

Observation Deck

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Cash is King

Ninh Chung, *Portfolio Manager*

The expression “cash is king” could not be more true than during times of financial distress. This time around is no different. What has changed however, is the way corporate treasurers view and define cash. Prior to this current financial crisis, which was described by Alan Greenspan as “a once-in-a-century credit tsunami,” corporate cash investors had viewed cash as a brainless temporary investment alternative for idle funds.

What is “cash”?

In finance, cash—or sometimes known as cash equivalents—is any investment with a known value that can be bought or sold with ease. This includes hard currency in hand, savings and checking accounts, Treasury bills with less than 90 days to maturity, short-dated insured certificate of deposits, and shares of money market mutual funds. The overall assumption is that these investments feature liquidity and can be sold with short notice and at no less than the original cost.

During the past several decades, investors have been bombarded with newly created “cash-like” vehicles; for example, enhanced money market funds which seek higher yields by extending duration or lowering credit requirements or both, extendable commercial paper and auction rate securities. These cash-like investments have failed the test of capital preservation and the ability to fulfill liquidity needs in a timely manner.

Markets	
Treasury Rates	
3-Month	0.38%
6-Month	0.95%
1-Year	1.31%
2-Year	1.56%
5-Year	2.83%
10-Year	3.96%
October Total Returns	
ML 3-Month Treasury	0.11%
ML 6-Month Treasury	0.41%
ML 12-Month Treasury	0.57%
S&P 500	-16.79%
Nasdaq	-17.69%

Source: Bloomberg, as of 10/31/08

Tradition Challenged

The investment vehicle of choice for many investors when seeking the features of cash investments has been the use of prime money market funds. One of the largest beneficiaries during this financial crisis has been the money market fund industry. Since the start of the credit crunch, money market funds have grown from \$2.0 trillion to approximately \$3.6 trillion collectively because of their reputation for their ability to preserve capital, provide liquidity and provide a competitive rate of return. This traditional strategy changed drastically when the Reserve Primary Fund, a prime money market mutual fund, fell below one dollar in net-asset-value on September 16—a phenomenon known as “breaking the buck.” After the Reserve Primary Fund fell below its one dollar net-asset-value, government money market funds, including Treasuries grew by more than 50 percent while prime funds declined by more than 20 percent. For now, prime funds have taken a back seat to Treasury funds but we believe this will reverse in time.

What's next?

First, investors should reassess their liquidity needs to ensure their entire investment portfolio can meet their requirements adequately. If there is a liquidity shortfall, then selling existing investments may be the only viable option; however, corporate treasurers should avoid the fire-sale trap for the sole purpose of building cash. The frozen credit environment has caused tremendous drops in trading volume of all credit-related fixed income securities; in turn, this has caused these securities to decrease in value. Corporate treasurers should consult with their investment manager to determine if the difference between the fire-sale market value and the hold-to-maturity valuation is a result of overall market illiquidity or warranted balance sheet concerns about the investments. Although the trading volume of credit products are at historic lows, market participants are more than willing to bid fire-sale prices for high creditworthy investments. Investors should avoid feeding into this vulture-like behavior unless driven by liquidity needs.

Next, investors should examine their current cash allocation. If you are invested in a prime money market fund and do not directly benefit from the Treasury's Temporary Guarantee Program, you may consider lowering your credit risk by investing in a government or Treasury money market fund. The lower yield may be worth the extra sleep knowing you are invested in U.S. Treasuries and government-sponsored enterprises.

Economic Vista

Minh Trang, *CFA, Portfolio Manager*

The economy continued to weaken as firms cut back on hiring and increased layoffs. The labor market lost 159 thousand jobs in September, bringing the total number of job losses to 760 thousand for the year. The unemployment rate held at 6.1 percent, but is expected to rise as further job cuts are forecast for the coming months. This has clearly had an impact on the housing sector. Home foreclosures are up 71 percent from last year. In the third quarter, nearly 766 thousand households received a foreclosure notice.

In addition, several major tremors shook the financial markets in October and the credit freeze intensified. Despite the government passing a \$700 billion rescue bill, fear of a sustained recession continued to drive down domestic and global equity markets. Illiquidity remained at the epicenter of the turmoil, as LIBOR rates rose dramatically. In an intra-meeting move in early October, the FOMC and several central banks uniformly reduced respective target rates by 50 basis points to alleviate credit strain. On October 29, the FOMC reduced the target rate by another 50 basis points. In addition, the Federal Reserve and U.S. Treasury have announced numerous programs to further stabilize the overall credit market and aid the ailing economy. These programs, however, will take time to implement. Only time will determine whether or not they will be effective.

Credit Vista

Melina Hadiwono, *CFA, Head of Credit Research*

Over the past several weeks, governments around the world have deployed a range of unprecedented steps to contain the financial crisis and preserve the world's economies. The credit markets have been under pressure for the better part of a year. With the failure of Lehman Brothers in mid-September, however, the markets experienced true crisis levels. Governments began taking steps to initiate programs, viewed as a broad systematic response to the pressures that have been crippling the credit markets over the past few weeks. Steps taken include: increasing deposit insurance; guarantee bank lending; providing funds for asset purchases; and taking preferred equity positions in key financial institutions.

While many of these programs will take time to implement, they are designed to address the risk of banks losing access to vital short-term funding in the same way that the deposit guarantees limit the risk of a "run-on-the-bank" scenario. While the inter-bank lending and credit markets have improved slightly at the end of October, they are not functioning well. We are about to see how deeply the financial turmoil has impacted the world's economy. It is clear that the regulators

hope to restore confidence in the financial markets and encourage bank lending to drive economic growth. What is less clear is whether or not their actions will ease lending conditions across the corporate and consumer sectors to a degree that the regulators find acceptable.

At the moment, lending policies remain at the discretion of bank management. Banks are likely to use governments' unprecedented steps to rebuild their capital instead of extending credit. Much of the crisis was due to negligent lending policies. Now banks must react defensively by hoarding capital to service a range of existing contingent commitments—such as revolving lines of credit; and offsetting the increased losses on the loan portfolio given the rapidly deteriorating economy. Going forward, as the banking system reforms itself and adapts to new rules, we can expect they will apply a newfound discretion to their activities that will likely prolong the phase of economic weakness.

Trading Vista

Hiro Ikemoto, *Money Market Trader*

If Mark Twain was a bond trader, he might have said, "The coldest winter I ever spent was October 2008 in the credit markets." With short-term lending between banks frozen, most investors are staying on the sidelines awaiting the effects of TARP, CPFF and other government actions designed to help thaw out the market. Little trading has taken place in the past month. Spreads widened on corporate bonds as high-grade issues maturing in one year were being offered at 300 to 500 basis points above LIBOR and bid at 400 basis points and up. Due to the uncertainty of future liquidity, buying incentives are limited. Three-month commercial paper rode the wave of three-month LIBOR as yields peaked on October 10 at 4.68 percent and ended at 2.86 as liquidity started to come back in this maturity range by month-end.

Bidding for short Treasury bills overwhelmed the market as "flight-to-quality" trades continued. With a finite number of Treasury bills in the market, this squeeze caused yields to go to zero for very short bills as money fund managers needed to collateralize their repurchase agreements with Treasuries. Additionally, the inflow of funds to Treasury money market funds caused a further lack of Treasuries in the market. Agency discount-note yields fell below the two-handle mid-month and were at 1.70 by month-end.

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