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Getting the Horse Back in Front of the Cart

Adding return back to your investment strategy

I DON'T CARE ABOUT YIELD!

Since when has “return” been a dirty word? Investors are in great pain these days, particularly in the money market arena. This once-dismissed and neglected market segment is now the focus of investment committees around the world. Decision makers are running scared stressing that they “don’t care about yield,” and simply want the safest investments available. Is this the correct approach? We don’t believe so.

From 2003 through 2006, the content of our client meetings were quite predictable. We would present our economic view and outlook for the future, discuss the current and potential future investment strategies and finally present performance versus appropriate market benchmarks. Clients would smile and nod politely, but come alive only during the performance discussion. Almost 100 percent of the time, their interest was geared toward increasing performance on the account, with little interest in the intricacies of financial instruments to be used.

Time and again, we had to talk our clients off the ledge with regard to investment strategies such as auction rate securities (ARS), which were performing nicely in those days. Most of our clients would leave those discussions with a better level of comfort as to why we were avoiding the sector but disappointed they couldn’t get the extra 15 to 25 basis points of return they thought was available at no additional risk.

In fact, we lost many prospects in those days because we refused to play in that market. “Why won’t you take this ‘free money’ with a AAA rating?” we were often asked. Simply put, we didn’t feel the reward — a modestly higher yield — was enough to compensate for the risk — reduced liquidity.

Today, of course, many CFOs have massive regrets and many brokers are facing multi-million dollar lawsuits as a result of their ARS investment strategies. Even those investors who avoided the ARS mess are running toward the sidelines virtually eliminating “return” as a strategic objective.

Instead of riding a pendulum that has moved from a blind pursuit of yield, to avoidance of risk at all costs, investors must return their focus to their long-term objectives: capital preservation, liquidity provision, and return — in that order. We believe all three of these can be achieved; they are not mutually exclusive objectives.

Rather than eliminating return to achieve capital preservation, the prudent approach is to consider probable return prospects in conjunction with their expected risks. There is no investment with zero risk. The goal, however, is to get paid appropriately for taking an acceptable level of risk. The primary limitation, of course, is that the new “acceptable level of risk” is extremely low.

WHERE DO WE START?

First of all, let's look at the ground rules. A simple review of your investment policy should confirm that the objectives of your investment strategy are to primarily preserve capital and liquidity, followed by achieving return. After all, your primary business is your business, not your portfolio.

Now that investors' focus has shifted almost entirely from return to the absence of return, we encourage our clients to go back to their investment policies and reinforce the top three priorities. There is a reason why return remains a part of investment policies, and there is also a reason it is the third priority.

Today, many investors have shifted entirely to money market mutual funds governed by SEC Rule 2a-7 or U.S. Treasuries. This knee-jerk reaction may have been appropriate in the midst of all the negative events over the past few months, but in the long run, a Treasury-only portfolio is clearly inappropriate. Certainly, consideration needs to be paid to internal communication and education regarding risk and reward in the markets, but a long-term strategy accepting less than 1 percent handle returns is not a winner.

The second — and probably most significant — step is for investors to consider whether they are partnering with the appropriate investment professional. Do you work with an SEC Registered Investment Advisor (RIA) or a transactionally-focused broker-dealer? Since an RIA is required to provide fiduciary duty — meaning a client's interests must be elevated above the RIA's interests — they can sit on the same side of the table as an investor, share the same view of their investment objectives and minimize potential conflicts of interest. A broker-dealer relationship can

be just the opposite since it is a more sales-oriented environment.

We have yet to hear of any RIAs whose clients own failed auction rate securities. Only brokers seem to have gotten their clients mixed up in these securities at the wrong time. Most of the brokers in question are affiliated with RIAs. Why weren't those RIAs buying auction rates as their broker-dealer sister company was pushing them on uninformed clients? A different business model. A different motivation. Make sure your advisor's motivation is in line with yours.

BUT THERE ARE NO RETURN OPPORTUNITIES TODAY!

Incorrect. Today, opportunities exist to add return without taking on appreciable risk. Look to your RIA to ferret these opportunities out for you, monitor them and adjust your portfolio as needed.

There are a few obvious sources of return that should not be overlooked. Government securities, particularly in the form of money market mutual funds, can add promising return without appreciable risk. The primary objection to owning the senior debt of Fannie Mae and Freddie Mac is the potential for the government to allow for a default. Without getting too far off track, \$3.5 trillion of direct obligations of these entities would be a massive default, especially considering the holders of this debt include central banks the world over. There is simply no way the government can allow these securities to default, nor will it.

Today, we have many clients that are choosing to stay away from this sector. We believe this is due to the never written, but always present, fourth objective: distraction minimization. Specifically,

if it takes repeated board presentations and high level discussions to get Audit Committee members comfortable with holding this debt, then the extra yield is probably not worth it. More value can be added by using this time and energy to manage the business as opposed to discussing portfolio risks.

A second potential source of return comes in the form of yield advantage offered through the recently enacted Temporary Liquidity Guaranty Program (TLGP). Essentially, financial corporations can now issue commercial paper and corporate bonds that are guaranteed 100% by the FDIC including both interest and principal. There are specific limitations to the amount of this debt that may be issued, but we believe offerings under these programs are attractive and will grow considerably.

Having a solid investment policy in place along with a good relationship with your RIA will help you take advantage of these and other market opportunities as they arise.

WHERE DO WE GO FROM HERE?

If our economic view of a market malaise lasting quarters or perhaps years is correct, it will be important to monetize opportunities afforded by market volatility and changing market regulations. This will enable you to maximize return within the constraints of preserving both principal and liquidity.

Successful investors aren't hanging on the pendulum ball. There is a trade-off between return and risk in both good markets and bad. The most successful CFOs understand this relationship and manage "toward the middle" in all markets. Of course, it makes sense to adjust risk levels in portfolios, but those tactical decisions need to be made inside of a strategic framework laid out by your investment policy and managed professionally by your registered investment advisor.

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