

Crafting Investment Guidelines

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Crafting Investment Guidelines

- The dilemma facing today's corporate treasurer:
 - Balancing responsibilities beyond money management
 - Guidelines are often static:
 - Tied to corporate policies and procedures
 - Require Board approval for change
 - May not reflect current opportunity set



Crafting Investment Guidelines

- Purpose of Investment Guidelines:
 - Set boundaries, yet allow for growth and market change
 - Establish limits consistent with your company's risk tolerances
 - Provide appropriate benchmarks for performance
- Goals for today:
 - Outline benefits of comprehensive and adaptable guidelines
 - Discuss appropriate avenues for corporate cash by varying investment guidelines
 - Identify critical issues in writing your investment guidelines

In Focus: Important Issues

- Varying guidelines
 - May differ across organization and investment managers
- Financial statement disclosure
 - Broader set of securities and strategies drives more disclosure
- Understanding risk of opportunity set
 - Liquidity risk, interest rate risk, credit risk and structural risk
- Potential P&L volatility
 - Are you prepared for a multiple standard deviation event?
- Pre-Tax versus after-tax objectives
 - Will largely drive investment strategy
 - May change from NOL to AMT to fully taxable over time

In Focus: Important Issues

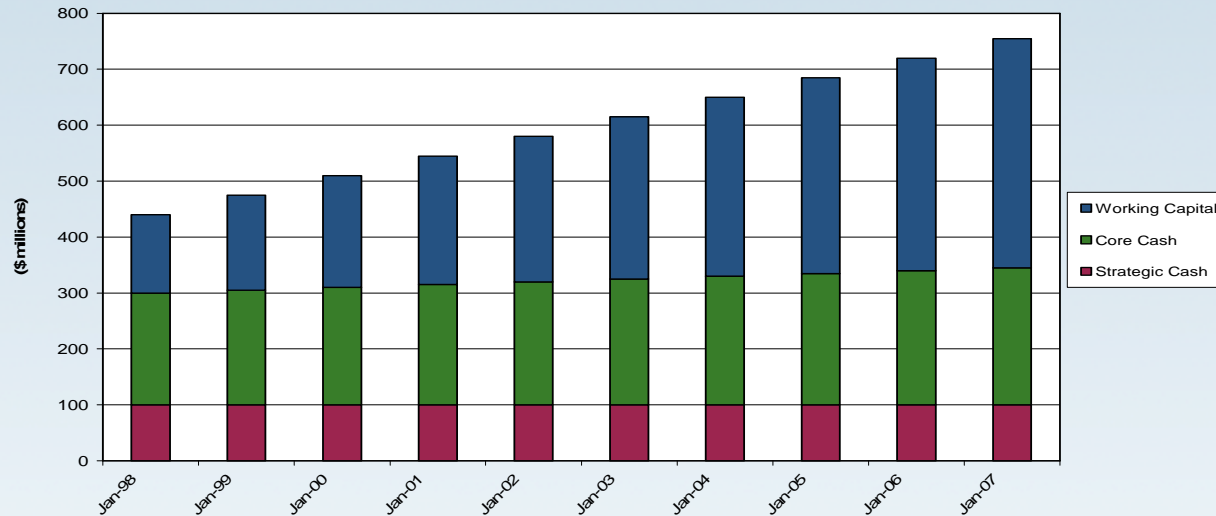
- Classifying Pools of Cash
 - Investment horizon and strategic needs
- Selecting Securities
 - Matching selection with investment goals and liquidity needs
- Identifying and Managing Risk
 - Liquidity Risk, Credit Risk, Interest Rate Risk
- Optimizing Returns in Various Environments
 - Importance of flexible guidelines
- Choosing An Appropriate Benchmark
 - Appropriately tracking performance – internally and externally
 - Achieving overall investment goals

Varying Guidelines

- Layers of liquidity
 - Closer buffers require less risk
 - Adjust both credit and interest rate risk
- Match guidelines with skill set
 - Corporate treasury given more latitude than regional finance
 - Outside investment managers further latitude
- Strong partnerships with outside managers makes this possible

Identifying Use of Cash Pools

Classifying Pools of Cash



Working Capital	Core Cash	Strategic Cash
<ul style="list-style-type: none"> Investment horizon overnight liquidity Regular access to cash <p>OR</p> <ul style="list-style-type: none"> “Sticky” cash but same-day settlement required 	<ul style="list-style-type: none"> Investment horizon 6 months+ Access to portion of cash on occasional basis Sensitivity to realized gains / losses 	<ul style="list-style-type: none"> Investment horizon 12 - 24 months+ Accessibility of cash decided according to client need upfront Focus on optimizing investment returns

Financial Statement Disclosure

- Marketable securities on balance sheet
 - Must also determine short-term or long-term classification
- Distortion to cash flow statement
 - Purchases and sales in investing section in 10Q
 - May not purchase M/S greater than capital expenditures
- Annual footnote requirements
 - Break out sectors and final maturity ranges in 10K

Representative Account Profiles

Mandate A	Mandate B	Mandate C
Index <ul style="list-style-type: none"> •Merrill Lynch 3 Month LIBOR Constant Maturity Index •Alpha target: +25 bps 	Index <ul style="list-style-type: none"> •Merrill Lynch 3 Month LIBOR Constant Maturity Index •Alpha target: +50 bps 	Index <ul style="list-style-type: none"> •Merrill Lynch 3 Month LIBOR Constant Maturity Index •Alpha target: +75 bps
Duration <ul style="list-style-type: none"> •Portfolio: maximum one half year •Security: maximum three years 	Duration <ul style="list-style-type: none"> +/-0.75 years around the duration of the Index 	Duration <ul style="list-style-type: none"> +/-0.75 years around the duration of the Index
Eligible Sectors <ul style="list-style-type: none"> •Treasuries/Agencies •Pass-throughs •Floating rate mortgages •CMOs •CMBS •ABS •Corporates •Municipals 	Eligible Sectors <ul style="list-style-type: none"> •Treasuries •Agencies •Pass-throughs •Floating rate mortgages •CMOs •CMBS •ABS •Corporates •Municipals 	Eligible Sectors <ul style="list-style-type: none"> •Treasuries •Agencies •Pass-throughs •Floating rate mortgages •CMOs •CMBS •ABS •Corporates •Municipals •Non-US denominated securities •Emerging Market Debt •High Yield •CDS
Hedging Instruments <ul style="list-style-type: none"> •None 	Hedging Instruments <ul style="list-style-type: none"> •Swaps •Options •Swaptions •Futures •MBS •Treasuries/Agencies 	Hedging Instruments <ul style="list-style-type: none"> •Swaps •Options •Swaptions •Futures •MBS •Treasuries/Agencies
Leverage <ul style="list-style-type: none"> •None 	Leverage <ul style="list-style-type: none"> •None 	Leverage <ul style="list-style-type: none"> •Maximum of 25% used as prudent
Limitations <ul style="list-style-type: none"> •Investment Grade 	Limitations <ul style="list-style-type: none"> •Investment Grade (AAA focus) 	Limitations <ul style="list-style-type: none"> •Max 5% High Yield •Unhedged foreign currency exposure limited to 5%

Potential Opportunity Set

- Money market investments
 - Lower credit risk, minimal interest rate and liquidity risk
- Fixed income investments
 - Longer tenors have increased interest rate and credit risk
 - ARS, ABS and MBS have increased liquidity and structural risk
- Active management
 - Potential for increased returns on a net alpha basis
- Extended asset classes
 - High yield and emerging market debt securities
 - May not be appropriate for intermediate corporate cash needs
 - Dependent on industry and company specific liquidity needs

Understanding Primary Risk Factors

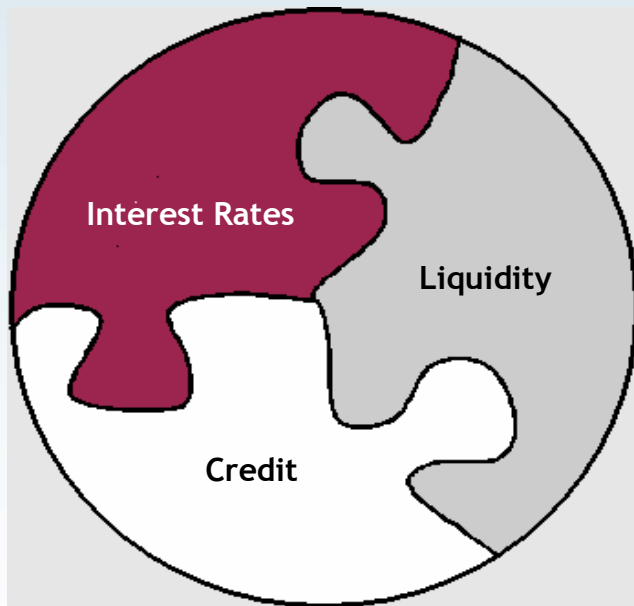
Determine Investment Objective

- Capital Preservation

“I am not so much interested in return on investment as I am in return OF investment.” -- Will Rogers

- Total Return

Strategy to seek a combination of growth and income



Duration Guidelines / Interest Rate Risk

The risk that an investment's value will change due to a change in the absolute level of interest rates, in the shape of the yield curve or any other interest rate relationship.

Credit Criteria / Exposure

Associates adverse changes of a security's value due to a ratings downgrade of the investment or in a distressed case, default of the security.

Security Selection / Liquidity Risk

Liquidity doesn't matter until it matters, then it's the only thing that matters.

Potential P&L Volatility

- Designation of marketable securities
 - Trading account (mark-to-market P&L) is most conservative
 - Available for sale (balance sheet OCI) for unrealized gains (losses)
 - Hold to maturity (no mark-to-market) difficult to support and hampers flexibility
- Impairment issues
 - May drive P&L volatility despite chosen accounting methodology
- Liquidation issues
 - Realized gains (losses) for unplanned cash needs
 - Volatile bid/ask and credit spreads may make liquidation unpalatable

The Impact of the Yield Curve

Duration Guidelines / Interest Rate Risk

Historical Risk / Return Analysis

June 30, 1997 to June 30, 2007

	Total Return Annualized	Average Monthly Return	Total Return Volatility
3 Month Treasury Bill	3.79%	0.31	0.15
6 Month Treasury Bill	3.97%	0.33	0.16
1 Year Treasury	4.19%	0.34	0.25
2 Year Treasury	4.44%	0.35	0.50
3 Year Treasury	5.24%	0.42	0.77
5 Year Treasury	5.25%	0.42	1.29
10 Year Treasury	5.35%	0.43	2.03

Optimal Portfolio Positioning

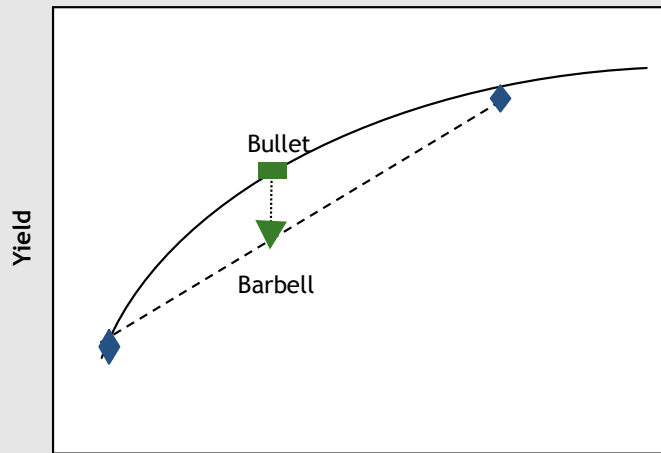
Historical Incidence of Loss

	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	10 Year T-Note
Monthly (120 months)	0	0	10	24	34	42	46
Quarterly (40 quarters)	0	0	1	4	8	15	16
Annually (10 Years)	0	0	0	0	0	1	2

Loss defined as negative total return. 2007 data is year-to-date. Volatility is computed as the standard deviation of monthly total returns. Source: Bloomberg (Merrill Lynch Indices)

The Impact of the Yield Curve

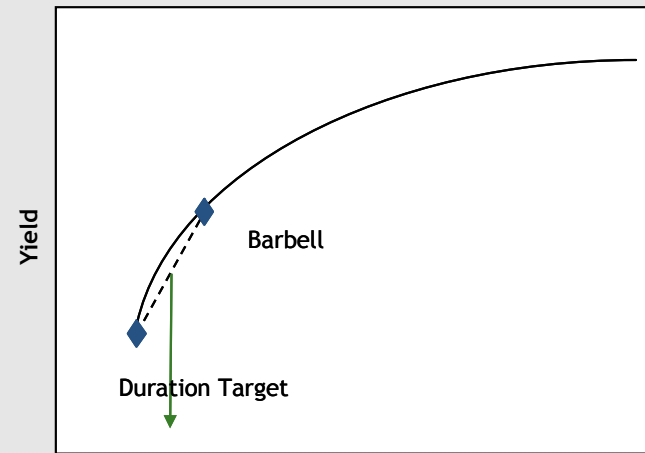
Strategic Cash



Average Portfolio Duration (Years)

- Normal yield curve presents attractive roll down opportunity.
- Emphasis on a bullet structure increases current yield.
- May change yield curve tactics to anticipate expected changes in the shape of the curve.
- Example: Move to a more barbelled position if a flattening is expected.

Tactical Positioning



Average Portfolio Duration (Years)

- Less demand for issues beyond 13 months enhances yield pick-up for issues just beyond MMF eligibility.
- Target average duration of 6-12 months; barbell strategy takes advantage of the favorable technicals.
- Shorter mandates may require a portion be more liquid in case of unexpected liquidity needs.
- Example: Strategic barbell position keeps some cash short with the remainder invested for term exposure.

The Impact of Adding Credit Exposure versus Curve Exposure

Credit Criteria / Exposure

Representative 10-Year Span (06/30/97 - 06/30/07)

STARTING POINT	Average	Annual	Std Deviation	Incidence of Loss		
	Duration	Returns	(Returns)	Monthly	Quarterly	Annually
1-3 Year US Treasury Index	1.68 years	4.61%	0.44	22	2	0

POSSIBLE ALTERNATIVES	Average	Annual	Std Deviation	Incidence of Loss		
	Duration	Returns	(Returns)	Monthly	Quarterly	Annually
1-3 Year US Agency Index	1.70 years	4.88%	0.43	19	2	0
1-3 Year A-AAA Rated US Corporate Bond Index	1.85 years	5.39%	0.45	20	2	0
1-5 Year US Treasury Index	2.72 years	4.88%	0.78	28	6	0

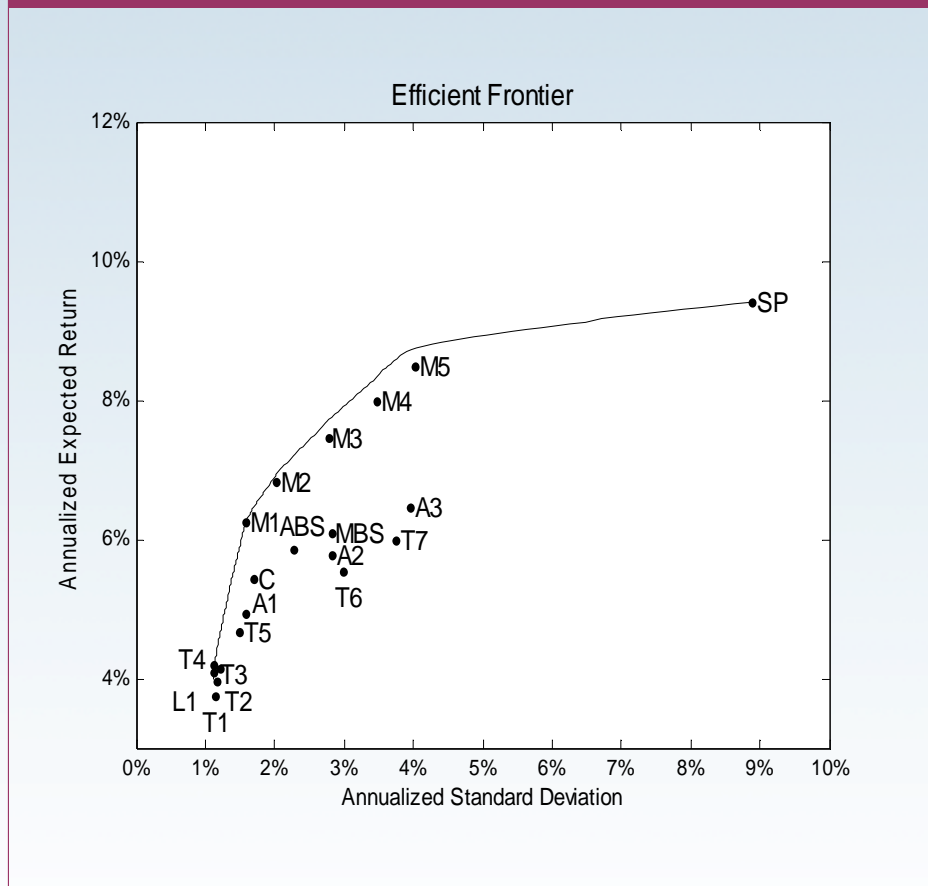
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Pre-tax or After-tax Objective

- Pre-tax
 - Advantage of simplicity
 - Appropriate for low tax jurisdiction
 - Broader opportunity set, potential for increased alpha
- After-tax
 - Compelling on a seasonal basis for money market municipals
 - Municipal and DRD securities for federal deduction
 - Federal and agency securities for state deduction
 - Need accounting and tax coordination
 - Design upfront tax designations (e.g. state deductible only)
 - Availability of tax return support
 - Recognition of benefit in tax provision

Risk/Reward Trade Offs – The Efficient Frontier

Fixed Income and S&P500 Indices' Annual TRR & Volatility



Time series from 12/31/96 to 12/31/06, marginal tax rate of 35%

Lehman
Indices/Sub-Indices

Label	Index/Sub-Index
M1	1-2 Year Muni
M2	2-4 Year Muni
M3	4-6 Year Muni
M4	6-8 Year Muni
M5	8-12 Year Muni
L1	3 Mo Swap
T1	1-3 Mo Treas
T2	3-6 Mo Treas
T3	6-9 Mo Treas
T4	9-12 Mo Treas
T5	1-3 Year Treas
T6	3-5 Year Treas
T7	5-7 Year Treas
A1	1-3 Year Agcy
A2	3-5 Year Agcy
A3	5-7 Year Agcy
C	1-3 Yr Credit
MBS	Fixed Rate MBS
ABS	AAA ABS
SP	S&P 500 Index

Measuring Performance

An Appropriate Benchmark Should Be:

- Consistent with the security types and asset classes approved within the guidelines.
 - Corporate and Bank obligations --- LIBOR based
 - Treasury and Agency obligations --- Treasury Bill based
- Consistent with the duration or average weighted maturity risk tolerance within the guidelines.
 - 1 month, 3 month, 6 month, etc.
 - Longer benchmark duration, longer end of maximum maturity range used

LIBOR (Flat) LIMEAN (LIBOR -6) LIBID (LIBOR -12)

Conservative



Aggressive

Conservative



Aggressive

	Bill Indices	LIBID	LIMEAN	LIBOR
1-Month	Treasuries & Agencies	A-1/P-1 & A+/Aa3 Minimum	A-1/P-2 A-2/P-1 (Split Rating) A/A-1 Minimum	A-2/P-2 ABS/MBS BBB/Baa1 Minimum
3-Month				
6-Month				

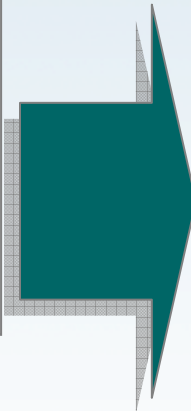
Compliance and Controls

- What exists internally at Lexmark?
 - Detailed corporate policy
 - Objective, maximum WAL, diversification and sector requirements
 - Daily compliance system through custodian
- What do you look for in an Asset Manager in regards to compliance standards?
 - Good governance, compliance independent and senior level
 - Adequate resources, both people and systems
 - Comprehensive design, both pre and post trade confirmation

Investment Policy Decisions

Conceptual Characteristics

- Investment Objectives of the Organization
 - Return Expectations
- Risk tolerances
- Investor Constraints
 - Liabilities
 - Accounting
 - Legal
 - Regulatory
- Time Horizon
- Liquidity Needs
- Unique Circumstances



Working Guidelines

- Maximum duration on any single security
- Maximum average maturity/duration for the portfolio
- Maximum percentages invested in particular sectors
- Minimum allocations to meet liquidity needs
- Limits on use of structured securities
- Credit quality constraints
- Specification of the benchmark