SECURITIES LITIGATION & CONSULTING GROUP

Charles Schwab YieldPlus Risk[1]

by

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From June 2007 through June 2008, the total return on Schwab's YieldPlus fund[2] was -31.7% when other ultra short bond funds had little or no losses. These large losses occurred because Schwab's YieldPlus fund was not an ultra short bond fund as claimed by Schwab. It was instead an ultra *long* bond fund.

YieldPlus held large amounts of securities backed by illiquid, long-term, private label mortgages. It also held long maturity corporate bonds and trust preferred securities. In doing so, Schwab's fund violated concentration and illiquidity limits stated in its prospectus and had much more credit and liquidity risk than it disclosed in its SEC filings and marketing materials. YieldPlus' long term securities including private label mortgage backed securities gave it a slight advantage over its peers prior to 2007. Unfortunately, the extra yield was an order of magnitude smaller than the losses that followed when credit and liquidity spreads widened and the value of its long term holdings dropped significantly in 2007 and 2008.

YieldPlus's heaviest reported losses occurred in early 2008, yet Schwab still appears to have understated these losses by significantly inflating the value of the fund's holdings and therefore its NAV.

I. Introduction

Schwab categorized the YieldPlus fund as an ultra short bond fund. The YieldPlus fund made large, risky investments in long maturity structured products, such as subprime Residential Mortgage Backed Securities ("RMBS") that were inconsistent with the SEC's definition of an ultra short bond fund. Schwab marketed the fund as a cash equivalent investment and as a safe alternative to money market funds with a higher yield and only slightly more risk. Such a claim would be incorrect for a typical, conventionally managed ultra short bond fund, but was especially false when made by Schwab on behalf of the YieldPlus fund. In its marketing materials, Schwab compared returns on the YieldPlus fund to returns on the Lehman Short U.S. Treasury 9-12 month index. The Treasury securities included in the Lehman index have no credit risk, are highly liquid and have short maturities. The holdings of the YieldPlus fund generally shared none of these attributes.

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[2] There are two YieldPlus Funds: Schwab YieldPlus Investor Shares (SWYPX), and Schwab YieldPlus Select Shares (SWYSX). The funds are managed identically, but the Investor Shares have a lower minimum investment and higher fees. We will refer to a single find, Schwab YieldPlus, unless it is necessary to make a distinction.

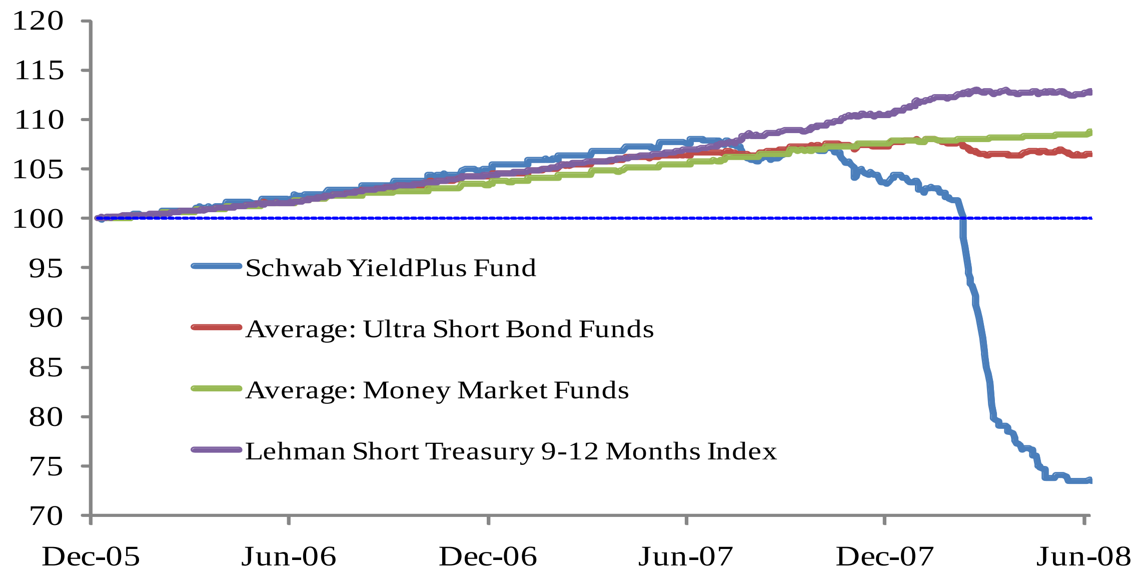
YieldPlus, unlike most ultra short bond funds and unlike any money market fund, held large amounts of illiquid, long maturity structured finance securities, primarily private label RMBS backed by risky home loans and trust preferred securities issued by banks. As a result, investors in YieldPlus suffered larger losses than those suffered by investors in any other retail ultra short bond fund.

Schwab falsely claimed that 60.3% of its holdings matured within 6 months and that its weighted average maturity was only 0.5 years in its August 31, 2007 Annual Report. Only 1.7% - not 60.3% - of YieldPlus' August 31, 2007 holdings matured within 6 months and its weighted average maturity was 25.1 years – not 0.5 years.

YieldPlus's private label mortgage backed securities holdings violated industry concentration limits defined by the Investment Company Act of 1940, the SEC, and the YieldPlus fund's prospectus. The same holdings also violated limits on illiquid securities stated in the YieldPlus fund's prospectus.

Figure 1 shows the value of $100 invested on December 31, 2005 from January 1, 2006 through June 30, 2008. Four different investments are considered: 1) an investment in the YieldPlus fund, 2) an investment in an equally weighted portfolio of other ultra short bond funds, 3) an investment in an equally weighted portfolio of money market funds and 4) an investment in the securities tracked by the Lehman Short Treasury 9-12 months index. The YieldPlus fund had slightly higher returns than the average ultra short bond fund and average money market fund up through the first half of 2007. Thereafter, the YieldPlus fund's returns were significantly less than its self-selected comparators - calamitously so in early 2008.

Figure 1: YieldPlus Fund Total Return Comparisons to Other Benchmarks. Through the first half of 2007, the YieldPlus fund's returns were slightly higher than the returns of other ultra short bond funds, money market funds, and the Lehman Short Treasury 9-12 months index. In the latter half of 2007 and in the first half of 2008, however, it lost considerably more than its self-selected comparators.



YieldPlus' total return between June 30, 2007 and December 31, 2007 was -3.6% while the average total return of ultra short bond funds was 0.9%. YieldPlus's poor returns in the second half of 2007 led to heavy investor redemptions, forcing Schwab to sell over $10 billion of YieldPlus portfolio holdings between September 1, 2007 and August 31, 2008. By early 2008 at the latest, Schwab was inflating YieldPlus's NAV by carrying portfolio holdings at valuations approximately 15% higher than prices at which the securities were sold.[3] When Schwab was then forced to sell holdings to meet redemptions, the overstated valuations were suddenly transformed into large realized losses. Redemptions did not cause the YieldPlus fund's precipitous losses in early 2008. Instead, the redemptions forced Schwab to correctly value YieldPlus's holdings at market based prices, which in turn caused prior losses to be realized and to finally be revealed to investors.

II. Schwab Misrepresented YieldPlus as a short term bond fund

A. Schwab misrepresented YieldPlus as an ultra-short bond fund.

Schwab described the YieldPlus fund as an ultra short bond fund in all its marketing materials and in its SEC filings.

The SEC defines ultra short bond funds as follows:

Ultra short bond funds are mutual funds that generally invest in fixed-income securities ***with extremely short maturities, or time periods in which they become due for payment****. Like other bond mutual funds, ultra-short bond funds may invest in a wide range of securities, including corporate debt, government securities, mortgage-backed securities, and other asset-backed securities [emphasis added.* [4]

Schwab reported weighted average maturities of 0.5 years to 1.5 years in its SEC filings. Schwab's portfolio was actually a portfolio of very long maturity bonds. Since most of the securities held by YieldPlus were floating rate bonds tied to LIBOR the securities' value wasn't very sensitive to shifts in LIBOR. Nonetheless they were 25-year maturity bonds, not 6-month bonds, on average and so were extremely sensitive to credit risk and liquidity risk.

B. Schwab misrepresented YieldPlus as a Cash Equivalent Investment

Schwab marketed the YieldPlus fund as a cash equivalent investment offering a higher yield, with only slightly more risk than a money market fund. For example, Schwab stated in a January 2006 marketing brochure:

If you're comfortable accepting a slightly higher amount of risk in exchange for a return that's generally better than ***other cash-equivalent investments****, consider this ultra short term bond fund [emphasis added]*.

Black's Law Dictionary[5] defines a "cash equivalent" security as:

A short-term security that is liquid enough to be considered equivalent to cash.

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[3] This estimate of Schwab's overstatement of the YieldPlus's NAV is based on a cash flow analysis of quarterly holdings data from SEC filings, and financial statements from YieldPlus Fund semi-annual and annual reports.

[4] "Ultra-Short Bond Funds: Know Where You're Parking Your Money" at http://www.sec.gov/investor/pubs/ultra-short_bond_funds.htm.

[5] See Garner, Bryan A. (Ed)., *Black's Law Dictionary*, 7th ed. St. Paul: West Group, 1999.

Residential mortgage backed securities are not generally short term securities – they typically have maturities of many years. They are also not liquid enough to be considered cash equivalents. Thus, Schwab's characterization of the YieldPlus fund as a cash-equivalent investment was misleading.

C. Schwab misrepresented YieldPlus as only slightly more risky than money market funds

Schwab also compared the YieldPlus fund to money market funds. In a September 2006 mailing to customers, Schwab claims that the YieldPlus fund

offers higher potential returns than money market funds with only marginally higher risk

and on an August 2006 webpage Schwab stated:

The Schwab YieldPlus fund…can be a smarter alternative to investing in money market [funds].

A November 2005 "Schwab Report" states:

Ultra-short bond funds…have numerous advantages including…being free to use many investments ***just*** *outside the approved limits of money market funds [emphasis added]*.

The SEC defines a money market fund as follows:[6]

A money market fund is a type of mutual fund that is required by law to invest in low-risk securities. These funds have relatively low risks compared to other mutual funds and pay dividends that generally reflect short-term interest rates. Money market funds typically invest in government securities, certificates of deposit, commercial paper of companies, or other highly liquid and low-risk securities.

The risk of a fund that invests heavily in long maturity, illiquid, highly-leveraged private label RMBS is not comparable to the risk of a money market fund as described by the SEC. Moreover, the YieldPlus fund's investments lie **considerably** outside the approved limits of money market funds.

D. Schwab inaptly compared YieldPlus to Lehman Brothers Short U.S. Treasury 9-12 Months index.

In its marketing materials, Schwab compared the YieldPlus fund's returns to the Lehman Brothers Short U.S. Treasury 9-12 month index. This comparison was inappropriate for several reasons. First, the index effectively has no credit risk. The YieldPlus fund, in contrast, was exposed to a substantial amount of credit risk as a result of holding private label mortgage backed and asset backed securities, corporate bonds and trust preferred securities. Second, the YieldPlus fund held securities with maturities much longer than 9-12 months. The average maturity of YieldPlus' holdings on August 31, 2007 was 25.1 years. Third, U.S. Treasuries are traded in extremely liquid markets. In contrast, the YieldPlus fund held securities that were illiquid to begin with and that became highly illiquid during 2007 and 2008.

[6] "Money Market Funds", http://www.sec.gov/answers/mfmmkt.htm

E. Schwab sold YieldPlus to investors for their "investment cash".

A December 2005 Schwab webpage describes to types of cash as follows:

Transactional cash *is typically generated from a recent transaction, and is waiting for you to put it back to use in the very near term. Schwab automatically provides a Sweep Service to ensure you earn a yield on this short-term cash holding.*

Investment Cash *is generally a longer-term holding, often intended to provide enhanced diversification and liquidity as part of an overall portfolio allocation strategy. More active management of Investment Cash is required to tap its earnings potential. Investment cash can be invested over different time periods, generally producing higher earnings the longer the investment period.*

The webpage then offers YieldPlus as a choice for "Investment Cash." "Investment Cash" is not a standard term used in the investment management industry and its purpose may have been to blur the distinction between cash and risky investments. It appears to have been part of a marketing strategy to induce Schwab customers to transfer cash from traditional money market funds and cash equivalent investments to the YieldPlus fund.

III. YieldPlus held securities with very long term maturities not ultra short term maturities and these misrepresented long term securities caused the losses.

A. Schwab in marketing materials and SEC filings claimed that YieldPlus' weighted average maturity was 0.5 years to 1.4 years.

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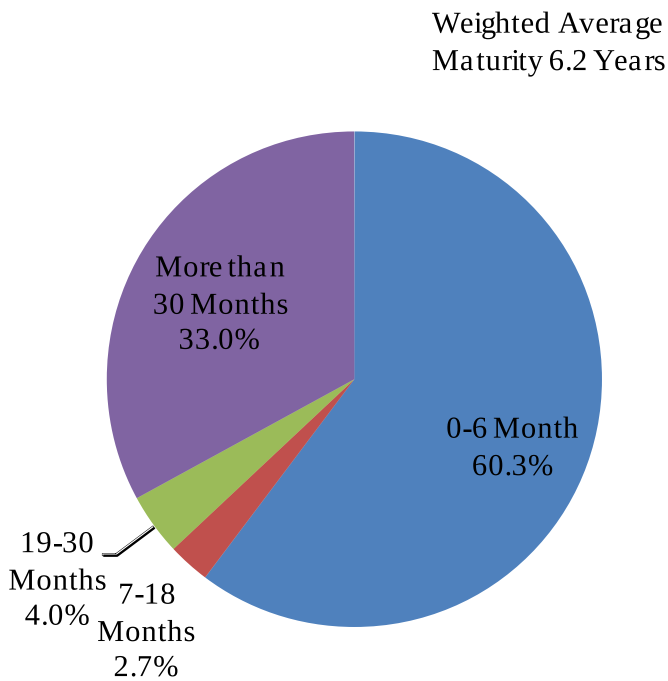
A. The weighted average maturity of YieldPlus' August 31, 2007 holdings was approximately 25 years, not 0.5 years.

Figures Y shows the maturity distribution reported by Schwab for the YieldPlus fund on the summary page of their August 31, 2007 annual report. This maturity distribution is consistent with the maturities that Schwab reports for individual YieldPlus holdings in the portfolio holdings section of the report. The weighted average maturity that corresponds to the reported maturities of the individual holdings is 6.2 years. This is inconsistent with the weighted average maturity of .5 years reported by Schwab on the summary page of the report. Thus, the annual report would have mislead investors who saw the summary statistic of .5 years and did not analyze the maturity distribution. (As a simple proof of the inconsistency, if all of the securities in each maturity category had maturities at the lower bound of each category - which is not actually the case - the weighted average maturity would still be almost 11 months.)

Figure Y: Schwab's August 31, 2007 Reported Distribution of Maturities. Schwab's reported distribution of maturities was inconsistent with its reported weighted average maturity and with its own definition of maturity.



The maturity distribution in Figure Y is itself severely biased and understates the maturities of the fund's holdings. To understand why, it is necessary to focus on the definition of the term "maturity."

In the glossary section of the August 31, 2007 YieldPlus annual report Schwab defines "maturity" as:

The date a debt security is scheduled to be "retired" and its principal amount returned to the bondholder.

Schwab's definition is in agreement with standard industry definitions of the term. For example, Bloomberg defines maturity as:

Date the principal of a security is due and payable.

In stating the maturities of individual YieldPlus holdings, however, Schwab often chose to not use their own definition of maturity as stated in the glossary of their annual report. As an example, in the portfolio holdings section of the annual report, Schwab states:

For variable rate obligations, the rate shown is the rate as of the report date, and the ***maturity date shown is the next interest rate change [emphasis added]****.*[7]

For example, Schwab lists "MBNA Capital B" as one of the YieldPlus fund's holdings in the annual report. This is a floating rate note issued by MBNA Capital. The note's coupon is paid quarterly and is set to 3 month LIBOR plus 80 basis points (on an annualized basis). Schwab lists the maturity date of the note as 11/1/2007 which corresponds to a time to maturity of .17 years. This number is consistent with setting the maturity to the next interest rate reset

[7] The interest paid on a variable rate obligation is reset periodically and typically at frequent intervals.

date. In contrast, Bloomberg provides a maturity date of 2/1/2027 which is equivalent to a time to maturity of over 19 years as of the annual report date.

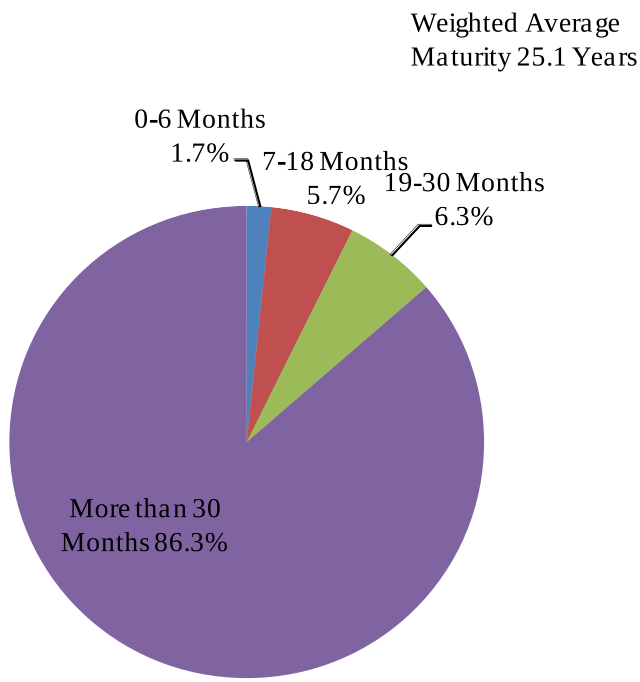
Schwab's use of .17 years as the time to maturity confuses the concept of effective duration with the concept of maturity. Effective duration is the sensitivity of a security to interest rate changes, such as changes in LIBOR rates. Prices of variable rate securities are typically insensitive to changes in interest rates because their cash flows adjust quickly as their interest rates reset. In the case of the MBNA note, however, even though the security is insensitive to changes in interest rates, it's principal will not be returned for many years.

This is a crucial distinction. Many investors are concerned with the actual maturity of their investments rather than interest rate risk. Long maturity securities have more credit risk and more liquidity risk than short maturity securities. They are also more difficult to value.[8] The maturity date reported by Schwab provides investors with no information about the actual maturity of the MBNA note.

Figure Z shows what the distribution of maturities would have been had Bloomberg's maturities been used for each individual holding. The differences are substantial: The YieldPlus Fund's weighted average maturity using Bloomberg maturities is 25.1 years versus 6.2 years using Schwab maturities. In Figure Y, Schwab reports that 60.3% of the fund's holdings have maturities ranging from 0-6 months. Figure Z shows that only 1.7% of the fund's holdings have maturities in the same 0-6 month range when Bloomberg maturities are used. Recall that Bloomberg's definition of maturity closely matches Schwab's definition in their annual report glossary. Thus, had Schwab used their stated definition of maturity they would have produced a maturity distribution close to that shown in Figure Z.

[8] For example, a 30-year forecast of home prices is required to value a mortgage-backed security with a maturity of 30 years whereas only a 1-year forecast is required to value a mortgage-backed security with a maturity of 1 year.

Figure Z**: August 31, 2007 True Distribution of Maturities (per Bloomberg).** Bloomberg's maturities showed that Schwab dramatically understated the maturity of the YieldPlus Fund's holdings.



Schwab's decision to disregard their own definition of maturity was unfortunate and their designation of long maturity securities as short maturity securities was misleading. Since the risk of fixed income securities are fundamentally related to their maturities, YieldPlus investors would have been unable to accurately assess the risk of their investments using Schwab's reports.

IV. YieldPlus held large amounts of mortgage backed securities.

B. Agency MBS

Agency MBS are mortgage-backed securities that are securitized by government or quasi-government agencies (Ginnie Mae, Fannie Mae and Freddie Mac). The agencies guarantee payment of principal and interest on the mortgage-backed securities. Ginnie Mae is backed by the full faith and credit of the US government. Fannie Mae and Freddie Mac are considered to be implicitly guaranteed by the U.S. government; both were placed in government conservativorship in 2008 after they suffered severe financial distress due to mortgage credit issues. The agencies will only accept mortgage loans for securitization that conform to certain standards. Among these are limitations involving the credit quality of borrowers and the size of the loans. Loans that are not acceptable for securitization by the agencies must be securitized by private entities or not securitized at all. Agency MBS have virtually no credit risk as a result of their guarantee, however, they are subject to prepayment risk (the risk that borrowers prepay their loans when interest rates fall) and liquidity risk.

C. Private Label RMBS

Private label RMBS were responsible for the majority of the YieldPlus fund's large losses. The YieldPlus fund invested in three main types of private label RMBS.[9] The loans backing these RMBS are typically not acceptable for insured securitization by Fannie Mae or Freddie Mac. Instead, the loans are securitized by private issuers like Countrywide and New Century who do not provide meaningful credit insurance. As a result, private label RMBS investors bear the risk that homeowners will default on their mortgages.

Jumbo RMBS are backed by prime quality mortgage loans that conform to Fannie Mae and Freddie Mac underwriting guidelines, but with principal balances too high to be included in Fannie Mae or Freddie Mac securitizations.

Subprime RMBS are backed by subprime mortgage loans. These loans have been extended to homeowners with prior credit difficulties and have a much higher risk of default than mortgage loans that meet Fannie Mae and Freddie Mac underwriting standards. The borrowers' credit issues keep the loans from being classified as "prime" and make them unacceptable for securitization by Fannie Mae and Freddie Mac.

Alt-A RMBS are backed by so called "Alt-A" loans which lie somewhere between prime and subprime collateral in terms of credit quality. Alt-A loans are unable to qualify for securitization by Fannie Mae and Freddie Mac often because they have been extended to borrowers without adequate documentation.

D. Amortizing Residential Collateral Trust, Series 2002-BC1

Table 1 illustrates the capital structure of a typical subprime deal. *Amortizing Residential Collateral Trust Series 2002-BC1*, invested in subprime mortgages with a mix of floating and fixed coupons. The loans are collateral for the trust's liabilities (i.e., the RMBS tranches) and the principal and interest from the loans are used to pay principal and interest on the RMBS tranches. The trust issued approximately $2.1 billion of RMBS, consisting of two senior tranches (A1 and AIO), two mezzanine tranches (M1 and M2), three subordinate tranches (B, P and X) and one residual tranche (R). The senior classes have the highest priority for receiving principal and interest payments, followed by the mezzanine tranches and then the junior tranches. The tranches are listed in Table 1 in order of priority for receiving cash flows; the tranches higher in the capital structure receive their scheduled cash flows in full before lower tranches receive their cash flows. The YieldPlus fund owned the M2 tranche which was to receive scheduled interest payments of 1-month LIBOR[10] plus 1.1% (annualized).

[9] These securities are discussed in detail in Chapters 5, 9 and 10 of Fabozzi, Frank J. (Ed). *The Handbook of Mortgage Backed Securities*, 6th ed. New York: McGraw Hill, 2006.

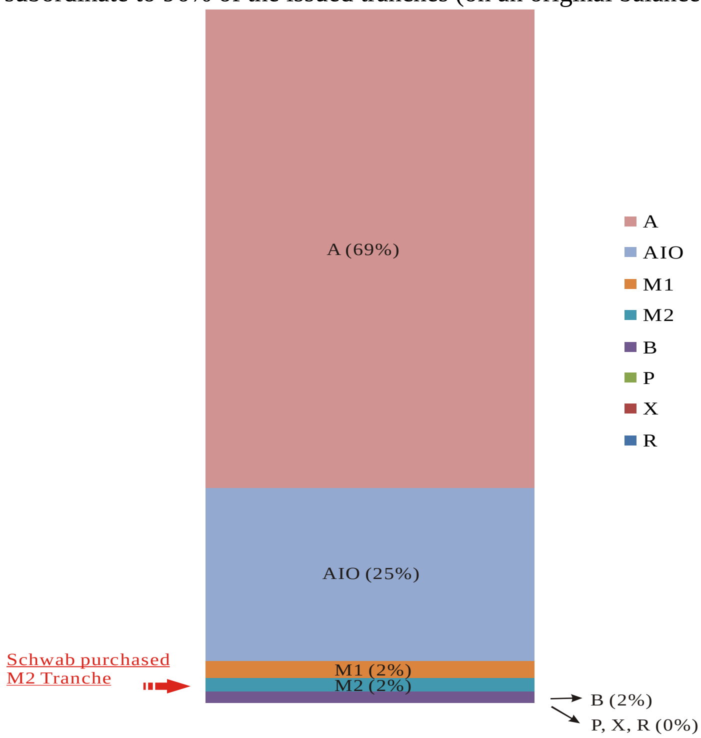
[10] LIBOR (London Interbank Offered Rate) is the interest rate at which banks borrow from each other in the London interbank market.

Table 1: ***Amortizing Residential Collateral Trust, Series 2002-BC1.*** The tranches in this subprime trust are listed in order of increasing risk. The M2 tranche was held by YieldPlus.

Tranche	Tranche Type	Original Balance	Interest Rate	Moody's/S&P Initial Rating
A	Senior	$1,433,769,000	1M LIBOR + 0.34%	Aaa/AAA
AIO	Senior (IO)	$517,097,194	Not Applicable	Aaa/AAA
M1	Mezzanine	$50,926,000	1M LIBOR + 0.85%	Aa2/AA
M2	**Mezzanine**	**$39,174,000**	**1M LIBOR + 1.10%**	**A2/A**
B	Subordinate	$35,256,000	1M LIBOR + 2.05%	Baa2/BBB
P	Subordinate	Not Applicable	Not Applicable	NA/NA
X	Subordinate	Not Applicable	Not Applicable	NA/NA
R	Residual	Not Applicable	Not Applicable	NA/NA

The M2 tranche held by the YieldPlus fund leverages (or magnifies) the already substantial risk that subprime borrowers will be unable to make their mortgage payments. Figure 3 illustrates the position of the M2 tranche in the trust's capital structure: the height of each tranche is proportional to its original principal amount. 96% of the issued tranches are senior to the M2 tranche as measured by original balance.

Figure 3: Position of the M2 Tranche in the *Amortizing Residential Collateral Trust, Series 2002-BC1.* The M2 tranche, held by YieldPlus, is subordinate to 96% of the issued tranches (on an original balance basis).



The M2 tranche is far riskier than simply holding the mortgage loans directly because investors in the M2 tranche hold claims which are subordinated to nearly all other claims - all of the tranches above the M2 tranche in Figure 3 receive their principal and interest payments before the M2 tranche receives any payments.

C. Residential Accredit Loans, Inc., 2006-QA1

Table 2 illustrates the capital structure of a typical Alt-A deal. *Residential Accredit Loans, Inc., 2006-QA1*, held mostly hybrid adjustable-rate Alt-A mortgages. Many of the mortgages had “interest only” features, meaning that the homeowner was not required to make principal payments for a specified period. “Interest only” loans expose homeowners to substantial payment shocks when the “interest only” period ends; these shocks can result in delinquencies and ultimately in defaults. The trust issued approximately $604 million of RMBS, consisting of seven senior tranches, three mezzanine tranches, and three subordinate tranches.

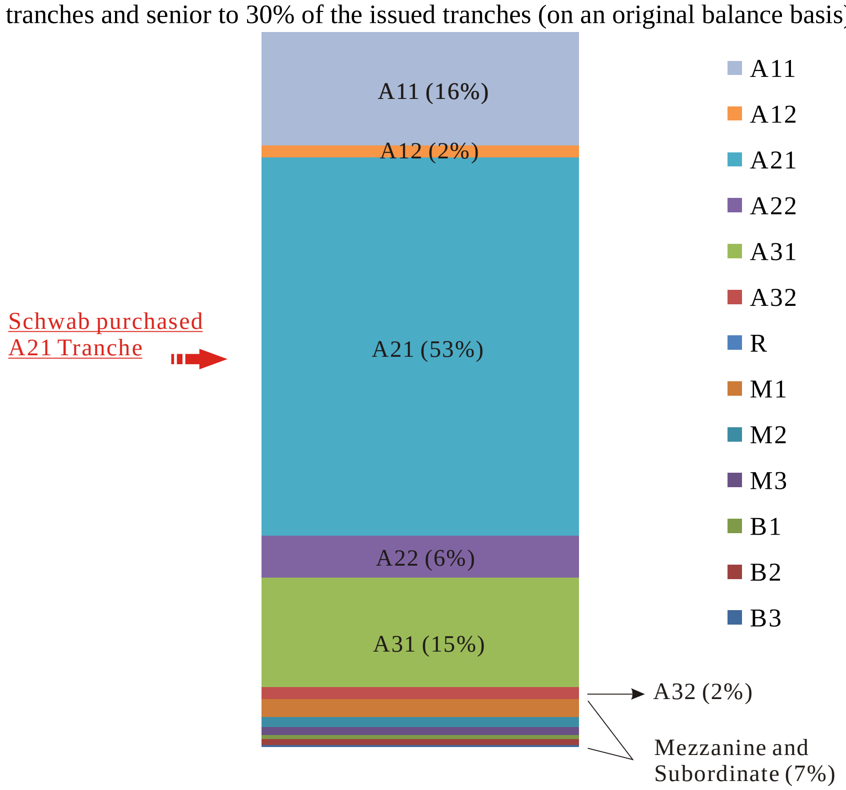
YieldPlus owned the A21 tranche which initially paid an interest rate of 6.02%. Unlike the M2 subprime tranche discussed in the previous section, the interest rate of the A21 tranche is not directly indexed to LIBOR. Instead, the rate is based on a weighted average of the rates on the underlying Alt-A loans, which may change over time. Although the A21 tranche is a classified as a senior tranche, it occupies the approximate middle of the trust’s capital structure: by original balance, 18% of the tranches lie above it and 30% below it. Thus, the tranche is only slightly less risky than holding the Alt-A loans directly.

Table 2: ***Residential Accredit Loans, Inc., 2006-QA1.*** The tranches in this Alt-A trust are listed in order of increasing risk. This A21 tranche was held by YieldPlus.

Tranche	Tranche Type	Original Balance	Interest Rate	Moody's/S&P Initial Rating
A11	Senior	$95,605,900	5.94%	Aaa/AAA
A12	Senior	$10,623,000	5.94%	Aaa/AAA
A21	**Senior**	**$318,919,000**	**6.02%**	**Aaa/AAA**
A22	Senior	$35,435,000	6.02%	Aaa/AAA
A31	Senior	$92,318,000	6.30%	Aaa/AAA
A32	Senior	$10,257,000	6.30%	Aaa/AAA
R	Senior	$100	5.94%	Aaa/AAA
M1	Mezzanine	$15,402,000	6.06%	Aa2/AA
M2	Mezzanine	$9,360,000	6.06%	A2/A
M3	Mezzanine	$5,435,000	6.06%	Baa2/BBB
B1	Subordinate	$4,529,000	Not applicable	NA/BB
B2	Subordinate	$3,623,000	Not applicable	NA/B
B3	Subordinate	$2,418,251	Not applicable	NA/NA

Figure 4 illustrates the position of the A21 tranche in the trust's capital structure graphically.

Figure 4: Position of the A21 Tranche in *Residential Accredit Loans, Inc., 2006-QA1*. The A21 tranche, held by YieldPlus, is subordinate to 18% of the issued tranches and senior to 30% of the issued tranches (on an original balance basis).



V. YieldPlus returns and holdings

A. Fund Returns

Table 3 reports cumulative total return indices (capital gains plus distributions) from December 31, 2005 for 1) the YieldPlus fund, 2) the average of other ultra short bond funds, 3) the average of money market funds and 4) the Lehman Short Treasury 9-12 months index.

$100 invested in the YieldPlus fund on December 31, 2005 (with reinvested distributions) would have been worth $108.02 on June 30, 2007. The same investment in the ultra short bond fund composite would have been worth $106.78 on June 30, 2007. This 1.24% difference in returns over an 18-month period reflected the higher yields on the structured securities, especially those backed by residential mortgages that comprised a disproportionate part of the YieldPlus portfolio.

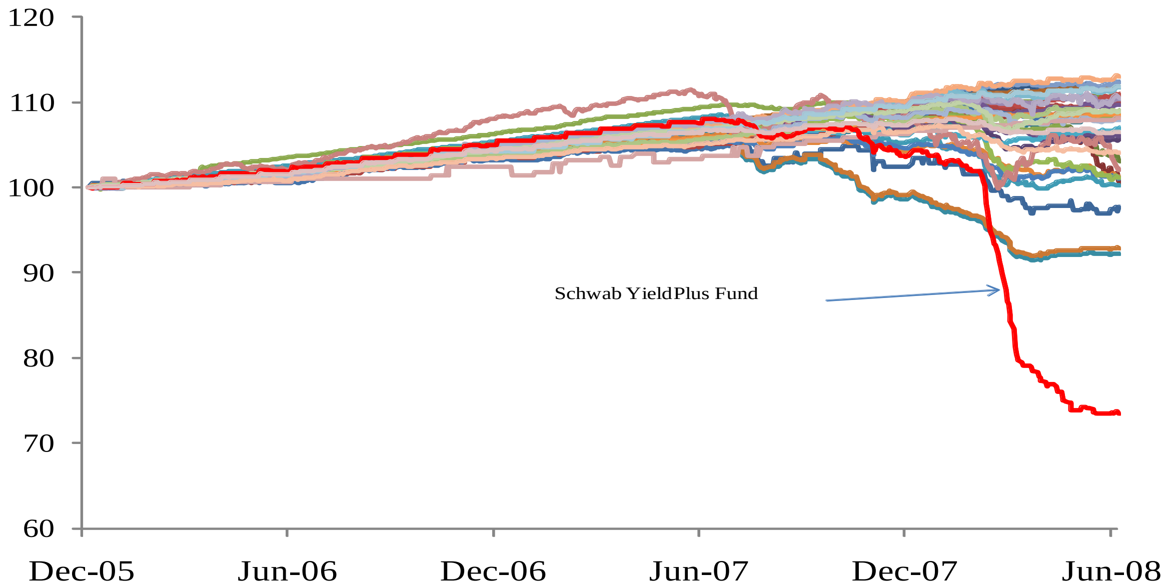
Table 3: YieldPlus Fund Total Return Comparisons to Other Benchmarks. The YieldPlus fund's returns were slightly higher than returns of other ultra short bond funds, money market funds, and its Lehman Index benchmark through the first half of 2007. In the latter half of 2007 and the first half of 2008, however, it lost considerably more than its self-selected comparators. From June 2007 through June 2008, the YieldPlus fund suffered losses of 31.7%. (Data for 35 other ultra short funds was available over the required time period.)

Quarter Ending	Schwab YieldPlus Fund	Average of Ultra Short Bond Funds	Average of Money Market Funds	Lehman Short Treasury 9-12 Months Index
Dec-05	$100.00	$100.00	$100.00	$100.00
Mar-06	$101.14	$100.86	$100.90	$100.79
Jun-06	$102.40	$101.83	$101.85	$101.69
Sep-06	$103.85	$103.27	$102.77	$103.22
Dec-06	$105.45	$104.53	$103.73	$104.38
Mar-07	$106.84	$105.80	$104.78	$105.69
Jun-07	$108.02	$106.78	$105.84	$106.96
Sep-07	$106.89	$107.29	$106.91	$108.93
Dec-07	$104.15	$107.73	$107.86	$110.51
Mar-08	$83.46	$106.59	$108.21	$112.81
Jun-08	$73.75	$106.60	$108.74	$112.73
Selected Total Returns:				
Yield Plus				
Dec 2005 - Jun 2007	8.0%	6.8%	5.8%	7.0%
Jun 2007 - Jun 2008	-31.7%	-0.2%	2.7%	5.4%
YieldPlus Fund Relative to Others				
Dec 2005 - Jun 2007		1.2%	2.2%	1.1%
Jun 2007 - Jun 2008		-31.6%	-34.5%	-37.1%

From June 30, 2007 through June 30, 2008, the YieldPlus fund's losses were much worse than those of all other ultra short bond funds. The YieldPlus fund lost 31.7% over this period versus a loss of only .2% for the average ultra short bond fund. The YieldPlus's funds disproportionate holdings of private label RMBS contributed heavily to its large losses.

Figure 5 shows the total returns of the YieldPlus fund relative to the total returns of each of its competitors. Not only did YieldPlus suffer much larger losses than the average of ultra short bond funds, its returns were worse than every one of the 35 ultra short funds for which data was available on Bloomberg - even considerably worse than the fund with the second worst return.

Figure 5: YieldPlus Fund Total Return Comparisons to Other Ultra Short Bond Funds. The YieldPlus fund's returns were considerably worse than every one of the 35 ultra short bond funds for which data was available on Bloomberg.



C. YieldPlus' Losses were due to long term RMBS and other long maturity securities

Table 4 lists YieldPlus's holdings at the end of February 2008 compared to holdings of all other ultra short bond funds for which data was available on Bloomberg.[11] YieldPlus invested over 47% of its portfolio in private label RMBS - almost five times as much as the median ultra short bond fund. 25% of the other ultra short funds held no private label RMBS at all. Instead, many ultra short bond funds invested heavily in agency RMBS (i.e., residential mortgage backed securities whose credit risk is explicitly or implicitly guaranteed by the US Government) and into securities backed by assets other than residential mortgages (ABS). YieldPlus also held large positions in corporate bonds - more than most other ultra short bond funds.

Table 4: YieldPlus Fund Holdings Comparison with Ultra Short Bond Fund Universe (as of February 29, 2008). The YieldPlus fund held over 47% of its holdings in private label RMBS – much

[11] These composition percentages are all calculated using the funds' reported valuations. Some funds do not follow the same reporting calendar as the YieldPlus fund. In those cases, holdings data for the closest date to February 29, 2008 was used.

more than most other ultra short bond funds. (Data for 33 other ultra short funds was available for the comparison.)

	Private Label RMBS	Agency RMBS	Corporate Bonds	ABS	Other
Schwab YieldPlus	47.3%	8.1%	34.0%	3.1%	7.5%
All Ultra Shorts					
Mean	16.2%	36.2%	13.1%	9.6%	24.8%
75th Percentile	27.0%	54.9%	25.4%	15.6%	33.1%
50th Percentile	10.8%	24.6%	4.5%	3.7%	16.4%
25th Percentile	0.0%	8.6%	0.0%	0.0%	7.2%

Table 5: YieldPlus' Weighted Average Maturity with Ultra Short Bond Fund Universe (as of August 31, 2007). [made up the numbers below as examples]

	Claimed WAM	WAM based on Reported Maturities	WAM based on True Maturities
Schwab YieldPlus	0.5 years	6.2 years	25.1 years
All Ultra Shorts			
Mean			
75th Percentile			
50th Percentile			
25th Percentile			

The YieldPlus fund suffered most of its large losses from February 29, 2008 through May 31, 2008. During this period, the fund's total return was a loss of 27.1% with a corresponding capital loss of 28.1%. Table 5 shows estimates of how much various asset classes held by the fund contributed to this overall capital loss.[12] Private label RMBS were responsible for almost 80% of the YieldPlus fund's large capital loss over this three month period.

Table 5: Attribution of YieldPlus Fund Capital Loss from February 29, 2008 through May 31, 2008. YieldPlus suffered a capital loss of 28.1% from February 29, 2008 through May 31, 2008. The majority of this capital loss was due to the fund's large holdings in private label RMBS and much of the remainder was due to the fund's holdings in corporate bonds.

Sector	Capital Loss Explained	Fraction of Capital Loss Explained
Private Label RMBS	-22.1%	78.7%
Agency RMBS	-0.9%	3.1%
Corporate Bonds	-3.5%	12.6%
ABS	-0.3%	1.0%
Other	-1.3%	4.6%
Total	-28.1%	100.0%

D. Corporate Bond Holdings

We need to explain the corporate bonds are trust preferred securities with very long maturities.

[12] Estimates use publically available SEC filings of YieldPlus holdings data and are based on Schwab valuations. Since this data is only issued quarterly, these results are estimates and not exact calculations.

Some of the YieldPlus fund's corporate bond holdings were exposed to the same risks as the fund's private label RMBS. Table 6 lists the 10 corporate bonds held by the YieldPlus that suffered the largest percent decrease in price (based on Schwab's valuations) from November 30, 2007 through February 29, 2008. According to Bloomberg, all of the bond issuers are members of the financial sector. Consequently, many of the bonds were exposed to the same risks as residential mortgage backed securities. For example, "TWIN REEFS PASS-THROUGH" was a capital facility for XL Financial Assurance Ltd, a subsidiary of Security Capital Assurance Ltd (SCA). SCA had significant exposures to Collateralized Debt Obligations (CDOs) backed by subprime mortgages.[13] Schwab's valuation of "TWIN REEFS PASS-THROUGH" fell 70.4% from November 30, 2007 through February 29, 2008. As another example, "LEHMAN BROS E-CAP TRST I" is a trust preferred security which is currently in default. Lehman, of course, was forced into bankruptcy largely as a result of its substantial holdings in private label RMBS. Finally, "RBS CAPITAL TRUST IV" is another trust preferred security issued by the Royal Bank of Scotland. RBS was heavily involved in RMBS and was forced to take large writedowns as a result of its exposure to the subprime sector.[14] Thus, the YieldPlus fund was exposed to U.S. housing market risk and to the risk of poor mortgage loan underwriting practices through its corporate bond holdings as well as its private label RMBS holdings.

All the securities listed in Table 6 are long term securities.

Table 6: YieldPlus Corporate Bond Holdings with Largest Percentage Decreases in Price (based on Schwab valuations) from November 30, 2007 through February 29, 2008. According to Bloomberg, all of the bond issuers are members of the financial sector. Many of the bonds were exposed to the same risks as private label RMBS.

CUSIP	Issuer	Maturity Reported by Schwab	True Maturity	Percent Value Change
901704AA4	**TWIN REEFS PASS-THROUGH**			**-70.4%**
011588AH3	ALAMOSA DELAWARE INC			-13.1%
00845WAD0	AGFIRST FARM CREDIT BANK			-12.6%
52520YAB3	**LEHMAN BROS E-CAP TRST I**			**-12.2%**
19075QAA0	COBANK, ACB			-12.0%
225448AB5	CREDIT SUISSE GUERNSEY			-11.8%
74927FAA9	**RBS CAPITAL TRUST IV**			**-11.2%**
44965TAA5	ILFC E-CAPITAL TRUST I			-10.6%
37930JAB1	GLITNIR BANKI HF			-10.4%
677879CE6	OIL INSURANCE LTD			-9.3%

VI. Concentration and Illiquidity LIMIT violations

A. Concentration Limit Violations

[13] See "News Focus - Monoline Insurers - XL is Latest Victim of Monoline Implosion," *Reinsurance Magazine*, February 1, 2008.
[14] See "RBS Slams a Lid on Subprime," *Forbes.com*, December 6, 2007 and "RBS Announces Sub-Prime Writedowns," *Banking Times*, December 7, 2007.

The YieldPlus fund Statement of Additional Information (SAI) of November 15, 2004, which the prospectus incorporates by reference, states that:

The Schwab YieldPlus fund …. may not…concentrate investments in a particular industry or group of industries, as concentration is defined under the 1940 Act, or the rules or regulations thereunder, as such statute, rules and regulations may be amended from time to time.

The same SAI later presents the definition of concentration:

The SEC has presently defined concentration as investing 25% or more of an investment company's net assets in an industry or group of industries…

These industry centered definitions are oriented toward corporate issuance and not mortgage backed securities. Accordingly, in reference to mortgage backed securities, the same SAI goes on to say:

Based on the characteristics of mortgage backed securities, each fund has identified mortgage-backed securities issued by private lenders and not guaranteed by U.S. government agencies or instrumentalities as a separate industry for purposes of a fund's concentration policy.

Thus, Schwab defined private label mortgage backed securities as an industry in which it would not invest more than 25% of its YieldPlus portfolio. Schwab's exclusion of agency mortgage backed securities and inclusion of all private label mortgage backed securities from its industry definition made economic sense since it specifically isolated mortgage credit risk – the risk of homeowners defaulting on their mortgages.

In a September 1, 2006 amendment to its November 15, 2005 SAI Schwab **removed** the concentration standard for mortgage backed securities:

The funds have determined that mortgage-backed securities issued by private lenders do not have risk characteristics that are correlated to any industry and, therefore, the funds have determined that mortgage-backed securities issued by private lenders are not part of any industry for purposes of the funds' concentration policies. This means that a fund may invest more than 25% of its total assets in privately-issued mortgage-backed securities…

Figure 7 shows a time series of the percent of mortgage backed securities held by the YieldPlus fund that excludes subprime mortgage backed securities. That is, Figure 7 only plots Jumbo, Alt-A and CMBS holdings as a percent of total YieldPlus fund holdings.[15] By May 31, 2006, the YieldPlus fund's holdings of non-subprime private label mortgage backed securities had exceeded the 25% concentration limit. On September 1, 2006, after the 25% limit had been exceeded, Schwab amended the November 15, 2005 SAI to remove any concentration limit for mortgage backed securities. Thus, Schwab violated the fund's prospectus and then amended the SAI to allow YieldPlus to exceed the 25% limit. YieldPlus's holdings in private label MBS subsequently peaked at 40% on February 29, 2008. The SAI amendment was made at a time

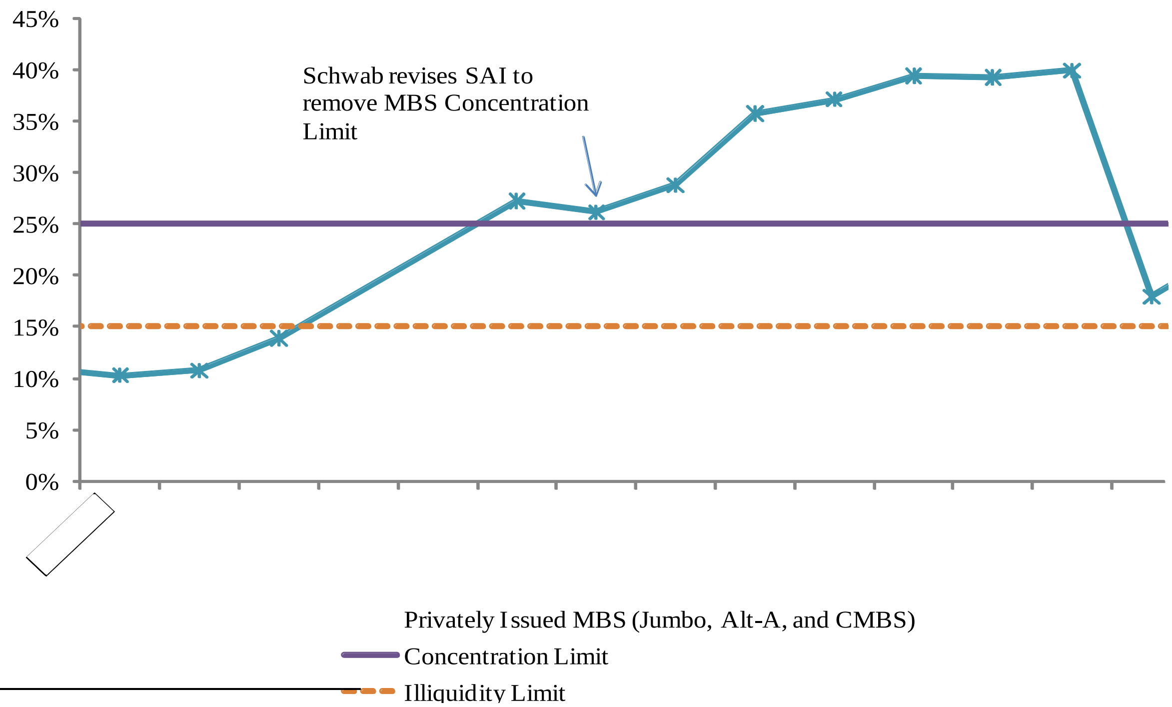
[15] Since Schwab classifies its subprime backed securities as asset backed securities, we do not include them here. Since the November 15, 2006 SAI description references both commercial and residential mortgages, we do include commercial mortgage backed securities.

when the higher yields of MBS provided a competitive advantage to YieldPlus over other ultra short bond funds. This competitive advantage proved to be illusory, given that the additional promised yield foreshadowed major mortgage credit problems.

Securities backed by subprime loans are sometimes called ABS rather than MBS. Schwab appears to have categorized them as ABS and not MBS in their SEC filings. Of course, logically and economically, securities backed by subprime mortgages are as much mortgage backed securities as securities backed by Jumbo and Alt-A mortgages. Many large financial institutions refer to subprime backed securities as MBS. For example, as we do in this paper, Moody's classifies securities backed by subprime loans, along with securities backed by Alt-A and Jumbo loans, as Private label MBS.[16] Broker/dealers often issue and trade subprime tranches from their asset backed securities desks which may explain why subprime mortgage backed securities are sometimes referred to as asset backed securities. The way in which investment banks organize their trading desks, however, is not relevant in determining the correct assessment of the mortgage-related risk in a portfolio or the definition of private label mortgage backed securities for applying a concentration limit; "privately issued mortgage backed securities" should include all privately issued securities that are backed by mortgages, since mortgages share many common risks.[17] For example, all types of mortgage loans, especially subprime loans, were exposed to the risk that U.S. home prices would depreciate.

Figure 8 corrects Schwab's definition of "privately issued MBS" by including subprime

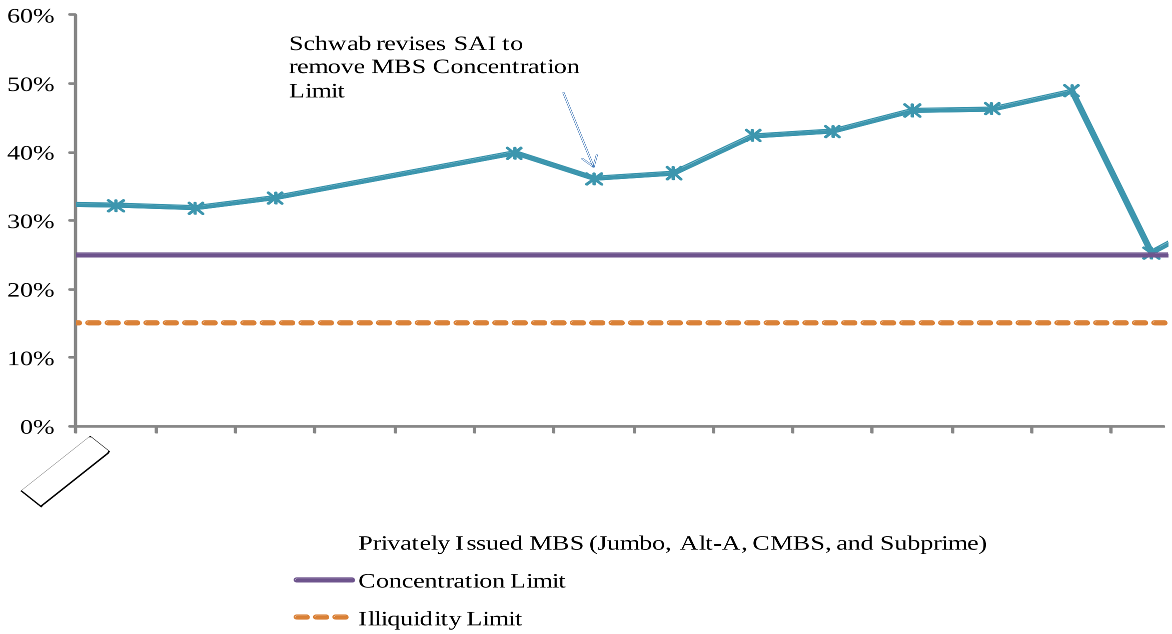
Figure 7: Private Label MBS Concentration and Illiquidity Limit Analysis. Schwab's holdings of private label MBS (excluding subprime) violated a limit in the fund's SAI prior to Schwab removing the limit altogether.



[16] See "Challenging Times for the US Subprime Mortgage Market," *Moody's Investors Service*, March 7, 2007.
[17] The terminology used in mortgage markets can be confusing in many ways. For example, first lien subprime loans were commonly called Home Equity Loans (HELs), especially earlier in their history. However, the term "HEL" was also used to refer to revolving home equity lines of credit (HELOCs) which are completely different from first lien subprime loans.

mortgage backed securities. Using this more economically meaningful definition, the YieldPlus fund exceeded the 25% concentration limit for the entire time analyzed: from December 31, 2005 through May 31, 2008. Thus, Schwab first ignored significant holdings of some types of mortgage backed securities when applying its concentration limit; then it deleted the concentration limit altogether when it stood in the way of making risky, illiquid investments. The large positions in privately issued MBS which allowed the YieldPlus fund to report slightly higher returns prior to June 30, 2007, were the major factor leading to the fund's large subsequent losses.

Figure 8: Privately Issued MBS Concentration and Illiquidity Limit Analysis (expanded to include subprime). Schwab's holdings of private label MBS (including subprime) violated a concentration limit in the fund's SAI for the entire period considered.



B. Illiquidity Limit Violations

Even before 2007, private label MBS were not considered to be liquid investments. In fact, in 2006, Markit, a financial information services company, introduced tradable ABX indices in an attempt to build liquidity in subprime MBS markets.[18] Soon after the introduction of these indices, however, any possibility of building liquidity was preempted by problems with subprime credit.

By August 2007, at the latest, private label MBS had become highly illiquid. Various sources of information such as articles in the financial press and quotes from managers of financial institutions support this statement. Moreover, these sources indicate that private label MBS, in general, had become illiquid by August 2007 – not just subprime MBS.

[18] See "First American LoanPerformance Announces Full Coverage of All ABX-HE Deals," Press Release by First American LoanPerformance, February 1, 2007 and "ABX Indices: The New US Asset Backed Credit Default Swap Benchmark Indices," *Markit Presentation*, January 2006.

For example, an August 1, 2007 letter from Indymac's CEO to its employees states:

Unfortunately, the private secondary [mortgage] markets (excluding the GSEs and Ginnie Mae) continue to remain very panicked and illiquid. By way of example, it is currently difficult, at present, to trade even the AAA bond on any private MBS transaction.[19]

On the following day, Sterling Edmunds, head of SunTrust Banks' mortgage unit is quoted:

Over the past week there's been no liquidity in the non-conforming mortgage market.[20]

In the first half of August 2007, respected members of the financial press separately described Alt-A, subprime and Jumbo MBS in ways that indicated that they were each illiquid:

Rising delinquencies, together with investor unwillingness to buy or hold securities backed by Alt-A loans, has caused [Wells Fargo, National City, UBS AG and Wachovia]and other lenders to curb Alt-A loans.[21]

Marking subprime assets to market is controversial because unlike stocks or bonds listed on an exchange, they can't be readily bought or sold.[22]

Thornburg [a REIT] originates and holds…mostly jumbo adjustable rate mortgages… With the continued liquidity crisis, [Thornburg] could become a binary stock…Mortgage holdings have become highly illiquid in recent months…The weak demand has made it nearly impossible to sell and properly value them.[23]

In December 2007, Toomre Capital, a financial engineering consulting firm describes the effective disappearance of the mortgage market:

For all practical purposes, the mortgage sector has virtually stopped trading.[24]

Schwab states in the YieldPlus November 15, 2006 SAI that:

The Schwab YieldPlus fund may not…invest more than 15% of its net assets in illiquid securities.

and:

Illiquid Securities generally are any securities that cannot be disposed of promptly and in the ordinary course of business at approximately the amount at which a fund has valued the instruments. The liquidity of a fund's investments is monitored under the supervision and direction of the Board of Trustees.

As shown in Figures 6 and 7, the YieldPlus fund typically held total amounts of privately issued MBS that exceeded 15% of its holdings - in spite of their illiquidity. In 2008, Schwab admitted that the YieldPlus fund was holding significant amounts of illiquid securities and that

[19] See "IndyMac CEO: Private Secondary Markets 'Panicked and Illiquid'," *HousingWire*, August 2, 2007.
[20] See "IndyMac, Rivals Make `Major Changes' in Home Lending," *Bloomberg*, August 2, 2007.
[21] See "S&P May Downgrade Alt-A bonds Once Thought Safe," *Reuters*, August 7, 2007.
[22] See "Seeking Hidden Losses, Regulators Comb Books of Wall Street Titans," *Wall Street Journal*, August 10, 2007.
[23] See "Mortgage Woes Force Thornburg To Delay Dividend," *Forbes.com*, August 14, 2007.
[24] See "Where is Value in Structured Mortgage Products?" *Toomre Capital Markets LLC Website*, December 11, 2007.

these illiquid positions had imposed real costs on YieldPlus fund shareholders. Schwab's president, Randall W. Merk, stated in an August 2008 letter to shareholders:

…the YieldPlus fund was particularly affected by these deteriorating market conditions…In our view, this decline has been more the result of the unprecedented market illiquidity, and less about the underlying credit quality or fundamentals of the portfolio.

VII. INFLATED VALUATIONS OF HOLDINGS

There have been recent allegations that some mutual funds inflated the value of their mortgage backed securities holdings. This behavior would result in inflated mutual fund NAVs and the communication of misleading information about the quality of a fund's assets to its investors. Inflated NAVs would also cause investors to buy and sell their shares at incorrect prices.

As an example, the Securities and Exchange Commission found that Evergreen Investment Management Company overstated the value of residential mortgage backed securities in the Evergreen Ultra Short Opportunities Fund ("the Ultra Fund"). In an Order Instituting Administrative Cease-and-Desist Proceedings against Evergreen Investment Management Company, LLC and Evergreen Investment Services, Inc., the SEC states:

From February 2007 through its closing on June 18, 2008, the Ultra Fund overstated its per share net asset value ("NAV") by as much as 17%.

The same Order later states:

Since its inception, the Ultra Fund valued many of the securities it held in accordance with prices provided by a vendor such as Standard & Poor's, PricingDirect, Interactive Data Corporation, and Reuters. In addition, at least as far back as August 2007, the Ultra Fund valued one or more of the securities it held in accordance with prices provided either by a single broker-dealer or the Fund's portfolio management team -- sometimes in the form of a vendor override (when a vendor price was available) and sometimes not (when no vendor price was available). However, as early as February 2007, the Ultra Fund failed to take into account in its valuation of certain vendor-priced, broker-priced and/or portfolio management team-priced residential mortgage-backed securities readily-available negative information concerning the value of those holdings. For example, beginning at least in February 2007, the media widely reported that, due to rising mortgage defaults and delinquencies, an index that served as a benchmark measure of the riskiness of residential mortgage-backed securities had substantially weakened, with the portion of the index based on subprime mortgages hitting record levels. In addition, on multiple occasions, the Fund's portfolio management team did not properly factor readily-available data showing an increase in the default or delinquency rate for the subprime residential mortgages backing a collateralized debt obligation security ("CDO") owned by the Fund into the security's valuation. As a result, the Evergreen Adviser caused the Fund's NAV to be overstated from February 2007 through June 2008.

The overall size and composition of the Schwab YieldPlus fund's private label RMBS holdings were similar to those of Evergreen's Ultra Short Opportunities Fund. For example, at the end of June 2007, 49% of the Evergreen Ultra Short Opportunities Fund's overall holdings were in private label RMBS with 3% backed by subprime loans and the remainder backed by Alt-A and Jumbo loans. At the end of May 2007, 42% of the YieldPlus fund's overall holdings were in private label RMBS with 6% backed by subprime loans and the remainder backed by Alt-A and Jumbo loans. Given the close similarity in holdings, the SEC's logic implies that Schwab, like Evergreen, could have observed the behavior of the ABX index and used this information to help them correctly value RMBS held by the YieldPlus fund. The analysis in the remainder of this section strongly suggests that Schwab did not do this. In fact, we estimate that Schwab overstated the YieldPlus fund's NAV by over 15% in 2008 - close to the 17% overstatement found by the SEC in the Evergreen fund. Moreover, our analysis of individual holdings shows that YieldPlus's private label RMBS holdings, in particular, were overvalued by large amounts.

A. Comparison with Other Pricing Sources

To evaluate whether Schwab was overpricing YieldPlus fund holdings, we compare Schwab's valuations of ten subprime RMBS tranches held by the YieldPlus fund in late 2007 or early 2008 to valuations made by other mutual funds or provided by Bloomberg (see Table 7).

The last column in the upper half of Table 7 lists estimates of Schwab's overvaluations. In each of the first seven examples, Schwab's reported valuation for the tranche held by YieldPlus was considerably higher than contemporaneous valuations of a tranche from the same securitization that was more senior in the capital structure. This comparison results in a conservative estimate of the overpricing, as the more senior tranches should have significantly higher values than the corresponding junior tranches held by YieldPlus.

In each of the last three examples, Schwab's valuation on February 29, 2008 was much higher than another fund's valuation for the same tranche on December 31, 2007 despite the dramatic market-wide declines in the value of private label RMBS over this period. *See* Table 8.

Table 7: Examples of Inflated Valuations in the YieldPlus Fund. Schwab significantly overvalued many of the tranches held by the YieldPlus fund in late 2007 and early 2008.

Deal Number	Tranche	Valuation Date	Schwab Valuation	Tranche	Alternative Valuation Date	Alternative Valuation	Percent Overvalued
1	M2	11/30/2007	97.42	M1	**11/30/2007**	88.69	9.8%
2	MV5	2/29/2008	92.00	BF	**2/29/2008**	43.78	110.1%
3	M1	2/29/2008	88.28	A3	**2/29/2008**	75.72	16.6%
4	M1	2/29/2008	98.20	A7	**2/29/2008**	91.09	7.8%
5	M1	2/29/2008	96.76	A2	**2/29/2008**	89.81	7.7%
6	M1	2/29/2008	89.90	A4	**2/29/2008**	84.56	6.3%
7	M2	2/29/2008	87.70	3A2	**2/29/2008**	81.91	7.1%
8	M2	2/29/2008	82.22	**M2**	12/31/2007	78.00	5.4%
9	M2	2/29/2008	91.10	**M2**	12/31/2007	75.21	21.1%

10	M2	2/29/2008	80.00	**M2**	12/31/2007	53.95	48.3%
						Average:	**24.0%**

Deal Number	Deal Name	Alternative Valuation Source
1	Argent Securities Inc., Series 2003-W9	Fidelity Short-Term Bond Fund
2	Countrywide Asset-Backed Certificates, Series 2004-10	Bloomberg
3	Morgan Stanley Capital Inc, Series 2003-HE3	Bloomberg
4	Morgan Stanley Capital Inc, Series 2004-HE8	Bloomberg
5	NovaStar Home Equity Loan, Series 2003-2	Bloomberg
6	Park Place Securities Inc, Series 2004-MHQ1	Bloomberg
7	Structured Asset Investment Loan Trust, Series 2003-BC7	Bloomberg
8	Asset Backed Funding Certificates, Series 2004-OPT2	Putnam Diversified Income Trust
9	Countrywide Asset-Backed Certificates, Series 2003-2	Blackrock International Opportunities
10	Option One Mortgage Loan Trust, Series 2002-6	Blackrock International Opportunities

Table 8: ABX 06-2 Prices. Prices on ABX indices are indicative of a dramatic market wide decline in the values of private label RMBS from December 31, 2007 through February 29, 2008.

Date	06-2 AAA	06-2 AA	06-2 A	06-2 BBB	06-2 BBB
12/31/2007	86.84	62.15	39.48	20.49	19.33
2/29/2008	73.41	43.66	17.50	13.25	12.71

B. Cash Flow Analysis

The previous section provides strong anecdotal evidence that Schwab was inflating the value of YieldPlus's portfolio holdings. In this section, we assess Schwab's YieldPlus fund valuations more generally using an accounting based methodology. This approach is independent from the comparison of individual securities presented in the previous section. To implement it, we first construct a statement of cash flows using standard cash flow analysis techniques with the following key difference: cash proceeds from asset sales and cash payments for asset purchases are based on valuations that Schwab reported in the fund's SEC filings. All other cash flows are taken directly from annual and semiannual YieldPlus fund reports. If assets were bought and sold at the price at which Schwab valued them in nearby SEC filings, sources of cash should equal uses of cash. The likely source of any significant cash flow imbalance is the recording of asset values at prices different from their transaction prices.[25] If sources of cash do not equal uses, the amount of the imbalance can be used to estimate the degree of the mispricing. Details and assumptions of the methodology, as well as validation tests on other mutual funds, are discussed in Appendix A.

Table 9 lists our results. In both periods examined, September 2007 to February 2008 and March 2008 to August 2008, net redemptions were significant and so securities sales far exceeded securities purchased. For the earlier period shown in Table 9, estimated sources of cash exceed uses by $118mm. This translates into fund assets being overpriced, on average, by at least 2.0%. In the later period, however, sources of cash exceed uses by $645mm, which translates into a sizeable overpricing of at least 15.3%. Although this estimate is made using only holdings that were bought or sold, we believe that it is indicative of valuation practices for the entire YieldPlus fund portfolio. Our methodology is biased against finding overpricing; it generates negative numbers – underpricing - when there is in fact no mispricing. Consequently, the 2.0% and 15.3% estimates of overpricing in Table 9 understate the likely amount of overpricing in the YieldPlus securities that Schwab sold during the period covered.

Thus, in early 2008, YieldPlus fund investors were misled into thinking that their shares were worth 15% more than they actually were. This missing information would have been an important factor in helping existing investors to evaluate the value and riskiness of their positions and to decide whether or not to sell their shares.

[25] This analysis assumes that round trip transactions within the reporting periods generate net profits or losses that are small. While this may not be true in every case, it appears to be true for YieldPlus during the periods we analyzed.

Table 9: Determination of Valuation Inflation Using Cash Flow Statement Analysis. In early 2008, YieldPlus fund investors were misled into thinking that their shares were worth 15% more than they actually were.

All dollar amounts are in $Thousands

	Sep 2007 - Feb 2008	Mar 2008 - Aug 2008
Sources		
* Net Assets Sold	5,500,966	4,597,281
Investment Income	240,729	30,550
Total Sources of Cash	**5,741,695**	**4,627,831**
Uses		
Fund Expenses	18,240	2,167
Change in Cash	60,624	342,888
Net Cash Share Redemptions	5,469,846	3,625,578
Cash Distributions	75,273	11,703
Total Uses of Cash	**5,623,983**	**3,982,336**
Sources - Uses	**117,712**	**645,495**
**Estimated Percent Overpricing	2.0%	15.3%
YieldPlus Return	-4.0%	-27.8%

*Assuming Schwab Prices for Asset Sale Proceeds

**(Excess Sources)/(Assets Sold - Excess Sources)

VIII. CONCLUSION

Schwab marketed its YieldPlus fund as an ultra short bond fund, and as a higher yielding alternative to a money market fund with only marginally higher risk. Based on these representations, investors switched personal savings – savings that that they had designated for safekeeping – from money market and other cash-equivalent investments to the YieldPlus fund.

Yet, the YieldPlus fund was not managed like a typical ultra short bond fund, to say nothing of a money market fund. In fact, from December 31, 2005 through June 30, 2008, it suffered greater losses than every other ultra short bond fund tracked by Bloomberg. By violating concentration limits and illiquidity limits in its prospectus, Schwab was able to hold unusually large amounts of illiquid, risky, private label mortgage backed securities. These higher yielding securities initially gave Schwab a small competitive edge over well-managed ultra short bond funds. Ultimately, private label mortgage backed securities were responsible for a majority of the fund's large losses. Making matters worse, Schwab ignored widely available market information which signaled much lower market values for a significant portion of YieldPlus' assets. Schwab continued to carry these assets at inflated prices, withholding valuable information from its investors.

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APPENDIX A – CASH FLOW ANALYSIS DESCRIPTION AND TESTS

A. Methodology

In the cash flow analysis presented in Section VIII, the dollar value of "Assets Sold" and "Assets Purchased" is estimated using quarterly holdings data from Schwab SEC filings as follows:

$$Assets\ Sold\,(Using\ Schwab\ Valuations) = \sum_{i=1}^{M} Q_i^S V_i^S$$

$$Assets\ Purchased\,(Using\ Schwab\ Valuations) = \sum_{i=1}^{N} Q_i^P V_i^P$$

There are M sales and N purchases during the period. Q_i^S is the quantity sold in sale i, V_i^S is an estimate of Schwab's valuation of the asset sold in sale i, Q_i^P is the quantity bought in purchase i, V_i^P is the estimate of Schwab's valuation of the asset bought in purchase i. The quarterly estimates are added to obtain the semiannual estimates shown in Table 9.

Except for "Assets Sold" and "Assets Purchased," all other sources and uses of cash are taken directly from the YieldPlus fund's financial statements. Thus, the only reason why the imbalance (Total Sources of Cash – Total Uses of Cash) should be non-zero is because Schwab buys and sells assets at prices different than their valuations. Thus,

$$Imbalance = \sum_{i=1}^{M} Q_i^S (V_i^S - P_i^S) - \sum_{i=1}^{N} Q_i^P (V_i^P - P_i^P)$$

where P_i^S and P_i^P are the sale and purchase prices for sale i and purchase i, respectively.

A positive value of the imbalance indicates that assets sold were overvalued or that purchased assets were undervalued. As shown in Table 9, the YieldPlus fund shows a positive imbalance over the period September 2007 – February 2008 and a large positive imbalance from March 2008 – August 2008. During these periods, the vast majority of the transactions were sales, so the positive imbalances indicate that assets sold were being valued above their sale prices.

The quarterly holdings reports provide only end of quarter prices. Since transactions occur throughout the quarter, the valuation at the time of the transaction must be estimated. To provide conservative estimates of the overvaluations, for sales, we use the smaller of 1) the price at the beginning of the period and 2) the price at the end of the period. The larger of these two prices is used for purchases. For many sales, no end-of-period valuation is available since all of the holdings of that particular security were sold. For the purchases, beginning-of-period valuations are not available, for similar reasons. In these cases, the missing valuation is estimated using the average valuation change (in percent) for the asset class in question from the YieldPlus fund's other holdings.

A percentage estimate of the degree to which assets are mispriced can be obtained by assuming that the entire imbalance is generated from sales:

Percent Mispricing = Imbalance/(Value of Assets Sold using Schwab Valuations – Imbalance)

The numerator is the dollar overpricing of the assets sold and the denominator is an estimate of the actual dollar proceeds from the sales. Thus, the ratio is the estimated overvaluation in percent. Assuming the entire imbalance is generated from sales is justified for two reasons: 1) Sales as a percent of total transactions are large – considerably greater than 90%. 2) The imbalance calculation is done very conservatively as discussed previously.

B. Validation Tests

Since large capitalization equity funds hold stocks that are traded in highly liquid and transparent markets, these funds would have valued their holdings at prices very close to realizable transaction prices. Therefore, we use three of these funds to validate our methodology. As described above, we use the lowest valuation available for sales and the highest valuation available for purchases to provide as small (conservative) an imbalance as possible. Thus, a fund that values its assets at realizable transaction prices should exhibit an estimated imbalance less than or equal to zero. We analyzed the Fidelity Advisor Growth Income Fund, the John Hancock Large Cap Equity Fund and the Schwab Large Growth Select Fund. All three funds have negative estimated mispricing, providing evidence that the methodology is valid and that the estimated mispricing for the YieldPlus fund is indeed a conservative indication that Schwab was significantly overstating YieldPlus's NAV.

APPENDIX B – ULTRA SHORT BOND FUNDS USED IN HOLDINGS AND RETURN COMPARISONS

Fund Name	Ticker	Holdings Comparison	Return Comparison
AIM LIBOR Alpha	EASBX	X	
Allegiant Ultra Short Bond	ASDAX	X	X
AMF Ultra Short	AULTX		X
AMF Ultra Short Mortgage	ASARX		X
BlackRock Enhanced Income	BRIVX	X	X
Calvert Ultra-Short Floating Income	CULAX	X	
CMG Ultra Short Term Bond	CMGUX	X	X
DFA One-Year Fixed-Income	DFIHX		X
Dreyfus Yield Advantage	DPYBX	X	X
Evergreen Adjustable Rate	ESAAX	X	X
Federated Gov Ultrashort Duration	FGUAX	X	X
Federated Ultrashort Bond	FULAX	X	X
Fidelity Advisor Ultra Short Bond	FUBAX	X	X
Fidelity Ultra-Short Bond	FUSFX		X
Fifth Third Short Term Bond	KNLCX	X	X
Franklin Adjustable U.S. Govt Secs	FCSCX	X	X
GMO Short-Duration Investment III	GMSIX	X	X
Goldman Sachs Enhanced Income	GEIAX	X	
Goldman Sachs Ultra-Short Dur Gov	GSAMX	X	X
JPMorgan Enhanced Income Instl	JEIFX	X	X
JPMorgan Ultra Short Duration Bond	OGUCX	X	X
Legg Mason Partners Adj Rt	ARMGX	X	X
Managers Short Duration Government	MGSDX	X	X
Metropolitan West Ultra Short Bond	MWUIX	X	X
Payden Limited Maturity	PYLMX	X	X
Permanent Portfolio Treasury Bill	PRTBX		X
PIA Short Term Securities	PIASX	X	X
PIMCO Floating Income	PFNCX	X	X
PIMCO Short-Term	PFTCX	X	X
Principal Ultra Short Bond	PULAX	X	
RidgeWorth Limited Duration	SAMLX	X	X
RidgeWorth Ultra-Short Bond	SISSX	X	X
RidgeWorth US Gov Sec Ultra-Short Bd	SIGVX	X	X
SM&R Primary	SMRPX	X	X
TCW Short Term Bond	TGSMX	X	X
Touchstone Ultra Short Dur Fixed Inc	TSDOX	X	X
Trust For Credit Unions Ultr-Sht Dur Gov	TCUUX	X	X
Wells Fargo Advantage Ultra S/T Inc	WUSDX	X	X
Wells Fargo Advantage Stable Income	WSICX		X
Total Number of Funds		33	35