Coping with Zero Percent Treasury

Four Smart Money Moves for Cash Investors

EXECUTIVE SUMMARY:

Investment Considerations:

- Government Sponsored Enterprises
- Government Money Market Funds
- FDIC TLGP Guaranteed Debt
- Foreign Government Guaranteed Debt
- Beware Certain "Industrial" Credits

Institutional cash investors found themselves in a pickle when the market's desire for safety made treasury securities and treasury money market funds inaccessible. However, when the default option is no longer an option, alternative avenues may help investors mitigate credit and liquidity risks in challenging environments.

Our core strategy involves investments in securities supported, directly or indirectly, by the U.S. and certain foreign governments and steers clear of non-government credits at this time. This is a transitional strategy until we have a better assessment of the stability of global financial systems and the long-term impact of global government stimulus efforts. Even though it involves only government credits, due diligence remains crucial to this strategy.

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AS TREASURIES HIT NEGATIVE YIELDS, WHAT NOW?

No one will dispute that 2008 was an extremely challenging year for all, and specifically for corporate cash managers. In past market cycles, credit calamities were often little more than a spectator sport for ultra risk-averse cash investors, but 2008 was an excruciating year as many suffered direct losses in this non-stop, 17-month credit Tsunami. After years of neglect, Treasury securities gained new-found fame with corporate treasurers as institutional investors switched from corporate "prime" money market funds to Treasury funds en masse.

But this change in philosophy created a new, pressing problem. As investors fled commercial paper investments and prime money funds seeking the protection of safe-haven treasury securities, demand overwhelmed supply to the point that short-term Treasury bill rates became negative. This means that, in addition to foregoing interest, investors are giving up part of their investment principal so that their cash can be "parked" in treasuries. This phenomenon has persisted since December 9, 2008 when the Treasury sold $27 billion of its three-month bills at a rate of 0.005%.

Treasury money market funds are now feeling the add-on effect of this new investor ideology. As we've previously mentioned, treasury funds are faced with unprecedented challenges of extraordinary fund inflows, dangerously low yield levels, and the risk of principal invasion from fund expenses. As a result, many large fund families have instituted fee rebates, trading limitations, and fund closings in order to prevent the funds from "breaking the dollar" and to minimize costs to fund sponsors who subsidize fund expenses.

Meanwhile, economic fundamentals have deteriorated in recent months and remain dreadful. Earnings shortfalls and funding challenges continue to challenge issuers of commercial paper and corporate debt. For the few issuers able to issue unsecured debt, secondary market liquidity can be spotty as securities dealers are less willing to increase their corporate inventories while they de-lever their balance sheets.

Suddenly, treasury managers have a serious cash problem on their hands. Unlike individual investors, who may receive up to $250,000 FDIC insurance on their

bank deposits, corporations with large pools of cash are running out of options that provide safety and liquidity. If T-bills become a losing proposition and treasury money funds are off the table, are there any viable options for the institutional cash investor? Our answer is yes. We think the start of this New Year may be a good time to talk about how to fortify investment portfolios in this most challenging environment.

GOVERNMENT SPONSORED ENTERPRISES (GSE) DEBT

When T-bills become a non-option due to negative yield, we consider the GSE discount note programs to be viable substitutes. We remain a strong advocate for the GSE debt issued by Fannie Mae, Freddie Mac, and the Federal Home Loan Banks (FHLBs), and the recent government action in placing Fannie and Freddie under conservatorship further demonstrated the systemically essential presence of the housing GSEs. As housing conditions worsened, the Federal Housing Finance Agency (FHFA), the regulator and new housing boss, took aggressive steps in turning the former for-profit mortgage giants into functional government agencies in the battle against home foreclosures. Such actions include the recapitalization of Freddie Mac and may include future capital injection or loan guarantees to the FHLBs. We, therefore, consider the GSE debt's credit quality to be on par with that of treasury securities through at least the duration of the conservatorship, which will remain intact in 2009.

As investors began to warm up to the concept of an "effective" US government guarantee, the discount notes' yield spreads tightened dramatically and their secondary market liquidity improved. As treasury securities continue to become more inaccessible, we envision even better liquidity and market demand for GSE debt.

GOVERNMENT MONEY MARKET FUNDS

With more fund families restricting daily inflows into treasury money market funds, we think certain government funds can be viable substitute sweep funds to position some excess cash as part of a comprehensive investment strategy. The primary factor of our assessment is our position of confidence regarding government support for the underlying investments, which consist of debt issued by the three housing GSEs and a small number of other government agencies and GSEs. Another factor is that the relatively higher yield offered by GSEs helps lessen the likelihood of operating expenses invading the funds' net asset value, thereby reducing the financial stress on fund sponsors.

However, our endorsement of the government money funds is a qualified one. We are cautious about government funds investing in long-maturity government securities, as the SEC Rule 2a-7 allows the maximum maturity of an eligible government security to be 762 days, compared to 397 days for non-government securities. Long dated securities may expose a fund's principal value to both higher shareholder redemptions and a sharp rise in the interest rates, especially in an abnormally low yield environment.

For funds that use repurchase agreements (repos), investors in general need to be wary of repo investments longer than a day. Since a repo is a form of collateralized borrowing, investors also should be aware of a fund's policy of overcollateralization (100% to 103% of market value), the types of collateral (senior notes or agency-guaranteed mortgages), and how the collateral is delivered and held (direct delivery or tri-party). Although the immediate risk of a repo fund may appear to be the risk of the repo dealers, the real risk is the potential loss of market value of the collateral should a dealer fail to return the money at maturity. In short, although certain government funds may be good substitutes for treasury funds, fund due diligence remains crucial.

FDIC TLGP GUARANTEED DEBT

In the current environment, treasury and government money market funds as pooled investment vehicles do not necessarily insulate investors from principal losses or fund closures, a la the Reserve U.S. Government Fund. Thus owning individual, high quality short-term investments can be a defensive strategy against sudden market events. In addition to T-bills and GSE discount notes, we think bank debt under the FDIC's Temporary Liquidity Guarantee Program (TLGP) offers the credit protection of the U.S. government with an attractive yield advantage.

In its final ruling on December 2, 2008, the Federal Deposit Insurance Corporation (FDIC) specifically addressed the issue of the debt guarantee mechanism as being backed by the full faith and credit of the U.S. government and that the FDIC would ensure the timely payment of both principal and interest payments. Banks and certain non-bank entities, such as General Electric Capital Corp and John Deere Capital Corp, have been issuing Aaa/AAA rated debt under the TLGP program since November 2008. The TLGP program is in effect for debt issued prior to June 30, 2009 and remains in effect through June 30, 2012.

FOREIGN GOVERNMENT GUARANTEED DEBT

The global financial crisis prompted independent and coordinated efforts by national governments to provide liquidity, credit and capital support to the systemically essential financial institutions of their respective countries. A number of strong industrialized nations, such as Australia, the United Kingdom, Germany and Ireland, have instituted full guarantees of domestic and foreign bank debt. We believe that the guaranteed US dollar denominated debt issued by strong industrialized countries presents good risk diversification from US government debt

When considering these non-corporate sovereign-backed issues, credit analysis remains crucial. Although defaults by investment-grade sovereign borrowers are extremely rare, their political, economic and financial situations can be vastly different from one another. In addition to ratings criteria, investors may need to assess the development and diversification of the national economies, the effectiveness of their regulatory framework, the openness of the financial systems, the stability of the political structures, the levels of government debt and debt service costs, the severity of their current downturns, and the impact of the debt guarantees on their debt ratings. Additionally, guarantee terms vary from country to country and secondary market liquidity may be influenced by the individual issuers' name recognition in the US market. It is also important to note that investors may have investment policy restrictions that must be taken into consideration, even though the credit concerns of sovereign-guaranteed debt may be minimal.

BEWARE OF CERTAIN "INDUSTRIAL" CREDITS

Lastly, we remain skeptical of the fundamental outlook for corporate credits at this time. We think that the great debate of investing in "financial" vs. "industrial" names is somewhat misguided, as industrial credits sensitive to economic cycles may be just as likely impacted as financial issuers in a recession. We think the strong and diversified market-share leaders such as General Electric and Toyota Motors, notwithstanding their probable ratings downgrades, will continue to have sufficient debt servicing capacities, but the smaller cyclical companies may face additional funding and ratings pressure. Even though the risk of default may be quite remote, many of these issuers have seen a dramatic reduction in their paper's secondary market liquidity in recent months.

WHEN YOU CAN'T HIDE YOUR HEAD IN THE SAND, OPTIONS ARE AVAILABLE

To sum up, institutional cash investors found themselves in a pickle when the market's desire for safety made treasury securities and treasury money market funds inaccessible. However, when the default option is no longer an option, alternative avenues may help investors mitigate credit and liquidity risks in challenging environments.

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