clearwater ADVISORS

MARKET Commentary

Extend Now?

October 2010

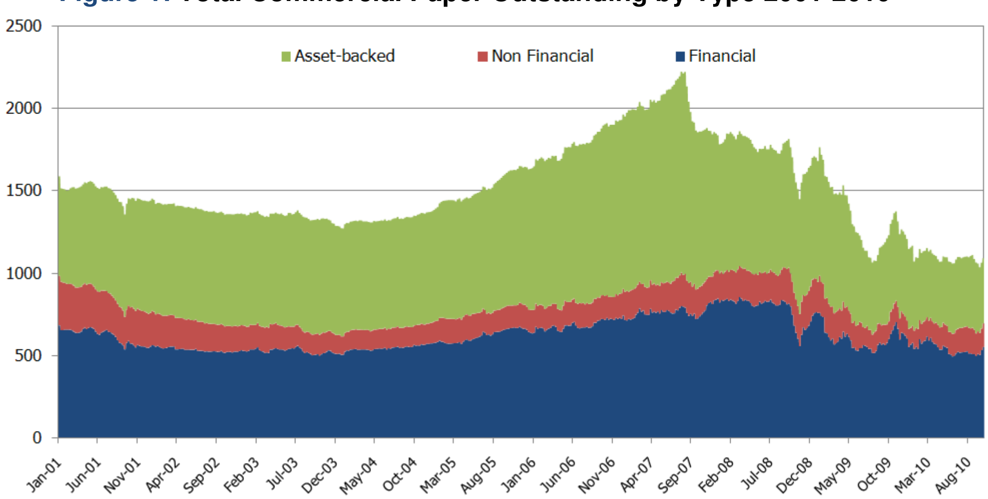
Two questions have been weighing on our minds the last several months: 1) What will the money markets look like in the coming years, and 2) How will the changing landscape affect short-duration investors?

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.

Diminishing Supply

The supply of money market product has experienced significant contraction since the start of the credit crisis and shows little promise of a quick rebound. The commercial paper market, which has traditionally been a staple for short-duration investors and money market funds, has been particularly affected. The amount of commercial paper outstanding has decreased nearly 50% from the peak, with the asset-backed commercial paper market experiencing an even more precipitous decline of 65%.

Figure 1: Total Commercial Paper Outstanding by Type 2001-2010



Source: Bloomberg

The Federal Reserve and Treasury have facilitated the removal of a large amount of short-term paper from the money markets in an attempt to provide greater stability to the credit markets. In October 2009 the Federal Reserve instituted the Commercial Paper Funding Facility (CPFF) which helped institutions roll maturing short-term debt at artificially low interest rates. At the peak of the program, the Federal Reserve owned roughly 21% of the total $1.688 trillion commercial paper

US Treasuries

As of 30-Sep

Benchmark	Yield
3 Month	0.10%
6 Month	0.19%
1 Year	0.25%
2 Year	0.43%
5 Year	1.27%
10 Year	2.51%
30 Year	3.69%

Merrill Lynch Indexes

31-Aug to 30-Sep

Index	Return
1-3 Yr Gov/Corp ≥ A	0.22%
1-3 Yr Municipals	-0.11%
1-3 Yr Agencies	0.19%
0-3 Month UST	0.01%
S&P 500	8.92%

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Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan outstanding at the time. To the detriment of short-duration investors, much of this paper has not returned to the market and investors have been forced to bid up prices of the meager amount remaining, reducing overall money market yields.

Corporate Issuance Soars

The Federal Reserve's quantitative easing (QE) program has also contributed to the gradual exodus of many high grade issuers from the short-term market through the lowering of long-term interest rates. The dramatic decline in long-term interest rates has led to an explosion in corporate debt issuance. In 2009 net investment grade issuance (new issuance minus redemptions) reached $701.2 billion. The issuance in 2010 has been $501.8 billion, highlighted by September's $127.7 billion (the largest issuance in September on record).

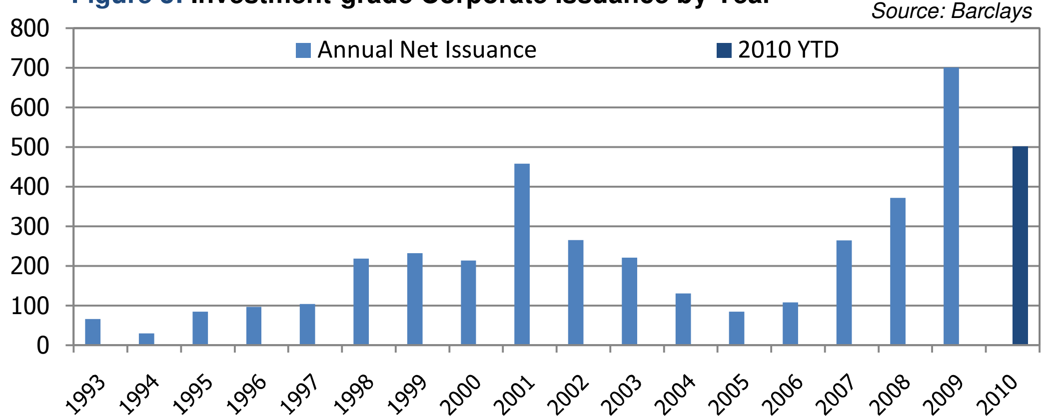
Figure 2: Yield on the US 5-year Treasury Note

Source: Bloomberg

Microsoft recently issued 3- and 5- year paper at the lowest coupons ever recorded for those maturities at 0.875% and 1.625%, respectively, and Johnson & Johnson recorded the lowest coupon on a 10-year note at 2.95% in the quarter. We expect that high-grade corporations will continue to take advantage of the current environment and issue debt in the term market at attractive levels.

Figure 3: Investment-grade Corporate Issuance by Year

Source: Barclays



Strong industrials like General Electric, ConocoPhillips, John Deere, Wal-Mart and Coca-Cola have all reduced commercial paper issuance in favor of the term market. For example, Wal-Mart has taken advantage of the low rates to issue $4.5 billion in 10-30 year debt since the beginning of 2008. During this time, Wal-Mart has also reduced the amount of commercial paper outstanding from $5 billion as of December 2007 to $523 million at the end of 2009.

The gradual shift of many high-grade industrials away from short-term funding has left that market dominated by less-credit-worthy borrowers. Many of these issuers are forced to fund in the short-term market because access to the term market has been all but cut off to them. The European financials are a prime example of less-credit-worthy borrowers who still rely heavily on government support programs to issue term debt. Short-duration investors should be conscious of the higher concentration of weaker credits in the short market in order to navigate the current environment safely.

More Regulation = More Hesitation

The lasting effects of additional government regulation, namely new 2a-7 guidelines and proposed Basel III requirements, will present additional challenges to investors in the short-term market. The implementation of recently passed 2a-7 rules has put downward pressure on both prime money market fund yields and rates of short-term product like Treasuries, agencies, commercial paper and certificates of deposit as money funds comply with new WAM and liquidity restrictions. We expect the rates on prime money funds to remain low, and any increase in fund yields can likely be attributed to an increased fund allocation to riskier credits. A recent WSJ article we cited mid-month pointed out various tactics, including “step-up” certificates of deposit and repo backed by risky assets, that money funds employ in an attempt to buoy historically low fund yields. With money funds chasing diminishing supply, investors need to be extra vigilant in examining the holdings of their money funds.

Proposed Basel III requirements will make banks less supportive of sponsoring commercial paper programs by reducing their willingness to provide liquidity facilities and lines of credit that are often necessary for commercial paper programs to obtain top-tier ratings. Asset-backed commercial paper programs will be hit particularly hard as acceptable ratings can usually only be obtained through third-party credit enhancement. If passed, the proposed Basel III requirements will be phased in over the next several years, but we expect that the banks will act much sooner than required in complying with the new standards, further diminishing the supply of short-term product.

A Case for Extension

Based on our outlook for the economy and the structural factors outlined above, we expect this low rate environment to persist into late 2011 or early 2012. We also expect that yields will push lower in the next three months as investors prepare for year-end window dressing. Short-duration investors should seriously consider extending part of their investment portfolios or face the prospect of little to no yield in this low-rate environment going forward.

Investors typically view a portfolio’s return in terms of either yield or total return. Yield-based return centers on the purchase yield of securities and the assumption that positions will be held to maturity. Total return, on the other hand, is a more comprehensive approach in evaluating a portfolio’s return (taking into account portfolio yield, curve roll-down, and changes in interest rates) and is important to understanding the benefits and risks of extending duration to seek higher returns.

The Total Return Approach

Below is a hypothetical example showing how the total return of three portfolios—a government money fund, a short 0-1 year treasury-only portfolio and a 1-2 year treasury-only portfolio—are affected by portfolio yield, curve roll-down, and changes in interest rates, the elements of total return.

In our example, the yield curve is perfectly linear and positively sloped or normal (i.e., long interest rates are higher than short interest rates) with the 2-year rate at 40 basis points and the overnight rate at 10 basis points. The portfolio size is $100 million. The yield and duration of each portfolio is provided in the table below.

Figure 4: Yield and Duration on Three Sample Portfolios at Initial Investment

	Original Investment		
Portfolio	Purchase Yield	Duration	Yearly Income
Money Market Fund	0.03%	0.00 Years	$ 30,004.13
0-1 Year Portfolio	0.17%	0.50 Years	$ 217,639.04
1-2 Year Portfolio	0.33%	1.50 Years	$ 374,307.21

Source: Clearwater Advisors

The longer portfolio is out-yielding the money fund and 0-1 year portfolio by 30 and 16 basis points, respectively at time of investment. Assuming interest rates do not change and maturing or rolling off securities are reinvested at the upper duration limits of portfolio guidelines, the long portfolio will result in approximately $344,303 and $156,668 of excess return, respectively, over a one year period before fees. In a positively sloped yield curve, it pays to extend.

Curve Roll-Down

Portfolios also benefit from the phenomenon of curve roll-down in a normal interest rate environment. Curve roll-down is the added price boost that a portfolio 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: Yield, Duration, Income, Curve Roll-down and Total Return After 3 Months

	After 3 Month				
Portfolio	Yield	Duration	Income	Roll-down Benefit	Total Return
Money Market Fund	0.03%	0.00 Years	$ 7,500.19	$ -	$ 7,500.19
0-1 Year Portfolio	0.17%	0.50 Years	$ 45,833.93	$ 13,677.54	$ 59,511.47
1-2 Year Portfolio	0.33%	1.50 Years	$ 84,966.20	$ 46,286.23	$ 131,252.43

Source: Clearwater Advisors

Continuing with the previous example, three months have passed since we invested the portfolio. The 0-1 year portfolio and 1-2 year portfolio are now in unrealized gain positions of $13,677.54 and $46,286, respectively. This unrealized gain should be added to the portfolio yield for those three months in order to calculate the total return over the stated period.

To understand the mechanics of curve roll-down imagine the 1-2 year portfolio is a single security with a purchase yield 0.33% and duration of 1.5 years. If this security is held for three months time, the security is roughly 1.25 years in duration with a market yield of 0.29% based on out linear yield curve. Imagine buying that security at 0.33% and immediately selling it to another party at 0.29%. In this case, a change in yield of 4 basis points [(4 basis points) x (-1.25 x $100 million)] result in an instant gain of $50,000 for the portfolio.

When the yield curve is expected to keep its current shape or bull-steepen, it pays to extend the portfolio.

Are Interest Rate Shocks Really So Scary?

The last component of total return is changes in interest rates. The fear of large and unforeseen changes in interest rates has proven to be the strongest deterrent to investment professionals extending a portfolio’s duration. As we have consistently cited over the last year, we believe that the probability of such an event occurring is quite low. Over the last two years, the lost opportunity cost of deciding to keep portfolios short has proven much greater than the pessimistic scenarios outlined by many professionals when that decision was made.

Consistently predicting interest rates in the short run is nearly impossible and investors should avoid attempting to do so. Short-term volatility can cause interest rates to do many things contrary to the themes we outline in our market commentary. We have talked extensively about the 2-year rate and how throughout 2009 it continued to experience “false starts” with any positive sign of an economic recovery. While occasionally surprised by the strength and suddenness of rising rates at those times, the fundamentals, which usually prove to hold out in the long run, confirmed our long-held view that interest rates would push lower.

Looking Forward

We expect that interest rates will remain exceptionally low for an extended period and investors should consider extension. We continue to monitor inflationary pressures, inflation expectations and unemployment as leading indicators of when the FOMC will shift towards a tightening bias and begin removing liquidity from the system. Recent comments from Federal Reserve officials confirm our view that deflationary pressures and a potential double-dip recession are more immediate risks than inflation.

Please feel free to contact the desk with any questions.

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