FDIC-Insured Solutions in an Uncertain World

Cash management strategies have never been more important to a well-constructed portfolio than they are today. Volatility in the stock and bond markets has created the need for a portfolio stabilizer. This need is even more acute for investors at the front edge of the demographic wave of retiring baby boomers, whose needs are shifting from the long-term accumulation of capital (a need aligned with the recent bull market) to the preservation of capital for retirement and other objectives. Put another way—the return of capital has become more important for many investors than the return on their capital. As a result, for many investors and investment professionals, cash has gone from being a residual of the investment process to a core consideration.

Contents

Cash Management Strategies in an Era of Uncertainty....................1

The Promise of FDIC Insurance......2

A Range of Insured Options 4

Conclusion 9

Cash Management Strategies in an Era of Uncertainty

One of the greatest challenges facing investors and their investment professionals today is employing cash management strategies in an environment that is substantially different from anything they have seen before. The traditional approach, for all but the largest corporations, has been to select the investment company-issued money market fund with the most attractive combination of yield, credit quality, and taxable status, and to focus attention on the more "active" portion of the portfolio in other asset classes. However, recent events have called this approach into question.

In 2008, the worsening credit crisis led to a series of high-profile difficulties at prime and government money market mutual funds. Although only one fund sponsor "broke the buck," credit challenges led to a widespread movement away from such funds and toward the perceived safety of securities backed by the highest available credit quality—that of the U.S. Treasury. The price of this approach, however, has been high. Monetary policy has suppressed yields on short-term Treasuries, and the effect has been compounded by overwhelming investor demand for the issues. Taken together, these two forces have driven yields to record lows, and even to negative levels briefly in late 2008. The impact on Treasury-focused money market mutual funds has been severe, with several closing to new investors to protect their existing fund shareholders.

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Yet, Treasury bills and money market mutual funds are not the only options for investors seeking preservation of capital. An array of new and existing approaches allows investors willing to look further afield the opportunity to invest in assets that enjoy the safety of a government guarantee.

Temporary Guarantee Program for Money Market Funds

Although money market mutual funds are not FDIC insured, many are currently guaranteed under the U.S. Treasury Department's Temporary Guarantee Program for Money Market Funds, which opened on September 29, 2008. The program guarantees the share price of any publicly offered eligible money market mutual fund that applied and paid a fee to participate, which many fund families did. The guarantee applies to amounts held in participating funds as of the close of business on September 19, 2008, the date the program was first announced. There is no limit on the amount of shares covered, provided the designated shareholder of record owned the shares as of September 19, 2008. If the participating fund's net asset value (NAV) falls below $0.995 (commonly referred to as "breaking the buck") and the fund liquidates, the guarantee is triggered. The program is effective through September 18, 2009 for those funds that have maintained their participation. More detailed information on the Temporary Guarantee Program for Money Market Funds can be found at http://www.treas.gov/offices/domestic-finance/key-initiatives/money-market-fund.shtml.

The Promise of FDIC Insurance

The Federal Deposit Insurance Corporation (FDIC) was established in 1933 to support the U.S. banking system. It operates as an independent agency of the U.S. government that protects against the loss of insured deposits if an FDIC-insured bank or savings association fails. FDIC deposit insurance is backed by the full faith and credit of the U.S. government, and no depositor has ever lost a single penny of FDIC-insured funds.[1]

FDIC insurance covers all types of deposits received at an insured bank, including deposits in checking, negotiable order of withdrawals (NOW), savings and money market deposit accounts as well as time deposits (i.e., certificates of deposit [CDs]). This coverage is automatic; depositors need not apply for it.

[1] Source: http://www.fdic.gov/about/learn/symbol/index.html

SIPC® Protection

Mutual funds, stocks, bonds, U.S. Treasury and municipal securities, life insurance policies and annuities are not insured by the FDIC, even if they were purchased from an insured bank or its affiliated broker-dealer. It should be noted, however, that certain categories of these securities, if held within a brokerage account, are protected by a separate type of insurance provided by the Securities Investor Protection Corporation (SIPC®). In the event a brokerage firm that is a member of SIPC is closed due to bankruptcy or other financial difficulties and customer assets are missing, covered assets may be protected up to $500,000, including a $100,000 limit for cash. Some brokerage firms obtain private insurance to provide protection beyond SIPC limits. SIPC does not protect against losses due to market volatility and the coverage it offers is not the equivalent of FDIC insurance.

FDIC Insurance Limits

FDIC insurance coverage for certain retirement accounts, which include all Individual Retirement Account (IRA) deposit accounts, was permanently increased to $250,000 per depositor in 2006. On October 3, 2008, FDIC deposit insurance for all other deposit categories was temporarily increased from $100,000 to $250,000 per depositor, per insured bank. The standard coverage limit for these deposits is currently scheduled to revert back to $100,000 on January 1, 2014.

The FDIC provides separate coverage for deposits held in different account ownership categories. In other words, it is possible to have deposits of more than $250,000 at one insured bank and still be fully insured, provided the deposits are held in accounts with different categories of ownership. These categories include single, retirement, joint and revocable trust accounts. A depositor cannot increase their insurance coverage by simply placing deposits at different branches of the same insured bank. If banks are affiliated, such as having a common holding company, but are separately chartered (i.e., they have different FDIC certificate numbers), deposits in each bank would be separately insured.

The coverage limits shown in the following chart refer to the total of all deposits that an account holder has in the same ownership categories at each FDIC-insured bank. The chart shows only the most common ownership categories that apply to individual and family deposits, and assumes that all FDIC requirements are met.

Basic FDIC Deposit Insurance Coverage Limits (through 12/31/13)*	
Single Accounts (owned by one person)	$250,000 per owner
Joint Accounts (two or more persons)	$250,000 per co-owner
IRAs and certain other retirement accounts	$250,000 per owner
Revocable Trust Accounts	$250,000 per owner per beneficiary up to five beneficiaries (more coverage available for six or more beneficiaries subject to specific limitations and requirements)
Corporation, Partnership and Unincorporated Association Accounts	$250,000 per corporation, partnership or unincorporated association
Irrevocable Trust Accounts	$250,000 for the non-contingent, ascertainable interest of each beneficiary
Employee Benefit Plan Accounts	$250,000 for the non-contingent, ascertainable interest of each participant
Government Accounts	$250,000 per official custodian
Non-Interest-Bearing Transaction Accounts	Unlimited coverage – only at participating FDIC-insured banks and savings associations**

* Source: http://www.fdic.gov/deposit/index.html

** Unlimited deposit insurance coverage is available through December 31, 2009, for non-interest-bearing transaction accounts at institutions participating in FDIC's Temporary Liquidity Guarantee Program.

A Range of Insured Options

While FDIC insurance is clearly a welcome umbrella for investors seeking security for their assets, the question of implementation remains a key consideration. Many individuals are likely to view FDIC insurance as covering only traditional banking products such as checking accounts and CDs. Fortunately, there is now a broad spectrum of FDIC-insured options spanning a range of factors including time horizon, liquidity and potential return that can allow informed investors and investment professionals to craft customized solutions. These products may offer a compelling alternative for investors whose primary objective is protecting the value of their principal within the context of their own individual needs.

Brokered CDs

One of the most well-known products is the CD. Issued by banks, CDs pay investors a fixed rate for holding the money for a specified time period and are widely considered as safe and "risk free" as a savings account. Although CDs are issued by banks, banks are not the only financial institutions that make bank-issued CDs available. Brokered CDs are essentially bank CDs that are sold by a brokerage firm. By providing another access point for CDs, these brokerage firms expand the breadth of choices for investors, while providing the same simple strategy for seeking safety and market-based yields.

How they work

With a brokered CD, the brokerage firm acts as an intermediary and provides access to a broader range of banks than may otherwise be available. The brokerage firm works with the investment professional and investor to understand the investor's investment goals, and then searches for the most appropriate CD at banks across the country. In certain instances, brokerages may also negotiate more competitive rates with banks by agreeing to bring in deposits of a certain size, which are broken into smaller CDs that are then sold to investors.

Benefits

Brokered CDs offer some unique features and differ from those of a directly purchased bank CD. One of the main differences is that a secondary market may exist for brokered CDs. A bank CD is intended to be held until maturity and assesses a penalty fee for early withdrawal. In contrast, a brokered CD may be resold on the secondary market if an investor wishes to redeem it prior to maturity.

An investor also has a broader set of choices with a brokered CD. A local bank will only offer its own CDs, whereas a brokerage firm can look for more competitive rates at banks offering FDIC-guaranteed CDs anywhere in the U.S. Furthermore, investors choose brokered CDs for the convenience of managing all investments within one brokerage account. Investors receive a consolidated statement from the brokerage firm and need only deal with their own investment professional, thereby reducing the administrative burden of dealing with a separate bank and separate accounts.

Finally, brokered CDs have the same FDIC insurance protection as directly purchased bank CDs. The coverage for CDs was temporarily increased through December 31, 2013, to $250,000 in principal and interest, per financial institution, per depositor. However, if a CD matures after December 31, 2013, its coverage limit will revert back to $100,000 on January 1, 2014.

Risks

The secondary market feature of brokered CDs introduces investors to market risk, or the risk that the CD may be sold for less than the investor paid for it, particularly if interest rates rose and there was less demand for a lower-yielding CD. Conversely, the resale could potentially generate a profit under certain conditions, such as if interest rates declined and demand remained strong for a higher-yielding CD.

Additionally, although brokered CDs are covered by FDIC insurance, investors must be mindful of where the brokerage firm is placing any deposit. It is possible for an investor to exceed FDIC insurance limitations with a particular issuing bank. Secondly, should the issuing bank fail, a brokered CD investor may be subject to delays in receiving repayment from the FDIC because the brokerage firm serves as an intermediary between the issuing bank and the CD holder, whereas a direct bank CD holder would generally receive repayment the next business day.

Certificate of Deposit Account Registry Service® CDs or CDARS® CDs

CDARS CDs are an alternative for individual or institutional investors who seek the safety of CDs but have deposits exceeding the FDIC insurance limits for any one bank. CDARS CDs generally provide investors with access to up to $50 million of FDIC insurance per depositor for deposits held in the same insurable capacity. As with CDs in general, the investor may choose maturities from four weeks to five years, with rates that typically have been competitive with those of traditional brokered CDs and historically have compared favorably with U.S. Treasury rates. Of course, past performance is no guarantee of future results.

How they work

CDARS allocates an investor's deposit in increments less than $100,000 (or $250,000 depending on maturity) across CDs at member banks across the country, thereby allowing the principal and interest to remain fully insured. This distribution process is invisible and seamless to the investor.

> The CDARS CD program is managed by Promontory Interfinancial Network, which matches member banks with deposits and enables these local banks to keep these deposits on their own books. Financial institutions, including banks, must join the network in order to offer CDARS CDs to their investors.

Furthermore, regardless of how many member banks or individual underlying deposits are involved, the investor receives the same rate for each deposit and a consolidated monthly statement. Investors may also opt to allocate across a range of maturities (known as a CD "ladder") with a single deposit, which can easily be tracked with the consolidated statement.

Benefits

CDARS CDs allow investors to optimize FDIC insurance coverage in a streamlined and convenient way, with the same limitations as investing in a CD or time deposit at a local bank. Investors sign a single agreement with the investment professional's firm, and receive one rate, regardless of how many underlying deposits may be needed.

CDARS CDs also offer a simplified approach to laddering maturities in a single deposit, while still optimizing FDIC insurance protection. This strategy enables investors to more actively manage liquidity needs and mitigate reinvestment risk over an interest rate cycle. The underlying deposits are allocated across the increments of the investor's choosing, such that FDIC limits are not exceeded within any one member bank.

The inconvenience of making individual deposits at different local banks and tracking each account is eliminated. At maturity, as with "traditional" bank CDs, investors generally have the option of rolling CDARS CDs into new CDARS CDs, reinvested at current rates.

Risks

CDARS CDs are subject to liquidity limitations similar to those of a traditional CD or time deposit at a local bank. CDARS CDs are expected to be held until maturity, and no secondary market exists for these instruments. Therefore, CDARS CDs are subject to early withdrawal penalties, which may invade principal.

Additionally, the rates available through the CDARS CD program at an investor's bank of choice may be potentially lower than those offered by other banks or by traditional CDs. Member banks pay a fee to participate in the CDARS CD program, which can lower the rate that investors receive. However, investors may select a participating bank other than their own local member bank, if they believe it offers more attractive rates.

FDIC-Insured Bank Deposit Sweep Vehicles

FDIC-insured bank deposit sweep vehicles build on the strengths of traditional sweep vehicles to offer a blend of the convenience of automated sweep programs with the confidence of FDIC insurance. Please note that FDIC-insured bank deposit sweep vehicles are not money market mutual funds, are not registered with the Securities and Exchange Commission, and are not covered by SIPC protection.

How they work

Excess cash in a brokerage account, such as that from sold or maturing investments, dividends or interest payments, is swept into FDIC-insured accounts, typically money market deposit accounts and transaction accounts at participating banks. The funds are swept daily across multiple banks, enabling greater aggregate FDIC insurance—usually up to $2.5 million for single account holders and $5 million for joint account holders. To ensure the balances remain fully covered by FDIC insurance, the principal amounts are typically limited to slightly less than the coverage limit per account per bank (currently $250,000) and assets at each bank are continuously monitored.

Benefits

FDIC-insured sweep vehicles allow idle cash to continue working while also ensuring safety of both principal and accrued interest. They generally offer daily liquidity and the flexibility to customize the program to suit an investor's particular needs. Often the interest earned on cash sweep balances is tiered and based on the aggregate value of an investor's brokerage account, not just the cash sweep balance, which may enable an investor to realize greater income. Sweep accounts work automatically and seamlessly, meaning no time or resources need to be dedicated to managing daily investment transactions. Additionally, bank deposit sweep programs typically allow investors the flexibility to select certain banks as ineligible to receive deposits in the event they already have money on deposit there, outside of the brokerage account.

Risks

FDIC-insured bank deposit sweep accounts involve traditional bank deposits, and as such, they can be subject to the varying rules of the underlying banks. Investors should

be aware that these banks do have the right to hold funds on deposit for up to seven days after a request to withdraw funds is received by the bank, though they rarely do.

FDIC-Backed Bank Bonds

Recent actions by the U.S. government in response to the liquidity crisis have resulted in the creation of a new type of security that offers the same FDIC protection as a CD, attractive yields and the liquidity of a traditional bond. These FDIC-backed bank bonds were created under the auspices of the FDIC's Temporary Liquidity Guarantee Program, established on November 21, 2008 in an effort to reduce funding costs and increase lending, called the Debt Guarantee Program.

How they work

For banks electing to participate in this new program, the FDIC is guaranteeing all newly issued senior unsecured debt (up to certain limits) issued between October 14, 2008, and October 31, 2009. The guarantee on debt issued before April 1, 2009, will expire no later than June 30, 2012. The guarantee on debt issued on or after April 1, 2009, will expire no later than December 31, 2012.

Any FDIC-insured depository institution, U.S. bank holding company (including financial holdings companies), and certain U.S. savings and loan holdings companies are covered under the Debt Guarantee Program, unless they opted out of the program in December 2008. Participating banks pay an annual fee of 50 to 100 basis points, depending on the maturity of the new debt issuance, to obtain the FDIC insurance. Banks have generally been eager to take advantage of the guarantee program as it enables them to borrow at attractive rates, and increases the availability of capital for them to lend.

Benefits

FDIC-backed bonds typically offer higher yields than U.S. Treasuries of similar maturities but with comparable risk, as the FDIC is guaranteeing the timely payment of principal and interest should an issuer default on payments. Additionally, FDIC-backed bonds allow investors to maintain the federal guarantee above the current $250,000 limit on bank deposits.

Risks

FDIC-backed bank bonds are typically issued for $100,000 or more, whereas the minimum purchase amount for Treasury bills or notes is $100. However, retail investors can access FDIC-backed bonds through select bond funds, and some investment companies are offering customers the opportunity to purchase the bonds on the secondary market. Investors also need to keep in mind that the government guarantee is only currently effective through December 31, 2012, even if a bond's maturity exceeds that date. Bonds are generally subject to market risk if sold prior to maturity. For more information on FDIC-backed bank bonds, visit http://www.fdic.gov/regulations/resources/TLGP/index.html.

Conclusion

For those investors seeking capital preservation—and most are—in today's market, cash is still king. Investment professionals and their investors have access to a broad spectrum of FDIC-insured solutions that not only address, but also take advantage of, the special challenges and opportunities presented in the current environment. In particular, FDIC-insured products are the direct beneficiaries of recent extensions in FDIC insurance coverage, and may offer an attractive solution to those investors seeking the benefits of such protection.

With investors more acutely attuned to safety of principal, the challenge for investment professionals is to remain a valued provider of investment advice. The insured solutions presented in this paper may be applicable to a range of investor needs, from short-term liquidity to buffering long-term market volatility exposure, and are comprehensive, thereby allowing investment professionals to make tailored and timely portfolio recommendations. A discussion of such solutions may sustain an ongoing investment dialogue or re-open a closed dialogue, giving investors much-needed guidance in an uncertain environment.

The renewed emphasis on, and the importance of, cash management strategies cannot be underestimated for those seeking to build and preserve wealth, whether as an investor or an investment professional.

This guide is designed to help investment professionals and financial services firms identify trends, enhance operations and grow revenue.

To learn more about Pershing, visit us on the web at www.pershing.com.

Mutual funds are sold only by prospectus and all funds may not be available in all jurisdictions. Please consult the prospectuses of individual mutual funds for a complete explanation of risks, fees and investment minimums.

An investment in a money market mutual fund is not insured or guaranteed by the Federal Deposit Insurance Corporation (FDIC) or any other government agency. Although the funds seek to preserve the value of an investment at $1 per share, it is possible to lose money by investing in a money market mutual fund. The prospectus contains this and other important information. Read the prospectus carefully before investing.

An investment in an FDIC-insured deposit program is not protected by the Securities Investor Protection Corporation (SIPC).

Promontory may not be able to place all of a client's funds on an order placement date. Unplaced funds will be returned to the client and the client may resubmit them for placement through CDARS on another day on which Promontory performs its allocation service. Funds may be submitted for placement only after a depositor enters into a CDARS Deposit Placement Agreement. The agreement contains important information and conditions regarding the placement of funds.

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Notes

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