Prudent Risk Diversification:

Challenges to and Solutions for Short-Duration Investors

Abstract:
A common misconception of risk diversification may be that additional credits automatically result in a safer portfolio. Today however, one of the primary challenges in developing a successful diversification strategy for short duration investors is a smaller pool of eligible investments. A mad dash into European financial debt, certain sovereign debt, municipal debt, and bank deposits by money funds and other investors provides evidence that some diversification strategies may actually increase, rather than decrease, risk. A fundamental credit evaluation process remains the best weapon against credit risk and it should form the basis of any successful diversification strategy. When the eligible investment pool shrinks, investors may be better off increasing concentration in higher quality credits than blindly diversifying into highly rated, but unfamiliar, names.

Introduction
The benefits of risk diversification are so widely accepted these days that almost every investment policy statement (IPS), including those for short-duration portfolios, requires diversification targets for specific investments. However, investors may not be aware that the pool of eligible investments has shrunk dramatically in recent years. Diversification for diversification's sake, thus, may increase credit risk and reduce portfolio performance. This is especially true for short-duration portfolios in which an increased probability of default may overshadow the incremental yield gained when adding peripheral credits to satisfy diversification targets.

In last month's newsletter, we attempted to summarize Eurozone bank credit exposures in U.S. prime money funds. One observation we made from the datasets was that the largest exposures tended to be found within large and systemically important entities. This phenomenon illustrates the trade-off that managers of money funds and separate accounts may often have to make: concentration in large and stronger names versus diversification into smaller, less liquid, and perhaps less credit-worthy names. Our commentary traces the sources of the current dilemma and some possible responses to this issue. Ultimately, we hope to establish that individual credit selection should be at the core of the decision process.

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A Diminishing Pool

The basic premise of risk diversification is to spread investments among a pool of qualified assets to reduce the idiosyncratic risk unique to individual assets. But, the challenge faced by short-duration investors in recent years has been the shrinking pool of worthy investments.

One reason for the shrinking pool is the general downward migration of ratings in many industries. You may recall that some bond issuers in the telecommunications (e.g. AT&T), automobile (e.g. GM) and pharmaceuticals (e.g Pfizer) industries were once triple-A rated. Likewise, many major financial issuers (e.g. AIG, Citigroup and Morgan Stanley) used to be double-A credits. Nowadays, many of these names have dropped to single-A, triple-B or even junk-rated status. Lacking a ready supply of traditional and eligible investments, a portfolio with a triple-A or double-A ratings mandate may be forced to search for yield in exotically packaged securities that meet the high ratings criteria but which also may have untested underlying credit or liquidity characteristics.

Secondly, the pool has shrunk because of investor self-censorship. The recent credit crisis exposed the opacity and structural vulnerability of exotic investments such as structured investment vehicles (SIVs) and subprime mortgage related asset backed securities (ABS). In the aftermath of their demise, many investors decided to shun all types of securitized investments, even though many credit card and auto ABS and asset-backed commercial paper (ABCP) investments offer high ratings along with good risk diversification as a result of their high quality collateral.

A final factor contributing to the shrinking pool of eligible investments is the reduction in the number of securities dealers on Wall Street. For investors of commercial paper (CP) and repurchase agreements (repos), this represents a sizable slice of risk management. A typical CP program has three or more designated dealers marketing its short-term debt offerings and investors also typically conduct repo activities with multiple dealers to spread out the risk. But, a major result of the credit crisis has been the reduction of the pool of counter-parties. Of the five major independent broker-dealers prior to the credit crisis, only two, Goldman Sachs and Morgan Stanley, remain today. For investors, this development means that intermediary risk further limits the implementation of an adequate diversification strategy.

Poor Diversification Strategies Introduce New Risks

The aforementioned factors significantly challenge a short-duration portfolio, be it a separately managed account or a prime money market fund, to find ways to diversify

risk through investing in other asset categories. Over the three years since August 2007, we have noticed several trends in risk diversification that actually introduced new risks to credit portfolios.

Less Liquid Foreign Financials: This first trend arose from the ruins of the SIV debacle in late 2007. Money funds and securities lending portfolios that used to invest heavily in ABCP programs drastically reduced their exposure to this sector while increasing concentration in smaller European financial issuers with which they had little previous experience. These names included German landesbanks, British and Irish mortgage banks, and Spanish and Portuguese savings banks that carried high credit ratings because of assumed government support and financial backing. However, their credit worthiness was seriously misjudged by many investors. Before long, the subprime bonfire that engulfed the ABCP sector also threatened these banks with related loan exposures and many were placed on life support by their respective governments forcing investors to search for another source of diversification.

Sovereign Guarantors: Fresh credit concerns developed courtesy of the Lehman Brothers bankruptcy in September 2008 when global governments rushed to institute massive liquidity and credit support schemes for their respective banking institutions. Thus, a burgeoning sovereign-guaranteed bond market was born. From Austria to Australia and New Zealand to the Netherlands, sovereign governments replaced the banks they support as the debtors of the bonds, similar to the U.S. FDIC bond guaranteed program. Attracted by the triple-A and double-A ratings on these bonds, short-duration investors increased their concentration in sovereign names. Regrettably, this wave was also short-lived. The crisis of confidence involving the Hellenic Republic's fiscal solvency early this year eventually evolved into a buyers' strike on bonds of most southern European sovereign borrowers. Investors, again, had to find new and creative places to park their cash and diversify their holdings.

Municipal Bonds: Yet a third trend of diversification involves taxable investors, including prime money funds, buying tax-exempt securities in the municipal bond market. Two years after the widespread credit downgrades of the bond guarantor industry to "junk" status, the short-term municipal market, which relies on the guarantees for insured AAA-ratings, has yet to recover. Mounting benefits liabilities and drastically lower tax revenues also presented funding pressures for municipal issuers at all levels. Reflecting an unusual lack of interest from investors, yields on tax-exempt municipal bonds rose to above those on taxable instruments. Although some of these bonds may offer bona fide diversification benefits, the very fact that tax-exempt

bonds offer higher yield than their taxable counterparts ought to sound alarms for potential investors. We also note with worry that many of these bonds contain put features that allow investors to tender at par to "liquidity" banks, many of which may also be held as individual credits in portfolios. In this instance, investors have effectively negated the diversification benefits they had hoped to reap by holding municipal bonds.

Caution on Bank Deposits

Another popular, although somewhat less obvious, strategy of diversification is to fallback to simple bank deposits. One of the beneficiaries of the flight from prime money funds after the Reserve Primary fund debacle in 2008 has clearly been the banking sector which benefits from both the liquidity support of the Federal Reserve discount window and the deposit insurance of the FDIC. In the context of this commentary, we would like to comment on two potential drawbacks of good old bank deposits.

Money Market Deposit Accounts (MMDAs): As part of the Treasury Department's emergency liquidity measures, the FDIC's Transaction Account Guarantee (TAG) program expired on December 31, 2009, but banks with weak funding access can still continue to tap into the program through December 31, 2010, albeit at higher opt-in fees. Commercial banks sought to retain deposits after the TAG expired by offering depositors higher rates on MMDA balances, which double as sweep accounts. But without the benefit of the TAG, large corporate accounts essentially take on the credit risk of the banks at which they keep their accounts. Investors should recognize that the regional banking sector remains in a negative credit environment because of its disproportionate exposure to commercial real estate impaired loans and capital shortfalls. The pending financial reform bill could further erode the implicit government support for the banking sector in general, thus potentially beginning a cycle of credit rating downgrades and resulting reduced market access which could further put pressure on bank credit. In short, we caution investors to consider such deposits as unsecured bonds of the respective lending institutions and we recommend that they diversify accordingly.

Aggregated Insured Deposits Programs: In recent years, deposit aggregators also wooed short-duration investors with aggregated insured deposits from banks in their networks that each offer up to the $250,000 FDIC insurance limit. While these programs have merit in that they facilitate greater access to deposit insurance for smaller community banks to the savers community, large corporate accounts should

take note of the programs' inherent limitations. Along with the non-marketable nature of the investments and steep early withdrawal penalties of some of these programs, these deposits are generally operated by a centralized entity that negotiates rates, facilitates transfers, administers recordkeeping and processes subscriptions and redemptions. As in the case of a repo dealer, investors of such programs may be exposed to the counter-party risk of a single dealer, despite having a portfolio of so-called "diversified" deposits from banks throughout the country. Thus, the benefit of diversification may be greatly reduced.

Credit Selection, the Key Ingredient of Risk Diversification

Having pointed out the potential diversification pitfalls that may be found when chasing popular products, we hope to have illustrated that diversification, in and of itself, does not necessarily reduce risk for the short-duration investor. Because each and every new credit is a new source of risk, the key driver for a successful diversification strategy remains a sound fundamental credit analysis process. And in the absence of good risk diversification candidates, we argue that portfolio managers should err on the conservative side by holding a potentially larger than usual concentration in the strongest credits or government securities rather than diversifying into unproven asset types.

For example, when faced with a limited supply of highly rated corporate issuers, it may be more prudent for managers of portfolios with a double-A ratings mandate to skew the portfolio holdings more heavily towards government agency bonds than to venture into unfamiliar names that satisfy the ratings. Investors shouldn't stop there however. It's equally as important to have a bottom-up process that builds a list of pre-approved credits, each qualified as a suitable investment on its own merits of credit quality and liquidity. Diversification can then take place among these names and only these names. From time to time, portfolios built with this methodology may look less diversified due to their smaller number of issuers, but investors may be better off than if invested in a larger portfolio of credits that are less familiar to them. We think there is truth in the old adage: it is better to deal with the devil you know than the devil you don't.

This is especially true with money market funds, which are managed to a "zero loss" mandate to satisfy the constant $1.00 net asset value (NAV) requirement. The SEC's Rule 2a-7 which requires a 5% per issuer concentration does not require issuers to be economically unique, meaning several issuers may share a common parent company or liquidity provider. It is, then, operationally impossible to reduce a portfolio's individual credit exposures to a point which does not threaten its NAV, because it only takes a

default equal to 0.5% of the portfolio to "break the buck". When you layer on the fact that financial issuers tend to have high risk correlation with each other, you can start to appreciate the challenges fund managers face in risk minimization tasks. Knowing your credits, thus, becomes an even more compelling argument in effective credit risk mitigation.

Conclusions: Diversification and Credit Selection Should Go Hand in Hand

Risk diversification strategies, when not appropriately executed, may actually increase portfolio risk and reduce performance. The root of this dilemma is the diminished pool of eligible securities for short-duration investors, either due to negative ratings migrations, self-censorship or the disappearance of market makers. A hunt for diversification recently led investors to European financial firms, sovereign entities, municipal issuers, and bank deposits. While not all of these issuers are problematic, recent developments in the Eurozone and in U.S. municipal finances provide evidence that some of these investments proved to be risk *increasers* rather than risk *reducers*.

We conclude this article with an assertion that a fundamental credit evaluation process remains the best weapon against potential credit risk and should form the basis of any successful diversification strategy. When a pool of eligible investments shrinks, investors may be better off increasing their concentration to higher quality government and corporate credits, rather that diversifying into unfamiliar, less liquid issuers.

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