

Sector	S&P 500 Benchmark Weight	Dow Jones Wilshire 5000 Benchmark Weight	Schwab's Current Recommended Deviation from Benchmark	Date Sector View Last Changed	Year-to-Date Return as of 01/22/09
Consumer Discretionary	8%	9%	Marketperform	02/15/2008	- 8.04
Consumer Staples	14%	12%	Underperform	01/23/2009	- 4.77
Energy	14%	12%	Marketperform	09/26/2008	- 4.17
Financial	10%	16%	Marketperform	06/24/2005	- 30.56
Health Care	16%	14%	Outperform	11/19/2004	- 1.84
Industrials	11%	11%	Marketperform	07/28/2006	- 9.23
Info Tech	16%	16%	Outperform	12/19/2008	- 3.86
Materials	3%	3%	Marketperform	01/23/2009	- 4.41
Telecom	4%	3%	Underperform	02/15/2008	- 7.73
Utilities	4%	4%	Marketperform	01/18/2008	- 1.24
S&P 500					- 8.27

Schwab Sector Views

This week, as we consider the reflationary efforts being made by governments around the globe, we continue our incremental moves to a slightly more cyclical sector stance.

A roundup of the changes:

- A few weeks ago, we moved **tech** to an **outperform** view.
- Now, we are bumping up **materials** from underperform to **marketperform**.
- We are also moving **consumer staples** to **underperform**.

These viewpoints remain steady:

- **Positive** outlook for **health care** and **technology**.
- Relatively **negative** on the outlook for **telecom**.

If you're an investor looking for tactical ideas, read our views and consider using them as a basis for some small, near-term adjustments. Note that market conditions change quickly and, as such, we can and do update our sector viewpoints accordingly. Check back often for our latest views.

Consumer discretionary: Marketperform

Now that December's retail sales numbers are in, we can confirm that shoppers are pulling back on their spending. Many are attempting to deleverage their personal balance sheets—either through choice or by force as access to credit still remains tight. In this constricted environment, stores' profit margins were dismal. Oftentimes, retailers slashed prices to lure reluctant shoppers. Meanwhile, the near-term outlook doesn't provide a lot of hope.

On the up side, the stock market is forward-looking, and much, if not all, of the aforementioned bleakness is already well-known by people who invest in the market. Further, massive amounts of stimulus continue to enter the economy, which may help support the consumer (and, hopefully, consumer spending) in the coming months. Consumers are also getting a bit of relief in the form of lower energy costs and declining mortgage rates.

Could outperformance be in the offing?

We're keeping our eye on the possibility of moving the consumer discretionary sector to outperform because we believe that some attractive valuations could spur buying in the coming months but, in the near term, we will retain our marketperform view. Many pressures continue to weigh on the sector: rising unemployment, tight credit standards and hindered consumer discretionary spending. More bad data could lie ahead.

We are watching the sector closely, and believe that this group could be the one to lead performance as things continue to stabilize. For the time being, we're remaining cautious.

Positive factors:

- **Consumers' cash savings** continue to expand and are now at a record level, which could provide a partial cushion against a severe consumer slowdown.
- **More than 60% of homeowners** have more than 30% equity in their homes, which could help support consumer spending despite the slowing housing market.
- **When the Consumer Price Index (CPI)** rolls over, as it certainly appears to be in the process of doing, it has been a positive sign for the discretionary sector (based on historical performance).
- **The discretionary sector** is highly negatively correlated with the price of oil. If the price of crude continues its downward trend, this could be helpful.
- **Marginal tax rate cuts** have traditionally helped retailers start to outperform, which could benefit the group if the new Administration makes that part of the stimulus package.
- **Mortgage rates** have declined, which could aid homeowners and put more money in consumers' pockets.

Negative factors:

- **Consumer spending (excluding energy and interest payments)** is near the bottom of its historical range, which coincides with a climb in interest- and energy-related spending to the highest levels since 1980.
- **Margins in the retail space** appear to be at risk as inventories creep higher, expenses continue to rise and pricing power at the consumer level continues to be lackluster.
- **The unemployment rate** continues to move higher, which could inspire even those with jobs to be more cautious about their spending.
- **Real retail sales growth** is now in negative territory, which could hurt margins as prices are dropped in an effort to drive traffic.
- **Savings rates in the United States** are starting to increase, which, if sustained, would result in lower spending by the American consumer.
- **The percentage of banks tightening standards** for mortgages, according to the Federal Reserve's Senior Loan Officer Survey, continues to move higher. Also, banks are tightening standards for installment loans, which tend to correlate with lower retail sales.
- **The credit card** delinquency rate continues to move higher.
- **Revolving credit limits** are being reduced, potentially squeezing consumers' ability to spend.
- **Delinquency rates** for prime mortgage loans continue to rise.

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Consumer staples: Underperform

The defensive characters of the consumer staples sector enabled it to benefit (on a relative basis) from the market downturn. By this point, we believe that the overall move toward this group has run its course, and we're increasingly concerned about valuations.

As a result, we are downgrading our outlook on the staples group to underperform as part of our continued modest shift toward a more cyclical outlook. For now, the primary reasons for our underperformance view on consumer staples are increasing global competition; lack of pricing power; and concerning valuations.

Although the staples group has held up better than most during this time of consumer belt-tightening, companies in the sector are susceptible to economic pressures like everyone else. As global competition heats up, we believe margins will continue to be compressed. While companies compete for the increasingly scarce spending power of consumers, the resulting price wars (and decreased profit margins) would likely escalate.

Positive factors:

- **The packaged food industry** has the potential to lend support to the sector as industrial production in the space has moved higher, capacity utilization has moved to the highest levels of the decade and personal spending growth on food is high.
- **Growth in staples sales** is far outpacing discretionary sales.
- **The recent correction** in food commodity prices could help to support margins in the packaged food group.
- **Defensive sectors (such as staples)** have tended to perform well when homebuilders' expectations fall.

Negative factors:

- **Competition continues to accelerate** and is exacerbated by the increasing emergence of Chinese production, potentially causing pricing power in the group to evaporate, compressing margins and squeezing earnings.
- **Improving U.S. economic growth prospects**, helped along by recent government action, would likely undermine performance for this traditionally defensive group. The massive stimulus being injected into economies around the world could contribute to this.
- **Valuations in some of the group** are getting to levels that have resulted in pullbacks in the past.

Energy: Marketperform

The energy sector has largely traded in-line with the price of oil, so our view on the commodity is crucial to our outlook. Oil trading continues to be volatile, with prices again pulling back recently. It appears to us that we are in the process of trying to find a floor in the price of oil which would, of course, affect the future performance of the energy sector. OPEC is cutting production in order to defend the price while governments around the world are attempting to stimulate economic growth through massive infusions of cash and substantial rate cuts.

These measures and the already precipitous decline we've seen lead us to believe we may be near a bottom, and we continue to believe that the group will stabilize and perform in-line with the market in the near term.

The oil bubble popped, but when it corrects, will it overcorrect, as is so often the case? We may be seeing that overshoot as oil dips below \$40/barrel, but we aren't convinced as of yet. A few weeks ago, we noted that the weakening of the dollar and news that OPEC would likely curtail oil production could help trigger a short-term rally. Although we got one, it wasn't sustainable.

While we maintain our marketperform view in the near term, we now monitoring situations that could result in the sector outperforming. Longer-term, we have a more positive outlook for the energy sector. Developing countries will continue to demand more fuel and, once economies around the world start to recover, we believe that will shore up demand again. We will continue to monitor demand growth rates and economic developments around the world in an attempt to foresee future moves.

Positive factors:

- **The International Energy Administration** warned that exploration and production investment has not been growing nearly enough to keep pace with growing demand.
- **Global uncertainties** could threaten some supplies, exacerbating an already-concerning situation.
- **Demand for oil has risen 33%** during the past 20 years while refining capacity has increased by 15%.
- **Chinese banking officials** are now implementing expansionary policies, which should help to stem the decelerating growth in the country.
- **China's government** recently announced a fiscal stimulus package that may help to boost demand.
- **Stability or renewed weakness** in the dollar would likely aid in supporting the price of oil, helping boost the outlook for the energy sector.

Negative factors:

- **Supplies** could increase dramatically with a renewed commitment to exploration and technological improvements. Should oil companies step up efforts to access those supplies, upward pricing pressures could dwindle.
- **U.S. consumption** of refined product is now declining.
- **Refining margin growth** is now approaching negative territory while light truck sales are falling, which could further dampen demand for refined product.
- **U.S. vehicle miles traveled** are now declining year over year while Chinese auto sales growth rates appear to have peaked for the time being.
- **The leading index in China** has dropped dramatically, which could pressure demand for commodities—including oil.
- **Iraqi oil production** is now back at prewar levels and Iraqis are seeking foreign investments into the development of the oil infrastructure, which could continue to boost the amount of oil coming from the country.
- **Reserve replacement costs** have surged recently, which could result in a squeezing of margins in the energy space.

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Financials: Marketperform

Government and central banking officials continue to throw massive amounts of money at the financial crisis, but we're not out of the woods yet. Financials have now taken strong hold of the worst performing sector of the year after a terrible couple of weeks that saw continued write-downs and warnings, disappointing investors who had hoped the massive stimulus efforts would start to bear fruit.

In spite of these efforts, financial companies are still beaten down. They're still dealing with deteriorating balance sheets while simultaneously restricting access to credit, which will likely dampen incoming revenue streams for the foreseeable future.

We see some signs of improvement, and the extreme fear in the financial sector has eased slightly. There's no doubt that the sector has been beaten up, resulting in what will likely turn out to be some excellent buying opportunities. But is outperformance poised to begin?

It might still be a bit too early to jump in with both feet. The government's unprecedented actions to try to stabilize the financials sector are but one piece of the puzzle that needs to come together before outperformance can begin. We would love to time the exact bottom in financials, but no one has that ability.

We continue to want to see how the new administration's stimulus plans develop and note that sentiment toward the efforts has improved modestly as of late. Even still, some investors seem to be expressing more doubt about the ability of the government to effectively implement its programs. Remember that the housing crisis is at the heart of the problems in financials, and that situation is just now starting to be directly addressed.

No doubt recent actions by both the government and the Fed have already started to at least partially stabilize the market, resulting in us feeling relatively comfortable with the marketperform rating on the sector. We will continue to watch the situation as more details unfold, and are looking for an opportunity to upgrade the group depending on the evolution of coming events.

Positive factors:

- **Employment in the financials sector** continues to fall, which has the potential to be good news for margins in the space.
- **The financials sector** has traditionally rebounded quite well from financial crises in the past.
- **The government's and the Fed's recent actions** show they are both willing to go to extremes to try to put a floor in under financials.

Negative factors:

- **Revolving home equity loans** are declining, which has typically been a bad sign for bank profits and stock performance.
- **Delinquency rates** for all consumer loans have spiked recently, which could negatively affect consumer finance companies.
- **Bank stocks** have traditionally underperformed the overall market during periods of declining growth in existing home sales.
- **New regulations** have severely restricted the ability of lenders to offer "exotic" mortgages, cutting back on the volume of business they can do.
- **Lending standards continue to tighten**, which could affect profitability in the near term.
- **Although improved after government action**, confidence in the financials sector remains fragile. Concerns over the continuing dismal housing market—combined with slowing economies, the election and likely increased regulation—continue to hover over the group.
- **Uncertainty as to how massive government intervention** will affect the financial industry going forward could hold performance back for the foreseeable future.

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Health care: Outperform

Although we are pulling back on the defensive consumer staples group this week, we are sticking with our outperform recommendation for health care. One reason for our positive outlook in contrast to staples is the vastly different valuation levels for the two, and health care valuations are attractive to us.

The health care sector is trading water but has performed relatively well so far this year. We continue to believe that this is just the start of what may be a period of sustained outperformance for the group. Importantly, its defensive characteristics are not the only factors that we believe will lead to outperformance.

We're on the bullish side for several reasons. Relatively low valuations likely limit the downside risk. Solid dividend yields and increased merger-and-acquisition activity (which has spiked in the pharmaceutical space as of late) contribute to the upside potential. Additionally, balance sheets in the group are relatively solid, with large cash balances, which are attractive in this tight credit environment, and enable companies in the group to maintain their dividend payments.

The presidential election largely came out as expected by the market, leading us to believe that most possible legislative concerns have already been priced into the stocks. We will continue to watch developments in Washington and respond as necessary.

Positive factors:

- **The aging population** could provide a boon for the industry as an increasing number of Americans require more extensive drug treatments and medical care.
- **Consumer spending on health insurance** as a percentage of total spending typically increases as retail sales growth falls, which has been a good sign for the managed health care group.
- **The Producer Price Index (PPI) for medical equipment and supplies** continues to move higher—indicating pricing power for the group.
- **The last time retail sales growth** slowed substantially, the medical equipment industry performed relatively well.
- **The number of drug approvals** by the FDA is now moving higher, which has led to an increase in pharmaceutical sales in the past.
- **Net profit margins** in the pharmaceutical space appear to be moving higher, which has been a sign of outperformance in the past.
- **Balance sheets in the health care sector** remain flush with cash, boosting the possibility of an increase in share-enhancing stock buybacks and increased dividend payments while also increasing the possibility of mergers and acquisitions in the space.

Negative factors:

- **Governmental regulation** could increase during the coming years as more seniors demand intervention in order to theoretically lower their out-of-pocket health-care costs. The Democratic sweep increases the chances that more governmental intervention into the health care system will occur, which could put profits at risk for the group.
- **Nominal consumer spending** on prescription drugs has been slowing.
- **Growth in consumer spending** on health insurance has been trending lower recently—potentially putting managed care shares at risk.
- **The Federal Drug Administration (FDA) has become more concerned with potential side effects** of new drugs, according to drug companies, making the approval process longer and more expensive for drug firms.

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Industrials: Marketperform

The industrials sector has performed largely in-line with the market in recent weeks, despite the continued deterioration in the global economic environment. Certainly, the group faces challenges as emerging-market demand appears to be slowing rapidly, especially in China, while the picture in the United States is also relatively poor, as indicated by continued weak readings in the ISM (Institute for Supply Management) manufacturing survey.

However, in many cases, businesses remain flush with cash. In our opinion, demand from Asia, (despite slowing from its rapid expansion phase), will remain relatively solid as countries continue to attempt to improve infrastructure that is desperately needed. In fact, recent action by the Chinese government indicates its leadership is now more interested in promoting growth than aggressively fighting inflation and, indeed, we are seeing some nascent signs that their economy may be turning up marginally.

Also, infrastructure projects are often popular targets of additional government spending as they look to prop up growth and, indeed, have been prominently mentioned by President Barack Obama's incoming administration as a possible recipient of government stimulus. We continue to watch developments and world reaction to the ongoing financial crisis as we determine the next potential move for the sector.

Positive factors:

- **Corporate balance sheets** remain relatively cash rich, which could help push management to invest in new, more efficient equipment in order to help offset higher energy costs.
- **Finished core good producer prices** have been moving higher during the past year as the sector demonstrates improving pricing power.
- **Construction and farm equipment** shares could benefit as pricing power remains relatively healthy while wage growth in the space has slowed considerably.
- **Lower energy prices** could help to support profits and year-over-year earnings comparisons.

Negative factors:

- **Business spending** continues to be restrained as executives remain relatively cautious, opting for share repurchases and increased dividend payments as opposed to capital expenditures.
- **Medium and heavy truck sales** have weakened, which could be a sign of increased caution in business capital expenditures (capex).
- **Transportation producer prices** are now growing at a negative rate.
- **Various measures** show capex throughout various industries continue to deteriorate.
- **Producer price growth** in the aerospace product and parts arena has been slowing.
- **Inventories** in the aerospace and defense space are growing.
- **Tightening lending standards** are likely to hurt the expansion of capex.

Information technology: Outperform

The tech sector has typically led the market off the bottoms reached during previous sell-offs. We believe that could be the case again and have seen signs that the market is attempting to establish a firm bottom. As a result, we believe that the group will return to outperformance during the next several months.

We believe that if businesses are going to invest in any capex, it's likely to be tech. These investments are typically attractive because they tend to increase the efficiency and productivity of companies seeking to squeeze every dollar possible out of each worker. There will, however, likely be some more bumpiness in the market in general as we've seen, and in the tech sector specifically, but we believe the general trend going forward will be outperformance.

What's the reasoning behind our modestly bullish view? Technology companies continue to have good cash balances and solid balance sheets which are especially attractive characteristics in this tight credit environment. The recent decline in the dollar should help to boost earnings in the current quarter because a large percentage of revenue in the tech sector comes from foreign sources.

We will continue to watch developments in the sector closely. For now, the potential for outperformance outweighs the risks.

Positive factors:

- **Typically, as overall profit margins have declined** following a run-up, (as we've seen recently), business investment in technology as a percentage of total spending has increased.
- **Productivity growth** has slowed, which has typically led to increased investment in software.
- **Increasing money supply growth**, as we are now seeing, has tended to lead to semiconductor outperformance.
- **Growth in business investment in technology** is now outpacing the growth in total business investment.

Negative factors:

- **Increasing global competition**, especially in low labor-cost environments, will likely continue to compress profit margins.
- **Business confidence** has been falling as of late, which has been an indicator of weaker growth in equipment and software expenditures in the past.
- **New orders** for communications equipment are now falling while production appears to be lagging.
- **New orders for computers** are declining while Taiwan's inventories are rising, potentially putting further pressure on prices.
- **There are signs that companies** are continuing to be reluctant to increase capital spending.
- **Tightening lending standards** have tended to lead to slower growth in equipment and software expenditures.

Materials: Marketperform

The recent pullback in the materials sector, and in the overall market, provides us with the opportunity we have been looking for to upgrade the sector to marketperform from underperform. This move continues our recent shift to an incrementally more cyclical outlook.

The reflationary policies currently being put into place by governments around the world will begin to take hold, and create a monetary environment that increasingly benefits more cyclical areas of the economy like the materials sector.

Although we recognize that economic data will likely remain dour for the foreseeable future, we appear to be well into the downturn in the economy and, specifically, the materials sector. We believe we are nearing a time of at least stabilization, if not some outperformance resulting from oversold conditions and attractive valuations.

We will continue to watch economic and fiscal events unfold and will adjust our outlook rapidly should it be warranted.

Positive factors:

- **A renewed fall in the dollar** could help specific, international-intensive industries gain market share and expand margins.
- **Recent action by the Chinese government** indicates that it is now more interested in promoting growth than aggressively fighting inflation.
- **Global government stimulus** is reflationary in nature, which could help the materials sector's performance.
- **Lower energy prices** should help to support margins in the energy-use intensive materials group.
- **The Baltic Index**, after a dramatic decline, has started to rebound, which could be a sign of some solidifying demand around the globe.

Negative factors:

- **Chinese demand** for processed commodities may be slowing as technological advances and a buildout of production facilities allow the country to produce more of its own materials. China recently transitioned from a net importer of steel to a net exporter.
- **Chemical shipments** have had a relatively close correlation with house and auto sales, which, given the recent trend in both, doesn't necessarily bode well for the space.
- **Railcar shipments** of chemical products have fallen off sharply and inventories are climbing.
- **Aluminum production** in China is increasing relatively rapidly, which could put pressure on prices as new supply comes online.
- **Previous slowdowns in housing** have led to inventory builds in copper and, in fact, we've seen prices for copper fall sharply as of late.

Telecommunications: Underperform

The telecommunications sector has retreated from the slight strength we saw in the beginning of December, much as we predicted it would, and we continue to believe that the group will continue to underperform. First, we believe that the sector's stature as a defensive stalwart is no longer as applicable as it has been in the past, as the group has transitioned from the regulated fixed-line business to the more consumer-dependent wireless arena.

As consumers try to save money, telecom upgrades are something they could forego. As such, the telecom sector could feel more pain.

Traditionally, this sector has performed relatively poorly following the end of a rate-cutting cycle while also struggling during periods of high credit spreads—much as we have recently experienced. Additionally, there continues to be intense competition and relatively high costs as firms in the group battle both each other and cable companies for the communications and home entertainment dollars of the American and global consumers.

As a result of these concerns and despite the group being seen in the past as a defensive play, we continue to believe underperformance is the most likely path.

Positive factors:

- **Wireless demand** appears to be increasing as more communication and media devices move to the wireless arena.

Negative factors:

- **Consumer spending** on telecom versus total spending is now falling, which has typically coincided with underperformance for the sector.
- **Business confidence** has been falling, which has typically led to a fall in telecom service sales.
- **New cell phone purchases** have fallen as the economy has struggled.
- **Average weekly hours worked** are now falling, which has typically been an indicator of negative earnings revisions.
- **Net profit margins** are declining for the telecom sector as competition squeezes margins.
- **Growth in consumer spending** on telecom versus total spending is now falling sharply, which has typically coincided with underperformance for the sector.
- **Telephone services CPI** has moved lower, contrasting with an upward move in cable TV CPI.

Utilities: Marketperform

With the defensive characteristics of the group balanced with valuation and cost concerns, we believe the sector will perform roughly in-line with the market in the near future.

Although the utilities sector has had some periods of outperformance, the sector appears unable to gain any real traction as concerns build that the group may have trouble recouping its increased expenses due to higher energy costs—at least in the near term as rate increases tend to lag actual economic events. We also continue to be concerned that valuations based on the dividend payout ratio remain relatively high and believe that could temper some of the enthusiasm that might otherwise be generated in this turbulent environment.

Positive factors:

- **Dividend-paying** stocks remain attractive as long as yields on fixed income products remain relatively low. Should economic growth slow further than currently expected, defensive, dividend-paying issues could become more attractive.

Negative factors:

- **Utilization rates** of electric and gas utilities have moved down modestly while production has spiked—indicating a potential oversupply issue that could pressure margins.
- **A continued slowdown** in housing could have a negative impact on electricity production.
- **Producer prices** for utilities have fallen sharply lately while CEO confidence remains tentative.
- **Capacity growth** in utilities has been rising, which has been a sign of underperformance of the sector in the past.
- **The dividend yield** of the utilities sector is well below its three-year normal level, and the price-to-dividend ratio is near a record high.
- **The highly regulated utilities** could experience a lag in the ability to pass on increased costs to consumers, which could threaten profit margins.
- **Some politicians are suggesting** raising the tax rate on dividends, which could scar the attractiveness of this high-yielding group.

Important Disclosures

About Schwab Sector Views

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Explanation of columns in chart:

The benchmark weights are provided for reference and represent each sector's market capitalization weight in its index.

Schwab's current recommended deviation from the benchmark represents our current view on each particular sector. All investors should be well diversified across all sectors, however investors that want to tactically over- or under-weight particular sectors may want to consider over- or under-weighting up to the amounts reflected in this column. The percentage over- and under-weights refer only to the domestic equity portion of investors' portfolios.

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