

Observation Deck

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The Trouble with CDs

Adam Dean, CFA, President

What's a broker to do? Faced with zero client appetite for their high-payout products such as mortgage backed and auction rate securities, the broker business suddenly isn't what it used to be. Their clients now demand ultra-safe investments such as money funds and treasuries, and frankly, those don't pay much. Enter the Certificate of Deposit and CD placement programs.

The sales pitch is compelling, FDIC insured up to \$100K, stable value, but with yields that are higher than anything else backed by the government. For corporations looking for safety and return, CDs may sound like the best of both worlds. But there is, of course, more to the story. Aside from the FDIC coverage, very little else about the higher yield CDs offered meets the liquidity, transparency and safety standards of a conservative cash investment policy. In other words, there's a reason for the higher yield, and with a considerable payout to the broker selling that yield, there is at least one reason you are hearing about this CD. For corporations allowing investment in CDs, make sure your investment policy clarifies the terms on which you are willing to buy them. If it doesn't specify the terms, brokers will be happy to sell them to you on their terms.

Liquidity: Typically these higher-yield offerings are non negotiable, meaning they cannot be liquidated prior to maturity without penalty and subject the investor to magnified interest rate risk. Functionally they are the same as a passbook savings account at your local bank. 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.

Transparency: The importance of knowing what you own (think CMOs, 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, the CDARS® program 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, the failure and the FDIC takeover process can often remain invisible to the client. The selling broker has no obligation to notify the client. 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: Especially for smaller banks, CDs are an essential tool for keeping their balance sheets healthy. How much they are willing to pay you for that deposit is a good proxy for how much they need that cash. If they are offering a rate well above market, ignore the FDIC insurance 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. If not convinced, envision the conversation with your board when explaining that the regional bank that you bought the CD from has collapsed. The presence of FDIC insurance may not keep you on the same standing you had before that conversation.

Lastly a note about CDARS, a CD placement program affectionately pronounced "cedars". Essentially this is an investment in CDs spread across many banks, with an insurance plan up to \$50 million but with little ability to assess the net underlying credit of your investment. If one of the underlying banks, or the home bank, is taken over by the FDIC, it is unclear as to when your investment is returned to you. As to what you are investing in, Mark Jacobsen, president of Promontory Interfinancial Network LLC which runs all CDARS, clarified this a bit recently by confirming that "from the customer's perspective it's invisible," in an interview posted on bankrate.com. Inadvertently the banner ad on this site clarified things a bit further; it was advertising very attractive CD rates from IndyMac (Federal) Bank, currently under receivership by the U.S. government.

Economic Vista

Minh Trang, CFA, Portfolio Manager

When it comes to the economy, it certainly feels a bit like Bill Murray's *Groundhog Day*. We've been seeing more of the same data on the housing market, employment figures, and inflation. The housing sector remains soft, with existing and new home

Markets

Treasury Rates

3-Month	1.66%
6-Month	1.86%
1-Year	2.26%
2-Year	2.51%
5-Year	3.24%
10-Year	3.95%

June Total Returns

ML 3-Month Treasury	0.18%
ML 6-Month Treasury	0.32%
ML 12-Month Treasury	0.33%
S&P 500	-0.84%
Nasdaq	1.45%

sales declining -2.6 percent and -0.6 percent respectively in June over the previous month. The labor market also continues to be weak as the economy has now experienced six consecutive months of negative job growth, shedding 438,000 jobs for the first half of 2008. Finally, inflation remains elevated as seen through headline CPI hitting 5.0 percent (YoY) and PPI surging 9.2 percent, respectively (YoY). The Fed, however, continues to believe that the slowing economy will help alleviate inflationary pressures in the coming months.

The most prevalent headline throughout the month has been focused on the financial status of Fannie Mae and Freddie Mac. Both of these government sponsored enterprises (GSEs) came under immense scrutiny as rumors spread that they would require a government bailout to remain solvent. To help maintain market stability and preserve the fragile credit market, the Federal Reserve and U.S. Treasury quickly announced several measures to support the agencies. These measures included liquidity and capital support to ensure that Fannie and Freddie have sufficient access to funds to continue their operations. The rapid government response has helped to ease the fear of market participants. The overall economy, however, remains sluggish as many institutions are still mending their balance sheets. Hopefully the upcoming earnings releases will provide better news for the whole financial system.

Credit Vista

Melina Hadiwono, *CFA, Head of Credit Research*

Regulators and central bankers are intensifying behind-the-scenes discussions about the shape of the financial architecture in response to the credit turmoil. Both international and U.S. accounting bodies are working on rule changes. A key component of these pending rule changes will be the accounting regime for off-balance-sheet vehicles, with some senior regulators pressing for a global initiative to bring these vehicles back onto the balance sheet—not just in the U.S. but in Europe as well. In the U.S., FASB is considering adjusting FAS 140 and a related exemption from rule FIN 46R. These rules cover off-balance-sheet structures such as mortgage-backed securities, credit card securitization and asset backed commercial paper conduits which could cause further strain on the already burdened capital levels for financial institutions. The off-balance-sheet vehicles have been used by financial institutions to keep some assets off their balance sheets, thereby avoiding the need to hold regulatory capital against them. Currently, FASB is still studying actual implementation and disclosure issues.

While the potential impact on regulatory capital ratios could be significant, the real key will be whether we'll see a relaxation of the regulatory capital rules.

The European Union is also considering rules that would force banks to set aside more capital on some of the securitized assets—the same securities that have been at the heart of the financial crisis. The regulators' goal is to align the incentives of the sellers with those of the buyers of securitized assets. In the "originate and distribute" model, banks have transferred the risk of loans to investors, prompting accusations that this encouraged banks to make risky loans. Historically, banks held on to any loans they made; in other words, they remained exposed—and informed—of their risks. The European Union Commission is seeking input from bank trade groups and others before approving the requirements. The European Parliament is expected to ratify these rules by the end of the year.

Trading Vista

Hiro Ikemoto, *Money Market Trader*

With oil reaching an all-time high of \$145.18 a barrel on July 14, the 2-year Treasury note's yield dipped to 2.43 percent, as investors fled to Treasuries on fears that rising energy prices will continue to slow the economy. Corporate bonds in this area remained steady yielding plus 60 to plus 160 basis points to the 2-year Treasury yield, while agencies widened to plus 80 from plus 70. Questions related to the GSE's solvency continued to make headlines throughout the month. However, the 2-year Treasury note did sell off by month-end yielding 2.512 percent, as oil prices dropped to \$124.08. One-year LIBOR started the month around 3.00 percent and ended July at 2.95 percent. High-grade corporate industrial bonds were trading between minus 5 to plus 20 to LIBOR while financials hovered at plus 15 to plus 60. Three-month commercial paper yielded an average of 2.75 percent for the month, flat against LIBOR. With headlines stirring over Fannie and Freddie, GSE three-month discount notes as a whole were being offered at 2.45 percent at the end of July. This is compared to the 2.40 percent offered at the end of June.

Contact

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

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