

Observation Deck

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Know Your Manager

Minh Trang, CFA, Portfolio Manager

In light of the Madoff Ponzi scheme and Stanford Financial Group fraud case, it is a good time for corporations to evaluate or reassess the safeguards for their investments. In particular, clients should have a clear understanding of the business structure and history of their asset manager or broker. Fortunately, there are various resources that any firm can use, and documentation that should be provided by the broker or asset manager before establishing any relationship ties.

Form ADV and FINRA

One of the first steps an investor should take is to review the Securities and Exchange Commission (SEC) Form ADV that would be provided by the asset manager if he or she is a Registered Investment Adviser (RIA). The ADV has two parts, and is an information and disclosure document required of all SEC-registered investment advisers to give full disclosure on their business and where potential conflicts of interest may arise in the course of that business. Part 1 of the ADV contains information relating to the RIA's business, key personnel, and whether they have been the subject of any regulatory or civil actions. The second part outlines the RIA's services, fees and investment strategies. An RIA's most recent Form ADV Part 1 can be found online by visiting the SEC's Investment Adviser Public Disclosure (IAPD) website.¹ Part 2 must be delivered by your RIA. Reviewing this form will help an investor evaluate the appropriateness of a prospective investment manager. For brokers, a client can use the Central Registration Depository (CRD), which is a computerized database that contains information about most brokers, their

representatives, and the firms they work for. A client can access this through the Financial Industry Regulatory Authority (FINRA)² web site in gathering additional information on a broker. This information would include the broker's qualifications, registration, employment history, some of their customers' disputes, if any, and any finalized disciplinary events.

Business Structure

Obviously, reviewing the background and history of a potential manager or broker is an important start. Other key elements, however, should also be taken into consideration. This should include understanding your custodian's structure and knowing exactly where client investments are being held. It is highly recommended that the adviser and client use a third-party custodian where assets are not commingled and accounts are properly established in the client's name. (By comparison, Madoff's approach of self custody made his fraud much easier to accomplish.) This structure minimizes greatly the potential for conflicts of interest and increases transparency. In addition, regardless of the future of your manager or custody bank, the custody structure ensures the return of your assets to you, the beneficial owner.

For asset managers, it is also important that they have internal measures to ensure proper compliance. RIAs are required to place the client's interests above all else, i.e., they have an explicit fiduciary obligation to their client.

Lastly, it is vital that all associated business controls that the investing firm relies upon are thoroughly audited by established organizations at least annually. A targeted SAS70 should be provided by the asset manager, the custodian and the reporting entity to ensure that the controls in place at each of these providers are robust and functioning on your behalf.

Conclusion

It is an industry standard that financial professionals know their clients. In light of the recent fraud activities, however, it is equally important that clients know their investment professionals. Doing a thorough background check on an adviser or broker is an important and surprisingly painless first step in the due diligence process. In addition, the client should be comfortable that there is current regulatory oversight in regard to the structure and operation of the business.

¹ www.adviserinfo.sec.gov/IAPD/Content/Search/iapd_OrgSearch.aspx

² www.finra.org/Investors/ToolsCalculators/BrokerCheck/index.htm

Markets

Treasury Rates

3-Month	0.20%
6-Month	0.42%
1-Year	0.54%
2-Year	0.80%
3-Year	1.12%
5-Year	2.25%
7-Year	2.25%
10-Year	2.66%

March Total Returns

ML 3-Month Treasury	0.04%
ML 6-Month Treasury	0.10%
ML 12-Month Treasury	0.24%
S&P 500	8.74%
Nasdaq	1.02%

Economic Vista

Debi Hanson, *Portfolio Manager*

March brought little good news to the economy as job losses continued and oil and gas prices rose. Non-farm payroll, the key jobs report, showed an additional 651,000 jobs lost during the month of February. This brings the total Americans who have lost jobs since January 2008 to nearly 4.6 million. The number of Americans still receiving unemployment benefits rose to a record high of 5.47 million. Not surprisingly, with the continued job losses, retail sales were reported down by 0.1 percent for the month.

Housing prices continue to drop; down 18.9 percent according to the S&P/CaseShiller Home Price Index. Adding to the pressure in the housing market, mortgage delinquencies rose to 21.88 percent for subprime loans and 5.06 percent for prime loans. On a positive note, existing home sales rose 5.1 percent, as bargain hunters came into the market.

The U.S. inflation numbers released were mixed, with the core (excluding food and energy) Producer Price Index falling slightly and core Consumer Price Index rising slightly. These numbers are not a concern at this time as the expectations are for inflation to come down in the near term as a result of the recession. Down the road though, we may see inflation rise as a result of the massive government spending.

Credit Vista

Melina Hadiwono, *CFA, Head of Credit Research*

The U.S. government has implemented various measures to restore financial market functioning and the flow of credit. While these measures are unprecedented in scope and size, their effectiveness can ultimately be gauged by whether the flow and costs of credit have improved. To date, financing conditions have improved for investment-grade, non-financial firms. Corporate bond issuance has picked up from the lows of last fall, even as rates remain higher than they have been in recent years, with spreads remaining quite wide. Commercial paper issuance increased initially after the Fed began buying through the Commercial Paper Funding Facility (CPFF), but firms have been taking advantage of favorable market conditions in recent months and terming out their debt. Financial firms suffered more than any other sector as the crisis unfolded, but have benefited the most from various government programs. The Temporary Liquidity Guarantee Program (TLGP) and CPFF have restored much-needed stability to the commercial paper and bond markets and brought down rates substantially. Investor demand for bonds issued under TLGP has been strong and these securities have traded at comparable valuations to agency debt.

The government has taken various steps to ease the credit conditions affecting households. The Fed's purchase of agency

Mortgage Backed Securities (MBS) has reduced mortgage rates significantly and should help ease credit constraints further. In its latest directive, the Fed has dramatically increased its asset-buying program with an additional \$750 billion in MBS and \$100 billion in agency debt through the end of the year. Moreover, the Fed has decided to buy \$300 billion in longer-term Treasury securities, over the next six months. The total buying program has expanded from \$600 billion to \$1.75 trillion to provide greater support to mortgage lending and housing markets. The Federal Reserve has launched the Term Asset-Backed Securities Loan Facility to facilitate the extension of credit to households and small businesses and anticipates that the range of eligible collateral for this facility is likely to be expanded to include other financial assets. These various programs show policymakers' continued focus on developing appropriate solutions. While there has been some progress in easing credit supply constraints, we expect that the recovery will take time as the staggering destruction of wealth sustained by consumers and the global scope of the downturn means that the demand for credit from both consumers and business will remain subdued for some time.

Trading Vista

Hiro Ikemoto, *Money Market Trader*

With the combination of the announcement that the Fed will be buying \$300 billion worth of Treasuries, and quarter-end window dressing to clean up portfolios, short-term yields across the curve fell. The two-year Treasury note yield ended the month at 0.82 percent, after peaking at 1.03 percent on March 10. Yields on Treasury bills ended the month about 10 basis points richer than in the beginning of March, with the three-month at 0.21 percent, six-month at 0.42 percent and the one-year at 0.55 percent by month-end. Short-term agencies have also tightened up, with yields plus 5 to 10 basis points against Treasuries.

In the corporate sector, three-month commercial paper ended the month at 0.85 percent about 30 basis points below three-month LIBOR. We did not see much being offered in the way of TGLP commercial paper, and the few that were out there were offered at 0.25 to 0.30 percent interest in the three-month range. Spreads on investment-grade industrial bonds tightened up in March with yields in the nine-month to one-year maturity at flat to plus 40 basis points to LIBOR spot, while financial names with similar ratings were at plus 125 to 250 basis points. High-quality two-year bonds were being offered plus 200 to 450 basis points over the two-year Treasury.

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