# Observation Deck

December 2009

## No Risk vs. Know Risk

Adam Dean, *President*

Uncertainty in capital markets has made some firms (and boards) opt to forbid investing any of their precious cash in securities that have credit risk. Even fixed-income issuers and money funds with well-understood and transparent risk profiles, both before and after the credit crisis, have been categorized by some as unacceptable or "unknowable" risks as a result. With government money funds, short-term treasury and government-backed agencies perilously close to zero yield now and in the near future, the time has come to reassess that approach.

Principal loss or frozen investments caused by a corporate asset manager's decisions should always be a termination-worthy offense. But, income lost by foregoing investment in credits that can be confidently measured by a professional asset manager *and* the investing firm is ultimately the same as principal lost.

Instead of saying "no risk," we argue that the better approach going forward is to actually know your risk. Instead of simply relying on credit ratings or trusting a broker's advice, firms today can, with little incremental effort, accurately and confidently measure and restrict the risk in their investments. Much of this ability comes from securing direct access to a dedicated credit team with a fiduciary mandate and a track record of preserving client capital regardless the of market environment.

**Utilize a credit research *team* focused solely on corporate cash.** One weakness of many asset managers is the lack of emphasis they actually give to credit. Expect an experienced team, and get access to it. The Reserve money fund, which broke the buck last year, was documented as having one credit analyst overseeing their entire $65 billion fund. Expect and ask for direct access to your asset manager's credit experts and make sure their sole focus is evaluating the risk in the investments that they allow on their approved issuer list. Expect that the credit team reports up and away from the portfolio management and portfolio strategy side of the asset manager and that there are no biases in their decision process aside from asking and answering this fundamental question: "*Will this investment lose my clients any principal or interest between now and investment maturity?"* If you have questions about a specific credit, ask to see their independent research, ask for them to explain why they are comfortable with the credit. To arrange to speak with our credit team please contact:

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**A credit team's job doesn't end at money funds.** If your asset manager employs a money fund on your behalf, they have an obligation to know that fund, its strategy, its managers and its security allocations, extremely well. If you utilize a manager with an explicit fiduciary obligation (an SEC-registered investment advisor, or RIA) that manager's obligation extends to continued due diligence on money funds alongside every other security you consider. Instead of relying on a fund prospectus, a legally mandated disclosure report given at initial investment, the insight you should have into the funds you employ should be provided monthly, at least. You can expect key fund data, such as security types purchased, total fund assets, maturity and expenses, to be accessible daily.

**Eliminate Objectivity Crises.** One overlooked tool is the value of utilizing a money fund that is not structurally related to your asset manager. In times of crisis, when pressure on funds is highest, your asset manager's perspective on the safety of your fund should not be colored by a desire to minimize fund redemptions. If the manager hired is offering its own fund, you are essentially giving the manager the ability to decide between preserving its own fund or its clients' capital in times of extreme stress. This is not a decision that the asset manager should have.

*For a detailed summary of key elements that an asset manager can provide to help see and mitigate your investment risks, read our new advisory, "What to Look for From Asset Managers," at:*
*www.svb.com/pdfs/sam/SAM_ADVAssetMgrs_1109.pdf*

### Markets

| Treasury Rates | |
|---|---|
| 3-Month | 0.05% |
| 6-Month | 0.15% |
| 1-Year | 0.24% |
| 2-Year | 0.66% |
| 3-Year | 1.10% |
| 5-Year | 2.00% |
| 7-Year | 2.69% |
| 10-Year | 3.20% |
| **November Total Returns** | |
| ML 3-Month Treasury | 0.01% |
| ML 6-Month Treasury | 0.04% |
| ML 12-Month Treasury | 0.18% |
| S&P 500 | 6.00% |
| Nasdaq | 5.05% |

*Source: Bloomberg, as of 11/30/09*

## Economic Vista

Minh Trang, *CFA, Portfolio Manager*

The economic landscape remains relatively calm, with the main themes focused on jobs and recovery. The Federal Reserve kept its target rate unchanged in early November. The committee again restated its intention to keep interest rates low for "an extended period," citing improved conditions tempered by high unemployment and subdued inflation. The jobless rate climbed to 10.2 percent for October, the highest level since 1983. October payrolls also shed another 190,000, and total job losses for the year now stands at 4.2 million. Inflation continues to be benign, for now, with year-over-year core Personal Consumption Expenditures at 1.4 percent for October. This indicator remains within the Fed's historical comfort range of 1 to 2 percent.

One bright spot has been in the housing sector, where October existing home sales jumped 10.1 percent to an annual rate of 6.1 million units. Home buyers have been encouraged to take the plunge, given low mortgage rates, cheaper properties, and the government's multiple home-ownership initiatives. With the busiest shopping season upon us, scrutiny will now be on consumer spending and retail sales. The high unemployment rate, however, may dampen consumers from adding much more to the current economic rebound.

## Credit Vista

Sook-Kuan Loh, *CFA, Senior Credit Analyst*

With credit fundamentals being tied closely to the global economy and interest rate environment, we have been monitoring the varying degrees of economic rebound, which have drawn a range of policy decisions from various central banks. On October 5, Australia led the way with a 25 basis point rate hike to the Reserve Bank of Australia daily cash rate, and another 25 basis point increase on November 3. Norway led the way in Europe with a 25 basis point increase to its Norges Bank key policy rate on October 29. Despite leaving key interest rates unchanged in early November, the European Central Bank's and U.S. Federal Reserve messages were positive. The ECB announced that it received information that "*… continues to signal an improvement in economic activity.*"

From our credit viewpoint, the rate increases and positive messages are encouraging. We believe that the central banks have been particularly sensitive on managing the local interest rate environment in order to promote continued economic growth. This is likely a sign of improving global market conditions despite continued concerns that we may not have turned the corner yet.

Global market conditions are important in our credit analysis, as the majority of issuers on our approved list either are not based in the U.S. or have some meaningful degree of international business exposure. In addition, the approved issuers have weathered fairly well in the global economic turmoil for the past two years and the improving market conditions would only boost their credit worthiness. Many have already taken the opportunity provided in the current environment to bolster their balance sheet strength for oncoming business prospects as well as strengthening their market position.

However, we are cognizant that many countries are still not out of the woods, with only six countries in the G20 reporting positive GDP as of end November 2009. In the next few quarters, we will continue to review the credit impact of the announcement of various central banks' exit strategies as well as various regulatory reform initiatives on banking industries. As such, we remain cautiously selective of the names on our approved list and continue to monitor and search for prudent investment opportunities for our clients.

## Trading Vista

Hiro Ikemoto, *Money Market Trader*

The short end of the yield curve remains depressed. The bond market rallied with the two-year Treasury note falling below 80 basis points after Chairman Bernanke's speech on November 16, where he indicated that the central bank intended to maintain a low interest rate environment amid economic "headwinds."

The new two-year note auctioned off on November 23, stopping at 0.802 percent, the lowest on record. The note ended the month yielding 0.66. As for the Treasury bill market, yields were near zero as many investors locked in their positions over year-end. The three-month Treasury bill ended the month at 0.05, the six-month at 0.15 and the one-year at 0.24.

As Treasury yields fell, spreads on corporate bonds tightened. Industrial bonds maturing in the two-year area were yielding plus five to plus 20 basis points to the two-year Treasury and financial bonds were yielding plus 45 to plus 100. In the one-year maturities, industrial bonds were minus 10 to plus five basis points against Spot LIBOR and plus 5 to plus 35 for financial issuers. Three-month commercial paper fell 3 basis points to 0.18 at month-end, while the spread on agency debt against similar-maturing Treasuries were at plus one basis point in the three- to six-month maturities and up to 12 going out two-years.


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