October 2008

Avoiding Danger, Seizing Opportunity

By Jill King, Vice President, Senior Portfolio Manager

The world has changed considerably since our last portfolio commentary. Who would have thought in August that Lehman Brothers would be no more, Goldman Sachs and Morgan Stanley would become banks and Citigroup and Wells Fargo would wage war over Wachovia? Add to that the wild gyrations in both fixed income and equity markets and the deluge of new US Government-sponsored bailout programs. It is a brand new world for everyone.

In Chinese the word 'crisis' is composed of two characters: one represents 'danger', the other 'opportunity'. Over the past two months, we have endeavored to avoid any possible 'danger' in the market and to find the 'opportunity' that the market made available. To accomplish this, we shortened the term on Commercial Paper investment to only overnight and we invested exclusively in Top Tier (Rated A1/P1/F1 by at least one major rating agency). This was a temporary measure that we felt was prudent given the distress in the short-term market. At the same time, however, there has been tremendous opportunity in the overnight CP. Because of the dislocation in the short-term market, many issuers of CP have issued at very high rates relative to other short and overnight investments. For those clients that allow us to purchase CP, we have taken advantage of the short-term disruption and purchased CP at levels ranging from 5.5% to 6.5% overnight. As the market for CP has begun to normalize, we do not expect these levels to continue long-term. But they proved to be very attractive alternatives to Agency and Treasury repo rates that have been sub 1% for the past 6 weeks.

U.S. Agency securities have also presented tremendous value. The U.S. Treasury announced that it will guarantee any new issue bank paper that has a maturity of three years or less. Because of this "guarantee", U.S. Agency securities have widened out considerably. Federal Home Loan Bank (FHLB) just issued a 1-year, non-call 3-month bond that starts with a 3.5% coupon stepping to a 5% coupon in January 09, if not called. We find this type of structure very attractive and continue to find value in short callable agency securities.

Another opportunity that is just beginning to prove interesting is the short T-Bill market. As you know, the recent and massive flight to quality has caused T-Bill rates to trade at ridiculously low levels: at the extreme, with negative yields! The T-Bill market has become the choice of the U.S. Treasury to raise the needed funds for its proposed $750 billion bailout and numerous other government-sponsored bailout programs. To date, $600 billion in supplemental bills has been issued from 9/18 - 10/23. Absorbing this tremendous amount of paper was met at first with overwhelming demand. As the issuance has continued unrelentingly, demand has been saturated and yields have begun to increase substantially. The Commercial Paper Funding Facility (CPFF) begins on October 27th. This vehicle may further remove demand from the T-Bill market, which could increase yields even further. We find this to be a very attractive time, for many of our accounts, to begin allocating funds out of overnight repo and into T-Bills. Currently, 1-year T-Bill rates are trading 10 basis points cheaper than the 2-year Treasury Note. We expect this situation to continue in the near-term and to create significant opportunity in the T-Bill market.

It appears that we have turned the corner in the recent financial distress. It remains to be seen if this is permanent improvement or just another round of short-lived stability. In either case, we at Horizon remain vigilant both in seeking out opportunities and avoiding trouble spots in a volatile and unpredictable market environment.

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