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New Beginnings, Traditional Values

By Jill King, Vice President, Senior Portfolio Manager

A collective sigh could be heard worldwide as the clock struck midnight, and 2008 became 2009. The hope and prayer for the New Year was that we would awaken on New Year's Day to strong and solvent banks, a robust housing market, and budget surpluses. Unfortunately, only Rip Van Winkle could have slept long enough for the world to recover from what ails it. We begin 2009 much the same as we started 2008. The U.S. economy is buckling under the weight of the burst housing bubble, financial institutions continue to struggle and the consumer and small businesses still find it virtually impossible to borrow money.

The start of a new year is a perfect time to evaluate where you have been and where you are going. Despite the rigorous economic conditions of the past 12 months, we're pleased to have:

- ▶ steered clear of the well-publicized "land mines" that impacted a substantial number of institutional investors
- ▶ affirmed the appropriateness of separately managed accounts, rather than commingled assets
- ▶ provided helpful guidance and reassurance to clients after the Lehman Brothers implosion and The Reserve's Primary Fund "breaking the buck" sent shockwaves through the institutional investor community

Going forward we will focus - as we always have - on our core objectives of capital preservation and incremental yield enhancement. We will continue to seek and uncover opportunities in the market that achieve these two goals. With interest rates likely to remain low throughout 2009, finding sectors that provide additional yield will be especially important.

There are several areas in which we have found incremental value without incremental risk. In late 2008, the Federal Government announced a program called Temporary Liquidity Guarantee Program or "TLGP". This program was designed to allow U.S. financial institutions to "roll" maturing short term debt. The program guarantees new issue corporate notes with maturities no longer than 6/30/12. (The Treasury is proposing to extend the final maturity to 10-year.) Participating institutions pay a fee to be part of this program and to issue debt that is both guaranteed by the FDIC and carries the "full faith and credit" of the U.S. Government. All the major financial institutions have participated: Bank of America, Citigroup, JPMorgan, Goldman Sachs, and Morgan Stanley. Although the yield differential between these bonds and U.S. Treasuries has narrowed since they began issuing the paper in late November 2008, these government-backed offerings provide an attractive alternative to U.S. Treasury securities and U.S. Agency securities.

Fannie Mae (FNMA), Freddie Mac (FHLMC) and Federal Home Loan Bank (FHLB) have all been active in the new issue market. All three government-sponsored enterprises (GSEs) have begun to issue "step-up" bonds. These are bonds that start off with a current coupon that is reset to a higher coupon a year from now. These structures offer an attractive short term yield, with the protection of a higher coupon a year from now. In this extremely low interest rate environment, the higher coupon gives added protection if rates rise in 2010. One example of such a structure is: FHLMC 1.50% to 2/11/10, 3% to 2/11/11, callable quarterly. Those who purchase get paid a coupon which is 105 basis points higher than the 1-year T-Bill and have the potential to step up to a 3% coupon next year.

Like the year that preceded it, 2009 should prove to be both volatile and challenging. We continue to monitor and adapt to the ever-changing market environment. Adhering to our mandate of capital preservation, we'll continue to search for those opportunities which provide attractive yield enhancement without incremental risk.

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