

**MANAGING A STOCK PORTFOLIO  
USING SCHWAB EQUITY RATINGS®**

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# MANAGING A STOCK PORTFOLIO USING SCHWAB EQUITY RATINGS

## PART I: PLANNING YOUR PORTFOLIO

The purpose of this guide—*Managing a Stock Portfolio Using Schwab Equity Ratings*—is to describe a systematic, disciplined process that utilizes the power of Schwab Equity Ratings to create and manage a portfolio of common stocks. The Ratings represent a tool that can potentially improve portfolio performance, reduce research time, and avoid common mistakes in constructing and managing your stock portfolio.

Before addressing the details of how to select stocks and manage and grow your portfolio (to be covered in parts 2 and 3 of this series, respectively), let's focus on the critical first step: planning, or laying the foundation of your investment program. If you can get your plan right early, the future is potentially bright. Get it wrong, and you may find it difficult to reach your goals.

### **Your Investment Goals: Is Active Investing Appropriate?**

Schwab generally recommends that equity investors consider starting with a core of diversified, low-cost mutual funds as one of the most cost-effective ways to participate in the various styles, sectors, and size categories of the stock market. Once that's accomplished, you might then seek to become an active individual-stock investor, with a goal that might be stated as:

*To actively manage a diversified portfolio of common stocks designed to provide superior long-term returns, relative to an appropriate benchmark.*

But before adopting such a goal, you should determine whether active investing in individual stocks, versus passive or active equity investing via mutual funds, is truly a suitable strategy for you. Are you up to the task of active stock management? That's a crucial question. The answer is essential to your long-term success—and can help you avoid poor decisions, frustration and disappointment.

Begin by asking yourself these four straightforward questions:

- **Do you believe in the premise of active management?** The premise of active management is that some stocks are incorrectly priced, and that buying or selling those stocks—individually or through actively managed mutual funds—can potentially boost returns. If you accept this premise, active investing may be for you. Passive investors believe stock prices reflect all information relevant to a stock's intrinsic value, so they may be better served by diversified index funds that seek to match the risk/return profile of the broader market.
- **Do you have sufficient financial capital?** We recommend a financial commitment to active stock investing of a minimum of \$100,000. Our research

finds that in order to be adequately diversified and improve the probability of utilizing the predictive power of Schwab Equity Ratings, you need a portfolio of at least 40 high-quality stocks. Starting with a smaller amount means you'll have smaller positions in each stock, and higher transaction costs relative to the size of each position. Active funds may be a better alternative if you start with less than our suggested minimum financial commitment.

- **Will you make the personal commitment?** You must be willing to make a personal commitment of time, discipline, and a thoughtful temperament to manage your portfolio well. If you lack one or more of these, fund investing may be more appropriate. Building a diversified, thoroughly researched stock portfolio can take as many as 40 hours of careful, thoughtful work, plus roughly one hour per week to monitor and maintain it.
- **How much risk can you tolerate?** Many investors overestimate their tolerance for risk and overreact to losses, often selling at the worst time. Psychological studies have found that the perceived pain of a given dollar loss is about three times the pleasure of a similar gain.

Stock prices, particularly over short periods, can fluctuate wildly. The S&P 500® index has experienced annual returns ranging from -22% to +29% over the past ten years.<sup>1</sup> On average, individual stocks exhibit even more volatility! So think carefully about how much pain you can stand. If you can't accept potentially higher volatility over short periods as the price of potentially positive returns over longer periods, you might want to consider mutual funds instead of individual stocks.

If your answers to these questions suggest that active stock investing is appropriate for you, let's continue with our planning.

## **Step 2: Tilt the risk-reward equation in your favor**

A key aspect of active stock investing is reducing, as much as possible, known sources of risk. Financial theory divides a stock's risk into "firm-specific risk" (risk related to an individual stock) and "market risk," or the general risk of investing in stocks. Firm-specific risk can be reduced by holding a diversified portfolio; market risk cannot. Indeed, increasing expected portfolio returns requires taking higher market risk—a strategy best achieved not by picking riskier stocks, but by allocating more of your portfolio to stocks versus bonds or cash.

To illustrate these two kinds of risk, take a look at the chart below. As you can see, the firm-specific portion of total risk falls sharply as the number of stocks in your portfolio increases, because poor returns for some stocks will generally be offset by good returns for others – if you hold more stocks! In contrast, an undiversified portfolio can mean a higher chance of losses without any increase in expected returns. For example, suppose in October 2001 you owned only two stocks: Enron and Tyco. Do you think you'd have a

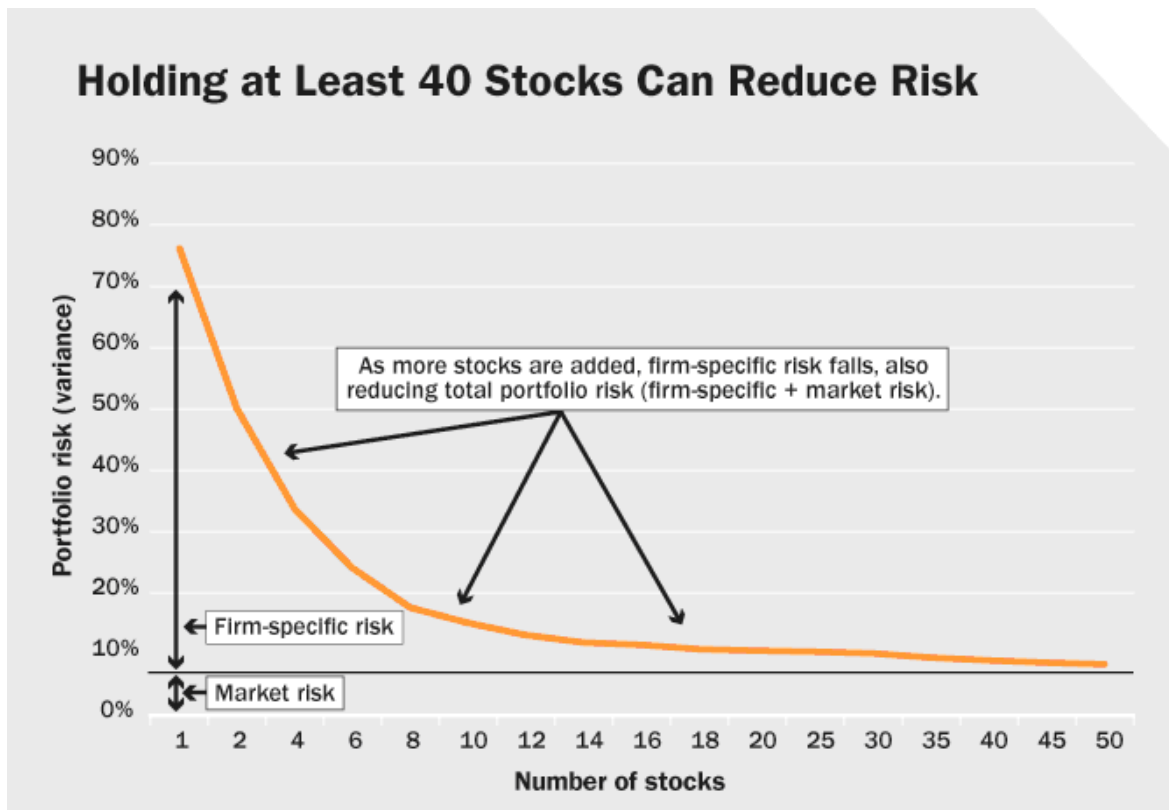
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<sup>1</sup> Source: Schwab Center for Financial Research, using data from Ibbotson Associates, Inc.

higher chance of losses than someone with a well-diversified portfolio of 40 stocks?

**Quick Quiz (answer at the end of Part I):**

Jack's portfolio consists of three stocks, each with about the same risk as the overall market. Jill's portfolio has 30 stocks, with greater market risk than the overall market. Whose portfolio has 1) the highest firm-specific risk, 2) the highest total risk and 3) the highest expected return, based on risk?



Source: Schwab Center for Financial Research. Portfolio is hypothetical and for illustrative purposes only.

Academic research suggests that you need to hold a large number of randomly selected stocks (50 or more) to significantly reduce firm-specific risk. But because we believe that Schwab Equity Ratings represent a smarter approach than random selection, we believe you can substantially improve your risk-return trade-off by building a portfolio of 40 highly rated stocks—20 large-cap and 20 small-cap, with your dollar investment in each

category weighted to match your asset allocation plan<sup>2</sup> and with each of the economy's 10 sectors represented in proportion to its benchmark weight.<sup>3</sup>

There's an additional reason to hold a larger number of stocks as well. Schwab provides ratings on approximately 3,000 stocks, with 5% (approximately 150 stocks) rated A. Our research has found that 51%–53% of A-rated stocks performed better than the market (defined as the average of all rated stocks) over 12-month periods.<sup>4</sup>

The chance that your **portfolio** will outperform the market depends on two things: the success of your stock-picking strategy (the 51%–53% statistic) and how many stocks you hold. The connection is as follows: imagine grabbing a handful of marbles from a jar holding red and blue marbles. The probability that your handful will match the jar's proportion of red and blue depends on the actual red/blue proportion in the jar and the size of your fist. A giant's handful is more likely to successfully mimic the mix in the jar than a toddler's.

How does this work with stock-picking strategies? Different strategies will have different degrees of success (measured by outperforming the market). A strategy resulting in 52% of your stocks outperforming will boost portfolio performance more than a strategy in which 50% outperform. But for any strategy, your portfolio's odds of outperforming depend on the number of stocks held.

Figure 2 illustrates this point. The different curves represent strategies with different degrees of success. A strategy that has a 53% ratio of outperforming stocks will aid your portfolio's performance more than a strategy with a 50% ratio of outperformers. But for any given ratio of outperformers – that is, moving along any line on the graph – the probability that your portfolio consists of 50% or more outperforming stocks depends on the number of stocks held. Simply stated, we believe the best way to harness the predictive power of Schwab Equity Ratings is to hold larger portfolios.

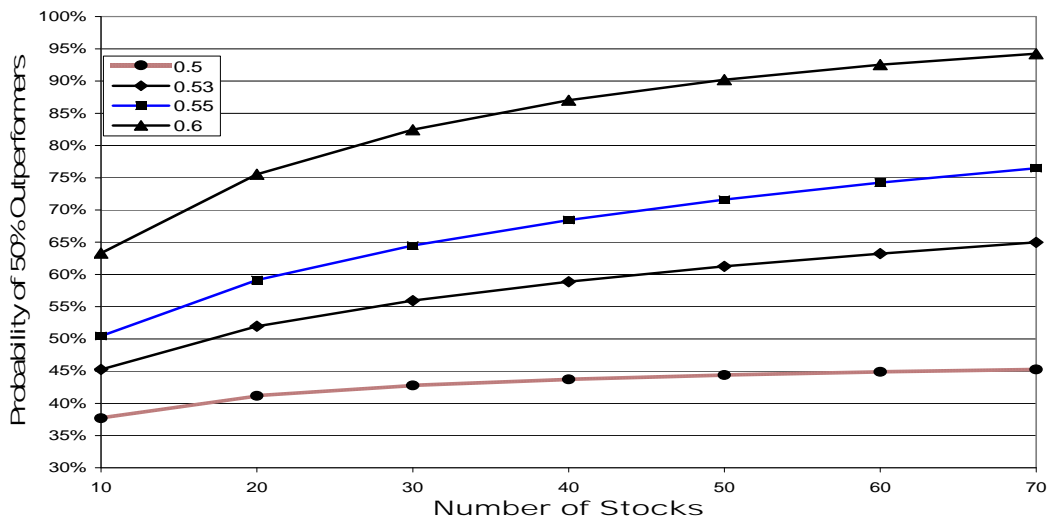
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<sup>2</sup> Schwab recommends approximately 70-80% of your domestic equity portfolio's value be allocated to large-cap stocks. See "The Portfolio Pyramid: How to Diversify Your Investments" for Schwab's asset allocation models.

<sup>3</sup> For benchmark weights for the S&P500 and Dow Jones Wilshire 5000 indexes, log in at [schwab.com/sectors](http://schwab.com/sectors) and click on the "Schwab Sector Views" PDF link. For example, a benchmark weight of 10% would suggest holding 4 stocks (out of 40) from that sector.

<sup>4</sup> Analysis of 12-month buy-and-hold returns, rebalanced monthly beginning December 31, 1989 and ending July 31, 2008, using simulated ratings prior to May 2002.

**Figure 2: The Probability of 50% Outperformers**



Source: Schwab Center for Financial Research. Hypothetical results reflected in the chart are displayed for illustrative purposes only.

### Step 3: Set realistic expectations

Although most investors aim to achieve superior long-term returns, it's important to set realistic expectations—and to measure your performance appropriately. So, once your portfolio is in place, you'll want to avoid some of the most common pitfalls that often prevent investors from staying on track:

- Evaluate **portfolio** performance—don't focus on a small number of winning or losing stocks. Schwab Equity Ratings will not accurately predict every single stock, and in any period, some A- and B-rated stocks are almost certain to decline relative to the market in general.
- Measure your results over a specified time horizon – at least annually, but ideally over a full market cycle (peak-to-peak or trough-to-trough). Avoid the temptation to evaluate performance on a short-term basis, such as daily, weekly or monthly.
- Understand that even the best stock-selection strategies won't work all the time. In periods when investors exhibit "risk-loving" behavior (e.g., the late 1990s), Schwab Equity Ratings may not perform as expected. Look past the short term and focus on the long term in evaluating your strategy.
- Finally, focus on relative, not absolute, performance. A 5% gain could represent poor performance if your portfolio's benchmark has risen 10%, and an 8% loss in your portfolio's value may represent exceptional performance if your benchmark has fallen 20%.

### Step 4: Pick proper benchmarks

A benchmark is a standard for measuring investment success. You're probably already familiar with stock indexes—averages of the performance of securities in a particular market or market segment—as barometers of the market's behavior. But indexes (and

index funds, which attempt to match the performance of specific indexes) may also be used as performance benchmarks.<sup>5</sup>

Your portfolio's benchmark should represent the types of stocks you want to hold. Just as we wouldn't hold this year's Little League champions to the same standards as the New York Yankees, the performance of your stock portfolio should be measured against an index that's representative of the types of stocks you hold.

Some common stock indexes, and the types of stocks they represent, are shown below. Assuming that you utilize Schwab Equity Ratings to construct and manage a diversified stock portfolio that holds both large- and small-company stocks drawn from all economic sectors, we suggest that you utilize the average performance of all stocks rated by Schwab Equity Ratings as a benchmark. Performance data for this measure are provided on the schwab.com website.<sup>6</sup>

<b>Index</b>	<b>Number of Stocks and Composition</b>	<b>Weighting Method</b>	<b>Appropriate Benchmark for:</b>
Standard & Poor's 500 Stock Index	500 leading US companies	Market value	Large-cap stocks
Russell 2000 or S&P 600	Smallest 2,000 stocks in the Russell 3000 Index, smallest 600 stocks in the S&P 1500	Market value	Small-cap stocks
S&P 400	400 mid-capitalization companies	Market value	Mid-cap stocks
Dow Jones Wilshire 5000 Total Market Index	Approximately 6,000 US stocks with generally available market data	Market value	General stock market
Average of All Stocks with Schwab Equity Ratings	Approximately 3,000 stocks headquartered or located in the US and certain foreign nations	Equal weighting	Diversified, SER-driven stock portfolios

A final comment on benchmarks: "Making money" is not a reasonable benchmark for stock investors—particularly over short periods. In general, only very conservative investments like money market funds or Treasury bills tend to hold their nominal values in most periods (though they can lose value after the effects of taxes and inflation are taken into account).<sup>7</sup> Equity investing should be for long-term capital growth, not short-term money making.

The next two parts of this document will discuss how to select stocks and how to monitor and maintain a portfolio. If you follow our guidelines, what might you expect? We believe a reasonable goal would be for your portfolio to beat its benchmark in roughly two out of

<sup>5</sup> It's also possible to use non-index mutual funds as benchmarks. But funds can vary significantly in terms of their investment style, deviation from stated policy, and risk. Understanding and adjusting for those variations can make it difficult for the average investor to use fund performance as a benchmark.

<sup>6</sup> After logging in, click on "Research," then select "Stocks," then select "Schwab Equity Ratings Performance."

<sup>7</sup> See Laurence B. Siegel and David Montgomery, "Stocks, Bonds, and Bills after Taxes and Inflation," *Journal of Portfolio Management*, Winter 1995.

three years of an entire market cycle. Over time, that kind of outperformance can really help build wealth.

#### Quiz Answers:

1. With only three stocks, Jack's portfolio has more firm-specific risk. Jill's larger portfolio benefits from diversification.
2. Jack's portfolio also has more total risk, because the higher firm-specific risk of his small portfolio more than offsets his slightly lower market risk.
3. The final answer may surprise you: Jill's portfolio has a higher expected return because it has higher market (not total) risk than Jack's. And remember, only market risk is rewarded with higher expected return!

## MANAGING A STOCK PORTFOLIO USING SCHWAB EQUITY RATINGS

### PART II: HOW WE PICK STOCKS

With Schwab Equity Ratings as a starting point, you'll find roughly 150 A-rated stocks, with approximately 5% of the stocks in every economic sector rated A and 25% rated B. With that many possibilities to choose from, your initial focus should be to eliminate stocks that you consider questionable. Consider the research process we suggest here as a process of elimination. If a stock passes through the filters represented by the following steps, consider buying it. If it doesn't, just move on to the next candidate.

#### The Three Stages of Stock Research Using Schwab Equity Ratings

Schwab believes that stock selection involves three levels, or stages, of research:

- **Primary Research:** Start by finding stocks rated A or B by Schwab Equity Ratings. Check to make sure that the stock is appropriate for your portfolio, understand the perspectives on the stock that are embodied in its Rating, and gain a basic knowledge of the company and its industry.
- **Secondary Research:** Next, check for recent information that may not yet be incorporated in the stock's Rating. This might include recent news, price trends, earnings history and upcoming earnings announcements, and the opinions of other research providers.
- **Optional Research:** As the term suggests, optional research is not as important as that described above. This is a "time permitting" step delivering additional insight into the company, its operations, its Sector and sub-industry, and its environment.

The Schwab Equity Research team developed the following nine-step process to winnow our choices. If you're a Schwab client, log in to apply the method to your own portfolio.

#### Primary Research

**1. Start with A's and B's.** This rule is the core principle of our recommended research process, in terms of what to consider for purchase. Schwab research has found that from the inception of Schwab Equity Ratings in May 2002 through July 20, 2009, A-rated stocks have outperformed the average stock by 2.9% and B-rated stocks have outperformed by 1.7% on average for all 52-week periods.<sup>8</sup> A-rated stocks are preferred to B-rated, and more highly-ranked B's are preferred to lower-ranked B's.

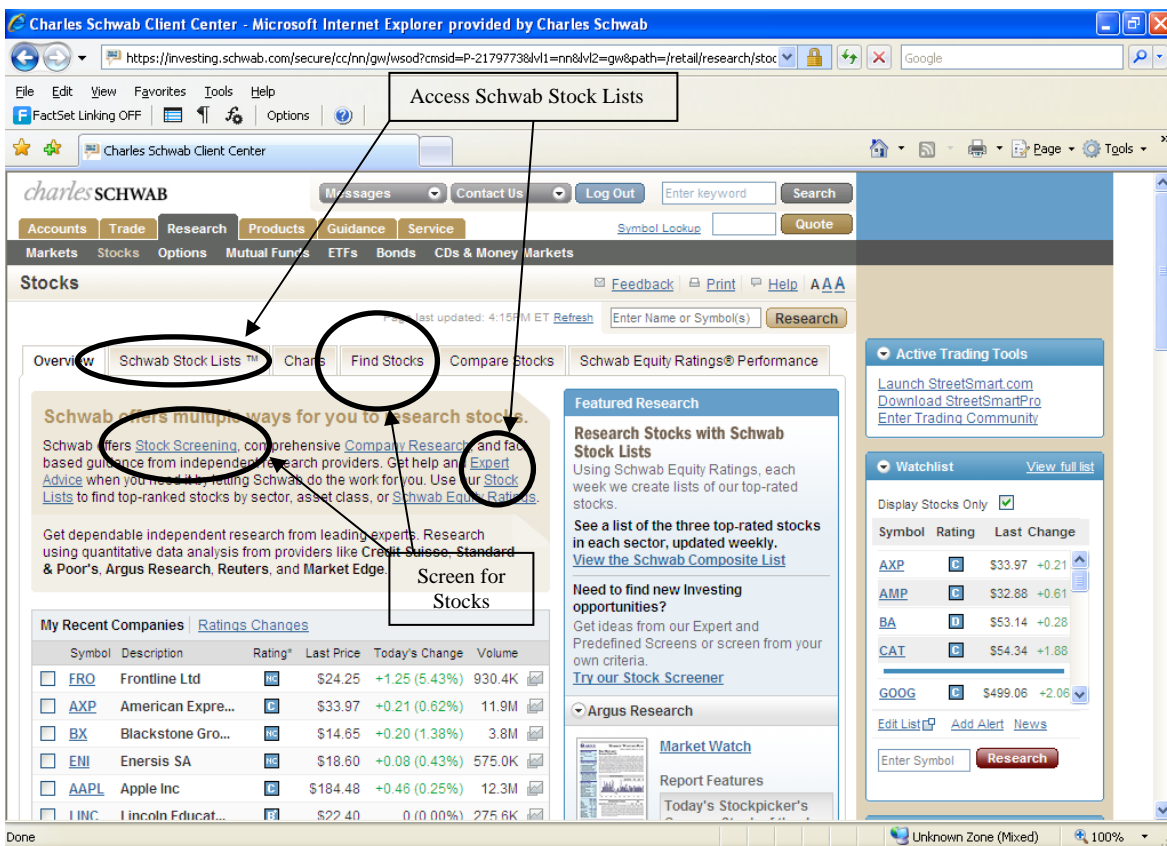
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<sup>8</sup> See footnote 6 for the location of Schwab Equity Ratings performance data.

How do you find A- and B-rated stocks on the schwab.com website? An easy way to find A- and B-rated stocks is to use Schwab's Stock Lists:<sup>9</sup>

- Composite list presents three top-rated stocks from each sector.
- Individual Sector lists compile five top-rated stocks in each of the 10 sectors.
- Four Style lists contain 10 top-rated stocks in the large- and small-cap growth and large- and small-cap value style categories.

Additionally, the Schwab Stock Screener can help you find stocks using specific criteria (for example, high dividend yields) that meet your personal objectives. You can access the Stock Screener by selecting the “Find Stocks” tab, or by clicking on the “Stock Screening” link as shown below.



Sometimes you may need to use both methods to find a desired stock. For example, a specific sector may not show any A-rated large-capitalization stocks in the Composite, Sector, or Style lists. In that case, the Stock Screener may be able to identify large-cap, A-rated stocks in the desired sector.

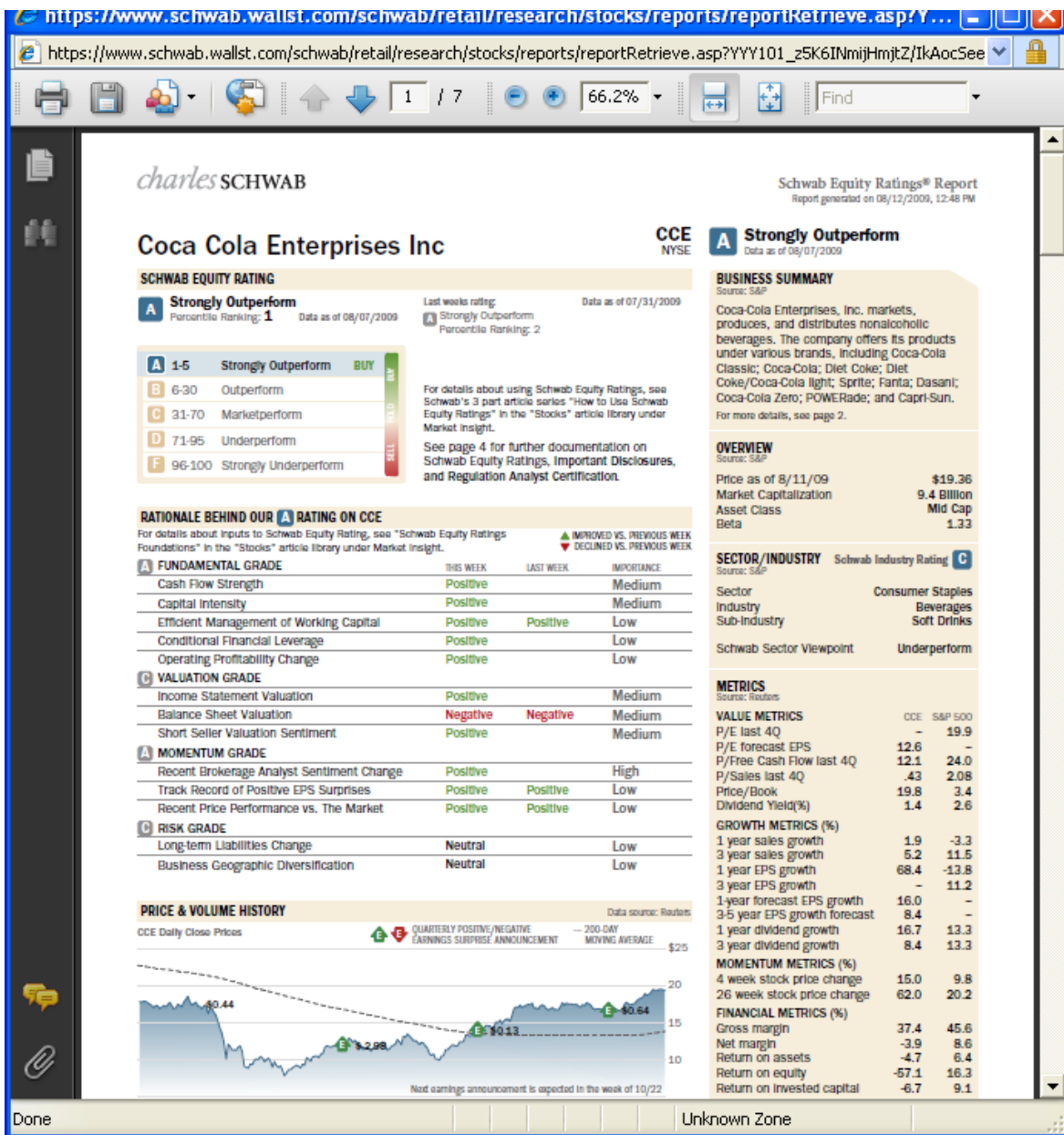
Schwab Equity Ratings are structured as a “sector-neutral” stock selection methodology. In other words, the highest-ranked 5% of all rated stocks within each market sector—

<sup>9</sup> After logging in, select Research and Stocks, then click on the “Schwab Stock Lists™” tab or the link to “Stock Lists.”

Energy, Utilities, Industrials, Health Care, and so on—will be A-rated. The next highest-ranked 25% of each sector's stocks will be rated B. This simplifies the process of creating and maintaining a portfolio of stocks diversified across sectors, as you will always be able to find A-rated and high B-rated stocks in every sector.

**2. Print a Schwab Equity Ratings Report.** Once you've identified an A- or B-rated stock as a possibility, your next objective is to understand the stock's Rating and its potential fit within your portfolio. Enter a stock's name or ticker symbol in the "Research" field, then click on the Schwab Equity Ratings letter grade (if you found the stock by using a Stock List or the Stock Screener, simply click on the letter grade). In the Schwab Equity Ratings Summary window that pops up, click on the link to the Schwab Equity Ratings Report. The Report has been specifically designed to help you with the research process outlined here. Print the report and use it in the following steps.

**3. Get inside the rating.** The Schwab Equity Ratings Report displays a stock's current rating and percentile rank, last week's rating and rank, and a visual display of the rating on a scale from 1-100. A rating with an asterisk indicates that a potentially significant event affecting the company has occurred—more on that later.



Example of Schwab Equity Ratings Report appears for illustrative purposes only and is not intended to be representative of a current report you could expect to view. Schwab Equity Ratings are updated on a weekly basis and you would want to log onto schwab.com for current information.

The left side of the Report's first page displays the *Rationale Behind Our \_\_\_ Rating on \_\_\_* section. This section provides useful details on Research Concepts—the variables, described in general terms, that underlie each of the Component grades (Fundamentals, Valuation, Momentum, and Risk). You can see each Concept's current value, its importance, and any change from the previous week. Declines in the past week are indicated by downward-pointing arrows, and upward-pointing arrows indicate improvements. You can also see a more detailed explanation of the Research Concepts by

entering a ticker, clicking on the **Ratings** tab, and looking at the **Schwab's Viewpoint** tab. Simply click on the “expand all” link for a fuller description of the Research Concepts.

If a Component grade has changed, you'll want to find out what drove the change. For example, in the Valuation component, if short sellers feel that the stock's prospects are improving and they reduce their short positions in that stock, it might be an indication that they believe the stock is undervalued. Or, in the Momentum component, recent changes in the recommendations and earnings estimates of brokerage analysts can be interpreted as an early sign of changing market sentiment.

Keep in mind that there's no reason to favor recent ratings upgrades. Schwab research suggests that stocks that recently became A-rated are neither more nor less likely to outperform the market than a stock that's been rated A for a longer period.

**4. Ask yourself if the stock is appropriate for your portfolio.** Does the stock fit your strategy and objectives, as well as the specific needs of your portfolio? The *Overview*, *Sector / Industry* and *Metrics* sections on the right-hand side of the Schwab Equity Ratings Report can help answer this question. For example, check a stock's Asset Class in the Overview section for its market capitalization category. The Metrics section displays common valuation, momentum and growth measures (relative to the average for companies in the S&P 500® in most cases). And check the company's expanded business description on the second page of the Schwab Equity Ratings Report. It will provide you with a fuller understanding of the company's industry, geographic areas of operations, and other aspects of its business.

**5. Check the stock's Schwab Industry Rating™.** The Schwab Industry Rating, located on the right-hand side of the Schwab Equity Ratings Report in the Sector/Industry section, is an assessment of the investment attractiveness of the stock's industry.<sup>4</sup> Our guidelines for using Schwab Equity Ratings and Schwab Industry Ratings together can be summarized as follows:

- **Buying Stocks:** Schwab Equity Ratings are believed to offer greater predictive power and more consistent performance than Schwab Industry Ratings. Therefore, your primary rule should be to begin your search for “buy” candidates with stocks with Schwab Equity Ratings of A or high B (percentile ranks between 6 and 10). Next, within the stock's economic sector, select industries with Schwab Industry Ratings of A, B, or C in preference to Industry Ratings of D or F. If no Industries are available with ratings of A, B, or C, buy the stock with the best (lowest) Schwab Equity Ratings percentile rank, regardless of the Schwab Industry Rating.
- **Holding Stocks:** In general, hold stocks with Schwab Equity Ratings of C. However, if a C-rated stock is a member of an F-rated industry, consider selling the stock.
- **Selling Stocks:** In general, consider selling stocks with Schwab Equity Ratings of D or F, regardless of their Industry Rating.

## **Secondary Research – Checking for New Information**

Schwab Equity Ratings are recomputed each weekend and published Sunday evening. Information arriving during the subsequent week won't be captured in a Rating until the next update. Secondary research is intended to check for significant, very recent information that may not yet be reflected in a stock's Rating. Keep in mind that if you discover news that makes you unwilling to purchase a particular stock, eliminate it and move on. There are approximately 140-160 other A-rated stocks and 500-640 B-rated stocks available (with 140-160 B-rated stocks having percentile ranks of 6 through 10), so an acceptable alternative should be relatively easy to find.

Conduct your secondary research using the following process:

**6. Do a Market Sentiment Check:** A “sentiment check” looks for evidence of recent changes in investor perception as reflected in the stock's price history. Price charts offering comparisons with a 200-day moving average of the stock's price, its weekly trading volume, the last 4 quarterly EPS values, and its performance relative to the Standard & Poor's S&P 500 Index are shown in the lower left-hand corner of the first page of the Schwab Equity Ratings Report.

- Consider how the stock's price has moved over the prior 3 months, relative to a broad market index.
- If the stock is in the midst of a major (20% from peak) downswing, eliminate it and move on.
- If you see price or volume spikes (up or down) in the last 1-2 weeks, check the news (see below) and the company's earnings. At the individual-company level, markets react for a reason, so attempt to determine the reason for any unusual price or volume behavior.

**7. Check the company's earnings:** The second page of the Schwab Equity Ratings Report contains, in the upper left-hand corner, important information about the company's reported and expected quarterly and annual earnings and revenues, its quarterly and annual dividends, and information about current consensus (i.e., the average of analysts who follow the company) forecasts of expected earnings and expected long-term earnings growth rates.

- Earnings Per Share – Some things to consider:
  - Check the expected date of the next EPS announcement – if it's within the next 1-2 weeks, you may want to wait until shortly after this date to assess the market reaction to the earnings announcement.
  - Check the rows that display the percentage changes in EPS versus the year-ago quarter or prior year and the stock's “Earnings Surprises.” If the last quarterly earnings report was a negative surprise of 5% or more—in other words, if quarterly earnings were 5% or more below the consensus estimate—eliminate the stock and move on.

- If a company failed to report its earnings by the expected EPS report date, eliminate it and move on. Late reporting often signals looming problems.
- Annual Earnings Forecast: this section displays the consensus forecast of fiscal-year earnings for the current and next fiscal years and for long-term EPS growth. If the 30-day consensus change for any of these measures is negative, eliminate the stock and move on.

**8. Check the News:** Review two primary news sources: recent news stories<sup>10</sup> and “Pertinent News.” Many news stories are simply not relevant in terms of impacting stock prices. Focus instead on non-quantitative but significant news items. “Pertinent News” about a company, denoted by an asterisk (“\*”) next to a stock’s Rating, means that a potentially significant business event involving the company has occurred. Click on the Rating letter to view more details about the nature and date of this news. Examples of the things a news check should search for include, but are not limited to,

- product news (recalls, new product releases, patents granted or ending)
- company news (management changes, changes of auditors)
- competitive developments
- significant litigation (e.g., product liability or environmental issues)
- an investigation by a tax, regulatory, or investigative body
- an announced offering of new shares that may dilute earnings per share
- announced merger or acquisition activity
- significant volume of insider sales
- delayed filing of financial statements or restatements of prior filings

Schwab assigns Pertinent News asterisks based on analysis of company press releases, Securities and Exchange Commission filings, and other information sources. Whether Schwab will assign a Pertinent News asterisk or an “NR” (Not Rated) depends on the nature and materiality of the business event—if analysis suggests the event may impact Schwab’s ability to reliably determine a rating, the stock won’t be rated (“NR”). Note that Schwab does not review all rated stocks, focusing its efforts on A- and B-rated stocks.

The existence of news regarding these events does not necessarily eliminate a company from consideration, but you should familiarize yourself with the nature of the event and evaluate its potential impact on the stock before proceeding. You may want to view the Schwab News Impact Report to evaluate the market’s reaction to current or past news stories. If a news event makes you unwilling to invest in a stock, eliminate it and move on.

**6. Check investor sentiment.** Look for evidence of recent changes in investor perception as reflected in a stock’s price history. Once you enter a ticker, the *Charts* tab allows you to create, modify, and save charts of a stock’s price movements and trading volume over

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<sup>10</sup> To see recent headlines, enter a ticker symbol. The Summary tab will display “Recent Headlines” for today and the prior day. Click on the *News* tab to see a more extensive listing of news stories as well as links to Securities and Exchange Commission company filings and company press releases.

various periods, relative to various market indexes, and with events such as stock splits, dividends, and earnings announcements identified by date of occurrence. A simple, useful standardized chart might display a stock's price movement relative to the S&P 500 during the past three months.

If, during the past one or two weeks, a stock's price has been in a short-term relative decline of 10% or more, eliminate it from your list. Likewise, if you see price changes of 10% or more, or trading volume well above the average observed during the past three months, check the firm's earnings as described above. At the individual company level, stock prices move for a reason, so try to determine what the reason might be. If you find anything that makes you hesitant, eliminate the stock from consideration and look for another.

### **Optional Research: If You Have Time**

The goal of optional research is to check for more detailed information, principally for informational purposes. If you have time, consider the following sources, most of which are available on the Reports tab of the Quotes & Research / Stocks page:

- **More Detailed Business and Industry Information:** Check the Schwab Company Report and reports provided by third-party sources.
- **Sector Outlook:** The Schwab **Sector Views Report** summarizes recent developments in each economic Sector.
- **Sub-Industry Outlook:** The **S&P Sub-Industry Outlook** report provides an overview and evaluation of the sub-industry of a selected stock.
- **Independent Third-Party Research:** Schwab provides research from several other organizations that can provide additional information about companies. You can find the recommendations of other independent third-party research providers on the second page of the Schwab Equity Ratings Report, or click on the **Ratings** tab and select **Other Ratings**. Don't expect total agreement between Schwab Equity Ratings and the recommendations of independent third-party research providers, but note any major difference. If a stock's Schwab Equity Rating is A or B but one or more third-party recommendations are "Sell," "Underperform," or the equivalent, try to determine the reason for the negative rating. Negative ratings from third-party sources are relatively rare.

### **Advanced Trading Tips**

Your trading goal should be to establish positions quickly and with as little cost impact as possible. Attempting to save a few cents per share by timing purchases to "buy on weakness" is counterproductive. Think of investing as dollars over the long term, not pennies over minutes. A few suggestions:

**Minimize market impact:** The market impact of your trades can range from virtually zero to a significant amount, depending on your order size, the stock's price, trading volume, market capitalization and "free float" (the percentage of shares outstanding held

by the public rather than corporate insiders). For illiquid stocks,<sup>6</sup> it may be better to enter large purchases (e.g., more than 1,000 shares) in stages rather than all at once.

**Market vs. limit orders:** Market orders are generally preferable to limit orders if you're using Schwab Equity Ratings, given their longer-term time horizon. For stocks with large bid-ask spreads (i.e., greater than 3% of the bid price), limit orders (day orders, not good-till-cancelled) may be useful. If you use limit orders, don't enter round-dollar prices.

**Stop orders:** Schwab research has found that using stop-loss orders is generally not a successful strategy.<sup>7</sup> If you plan to try it, consider entering sell-stop orders immediately after purchasing a stock. Be aware that in fast-moving markets with large blocks traded, your stop may be filled below the stop price.

Establishing a “buy” discipline means you should also establish a “sell” discipline – a set of rules to guide sell decisions. We'll discuss sell disciplines in Part III of this guide.

## MANAGING A STOCK PORTFOLIO USING SCHWAB EQUITY RATINGS

### PART III: MANAGING YOUR PORTFOLIO

Once you've built your portfolio – a diversified portfolio of at least 40 large- and small-cap stocks drawn from all ten economic Sectors – you're in the “monitor and maintain” stage of the portfolio management process. In this stage, you'll learn how to monitor your portfolio to determine when you should sell stocks, rebalance your portfolio, and react to changes in your stocks' Ratings.

Keep the following points in mind:

- **Know Why You Bought the Stock—and Why You Would Sell:** We suggested a fairly simple set of reasons for your purchases in Part II of this Guide (A- or B-Rated, matched the Sector and market capitalization guidelines that assist in portfolio diversification, passed the criteria suggested by the Secondary Research steps). You should have an equally clear set of reasons for why you would sell.
- **Develop Sell Rules and Stick to Them:** Sell strategies are as important as buy strategies—don't neglect them! Schwab Equity Ratings provide a straightforward sell strategy: consider selling a stock if its Rating falls to D or below. This recommendation is as important as our suggestion to consider purchasing A- and B-rated stocks. Other sell rules, such as sales of overly concentrated positions or of stocks that no longer meet your portfolio's objectives, may also be applicable.
- **Buy and Hold – Until the Facts Change:** “Buy and hold” is sound advice at the asset allocation level. But for individual stocks, long-term investing does not mean “buy and never sell.” Even the greatest stocks can become mediocre performers at some point. Thoughtful investors should always be willing to consider selling when the facts suggest it, and when a better investing opportunity is available.
- **“There are No Holds, Only Buys and Sells” is Bad Advice:** Taxes should never be the sole consideration in your decisions, but they may argue in favor of holding a stock. Selling C-rated stocks results in higher turnover, and higher turnover means higher transaction costs, which can significantly reduce returns. Finally, C-rated stocks are expected to perform in line with the overall stock market – and unless a better candidate can be found, that may be an acceptable result.
- **Put Your Emotions On Hold:** Academic researchers have found that selling is much harder for the average investor than buying. Investors may become emotionally attached to a stock, fixate erroneously on the price they paid for it, or believe that selling is equivalent to admitting a mistake. None of these reasons has any basis in fact. And facts – not emotions – should drive your investment decisions.

### **Monitoring Your Portfolio**

Monitor your portfolio each week, preferably early in the week, by using the *Accounts* tab and selecting the *Market Value* view of the *Positions* tab to see the current Schwab Equity Rating of each stock in your portfolio.

What should you look for? Three things: the current Rating, “Pertinent News” asterisks, and the relative weight of each stock and each Sector within your overall stock portfolio. We’ll discuss the importance of the last point later in this Guide (under “Maintaining Diversification”).

- **What if the Rating has changed? Our guidance** for the appropriate response depends on the change itself.
  - From A to B/From A to C/From B to C: generally, no action is required. Since all stocks are rated relative to one another, a stock’s Rating change may be caused by changes in the Ratings of other stocks, not by any change in the characteristics of the stock itself.
  - Small changes in percentile ranks that lead to a change in the Rating (e.g., A-rated stock with a percentile rank 5 changing to B-rated stock with a rank of 6) are not significant. This phenomenon is known as “Ratings flutter” and occurs whenever a specific numerical boundary exists between ratings categories.
  - From A, B, or C to D or F: such a change suggests that you should seriously consider selling the stock. Check the “Schwab’s Viewpoint” tab to see which Research Concept(s) are driving the Rating change from the prior week by looking for the colored directional arrows.
  - Selling C-rated stocks leads to higher turnover, higher transaction costs, and at least potentially to higher taxes, since a larger fraction of your gains will be short-term in nature.
  - Ratings changes other than changes from A, B, or C to D or F have no further information content. For example, a B-rated stock that was A-rated last week has neither more nor less future investment potential than a B-rated stock that was C-rated last week. Nor do Ratings changes move in trends. A stock recently upgraded to B is no more likely to be upgraded to an A in the future than a stock that was recently downgraded from an A.
  
- **Pertinent News and Headline Risk:** “Pertinent news” asterisks were discussed in Part II of this Guide. In some cases, recent news may be so noteworthy that it creates “headline risk” – negative news that comes as a surprise to the market and has a significant negative effect on the stock’s price. Headline risk is by its nature unpredictable, by Schwab Equity Ratings or any other stock selection system. And since these events can’t be predicted, there’s no way to avoid them by careful stock selection or good research. When negative news appears, we suggest you take the following steps:

- Determine the reason for the asterisk. By clicking on the Rating letter, you can see the explanation for the asterisk and the date when it was attached to the Rating.
- Check *Schwab's Viewpoint*. The Components and Research Concepts react at different rates to news stories, with Momentum- and sentiment-related Concepts—particularly analyst sentiment—reacting first, Risk-related Concepts next, and Fundamental Concepts most slowly. Valuation-related Concepts may react in what seem to be an unusual way: as a stock's price falls, valuation-related Concepts may actually improve because the stock looks cheaper.
- Check independent third-party research sources. If a significant business event has occurred and the company is covered by one or more of the independent third-party research sources, you may be able to discover details about the event as well as its investment implications.
- Check the news. It may take some time before analysts at third-party research sources can react to recent news events, but news stories regarding the event are frequently available more quickly.

## **The Tax Man Cometh**

When it comes to selling stock, keep your portfolio goals in mind—we believe you shouldn't obsess about taxes. The fact that capital gains taxes may result is inevitable and shouldn't prevent you from selling when you need to.

### **Basics**

The capital gain or loss on a stock held in a taxable account is the difference between the proceeds from a sale, after commissions, and the stock's original cost, including commissions (your "tax basis"). Capital gains taxes are levied only on net gains minus losses, and depend on how long you hold the stock. Losses can offset gains without limit, plus \$3,000 of ordinary income.<sup>3</sup> Losses after that carry over without expiring.

Long-term gains (on stocks held more than one year) are taxed at a lower rate (currently 15%<sup>4</sup>) while gains on stocks held one year or less are short-term gains and taxed at your ordinary marginal income tax rate.

### **Harvest your losses**

If you have realized capital gains as year-end nears, consider selling losers to create realized losses to offset your tax liability on the gains (particularly if any are short-term). You may also want to realize losses when a stock with a meaningful loss (for example, 15% or more) can be replaced by one with a higher rating, creating a "loss storehouse" to offset future realized gains.

### **Low basis vs. low rates**

Investors with large gains in low-cost-basis stocks often become paralyzed by the tax consequences of selling. But holding big winners may increase risk if your portfolio lacks diversification. Avoiding a 15% tax doesn't make sense if the underlying stock experiences

a large downward move—as many investors with large positions in low-cost-basis stocks discovered the hard way during the tech-stock collapse of 2000–2002.

If you want to know what you're actually earning on your investments, it's important to factor in all costs, particularly taxes. Just remember not to get so wrapped up in tax calculations that you don't make good investment choices. As always, check with your financial advisor or tax advisor before you make any transactions that could have significant tax implications.

### **Rebalancing for Diversification**

Earlier we mentioned that your weekly portfolio monitoring process should review the relative weights of the stocks and Sectors in your portfolio's overall market value. Your portfolio's diversification can be undercut if one or more of the stocks in your portfolio experiences a significant increase in value. This may sound like a problem you'd love to have, but a lack of diversification may expose you to additional risk without an associated reward. Consider selling part of a position, or part of your holdings within a Sector, if:

- the market value of any individual stock in your portfolio is more than twice an equally-weighted share of your portfolio's value. For example, if you have a 20-stock portfolio, equal weighting would mean that each stock represents 5% of your portfolio. If a stock rises to 10%, consider selling a part of the position.
- the market value of any Sector in your portfolio exceeds more than twice the proportionate weight of that Sector in your benchmark index. You can find Sector weightings in a variety of benchmark indexes in the Schwab Sector Views.<sup>11</sup> For example, suppose that the Health Care sector was 11% of the Dow Jones Wilshire 5000 Index, which you use as a benchmark. If your Health Care stocks represent more than 22% of your portfolio's value, consider selling part of your position, starting with the stocks with the lowest Schwab Equity Ratings.

### **Portfolio Performance**

The final step in managing and monitoring your portfolio is to periodically evaluate your performance relative to your selected benchmark. Use the Performance feature of schwab.com to evaluate your performance, at least annually. But remember that short-term performance can vary considerably. Using Schwab Equity Ratings means that you are investing via a strategy – a strategy that emphasizes holding quality stocks, investing without emotion and for the long term. The most appropriate period for evaluating such a strategy may be a full market cycle (from one market peak to the next or one trough to the next). A focus on short-term performance can lead investors to abandon a winning strategy just at the very point when it should be maintained. Stick with your strategy until it has had time to work!

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<sup>11</sup> Quotes & Research >>> Industries >>> Explore the Schwab Sector Views

## **Important Disclosures**

**Investors should consider carefully information contained in the prospectus, including investment objectives, risks, charges and expenses. You can request a prospectus by calling Schwab at 800-435-4000. Please read the prospectus carefully before investing.**

**An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although a money market fund seeks to preserve the value of your investment at \$1 per share, it is possible to lose money.**

Past performance is no guarantee of future results, and your investment value and return will fluctuate such that shares, when redeemed, may be worth more or less than original cost.

Schwab Equity Ratings are assigned to approximately 3,000 of the largest (by market capitalization) U.S.-headquartered stocks using a scale of A, B, C, D and F. Schwab's outlook is that A-rated stocks, on average, will strongly outperform and F-rated stocks, on average, will strongly underperform the equities market over the next 12 months. Each of the approximately 3,000 stocks rated in the Schwab Equity Ratings universe is given a score derived from several research factors. Schwab Equity Ratings are not personal recommendations for any particular investor. Before buying, investors should consider whether the investment is suitable for themselves and their portfolio.

Schwab Industry Ratings provide Schwab's outlook for industries based on GICS groupings, such as Beverages, Pharmaceuticals and Software. Schwab Industry Ratings are assigned using an A, B, C, D and F rating scale and can be particularly helpful in evaluating which industries investors may want to emphasize within a specific sector. They can also be used in conjunction with Schwab Equity Ratings to help fill in gaps in a portfolio. See Schwab.com for more information.

The S&P 500 index is an index of widely traded stocks. Indexes are unmanaged, do not incur fees or expenses and cannot be invested in directly.

Small-cap stocks have historically been more volatile than the stocks of larger, more established companies.

This report is for informational purposes only and is not an offer, solicitation or recommendation that any particular investor should purchase or sell any particular security or pursue a particular investment strategy. All expressions of opinion are subject to change without notice in reaction to shifting market conditions. Examples are provided for illustrative purposes only and not intended to be reflective of results you should expect to achieve.

Diversification strategies do not ensure a profit and do not protect against losses in declining markets.

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