

The Charles Schwab Corporation

NASDAQ: SCHW

Dow Jones Indus: 15,494.78
S&P 500: 1,697.60
Russell 2000: 1,056.25
Index Component: S&P 500

Trigger: Yes
Type of Situation: Business Value, Consumer Franchise

Price: \$ 22.08
Shares Outstanding (MM): 1,282
Fully Diluted (MM) (% Increase): 1,288 (0.5%)
Average Daily Volume (MM): 8.9

Market Cap (MM): \$ 28,439
Enterprise Value (MM): \$ 23,835
Percentage Closely Held: Charles Schwab: 14.1%
52-Week High/Low: \$ 22.69/12.50
5-Year High/Low: \$ 24.09/10.75

Trailing Twelve Months

Price/Earnings: 33.4x
Price/Stated Book Value: 2.9x

Long Term Debt (MM): \$ 1,630
Implied Upside to Estimate of Intrinsic Value: 45%

Dividend: \$ 0.24
Yield: 1.1%

Net Revenue Per Share:

TTM: \$ 3.93
2012: \$ 3.83
2011: \$ 3.82
2010: \$ 3.56

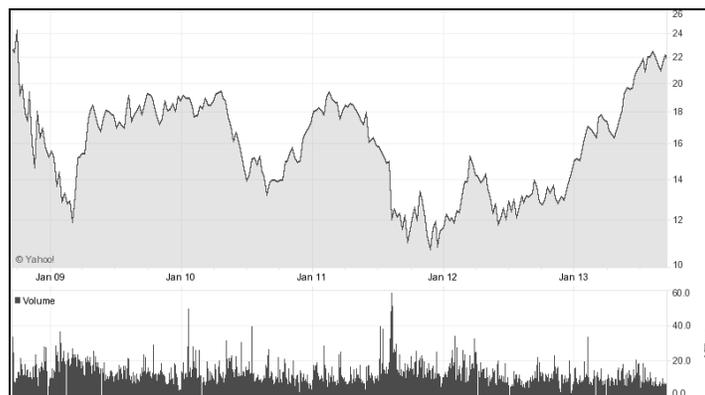
Earnings Per Share:

TTM \$ 0.66
2012: \$ 0.69
2011: \$ 0.70
2010: \$ 0.38

Fiscal Year Ends: December 31
Company Address: 211 Main Street
San Francisco, CA 94105
Telephone: 415-667-7000
CEO/President: Walter W. Bettinger

Clients of Boyar Asset Management, Inc. do not own shares of the Charles Schwab Corporation common stock.

Analysts employed by Boyar's Intrinsic Value Research LLC do not own shares of SCHW common stock.



Introduction

"The Coiled Spring Remains Intact."

– Charles Schwab CEO Walt Bettinger
April 25, 2013 during Schwab's Business Update

This is not your father's discount broker. By all accounts, the Charles Schwab brokerage firm upstart that successfully challenged the full service brokerage model during the early 1970s bears little resemblance to the current Company. Over the past two decades, Schwab has successfully transformed its business model from commission dependent to one that derives the vast majority of its revenues and profitability from either fee based or spread based businesses.

At June 30, 2013, asset management and administration fees (43% of 2Q 2013 net revenues) and net interest revenue (35%) accounted for nearly 80% of Schwab's total net revenues. Meanwhile, transactional based revenues including equity commissions now represent just 17% of total net revenues, down from 60% as recently as 1998. While a portion of the Company's changing mix reflects ongoing commission rate pressures, the strength of Schwab's asset gathering abilities should not be understated. Over the past 15 years, SCHW's total client assets have increased from \$491 billion to \$2.1 trillion, representing a 10% CAGR.

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New assets entering Schwab's various platforms are increasingly generating fees for the Company based on asset levels rather than commissions. Between 2009 and 2012, the Company's asset management and administration fees (excluding money market fund fees) increased to \$1.7 billion from \$1.1 billion representing a 17% CAGR. It should also be noted that nearly half of Schwab's total client assets (\$980 billion out of \$2.1 trillion) at 2Q 2013 were receiving some type of ongoing advice. The vast majority of these advice assets were generating an ongoing revenue stream for the Company. In addition to Schwab's asset gathering success, the Charles Schwab Bank, which was launched in 2003, has seen deposits explode contributing to a nearly 3 fold increase in interest earning-assets over the past 5 years to ~\$128 billion as of June 30, 2013. While lower trading volumes and competitive pressures have impacted the Company's traditional brokerage business, the decline in commission revenues has been more than offset by higher fee and spread based revenues.

We believe Charles Schwab will be a primary beneficiary of what we view as a rising interest rate environment in the coming years. As we detailed in the introduction of this 2013 Summer Double Issue entitled "*Stocks That Should Benefit from a Domestic Recovery and Higher Inflation*," we believe that interest rates are poised to increase markedly in a post-Bernanke world. The unprecedented low interest rate environment has been particularly challenging for Schwab and has masked the Company's true earnings power. Approximately 75% of the Company's interest-earning assets are currently tied to short term rates. In addition to the pressure on net interest revenue (net interest revenues have increased only modestly despite a 3 fold increase in interest-earning assets over the past 5 years), low interest rates have forced the Company to provide fee waivers for its money market funds in order for investors in these products to earn a satisfactory (read: positive) return from these vehicles. During 2012, money market fund fee waivers totaled a whopping \$587 million, representing nearly 30% of the Company's asset management and administration fees. While fee waivers have pressured earnings in recent years, we would not be surprised if this headwind soon pivots to a tailwind. It should be noted that the foregone fees represent a high margin revenue stream for the Company. As a result, as interest rates begin to increase this revenue component should experience a significant acceleration in earnings and have a disproportionate impact on SCHW's overall profitability.

In the wake of the financial crisis with many of its competitors in a weakened financial position, Schwab made a strategic decision to continue to invest in its client capabilities. It's hard to argue that this was not the right decision. The Company's customer loyalty and customer satisfaction are currently at record levels with Schwab garnering the top spot once again (for three straight years) in 2012 by the American Customer Satisfaction Index. Between 2008 and 2012, Schwab attracted \$500 billion in assets, which is \$200 billion more than its top four publicly traded competitors combined. While expenses continued to remain elevated, tracking in-line with revenue growth in recent years, management recently stated that expense growth during 2014 should be "muted" and trail revenue growth by ~300 to 500 bps. We believe this outlook is realistic reflecting Schwab's asset gathering progress and interest rate outlook coupled with the Company's disciplined expense management as the low interest rate environment has persisted. For example, during 2012, Schwab realized approximately ~\$80 million of annual expense savings.

There are a number of items that should allow Schwab to accelerate growth in the coming years including organic growth initiatives, strategic acquisitions, increased market share from the wirehouses and reversal of fund flows in favor of higher margin equity products. During 2012, the Company launched Schwab Index Advantage to become a much greater participant in the \$5 trillion 401(k) market by offering low cost mutual funds as well as professional advice. Recent results have been encouraging as Schwab was able to attract \$4 billion from 50 employers in just its first year. Schwab's recent decision to offer a marketplace of commission free ETFs should also help accelerate fee based revenues. While Schwab foregoes a commission payment, it now generates an attractive long-term recurring revenue stream tied to asset levels. Schwab's 2011 acquisition of Windhaven has proven to be a home run with assets under management rising to \$17 billion from \$4 billion subsequent to the acquisition. Windhaven utilizes primarily ETF securities in managing its three strategies. In 2012, Schwab acquired ThomasPartners, which manages dividend oriented portfolios. We believe that ThomasPartners' products will be increasingly sought after by investors. Finally, we believe that equity funds should begin to garner net inflows following 6 straight years of outflows. During the first eight months of 2013, Schwab experienced \$3.4 billion and \$1.6 billion of inflows into large cap and small/mid cap funds, respectively including inflows in 6 of the first 8 months. We would not be surprised if equity funds should continue to experience net inflows, which should have a positive impact on Schwab's profitability due to the higher fees Schwab receives from equity funds compared with bond funds.

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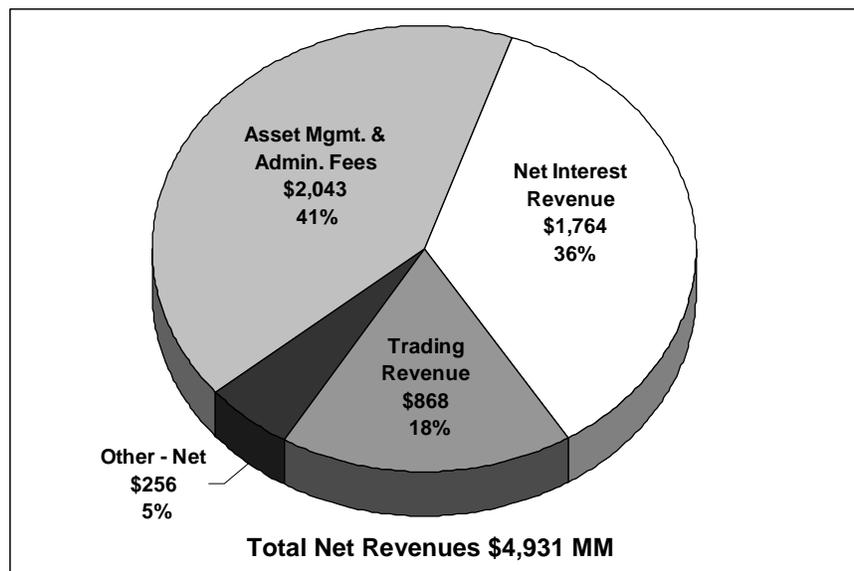
Schwab is well capitalized and is poised to return a significant amount of value to shareholders during a more normalized interest rate environment, in our view. At June 30, 2013, Schwab Bank boasted a Tier 1 Risk-Based Capital ratio of 18.6%, well above the 6% level deemed to be well capitalized. While the unfavorable interest rate environment has created its share of headwinds, the Company has taken advantage of historically low rates to secure capital at attractive rates. We would not be surprised if Schwab boosts its dividend or returns a significant amount of value to shareholders through share buybacks as soon as the Company receives more clarity on future capital requirements.

Based on our sum of the parts valuation, our estimate of Schwab’s intrinsic value is \$32 a share, representing 45% upside from current levels. We would not be surprised if this is conservative, especially as the Company’s true earnings power emerges. In addition, we would not rule out the potential for a takeout. Company founder Charles Schwab is 75 years old and controls over 14% of the stock. We believe the Company’s fee based business would be attractive for a number of large financial institutions.

Business Description

The Charles Schwab Corporation operates as a holding Company that provides a number of services including securities brokerage, banking, money management and financial advisory through its various subsidiaries. At June 30, 2013, Schwab held \$2.05 trillion in client assets, maintained 9 million active brokerage accounts, had 910k banking accounts and served 1.6 million corporate retirement plan participants. The Company’s major sources of revenues are derived from asset management and administration fees, net interest revenue and trading revenue. The following provides a breakdown of SCHW’s total net revenues by source at December 31, 2012:

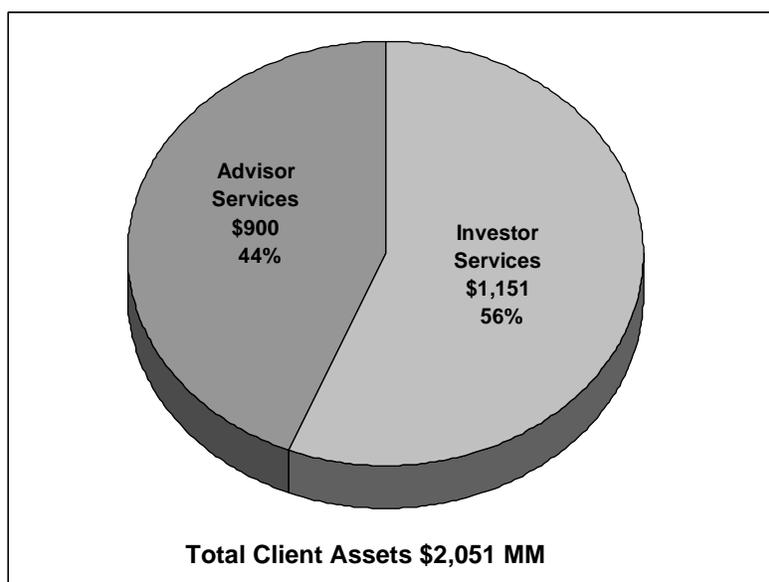
Schwab Sources of Revenue 2012 (\$MM)



Note: Excludes \$16 million deduction for provision for loan losses and \$32 million reduction due to impairment losses on securities.

The Company provides financial services to individuals through two reportable segments including Investor Services and Advisor Services. During the first quarter of 2013, SCHW realigned its reportable segments due to organizational changes. The segment formerly known as Institutional Services was renamed Advisor Services. In addition, the Retirement Plan Services and Corporate Brokerage Services business units are now part of the Investor Services segment. Under the new segment reporting, the Investor Services segment now accounts for 75% of Schwab’s total net revenues (66% under the old classification) while the Advisor Services business represents 23% of total net revenues (32% previously). The following provides a breakdown of client assets by business:

Client Assets by Business (\$MM)



Investor Services – The Investor Services segment provides retail brokerage and banking services to individual investors, retirement plan services, and corporate brokerage services. The following illustrates the components and trends of revenue within the Investor Services segment:

Investor Services

<i>Year Ended December 31,</i>	2010	2011	2012	Growth Rate 2011-2012
Net Revenues				
Asset management and administration fees	\$ 1,275	\$ 1,357	\$ 1,436	6%
Net interest revenue	1,363	1,542	1,559	1%
Trading revenue	598	667	612	(8%)
Other – net	80	98	123	26%
Provision for loan losses	(24)	(16)	(15)	(6%)
Net impairment losses on securities	(34)	(29)	(29)	-
Total net revenues	3,258	3,619	3,686	2%
Expenses Excluding Interest				
Income before taxes on income	\$ 927	\$ 1,050	\$ 993	(5%)
Income before taxes on income margin	28.5%	29.0%	26.9%	

Source: SCHW 2012 Annual Report; Reflects new segment classification

Advisor Services – The Advisor Services segment provides custodial, trading, and support services to independent investment advisors. In addition, the Company provides retirement business services to independent retirement plan advisors and recordkeepers whose plan assets are held at Schwab Bank. Notably, Schwab currently holds a 26% market share of advisors which is more than twice the share of its nearest competitor (Fidelity holds an ~12% market share). At June 30, 2013, Schwab served 7,000 advisors representing ~\$900 billion in assets comprised of over 2 million active accounts. The following illustrates the components and trends of revenue within the Advisor Services segment:

Advisor Services

<i>Year Ended December 31,</i>	2010	2011	2012	Growth Rate 2011-2012
Net Revenues				
Asset management and administration fees	\$ 547	\$ 571	\$ 607	6%
Net interest revenue	161	183	205	12%
Trading revenue	232	260	255	(2%)
Other – net	55	62	62	-
Provision for loan losses	(3)	(2)	(1)	(50%)
Net impairment losses on securities	(2)	(2)	(3)	50%
Total net revenues	990	1,072	1,125	5%
Expenses Excluding Interest				
	694	731	739	1%
Income before taxes on income	\$ 296	\$ 341	\$ 386	13%
Income before taxes on income margin	29.9%	31.8%	34.3%	

Source: SCHW 2012 Annual Report; Reflects new segment classification

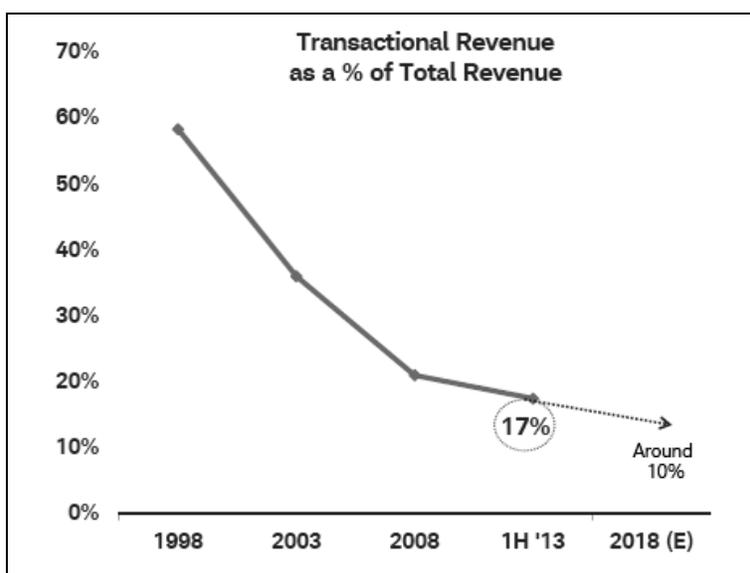
Schwab's Business Model Transformation – Good Growth in Fee Based Revenues

Charles Schwab, which celebrates its 40th anniversary during 2013, barely resembles the upstart that challenged the full service brokerage industry beginning in the early 1970s. A significant contributor to the Company's changing business model was the 1992 introduction of Schwab's Mutual Fund OneSource, a no transaction fee mutual fund service. Mutual Fund OneSource followed on the heels of the 1984 launch of Schwab's Mutual Fund Marketplace, which offered load and no load funds with a transaction fee. By December 31, 1993, Mutual Fund OneSource enabled customers to trade over 200 mutual funds in 25 well-known fund families without incurring brokerage transaction fees. At year end 1993, assets associated with Mutual Fund OneSource purchases totaled \$8.3 billion. The following provides a summary of major OneSource milestones.

Mutual Fund OneSource Milestones

	1992	1997	2002	2012 (March)
Fund Companies	8	125	221	430+
Funds	80+	800+	1,000+	4,000+
Mutual Fund OneSource Assets	\$1.6 Billion	\$57 Billion	\$84 Billion	\$214 Billion

Simplifying the mutual fund investing process was the brainchild of the Company's founder who was overwhelmed with the paperwork (multiple 1099s and fund company statements) and frustrated with the slow process associated with his direct investments in 8-10 mutual funds of several fund families. While the fund platform offered investors many benefits, the addition of a high margin recurring revenue stream based on asset levels rather than commissions was a boon to Schwab's business model. In our view, Schwab's business model continues to strengthen as the Company derives an increasing amount of its profitability from fee-based sources. As of June 30, 2013, nearly half of Schwab's client assets (\$980 billion out of \$2.1 trillion) were receiving some type of ongoing advice up from \$789 billion in advice-based assets at the end of 2011. The vast majority of these advice assets are generating an ongoing revenue stream for the Company based on asset levels. Thanks to the growth in Schwab's fee-based businesses, commission revenues now represent just 17% of total net revenues down from approximately 60% as recently as 1998.



Source: Company presentation, July 2013

To be sure, part of the decline in commission revenues reflects the competitive pressures within the brokerage industry. In addition, in recent years, commission revenues have been impacted by lower client trading volumes. It should be noted, however, that the decline in commission revenues has been more than offset by increases in both asset management and administration fees, and net interest revenues. Schwab Bank, which launched in 2003, has been a major contributor to the growth in net interest revenues, which have more than doubled to \$1.8 billion at year end 2012 from \$825 million at the end of 2002. While commission revenues have been under pressure, management expects commission revenues to be a source of growth, albeit modest (low single digit rate), going forward and are expected to increase in line with client acquisitions and new account formations.

Net Revenues 2002-2012 by Primary Source (\$MM)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Asset Mgmt. & Admin. Fees	\$1,753	\$1,832	\$2,091	\$2,269	\$1,945	\$2,358	\$2,355	\$1,875	\$1,822	\$1,928	\$2,043
Net Interest Revenues	\$825	\$728	\$936	\$1,022	\$1,434	\$1,647	\$1,665	\$1,245	\$1,524	\$1,725	\$1,764
Trading Revenues	\$1,135	\$1,097	\$936	\$778	\$785	\$860	\$1,080	\$996	\$830	\$927	\$868

Note: excludes other net, provision for loan losses and net impairment losses on securities

Although asset management and administration fees have expanded subsequent to the financial crisis, their true run rate is being masked by fee waivers the Company is offering for investors in certain of its money market funds. During 2012, Schwab's money market fund fee waivers were a whopping/record \$587 million, accounting for nearly 30% of the Company's reported asset management and administration fees. As soon as short interest rates begin to increase, the current headwind from the waivers will likely pivot to a meaningful tailwind, allowing Schwab to experience significant earnings acceleration.

Asset Management and Administration Fees Composition (\$MM)

	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>% Change 2009-2012</u>	<u>2012 Average Fee</u>
Schwab MMF before Fee Waivers	\$1,011	\$865	\$865	\$891	-11.9%	0.57%
<u>Fee Waivers</u>	<u>(\$224)</u>	<u>(\$433)</u>	<u>(\$568)</u>	<u>(\$587)</u>		
Schwab MMF after Fee Waivers	\$787	\$432	\$297	\$304	-61.4%	0.20%
Equity and Bond Funds	\$108	\$114	\$118	\$125	15.7%	0.26%
<u>Mutual Fund OneSource</u>	<u>\$446</u>	<u>\$608</u>	<u>\$680</u>	<u>\$680</u>	<u>52.5%</u>	<u>0.31%</u>
Total Mutual Funds	\$1,341	\$1,154	\$1,095	\$1,109	-17.3%	0.26%
<u>Advice Solutions</u>	<u>\$278</u>	<u>\$384</u>	<u>\$522</u>	<u>\$580</u>	<u>108.6%</u>	<u>0.48%</u>
<u>Other</u>	<u>\$256</u>	<u>\$284</u>	<u>\$311</u>	<u>\$354</u>	<u>38.3%</u>	
Asset Management and Administration Fees	\$1,875	\$1,822	\$1,928	\$2,043	9.0%	
Trading revenues	\$996	\$830	\$927	\$868		
Asst Mgmt & Admin Fees (ex Money Market Funds)	\$1,088	\$1,390	\$1,631	\$1,739	<u>3-Year CAGR</u> 16.9%	

It is also worth noting the growth in advice solutions revenues within the asset management and administration fees category. Advice solutions, which encompasses a wide range of products including separately managed accounts, has been the fastest growing component of revenue within the category and now represents 28% of total category revenues up from 15% in 2009. Furthermore, advice solutions assets commanded the highest average fee (48bps) after adjusting for the waivers on the Company's money market funds. With new advice products commanding significantly higher management fees (Windhaven, ThomasPartners, etc., discussed in greater detail in a later section) than some of SCHW's legacy programs (Schwab advisor network @ ~ 20 bps), we would expect the average fee on these assets to expand going forward.

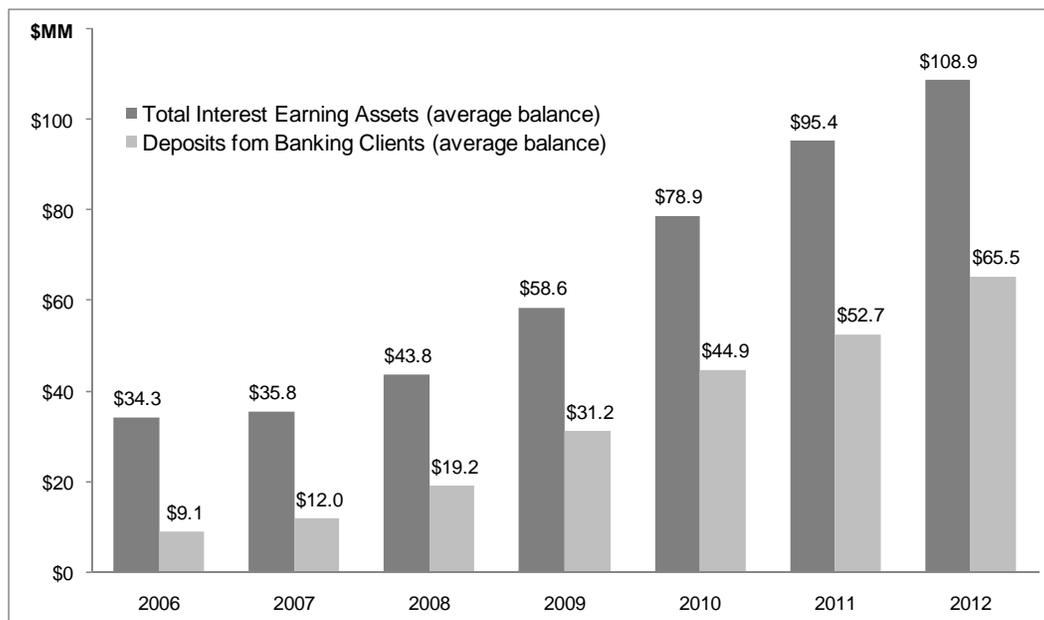
Schwab's Net Interest Revenues – Levered to a Recovery in Short-Term Interest Rates

“And I guess no conversation with Schwab management would be complete without reinforcing the fact that we retain all of the significant upside in our revenue and earnings in a rising interest rate world. The coiled spring remains intact. Our managerial discipline with respect to expenses remains intact. And of course our ability to organically grow the franchise also remains intact.”

– Charles Schwab CEO Walt Bettinger during April 2013 Business Update

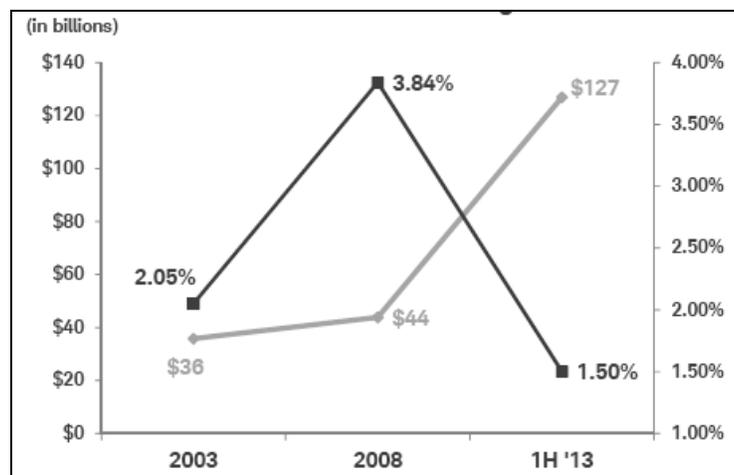
In addition to the pressure on fee based revenues from the low interest rate environment noted above, Schwab's net interest revenues (35% of total net revenues) have also been impacted. While net interest revenues have increased subsequent to the downturn thanks to good growth in interest earning assets (+14% CAGR over the past 10 years), their true run rate has been masked by the ongoing compression in net interest margin. The following chart illustrates the growth in Schwab's interest-earning assets and deposits.

Total Interest Earning Assets and Deposits (\$MM)



The unprecedented low rate environment has presented challenges with the yield on its interest earning assets declining at a much faster pace than the average rate paid on its funding sources. At June 30, 2013, approximately 75% of Schwab's interest-earning assets (~\$128 billion) were tied to a recovery in short term interest rates. The relatively short duration of Schwab Bank's investment portfolio (~2-3 years) is a position that Schwab has maintained for several years and reflects the Company's conservative approach to lending and investing. While this has proved to be an incorrect decision given the trend in interest rates, we believe that it will provide the Company with a significant improvement in earnings as interest rates begin to rise. As short-term interest rates begin to increase, Schwab should experience a greater impact as yields on interest-earnings assets are expected to increase faster than the cost of its funding sources. The following table illustrates the trend in net interest margin and net interest revenues. In addition, we have also provided below a graphic that illustrates the results of a gradual 100 basis points increase in market interest rates forecast on simulated net interest revenue over the next 12 months beginning December 31, 2013 and 2012.

Average Interest-Earning Assets (\$MM) and Net Interest Margin



Source: Company presentation, July 2013

Simulated Impact on Net Interest Revenue

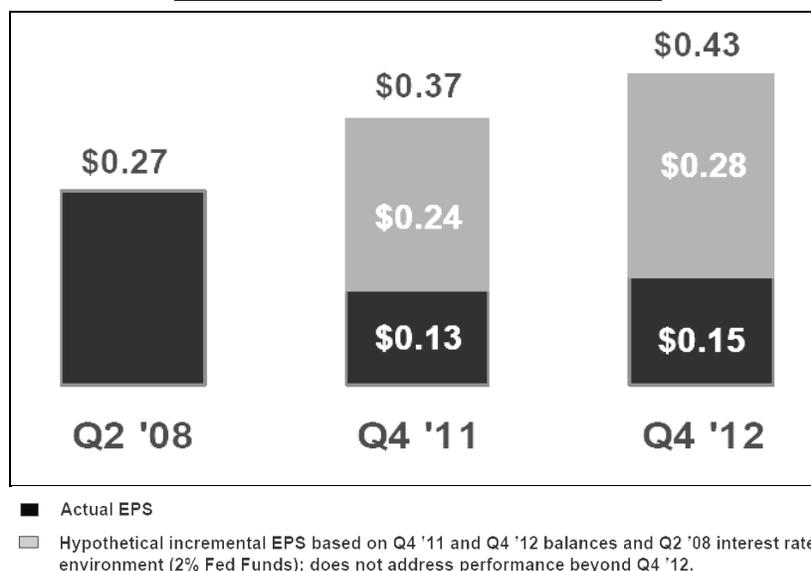
	June 30, 2013	December 31, 2012
Increase of 100 basis points	11.9 %	19.2 %
Decrease of 100 basis points	(5.8)%	(10.0)%

Source: SCHW 2Q 2013 10-Q

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It's not a big surprise that net interest revenues have been impacted amidst this environment given the compression in net interest margin. However, it is worth noting that the pressure on net interest revenue has occurred even as total earning assets experienced strong growth (up nearly 3-fold over the past five years). While bears may state that the Company is currently posting sub optimal returns, we would argue that the Company's growth in total earning assets is being overlooked and normalized earnings power is far greater than current levels of profitability. As illustrated in the table below, Schwab's run rate earnings based on its current assets and in a more normalized Fed Funds rate (Fed Funds rate of 2%, which was experienced in 2Q 2008) is significantly higher than recent reported earnings.

Schwab's Incremental Earnings Power



Source: Company presentation, February 2013

Utilizing Schwab's hypothetical 4Q 2012 earnings of \$0.43 a share, which includes Schwab's estimated incremental earnings in a 2% Fed Funds environment, translates to run-rate annual earnings in excess of \$1.70 a share. In our view, even this earnings level likely understates the Company's true earnings power as it does not reflect the potential for future asset growth and the Company's ongoing progress in gathering an increasing amount of assets in fee based accounts. While we are under no illusion that the current Fed Fund rate will immediately return to 2008 levels, we believe that an increase should begin to occur in the not too distant future, especially as Fed intervention winds down.

A Closer Look at Schwab Bank's Lending and Bank Investment Portfolio

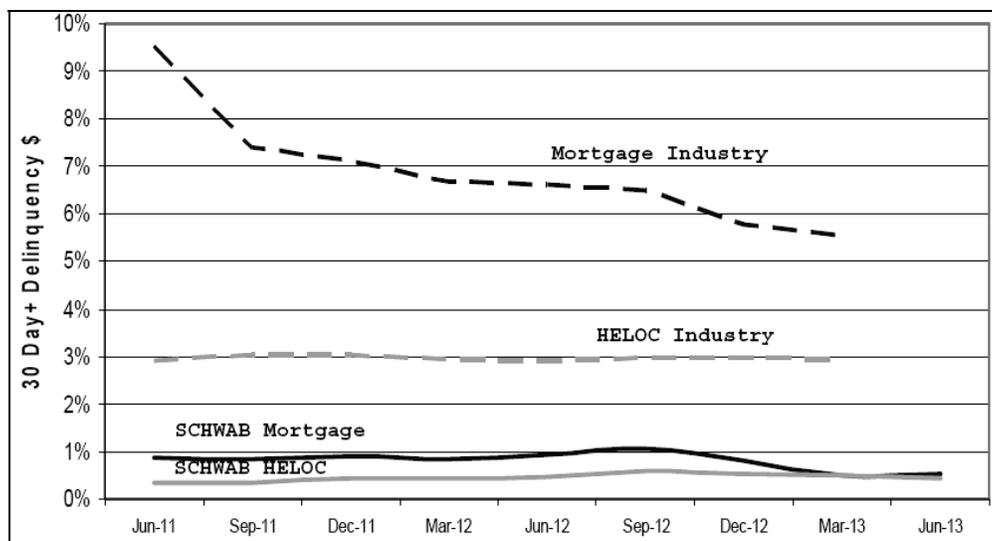
Given the rapid growth in Schwab's interest-earning assets, it is worth taking a closer look at the Company's lending and investment portfolio. The following table illustrates Schwab's loan growth and quality metrics.

SCHW Loan Quality Metrics as a % of Outstanding Loans

	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>
Total Loans to Banking Clients (\$MM)	\$3,450	\$6,062	\$7,391	\$8,773	\$9,866	\$10,782
Growth rate (%)	47.6%	75.7%	21.9%	18.7%	12.5%	9.3%
Loan Delinquencies	0.80%	0.54%	0.87%	0.96%	0.81%	0.77%
Non-accrual loans	0.12%	0.13%	0.46%	0.58%	0.53%	0.45%
Allowance for loan losses	0.20%	0.33%	0.61%	0.60%	0.55%	0.52%

It should be noted that a large amount of the increase in the lending portfolio occurred in the wake of the financial crisis. Accordingly, given Schwab's conservative lending standards, the Company has been afforded the opportunity to make extremely attractive loans in recent years, in our view. At June 30, 2013, the weighted-average estimated current LTV ratios were 55% and 63% for Schwab's First Mortgage and HELOC loan portfolios, respectively. In addition, the weighted-average updated FICO scores were very strong and stood at 770 for the First Mortgage portfolio and 767 for the HELOC portfolio. The conservative nature of the Company's loan portfolio is also reinforced by modest delinquency rates compared with the industry.

30-Day+ Delinquency Trend - Schwab vs. Industry



Source: Company presentation, July 2013

In addition to managing its loan portfolio in a conservative manner, the Company has continued to manage its bank investment portfolio prudently. At June 30, 2013, all of the corporate debt securities and non-mortgage asset-backed securities were rated investment grade or higher. The following provides a breakdown of Schwab Bank's investment portfolio:

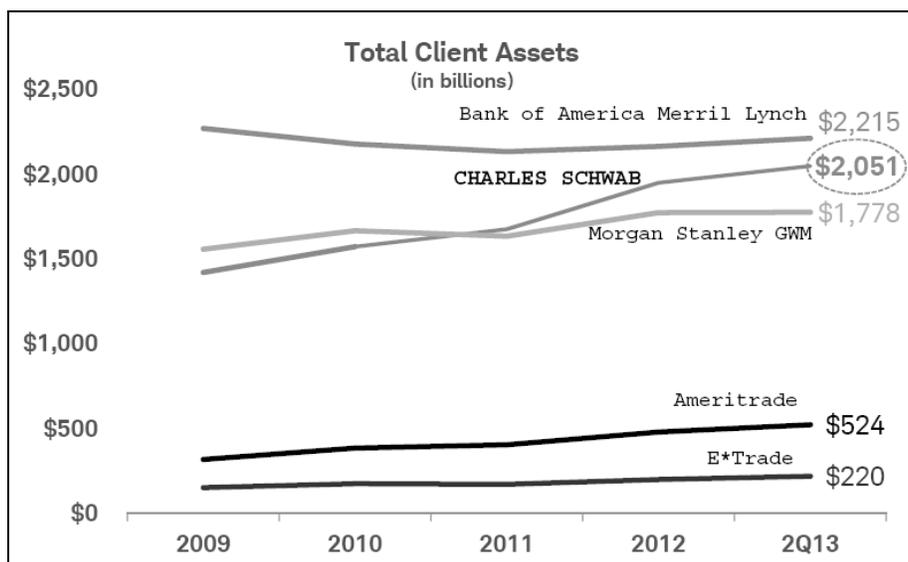
Schwab Bank's Securities Portfolio

June 30, 2013	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available for sale:				
U.S. agency mortgage-backed securities	\$ 18,422	\$ 202	\$ 16	\$ 18,608
Asset-backed securities	11,895	21	77	11,839
Corporate debt securities	8,306	39	26	8,319
Certificates of deposit	4,915	7	1	4,921
U.S. agency notes	3,740	-	105	3,635
Non-agency residential mortgage-backed securities	700	5	54	651
Commercial paper	160	-	-	160
Other securities	272	9	-	281
Total securities available for sale	\$ 48,410	\$ 283	\$ 279	\$ 48,414
Securities held to maturity:				
U.S. agency mortgage-backed securities	\$ 24,887	\$ 184	\$ 643	\$ 24,428
Other securities	931	-	71	860
Total securities held to maturity	\$ 25,818	\$ 184	\$ 714	\$ 25,288

Source: SCHW 2Q 2013 10-Q

Growth Investments Also Masking Schwab’s Operating Leverage

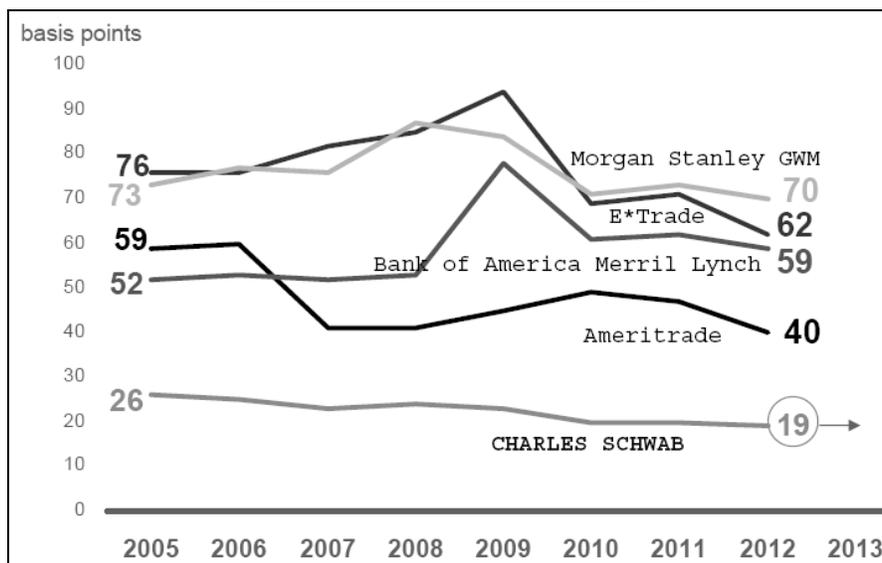
In addition to the reduction in money market fund fees and the pressure on net interest revenues, the operating leverage inherent in Schwab’s business model is also being masked by elevated spending in recent years. While Schwab has reduced costs to reflect the challenging operating/interest rate environment, the Company invested heavily in client capabilities in the wake of the financial crisis in order to drive growth and increase market share as its competitors were in a weakened financial position. For example, during 2012, Schwab invested more than \$160 million in client initiatives (following on the heels of \$180 million in client related projects during 2011). It’s hard to argue with the results Schwab has posted. Between 2008 and 2012, Schwab’s total assets increased by over \$500 billion, which is \$200 billion more than the asset growth of all of its four largest publicly-traded peers combined. During 2012, Schwab recorded core net new assets (before one-time flows) of \$112 billion, representing a 37% increase over the prior year. Notably, there were \$47.8 billion of core net new assets during the fourth quarter (more than double the year earlier level) while December 2012 was a record month in terms of core net new asset growth with \$23 billion, ~\$5 billion greater than the prior monthly record. While there were some one-time macro events that helped the strong asset growth during 2012 (tax law changes resulted in business divestitures, etc.), the Company’s strong momentum has continued into 2013. During the first half of 2013, core net new assets were up \$66 billion, up 54% from the first half of 2012.



Source: Company presentation, July 2013

While Schwab continues to see an opportunity to drive growth, future spending will likely be more muted in the coming years. Despite increased spending on client initiatives, Schwab’s expenses as a percentage of total client assets has migrated lower over the years notwithstanding an increase during the recent downturn. As part of a multi-year plan Schwab management put together in 2009, the Company’s plan targeted a 9% year over year increase in expenses during 2013 with expenses beginning to moderate during 2014. During the Company’s April 2013 business update, management noted that it now expects that expenses to increase ~7% during 2013 on a year over year basis and management stated that it expects expense growth during 2014 to be “quite muted.” This should translate to revenue growth during 2013 increasing 100-200 basis points above expenses. In April, management noted that during 2014 that gap could be much larger (300 to 500 bps) assuming current trading and interest rate levels. The following chart illustrates Schwab’s expense trends relative to its total assets and compared with its peers. Another chart illustrating Schwab’s expense discipline and operating leverage, is its expense ratio relative to its peers. Schwab boasts a meaningfully lower expense ratio relative to its publicly traded peers and this ratio has declined meaningfully over the past 8 years.

Total Expenses to Client Assets



Source: Company presentation February 2013

Fee Based Growth Opportunities Should Further Strengthen Schwab's Business Model

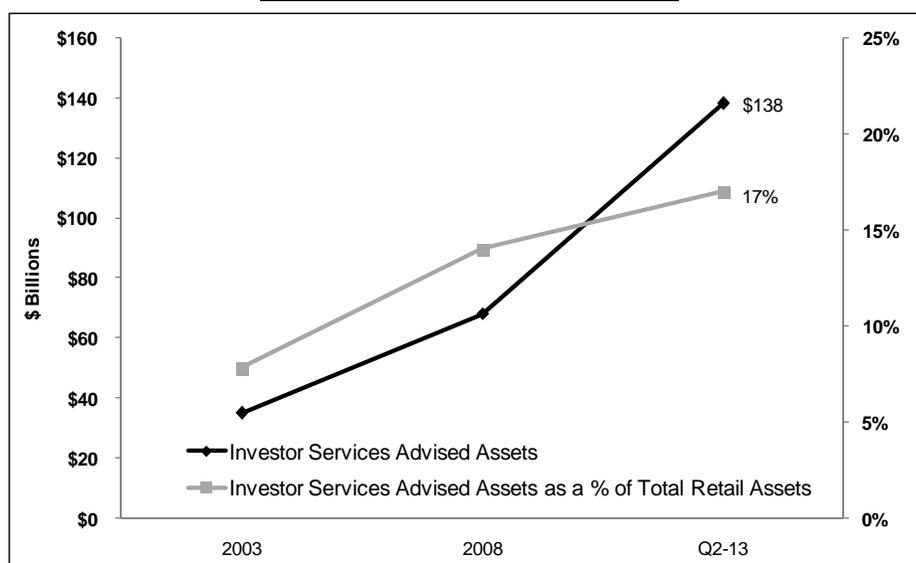
In addition to the potential of capturing higher fee based revenues from reduced fee waivers, we believe there are a number of items that could bolster Schwab's fee based revenues going forward. These items include Schwab's recently launched 401 (k) plan, new commission free ETF platform, opportunistic advisor acquisitions, and increased market share from full service brokerage firms. The following provides additional details on each of these items that we believe should favorably impact the Company's fee based revenues.

- Schwab Index Advantage and ETF 401(k) Plans** – Just as Schwab shook up the traditional brokerage industry during the 70s, the Company is now aiming to become a more meaningful player in the sizable \$5 trillion 401(k) market. During 2012, the Company launched Schwab Index advantage, which is a low cost 401 (k) plan offering significant savings for participants compared with traditional plans. A key component of the plan is that it provides index mutual funds with low operating expenses. According to Schwab, members in the Schwab Index Advantage 401(k) plans have seen their weighted average operating expense ratio (OER) decline by 77% to \$14.78 per \$10,000 compared with a weighted average OER of \$65.11 for these plans prior to transitioning. In addition, the program also comes with a low-cost professional, independent advisor service that develops a savings and investment program with the goal of helping participants increase retirement savings. According to Schwab CEO Bettinger, employees receiving customized advice save at twice the rate of employees who do not receive advice (10% of pay vs. 5%). Nearly 90% of the participants in Schwab Index Advantage plans are receiving low-cost, professional, third-party advice to help manage their 401(k) investments. In early 2013, Schwab noted that its Schwab Index Advantage assets were ~\$4 billion from 50 employers representing 36,000 participants. During the second half of 2013, Schwab intends to launch an ETF-only 401(k) plan for providers that offer employees the ability to invest in low-cost , index ETFs.
- Schwab ETF OneSource** – In February 2013, Schwab became the first industry participant to launch a broad-based (funds from multiple firms) commission free ETF platform. ETF OneSource debuted in early 2013 offering the largest number of commission-free ETFs from most of the industry's largest ETF providers. Schwab is compensated based on an ongoing servicing fee from the advisor based on asset levels. In our view, this arrangement has a number of advantages including further enhancing the company's fee based revenues. During Schwab's February 2013 business update Schwab CEO Walt Bettinger stated, "We would much rather be paid basis points on an ongoing basis rather than one-time transactional compensation that historically has been under pressure and could be under significant pressure out in the future." According to Schwab management, early indications are that the flows into

the ETF OneSource platform are coming out of commission oriented ETFs or commission equities rather cannibalizing Schwab's Mutual Fund OneSource program. This is important due to the fact the Mutual Fund OnceSource program is arguably more profitable than ETF OneSource. ETF OneSource assets (which includes Schwab ETFs) stood at \$12 billion and has increased by \$3 billion since the program launch earlier this year.

- Advice Based Solutions** – Schwab is increasingly generating fee based revenues from its retail asset base. While retail assets have historically generated commission revenues for the Company, retail assets in recent years are generating ongoing fees for the Company tied to some type of advice offering. We believe that this is important and will strengthen Schwab's business model by generating additional investment management fees and diversifying the Company's revenue streams. As illustrated in the chart below, 17% (or \$138 billion) of Schwab's retail client assets are now part of a fee based advice offering, up from approximately 5% of assets just 10 years ago. During the first half of 2013 net new flows into advice offers were up 62% compared with the prior year. Management recently stated that it would not be unreasonable for this amount to increase further (to ~34%) over a period of time. Indeed, during Schwab's July business update CEO Bettinger stated, *"We think there is significant room for that number to run."*

Retail Fee-Based Advised Assets

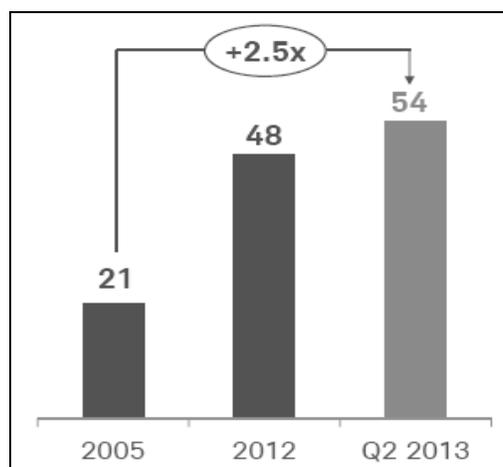


Source: Company presentation, July 2013

To further its fee based ambitions, Schwab has made a couple of strategic acquisitions recently of money management firms with differentiated product offerings. During 2010, Schwab acquired Windward Investment Management (rebranded as Windhaven) during 2010 for \$150 million in cash and stock. At the time of the acquisition, Windhaven managed ~\$4.24 billion. Windhaven, whose portfolios are comprised of primarily ETF securities, is currently the largest ETF based money manager and manages three strategies including diversified conservative, diversified growth and diversified aggressive. The acquisition has been nothing short of a home run for Schwab as total assets managed by Windhaven have increased nearly fourfold to over \$17 billion as of June 2013. In December 2012 Schwab acquired ThomasPartners for \$85 million. ThomasPartners, which managed approximately \$2.3 billion in equity portfolios, offers a growth-oriented, dividend-focused solution for clients that are looking for income. Windhaven and ThomasPartners should be able to take advantage of Schwab's strong distribution network. According to data from securities industry researcher Cerulli Associates, assets in separately managed account programs increased at a 12% CAGR between 1999 and 2011 versus 4.6% growth from long-term securities. Cerulli projects separately managed accounts will increase at a 14% CAGR between 2011 and 2015.

- Ongoing Market Share Gains from Wire Houses** - As we noted above, Schwab has gained a significant amount of market share in recent years relative to full service and discount brokers. We believe that Schwab can continue expanding its market share and there is a large potential universe of assets. At present there is nearly \$11 trillion in assets at full commission brokers, which is ~6x the amount of assets at Schwab's historical discount competitors. Notably, according to a recent survey by Cerulli Associates, nearly two-thirds of wire house investors do not believe that their firm is looking out for their interests. Schwab's retail affluent assets (clients with \$250k+ in assets) have increased to \$698 billion from \$404 billion between 2005 and the second quarter of 2013 representing a 7% CAGR. We believe that Schwab's retail asset growth can continue given the Company's strong level of customer satisfaction. Schwab's client promoter score (a measure of customer loyalty where anything over 0 is considered good and a ranking over 50 is deemed to be excellent) currently stands at 54 as of the second quarter of 2013, up from 21 in 2005. Schwab believes that its client promoter score is approximately 4 times greater than the typical wire house firm. In addition, in 2012 for the third straight year, Schwab ranked number one in customer satisfaction based upon the results of an independent survey conducted by the American Customer Satisfaction Index. Strong client loyalty and satisfaction is important for attracting new assets due to the fact that 40% of new clients come from referrals from existing clients and 60% of new retail clients do not utilize anyone but Schwab.

Client Promoter Score (CPS) for Affluent Retail Clients⁽¹⁾



Notes: Client segments based on assets held at Schwab.
⁽¹⁾ 2013 Affluent CPS based on weighted average Q4 2012/2013
 CPS of clients with \$250 K-\$1 M and \$1 M+ in assets.

Source: Company presentation, July 2013

- Shift to Equities from Bonds** – Flows out of equity funds are starting to reverse following six straight years of net outflows experienced by the industry. During 2012, industry equity mutual funds experienced approximately \$90 billion in net outflows representing the second largest year of outflows on record (in 2008 there was \$136 billion of outflows). Schwab has not been immune to the exodus from equity funds, with large cap mutual funds experiencing net outflows over the past 5 years. While the equity mutual fund outflows have been discouraging and have pressured Schwab's earnings given their relatively higher fees, there is reason to be optimistic that industry conditions are improving. Through the first eight months of 2013, Schwab experienced net inflows into Large and Small/Mid Capitalization funds of \$3.4 billion and \$1.6 billion respectively, with both segments generating inflows in 6 out of the 8 months.

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Mutual Fund Net Buys (Sells) ⁽¹⁾

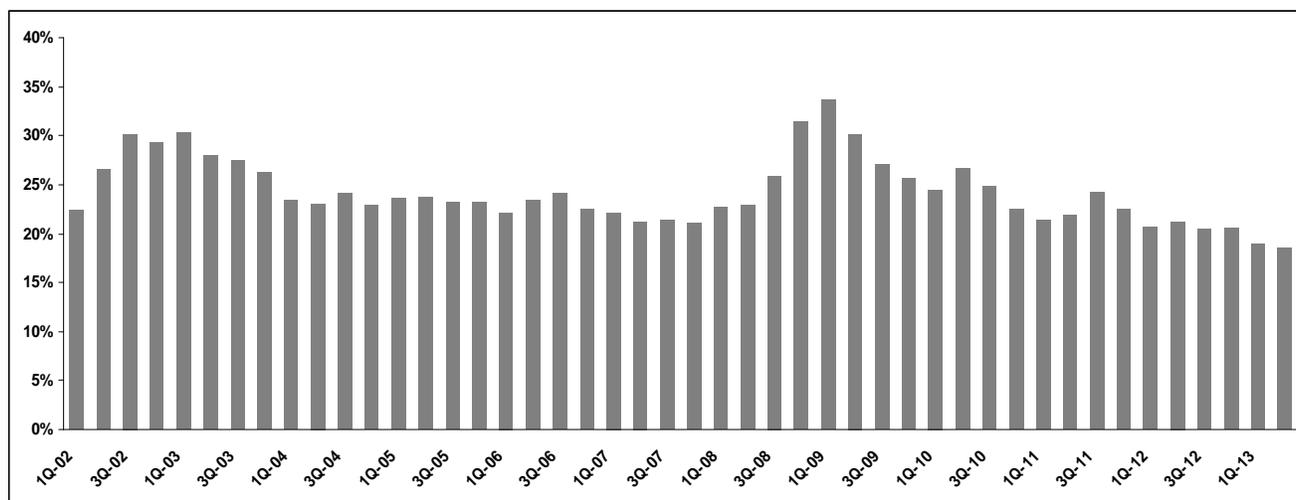
(in millions of dollars)	2007	2008	2009	2010	2011	2012	2013							
	Yr	Yr	Yr	Yr	Yr	Yr	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
Large Capitalization Stock	3,968 (5,967)	(1,889)	(2,714)	(5,281)	(7,304)	1,080	236	339	1,069	(233)	213	839	(186)	
Small / Mid Capitalization Stock	356 (3,225)	2,103	13	(3,323)	(3,720)	746	422	358	(452)	(123)	68	402	179	
International	9,103 (9,779)	3,255	3,071	(2,007)	3,322	2,714	1,752	1,623	1,149	1,249	850	1,205	1,482	
Specialized	286 (2,218)	1,966	703	1,761	733	545	434	453	77	474	120	431	320	
Hybrid	9,392	476	4,325	7,772	4,918	3,282	1,205	931	927	637	762	349	583	317
Taxable Bond	8,628	762	31,656	16,633	12,650	27,778	3,402	1,456	2,216	1,884	1,363	(5,150)	(705)	(2,117)
Tax-Free Bond	1,583	511	7,054	378	(411)	4,275	728	259	53	(539)	(264)	(1,227)	(563)	(922)
Money Market Funds	40,467	22,497	(38,882)	(16,675)	6,573	6,776	(6,031)	(1,610)	(945)	(3,782)	1,043	5,044	710	1,917

⁽¹⁾Represents the principal value of client mutual fund transactions handled by Schwab, including transactions in proprietary funds. Includes institutional funds available only to Investment Managers

Source: Schwab's Monthly Activity Report- August 2013; SEC Filings

While Investors have begun to exit bond funds, most of these funds have made their way into money market funds, which currently are generating low/reduced fees due to the aforementioned fee waivers. Ultimately, we would not be surprised if these funds made their way into equity mutual funds due to the strong performance commanded by this asset class in recent years. Although we expect bond mutual funds to be pressured in a rising interest rate environment, our conversation with Schwab management revealed that its clients have historically been underrepresented in the fixed income asset class. Utilizing the asset mix of Schwab's client's that own individual stocks and bonds as a proxy, fixed income has represented just 24% of Schwab's assets on a historical basis and now is at the low end of its range (19%). Accordingly, this should minimize the impact from potentially large bond outflows in the coming years.

Fixed Income Securities as a % of Schwab Customer Securities (Equity and Fixed Income)



Strong Balance Sheet and Capital Position Provides Flexibility to Return Value to Shareholders

While the low interest rate environment has presented a number of challenges for the Company, there have been a few benefits. Schwab has taken advantage of low interest rates and robust credit markets to raise long-term capital at attractive levels.

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The following provides a summary of the Company's recent capital structure activity:

July 2013:

- Issued \$275 million of 2.2% senior notes that mature in 2018.

2012:

- Issued \$850 million in preferred stock as part of a low cost non-dilutive way to fund future growth.
- Retired \$750 million of outstanding 4.95% senior notes due in 2014 through a debt exchange offer and subsequent redemption of the remaining balance. As part of the refinancing, Schwab exchanged \$256 million in 4.95% Senior Notes due 2014 for \$256 million 3.225% Senior Notes due 2022. Separately, the Company issued \$350 million of 3-year Senior Notes with a 0.85% coupon.
- Redeemed all of its \$202 million of remaining Trust Preferred securities and the underlying 7.5% Junior subordinated notes as the Federal Reserve's proposal to phase out those securities for regulatory capital treatment.

SCHW believes that up to approximately 15% of its capital structure could be comprised of preferred securities. This translates to about \$500 million of capacity now and management expects that it will grow over time to the extent that retained earnings grow.

Schwab Remains Well Capitalized

In the third quarter of 2012, Schwab reduced its target Tier 1 Leverage Ratio for Schwab Bank from at least 7.5% to at least 6.25%. Schwab attributed the change to its conservative approach to lending and investing, which results in a lower risk profile relative to the industry and risk based capital ratios significantly in excess of well capitalized levels. Commenting on the Company's leverage level at its July 2013 business update Nigel Murtagh who serves as an EVP, Corporate Risk at Schwab stated, *"Certainly we could get down to a 6.25%, 6% [Tier I leverage ratio], and given the quality of the way we manage our balance sheet, we're able to absorb those significant downturns, and still have a cushion to the regulatory minimums."* Despite the reduced target, we would still expect the Company to continue to maintain excess capital. According to Schwab's CFO Joe Martinetto during the Company's February 2013 business update, *"And then as a Company we tend to run with a little bit of a buffer to make sure that we are going to stay well in excess of that."* Nevertheless, at June 30, 2013, Schwab Bank boasted a Tier 1 Risk-Based Capital ratio of 18.6%, well above the 6% level deemed to be well capitalized. In addition, Schwab's net capital was \$1.3 billion (10% of aggregate debit balances), which was \$1.1 billion in excess of its minimum required net capital and \$634 million in excess of 5% of aggregate debit balances. The following provides a summary of Schwab's capital ratios (Schwab Bank) as of June 30, 2013:

The Regulatory Capital and Ratios for Schwab Bank at June 30, 2013

	Actual		Minimum Capital Requirement		Minimum to be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Tier 1 Risk-Based Capital	\$ 5,961	18.6 %	\$ 1,280	4.0 %	\$ 1,920	6.0 %
Total Risk-Based Capital	\$ 6,020	18.8 %	\$ 2,560	8.0 %	\$ 3,200	10.0 %
Tier 1 Leverage	\$ 5,961	6.6 %	\$ 3,637	4.0 %	\$ 4,546	5.0 %
Tangible Equity	\$ 5,961	6.6 %	\$ 1,818	2.0 %	N/A	

Source: SCHW 2Q 2013 10-Q

Returns to Shareholders Should Accelerate – Sizable Share Repurchases on the Horizon?

Schwab's strong capital position coupled with its robust balance sheet with \$6.2 billion of cash (including \$1.1 billion at the parent company) and just \$1.6 billion of long term debt position it well to return a significant amount of value to shareholders. In addition, we would expect Schwab to generate a significant amount of excess capital in the coming years as the Company's true earnings power unfolds. While there may be some near term uncertainty associated with new regulatory capital requirements, we believe Schwab's current capital buffer provides it with a sizable cushion. During the Company's April 2013 business update,

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CFO Martinetto stated, *“And we are, again, very comfortable with our capitalization. The stress test results that we have run internally would indicate that we have got adequate capital for some very severe scenarios that we’ve been able to run. So our comfort with our capital level is very high.”*

While the exact timing of an earnings recovery/acceleration is unclear, we believe that returning value to shareholders will become an increased priority as earnings improve and excess capital is generated. CFO Martinetto also stated at the April Business Update, *“But should we get to the point where that capital formation is outstripping the need to retain and to support the growth of the business then we will look to return it to shareholders as I think we’ve done it in the past.”* Schwab has a solid track record of paying dividends with the Company consistently paying a dividend since it initiated one in 1989 (including 19 increases). While Schwab’s current cash dividend of \$0.24 a share on an annual basis is well above targeted net income levels of 20%-30%, we believe there is a good chance that the payout will be increased further as earnings recover. In addition, we would not be surprised if share repurchases and/or special dividends (the Company did pay a \$1.00 special dividend in 2007) are utilized for excess capital. Management recently stated that if Schwab gets to the point where capital formation exceeds the amount needed to retain and grow its business then it will return capital to investors as it has done historically.

Money Market Fund Reform Regulatory Pressures Abating

“I think our take is very favorable on what finally came out in money fund reform. We were quite pleased to see some of our ideas incorporated into the proposal. Our belief is, we are heading toward a set of products which will allow us to continue to meet client demand for products like money funds, while continuing to basically preserve the economics of the product set. I think that was all pretty much good news as we saw it evolve.”

– Joe Martinetto CFO of Charles Schwab during July 2013 Business update

The topic of money market reform is an important consideration for Schwab investors. The money market industry has been under great scrutiny in recent years, especially since the Reserve Primary Fund “broke the buck” in September 2008. Some of the initial proposals for money market “reform” called for the complete elimination of the product. Given the importance of money market funds to Schwab’s business model, we believe the uncertainty has created an overhang on Schwab’s stock price. At June 30, 2013, Schwab managed \$162 billion in money market funds, and before fee waivers, these funds commanded the highest average fee (~57 bps during the first half of 2013) of the Company’s fee generating assets. In June, the SEC announced two proposals relating to money market reform. The first proposal would require that prime institutional funds, which are considered to be the higher risk funds, have an NAV that fluctuates with daily values compared with a stable \$1 NAV. The second proposal would retain the stable NAV for money market funds but impose restrictions on redemptions and charge withdrawal fees during financial turmoil. The SEC noted that it would be amenable to some sort of mixture of the two proposals whereby the floating NAV and the liquidity fees and gates proposals would be combined in a single reform package. While there continues to be uncertainty surrounding money market funds, and there could ultimately be additional capital requirements and expenses associated with the product, we believe an Armageddon scenario is now remote. Further, we believe that Schwab should be able to navigate any increased capital requirement associate with potential regulatory reform.

Valuation and Conclusion

Forecasting the exact timing of a sustained improvement in interest rates is likely a fool’s errand. Nevertheless, as we have detailed in our introduction, we believe that both short and long-term interest rates are poised to increase from currently depressed levels. Longer-term interest rates have begun their ascent in recent months with the 10-year treasury recently recording a multi-year high of ~3.0%, up from near record lows earlier this year at ~1.6%. While Schwab is more levered to a rise in short term rates, which continue to face pressure, we believe they will be set to rise too, especially as quantitative easing winds down and market forces become the primary driver of interest rates going forward. Under a scenario of higher short term rates, the relatively short duration of Schwab’s investment portfolio coupled with the absence of money market fund waivers will likely allow Schwab to experience a significant acceleration in future earnings. The Company’s current forecast for its net interest margin of ~1.5% is well below the ~3.5% NIM just prior to the financial crisis. Meanwhile the Company’s money market fund waivers continue to be at record levels despite the recent ascent of interest

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rates reflecting the fact the short rates have actually experienced pressure due to the shift of assets from bonds into shorter duration vehicles.

In determining our estimate of Schwab’s intrinsic value we have valued the Company’s two main segments including Investor Services and Advisor Services based on a percentage of total client assets. We believe that this approach is appropriate reflecting the Company’s asset base, which is increasingly generating recurring fees for the Company. While traditional fee based asset managers have historically commanded valuations in the ~2.5% of AUM level in a takeout scenario, we have applied a discounted multiple to Schwab’s businesses given the Company’s lower fee generation rate as a percentage of client assets. In valuing the Investor Services segment, we have applied a 1.5% multiple to our projected 2015E AUM level. For the Advisors Services segment, we have applied a higher 2.0% multiple to estimated asset levels due to that businesses higher profitability and growth rate. Our projection for client asset growth within Investor Services and Advisor Services is 5% and 7.5%, respectively, which is well below the 10% CAGR for the Company’s total client assets over the past 15 years. Based on our projections, our intrinsic value estimate for Schwab is \$32 a share, representing 45% upside from current levels. It should be noted that we have only given the Company credit for \$1.1 billion in excess capital, which represents the current amount of cash at the parent company. Given the Company’s strong capital position and earnings potential in a normalized interest rate environment, we believe that Schwab will be in the position to build a meaningful amount of excess capital and return a significant amount of value to shareholders in the coming years. Don’t rule out the potential for a takeout. Founder Charles Schwab is 75 years old and controls over 14% of the Company. We would not be surprised if he decided to sell the business to a strategic acquirer, especially as the Company’s true earnings power emerges. We suspect the Company’s fee based business would be sought after by a number of larger financial institutions.

<u>SCHW – Estimate of Intrinsic Value</u>	
	<u>Value (\$MM)</u>
Investor Services @ 1.5% of 2015E Total Client Assets	\$19,311
Advisor Services @ 2% of 2015E Total Client Assets	\$20,858
Current “excess” cash	<u>\$1,100</u>
Equity value	\$41,269
Diluted Shares Outstanding (current)	1,288
Per Share	\$32.04
% Upside to Estimate of Intrinsic Value	45.11%

It is worth highlighting that at our estimated intrinsic value for Schwab, the Company would be valued at ~1.8% of projected assets under management, which is in line with the trading valuation of Schwab at year end 2007. At current levels, Schwab is valued at just 1.2% of total client assets despite the fact that its business has expanded markedly. The following provides a comparison, between 2007 and June 2013:

	<u>Schwab Comparison</u>	
	<u>12/31/07</u>	<u>6/30/13</u>
Client Assets	\$1,446,000	\$2,015,000
Price	\$25.55	\$22.08*
Shares	1,222	1,288
Market Cap	\$31,222.10	\$28,439.04
EV/Assets	1.75%	1.18%
Interest Earnings Assets	\$12,722	\$127,626
Net Interest Revenue	\$1,647	\$1,892**
Brokerage Accounts	7mm	8.8mm
Corporate Retirement Accounts	1.2mm	1.6mm
Banking Accounts	262K	865k

* Price as of 9/16/2013

** Based on 6/30/2013 Run Rate

Risks

Risks that Schwab may not achieve our estimate of the Company's intrinsic value include, but are not limited to, continued historically low interest rate environment, increased capital requirements due to regulatory changes, inability to retain and attract new assets, fee pressure on the Company's product offerings, and deterioration in the Company's loan and investment portfolio. It is worth noting that at June 30, 2013, 46% of Schwab's residential real estate mortgages and 51% of its HELOC balances were secured by properties which are located in California

Analyst Certification:

Asset Analysis Focus certifies that the views expressed in this report accurately reflect the personal views of our analysts about the subject securities and issuers mentioned. We also certify that no part of our analysts' compensation was, is, or will be, directly or indirectly, related to the specific views expressed in this report.

THE CHARLES SCHWAB CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS

(In millions)
(Unaudited)

ASSETS	June 30, 2013	Dec. 31, 2012
Cash and cash equivalents	\$ 6,234	\$ 12,663
Cash and investments	27,011	28,469
Receivables from brokers, dealers, and clearing organizations	395	333
Receivables from brokerage clients — net	12,825	13,458
Other securities owned — at fair value	488	636
Securities available for sale	48,414	46,123
Securities held to maturity	25,818	18,194
Loans to banking clients — net	11,732	10,726
Equipment, office facilities, and property — net	711	675
Goodwill	1,231	1,228
Intangible assets — net	290	319
Other assets	758	813
TOTAL ASSETS	\$ 135,907	\$ 133,637
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits from banking clients	\$ 84,345	\$ 79,377
Payables to brokers, dealers, and clearing organizations	2,150	1,068
Payables to brokerage clients	36,852	40,330
Accrued expenses and other liabilities	1,210	1,641
Long-term debt	<u>1,630</u>	<u>1,632</u>
TOTAL LIABILITIES	126,187	124,048
Stockholders' equity:		
Preferred stock — \$.01 par value per share	867	865
Common stock — \$.01 par value per share;	15	15
Additional paid-in capital	3,932	3,881
Retained earnings	8,830	8,554
Treasury stock, at cost	(3,927)	(4,024)
Accumulated other comprehensive income	<u>3</u>	<u>298</u>
TOTAL STOCKHOLDERS' EQUITY	9,720	9,589
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 135,907	\$ 133,637