

Having Your Principal and Your Yield, Too

Cash Investors Don't Need to Accept Negligible Yields to Achieve Principal Protection

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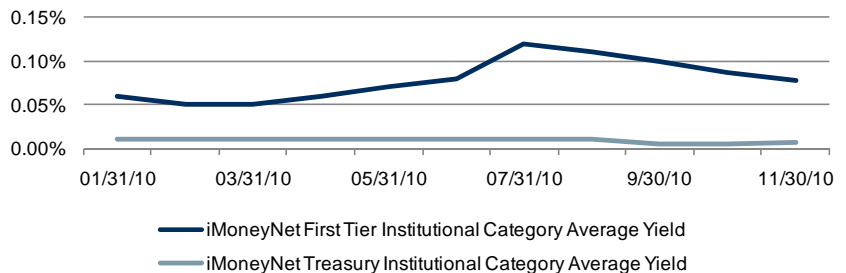
“By building a portfolio of cash investments... investors potentially can achieve both principal stability and yields sufficient to meet their goals.”

Reassessing the “Safe” Investment

In September 2008 — the height of the global financial crisis — the first widely held money market mutual fund “broke the buck,” its net asset value dropping below \$1 per share. Already spooked by the equity and bond markets’ violent gyrations that summer, investors yanked roughly \$300 billion in assets from money funds, a panic that abated only when Washington announced it would guarantee certain money fund balances.

Reminded that no investment is inherently “safe,” not even one long considered a refuge from market volatility, many cash investors have adopted an ultra-conservative investment program, parking their assets in U.S. Treasuries, Treasury money market mutual funds or bank deposits. Unfortunately that conservatism presents its own risk, namely that the investments’ paltry yields will make it difficult for investors to meet their financial goals. This is especially true if they have increased their allocation to cash in response to increased equity market volatility.

Prime Funds: An Alternative to U.S. Treasuries



Source: iMoneyNet

In our view, investors don't need to accept miniscule returns to protect their principal. With a diversified portfolio of high-quality cash investments, they may be able to achieve the optimal balance between stability and yield. To do so, however, investors need to think carefully about two variables that drive the performance of cash investments:

- Their risk tolerance
- The purpose of the cash they're investing

About the Author
As the chief investment officer at BofA Global Capital Management, Paul Quistberg oversees a team of portfolio managers, credit analysts and traders that specializes in the management of cash investments. Mr. Quistberg has more than 20 years of experience in the financial markets.

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Protecting Investors in Times of Crisis

Early this year, the Securities and Exchange Commission (SEC) strengthened the regulatory requirements governing the management of money market mutual funds. Intended to protect shareholders during market disruptions, the amendments to Rule 2a-7 under the Investment Company Act of 1940 reduce the risk profile of money market mutual funds, thereby promoting principal stability. The SEC's reforms include:

- **Liquidity requirements** – Under the new regulatory framework, 10% of a fund's assets must have daily liquidity, meaning they can be sold at their carrying value in a day, and 30% must have weekly liquidity. Previously, liquidity levels were at the manager's discretion.
- **Portfolio maturity limits** – The SEC has limited the maximum weighted average maturity of money market mutual funds' portfolios to 60 days (versus 90 days previously), a move that should reduce funds' exposure to certain risks, such as sudden interest rate movements.
- **Credit quality enhancements** – The new rules restrict fund managers from holding more than 3% of their funds' assets in "second-tier" — that is, lower-quality, less liquid — securities (versus 5% previously), and the maturities of those securities must not exceed 45 days (the limit had been 397 days).
- **Portfolio stress testing** – The SEC is requiring managers to examine their funds' ability to maintain a stable net asset value in the event of systemic shocks, such as a jump in interest rates, high redemption activity or sizeable changes to a portfolio's credit quality.

By reducing investment risk, the SEC amendments increase principal stability but also put downward pressure on yields. Moreover, because they apply to all fund managers, the amendments to Rule 2a-7 should reduce performance differentials among mutual fund managers. As such, it will make more sense to select a manager on the strength of a fund's sponsor and manager's reputation than on its yield, which will not vary much from those of other funds.

By carefully assessing their risk tolerance and identifying the purpose of the cash, they can better optimize the risk/return profile of their cash investments. That's important because even in today's low-rate environment, the incremental yield investors may pick up by adjusting the risk profile of their cash investments could potentially add up to a healthy increase in the value of their assets.

Stability First

Prior to the financial crisis, most investors assumed their cash would be safe if they put it in a money market mutual fund. When weighing one fund against another, they focused on the funds' yields thinking that yield alone differentiated the funds. Today, safety is not a given, and many investors are far more concerned about principal protection and liquidity than about yield. Some investors have limited themselves to bank deposits, which offer an obvious benefit, namely federal deposit insurance on the first \$250,000 in assets. Others have opted for only the most conservative money market mutual funds, such as those limited to U.S. government securities.

As we noted above, undue conservatism can come at a cost. For example, with a CD, the investor loses her access to that cash until the CD matures. If she restricts herself to U.S. Treasuries, she locks in yields that may be too low to meet her larger investment goals.

As they consider their investment options, investors should keep in mind that alternatives to bank deposits and Treasury money market mutual funds typically carry only a bit more investment risk than ultra-conservative investments, but have the potential to deliver better yields. Take prime money market mutual funds, for example. These funds can invest in securities like high-quality corporate debt and asset-backed commercial paper, investments that historically have provided better returns than government issues. And while it's true that prime money market mutual funds carry greater investment risk than Treasury funds, they still are very conservatively managed because they are subject to Rule 2a-7 under the Investment Company Act of 1940, which carefully restricts the amount of risk money fund managers can assume. Moreover, prime money market mutual funds are even more stable than they were just a year ago because Washington has reduced the risk prime funds can assume to protect investors' assets during market crises (see "Protecting Investors in Times of Crisis" at left).

A Powerful Alternative to Money Funds

If investors have sizeable holdings of cash, they may want to consider a potentially attractive alternative to money market mutual funds, the separately managed account (see "The Case for Separately Managed Accounts" on page 3). Customized to each investor's risk tolerance and investment objectives, a separate account strategy typically features higher credit and interest rate risk than do money market funds. However, a good investment manager potentially can convert that incremental increase in risk into higher yields than those available from money funds.

The Case for Separately Managed Accounts

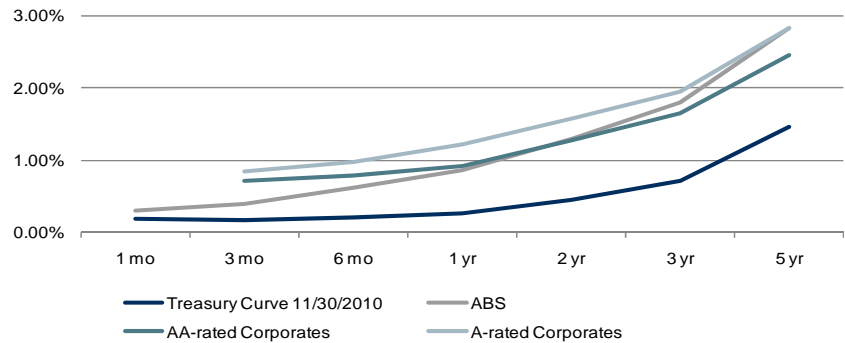
Federal rules governing the management of money market mutual funds limit portfolio risk and, by extension, fund yields. An alternative for yield-oriented investors is a separately managed account, which can invest in potentially higher-yielding securities than those available to fund managers.

The managers of separate account strategies can pursue higher yields by:

- **Adding lower-rated debt** – By adding securities with credit ratings that are slightly lower than those in money market funds, separate account managers may be able to achieve higher yields than those offered by money market funds.
- **Increasing portfolio duration** – By going farther out the yield curve, managers historically have been able to achieve a yield premium over shorter-term debt because investors must be compensated for the higher interest rate risk implicit in longer-maturity issues.
- **Optimizing the mix of securities** – By blending diverse securities, such as corporates, municipal bonds and structured product, a manager may be able to increase yield without assuming significantly more investment risk. For example, a portfolio may benefit from the inclusion of asset-backed securities (ABS), which are backed by receivables from auto loans and credit cards, because they offer a yield premium over government debt and some high-quality corporate bonds.

While many investors utilize separately managed accounts to boost the yield on their cash holdings, others utilize them to achieve benefits unrelated to performance. Because the investor owns individual issues rather than shares in a money fund, he or she can direct the portfolio manager to buy or sell specific securities or adjust the portfolio's weighted average maturity (the average maturity of all the securities in the portfolio) to reflect changes in his or her liquidity needs or view on the markets. In addition, the investor also can dictate the amount of buying and selling within the portfolio, which may provide certain tax advantages.

Historically Longer Maturities Have Brought Higher Yields



Sources: U.S. Treasury Department; BofA Global Capital Management

When weighing the risks and benefits of separately managed accounts, investors must identify the purpose of their cash because how they intend to use the cash determines their time horizon, which, in turn, drives the level of risk they should assume. For example, if the cash could be required at any time, it would be wise to invest it in a high-quality money market fund offering daily liquidity. If, on the other hand, the cash is for a longer-term use, such as an acquisition or technology investment, a separate account might be the better choice because the assets could be invested in issues with longer maturities and potentially higher yields. A longer time horizon might also allow the investor to increase the total credit risk in the separate account because there would be more time for individual securities to recoup a temporary loss of value from, say, a change in macroeconomic conditions or an issuer-specific event. Of course, adding credit and interest rate risk means that the value of the separate account could drop below the original principal amount if market conditions change.

Balancing Competing Needs

The market turmoil of two years ago reminded us that it is possible to lose money on any investment. Not surprisingly, many cash investors have since adopted a conservative approach to the management of their cash. The danger is that they will become too conservative and unnecessarily sacrifice the yield they need to meet their larger financial and personal goals.

Fortunately it isn't necessary to trade attractive yields for principal stability. By building a portfolio of cash investments — insured accounts, money market mutual funds and potentially higher-yielding separate account strategies — investors potentially can achieve both principal stability and yields sufficient to meet their goals.

Achieving the optimal balance between principal stability and return requires that investors accurately identify their true tolerance for risk. They also should try to avoid viewing their cash monolithically and investing it in a single investment vehicle — or in multiple investments with the same risk/return profile. Cash for long-term uses can and should be invested more aggressively than cash you may need immediately. Finally, they need to ensure their investment managers share their sensitivity to risk and those managers have the expertise and the resources necessary to achieve solid performance (see “Selecting the Right Manager” on page 4). In essence, the key to enhancing the return on their cash investments *and* protecting their principal can be captured in a simple mandate: investor know thyself — and thy manager.

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Selecting the Right Manager

When selecting a manager of your cash, it is important to conduct extensive due diligence on potential investment managers. This is especially true if you opt for a separately managed account because separate account managers have much more flexibility when it comes to security selection than do money market mutual fund managers. As such, manager experience and expertise play a large role in determining the performance of separate account strategies. When screening managers, you should look closely at several variables that can strongly influence managers' performance:

- **Focus** – For many investment firms, their cash investment management teams are adjuncts of their primary businesses, the management of core fixed-income portfolios. A firm focused solely on the management of cash, or at least one with a strong emphasis on it, may provide better results over time simply because the management of cash is central to its success as a business.
- **Philosophy** – Like investors, some investment managers are more aggressive than others. If your sole concern is principal stability, principal protection should be your manager's overarching goal. Even the managers of money market mutual funds, inherently conservative investments, have different attitudes toward the trade-off between risk and reward, so it behooves you to ensure your manager's risk tolerance is in sync with yours.
- **Resources** – The management of cash has grown more complex since the global financial crisis. To successfully manage cash portfolios, the investment manager must have talented professionals who have managed cash across market cycles. Obviously you want experienced portfolio managers overseeing your investment, but you also want to see a strong research function. Rigorous credit analysis may provide the portfolio manager with a more accurate picture of a security's credit quality than the rating designated by the ratings agencies, whose credibility was called into question during the financial crisis.
- **Scale** – Size alone does not guarantee good investment results, but firms with significant assets under management do enjoy certain advantages. Large trading volumes promote efficiency and solid execution of trades, while high-volume purchases of securities often allow the manager to negotiate favorable pricing.

Past performance is no guarantee of future results.

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Mutual funds and separately managed accounts have different fee and expense structures. Limitations and restrictions to investing in separately managed accounts include higher investment limits and net worth requirements. Separately managed accounts are sold exclusively through financial advisors. Please review prospectuses or offering documents for specific details.

Unlike CDs, which are insured up to certain limits and offer a fixed rate of return, mutual fund investments are subject to certain risks. An investor's principal and return will fluctuate with changes in market conditions so that the shares, when redeemed, may be worth more or less than their original cost.

For investments in ABSs generally, when interest rates decline, prepayments accelerate beyond the initial pricing assumptions, which could cause the average life and expected maturity of the securities to shorten. Conversely, when interest rates rise, prepayments slow down beyond the initial pricing assumptions, and could cause the average life and expected maturity of the securities to extend, and the market value to decline.

Treasury bills are less volatile than longer term fixed-income securities and are guaranteed as to timely payment of principal and interest by the U.S. Government.

Investing in fixed-income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments and yields and share price fluctuations due to changes in interest rates. When interest rates go up, bond prices typically drop, and vice versa.

iMoneyNet First Tier Institutional category includes only non-government institutional funds that also are not holding any second tier securities. Portfolio holdings of first-tier funds include US Treasury, US other, repos, time deposits, domestic bank obligations, foreign bank obligations, first-tier commercial paper, floating rate notes and asset-backed commercial paper. It is not possible to invest directly in an iMoneyNet category.

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