Achieving Portfolio Diversification, Transparency and Control

Treasury Experts Weigh In On Safety of Principal, Liquidity and Yield In A New Investment Environment
Corporate investment behavior is at a tipping point. Several factors are converging, putting pressure on corporate investment managers to reassess the risk in their portfolios. Money on the balance sheet is growing. By some accounts, US companies are sitting on $2 trillion in cash at home and abroad. Interest rates are now destined to stay at historic lows for the near to intermediate term. Money market funds (MMFs) are increasingly viewed with suspicion. What are companies doing with regard to managing the risk in their portfolio within a very conservative investment environment?

INTRODUCTION

Broader data shows corporate investors are still very risk averse. At the same time, the multiplicity of approaches corporates employ with regard to money management, points toward a greater focus on yield and managed accounts.

“It’s never all or nothing,” said Kevin Bannerton, Managing Director at DB Advisors, the institutional asset management arm of Deutsche Bank, which currently manages over $120 Billion in liquidity strategies globally. To manage risk, companies pursue a multi-layered strategy. “A good example of that is a corporation that runs multiple approaches. They may manage a very short liquidity or no-credit portfolio internally, but take strategies that require more dedicated research and expertise and outsource them,” he said. The firm makes the strategic decision to not build the expertise internally and instead plays more of an oversight role.

The Association for Financial Professionals’ 2011 liquidity survey revealed 77% of respondents reported that safety of principal was their number one concern, reflecting continued conservatism in the market. While only 5% listed yield as their primary motivation, “The percent of respondents citing ‘yield’ as their primary objective increased from 2010, suggesting that there may be (a little) more confidence in the market from a counterparty risk standpoint since the bank crisis started in 2008,” according to the survey.

Nearly 80% of respondents said they are holding their short-term investments in three traditional safe havens: treasuries, bank accounts and money market funds. While federally insured bank accounts seem to be the biggest beneficiaries of the fight to safety, MMFs, while still prevalent, are losing appeal. In August, data from Lipper showed the biggest outflows of cash out from money market funds—both equity and fixed income—since the financial crisis. During the first week of August, equity funds had a net outflow of $7.4 billion, while bond funds had a net outflow of $1.3 billion. This was the first time both sectors had net redemptions since December of 2010.

“We remain on the sidelines with MMFs,” said the senior director of treasury at an $8B cash-rich organization. This company pulled much of its money out of funds in the week leading up to the US downgrade. “We continue to be very guarded in our exposure to financial institutions,” this practitioner said. “We know we’re missing out on some yield but we want to avoid the headline risk,” he said.

However, staying on the sidelines forever is not an option for many companies. In the AFP survey, large companies said their cash balances grew 16% since 2010. A third expected those cash balances to continue growing, mostly as their operating cash balances grew 16% since 2010.

Many companies find it difficult to manage so much money on their own, particularly while entertaining the idea of adopting a modified investment strategy that accounts for an increasingly fluid market environment. In many cases, they don’t have the expertise, infrastructure or resources to navigate a changing investment landscape.

Not surprisingly then, 20% of all respondents said they are outsourcing their cash to external managers. Tellingly, of those who do outsource their cash investments, nearly half reported that they outsource at least half of their portfolio to professional managers. Once investors take the plunge, the benefits are clearly apparent.

MANAGING A SPECTRUM OF RISK

Corporations are deploying multiple tactics. “We’re finding more than anything that there are going to be different approaches,” said Bannerton at DB Advisors. “You’re seeing a lot of uncertainty with investors not knowing what to do,” he added. While some are taking the less-risky route and are sitting on the sidelines, others are moving to diversify their portfolios and their overall strategy to gain control of greater headline risk, regulatory risk, duration and credit risk.

Too often, investors have too narrow a definition of what risk is. Simply putting everything in a MMF does not mean it’s risk-free. In fact, growing concern about the contents of MMFs is driving many of the changes in the marketplace.

“There are a lot of different kinds of risk that need to be managed. A lot of the assumptions have been tested and need to be reevaluated,” Bannerton said. “The idea that treasuries cannot be counted on as a risk-free asset anymore, this is an example of why you have to look at risk more broadly.”

It is critical for organizations to take a step back and fully define the risks that they are most concerned about and develop a strategy for evaluating and managing those risks. Ideally, this is accomplished holistically, including various stakeholders in the organization. A final piece of the puzzle that is often overlooked is MMFs. “There is no such thing as a risk-free investment. Everyone talks about reduced risk and the ways of achieving those goals,” Bannerton said.

THE RISK MANAGEMENT PARADIGM

For treasurers and investment managers, “The core responsibility is risk management,” said Chris Growney, CFA, Business Development Manager and Founder at Clearwater®. Only the treasurer knows what every manager is investing in and what the risks are across the portfolio. It is his or her job to ensure the corporation is managing the full spectrum of investment risks, including:

- Duration
- Credit
- Operational
- Regulatory
- Compliance
- Accounting
- Headline

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Pedro Andrade, Dell Inc.

“Management teams need to understand that the landscape in the short-term investment market has changed and that their prior assumptions no longer apply. Investors need to change the way they react to how market conditions and regulatory reform have affected their investment options, including diversification, transparency and control. “The idea that you’re expanding your investment policy does not mean you’re increasing risk but approaching it in a different way,” said Bannerton. “Separate accounts are a way companies can create diversification across the yield and credit spectrum.”

Control, diversification and transparency became critically important in the wake of the financial crisis. “It’s important to look at today’s behavior in the context of the past,” said Richard Saperstein, Managing Director and Principal of Treasury Partners, a 15-person $8 billion money management firm in New York. While in the immediate aftermath of the financial crisis, treasurers moved into cash and MMFs, there has since been a gradual shift in the marketplace.
“It’s important to go back to the crisis to understand where we are today. As a result of the crisis, companies have risked their cash into treasuries and into MMFs. Over time, companies came out of the bunker and diversified their strategies as they grew more comfortable with the investment environment,” said Saperstein.

**MMFs LOSE THEIR APPEAL**

In the wake of the crisis, and because of regulatory changes, MMFs no longer attract the same corporate attention. Any whiff of crisis drives billions out of that market, as was the case in early August of 2008.

The data on MMF outflows was quite revealing. According to Lipper, all money market funds saw an outflow of 2.76%, or a total of $65 billion in early August; a huge number. All of that money had to go somewhere and by all accounts, it went primarily into federally insured bank accounts. However, it will likely not stay there. Some of it will move back into funds and some, with the clock ticking on FDIC insurance, will be placed in other investments.

One of the key risk factors with MMFs is that they are difficult to diversify because of regulatory requirements. As a result, they tend to be highly concentrated in the financial sector. They can have the same bank exposure in excess of 5% as long as indirect (e.g., credit support for ABCP programs) bank exposures as a whole are not more than 25% of the portfolio.

As a result, MMFs had a lot of exposure to banks, particularly U.S. and European banks. “We’re highly sensitive to diversification,” said Steven Boyd, Principal at $400 million Halyard Asset Management, LLC, a traditional fixed income money manager in White Plains, NY, of his own managed account business. “No more than 1-2% per issuer. The diversification helps you avoid problems like Lehman and European banks being too large a part of the portfolio.”

“Too often,” said Boyd, “people don’t think about the actual contents of their money market funds and too little thought goes into selecting them.” Not so with managed accounts. “We look at the market place and, given the company’s parameters for credit quality, rating liquidity and safety of principal, we build a portfolio around those criteria designed to hold the investor’s momentum.”

“When I look at a client’s money market fund holdings, I don’t know what’s in there,” said Fisher. “There are a lot of names in there. You have to ask yourself, ‘Would I want to hold this? Where is the primary risk?’” Many Treasury departments don’t. Treasuries generally don’t have staff to do that.

“Transparency for money market funds is not where it needs to be,” she said. The funds are so big one can’t possibly know what the fund contains. The question becomes, according to Fisher, “Do I look at 40 names [in a managed account] or do I look at 200 names [in a fund]?”

MMFs work fine as working capital management tools, but not as investments. “It’s very difficult to manage money funds as an investment, unless you have staff to review exactly what the fund is holding. There’s too much uncertainty. You have to be wary of that,” Fisher said.

The issue of transparency is critical. “I want to know what I hold and whether I can accept that risk. There’s still a lot of risk there and for what return? A couple of basis points?” she asked. Companies that wish to stay entirely off the risk grid are negotiating earning credits with their banks and moving idle cash there. They can get as much as 30-40 basis points off fees. In some cases, companies received as much as 75 bps off their fees. No MMF can achieve that. Companies cannot keep their funds in banks forever. They are not earning explicit yield, so there is no interest income on trillions in cash and the FDIC won’t insure unlimited amounts forever.

“Nor is the market volatility going to subside any time soon. ‘We’re not done,’ Fisher predicted. ‘I don’t see things settling down this year or next. What’s going to happen with the agencies? That’s just going to add more fear and volatility into the market,’” she said. “We’ve got a few more years of this, in which case people want to know exactly what they have.”

“As a result of the 2008 financial crisis and events like the Reserve fund freeze up, clients grew more conservative. Some clients wanted to build liquidity, others moved into treasuries and most made some sort of change to their investment policy,” Saperstein said. “They reduced exposure to banks and other financial issuers and upped their minimum and average credit ratings. Over time, some clients have remained very conservative by investing only in government-protected investments including treasuries, temporary liquidity guarantee bonds, or agencies.”

“Transparency leads to visibility and a sense of control. It makes companies feel a lot more secure. It’s important right now—our clients really want to know what they’re invested in.”

Laura Fisher, Silicon Valley Treasury Consulting Group
“Clearly, the MMF events of 2008 caused clients to rethink their strategies as they relate to money fund selection, sponsor and diversification of funds types,” Saperstein said. Clients are more sensitive to the securities held within the MMFs and are regularly seeking analytics on fund holdings. “We’re seeing a migration to stronger sponsors and increased diversification in terms of the number of funds clients hold. Clients are also keeping a larger portion of their balances in banks to receive the ECR (earnings credit rate).”

But there are clear signs of change. Other clients determined that the only way to protect against a declining interest rate environment, as well as increase control over security selection, is to put money into separately managed accounts and extend maturities. Investors are now tailoring what they want to buy. “Certain MMFs can have exposure to issuers or asset classes that clients do not want to hold,” Saperstein said.

The financial issuers bore the brunt of the financial crisis while industrials strengthened their balance sheets. “During the fall of 2008, BBB-rated, non-financial issuers had a better bid, and better liquidity than AA-rated financial issuers,” Saperstein said. As a result, companies say, “I want to limit my exposure to financials while increasing my exposure to non-financials. In a separately managed account, I can pick and choose my exposures and build a portfolio that matches my risk tolerances,” Saperstein said. “The firms that are establishing separately managed accounts can adjust their investment policies to regulate portfolio exposures.”

**MORE MONEY GOING INTO MANAGED ACCOUNTS**

The $8 billion cash rich company that pulled out of MMFs is a great example. To diversify its risk, this company invests a large portion of its excess cash in separately managed accounts. “We get some diversification from our managers,” he explained. While they’re all managing according to the same investment policy, they vary on duration, adding value to the portfolio. “We look at the metric of duration,” the practitioner at this company said. “Some are short duration, some neutral duration. Some are meaningfully short vs. our benchmark,” he explained. “The composition varies by manager. They have views on how much [credit] spread they want to have in our portfolio as well.”

More money was given to managers who outperformed the benchmark. The company stays in constant touch with its managers. “We talk to them monthly and do deeper dives at quarter end. They stand by their view and the recent volatility in the fixed income market hasn’t caused them to do anything differently.”

“Our portfolio diversification ushered us through the credit crisis. We weren’t selling everything during the crisis. It’s a conservative corporate investment policy that has been able to withstand the shocks to the market and has not required us to sell. We did not sell even at the height of the credit crisis and we don’t now. We’re happy with the performance of the portfolio,” this treasury director reported.

There’s indeed growing evidence that other companies are coming to this conclusion. DB Advisors’ business has grown from 2007 to 2011 from 10% managed accounts to 25% managed accounts, according to Bannerton. “We definitely see managed accounts as an essential component of corporate cash management,” Bannerton said. “It’s one of several approaches but it’s gaining momentum. It will be growing more and more over time.” Fisher too reported increased interest among her client base.
One point of evidence that more money is flowing into managed accounts was buried in the earnings report for Blackrock, the world’s largest money manager. Its net profit jumped 43% in the second quarter, 16% more than the same period last year. While Blackrock saw outflows out of MMFs just like everyone else, “the outflows were more than offset by investment performance and growth in fixed income and multi asset products,” according to the Wall Street Journal.

At Halyard, managed accounts amount to 80% of its business, and corporations make up 70% of its clients, according to Boyd. Halyard sees increased interest in not earning zero, but not going too much out the curve in terms of risk spectrum. “We maintain safety of principal through diversification, whereas MMFs do not need to be as diversified,” Boyd said.

Saperstein of Treasury Partners sees a similar trend. “I see more companies moving into managed accounts as a way of decreasing risk and increasing visibility. The ability to pick and choose your strategies that fit your investment objectives with managed accounts [is very attractive].” Portfolios can be customized for particular cash uses, such as money waiting for an acquisition or longer-term portfolios for offshore cash likely to remain offshore for a while. “It’s money-fund like but only has securities that they are comfortable with.”

Investors have daily portfolio visibility and they are comfortable with what they hold. They don’t have to fear that there’s going to be a run on funds.” Saperstein added: “I think that it [transparency] is going to be a focus for the clients going forward as they are becoming sophisticated enough to tailor portfolios for specific purposes. Throwing everything into one bucket is on the way out; more specialized portfolios are on the way in.”

THE BENEFITS OF MANAGED ACCOUNTS

Managed accounts provide greater control, greater access to resources that may not exist internally, clearer transparency and more diversification. “We see the issue of diversification come into play more and more,” DB Advisors’ Bannerton said. Some of the shift is related to regulatory change in the MMF industry where new rules are forcing funds to keep money short and squeezing their allowable universe of investments even further.

The other driver that will push more companies into managed accounts will be the next round of MMF regulatory reforms. “We’re not exactly sure how that would ultimately look, for example, if there’s a capital requirement,” Bannerton said. But whatever the specifics, he and others expect an increase in the cost of operating a stable fund that would put further pressure on net yield offered with MMFs. Clients will be presented with stable NAV vs. variable NAV or separate accounts. “For companies, there will be a wider spectrum of options introduced as markets become more stable and regulatory uncertainty subsides.”

There’s clearly a shift in the way companies think of their investment strategies already. “I think that investment strategy is very thought-out right now,” said Fisher. “The last five years have done wonderful things for Treasury. Before, it was fairly standard and robotic and the policies were similar. There wasn’t a lot of analysis and looking at risk/return portfolios,” she said.

“You have to accept the fact that there is risk in many different forms, and the emphasis should be about managing risk, instead of avoiding it.”

Kevin Bannerton, DB Advisors

“Changes in 2a7 funds are creating a narrower universe of eligible investments and a shorter duration; they’re creating a more commoditized product that is highly concentrated in the financial sector,” said Bannerton. “At the time they are trying to improve liquidity, you see the unintended consequence of less diversification. The issue becomes: how to create diversification across funds and sectors. Separate accounts are a way that a corporation can create diversification across the yield and credit spectrum.”

Another very important reason a corporate client would outsource investment portfolio management lies in their inherent level of specialized expertise and collections of extensive research, Bannerton calls it “strategic outsourcing,” i.e., taking advantage of the credit and risk management supplementary services that corporate treasuries have neither the budget nor the bandwidth to similarly develop.
HOW TO GET STARTED

Treasurers who want to begin outsourcing a portion of their cash to outside managers often face an uphill battle, both within finance—specifically accounting—and with senior management concerned about liquidity and headline risk.

For many, the first step in moving toward managed accounts is education. That’s what Dell did when it sought to double the investments it outsources to external managers from 10% to 20% over a year. Dell’s Investment Manager, Pedro Andrade, launched a campaign to convince Treasury, finance partners and the executive committee that putting money into managed accounts would not restrict their access to cash. It took some convincing, but Andrade’s structured methodology for implementing this new investment strategy ultimately won him the approval to move ahead.

His experience is not unique. “We have seen evidence of a disconnect between investment committees, senior management and the frontline investment staff. In some cases there’s been a wide gap in the tolerance of risk between these different groups,” said Bannerton. Bridging that gap is the Treasurer’s responsibility and arguing about yield enhancement is probably not the right tactic. Instead, the focus should be on the risk benefits of managed accounts: diversification, control and transparency.

Laura Fisher of Silicon Valley Treasury Consulting Group has said, “Companies feel much safer when they know precisely where their money is. To win management approval, Treasury needs to focus on these benefits. The landscape has changed. So should the investment strategy.” One treasury practitioner that has recently increased the mandates of its well-performing managers said, “We have a very conservative investment policy. You can have a conservative strategy and still outsource your investments. It’s all about risk management.”

Once Treasury, finance partners and the executive committee have bought into a new investment strategy that focuses on separately-managed accounts, the next step involves building an internal infrastructure of policy and technology. Treasury needs to work on creating the right framework even before it outsources a single penny. Having the right investment infrastructure is critical to the success of the program and can be instrumental in gaining audit committee buy-in. The last thing treasury wants is to delve into the program head-on and start experiencing compliance and other violations.

As Laura Fisher of Silicon Valley Treasury Consulting Group has said, “Treasury began taking a look at risk return profile, global risk, and looking at counter-party risk across the entire business operation. It was painful, but companies look at their investments more seriously than five years ago. We have become more sophisticated.”

Step 1: Investment Policies

Most companies are happy to share their investment policies. Investors who want to review an example can often lean on their peers for advice. Critical to forming an investment policy is that it needs to be flexible enough to allow Treasury some leeway in making investment decisions, and it should be written with long-term objectives in mind (even though most are reviewed at least annually).

Even investors not planning to invest in BBB-rated debt right away should have provisions in the policy at the time it is established, rather than add it on later on.

Policies tend to be relatively routine. Nearly 80% of the companies surveyed by the AFP already have them. That figure is higher (90%) for companies with revenues of over $1 billion. Most have three stated objectives: safety of principal, liquidity and yield.

1. Creating a comprehensive investment policy
2. Implementing the right accounting and reporting platform
Policies typically have a threshold credit rating of no lower than single-A rating, although some go down to the top levels of BBB-rated securities. In descending order, they typically list the following permissible investment instruments: treasuries, agencies, commercial paper, MMFs, repos, Eurodollar deposit, munis, ABS, enhanced cash funds (only 16% for companies with a billion or more in revenue according to the survey), variable rate demand notes (14%) and auction rate securities (6% - although most people have pulled out of that market even if their investment policy allows it).

Policies have percentage limits on individual names and on sectors. They list which counterparties they're willing to accept and whether or not the money can be outsourced to external managers —a particularly important provision.

**Step 2: Building an Accounting and Reporting Platform**

Once the policy is complete it’s time to create the infrastructure to support the investment strategy.

“One of the elephants in the room is how to manage the corporate accounting and financial reporting in addition to portfolio risk and compliance,” said Growney of Clearwater. “The security level, risk management, trading and credit monitoring capabilities with an external manager far exceed what can reasonably be expected within a corporate investment environment. A corporation’s ability to recruit, compensate a team of credit, portfolio management and back office professionals is limited relative to the institutional investment management space,” continued Growney.

Most custodians offer some form of basic accounting and reporting, but they are frequently built on legacy technology from disparate systems, with limited ability to expand and adapt to the changing accounting and regulatory environment and, often can be rudimentary.

Because bank systems can be disparate and operate independently, information has to be manually re-keyed. As such, there is no direct cross-over from the custodial data (where the securities are held) to the accounting and reporting system. Under such conditions, reports are cumbersome and, available only monthly or quarterly and offer little—if any—analytics and performance evaluation data by manager. The data is essentially static and rarely useful, without significant manipulation.

That’s why, according to Andrade at Dell, “It’s critical to build a separate infrastructure which acts as the backbone of the investment portfolio. The system must include accounting, compliance, performance and risk analytics. Additionally, all the components need to be integrated so that risk and accounting ‘speak’ to one another and the data is carried seamlessly from one module to the next.”

Investors should never work from different numbers for portfolio accounting, compliance, performance and risk analytics for management presentations. Those numbers should reconcile, and ideally, should be drawn from the same dataset. Being able to manipulate the portfolio by manager, issuer, security, or credit rating are all critical tools for treasury to perform its risk management role. A useful degree of manipulation is only possible, and can only produce actionable information, if the data reconciles across the entire portfolio.

A high-functioning infrastructure supports Treasury’s ability to not only effectively manage multiple internal and external portfolios, but also to manage the risk across these portfolios with the ability to know where the corporate cash is, how much of it is there, and what is the risk profile of the portfolio on a daily basis.

“You need a solid foundational system because transparency is only the first step in a continuum that ultimately leads you to diversification.”

Chris Growney, Clearwater
“Information must be accurate, timely and reliable. Streamlining data is important for our clients. Getting the accounting right is very important. You can buy systems to solve some of these issues, but if you can’t get it into your auditors and they don’t sign off on the accounting part of it, you’ll get nowhere,” Fisher said. Being able to close the books and get the accountants to sign off is very important.

Compliance has been very important as well. With the right system, investors can look at all relevant compliance factors. Given the market’s volatility, tracking compliance has become a more frequent and critical task for Treasury, particularly with recent downgrades. Counterparty risk can also be difficult to track and sometimes pushes investment policies out of compliance unknowingly. “Investors need to be able to answer the question ‘Who is responsible for the security?’ Risk analysis is also very important right now, whereas performance has been less of an issue,” continued Fisher.

**Finally, Select Managers**

For whatever portion of the portfolio an investor decides to outsource, it is important to find the appropriate manager(s). That’s not an easy task, which typically involves lengthy RFPs. The AFP website contains some examples. Peers may be willing to share their own selection criteria as a starting point. Relationship banks can be helpful as well. The ultimate goal is to find a set of managers that are familiar with corporate cash, since not all managers are. Some are accustomed to primarily managing pension fund money and are unfamiliar with corporate realities, like limitations on credit that do not match up with the benchmark, and restrictions on realized losses.

Working with a consultant to limit the universe can be particularly useful for investors who do not have the time to perform due diligence on a range of asset managers. Talking to peers about the managers they use is another great idea. Companies are often forthcoming with providing that list.

First-timers with limited cash may find that some managers require a large upfront commitment, perhaps too large, but relationship banks are typically willing to take smaller portfolios. This is often a good place to start.

“First-timers often go with better names, bigger firms, often the asset management arms of their banks,” said Fisher. The minimum entry points at some independent managers are very high. Investors should include the amount they intend to outsource in the RFP to weed out the big players. Sometimes, smaller companies have to go to boutique firms that are still willing to take $50-100 million accounts.

Investors can also look for general managers, although companies with specific investments targeted for outsourcing [i.e., ABS/MBS or BBB, or corporate credit] may want to narrow their search to firms that specialize in specific mandates.

**CONCLUSION**

Investors unquestionably find themselves in a unique period. Companies are sitting on more cash than ever, while interest rates are at historic lows. At the same time, risk aversion may be at an all-time high. There are a variety of strategies companies use to manage this difficult environment. Managed accounts are growing in popularity as a way to offset portfolio risk through diversification, greater control and transparency.

“Recession fears and Euro debt woes have culminated in an extraordinary, low interest rate environment,” said Saperstein of Treasury Partners. “Investors need to pay particular attention to what they hold,” he emphasized, noting that when things do change, they will change rapidly.

Treasurers need to be prepared for that risk. Keeping money in bank accounts or uncertain MMFs is no longer a risk-free proposition. Investors must proactively reduce their reliance on a single source and diversify risk in order to earn some yield. Managed accounts are the natural next step for the 80% of companies who are not already outsourcing. As Andrade of Dell said, “The pendulum has swung all the way to the other side. It’s time for it to find a new middle ground.”

Building an internal infrastructure of policy and technology will be critical for investors as they prepare for what could be a protracted period of market uncertainty. Structuring investment policies, implementing an accounting and reporting platform and selecting portfolio managers must be done logically and deliberately. In the end, investors should feel confident that there are alternatives that do not require them to assume additional risk. Given the right infrastructure, investors can still focus on safety of principal, liquidity and yield, without sacrificing diversification, transparency and control.
About Clearwater Analytics

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