clearwater ADVISORS

MARKET Commentary

A Renewed Case for Extension

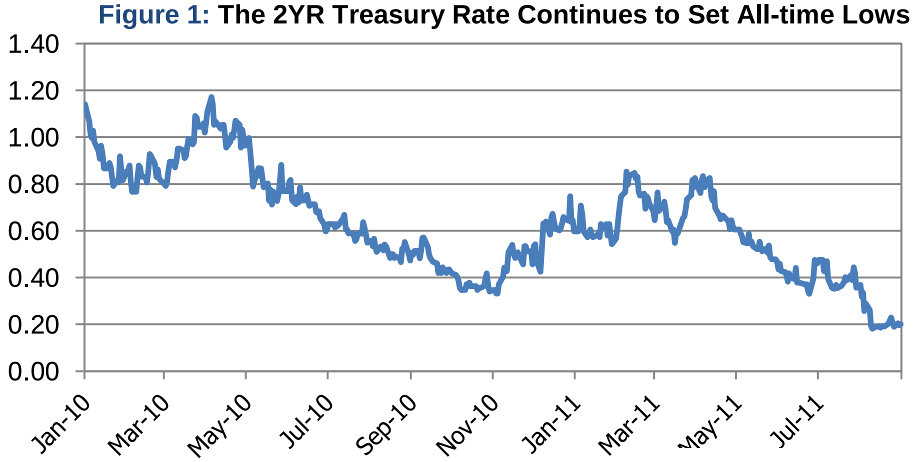
September 2011

"Extend Now?"

In October 2010, we dedicated our monthly commentary to answering this perplexing question. At that time, the 2-year Treasury rate was testing its all-time lows of 43 bp, and the Federal Open Market Committee (FOMC) was on the verge of announcing its second round of quantitative easing. Our answer to this question, particularly, whether or not investors should extend the durations of their ultra-short liquidity pools, was rooted in our conviction that persistent economic weakness and uncertainty surrounding increased regulations warranted the FOMC keeping rates exceptionally low for an extended period. We reasoned the following:

At a minimum we expect that persistently low interest rates and impending financial regulation will lead to an increased contraction in the supply of money market product (0-13 month maturities) and a further reduction in short-term yields. As a result, short-duration investors should seriously consider extending portfolio duration in this changing environment to optimize returns on historically high cash balances. Failing to adjust to the current reality in the money markets will lead to painfully low returns on investment portfolios well into 2012. "Extend Now? Clearwater October 2010 Commentary"

Figure 1: The 2YR Treasury Rate Continues to Set All-time Lows



Source: Bloomberg

Flash forward to August 2011.

A downgrade of the United States sovereign and related entities, lowered expectations for domestic and global growth and continued turmoil in Europe has again pushed 2-year interest rates to an all-time low, reaching 18 bp (25 basis points lower than October 2010 levels). The FOMC in dramatic fashion strengthened its accommodative policy stance and wrote in its most recent announcement that interest rates will remain exceptionally low into mid-2013. With short-duration investors under even more pressure to find yield in this unprecedented low-rate environment, we again address the question, "should short-duration investors be looking to extend now?"

The simple answer is "yes."

US Treasuries

As of 31-August

Benchmark	Yield
3 Month	0.01%
6 Month	0.05%
1 Year	0.10%
2 Year	0.20%
5 Year	0.96%
10 Year	2.22%
30 Year	3.60%

Bank of America/Merrill Lynch Indexes

28-July to 31-August

Index	Return
1-3 Yr Gov/Corp ≥ A	0.22%
1-3 Yr Municipals	0.25%
1-3 Yr Agencies	0.28%
0-3 Month UST	0.01%
S&P 500	-5.44%

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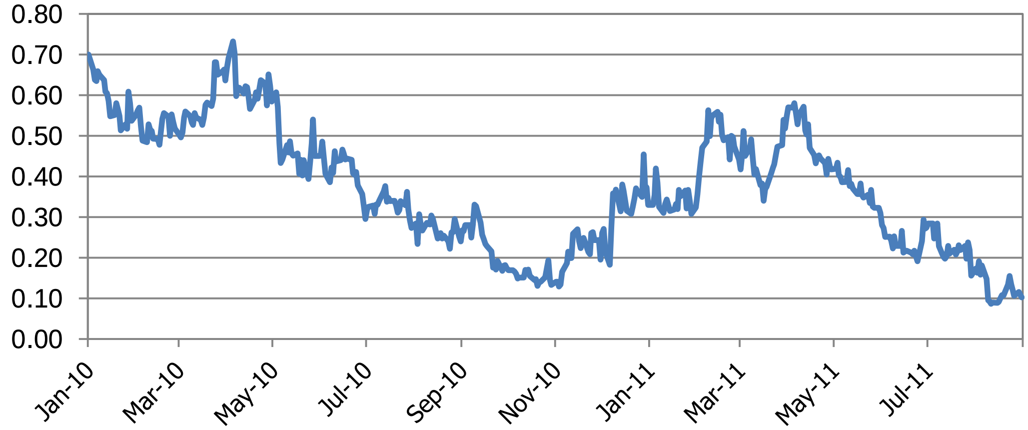
Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan, The Economist, S&P and Center on Budget and Policy Priorities

The Benefits of Extension

We recommend traditional short-duration investors (<13 months) look at extending into high-grade credits (i.e., corporates) on the 2-3 year part of the yield curve. We feel that the risk/return profile of extension into credit looks much more attractive than the opportunities in traditional-rate product like Treasuries and Agencies, something we highlighted in our October 2010 commentary. Employing such a strategy will allow short-duration investors to take advantage of higher absolute yields and the current steepness of the short end of the credit curve.

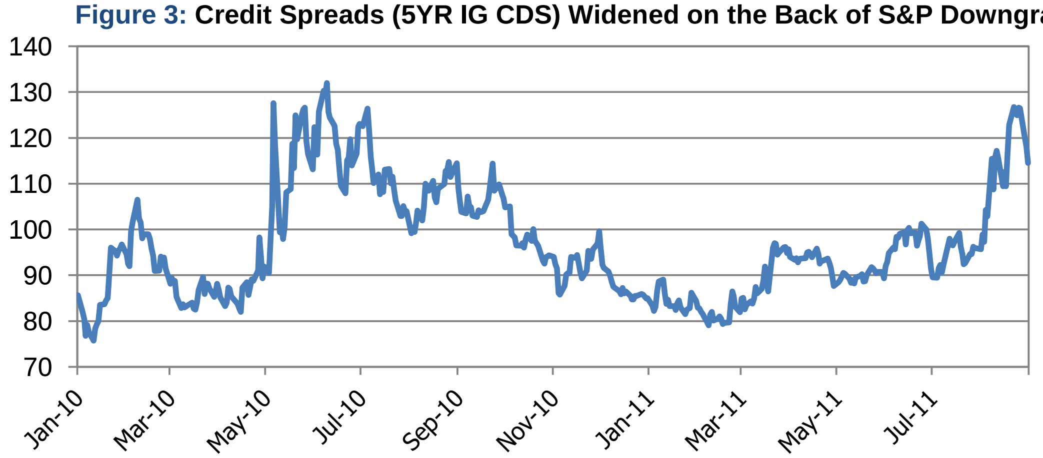
Figure 2: Spread between the 2YR and 1YR Treasury Offers Little Roll Down Benefit



Source: Bloomberg

Relative to the short credit curve, the Treasury curve looks unattractive based on low absolute yields and minimal curve roll-down. The current spread between the 2-year Treasury rate (0.19%) and 12-month T-Bill (0.10%) is a meager 9 basis points. With an expected yearly return of 0.19% (if held to maturity), the 2-year Treasury is unpalatable any way you slice it. A rise of only 10 bp in the 2-year Treasury rate would result in an immediate unrealized loss equal to the expected return over an entire year. At these low rates, staying solely in Treasuries may prove to be much riskier than anticipated due to limited protection against the potential of rising interest rates.

Figure 3: Credit Spreads (5YR IG CDS) Widened on the Back of S&P Downgrades



Source: Bloomberg

The short end of the credit curve displays the two characteristics that the Treasury curve currently lacks: relatively high yields and considerable roll down. These features of the credit curve were enhanced during the large risk-off trade following S&P's downgrade of the United States. The S&P downgrade, widespread lowering of estimates for global growth and concerns over capital adequacy of European and U.S. financials caused credit spreads in

August to widen materially. Bank of America Merrill Lynch highlights that the performance of high-grade credit relative to Treasuries had its worst month in August since November 2008. Even the most stalwart credits, such as Wal-mart, Deere and Chevron, suffered as a result of the increased market volatility.

The Total Return Approach

In our view, the volatility in the credit markets presents opportunities to buy high grade industrials and select financial institutions at attractive levels. One example of a credit which has widened in the recent volatility is General Electric, a highly rated industrial/finance name that is held in most investment portfolios. We have selected two GE bonds with roughly the same duration as the Treasuries previously outlined to illustrate the benefits of extension into high-grade credits:

Figure 4: A Yield Comparison of 1- and 2-year GE Bonds vs. Treasuries

	Original Investment		
Security	**Yield**	**Duration**	***Yearly Income**
T-Bill 0.0 08/23/12	0.09%	0.97 YR	$ 90,000
GE 3.5 08/13/12	0.80%	0.93 YR	$ 800,000
T-Note 0.125 08/31/13	0.19%	1.99 YR	$ 190,000
GE 5.4 09/20/13	1.40%	1.92 YR	$ 1,400,000

Source: Clearwater Advisors

*Assumes an initial investment of $100 million dollars (representative of a credit portfolio) with no reinvestment or compounding.

In this simplified example, the 1- and 2-year GE bonds are out-yielding their Treasury counterparts by 0.71% and 1.21%, respectively. On a $100 million investment, the opportunity cost of being in 1- and 2-year Treasuries vs. GE bonds over a 1-year period would be $710,000 and $1,210,000, respectively.

These securities also benefit from the effect of curve roll-down in a normal (i.e. upward sloping yield curve) interest rate environment, although to varying degrees based on their respective curves (Treasury curve vs. GE curve). Curve roll-down is the added price boost that a security receives as it approaches maturity or “rolls down” the curve. The degree of the benefit depends primarily on the steepness of the yield curve. In general terms, the steeper the yield curve the greater the benefit.

Figure 5: A Total Return Comparison of 1-year and 2-year GE Bonds vs. Treasuries after 12 Months

	Investment Returns after 12 Months					
Security	**New Yield**	**New Duration**	**12 Month Income**	**Roll-down Benefit**	**Total Return**	**Total Return (%)**
T-Bill 0.0 08/23/12	0.00%	0.00YR	$ 90,000	$ 0	$ 90,000	0.09%
GE 3.5 08/13/12	0.00%	0.00 YR	$ 800,000	$ 0	$ 800,000	0.80%
T-Note 0.125 08/31/13	0.09%	0.99 YR	$ 190,000	$ 99,000	$ 289,000	0.29%
GE 5.4 09/20/13	0.80%	0.92 YR	$ 1,400,000	$ 552,000	$ 1,952,000	1.95%

Source: Clearwater Advisors

In our simple exercise, let’s assume that the yield curves for both issuers (GE and Treasuries) remain perfectly constant (i.e. no movement in interest rates). After 12 months, the various investments accrue income based on each security’s purchase yield. However, each security also accrues additional return in the form of unrealized gains as each security rolls down the yield curve. This added benefit is directly attributed to the steepness of the security’s respective curve and the duration of each security.

When factoring in the benefit of curve roll-down, one can see that the return of the GE bonds vs. Treasuries looks even more impressive. In 12 months, the 2-year GE bond is expected to outperform the 2-year Treasury note by 1.66%, entirely due to credit. Twenty eight percent of the total return for this 2-year GE bond over that time period is attributed to the benefits of curve roll down.

Figure 6: Degree to which Total Return Insulates against Interest Rates Movements

Security	Duration	Total Return after 12 Months	Instantaneous Interest Rate Shock Needed to Result in an Unrealized Loss = Earned Return over 6 Months
T-Note 0.125 08/31/13	0.99 YR	0.29%	29 basis points
GE 5.4 09/20/13	0.92 YR	1.95%	211 basis points

Source: Clearwater Advisors

The excess return of 1.66% for 2-year GEs over Treasuries also plays an important role as the primary buffer against volatility in interest rates. The total return of 0.29% for the 2-year Treasury over the initial 12 month period offers little protection if interest rates rise unexpectedly. With a new duration of 0.99 years, an interest rate shock of a mere 29 bp would result in an unrealized loss equal to the yield and roll-down benefit earned over the past 12 months. In the case of the 2-year GE bond, it would take a 211 bp rise in interest rates to cause comparable damage, a scenario we do not see as very likely.

In this historically low rate environment, investors should look to extend into select high grade credits to take advantage of higher absolute yields and the current steepness of the credit curve.

A Case for Mortgages

In addition to high-grade credit, we think agency mortgages are an attractive asset class. We have been fielding an increasing number of calls and encouraging clients to look at the prospect of adding agency mortgage exposure to investment portfolios.

Due to heightened prepay concerns resulting from the very low interest rate environment, agency mortgage-backed securities are trading at or near historically wide spreads. We see value in 7-year seasoned, 15-year, agency mortgages with low coupons and favorable convexity characteristics. These bonds typically have a weighted average life of 2 years and yield north of 1% with very little extension risk. Mortgages offer good diversification away from credit and historically have provided superior risk-adjusted return to any asset class.

For more information about various extension options or additional color on the mortgage market, please feel free to contact the desk.

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.