



Holland Views: Schwab Inc. – Price: \$49; MCap: \$91bn

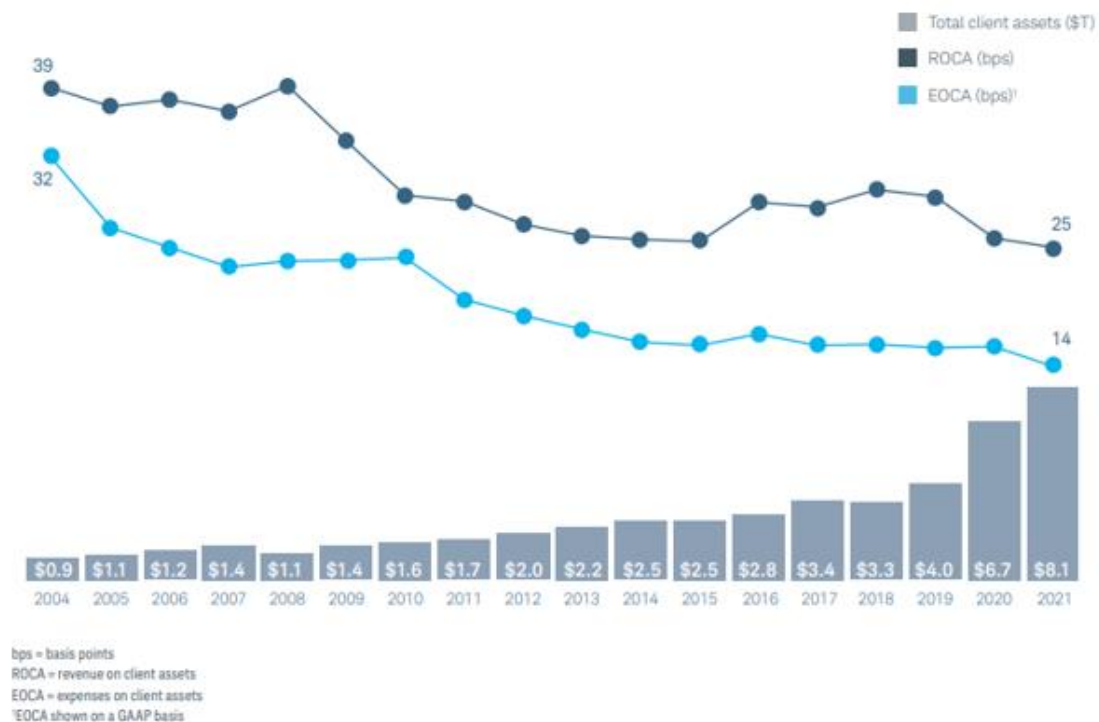
## Stormy weather

With your author first starting work in Equities in 1987 he has seen a few crises, banking and other, come and go. Along the way you learn a little (even a lot). During this Spring period that saw the collapse of SVB and the knock-on consequences, we were closely following the fortunes of Schwab. We were however aware that events can unfold fast and that in such periods it can take a while for the dust to settle enabling investors to see longer term consequences clearly. That is where we think we now are with Schwab. As such we share a few reflections. Clearly, they are events (SVB/First Republic) and reasons (higher interest rates and deposit flight) that brought us to this moment. We write assuming readers are fully aware of these.

### What we knew and what we missed

The work Holland have done to explain the Schwab business model over time we are proud of. Our suggestion that the company is the Amazon of finance is something we firmly stand behind. That comparison references Schwab’s commitment to both super low unit-costs and high customer service. This combination being what drives consistent future customer assets towards it, thus fueling further growth. It is arguably the only financial services company using the Scale Economy Shared (SES) model. Today Schwab’s total revenue as a percentage of customers \$7.6tn of assets is only 0.26%. Costs are only 0.16%. **Schwab is huge, efficient, and profitable.** As a tough, low-cost competitor however not all want to see it prosper..!

Fig.1: **The Moat** – Revenue and expense as a percentage of client assets, 2004-2021



### Banking background

We also observed in our work that despite Schwab's powerful investor platform, it is structured as a bank with all the capital needs and regulations that accompany that fact. This complexity of an asset light, SES platform and asset heavy bank we thought could offer potential to investors that bothered to understand it. We still think that to be true.

Having spent time looking at Schwab's accounts we also knew its balance sheet to be very safely invested (i.e. almost all in treasury securities). Thus we knew it had little or no credit risk in the bank.

What we missed was two factors that became evident in the last two months:

1. That whilst the company had little credit risk it had arguably (through its actions and market movements) assumed quite a bit of interest rate risk by owning long duration bonds as interest rates rose
2. That a good portion of its long bond portfolio was held in a Hold to Maturity (HTM) classification, meaning mark to market losses were not being taken to balance sheet capital.
  - As a category 3, not category 2 bank regulations were favourable on AOCI

This not 'marking to market' is perfectly legal and allowed (currently) by regulators of mid-size (Cat 3) banks. The long duration treasury security assets it owns will mature at par meaning such losses are temporary and will reverse in time as they mature. What has caused problems at other banks recently is where depositors leave, and such assets then need to be sold. The result is temporary losses become permanent.

### Updating our Schwab views

As recent weeks have unfolded, so has our thinking on Schwab – in light of new news and further reflections. Summarising these changes in our view however are not easy with much occurring at so many lines of both the company P & L and Balance Sheet. By chance, the other day we stumbled across an excellent investor letter from David Pope. He as a fellow Schwab shareholder summarised his thinking on it last week. Helpfully for us, his articulation perfectly summarises our evolved thinking on the company. We agree 100% with Mr Pope assessment in three areas:

- The power of the underlying Schwab model – which we think still intact.
- The shortcomings of how c.50% of its income is derived from banking income and all the volatility and regulatory complexity that brings.
- Thirdly on how Schwab might be better to charge its platform clients just a small fee to align its income more with its \$7trillion of client hosted platform assets rather than its c.\$300bn deposit base.
  - Indeed, on last weeks' investor call we submitted a question (which sadly was not called) on exactly that subject – i.e. *“is management in light of SVB looking at any pivots in its business model to better align its income with the platform it offers customers so as to rely less on banking income and the capital and regulatory complexities that accompany it?”*

### Schwab – The perfect summary: Extract from David Pope letter

I sometimes describe Schwab as the Costco of financial services. Others liken it to the auto insurer Progressive: it has the lowest operating costs in a huge, commoditized industry. Schwab passes on most of the savings from its low cost structure to clients, creating loyalty and trust, which in turn builds its brand. But Schwab has, over many years, reduced fees in so many areas that today it may be overly dependent on the net interest margin it earns on cash swept into its bank.

This has been intentional. Schwab management says investors pay very close attention to trading commissions and do not like paying them, even though they are not the most meaningful indicator of overall value delivered by a brokerage. Customers are less sensitive to the interest rate paid on the idle cash in their brokerage accounts. Schwab has opted for a model where it sweeps idle brokerage deposits into its bank and invests them, mostly in very safe instruments such as US Treasuries.

In the decade of rock bottom interest rates, clients didn't really care about this. And competitively, this model helps Schwab versus rivals because it has more client cash on hand to invest. In particular, when Schwab took most trading commissions to zero a few years ago, TD Ameritrade opted to sell to Schwab rather than try to compete with it.

However, this is an imperfect model. First, it depends on customers not paying close attention to their cash. Second, it means Schwab's earnings growth is only partly reliant on its operational excellence. Costco carries a very high valuation at all times because while it arguably underearns (Costco's prices are lower than they need to be to represent great value) its earnings are always 100% driven by improving member loyalty and spending. Schwab's earnings, by contrast, depend on the vagaries of interest rate spreads.

Schwab Bank ended 2022 with \$360 billion in deposits, on which it earned \$10.6 billion more in interest than it paid to depositors – half its total revenue. Schwab custodies roughly \$7.5 trillion for clients, a huge number, but it earns half its revenue from the 5% or so of their accounts held in cash.

Bank deposits have been declining for Schwab recently, which has been partially offset by higher interest rate spreads. If bank deposits plunged, Schwab's earnings would suffer and it might possibly be in a similar situation to First Republic, where it would have to sell long-term, low-yielding bonds it bought as investments to repay departing bank depositors. Schwab would then crystallize losses on bonds that would otherwise just generate low yields until they mature. This is an unlikely scenario, but not totally implausible. The stock reflects anxiety about this possibility.

This is frustrating because Schwab remains an exceptional asset gathering machine. During the banking panic in March, Schwab attracted some \$53 billion in new assets from investors. In a crisis, money flowed into Schwab, not away from it. However, that money is not flowing into bank deposits and it may be some time before Schwab actually shows earnings growth commensurate with asset growth.

I believe Schwab would be better off charging clients a bit more for the services it provides them and reducing its dependence on interest rate spreads. That might mean charging more for some kinds of trading, mutual fund distribution, wealth management products or even charging modest administrative fees to investment advisors. The current system of relying on interest rate spreads would be as if Costco's main earnings driver wasn't growing membership fees and retail sales but benefiting from volatility in food prices.

Schwab counters that clients prefer this economic system. By keeping other charges low, it grows rapidly while still earning high returns on capital. Schwab accepts that while earnings will wobble from time to time with interest rates, so long as it grows brokerage accounts and assets consistently, eventually earnings will follow. Over many years, clients have tended to keep at least 5% of their accounts in cash. So long as that remains true in the future, Schwab will be fine.

**Source: Giverny Capital Asset Management Investor Letter, Q1 2023**

### What happens next....?

We repeat that we think this above summary of Schwab an excellent update and we agree with every word. The only addition we might make is the regulatory changes that we suspect are coming down the track. Regulators we note, almost always address the problem of the last crisis in future oversight changes.

Thus it is quite likely that the current \$250,000 FDIC deposit protection will likely be officially raised sometime soon. Post SVB/First Republic that might be implicit, but all can see that making it explicit will likely improve system deposit stability. With already c.85% of Schwab deposits being below the current \$250k level a further rise will likely take the deposit flight risk off the table for Schwab once and for all. This is good news. What might be of less good news is the regulatory price this comes at....

Whilst not directly linked to this deposit limit change and regulatory intervention over the SVB, First Republic period, we think another regulatory change likely. We suspect that some (or all) Hold to Maturity (HTM) securities on mid-sized bank balance sheets will be required to be marked to market for the calculation of regulatory capital. Maybe a distinction is made between liquid assets, i.e., market securities needing to be M2M and illiquid ones (loans) not..?. Whatever the change it will not be perfect and likely have knock on implications. Most Schwab investors now know that were such an event to occur with immediate enforcement Schwab might not have enough regulatory capital. More likely such new rules would be gradually brought in.

Indeed, Schwab spoke to this prospect on last week's investor call. They pointed out that in such a scenario by both retaining profits and gradually seeing HTM securities move to par the company would rebuild any such capital internally. Whilst our calculations suggest this is correct, as investors we need to be clear that this changes one part of the Schwab investment story we had laid out in recent years. This being that the company had gone through a heavy capital retaining period, against increased internal deposits. Now we saw it as set to offer investors not just continued growth of the customer franchise, but also near-term cash returns in higher dividend or buy backs. i.e., it would soon offer growth and capital return, not just growth that required capital retention.

Potential or Schwab investors should look closely at the recent financial release and listen to the management call that accompanied it. Whilst we share some of managements' frustrations, we think some humility on their part would not go amiss. It should be acknowledged that some unintentional fragility was built into the Schwab model by using the bank structure and having a longer dated HTM portfolio.

### Complexity squared

That the Schwab model is seen as largely free by clients is a compelling customer offering. c.50% of its revenue is earned on c.5% of customers assets that sit in transactional cash. The disconnect between Schwab's customer offering (simple low-cost platform) and business model (complex assets heavy bank) we have known for some time. That 50% of the revenue of the company is derived from c.5% of customer assets (i.e., bank deposits) is not ideal in hindsight. During this last quarter the company saw its total assets rise, as its huge investment platform was seen as a safe port in the storm. At the same time customer cash deposits reduced c.\$100bn from the prior year. Whilst the former is impressive, the fact of the matter remains that the company's earns its income on the latter balance. This contradiction and complexity we understood, and we even admired the invisible way that customer paid Schwab without noticing (i.e. the interest earned on small amounts of idle cash).

However reflecting on all of this today a number of points are worth making:

1. When each of the lines in the below table are stable then investors can look at the outputs. Seeing as a result NIM rising or falling in a slow way mirroring market interest rates
  - a. With rates having been super depressed for years a normalisation to a higher NIM was/is now likely
2. However, with \$2.77bn (c.50% of the company's revenue) being derived from small changes in multiple line drivers of many assets and their cost, things become far more complicated:
  - a. Will deposits balances that have already fallen \$100bn, drop further?
  - b. Will the company have to borrow more at more expensive rates from facilities like FHLB at 5.0%
  - c. Will market movements impact Available for Sales security values?
  - d. Will HTM security losses gradually erode as they mature or be crystallised if the company were forced to sell them?

Sadly, Schwab investors are now forced to have opinions on all these factors, when in truth what they are just wanting to invest is the scale economy platform that is offered to Schwab clients. Again, we state that whilst Schwab management might feel under pressure currently, they have to accept that they created this structure. Just as this structure has accrued benefits (low costs and M+A strength) to management and shareholders. If it creates complexity, volatility and even dilution, the structuring of the company in this way was managements responsibility.

Fig.2. Net Interest Revenue – Now so many moving parts

**THE CHARLES SCHWAB CORPORATION**  
**Net Interest Revenue Information**  
(In millions, except ratios or as noted)  
(Unaudited)

	Three Months Ended March 31,					
	2023			2022		
	Average Balance	Interest Revenue/ Expense	Average Yield/ Rate	Average Balance	Interest Revenue/ Expense	Average Yield/ Rate
<b>Interest-earning assets</b>						
Cash and cash equivalents	\$ 37,056	\$ 413	4.46%	\$ 72,465	\$ 34	0.19%
Cash and investments segregated	40,068	432	4.31%	51,913	15	0.11%
Receivables from brokerage clients	60,543	1,084	7.16%	84,204	626	2.97%
Available for sale securities <sup>(1,2)</sup>	155,791	825	2.12%	284,526	947	1.33%
Held to maturity securities	170,889	746	1.75%	103,416	378	1.46%
Bank loans	40,248	391	3.92%	35,852	187	2.10%
<b>Total interest-earning assets</b>	<b>504,595</b>	<b>3,891</b>	<b>3.09%</b>	<b>632,376</b>	<b>2,187</b>	<b>1.38%</b>
Securities lending revenue		112			129	
Other interest revenue		13			3	
<b>Total interest-earning assets</b>	<b>\$ 504,595</b>	<b>\$ 4,016</b>	<b>3.19%</b>	<b>\$ 632,376</b>	<b>\$ 2,319</b>	<b>1.47%</b>
<b>Funding sources</b>						
Bank deposits	\$ 343,105	\$ 618	0.73%	\$ 452,692	\$ 16	0.01%
Payables to brokerage clients	77,169	75	0.39%	105,929	2	0.01%
Other short-term borrowings <sup>(3)</sup>	6,917	86	5.05%	4,717	4	0.33%
Federal Home Loan Bank borrowings <sup>(3,4)</sup>	24,458	304	5.05%	—	—	—
Long-term debt	20,290	139	2.74%	19,864	108	2.18%
<b>Total interest-bearing liabilities</b>	<b>471,939</b>	<b>1,222</b>	<b>1.05%</b>	<b>583,202</b>	<b>130</b>	<b>0.09%</b>
Non-interest-bearing funding sources	32,656			49,174		
Securities lending expense		22			7	
Other interest expense		2			(1)	
<b>Total funding sources</b>	<b>\$ 504,595</b>	<b>\$ 1,246</b>	<b>1.00%</b>	<b>\$ 632,376</b>	<b>\$ 136</b>	<b>0.09%</b>
<b>Net interest revenue</b>		<b>\$ 2,770</b>	<b>2.19%</b>		<b>\$ 2,183</b>	<b>1.38%</b>

<sup>(1)</sup> Amounts have been calculated based on amortized cost.

<sup>(2)</sup> Beginning in the first quarter of 2023, amounts include the impact of derivative financial instruments and the related hedge accounting on our available for sale securities.

<sup>(3)</sup> Beginning in the first quarter of 2023, Federal Home Loan Bank borrowings are presented separately from other short-term borrowings. Prior period amounts have been reclassified to reflect this change.

<sup>(4)</sup> Average balance and interest expense was less than \$500 thousand in the prior period.

Source: Schwab, Q1 2023 Earnings Release, April 2023

### The near-term future

Schwab management spelt out a future on their call last week. It was one where regulators *might* ask them to bring HTM losses into capital needs. Were that to occur, they believed could build the capital needed by retaining profits and in tandem running HTM assets to maturity. Whether Mr Market would see it that way, were such a regulatory change to come we are not so sure. The company might come under pressure to raise some equity under such a scenario, even if it did not think it needed it longer term. The company also accepted that its need for more expensive funding might last another 18 months or so.

We will admit to finding this an uncomfortable period. We are aware that not all “investors” are interested in long term franchises like we are. More speculative short sellers could not necessarily force a ‘run’ on Schwab, but they might be able to force some form of equity raise considering regulatory changes above, were they to occur. If enough noise were made to keep depositors away from Schwab just for a few quarters that impacts its earning power. We have had plenty of dilution experiences over our investing lives (UK banks during 2008/9 or more latterly easyJet in 2021 and Ryman Healthcare in 2022). A such we are mindful of not dismissing such dilutive threats to intrinsic value. Management will of course dismiss such an idea; our view is to consider all eventualities.

Fig.3. Schwab’s coming earnings power

THE CHARLES SCHWAB CORPORATION							
Financial and Operating Highlights							
(Unaudited)							
(In millions, except per share amounts and as noted)	Q1-23 % change		2023				
	vs. Q1-22	vs. Q4-22	First Quarter	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
<b>Net Revenues</b>							
Net interest revenue	27%	(9)%	\$ 2,770	\$ 3,029	\$ 2,926	\$ 2,544	\$ 2,183
Asset management and administration fees	5%	7%	1,118	1,049	1,047	1,052	1,068
Trading revenue	(7)%	—	892	895	930	885	963
Bank deposit account fees	(49)%	(57)%	151	350	413	352	294
Other	13%	6%	185	174	184	260	164
Total net revenues	10%	(7)%	5,116	5,497	5,500	5,093	4,672
<b>Expenses Excluding Interest</b>							
Compensation and benefits	6%	10%	1,638	1,488	1,476	1,426	1,546
Professional services	6%	(3)%	258	266	264	258	244
Occupancy and equipment	11%	(7)%	299	320	292	294	269
Advertising and market development	(14)%	(28)%	88	123	89	105	102
Communications	1%	1%	146	144	131	169	144
Depreciation and amortization	18%	1%	177	176	167	159	150
Amortization of acquired intangible assets	(12)%	(1)%	135	136	152	154	154
Regulatory fees and assessments	22%	34%	83	62	65	67	68
Other	17%	(1)%	182	184	187	187	156
Total expenses excluding interest	6%	4%	3,006	2,899	2,823	2,819	2,833
Income before taxes on income	15%	(19)%	2,110	2,598	2,677	2,274	1,839
Taxes on income	16%	(20)%	507	630	657	481	437
<b>Net Income</b>	14%	(19)%	1,603	1,968	2,020	1,793	1,402
Preferred stock dividends and other	(44)%	(52)%	70	147	136	141	124
<b>Net Income Available to Common Stockholders</b>	20%	(16)%	\$ 1,533	\$ 1,821	\$ 1,884	\$ 1,652	\$ 1,278

Source: Schwab, Q1 2023 Earnings Release, April 2023

### As the storm passes – Earnings power grows

Just for a moment we look past the current uncertainties to normalise Schwab’s earnings power. As the current asset book rolls forward against current market interest rates it will likely result in a NIM of 3.0% a few years out. The above table also extracted from the recent financial release puts this into context. Simply put the current \$2.77bn of net interest income is derived from two depressed metrics.

- Firstly, the net interest margin at 2.19%. The 30y NIM chart in the appendix puts this figure into historical context.
  - Each reader will have a different view on the normalisation of interest rates and thus the evolution of Schwab’s medium Term NIM

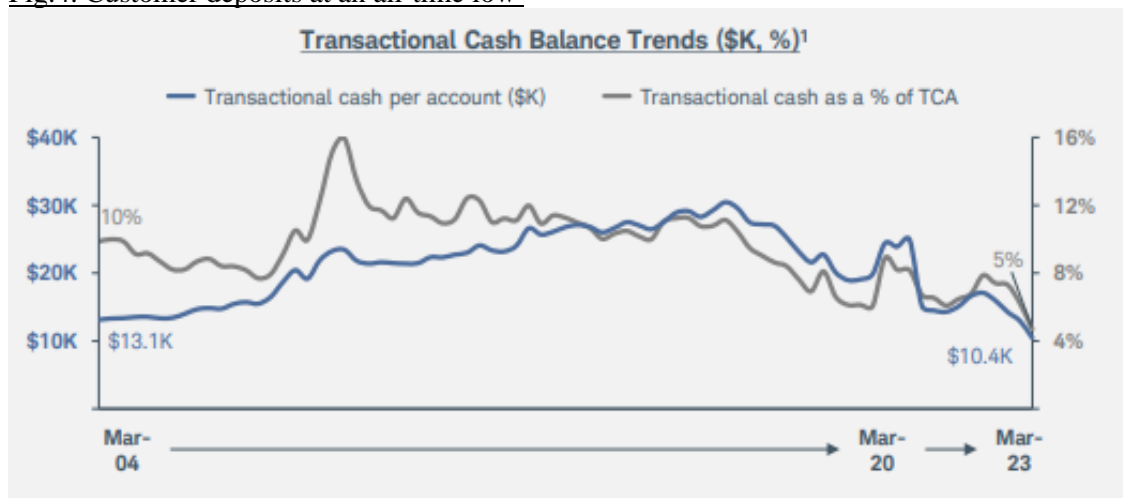
- We are in the camp that sees the scale of recent interest rate rises and how resilient the US economy has been even as they rose. As such we do not think we will revisit a ZIRP world again anytime soon
- Secondly the fact that current bank deposits as a percentage of assets are very low by historic standards due to customers actions (either due to fear or rate-shopping)

Rolling the company’s quite reasonable observation that c.2years out NIM might be 3.0%, up from todays 2.19% gives some interesting numbers:

- Assuming no growth in assets or deposits in that 2y period a NIM of 3.0% on today’s interest earning assets would result in net interest revenue rising from \$2.8bn in the current qtr. to \$3.8bn
- This extra \$1bn of revenue comes at zero extra operating cost
- Taxed at 25% this creates an extra \$750m on net income
- As such annualised net income might be \$9.1bn (\$1.53bn+0.75bn x 4), up from \$6.1bn (\$1.53bn x4)
- This compares with today’s market cap at \$49 of c. \$91bn... **So a PE of exactly 10x**
  - we reiterate that this assumes no growth in the franchise or the assets that accompany it at all

The second metric we observe as depressed above was the level of deposit balances. Table 1 shows that these have fallen from \$453bn to \$343bn in the last 12 months, but in isolation this means very little. For years this transactional cash (i.e. rump money that sits in customer accounts but not part of an allocation or investment in cash) has been monitored by Schwab. Its percentage of assets rises in periods of market uncertainty as investors hold off investing. It then falls in boom periods as investors are confident, resulting in lower cash. The below chart should be looked at in this context. Both absolute levels of customer deposit cash, and as a percentage of assets held with Schwab are at all time low levels. Assuming this storm passes and investors behaviour return to normal, most likely these balances would again rise. The NIM recalculation we make above is only done by moving the NIM rate to a look through basis on current deposit assets It does not also assume a recovery in customer cash levels that most likely would also occur as cash deposits are less forefront in customer minds. We note a small recovery in customer cash balances from 4% to c.5% might also add another strong lift in net interest income.

Fig.4. Customer deposits at an all-time low



Source: Schwab April 2023 Business update

### Uncertainty vs Risk

*“Wall Street sometimes gets confused between risk and uncertainty....  
here are few scenarios that are likely to lead to a depressed share price:  
High risk, low uncertainty  
High risk, high uncertainty  
Low risk, High uncertainty”*

**Mohnish Pabrai. The Dhandho Investor**

At Holland we spend much of our time identifying events that we think are uncertain, but not necessarily risky. Thus, we feel they offer investors opportunities. In the case of Schwab in 2023 so far, we are not prepared to suggest this is a low risk, high uncertainty event. Indeed, the nil value now accrued to the once respected First Republic Bank’s equity shareholders makes that point undebatable. What we conclude in Schwab’s case today is that the risks to this business are mostly in the short term (regulation/forced capital raise/need to retain capital). The opportunities remain in the longer term. What has always interested us about Schwab is not that its business model is powerful or better than its peers. These are true. More so it was that so few investors took the time to understand and see the model and what it offered to customers. As such we think it most likely that one day in the future Schwab will again be mispriced vs the compounding future in front of it. If near term uncertainties have by then passed the risk/return on offer might be better than today.

If no shareholder dilution event occurs at the company, then today is likely a wonderful buying opportunity to benefit from Schwab’s future compounding. However, with so much uncertainty surrounding the company’s balance sheet, earnings power, regulation, capital requirements, even business model it is easy for some of these to merge and create real risk.

We are also minded of the consistency bias we suspect will raise its head amongst Schwab management. The observation Mr Pope makes above about a pivot in Schwab’s business model to better align it with customer assets is something we agree with. However, a company under threat wants to show it is strong and has done nothing wrong. As a result, were such a model change to ever occur it might take much much longer to come to fruition than market observes might suspect.

If we sound confused, we are a little. No one said this job was easy. **We remain long term bulls of Schwab.** Its bank-backed model has thus far delivered the lumpy 15-17% IRRs vs the smooth c.10-12% ones that Buffett and Munger speak to. Such a comparison does not hold however if risks are different and real. We are finding out. This is an important period in the history of Schwab. Short term we have what could best be described as a ‘watch and wait approach’. Interconnected complexity makes this not a fat pitch...yet.

With kind regards

**Andrew**

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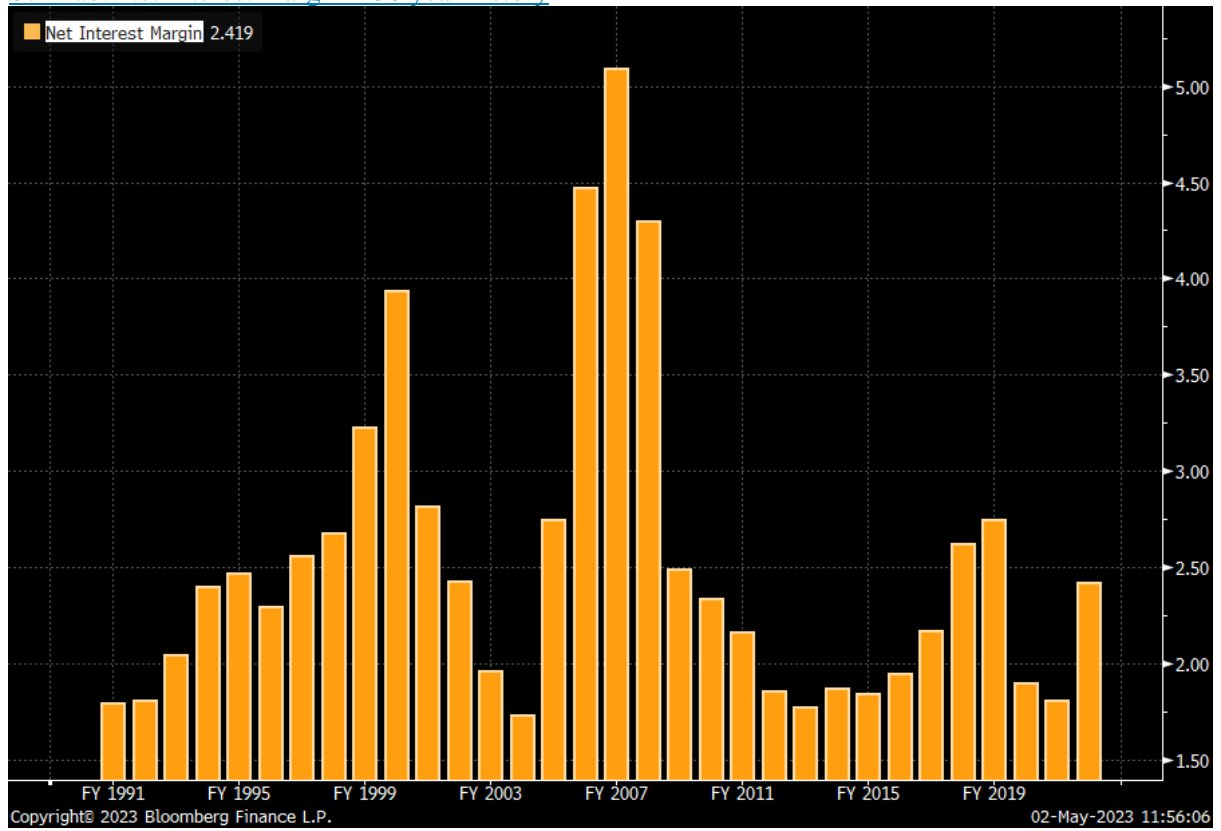
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Appendix

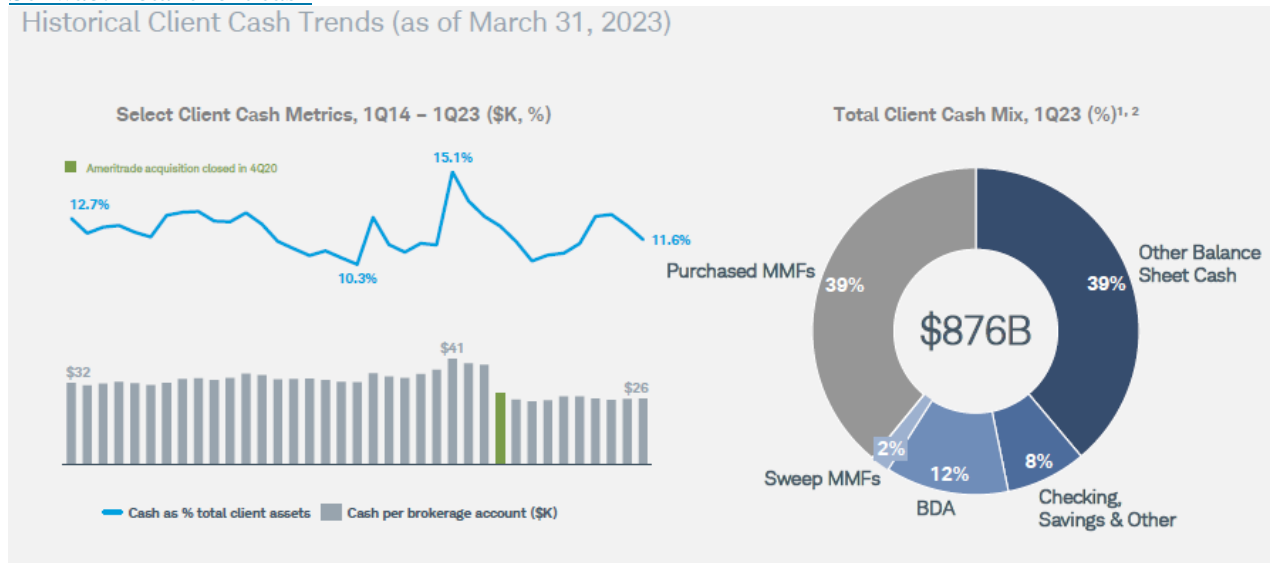
Schwab: Net interest margin – 30 year history



Source Bloomberg

Schwab: Total client cash

Historical Client Cash Trends (as of March 31, 2023)



Source: Spring 2023 Investor Presentation

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