clearwater ADVISORS

MARKET Commentary

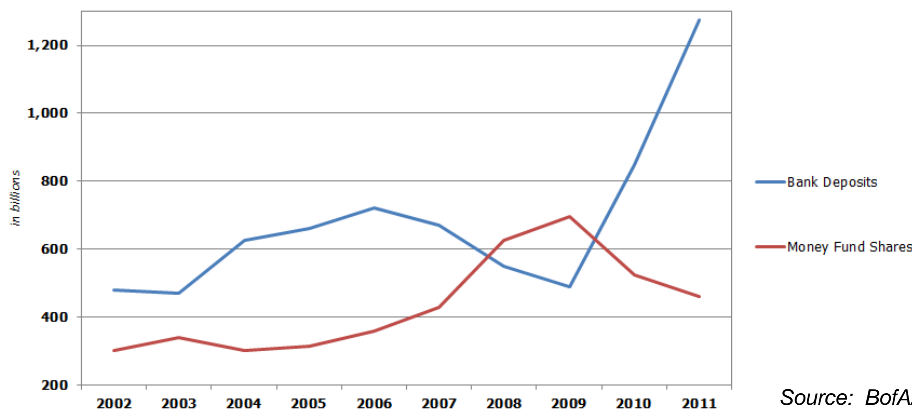
Credit Check

Investors have picked up where they left off in 2011 – embracing risky assets. Market participants, hopped up on a sugary elixir of easy monetary policy, are clamoring for yield. Consequently, spreads have compressed even as we face political uncertainty, a lackluster global economy, the largest sovereign default in history and the first developed country debt default in 60 years (Greek PSI). Moody's briefly interrupted the rush for risk in February, announcing the expected downgrade of a number of global banks with several large institutions facing a fall into the Baa range. As these downgrades will most likely occur before summer arrives, we shall examine the potential unexpected credit exposure a cash investor may be facing and discuss suitable alternatives.

Be Wary of Your Bank

Banks continue to face ratings pressure (see the appendix for a selective list of global bank ratings, updated from our November commentary) while their regulatory burden increases, capital market activity declines and earnings pressure festers as they work through troubled legacy assets of dubious value. However, money continues to pour into bank deposits (see Figure 1) due to the unlimited insurance on non-interest bearing accounts via the Transaction Guarantee Program (authorized by Congress in the Dodd-Frank Act). Effectively through December 2012, the U.S. government has removed credit risk from these accounts. Bear in mind, almost 90% of the assets in non-interest bearing accounts are above the regular $250,000 FDIC limit.

Figure 1: Bank Deposits vs. Money Fund Balances



Source: BofA/Merrill Lynch

The unlimited insurance is due to expire at the end of the year, exposing many cash investors to significant credit risk as compensation via earnings credits diminishes. Few money market investors would consider a portfolio concentrated in less than a handful of banks to be prudent, but that will be the situation in which they find themselves come January 1, 2013.

Beware of Your Money Market Fund

Short-term investors may be tempted to move bank-held assets to a prime money market fund in an effort to diversify credit risk or to a government money market fund to minimize it. However, as long time readers are well aware, prime funds typically maintain significant exposure (at times well over 50% of assets) to the European banking system which is in worse shape than its U.S. counterpart. True to form, prime funds have added Eurozone bank

March 2012

US Treasuries

As of 29-Feb

Benchmark	Yield
3 Month	0.08%
6 Month	0.13%
1 Year	0.16%
2 Year	0.30%
5 Year	0.87%
10 Year	1.98%
30 Year	3.08%

Bank of America/Merrill Lynch Indexes

31-Jan to 29-Feb

Index	Return
1-3 Yr Gov/Corp ≥ A	0.01%
1-3 Yr Municipals	0.24%
1-3 Yr Agencies	0.06%
0-3 Month UST	0.00%
S&P 500	4.32%

Contact Us

www.ClearwaterAdvisors.com
Trading@ClearwaterAdvisors.com

Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan, The Economist, S&P and Center on Budget and Policy Priorities, Wall Street Journal

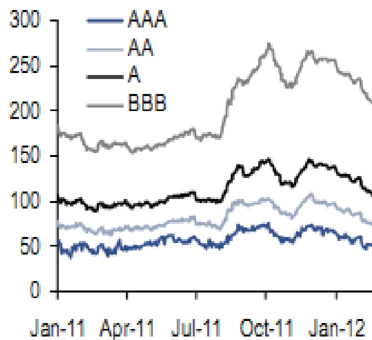
exposure in the first two months of 2012 and now have almost 50% of their banking sector exposure in Europe, according to data from iMoneyNet and JP Morgan. Meanwhile, government funds offer low single-digit basis point yields for a front row seat to the fiscal dysfunction in Washington.

Further complicating matters, the Securities Exchange Commission, in a bid to stave off another Reserve Primary Fund meltdown, recently proposed that money market funds put in place capital buffers (adding cost and reducing returns available to investors), redemption limits/liquidity fee (in times of stress, 95% of your investment is available for withdrawal with the remaining balance returned after 30 days provided the fund is still solvent) and/or floating rate NAV's (eliminating the fixed $1.00 share price). These options, if enacted, would significantly alter the perceived safety of money funds and would pass credit risk through to their investors. Fidelity, the largest U.S. money fund sponsor, went so far to say that the proposed changes would "ultimately destroy" the industry.

Clearwater Credit

Given these developments, now is as good a time as ever to move assets into a tailored, diversified portfolio managed by Clearwater Advisors – a portfolio that won't have outsized exposure to one financial institution, nor many of the issues complicating money funds. We continue to assemble portfolios with careful consideration to credit selection while striving to prudently match the risk tolerance of our clients. As we discussed in our January commentary, we favor select credit exposure, including issuers further down in ratings (but not necessarily further down in credit quality). Certain financials, excluding Europe, still look attractive and BBB industrials (see Figure 2) have lagged a bit in this rally, offering value.

Figure 2: Citi BIG Corporate Index – Non-Financial Spreads



Source: Citi Investment Research

We also find high-quality structured product attractive as well as, for clients with slightly longer duration mandates, GSE mortgage-backed securities. While many still bear the scars of the mortgage debacle of recent years past, we believe this sector, specifically Agency mortgages, warrants renewed consideration. The Agency Mortgage Master compares favorably to an all-corporate index of similar duration (analyzing Bank of America/Merrill Lynch index data). To maintain a AAA credit rating and exceed the performance of mortgages, an investor must extend duration considerably to 5.73 years in a corporate/government portfolio. The Agency Mortgage Master Index is composed entirely of Fannie Mae-, Freddie Mac- and Ginnie Mae- guaranteed mortgage-backed securities. There are no private label residential mortgage-backed securities in the index, nor do we invest in them.

Figure 3: Agency, Mortgage and Gov/Corp Characteristics and Returns

	Agency Mortgage Master Index	1-3 Yr U.S. Corporate Index	U.S. Corporate & Government Master (A and Above) Index
Rating	AAA	A2	AAA
Yield	1.80	1.70	1.58
Duration	2.06	1.83	5.73
Worst Annual Performance (Total Return, Year) – Last 20 Years			
	-1.6% (1994)	-2.7% (2008)	-3.3% (1994)
	+1.6% (1999)	+1.18% (1994)	-2.2% (1999)
	+2.6% (2005)	+1.76% (2011)	+1.4% (2009)
Best Annual Performance (Total Return, Year) – Last 20 Years			
	+17.0% (1995)	+14.7% (2009)	+18.9% (1995)
	+11.3% (2000)	+11.7% (1995)	+12.4% (2000)
	+9.3% (1997)	+7.8% (1992)	+11.6% (2002)

Source: BofA/Merrill Lynch, Bloomberg

Looking Forward

The past several years have proven tumultuous for fixed income investors. We expect the challenging environment to continue and look to take advantage of the opportunities that arise. Investors holding large balances with their bank or money fund should be preparing for changes that introduce significant credit risk without requisite compensation. It is an opportune time to consider shifting assets to a custom separately managed account that is tailored to your investment guidelines and prudently maximizes your yield.

Please contact the desk with questions or to discuss investment opportunities.

Appendix: Global Bank Long-Term Credit Ratings under Pressure

	November 2011				March 2012			
Name	**S&P Long-Term Ratings**	**Moody's Long-Term Ratings**	**S&P Outlook**	**Moody's Outlook**	**S&P Long-Term Ratings**	**Moody's Long-Term Ratings**	**S&P Outlook**	**Moody's Outlook**
American Express	BBB+	A3	STABLE	STABLE	BBB+	A3	STABLE	STABLE
Autralian & New Zealand Banking Group	AA	Aa2	STABLE	STABLE	AA-	Aa2	STABLE	STABLE
Banco Santander	AA-	Aa3	NEG	NEG	A+	Aa3 •-	NEG	NEG
Bank of America	A	Baa1	NEG	NEG	A-	Baa1 •-	NEG	NEG
Bank of Montreal	A+	Aa2	STABLE	STABLE	A+	Aa2	STABLE	STABLE
Bank of Nova Scotia	AA-	Aa1	STABLE	STABLE	AA-	Aa1	STABLE	STABLE
Barclays	A+	A1	NEG	NEG	A	(P)A1 •-	STABLE	NEG
BBVA	AA-	Aa3	NEG	NEG	A	Aa3 •-	NEG	NEG
BNP Paribas	AA-	Aa2	STABLE	STABLE	AA-	Aa3 •-	NEG	NEG
CIBC	A+	Aa2	STABLE	STABLE	A+	Aa2	STABLE	STABLE
Citigroup	A	A3	NEG	NEG	A-	A3 •-	NEG	NEG
Commerzbank	A	A2	NEG	NEG	A	A2 •-	NEG	NEG
Commwealth Bank of Australia	AA	Aa2	STABLE	STABLE	AA-	Aa2	STABLE	STABLE
Credit Agricole	A+	Aa2	STABLE	STABLE	A	Aa3 •-	STABLE	NEG
Credit Suisse	A	Aa2	STABLE	STABLE	A	(P)Aa2 •-	NEG	NEG
Deutsche Bank	A+	Aa3	STABLE	STABLE	A+	Aa3 •-	NEG	NEG
Goldman	A	A1	NEG	NEG	A-	A1 •-	NEG	NEG
HSBC Bank PLC	AA-	Aa2	STABLE	STABLE	A+	Aa2 •-	STABLE	NEG
ING	A	A1	STABLE	STABLE	A	A1 •-	STABLE	NEG
Intesa Sanpaolo SpA	A	A2	NEG	NEG	BBB+	A2 •-	NEG	NEG
JPMorgan	A+	Aa3	STABLE	STABLE	A	Aa3 •-	STABLE	NEG
Lloyds TSB	A	A2	STABLE	STABLE	A-	A2 •-	STABLE	NEG
Mizuho Corporate Bank Ltd	A+	A1	STABLE	STABLE	A+	A1	NEG	STABLE
Morgan Stanley	A	A2	NEG	NEG	A-	A2 •-	NEG	NEG
National Australia Bank	AA	Aa2	STABLE	STABLE	AA-	Aa2	STABLE	STABLE
Nomura	BBB+	Baa2	STABLE	STABLE	BBB+	Baa2 •-	STABLE	NEG
RBS	A	A3	STABLE	STABLE	A-	A3 •-	STABLE	NEG
Royal Bank of Canada	AA-	Aa1	STABLE	STABLE	AA-	Aa1 •-	STABLE	NEG
Royal Bank of Canada	AA-	Aa1	STABLE	STABLE	AA-	Aa1 •-	STABLE	NEG
Soc Gen	A+	Aa3	STABLE	STABLE	A	A1 •-	STABLE	NEG
Standard Chartered PLC	A	A2	STABLE	STABLE	A+	A2	STABLE	STABLE
Toronto Dominion	AA-	Aaa	STABLE	STABLE	AA-	Aaa	STABLE	NEG
UniCredit SpA	A	A2	NEG	NEG	BBB+	A2 •-	NEG	NEG
Wells Fargo	AA-	A2	NEG	NEG	A+	A2	NEG	NEG
Westpac Banking Corporation	AA	Aa2	STABLE	STABLE	AA-	Aa2	STABLE	STABLE

Source: Moody's and S&P

This material is for your private information, and we are not soliciting any action based upon it. Certain investments, including those involving futures, options and other derivative products give rise to substantial risk and are not suitable for all investors. The risks inherent in these investments may lead to material loss of capital. Past performance may not be indicative of future results. Results portrayed, including those of indices, reflect the reinvestment of dividends, as well as the effects of material market and economic conditions. Different market and economic conditions could have a material impact on performance. Index results are used for comparison purposes only and have been unaltered from their original state as received from independent sources. Historical results reflect returns that a typical investor would have received based on stated fees and do not necessarily reflect returns that actual investors received. Opinions expressed are our present opinions only. The material is based upon information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon as such. This document is intended for your internal use only and may not be distributed outside your organization. This is neither an offer to sell nor a solicitation of an offer to buy an investment product.

Form ADV Part II

Clearwater Advisor's annual Form ADV Part II disclosure is available to clients upon request. To make a request please email Compliance@ClearwaterAdvisors.com or call Brittany Pfister at 208-489-7550.