



# ***Enhancing Portfolio Returns in a Declining Interest Rate Environment***

***Treasurers Executive Network***

***September 11, 2001***

***Presented by:***

***Linda Ruiz-Zaiko, President***

***Bridgebay Financial, Inc.***

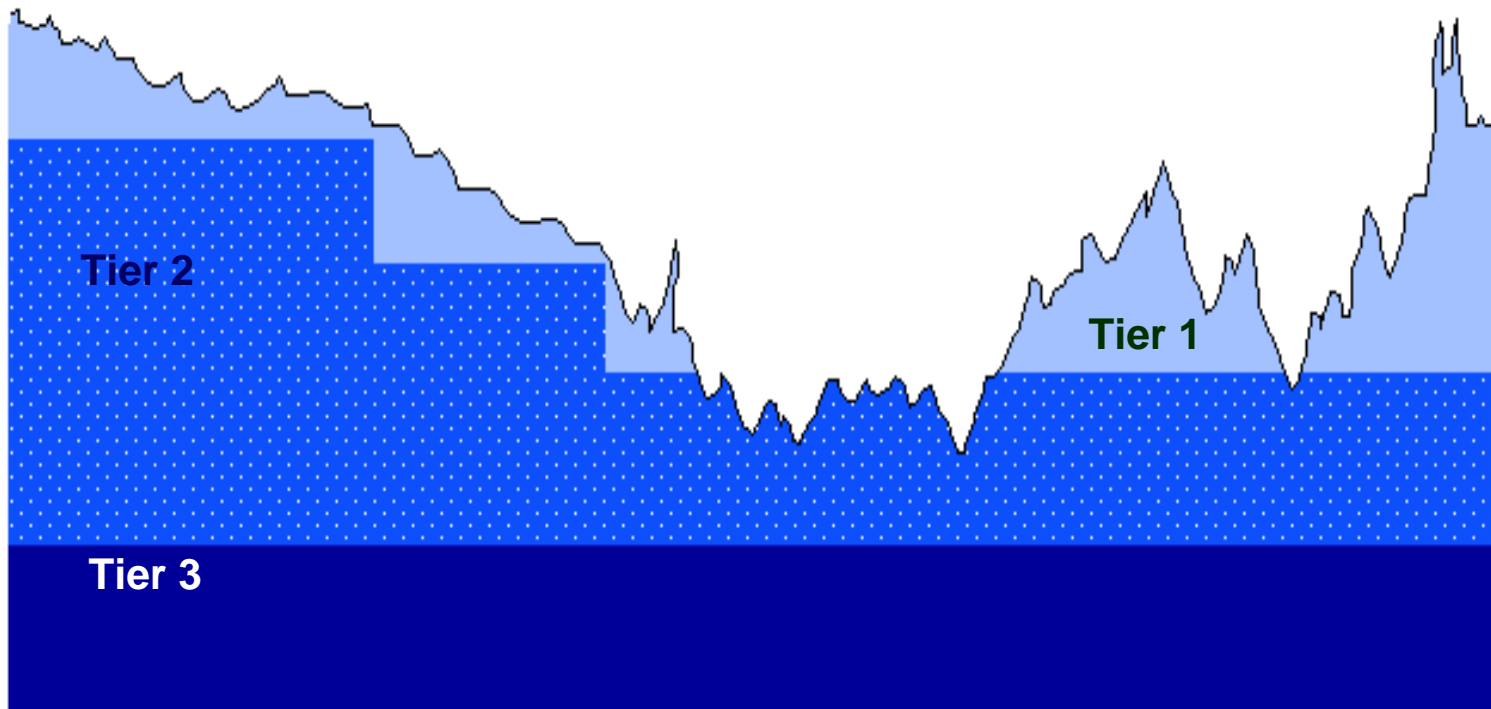
***[www.bridgebay.com](http://www.bridgebay.com)***

***925-743-0200***

***Bridgebay Financial, Inc.***



# Stratify Portfolios by Liquidity Need and Investment Horizon





# *Year 2001 Challenges Your Portfolio Management Skills*

- ◆ It's no longer a “no-brainer” strategy
  - ◆ A1/P1-rated
  - ◆ Household names
  - ◆ Yield
  - ◆ Hold to maturity
- ◆ Fed cuts since Jan., 2001 - most aggressive cuts since 1982
- ◆ Strategy now requires
  - ◆ Credit analysis
  - ◆ Yield curve decisions
  - ◆ Security selection
  - ◆ Structure research
- ◆ ***Research, liquidity, nimbleness*** are the watchwords for 2001





## ***Avoiding Credit Drift and Landmines Year 2001***

- ◆ 12/13/00 Moody's Investor Service Report
  - ◆ U.S. and Canadian bond defaults will triple in 2001
- ◆ 2/1/01 Moody's Report
  - ◆ After 100 basis point drop in rates, Moody's projects more rating downgrades and corporate defaults as economy weakens and credit tightens
- ◆ Credit markets are skittish and stressed
  - ◆ Sudden credit downgrades, skipping multiple notches
  - ◆ Ratings agencies that were slow to react now overreact
  - ◆ Tracking portfolio for credit watch not enough
  - ◆ Recent downgrades occurred without being on credit watch





## *Year 2001 Default Rates are Rising*

- ◆ Moody's Global Credit Research Report Feb. 2001
  - ◆ Corporate bond defaults surged in 2000 to 6.02% (highest since 1991)
  - ◆ Forecast to reach 9.5% through 2001
- ◆ Worldwide, US is largest source of defaults
  - ◆ 125 defaults on \$29.1 billion of corporate bonds in 2000
- ◆ Telecommunications sector was top defaulting sector \$6.48B
  - ◆ Followed by Construction/Building, Real Estate & Autos
- ◆ Year 2000 all-corporate trailing 12-month default rate was the highest since 1989
  - ◆ The high default rates in 2000 took investors by surprise
  - ◆ The default rate is rising in 2001





# Some Recent Credit Casualties

- ◆ **Xerox** went from a household name to Junk in 9 months
  - ◆ CP now rated A3 and bonds rated Ba1 with negative outlook
- ◆ **PG&E** and **Edison International**
  - ◆ Rapid deterioration from A1P1 11/00 to A3P3 in 1/01
  - ◆ Defaulted
- ◆ **Lucent Technology**
  - ◆ A2P2 to A3P3; now C;
  - ◆ BBB+ to BBB- on 2/12/01
  - ◆ Now BB- (negative watch)

Imagine that!





# Recent Credit Downgrades from A1P1

- ◆ **Daimler Chrysler** (A2/A)
  - ◆ Negative watch several times since December
  - ◆ Went from A1P1 in December to A2P2
  - ◆ Stabilized LT at A3
- ◆ **Ford/GMAC** on watch (negative)
  - ◆ CP may be downgraded but LT stable
- ◆ **France Telecom**
  - ◆ Downgraded last week from A1P1 to A2P2
  - ◆ Without warning or credit watch
- ◆ **ATT** rated A1/P1 (LT A2/A) on watch (negative)
- ◆ **SAFECO**
  - ◆ CP A1P1 to A2P2
  - ◆ LT A3/A- downgraded to Baa+





## *Year 2001*

# *Asset Backed CP*

- ◆ Some Asset Backed Securities (AAA) are bankruptcy-proof due to their collateral and structure
- ◆ Not all Asset Backed Commercial Paper (AAA-rated) are equal
- ◆ Some are 4(2) paper (private placement), less liquid
  - ◆ Purchase paper from a market maker or underwriter to ensure you have a bid if you need to sell
- ◆ Portfolio managers tier (AAA-rated CP) and price issues by:
  - ◆ Size of issue, number of market makers, soundness of liquidity provider and administrator of loan assets
- ◆ Understand the extent of the credit support, underlying collateral, and liquidity facilities
- ◆ If your brokers can't provide details on the issue then they are probably not one of the underwriters -- pass on the security





# *Year 2001*

## *Managing Credit Risk*

- ◆ Research, liquidity, nimbleness are the watchwords for 2001
- ◆ Place your entire portfolio on Bloomberg or any other service that notifies you immediately of any news, credit watch or credit downgrade
- ◆ Ask your broker or money manager that you expect to be notified immediately of any security in your portfolio placed on credit watch or downgraded
- ◆ Track earnings releases and stock price of corporate
- ◆ Expect your broker to make a market in that security
- ◆ Be diligent and proactive in managing credit risk





## *Interest Rate Risk*

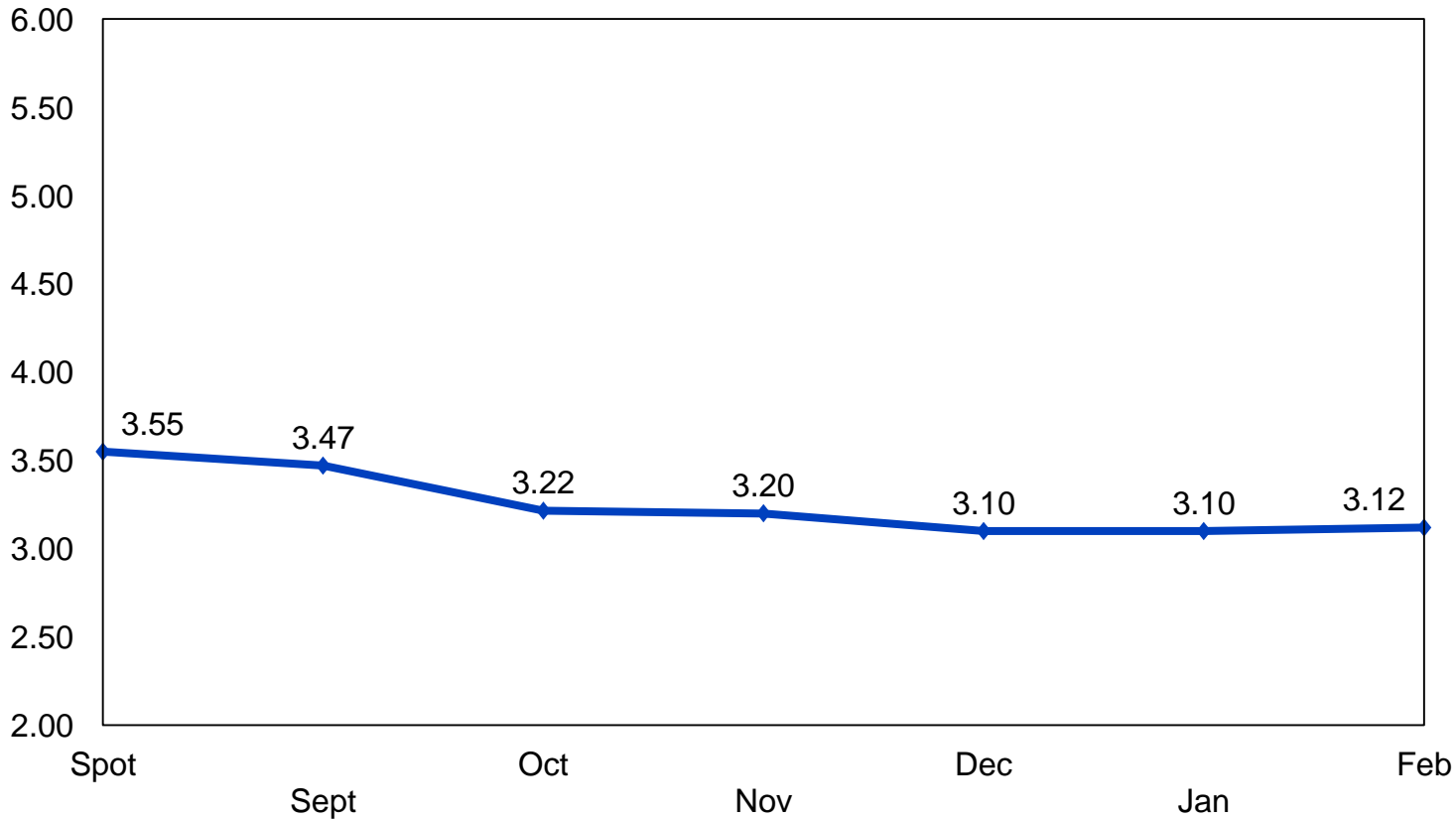
- ◆ Should you extend out the yield curve?
- ◆ Three scenarios if you extend duration
  - ◆ Interest rates dramatically rise
    - ◆ May generate unrealized losses
  - ◆ Interest rates remain stable
    - ◆ May generate gains from roll down yield curve
  - ◆ Interest rate decline
    - ◆ May realize capital gains





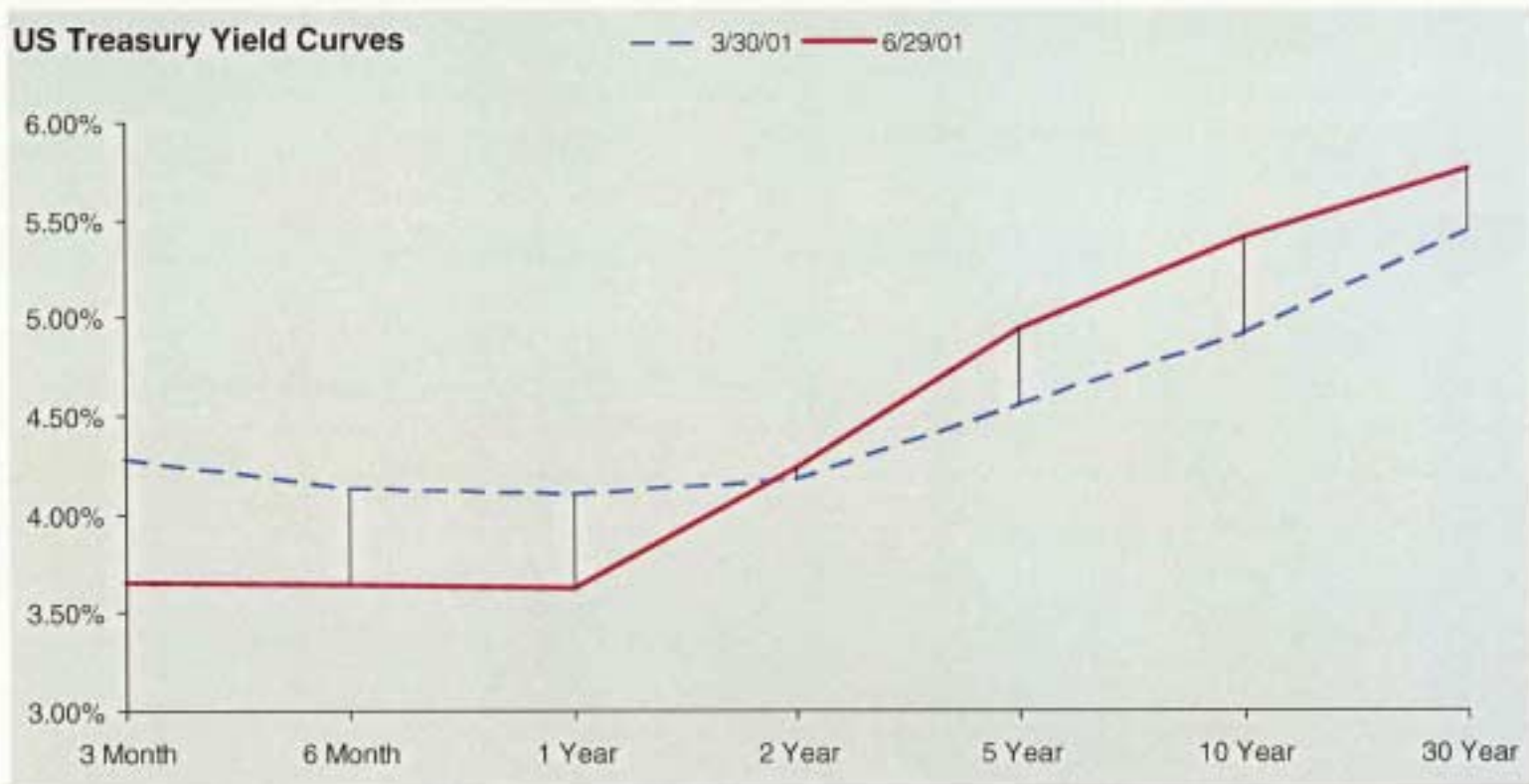
# ***Fed Fund Futures Contracts***

***Further Fed easing is expected  
and fully priced into the short-end of the yield curve  
as of 8/31/01***





# Treasury Curve Steepened Dramatically Over 2Q01

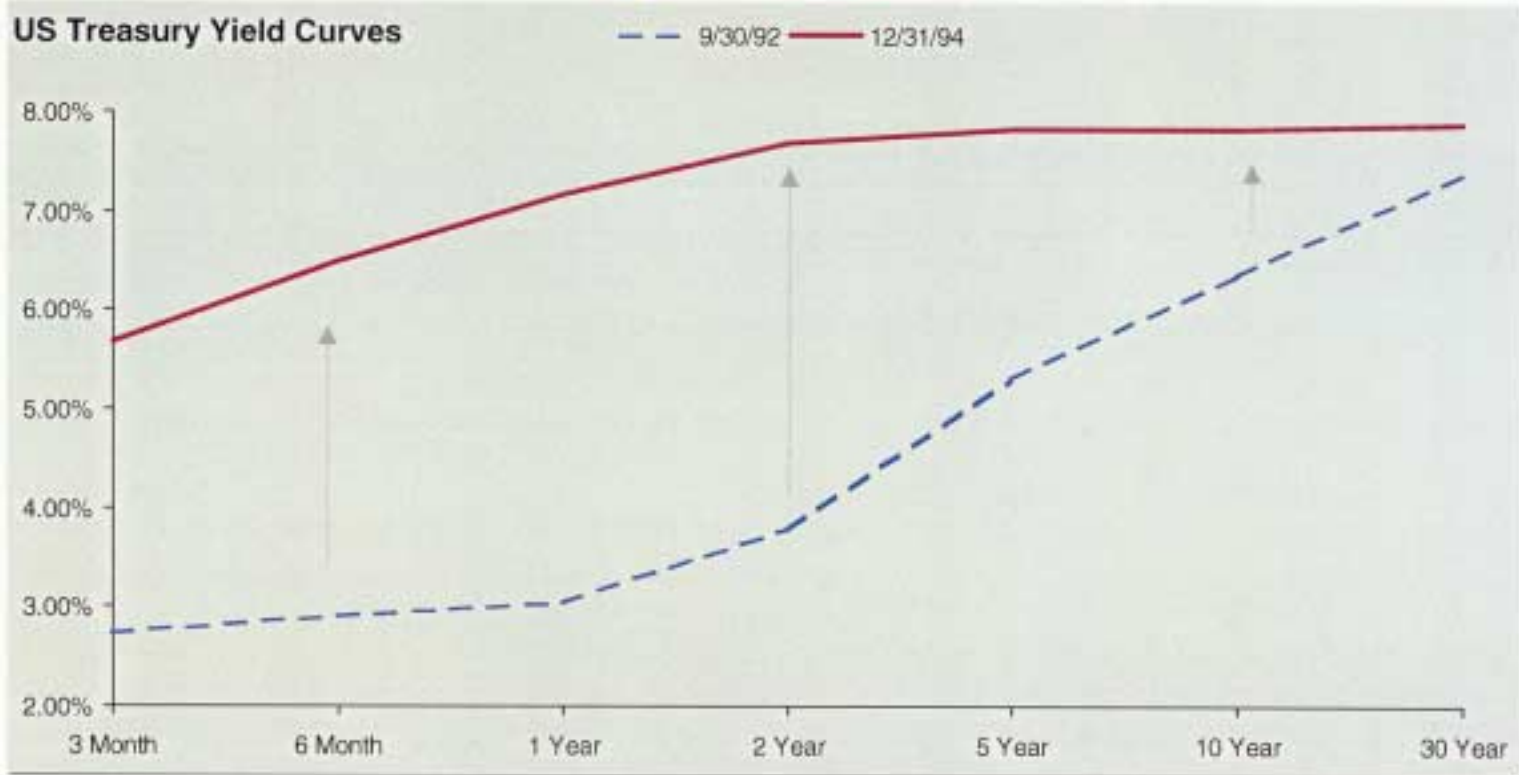


Source: Bloomberg





# Yield Curve Positioning



Source: Bloomberg





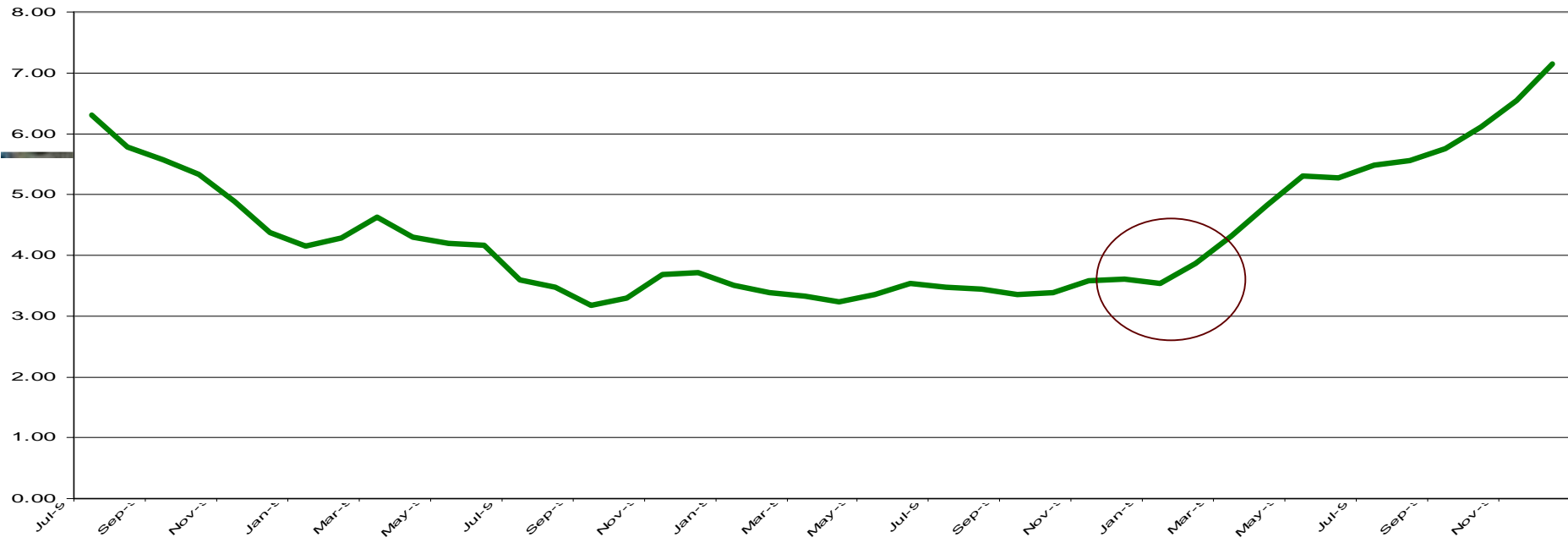
# History May Repeat Itself



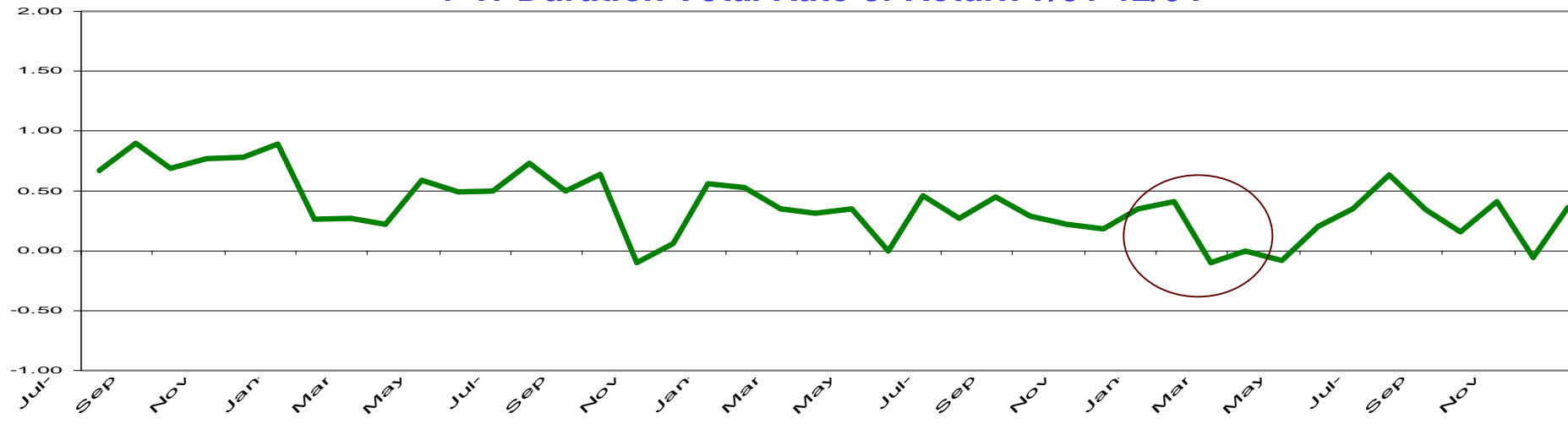
Source: Bloomberg

***Bridgebay Financial, Inc.***

## 1-Yr Treas Note Yield 7/91-12/94



## Portfolio 0-3 Yrs. 1-Yr Duration Total Rate of Return 7/91-12/94



## Comparative Yields 9/7/00-9/7/01

### Fed Funds, 10 Yr. Treasury Yield Curve has Steepened

GRAB

Comdty **HMSM**

Enter 1<GO> to SAVE changes or <CANCEL> to abort.

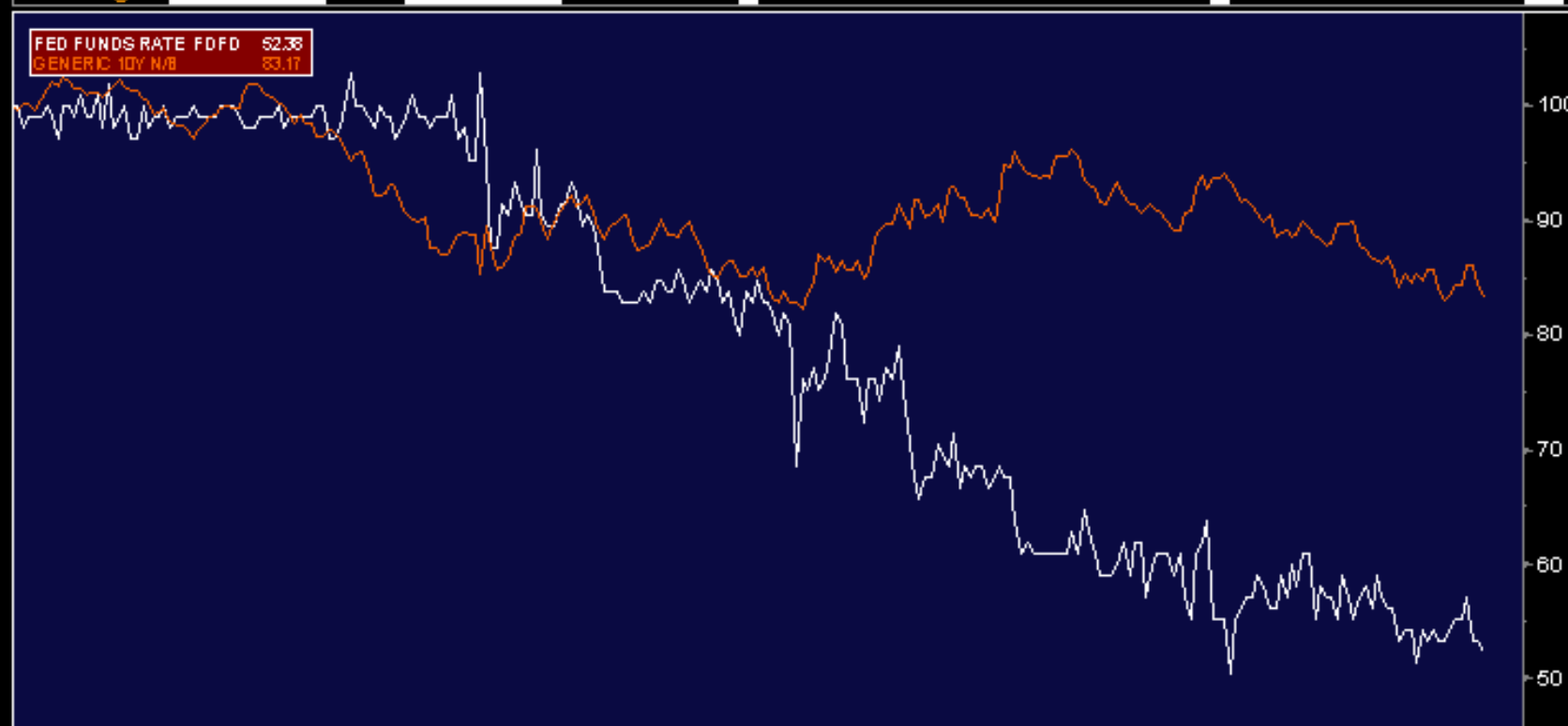
**4-IN-1 GRAPH**

Name: **TEST1**

**1** Name

Set # **2**

<b>1</b>	FED FUNDS RATE FDFD	Px <b>15.24</b>	<b>2</b>	GENERIC 10Y N/B	Yx <b>17.38</b>
<b>3</b>		Px <b>1</b>	<b>4</b>		Px <b>1</b>
Range		9/ 7/00	To	9/ 7/01	Period
				D(D-W-M-Q-Y)	Normalize
				Y(Y/N/O)	Dates
					<b>0</b>



07142128	091623	01081522	01081522	01081522	01081522	01081522	02091623	01081522	01081522	02091623	01081522	0310
2000 Oct	Nov	Dec	2001 Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	

**Comparative Yields 9/7/00-9/7/01**  
**Fed Funds, 6 Month Treasury Bill**  
**Short End of Yield Curve has been Inverted to Flat**

GRAB

Govt **HMSM**

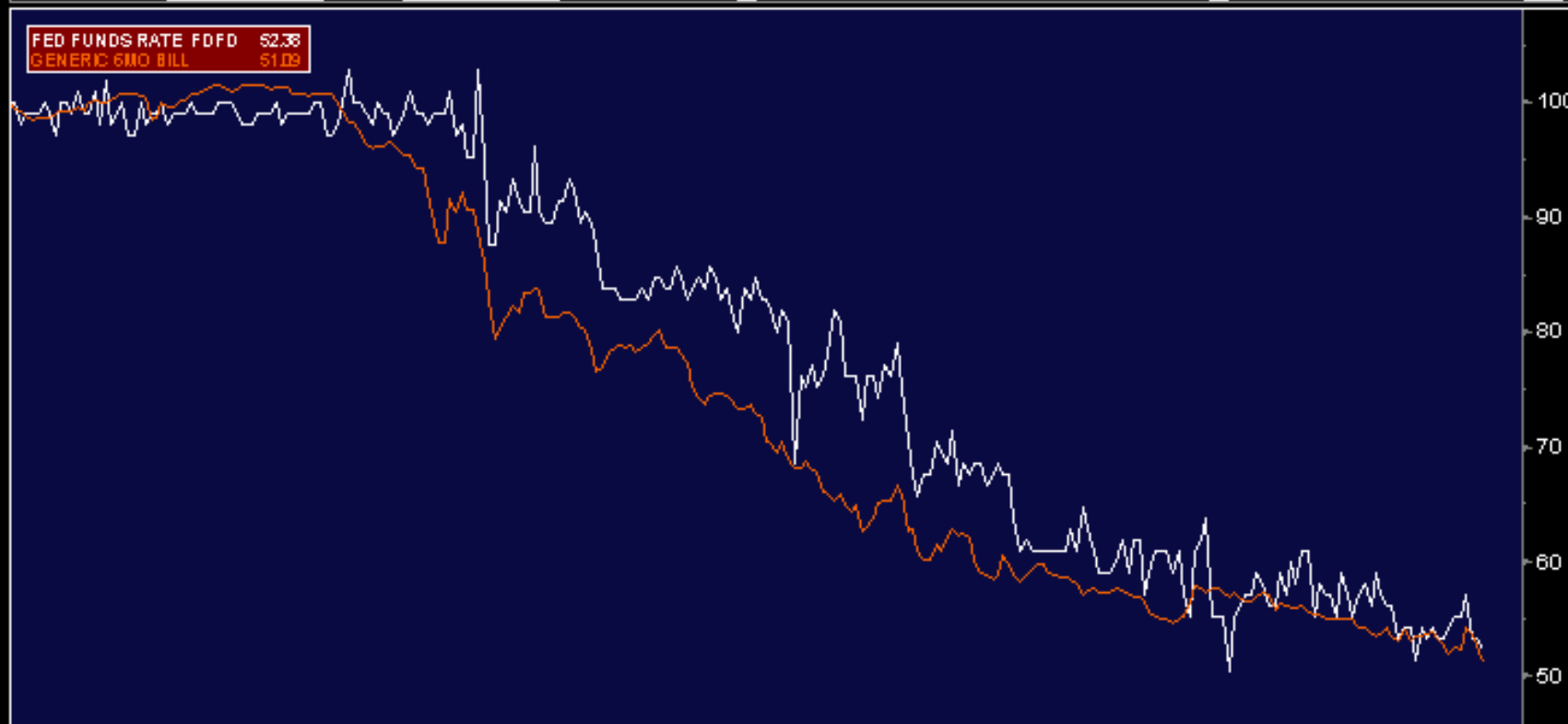
Enter 1<GO> to SAVE changes or <CANCEL> to abort.

**4-IN-1 GRAPH**

Name:  1 Name Set # 2

1	FED FUNDS RATE	FDFD	Px15.24	2	GENERIC 6MO BILL	Yx15.93
3			Px1	4		Px1

Range 9/ 7/00 To 9/ 7/01 Period D(D-W-M-Q-Y) Normalize Y(Y/N/O) Dates 0



07142128	091623	01081522	01081522	01081522	01081522	01081522	02091623	01081522	01081522	02091623	01081522	0310
2000 Oct	Nov	Dec	2001 Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	

# Comparative Yields 9/7/00-9/7/01

## Fed Funds, 1 Yr. Treasury

Short End of Yield Curve has been Inverted to Flat

GRAB

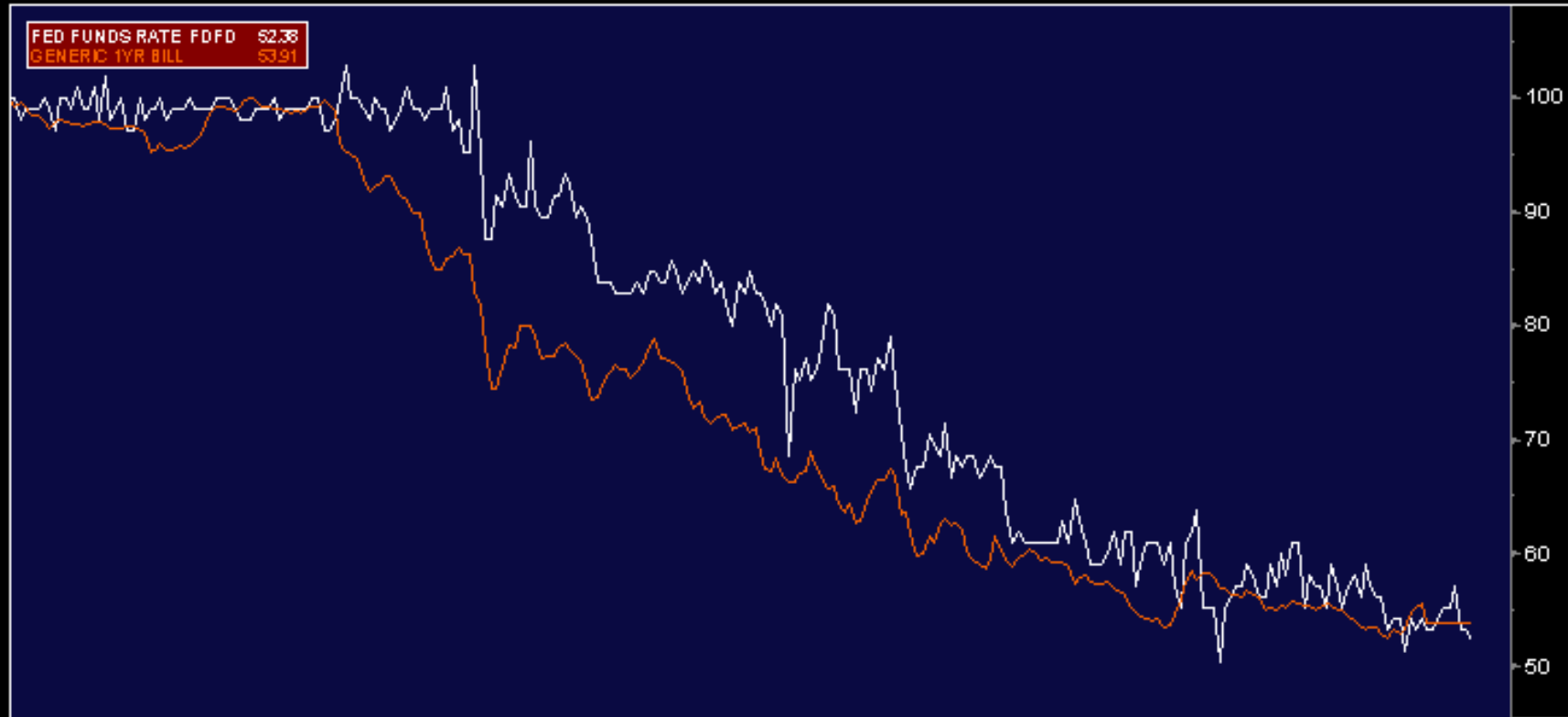
Govt HMSM

Enter 1<GO> to SAVE changes or <CANCEL> to abort.

**4-IN-1 GRAPH**

Name:  1 Name Set # 2

1	FED FUNDS RATE	DFD	Px15.24	2	GENERIC 1YR BILL	Yx16.08				
3			Px1	4		Px1				
Range		9/ 7/00	To	9/ 7/01	Period	D(D-W-M-Q-Y)	Normalize	Y(Y/N/O)	Dates	0



07142128	091623	01081522	01081522	01081522	01081522	01081522	02091623	01081522	01081522	02091623	01081522	0310
2000 Oct	Nov	Dec	2001 Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	

**Comparative Yields 9/7/00-9/7/01**  
**Fed Funds, 2 Yr. Treasury, 3 Yr. Treasury**  
**Yield Curve Changed from Inverted to Steeply Positive Slope**

GRAB

Govt **HMSM**

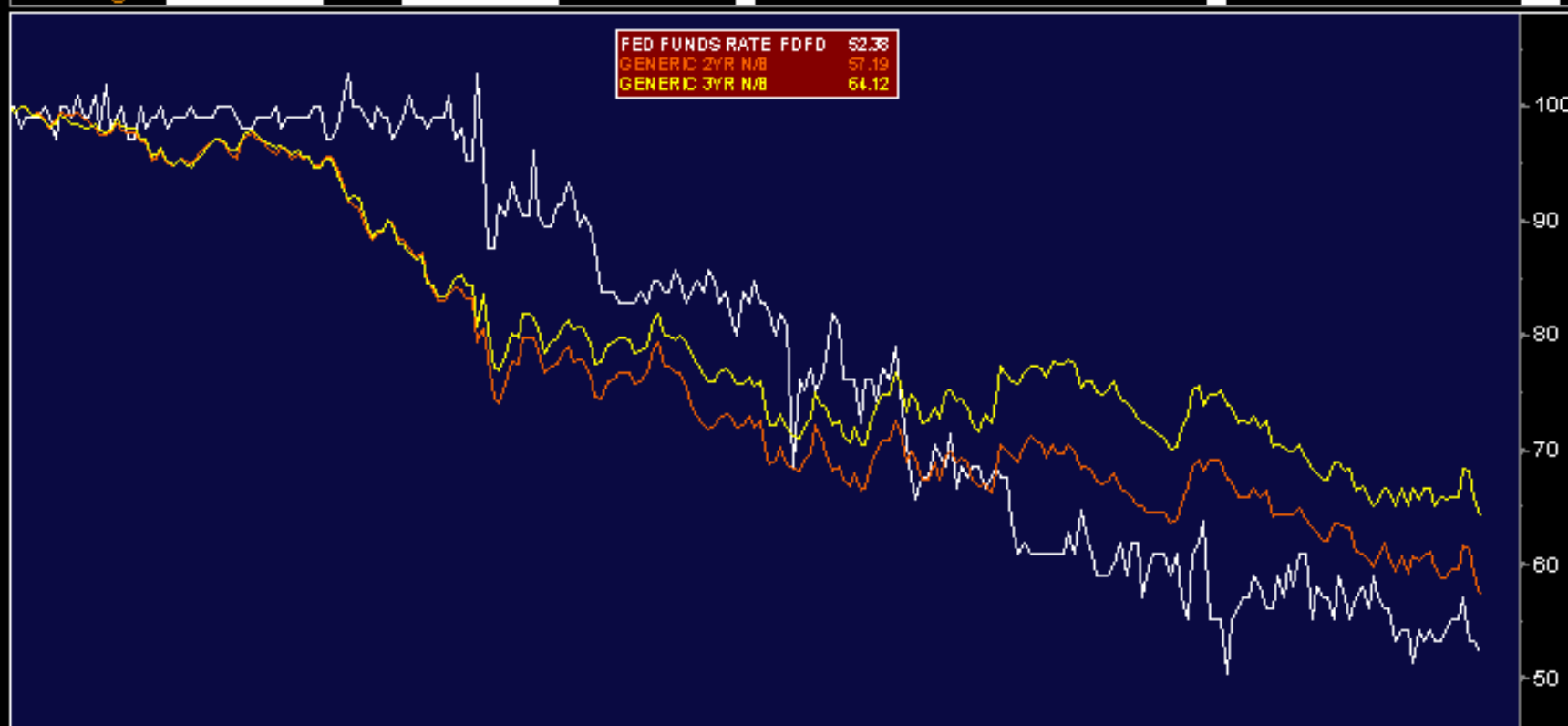
Enter 1<GO> to SAVE changes or <CANCEL> to abort.

**4-IN-1 GRAPH**

Name:  1 Name  Set # 2

<b>1</b>	FED FUNDS RATE FDFD	Px15.24	<b>2</b>	GENERIC 2YR N/B	Yx16.32
<b>3</b>	GENERIC 3YR N/B	Yx16.47	<b>4</b>		Px1

Range 9/ 7/00 To 9/ 7/01 Period D(D-W-M-Q-Y) Normalize Y(Y/N/O) Dates 0

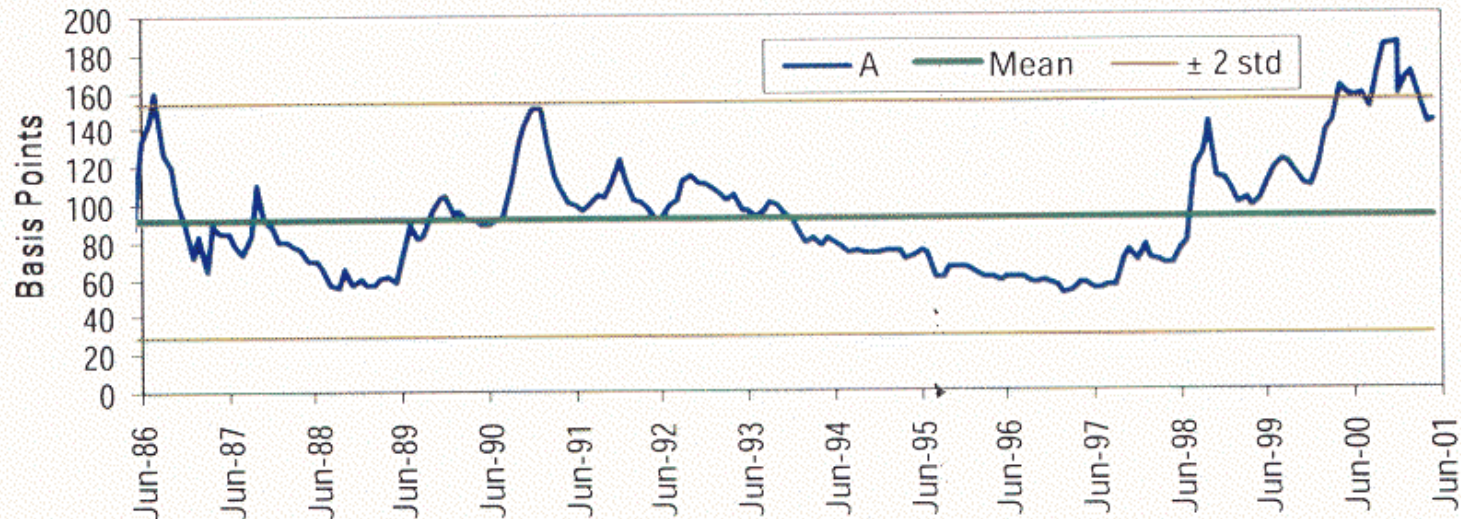


07142128	081623	01081522	01081522	01081522	01081522	01081522	01081522	02091623	01081522	01081522	02091623	01081522	0310
	2000 Oct	Nov	Dec	2001 Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	



# Corporate Spreads are Historically Wide

## A Rated Corporates



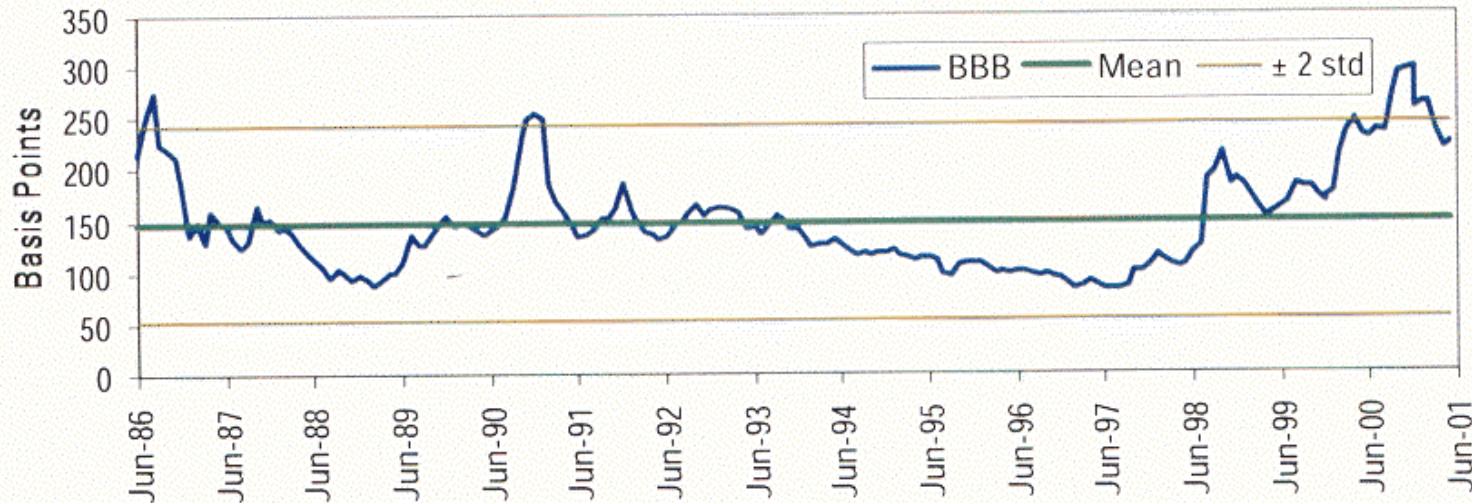
**High quality corporates are positioned to outperform other sectors once spreads tighten or revert to the mean.**





# Corporate Spreads are Historically Wide

## BBB Rated Corporates



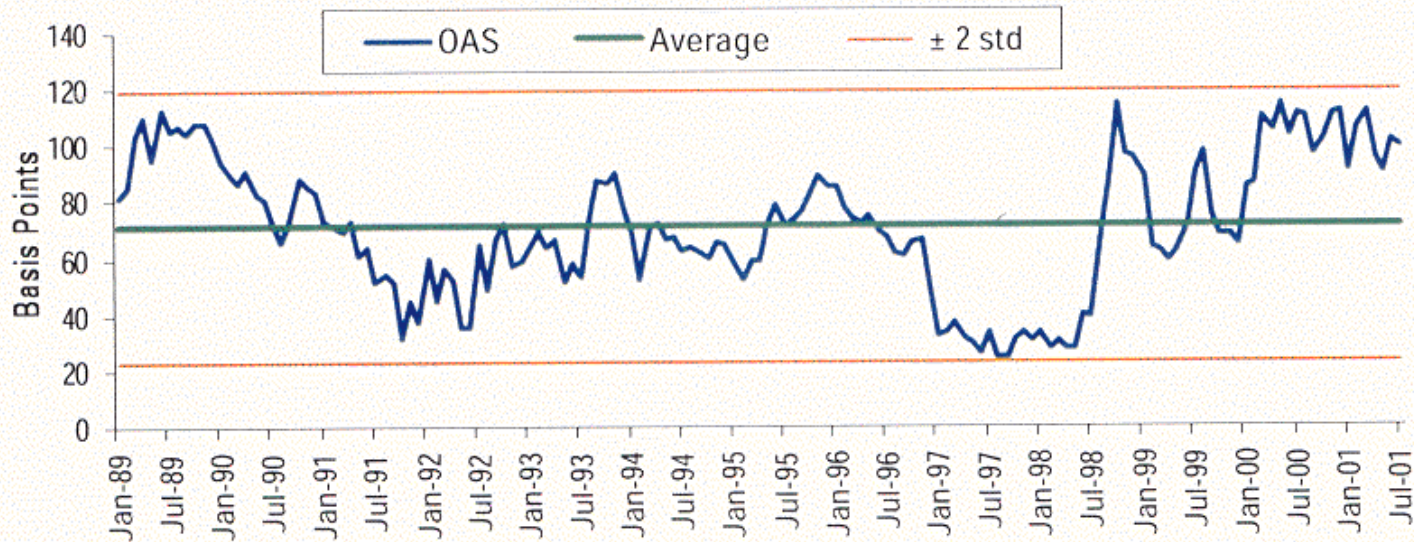
*As spreads tighten or revert to the mean, corporates may outperform other sectors.*





# Mortgage Sector Becoming Attractive

## Mortgage OAS Spread



**Once refinancing activity slows, the mortgage sector will experience less prepayments and will be more attractively valued. Spreads may remain wide so security selection is critical.**

**Bridgebay Financial, Inc.**





# Create Your Own Bond Fund

## Collective or Unit Investment Trust

- ◆ Separate account management with bundled fund features
- ◆ Lower institutional custody, management, advisory fees all netted against Trust assets, no SEC filing expenses
- ◆ Fees decline as assets increase
- ◆ Client controls timing of realized gains/losses
- ◆ Client controls level of interest income and strategy changes
- ◆ No FASB 115 reporting
- ◆ Booked at Unit Value

## Mutual Fund

- ◆ Multiple shareholders, Client is subject to untimely inflows and outflows
- ◆ Higher expenses include custody, management, advisory, SEC filing, prospectus, and marketing fees
- ◆ Fees never decline as assets rise
- ◆ Client cannot control timing of realized/losses
- ◆ No client control on strategy changes
- ◆ No FASB 115 reporting
- ◆ Booked at NAV





## ***There are still opportunities for high returns in the Bond Markets***

- ◆ Evaluate credit risk carefully
  - ◆ No more “name recognition” investments
- ◆ Yield curve analysis can add value
- ◆ Take advantage of extraordinarily wide credit spreads
- ◆ Security selection, sector are critical
- ◆ Diversify portfolio by issuer, credit, and security type
- ◆ Consider active portfolio managers with strong credit and structure research





## *Maturity or Duration Risk and Volatility Measure*

7% Coupon, 5 Year Maturity @ Par



7% Coupon, Callable in 2 years @ 101. 5 Year Maturity @ Par



Zero Coupon, 5 Year Maturity @ Par, IRR 7%

