

# Kiplinger's

PERSONAL FINANCE

**STOCKS** | Surprise! The discount broker's picks trounce those of its full-service rivals.

## Schwab 100, Wall Street 0

For important information regarding the Schwab Equity Model Portfolio performance in *Barron's*, see reverse.

**C**HARLES SCHWAB & Co. isn't the first name that comes to mind when you think about stock advice. Indeed, when Schwab rolled out its computer-driven rating system three years ago, critics derided it as a mechanistic toy. But lo and behold, in a bake-off of brokerages' model portfolios conducted by Zacks Investment Research, Schwab's 100 highest-rated stocks possessed the best three-year track record by a long shot, leaving Wall Street lions like Merrill Lynch and Smith Barney in the dust.

From 2002 through 2004, Schwab's recommended list returned an annualized 15%, versus 4% for Standard & Poor's 500-stock index. Credit Suisse First Boston came in a distant second, at 9% annualized. Smith Barney's and Merrill's picks returned 2% per year.

Schwab's stock-picking prowess came with the acquisition, in 2000, of Chicago Investment Analytics, a research firm that catered to big money managers. The system Schwab acquired

is strictly numbers-driven. Chicago Analytics co-founder Greg Forsythe, who became Schwab's head of equity research, had spent a decade studying the attributes that spell future success for a stock. Schwab wrapped up those traits in a formula that it describes only in general terms.

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**Over the past three years, Schwab's stock picks put those of full-service brokers to shame.**

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**Winning formula.** For starters, the system looks at the quality of a company's earnings—whether they come from increased sales or more efficient operations, for example, instead of one-time events. In determining value, a low price relative to earnings is important. To judge sentiment toward a stock,

the rating takes its cues from what Forsythe calls "smart money investors," such as companies that buy back their own shares. Then it factors in signs of risk, such as whether earnings growth has been on a steady track.

Every week, Schwab puts 3,000 firms through their paces. The stocks are ranked and assigned letter grades of A, B, C, D or F. To construct its 100-stock model portfolio, Schwab picks from among the 1,000 largest companies in proportion to the makeup of sectors in the S&P 500. So if a sector makes up 10% of the index, the model generally includes ten stocks from that group (there is wiggle room). The top 100 recently included names such as 3M, Barnes & Noble, Cigna, Electronic Data Systems, Valero Energy and Verizon.

Ironically, Schwab doesn't put this 100-stock model portfolio in front of its customers. To learn what's in it, you have to ask a Schwab rep. And if you're not a Schwab customer, you're out of luck. The list is for clients only. **K**

—Research: **JOAN GOLDWASSER**

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Please note, Schwab representatives may discuss the stocks on the Schwab Equity Model Portfolio List with Schwab customers. However, Schwab Equity Ratings are updated weekly. And accordingly, Schwab provides a range of stock lists which may be more appropriate for a client's needs.

For important research disclosures on the companies listed in this material, please write to: Charles Schwab & Co., Inc., 101 Montgomery Street, Mail Code SF120KNY-27-210, San Francisco, CA 94104.

*Barron's* awarded Schwab the first-place rank for the three-year period from December 31, 2001, to December 31, 2004, for "best of" recommendation lists submitted by certain brokerage firms to Zacks Investment Research, Inc. ("Zacks"), an independent firm that analyzes broker research. Schwab's performance results are simulated model portfolio performance, which does not represent actual investment performance or trading. The performance is past performance and no indication of future results. No representation is being made that any investor will or is likely to achieve profits or losses similar to those shown in relying on Schwab Equity Ratings or any stock model or list. As described in the article, the Schwab Equity Model Portfolio utilized the Schwab Equity Ratings and final investment selection was made by a portfolio manager. The Schwab Equity Ratings and stock lists or models are not personal recommendations for any particular investor and do not take into account the financial, investment or other objectives and may not be suitable for any particular investor. Before buying, investors should consider whether the investment is suitable for themselves and their portfolio. Additionally, investors should consider any recent market or company news. Stocks can be volatile and entail risk and individual stocks may not be suitable for an investor. All hypothetical buy and sell trades for the model equity portfolio were charged a 1% commission and assumed to take place at the stock's closing price. Performance of the portfolios submitted was calculated using an equal-weighted return methodology that is administered by Zacks; whereas the performance of the S&P 500®, as noted by *Barron's*, is stated as the capitalization-weighted return. The S&P 500 Index represents a list of 500 leading companies from leading industries. Indices are unmanaged, do not incur management fees and expenses, and cannot be invested in directly. Each brokerage firm had its own methodologies in picking its stock lists, which differed in many respects, including the number of issues held, frequency of trading and changes of selection criteria over time. *Barron's* is a registered trademark of Dow Jones & Company, Inc. All rights reserved.