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SCHWAB (CHARLES) CORP (SCHW) Earnings Report: Q3 2015 Conference Call Transcript

The following SCHWAB (CHARLES) CORP conference call took place on October 27, 2015, 11:00 AM ET. This is a transcript of that earnings call:

Company Participants

- Rich Fowler; The Charles Schwab Corporation; Head of IR
- Walt Bettinger; The Charles Schwab Corporation; President & CEO
- Joe Martinetto; The Charles Schwab Corporation; CFO

Other Participants

- Chris Harris; Wells Fargo Securities, LLC; Analyst
- Rich Repetto; Sandler O'Neill & Partners; Analyst
- Bill Katz; Citigroup; Analyst
- Alex Kramm; UBS; Analyst
- Brian Bedell; Deutsche Bank; Analyst

MANAGEMENT DISCUSSION SECTION

Rich Fowler (Head of IR):

Welcome to the fall Schwab business update.

This is Rich Fowler, Head of IR for Schwab , coming to you, as always, from beautiful San Francisco. We hope the fall season starting out well for everyone. We are getting our usual late start our here, but the mornings are finally getting a bit cooler and cloudier, at least every now and then. I finally have to start wearing a sweater with the top down every now and then and, at least at the Fowler household, leaf management can no longer be postponed.

Thanks for joining us on another busy day. With me here in the studio are Joe Martinetto, our CFO, and Walt Bettinger our President and CEO. Per our usual practice with these interim updates, we will spend a focused hour with these two sharing their perspectives on life at Schwab right now, starting off with some prepared comments and following up with Q&A until it is time to wrap up. As the agenda shows, Walt's going to start us off, but let's been a minute on the ever important forward-looking statements page, the main point of which is remind everyone that outcomes can differ from expectations, so please keep an eye on our revolving disclosures. Let's cover the dial-in, just in case anyone gets bumped off, right up there on the screen, no fumbling by the narrator required. Let's cover questions. As usual, we will do so via the webcast counsel as well as the dial-in and when we start the Q&A session, we'll ask the operator to remind us how the process works. With that, I think we're ready to go, so Walt, please take away.

Walt Bettinger (President & CEO):

Good morning, everyone Thanks a lot, Rich, appreciate it. Hope everyone is doing well. We start out here on slide . Our success in the marketplace continues to accelerate. While from the client standpoint, as we all recognize, the recent months have been quite volatile, from a Company standpoint, we are facing a period of forward planning uncertainty. Even the smallest rate hike by FOMC could deliver significant

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upside to our revenue model, but we are not really waiting on that. Our focus remains steadfast. We are executing on our strategy of through clients' eyes, we're billing scale, constantly improving both the quality of the client experience as well as the breadth of services that we offer to our valued clients.

Taking a look at what's going on in recent months, as one would expect, as market volatility escalated in late August, client-initiated interactions with us surged also, both on the phone as well as on the web. But then as you can see via the chart, they began to return to more normal levels as we moved into September. It's during times of market volatility like this that our model actually shines. The advisory services that are delivered by our investor services unit recommend high levels of diversification and they also recognize that the long-term psychology of investing benefits from downside diversification. We can achieve that via option strategies, stop-loss strategies, appropriate levels of long-term investment cash, but it's an important factor when we offer advice to clients that we understand the psychology and the challenges for individual investors to stay in markets.

In addition, we offer volumes of timely real-world counsel and advice from trusted industry professionals like Liz Ann Saunders, Jeff Kleintop, Kathy Jones, Randy Frederick and many others and we deliver this counsel in a series of different medium to match the diverse needs of a client base that extends to about million accounts. At the same time, the , independent investment advisors who entrust their client assets to our custodial services deliver common sense, real-time local advice, insuring that their clients' long-term goals are intact, and also to help them from over reacting to the market's volatility. Interestingly, once again we saw that when the markets turn volatile, more than ever it seems that investors look for a trusted professional to guide them through and not surprising, net new assets from independent investment advisors who work with us rose % year over year and actually reached a record level for the third quarter of any calendar year.

Not surprising, trading was also a bit elevated during the third quarter. We saw long-term investors and advisors re-balance their portfolios and we saw some more trading oriented investors be opportunistic as they look to buy during some of the market dips. On slide , one of the keys to successful long-term investing, as we all recognize, is not over reacting during periodic periods that markets decline and our clients demonstrated their mettle by being net buyers actually of securities in both August and September. Client cash continues to grow pretty much along with the overall growth of the franchise. It ticked up a little bit as a percentage during the quarter, but that was due as much to the denominator shrinking from market losses than it was from clients actively moving their money into cash.

Of particular interest might be the way our digital advisory program that combines online advice with access to live professionals //, what is known as Schwab intelligent portfolios, performed during the most challenging market periods in August. Due to the sophisticated asset allocation algorithms that are designed around downside protection, we actually saw net enrollments and new enrollments spike as the market fell and also realized low levels of unenrollments.

From a client standpoint, we just continue to win, continuing to win in the marketplace. New brokerage accounts grew a fairly significant % year over year off fairly large -- off a fairly large base. The value of net transfers, the purest form of competitive measure as we view it, grew % year over year in our largest unit investor services. In our trading services segment, set records for both net new assets and new-to-firm clients. We think this is a result of our new trade source feature set on Schwab.com, some first-class marketing and a broad-based client experience that we think out shines much of our competition. Firm-wide, we crossed the $ billion threshold for core net new assets year to date. This will mark the fourth consecutive year that our clients have chosen to entrust us with more than $ billion in net new money.

Taking a look at slide , our full-service model is increasingly leveraged by our clients. They're attracted to the breadth of the offerings. We continue to experience strong growth in programs like our pledged asset line offering from Schwab Bank as well as our industry-leading ETF OneSource program. What's very

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important for our long-term growth and to help ensure potentially better outcomes for our clients, investment advisory solutions also saw strong growth during the third quarter. Our overall enrollments were up % year over year and new enrollments during the third quarter over % ahead of the same period from year ago.

I know that there will be interest in Schwab Intelligent Portfolios. At quarter end, we were over $ billion. We're well on the way to $ billion as we speak today, and as we predicted early on, enrollments from new-to-firm clients would build over time, as awareness grew beyond our existing client base. Today about a third of the new asset flows and a fourth of the new accounts are coming from new-to-firm investors. The majority of the remaining enrollments come from historically self-directed investors.

I'd like to take just a minute and emphasize again that it's our belief that digital advisory is not an age-based concept. It is not significantly more attractive to millennials than to other generations of investors. We see enrollments in all age brackets, from young investors to those over age . But rather, our business model for Schwab Intelligent Portfolios, as designed with no net advisory fees, is intended to be attractive to what we see as formerly self-directed investors of all ages and it's working.

Keep in mind, we also have a variety of other advisory solutions that are used for different types of investors. As you know, under Schwab Intelligent Portfolios, clients pay the management fees of the underlying ETFs in the program, as they do in any other online or digital advisory service. One of the things that's unique about Intelligent Portfolios is that unlike any other program of its type in the industry, clients can count on being invested in the lowest-cost ETF in each asset class. Whether it's a Schwab ETF, a Vanguard ETF, or any other ETF manufactures' product, when you measure it by the annual operating expense, which is of course the most critical factor for any buy-in hold investor.

During the second half of this year, we've continued making strategic investments in key areas. Let me just touch briefly on three of them. In the -k area, we can now offer the ability for an independent investment advisor or independent -k consultant to be the author of the asset allocation strategies that are delivered under automatic enrollment to the employees of companies who sponsor a -k program that's serviced by Schwab . This is a really important future. It allows the advisor or the consultant who is intimately familiar with the specific needs of a company and its employees to be able to customize the asset allocation and advise to the unique needs of that company or that employee population.

The advisor or consultant is fairly compensated for this service in a fully disclosed manner and I think very importantly that the cost to the end client is the same, whether the client chooses to use a national brand like MorningStar or, again, their local advisor or consultant to build out these strategies. In addition, in a correction for some of the misnomers we've seen publicly, contrary to some press reports, the advisor or consultant can also mix in certain actively managed investment funds along with the more traditional index-oriented funds that we often use in -k plans serviced by Schwab .

Taking a look at our ETF OneSource program, we continue to enhance it, adding more ETF choices from premier investment managers. We offer more commission-free ETFs than any competitor and importantly, we do so without the strings-attached approach that impacts things like investor margin ability or requires speed bumps like enrollments, as other programs might. We believe that we custody more retail investor ETF dollars than any other firm and we are committed to remaining the optimal choice for retail investors and advisors interested in investing through exchange traded funds and products.

Last, we continue to make substantial investments in the safety and security of our clients' confidential data and personal information. In addition to being the first firm in the industry to offer a security guarantee, we recently introduced Schwab Safe. It's a very rich site with information for clients and prospects on how we can both work together to optimize client information security. Also, we enhanced many of our password capabilities to allow for complex and lengthy passwords. Now, we recognize that

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password complexity is actually very seldom a key factor in data or information theft, but we know that many clients feel more comfortable when they can establish very complex and lengthy passwords.

As I come to the conclusion of my section, I just simply want to remind everyone that we continue to invest aggressively for the future. Despite the FOMC's historically unparalleled interest rate experiments that we all know have a negative impact on our revenue, we continue to make the difficult trade-off decisions that enable us to make ongoing strategic investments. Just a couple of them; I've bucketed them into four categories, but just a few to mention, we continue opening a series of new branches in key retail markets, implementing a new CRM system for all of our client relationship professionals, ongoing enhancements in our financial planning capabilities, expansion of our personal trust services to serve a broader array of retail investor clients. We continue to build out our Financial Consultant Academy. In , we started small, with about positions. We had high quality applicants for every open position in the Academy this year. You should expect to see that program ramp up in the future as interest rates rise.

We continue to enhance the flexibility and customization of institutional intelligent portfolios, that program that is used by our independent investor advisors. To date, we have almost independent investment advisory firms that have up signed up to use that program. We continue with ongoing investments in next generation of Portfolio Connect, that is utilized by many investment advisory firms. Introduction for that planned in late . Making significant investments in automation, paper-less processing, all designed to make it easier to do business with us. Continuing our efforts to prepare for the multi-year broker dealer platform modernization initiative that we've discussed with you.

Ongoing investments in process management efficiency, continued expansion of our use of big data to both better serve existing clients as well as to proactively reach clients or prospects on topics that we can determine from that data would be of interest to them. Significant ongoing investments in data infrastructure, integrity and information security, efforts around CCAR readiness, including documentation and model validation and of course, no list would be complete without discussing our already sophisticated capabilities around capital stress testing and LCR liquidity coverage ratio monitoring and reporting.

Let me go ahead and wrap up. Just to summarize, from a client standpoint, we are winning. We are growing assets at a rapid rate and, in many areas, at record levels. We are taking market share from competitors at rates we have not seen before in our firm's history. We continue to execute on our strategies, serving an ever-broader array of our clients needs and at the same time building deeper and deeper levels of trust. From a shareholder standpoint, we believe we're making expedient trade-off decisions, delivering reasonable short-term results, again despite the FOMC's interest rate experiments, and all the while retaining that coiled spring that you're all so familiar with in terms of revenue while we invest for the future with prudent strategic moves that we think advance our structural advantages and ensure long-term differentiation.

Our focus is steadfast. We are going to continue to execute through client-side strategy and quite aware that things could change rapidly if, in fact, the FOMC does decide to make any changes in rates in the coming months. Let me stop there and, Joe, turn it over to you.

Joe Martinetto (CFO):

Great. Thank you, Walt. That was, as always, a great summary of all the things that we're doing to serve our clients, which is a key factor in why we continue to win the marketplace and gather assets and build the power of the franchise over time. I'd like to assure everybody that's are just as much attention that were paying to the financial performance side so that growth in the franchise is turning into growth in earnings as well. That implies focusing on the things that we can control, like expense management and our balance sheet strategies and implementing the client cash strategies as well, as Walt said, making

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the right trade-offs and reacting appropriately to some of the market factors that are out of our control. We'll spend a little time talking about how all this comes together, both the context of Q earnings as well as outlook for the remainder of the year and some thoughts on planning.

For once, and maybe it's unfortunately for once, but the key market factor for Q was not interest rates. That turned out to actually be what happened in the equity markets and equity market valuations. As you can see from the chart, the relatively straight line is the equivalent of the baseline scenario that we laid out earlier this year and over the course of Q, we spent the majority of the period below to far below that line in terms of market valuations. So I think you can characterize this market as choppy. As of last night or this morning, we were about on track with that line again, so I think we can all hope that this was maybe just a summer swoon and we're maybe back on track with market valuations and we'll have to keep an eye on that. We're certainly paying attention because it has implications for ability to drive asset management fees in Q -- or Q and beyond, so something we're watching we would expect that the investment community is also continuing to pay attention to as you're updating your forecasts.

As Walt said, the strength of the franchise continues to be demonstrated in some of the client numbers. Even with the swoon that we saw in market valuations which reduce the overall value of client assets by over $ billion in the quarter, we still were able to show numbers that were up about % year over year to a little over $. trillion in client assets, so continuing to have acquisition drive strong outcomes in terms of the size of the client base. We continue to implement the client cash strategy, average earning assets up to $ billion in the quarter as well as manage expenses consistent with the commentary we've made in the past. Expenses were, again, basis points of average client assets. Technically that's down two basis points over the third quarter of last year, but I'd remind folks that third-quarter number was a little higher than probably run rate, given that there was a $ million charge in there related to some of our geographic footprints initiatives.

Pulling this all together into financial performance, when you look at the revenue picture, third quarter of was a record third quarter for us. Trading revenue on the back of some of that activity that we saw in August with the market volatility was up % year over year, which was a nice thing to see as trading has been a little bit harder to come by over the course of the last couple of years, certainly proving out that the value of the diversified revenue stream helps to smooth out some of the trajectory in earnings over times. You can see the counterpoint to that. Asset management fees were only up % given what happen with market valuations and net interest revenue was up % as we continued to see a little bit of pressure on the NIM, but the growth in the balance sheet was more than enough to offset that pressure.

If you look at the total growth on a GAAP basis, we reported revenues up %. If you exclude the insurance recovery that was in the third quarter of last year, that number would've been % more on an operating basis. From an expense perspective, we are pretty much on track to maybe even being a little bit better than we had indicated in our original scenario for the year. Year-to-date expenses are up .% on a GAAP basis. If you look at the Q to Q year ago, they were actually down %. If you take out that $ million from the restructuring charge from third quarter of last year, it would have been up %. So some financial leverage showing through in the model. Revenues up %, expenses up % on an operating basis, leading to a pretext profit margin which is the best that we've put up since the fourth quarter of of .% and year to date, we've got record earnings through the third quarter of just about $ billion. So very solid financial performance even in a market that's been little bit tougher than we had expected as we started talking about our plans for the year.

When you look at the balance sheet, that growth in earning assets that I talked about as being driven by growth in bank deposits, so I'd remind people that we are sort of midstream in terms of executing another tranche of movement of client cash out of money funds onto the balance sheet. We had talked about moving $ billion in total of advisor services client cash onto the balance sheet. A little over $ billion of that moved in September. There's about $ billion of that yet to come here in the fourth quarter.

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We did raise a little bit more preferred and you can see the impact of that in the capital ratios, so we are little bit ahead of the our target range of .% to % on leverage, which gives us plenty of room to support organic growth or even to continue to look at other alternatives for bulk transfers down the road. The last thing I'd say on this page is we do have about $ million of debt that's been churning here in the fourth quarter. You would expect to see us in the markets looking to refund that debt and if the conditions are really solid, we might do a little bit more than that, but we are going to have to see as we get to market exactly how things shape up on that front.

Moving onto net interest margin, I already made some comments here about what we saw in the third quarter and I think we would expect to see more of the same in the fourth quarter, so not really anything particularly new here. At today's level of interest rates, the investment rates are little bit below the average portfolio yields, so as we continue to put dollars to work, it's exerting a little bit of downward pressure on the net interest margin. We do continue to expect that the growth in the balance sheet is going to be more than enough to offset that impact on the net interest margin, so we should see net interest revenues continue to grow as we continue to build upon client cash balances on the balance sheet.

On money fund side, the picture is actually a little bit better. We have seen some improvement in yield in some of the credit-sensitive sectors, which have allowed us to take a little bit better advantage of some of the investment rates on the money fund side, so we've seen net money fund revenues improve now for a couple of quarters. We would expect that in Q if rates stay about what they are, that we would stay with net revenues about consistent with the third quarter. We're watching what's going on in the treasury market pretty carefully. That's obviously been a place where supply has gotten pretty tight and rates have been a little bit challenging but overall, we've more than offset the impact on the treasury curve with what's going on in the credit-sensitive parts of the money fund portfolios, so a little good news there.

As we look forward to the remainder of the year, and it shouldn't be a surprise to everyone that the environment has been I'll bit tougher than what we laid out in our baseline and even today, I'd say we are sitting little bit off of that baseline trajectory. We expected that the market would be up about .% year over year and we spent, as we said, the majority of the third quarter below that trajectory. We look to be back on now so if we can maintain that for the remainder of the quarter, asset management fees should be more line with our initial expectations, but we are going to have to watch that.

Interest rates have been below the scenario that we laid out. We've been able to offset some of that pressure, which is really smart investing and some of that with a little bit of extra activity on the balance sheet, but that continues to provide a little bit of a challenge for us in terms of hitting that baseline scenario, and then trading, even with the large amount of activity that we saw in August that pulled us back to about flat year over year, but that baseline scenario was looking for a % improvement year over year, so a little bit softer than what we thought in terms of the market drivers. Expenses, we're doing a little bit better in terms of management, so while I think we would've said that we were more in that % range as we've made our way through the year, we've now sort of altered our thoughts more like % to % and are continuing to manage expenses pretty carefully in the face of the market dynamics that we've seen.

That said, we've done about all we are expecting to do for the moment in terms of expense management, so if we don't see a materially weaker environment, we're likely to be about on this trajectory for expenses as we move forward through the remainder of the year. As Walt alluded to, we are making significant investments in want to be able to continue to make those in the face of the opportunities that we continue to see. When you pull it all together, we do expect over the course of the year to be able to show a little bit of financial leverage, but probably a little bit more modest than we had originally anticipated as we started the year. Finally, I'd remind people, if you're looking at your models for Q, we

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do have the Series C preferred dividend. Make sure that you get that factored in appropriately. That dividend's been declared so you should be up to get the exact numbers out of our press release if you want to go look those up.

Moving onto , all of the factors that we've been talking about have to be considered in the context of planning. The rates in particular, as Walt alluded to, have a particularly powerful potential impact in terms of our ability to produce more outsized growth in revenues year-over-year. We are planning right now to start the year with a relatively conservative expense plan as a result of the fact that we just don't know what the fed's going to do. Maybe we'll get a little bit of clarity with the statement here that should be coming out shortly, maybe we wait til December, maybe we go past year end. We, like you, are going to just have to wait and see where the fed comes out and what guidance that they're going to give us and whether we do get any moves.

From an expense management perspective, which is more controllable, we will look to keep our hands around expense growth, but I would let people know that we have done some hiring this year and the natural pace of expense growth is probably a little bit bigger as we head into next year than you've seen from us for the past couple of years. I don't mean to imply alarmingly large numbers, but we may not be in that % to % kind of expense growth number, but a little bit higher than that as we absorb the impact of that hiring some of our full-year numbers as we head into next year. We're not going to go a lot further in terms of providing scenarios at this point. Were going to beg your indulgence to let -- give us a little bit more time. Let's get a little bit more information on how this environment looks like it's going to play out and the next time we talk, we will provide a little bit more if transparency around the scenario. All of that, I think, wraps up into -- we're going to keep managing expenses cautiously until we see rates move and otherwise, stay tuned.

Not a lot of new news as we move on to managing client cash that -- I made reference to the fact that we have $ billion kind of in flight with $ billion to go. Nothing has changed in terms of our target range, so we still want, long run, to execute in that .% to % kind of leverage range and the same priorities exist for deploying cash. To the extent we see opportunities, we would look to invest it in growth of the business. We continue to have opportunities around migrating client cash onto the balance sheet, so that's the first thing that we'll look to do with capital that's generated.

Pulling it all together, I hope people get a sense that this is a business model that's delivering results, even in an environment that's maybe a little bit tougher than we had anticipated. We expect to be able to continue to do that as we move forward here. Clearly, even without the impact of interest rates we are putting up numbers that are better over time and we would expect as interest rates do move up, we have that one-time opportunity with the uncoiling of the spring to see some pretty powerful impacts on our financial picture. Regardless of that, we're not waiting. We're continue to make the investments we need to drive the growth of the business and making the trade-offs as necessary to continue to produce some sound results in the face of whatever market we find ourselves in.

I think that's it for the prepared comments. I will turn it back over to our moderator, leaf man Mr. Rich Fowler, to moderate to questions.

QUESTIONS & ANSWERS

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Rich Fowler (Head of IR):

Thanks, gents. Operator, will you run us through the protocol for Q&A via the phone, please?

Operator:

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(Operator Instructions)

Chris Harris.

Chris Harris (Analyst - Wells Fargo Securities, LLC):

You've got about % of your client assets in advice solutions today. That's been -- that ratio's been ticking higher. Clearly, that's very positive for you. It's your highest fee proposition. I'm just kind of curious to get your guys' thoughts as to where so you think this ratio can go. Obviously higher, I know, but I'm just trying to gauge what a realistic target might be over the medium term.

Walt Bettinger (President & CEO):

Thanks, Chris. I think the number is maybe % of our investor services assets. Of our -- let me be clearer. Of our traditional retail investor services assets are in fee-based advisory solution. We think that there's considerable room for that number to move up.

I don't know that we necessarily are quoting a particular number, but we think that there is significant room and I think when you look at the trends, the rate at which these clients are enrolling in advisory, year over year up % into advisory when you look at the fact that we continue to broaden out our advisory solutions to meet more of their needs. For example, Chris, intelligent portfolios is really designed directly for formerly self-directed people who are averse to paying advisory fee. We not only have the movement of clients in the direction of wanting advice, but we are broadening out our solutions to meet varying needs of investors who want to pay in different ways. We think there's a lot of room for that % to run.

Chris Harris (Analyst - Wells Fargo Securities, LLC):

Okay, great. And then maybe a follow-up for Joe. If rates stay sort of where they are and it becomes some clearer that the fed might not be doing anything for a while, would you guys consider doing more of these preferred issuances to support transfers, bulk transfers, over to the bank or do you feel like what you've done already is probably sufficient for a while?

Joe Martinetto (CFO):

No. I think we've been on a path here where we've been managing preferreds to about % of the capital structure. We've got some capacity beyond that, but we've chosen to kind of hold it to % for now to give us some flexibility if we need to be in the markets for some unanticipated movement in the balance sheet. As the balance sheet continues to grow, as capital continues to build, I would expect to see us continue to utilize preferreds as an important part of our capital structure to basically help manage down the weighted average cost of capital and allow us to move little faster.

The question you didn't ask is, if this is such a great opportunity, why don't you guys consider issuing common stock. That is math that we do run fairly frequently. It's a bit of a borrowing from the future to take advantage of opportunities today, given the fact that you've got kind of a finite capacity of money that could be moved and at some point when that's exhausted, you are generating excess capital if you end up buying back stock that you issued more cheaply before you deploy the strategy it's basically time value kinds of math to determine whether that's something you might want to do or not. As of now, we've not chosen to do that, but there may even come a point in time where that make sense to move more quickly.

I will say that from a client perspective, we would like to be able to get as much moved as possible while rates are still low, given that the differential in the product yields are de minimus to not existent today and that's a little bit more noticeable when rates are higher and some of the money fund yields start to

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pull away a little bit from some of the balance sheet cash. So we are, I guess, motivated to try to move it as quickly as possible but doing it in a way that makes sense in the context of capital structure as well as from shareholder value creation.

Chris Harris (Analyst - Wells Fargo Securities, LLC):

Okay, thank you.

Rich Fowler (Head of IR):

Okay, one more from the phone.

Operator:

Rich Repetto.

Rich Repetto (Analyst - Sandler O'Neill & Partners):

Good morning, Walt. Good morning, Joe. I guess my question first is around the expenses. I think, Joe, you acknowledge that the operating leverage might not be what you'd anticipated earlier in the year given the revenue environment. I assume are talking about the basis point spread. If you could talk about that. And then the bigger question is that you hinted that you could be over the % to % and it's still in the planning stage, but I guess the question is what level would you allow expenses to grow year over year it if the fed didn't -- if you didn't get a revenue uptick or more revenue-friendly environment.

Joe Martinetto (CFO):

Sure. I'll make a couple of comments here. One is that, that basis points was in the context of a market that was a little bit better than we've experienced here. It is a tough environment when market values are basically flat, interest rates are down to flat, and trades are flat, to produce a lot of revenue growth. Even in the face of that, we're still putting up some revenue growth, single-digit revenue growth, but revenue growth and we're managing expenses to be slightly below that and putting up some financial leverage. In a pretty tough environment, I feel like we're making the right trade-offs and delivering appropriately.

As you get into next year, you've got to start making assumptions about, even without rates, what you expect from markets and trades and some of those other factors. It's a tough environment if you project what we have just been through for the last nine months forward all the way through next year. If you have a little bit friendlier market valuation picture, or a little bit different point of view on trades, revenues are little bit easier to come by and that financial leverage is a little bit easier to produce. I say all that just to make sure that people understand that we are not going to always respond immediately to short-term implications around revenue generation with immediate responses to cuts in expenses. That's just not a healthy way to run a business, particularly the business where so much of the expense base is tied to people in the short run. That's a piece of the factor.

The other thing that I'd note is if you look at our employee counts, we are up about % year over year, so that is a bigger number than you have seen over the course of the past few years as we have looked to make some bigger investments and, frankly, to add some people to deal with some of the regulatory challenges that continue to come in front of us as well. I guess if you think that comp is %-ish of our expense base -- or revenues, excuse me, a little bit more of that of our expense base and you've got that % already built in, you can kind of back into the piece of the pressure that's beyond what we have seen to manage to that % to % kind of expense number for the past couple of years. We're not talking about % growth in expenses but a little bit higher single-digits kinds of growth in expenses if we continue to operate at roughly the same level of investment and roughly the same level of marketing and absorbing

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the people that we've already got onboard.

I'm not going to go a whole lot further than that, because I really like to build to put it all together in the context of revenue scenario when week actually pin down all the pieces. The last thing I would say we are continue to manage pretty carefully on the expense front, just not knowing where were going to see what happens with markets and interest rates. We don't want to put ourselves on a trajectory where we find we have to make big course corrections. Again, that doesn't tend to be healthy for the business, so we rather be a little cautious going in and leave ourselves little room to invest a little bit more as opposed to be overextended and have to cut back.

Rich Repetto (Analyst - Sandler O'Neill & Partners):

That's very helpful, Joe. Appreciate it. I'll try to be brief with the follow-up. The deposit growth, due to the sweeps and even X the sweeps, have been phenomenal. I guess the question is, with the bit of excess capital and the little door you opened in regards to even looking at equity, how much of the bulk sweeps do we -- could we still potentially do other than the, I guess, $ billion left? And then just quickly, the economics. I know you've gone through them before, but the improvement in economics when you do that.

Joe Martinetto (CFO):

It's still a pretty big number. I think when we started talking about this, we had roughly $ billion in money funds and said that we thought we could take maybe half of it onto the balance sheet. If we moved round numbers, $ billion, that leaves roughly $ billion sitting out there that I think is still a reasonable estimate of how much more that we think we can pull forward over time. Today, I'd say marginal investment rates more like basis points versus something that's getting close to basis points on money fund yields. So the net incremental values is about basis points, so that spread is getting a little tighter than what we had seen in the past. Still worthwhile putting the capital up to harvest that, but it's becoming a little bit more challenging to really drive meaningful revenue growth with the transfer, given the capital dynamics as we continue to see pressure the long end of the curve and improving revenues coming out of the money funds.

Rich Repetto (Analyst - Sandler O'Neill & Partners):

Got it. Very helpful. Thanks for taking my calls -- my questions.

Rich Fowler (Head of IR):

Operator, I'm going to do a couple of webcast questions and then we'll go back to the phones. First off, gents, there's a fair amount of interest out there in terms of where we stand, perspective-wise, vis-a-vis the DOL, how proposal how we feel about our positioning there. If we could spend a minute on that?

Walt Bettinger (President & CEO):

Sure, Rich. Is difficult to be very specific, because the DOL proposal is in such a state of flux. We do believe there are aspects to the initial proposal that are set in stone and not likely to change, but the leadership at the Department of Labor has indicated that in a number of other areas, they are open to modifications. I think that on a relative basis, we are likely to fare better than many of the firms that we compete with, given our model. I think net-net, our view is that although there will be some modest changes in the way we will have to manage a couple of client solutions, we think net-net we would be a winner in the outcomes that could come out from the Department of Labor proposals.

Rich Fowler (Head of IR):

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Thanks, Walt. Maybe one more before we go back to the phone. Some interest, if you would elaborate a bit on the SIP story in terms of with existing clients coming into the program, what sorts of asset classes are those assets coming from? Do we view this has revenue neutral, positive, negative, et cetera? How do we think about that?

Walt Bettinger (President & CEO):

The mixture of assets coming in from self-directed investors mirrors sort of the overall client holdings in our retail business. The net present value of the revenue stream is significantly better in Schwab Intelligent Portfolios than it is for those clients are sitting today.

Rich Fowler6 Okay, great. Thanks, Walt. Let's go back to the phones, Operator.

Operator:

Bill Katz.

Bill Katz (Analyst - Citigroup):

Thanks very much. Appreciate the update today. Couple questions for you, maybe just continuing along on the balance sheet migration strategy a little bit. Given the shape of a forward curve and what's been happening with interest rate expectations and fed fund futures, et cetera, what kind of pace -- or has the pace changed in your mind of how quickly you might be able to migrate that $ billion over to the balance sheet?

Walt Bettinger (President & CEO):

I'm not sure that we've moderated the pace based on the shape of the curve as much as we've been managing the pace based on capital formation and some preferred capacity in making sure that we're taking advantage of that as it comes up. As long as we can get returns on capital in excess of our cost of capital, I think we would look to continue to deploy whatever capital generation methodologies we can that make sense to continuing to migrate those balances over. One thing we really didn't touch on, given the shape of the curve and where interest rates are going, we are looking to manage the portfolio a little bit longer than where we have been, more kind of at the high end of the range of duration. That should help a little bit with some spread generation.

I'd say a couple of factors are driving that. One is that we just don't necessarily believe that even if we get a shift from the fed that were going to see a parallel shift. Two is, with the pace of growth that we're seeing, our loan growth, which is where we pick up a lot of our natural duration, just hasn't kept up with the pace of the growth of the overall balance sheet, so we need a little bit more duration in the investment book to keep the Company kind of in the same net place. While we've been managing, I'd say, over the long run kind of in a range of between and . years and more recently kind of around . years, we are likely to push the investment securities portfolio out to probably closer to that . point, which should help marginal investment rates a little bit over time here as well, but shouldn't have a material impact in terms of the overall risk exposure to the Company, given the other changes in mix.

Bill Katz (Analyst - Citigroup):

That's helpful. If you are successful in driving the assets over, your assets would be pushing pretty significantly in the bank. What's the conversation with the regulators and what's the risk of potential SIFI designation?

Walt Bettinger (President & CEO):

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Yes, at this point I can't speak for our regulators. I would tell you that we haven't heard any commentary about designation for us as a SIFI. The next big sort of already written potential hurdle for us will be advanced approaches if we get to $ billion in total assets. We are doing some work now to prepare for that because with our growth aspirations, frankly, we think it's inevitable that were going to hit that level. So there's some work is going on inside the Company that will help to prepare us to meet some of those additional obligations around the advanced approaches requirements, particularly around some of our financial systems and reporting and automation of some processes that, when you're doing report quarterly, you can afford some manual intervention. If you have to do it monthly or daily in the case of the LCR, you pretty much have to have it completely automated or you're not going to be able to meet the reporting requirements. We're doing that work now to make sure that we're going to be ready. There shouldn't be any big surprises as we get to that $ billion hurdle, but even if at the pace that we've shown of balance sheet growth of late, we still have some time measured in years, not months or quarters, to finish some of that work.

Bill Katz (Analyst - Citigroup):

And just one last one. Thanks so for much for taking the questions this morning. You mentioned earlier in the remarks, Walt, that your investment spend is still pretty high on the priority list. How are you thinking about acquisition opportunity? I know you've talked about in the past of sort of extending any kind of service or product capability you may not have, but if the industry still remains mired here with the flat-rate backdrop, any sense of a pickup in industry consolidation and how Schwab might be thinking about that more broadly?

Walt Bettinger (President & CEO):

It's tough for me to comment on industry overall, but I think from our perspective, we would respond responsibly take a look at any opportunities that presented themselves to us and try to make an evaluation whether they were propositions that made sense for shareholders and were consistent with our long-term strategy, so that would be the lens with which we would view any consolidation opportunities that potentially presented themselves.

Bill Katz (Analyst - Citigroup):

Okay. Thanks for taking my questions today.

Rich Fowler (Head of IR):

One more from the phone.

Operator:

Alex Kramm.

Alex Kramm (Analyst - UBS):

Just coming back the expense outlook for second year, I guess a couple of questions. Walt mentioned a lot of investment spending and I think in the past you've outlined also the kind of things you really want to do when rates move higher. Absent any sort of rate hike, when -- what would make you actually become impatient and actually start spending a little bit more? What kind of opportunities would you see, or would you have to see to actually spend a little bit more and go above that maybe double-digit expense growth that Joe laid out? On the flipside, if you do get a rate hike, Joe, do you think still % of money from higher rates falling to the bottom line a fair way to think about it, even in ?

Walt Bettinger (President & CEO):

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I would say I didn't say double-digit expense growth. I said something less than that in single digits, but higher than where we were for the past couple of years, so just to make sure everybody heard the same thing there. I think we're always evaluating opportunities in the market and making trade-offs. We're spending a couple hundred million dollars on investment spending pretty consistently for the past couple years and look forward to that same kind of capacity as we move into next year.

If we see rates move up, we could move more aggressively. We do see good opportunities. On the flipside, I think were chipping away at some of those opportunities at a pretty consistent pace even in this kind of a rate environment. So over time, these are trade-offs what we are going to have to continue to make. I don't know if it's as much about impatience as it is about if we see something that would think makes a tremendous amount of sense, will make a decision as to whether it's something that we want to prioritize or not. And then we will make sure that we are telling folks what we're doing so that you can hold us accountable for doing what we said and delivering the results that we would've expected to deliver in the face of that opportunity.

So not a whole lot different than the way we traditionally run things anyway. But if we see one of those things that looks too good to be true were not going to sit our hands and pass it up just because right now we can't figure out how to squeeze out the money to take advantage of it. I think we've got the flexibility we need even without a rate movement, but it's a balancing act as we continue to say making the trade-offs of investing for the long run and delivering reasonable near-term results.

Alex Kramm (Analyst - UBS):

In just specifically on the % that I think you'd outlined for falling to the bottom line from higher rates, is it too early to think about the number for or do you have any sort of marker there yet?

Joe Martinetto (CFO):

I think it's just too early to talk about in general. There's -- we're running a lot of scenarios in doing a lot of math and it is immensely complicated as you start pushing different kinds of rate movements through the models and see what it does to various points in terms of impact on revenue, long end versus short end versus money funds and balance sheets and how all of it comes together and then you start throwing timing implications on top of that. The range of potential outcomes is extraordinarily broad at this point. So it's very hard that if we get a smaller move later in the year to say that, that number might not be much smaller than that. We might end up investing a larger component of it whereas if you get a larger move earlier in the year and the impacts are bigger, it might be bigger than that.

And so I think as we're actually getting closer to a real potential move and it's not sort of that what we envision early on, the V-shaped quick snap back on rates, I think were going to have to be a little more careful about trying to tie it to specific scenarios and letting people know exactly what we're doing in those scenarios. Hard to do that without a little bit more context.

Alex Kramm (Analyst - UBS):

Great, thanks. Real quick, on the trading side, we don't talk about that often, given it's a smaller percentage of your revenue, but look back year over year. Trading fees, commissions are actually down year over year. Some of your peers are still growing. So two things. One, I think rate per trade has actually come down a lot again in the third quarter. Maybe you can flesh out what's happening there in terms of competitive dynamics in any sort of incentives for certain traders. And then secondly, just broader picture, do you compare yourself to some of the peers out there? Do you think you're losing anywhere? Do you think you're -- you could become stronger somewhere else or need to be more competitive or is it just because you're essentially giving a lot away for free on the ETFs and other places? Thanks, that's it for me.

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Walt Bettinger (President & CEO):

I think that the difference is business model differences. At Schwab , we have been undertaking for over a decade a strategy to move revenue away from trading, which we consider long-term to have a lower net present value then other revenue streams, whether it is to advisory fees or asset-based revenue, for example, we might generate an ETF OneSource. I think it's the manifest of the strategies we've been pursuing that you see. At the same time, we did share, in my slides, the success we're having in trader services with record new-to-firm households as well as record net new assets in the third quarter. That part of the business is experiencing meaningful growth and it shows up in our metrics potentially in a different way than it shows up in some of the metrics maybe of other firms you'd be comparing us to

Joe Martinetto (CFO):

Alex, I'd just add that if you want to track the impact of the business model, look at the difference between dabs and darts. I think you'll get a different conclusion a comparing total trades to some of the competitor trading activities than if you compare darts to darts. And as Walt said, we continue to find other ways to monetize trades that we think are more consistent and higher NPV for the long run.

Alex Kramm (Analyst - UBS):

Absolutely. Thank you

Rich Fowler (Head of IR):

Thanks, Alex. Let's go to another webcast question. Walt, this has come up some off and on in recent quarters, but OneSource looked a little soft again in terms of asset values during the quarter. What sort of perspectives could we offer on what's going on in OneSource land?

Walt Bettinger (President & CEO):

We've definitely have a fairly meaningful move on the part, particularly in the investment advisor segment of the business over the last half dozen years away from the usage of OneSource funds more towards ETFs or transaction fee mutual funds away from OneSource mutual funds. That's been a broad trend I think we've talked about in the past and that's continuing to the point that I would say that the usage of OneSource mutual funds by RIAs is fairly modest today. You've seen that reflected in the lack of growth in OneSource. Clearly, it's been helped to some extent by equity market depreciation, but frankly what you see there is no different than what you see in many of the actively managed mutual funds complexes that are publicly traded. The market has been helping and the flows have been hurting. I think what's positive for us is that in anticipation of this, we've been, for a number of years, building out other solutions, other ways to monetize, as we expected clients and advisors to move away from OneSource funds to some extent move away over time.

Rich Fowler (Head of IR):

Thanks. I think we have time for maybe one more from the phone.

Operator:

Brian Bedell.

Brian Bedell (Analyst - Deutsche Bank):

Thanks. Walt, just to get back to the Schwab Intelligent Portfolios, if you could just talk about the take up on the institutional side, how that shaping up now that it's launched and all also your expectation for the portion over the long term of net new assets could to see the number come up from the % to the %-plus.

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How do you think that will shape go forward? And then also just on the if we do get the DOL rules as proposed, do you anticipate marketing this product much more heavily?

Walt Bettinger (President & CEO):

Let's see. First part of the question was around institutional -- as I mentioned, we've got about just shy I believe of RIA firms that have signed up. As I mentioned that our last update, we also have a fairly significant amount of interest from other larger financial institutions, whether they be banks or insurance companies or even brokerage firms that are planning to introduce some form of digital advice. As I said I think a year ago, within a few years every financial services firm of consequence will offer some form of digital advisory solution and the idea that early movers, or first movers, will have some unique place, I think, is naive.

In terms of usage, the investment advisers are in the middle of building out business models for most of the RIAs. What Intelligent Portfolios does is broaden their reach. It lets than pursue segments of the market, particularly down market, that historically their business model and its people-intensive aspects have prevented them from going after. That's the view from the RIA side. I think we've indicated that we're not going to break out asset balances between retail in the advisor side in that program, but we do expect significant asset flows over time from the institutional side of that.

On to the DOL side, I'm not sure whether it really changes the marketing of intelligent portfolios if we get the DOL rule as propose now. Again, I think virtually all of our advisory programs with minor tweaking would fit very well under the DOL's current proposal and so I'm not sure that SIP in particular gets called out anymore uniquely than does any of our other programs. I will say that among some of the larger financial services firms that we're talking with, they view that their model could be under significant pressure and it's generating interest in partnering with us in our IIP, or Institutional Intelligent Product, as they tried to determine how to adjust your business model for a future world.

Brian Bedell (Analyst - Deutsche Bank):

Okay, that's helpful. And then maybe just one last one for Joe on the money market fund sweeps. If we have an environment where, let's say, we do not get a fed hike in and you choose not to raise common equity, what type of environment would that -- I guess the more direct question is, what would you be thinking of for transferring money market balances onto the balance sheet in that environment? Then also if you could comment on the run rate that you're getting from the institutional segment, given the future switch you made a while back. I think it was an $ billion annualized run rate, latest we had on that?

Joe Martinetto (CFO):

Sure. I think we would look to continue to move a pace with any excess capital generation, so it's kind of hard to make specific projections on balance transfers without getting into specifics of earnings, but to the extent that we have capacity available, we will look to utilize that capacity to contain and move balances over. Without a rate rise, there's not as much of a lift in earnings. There's less excess capital generated, but we would like to take advantage of any capital that is generated and to the extent that we have some more capacity that builds around preferreds, we look to take advantage of that as well. I'm sorry, what was the second half of that?

Brian Bedell (Analyst - Deutsche Bank):

The future switch for the advisors that was originally bringing $ billion annually in and I think it went up to $ billion the last couple quarters on an annualized basis. Just if that's the same, or --

Joe Martinetto (CFO):

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Yes, we're actually running kind of at the high end to a little bit better than even those updated projections that -- I think we were a little bit imprecise in some of those early estimates of just how much money comes into the advisor relationship for new accounting cash and how long it takes an advisor to get that cash invested in the market. We're seeing, I think, kind of the trailing off now as we've had it up and running for a year and those balances or the accounts have been open, they've brought in the money, the money's gotten invested, we're seeing a little more stability in those balances but I think we did little bit better, probably more in the $ billion-ish kind of range than the $ billion-ish dollar range in terms of annual impact over the course of the last year. I don't know that I would necessarily project that it will stay at that elevated level, because you kind of build the cash, but now we've got money that's going out the door as they're continuing to invest over time. It ended up building a little bit more rapidly than we thought, but may not -- what we may see is we end up being about $ billion bigger consistently as opposed to continuing to build at the same pace going forward.

Brian Bedell (Analyst - Deutsche Bank):

Got it. Thanks very much

Rich Fowler (Head of IR):

Okay. Thanks, Brian. We're a little bit over. Sorry about that.

Thanks, everyone. We really appreciate you spending the time with us today. I know it's super busy.

The slide should be up on the site now and available. We will see you again in another three months. Thanks much. Take care.

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