SVB Financial Group | SVB Asset Management

Observation Deck

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When Treasuries Attack

Joe Morgan, *Head of Portfolio Management*

To effectively evaluate the performance and risk taken by an investment manager, it is essential to utilize a market-related benchmark. The goal of choosing an appropriate benchmark is to replicate a "dummy" strategy that would demonstrate returns under an inactive approach to the markets. For this reason, all of our clients utilize a benchmark to help review our performance on a monthly basis.

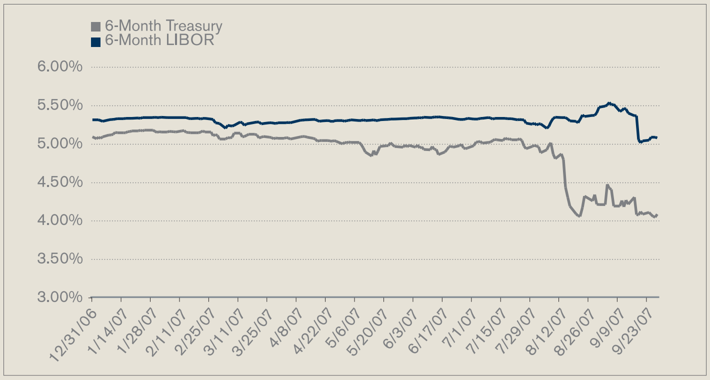
Given the level of volatility in today's markets, each purchase decision must be evaluated in an active management framework rather than a strategy of simply diffusing liabilities. However, many investors still presume that they "can't beat the market" and should just target investments to cash needs.

Although many benchmarks are available in the short end of the bond markets, Treasury benchmarks are the most widely accepted. There are important limitations to these indices, however. First, they do not really qualify as an appropriate "dummy" strategy because it is not appropriate to invest entirely in a portfolio of Treasuries when a well-diversified money market fund provides a higher return with limited credit risk. Second, the indices typically do not hold any investments to maturity, which is not often an option for corporate cash investors.

Markets

Treasury Rates	
3-Month	3.80%
6-Month	4.08%
2-Year	3.98%
3-Year	4.02%
5-Year	4.24%
10-Year	4.59%
September Total Returns	
ML 3-Month Treasury	0.38%
ML 6-Month Treasury	0.42%
ML 12-Month Treasury	0.53%
S&P 500	3.74%
Nasdaq	4.09%

Source: Bloomberg, as of 10/01/07



Source: Bloomberg, SVB Asset Management

The limitations of Treasury benchmarks were amplified in the third quarter. The chart on this page compares the 6-Month Treasury yield performance with 6-month LIBOR, a proxy for non-Treasury yields. During the first six months of the year, the relationship was quite stable. But in Q3 there was major dislocation between the two indices, with Treasury yields declining much more than LIBOR. This has caused the Treasury indices to provide a very high return, due to Treasury prices rising in comparison to any other investment class.

For example, during the third quarter, the Merrill Lynch-calculated versions of the 3-month, 6-month, and 12-month benchmark indices have returned 5.40%, 6.30%, and 7.57% on an annualized basis. Of course, the notion that these indices will continue to perform at this level for an entire year is ridiculous because the yields of the associated securities now stand at just 3.80%, 4.08%, and 4.08%, leaving little room for further declines over the next nine months. September returns are listed in the adjacent Markets table.

Even though the indices have demonstrated outstanding performance in the third quarter, it is extremely unlikely this trend will continue. Mathematically, yields can only go to zero. With a Fed that is now aggressively addressing the market issues, yield on "spread product" (securities that trade at a spread to Treasuries) has stabilized and will most likely outperform as the market recovers. As a result, we are maintaining our corporate and asset-backed concentrations to benefit from potential future outperformance.

Economic Vista

Debra Hanson, *Portfolio Manager*

The big surprise on the economic front came early in the month with the release of the August jobs data. Nonfarm payroll unexpectedly fell 4,000 versus expectations for a total of 100,000 jobs created. This was the first decline in payrolls since 2003 and many market observers viewed this decline as a good reason for the Fed to ease monetary policy.

And, ease they did. At the September FOMC meeting, the Fed cut both the target federal funds rate and the discount rate by 50 basis points to 4.75 percent and 5.25 percent, respectively. Even so, the markets remain under pressure from the fallout in the housing and mortgage markets. Some feel this dramatic move on the part of the Fed is a "one and done" move, although calls for further cuts are heard more frequently these days as is the word "recession". We have yet to see hard data supporting this call, but jobs and consumer spending data will be key indications of whether this one move was sufficient or if there will be a need for further cuts.

On the inflation front, core PPI, CPI and PCE have been reported in the 2-percent area the past few months, but elevated commodities prices are still a concern. Gold hit another high of over $731/ounce and oil broke through the $80/barrel level.

Credit Vista

Melina Hadiwono, *Manager of Credit Research*

The recent shock in subprime mortgage defaults has resulted in widespread increased risk aversion and uncertainty about asset values. This stands in sharp contrast to the previous market turmoil of 2001-2003 when a wave of corporate scandals brought corporate credit quality into question. Part of the current market anxiety is due to the difficulty in locating potential losses. As accounting and disclosure practices vary globally, the full costs of these losses are more likely to surface during the next few months at the earliest.

Despite the market upheaval, investment grade issuers are generally better prepared than they were during the last credit crunch. According to a recent Moody's report, a growing economy and historically low interest rates have contributed to a five-year trend of improving profitability and operating cash flow. The improving cash flow trend has been undercut by large payments to shareholders through higher dividends and share repurchases. However, companies often have flexibility to reduce these payments if changing conditions cause operating cash flow to deteriorate. In addition, some companies have taken advantage of the favorable market conditions by pushing out debt maturities and negotiating more favorable bank credit agreements. As a result, although the market dislocation has led to rising funding costs for corporate issuers, investment grade issuers are generally expected to have the resources to withstand the recent market turmoil.

Trading Vista

Hiroshi Ikemoto, *Money Market Trader*

With credit concerns and liquidity issues still high at the start of the month, commercial paper yields held at 5.40 to 5.55 percent in the 30- to 90-day range. However, after the Fed unexpectedly cut the overnight benchmark rate 50 basis points instead of the 25 bps forecast, 1-year LIBOR yield dropped to 4.72 from a high of 5.04 percent, while the 2-year Treasury benchmark yield fell to 3.97 percent from 4.14 percent. Commercial paper yields also dropped to the 5.00 to 5.12 percent level in the 30- to 180- day range and spreads tightened on high-quality issuers that were not affiliated with the credit meltdown. Although high quality commercial paper in the short end looked attractive during the first few weeks of the month, money fund yields were expected to hold up given their lag time in adjusting to new rate levels. Once money fund yields have reset to the new lower levels, short-term commercial paper investments will once again rule the day.

New Fixed Income Advisory

SVB Asset Management has recently published a critique of the auction rate securities market and why we feel they are not an appropriate cash management tool. Certain auctions in this security class have since encountered significant liquidity problems and auction failures. We invite you to download http://www.svbassetmanagement.com/pdfs/AuctionRateSecurities0907.pdf this valuable report.