Pulling Back from the Abyss

Back On the Path to Credit Investing

Over the past two years, as we anticipated the credit cycle downturn, we gradually and methodically worked to reduce credit exposure in our managed portfolios. In light of the dramatic capital markets disruptions and the extreme market illiquidity after the bankruptcy of Lehman Brothers, we temporarily ceased purchases of all non-government guaranteed debt. Additionally, we eliminated indirect credit exposure by moving the liquid portion of our client portfolios into a government money market fund.

Since the spring of 2009, global capital markets have slowly begun to return to normal, as suggested by the plummeting yield spreads of credit investments and a rebounding new issues market. The massive government stimulus package also appears to have worked in stalling the economy's freefall.

In light of these positive credit developments, we began a gradual and methodical process of layering credit investments in our portfolios since early summer - first in non-financial issuers, then credits of systemically important financial firms, and most recently, moving back into a prime money market fund. Our decision to move back into corporate credits is based on a number of considerations.

POSITIVE FORCES AT WORK

Trajectory of Growth Turns Positive: As we stated in our June 2009 newsletter, our decision to invest in corporate securities must be preceded by credible signs of an economic recovery. We give Fed Chairman Ben Bernanke the credit of correctly identifying the timing of this recovery. After the famous remark of "green shoots" in the economy in early spring, the Chairman declared in September that the "recession is very likely over at this point".[1] A downward revision to the third quarter GDP still places growth at 2.8%, the first quarterly growth in two years. Elsewhere, GDP growth in Germany and France, two of the largest European economies, also moved into the black. In addition, the improved economic vitality of the Asian economies has been apparent for several quarters.

Although we suspect that growth may be uneven, and that tight credit and tarnished consumer balance sheets may lead to unimpressive rates of growth, we believe the growth trajectory in the U.S. will remain intact. Based on this analysis, we think diversified corporate issuers with strong capital bases and profitability will benefit from the recovery and thus are good candidates for our investment strategies.

Financial Institutions' Systemic Risk Has Diminished: Thanks to unprecedented government intervention and improved capital markets conditions, the systemic risk of global financial institutions has diminished substantially in recent months. Bank earnings in the second and third quarters of 2009 showed marked pre-provisioning profit improvement. Low interest rates brought in a windfall as net interest revenue improved and more trading and fee income came

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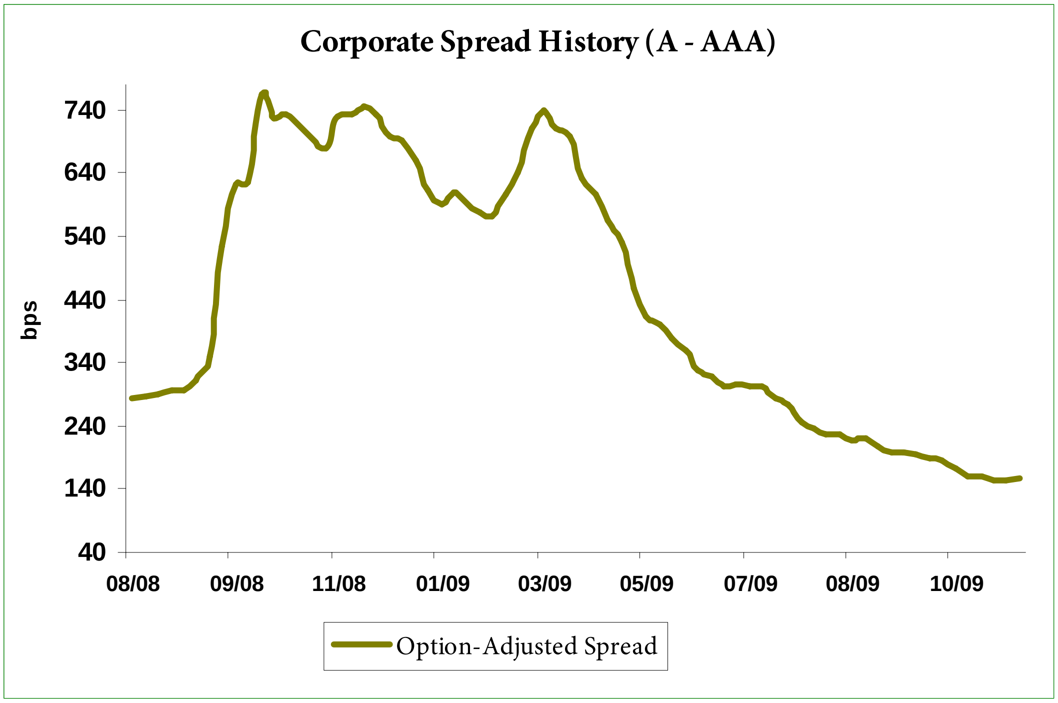
from the securities business. In addition, although losses and provisions for losses continue to trend higher, early delinquencies are dropping off, suggesting fewer new loans are going bad.

Most of the first nine recipients of the Troubled Asset Relief Program (TARP) investments have repaid the government since last summer, a sign of improved capital strength and a vote of confidence from the regulators. Last month, the Federal Reserve disclosed that nine of the ten largest banks subject to the systemic bank capital stress tests "now have increased their capital sufficiently to meet or exceed their required capital buffers."[2] In fact, Treasury Secretary Tim Geithner felt strong enough about the strength of the financial system that he is "working to put the TARP out its misery."[3] Likewise, major banks in the U.K., France, the Netherlands and Germany had similar successes in raising equity capital and repaid government investments.

We believe that all these signs point to diminished systemic risk in our financial system, which means the credit migration of major financial issuers will likely be much less erratic than in the fall of 2008. Our decision to invest in the strongest, systemically important financial institutions also draws comfort from the government's past decisions to support these entities. We believe that, should systemic risk re-emerge, governments will remain accommodative in the senior, short-term debt obligations of these institutions, given lessons learned from the virtual market lockdown in late 2008.

Government Policies Remain Supportive: On a related point, we believe regulatory policies will remain supportive for an extended period of time, which reduces the risk of a sudden, unpredicted reversal of credit market conditions. With the double-digit unemployment rate and the absence of inflationary pressure, we expect the Federal Reserve to anchor the short-term rates at near zero for the foreseeable future which, in turn, will reduce the issuers' debt burden and improve profitability. The unwinding of government emergency liquidity measures, as we discussed in our August 2009 newsletter, has been carried out in an orderly fashion with contingent provisions in the event of a sudden need for emergency support. Even the very discussion of requiring banks to pay for their own unwinding and the creation of a systemic regulator are positive developments to protect senior debt holders of these financial institutions.

Improved Market Technicals: Improved market liquidity is another major factor in our decision. The trend has continued in recent months. For example, the yield spread over Treasury of the Merrill Lynch 1 to 3 Year Corporate Index improved from 7.64% in October 2008 to 1.57% as of 11/27/2009[5]. The 6.11% reduction in the risk premium of short-term securities in a roughly one-year period is simply astonishing[4]. Similarly, the yield spread of the 3-month LIBOR over 3-month Treasury bills (known as the TED spread or "fear gauge"), dropped from 4.63% to 0.23% in the same period[5]. The virtual evaporation of risk premium is a clear indication that cash investors in general have no difficulty in owning and trading credit instruments. While we suspect there is a "price for perfection" tendency in the short-term market, the much improved market liquidity is beyond dispute.



Source: Bank of America Merrill Lynch Global Index Systems

THE CASE FOR PRIME MONEY MARKET FUNDS

Our decision to invest in prime money market funds is linked to our overall assessment of the health of the financial debt market. This is because non-government funds have always been major investors in financial institutions' debt. The concentration in financial debt is a function of the integrated funding market, where financial and non-financial borrowers may borrow either through their corporate banks or through off-balance channels such as asset-backed commercial paper programs. The collective purchasing power of prime money market funds ($1.8 trillion as of 11/13/09 according to the ICI website) and financial institutions' key role as intermediaries means that the majority of investments in a typical fund will continue to be bank debt.

While in the process of assessing our view of financial institution debt during recent months, we underwent a rigorous process of due diligence and manager interviews. Our analysis shows that the general risk profile of large prime money market funds has improved beyond the pre-credit crisis days, and the average fund now has better liquidity, better credit quality and lower structural complexity (Please refer to our November newsletter, "How Safe Are Prime Money Funds?" for more details). Average fund asset levels of large prime money market funds have increased beyond pre-crisis levels and no material outflows have occurred as a result of the expiration of the US Treasury's Temporary Money Market Fund Guarantee in mid-September of this year.

As a result of these factors, we recently directed our clients to move the liquid portion of their portfolios into a prime money market fund. As noted in our August newsletter, investment style and risk appetite vary greatly among prime funds. Investors should conduct similar scrutiny and periodic assessment of the prime funds they choose.

FACTORS THAT CAUSE US TO BE CAUTIOUS

At the current stage, our investments in non-government securities are limited to a small number of strong industrial credits and systemically important financial institutions. There are factors however, that would cause us to pause before an all-out "overweight" stance on credit instruments.

First, we recognize that the current economy remains fragile and the recovery is unbalanced across regions and industries. Another big factor is the current low yield environment. We think the near zero Federal funds rate has created new challenges for cash investors. After brushing with negative yields in late 2008, the 1-month Treasury bill is again nearing negative territory. It is at 0.03% as of 11/27/2009[5]. In addition, the TED spread hit an all time low of 0.16% in September before settling at 0.23%.

We see at least two risks associated with this phenomenon: 1) Investors who purchase securities at extremely low levels may fall victim to the "bear trap" and sustain sizable losses if they have to sell to raise liquidity when rates move higher. 2) Low yields may also induce investors to purchase riskier securities inappropriate for cash investors or may build asset bubbles elsewhere in the capital markets. We suspect low yields may be correlated with the recent rallies in the equity market. In considering credit investments, we are mindful of the duration risk and will be conservative on the maturities we purchase.

CONCLUSION: TAKING THE FIRST STEP

In summary, our decision to return to credit investing coincides with an improved outlook on economic fundamentals and a healthier financial system. We are cognizant of the nascent state of the recovery and the long process it will take to get back to full health. Our choice selection of economic bellwethers and systemically important financial institutions as investment candidates is our first step back to credit investing. As our outlook improves, we may consider other value added credit instruments.

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[1] Sara Murray and Ann Zimmerman, Bernanke: Recession 'Likely Over', the Wall Street Journal, page A2, September 16, 2009. http://online.wsj.com/article/SB125301730771311713.html

[2] Press Release dated November 9, 2009, The Federal Reserve's website: http://www.federalreserve.gov/newsevents/press/bcreg/20091109a.htm

[3] Jennifer Liberto, Is TARP bailout helping the economy, CNNMoney.com, November 19, 2009. http://money.cnn.com/2009/11/19/news/economy/TARP_impact_unclear/index.htm

[4] Based on Weekly OAS history of the Merrill Lynch Index (C1A0), available on Bank of America Merrill Lynch's Global Index System (MLX) website. http://www.mlx.ml.com/GIS/bin/default.asp Subscription required.

[5] Bloomberg data.