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Annual Conference

San Francisco | October 4-7, 2009 —

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Strategies for Managing Your Portfolio Through This Financial Crisis

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Suppliers

Customers



Inputs

Outputs

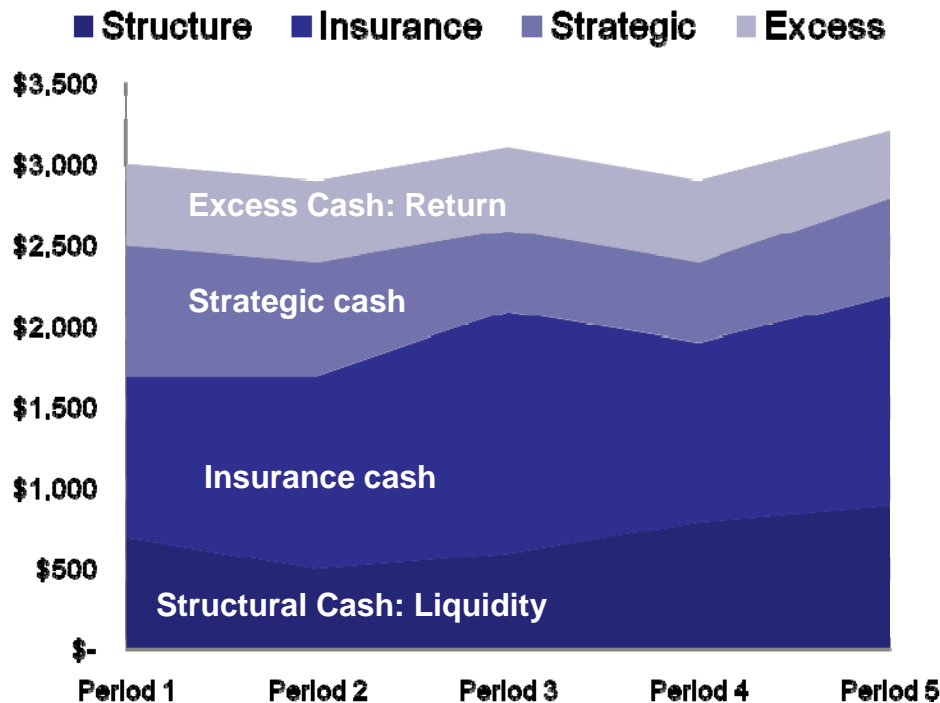


Know Your Objectives

Capital Preservation
Liquidity
Total Rate of Return

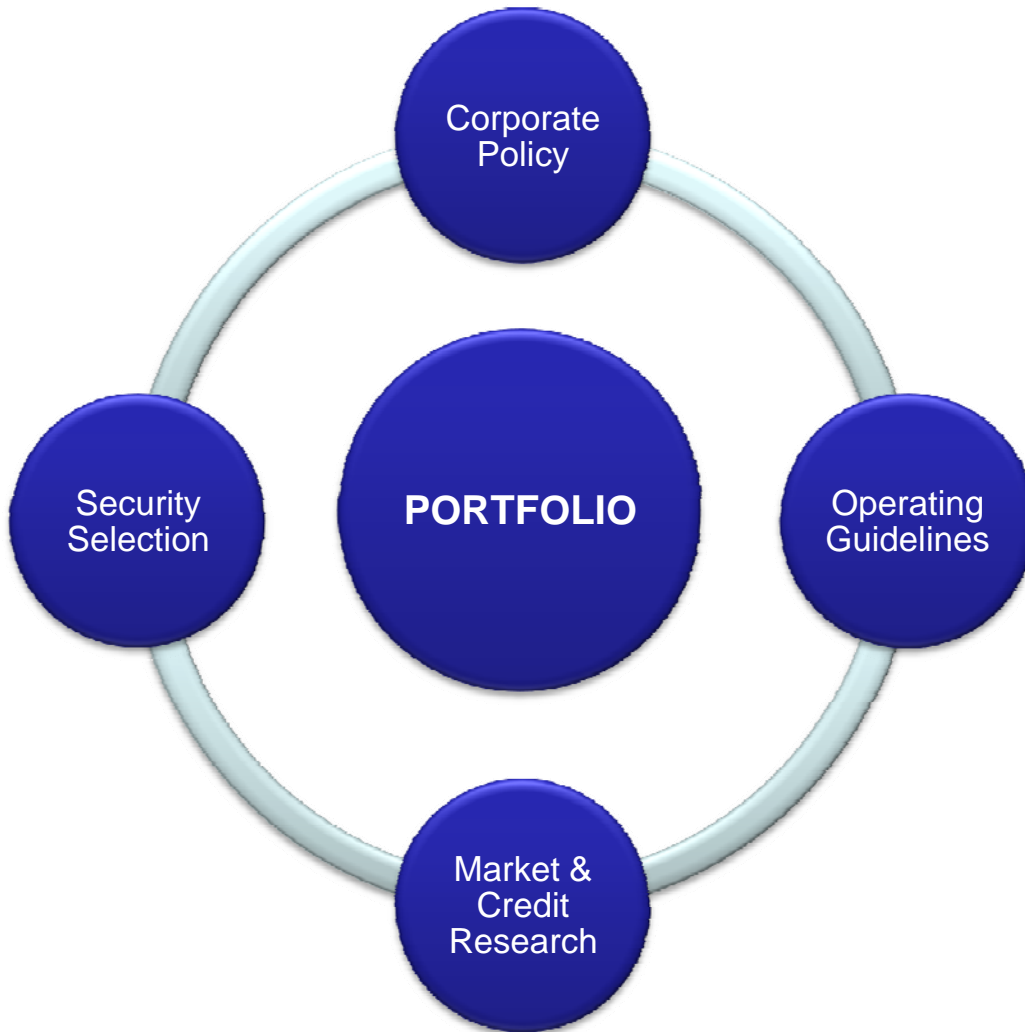
Managing Investment Objectives Know Your Cash Profile

Tier Strategy



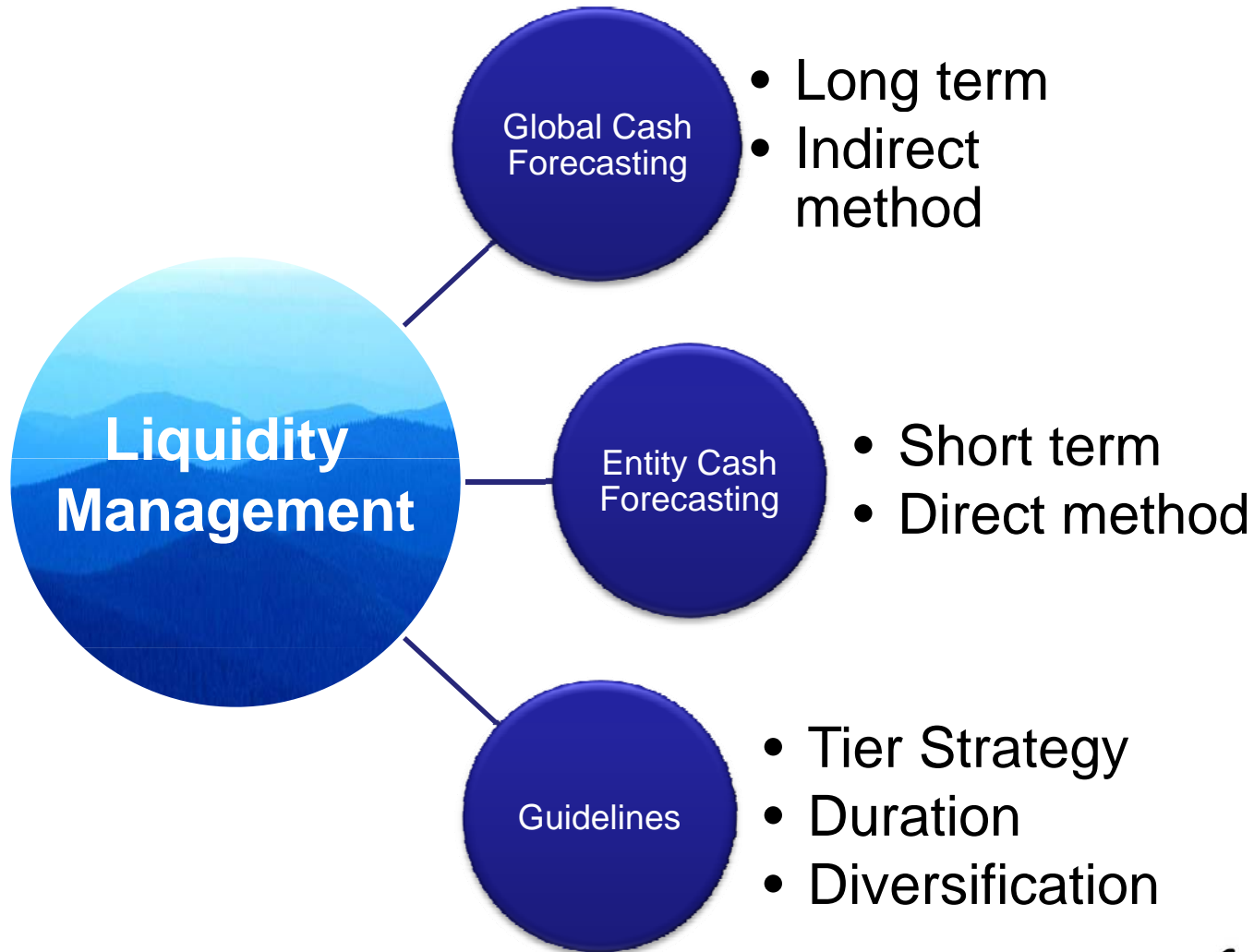
- **Excess Cash:** available for capital structure transactions (such as share/debt repurchase and dividends)
- **Strategic Cash:** available for organic/inorganic growth (such as acquisitions, on-book leasing program and utility/ subscription pricing programs)
- **Insurance Cash:** cash balance after Structural Cash required to avoid costly (and potentially unavailable) external financing and retire debt
- **Structural Cash:** used to bridge the interval between the receipt of income and its disbursement

Managing Capital Preservation Assess Risks



- **Issuer Risk**
 - ✓ Concentration limit
 - ✓ Credit quality
- **Duration Risk**
 - ✓ Liquidity requirements
- **Event Risk**
 - ✓ Frequency of portfolio review
 - ✓ OTTI review
- **Sector Risk**
 - ✓ Concentration limit
 - ✓ Research
- **Operational Risk**
 - ✓ SOX
 - ✓ Custodian
 - ✓ SAS 70

Managing Liquidity Know Your Cash Requirements



Managing Total Rate of Return

Portfolio
Management

Benchmark
(Index &
Peers)

Performance
Monitoring &
Measurement

**TOTAL
RATE
OF
RETURN**



Corporate Policy and Operating Guidelines

- Contents
- Clarity and Specificity of Terms
- Frequency of Review & Update

Policy: The Contents

- List of allowed securities
- Duration – portfolio and security level
- Rating
- Roles and responsibilities
- Performance review process
- Investment Manager hiring and firing process
- SOX key controls and compliance monitoring



Policy: Clarity & Specificity of Terms

Wording for eligible investments

General:

- AAA rated Asset Backed Securities

Specific:

- AAA rated Asset Backed Securities with maximum 2 year WAL. Must be in senior tranche. Assets that are second liens, home equity loans with long stated final maturities and are sensitive to large repayment are not eligible.

Policy: Frequency of Review

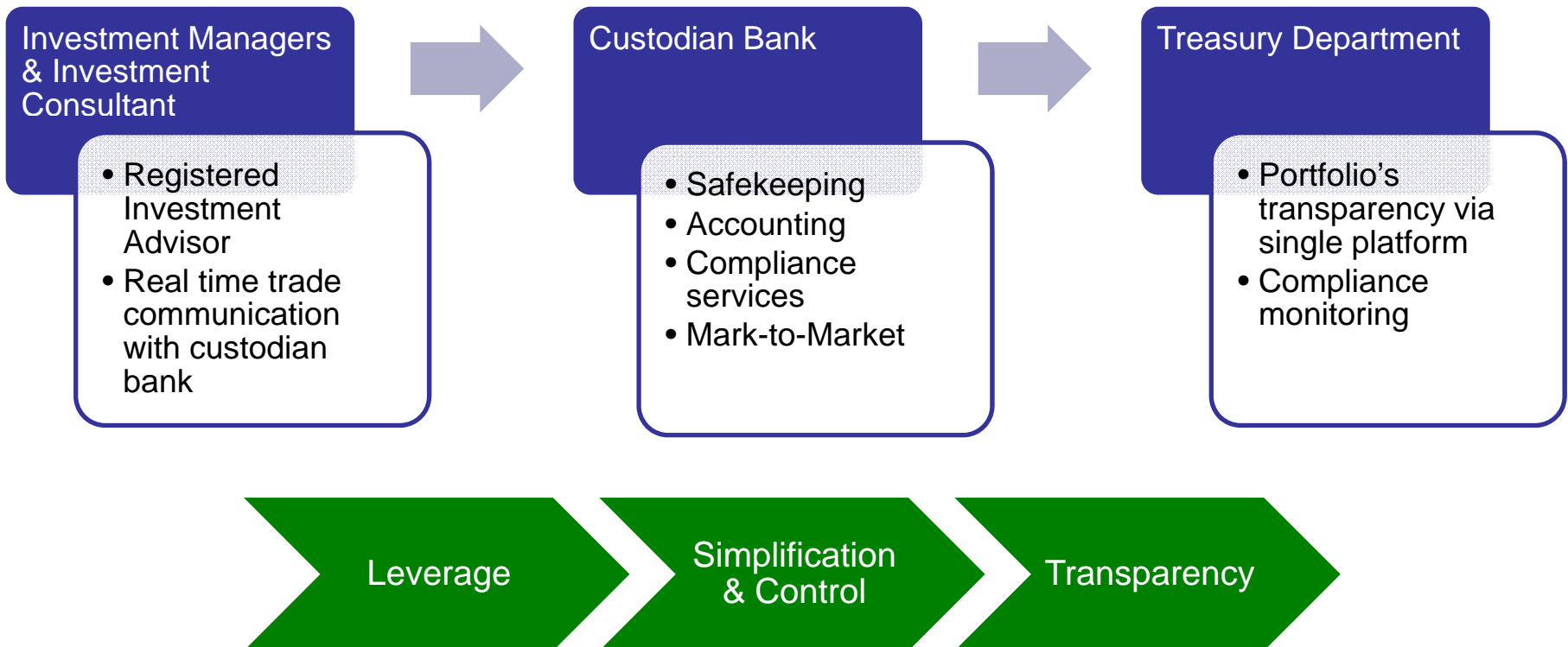
- Treasury - Guidelines
 - ✓ Monthly
 - ✓ Business outlook
 - ✓ Adjust to market conditions
- Investment Committee - Guidelines
 - ✓ Quarterly
 - ✓ Company's objectives
 - ✓ Risk tolerance
- Board of Director – Corporate Policy
 - ✓ Annual
 - ✓ Strategy & performance review
 - ✓ Change recommendations



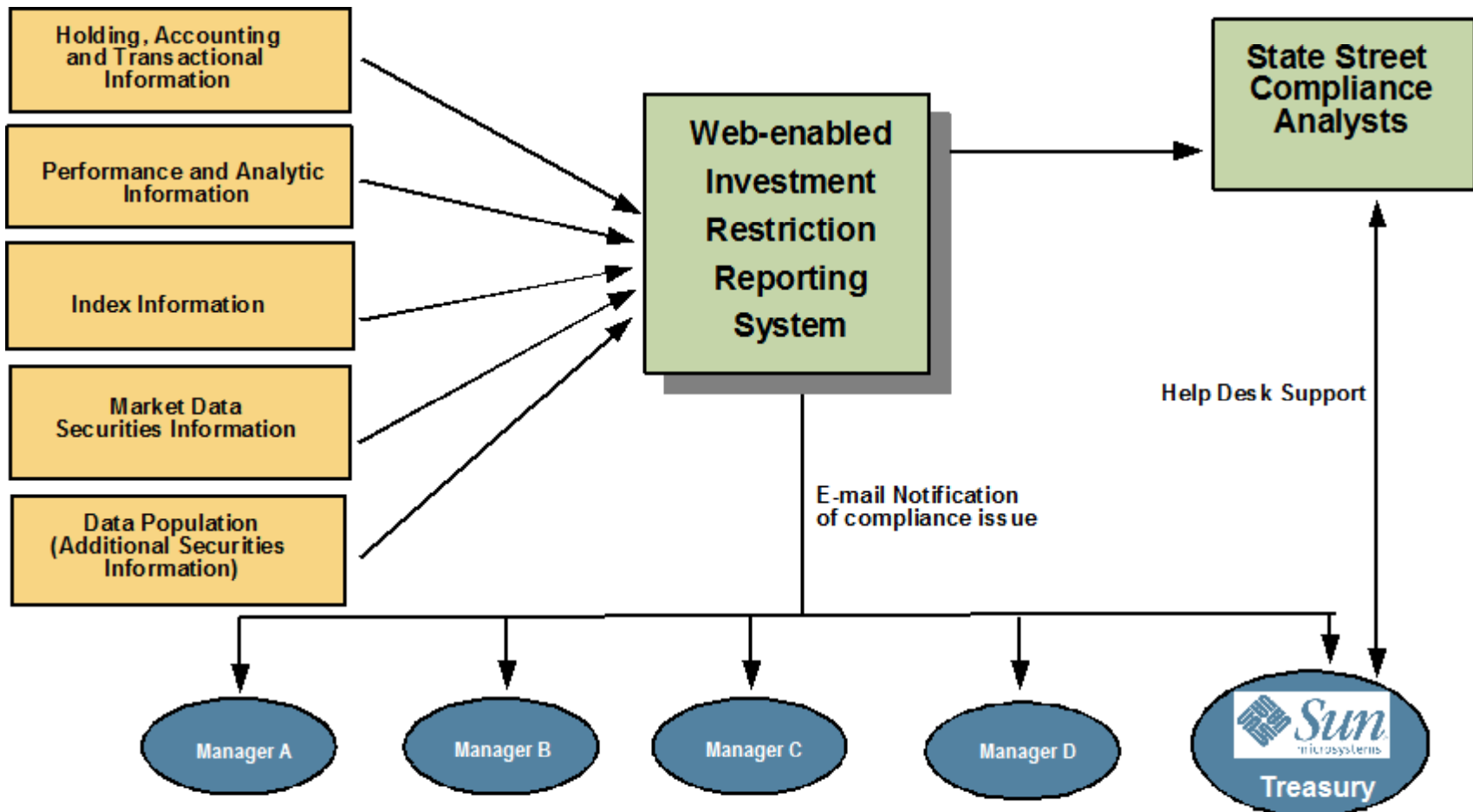
What is an Optimal Investment Process?

- Scalability
- Cost Effectiveness
- Straight-Thru-Processing
- Visibility
- Risk Control

Case Study: Investment Process



Case Study: Compliance Process



Investment Manager: Monitoring

Investment Consultant Process Independent Third Party Bridgebay



Investment Manager's Organization

- Mergers
- Personnel Change
- Litigation
- SEC Investigation
- Turn-over
- Accessibility to Portfolio Manager
- Internal process for enacting investment strategies
- Segregation of duties



Portfolio & Performance

- Performance benchmarking
- Peer benchmarking
- Total rate of return vs. book yield
- Capital gain/loss management
- Security risk profile
- Usage of sweep fund



Compliance & Internal Controls

- Reconciliation with custodian bank
- Compliance reports & practices for compliance
- Process to handle credit downgrades and headline risks
- Conflicts of interest



Look Our for Potential “Red Flags”



Example of “Red Flags”

- Surprise downgrades
- Headline risks
- Significant changes in fair value
- Lack of accessibility to Portfolio Manager
- Timeliness of information and communication
- Returns significantly exceed norm



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Portfolio Manager Red Flags

- ✎ Client calls manager first
- ✎ Manager wants client to sign off on sale
- ✎ Panic selling
- ✎ Poor trade execution - block trades
- ✎ Slow responses - cleared through compliance
- ✎ Emotional responses - needs Valium
- ✎ Reacts after the news - not in advance
- ✎ Downgrades – never on PM’s credit watch
- ✎ Rely on AAA rating – not understand collateral



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Blame Game

↳ Portfolio manager makes excuses
and blames the client



Strategy Red Flags

- ✎ High sector concentrations
- ✎ Subordinated issues of AAA securites
- ✎ Use of reverse repos, CDS
- ✎ Tracking duration but not WAL on ABS, MBS
- ✎ Exceptionally high credit –
 - ✎ Concentrations in structured product
- ✎ High concentration in insurance wrappers
- ✎ High negative convexity – high extension risk
- ✎ Inflexible strategy



Who Succeeded and Why

- **Firms with best execution were the winners**
- **Best Execution**
 - Broad broker network 20-30+
 - Acted as agent
 - Worked an order, bid list quietly handled
 - ***Small to medium sized firms with broad networks excelled***
- **Worst Execution**
 - Block trades concentrated with few B/D
 - Large B/D use own capital to take in positions failed
 - B/Ds gave terrible prices to protect their capital
 - Bad prices punished the market worse
 - Now are developing broader dealer network
 - ***Mega firms relying on block trades were disadvantaged***



Inflexible Strategies

- Strict adherence to strategy and unfavorable sectors
 - Fear accusation of “market timing”
 - Taking portfolio to 100% Treasuries perceived as market timing and deviation from investment strategy
- If “Stay the course” cannot be sued
- Compliance dictated that sectors could not be exceeded
- Performance required investment in same benchmark sectors
 - Followed the benchmark down
- Some firms were in “denial”
 - Inexperienced portfolio managers slow to react - frozen with fear



Credit Process Failed

- 3 Step Credit Process
 - Buy List
 - Research intensive
 - Clearly defined
 - Maintaining Compliance
 - Credit review “gray” area
 - Sell discipline
 - Based on swap opportunities
 - Non-compliant
 - Credit downgrade
- ***Failure was the disconnect between the decision makers***
 - ***Buy***
 - ***Hold***
 - ***Sell***



Loss Constraints

- Strict loss constraints does not mean you won't lose money
 - A **zero loss** tolerance **causes bigger losses** in a bear market
- Loss constrained **buy and hold failed** in the meltdown
- You can't budget losses in a crisis
- Short –term losses may save you from total loss later
- Unrealized gains are not real until they are realized
- Monetize gains in up markets

A security is only worth what someone will pay you for it



Due Diligence Madoff Syndrome

- **Madoff Syndrome** – Affinity Groups
 - AFP, Treasurers, peer companies
 - Don't assume someone else did the due diligence
- **Benchmarking**
 - It's an industry practice – but why?
 - Our industry is different from others – really?
- **RFP by Consensus**
 - They have a lot of numbers, offices, analysts, assets
 - The numbers may not be relevant to your portfolio
 - Big companies hire them so they are OK – why?
 - Banking relationship, customer
- **Understand the Strategy**
 - Whose track record is it?
 - Are they still there?

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Strategies for Managing Your Portfolio Through A Financial Crisis

- Higher Power Strategy
- Tantrum
- Assume the Crash Position
- End of the World
- Survive and Thrive

Most corporate investment policies have these primary traits in common:

Preservation of Capital
Liquidity
Total Rate of Return

The most important aspect is the order of priority.

Internally Managed Portfolios

- Know what you are buying (before you buy it)

- Do you know what your investment “risk” is by security?
 - Credit, structure, term, liquidityor all of the above
- Can you explain the security to the CFO or Audit Committee in detail?
- Does your corporate liquidity profile allow you to hold until maturity?
- Monitor for material news developments constantly
- This does not mean the following: It meets our credit rating, maturity or permissible asset class criteria

- Diversification is critical

- Potential impact on income statement in addition to % of portfolio assets needs to be taken into consideration

- **These principles apply to money market funds and individual securities**

Internally Managed Portfolios

- Operational Flexibility

-Most corporate investment and wire policies require multiple levels of approval and review prior to actionable buy and sell decisions

-Consider investment policy amendments allowing more timely lower level decision-making approval for buy and sell transactions that decrease portfolio risk

-Allows you to move more quickly in order to preserve capital

Internally Managed Portfolios

- Sharks and Minnows

- Minnows always at an information disadvantage
 - There is “no free lunch” concept.
 - Read the email exhibits to these lawsuits from the State of Massachusetts:
<http://www.sec.state.ma.us/sct/sctml2/ml2idx.htm>
<http://www.sec.state.ma.us/sct/sctubs2/ubs2idx.htm>
- Fixed income has an asymmetric risk profile
- Have very deep broker relationships
 - Market intel they provide can be invaluable
 - Will usually buy the paper they sold you

Internally Managed Portfolios

- Understand the compensation structure

-Broker/Dealer indicative pay ranges by product

- | | |
|--------------------------|-----------|
| -Treasuries and Agencies | 0-1 bps |
| -Commercial Paper | 1-3 bps |
| -Money funds | 2-8 bps |
| -Auctions | 10-12 bps |

Externally Managed Portfolios

- Manager: Selection Criteria

- Credit Cycle Performance
- Interest Rate Cycle Performance
- Know the person/team managing your money
- Understand performance attribution drivers
 - Curve, sector, security, concentration/diversification
- Review Detailed Model Portfolios
 - By security not by asset class

- Manager: Monitoring

- Understand their macro and micro positions
- Trust, but verify
- Watch for style drift and key personnel turnover
- Performance versus Benchmark and Peers

What is Coming Next?

- Monitor Market Liquidity

- Fewer broker/dealers
- Less appetite to increase balance sheet
- Gradual withdrawal of government liquidity and support programs

- Yield Chasing

- Credit has rallied in
- Yield curve
 - Slope/Shape
 - Rates
 - Printing press
 - Withdrawal of government intervention
 - Foreign buyers behavior
- The sausage machine