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Observation Deck

June 2010

The Fixed-income Environment

Ninh Chung, *CFA, Head of Portfolio Management*

The global economic recovery remains in question, as evidenced by the instability in the euro zone and 10 percent unemployment in the United States. Although the U.S. is seeing robust hiring in the manufacturing sector, the impact is diminished because the service sector constitutes 70 percent of U.S. gross domestic product. Complicating the global recovery scenario will be Europe's prolonged period of relatively weak economic performance due to austerity measures imposed as result of the nearly $1 trillion rescue package.

In the short term, U.S. government fixed-income securities could outperform other fixed-income sectors as expectations for federal funds rate hikes in 2010 are pushed out to 2011. However, the upside is limited by historically low interest-rate levels. Under these conditions, corporate cash investors are left with limited investment options.

Duration Neutrality

Given these challenges, an investor may consider adopting a neutral duration strategy for fixed-income portfolios. Under this strategy, an appropriate benchmark is established and the duration of the portfolio is managed in concert with the benchmark duration. The process of establishing the benchmark begins with knowing a) the specific liquidity needs from the portfolio b) length of liabilities being funded c) the overall ability to assume risk and d) any portfolio-specific objectives. As with any prudently managed portfolios, the benchmark and hence the duration should be evaluated over time. Furthermore, should the objectives of the portfolio or investment situation change, the duration would adjust accordingly.

One of the appealing aspects of duration neutrality is the removal of excess interest-rate risk relative to the benchmark. Unlike an active duration management portfolio, where the portfolio timeline is shortened or lengthened based on interest-rate assumptions, the duration neutral portfolio seeks to control this key element of risk in the portfolio.

Adding Value to a Portfolio

By analyzing the yield curve (for example the overall shape, movement, steepness, and other factors) on a continual basis and spotting points on the curve with the greatest return characteristics, the portfolio could generate incremental returns in excess of benchmark returns. Under a normal yield curve scenario, an investor may adopt a bullet structure where a majority of investments is allocated to a single maturity. In the current investment climate, a barbell strategy approach to achieving duration neutrality could provide more opportunity to exceed benchmark returns. A barbell maturity structure would emphasize an overweight position in the shortest parts of the investor's investment horizon. By favoring the short end, the portfolio gains a favorable liquidity profile while longer-term investments will increase overall portfolio yield.

Combining sector rotation, security selection and competitive execution with yield curve management, the duration neutral portfolio could add incremental returns above and beyond benchmark returns. Another aspect of achieving higher returns is the selective deployment of specific issues in the most cost-effective manner along the yield curve. By performing in-depth relative value analysis across and within sectors a portfolio could garner higher risk-adjusted returns.

Conclusion

We realize a zero-bound interest-rate environment, along with uncertainty in economic growth globally, has limited investment choices for corporate cash investors. Complicating the situation is the probability that the Federal Reserve may leave the federal funds rate at exceptionally low levels for the rest of the year. Given these challenges an investor should explore the advantages of a duration neutral strategy that encompasses liquidity needs, overall risk tolerance and aversion, and any future liabilities.

Markets

Treasury Rates	
3-Month	0.16%
6-Month	0.22%
1-Year	0.32%
2-Year	0.77%
3-Year	1.23%
5-Year	2.09%
7-Year	2.75%
10-Year	3.29%
May Total Returns	
ML 3-Month Treasury	0.02%
ML 6-Month Treasury	0.05%
ML 12-Month Treasury	0.06%
S&P 500	-7.98%
Nasdaq	-8.16%

Source: Bloomberg, as of 05/28/10

Economic Vista

Debra Hanson, *Portfolio Manager*

The trend of positive economic data continued throughout May. Leading the way were extremely positive job numbers. Nonfarm payrolls jumped 290,000 and the April number was revised upward from 162,000 to 230,000. The unemployment rate increased from 9.7 percent to 9.9 percent, a positive sign as more previously discouraged workers are back looking for work.

The inflation numbers came in very tame on the core level for both the Producers Price Index and the Consumer Price Index, keeping inflationary fears at bay. And, as consumer spending and retail sales data has been surprising to the upside, producers have very little pricing power in this environment. Home sales continued to surprise on the upside, too, as first-time buyers rushed to purchase before the tax credit expired, and prices seem to have stabilized for the time being. While this is positive news, we are still seeing delinquencies and foreclosures rise, with the expectations that these will continue to go up as the year goes on. The second reading on first-quarter GDP growth came in lower than initially reported, revised to 3.0 percent from 3.2 percent. In the Federal Reserve Board's minutes released in May, the Fed raised its GDP growth estimates for the year to as high as 3.7 percent.

Credit Vista

Melina Hadiwono, *CFA, Head of Credit Research*

European leaders have finally made a big gesture with regards to the sovereign debt crisis, by announcing establishment of a €750 billion European Union/International Monetary Fund package. This unprecedented measure is to provide a framework to stabilize markets, and reduce pressure on the euro, some sovereigns, and the banking systems. Nonetheless, the market appears to be rethinking the likelihood of success and believes that this package will only provide time for the EU to make necessary, painful adjustments to bring fiscal deficits under control. We can expect further debate on this important matter in the coming months.

On May 21, The U.S. Senate approved the Restoring American Financial Stability Act of 2010 (S3217). We discussed the potential implication in the April 2010 Observation Deck Credit Vista article.* This bill will need to be reconciled with the House bill that was passed in December 2009, before it can be sent to President Obama to be signed into law. Although it is unclear what provisions will be included in the final legislation, future enactment of this legislation will have both positive and negative implications to financial institutions' stand-alone credit profile, including rating agency views about ongoing support for systematically important institutions.

Similar to the "living wills" provision included in the Senate bill, the FDIC voted unanimously to issue a proposal to require large banks to submit "contingent resolution plans." Living wills specify procedures for the orderly winding down of a troubled institution. They are another step to provide U.S. regulators with the tools to resolve the problems of a failing institution without triggering a systematic crisis. Taken as whole, we expect that that the regulatory reform could result in lower debt and deposit ratings for U.S. banks and other financial institutions whose ratings currently benefit from assumed U.S. government support. The degree of reduced support assumptions will depend on the law's potential benefits and costs to bank's stand-alone credit strength and regulatory flexibility in dealing with troubled institutions or systematic risk issues.

Trading Vista

Hiroshi Ikemoto, *Money Market Trader*

April's market calm was short-lived in May, as story after story hit the wire, from fat-finger trading to European contagion to financial reform to fears of a double-dip. All of this led to "flight-to-quality" trading. We saw Treasuries rally, with the two-year note ending the month at 0.77 percent. As for the Treasury bill market, we saw yields flatten, with only minimal basis points separating the seven-day bill, at 0.12 percent, from the one-year bill, at 0.32 percent.

Yields on government agencies held, widening the spread in the one-year area from 15 to 21 basis points against Treasuries.

In the corporate sector, we saw a widening in yield between high-grade financial issuers versus industrials. This was mainly due to uncertainty about the effects the financial reform bill will have on banks. The yield spread between financial bonds maturing in the one-year area and spot LIBOR increased to 20 to 40 basis points, while industrial bonds tightened to minus 5 to minus 15 basis points to spot LIBOR. The euro-region disruption pushed LIBOR yields up in May, bringing 90-day commercial paper yields to 0.50 at the end of May. This was an increase of 20 basis points.

* The April 2010 edition of Observation Deck can be downloaded at http://www.svb.com/Publications/Investment-Insight/Observation-Deck/The-Fed-s-Exit-Strategy-(PDF)/

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555 Mission Street, Suite 900
San Francisco, California 94105
Phone 1.866.719.9117
service@svbassetmanagement.com