



## MEMORANDUM

To: PCA Clients

Date: July 29, 2011

From: Jeremy Thiessen, Principal

**RE: Response to Possible Downgrade of U.S. Treasury Debt**

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Recent economic and financial market news has no doubt been dominated by discussions of the U.S. government debt ceiling. While the debate continues, the outcomes of the events surrounding this issue remain uncertain. Of immediate importance is the possibility of a credit rating downgrade to U.S. debt and how this might affect our client's portfolios as it could potentially force certain holders of U.S. Treasuries (Treasuries) to sell into a strained market. **Therefore, PCA recommends that our clients review their fixed income guidelines to ensure that temporary mechanisms are in place to avoid the forced selling of Treasuries.**


While the debt ceiling has been raised many times in the past, recent news has been dominated by the ongoing debt ceiling debate among lawmakers. Behind these headlines are the following issues, none of which have very certain outcomes.

- Continuing debate among lawmakers on how to resolve the immediate debt ceiling issue
- Possibility of a default by the U.S. government on its debt
- Possibility of a downgrade to the U.S. credit rating

Of particular importance to our client's portfolios is the possibility of the credit rating for U.S. debt being lowered. Recently, rating agencies such as S&P have placed significant pressure on the U.S. government regarding its long-standing AAA credit rating and have warned of the possibility of a downgrade to AA+. PCA is uncertain, however, if such a downgrade would extend across all of the major rating agencies (Moody's, Fitch, A.M. Best) as it appears that S&P's tone is more ominous than the other rating agencies.

PCA views this issue as temporary and recommends as a preventative measure that our clients review their fixed income investment guidelines. Of primary importance is the assurance that guidelines allow client portfolios to continue to hold Treasuries despite a downgrade in credit rating. Recall that during the market events of 2008, many institutional investment managers had significant holdings in mortgage-backed securities, which were under tremendous downward pressure and pricing inefficiencies. During that time, many holders of these securities were forced to sell into a strained market resulting in tremendous losses. For those portfolios that had the ability to weather periods of underperformance, much of the losses were recovered and in most cases with additional upside as markets normalized.

With respect to our client's portfolio guidelines, consideration should be given towards temporarily relaxing restrictions such as requiring that Treasury bond holdings have an average credit rating of AA+ (for example) and adjust this restriction to AA. In similar fashion, guidelines requiring that individual holdings have a minimum credit rating of at least AAA should be adjusted to AA+. Allowing this flexibility will minimize any forced selling of Treasuries into a potentially volatile market. Clients should assess their specific portfolio and guideline needs



and address any areas within their fixed income guidelines that contain restrictions relating to credit quality.

Over the next few weeks, the results of the issues highlighted in this memo will come to fruition as markets adjust to the continual release of news items and headlines surrounding U.S. government debt issues. In the interim, reviewing and adjusting portfolio guidelines can provide preventative and temporary measures to mitigate the likelihood that holders of Treasuries be forced to sell due to market noise.