeed, within its brochure disclosure, Schwab itself notes: "B*ecause Schwab Bank earns income on the Sweep Allocation for each investment strategy, [Schwab Wealth Investment Advisory] has a conflict of interest in setting the parameters for the Sweep Allocation. In most of the investment strategies, this results in a Sweep Allocation which is higher than the cash allocation would be in a similar strategy in a managed account program sponsored by a Schwab entity or third parties. A higher cash allocation can negatively impact performance for an investment strategy in a rising market."*

- **Free offering may prove expensive for Schwab clients:** Wealthfront and Betterment both charge clients roughly 25 basis point advisory fees. In contrast, Schwab will charge no advisory fee. However, if we were to assume that the average Schwab SIP managed account had 15% of its assets in cash and further assume a blended 70% stock/30% fixed income fund were to return 5% over the long run, having a 15% cash allocation will cost Schwab clients 75 basis points. Thus the cost of having such a high cash allocation can easily exceed the upfront savings to Schwab PIS customers. While we have no doubt that SIP will still attract substantial client interest due to the power of Schwab's brand and its existing customer reach, in our view this allocation to cash creates a client unfriendly product that will face significant criticism from competitors.

Rating

Market Perform 3

Current Price

Current Price (Feb-18-15 close)	$29.09
52-Week Range	$31.00 - $23.35
Suitability	Aggressive Growth

Market Data

Shares Out. (mil.)	1,316.0
Market Cap. (mil.)	$38,282
Avg. Daily Vol. (10 day)	7,687,604
Dividend/Yield	$0.24/0.8%
Book Value (Sep-14)	$8.74
ROE %	12%
LT Debt (mil.)/% Cap.	$1,900/14%

Earnings & Valuation Metrics

	2014A	2015E	2016E
GAAP EPS	$0.96	$1.05	$1.70
P/E Ratios (GAAP)	30.3x	27.7x	17.1x
Revenues (mil.)	$6,058	$6,513	$8,244
Operating Margins	36.1%	37.2%	46.9%

Company Description

The Charles Schwab Corporation, headquartered in San Francisco, California, provides brokerage, financial advisory, and banking services to its clients through its online presence as well as more than 300 branch offices. Charles Schwab serves over 8.8 million retail brokerage accounts, 1.6 million corporate retirement plan participants, and 881,000 banking clients. The company also runs a leading mutual fund marketplace (Schwab Mutual Fund OneSource) and is the largest provider of processing and custody services to independent financial advisors. Schwab acquired online brokerage firm optionsXpress in September 2011, expanding the firm's derivative and active trading capabilities.

Footnotes: UR: Under Review.

Please read domestic and foreign disclosure/risk information beginning on page 2 and Analyst Certification on page 2.

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Outperform (MO2) Expected to appreciate and outperform the S&P 500 over the next 12-18 months. For higher yielding and more conservative equities, such as REITs and certain MLPs, an Outperform rating is used for securities where we are comfortable with the relative safety of the dividend and expect a total return modestly exceeding the dividend yield over the next 12-18 months.

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Underperform (MU4) Expected to underperform the S&P 500 or its sector over the next six to 12 months and should be sold.
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Market Perform (MP3) The stock is expected to perform generally in line with the S&P/TSX Composite Index over the next twelve months and is potentially a source of funds for more highly rated securities.
Underperform (MU4) The stock is expected to underperform the S&P/TSX Composite Index or its sector over the next six to twelve months and should be sold.

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Strong Buy (SB1) Expected to appreciate and produce a total return of at least 25.0% over the next twelve months.
Outperform (MO2) Expected to appreciate and produce a total return of between 15.0% and 25.0% over the next twelve months.
Market Perform (MP3) Expected to perform in line with the underlying country index.
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	Coverage Universe Rating Distribution*				Investment Banking Distribution			
	RJA	RJL	RJ LatAm	RJ Europe	RJA	RJL	RJ LatAm	RJ Europe
Strong Buy and Outperform (Buy)	54%	64%	50%	44%	25%	39%	0%	0%
Market Perform (Hold)	40%	34%	50%	35%	9%	22%	0%	0%
Underperform (Sell)	6%	2%	0%	21%	2%	0%	0%	0%

* Columns may not add to 100% due to rounding.

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Total Return (TR) Lower risk equities possessing dividend yields above that of the S&P 500 and greater stability of principal.

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Aggressive Growth (AG) Medium or higher risk equities of companies in fast growing and competitive industries, with less predictable earnings and acceptable, but possibly more leveraged balance sheets.

High Risk (HR) Companies with less predictable earnings (or losses), rapidly changing market dynamics, financial and competitive issues, higher price volatility (beta), and risk of principal.

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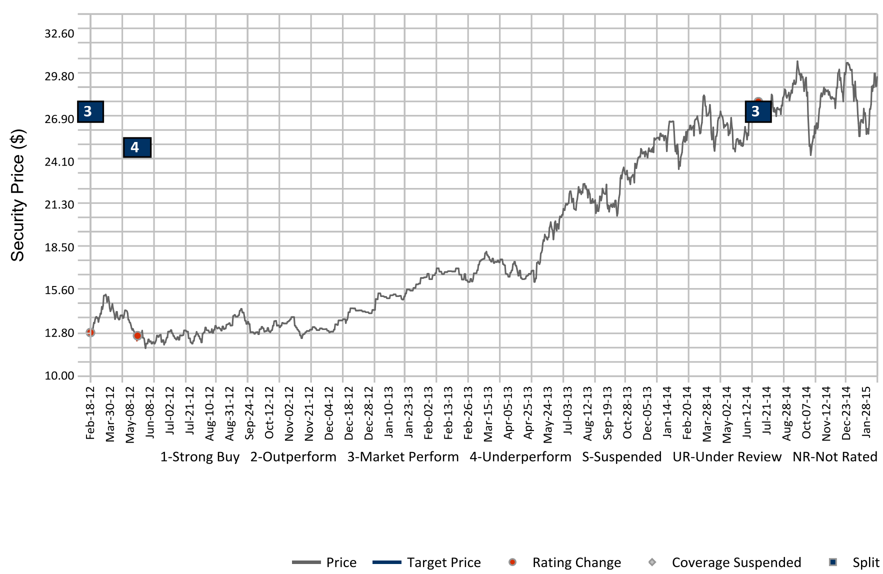
Target Prices: The information below indicates our target price and rating changes for SCHW stock over the past three years.

The Charles Schwab Corporation (SCHW:NYSE) Date: February 17 2015



Rating & Target changes

Date	Curr.	Price	Target	Rating
Jul-07-14	$	28.10	NM	3
May-22-12	$	12.66	NM	4
Feb-18-12	$	12.87	NM	3

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