

Observation Deck

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The Trouble with CDs (2010 edition)

Adam Dean, CFA, President

What's a securities broker to do? The boards and CFOs that have employed them to manage corporate cash have largely and perhaps permanently lost all appetite for the products that were once so lucrative for brokers to sell. Auction rate securities, self-underwritten debt, investments with low liquidity and high underlying risk; because of the pain these investments caused their corporate clients and boards, the broker business isn't nearly what it used to be. Corporations now demand extremely liquid and ultra-safe investments such as money funds, agencies and treasuries, and frankly, those don't pay brokers much. Enter the non-negotiable Certificate of Deposit and CD placement programs. For corporations looking for safety and yet hungry for yield, CDs sounded like the best of both worlds. Today that yield benefit is largely gone.

Markets	
Treasury Rates	
3-Month	0.15%
6-Month	0.23%
1-Year	0.38%
2-Year	0.96%
3-Year	1.48%
5-Year	2.42%
7-Year	3.11%
10-Year	3.65%
April Total Returns	
ML 3-Month Treasury	0.01%
ML 6-Month Treasury	0.03%
ML 12-Month Treasury	0.56%
S&P 500	1.58%
Nasdaq	2.68%

Source: Bloomberg, as of 04/30/10

Bank CDs are 100 percent FDIC guaranteed, provided you invest no more than \$250,000 with any one bank. Central to the selling of non-negotiable CDs (meaning they cannot be liquidated prior to maturity without penalty) and CD placement programs is the considerable payout brokers get relative to other standard money market options they could offer their clients. In other words, if you are interested only in government-backed investments, there is at least one reason you may be hearing about a CD-only investment strategy instead of a diversified treasury, agency and money fund strategy that leverages a credit research team and fiduciary oversight.

The other reason you may have heard of them was yield. What CDs and CD placement programs used to have relative to more liquid investments was yield. This despite the fact that the unrated regional and community banks that typically use broker sales channels like CD placement programs comprise the majority of the 220 bank failures observed since 2008 and the 57 that have occurred so far in 2010. At the end of 2009, the FDIC classified 702 banks out of 8,022 banks as "problem banks," a sharp rise from 252 banks in the prior year. Yet in this environment, the yields of these non-negotiable CDs have gone down, not up.

There are two reasons for lower CD rates. One is that the FDIC has moved to cap the yields that banks can offer on FDIC-guaranteed CDs. A number of banks were essentially staying in business by offering CD rates well above market. By opting to attract yield-hungry depositors via high-yield CDs, banks could put off

addressing the balance sheets issues that made the need for capital so pressing to begin with. With “hot-money” depositors masking weaknesses in such banks’ capital structure, these banks were arguably becoming less stable, not more, and doing it via FDIC-insured CDs.

The second reason is driven by better-capitalized banks. Yields are down across the board because government-guaranteed safety is not something that most banks need to offer much yield on to attract depositors. Their market-setting rate pushes down the yield that deposit-hungry banks can offer.

With the yield benefit largely gone, very little else about non-negotiable CDs meets the liquidity, transparency and credit standards required of every other investment typically allowed in a conservative cash investment policy.

For corporations allowing investment in CDs, make sure your investment policy clarifies the terms on which you are willing to buy them. If you are making exceptions to the liquidity, transparency and credit standards you require of each your other investments, make sure you are stating this in your investment policy.

Liquidity: The higher-yield CD offerings are almost exclusively non-negotiable. Every security type permitted in your corporate investment policy should include the ability to easily sell back into an open market on demand and without incurring an early withdrawal penalty prior to maturity. Non-negotiable CDs don’t meet this standard. We recommend allowing only negotiable CDs in domestic portfolios.

Transparency: The importance of knowing what you own (think CDOs, auction rates, and the value of relying on bond insurance or a triple-A credit rating) applies here like it does for any investment. CDs are a loan to a bank. Knowing the condition of the bank you are making the loan to should be mandatory for a corporation. With CD placement programs, individually brokered CDs, or even direct investment in CDs from regional banks, an ability to accurately assess their health requires a considerable investment in time that the selling broker has almost certainly not done for you. In the event of bank failure, an active claim to the FDIC must be made in order to receive your funds. You are dependent on the broker to make this claim and recover the funds on your behalf in a timely manner following procedures laid out by FDIC. Therefore your claim on these funds is dependent upon the health, intentions, and diligence of your broker. We recommend allowing only direct investment in CDs where your corporation is the beneficial owner and the issuing bank is approved by the credit team of your asset manager.

Safety: If a certain CD is yielding well above market, ignore the FDIC insurance for a moment and look at the bank’s actual credit rating. We recommend that your investment policy require issuers of CDs to have at least the same minimum credit rating that you require of your other investments. Measure your desire for that incremental yield relative to your comfort in potentially having to explain to your board that the regional bank that you bought the CD from has collapsed but was FDIC insured.

Client case study

See how a private, venture-backed company solved its problem of an illiquid cash portfolio, at http://www.svb.com/pdfs/sam/SAM_illiquid_casestudy.pdf

Economic Vista

Minh Trang, *CFA, Portfolio Manager*

The second quarter began with positive news in jobs and consumer spending. Non-farm payrolls for March rose by 162,000, the most in three years. The increase included 48,000 temporary census workers hired by the government. After two years of job losses, the first three months of 2010 look to have reversed the trend. The unemployment rate, however, remains at 9.7 percent as many out of the workforce resumed their job search. For March, retail sales also showed an improvement, increasing 1.6 percent. Excluding auto sales, the increase was 0.6 percent.

The FOMC kept its overnight target rate in the range of zero to 0.25 percent, citing the need to remain accommodative to an economy still in the nascent stages of a recovery. The Fed commented that the labor market has improved and inflationary pressures remain benign due to excess capacity. Credit and lending, however, remain restrained. The Fed reiterated its intent to keep rates exceptionally low for “an extended period.”

In the coming weeks, corporate earnings will take center stage. The market, however, will refocus back to the economy for further clues that some of these small improvements can be maintained.

Credit Vista

Melina Hadiwono, *CFA, Head of Credit Research*

On April 16, in a civil complaint, the SEC accused Goldman Sachs of fraud in the marketing and origination of a synthetic collateralized debt obligation. On the same day, Goldman Sachs denied the SEC’s allegation. This allegation underscores the headline risk when the reputation of a confidence-sensitive bank is tarnished, in addition to heightened regulatory risks in the banking sector. Over the next several quarters, a key theme to play out will be tighter regulation of the financial sector. Lawmakers will likely err on the side of excessive restrictions, with the major banks that have survived the financial market meltdown being scrutinized. The revised bill from Senator Christopher Dodd has passed the Senate Banking Committee and will continue to be debated on the Senate floor.

The charges against Goldman could bolster the case for passage of a more transformative regulatory reform by Congress, with the greatest impact on the major financial institutions, especially those with large trading business.

One key feature of the recent crisis was the fact that some of the largest losses suffered were from a sharp decline in the value and liquidity of the credit-traded assets held in the trading book, rather than the more traditional deterioration in loans held in the banking book. Understandably, the review of regulatory capital requirements for market risk in the trading book has been one of the key issues in the overall banking regulatory reform.

Going forward, while the major banks may reconsider the allocation of capital among business lines and may further reduce their business in certain more complex credit-traded products, they will continue to be under pressure to find ways to enhance profitability to meet shareholder expectation. Hence, regulators face challenges in keeping up with investment banks’ product innovation, adjusting capital requirements to limit regulatory arbitrage and addressing new risks as they emerge. For a number of years, we have been very selective about the financial institutions in SVB Asset Management’s Approved List, and we remain confident of their robustness and resiliency for facing further challenges ahead.

Trading Vista

Hiro Ikemoto, *Money Market Trader*

With credit-rating downgrades of Greece and Portugal at the end of April, the Treasury market rallied, with the two-year Treasury note ending the month at 0.96 percent, 6 basis points lower than the previous month. Yields were also lower across the Treasury bill market, with the one-year ending at 0.38 percent, the six-month at 0.23 percent, and the three-month at 0.15 percent. Agency yield spreads against similar-maturing Treasuries were at plus 3 basis points in the six-month area to plus 12 basis points going out to two-years.

One-year corporate bond spreads against Spot LIBOR remained the same from the previous month with industrial issuers at minus 10 to flat and financial issuers plus 10 to plus 25. Yields on commercial paper in the three-month area increased roughly 2 basis points to 0.25 percent to 0.30 percent.

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