Illustration of a black hole by NASA.
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IP-Participações

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In this report, we discuss a new investment: Charles Schwab. We started purchasing shares throughout 2019, as the stock plunged 40% from its 2018 peak.

Charles Schwab is XP’s stated benchmark. Both companies have similar business models and are run by highly skilled and assertive people who have transformed capital markets in their respective countries.

We had not stumbled upon a company as customer-centric as Charles Schwab since analyzing Amazon. For this reason, we chose to briefly recount its story. We will mainly focus on Schwab’s initial years and major setbacks, as well as its recent decision to acquire TD Ameritrade.

THE ORIGIN AND RISE OF CHARLES SCHWAB

Charles Schwab began in 1974 as a brokerage firm focused on a segment that was entirely neglected by Wall Street: the small individual investor. While most brokers adopted a predatorial approach towards inexperienced investors, Charles ‘Chuck’ Schwab believed every investor should have his or her interest made a priority. This concept may seem cliché today, but in the 1970s it was revolutionary. In an industry rife with conflicts of interest, Chuck saw an opportunity.

In a traditional broker-investor relationship, the broker is a salesperson who receives a commission when recommending a purchase or sale of a stock. Chuck loathed this model, disapproving the obviously misaligned incentive brokers had to push the product which would yield the highest commission instead of what was ultimately in the best interest of the client. Chuck decided to invert this logic by replacing commissions with fixed salaries and abolishing active calls to clients. Clients would come to Schwab whenever they wanted to — not the other way around. Gone were the lavish offices, customer lunches and general expendable costs associated with client-pampering. Right then, the first discount broker in the United States was born.

Determined to become the industry’s low-cost provider, Chuck quickly adopted a spartan mentality to minimize the company’s cost structure. Not surprisingly, when his uncle William - one of Schwab’s first investors - suggested opening branches, Chuck immediately rejected the idea. After all, why would a discount broker want to absorb the cost of physical branches?

This discussion gave rise to an essential insight in Schwab’s early years: though somewhat counterintuitive, opening physical branches was paramount to the success of the business. No one really knew the discount brokerage model by then. It was only natural that potential clients were hesitant to entrust their hard-earned assets to the company.

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1 In December 2019, Brazilian financial services platform XP Inc. had its IPO on New York’s NASDAQ exchange. It raised US$2.25 billion (both primary and secondary offerings) and was worth US$60 billion at the end of 2019.

2 It is hard to overstate the importance of credibility and brand equity in this business. For example, XP’s asset growth accelerated significantly after Itaú became a shareholder in 2017.
With each branch inauguration, however, Chuck noticed a dramatic step-up in asset growth. Despite the significant fixed cost, branches produced a powerful psychological effect, giving the Schwab brand the credibility it required to gain scale and capillarity.

After disrupting the stock brokerage market, Schwab set out to break new ground. It was the first company to see the potential in the registered investment advisor (RIA) channel in the 1980s and the creator of the first mutual fund supermarket - Schwab OneSource - years later.

The company’s journey was relentless. During the 1990s, Schwab’s assets under custody sprang from US$31 billion to US$872 billion. During this same period, its stock multiplied by 100 - the best performance in the entire US financial services industry.

RING OF FIRE

“We’ve just seen our revenue go down 40% post-Internet bubble; now you’re saying we should take it down another 20 or 25%?”

Charles Schwab: “We will return to being the Schwab of old, which did the right thing by every customer. And in return, clients will choose to bring business to us.”

Schwab’s seemingly endless success suffered two major blows around the turn of the century. The first came with the implosion of the dotcom bubble in the early 2000s. As the NASDAQ index crashed and trading volumes evaporated, Schwab’s brokerage revenues halved in less than a year.1

The second blow came from increasing competition. Smaller companies such as E*trade, TD Waterhouse, and Ameritrade were becoming greater nuisances by increasingly targeting price-sensitive and trading-intensive clients. With far more aggressive prices than Schwab’s, asset growth was seriously hindered.

The years of steady growth also masked some cracks in Schwab’s business model. Throughout the years, the company succumbed to unnecessary acquisitions and lost focus. Customer service levels deteriorated, corporate costs ballooned, and hiring criteria was relaxed.

Additionally, while trying to plug the revenue gap, Schwab committed serious execution blunders. For instance, the company began segmenting its clients into wealth brackets and charging more from smaller and less active investors. The small individual investor, Schwab’s original client, was gradually being neglected.

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1 At the time, brokerage revenues accounted for around 50% of total revenues.
2 In 2005, brokerage revenues accounted for around 18% of total revenues.
By 2004, Schwab’s stock had tumbled by 75% from its 2000 peak. The company was losing market share, customer satisfaction metrics were deteriorating, and employee morale was at an all time low. The Board of Directors convinced Chuck to come back as CEO. Schwab needed to return to its origins.

Chuck quickly set a restructuring plan in motion: he sold non-core assets, simplified the hierarchical structure, cancelled customer segmentation, and strengthened the customer service department. However, it was still insufficient. To reestablish the company as the market consolidator, Schwab needed to deliver greater value to customers. To win, Chuck knew he had to forfeit revenue.

After convincing the Board of Directors, Chuck implemented his plan. From his return, in mid-2004, until the end of 2005, Schwab’s brokerage fees were slashed in half. Accordingly, the company resumed its growth path. Within a few years, satisfaction metrics reached industry record levels. After the turmoil, Chuck chose a successor in 2008 – Walter Bettinger – and returned to the position of Board Member.

From the 2004 turnaround until 2019, Schwab’s assets under custody grew nearly four times, soaring from just over US$1 trillion to about US$ 3.9 trillion.

A CULTURE OF SELF-DISRUPTION

The “one step back, two steps forward” approach is a trademark of Schwab’s, disseminated over the years by its founder. In wartime, it was key to restore competitiveness and perpetuate the business model. More impressive, though, was the company’s boldness in using this device during peaceful periods. In several moments during its history, even while delivering excellent results, Schwab deliberately chose to cut revenues, knowing this decision would yield an attractive long-run payoff.

It is not simple to change the status quo when all is sailing smoothly – especially when key metrics of variable compensation are tied to the stock price. There is a long list of executives who have discarded value-additive decisions solely based on their reluctance to present shareholders with a short-term decline in earnings.

Chuck, on the other hand, has always lived by the “best defense is a good offense” adage. For example, in 1992, before Schwab OneSource (the mutual fund platform) existed, it was common market practice to charge a fee for the convenience of selecting a fund to invest. The decision to abolish this fee meant a deep cut to profitability, while revenue projections were inconclusive. Even so, the company decided to move forward. At the time, Chuck would say, “Damn the marketing research, we need to do this. People will bang down our doors to use this product.” His intuition was spot-on.

Throughout its history, Schwab has continually cut the cost of investing through its platform and kept...
its competitors under constant pressure. Its evolution from a pure brokerage to a ‘financial services’ Walmart was only made possible by the company’s impressive ability of continuous self-disruption.

IN 2019, SCHWAB STRIKES AGAIN

In September, Schwab surprised the industry by announcing it would eliminate all stock brokerage fees. Although these fees represented only 6% of the company’s total revenue, the decision was iconic: a company born as a broker had evolved to no longer monetize this line of business. This is what makes Schwab special: its capacity to reinvent and adapt itself constantly to meet clients’ needs.

Months later, Schwab announced a stock-swap merger with one of its largest competitors - TD Ameritrade - creating a goliath with assets under custody of about US$5.3 trillion. Unlike Schwab, TD Ameritrade has a greater dependence on its brokerage business, accounting for 34% of its revenues. This revenue was approximately cut in half with Schwab’s zero-fee announcement. TD bled the most in this battle and ultimately became a target for acquisition.

With more assets under custody, Schwab continues to feed the virtuous cycle that propels its business: the larger the asset base, the greater its scale and ability to transfer efficiency gains (in the form of lower costs) to clients. As such, the company wins more and more assets. A machine that continually nourishes itself, increasing its strength over time.

CUSTOMER ASSETS UNDER CUSTODY (US$ TRILLION)

Charles Schwab  JP Morgan  Bofa Merrill Lynch  Morgan Stanley  Wells Fargo

SEP/2009  SEP/2019

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1 Today, the company’s main source of revenue is interest income from customers’ deposit accounts.
2 The merger is still pending regulatory approval.
3 Source: Boston Consulting Group.
4 The main sources for Schwab’s history were the books: ‘Charles Schwab: How One Company Beat Wall Street and Reinvented the Brokerage Industry;’ by John Kador; ‘The Founder’s Mentality,’ by Chris Zook; and the paper ‘The Charles Schwab Corporation in 2007: Fixing and Redefining the Core Business,’ by Stanford University.
Charles Schwab’s Transformation in Numbers Over the Last 30 Years:

<table>
<thead>
<tr>
<th></th>
<th>1990</th>
<th>2000</th>
<th>2010</th>
<th>2019</th>
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<tbody>
<tr>
<td>Assets in Custody (US$ Billion)</td>
<td>31</td>
<td>872</td>
<td>1.575</td>
<td>3.900</td>
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<td>Asset Revenue (in bps)</td>
<td>160</td>
<td>73</td>
<td>29</td>
<td>30</td>
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<tr>
<td>Stock Brokerage Rate (US$)</td>
<td>85.00</td>
<td>29.95</td>
<td>12.95</td>
<td>4.95</td>
</tr>
<tr>
<td>Brokerage on total revenue</td>
<td>64%</td>
<td>49%</td>
<td>20%</td>
<td>6%</td>
</tr>
<tr>
<td>Operating margin</td>
<td>7.5%</td>
<td>23.3%</td>
<td>29.7%</td>
<td>45.5%</td>
</tr>
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In December, after accompanying Schwab for many years, we had a collateral gain.

As a general rule, we do not participate in IPOs. In some cases, we can spend years examining a company until we create the conviction to invest. The lack of sufficient time for proper analysis and the information asymmetry inherent to the IPO process tends to create an unfavorable setting for buyers. However, given our built-up knowledge of Schwab and our admiration for the business model, we decided to participate in XP’s IPO in the IP-Participações fund.

We believe this to be one of IP’s key competitive advantages. By splitting our time between Brazilian and foreign companies, our knowledge of the same industry across different countries can benefit us in multiple occasions. Many similar situations have occurred and we are certain several more lie ahead.

Thank you for your trust.
"Our basic philosophy is to ask, ‘Who’s getting screwed, where and why?’ Let’s go out and solve that problem."

— Charles Schwab

"Thank you for calling Charles Schwab & Company. This is Chuck Schwab. May I help you?"

— At a time when Chuck himself helped answer the customers’ calls.

“Disruption occurs when someone listens more carefully to customers, or better anticipates what customers might want before they even realize it themselves. Most companies are disrupted because they lack the will and courage to disrupt themselves first.”

— Walter Bettinger, current CEO of Charles Schwab

"People often say to me, 'Well, isn't the ultimate measure what your stock price has done?' No. The ultimate measure is whether clients entrusted us with their money. Stock price comes after the fact. Financial results are a result of doing the right thing in serving others and doing the right thing in serving our clients."

— Walter Bettinger

"The reasonable man adapts himself to the world. The unreasonable one persists in trying to adapt the world to himself. Therefore, all progress depends on the unreasonable man."

— George Bernard Shaw
“Don’t be afraid to change the model.”
— Reed Hastings

"The last man standing is patience. We call it time arbitrage. That’s really in short supply and it’s not getting better. Things are moving to faster and less patience. So that’s really the secret."
— Joel Greenblatt

"Many people believe that investors must make the macro decision to be either bullish or bearish. Our preference is to be agnostic, objectively finding absolute bargains, and in their absence, holding cash. In short, we are neither bullish nor bearish. We are value-ish."
— Seth Klarman

"There’s no asset class that too much money can’t spoil."
— Barton Biggs

“When someone comes to you and offers a billion dollars for eleven people, what do you say?”
— Kevin Systrom, co-founder of Instagram, bought by Facebook in 2012, when recently asked if it would not have been better to stay with his company.