High Quality Corporate Notes as an investment option?

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Winners from your Economic Predictions at the last ICCCFO Conference

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&
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• Continuum of investment options
• Investment policy sample
• What is a corporate note?
• Why utilize corporate notes as an investment option?
  – Increase interest income (higher rates available)
  – To plan for the reduction of other traditional investment options
  – Because it has been done successfully in other states
• Risks/default studies
• Criteria to be considered
• Legislative efforts
Risk/Return Continuum of Investment Options

Risk and return are directly correlated

Risk Factors
- T-Bill
- Agency Disc. Note
- Gov’t Repo
- CD
- BA
- Commercial Paper
- Longer Term Treasury Note
- Longer Term Agency Note
- Longer Term Corp Note
- MBS

Return

Less Risk → More Risk

1 2 3 4 5 6 7 8 9 10
Permitted Investments for Investment Policy

A. US Treasury
B. US Agency
C. Bank Deposits
D. Commercial Paper
E. Money Market Funds
F. Repurchase Agreements
G. Corporate Notes ?
• Corporate Note:
  – An unsecured debt instrument issued by a corporation with a maturity of greater than one year and less than ten years
Credit Rating Distribution of Merrill Lynch 1-5 Year Investment-Grade Corporate Index as of February 2010

Sample Long-Term Issuer Ratings

<table>
<thead>
<tr>
<th>Company</th>
<th>Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exxon Mobil Corp.</td>
<td>AAA</td>
</tr>
<tr>
<td>Microsoft Corp.</td>
<td>AAA</td>
</tr>
<tr>
<td>General Electric Co.</td>
<td>AA+</td>
</tr>
<tr>
<td>Pfizer Inc.</td>
<td>AA</td>
</tr>
<tr>
<td>Wal-Mart Stores Inc.</td>
<td>AA</td>
</tr>
<tr>
<td>Procter &amp; Gamble Co.</td>
<td>AA-</td>
</tr>
<tr>
<td>Wells Fargo &amp; Co.</td>
<td>AA-</td>
</tr>
<tr>
<td>Abbott Laboratories</td>
<td>AA/A</td>
</tr>
<tr>
<td>Kraft Foods, Inc.</td>
<td>AA</td>
</tr>
<tr>
<td>Sara Lee Corp.</td>
<td>AA</td>
</tr>
<tr>
<td>Caterpillar Inc.</td>
<td>A/BBB</td>
</tr>
<tr>
<td>Boeing Co.</td>
<td>A/BBB</td>
</tr>
<tr>
<td>Deere &amp; Company</td>
<td>AA/A</td>
</tr>
<tr>
<td>Walgreen Co.</td>
<td>A/BBB</td>
</tr>
<tr>
<td>Motorola Solutions Inc.</td>
<td>BBB</td>
</tr>
</tbody>
</table>

Credit Rating Distribution:
- AAA: 2%
- AA: 16%
- AA/A: 14%
- A: 34%
- A/BBB: 8%
- BBB: 25%
- BBB/BB: 1%
- AA/A: 14%

Corporate Note Credit Rating Breakdown
Why utilize corporate notes as an investment option?

• Why expand the Illinois state statutes to include high-grade corporate notes into the Illinois Public Funds Investment Act?

  1. To improve overall investment returns

  2. To plan for an ever-changing investment world
     1. Fewer banks offering deposit products such as CDs
     2. Primary U.S. Agencies (Fannie Mae and Freddie Mac) to be phased out

  3. It has been successfully done in other states throughout the country
Corporate Note Rate Comparison as of April 8, 2011

Source: Bloomberg
Spread of Corporate Notes to Agencies

Yield spread above Agencies (last 10 years)
AAA Spread = 55 basis points
AA Spread = 73 basis points
A Spread = 118 basis points

Source: Bank of America/Merrill Lynch Global Indices. Data reflects 1-5 Year Corporate index
“Any security which matures or which may be tendered for purchase at the option of the holder within not more than 7 years of the date on which it is acquired, if that security has a rating which is the highest or 2nd highest rating category assigned by Standard & Poor’s corporation, Moody’s investors service or other similar nationally recognized rating agency or if that security is senior to, or on a parity with, a security of the same issuer which has such a rating.”

- Wisconsin State Statutes, Chapter 66, Subchapter VI, Section 66.0603(4)

“… in notes issued by corporations that are incorporated under the laws of the United States and that are operating within the United States, or by depository institutions that are doing business under authority granted by the United States or any state and that are operating within the United States, provided both of the following apply:

a) The notes are rated in the second highest or higher category by at least two nationally recognized standard rating services at the time of purchase

b) The notes mature not later than two years after purchase”

- Ohio Revised Code, Title 1, Chapter 135, Section 135.35

“Medium-term notes, defined as all corporate and depository institution debt securities with a maximum remaining maturity of five years or less, issued by corporations organized and operating within the United States or by depository institutions licensed by the United States or any state and operating within the United States. Notes eligible for investment under this subdivision shall be rated “A” or better by a nationally recognized rating service. Purchases of medium-term notes shall not include other instruments authorized by this section and may not exceed 30 percent of the agency’s surplus money which may be invested pursuant to this section.”

- California Government Code, Chapter 4, Article 1, Section 53601(j)
Financial Effects of the Credit Crunch of 2007 – 2010

• From January of 2008 to March of 2010:

  – Over 70% of outstanding debt from corporations rated AAA in 2008 were downgraded to AA by 2010

  – Over 55% of outstanding debt from corporations rated AA in 2008 were downgraded to A by 2010

  – Over 20% of outstanding debt from corporations rated A in 2008 were downgraded to below investment grade or defaulted by 2010

  – Only 3% of outstanding debt from corporations that had an investment grade credit rating in 2008 defaulted on their debt by 2010

  – Independent credit analysis that establishes a limited approved list of high quality corporate issuers was able to eliminate defaulted corporate notes from PFM’s portfolios

Source: Bank of America/Merrill Lynch Global Indices. Data reflects 1-10 Year Corporate Master index. More detail is available upon request.
Credit Analysis is Key - Beyond Ratings

**Universe of Potential Issuers**
- Minimum rating requirements
- Availability of supply
- Relative value analysis

**Preliminary Screen**
- Improving or stable ratings
- Diversity of revenue/profits
- Capital structure
- Strength of financial position
- Leader in industry
- Superior product
- Management team

**Industry Screen**
- Economic outlook
- Outlook for industry growth
- Geographic exposure
- Changes in regulatory environment

**Issuer Screen**
- Improving or stable ratings
- Diversity of revenue/profits
- Capital structure
- Strength of financial position
- Leader in industry
- Superior product
- Management team

**Where do we get our information:**
- Independent research
- Company releases
- Sell side analysis
- News releases
- Company financials
- Ratings reports
- Security Valuation

**Approved Issuer List**

**Sources:**
- Bloomberg
- MarketAxess
- Tradeweb
Criteria to be Considered

• Certain decisions with regards to the criteria in the Illinois statute language would have to be considered, such as:

  – Minimum credit rating (“AAA” or “AA” or “A”)
    • Balance needs of different levels of sophistication
    • Language to include “at the time of purchase”

  – Maximum maturity limit (3 years, or 5 years, or 7 years)

  – Concentration limit on overall portfolio (i.e., current 33% maximum limit on Commercial Paper investments) – 25% max. is recommended for corp. notes

  – Issuer limitation (limit the amount of exposure to any one issuer in the overall portfolio)

  – Opt-in: Only if the board of a public agency approves the corporate note language in the agency’s investment policy
    • Provides a municipality with a choice option to include or corporate notes or not in its investment strategy
Legislative Efforts

• Bill #
Market Update
Current Theme: Uncertainty…

Japanese Nuclear Disaster  Political Turmoil in the Middle East

Internal Debate at the Fed  Budget Battles/Government Shutdown?
Biggest Risks in 2011:

- European sovereign debt crisis
- China tightening rates, trigger economic slowdown
- Turmoil in the Arab world, rising oil prices
- Japanese recession threat

Source: CNNMoney Market Survey
Impact on Japanese Production

Japanese Manufacturing Earthquake-Related Plant Closings

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Facilities Closed</th>
<th>Products Affected</th>
</tr>
</thead>
<tbody>
<tr>
<td>Toyota Motor Corp</td>
<td>16</td>
<td>Autos</td>
</tr>
<tr>
<td>Canon Inc.</td>
<td>3</td>
<td>Cameras, Lenses, related parts</td>
</tr>
<tr>
<td>Honda</td>
<td>2</td>
<td>Autos</td>
</tr>
<tr>
<td>Mitsubishi Motors Corp.</td>
<td>2</td>
<td>Autos</td>
</tr>
<tr>
<td>Sony Corp.</td>
<td>2</td>
<td>Blue-ray discs, batteries, magnetic tape</td>
</tr>
<tr>
<td>Toshiba Corp</td>
<td>2</td>
<td>Semiconductors, LCD panels</td>
</tr>
<tr>
<td>Asahi Breweries Ltd.</td>
<td>1</td>
<td>Beer</td>
</tr>
<tr>
<td>Nissan Motors Corp.</td>
<td>1</td>
<td>Autos, engines</td>
</tr>
<tr>
<td>Sapporo Holdings Ltd.</td>
<td>1</td>
<td>Beer</td>
</tr>
</tbody>
</table>
Gross Domestic Product (GDP) is a measure of the United States’ production over the quarter, often shown as quarter over quarter change. GDP includes consumption, government spending, investment, and net exports. It is the measure of economic activity in the United States.

Source: Bloomberg
Intermediate-Term Yields March Higher

2-Year U.S. Treasury Note Yield
March 31, 2010 through April 6, 2011

Source: Bloomberg
Unemployment Rate Continues to Improve

Change in Non-Farm Payrolls/ Unemployment Rate
March 2005 – March 2011

Source: Bloomberg
Stocks Trend Higher

S&P 500
January 2007 – April 2011

Source: Bloomberg
Fed Funds Stay Near Zero

Fed Funds Target Rate
January 2005 – April 2011

Source: Bloomberg
But Housing Prices Remain Depressed

The S&P/Case-Shiller home price index tracks monthly changes in the value of residential real estate in 20 metropolitan regions across the U.S. *The value on the left represents an index price that was set at 100 on January 2000.

2008 -19%
2009 -0.7%
2010 -3%
Internal Debate at the Fed

• “Monetary policy will have to reverse course in the not-too-distant future and begin to remove the massive amount of accommodation it has supplied.”  
  - Philadelphia Fed President Charles Plosser; March 25, 2011

• “QE was appropriate, But more is not called for.”  
  - Chicago Fed President Charles Evans; March 28, 2011

• “The FOMC may not be willing or able to wait until all global uncertainties are resolved to begin normalizing policy.”  
  - St. Louis Fed President James Bullard; March 29, 2011

• “It's "certainly possible" the Fed's target for short-term interest rates, now near zero, would be lifted by more than half a percentage point late this year.”  
  - Minneapolis Fed President Narayana Kocherlakota; March 31, 2011

• “The recovery is still tenuous. And, we are still far from the mark with regard to the Fed's dual mandate.”  
  - New York Fed President William Dudley; April 1, 2011

• “Improving economy warrants current Fed stimulus.”  
  - Chicago Fed President Charles Evans; April 4, 2011
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## Economic - Financial Survey

<table>
<thead>
<tr>
<th>Economic Measure</th>
<th>Fall 2010 ICCCFO actual</th>
<th>Spring 2011 ICCCFO actual</th>
<th>Fall 2011 ICCCFO prediction</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>1.8%</td>
<td>3.1%</td>
<td></td>
</tr>
<tr>
<td>2 Year Note Yield</td>
<td>.33%</td>
<td>.82%</td>
<td></td>
</tr>
<tr>
<td>Unemployment Rate</td>
<td>9.5%</td>
<td>8.8%</td>
<td></td>
</tr>
<tr>
<td>S&amp;P 500 Index</td>
<td>1160</td>
<td>1328</td>
<td></td>
</tr>
<tr>
<td>Fed Funds Rate</td>
<td>.25%</td>
<td>.25%</td>
<td></td>
</tr>
</tbody>
</table>

- Name ________________________________
- College ________________________________