

**AFP®**



# Annual Conference

OCTOBER 27-30, 2013 | LAS VEGAS

ORIGINAL → ESSENTIAL → UNBIASED → **INFORMATION**

## Delivering a Smarter Investment Strategy: How UPS Created a Unique Tool for Analyzing Counterparty Risk

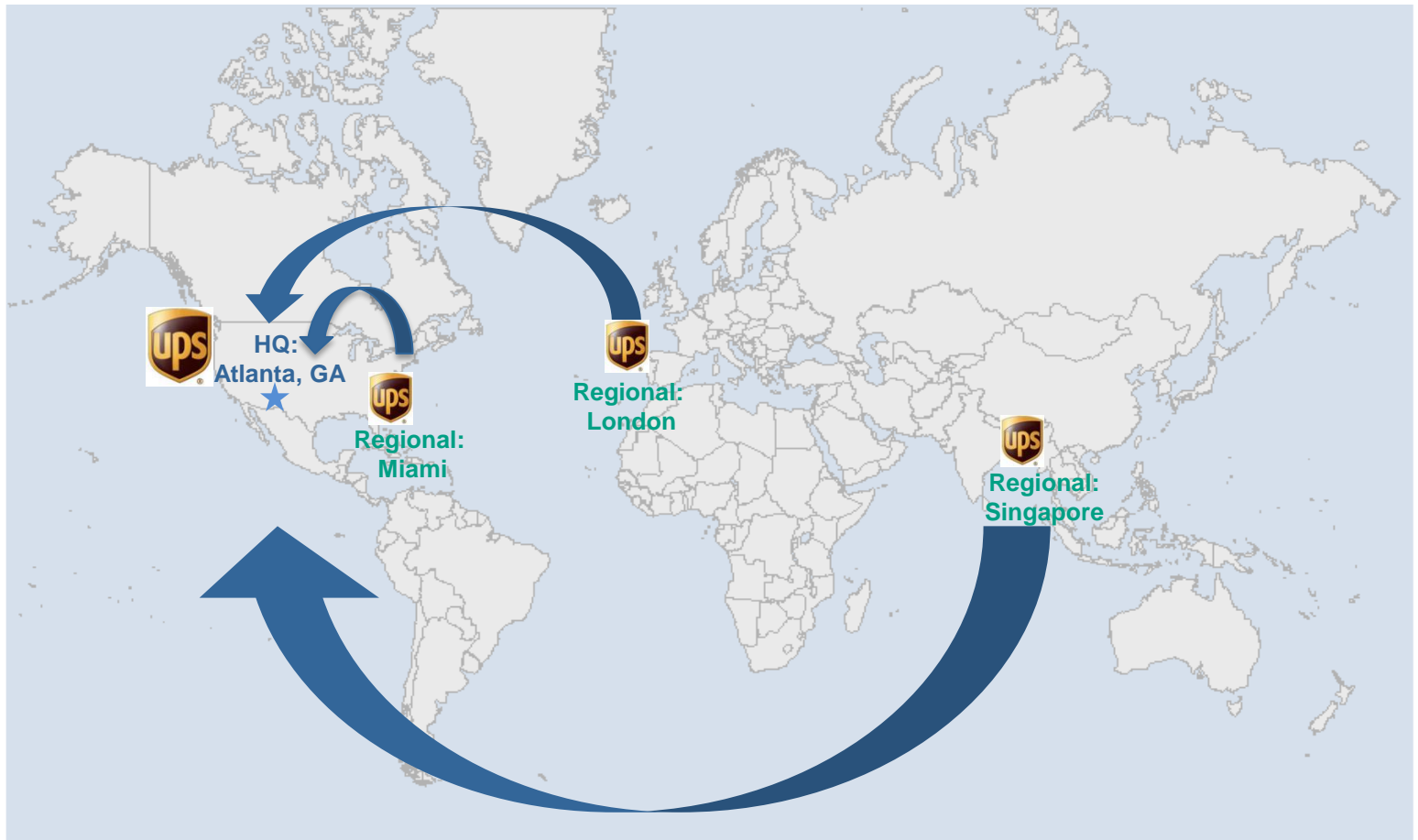
**Jimmie Irby,  
Credit and Risk  
Administration,  
J.P. Morgan Global  
Liquidity**

**Jennifer Powers,  
United Parcel Services**

# Agenda

- **Overview of the UPS Short Term Investment Policy**
- **How does UPS evaluate counterparties?**
- **How does a money fund evaluate counterparties**
- **Q&A**

# Structure of Cash Organization



# Counterparty Evaluation starts with the UPS Short Term Investment Policy

## Primary Investment Objectives

The primary investment objectives of each portfolio, in order of importance, should be:

### Preservation of Principal

- **Safety of principal is the foremost objective of the investment program. Investments will be undertaken in a manner that seeks to ensure the preservation of capital in the overall portfolio**

### Yield

- **The investment portfolio shall be managed with the objective of attaining a competitive and consistent rate of return, based on the benchmark criteria and investment constraints outlined in this policy**

### Liquidity

- **The investment portfolio shall remain sufficiently liquid to meet all operating requirements that may be reasonably anticipated. This will be accomplished by structuring the portfolio so that securities mature concurrent with cash needs to meet anticipated demands**

### Portfolio Diversification

- **The Company's investment portfolio will be adequately diversified as to quality, maturity and issuers. Market conditions and relative value will determine portfolio composition**

# Key Facts about the UPS Short Term Investment Policy

- The majority of the portfolio is self-directed by an experienced team of traders based in the Atlanta Headquarters
- Cash is global, with all decisions made at the HQ and regional teams implementing designated strategy
- There are two core investment portfolios that must adhere to the counterparty limits stated in the investment policy
- The weighted average maturity (WAM) of the combined portfolios cannot exceed one year
- The Company maintains its investment values on a current basis; all portfolio assets are revalued at current market prices
- At least quarterly, the UPS Corporate Treasury Investment Committee will review a status report of the portfolio, which must contain, but is not limited to the following:
  - Breakdown of securities held in each portfolio, including maturity date and current yield
  - Performance relative to benchmark
  - Portfolio credit quality
  - Investment allocation by type and maturity
  - Out-of-compliance and/or downgraded positions

# UPS CORPORATE TREASURY

## Permitted Investment Guidelines

Permitted Investment Type	Counterparty Bank Rating	Investment Type as % of Portfolio	Purchase Commitment as % of Investment Portfolio	Maximum % of Security's Outstanding Amount	Notes
Systemically Important Bank Owned and Non-Bank Owned Money Market Funds	A-/A-/A3 or better	100%	N/A	10%	UPS may own no more than 10% of the fund portfolio. ALL MONEY MARKET FUNDS MUST BE AAA RATED
Non-Systemically Important Bank Owned and Non-Bank Owned Money Market Funds	N/A	40%	N/A	5%	UPS may own no more than 5% of the fund portfolio ALL MONEY MARKET FUNDS MUST BE AAA RATED
Repurchase Agreements	AA-/AA-/Aa3 or better	100%	N/A	N/A	Maximum Investment 8% of Total Investment Portfolio Collateral types and margin % based on Appendix 'B'
Repurchase Agreements	A-/A-/A3 or better	100%	N/A	N/A	Maximum Investment 6% of Total Investment Portfolio Collateral types and margin % based on Appendix 'B'
Direct Obligations of the U.S. Government (Including Treasury bills & notes)	N/A	100%	N/A	N/A	
Supranational & Sovereign Debt Obligations	N/A	50%	5%	10%	A-/A-/A3 or better: Maximum exposure to a single country is \$500MM Below A-/A-/A3: Maximum exposure to a single country is \$300MM.
Government Agencies (Fully Guaranteed)	N/A	100%	N/A	N/A	
Government Agencies (Implicit Guarantee)	N/A	50%	5%	10%	
Certificates of Deposit, Time Deposits, EuroDollar Deposits & Banker's Acceptances (Issued by Banks or their Foreign Branches)	A-/A-/A3 or better	50%	5%	N/A	Counterparty Bank Minimum Asset Size: \$5B

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Certificates of Deposit, Time Deposits, EuroDollar Deposits & Banker's Acceptances <i>(Issued by Foreign Banks)</i>	A-/A-/A3 or better	30%	5%	N/A	Counterparty Bank Minimum Asset Size: \$40B
Corporate Bonds	N/A	40%	5%	10%	
Taxable Commercial Paper	N/A	40%	5%	10%	
Tax-Exempt Commercial Paper	N/A	50%	5%	10%	Tax-exempt purchases within 2% safe harbor guideline
Taxable & Tax-Exempt Municipal Bonds	N/A	50%	5%	10%	Tax-exempt purchases within 2% safe harbor guideline
Tax-Exempt Securities	N/A	50%	5%	10%	Tax-exempt purchases within 2% safe harbor guideline
Called Securities	N/A	25%	5%	10%	
VRDN's, VRDO's, Option Tender Bonds	N/A	25%	5%	5%	Prior Approval Only
Preferred Stock, Common Stock, Equity Related Instruments	N/A	75%	75%	N/A	Prior Approval Only
Securitizations <i>(Including MBS, CMBS, &amp; Credit Cards)</i>	N/A	25%	5%	5%	Prior Approval Only
Money Market Preferred Stock & Auction Rate Securities	N/A	40%	5%	5%	Prior Approval Only

# Evaluating Counterparties—What does UPS look at when selecting securities

- Short term and long term ratings
- Systematically vs. Non-Systematically important banks
- 5 year Credit Default Swap (CDS) rates
- Standard deviation vs. historical norms for CDS rates
- Annual revenue minimums for counterparties
- Ratings on money funds
- Bank owned vs non-bank owned money funds



# Evaluating Counterparties– How does UPS deliver?



- **UPS Traders utilize a Bloomberg terminal to update an excel spreadsheet on a daily basis**



- **5 year CDS rates for relationship banks are entered into the spreadsheet and established formulas are used to determine the portfolio allocation**



- **Standard deviation “triggers” are set so that if the CDS rates go above certain levels, UPS will reduce exposure**

# Credit Risk Management Process– Tool in order to assist decision making in a consistent manner globally

Add a new date & copy formula from previous day	BANK 1	BANK 2	BANK 3	BANK 4	BANK 5
8/1/2013	111.734	116.203	117.812	105.66	163.807
8/2/2013	112.725	117.036	116.715	106.337	164.188
8/5/2013	111.237	117.054	117.597	105.292	163.98
8/6/2013	110.907	117.701	116.898	104.251	162.45
8/7/2013	112.305	119.349	120.209	105.406	163.255
8/8/2013	111.577	117.898	117.082	103.421	152.709
8/9/2013	111.067	117.747	116.492	103.413	151.094
8/12/2013	110.575	117.986	115.946	104.238	151.383
8/13/2013					
8/14/2013					
8/15/2013					
8/16/2013					
8/19/2013					
8/20/2013					
<b>30-day Mean (Change formula to current)</b>	119.89	142.21	137.42	114.97	167.36
<b>Standard Deviation Calculation</b>					
<b>Mean since 09/15/2008 (Change formula to current)</b>	189.16	148.93	132.99	211.61	154.16
<b>Standard Deviation Formula (Change formula to current)</b>	82.00	46.44	69.21	102.08	69.99
	164.00	92.88	138.42	204.16	139.98
	246.00	139.32	207.63	306.24	209.97
<b>Automatically Calculates</b>					
1 $\sigma$	271.16	195.37	202.20	313.69	224.15
2 $\sigma$	353.16	241.81	271.41	415.77	294.14
3 $\sigma$	435.16	288.24	340.62	517.85	364.14

# A Snapshot of the UPS Portfolio

## UPS Corporate Treasury Portfolio Summary—As of: August 13, 2013

Investment Type	Total Amount	Investment Type as % of Portfolio	Portfolio Limits	UPICO	% to Portfolio	GTP	% to Portfolio
Called Bonds	\$0.00	0.00%	N/A	–	0.00%	–	0.00%
Certificates of Deposit, Time Deposits, etc. (Foreign Banks)	\$697,581,298.29	16.18%	30%	\$214,000,000.00	4.96%	\$483,581,298.29	11.21%
Certificates of Deposit, Time Deposits, etc. (U.S. Banks)	\$100,000,000.00	2.32%	50%	\$100,000,000.00	2.32%	–	0.00%
Corporate Bonds	\$328,544,925.16	7.62%	40%	\$328,544,925.16	7.62%	–	0.00%
Direct Obligations of the U.S. Government	\$0.00	0.00%	100%	–	0.00%	–	0.00%
MMP & Auction Rate Securities	\$0.00	0.00%	40%	–	0.00%	–	0.00%
Money Market Funds (Bank Owned/Guarantied)	\$470,239,378.23	10.90%	100%	\$256,940,633.85	5.96%	\$213,298,744.38	4.95%
Money Market Funds (Non-Bank Owned/Guarantied)	\$60,923,322.70	1.41%	40%	\$60,923,322.70	1.41%	–	0.00%
Municipal Bonds	\$10,587,990.00	0.25%	50%	\$10,587,990.00	0.25%	–	0.00%
Preferred/Common Stock & Equity Related	\$0.00	0.00%	75%	–	0.00%	–	0.00%
Repurchase Agreements	\$1,479,988,086.29	34.32%	100%	\$250,000,000.00	5.80%	\$1,229,988,086.29	28.52%
Securitized	\$0.00	0.00%	25%	–	0.00%	–	0.00%
Supranational & Sovereign Debt	\$493,795,307.93	11.45%	100%	\$493,795,307.93	11.45%	–	0.00%
Tax-Exempt CP	\$57,090,000.00	1.32%	50%	\$57,090,000.00	1.32%	–	0.00%
Tax-Exempt Securities	\$0.00	0.00%	50%	–	0.00%	–	0.00%
Taxable CP	\$613,626,245.71	14.23%	40%	\$405,930,055.20	9.41%	\$207,696,190.51	4.82%
U.S. Government Agencies (Fully Guarantied)	\$0.00	0.00%	100%	–	0.00%	–	0.00%
U.S. Government Agencies (Implicit Guaranty)	\$0.00	0.00%	50%	–	0.00%	–	0.00%
VRDNs, VRDOs, Option Tender Bonds	\$0.00	0.00%	25%	–	0.00%	–	0.00%
<b>Total</b>	<b>\$4,312,376,554.31</b>	<b>100.00%</b>		<b>\$2,177,812,234.84</b>	<b>50.50%</b>	<b>\$2,134,564,319.47</b>	<b>49.50%</b>

# How do money market funds assess counterparties?

- **Key objective: limit credit and headline risk**
  - Redemptions occur at 1 unit/share
  - Uniform, defensive standards curb event risk
- **Credit factors**
- **Important money fund sectors**
  - Sovereigns and agencies
  - Banks and bank funding vehicles
- **Structural and security considerations**
- **Continuous, collaborative review process**

# J.P. Morgan internal credit ratings

All issuers are assigned internal short-term ratings using a long-term rating scale, which reflects better risk delineation

Internal ratings establish ceilings for firm limits, account concentrations, and maturity restrictions

- Higher concentrations and longer dated issues require solid, stable ratings quality
- Greater diversity and shorter maturities are mandated for lower-rated or deteriorating credits
- Actively monitor purchase limits as appropriate

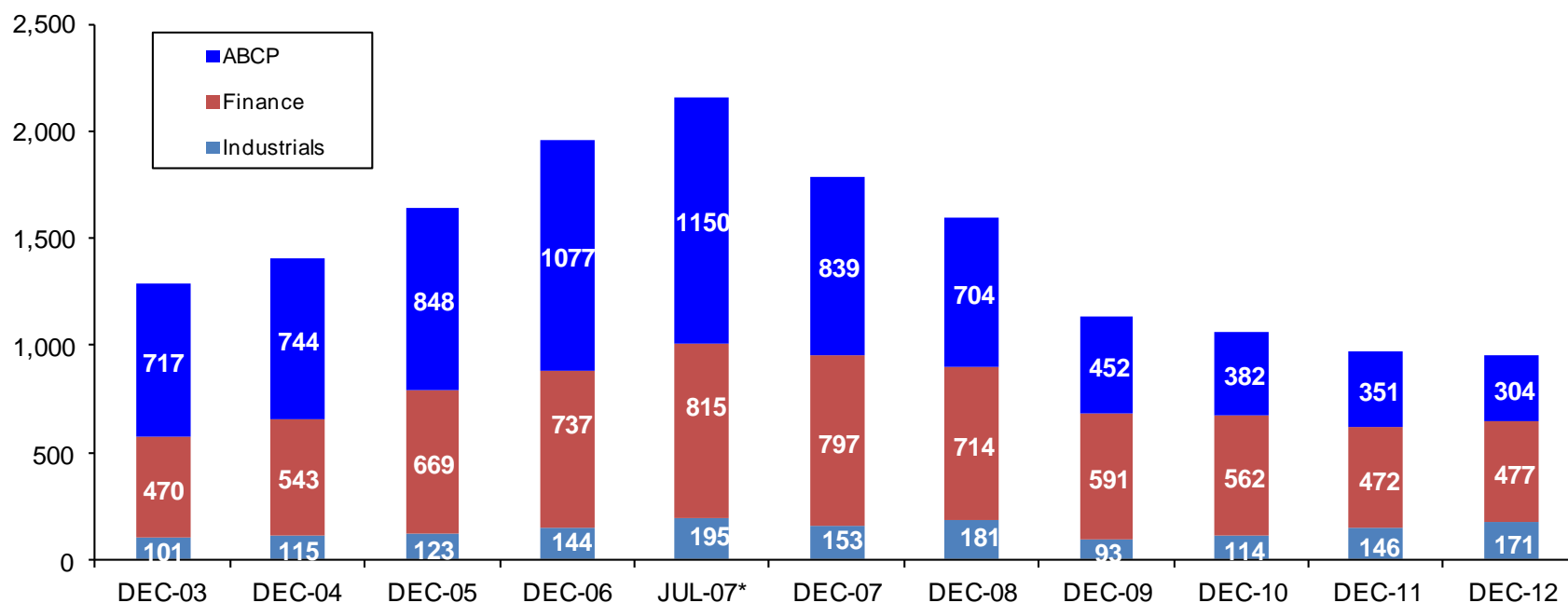
Issues and issuers must be approved by an analyst prior to purchase

Moody's Rating Scale	JPM Internal Ratings	Global Cash		Managed Reserves		
		Tenors (days)	Account [Conc]	Tenors (days)	Account [Conc]	
P-1	Aaa	AAA	397	5.0%	1100	3.00%
	Aa1	AA+	397	5.0%	1100	2.75%
	Aa2	AA	397	5.0%	1100	2.50%
	Aa3	AA-	370	4.5%	1100	2.00%
	A1	A+	275	3.0%	1100	1.50%
	A2	A	190	2.0%	1100	1.25%
P-2	A3	A-	35	0.5%	740/1100 *	1.00%
	Baa1	BBB+	NA	NA		740
P-3	Baa2	BBB	NA	NA	740	0.50%
	Baa3	BBB-	NA	NA	NA	NA
NP	Ba1	BB+	NA	NA	NA	NA

\* 1100d for non-bank issuers only  
Shown for illustrative purposes only.

# J.P. Morgan internal credit ratings

## Commercial paper outstandings (\$ billions)



Source: Federal Reserve Bank (not seasonally adjusted). \* Represents peak in commercial paper.

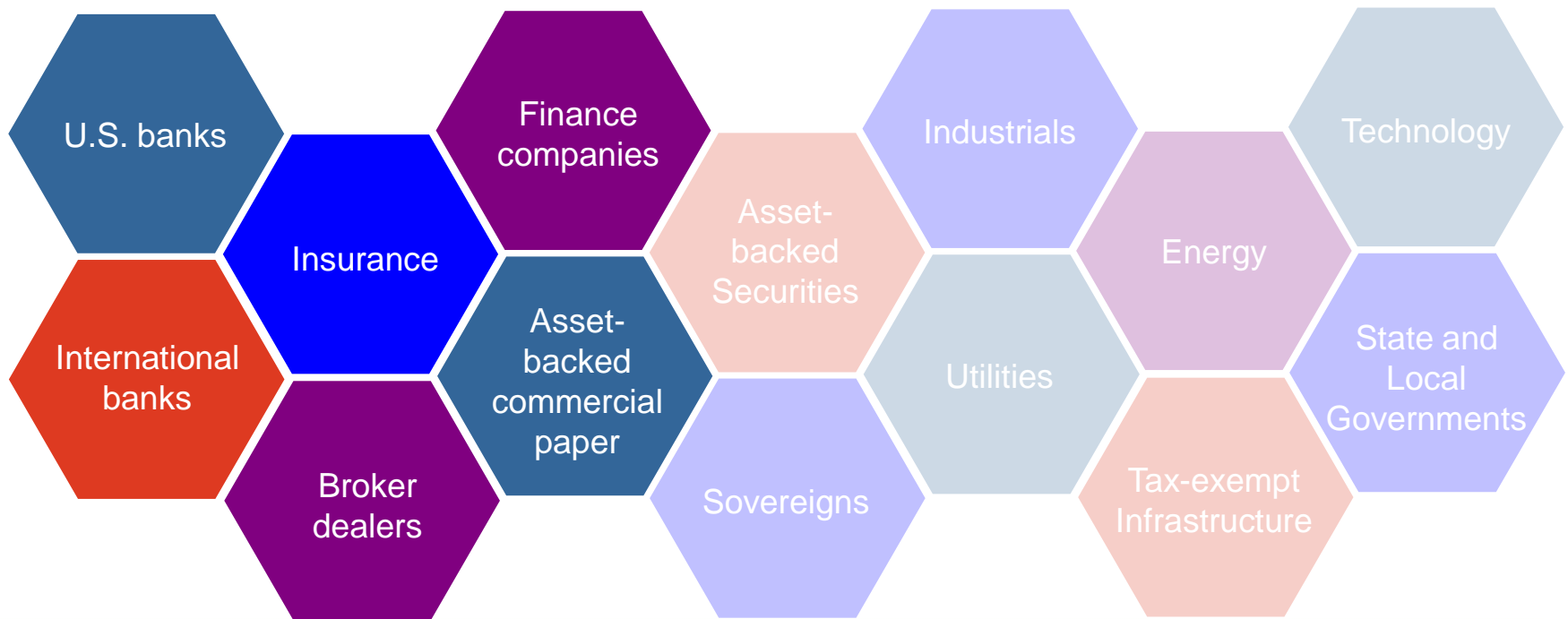
Shown for illustrative purposes only.

*Adding certificates of deposit, time deposits and repurchase agreements into the mix, finance likely comprises 95 – 98% of the cash market*

# Credit sector specialization

The financial sector encompasses all issuers deriving substantial revenue from financial assets (positive spread carry)

- Finance companies underwrite assets — or the risks associated with those assets — with shorter dated funding from wholesale and retail sources



# Assessing sovereign risk

## Political structure

- Stability of political institutions
- Transparency of elections and economic policy
- Public security

## Economic growth prospects

- Economic diversity
- Labor flexibility
- Credit availability to facilitate economic growth
- Effective financial sector
- Employment and prosperity levels

## Debt burden

- General government debt level
- Share of revenue devoted to interest payments
- Depth and breadth of local capital markets
- External liquidity/external debt burden

## Fiscal & monetary control

- Revenue, expenditure and surplus/deficit trends
- Ability and effectiveness in raising revenue
- Fiscal policy to manage debt

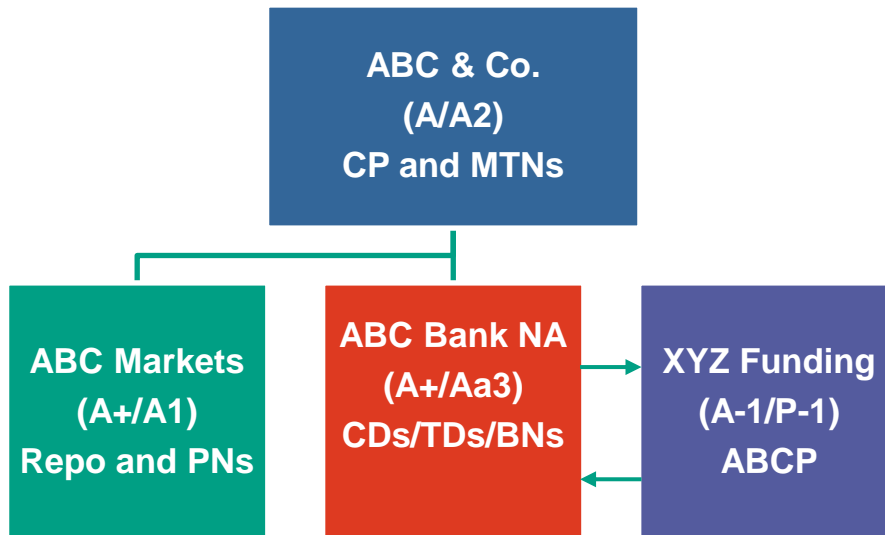


# Primary credit factors

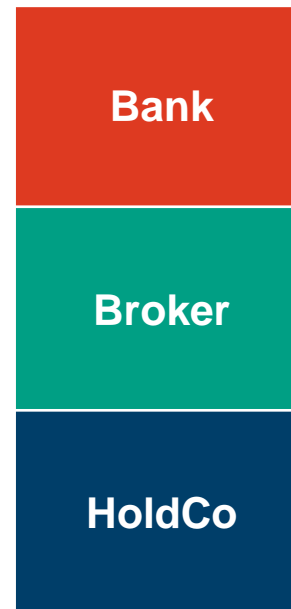
<b>Capital</b>	<ul style="list-style-type: none"><li>• Should be inversely proportionate to earnings volatility (low earnings volatility requires less capital, high earnings volatility requires more capital)</li></ul>
<b>Asset quality</b>	<ul style="list-style-type: none"><li>• Assess underlying credit quality and inherent liquidity of underlying assets</li></ul>
<b>Management</b>	<ul style="list-style-type: none"><li>• Should demonstrate integrity</li></ul>
<b>Earnings</b>	<ul style="list-style-type: none"><li>• Review for consistency and quality over different time periods</li></ul>
<b>Liquidity</b>	<ul style="list-style-type: none"><li>• Match funding, back-up credit lines or stable retail funding base</li></ul>
<b>Industry and operating trends</b>	<ul style="list-style-type: none"><li>• Reviews operating trends, cash flows, industry or product dominance and relative performance, compared with a peer group</li></ul>
<b>Alternative repayment options</b>	<ul style="list-style-type: none"><li>• Check that underlying collateral securing an investment can be sold in the event of default</li></ul>

# Comparing structure and security

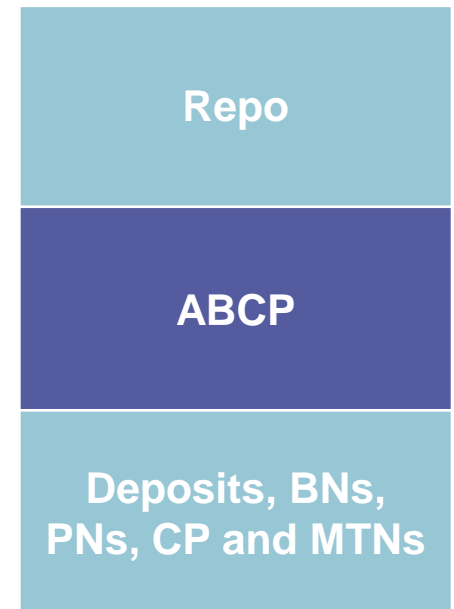
## Company Structure, Ratings & Issuance



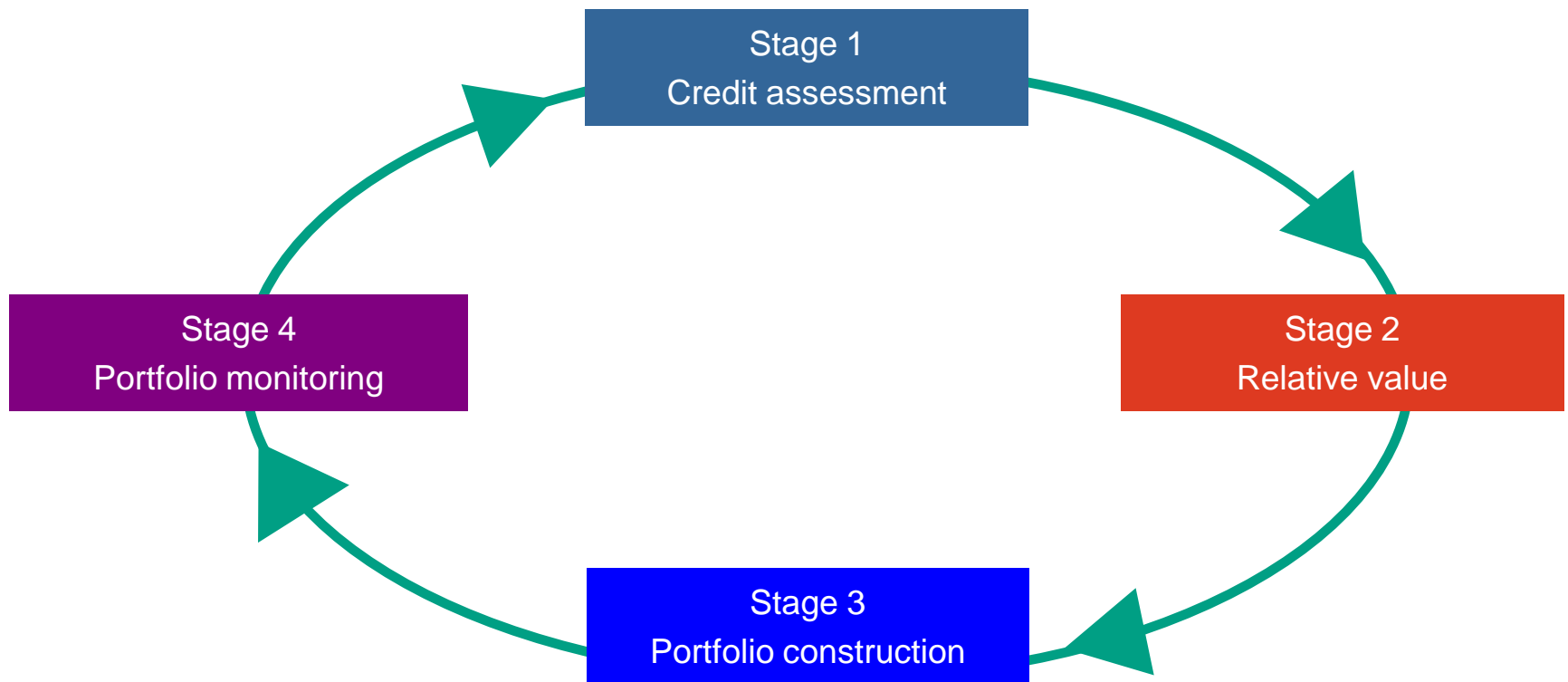
## Priority



## Security



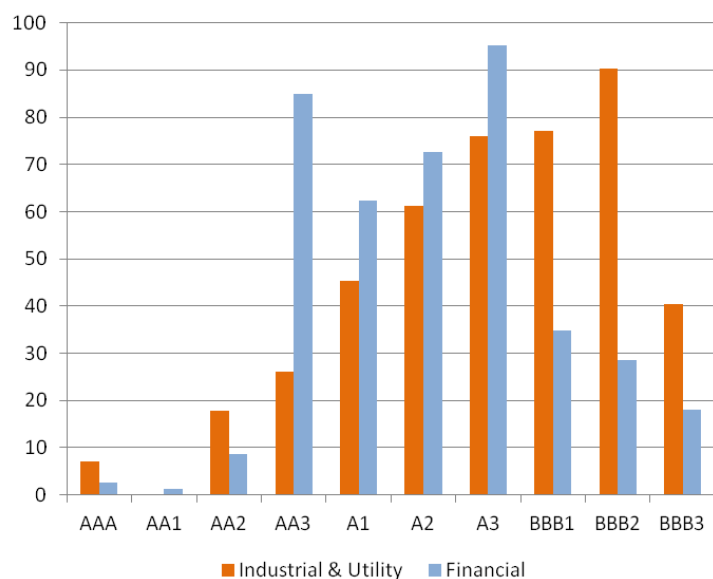
# Micro process continually monitors security selection



- Active management of interest rate duration (WAM limited to 60 days)
- Constant evaluation of spread duration — credit WAM carefully controlled and monitored
- Ongoing dialogue and review of sponsor/administrators, dealers and rating agencies

# BofA Merrill Lynch 1-3 Year Corporate Index (C1A0)

Sector Outstandings by Composite Rating (\$billions)



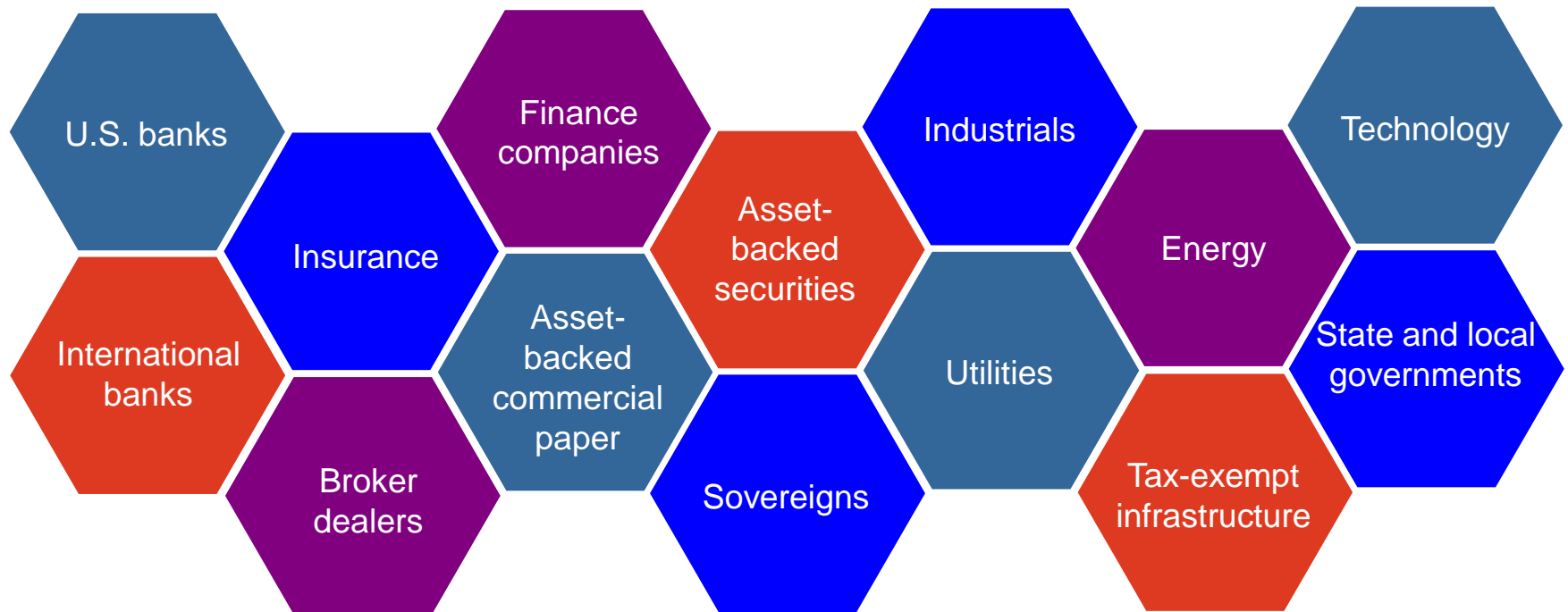
(Outstandings in \$billions)			Largest*	
Sector	Issuers	Outstandings	Issuers	Outstandings
Automotive	13	36	9	33
Basic Industry	34	35	12	24
Capital Goods	24	29	8	21
Consumer Cyclical	22	20	4	10
Consumer Non-Cyc	38	42	12	30
Energy	66	70	21	47
Healthcare	39	52	20	43
Media	16	23	6	16
Real Estate	20	13	3	6
Services	26	15	2	3
Tech & Electcs	24	37	9	30
Telecom	17	38	9	32
Utility	39	33	12	21
<b>Grand Total</b>	<b>378</b>	<b>442</b>	<b>127</b>	<b>316</b>
<b>Banking</b>	<b>93</b>	<b>335</b>	<b>66</b>	<b>320</b>
<b>Financial Srvc</b>	<b>18</b>	<b>37</b>	<b>7</b>	<b>32</b>
<b>Insurance</b>	<b>29</b>	<b>37</b>	<b>7</b>	<b>25</b>
<b>Grand Total</b>	<b>140</b>	<b>409</b>	<b>80</b>	<b>377</b>

\* Issuers with outstandings greater than or equal to \$1 billion

	Ratings	AAA	AA1	AA2	AA3	A1	A2	A3	BBB1	BBB2	BBB3	Total
<b>Industrial &amp; Utility</b>	Outstandings	7.2	0.0	17.8	26.2	45.4	61.3	75.9	77.0	90.3	40.5	441.6
	Issuers	5	0	7	11	23	43	49	89	110	58	395
<b>Financial</b>	Outstandings	2.6	1.4	8.6	85.0	62.4	72.6	95.3	34.9	28.5	18.0	409.2
	Issuers	2	3	5	19	24	27	30	24	29	21	184

# Credit sector specialization

- Dedicated personnel — career path
- More than 20 analysts — over 15 years average experience



As of April 30, 2009.

# Financial sector – bank analysis

**Rating Assessment Factors** (scaled 1 to 5; 1 is best)

	Weight	Inputs
<b>Franchise</b>	35%	Assets, customer deposits, Market shares
<b>Liquidity</b>	15%	Wholesale funding and funding gaps
<b>Profitability</b>	10%	Preprovision operating profit (PPOP)
<b>Capital adequacy</b>	10%	Tangible common and Tier 1
<b>Asset quality</b>	10%	Non-performing assets, AOCI, reserves
<b>Stress test</b>	20%	Embedded losses, AOCI, 2 yr PPOP, reserves

- Franchises are valued based on size and core deposits. Market shares in profitable lines also contribute to a higher rating
- Current financial measures—like capital, asset quality, earnings and liquidity—account for nearly half an issuer’s rating
- The stress test is a prospective measure designed to reduce exposures to deteriorating credits
- Additional factors include potential sovereign support, and that sovereigns’ ability and willingness to pay when an issuer is distressed

# Structural issues

Holding Company

Operating Company

Regulatory Considerations

## HoldCo versus OpCo

- The HoldCo acts as parent for its various OpCos, as well as a consolidating entity for reporting purposes.
  - HoldCo will issue debt and push proceeds to OpCos
  - US, UK and Japan often use HoldCo structures
- OpCos control operating assets and cash flows generated by those assets
  - Banks and broker/dealers
  - Utilities
- Depending on conditions, jurisdictional regulators may limit an OpCo's ability to upstream earnings to its HoldCo

# Security issues

## Unsecured debts

## Bank deposits

## Secured debts

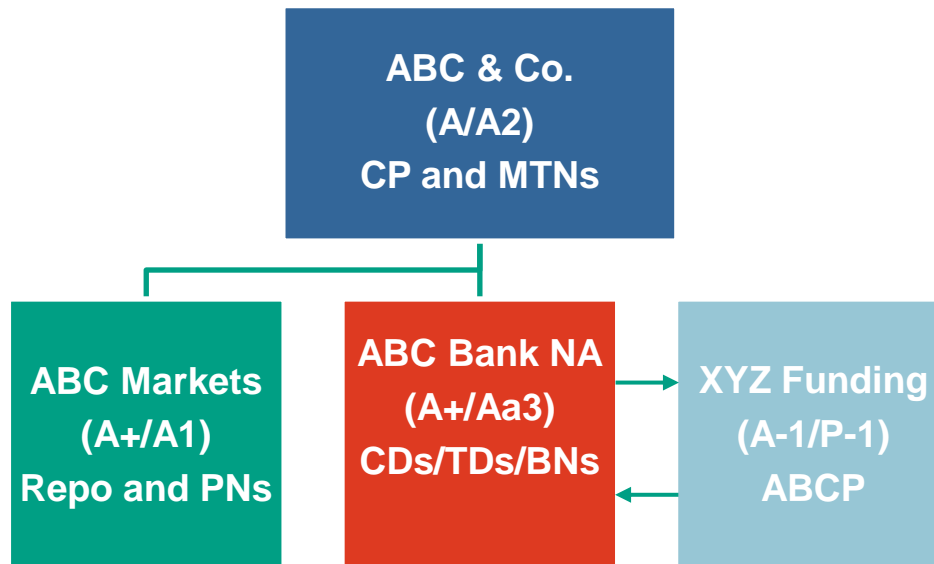
### Secured versus Unsecured debt

- Most investment grade debt is issued on a senior, unsecured basis
  - US Bank HoldCos issue CP and MTNs
  - Bank OpCos issue deposits and bank notes
- Although unsecured, deposits may garner special protections from regulators
- Collateral considerations
  - Repurchase Agreements
  - Structured funding vehicles (ABCP)
  - First mortgage bonds (utilities)



# Comparing structure and security

## Bank Holding Company Structure, Ratings and Issuance



- ABC & Co (holdco) owns ABC Markets (broker) and ABC Bank NA (both opcos)
- CP and MTNs are senior unsecured obligations of the holdco
- Deposits are senior unsecured obligations of the bank
- Repo has an effective put from the broker; should the broker fail the collateral may be seized and sold
- XYZ Funding is an SPE with assets, capital (ABC Bank LOC) and liquidity support (also ABC Bank)
- ABCP is heavily supported by the bank; should the bank fail the SPE's underlying assets offer a secondary source of repayment

# Credit Research Summary

## Extensive

- Team breadth: Sector specialization
- Depth: Experienced analysts follow issuers' entire debt spectrum; complete comprehension of capital structure and liquidity
- Market access: JPMorgan Global Liquidity analysts' control nearly \$500 billion in world-wide corporate credit

## Defensive

- Guidelines limit downside risk
- Money market funds: No transitions to Tier 2
- Managed Reserves accounts: No Junk

## Collaborative

- Portfolio managers identify meaningful issuance
- Once identified, analysts delineate credit quality and set hard limits
- Sales groups deliver clients' perceptions
- Continuous feedback between these three teams ensures constant refining

# Disclosure

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