



BofA Global Capital Management Investor Briefing

A Quarterly Conversation with Michael Pelzar, President

Michael Pelzar is the president of BofA Global Capital Management, Bank of America's dedicated manager of cash portfolios for individual and institutional investors. In the Q&A below, Mr. Pelzar shares his thoughts on the Greek debt crisis, the impact of the crisis on the global financial system, and the debate over proposed reforms to make money market funds more resilient to runs during market crises.

The Greek debt crisis seems to flare up every few months. Can the Greek government's debt issues be resolved without the debt restructuring the European Central Bank seems so determined to avoid?

I don't think it will be resolved without investors in Greek debt absorbing some losses. I think everybody realizes investors are going to need to share in some of the pain here, the real question is when. The European Central Bank has been trying to delay the day of reckoning because European banks have significant exposure to Greek debt and other troubled European countries. By forestalling the restructuring, the ECB buys time for the banks to gradually write off that debt and "earn their way" out of the problem by slowly increasing their capital levels, which need to be higher to absorb the write-downs a restructuring would trigger.

Is the ECB's approach working in your view?

Well, it is preventing — or at least delaying — the restructuring so many of us anticipate, but the loans to the Greek government come at a cost, which is the risk the ECB is assuming by effectively acting as the buyer of last resort for Greek debt. In attempting to shield European banks from

the blowback generated by a Greek default and contagion elsewhere in Europe, it is increasing its credit risk. The second cost is the lingering uncertainty created by the bailouts. The longer current levels of uncertainty continue, the more the crisis drags down the global financial system and the world's economies. So the question is whether you continue to prolong the inevitable, or take the pain and move on? Obviously there are different schools of thought on that.

How has the European debt crisis affected the short-term debt markets?

There really hasn't been a great deal of direct impact because cash managers have been steadily reducing their exposure to European sovereign debt for months. While no money market fund managers have any exposure to Greek, Irish or Portuguese debt, many of our competitors are still invested in the debt of Italy and Spain. We have no investments in any of the so-called PIIGS countries, which is in keeping with our strong emphasis on risk management and protection of investors' principal. Of course, the issues in Europe have indirect impact on the cash space because of the volatility they create within the financial markets overall.

About BofA Global Capital Management

BofA Global Capital Management is Bank of America's cash asset management division. The firm serves both retail and institutional clients through a family of high-quality pooled investment vehicles, including taxable and tax-exempt U.S. money market funds, as well as euro- and U.S. dollar-denominated global liquidity funds. For institutional and high-net-worth investors, BofA Global Capital Management offers customized separate account strategies that can be structured to address each investor's unique liquidity needs. Investment advisors may leverage BofA Global Capital Management's expertise on behalf of their clients by accessing the firm's sub-advisory services.

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We continue to closely monitor and analyze the potential impact of various European default scenarios on the credits we hold. Investors should ensure they understand the credits in their money funds, and I would suggest that this is not the time to be trying to pick up those last few basis points of yield by taking on this risk.

We know from the financial crisis in 2008 that money market funds are vulnerable to runs in the wake of severe market disruptions. How dangerous would a Greek debt default be for U.S. money market funds?

A lot has been written about the vulnerability of money market funds to a Greek debt restructuring, but the real issue isn't about funds overall, but about the ability of individual funds to weather a crisis. In other words, the degree to which a fund is vulnerable to a run is determined by that fund's holdings, which is a reflection of its investment philosophy.

We have no direct exposure to PIIGS sovereign debt or to the banks in any PIIGS nation because we want to be positioned to absorb the hardest hits the markets may deliver. That's a very conservative approach that not all fund managers embrace. My point is that it's more productive to assess the vulnerability of the specific fund or funds one may be considering than to focus on the funds industry generally.

I would also suggest that investors be somewhat skeptical about what they read and hear in the press. As I see how our portfolios — and those of many in our industry — are positioned, I believe much of the recent press has been overly sensational regarding the likely impact of a Greek default on money market funds. We've seen this issue coming for well over a year and a half, and money fund investors should understand that. What we can't control is investor behavior, so I would encourage investors of all types to look closely at the positioning of their funds before they jump to conclusions about the risks associated with the Greek debt situation.

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Certainly, though, there are systemic risks associated with a sovereign debt default that could negatively impact money market funds?

Of course, but the breadth and depth of the impact will depend on the positioning of each fund individually, just as the stability of a bank or other business during a crisis is driven by its unique balance sheet. There's another point that is important to remember, which is that it isn't a one-way street with only money market funds striving to maintain the confidence of investors during a crisis. The banking system globally is very dependent on money market funds for short-term funding. If funds lose confidence in a bank or other issuer, they might decide it's in the best interest of their shareholders to stop rolling over the issuer's commercial paper, which translates into a loss of liquidity for that issuer. We know from 2008 that liquidity challenges can be fatal for even an otherwise healthy company because during panics investors cease to make the distinction between liquidity risk and credit risk. That undermines confidence even in high-quality names, which, in turn, exacerbates liquidity challenges for those companies and further erodes confidence in them. This is why panics are so dangerous and so damaging.

So given the interconnections among money market funds, the banking sector and the corporate sector generally, what do you do if you're a money fund manager to insulate your fund from the most damaging fallout from a crisis?

First, you leverage your credit research capabilities to invest only in very high-quality names. That's a given. Second, you do what we're doing, and you keep your maturities relatively short, which again is only common sense because in the current environment, the yield pickup you get from going farther out the yield curve isn't large enough to justify the added risk. Our maturities are short-dated relative to those of many fund companies because we like knowing that if a holding's credit quality starts to deteriorate, we're not stuck in it for a long period of time.

How is it that money market funds have become so crucial to the successful functioning of the global financial markets?

They've always been very important, but not everybody understood exactly how important until the global financial crisis. Money market funds hold almost \$2.7 trillion today, and the industry has gotten that large for a reason.¹ The funds represent an extremely inexpensive and efficient borrowing and lending mechanism that helps support our economy. Further, funds are extremely transparent. Fund companies provide monthly reports that detail their holdings, which makes it much easier to parse the risks embedded in funds than to evaluate, say, the balance sheet risk of a large lender.

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Some funds, like BofA Global Capital Management's BofA Funds, make their portfolio holdings available weekly. And, of course, the principal stability, liquidity and convenience they've offered have made them very attractive to both retail and institutional investors. That popularity creates its own issues, however, primarily being the need to manage the systemic risks associated with any large financial intermediary.

And it's the size and importance of money market funds to the financial system that has prompted the Securities and Exchange Commission to revamp the federal regulations governing money funds, correct?

Washington doesn't want to have to step in and guarantee money market fund investments during the next crisis, which is what it did in 2008, and the industry doesn't want that kind of intervention again either. That is why the Securities and Exchange Commission amended Rule 2a-7 under the Investment Company Act of 1940 to restrict the amount of credit and interest rate risk fund managers can assume and to require managers to increase their liquidity levels. It is also why federal regulators are mulling a more profound change: retiring the defining feature of money market funds — the stable \$1 net asset value or NAV — and replacing it with a floating NAV. Those in favor of the change believe it will reduce the likelihood of runs during volatile markets because investors who understand that the market value of the fund's assets can drop below \$1.00 per share will have less incentive to redeem their shares. Supporters of a floating NAV believe investors would become accustomed to moderate fluctuations in the value of their investments — as they are with other asset classes. More comfort with fluctuating asset values should theoretically rein in the urge to be first in line to exit an investment during volatile markets.

Critics of the proposal to jettison the stable NAV question the extent to which a floating NAV would, in fact, reduce the susceptibility of money market funds to runs. Money market funds would continue to act as financial intermediaries that offer investors daily liquidity but hold assets issued by borrowers seeking term funding. Money market funds would remain subject to interest and credit risk. These critics point out that ultra-short-term bond funds in the U.S. and French floating NAV money market funds each experienced significant redemptions during the financial crisis. Some observers, in fact, argue that a floating NAV could exacerbate, not mitigate, market runs by highlighting small changes in market values.

¹Source: iMoneyNet as of July 7, 2011

What is your view on replacing the \$1 NAV with a floating NAV?

I think that any measure that stabilizes money market funds during a crisis or at any other time is positive. The issue is that we really don't know whether a floating NAV would reduce the risk of runs during a crisis. As I noted earlier, the 2008 crisis saw larger runs on French money market funds with floating NAVs than there were on \$1 NAV money market funds in the U.S. So it's difficult to know whether a floating NAV would succeed in preventing runs during highly volatile markets.

How would the shift to a floating NAV impact the financial system?

Some observers believe corporations and other large issuers of the short-term debt purchased by money market funds would turn to alternative sources of financing, most likely banks. Such a move would probably raise the banks' borrowing costs. Proponents of the floating NAV argue that a shift to bank financing would be beneficial because banks are better capitalized than the money market funds industry, and thus borrowers' source of liquidity would be more stable during disrupted markets.

The problem with that argument is that the banks probably don't have enough balance sheet capital to absorb the additional deposits and loan demand that would occur if corporations significantly decreased their short-term debt issuance in favor of bank financing. This is a complex subject, and the debate is very heated because the stakes are high, not only for fund investors and the funds industry, but also for the global financial system. This question gets at the very heart of how the financial system should conduct the short-term borrowing and lending activities the money markets provide today. A floating NAV could also lead institutional investors to move assets to less regulated — or unregulated — cash management vehicles, such as offshore money market funds, enhanced cash funds and other stable-value vehicles that are not subject to 1940 Act restrictions.

Federal Reserve Chairman Ben Bernanke indicated that the Fed is unlikely to raise rates for several more months, perpetuating low yields for cash investors. What do you recommend to investors seeking enhanced yield?

There's not a lot you can do right now to significantly increase yield on money market fund investments. What we're telling our clients now is to consider separately managed accounts, which can be customized to the risk tolerance, liquidity needs and performance objectives of each investor. Separate accounts can invest in potentially higher-yielding credits because they are not subject to the federal regulations that restrict money fund managers in terms of liquidity, duration and credit quality. We believe a separate account can be a very good option for investors who are comfortable with separate accounts' floating NAVs and who don't require the high level of daily liquidity offered by funds because the cash they're investing is strategic or core cash rather than operating cash, which typically requires a more liquid investment.

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How are BofA Global Capital Management's separate account managers enhancing yields while maintaining their focus on principal protection?

One approach that has worked well for us is for our separate account managers to move farther out the yield curve than money market fund managers can go. Beyond 13 months, which is the maturity limit for money market funds, managers have historically achieved a better yield than they have with shorter-dated credits. The yield curve steepens

quite a bit just beyond money market fund limits, and we like the risk/return profile of securities in that range. Separate account managers have many ways to enhance yield, but we especially like the approach I mentioned because you can potentially increase yield without significantly increasing credit risk, which we're wary of doing.

Shifting from the macro to the micro, what initiatives is BofA Global Capital Management pursuing to better serve cash investors?

We have several initiatives in the works — launching a new website, improving our client reporting capability, and upgrading our risk management and trading systems, to name a few. Beyond those specific projects, we're looking very closely at how we serve investors who have multiple relationships with Bank of America. We often team up with the bank's commercial lenders, treasury services professionals and other bank businesses to develop multi-discipline liquidity solutions for our shared clients.

We're reaching out to our partners to identify best practices that promote better communication and closer working relationships with them. The idea is that the better Bank of America's businesses work together, the better the solutions we can devise for the bank's clients. If we efficiently attack a client's challenges from all the angles covered by our respective businesses, we develop a more holistic view of the client and its needs, which we believe will translate into more comprehensive and value-added solutions. The key to achieving all of that is building stronger connections among our Bank of America colleagues, and all of us are focusing on that goal. We really believe this effort will bring greater value to our clients.

Michael Pelzar

President, BofA Global Capital Management

Michael Pelzar serves as the president of BofA Global Capital Management, an asset management division of Bank of America. Mr. Pelzar also serves as a Director of Banc of America Capital Management (Ireland) Limited and Bank of America Global Liquidity Funds, PLC. Previously, Mr. Pelzar was head of product management at Columbia Management, Bank of America's former asset management affiliate. In this role, Mr. Pelzar and his team drove the expansion and acceleration of product development and delivery, partnering closely with the institutional, intermediary and retail distribution groups and the investment area. Prior to his role as head of product management, Mr. Pelzar was head of business development and mergers and acquisitions for Bank of America's Global Wealth & Investment Management business. Mr. Pelzar joined Bank of America in 2006 and has been a member of the investment community since 1990.

Prior to joining Bank of America, he was managing director and partner at a boutique investment bank, where he specialized in financial services. Previously, Mr. Pelzar served in the corporate development and product marketing groups at Putnam Investments. He spent several years with Goldman Sachs & Co. in a variety of roles in the firm's money market and investment banking divisions in New York, Hong Kong and Tokyo.

Mr. Pelzar earned a B.S. in finance from the Wharton School of the University of Pennsylvania and an M.B.A. from the Amos Tuck School of Business at Dartmouth.

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Liquidity risk is the risk stemming from the lack of marketability of an investment that cannot be bought or sold quickly enough to prevent or minimize a loss.

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