

CHARLES SCHWAB

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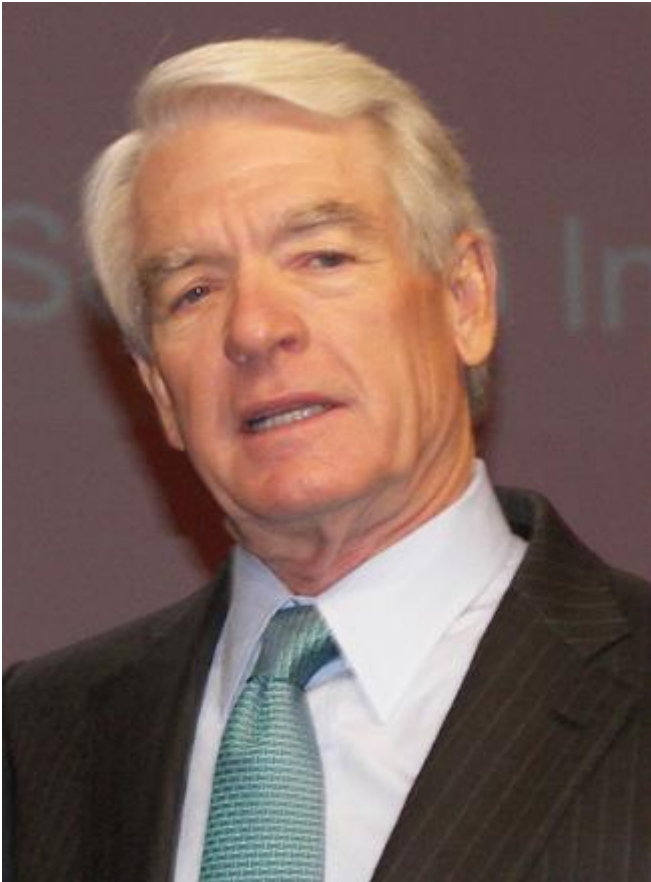


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Disclaimers

- These are my honest views as of today
- I have a position in Charles Schwab
- This isn't investment advice
- You shouldn't rely on this presentation to make investment decisions
- There is no guarantee I am right
- If you do decide to invest, do your own damn work!

Schwab Today



- \$37 billion market cap, full-service financial institution
- \$2.6 trillion in client assets
- Very well known brand

So Why Discuss Schwab

- Industry has changed radically over last few decades and Schwab's business model has changed with it – makes for an interesting story
 - Schwab typically thought of as a discount broker – now only gets 13% of revenues from brokerage commissions
 - Schwab increasingly looks like a bank
- Stock looks expensive but is actually cheap
 - Stock trades at 27X 2015 earnings
 - Under-earning because of low interest rates
 - Lots of additional value hiding in plain sight

SCHWAB'S CHANGING CUSTOMER BASE

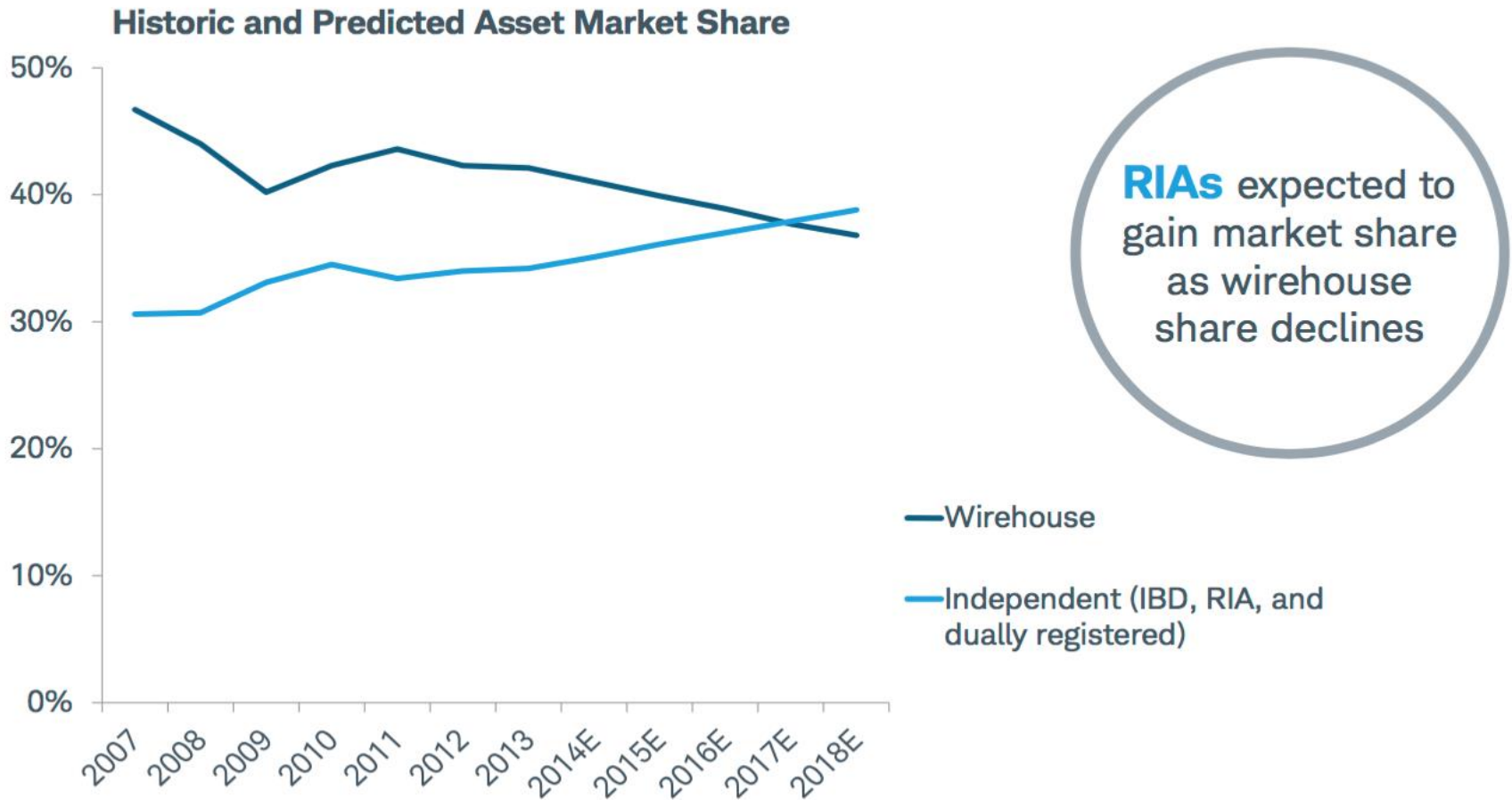
Schwab's Changing Customer Mix

- Old Customer Mix:
 - Mainly individual retail customers
 - Mostly DIYers
 - Mostly trade individual equities



- Current Customer Mix:
 - More than half are in some sort type of advisory relationship
 - Invest more passively
 - Trade less frequently

Long-Term Trend of Assets Moving Away from Wirehouses

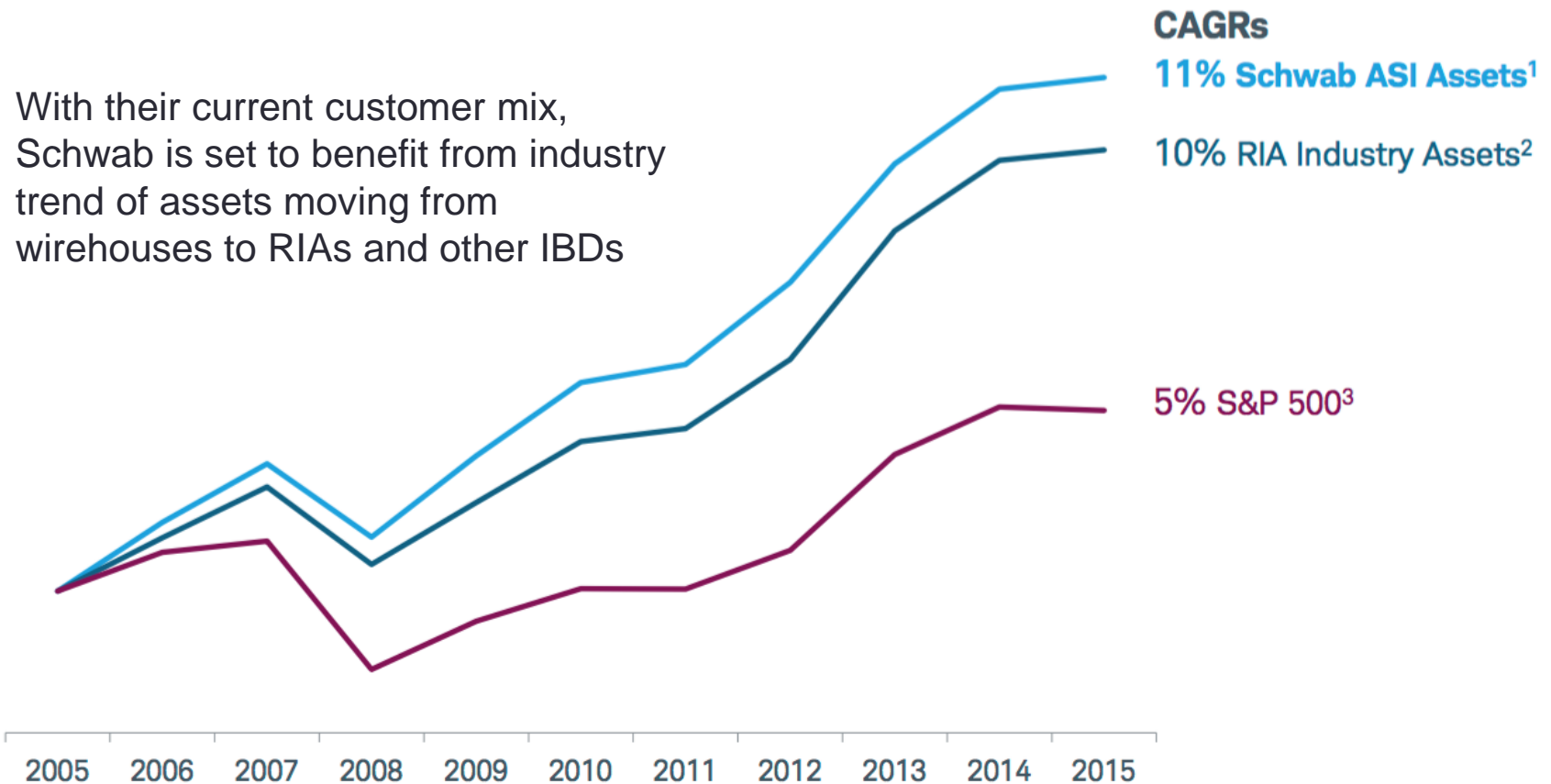


Source: Cerulli Associates

Services to RIA's and 401(k)s

- Schwab provides custody services to RIAs
 - Double digit growth in client assets over the last decade
 - Client assets over \$1.1 trillion
- Schwab provides custody and brokerage services to 401(k) plans
 - Over 1.5 million participants

Schwab Captures Increasing Share of RIA Custodian Market



Source: Schwab Investor Presentation

Today's Retail Customers are Different

- Invest more passively
 - They buy indexes, mutual funds and ETFs as opposed to buying individual equities
 - Hire Schwab to manage their money
 - Robo-Advisors?
- Want and need more assistance with financial affairs than deep discounters (such as IB) provides

Schwab's Ability to Compete Over Time

- Set to benefit from industry trends
 - Assets moving to RIAs
 - Trends toward passive investing
- Client assets have grown at more than 8% annually since 1999, faster than industry and equity markets
- Shown willingness to introduce services that disrupts their existing business
 - Proprietary ultra low-cost ETFs
 - Robo-advisors
- Good marks for customer service

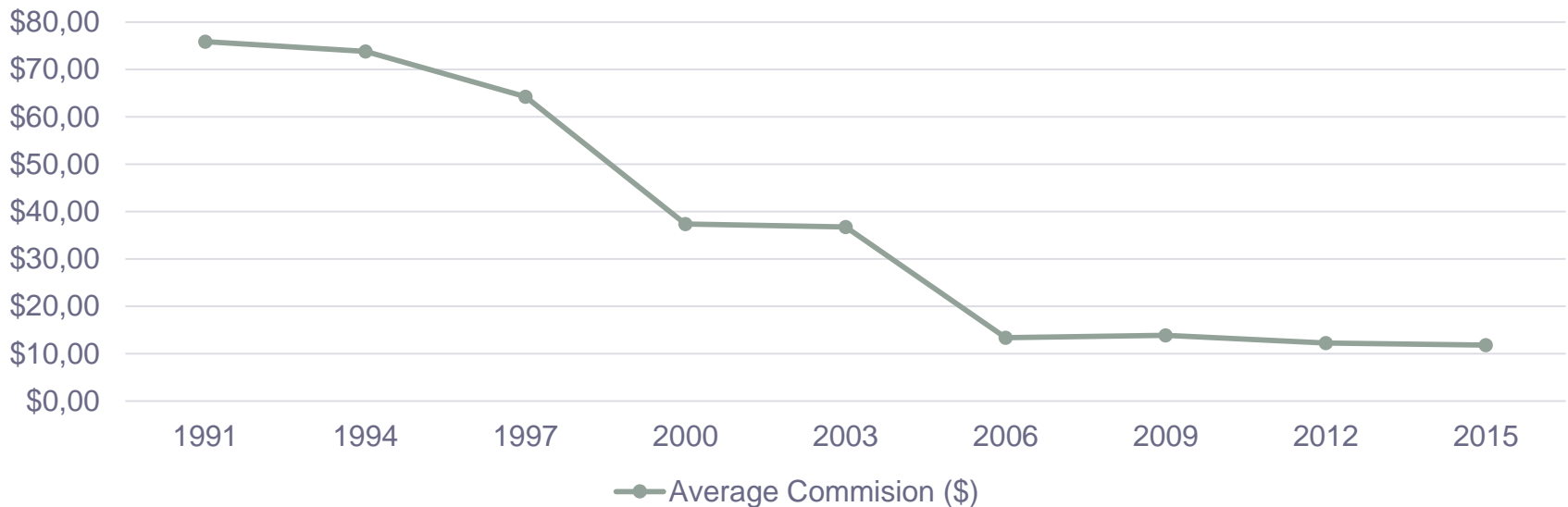


SCHWAB'S CHANGING BUSINESS MODEL

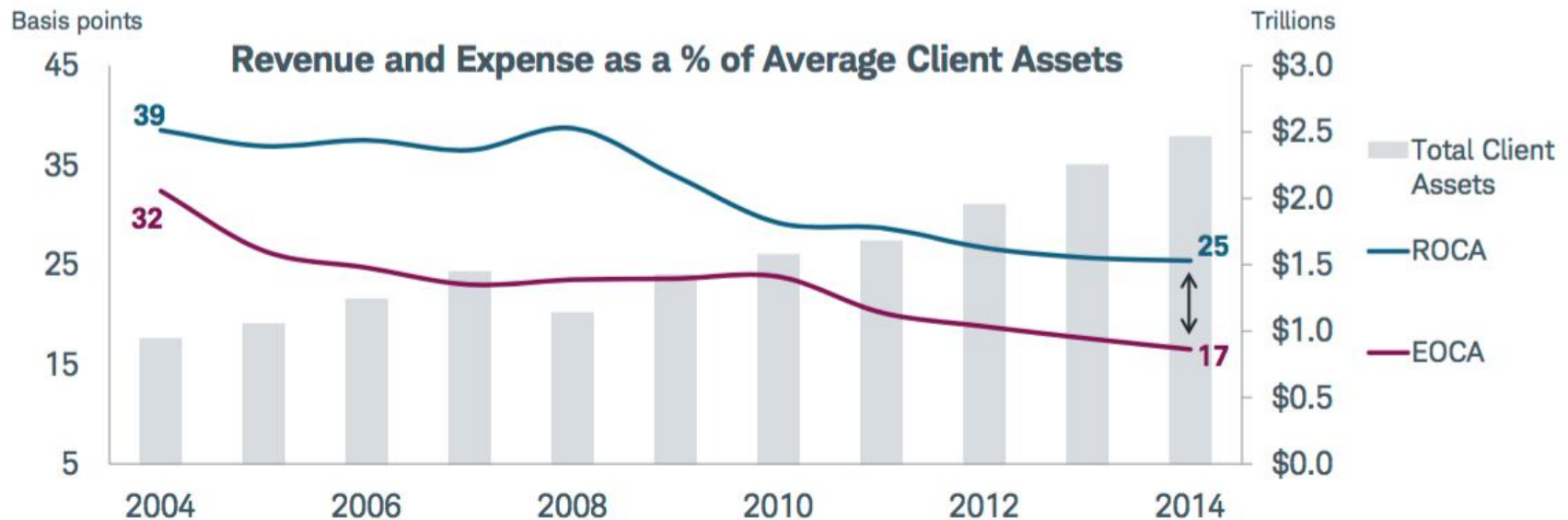
Inexorably Declining Commission Rates

- Schwab's revenues were once primarily commission based
- Now, more revenues are based on % of assets rather than trading activity
- Commission revenue peaked in 2000, has since declined by 50%
- Asset based fees also under pressure and revenue as a percent of assets has declined

Average Schwab Commission Rates




Revenues as a % of Client Assets Has Declined But Expenses Declined Faster



Income Statement Comparison

Note the large increase in Net Interest Revenue – the type of line item you might expect to see on a bank income statement



	Q1 2004	% of Revenue	Q1 2016	% of Revenue
	(in millions \$US)			
Revenues:				
Asset Management	505.0	42.4%	699.0	39.6%
Net Interest Revenue	210.0	17.6%	772.0	43.8%
Trading Revenue	442.0	37.1%	232.0	13.2%
Other	33.0	2.8%	63.0	3.6%
Provision for Loan Losses	0.0	0.0%	-2.0	-0.1%
Total Revenues	1,190.0	100.0%	1,764.0	100.0%
Expenses:				
Compensation and Benefits	528.0	44.4%	626.0	35.5%
Professional Services	60.0	5.0%	116.0	6.6%
Occupancy and Equipment	106.0	8.9%	98.0	5.6%
Advertising and Marketing	62.0	5.2%	70.0	4.0%
Communications	65.0	5.5%	60.0	3.4%
D&A	59.0	5.0%	56.0	3.2%
Other	63.0	5.3%	83.0	4.7%
Total Expenses	943.0	79.2%	1,109.0	62.9%
Pre Tax Income	247.0	20.8%	655.0	37.1%

What is Net Interest Revenue?

- Financial institutions don't like to talk too much about it, but they have always made money off of their clients cash balances
- Brokers can commingle uninvested client cash, and invested it for their own account
- Earn the spread between interest earned on investments and interest paid to clients

Monetizing Client Cash

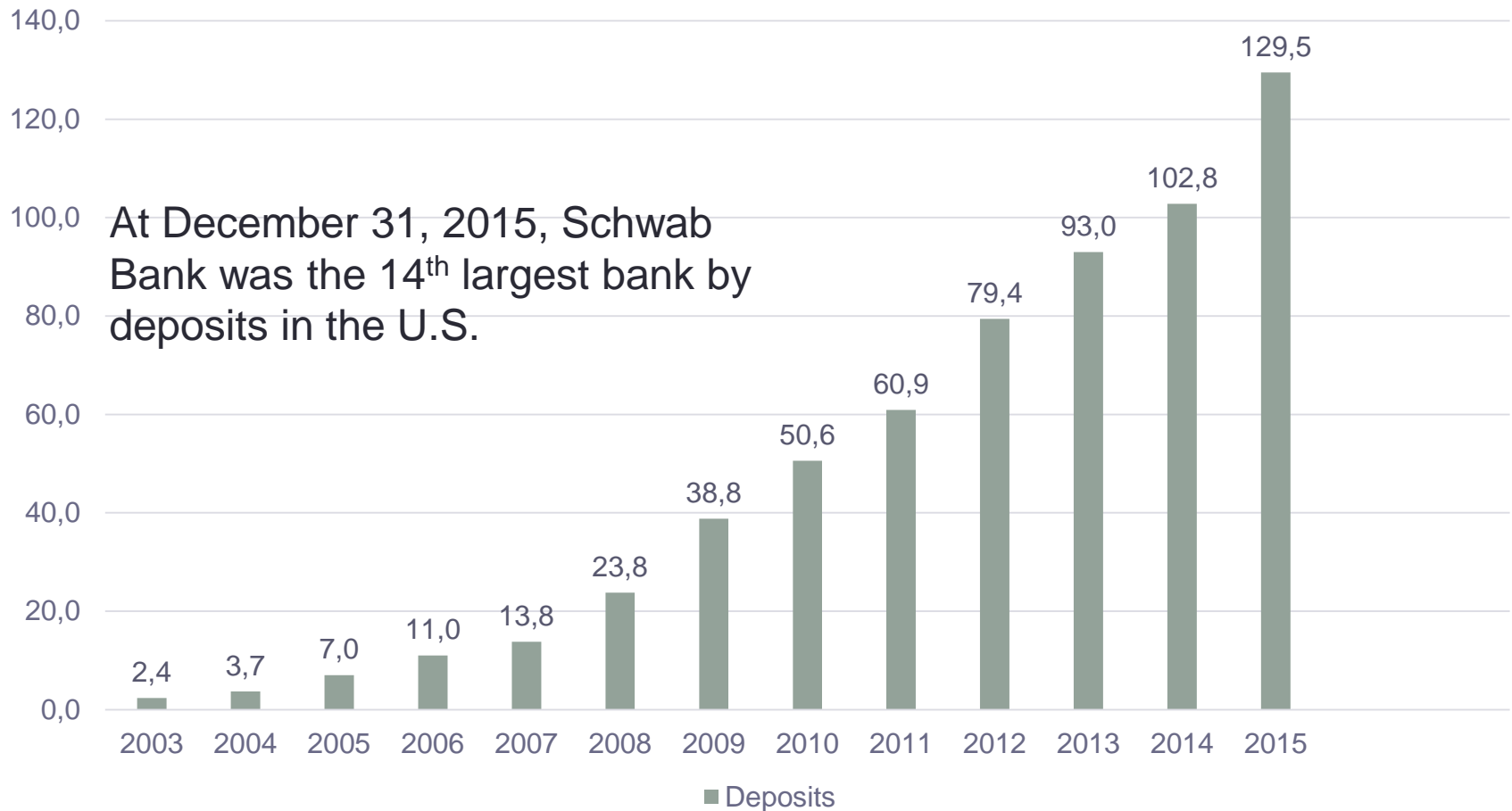
- Uninvested cash balances in brokerage accounts can be invested but face regulatory limits
- Most brokers have set up banking subsidiaries – uninvested cash is swept to a bank deposit account
 - Client gets easier access to cash with check writing and bill paying, as well as debit cards and ATM cards
 - Bank subsidiary can use deposits to fund loans and investments and make a much higher spread

Schwab's Approach to Client Cash

- Prior to 2003, Schwab offered clients the option to have uninvested cash automatically swept to a money market fund
 - Schwab normally charges 59 basis points to managed the MMF
- In 2003, Schwab set up Schwab Bank
 - Began to offer option to have cash swept to Schwab Bank
 - Clients get easier access to cash and can consolidate banking and investing accounts
 - Schwab earns a net interest margin on deposits well above the 59 basis points it charges on MMF cash sweeps

Schwab Bank Sees Dramatic Growth

Schwab Bank Deposits (in billion US\$)



Schwab's Opportunity

- Schwab manages \$167 billion in money market funds
 - 90% is sweep cash
- In April 2016, Schwab notified clients that it is eliminating the option to have cash swept to MMFs
 - Default option for all new accounts is cash sweep to Schwab Bank
 - Notified existing client that cash would be moved to Schwab Bank “over time”
- Schwab will move the bulk of the cash to Schwab Bank
- Will have huge positive impact to earnings

Risk to the Banking Model

- The E*Trade experience:
 - E*Trade blew themselves up in the financial crisis
 - Used bank deposits to fund risky mortgage loans and HELOCs, and to purchase RMBS
 - E*Trade avoided bankruptcy, but the stock is still down 90% from pre-crisis peak
- Schwab mainly investing in high quality securities
 - Invest in Treasuries and Agency securities
 - Small percentage of portfolio is mortgage loans and margin loans
 - Credit quality is very high
 - Low duration (2.5 yrs) and 2/3rds to short-term rates

VALUATION

Valuation

- 2015 earnings - \$1.04 per share
- Current stock price - \$28.50
- Trailing P/E multiple – 27.4X

- Earnings depressed due to
 - MMF fee waivers
 - Depressed net interest margins due to zero interest rates

- Earnings set to rise rapidly as Schwab moves cash from the MMFs to Schwab Bank

MMF Fee Waivers

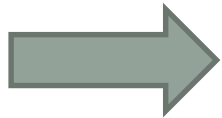
Year Ended December 31,	2015			
	Average Client Assets	Revenue	Average Fee	
Schwab money market funds before fee waivers	\$ 161,381	\$ 947	0.59%	
Fee waivers		(672)		
Schwab money market funds	161,381	275	0.17%	

Source: Schwab 2015 Form 10-k

- Zero interest rates = low earnings for MMF funds
- Schwab waived most of its management fee to prevent MMF returns from being negative
- In 2015, Schwab waived \$672 million in fees

MMF Fee Waivers

- The Fed raised interest rates 25 bps in December 2015



- In Q1 2016, Schwab was able to reduce the MMF fee waivers by 40%

- The Fed is widely expected to raise rates an additional 25 bps in the next few months



- Once this occurs, Schwab should be able to eliminate the fee waivers almost entirely

- Schwab's 2015 pre-tax earnings were \$2.279 billion.
 - Eliminating the fee waivers would increase pre-tax earnings by nearly 30%

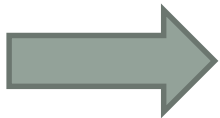
Net Interest Margin

- The Fed raised interest rates 25 bps in December 2015



- In Q1 2016, Schwab's NIM rose by 13 bps

- The Fed is widely expected to raise rates an additional 25 bps in the next few months



- Once this occurs, Schwab NIM is expected to rise by an additional 15 bps

- At the end of 2015, Schwab had about \$160 billion of interest earnings assets.
 - If NIM goes up by 28 bps, pre-tax income would go up about 20% over 2015 levels
 - Each additional 25 bps of rate increases would increase earnings by an additional 10%

Base Level Earnings

- With one additional 25 bps rise in interest rates, Schwab's run rate earnings will rise nearly 50% over 2015 levels to \$1.50 per share
- Schwab's P/E multiple will decline to 19X, less than the market as a whole

Schwab Bank Growth Leads to Rapid Earnings Growth

- Schwab had \$167 billion in MMFs at the end of Q1
 - 90% of this is cash sweeps
- Schwab's earnings plus preferred stock issuance should allow Schwab to move \$30-40 billion to Schwab Bank per year
- Will increase earnings by about \$400 million or 20% annually based on current interest rates
- The benefit to Schwab increases as their NIM goes up

Benefit of Moving Cash to Schwab Bank

- Typical MMF management fee: 0.59%
- Current NIM at Schwab Bank: 1.73%
- Net current annual benefit: 1.14%
- Schwab expects NIM to go up 60 bps for each 100 bps increase in short term rates – the benefit of moving cash to Schwab Bank goes up as interest rates go up

Schwab Earnings

- Effect on EPS of changes in short term interest rates and the amount (in \$millions) that Schwab is able to move to Schwab Bank.

	0	30,000	60,000	90,000	120,000	150,000	180,000	210,000
0.50%	\$1.50	\$1.69	\$1.87	\$2.06	\$2.24	\$2.43	\$2.62	\$2.80
0.75%	\$1.63	\$1.84	\$2.04	\$2.25	\$2.46	\$2.67	\$2.87	\$3.08
1.00%	\$1.76	\$1.99	\$2.22	\$2.45	\$2.67	\$2.90	\$3.13	\$3.36
1.25%	\$1.89	\$2.14	\$2.39	\$2.64	\$2.89	\$3.14	\$3.39	\$3.64
1.50%	\$2.02	\$2.29	\$2.56	\$2.83	\$3.10	\$3.38	\$3.65	\$3.92
1.75%	\$2.14	\$2.44	\$2.73	\$3.02	\$3.32	\$3.61	\$3.91	\$4.20
2.00%	\$2.27	\$2.59	\$2.90	\$3.22	\$3.53	\$3.85	\$4.16	\$4.48
2.25%	\$2.40	\$2.74	\$3.08	\$3.41	\$3.75	\$4.08	\$4.42	\$4.76
2.50%	\$2.53	\$2.89	\$3.25	\$3.60	\$3.96	\$4.32	\$4.68	\$5.04

Conclusion

- Schwab is a high-quality company
 - High margins
 - History of high ROEs
- Long term record of growth and set to benefit from industry trends
- Base level earnings 50% higher than 2015 levels
- Huge earnings growth as cash is moved to Schwab Bank
- Additional large upside if interest rates normalize
- Stock very cheap compared to likely future earnings



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