

Observation Deck

June 2008

SVB Asset Management Quick Links:

[Login to Accounting Reporting](#)
[Online Commentary Archive](#)

Spotlight on Money Market Fund Allocations

Minh Trang, CFA, Portfolio Manager

Money market funds (MMFs) have been around for over 35 years and are a very popular, relatively low-risk place for investors to park their cash during uncertain times. MMFs invest in the short-term debt of U.S. corporations and other money market instruments. MMFs provide daily liquidity and are governed by SEC Rule 2a-7, requiring the funds to maintain a stable net asset value which MMFs set at \$1 per share.

Given the events stemming from the liquidity crunch over the past nine months, money funds have ballooned to almost \$3.5 trillion as of April 2008. These MMFs have become temporary safe havens and an important source of competitive yields in this declining interest rate environment.

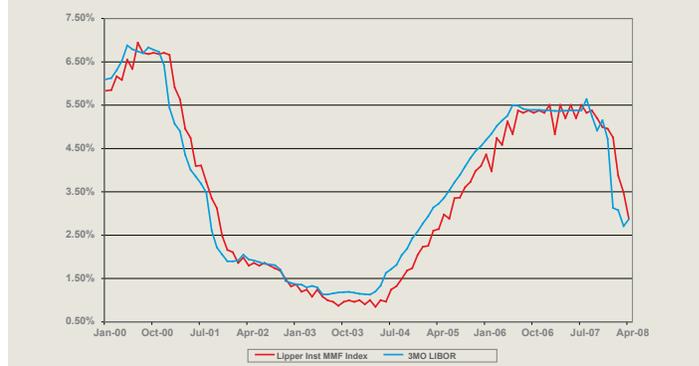
Since last September, the Fed has cut rates seven times, driving the target rate down from 5.25 to 2.0 percent. With each successive cut, the yield on most short-term debt has correspondingly been driven down. With MMFs, however, there is an inherent lag due to the existing holdings within the fund's portfolio—existing investments delay the impact of the lower prevailing market yields until the securities mature, thus allowing a temporarily higher yield. A good indicator of the span of the lag will be based on the length of the weighted average maturity, which for the typical MMF usually ranges between 45 to 55 days.

Using the Lipper Institutional Money Market Fund Index as a proxy for general MMFs and the 3-month LIBOR for prevailing rates, we can track this lag over the different monetary phases.

Markets	
Treasury Rates	
3-Month	1.88%
6-Month	2.01%
2-Year	2.64%
5-Year	3.42%
10-Year	4.06%
April Total Returns	
ML 3-Month Treasury	0.03%
ML 6-Month Treasury	0.00%
ML 12-Month Treasury	-0.04%
S&P 500	1.30%
Nasdaq	4.69%

Source: Bloomberg, as of 05/30/08

Lipper Institutional Money Market Index & 3-Month LIBOR



Source: Bloomberg, Lipper

For example, over the last two declining rate periods the Lipper Index outperformed LIBOR by about 0.26 percent. During current easing phase, the disparity has been even greater with the Lipper averaging 0.46 percent more over the period from September 2007 to March 2008. This is due to the fact that the Fed's aggressive actions have forced rates down much faster than the resetting of investments within the money fund portfolios. The active strategy of aggregating cash during this period has helped clients avoid much of the credit crisis, while providing relatively competitive yields.

As the Fed has slowed its easing stance, the disparity between money funds and current short-term debt yields has narrowed considerably. The benefit from the lag has slowly diminished, and we are entering a period where extending maturities will provide the more competitive yield. It is expected that as the market transitions from a flat to a steeper yield curve, MMFs will exhibit the same lag effect. The same indexes show that LIBOR rates moved up much faster than money funds in the last period of rising rates. From March 2004 to July 2006, three-month LIBOR averaged 0.48 percent higher than the Lipper Index. The benefit from the earlier lag is now reversed, as the existing securities in the money fund portfolio can become a drag on performance.

Our recent strategy of overweighting MMFs has succeeded in protecting client assets while maintaining competitive yields. As the yield curve continues to steepen and credit markets become more stable, benefits will sway to slowly extending maturities and taking advantage of higher market yields. As always we encourage a thorough review of your investment portfolio with your portfolio manager and advisor to determine the best course of action.

Economic Vista

Ninh Chung, *Portfolio Manager*

Headline CPI rose just 0.2 percent and core consumer inflation rose just 0.1 percent in March, compared with market expectations for a 0.3 percent increase. With crude oil and other commodity prices trading higher in May, energy prices are expected to rise during the summer; however, weakening economic activities could negate substantial gains in core inflation.

The April FOMC meeting minutes revealed the Fed is encouraged by improvements in the financial markets, although the committee also noted, "...the generally better state of financial markets had caused participants to mark down the odds that economic activity could be severely disrupted by a further substantial deterioration in the financial environment." The FOMC lowered their 2008 growth forecast significantly. In January, this year's real GDP growth was predicted at 1.3 to 2.0 percent. Today GDP expectations have been revised down considerably to 0.3 to 1.2 percent. The Fed is optimistic that the economy will rebound this year given previous rate cuts. With crude oil and other commodity prices trading near all-time highs, any economic rebound could face a strong headwind.

Credit Vista

Melina Hadiwono, *CFA, Manager of Credit Research*

During periods of heightened volatility in the credit markets, such as 2008 to date, the pain is usually expressed by a dramatic reduction in debt issuance volumes as declining market sentiment causes corporations to pull back on new expenditures. However, this was not the case in 1Q08 where the issuance of \$174 billion was only 16 percent lower than 4Q07. This contrasts with the experience of 2002 when the investor risk appetite evaporated in the third quarter and volumes fell to half the level seen in the preceding three months.

A record \$102 billion of investment-grade bonds were issued in April, which exceeds the previous high of \$80 billion in May 2001. About 50 percent were issued by financials, taking advantage of the improved market condition as the spreads continued to tighten. While caution surrounding the housing market and consumer spending is still high, the primary bond market remained open albeit at spreads far wider than just a few months ago. As the need to recapitalize continues, we expect to see more high grade financial issuance as a way of bolstering the capital base and increasing financial flexibility.

Trading Vista

Hiro Ikemoto, *Money Market Trader*

On the heels of the 25-bps-tightening by the Fed at the end of April, three-month LIBOR rates slowly fell during the month of May from 2.78 percent to 2.68 percent. Yields on three-month commercial paper fell in line with LIBOR, 15 bps to 2.65 percent by month-end, while agency discount notes yielded -55 bps to commercial paper. With growing speculation that the Fed is done easing the Fed target rate, one-year LIBOR ended the month relatively flat at 3.16 percent, though it did spike on May 14 to 3.18 percent due mainly to the weak CPI number released that day. This also holds true for the two-year Treasury note yield which began the month at 2.37 percent and ended 2.64 percent and had a similar late-month spike to 2.68 percent.

Nine-month to one-year, high-grade corporate-bond issues were trading relatively flat to LIBOR. One-and-a-half to three-year spreads have widened to +100 bps to +140 bps over the two-year Treasury as Fed Funds Futures traders are showing a 21 percent chance of a rate hike by September. This is the first hint of a rate hike in over nine months.

Contact

SVB ASSET MANAGEMENT
185 Berry Street, Suite 3000
San Francisco, California 94107
PHONE 1.866.719.9117
service@svbassetmanagement.com

© 2008 SVB Asset Management, a registered investment advisor, is a non-bank affiliate of Silicon Valley Bank and member of SVB Financial Group. Products and services offered by SVB Asset Management are not FDIC insured, are not deposits or other obligations of Silicon Valley Bank, and may lose value.

This material, including without limitation to the statistical information herein, is provided for informational purposes only. The material is based in part on information from third-party sources that we believe to be reliable, but which have not been independently verified by us and for this reason we do not represent that the information is accurate or complete. The information should not be viewed as tax, investment, legal or other advice nor is it to be relied on in making an investment or other decision. You should obtain relevant and specific professional advice before making any investment decision. Nothing relating to the material should be construed as a solicitation, offer or recommendation to acquire or dispose of any investment or to engage in any other transaction. 0608-0149