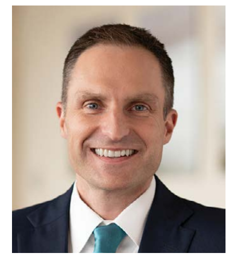
Inflation Up and Equities Down

Navigating market volatility and staying invested with target date funds



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Investors and 401(k) plan participants have faced tests to their resilience over the past 15 years seeing retirement account balances fluctuate wildly with the global financial crisis, European debt crisis, and early phases of the COVID-19 pandemic. Yet, economic conditions today and market volatility are unlike anything we have seen in the last 40 years. Higher inflation, lingering COVID-19 related shutdowns/shortages, and war in Ukraine are the triple threat disrupting markets and forcing the Federal Reserve's hand on interest rates. In response, both equity and fixed income indices have fallen sharply in 2022, leaving few places to hide amid the volatility. These conditions tend to make investors nervous and may influence behavioral reactions to take action to avoid further losses. Loss aversion is a well-known and natural emotional response created by lingering uncertainty, yet the adage of staying the course is as true today as ever before. Staying focused on long-term investment goals and existing plans is often the best way to avoid greater disruption to investment outcomes. Time in the market is more important than timing the market, as missing just a handful of top performing days in the market can significantly impact one's long-term returns.

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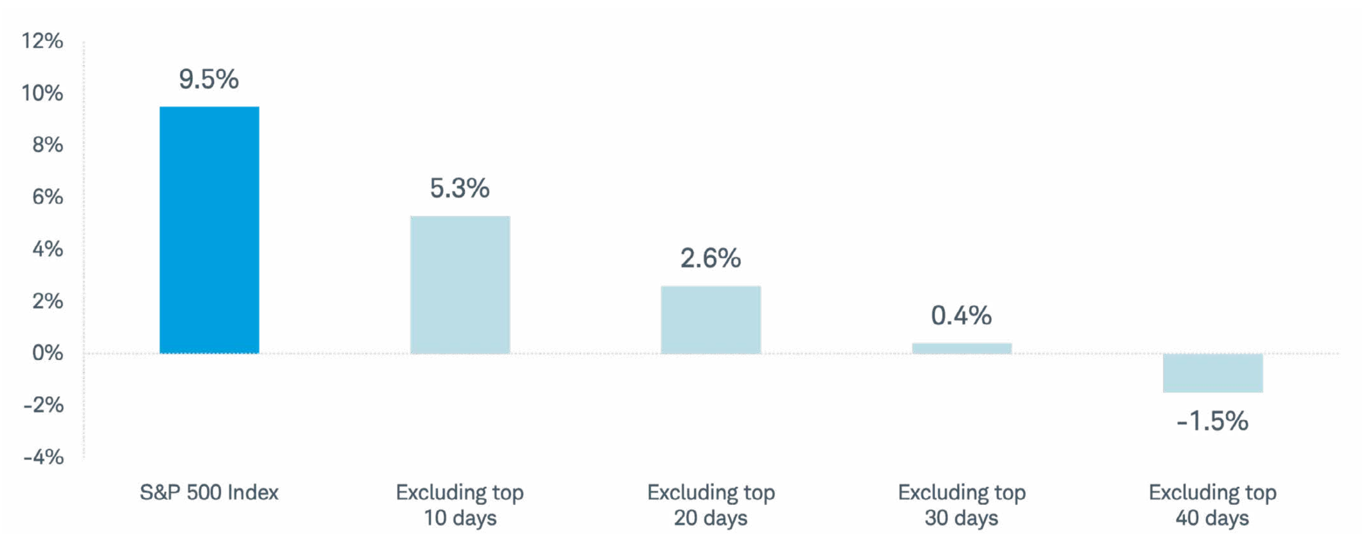
Index annualized total return (2002-2021)



Source: Schwab Center for Financial Research with data provided by Standard and Poor's. Return data is annualized based on an average of 252 trading days within a calendar year. The year begins on the first trading day in January and ends on the last trading day of December, and daily total returns were used. Returns assume reinvestment of dividends. When out of the market, cash is not invested. Market returns are represented by the S&P 500® Index which represents an index of widely traded stocks. Top days are defined as the best performing days of the S&P 500 during the twenty-year period. Indices are unmanaged, do not incur fees or expenses, and cannot be invested in directly. For more information, please see Schwab.com/Index Definitions. **Past performance is no guarantee of future results**.

Designed to help investors navigate periods of market turbulence

Schwab Asset Management and Schwab Trust Bank design their target date funds to help investors navigate volatility and stay on course through a variety of potential market environments. Investment professionals follow a rigorous annual investment process designed to adapt to changing conditions yet remain strategically anchored to long-term investment outcomes. We aim to align portfolio risk in our target date funds with investors' capacity for risk as they progress through different life phases heading into and through retirement. Younger investors with longer time horizons and lower account balances generally have greater capacity for risk given the potential to steadily invest money on a regular basis (dollar-cost average) and a longer window of opportunity to recover losses over time. Disciplined savings during periods of volatility may lead to better outcomes over the long run as investors may be able to buy more shares at lower prices. However, investors closer to, or in retirement typically have lower capacity for risk. Shorter time horizons and higher account balances create a higher risk of disruption to investment outcomes. To help guard against this disruption, we adjust the composition of asset classes in our target date funds to help reduce risk and the potential impact from down markets as an investor approaches retirement. For example, not only do we reduce the overall amount of equity in the portfolio as retirement nears, we also select traditionally less risky asset classes such as U.S. large cap, over equities that tend to be more volatile such as international emerging markets.

Adjusting to an environment of rising interest rates and elevated inflation

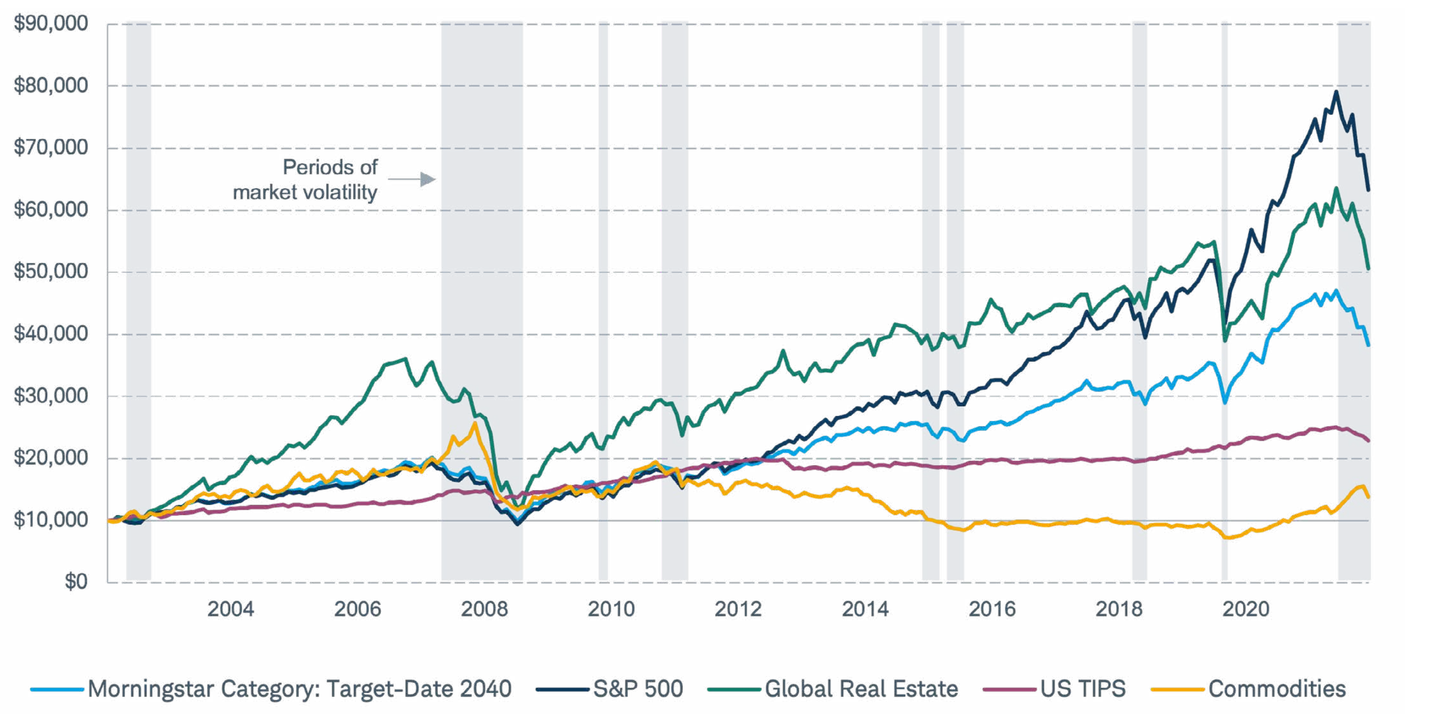
Earlier this year, we updated the overall fixed income asset allocation in our target date funds to help reduce interest rate risk. Additionally, we increased exposure to Real Estate (REITs) an asset class we believe to be responsive to inflation. Allocations to REITs were increased from 5% to 7% of total equities, given the asset class ties to physical buildings with rental income and its relatively low correlation to traditional equities. This dedicated exposure in Schwab Target Date Funds[1] offers unique diversification given that rental income originates from many types of commercial real estate properties such as lodging/resorts, office, health care, retail, and data centers. As inflation may impact parts of the economy differently, this diversified exposure helps to mitigate inflation risks.

The team also reduced allocations to fixed income securities given low interest rates in late 2021 and prospects for higher interest rates in 2022. While core fixed income allocations fell, allocations to Treasury Inflation-Protected Securities (TIPS) remained steady and became a larger portion of fixed income exposure for investors preparing for or in retirement. TIPS offer unique inflation protection for investors because the principal value is adjusted periodically in accordance with the rise and fall in the inflation rate. At maturity, TIPS may return the adjusted principal or the original principal, whichever is greater.

What about other inflation sensitive assets? Some may point to commodities as an asset class showing strong returns amid the high inflation of 2022 and inquire about the potential benefits of including commodities within a portfolio. However, despite shorter-term positive returns in 2021 and 2022, our research indicates that longer-term investments in commodities tend to come with high volatility and limited upside return potential. During much of the 2010s, commodity investments experienced significantly lower returns than traditional equities, as supply and demand were mostly balanced. In addition, rapidly evolving technologies on both the production side and consumption side create uncertainty about the long-term ability to produce sustained positive returns for the asset class.

1. Schwab Target Date Funds include Schwab Managed Retirement Trusts (SMRT) and Schwab Index Retirement Trusts (SIRT), collective trust funds maintained by Charles Schwab Trust Bank (CSTB), and Schwab Target Funds and Schwab Target Index Funds, mutual fund managed by Schwab Asset Management.

Cumulative growth of a hypothetical $10,000 investment



Past performance is no guarantee of future results. Investment return and principal value will fluctuate, and shares/units, when redeemed, may be worth more or less than original cost. Performance is net of fees. Asset classes are represented by the following indices: S&P 500 Index (S&P 500), FTSE EPRA Nareit Developed Index (Global Real Estate), Bloomberg US Treasury US TIPS Index (US TIPS), and Bloomberg Commodity Index (Commodities).

Source: Morningstar, Inc.

Designed to balance growth and value investment styles as markets shift over time

Our portfolio construction also aims to balance investments across equity investment styles, such as growth and value. Too much emphasis on one investment style increases the risk of poor investment performance when that cycle is out of favor. Prior to 2022, growth stocks were all the rage. Technology companies and e-commerce companies saw strong revenue and profit growth as people stayed at home during the pandemic. Yet consumer behavior changed quickly as people returned to pre-pandemic lifestyles. Many companies with high growth expectations saw dramatic selloffs in late-2021 and 2022 as concerns about rising interest rates and slowing economic growth led to doubts about future profits. Portfolios with too much of a style-bias toward growth stocks became vulnerable as value-oriented stocks outperformed. In building our target date funds, we believe a balanced approach to investment styles will drive more consistent results over time.

Take a thoughtful approach in assessing expenses and time horizon to retirement

One of the most important considerations for investors and 401(k) plan participants during this time is to be thoughtful about one's time horizon to retirement. Target date funds are designed to reduce risk as time horizons shorten and financial assets increase. Choosing a retirement date is a critical decision that can impact the sustainability of living off one's investments throughout retirement. Shifting from saving to spending in retirement is an important transition, and longer periods of retirement spending may decrease an investor's chances of success in covering expenses during this phase. Investors should focus on what they directly control and understand and estimate which expenses are essential and which are discretionary, to determine how much flexibility one has in the retirement date. In evaluating expenses, investors and plan participants should also evaluate how inflation may be impacting both essential and discretionary expenses.

Schwab Target Date Funds are designed to increase exposure to asset classes that have lower probability of sharp selloffs and higher predictability. The philosophy emphasizes investments in larger, domestic companies and lower exposure to smaller or emerging market companies. Within fixed income, exposure to securities with lower interest rate sensitivity also helps ease the planning process around retirement.

Stay focused on your investment plan and stay the course through periods of volatility

Overall, target date funds can help investors navigate choppy markets by maintaining a long-term focus on objectives and professional management throughout volatile times. Schwab Target Date Funds continue to adapt as markets evolve and provide diversified exposure for investors saving for retirement.

Now is the time to stay focused and stay the course. Review your investment plan, reconfirm retirement timelines and expenses, and maintain contributions wherever possible when saving for retirement.

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