

Commentary

Europe—Why Worry?

By: SEI Investment Management Unit

- Recent troubles in Italy and Spain show that the financial problems facing Europe are no longer limited to Greece and other minor, peripheral countries.
- Despite the turmoil, SEI believes our money market funds are relatively well positioned for a negative credit environment.
- In our equity and fixed-income funds, SEI is first and foremost an active manager. Country and sector allocations are secondary in all of the funds, resulting from fundamental security analysis and active security selection by the underlying managers. We reviewed the portfolios and have confidence in the quality of the underlying holdings.

European leaders are working out the details in the latest effort to mitigate the financial crisis that began in Greece and started to spread to other European nations. While it may be difficult to understand, at first glance, how Greece is relevant to the global financial markets (the country is not a financial, industrial or military power, is not a strategically important commodity exporter and contributes only about half of a percent to world gross domestic product), a default on the country's debt poses the risk of a financial meltdown similar to the one that followed the failures of investment bank Lehman Brothers and insurance giant AIG in late 2008.

The Decoupling Myth Revisited

The fiscal and economic challenges faced by several peripheral eurozone countries are well-known at this point. The governments of Greece, Ireland and Portugal face challenges in rolling over their maturing debt, and in order to obtain financial assistance from the European Union (EU) and International Monetary Fund (IMF), they are implementing harsh austerity measures, including tax hikes, spending cuts and the sale of state-owned assets to private buyers. During the first quarter of 2011, Greece's economy remained mired in a deep recession, while the more fiscally stable German economy grew at its fastest rate since 1990. The stark change of fortune between the two countries is shown in Exhibit 1. Worse,

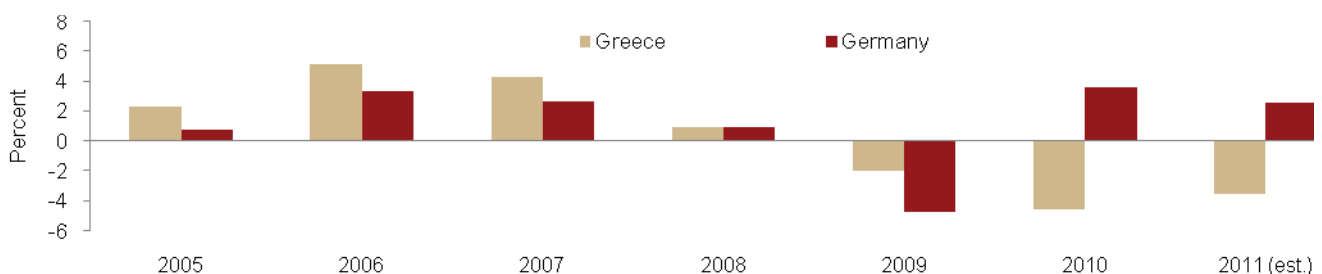
the recent troubles in Italian and Spanish government debt markets show that the financial problems facing Europe are no longer limited to minor, peripheral countries.

Heading into the global recession of 2007-2009, there was speculation among some market observers that certain emerging markets might be able to "decouple" from the troubled economies and financial systems of some advanced nations, but this idea was eventually proven wrong. Today, while the core and peripheral economies of the European Monetary Union (EMU) have decoupled to some extent, it's very clear that its national banking systems have not. In fact, investors, politicians and regulators have grown increasingly worried about the damage that a Greek or other sovereign default could inflict upon the financial sectors of France, Germany and other core countries, and whether such a shock could be transmitted globally. As was the case in 2008, these concerns are focused squarely on the banking and insurance sectors.

Banks and Insurers—A 2008 Repeat?

Markets, politicians and others are so closely attuned to events in Europe because in a worst-case scenario, a sovereign default could cause the same sort of financial and economic dislocation that ensued

Exhibit 1: Annual Change in Real GDP



following the failure of investment bank Lehman Brothers and near-failure of insurer AIG at the height of the 2008 global financial crisis. It's not a coincidence that attempts to involve Europe's private sector in developing a solution to the Greek debt crisis are focused specifically on banks and insurance companies. To understand why, it helps to have a basic understanding of how these industries operate, and how they got into trouble in 2008.

A fundamental concept in banking is financial leverage, which banks employ when, for example, they make loans. If a bank's capital is levered ten-to-one, it indicates that for every \$1 of its own capital, it carries \$10 in loans or other financial assets. While this can enhance the returns on a bank's capital, it also amplifies downside risk. For instance, with leverage of ten-to-one, a 1% loss on a bank's assets would translate into a 10% loss on its capital base (the loss in dollars is the same, but as previously noted, capital is only one-tenth the size of its assets). In 2008, Lehman Brothers incurred repeated asset and capital losses on its highly levered balance sheet, and when it was no longer able to borrow the funds necessary to cover those losses, it had to file for bankruptcy protection.

A similar concept to leverage in the insurance industry is known as "reserves." In order to protect against losses incurred by its policyholders, an insurance company must maintain adequate financial reserves (cash on hand). Additionally, insurers must be careful not to write insurance policies against catastrophic risks that could easily wipe out their capital reserves. This is why it's difficult to obtain flood or earthquake insurance in certain regions of the world, and why most insurance policies exclude events caused by war, nuclear meltdown and other catastrophes that would cause widespread and thus uninsurable damage. Unfortunately, AIG made the dangerous assumption that defaults on financial securities would be random and isolated enough that it could safely write an enormous amount of insurance on them. By 2008, AIG had written coverage on over \$440 billion worth of financial securities (incredibly, some of this 'coverage' was provided to financial institutions to help them conceal the extent of their financial leverage from investors and regulators). When the 2008 crisis hit, it was the financial market equivalent of a massive flood or earthquake. The financial damage incurred by AIG caused major shockwaves that threatened the entire global financial system and eventually resulted in a combined lifeline of over \$100 billion from the U.S. Federal Reserve and U.S. Treasury.

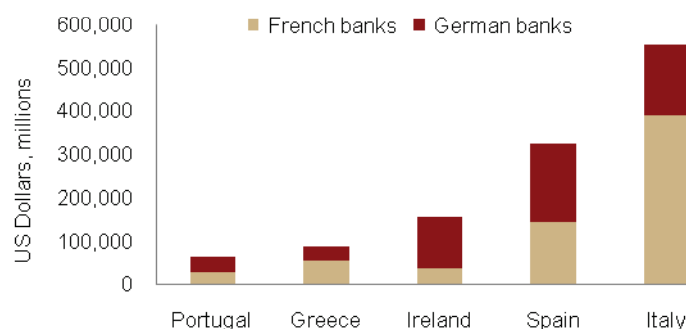
Today, a staggering number of these insurance-like arrangements still exist, and they create a significant degree of interconnectedness between financial institutions, markets and national economies. While bank leverage ratios have come down from where they stood heading into 2008, there's still enough opacity around banks' balance sheets to keep financial markets on edge.

Bank Leverage in the Eurozone Core

The higher a bank's leverage, the more susceptible it is to having its capital completely wiped out by a decline in the value of the financial assets that it holds. In the case of Europe, it's worrisome to note that a 2008 study by the Centre for European Policy Studies (CEPS) reported that (as of 2007), "the level of leverage in the EU is almost double that in the US."¹ The same report showed that among EMU member nations, banks in France and Germany held the greatest amount of assets and carried the highest leverage. If this is still holds true today, then a seemingly small loss on Greek or other sovereign debt holdings could do major damage to banks in both France and Germany.

This concern is evident in increasingly strained lending markets for European banks. Exposure of French and German banks to the debt of public and private issuers in troubled periphery nations, as well as to Italy and Spain, is shown in Exhibit 2.

Exhibit 2: Consolidated Financial Claims of Reporting Banks¹



Source: Bank for International Settlements

Is Contagion Inevitable?

Financial crises are worrisome due to the damage they can cause to investors' portfolios and the spillover effects they can have on an economy (for example, many economies are still feeling the after-effects of the 2008 crisis). But the ultimate concern caused by financial leverage, systemic risk and market and institutional interconnectedness is contagion, which could cause the global payments or banking system to grind to a halt, just as it threatened to do in 2008. As unlikely as it sounds (imagine not being able to withdraw funds from your checking account), such an event would leave most of the world at least temporarily insolvent. This ultimate fear is what moved policymakers to action in 2008, and it's driving the widespread concern over the eurozone debt crisis today.

As banks and insurance companies have been forced to write down the value of any periphery eurozone debt they hold or insure against default, concerns have risen

¹ Karel Lannoo, "Concrete Steps Towards More Integrated Financial Oversight: The EU's Policy Response to the Crisis", CEPS Task Force Report, Centre for European Policy Studies, Brussels. ² As of 12/31/2010

over the impact this could have on their capital and thus their financial stability. As a result, their own financial securities—equity, debt, short-term paper, etc.—have begun to suffer alongside those troubled sovereign securities. With sufficient leverage and losses in the system, a banking crisis becomes very likely, as occurred in 2008. There are some key differences between that episode and the current one, however.

In 2008, policymakers did not seem fully aware of the extent of the losses on financial institutions’ balance sheets or of the overall systemic leverage until Lehman Brothers collapsed and AIG threatened to do the same. Today, policymakers seem to be much more attuned to leverage, losses, and the possibility of financial contagion and cascading institutional failures. This awareness has been on display in the actions and comments of policymakers in Europe and elsewhere. Overall leverage and systemic fragility also appear to have eased since the 2008 crisis. While these risks are by no means absent, this would imply that there’s a greater margin for absorbing losses than there was in 2008 (although given the notable size of their national debt, a crisis of confidence in Italy or Spain’s solvency would almost certainly overwhelm any extra margin of error).

Our View

It’s still difficult to see how Greece can avoid an eventual default or restructuring of some kind. The EU and EMU may simply be trying to buy enough time for the planned European Stabilization Mechanism (ESM)—the EMU’s answer to its lack of a central fiscal authority such as the U.S. Treasury or U.K. Exchequer—to commence operations in 2013. The ESM will be able to provide permanent fiscal support to troubled member states as long as they meet certain conditions. The two years should also allow banks (and insurers) more time to work troubled assets and other exposures off of their books. Given Greece’s lack of economic competitiveness and the ongoing resilience of the euro, it might even make sense for the troubled country to depart the EMU at some point.

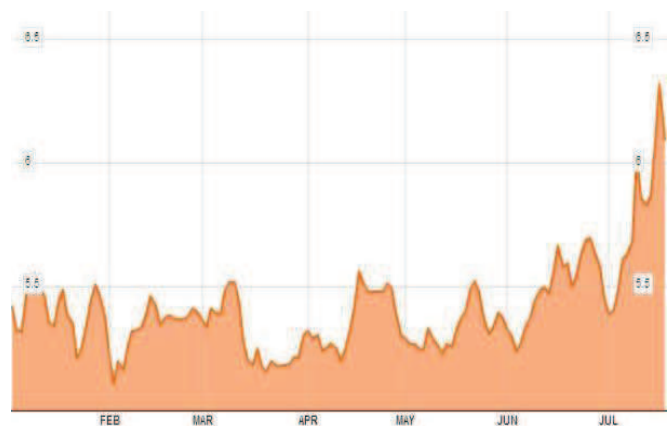
In the meantime, harsh austerity measures will continue to be demanded of Greece by the EU and IMF. European banks and insurers will be called on to absorb some of the pain, and rating agencies will continue to release potentially destabilizing downgrades. Ireland and Portugal remain ongoing risks, and if the recent loss of confidence in Italian or Spanish government debt shown in Exhibits 3 and 4 continues (bond yields move inversely to prices, so the steep rise in yields equates to a sharp decline in price), things could get particularly ugly. The Italian and Spanish economies are the eurozone’s third and fourth largest respectively, and they are the eighth and twelfth largest economies in the world.³ If these stresses

Exhibit 3: 10-Year Italian Government Bond Yield



Source: Bloomberg
Data is 2011 year-to-date as of July 20.

Exhibit 4: Ten-Year Spanish Government Bond Yield



Source: Bloomberg
Data is 2011 year-to-date as of July 20.

continue, the European Central Bank (ECB) could play an increasingly critical role, along with other major central banks of the world. As we noted in our most recent commentary on Greece, “In a worst case scenario, if the ECB, IMF and European finance ministers were to take their collective eyes off the ball, it could pose a systemic risk to the global financial system similar to the near-meltdown that followed the collapse of Lehman Brothers in 2008.” This still holds true, but for the moment, the EU seems intent on smoothing things over with Greece (however temporarily), and there’s also been a pause in the selloff of Italian and Spanish government debt.

Our Funds

Given the systemic risks involved, SEI is keeping a close eye on its funds’ exposures to the securities of both troubled eurozone governments and of companies that hold, insure or are otherwise significantly exposed to them.

³ As of 2010, based on average exchange rates, according to the IMF, World Bank and CIA

Like many prime money market funds, SEI's money market funds carry significant exposure to banks and other issuers based in eurozone countries. This is due to the fact that the commercial paper market in the United States has contracted severely since the 2008 financial crisis. U.S. firms' balance sheets are in relatively good shape, and are therefore not as reliant on short-term financing as they were prior to 2008. Thus, non-U.S. companies have become increasingly important issuers for money market funds that invest in commercial paper, and European banks are prominent among them. Exposure of our money market funds to issuers domiciled in France and Germany are shown in Exhibit 5. These include all sectors, but banks make up the majority of issuers in both countries.

Exhibit 5: Money Market Fund Exposures to French & German Issuers

Fund	Weight
SDIT Prime Obligation	21.36%
SLAT Prime Obligation	17.60%
SDIT Money Market	19.10%

Source: BlackRock

As of 5/31/2011; holdings are subject to change.

Although these exposures are significant, SEI takes a careful approach to risk management in its money market funds. SEI's Fixed Income Management Team holds veto power over eligible money market fund securities. The team has used that power, based on reviews by our internal credit analysts, to maintain a relatively conservative posture. We view diversification as key, and many of the funds' holdings are in very short-term instruments such as overnight securities. While there is no guarantee that these funds will be unaffected by further credit market turmoil, we believe they are relatively well positioned for a negative credit environment. The trade-off, of course, is a lower yield, and the funds' relative performance may suffer when there are positive surprises in credit markets. Investors should be aware that there are many types of money-market mutual funds, and should consult with their financial advisor to determine which type of fund is most appropriate to their circumstances.

Exhibit 6: SEI Equity Fund Exposures to European Financial Sector

Fund	Benchmark Index	Fund Weight (Absolute Exposure)	Benchmark Weight	Difference (Relative Exposure)
SIIT ACWI	MSCI All-Country World Ex-U.S.	7.02%	9.31%	-2.29%
SIIT Screened ACWI	MSCI All-Country World Ex-U.S.	7.94%	7.89%	0.05%
SIIT International Equity	MSCI EAFE	9.91%	13.23%	-3.32%
SIT International Equity	MSCI EAFE	9.75%	13.23%	-3.48%

Source: BlackRock

Defined as banks based in France, Germany, Ireland, Italy, the Netherlands, Spain, Sweden, Switzerland or the U.K.

As of 5/31/2011; holdings are subject to change.

Equity fund exposures to the European Financials sector—defined as issuers based in France, Germany, Ireland, Italy, the Netherlands, Spain, Sweden, Switzerland or the U.K.—are shown in Exhibit 6. Our international equity funds were underweight European Financials by two to three-and-a-half percent as of May 31, except for the Screened All-Country World Ex-U.S. Fund, which was overweight 0.05%.

Fixed income fund exposures to the European Financials sector—defined in the same way as for our equity funds—are shown in Exhibit 7 on the following page. As of May 31, the largest absolute weights were in the STET Tax-Advantaged Income (10.2%), SDIT and SIIT Ultra Short Duration Bond (5.6% and 5.76%, respectively) and SIT International Fixed Income (5.3%). The largest relative overweights are in the STET Tax-Advantaged Income Fund (10.2%) and the SDIT and SIIT Ultra Short Duration Bond Funds (5.6% and 5.76%, respectively). All other funds were within two percent of benchmark weight as of May 31.

It's important to keep in mind that country and sector allocations are secondary in all of the funds, resulting from fundamental security analysis and selection by the underlying managers. SEI has paid close attention to this issue for some time and will continue to do so.

Prior Publications

- "Greece, Europe in Renewed Turmoil", June 2011
- "An Update on the Greek Sovereign Debt Crisis", May 2010
- "Outlook on Sovereign Debt", March 2010
- "Greece: Testing the Stability of the Eurozone", February 2010
- "Greece Under Pressure", February 2010

Exhibit 7: SEI Fixed Income Fund Exposures to European Financial Sector

Fund	Benchmark Index	Fund Weight (Absolute Exposure)	Benchmark Weight	Difference (Relative Exposure)
SIIT Core Fixed Income	Barclays Capital U.S. Aggregate	1.87%	0.49%	1.38%
SIMT Core Fixed Income	Barclays Capital U.S. Aggregate	2.20%	0.49%	1.71%
SIMT US Fixed Income	Barclays Capital U.S. Aggregate	1.21%	0.49%	0.72%
SIIT Long Duration	60% LCREDLONG / 40% GOV_10P	1.67%	0.69%	0.98%
SIMT Enhanced Income	BofA ML 3 Month LIBOR Constant Maturity (LUS3)	1.39%	0.00%	1.39%
SDIT Ultra Short Duration Bond	Barclays Capital Treasury 9-12 Month	5.60%	0.00%	5.60%
SIIT Ultra Short Duration Bond	Barclays Capital Treasury 9-12 Month	5.76%	0.00%	5.76%
AMT Tactical Offensive Fixed Income	S&P 500 (Gross) (USD)	1.08%	0.46%	0.62%
SIMT High Yield Bond	BofA Merrill Lynch US High Yield Master II Constrained	0.25%	0.65%	-0.40%
SIIT High Yield Bond	BofA Merrill Lynch US High Yield Master II Constrained	0.22%	0.65%	-0.43%
STET Tax-Advantaged Income	Barclays Capital 60/40 Barclays HY Muni & Barclays Muni	10.20%	0.00%	10.20%
SIT International Fixed Income	Barclays Capital Global Aggregate ex-USD, Hedged (USD)	5.30%	3.38%	1.92%

Source: BlackRock

Defined as banks based in France, Germany, Ireland, Italy, the Netherlands, Spain, Sweden, Switzerland or the U.K. As of 5/31/2011; holdings are subject to change.

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice. This information is for educational purposes only.

There are risks involved in investing, including loss of principal. Diversification may not protect against market risk. It is important to keep in mind that bond will decrease in value when interest rates rise. Current and future portfolio holdings are subject to risks. International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principals or from economic or political instability in other nations.

An investment in a Money Market Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the Fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in the Fund

SEI Investments Management Corporation (SIMC) is the adviser to the SEI Funds, which are distributed by SEI Investments Distribution Co. (SIDCO). SIMC and SIDCO are wholly owned subsidiaries of SEI Investments Company.

To determine if the Fund(s) is an appropriate investment for you, carefully consider the Fund's investment objectives, risk factors and charges and expenses before investing. This and other information can be found in the Fund's prospectus, which can be obtained by calling 1-800-DIAL-SEI. Please read it carefully before investing.