

AFP[®] Annual Conference



November 7-10, 2010 | San Antonio

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Liquidity management: Best practices for a new era

Kevin Bannerton
Managing Director, Liquidity Management
DB Advisors

Devin Parker
Director, Treasury Capital Markets
Western Union

Effective liquidity management in a new era

Defining objectives and risk within the new market reality

- Questions all investors should be asking
- Implications of the new market reality
- Disclosure and transparency remain critical

Investor case study in transparency: Western Union

- Identifying liquidity characteristics
- Investment risk
- Investment transparency

Investment manager perspective: DB Advisors

- Transparency in the investment process
- Monitoring tools
- Anticipating event risk

Questions all liquidity managers should be asking

- Should I change my strategy or objectives in the post-crisis environment?
- Do I have sufficient transparency into portfolio holdings and characteristics?
- Do I need a dedicated, in-house credit research team?
- Could an external manager add value to our liquidity management function?

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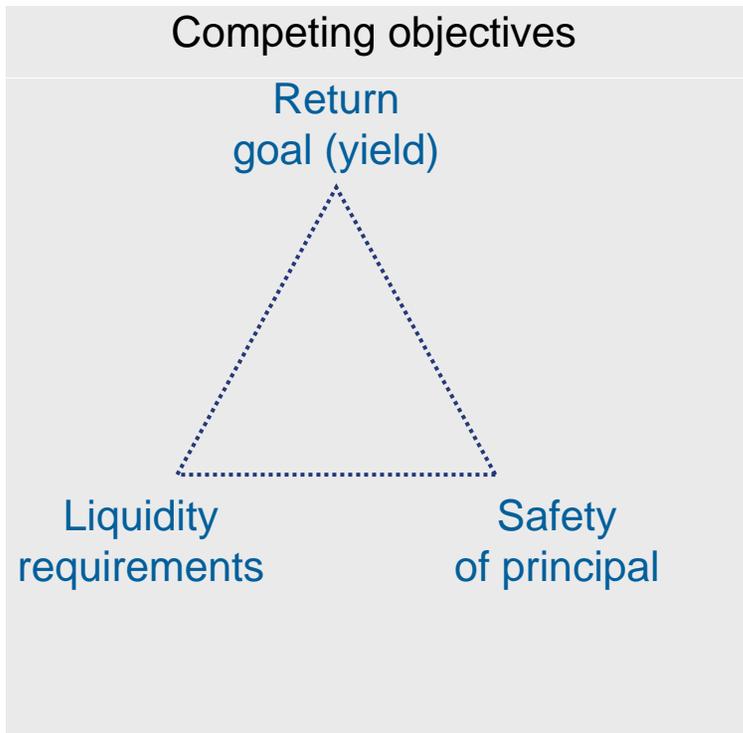
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Defining objectives and risk in the new era

Same objectives in a new market environment

Safety of principal, liquidity and yield remain the primary objectives . . .



. . . however, preferences may have shifted:

- **New era implications:** Investors must consider how objectives fit within a new market reality
- **Risk tolerance:** Investors must re-evaluate their organization's risk tolerance
- **Priority:** For some, prioritization among the three objectives may have changed

Key issue: Performance in periods of market stress

Will my objectives be met throughout changing market conditions – i.e., in periods of stress as well as stable environments?

Relative safety

- Credit migration
- Counterparty risk
- Price
- Principal preservation
- Diversification
- Strength of sponsor & advisor

Liquidity

- Access to investments
- Market effect on liquidity
- Investment structure
- External factors
- Operational risks

Yield

- Appropriate risk premium
- Return vs. “risk free” rate
- “Total return” vs. “Yield”

Disclosure is better, but challenges remain

- Inconsistent data: “Apples / oranges”
- Frequency is often insufficient
- Confusing terminology
- Limited depth
- Data format is static: PDF
- No industry standard
- Requires consolidation and analysis



Do investors need fully trained credit analysts?

Challenges:

- Few treasury organizations have dedicated in-house credit research teams
- Unrealistic for treasury staff to analyze detailed issuer-level fund holdings
- The range of risk factors is extensive – and growing

Solution: Establish policy and implementation plan

Determine risk tolerance – for all types of risk

- Direct investment in Treasuries avoids credit risk but entails interest rate risk

Define eligible investment universe

- Determine whether to invest in direct instruments, money market funds or separately managed accounts
- Cost/benefit and risk/return analysis

Approach: Outsource or manage internally – or both

- Investments may be managed in-house or they may be outsourced
- How can an outside investment advisor add value?
 - Operational efficiency
 - Manage investment risk; deliver higher total returns
 - Strategy diversification
 - Research, an extension of treasury resources

Post implementation: Ongoing evaluation of risk

Portfolio risks

- Interest rate duration
- Credit duration
- Credit quality
- Liquidity

Concentration risks

Shareholder composition

- Concentration of shareholders
- Direct vs. indirect investors

AUM size and volatility

- AUM held by sponsor/advisor
- Volatility of AUM

Organizational risks

Sponsor stability

- Financial strength of sponsor
- Bank-affiliated or independent

Advisor track record

- Track record of investment team
- Track record of credit research team

Regardless of process, transparency is essential

Transparency: Providing investors with sufficient disclosure regarding investment alternatives so that they can make more informed decisions”

Benefits of greater transparency:

- Provides tools to better understand the components of risk
- Demonstrates ongoing surveillance with various stakeholders
- Increases confidence in investment manager and fund selection
- Facilitates “apples to apples” comparisons
- Delivers information in usable formats: Ability to download, sort and print
- Alleviates confusion: Explain what information provided in holdings reports
- Improves timeliness of reports

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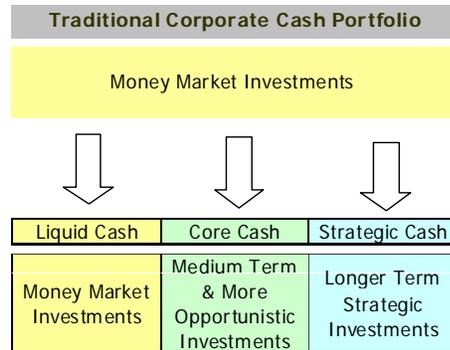


Investor case study in transparency: Western Union

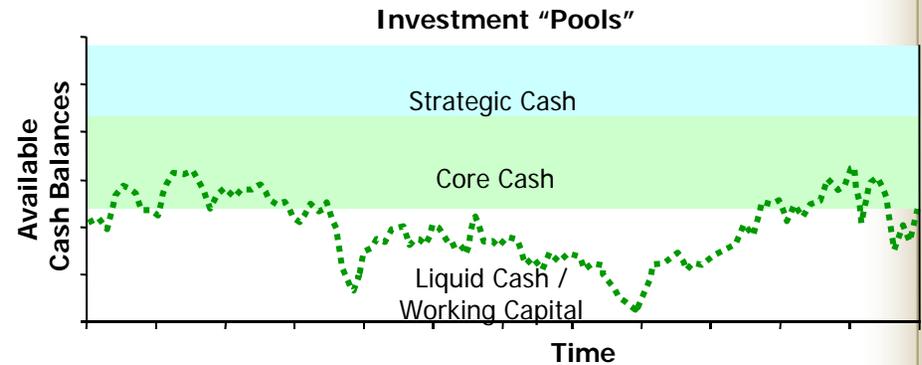
Identifying liquidity characteristics

Cash flow patterns and investment horizon

Many companies rely solely on money market investments despite the fact that immediate liquidity needs are only a portion of cash balances



Consider creating two to three distinct "pools" of cash to improve returns while meeting liquidity needs



Sample Investment Pool Characteristics

	Liquid Cash	Core Cash	Strategic Cash
Investment horizon	0 to 6 months	6 months or longer	1 year +
Typical portfolio duration	60 Days	6 months to 1 Year	2 Years
Cash Flow Volatility	High	Low	Very Low
Objective	Preservation of capital and immediate liquidity	Enhanced returns with minimal principal risk	Risk constrained total return
Strategy	Money Market type investments	Curve and Credit primarily beta exposure	Curve and credit exposure + manager skill / alpha exposure
Return Expectation	Low	Improved	Highest

Consider incorporating "best practices" for investment management – matching liquidity considerations, investment horizons, and risk tolerances

Investment considerations & approach

1. Identify Liquidity Characteristics



2. Formulate Investment Objectives and Establish Guidelines



3. Construct Optimal Portfolio Allocation



4. Actively Manage Portfolios / Managers

- Liquidity needs
- Investment Horizon – Acquisition plans, capital spending
- Cash Flow Considerations – frequency/magnitude of position changes
- Risk / Return Objectives and Tolerance
- Benchmark Selection
- Guideline Parameters
- Accounting and Tax Considerations
- Manager Selection
- Seek to:
 - Maximize Returns given risk tolerance
 - Diversify Risks
 - Hedge Unwanted Risk
- Sector Allocation
- Security Selection
- Yield Curve Structure
- Daily Risk Management

Developing a successful investment strategy requires thoughtful consideration of cash flow planning, investment objectives and risk tolerances

Investment risk

Risk tolerance considerations

- Tradeoffs of yield versus volatility
- Potential for negative returns
- Effect of interest rate moves

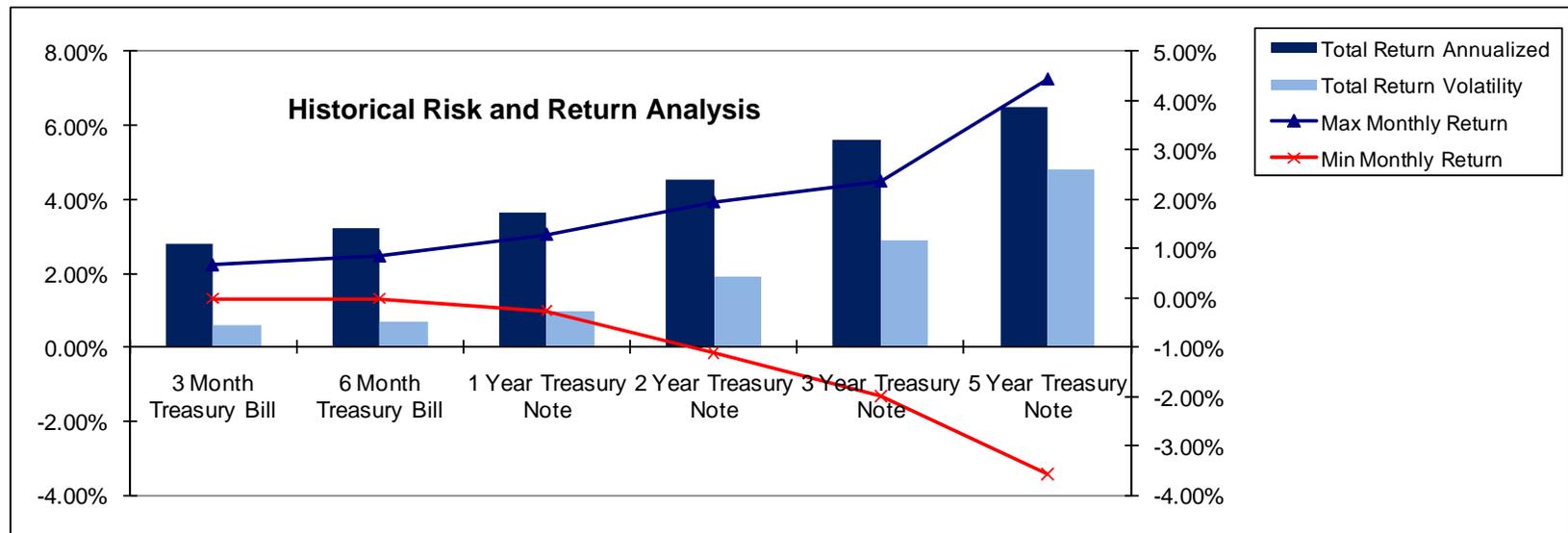
Descriptions of certain investment risks

- **Interest Rate Risk** - the risk that an investment's value will change due to changes in the absolute level of interest rates or the shape of the yield curve; risk rises with increasing duration.
- **Credit Risk** - adverse changes of a security's value from actual or perceived deterioration in credit quality. Types of risks factors evaluated under credit risk include: profitability, leverage, quality of assets, capital, liquidity, corporate governance, legal risk, and event risk.
- **Liquidity Risk** – risk that a security may not have a ready and deep market into which it may be sold without a substantial discount to price.

Pursuing incremental yield requires a willingness to assume measured risks

Target duration of 6 months limits interest rate risk

	Total Return Annualized	Total Return Volatility	Max Monthly Return	Min Monthly Return	% of Max Return	% of Max Volatility
3 Month Treasury Bill	2.80%	0.60%	0.66%	-0.01%	43%	12%
6 Month Treasury Bill	3.20%	0.67%	0.84%	-0.01%	49%	14%
1 Year Treasury Note	3.63%	0.97%	1.28%	-0.26%	56%	20%
2 Year Treasury Note	4.53%	1.91%	1.94%	-1.12%	70%	40%
3 Year Treasury Note	5.59%	2.88%	2.36%	-2.00%	86%	60%
5 Year Treasury Note	6.51%	4.82%	4.43%	-3.58%	100%	100%

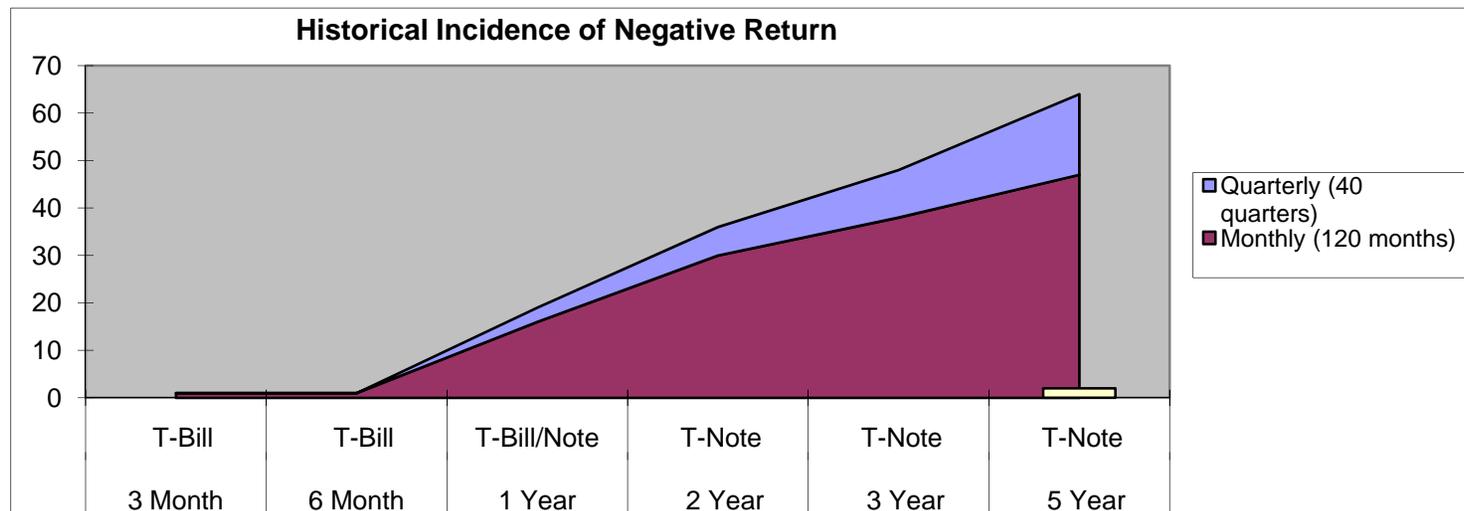


Source: Bloomberg / Bank of America ML indices 12/31/1999 - 08/31/2010

Lowest incidence of loss with 3-6 month duration

- At the 3-month and 6-month average duration target, there has been only one monthly period of negative return over the past 10+ years
- At 12-month and longer, there is a notable increase in the frequency of monthly and quarterly negative returns

Number of Periods	3 Month T-Bill	6 Month T-Bill	1 Year T-Bill/Note	2 Year T-Note	3 Year T-Note	5 Year T-Note
Monthly (120 months)	1	1	16	30	38	47
Quarterly (40 quarters)	0	0	3	6	10	17
Annually (10 years)	0	0	0	0	0	2



Source: Bloomberg / Bank of America ML indices 12/31/1999 - 08/31/2010

Transparency: Stakeholder communication

Treasury departments must communicate with a broad range of stakeholders about their investment portfolios:

Treasurer / CFO

Frequent reporting on risk

Business Units

Partner on planning and pricing

Financial Planning and Analysis

Forecasting process

Investment Counsel

Cross functional organizational communication

Board of Directors

Agreement on policy, periodic updates on risks

Shareholders

SEC disclosures

Regulators

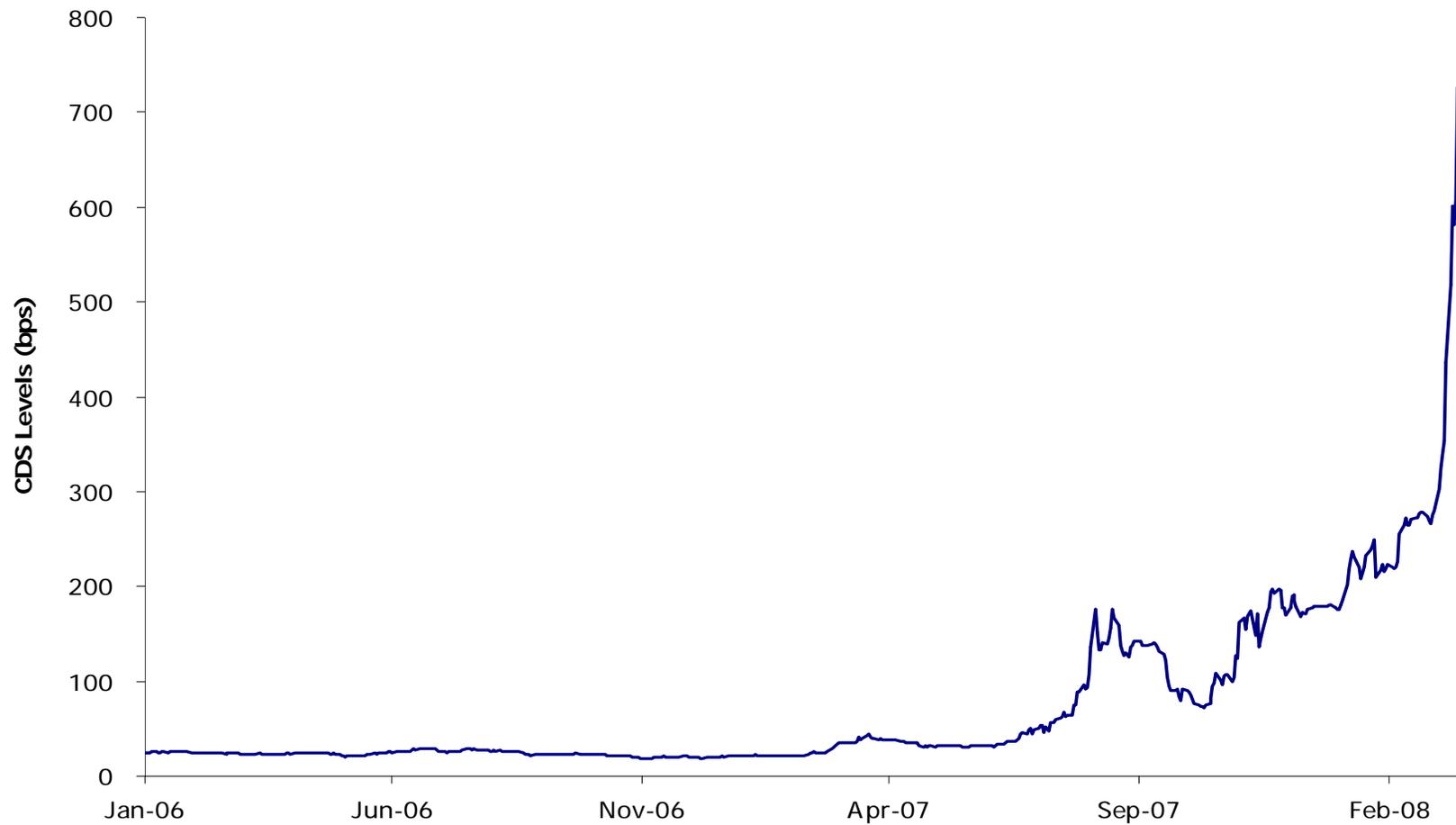
Periodic examinations and reporting

Need for increased transparency

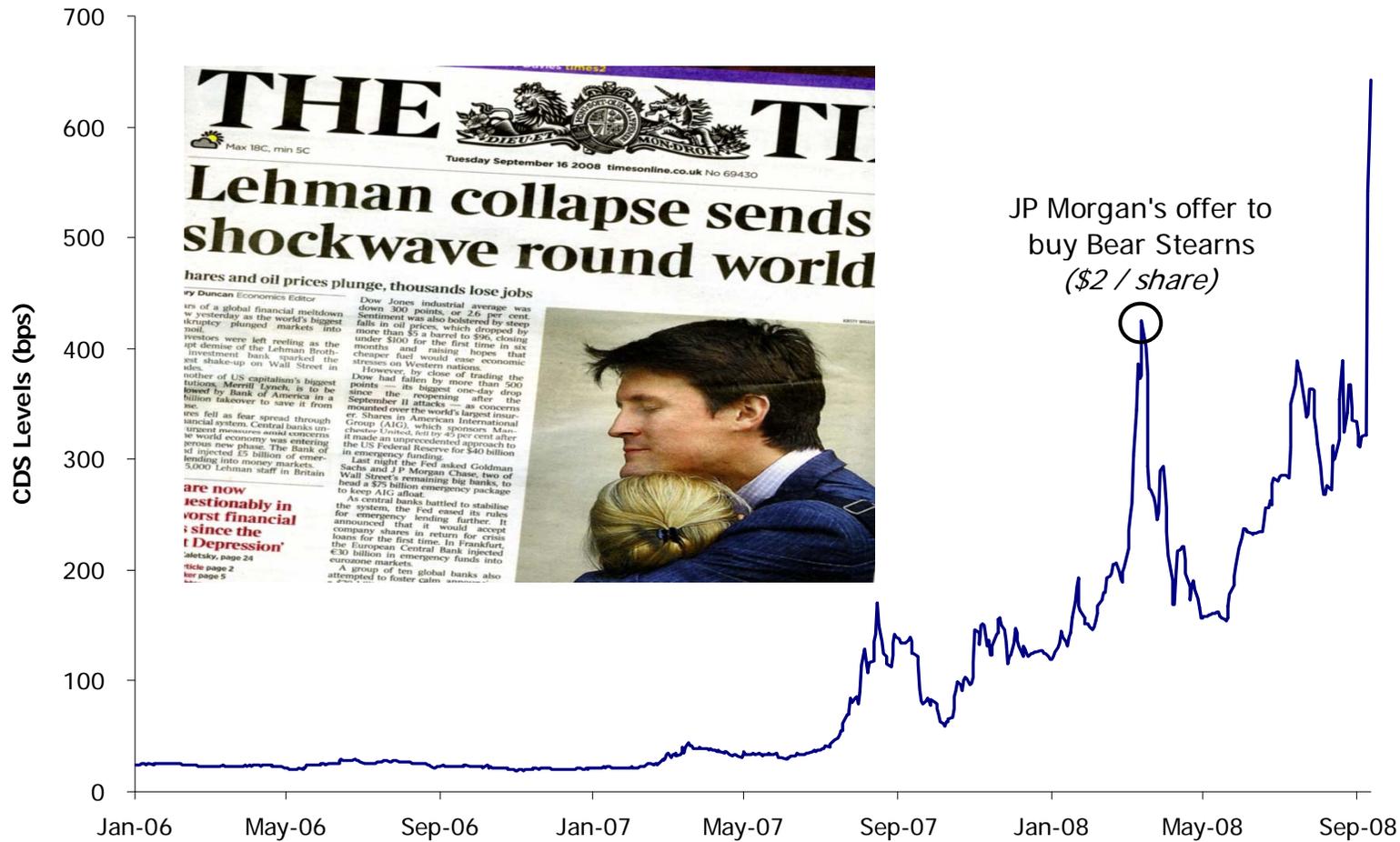
Market volatility drove desire for further transparency into money market funds

- Financials were at the epicenter of the recent financial crisis
- These issuers represent a significant majority of the prime fund investment universe
- Certain of these issuers came under significant pressure in the financial crisis
- During these times of high volatility, market based measures were indicative of potential issues to come
 - Including CDS and to some extent stock price

Market volatility: Bear Stearns CDS levels



Market volatility: Lehman CDS levels



Developing transparency: Money market funds

Holding reports, provided by fund companies, were helpful by providing a detailed list of securities

- However, these reports did not show aggregate exposures
 - Concentration by issuer
 - Concentration by investment type (i.e., CP, ABCP, Repo)
- More critically needed was a way to measure market sentiment of the risk in underlying issuers
 - Market data was available – built an interface using Bloomberg

Sample template: Fund / Management company

FUND - X

\$ in Millions (unless otherwise indicated)

Profile Updated:

29-Sep

Fund Profile

Current Fund Size	\$75,000
Fund Rating	AAA/Aaa
WAM - days	55
Liquidity: Overnight Maturities	10%
Liquidity: One week Maturities	15%
Liquidity: One Month Maturities	55%
Reporting Frequency	Monthly
Reporting Lag	+ ~1 week
WU \$100MM Cap Investment as % of Fund	0.1%

Change

3 Day	Last Summary
-1.4%	-3.5%
No Change	No Change
4	na

Management Company

Market Capitalization	\$20,000
CDS	na
5% of Fund expressed as % of Mkt Cap	10.0%
Assets Under Management	\$500,000
Ratings S&P	A+ STABLE
Ratings Moody's	A1 STABLE

Change

52 Week High / % off High	52 Week Low / % off Low
\$30,000 33%	\$12,000 67%
na na	na na

Sector Allocation

	% Fund
ABCP	15%
CP	5%
CDs / Time Deposits	45%
FRNs / Munis	10%
Treasury	0%
Agency	20%
Repo	5%
	100%

75% Contains Credit

Repo/Counterparty Arrangements

Counterparty	% Fund	Collateral
Bank X	1.0%	102% Treasury & Agency / Tri-Party
Bank Y	0.5%	102% Treasury & Agency / Tri-Party

Sample template: Underlying holdings

Top Holdings (excluding Repo) as of - Jun-09

Holding	ABCP Sponsor	% of Fund	Credit Ratings & Watch*			
			Moody's		S&P	
BANK X		5.1%	Aa2	STABLE	A+	STABLE
BANK Y		5.0%	Aa2	NEG	A+	STABLE
BANK Z		4.9%	Aa1	NEG	AA	NEG
CORP 1		4.7%	Aa2	NEG	AA	NEG
CORP 2		4.4%	A1	STABLE	A	STABLE
CORP 3		4.4%	A1	STABLE	A	STABLE

↓ (top holdings)

Top Holdings (excluding Repo) as of - Jun-09

Holding	5-Yr CDS	Change in CDS			Change in Stock Price			
		1 Week	% off 52 Week High	% off 52 Week Low	Current	1 Week	% off 52 Week High	% off 52 Week Low
BANK X	95	-5	-74%	7%	\$20.00	0%	-20%	134%
BANK Y	80	-2	-50%	40%	\$55.00	7%	-19%	209%
BANK Z	55	0	-63%	46%	\$60.00	4%	-21%	180%
CORP 1	80	4	-57%	45%	\$15.00	1%	-4%	177%
CORP 2	105	-2	-54%	72%	\$105.00	-3%	-52%	326%
CORP 3	110	-3	-65%	37%	\$52.00	-3%	-74%	420%

↓ (top holdings)

Additionally, a security watch-list was kept against which fund holdings were checked

Transparency process

- Process provided the needed information; however, it was manual and time intensive taking ~1 hour to format for every fund
 - Fact gathering process vs. value added analysis
- Partnered with money fund portal provider, ICD to help automate and enhance the process
- Benefits of enhanced “Transparency Plus” tool include:
 - Significantly reduced time preparing transparency reports
 - Increased transparency – addition of fund aggregation
 - Ability to see aggregate exposures across funds
 - Ability to search for certain exposures
 - Ability to run scenario analysis

Transparency plus reports

Holdings

July 28, 2010 | Welcome

TRANSPARENCYPLUS BETA

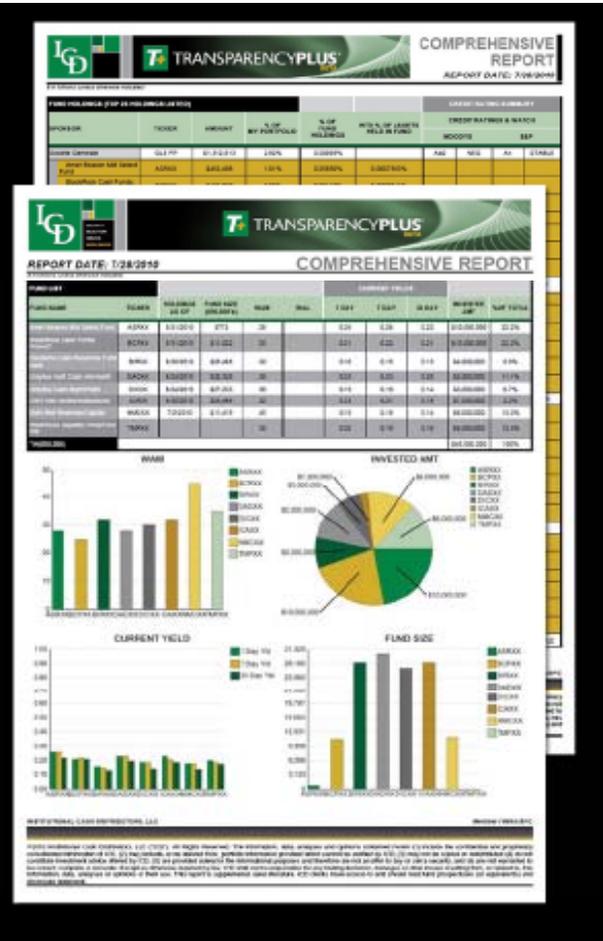
SEARCH: USER PREFERENCES TUTORIALS LOG-OUT

HOLDINGS

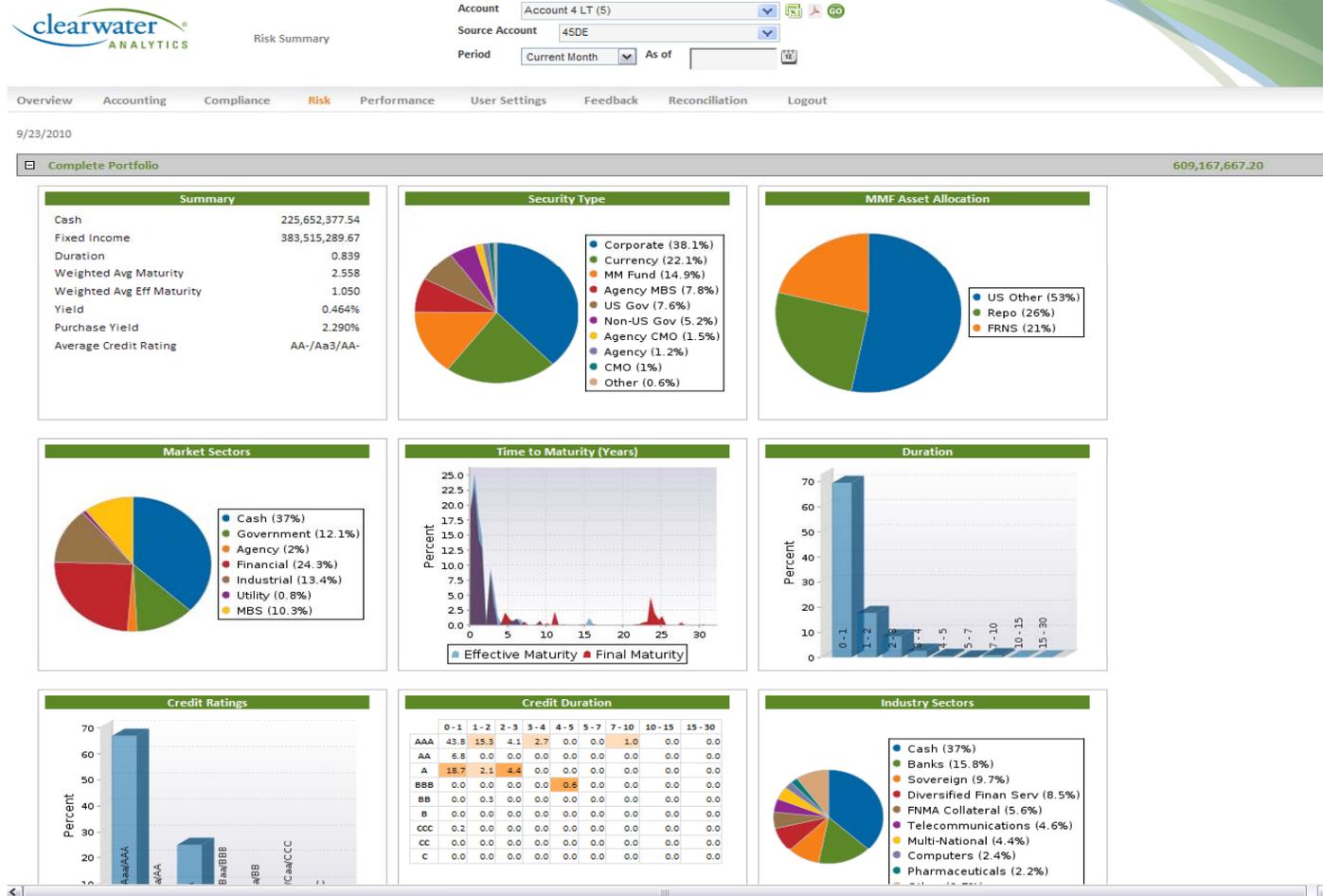
GROUP SELECT	VIEW	AMOUNT	FUND NAME	FUND CATEGORY	ML RTR	1 DAY YIELD	7 DAY YIELD	30 DAY YIELD	ALM	WAM	FUND COMPANY	PARENT
		\$10,000,000	Ameri-Bond MM Bond Fund (ABNDX)	Prime AAA Funds	0.00007124	0.20	0.20	0.20	785.7	28	American Bond Money Market Bond Fund	Prudential Capital Group LLC
		\$10,000,000	BlackRock Cash Funds: PrimeC (BCPKX)	Prime AAA Funds	0.00000000	0.21	0.21	0.21	14,320.0	29	BlackRock Cash Funds - Prime	BlackRock Inc
		\$5,000,000	BlackRock Liquidity TempFund Inst (TLMIX)	Prime AAA Funds	0.00000000	0.20	0.19	0.19	58,755.7	31	BlackRock Liquidity Funds TempFund Portfolio	BlackRock Inc
		\$5,000,000	BofA-MHFI Reserve/Capital (BMCKX)	Prime AAA Funds	0.00004005	0.18	0.18	0.18	11,174.8	40	AAA Funds Series Trust BofA Money Market Reserve	Bank of America Corp
		\$4,000,000	Deutsche Cash Reserves Fund Inst (DCRUX)	Prime AAA Funds	0.00000477	0.18	0.18	0.18	28,084.7	33	DWS Cash Reserves Fund	Deutsche Bank AG
		\$3,000,000	Dreyfus Cash MgmtInst (DCDC)	Prime AAA Funds	0.00000539	0.18	0.18	0.18	27,335.0	36	Dreyfus Cash Management	Bank of New York Mellon Corp/The
		\$3,000,000	Dreyfus Inst Cash AdvInst (DCAIX)	Prime AAA Funds	0.00000077	0.23	0.23	0.23	30,230.0	28	Dreyfus Cash Advantage Fund	Bank of New York Mellon Corp/The
		\$1,000,000	DWS MM SeriesInstInstal (DCAIX)	Prime AAA Funds	0.00000180	0.20	0.21	0.21	28,084.7	33	DWS Money Market Series	Deutsche Bank AG
		0.0	Evergreen Prime Cash MgmtInst (EPCMX)	Prime AAA Funds	0.00000072	0.18	0.18	0.18	2,724.4	17	Evergreen Prime Cash Management Money Market Fund	Wells Fargo & Co
		0.0	Federated Prime Cash ObligInst (FCOIX)	Prime AAA Funds	0.00000443	0.24	0.24	0.24	19,326.0	38	Federated Prime Cash Obligations Fund	Federated Investors Inc
		0.0	Federated Prime Oblig FundInst (FOIX)	Prime AAA Funds	0.00000706	0.24	0.23	0.23	43,660.2	37	Federated Prime Obligations Fund	Federated Investors Inc
		0.0	Fidelity Inst Prime MMTF (FIDAX)	Prime AAA Funds	0.00000007	0.24	0.23	0.23	64,580.1	34	Fidelity Institutional Money Market Fund - Prime Money Market Portfolio	FMR LLC
		0.0	First Amer Prime Oblig 2 (FADZ)	Prime AAA Funds	0.00000171	0.12	0.11	0.10	19,380.0	46	First American Prime Obligations Fund	US Bancorp
		0.0	Goldman Sachs PE MMTF Inst (GPMDC)	Prime AAA Funds	0.00000001	0.20	0.20	0.21	14,810.4	26	Goldman Sachs Financial Squared Fund - Money Market Fund	Goldman Sachs Group Inc/The
		0.0	Goldman Sachs Fx Prime ObligInst (FXDC)	Prime AAA Funds	0.00000036	0.17	0.16	0.16	29,262.2	33	Goldman Sachs Financial Squared Fund - Fx Obligations Fund	Goldman Sachs Group Inc/The
		0.0	Invesco Liquid Assets PostCapital (ALITCP)	Prime AAA Funds	0.00000001	0.20	0.19	0.19	20,813.2	41	IM LIT - Liquid Assets Portfolio	Invesco Ltd
		0.0	Invesco STIC Prime PostCapital (STTPCP)	Prime AAA Funds	0.00000001	0.18	0.18	0.18	3,117.7	17	IM STIC STIC Prime Portfolio	Invesco Ltd
		0.0	JPMorgan Prime MMTF Capital (JPMDC)	Prime AAA Funds	0.00000000	0.19	0.19	0.19	128,523.4	36	JPMorgan Prime Money Market Fund	JPMorgan Chase & Co
		0.0	Morgan Stanley Int LigPostInst (MPOIX)	Prime AAA Funds	0.00000000	0.18	0.20	0.21	14,585.0	18	Morgan Stanley Institutional Liquidity Funds - Prime Portfolio	Morgan Stanley
		0.0	Northern Inst Divd AssnInstal (NIDAI)	Prime AAA Funds	0.00000000	0.00	0.00	0.00	8,910.0	38	Northern Institutional Squared Fund Assn Portfolio	Northern Trust Corp

VIEW SELECTED

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Additional transparency tools: Separate accounts



More transparency tools: Aggregating exposures

- Treasury department has developed additional reporting to aggregate into one report global exposures to banks across a variety of activities including:
 - Foreign Exchange Trading
 - Interest Rate Derivatives
 - Bank Deposits
 - Money Funds
 - Separate Account Portfolios
- Detail includes financial information on exposures including:
 - Credit default swap levels
 - Financial information such as core capital ratios
 - Credit Ratings and outlooks
- Reporting is updated weekly and linked to real time market data

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Investment manager perspective: DB Advisors

Information: Selectivity trumps quantity

“What information consumes is rather obvious: it consumes the attention of its recipients. Hence a wealth of information creates a poverty of attention, and a need to allocate that attention efficiently among the overabundance of information sources that might consume it.”

– Herbert A. Simon Ph.D.

Nobel Memorial Prize in Economic Sciences in 1978

Credit analysis: Focused on capital preservation

- Credit analysts tailor research to the specific type of issuer using an anticipatory, fundamental approach.

Primary focus:

Preserve capital by avoiding potential credit downgrade

- Counterparty credit team seeks to ensure DeAM trades only with top tier, credit-worthy counterparties

Analytical framework by issuer type		
Corporate credit	Bank credit	Asset backed
<ul style="list-style-type: none"> – Business position and strategy – Financial analysis – Liquidity analysis – Market related input <ul style="list-style-type: none"> – CDS spreads – Equity price estimates 	<ul style="list-style-type: none"> – Business position and strategy – Liquidity and funding – Asset quality – Profitability – Capital adequacy – Market related input <ul style="list-style-type: none"> – CDS spreads – Equity price estimates 	<ul style="list-style-type: none"> – Quality of sponsor and strength of management – Program legal structure – Collateral types, credit quality – Credit enhancement – Liquidity support – Event risk

Analytical framework for counterparty credit		
<ul style="list-style-type: none"> – Capital adequacy – Management 	<ul style="list-style-type: none"> – Asset quality – Earnings 	<ul style="list-style-type: none"> – Liquidity – Systemic vulnerability

Integrated process with multiple sources of input

Fundamental credit analysis and monitoring

I. Monitor short-term markets for eligible credits

Subject to:

- Investment policy limitations
- Global Credit Control limits

II. Determine suitability for portfolio, considering policy limitations

III. Include credit in portfolio

IV. Manage credit per Global Credit Control criteria

Macroeconomic analysis

– 1-year Treasury bill

– 2-year Treasury note

– 3-month LIBOR

– TED spread

– Barclays 1-3 Yr Credit OAS

– 10-year US Treasury

For illustrative purposes only.

Risk management: Interest rate surveillance

Welcome to the Attribute Management Tool

10/6/2010 10:40:37 AM

Signal drivers

Forecast

US 10yr Interest Rate

[add to watchlist]

Current Views

Short-Term View			
View	Current	Entry	P/L Review Levels
-	-	-	-

Long-Term View			
View	Current	Entry	P/L Review Levels
-	-	-	-

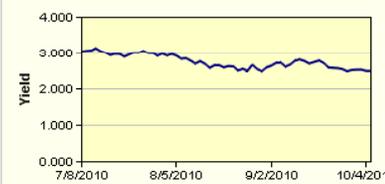
Instrument Details

Ticker: USGG10YR Index
 Description: US Generic Govt 10 Year Yield
 Category: Rates > Interest Rate
 Feed: Bloomberg
 Maturity: 10yr
 Quote Range: 1/2/1990 - 10/5/2010

View Owners

Short-Term:
 Long-Term:

3-Month Px History



Research (Drivers | Newsflow | Attributes | Blueprints)

Add Driver

Active Drivers						
Driver	Proxy	Updated	Forecast	Stats	History	Edit
Economic Growth (US)	GDP US Chained 2005 Dollars QoQ SAAR Subproxy: Chicago Fed National Activity Index Subproxy: Conference Board US Leading Index MoM Subproxy: ECRI Weekly Leading Index Growth Rate Subproxy: ISM Manufacturing PMI SA Subproxy: US Capacity Utilization % of Total Capacity SA Comments: The economic data has recently weakened.	7/13/2010	D	View	View	Edit
Fiscal Policy (US)	US Treasury Federal Budget Deficit Or Surplus as a % of Nominal GDP Comments: Treasury issuance is stabilizing.	7/13/2010	N	View	View	Edit
Inflation (US)	US CPI Urban Consumers Less Food & Energy MoM SA Subproxy: Commodity Research Bureau/Reuters US Spot Raw Industrials Subproxy: Federal Reserve Money Supply M2 MoM % Change Annualized Subproxy: ISM Manufacturing Report on Business Prices Index NSA Subproxy: US Import Price Index by End Use All YoY NSA Subproxy: US Real Average Weekly Earnings Current USD MoM SA Comments: High unemployment, excess capacity and global competition will continue to exert downward pressure on inflation.	7/13/2010	D	View	View	Edit
Market Risk Tolerance and Liquidity (US)	Bloomberg United States Financial Conditions Index Subproxy: CBOE SPX VOLATILITY INDX Subproxy: Deutsche Bank FX Volatility Index Subproxy: TED Spread Comments: The European debt crisis has increased risk aversion.	7/13/2010	D	View	View	Edit
Monetary Policy (US)	Federal Funds Target Rate US Subproxy: Commodity Research Bureau/Reuters US Spot Raw Industrials Subproxy: US CPI Urban Consumers Less Food & Energy MoM SA Subproxy: US Employees on Nonfarm Payrolls Total MoM Net Change SA Comments: Fed on hold for foreseeable futures.	7/13/2010	N	View	View	Edit
Valuation (US)	Market Matrix US Sell 3 Month & Buy 10 Year Bond Yield Spread Subproxy: Federal Funds Target Rate US Subproxy: Reuters/Jefferies CRB IX Subproxy: US Breakeven 10 Year Comments: The yield curve will remain steep until market prices in Fed tightening.	7/13/2010	N	View	View	Edit

Risk management: Credit surveillance

- Key market signals for approved issuers are monitored daily

Default probability indicators
Various swap spreads to assess perceived credit risk
Equity prices

IVG US - 21.04.2008														
Issuer	Bond	BDP Score	BDP Change	BDP Rat. adjusted	Rating Indicator	ASW 1 day Change	ASW 5 day Change	OAS 5 day Change	Abs. OAS Sp. Level	CDS 1 day Change	CDS 5 day Change	Abs. CDS Sp. Level	Equity change vs index 1 day	Equity change vs index 5 day
American Internat..	5.050001102015USD	■	■	■	■	■	■	■		■	■	169.89	■	■
Amgen Inc	5.850001062017USD	■	■	■	■	■	■	■	170.64	■	■	82.01	■	■
Anadarko Petroleu...	5.8500015062016USD	■	■	■	■	■	■	■	223.55	■	■	66.43	■	■
Anheuser-Busch Co..	5.500015012018USD	■	■	■	160.38	■	■	48.45	■	■				
Apache Corp	4.375015052015USD	■	■	■	168.60	■	■	56.50	■	■				
Archer-Daniels-Mi...	8.375015042017USD	■	■	■	■	■	■	■	182.01	■	■		■	■
Archstone-Smith O...	7.900015022016USD	■	■	■		■	■		■	■				

- Maturity limits are continually refreshed to reflect current views on credits

GCC Main | Definitions | Exposure | [UPC/Issuer Overview](#) | Reports | Task

You are here: | GCC | UPC/Issuer Overview | [Track Record](#)

Company/Issuer	Up to 397 days (exposure)	Up to 397 days (limit)	Up to 2 years (exposure)	Up to 2 years (limit)
	6.7	11.0	0.0	0.0
	4.9	11.0	0.0	0.0
-- SEN_UNSEC	4.9	11.0	0.0	0.0

Manage process risk throughout trading platform

Process risk management

Oversight

Pre-trade screening

- Front end compliance ensures adherence to guidelines *before* trades are executed
- Enforcement of GCC credit limits and maturity caps

Post-trade review

- Daily review of target allocations
- Continual monitoring of credit recommendations
- Monthly review of performance by investment team
- Annual review by Investment Committee

Sell discipline

- Quantitative
Minimal tolerance for downside credit migration
- Qualitative
Continual assessment of issuers' management and business environment
- Investment thesis has changed

Firm risk management

- Systemic controls
- Internal audit
- Compliance¹
- Legal
- Manage counterparty risks under oversight of credit officer
- Market risk review

SAS 70 Type II Audit

Unqualified opinion by Ernst & Young of the effectiveness of DB Advisors' operating controls²

¹DB Advisors is "walled off" from the Corporate & Investment Bank (CIB) by internal compliance. DB Advisors enters into transactions with CIB only where deemed to be in the best interest of its advisory clients. Specific procedures and controls are in place to ensure that all trades with CIB are conducted on market terms.

²Source: DB Advisors

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Extra-financial risks cannot be ignored

US financial industry will be changed by reform

End of “too-big-to-fail”

- New capital requirements to limit the size of banks
- Increased bank regulatory powers to unwind large, systemically significant firms

Modified Volcker rule

- Ban on proprietary trading
- Bank investments in hedge funds and private equity funds restricted to 3% of Tier-1 capital / 3% of fund’s overall capital

Derivatives

- Banks allowed to trade interest rate and FX swaps
- CDS and commodities OTC derivatives will be moved to affiliated holding companies

Systemic risk regulator

- Financial Stability Oversight Council, led by Treasury to monitor systemic risk

Consumer Financial Protection Bureau

- Authority within Fed has jurisdiction over banks and credit unions having assets greater than \$10 billion

Securitization

- 5% risk retention requirements (vertical slice and not a first loss piece)
- Credit rating agencies largely unaffected

Registration requirements

- New registration requirements for hedge funds and private equity funds with assets greater than \$150 million

Federal Reserve

- Retains supervisory responsibilities of banks; will have to disclose banks who used discount window (two-year lag)

Source: Deutsche Bank Global Markets Research

Corporates also face uncertainties requiring analysis

Evaluating risk comprehensively:

- Incorporating “extra-financial” criteria as part of standard analysis
- ESG: Environmental, Social, Governance or ethical issues in addition to financial analysis
- Corporates will increasingly be judged on these issues
- Example: Significant headline or event risk

Four dimensions of an investment



Timeline of events: BP as an example



Were there early signals of a problem?

ESG research database¹ flagged employee safety risks

- Prior to the spill, BP had an overall “CCC” rating on a scale of AAA-C, with “AAA” being the best ranking
- This score is determined by a weighted evaluation of over 200 separate ESG data indicators
- Perhaps the most relevant metric is BP’s Employee Safety rating: “C,” the lowest possible, even before the recent disaster

BP removed from Global Sustainability Index (GSI)² in Nov 2007

- The GSI removal was motivated by several factors including the poor employee safety performance noted above

BP removed from Global Climate 100 (GC100)² in Mar 2008

- For the GC100, the deciding factor was the firm’s decision to lessen its commitment to solar energy while increasing its investment in oil sands

¹ Global Socrates is a comprehensive ESG research database of more than 4000 companies worldwide.

² RiskMetrics maintains a detailed historical record of the ESG practices of thousands of companies worldwide

Strategies for incorporating ESG analysis

- **Positive / negative screening**
Selection on the basis of environmental and social criteria
- **Best in class**
Companies that show the best relative environmental and social performance
- **Engagement**
Concept of shareholder activism
- **Integration**
ESG criteria are explicitly integrated in the investment analysis and decision making process; the PRI initiative encourages integration

Key takeaways

- **Liquidity managers' objectives remain the same**, but their prioritization may have shifted
- **The critical question:** “Will the objectives be met throughout changing market environments?”
- **Transparency and standardization still need to be improved;** selectivity of data is more important than quantity
- **An outside investment advisor can add value** by providing greater transparency, operational efficiency and risk management
- **Going forward, “extra-financial” risks must be considered** in order to effectively balance investors' objectives of liquidity, safety and yield

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