Merganser Investment Memorandum

Risk vs. Return - A Great Balancing Act

Autumn 2009

"We learn geology the morning after the quake." Ralph Waldo Emerson

Emerson made this observation in his book titled, "The Conduct of Life," which was published in 1860. Almost a hundred and fifty years later, we are re-examining the geology of the capital markets after the recent quake. As part of that process, we are engaging investors in a discussion about the relationship between risk and return in the aftermath of the recent market turmoil.

During the credit crunch, there was a significant flight to quality and to money market funds, particularly those with allocations to government securities. Over the last few months, we have been receiving queries from plan sponsors regarding "safe" alternatives to their very low yielding portfolios. More specifically, they seek to understand the trade-off between incremental return and incremental risk. The purpose of this memorandum is to relate our views on some of these trade-offs in the context of near cash accounts with 0-3 year duration targets, and to use six Merganser portfolios to demonstrate how we put these beliefs into practice for our clients.

Risk/Return Trade-Off

It is very important for the client and the investment manager to have a clear understanding of the appropriate level of risk in the portfolio. For short-duration cash funds, we strongly believe that capital preservation and liquidity are more important considerations than increased incremental return. That does not mean that the only alternatives for cash funds are Treasury securities or money market funds. Defining the risk parameters (what is considered "safe"), however, is the challenge.

There are some compelling opportunities in the current market to trade reasonable levels of risk for significant return on the short end of the maturity spectrum. The steepness of the yield curve is very attractive to those investors who are able to modestly extend duration. The current reward for moving from a one year security to a three year is over 100 basis points. The risk of price decline if interest rates rise is offset by the fact that the Fed has the yield curve anchored close to zero at the short end for the foreseeable future.

Short term investors can further increase yield by buying securities with modest levels of credit risk at a spread over Treasuries. Spreads on short term, high quality securities have compressed significantly in 2009, but are still attractive, as we will show with our sample portfolios. The risk of price declines due to spread widening is mitigated by our ability to select credits that will ultimately return principal. That is, any price declines due to spread widening should be recovered as the security reaches maturity.

From the Management Committee

Jeff Addis ◆ Ed Bedrosian ◆ Doug Kelly ◆ Mike Siciliano ◆ Andy Smock

Merganser Welcomes Two New Ducks

We are pleased to announce the two most recent additions to the Merganser organization. In March, Valerie Krempus joined us from Wellington Management, where she worked for several years as a Marketing Analyst. In this role, she worked closely with the relationship management and business development groups. Valerie serves as a Relationship Manager at Merganser, responsible for client service. She resides in Boston with her husband and will be completing her MBA degree at Northeastern University in April 2010.

Michael Siciliano, Director of Sales & Marketing, joined the firm in June of this year. He was also recently added as a member of Merganser's Management Committee. Mike brings to us over twenty years of sales and marketing experience in the financial services industry, having worked previously for ING Investment Management, BNY Mellon and GE Asset Management. Mike lives on the south shore with his wife and three children, and enjoys fishing in his spare time.

There are a variety of risks we feel are NOT appropriate for cash accounts, including the risk of rating downgrade and variability in cashflows. Securities at risk of downgrade do not belong in cash accounts. Further, highly variable timing of principal and interest receipts is also an inappropriate risk. The rating agencies have lost a tremendous amount of credibility since the credit crunch as they mis-assessed the true risk inherent in some structured securities. They continue to change their models and downgrade wide swaths of the market. We have over 20 years of experience analyzing these securities and have long been skeptical of their ratings. By looking through the ratings to the underlying loans, we have successfully avoided the mass downgrades experienced by the broad market. As for structured risks, even securities whose principal repayment is guaranteed, such as 15 and 30 year agency mortgage backed securities, do not belong in very short accounts due to the likelihood of duration extension during periods of rising interest rates.

Merganser Portfolios

We have helped design a number of portfolios for our clients using the philosophies of appropriate risk/reward outlined above. Exhibit 1 shows six examples of portfolios that have been tailored to the clients' specific needs, which

Merganser Capital Management, Inc.

An Annaly Company

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Exhibit 1. Comparative Liquidity Portfolios (as of September 30, 2009)

	Portfolio 1	Portfolio 2	Portfolio 3	Portfolio 4	Portfolio 5	Portfolio 6
Characteristics						
Yield to Maturity	0.74%	1.05%	1.27%	1.28%	1.89%	3.06%
Effective Duration (years)	0.97	0.88	0.98	1.31	1.73	1.78
Average Quality	AAA	AA1	AAA	AA1	AAA	AA1
Sectors						
Money Market	3.2%	15.6%	7.3%	12.4%	1.0%	1.4%
Government	90.2%	23.8%	31.7%	50.3%	47.8%	20.5%
Asset Backed	1.9%	29.3%	52.0%	2.3%	17.4%	26.0%
Corporate Domestic	4.7%	21.1%	0.0%	14.2%	15.6%	25.9%
Corporate International	0.0%	9.7%	0.0%	10.6%	0.0%	2.1%
Commercial MBS	0.0%	0.0%	4.2%	5.0%	9.8%	13.9%
Residential MBS	0.0%	0.5%	4.8%	5.2%	8.4%	10.2%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Treasury Yield	0.41%	0.32%	0.44%	0.53%	0.77%	0.84%

Results do not reflect the deduction of advisory fees or other expenses that a client would have paid or actually paid. Past performance in not indicative of future results; investments can and may lose money. Material economic and market factors could impact the adviser's decision making for specific client accounts.

range in size from $40 million to several hundred million dollars. These portfolios have durations ranging from approximately 1.0 year to 1.8 years with yields ranging from about 0.75% to 3.00%, respectively. They are high quality (AA1 – AAA) and have all had positive total annual returns, even during the recent credit crunch. We were able to provide attractive alternatives to holding cash for each of our clients.

The differences in the portfolios pertain to the relative degree of risk in each portfolio, albeit within conservative risk parameters. The risk generally comes in the forms we discussed above: interest-rate risk (duration), credit risk (risk of default) and structural risk (timing of cashflows). It should be noted that each portfolio is managed to customized guidelines that match the specific risk criteria of each organization.

Portfolio 1 is the most conservative portfolio. It has 90% in government securities, a duration of 1.0 year and a yield of 0.74%. Conversely, Portfolio 6 has 20% in government securities, a duration of 1.8 years and a yield of 3.06%. Portfolios 2 through 5 range in degrees of relative risk between Portfolios 1 and 6.

Given the relatively low level of interest rates, the possibility of rising rates offsetting the yield advantage is an important consideration. For example, over a one year holding period, an instantaneous increase of 75 basis points in market interest rates for Portfolio 1 would eliminate the positive yield. Comparably, for Portfolio 6, the breakeven rise in interest rates (and/or spread widening) is about 175 basis points. Although it is counter-intuitive, some might argue that Portfolio 6 is therefore “safer” than Portfolio 1.

The appropriate degree of risk applicable to each client’s portfolio, therefore, comes down to the definition of what is “safe.” From our perspective as a bond manager, all six portfolios in Exhibit 1 are “safe.” Nevertheless, knowing the unique circumstances of the Portfolio 1 client, we can well understand why being 90% in government securities is very appropriate, particularly when we harken back to our own plan sponsor origins.

Gatekeepers of Risk

Ed Viesturs, famed mountaineer and high altitude adventurer who has summited all 14 of the world’s highest mountains, was interviewed recently on National Public Radio. Viesturs is quite candid in expressing his opinion about the risks of such endeavors. He observes that people are so enamored with getting to the top that they take undue risks that can lead to death. In fact, he views himself as a gatekeeper of risk in that he manages risks in a safe way with the ultimate goal of getting home.

There are some parallels between Viesturs and Merganser. While no one has died from investing in the bond market, many felt as if they had near-death experiences during the recent credit crisis. Like Viesturs, we view ourselves as gatekeepers of risk with the ultimate goal of getting home safely (preserving capital). Defining the risks for each portfolio, therefore, is both unique and challenging, just as it is for each mountain. And, as with Ed Viesturs, it is what we love to do.

Merganser Investment Team

Merganser

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