

Charles Schwab Corp Spring Business Update

Company Participants

- Peter Brooks Crawford, Executive VP & CFO
- Richard G. Fowler, SVP of IR
- Walter William Bettinger, President, CEO & Director

Other Participants

- Brian Bertram Bedell, Director in Equity Research, Deutsche Bank AG, Research Division
- Christopher Meo Harris, Director and Senior Equity Research Analyst, Wells Fargo Securities, LLC, Research Division
- Craig William Siegenthaler, MD, CrÃ©dit Suisse AG, Research Division
- Devin Patrick Ryan, MD and Senior Research Analyst, JMP Securities LLC, Research Division
- Kenneth Brooks Worthington, MD, JP Morgan Chase & Co, Research Division
- Richard Henry Repetto, Principal of Equity Research, Sandler O'Neill + Partners, L.P., Research Division
- William Alfred Nance, Research Analyst, Goldman Sachs Group Inc., Research Division

Presentation

Operator

Welcome and thank you for standing by. Today's call is being recorded. (Operator Instructions)

Richard G. Fowler {[BIO 13387465 <GO>](#)}

All right. So we're live. Good morning, everyone. Welcome to Schwab's Spring 2019 Business Update. This is Rich Fowler, Head of Investor Relations for Schwab, coming to you from a slightly foggy San Francisco. It is still a top-down day, although it is spring and therefore allergy season and so I'm getting a full dose of that myself. My -- for me, it's eyes. So hopefully, everyone is having a tolerable pollen season starting out here. Also with me in the studio today are Walt Bettinger, our President and CEO; and Peter Crawford, our CFO.

Our agenda today is going to seem pretty familiar, given the interim update structure. So we'll spend a focused hour sharing our perspectives on Schwab. Walt will start it off with a strategic picture, Peter will then take a look at our recent financial performance and current outlook. And then we'll go to Q&A until it's time to wrap up.

And while we're talking about Q&A, as usual, we're going to ask that we follow the one question plus one follow on approach so we can get through as many questions as possible. We will take questions from both the webcast console and the dial-in. So again, as usual. Then before we start, the last thing to cover is the wonderful wall of words. Forward-looking statements, which we always include to remind ourselves that things will change and therefore, please stay in touch with our disclosures as we go through the year, keep up with what's going on. For those of you who are looking for slides, we will post them as usual around the end of the prepared comments, which is usually, as you know, around the half-hour mark.

So with that, I think we're ready to begin. Walt, would you please start us off?

Walter William Bettinger [{BIO 6638158 <GO>}](#)

Thanks, Rich. Good morning, everyone. Thanks for joining us for our spring update. It's a -- we're very pleased here as we kick off 2019 with both our client metrics and our financial results. Clients are actively engaged, they continue to be and we continue to win in the market. I'll reference a bit later, highlighted by for example, March, which was our second best month in firm history for new to firm retail households. So very strong client engagement for us here in Q1. At the same time, I think we're realistic. We're a bit cautious about the environment for the rest of the year, given where market valuations are and of course what seems to be a likely pause when it comes to interest rates.

So our Through Clients' Eyes strategy and Virtuous Cycle execution remain consistent. You've all seen this chart many, many times before. We strive to operate the company with the -- based on the golden rule. We have a confidence that by doing right by our clients, they'll choose to do more business with us, they will choose to refer others that are within their circle of influence to Schwab. And so we're committed to that approach. We're also committed to what we believe is the no trade-offs concept. That in this era, clients expect effectively everything. Great pricing, great service, great advice, multi -- omnichannel service. And we'll continue to invest. We have great optimism about our long-term growth as well as our prospects.

So Q1 was a bit unique from an investor standpoint. Of course, we came on the heels of a very difficult Fourth Quarter for the equity markets. The yield curve recently inverted in March. Of course, we lived with predictions from some analysts about a potential recession. We all understand the uncertainty that we've had from a global standpoint. And yet, even with all that going on, equity markets powered forward to near record levels and of course, excuse me, as we moved into April, now we've seen some record levels. And at the same time, all this occurred against a backdrop of what we would consider relatively low volatility in the equity markets themselves.

Now from a client standpoint, investors pulled back a bit. We saw modestly lower trading levels, margin balances, even financial and investment planning conversations were down modestly from a year ago. Certainly, the euphoria of the First Quarter of 2018 was not replicated in terms of new brokerage accounts. However again, still a very strong quarter as you can see in the upper right-hand -- I'm sorry, in the upper left-hand side of the chart. And again, as I mentioned, March for us was the second highest month in the firm's history for new to firm retail households, I think only exceeded by January of 2018.

And while there were some areas, as I mentioned, that showed client hesitation, there are other areas that continue to show high levels of client engagement and interest in our products and services. Assets in our Schwab-managed ETFs, mutual funds, money market funds, fixed income securities, all those showed growth in the 20% or more range. So quite a bit of engagement with many aspects of our firm and the offerings we have for clients.

In terms of net new assets, the quarter was within the long-term range, what we've come to expect and what we've communicated consistently with you, somewhere between 5% and 8%, depending largely on the environment as well as client sentiment. I think what the quarter does is it again demonstrates our ability to drive strong, organic growth, even as we serve more and more clients and even, of course, as we maintain a much larger client asset base.

Taking a look at the Retail side. The Retail investors remained engaged with our advisory solutions. We have CAGRs of 12% or so in recent years, for both accounts and assets that are in our advisory solutions. I think what's notable about this is that the assets in our Retail advisory

solutions are growing faster than assets at the firm overall. And that continues to demonstrate the significant opportunity before us to continue to serve more clients with our revenue-generating advisory programs.

So diving a little bit deeper into some of our clients and client acquisition, our success with investors is really across all ages. You can see that over half of our new-to-firm Retail clients are under the age of 40. And I think what's very important about that is we're acquiring these younger investors with no trade-off in the affluence of them. We now serve about 900,000 households in our Retail business that we consider affluent. We define that as \$250,000 or more invested at Schwab. Really, the success across age groups and generations is a reflection of our strategic efforts. We want to continue growing our Baby Boomer and Generation X clientele. They tend on average to be more affluent but, at the same time, we want to continue winning large volumes of millennial investors, those who really are becoming and will become the mass affluent clientele of the future.

Take a look at our adviser business. We continue to capture market share. We had a net transfer ratio in the First Quarter that was just shy of 3:1 versus our key competitors. I think our net new assets, although strong from a historical standpoint as you can see on the right side, they were impacted a bit during the First Quarter. We had the government shutdown that inhibited the creation of new RIA firms for a period in Q1. But also, I think you can't discount the difficult Fourth Quarter in the equity markets that often will cause those considering moving to the independent model to maybe pause until they feel on firmer footing with some of their clients, who they hope to follow them into the independent space.

And as we've been doing for a number of years and sharing with you, we continue to invest for the future. We're making substantial investments. They're designed to both drive long-term growth, continue to manage risk in an appropriate manner and really to fundamentally change our cost profile over time via the usage of greater digitalization, automation, scale. All of those are key parts of the investments that we've been making. And we also continue to invest in our clients. So offering enhancements to our client solutions such as in the Fourth Quarter, our industry-leading ETF OneSource program. We're now over 500 commissioned for ETFs, including those from virtually all of the major providers in the ETF space. And we continue to build scale in our low-cost, internally managed ETFs that really are designed as core building blocks for principally buy-and-hold investors.

I want to spend a little bit of time this morning in an area that has gotten a fair amount of interest lately. As you all know, in the First Quarter, we introduced what really, I suppose you could say, is a groundbreaking subscription pricing model designed for financial planning. The way it works is it's really a premium offer that accompanies our Schwab Intelligent Portfolios, a digital advisory program. The subscription-pricing model is a program that offers unlimited access to a certified financial planner for a subscription fee of \$30 a month after paying a one-time fee of \$300 for what is a comprehensive financial plan built by a certified financial planner. Maybe to add some color, why we moved to subscription pricing for financial planning, we've really always been committed the simple, transparent and low-cost pricing across everything that we do. And at the same time, we see that consumers are more and more comfortable with. And in some cases even asking for subscription pricing models. So we saw that the planning area was really the perfect place to bring together our commitment for this simple and transparent pricing with what consumers are looking for in many areas. Again, subscription models.

In terms of results, early results have been quite strong. Since the launch, we've seen about a 30% increase in traffic to our digital advisory sites. Our daily account opens are up about 15% for our digital advisory standalone solution. Again, Schwab Intelligent Portfolios. And they're up

almost 35% for those who are signing up for the subscription model under Schwab Intelligent Portfolios premium.

Now I think the big question, does this mean that we're going to move to subscription pricing for everything we do? And of course, the answer to that is no. We see a role for subscription pricing. But I don't think we see it displacing asset or transaction pricing. Rather, you're probably looking at a mixture of the 3 over a period of time. And again, at the same time, scalable financial planning, which is something that is needed with so many mass affluent investors. And we just thought it was the ideal place to launch it.

I guess in summary, I'd just say this is another one of those examples of where, at Schwab, we're skating to where the puck is going and leading the industry as opposed to being a follower to others.

So one of our competitive advantages is our efficiency. We talk about it often, our efficient operating focus and scale. At quarter end, our operating expenses as a percentage of client assets were about 16 basis points. That's not a number that we're satisfied with. We're investing in a variety of areas, including digital, to bring that figure down over time. And what this slide does is it just illustrates a small number of examples is -- to some of the early day of returns and rewards that we're getting from the investments that we're making in technology and continuing to enhance our omnichannel ability to serve clients.

And of course, as we make investments, we make them across the firm. They benefit both our Retail clients as well as the end clients of the investment advisers that we serve. But in addition, we make very specific investments just to benefit the independent investment advisers. Some of the more recent ones here, push status updates, digital account open, direct data delivery without having to reconcile or download, all capabilities that we continue to deliver to advisers without any additional fees or costs. And I think continue to solidify our industry-leading market share in that important and fast-growing space.

So just in closing, I often like to say that we're running a marathon here at Schwab, we're not running a sprint. Now that's not saying that we can just jog along the way. But rather it reminds everyone that we're playing a long game here. We recognize that environments change, markets go up, markets go down, interest rates go up, interest rates go down. But we're really focused on the long term. And I think we're positioned ideally for where the wealth management as well as the RIA space is today as well as where it's going. And so with our tried-and-true strategy execution model, we're very confident in our long-term health and -- as well as confident in our ability to reward our long-term stockholders.

So let me go ahead and wrap up, Peter. And turn it over to you.

Peter Brooks Crawford {[BIO](#) [19916258](#) <GO>}

All right. Well thank you very much, Walt. It's great to be with all of you here today and on the webcast and on the phone and really reflect on the quarter we just had and discuss how we see the future. So Walt talked about the strong momentum we have in the marketplace, the success we're having in winning new clients and the innovations we're making in driving growth and also some of the early wins we're seeing with our broad-based efforts to drive greater efficiency really throughout our whole business.

For my time today, I'll talk about how that business momentum allowed us to produce record financial results in the First Quarter of 2019. I'll also give you an update on how we're thinking about the rest of the year, recognizing there are a lot of moving pieces and unknowns. And finally,

I'll talk about client cash and about capital, two topics that I know are on the minds of many of you.

And the summary is that we are done with the transfers of Sweep Money Funds over the balance sheet, which has several implications, including the opportunity to free up capital for buybacks in the quarters ahead.

So Walt shared a number of graphs, data points and visuals that speak to our success in winning new clients; our ability to sustain high levels of organic growth, even as our client base has grown; and the growing interest in our various products and services. Not surprisingly, all that momentum translated into robust growth in our client base, with total brokerage accounts, total client assets and advised assets up 7% to 9% year-over-year.

Now at the February business update, we shared our thoughts on some of the factors that would influence our financial performance for the year and described the range of possible financial outcomes, given a specific macroeconomic scenario. It's early in the year, of course. But I think it's safe to say the conditions, as Walt mentioned in 2019, on the whole have started off a little bit behind that baseline set of assumptions. The equity markets have clearly been a big positive, with the S&P 500 continuing the strong start that we witnessed in January. But interest rates haven't been as helpful. With the Fed now universally expected to pause for a while, we've seen a drop in short term rates and a more dramatic flattening and even for a moment, inversion of the yield curve. And as Walt noted, some (inaudible) client trading activity in the last year's record First Quarter, though it was still high by historical levels.

So our financial results for the quarter are quite strong, considering the somewhat mixed conditions I just described. And in part reflect the environment we experienced in 2018 and the actions we took last year. Our revenue was up 14% year-over-year, driven by 30-plus-% growth in net interest revenue due to higher rates and higher balances. Asset management and admin fees were down year-over-year, mostly due to balances moving out of Sweep Money Funds that we either transferred to Bank Sweep or clients reallocated into purchase money funds and other products. And Other revenue, though it's not on this page here, was up mostly due to one-time gain related to the reassignment of our lease at 215 Fremont in San Francisco, for which we received an upfront payment. Expenses were up just 5%, which was generally consistent with our expectations. The biggest driver of the increased was increased staffing as we have been ramping up our digital and technology areas to drive greater efficiency over the next several years, as Walt discussed. And offsetting that has been the elimination of the FDIC surcharge in the end of the Third Quarter last year. With 900 basis points of operating leverage in the quarter, we increased our pretax margin by 4.5 points from Q1 of 2018 to over 46%. And we delivered our third consecutive quarter with an ROE of 20%.

Turning our attention to the balance sheet. We executed over \$11 billion of transfers in the First Quarter, essentially completing that process except for a few \$100 million of transfers we did in April, which as I said, finished up our transfers. The size of our balance sheet decreased by a bit under 5% from the high watermark that we saw at the end of 2018, which resulted from a surge of -- in deposits in December, given the equity market weakness and typical seasonal flows. Now this decrease in deposits was consistent with our expectations, as clients deployed the December cash into the markets and continued with the sorting process we've discussed at great length.

In terms of capital, as you no doubt saw, the Board authorized a 31% or \$0.04 increase in our quarterly dividend and a new \$4 billion buyback authorization. And we didn't however, purchase any stock in the quarter and you may ask why. You'll remember that our Tier 1 leverage ratio is

based off of average assets. And while we ended Q4 at a ratio of 7.1%, given the surge in balances at the end of December, our spot ratio, if you will, entering Q1 was somewhat lower than our operating objective. So we wanted to ensure our capital ratio finished the quarter on the upper end of our operating objective of 6.75% to 7%.

There was a lot of interest in this page when it made its debut at the winter business update. For those of you who weren't there, it describes the behavior of our clients with regard to their cash, both their Sweep Money Funds and Bank Sweep. If you start on the left, you can see that at the end of 2018, there was roughly \$30 billion remaining in Sweep Money Market funds. About \$6 billion of that amount or 20% moved on its own, either in accounts impacted by the transfer but ahead of us actually moving the money, or in accounts completely separate from that process. Then we moved about \$12 billion, leaving us with about \$14 billion remaining in Sweep Money Funds as of the end of the quarter. What was the impact on Bank Sweep? If you look at the graph on the right, you can see that we ended the year with \$212 billion in Bank Sweep. Some of the \$52 billion in NNA in the First Quarter came in the form of cash. Now we continue to see sorting as we expected and then we saw the benefit of the transfers. Some flows into those accounts and then some sorting. The difference between the \$10 billion on the right and the \$12 billion on the left is the money we've transferred from Sweep Money Funds over to brokerage sweep versus the Bank Sweep.

Now a couple of points I'd make. First is that the ratio of what got sorted is pretty similar for the clients using Sweep Money Funds versus those already in Bank Sweep, which supports our -- what we've talked about as this is fundamentally a decision about transactional cash versus investment cash. Second is that the clients whose accounts were actually switched moved a lower % of their cash post transfer into other solutions than the overall population. Now this may mean that there's a little bit of sorting left for that group. But it's also a function of the fact that some of that cash actually moved ahead of the transfers as I've talked about on the left. And third and finally, that sorting process that we saw in the First Quarter was not evenly spread throughout the quarter. The net outflows were highest in January as we saw clients reengage in the markets. The outflows were less in February than in January and then less in March than they were in February.

So now let's shift from the past to the future. And as I noted earlier, there are a lot of moving pieces, which makes developing expectations for financial results this year even more challenging than usual. In addition to the usual dependencies on interest rates, fed policy, equity values and trading, we had this additional dependency around how long this sorting process will take to complete.

Now the year is starting off to be a bit more challenging than those baseline assumptions we communicated nearly three months ago. Client cash allocation activity, however, has generally been consistent with what we expected to start the year. But to reiterate what I said back then, back in February, our balance sheet growth and the resulting revenue growth depends on how long this process plays out. The short rate's down a bit, 1-month LIBOR is down 1 basis point or 2 to start the year and 3-month LIBOR is down a little over 20 basis points. Our expectations for NIM -- for full year NIM are now somewhere in the mid-2.40s, plus or minus a couple of basis points, assuming -- this is really important, assuming the Fed doesn't move and rates stay where they are.

So what are we thinking in terms of revenue growth for 2019? It's early in the year, you've heard me say that a few times before. And there are too many uncertainties to give you a clear direction on that. I'd remind you instead of the sensitivities we shared previously. And note that we think these are still valid as adjustments to the range of outcomes we shared back in February, which means we could still be in the range we communicated previously adjusted for

these sensitivities. Let me just repeat that. I'm saying that if you take that original range of revenue that we talked about back in February and make adjustments based on how the year has started and how all of you expect the year to unfold, that should still be a reasonable range of revenue for the full year.

So turning to expenses. There hasn't been a major change in how we're thinking about our spending levels and about our spending priorities. A large portion of this year's growth and expenses is going to efficiency and scale initiatives that will help us drive down EOCA, or expense line client assets, that really, really important, competitive advantage that we have. Enable us to limit expense growth through the cycle to the low; to mid-single-digit range. Our current expectations around full year expense growth is it will probably be on the low end of the 6% to 7% range year-over-year that we communicated earlier.

Now at last year's winter business update. So back in 2018, we said we were entering a couple year stretch during which our CapEx would be higher than it traditionally has been due to the build out of our facilities in Denver, Austin and Dallas. We have found these to be great markets to attract talent at a reasonable cost. And while building these company-owned facilities requires more cash upfront, the lifetime cost is lower than when we leased space. The key point is that we expect to have another step up in CapEx in 2019. But then for it to return to the more normalized levels in 2020 or -- sorry, 2020 and 2021.

So we have the opportunity this year and beyond to be that rare company that is both growing top line revenue and returning capital to stockholders. With the transfers now behind us, we should be in a position to build excess capital over the next several quarters, barring of course a surge in deposits. We should expect our dividend to increase as our earnings increase. While it's been in the lower part of our 20% to 30% range over the last several years as we conserved our capital to enable more transfers, I think it's likely we'll look to keep it more in the mid to upper part of that range in the near future.

To the extent we have capital in excess of our 6.75% to 7% operating objective for Tier 1 leverage, our focus will be on utilizing our \$4 billion buyback authorization opportunistically. I'm often asked, how close to that operating objective can we run, given the potential for an unexpected surge in deposits like what we saw in December? The answer is we have several tools at our disposal to handle short-term inflows, giving us the confidence to stay pretty close to that line. And we'll aim any repurchase activity to move us towards but not through our operating objectives. Now that does not mean, however, that you should expect our level of capital return to be the same every month, or that our reported Tier 1 leverage ratio will be exactly 7% or exactly 6.75% every single quarter. There will be some lumpiness to all of this for a variety of reasons.

So let me close by reinforcing a few things that hopefully came through today. First is our strategy is working, producing strong business momentum and record financial results. Second, with the completion of transfers from money funds to Bank Sweep, we should have the opportunity to reserve more robust levels of capital return. There are a number of uncertainties in the market. But we're controlling the things that we can control; doing right by clients, which has allowed us to be the premier asset gatherer in our industry; figuring out ways to monetize those assets; and operating with discipline and how we manage expenses and capital. It's a similar frame to what you've heard from us before. But it's worked through multiple cycles and we're confident it's the right approach in the years ahead.

With that, let me turn it over to Rich for some Q&A.

Richard G. Fowler [{BIO 13387465 <GO>}](#)

All right. Let's plunge right in. I'm going to ask the operator to start us off and maybe we'll take the first call and then we'll see what we've got on the web.

Questions And Answers

Operator

(Operator Instructions) Our first question comes from Rich Repetto of Sandler O'Neill.

Q - Richard Henry Repetto [{BIO 1901226 <GO>}](#)

I guess the first -- just a little bit more color on a favorite topic here, the client sorting. Thanks for the metrics, the inter-quarter metrics, Peter. I guess the general question is you issued some pretty wide guidance in February in regards to client sorting. So given what you're seeing inter-month and other metrics probably that you didn't mention, can you just speak to -- are we subjectively -- are we towards the end or we're in the range you think we might come out in this client sorting? It's been a hot topic.

A - Peter Brooks Crawford [{BIO 19916258 <GO>}](#)

Rich. So to refresh everyone's memory, the range of outcomes that I talked about back in February on client sorting varied. We talked about a range of balance sheet growth of minus 8% or 9% to a plus 3% or 4% and that range depended on when the sorting -- we expected the sorting to stop. The lower end of that range assumed that the sorting continued through basically 2019 and the upper end of that range in terms of balance sheet growth assumed the sorting stopped at the end of Q1. So thus far, I would say nothing we have seen suggests that we're falling outside of that range in terms of the balance sheet growth. But it's a little bit hard to say exactly what the next couple of quarters are going to look like because we're not in those quarters yet. We're obviously a month into the Second Quarter. But of course, April is an unusual month, given tax-related payments and inflows and such. What I'd say on the sorting though, is our expectation is that the sorting will go down over time, that the most yield-sensitive cash sorts first, if you will. And then over time it should decrease. And if the Fed is on pause, one would think that, that sorting would end sooner than it would otherwise. The exact pace of which that happens, a little bit hard to say right now, sitting here towards the end of April. But it's something we'll be monitoring in the -- clearly. And I know you'll all be monitoring in the months ahead.

Q - Richard Henry Repetto [{BIO 1901226 <GO>}](#)

Got it. That's helpful, Peter. And I guess my one follow-up would be for Walt. And thanks on the color on the folk -- how you've done with the Retail house -- new Retail households, et cetera. I guess one of the things I was looking at was adviser assets. And if you looked at back quarterly, just on adviser net new assets, it seemed like they peaked around 4Q of '17, 1Q of '18. It ran up to that point and then from that point on, it seems like we've come down generally. And I'm trying to understand, Walt, am I missing a trend or is this just market related? Or what's behind the numbers I guess on the net new assets for the adviser space?

A - Walter William Bettinger [{BIO 6638158 <GO>}](#)

Rich, I think you have cyclical in there for one that we have to be careful with and not to extrapolate cyclical into a trend line. But there's no doubt that Q1 was softer on the RIA side. And we really do -- we believe, particularly when we look at the pipelines, which are quite robust, we really do believe that the two factors I mentioned were the principal drivers behind the softer

relative Q1 assets. And when the SEC was closed, of course, we know that those folks looking to start new RIAs were unable to get their paperwork through and processed. Then I just would not discount the difficult Fourth Quarter. I mean, if you're looking to breakaway. And of course you're making a bet on 9 out of 10 of your clients following you into a new model and those clients may have just experienced quite a bit of volatility or even paper losses in their accounts, that's a difficult time to have the confidence that they will follow. So I think the combination of those two factors played a role. But when I look again at pipeline, I don't see anything that tells me there's a structural issue or a competitive issue or anything in the RIA business that causes me longer-term concerns.

A - Richard G. Fowler [{BIO 13387465 <GO>}](#)

Okay. Operator, we're going to take one of the webcast questions before going back to the calls. We've had a couple of versions of this come in and so to paraphrase the question from Bill Katz, can we talk a little bit about the RIA reaction to subscription pricing and the impact on their businesses? Any other feedback we're getting?

A - Walter William Bettinger [{BIO 6638158 <GO>}](#)

Sure, sure. Yes. So I've heard from and spoken with a fair number of RIAs. I think the vast majority of them understand that this is a program for a financial plane that's combined with a digital advisory capability. So that is a model that is vastly different than almost all the RIAs that we work with. It's vastly different than what they do for their clients. So they're not really seeing that as some form of competitive threat. Now, obviously, when you serve 7,000 to 8,000 RIAs, if a blogger wants to go out and find an RIA who wants to express concern with it, that's not too hard to do, given that volume. Then again, those same folks probably express concerns with virtually everything that we do. I also want to make sure I emphasize the other side of the coin though. I've also spoken with RIAs who have been almost congratulatory on what we've done because their view is what we're doing here is we're making access for financial planning more affordable and more accessible to more people. And that's a good thing, they say. They're not worried about competitive issues, they're focused on more citizens getting the kind of financial planning help that they should. And if this helps more of them do so, that's a good thing.

A - Richard G. Fowler [{BIO 13387465 <GO>}](#)

Okay, let's go back to the calls.

Operator

Our next question comes from Ken Worthington of JPMorgan.

Q - Kenneth Brooks Worthington [{BIO 3303320 <GO>}](#)

Maybe first, I appreciate the comments on NIM, I wanted to dig maybe a touch deeper. When you look at the fixed and variable rate investments, how did the yields on maturing, say mortgages and securities compare to the yields on the new mortgages and new securities in which you're investing? Like, what is that yield differential? Is it flat? Positive? Negative? Where does it stand right now?

A - Peter Brooks Crawford [{BIO 19916258 <GO>}](#)

Okay, Ken. So without getting into the sort of security by security mechanics or details, what I'd say is in aggregate, the reinvestment rates today are higher than our overall portfolio yield, with the benefit really happening on the fixed side of the portfolio with those longer-term rates. Now,

some of you may say well, why is that? Longer-term rates have been down a little bit but of course, even where they are today, the longer-term rates and the rates on the new fixed rate investments we're making are still higher than they've been for much of the last 5 to seven years. So we're able to reinvest at higher rates. There has been a little bit of a tightening of credit spreads that affects the reinvestment rates on some of the floating-rate securities. But on the whole, the reinvestment rates overall are a bit higher than the overall portfolio yield.

Q - Kenneth Brooks Worthington [{BIO 3303320 <GO>}](#)

Awesome. Then to follow up on Rich's question on cash sorting. I was hoping to maybe get a better sense of the outlook here and see if I'm interpreting your comments correctly. So I think what you were saying as we saw slowing from January to February and February to March. And our data might suggest that you saw further slowing in April. I guess maybe one, do you think there's any reason for sorting to pick up after tax season is kind of complete? And I felt that your comment suggested that the cash sorting seems to be winding down. Is that a fair interpretation of your comments?

A - Peter Brooks Crawford [{BIO 19916258 <GO>}](#)

Yes. It's hard to say. I mean, the short answer is it's hard to say. We don't know. I think May will be an interesting month to see what happens. April is an unusual month. So I don't want to -- I wouldn't characterize it as less sorting or more sorting at this point. I think it's too early to say, we haven't even finished the month yet. I wish I could say yes, I called the end and ringing the bell for the end of sorting. I just don't think that's -- I don't think we know quite yet. We do know that at some point, we'll get back to normalized levels and then cash balances will grow consistent with the growth in total client assets and the growth in accounts. The other dynamic we have of course is now at the end of the sweep transfers, to the extent that the sweep transfers were a catalyst for some portion of that, that being more in the rearview mirror, perhaps that helps a bit as well. But we'll have to see and it's something we'll have to monitor in the next -- over the next couple of months.

A - Richard G. Fowler [{BIO 13387465 <GO>}](#)

Okay. Next question?

Operator

Our next question comes from Chris Harris of Wells Fargo.

Q - Christopher Meo Harris [{BIO 20931793 <GO>}](#)

Well the goal of stock buybacks and other capital actions you guys might decide to take, will it be to keep that Tier 1 leverage ratio near the target? Or is there a scenario where we can see that leverage ratio build quite a bit above the target? And the reason I ask the question is if the balance sheet ends up shrinking close to 10%, that's going to free up quite a lot of capital.

A - Peter Brooks Crawford [{BIO 19916258 <GO>}](#)

So I mean, I guess what I'd say is a couple of things on that. I mean, our objective is to use that available capital to enable the buybacks and to keep that leverage ratio relatively close to that 6.75% to 7% objective. Is there a scenario where it could go well above that? Perhaps, I don't know. I mean, there's a lot of potential scenarios. But our objective is really to keep it at that level and I think that the way that the balance sheet evolves typically tends to be a little bit slower. So

it's not like it suddenly leaps in one month from 7.2% to 9%. So it gives us a little bit of time to continue those buybacks over a period of time.

A - Richard G. Fowler [{BIO 13387465 <GO>}](#)

Okay. Let's keep going.

Operator

Your next question comes from Craig Siegenthaler of Credit Suisse.

Q - Craig William Siegenthaler [{BIO 15021209 <GO>}](#)

Just a follow up to the last one. But given that your Tier 1 ratio kept you from repurchasing stock in the First Quarter, can you talk about your ability to buy back stock over the next year, just given that positive deposit growth and a cheaper share price tender (inaudible) in the same quarter?

A - Peter Brooks Crawford [{BIO 19916258 <GO>}](#)

So we have this \$4 billion authorization for buybacks. Our plan is to begin to utilize that in the coming months/quarters. In terms of the actual amount of that, that we're able to use, it really depends on what we see from the balance sheet growth. So it's hard for me to say it's going to be X or Y because it depends on -- in a scenario where the balance sheet shrinks by that 8% or 9% that I -- the lower end of that range, that obviously would free up a lot more capital to enable buybacks. So say balance sheet grows by 3% or 4% or we see an equity market downturn, a flood into cash, the balance sheet potentially grows even higher than that. That obviously absorbs more capital and you'd see less on the buyback front in that scenario.

Q - Craig William Siegenthaler [{BIO 15021209 <GO>}](#)

So and then...

A - Richard G. Fowler [{BIO 13387465 <GO>}](#)

No, go ahead Craig. Sorry.

Q - Craig William Siegenthaler [{BIO 15021209 <GO>}](#)

Sorry. You go, Walt.

A - Richard G. Fowler [{BIO 13387465 <GO>}](#)

No. This is Rich. I just was going to just try to maybe hammer on this a little bit more for folks. So Peter, is it fair for folks to assume that allowing for some chunkiness in terms of how this activity might unfold, that literally our intent is, to the extent the balance sheet does in fact shrink, to use that room during the course of the year to go on the buybacks appropriately from a valuation perspective?

A - Peter Brooks Crawford [{BIO 19916258 <GO>}](#)

Yes. Absolutely. I mean, that is certainly in a scenario where the balance sheet is shrinking. I think you threw up a number of 10%. And a scenario where the balance sheet's shrinking 10%, you're right, that does free up a fair amount of excess capital and that would enable us to do more of these buybacks. And we don't have a lot of interest in necessarily hoarding excess capital. It's not

really our capital, it's our stockholders' capital. And if we don't need it for balance sheet growth or to support some of the CapEx and things like that, then we look to return it to the stockholders.

Q - Craig William Siegenthaler {[BIO 15021209](#) <GO>}

Got it. Very clear, Peter. So I wanted to get your thoughts on a question that you get from time to time. But looking at what you do in the U.S. and then looking at what you do outside the U.S., why not replicate your model more aggressively in Europe and Asia, really outside your small focus? Because I know you have operations in like Hong Kong, Singapore. And if you eventually do, do that, isn't it better to kind of do this sooner rather than later as there's more a kind of -- as the competitors can build up moats and the markets mature?

A - Walter William Bettinger {[BIO 6638158](#) <GO>}

Yes, Craig. Thanks. So I think there is some opportunity outside the U.S. One thing that exists though, as you all know, is the economics of our traditional business on the Retail side is fairly dependent on bank and balance sheet. And so an aggressive expansion on the Retail side of our business would necessitate us likely acquiring charters in dealing with the regulatory issues inherent in potentially having charters in a variety of different regulatory schemes. What might be more appealing in the near term at least would be the possible expansion of our RIA business internationally to the extent other parts of the globe are headed more and more toward a fee or a transparent model around investment advisory. But that's probably the principal barrier to a much more aggressive expansion. There are also opportunities for us, particularly in the Far East, around people that want to leverage some of our capabilities in the digital advisory space so you could see some nontraditional steps that we could take internationally. But that's some of the thinking around the opportunities for us outside the domestic environment.

A - Richard G. Fowler {[BIO 13387465](#) <GO>}

Okay. Next?

Operator

Our next question comes from Devin Ryan of JMP Securities.

Q - Devin Patrick Ryan {[BIO 5863151](#) <GO>}

Just a follow-up here on the sorting. Because you guys have a lot more data internally than we can see from the outside. And I'm just curious, when you look at the cash that's being held in the bank today versus what's been moving out there, for example, purchase money, money market funds, are there any consistent themes of kind of what's left in terms of the types of accounts or size or anything else that just gives you maybe some comfort that there's a certain type of account that's remaining and so therefore that may also give evidence that we're kind of late in the sorting cycle?

A - Peter Brooks Crawford {[BIO 19916258](#) <GO>}

Yes. So that's a great question. So I guess what I'd say is a couple of things. I mean, what we've typically seen is that activity is highest with our most engaged clients which -- who are often our most affluent clients. And so as we have been -- so you do see a higher level of that activity happened with the more affluent households. It also tends to be correlated with, not surprisingly, with accounts that have higher portions of cash in the account. You tend to see more engagement there as well. I'd say those are probably the two general themes that we've seen. And of course, with some of the transfers, we moved some of those more affluent clients more

recently. So again, now that we're done with that, hopefully that starts to normalize and we expect it will start to normalize.

A - Walter William Bettinger [{BIO 6638158 <GO>}](#)

Just to weigh in real quickly, Devin. It's important to walk through the process of how these transfers occur. So the client is notified substantially in advance of any transfer date. At that point, for example, on the Retail side, our financial consultants are contacting those clients proactively. And having conversations about their cash, explaining to them what's going to happen, educating the client as to how do you view your cash, how much of your cash is investment cash, how much of it is really transaction cash that you intend to use to be buying and selling securities or doing bill pay or all the variety of things people do with their transactional cash. So that's all going on before there's even transfers. And I think the chart that Peter shared illustrated how you get significant movement long before the transfers even occur. Then those conversations continue because of course, not every client takes action or not every client may be reached. And so those conversations continue for some period of time after that money has moved. But from my time in the field and talking with financial consultants, those conversations are concentrated in the couple of months before and a couple of months after the actual movement occurs. Now that's not me trying to jump in and say therefore, I have some special insight that tells you that we're late in the sorting process. But that's the practical sequence of what goes on here. And of course, on the RIA side, those conversations go on earlier and largely the RIAs make their decisions very, very quickly because they're dealing with large numbers and a bulk decision around all of their clients as opposed to Retail where you've got to talk with the clients one by one. So I think the process is important to understand. It adds color and helps maybe enlighten a bit, Devin, in terms of what we're actually doing with clients and what's going on behind the sorting process.

A - Peter Brooks Crawford [{BIO 19916258 <GO>}](#)

And let me just add one further point to what Walt said, is -- I think we said this before. But the majority, the vast majority of the sorting that's happening is not actually clients who are going through the -- who have been impacted by the transfers. It's actually -- it's all the other clients because it is fundamentally this decision about transactional cash versus investment cash. I mean certainly, the money -- the process of the transfer as Walt mentioned is a catalyst, is a moment of engagement and people do engage on it. But it's -- there's other clients there that are making the same decisions as well.

Q - Devin Patrick Ryan [{BIO 5863151 <GO>}](#)

Okay, terrific. Just a follow-up here. There's obviously quite a bit of our pricing pressure, I think competition across the business. But we've been in a pretty aggressive fee war on indexed mutual funds and ETFs, maybe some of the more commoditized types of products and I'm just curious whether you see this trend kind of maybe broadening out within some of the other areas within proprietary products, maybe some of the less commoditized areas and just what you're expecting there.

A - Walter William Bettinger [{BIO 6638158 <GO>}](#)

Yes, I think our view is that asset management in all areas is likely to continue to receive pricing pressure. And I'm differentiating asset management from investment advisory. But asset management, we see it of course in the active side where there are challenges around consistent output creation. I think in the factor or fundamental investing area, you see pricing pressure. I just expect it to continue across the board. I do have some questions around the prudence of what's going on with some of the O expense ratio moves, particularly to the extent

it's talked about in the ETF space as opposed to the mutual fund space because as we know in the ETF space, you can't really control the distribution and/or volume that you receive since they're exchange-traded. But I think at the global level, we expect to see continuing pricing pressure across all areas of investment management, again, differentiated from investment advisory.

A - Richard G. Fowler {[BIO 13387465 <GO>](#)}

Okay, next.

Operator

Our next question comes from Brian Bedell of Deutsche Bank.

Q - Brian Bertram Bedell {[BIO 20840692 <GO>](#)}

Walt, staying on the ETF scene, maybe what are your initial views on the approval of the active nontransparent ETF at the SEC? And do you think you will see good demand for that if asset managers actually want this product both from Retail investors at Schwab and I suppose, the RIA?

A - Walter William Bettinger {[BIO 6638158 <GO>](#)}

Well yes, it's a really good question, Brian. I mean, the interesting thing we all recognize by the ETFs is they've been given a wrapper advantage, right, from a product standpoint relative to mutual funds, particularly from a tax perspective primarily. And so when you're talking after tax investing, there would be certain benefits. Now the dilemma is people that have meaningful after-tax dollars that might be invested in mutual funds may also have meaningful billed and taxable gains. And so we have to see whether there's an opportunity for them to make adjustments without the possible taxation of gains outweighing the benefit of the more efficient wrapper that the ETF holds. The other thing is often with consumers, any time you get something new and unique, it takes time. I mean, people don't just flood to new things even if they are potentially advantageous. There's an education process, there's a comfort process. And so it may well create movement over time. But I think often people maybe over-anticipate the pace at which those things will occur.

Then the last thing I'd share is that I think arguably, a significant percentage of flows today that still go into mutual funds are going in through the tax qualified plan area, specifically the 401(k) area. And with the exception of us and -- I'm not really sure anyone else of size, no one has a recordkeeping system that truly does intra-day, processing and trading of ETFs for 401(k). So the entrenched providers there have a significant motivation from an investment and their technology standpoint to continue to downplay the potential of ETFs and the 401(k) world as they have been doing for quite a number of years and I would say relatively successfully doing. So I don't see the nontransparent ETFs causing a change in the 401(k) space as long as the entrenched providers are telling employers that it's not something that creates benefit. So interesting, some opportunity, probably will take longer than many people think. And the real flows in mutual funds I think today of consequence are occurring in the tax qualified area. I don't see that -- those people switching to ETFs in the near term.

Q - Brian Bertram Bedell {[BIO 20840692 <GO>](#)}

Right. And this would also be a long-term question then. As you think about your development of ETF OneSource versus mutual fund OneSource and again, realizing this will take a long time. But how do you think about potentially the pricing of actively and nontransparent ETF? Given the

select list is typically a high area of inflows, a lot of people rely on that. Could you really replicate that with actively managed ETFs? Then maybe just one question on -- with the expansion of the commission-free ETFs, any thoughts on how that's impacting DART?

A - Walter William Bettinger {[BIO 6638158](#) <GO>}

Yes. So let me do the second one first. I mean, I think the more solutions that we offer for clients that are commission-free, DARTS are going down. That's why DATs are important to look at too. But we're really making a trade-off there between (4.95) on a periodic basis versus x basis points that is more stable and grows as asset valuations grow. And of course, because it's not coming from the pocket of the client, the client is benefiting, which is most important in all of that when we think about ETF OneSource. With respect to your first question, I think it remains to be seen how the pricing is done on semi or nontransparent active ETFs. I mean, we don't know how they're pricing. If they're going end up priced as per se a true clean share, then there's going to be a difference in the way we try to recoup our cost of serving clients and handling the servicing side that we do. But I think it just remains to be seen how those products end up being priced, as well as remains to be seen whether there really is momentum that gets behind these or whether it's just more of the industry hoping and the consumer choosing maybe not to follow.

A - Richard G. Fowler {[BIO 13387465](#) <GO>}

Let's go on to the next call. We've got a little bit more time here.

Operator

Your next question comes from Will Nance of Goldman Sachs.

Q - William Alfred Nance {[BIO 20732798](#) <GO>}

Maybe if I could just ask one on expenses. If I think about the 6% to 7% expense growth you're seeing this year and I think about some of the tailwinds from last year such as the FDIC, some of the one-off spending you had late in the year, I think core expense growth is probably still closer to the double digits. And so looking out into next year, if we continue to see the sort of top line headwinds that we've experiencing, can you talk about some of the levers that you could pull to get the expense growth down closer to the longer term expense guidance and continue to make some of the investments in the business that you outlined in the business update?

A - Peter Brooks Crawford {[BIO 19916258](#) <GO>}

Yes. So as we think about expense growth, I mean it's certainly something we're very focused on and as I mentioned and as Walt mentioned, that expense line client assets is a key metric, a key advantage for us and something we're very, very focused on. The key thing on managing expenses is doing so in a way that doesn't come at the expense of the client experience or doesn't come at the expense of our ability to grow. And so that's why these investments that we're making at modernization and business process transformation and digital work are so important is because they do give us the opportunity to bring down that rate of expense growth. But do so in a way that is at worst neutral and, in many cases, a very -- a real positive for clients and for the client experience. In terms of expense growth for next year, I would say it's too early to say exactly what that's going to be. But our expectation is to continue to bring our rate of expense growth down to that longer term average that we talked about in that low; to mid-single-digit level. Whether that happens in 2020 or not, again, too early to say. But I think it's reasonable to expect that they will be continuing to bring that rate of expense growth down.

A - Walter William Bettinger [{BIO 6638158 <GO>}](#)

Will, let me just add that what you described at the outset of your question is something that we understand fully, have understood and have planned for. So when we talk about bringing our expense growth rate down, it is cognizant of the one-time issues that you mentioned that were more helpful in lowering it this year. And therefore, a recognition of the discipline that it will require to have that number trend toward the range that Peter mentioned in 2020 and on into 2021.

Q - William Alfred Nance [{BIO 20732798 <GO>}](#)

Got it. And maybe a follow-up on the margin. If reinvestment rates are still kind of in the money. So to speak, on the securities portfolio, are you seeing something on the liability side that would prevent the margin from kind of grinding higher from here, given we're kind of already at the full year guidance?

A - Peter Brooks Crawford [{BIO 19916258 <GO>}](#)

Yes. So great question. So reinvestment rates are really only one part of the story around what drives NIM. There's really 4 -- if you think about it, there's really 4 levers, there's reinvestment rates; there's interest rates. And interest rates have probably put in credit spreads; there's the deposit rates; and then there's how we manage the portfolio. I talked about reinvestment rates and those are providing a little bit of a tailwind for us or even more than a little bit of a tailwind for us and should hopefully do so if you need to do so over time. On the liabilities side, that's not -- there is no change there. Our -- we have moved deposit rates as the Fed has moved their rates and if the Fed is on pause, I think it's reasonable to expect that we'd keep our deposit rates steady as well. Interest rates, as I mentioned, interest rates are entering or entered Q2 a little bit lower on the short end than they did on the -- entering Q1. And so on the floating-rate portfolio, that creates a little bit of headwind. Again, it's just 1 basis point or 2 and 1-month LIBOR a little bit more. In 3-month LIBOR, I think you guys probably know we're probably 5:1 levered more towards 1-month LIBOR than 3-month LIBOR. But that creates a little bit of downward pressure, if you will. Then in terms of the portfolio management, we're still managing within the same duration target. But we did build up some liquidity at the end of the First Quarter to handle what we expected would be some tax-related outflows from the balance sheet in April and potentially, the continuation of some of the sorting. And so that comes at the expense of a little bit of investment yield as well.

A - Richard G. Fowler [{BIO 13387465 <GO>}](#)

Okay. All right, I think we're going to hold there on questions. And I think we're going to move to closing out. Peter, do you have some final thoughts for us?

A - Peter Brooks Crawford [{BIO 19916258 <GO>}](#)

Yes. Well thank you all very, very much for your questions on the -- and your attention on the call today. And I know we've spent a lot of time talking about sorting and cash dynamics and those are clearly very important and things that we as a management team are very, very focused on. But we're even more focused on the things that we believe are the key drivers of our long-term success, the long-term growth and long-term performance of the business. And those are our ability to delight clients, our track record in attracting assets, the opportunities we have to both continue growing and the opportunities to continue driving greater efficiency throughout our business, how we balance the delivery of those near term performance with the investments in

the longer term growth of the business and the discipline with which we manage expenses and we manage our capital.

No matter the environment, no matter where we are in the cycle, that's what you have come to expect from this management team and what we continue to be keenly focused on, what you can continue to expect from us in the quarters and years ahead.

We look forward to seeing many of you hopefully at our stockholder meeting and then in the next business update in July. Thank you.

A - Richard G. Fowler [{BIO 13387465 <GO>}](#)

Thank you. Have a good day. We'll see you in three months.

Operator

Thank you. That concludes today's conference. Thank you, all for joining. You may now disconnect.

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