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Inflation and the Long View

Why investors shouldn’t be too complacent about rising prices.

Inflation has been so low for so long that investors could easily have become complacent about the impact of this value-eroding force on their portfolios. That would be a serious mistake. Even relatively mild inflation has a significant effect on your investments over time.

Some inflation can be a good thing for the economy. A steady rise in prices can encourage spending by consumers and businesses. And working people usually don’t mind a bit of inflation, as wage increases tend to keep pace with rising consumer prices.

It’s a different story for savers and retirees. After all, money loses value because of inflation—prices nearly tripled between 1980 and the end of 2014—and rising prices eat away at the real returns on your investments.

Ever since the financial crisis, the annual rate of inflation has generally been below 2%. But if you go back a few decades, things start to look a little different. The average annual inflation rate was about 3.5% between 1980 and 2014. Your investment returns over that period would have had to match that rate just to keep your portfolio treading water. To build wealth, of course, you need to do better. And the recent era of low interest rates hasn’t helped.

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Inflation-Linked Securities

Treasury Inflation-Protected Securities (TIPS) are inflation-linked securities issued by the U.S. government whose principal value is adjusted periodically in accordance with the rise and fall in the inflation rate. Thus, the interest amount payable is also impacted by variations in the inflation rate as it is based upon the principal value of the bond. It may fluctuate up or down. Repayment at maturity is guaranteed by the U.S. government and may be adjusted for inflation to become the greater of either the original face amount at issuance or that face amount plus an adjustment for inflation.

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The good news is that there are several precautions you can take to help insulate your portfolio against inflation. Stocks have historically delivered solid inflation-adjusted returns. You could also consider adding Treasury Inflation Protected Securities (TIPS) to your bond portfolio. The coupon rate on TIPS is fixed, but the principal value is adjusted to keep pace with inflation—so interest payments fluctuate along with inflation. Real estate and commodities can also help protect a portfolio against rising prices.

So check in with a Schwab representative to find out what steps you could take to add inflation-hedging features to your portfolio.

Sincerely,

Walt Bettinger
President & CEO

“The good news is that there are several precautions you can take to help insulate your portfolio against inflation.”


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(0915-3780)
In Search of a Smoother Ride
Low-volatility ETFs try to mitigate big market swings.

Stock market volatility has been part of the investing landscape in 2015. This volatility has pushed some investors into low-volatility exchange-traded funds (ETFs), which seek to minimize the effect of large market swings. The assets in such ETFs jumped by about 26% in the first four and a half months of the year. Low-volatility ETFs have been around for less than five years, but have already attracted $18.4 billion in assets.

Low-volatility ETFs generally work in one of two ways. One type screens and weights the stocks included in an index—such as the S&P 500® Index—according to their volatility. The least volatile stocks are given larger weightings. This usually means including more utility and consumer staples stocks, which tend to experience smaller price movements than stocks in other sectors.

The other type of low-volatility ETF includes a broader universe of stocks and weights them based on how correlated, or linked, their price movements are with each other. While such ETFs don’t explicitly avoid volatility per se, their weighting methodology tends to result in holdings that negate each other’s price swings. This can result in less-volatile performance, whether the market is rising or falling.

Whether low-volatility ETFs make sense for you depends on your expectations for the market and your returns, says Michael Iachini, Managing Director of ETF and Mutual Fund Research at Charles Schwab Investment Advisory, Inc. “Low-volatility ETFs may be right for investors who aren’t necessarily pessimistic about the market but who would prefer to avoid large swings in the value of their portfolio,” he says.

One thing to consider with these ETFs is that limiting losses likely limits gains as well. In other words, when you invest in low-volatility ETFs you could be giving up some potential upside when markets are rising. “In a long-running bull market, lower volatility funds typically have a hard time keeping up,” Michael says.

Depending on the market segment, low-volatility ETFs may also have higher operating expenses than standard index funds, Michael says. That is because minimizing volatility generally requires more frequent rebalancing. For example, ETFs weighting U.S. large-capitalization companies by volatility tend to have higher expenses than other U.S. large-cap stock ETFs.

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1Morningstar Direct as of 4/20/2015.
2Ibid.

See page 42 for important information.

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.

Charles Schwab Investment Advisory, Inc. (“CSIA”) is an affiliate of Charles Schwab & Co., Inc. (“Schwab”), (0915-3248)
ETF Expenses to Watch

Small differences in fees can add up.

It's easy to see why exchange-traded funds (ETFs) are popular. They can offer exceptional liquidity and are a relatively inexpensive way to gain exposure to a variety of asset classes.

But some ETFs are cheaper than others. Here are three expenses to watch.

**Commissions.** Because ETFs trade on an exchange, you may have to pay a commission when you buy or sell one. Though some ETFs are available commission-free, many are not.

**Operating expenses.** These costs are generally levied at an annual rate known as an operating expense ratio (OER). Such fees cover the day-to-day costs of managing the ETF's assets, administration and other costs. Investors don't pay these fees directly. Rather, fund managers deduct the operating expenses daily from an ETF's total average assets.

OERs are listed in an ETF's prospectus. They can vary widely: from as little as a few basis points to as much as a few percentage points, with some ETFs charging up to 3.87%.

Even small differences in fees can have a big impact on your portfolio over time. For example, imagine you invested $100,000 in an ETF with an OER of 0.1%. Assuming an annual return of 6% and no other fees, after 20 years your investment would have risen to $314,360. Now imagine you invested the same amount in an ETF with an annual OER of 0.5%. After 20 years, you'd have just $290,121.

**The bid/ask spread.** The difference between the price at which an ETF can be sold (“bid”) and the price at which an ETF can be bought (“ask”) is an often-overlooked cost. It is built into the market price and is paid on each roundtrip purchase and sale of an ETF. The larger the spread and the more frequently you trade, the more relevant this cost becomes.

Factors driving bid/ask spreads can include market liquidity and inventory-management costs recouped by the market makers who facilitate ETF trades. Bid/ask spreads tend to be lower for more actively traded and more liquid ETFs.

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Less Than Zero

Negative European bond yields are intensifying the global search for yield.

Why would anyone buy a bond with a negative rate of return? It's a question investors in some European country bonds are grappling with after yields dipped below zero in recent months. That means investors are paying countries for the privilege of lending them money.

Unfortunately for U.S. investors, the effects of negative yields aren't restricted to the market for euro bonds. Negative yields overseas may be drawing more income-seeking global investors to the U.S. bond market, where yields are still above zero. That extra demand may be suppressing Treasury yields.

Once a rare occurrence, negative yields on bonds have now become quite common. More than $1.9 trillion of the euro region's government securities had a negative yield at the end of February.

What's causing it? To help fight off deflation and spur economic growth, central banks in Europe have adopted negative interest rates in the hope banks will start lending more to consumers and businesses. Meanwhile, the European Central Bank cranked up a sovereign bond-buying program to further stimulate the economy. As a result, yields on bonds tumbled from already low levels.

Most of the demand for such bonds comes from institutions that are required to allocate a portion of their holdings to state-issued securities.

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DO THE RESEARCH

To compare ETF costs, log in to schwab.com/OETF screener and select “basic criteria.”

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1 Charles Schwab analysis of ETF annual report data in Morningstar Direct as of 4/16/2015.
2 Based on calculations using the Financial Industry Regulatory Authority’s Fund Analyzer. Results are hypothetical.

See page 42 for important information.

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.

Investment returns will fluctuate and are subject to market volatility, so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost. Unlike mutual funds, shares of ETFs are not individually redeemable directly with the ETF. Shares are bought and sold at market price, which may be higher or lower than the net asset value.

---

Kathy Jones, Senior Vice President and Chief Fixed Income Strategist at the Schwab Center for Financial Research, says most individual investors would be better off staying away.

She notes that Treasuries remain a better choice—yields are low, but they still have a way to go before they fall below zero—and cash might be the next best option.

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CALL US

For help with your bond investments, call 866-893-6699 to speak with a Schwab Fixed Income Specialist.

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See page 42 for important information.

(0915-3358)
What’s in your index?

Does your portfolio reflect the latest thinking on index construction?

**Start with the same group of stocks**

Both indexes use the Russell 3000® Index as the starting point.

**Russell Fundamental U.S. Large Company Index**

Selects and weights stocks based on the financial characteristics of the underlying companies in the Russell 3000.

**Russell 1000 Index**

Represents the highest-ranking 1,000 stocks in the Russell 3000 Index in terms of market cap.

**Analyze stocks**

Each index uses a different methodology to identify which stocks to include.

**Russell Fundamental**

\[
\text{Adjusted sales} + \text{Retained operating cash flow} + \text{Dividends plus buybacks} = \text{Stock's composite fundamental score}
\]

**Russell 1000**

\[
\text{Outstanding shares} \times \text{Market price} = \text{Market cap}
\]

**Source:** Schwab Center for Financial Research. Index data from Russell Indexes and Research Affiliates as of 3/31/2015. Constituents are subject to change without notice. For illustrative purposes only; this is not a recommendation to buy or sell any particular security.

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The Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000 Index and...
At Schwab, we believe a well-diversified portfolio combines more than one approach to indexing. Traditionally, indexes have been constructed using market-capitalization strategies, which analyze stocks according to their market size. By combining market-cap indexes with indexes that are constructed based on the stocks’ fundamental criteria, investors may achieve greater portfolio diversification.

So what makes the two indexing styles different? Just like two competing teams, each index has its own set of attributes—in this case, the system it uses to screen and weight individual stocks—that distinguishes it from the competition. Let’s look at how two indexes, the Russell Fundamental U.S. Large Company Index and the Russell 1000® Index, are created.

### Why indexing methodologies matter

Both indexes include many of the same stocks, but the weights of those stocks often vary widely. As a result, these two indexes tend to perform differently during different market cycles.

**Having exposure to both types of indexes can provide diversification benefits.**

<table>
<thead>
<tr>
<th>Russell Fundamental rank</th>
<th>Russell 1000 rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stocks are ranked by fundamental score and assigned percentage weights based on those scores.</td>
<td>Stocks are ranked by market cap. Weights in the index are calculated by dividing a stock’s market cap by the index’s total market cap.</td>
</tr>
</tbody>
</table>

### Top 10 holdings

<table>
<thead>
<tr>
<th>Stock Name</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exxon Mobil</td>
<td>4.38%</td>
</tr>
<tr>
<td>Chevron</td>
<td>2.45%</td>
</tr>
<tr>
<td>AT&amp;T</td>
<td>2.07%</td>
</tr>
<tr>
<td>Microsoft</td>
<td>1.67%</td>
</tr>
<tr>
<td>Wal-Mart Stores</td>
<td>1.56%</td>
</tr>
<tr>
<td>Procter &amp; Gamble</td>
<td>1.47%</td>
</tr>
<tr>
<td>Pfizer</td>
<td>1.42%</td>
</tr>
<tr>
<td>Apple</td>
<td>1.34%</td>
</tr>
<tr>
<td>IBM</td>
<td>1.33%</td>
</tr>
<tr>
<td>JPMorgan Chase</td>
<td>1.32%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Stock Name</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apple</td>
<td>3.55%</td>
</tr>
<tr>
<td>Exxon Mobil</td>
<td>1.73%</td>
</tr>
<tr>
<td>Microsoft</td>
<td>1.59%</td>
</tr>
<tr>
<td>Johnson &amp; Johnson</td>
<td>1.35%</td>
</tr>
<tr>
<td>Berkshire Hathaway</td>
<td>1.25%</td>
</tr>
<tr>
<td>Wells Fargo</td>
<td>1.23%</td>
</tr>
<tr>
<td>General Electric</td>
<td>1.18%</td>
</tr>
<tr>
<td>JPMorgan Chase</td>
<td>1.08%</td>
</tr>
<tr>
<td>Pfizer</td>
<td>1.05%</td>
</tr>
<tr>
<td>Procter &amp; Gamble</td>
<td>1.05%</td>
</tr>
</tbody>
</table>

Includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership.

The Russell Fundamental U.S. Large Company Index ranks companies in the Russell 3000 Index by fundamental measures of size and tracks the performance of those companies whose fundamental scores are in the top 87.5% of the Russell 3000 Index.

Indexes are unmanaged, do not incur management fees, costs or expenses, and cannot be invested in directly.

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Time to Hedge?
A soaring dollar raises hedging questions.

The U.S. dollar had a strong start in 2015. During the first quarter, the dollar hit a 12-year high against the euro, and an eight-year high against the Japanese yen.2

These gains—resulting largely from the relative strength of the U.S. economy compared to overseas economies—create a challenge for people with international investments. Stock and bond investments denominated in euros or yen look a lot less valuable when you convert them into U.S. dollars.

This isn’t to suggest that investors should think twice about investing abroad. Foreign assets offer the potential for diversification and other benefits that shouldn’t be ignored. But the situation has left some investors wondering whether they should try to hedge their portfolios against potential currency swings.

When you hedge, you try to minimize the effect of currency fluctuations on your portfolio by investing in assets that move in the opposite direction of your target currency. For example, if you think the euro is going to fall against the dollar, you might seek out investments that will rise as the euro weakens, negating the effect of the change.

There are several ways to hedge. You could short foreign currency futures, but doing so can be complex and expensive. For this reason, many investors opt for investments that do the work for them, such as exchange-traded funds (ETFs) or mutual funds that hedge currency exposure. Some ETFs and mutual funds state their hedging policy in their prospectus or annual reports. (If this information isn’t available, you could call the fund company and ask, though proprietary information may not be shared.)

Before deciding whether to hedge, you should remember that while currency hedging may smooth the performance of a portfolio when currency markets are volatile, it also removes some of the diversification benefit that comes from investing overseas. The dollar isn't likely to be strong forever, and if it weakens, the returns on overseas assets will get a boost.

In general, Schwab doesn't usually suggest hedging currency exposure in equities because it can be costly. However, given the low yields on international fixed income investments, there may be a case for hedging this part of your portfolio, says Kathy Jones, Senior Vice President and Chief Fixed Income Strategist at the Schwab Center for Financial Research.

“The yields on many fixed income investments generally are going to be small—maybe less than or equal to what investors will get in the United States—so investors might want to ensure that currency swings don't erode those thin returns,” she says. ■

2“Dollar Rises to 8-Year High Against the Yen,” Reuters, 3/10/2015.

See page 42 for important information.
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. Past performance is no guarantee of future results. (0915-3221)
Does Smaller Mean Better?
Small-cap stocks’ fortunes tend to rise with the dollar.

Stocks with small market capitalizations—generally, those with a market value of less than $1 billion—had a much better start to 2015 than their large-cap counterparts. The Russell 2000® Index, a proxy for small-cap stocks, returned 4.4% during the first quarter, while the large-cap Dow Jones Industrial Average™ fell 0.3%. By mid-May, the Dow had narrowed the gap, returning 3.63% compared with the Russell Index’s 4.84%, but the difference was still noteworthy.

Much of the disparity has to do with small-caps’ heavier reliance on the domestic economy. Improving economic conditions have been a boon for smaller companies in terms of demand. Growing sales, combined with favorable borrowing conditions, have made it easier for small companies to secure the financing they need to expand.

Then there’s the strong U.S. dollar. A rising dollar hurts the earnings of companies that do a lot of business in overseas markets with weaker currencies. This generally affects large companies more than small ones.

However, the factors that have recently buoyed small-cap stocks also tend to make such stocks more volatile, says Brad Sorensen, Director of Market and Sector Analysis at the Schwab Center for Financial Research. For example, their relative lack of overseas exposure may give small-caps an advantage over large-caps when the U.S. economy is growing, but that advantage becomes a liability when domestic growth slows. Small companies may not be able to rely on overseas sales to make up for weakness at home.

And because they generally lack the financial resources of large companies, small companies are more sensitive to tightening credit conditions, which could be a problem in a rising interest rate environment.

Still, it makes sense for most investors to include small-caps in their stock portfolio, Brad says. After all, because small-caps tend to perform differently than large-cap stocks, they could provide diversification benefits. But investors should proceed cautiously.

“Spread your small-cap investments among multiple stocks because investing in individual small-cap stocks is just adding another layer of risk,” Brad says.

Exchange-traded funds (ETFs) and mutual funds that focus on small-cap stocks are a straightforward way to diversify your exposure to this group at a relatively low cost.

See page 42 for important information.
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.
Investment returns will fluctuate and are subject to market volatility, so that an investor’s shares, when redeemed or sold, may be worth more or less than their original cost. Unlike mutual funds, shares of ETFs are not individually redeemable directly with the ETF. Shares are bought and sold at market price, which may be higher or lower than the net asset value (NAV).
Past performance is no guarantee of future results.
(0915-3200)
Dear Carrie,
I'm thinking about downsizing my home when I retire. Will I get hit with a tax bill when I sell my house?
—A Reader

Dear Reader,

Pardon the pun, but this topic hits very close to home for me. As I prepare this column, my husband and I are packing up the past 14 years of our lives to move to a smaller home. Our youngest is off to college, and like so many others at this stage of life, we made the tough decision to leave our rambling (and high-maintenance) family abode.

Personal issues aside, there's no question that downsizing can have many financial advantages. Having a smaller house can mean less upkeep and lower monthly expenses—to say nothing of potential cash from the sale. And as you mention, taxes can be a big part of the decision.

There has been a fair amount of confusion over this topic ever since the rules changed dramatically back in 1997. Many of us Baby Boomers remember the old days when you could trade up to a more expensive home within two years to postpone taxes, or take advantage of the once-in-a-lifetime exclusion for those who were 55 or older.

But it's a new day. Under current law, if you sell your principal residence for a profit, up to $250,000 of that capital gain is excluded from tax.\(^1\) Married couples filing a joint return can exclude up to $500,000.

This means that many people won't have to pay capital gains tax at all. Others, though, especially those who have owned their homes for decades and who live in areas that have experienced considerable appreciation, could face a significant bill.

First, the basics

In order to claim the maximum exclusion, you have to pass what the IRS calls the ownership and use tests. This means:

1. You must have owned the house for two years.
2. And you must have lived in the house as your principal residence for two out of the last five years, ending on the date of the sale.

There are a few exceptions to these rules. For example, if you had to move before owning the home for two years because of a job change, or because you experienced what the IRS designates an “unforeseen circumstance,” such as a divorce or natural disaster, then the IRS will allow you to prorate the exclusion. (If you go through a divorce after having lived in the home for just one year, you would be entitled to 50\% of the exclusion.)

And the two years of residency don't have to be consecutive—you just have to have lived in your...
In order to claim the maximum exclusion, you have to pass what the IRS calls the And you must have lived in the house as your principal residence for two out of the last five years, ending on the date of the sale. There are a few exceptions to these rules. For example, if you had to move before owning the home for two years because of a job change, or because you experienced what the IRS designates an “unforeseen circumstance,” such as a divorce or natural disaster, then the IRS will allow you to prorate the exclusion. (If you go through a divorce after having lived in the home for just one year, you would be entitled to 50% of the exclusion.) And the two years of residency don’t have to be consecutive—you just have to have lived in your home for a total of 24 months out of the five years prior to the sale. Interestingly, you can claim this exclusion on multiple sales—as long as each home was your principal residence for at least two of the last five years.

**Calculate your cost basis**

To determine capital gains on the sale of your home, you simply subtract your cost basis from the selling price. But what exactly is your cost basis? It’s not just the purchase price. It also includes certain settlement fees, closing costs and commissions associated with both the purchase and the sale (excluding escrow amounts related to taxes and insurance, etc.).

Add to this the cost of significant capital improvements (but not repairs) you made over time for renovations, additions, roofing, landscaping and other upgrades. All of these improvements will increase your cost basis, and therefore lower your potential tax liability. Hopefully, you’ve kept good records because this can add up!

On the other side of the equation, there are a few things that can reduce your cost basis. A lower basis will increase your profit, and potentially your tax. For example, if you have a home office and have claimed depreciation over time, you now have to subtract those deductions from your cost basis. Or if you received tax credits for energy-related improvements, you have to subtract that amount as well.

---

**Capital improvement or repair?**

Tax rules let you add the cost of a capital improvement to your cost basis, but not the cost of a repair. The difference? A capital improvement increases the value of your property. A repair simply restores your property to its original condition.

A new deck is a capital improvement. Fixing your plumbing is a repair. Sometimes, though, the distinction is less clear. For example, if you replace your entire roof, that’s a capital improvement. But if you simply replace some of the shingles, that’s a repair.
A sample tax bill

Jon and Jane bought their home in 1988 for $250,000. Now in their mid-60s, they’ve decided to downsize. They sell their home for $875,000. Over the years, Jon and Jane did a lot of remodeling and made many home improvements. Because Jane has a home office, they’ve claimed depreciation on their income tax return, which now has to be subtracted from the cost basis. They are in the 25% tax bracket and pay a 15% long-term capital gains tax rate. Here are the numbers:

<table>
<thead>
<tr>
<th>What did they spend?</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase price of home</td>
<td>$250,000</td>
</tr>
<tr>
<td>Allowable settlement fees and closing costs:</td>
<td></td>
</tr>
<tr>
<td>Kitchen and bath remodels:</td>
<td>$50,000</td>
</tr>
<tr>
<td>New roof:</td>
<td>$20,000</td>
</tr>
<tr>
<td>New landscaping:</td>
<td>$15,000</td>
</tr>
<tr>
<td>Depreciation from home office</td>
<td>($50,000)</td>
</tr>
<tr>
<td>COST BASIS</td>
<td>$297,500</td>
</tr>
</tbody>
</table>

| What did they sell it for?                   |                |
| Sales price                                  | $875,000       |
| Commission and sales fees                    | ($55,000)      |
| GROSS PROFIT                                 | $820,000       |

| How much did they make?                     |                |
| Gross profit                                 | $820,000       |
| Cost basis                                   | ($297,500)     |
| CAPITAL GAINS                                | $522,500       |

| How much do they owe in taxes?              |                |
| Capital gains                                | $522,500       |
| Capital gains exclusion:                     | ($500,000)     |
| Rate (15%)                                   | 0.15           |
| TAXES DUE                                    | $3,375         |

Note: Jon and Jane must also include the $50,000 depreciation deduction on their tax return as “unrecaptured section 1250 gain.” It will be taxed at a rate of 25% ($12,500). They would have to do this even if their capital gain was less than their $500,000 exclusion.

“Having a smaller house can mean less upkeep and lower monthly expenses—to say nothing of potential cash from the sale.”

Looking ahead: Rent or buy?

Your next big decision will be figuring out where to live. Downsizing may mean buying a smaller house or moving to a less expensive area. Alternatively, you could decide that it would make more sense to rent.

On the plus side, renting releases you from worry about things like property taxes and upkeep, potentially giving you more freedom both economically and emotionally. If you don’t sink your money into another house, it could also give you a nice retirement nest egg. On the minus side, if you rent you won’t be building equity and you’ll be subject to the whims of a landlord. There’s no right or wrong answer. A lot will depend on where you live and whether you plan to stay in your next home long term.

In either case, if you make a considerable profit on the sale of your home, talk to Schwab about the best way to invest this money in light of your overall financial situation.

Carrie Schwab-Pomerantz, CFP®, is President of Charles Schwab Foundation and Senior Vice President of Schwab Community Services at Charles Schwab & Co., Inc.

1IRS Publication 523.
2Ibid.

See page 42 for important information.

(0915-3247)
Washington Gridlock

How markets may react to the latest round of brinkmanship.

BY MICHAEL TOWNSEND

Among the most basic responsibilities of Congress is appropriating funds to operate the federal government. Another is ensuring that the United States does not default on its debts.

Yet these and other fundamental obligations have become the focus of bitter partisan battles that regularly remain unresolved until the very last minute—or beyond. The uncertainty roils the markets and provokes investor anxiety.

This fall, Washington is readying itself for another round of fiscal brinkmanship. Congress will once again either have to strike an agreement to fund the government or risk a shutdown. Lawmakers also face a deadline to raise the debt ceiling and avoid a default.

The news media will likely make much of this, issuing warnings of impending economic disaster.

But should these disputes raise concerns among investors? That remains to be seen.
Broken budget process
The congressional budget process is a cumbersome one, to say the least. It begins with the president making a budget proposal, which is usually unveiled in February. This document is essentially symbolic, serving to highlight the White House’s policy priorities.

Congress then develops its own plan, known as a “budget resolution,” which provides a broad framework for government spending. Next, the appropriations committees in the two chambers fill in the details, allocating funds on an agency-by-agency and program-by-program basis. There are 12 appropriations bills, each of which must be approved in identical form by both the House and Senate and then signed into law by the president. Congress is supposed to complete this task before the government’s fiscal year begins each October 1.

When Congress misses this deadline, it resorts to “continuing resolutions” to fund the government while lawmakers try to finalize the appropriations bills.

Where do things stand now?
With Republicans now in control of both chambers, Congress was able to approve a budget resolution earlier this year. However, passing the appropriations bills remains difficult. Congress hasn’t succeeded in passing all 12 bills on time since 1996.

Congress failed to pass a single appropriations bill in 2014. Legislators used a series of short-term continuing resolutions to keep the government operating through the election in November. In December, Congress finally agreed to a longer continuing resolution that funded the government for the remainder of fiscal year 2015, which ends September 30. Unless Congress can agree to a new measure, a government shutdown looms on October 1.

Should investors be concerned? We think the chances of another government shutdown are relatively low. Congress will likely want to avoid a repeat of the 16-day shutdown in 2013 since both parties drew public ire for their inability to reach consensus.

However, that doesn’t mean a long-term solution is likely. So get used to hearing the phrase “continuing resolution,” because Congress will undoubtedly have to resort to a series of short-term agreements to keep the lights on.

Debt ceiling debacles
In the coming weeks, lawmakers will also face a deadline to increase the government’s debt ceiling, which currently stands at about $18.1 trillion. This number represents the amount of debt the Treasury Department can issue to pay for things like Social Security, military salaries and interest on the national debt. When Congress raises the ceiling, it isn’t authorizing new spending. It is just allowing the Treasury to finance its existing commitments.

For decades, increasing the debt ceiling was a routine matter. Only in the last 10 years or so has it become controversial. Some cites the ceiling as evidence that politicians can’t control spending.

Where do things stand now?
After repeatedly clashing over whether or not to raise the ceiling, Congress agreed in February 2014 to simply suspend it altogether. That agreement ended on March 15 of this year, so the ceiling was reinstated—at the current level of outstanding debt. Unable to borrow more, the Treasury immediately began employing so-called “extraordinary measures”—such as suspending issuance of state and local government securities and making changes to how federal retirement funds are invested, among other actions—to avoid default.

Extraordinary measures are basically accounting techniques designed to buy Congress time, usually from a few weeks to a few months, depending on other economic conditions. But they are not a permanent solution.
The Congressional Budget Office has estimated that the Treasury could run out of cash by the end of the year. What happens if Congress can't agree on an increase? You may recall that in August 2011, Congress brought the country close to its first default after failing to raise the ceiling. The uncertainty caused the S&P 500® Index to drop 13% in the first week of August 2011. The market reaction eventually helped push lawmakers into an agreement to increase the debt ceiling.

So what are the odds of another showdown this time?

A growing number of conservative Republicans have refused to support any increase in the debt ceiling in recent years. Another group of Republicans have said they will support a debt ceiling increase only if it is paired with a corresponding amount of spending cuts, which President Obama has rejected. Meanwhile, Democrats are threatening not to help Republicans pass a debt ceiling increase this year.

The path forward remains uncertain, and a long-term solution that would help lower the nation's accumulated debt continues to be elusive. Some have proposed eliminating the debt ceiling entirely, or at least changing it. For now, we're stuck with the current process.

**Takeaways for investors**

As this fall's drama unfolds, investors could see some market volatility. But that's no reason to panic. Looking back to the debt ceiling crisis of 2011 could give us some insight into what markets might make of another congressional showdown.

As mentioned above, the S&P 500 notched a 13% decline during the first week of August 2011. That was just the start of what would eventually be a 20% drop, accompanied by a rise in volatility. As we now know with the benefit of hindsight, that plunge created a spectacular buying opportunity for equity investors.

The situation in the bond market was another story. Courtesy of anxious investors fleeing to the perceived relative safety of U.S. government bonds, Treasuries rallied quite sharply even as the country faced a potential default. This happened despite pundits' warnings that a possible debt default, and related downgrade of the United States' credit rating, would lead to soaring Treasury yields.

Why did this happen?

- When all else is going wrong, investors still flock to U.S. Treasuries. The prospect that the government might be shut down raised the risk of an economic downturn as public spending dried up. The economy wasn't very strong at the time, so the extra drag on growth could have risked tipping the economy into a recession. Demand for bonds from concerned investors may have helped pull down yields.
- Some also thought the Federal Reserve would go out of its way to pump liquidity into the financial system to offset the impact of a contracting government sector.
- Some simply didn't believe Congress would let the worst come to pass. With the stock market falling and an uncertain economic outlook, investors assumed the government would make good on its promises. After all, it wasn't unable to pay its bills, just unwilling.

Of course, this isn't to suggest that history will repeat itself this fall. But it may still be reassuring to know that financial markets weathered the last major showdown in Washington.

**Michael Townsend is Vice President of Legislative and Regulatory Affairs at Charles Schwab & Co., Inc.**

See page 42 for important information.

Past performance is no guarantee of future results.

(0915-3742)
Ready for Higher Rates

Ladders and barbells can help prepare your bond portfolio for rising rates.

BY KATHY JONES

For the past decade, the Federal Reserve has kept interest rates low in a bid to support the economy—first by cutting a benchmark lending rate down to zero and then, when it couldn’t cut any further, adopting other rate-suppressing actions. Now that the end of this accommodative approach is at hand, bond investors face a dilemma. On one hand, investors will have to contend with falling bond prices as interest rates rise. On the other, higher interest rates will help them earn more income from their bond portfolios.

With rates poised to rise, now is a good time to review your bond portfolio to see whether it is positioned for changing conditions in the fixed income market.

The case for higher rates

The U.S. economy may be improving, but there are still potential weak spots in the labor market and inflation is hovering below the Fed’s long-term 2% target. So why raise rates at all?

First of all, it takes time for the full effects of changes in monetary policy to be felt in the economy. If the Fed waited until employment and inflation were both rising strongly before hiking rates, it could risk over-stimulating the economy. In addition, the Fed has expressed concern that leaving rates too low for too long could encourage excessive risk-taking by investors.

Finally, leaving benchmark rates near zero robs the central bank of one of its tools for influencing the economy. Adopting a more “normal” footing gives the Fed room to cut rates in the future if the economy needs a shot of stimulus.

The thing to keep in mind about the Fed is that it tends to move cautiously, and any rate increases in the months ahead will likely be “slow and low” compared to previous tightening cycles.

How will the market react?

So what might that mean for the bond market? Although no two economic or policy cycles are alike, the previous three cycles of Fed tightening—1994, 1999 and 2004—could provide some guidance. Three things about these periods stand out:

- Volatility increased in the short term: The worst periods for bond market performance were generally the three months prior to and the three months after the first rate hike. Price declines for long-term bonds were greater than for short- and intermediate-term bonds during this time period.
- Long-term bond returns held up: In the one to two years following a rate increase, investing in long-term bonds delivered returns that were nearly as good as—or even better than—those from short- to intermediate-maturity bonds.
- Diversity was important: Holding a mix of maturities delivered returns with less volatility.

Given these findings, how might investors prepare their portfolios for a rising rate environment? Having a portfolio of diversified maturities is probably the best approach. Bond ladders and barbells are two strategies for spreading fixed income holdings across different maturities that can provide both flexibility and income.

Bond ladders

With a ladder, you diversify your fixed income holdings across a variety of maturities. For example, a 10-year bond ladder would have some bonds maturing each year over the next decade. As bonds mature, you can reinvest the principal in new longer-term bonds. This is where the “ladder” comes in—every rung (or
The thing to keep in mind about the Fed is that it tends to move cautiously, and any rate increases in the months ahead will likely be “slow and low” compared to previous tightening cycles.

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Given these findings, how might investors prepare their portfolios for a rising rate environment? Having a portfolio of diversified maturities is probably the best approach. Bond ladders and barbells are two strategies for spreading fixed income holdings across different maturities that can provide both flexibility and income.

Barbell
A barbell strategy basically divides the allocation of bonds between very short- and intermediate-term maturities in a bid to maximize the benefits of each. The short-term bonds provide liquidity that can be quickly reinvested in new bonds when rates rise, while the longer-term maturities provide income.

For investors sidelined with a high proportion of cash, waiting for interest rates to rise, a barbell strategy may be a good way to work into a bond ladder over time. As rates gradually rise, investors could add some intermediate-to-long-term bonds to the portfolio.

What to do now
The prospect of higher interest rates has investors both concerned about short-term volatility and hopeful about the opportunity to earn higher returns on their fixed income investments. It’s important to remember that bonds play a key role in your portfolio. They generate income, provide diversification from stocks and are useful for planning since most have fixed maturities. But when the Fed changes policy, fixed income investing can become more complicated.

Taking a few steps to diversify your fixed income holdings now could leave your portfolio better positioned to respond to shifting market conditions.

Kathy Jones (@kathyjones) is Senior Vice President, Chief Fixed Income Strategist at the Schwab Center for Financial Research.

CALL US
For help with your bond investments, call 866-893-6699 to speak with a Schwab Fixed Income Specialist.

See page 42 for important information.
(0915-3255)
Don’t Overlook Emerging Markets

They could offer attractive growth and diversification benefits.

BY JEFFREY KLEINTOP

The words “emerging markets” conjure different images for different investors. Where some think of emerging markets as an exciting category where high risks go hand-in-hand with potentially high rewards, others picture an exotic world that is best left to professionals. But investors shouldn’t get hung up on the name. Far from being a niche where the normal rules don’t apply, emerging markets play an important role in financial markets and the global economy. They account for more than half of the world’s economic output, 80% of its population and 10% of global stock market valuation.

Adding exposure to emerging-market investments to your portfolio offers the potential for growth and diversification. Here we’ll take a closer look at this sometimes misunderstood segment of the investing world.

Middle class spending by region

Between 2009 and 2030, consumption by the global middle class is forecast to grow from $21.3 trillion to roughly $55.7 trillion—more than 160%.

<table>
<thead>
<tr>
<th>Region</th>
<th>Value in trillions of dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>2030</td>
</tr>
<tr>
<td>North America</td>
<td>$5.6 $5.8</td>
</tr>
<tr>
<td>Europe</td>
<td>$8.1 $11.3</td>
</tr>
<tr>
<td>Central/South America</td>
<td>$1.5 $3.1</td>
</tr>
<tr>
<td>Asia</td>
<td>$5.0 $11.1</td>
</tr>
<tr>
<td>Middle East/Africa</td>
<td>$1.1 $2.8</td>
</tr>
</tbody>
</table>

Source: Charles Schwab, with data from “The Emerging Middle Class In Developing Countries,” Homi Kharas, OECD Development Center, 1/2010.

What’s in a name?

In general, “emerging markets” are low- or middle-income countries that are on the path to developed-country status. These countries typically have rapidly rising per capita income and economic growth. They also generally have fairly large and liquid financial markets. On the continuum of market designations, emerging markets are less mature than developed countries, but more mature than poorer and far riskier “frontier markets.”

The category encompasses a very diverse group of economies. Perhaps the most famous group of emerging markets was identified roughly 15 years ago when an analyst coined the term “BRICs” to recognize the economies of Brazil, Russia, India and China, which were growing fast at the time. Other well-known emerging economies include Mexico, Indonesia, South Africa and Turkey. MSCI, which assembled the benchmark MSCI Emerging Markets Index in the late ’80s, also considers relatively sophisticated economies such as South Korea and Taiwan to be emerging markets.

Growth expectations

In recent years, growth has slowed in many emerging markets, at least compared with the rapid rates during the BRICs era around the turn of the century. However, these economies still typically offer more rapid economic growth than developed economies such as the United States, Japan and many European countries.

Several factors are at work here. First of all, emerging markets have the potential to rise quickly as they develop. At the same time, many of them have young populations, which bodes well for consumption, especially if you compare them with those developed countries where aging populations will eventually lead to a decline in the number of consumers.

Many emerging markets have tidied up their fiscal situations after being upended in a series of crises in the ’90s. Their debt is lower relative to the size of their economies, and their citizens tend to save more than those in developed economies. In addition, emerging economies have flexible exchange rates and larger foreign-currency reserves than they once had.

Over the longer term, emerging markets could be the source of the most significant global demographic change for investors: the rise of the
global middle class. The World Bank estimates that by 2030, 93% of the global middle class will be in emerging market countries. This will likely be a major investment theme of the coming decade. (See chart on page 18.)

Global providers of household products, autos and many other categories may benefit from the middle class megatrend. At the same time, demand for services from finance to health care is also likely to rise.

Diversification benefits
Emerging markets also provide investors with diversification because they can perform differently than developed markets. As you can see in the chart at right, there have been periods over the past decade when emerging market stocks have performed significantly better than those in the U.S. and other developed markets, as well as periods when they have significantly underperformed.

Risks
Emerging markets may be on the path toward developed-country status, but they still have work to do to get there. That means they may come with their own set of risks.

For example, their corporate governance—the framework or set of rules under which companies operate—is generally regarded as being poorer than that of developed countries. There can be restrictions on how freely businesses operate as well as their ability to earn profits. It can also be difficult for investors to research emerging market companies.

In addition, geopolitical or social unrest might spur political change in some emerging markets, potentially ushering in instability. Trade and fiscal deficits may cause some emerging market countries to struggle if the Federal Reserve begins to hike interest rates. Also, China, the largest emerging market, has launched economic reforms that may slow growth.

At the same time, some investors may be concerned that the strong U.S. dollar—which set record highs against some emerging market currencies within the last year—diminishes the appeal of emerging markets stocks. A rising dollar is a drag on any investment not denominated in U.S. dollars. Some emerging market companies could struggle to service their dollar-denominated debt, as they could find themselves having to make payments with a weakened currency.

Part of a well-balanced portfolio
All investors, but mostly those with moderate to higher risk tolerances, might want to consider adding emerging market stocks as part of a diversified portfolio.

Even as emerging markets continue to contend with sluggish global growth, they will likely produce much faster growth than developed markets, which investors prize in a world where growth is scarce.

Jeffrey Kleintop (@jeffreykleintop) is Senior Vice President, Chief Global Investment Strategist at Charles Schwab & Co., Inc.

Emerging markets perform differently

Source: Morningstar Direct as of 12/31/2014. Calendar year performance. Domestic equities represented by the S&P 500® Index, international developed equities represented by the MSCI EAFE Index, and emerging market equities represented by the MSCI Emerging Markets Index. Past performance is no guarantee of future results. Dividends and interest are assumed to have been reinvested.

DO THE RESEARCH
See our emerging market ETF picks by logging in to schwab.com/OIETFselectlist and selecting “international equity.”

1Global output and population data from the International Monetary Fund’s World Economic Outlook as of April 2015. Global stock market valuation from MSCI as of 12/31/2014.

See page 42 for important information.

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.

Some specialized exchange-traded funds can be subject to additional market risks. Investment returns will fluctuate and are subject to market volatility, so that an investor’s shares, when redeemed or sold, may be worth more or less than their original cost.

(0815-3757)
Defensive Steps
How to use stop orders to help protect profits.

BY RANDY FREDERICK

Any traders use stop orders to help protect an unrealized gain or limit potential losses on an existing position. Such orders can be useful tools. They help you play defense by setting parameters for transactions, and may provide comfort when markets are volatile. However, stop orders aren’t without risks. I have heard from traders who have placed stop orders only to suffer losses when executions were triggered far below their stop price. Others have found themselves shut out of opportunities for appreciation.

Let’s examine three different types of stop orders and when it might make sense to use them.

Stop orders
With a regular stop order, you set a stop (or trigger) price below which you would no longer be interested in holding a stock. If that price isn’t reached, then nothing happens. However, if your stock declines to your stop price, a market order is placed to sell the stock at the next best available price.

Stop orders offer execution protection, but not price protection. That means that while execution is generally guaranteed when the price trigger is reached, the final sales price isn’t. If your stock price declines slowly, that might not be a problem—your trade would likely be executed at a price level that is close to your stop price. However, if a stock “gaps down,” or suffers a sudden sharp drop, your trade could execute at a price level far below your stop price.

Keep in mind that if your stock price rises, you may want to help protect your unrealized gains by canceling any existing stop orders and then resubmitting them at a higher price.

Stop-limit orders
A stop-limit order can address the price risk associated with regular stop orders by letting you set a floor under your stop order. In other words, you set two prices—a stop price and a limit price. If the stop price is triggered, a limit order is placed to sell at your specified limit price or better. However, if the next available price after the stop price is reached is below the limit price, then the order will not be executed.

Stop-limit orders offer price protection, but not execution protection. That means that while you can avoid having a trade execute far below your stop price, you can’t guarantee an execution will occur if your stock drops below your limit price.

Stop order strategies
Once you’ve picked what type of order you’d like to employ, you have to decide where to set your price levels. Where you position your stop and limit prices is important—the right price can help protect you from the downside while giving your position room to run.

Where to set the stop price ultimately depends on how much of a loss you are comfortable taking. Many traders have a standard policy of setting a trailing stop price 5–10% below the current price. You can also identify a level using the stock’s point value. Traders who determine the size of each trade based on the dollar amount invested may find the latter approach more effective than using a percentage.

It’s important for traders to approach every stop order differently, accounting not just for overall market conditions but also for the specific security’s volatility and trading history.

All three types of stop orders discussed above typically work well in slowly declining markets. They are less helpful in halted or gapping down markets due to the possibility of losses or an inability to execute.

Volatility could present other problems.
As with regular stop orders, you will have to cancel and resubmit existing stop-limit orders if you want to help protect unrealized gains as your stock price increases.

**Trailing stop orders**
A trailing stop order is essentially a stop order that adjusts upward with a rising stock, eliminating the need to cancel and resubmit orders as you would with a stop or stop-limit order. Once a stock stops rising and begins to move lower, the stop price freezes at the highest level it reaches. If the stock declines enough to trigger the order, it becomes a market order just like a regular stop order.

And like a regular stop order, a trailing stop order offers execution protection, but not price protection.

**Stop order strategies**
Once you’ve picked what type of order you’d like to employ, you have to decide where to set your price levels. Where you position your stop and limit prices is important—the right price can help protect you from the downside while giving your positions room to run.

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It’s important for traders to approach every stop order differently, accounting not just for overall market conditions but also for the specific security’s volatility and trading history.

**Context matters**
All three types of stop orders discussed above typically work well in slowly declining markets. They are less helpful in halted or gapping down markets due to the possibility of losses or an inability to execute.

Volatility could present other problems.

If stocks are experiencing major price swings, you may face a higher chance your stop order will be executed. The trick in volatile markets is to give your positions enough room to move around without triggering a premature sale. Short-term traders may also want to give themselves some breathing room to prevent locking in a loss too soon.

And then there’s the question of how volatile your particular stock is. If the stock you’re trading has a history of fluctuating as much as 5% in price daily, placing a stop order 5% below your entry price is likely to result in an unfavorable outcome. In contrast, a 5% stop order may be appropriate for a stock that has a history of fluctuating 5% in a month.

You can calculate the average daily price change for a stock with a few days of pricing data. The table on page 22 lists the hypothetical daily closing prices for stock XYZ over six consecutive trading days. As you can see, the average day-to-day closing price change for the week was $0.45, or about 0.82%. For the full week, the net change was $0.28, or about 0.51%. Entering a 5%, or a three-point, stop order on XYZ would likely provide adequate protection and reduce the risk of being stopped out too soon.

### Three types of stop orders

<table>
<thead>
<tr>
<th>ORDER TYPE</th>
<th>STOP ORDER</th>
<th>STOP-LIMIT ORDER</th>
<th>TRAILING STOP ORDER*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price protection</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Execution protection</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>If the stock price rises?</td>
<td>You must manually cancel and re-enter orders if you want to change your stop price.</td>
<td>You must manually cancel and re-enter orders if you want to change your stop and limit prices.</td>
<td>Automatically adjusts higher if your stock rises.</td>
</tr>
</tbody>
</table>

*Trailing stop orders are not available on all Schwab trading platforms.*
Trading

Schwab’s StreetSmart Edge® trading platform has a historical volatility chart that lets you gauge the recent volatility of any stock. The charts below compare the volatility of two hypothetical stocks, XYZ and ZYX. In the first chart, we can see that the 30-day historical volatility (the blue line) of XYZ is 21.82%. In the second chart, we see ZYX has a historical volatility of 68.83%. Clearly, ZYX is the more volatile of the two. If you wanted to use a stop order with ZYX, you would want to allow more room for price changes, whether you are setting it based on points or percentage.

In addition, you should look ahead to events like earnings releases that might cause an increase in volatility. I rarely leave a stop order in place if a company is going to report earnings after the market closes. Overnight stop orders create a false sense of security for many traders, who think they have more protection than they really do. The risk is just too great that the stock will open sharply lower if the company’s earnings disappoint.

Stop orders are mainstay tools for traders to manage downside risk and lock in potential profits, but make sure you understand their limitations. While each order type can help you protect your positions, you need to be strategic in using them. Carefully selecting the right tool and establishing the right pricing parameters can vastly help increase your success rate.

Randy Frederick (@randyafrederick) is Managing Director of Trading and Derivatives at the Schwab Center for Financial Research.

**NEXT STEPS**

Stay abreast of the markets with Charting the Market, a live analysis and Q&A session about current market action. Join us Tuesdays at 7 p.m. Eastern time and Thursdays at 1:30 p.m. Eastern time. Sign up at schwab.com/OItradinglearningcenter.

**See page 42 for important information.**

The trailing stop feature should not be confused with the stop order (order type). All StreetSmart Edge alerts with trailing stops or other conditional orders will be entered as a market order type (same day only).

(0915-3249)
Don’t let optimistic expectations put your retirement at risk.

Optimism is a fine thing, but it’s no substitute for careful planning when it comes to saving for retirement. Unfortunately, some people have misconceptions about how much they’ll need to support themselves in retirement—and the steps they’ll need to take to get there.

The Employee Benefit Research Institute’s (EBRI) 2015 Retirement Confidence Survey found that retirees are more likely to say their expenses in retirement are higher than expected (37%), rather than lower (24%). Only 35% say their expenses are about the same as expected. Meanwhile, many working-age people haven’t bothered to think about their retirement savings at all, with only 48% saying either they or their spouse had ever tried to calculate how much they will need to save in order to live comfortably in retirement.

This doesn’t mean that most people’s savings plans are doomed to come up short. Far from it. It’s entirely possible to save for the retirement you’ve been dreaming about. The bottom line is that some judicious saving and planning today can help you avoid some common pitfalls that could make your retirement more challenging.

Here we’ll look at a few misconceptions and rosy assumptions about retirement and the reasons why most people would be better off avoiding them.
“It’s safer to aim at covering 100% of your pre-retirement income, less whatever you’re saving for retirement.”
3 **YOU’LL BE IN A LOWER TAX BRACKET ONCE YOU RETIREE.**

Even with recent increases, marginal tax rates are still near historic lows, and it’s unlikely that most people will move to a lower bracket in retirement. Even if they do, the change will likely be just a few percentage points rather than a major shift. For example, for 2015, a couple with a pre-retirement income of $155,000 would have to earn less than half that amount to move from the 28% bracket to the 15% bracket. Sure, your salary will be going away (as will FICA taxes), but you will still have income, such as distributions from retirement accounts and Social Security benefits. (For married couples filing jointly, up to 85% of your Social Security income may be taxable if your modified adjusted gross income is more than $44,000.)

You should remember that as recently as the 1980s, the top federal tax bracket was a whopping 70%. While tax rates aren’t likely to return to that level anytime soon, it is possible rates could rise in the future. So if your taxable income remains the same in retirement as when you were working, higher rates in the future could boost your tax liability. Unless you have a very high pre-retirement income, it’s safer to assume that you will keep paying taxes at roughly the same rate after you stop working.

4 **THE STOCK MARKET WILL SAVE YOU.**

The market declines of 2002 and 2008 should have convinced most people that this is not a reliable assumption. But with the market rising again, it’s easy to forget that you may not see the kinds of returns going forward that you saw in the 30 years prior to 2000. It’s always better to be cautious when making assumptions about the market’s performance, and to have some cash and more stable investments in your portfolio to help you weather a bear market.

Whatever your risk tolerance, your retirement spending plan should consider a range of reasonable portfolio outcomes. You could plan for high-single-digit returns for stocks and about half that for bonds (despite today’s extraordinarily low interest rates). But don’t assume the same return every year.

Market returns fluctuate and a bear market in the early years of your retirement could have a significant impact on your ability to sustain cash flow.

Market gains can help your savings go further in retirement, but they aren’t a replacement for pre-retirement saving. And make sure that you have a cushion of less volatile investments in place when you reach retirement.

5 **THERE’S ALWAYS SOCIAL SECURITY.**

Some people head into retirement thinking they’ll be able to rely on Social Security to cover most of their needs. Others doubt that Social Security will even exist by the time they retire. Both scenarios are too extreme. The Social Security Administration projects that the current system will remain sound through 2036, but beginning in 2037, benefits could be reduced by 22% and may continue to decline annually if no changes are made to the program.

Social Security is likely to be a valuable resource for many retirees, but don’t get carried away. No matter what, Social Security is going to cover only a portion of your retirement spending, and you will need additional savings to bridge the gap.

All things considered, it’s important to be flexible and adjust your plans when needed. Don’t get into a situation where your retirement works only if one set of assumptions turns out to be true. But you should also avoid the kind of pessimism that might cause you to scale back to the point where you’re sacrificing more than necessary.

See page 42 for important information. (0815-3425)
Commodities—raw materials including agricultural goods like wheat and coffee, energy sources like oil and gasoline, and metals like gold and copper—had a rough ride in 2014. Ibbotson Associates and Morningstar Direct ranked commodities last among 13 asset classes in terms of performance for the year. The Bloomberg Commodity Index, which tracks the performance of 22 commodities, fell almost 17% in 2014. However, these recent challenges shouldn't overshadow the case for including a long-term allocation to commodities in your portfolio. Commodities offer diversification benefits, potential growth opportunities and inflation hedging, and they may give investors a way to tap into potentially fast-growing emerging markets in the years ahead. Here we'll look at why commodities deserve a place in a well-diversified portfolio.

**Diversification**

The case for including commodities in your portfolio starts with their historical tendency to perform differently than stocks and bonds in varying market conditions. You might recall that gold surged when stocks tanked during the 2008 financial crisis, as some investors gravitated toward the perceived safety of real assets. Since no asset class performs well consistently, having exposure to uncorrelated investments that don't move in lockstep helps reduce portfolio risk.

To see how the benefits of diversification might play out in a portfolio, consider how two...
Commodities’ recent struggles shouldn’t overshadow their long-term appeal.

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To see how the benefits of diversification might play out in a portfolio, consider how two hypothetical investments of $100 at the beginning of 1970 would have played out by the end of 2014:

- $100 invested in U.S. large-company stocks (as represented by the S&P 500® Index) would have grown to $8,854, excluding fees and expenses. That’s an average annual return of 10.48%.
- $100 invested in commodity markets (as measured by the S&P GSCI® Index) would have grown to $3,233, representing an average annual return of 8.03%.
Commodities have historically performed better than stocks when inflation is high

Inflation-adjusted performance of stocks, bonds and commodities

Now imagine that $100 had been invested in a 50/50 split between the two and rebalanced annually. That portfolio would have grown to $8,551—an average annual return of 10.39%. While the value of the 50/50 portfolio would have been slightly less than that of the U.S. large-company stock portfolio at the end of 2014, the 50/50 portfolio would also have been 16% less risky. In other words, combining stocks and commodities in a portfolio can help mitigate its overall risk. This is the value of diversification—smoothing the ride over time.

Growth potential

Unlike stocks, commodities don't generate earnings or dividends, so returns are driven by supply and demand. Commodity prices are influenced by consumption and the scarcity of raw materials, as well as speculation about future price movements.

We looked at how commodities’ inflation-adjusted returns stacked up against those of stocks and bonds from 1970 to 2014. As you can see in the chart at top left, commodities haven’t performed as well as stocks or bonds recently, but during some periods commodities have done very well.

A variety of factors hurt commodities in 2014—oil prices were wracked by rising supply and slowing global economic growth, a bumper grain harvest in the United States depressed prices, and a surging U.S. dollar forced other countries to pay more for commodities priced in dollars. While these factors seem set to persist over the short term, that doesn’t mean they’ll be around forever.

If global growth accelerates, commodities will likely benefit, particularly as demand and consumption recover in emerging markets. Increased middle-class consumption in China has been a boon for commodities in the past, just as strong growth in other emerging countries could give a boost to commodities in the years ahead.

Source: Morningstar Direct. Stocks are represented by the S&P 500 Index, long-term bonds are represented by the Ibbotson Associates SBBI U.S. Long-Term Government Bond Index Total Return, and commodities are represented by the S&P GSCI Index. Past performance is no guarantee of future results.
Inflation protection
Commodities have historically outperformed stocks during periods of inflation, which could make them a useful hedge against rising prices. The advantage of an inflation-hedging component in your portfolio may not seem as evident in periods when inflation is low, as it has been in recent years, but the benefits are quite clear over longer periods of time.

We compared how stocks and commodities performed between 1970 and 2014 during periods when inflation was below 2%, in a moderate 2–4% range and more than 4%. As the chart at bottom left on page 28 shows, commodity returns have increased in periods when prices are rising briskly. That kind of performance is valuable when inflation is eroding the returns on financial assets.

Investment considerations
Of course, not all commodities are the same—and each has its own unique risks. For example, the four-year drought in California may continue to hurt agricultural production, leading to higher prices. And turmoil in the Ukraine and the Middle East has led to wide swings in natural gas and oil prices.

Still, the case for allocating at least a part of your portfolio to commodities is clear. Commodities took a drubbing over the past 12–18 months, but that doesn’t mean investors should run for the hills and banish them from their portfolios.

See page 42 for important information.

For funds, 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.

Investment returns will fluctuate and are subject to market volatility, so that an investor’s shares, when redeemed or sold, may be worth more or less than their original cost. Unlike mutual funds, ETF shares are bought and sold at market price, which may be higher or lower than the net asset value.

Past performance is no guarantee of future results.

Since sector- and commodity-specific funds are not diversified and focus their investments entirely in a single sector, commodity or basket of commodities, the funds will involve a greater degree of risk than an investment in other diversified fund types.

Indexes are unmanaged, do not incur management fees, costs or expenses, and cannot be invested in directly. (0915-3683)
Getting to Know Dividend Stocks

DIVIDEND-PAYING STOCKS MAY OFFER VALUE EVEN IF RATES RISE.

In a world of persistently low interest rates and economic uncertainty, many investors have turned to dividend-paying stocks for income and stability. Many of those investors may have been dismayed earlier this year when the prospect of higher interest rates sent some dividend-paying stocks tumbling.

Historically, dividend-paying stocks have not been subject to the kind of interest rate risks that come with other income-focused investments.

Nevertheless, as the Federal Reserve contemplates its first interest rate increase since 2006, investors need to be more selective. Not all dividend-paying stocks are the same—a number of factors affect a company’s value and dividend payout. For example, utility and telecommunications companies, whose stocks are popular for their relatively high dividend yields, tend to be relatively slow growing and debt-laden. These characteristics could put pressure on a company’s ability to increase dividends in rising interest rate environments.

Let’s take a closer look at dividend-paying stocks, how they have fared in rising rate environments and how to assess them.

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Let’s take a closer look at dividend-paying stocks, how they have fared in rising rate environments and how to assess them.
SEEKING INCOME
Many investors like dividend-paying stocks because they can offer a relatively regular source of cash flows—most dividends are paid quarterly. Companies in the S&P 500® Index paid a record $45 billion in dividends in February, according to S&P Dow Jones Indices, and full-year payments are poised for a fifth straight annual gain of at least 10%.1

This resonates with income-focused investors such as retirees, who often rely on recurring sources of income to help pay their bills.

Those looking for growth as well as income might consider the benefits of reinvestment. Reinvesting your dividends—adding your earnings to your original investment—can help boost returns through the power of compounding. This can create a snowball effect, as the original investments, plus the income earned from those investments, can grow together over time. Or it can cushion losses during down periods.

For example, if you had invested $68.56 in the S&P 500 on December 31, 1974 (the closing value of the index on that date) and reinvested all of your subsequent dividend payments, your portfolio's value would have grown to $6,140.23 by the end of 2014, according to research by ThomasPartners,® Inc. Take dividends out of that equation and the simple price appreciation would have netted you $2,058.90 over the same period.2

DIVIDEND STOCKS AND INTEREST RATES
As the market awaits the Fed's interest rate hike, many investors are wondering how dividend-paying stocks will fare in a rising rate environment. As you can see in the chart below, research by ThomasPartners found that dividend payers, particularly those that increased or initiated a dividend, delivered returns that were consistently higher than those from both non-dividend payers and those that cut their dividend in the 36 months following an initial rate hike.

ASSESSING DIVIDEND-PAYING STOCKS
Dividend-paying stocks are not without risk. So what should you pay attention to when you're considering them?

First of all, it's worth emphasizing that dividend-paying stocks don't provide the downside protection afforded by many bonds if held to maturity.

Another major source of concern is the ability of a company to continue paying dividends at the current rate—or at all. Dividends are paid at the discretion of the board of directors, which can raise, lower or eliminate a dividend whenever it chooses.

In assessing dividend-paying stocks, you should ask yourself a few questions:
What is the stock's dividend yield? Steve Greiner, who leads the Schwab Equity Ratings® team within the Schwab Center for Financial Research, says

Historical performance after the Federal Reserve increased rates
CUMULATIVE TOTAL RETURN

<table>
<thead>
<tr>
<th>Year</th>
<th>GROWERS</th>
<th>CUTTERS</th>
<th>NO CHANGE</th>
<th>NON-PAYERS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Year</td>
<td>11.48%</td>
<td>8.17%</td>
<td>9.22%</td>
<td>1.08%</td>
</tr>
<tr>
<td>2 Years</td>
<td>27.89%</td>
<td>17.69%</td>
<td>1.15%</td>
<td>10.72%</td>
</tr>
<tr>
<td>3 Years</td>
<td>54.49%</td>
<td>45.12%</td>
<td>12.69%</td>
<td>29.46%</td>
</tr>
</tbody>
</table>

Source: ThomasPartners Empirical Research with data from Barclays Research and the CRSP® 1962 U.S. Stock Database. ©2014 Center for Research in Security Prices (CRSP), University of Chicago Booth School of Business. The results reflect the equally weighted average cumulative total return of stocks in the S&P 500 during Federal Reserve tightening cycles from 1/1/1972 through 3/31/2015, but may not include all periods of Federal Reserve monetary policy tightening during that period. Dates selected for initiation of each tightening cycle were determined by Barclays Research. Stocks in the S&P 500 were sorted into one of four categories and based on the company’s annual dividend policy over a three-year period following the initiation of a Federal Reserve tightening cycle. Indexes are unmanaged, do not incur management fees, costs, taxes or expenses and cannot be invested in directly. Past performance is no guarantee of future results.

“It’s worth it to be discerning when you invest. Beware of overly high dividend yields and pay attention to a company’s fundamentals.”
ThomasPartners

ThomasPartners seeks to deliver a regular, growing stream of dividend income by investing in companies that pay dividends—with the goal of growing those dividends in the future. ThomasPartners’ Dividend Growth Strategy has three goals:

- **Monthly income.** ThomasPartners’ strategy is designed to provide monthly income—whether the market goes up or down. You can take this income as a monthly dividend payout now or reinvest it for future growth.

- **Annual income growth.** The cost of living increases every year, so ThomasPartners aims to offset inflation with a dividend payout designed to grow every year, too.

- **Competitive total returns.** Investing has a lifelong purpose, so the strategy seeks to deliver long-term, competitive total returns over time.

The minimum investment in the ThomasPartners Dividend Growth Strategy is $100,000. If you’d like to learn more, visit schwab.com/Thomaspinners.

Portfolio management is provided by ThomasPartners, Inc. (“ThomasPartners”), a registered investment advisor and an affiliate of Charles Schwab & Co., Inc. There are risks associated with any investment approach, and the ThomasPartners Dividend Growth Strategy has its own set of risks. First, there are the risks associated with investing in dividend-paying stocks, including but not limited to the risk that stocks in the strategy may reduce or stop paying dividends, affecting the strategy’s ability to generate income. Second, investor sentiment could cause dividend-paying stocks, clients can log in to schwab.com/01stocks and select “screen for stocks.”

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his team takes special care to analyze each company’s ability to continue supporting its dividend and raise it over time.

One red flag is when a stock’s dividend yield—or the ratio of how much a company pays out in dividends each year relative to its share price—appears much higher than that of its peers. A rising yield isn’t always good because it can simply reflect a declining share price.

“When I see people chasing dividend yields of 5–6%, I really have to question whether that’s starting to become a distressed security,” Steve says. “In those cases, I have to wonder if the board hasn’t met recently to cut the size of the dividend.”

He says the “sweet spot” for dividend yields is between 3% and 4%, but higher levels could make sense for companies in certain industries, such as oil and gas.

**How does the company pay for its dividends?** Steve and his team also consider how companies are paying for their dividends. Those that take out additional debt to fund dividends, rather than simply paying them out of earnings, may be at risk of a dividend cut.

“You want your dividend-paying stock to have a strong balance sheet behind it,” Steve says. “Otherwise, you have to worry about the company weathering a tough environment.”

**How much free cash flow does the company have?** Greg Thomas, Senior Vice President and Chief Investment Strategist at ThomasPartners, says, “We look at whether a company is generating sufficient free cash flow to provide headroom for dividend increases.” Free cash flow refers to cash leftover after capital expenditures—or spending on equipment and other infrastructure needed to conduct business. Companies typically use such funds for dividends, stock buybacks or acquisitions.

Dividend-paying stocks can be a potential source of income and returns. However, they come with a different set of risks and aren’t a substitute for bonds in the income-generating part of your portfolio. It’s worth it to be discerning when you invest. Beware of overly high dividend yields and pay attention to a company’s fundamentals. Don’t worry about your quest for yield to leave you overburdened with risk.

**DO THE RESEARCH**

To find dividend-paying stocks, clients can log in to schwab.com/01stocks and select “screen for stocks.”


2Growth of this investment in the S&P 500 Total Return Index assumes reinvestment of dividends on December 31 of each year, includes capital gains and does not reflect the effect of taxes and fees. If fees and expenses were considered, returns would have been lower. Hypothetical performance is no guarantee of future results. Indexes are unmanaged, do not incur management fees, costs, taxes or expenses and cannot be invested in directly.

See page 42 for important information.

(0915-3777)
INFORMATION SECURITY AT SCHWAB

Schwab is always working to keep your personal information—and your money—safe.

Jim McGuire oversees Schwab’s technology innovation, development, infrastructure and operations.
Information security is a hot topic these days. The internet has given rise to a new world of convenience in shopping, banking and investing. Unfortunately, it has also provided another avenue for criminals to attempt sophisticated new types of fraud. The stakes are high, especially for financial services firms.

To learn more about how Schwab protects client information and assets, we sat down for a discussion with Jim McGuire, Executive Vice President and Chief Information Officer. In his role, Jim oversees Schwab’s technology innovation, development, infrastructure and operations.

Q: Information security is a key priority for a financial services firm like Schwab. How does the company safeguard client data?

Jim McGuire: Frankly, we try to keep the details of our methodology confidential to make it more difficult for would-be criminals to get a foothold. What I can tell you is that we have a strong culture of risk management at Schwab, and we protect client accounts in multiple ways. We maintain a multifaceted security program that combines complementary tools, controls and technologies to protect data. We continuously monitor our systems, and we work collaboratively with government agencies, law enforcement and other financial services firms to address potential threats.

All of the channels through which clients access Schwab are protected. While we have sophisticated procedures in place to protect client security online, it doesn’t end there. When you call us, our representatives ask for several pieces of identifying information before you can conduct transactions. When you visit a branch, we ask you for a photo ID to verify your identity.

Q: Can you describe the role technology plays in protecting client information?

JM: We use advanced encryption technology to secure communications on schwab.com. When clients access their accounts, our sites deploy multilayered protections that go well beyond login name and password. If we suspect unauthorized account activity, we ask for additional authentication before permitting access to an account. We also limit the number of unsuccessful attempts at logging into an account. Exceeding this limit triggers the need for additional authentication and a password change.

Our website also uses Extended Validation Certificates to help clients verify that they are accessing our authentic site and not a “spoofed” site masquerading as schwab.com. All you have to do is look for the green bar in front of the web address at the top of your browser to confirm that you’re on Schwab’s official, secure site. The “https://” and padlock icon in the address bar also confirm you are on our secure site.

Automated alerts and other actions play a behind-the-scenes role in our authentication and monitoring processes. We use pattern analysis and other advanced analytical
Keep your operating systems and security software up to date. Ensure you are using the latest versions of your web browser and operating system. Install anti-virus software and anti-spyware software on all technology platforms.

Be alert to potential “phishing” scams. These are efforts by cybercriminals to gain access to your private information or electronic files by sending you an email that looks like it came from a trusted source, usually by asking you to click on a link embedded in the message. The best way to avoid phishing scams is not to click on links in potentially suspicious emails.

Verify you’re on a secure website. When you log in to schwab.com, check the address bar for site validity.

Create a unique password for each financial institution you do business with. And be sure to change it every six months. If you think your password has been compromised, you should change it to a new password from a safe computer and contact us immediately.

Consider adding a verbal password to your Schwab account. This provides an extra layer of security when you call us. Also, make it a practice to never share your passwords.

Consider getting a free security token. This can make every login even more secure. To order a token, just call us at 877-566-1823.

WHAT YOU CAN DO

While Schwab does much of the work to keep account information secure, taking some basic, preventive steps can help. Many involve common sense, like routinely checking your monthly statements to make sure reported account activity is legitimate. You should also:

We have a strong culture of risk management at Schwab, and we protect client accounts in multiple ways.”

— Jim McGuire, Executive Vice President and Chief Information Officer at Schwab

What kinds of operational controls do you have in place?

JM: We limit the number of employees who have access to clients’ personal information, and all employees who handle sensitive information are trained to maintain privacy and security. We also enforce internal authentication measures to protect against systems to detect suspicious account activity and prevent unauthorized access. If we detect an unauthorized login, we lock the account and require either a phone call or a visit to a local branch.

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the potential for “social engineering.” That’s when a fraudster masquerading as a client or another employee tries to trick a company’s employees into inadvertently breaking normal security procedures and divulging personal information.

When sensitive transactions occur in a client’s account—such as money transfers, securities sales or purchases, or changes to personal information—we send an alert to the client.

Schwab’s fraud teams also monitor activity looking for suspicious behavior. Certain criteria cause various transactions to be reviewed by highly trained specialists. This allows us to spot attempted intrusions and act on them quickly.

Q: Are there steps clients should take to protect themselves?

JM: We believe security is a partnership between us and our clients. We work hard to do our part in keeping client information safe, and we provide the Schwab Security Guarantee to make sure our clients have peace of mind about the security of their information at Schwab.

The Schwab Security Guarantee simply states that Schwab will cover 100% of any losses in any of your Schwab accounts due to unauthorized activity. The terms of the guarantee are available at schwab.com/OIGuarantee.

But there are some important steps clients should take, including updating operating systems on all their devices, practicing good password discipline and guarding against attempts to “phish” their personal information. (See “What you can do” on page 35.)

CALL US
If you have questions or comments about information security at Schwab, please call us at 877-566-1823.

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Schwab Market-Cap Index ETFs

The lowest operating expenses and $0 commission ETFs.* See for yourself.

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<td>VO 0.09%</td>
<td>UH 0.12%</td>
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<tr>
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<td>VR 0.09%</td>
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<tr>
<td>Int'l Multi-Cap Core</td>
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<td>EWCS 0.59%</td>
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<td>SCHE 0.14%</td>
<td>VWO 0.15%</td>
<td>IEMG 0.18%</td>
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<td>VTIP 0.10%</td>
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<tr>
<td>Short Term U.S. Treasury</td>
<td>SCHQ 0.08%</td>
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<tr>
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<td>SCHR 0.09%</td>
<td>EDV 0.12%</td>
<td>IEI 0.15%</td>
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With operating expenses lower than competitors in their respective Lipper categories—and $0 commissions—Schwab Market-Cap Index ETFs give you a cost-efficient way to build a diversified portfolio.

For more information on Schwab ETFs™, visit schwab.com/LowCostETFs.

Call us at 1-866-294-7021.

Operating expense data was obtained from Strategic Insight Simfund, as of 5/31/2015.

Brokerage Products: Not FDIC-Insured • No Bank Guarantee • May Lose Value

*This claim is based on expense ratio data comparisons between Schwab Market-Cap ETFs and non-Schwab Market-Cap ETFs in their respective Lipper categories. Securities in Market-Cap ETFs are selected and weighted based on the size of their market capitalization. ETFs in the same Lipper category may track different indexes, have different holdings, and show different performance. Competitors may offer more than one ETF in a Lipper category. The non-Schwab Market-Cap ETFs shown represent the funds with the lowest expense ratio within their fund family in their respective Lipper category. Expense ratios are subject to change.

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Investment returns will fluctuate and are subject to market volatility, so that an investor’s shares, when redeemed or sold, may be worth more or less than their original cost. Unlike mutual funds, shares of ETFs are not individually redeemable directly with the ETF. Shares are bought and sold at market price, which may be higher or lower than the net asset value (NAV).

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Our mutual fund lists help you find expert fund choices.

**Mutual Fund OneSource Select List®**

Schwab's Mutual Fund OneSource Select List helps investors identify the most favorably evaluated OneSource funds based on research by Charles Schwab Investment Advisory, Inc. These funds all meet stringent screening criteria and have no loads or transaction fees. It's easy to use our experts’ list of actively managed funds to find the right selection for you.

**The Mutual Fund OneSource Select List prescreens quality, no-load mutual funds in many categories:**
- Large-cap stock funds
- Small- and mid-cap U.S. stock funds
- International stock funds
- Specialty funds
- Taxable bond funds
- Tax-free bond funds

Access our lists of selected funds at schwab.com/OIfaboutfunds.

**Income Mutual Fund Select List®**

As you near retirement, your investment focus will likely shift from accumulating wealth to generating income. You want your portfolio to sustain you through your retirement with regular income, but you don't want to sacrifice the potential for growth. The Income Mutual Fund Select List was developed to help investors like you achieve an income-producing portfolio through either interest or dividend payments.

The **Income Mutual Fund Select List gives you:**
- Prescreened, no-load, no-transaction fee mutual funds that match your portfolio goals
- Mutual funds with a history of making income distributions on a regular basis
- Yield-enhancing mutual fund categories such as multi-sector bonds, international bonds and real estate investment trusts (REITs)

Access our lists of selected funds at schwab.com/OIfaboutfunds.
Performance quoted is past performance and is no guarantee of future results. Current performance may be lower or higher. Visit schwab.com for month's.

Oakmark I (8/5/91) Large Blend OAKMX 8.37 17.18 14.64 8.96 13.10 107.24 108.94 0.87 0.87 18,563

Principal Equity Income A (5/31/39) Large Value P QIAX 3.26 12.04 11.88 6.99 8.75 91.90 98.16 0.89 0.89 6,077

Lord Abbett Growth Leaders A (6/30/11) Large Growth LG LAX 6.47 14.97 — — 13.49 98.09 82.62 1.02 0.85 1,624

Schwab Fundamental U.S. Large Co Index Fund (04/02/07) Large Value SFLNX 9.94 16.30 13.97 — 7.65 102.09 103.80 0.39 0.35 5,021

S&P 500 Index Fund (05/20/97) Large Blend SWPPX 12.60 16.01 14.36 7.97 7.01 99.68 100.18 0.09 0.09 21,505

Pressure from a rising dollar, falling oil prices and uncertainty about the timing of an expected

YEAR

INDEX

STOXX Europe 50 Index™

0.40%

$0

7/14/15 3:44 PM

FTSE

0.07%

0.14%

Would you still like to receive a printed copy of a Select List? Call 800-540-0078 to request a quarterly mailing.

EXCHANGE-TRADED FUNDS

For the quarter ended March 31, 2015

<table>
<thead>
<tr>
<th>EXCHANGE-TRADED FUNDS</th>
<th>ID</th>
<th>DESCRIPTION</th>
<th>Ticker</th>
<th>NAV</th>
<th>YIELD</th>
<th>INDEX</th>
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<tbody>
<tr>
<td>Large Core</td>
<td>SIA</td>
<td>Schwab U.S. Large Cap</td>
<td>SIA</td>
<td>3.56%</td>
<td>0.01</td>
<td>Schwab U.S. Large Cap Index</td>
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<tr>
<td>Large Growth</td>
<td>SIB</td>
<td>Schwab U.S. Large Growth</td>
<td>SIB</td>
<td>3.56%</td>
<td>0.01</td>
<td>Schwab U.S. Large Growth Index</td>
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<tr>
<td>Large Value</td>
<td>SIC</td>
<td>Schwab U.S. Large Value</td>
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<td>3.56%</td>
<td>0.01</td>
<td>Schwab U.S. Large Value Index</td>
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<tr>
<td>Mid Core</td>
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<td>Schwab U.S. Mid Cap</td>
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<td>3.56%</td>
<td>0.01</td>
<td>Schwab U.S. Mid Cap Index</td>
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<tr>
<td>Mid Growth</td>
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<td>Schwab U.S. Mid Growth Index</td>
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<tr>
<td>Mid Value</td>
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<td>Schwab U.S. Mid Value</td>
<td>SII</td>
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<td>0.01</td>
<td>Schwab U.S. Mid Value Index</td>
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<tr>
<td>Small Core</td>
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<td>SIS</td>
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<td>Schwab U.S. Small Cap Index</td>
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<tr>
<td>Small Growth</td>
<td>SIT</td>
<td>Schwab U.S. Small Growth</td>
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<td>3.56%</td>
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<tr>
<td>Small Value</td>
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<tr>
<td>Real Return Core</td>
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<td>0.01</td>
<td>Schwab U.S. Real Return Value Index</td>
<td>0.02</td>
</tr>
</tbody>
</table>

Do You Need Help Finding the Right ETF for Your Portfolio?

The ETF Select List® provides a list of low-cost ETFs picked by our experts.

With more than 1,600 ETFs available and more coming out every week, choosing an ETF can seem more overwhelming than ever. Our quarterly ETF Select List is designed to help you find a low-cost ETF and make more confident investing decisions.

The ETF Select List gives you:

- **Low-cost ETFs**: All ETFs on this list have been picked because they have the lowest cost among the qualifying ETFs in their respective category.
- **Broad diversification**: Representing more than 66 asset categories, you can build a portfolio of ETFs or explore niche categories to help you meet your goals.
- **Expert research**: All ETFs have gone through a rigorous analytical and qualitative review by the investment experts at Charles Schwab Investment Advisory, Inc.

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- **Easy to use.** Make purchases by holding your phone near a retailer’s contactless reader. You’ll see your Schwab Bank debit card on your screen. Place your finger on the Touch ID™ to complete the payment.
- **Safe and secure.** Merchants never see your debit card number.
- **Available for Apple Watch™.** Just load your Schwab Bank debit card information via the Apple Watch app.

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2If you use your debit card to withdraw foreign currency from an ATM or to pay for a purchase with foreign currency, we charge your account only for the U.S. dollar equivalent of the transaction. There is no additional percentage added for the foreign currency transaction. See the Schwab Bank Visa Debit Card Agreement for details.

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2010–2014 Primary Mortgage Origination and 2014 Mortgage Servicing

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Investing involves risks, including loss of principal. All expressions of opinion are subject to change without notice in reaction to shifting market, economic or geopolitical conditions. (p. 5, 8, 9, 13–15, 18–19, 26–29)

Examples provided are for illustrative purposes only and not intended to be reflective of results you can expect to achieve. (p. 5, 23–25, 26–29)

Data contained herein from third-party providers is obtained from what are considered reliable sources. However, its accuracy, completeness or reliability cannot be guaranteed. (p. 4, 5, 8, 18–19)

Investment returns will fluctuate and are subject to market volatility, so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost. Unlike mutual funds, shares of ETFs are not individually redeemable directly with the ETF Shares are bought and sold at market price, which may be higher or lower than the net asset value. (p. 4)

The information provided here is for general informational purposes only and should not be considered an individualized recommendation or personalized investment advice. The investment strategies mentioned here may not be suitable for everyone. Each investor needs to review an investment strategy for his or her own particular situation before making any investment decision. Examples are not intended to be reflective of results you can expect to achieve. (p. 4, 5, 8, 9, 16–17, 18–19, 20–22, 23–25, 26–29, 30–32)

This information is not intended to be a substitute for specific individualized tax, legal or investment planning advice. Where specific advice is necessary or appropriate, Schwab recommends consultation with a qualified tax advisor, CPA, financial planner or investment manager. (p. 10–12, 23–25)

Diversification strategies do not ensure a profit and do not protect against losses in declining markets. (p. 8, 9, 18–19, 26–29)

Fixed income securities are subject to increased loss of principal during periods of rising interest rates. Fixed income investments are subject to various other risks, including changes in credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications and other factors. (p. 5, 16–17)

International investments involve additional risks, which include differences in financial accounting standards, currency fluctuations, geopolitical risk, foreign taxes and regulations, and the potential for illiquid markets. (p. 5, 8, 18–19)

Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. (p. 8)

Commodity-related products, including futures, carry a high level of risk and are not suitable for all investors. Commodity-related products may be extremely volatile, illiquid and significantly affected by underlying commodity prices, world events, import controls, worldwide competition, government regulations and economic conditions, regardless of the length of time the investments are held. Investments in commodity-related products may subject the fund to significantly greater volatility than investments in traditional securities and involve substantial risks, including risk of loss of principal. (p. 26–29)

Schwab introduces its customers interested in trading futures to optionsXpress, Inc. Schwab and optionsXpress, Inc., are affiliates and subsidiaries of The Charles Schwab Corporation. Certain requirements must be met to trade futures. Please read the Risk Disclosure Statement for Futures and Options prior to opening a futures trading account. Call 800-435-4000 for a copy. (p. 26–29)

Indexes are unmanaged, do not incur management fees, costs or expenses, and cannot be invested in directly. (p. 4, 9, 18–19, 26–29)

The S&P 500 Index is a market capitalization-weighted index comprising 500 widely traded stocks chosen for market size, liquidity and industry group representation. (p. 4, 18–19, 26–29, 30–32)

The Russell 2000 Index is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market capital and current index membership. (p. 9)

The Dow Jones Industrial Average®, also referred to as The Dow®, is a price-weighted measure of 30 U.S. blue-chip companies. The Dow covers all industries with the exception of transportation and utilities, which are covered by the Dow Jones Transportation Average® and Dow Jones Utility Average®. (p. 9)

Some specialized exchange-traded funds can be subject to additional market risks. Investment returns will fluctuate and are subject to market volatility, so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost. (p. 4)

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. The MSCI EAFE Index consists of the following 21 developed market country indexes: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom. (p. 18–19)

The MSCI Emerging Markets Index captures large and mid-cap representation across 23 emerging markets countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country. It covers Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Russia, Qatar, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates. (p. 18–19)

The S&P GSCI Index is a broad-based, production-weighted index meant to be representative of the global commodity market beta. (p. 26–29)

The Ibbotson Associates SBBI U.S. Long-Term Government Bond Index is a market value-weighted index which measures the performance of long-term U.S. corporate bonds. (p. 26–29)


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The Schwab Center for Financial Research is a division of Charles Schwab & Co., Inc. (p. 4, 5, 26–29)

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Time In, Not Timing

Waiting for the “right” time to invest can be costly.

When it comes to investing, slogans are no substitute for strategy. But if there’s one investing adage that comes close to a rock-solid principle, it’s this: Time in the market is more important than timing the market.

For most people, building wealth is a long-term endeavor. It’s the product of disciplined saving and investing—and time. Obviously, no strategy can protect you against losses when markets tumble. But committing to a regular savings and investing plan that gives your investments time to grow is an important step toward your future financial security.

My own experience investing through an IRA was an important lesson. Back in 1982, I started contributing $2,000 to my IRA every year. When I converted the account to a Roth IRA 19 years later, I had contributed a total of $38,000 but the value of my account had grown to $201,658—despite significant market downturns along the way. That is the miraculous power of compound growth.

Your own returns may differ substantially depending on your preference for risk, chosen asset allocation and future market and economic conditions, but the principles remain the same. What’s important is that you commit to a regular investing schedule and take advantage of the only other factor you can control, which is time in the market.

If you’re waiting for the “perfect” moment to invest, there’s really no time like the present. Research by the Schwab Center for Financial Research has shown that putting your money to work as soon as possible is the best way to increase your wealth over the long term. Trying to “time” the market can cause you to miss the biggest market gains.

If you’re not comfortable investing large lump sums, you could make small, more-frequent investments. For example, with a dollar-cost averaging strategy you could invest a set amount of money on a regular basis, regardless of how the stock market is performing. When the market is down and prices are low, you’ll buy more shares. When the market and prices are up, you’ll buy fewer shares.

Again, investing takes perspective and discipline. But the costs of sitting on the sidelines can be high.

Charles R. Schwab, Founder & Chairman

See page 42 for important information.

Diversification and dollar-cost averaging strategies do not ensure a profit and do not protect against losses in declining markets.

(0815-3984)
Three common errors by today’s bond investors.

Buying and forgetting.

“Chasing” yield.

Failing to diversify.

Taking too much risk by chasing yield? Not keeping up with changes in the bonds you own? Not diversifying properly? These are a few of the common errors that bond investors make. Whether you want to invest on your own or turn the decision over to a professional, Schwab offers the specialized guidance to help you navigate today’s bond markets.

Get a free consultation with a Fixed Income Specialist. Call 1-866-893-6699. Hear from our experts at schwab.com/bondinvestors.

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- Monitors and rebalances your portfolio automatically
- Provides sophisticated portfolio management, including the option of tax-loss harvesting

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