Six Advantages of Separately Managed Accounts

A Logical Complement to Money Market Fund Solutions

Executive Summary

The complementary use of commingled and separate accounts may help in optimizing corporate cash management.

The percentage of corporate investors considering money market funds as permissible investments has been declining since 2009, while the permissible use of separately managed accounts has been climbing.

Six Advantages of Separately Managed Accounts:

1. Tailored Risk Management
2. Transparency
3. Higher Return Potential
4. Free from "Hot Money"
5. Income and Capital Gains Management
6. Versatile Reporting

Investments in time and research in a separate account relationship may bring just rewards in times of uncertainty.

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Introduction

One of the lessons corporate treasurers learned from the recent financial crisis is that, despite their appearance of safety and liquidity, pooled liquidity vehicles, including money market funds, are susceptible to lapses in investor confidence that may lead to runs. In 2007, after early blowups of supposedly conservative "yield-plus" and "ultra-short" funds, several state-owned local government investment pools (LGIPs) froze redemptions due to investments in troubled structured investment vehicles (SIVs). The Lehman Brothers bankruptcy in 2008 forced the $64 billion Reserve Primary Fund to "break the dollar," the second such instance in the history of money market funds. The U.S. Treasury had to institute an emergency guarantee program to prevent widespread runs on money funds beyond the four fund families that had already implemented fund freezes. These events evoked uneasiness among treasury professionals who routinely used commingled investment vehicles as mainstay cash management tools.

Since we revised the original paper of the same title in December of 2008 and again in May of 2012 the Securities and Exchange Commission (SEC) implemented new rule 2a-7 requirements 2014, effective in 2016, which will do away with the constant net asset value (NAV) for institutional prime funds, and also mandate that fund sponsors institute gates or fees under certain conditions. Not surprisingly, the money market fund industry and many institutional shareholders pushed back fiercely, suggesting that these potential reforms could result in a substantial reduction of money fund assets.

Meanwhile, based on our observations, interest in separately managed account (SMA) solutions has been building among institutional cash managers since the financial crisis. As of the 2012 revision of this paper, some of the primary drivers for this renewed interest were a desire for enhanced yield while the Federal Reserve held short-term interest rates near zero, concern over regulatory uncertainty with money market funds, and the need to diversify cash options before the expiration of unlimited FDIC deposit guarantees. Today, short-term interest rates are still historically low, changes to the money market fund industry have made them less attractive for many investors, and the need to diversify cash options still exists as markets evolve.

Whether to use a commingled asset pool like a money market fund or an investment manager in a separate account format is an age-old debate. Few would dispute the benefits of the daily liquidity offered by a money market fund today; however, a separate account investor with specific investment guidelines might have avoided the collateral damage and anxiety from some of the poorly conceived investment strategies in commingled vehicles. Shareholder frustration from the inability to assess and remedy undesirable credit exposures in a fund is perhaps more agonizing than the severity of actual credit risks.

The growth of electronic trading platforms, including web-based fund portals, took the popularity of fund investing to a new level. Credit events of the past few years, however, brought the argument for separate account management back to the forefront for many corporate investors. In this paper, we examine a number of advantages of SMAs. We believe that the right answer is not an "either-or" decision, but rather the complementary use of both strategies in optimizing cash management solutions for the corporate investor.

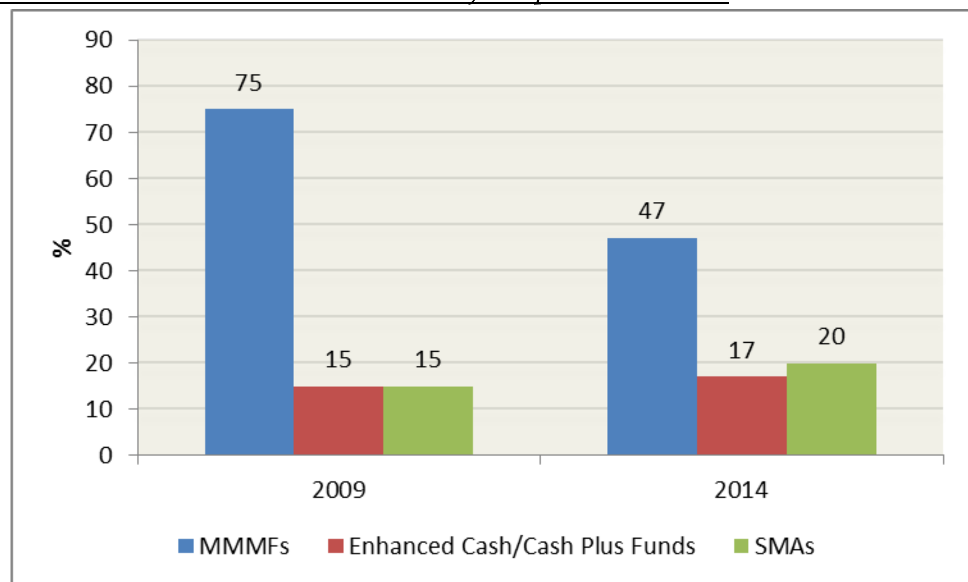
Separate Account Management Basics

As the title indicates, investors of SMAs own their investments directly, often in a custodial investment account registered under the investor's name. This is in contrast to investors owning shares of a mutual fund or other commingled vehicles that in turn own individual securities, such as stocks, bonds and/or derivatives. In both cases,

investors use professional investment managers to make discretionary investment decisions. Typical SMA investors include educational endowments, charitable foundations, pension plans and private wealth trusts.

In the area of corporate cash management, the use of separate account management has a long tradition, but with a limited following. According to the 2014 industry survey by the Association for Financial Professionals, about 20% of U.S. corporations permit separate account investing. This compares to 47% allowing money market funds and another 17% in other forms of commingled vehicles. The percentage of surveyed corporations which permit money market funds has been declining steadily since 2009, while the permissible use of SMAs has risen. Recent credit, yield and regulatory trends may have affected this transition. While we believe SMAs help improve transparency and oversight, their potential advantages do not stop at risk management.

Figure 1: Permissible Investment Vehicles by Corporate Investors



Taken from table: Permissible Investment Vehicles per Organization's Short-term Investment Policy in Addition to Bank Deposits and Treasury Bills, 2009 and 2014 liquidity survey results, Association for Financial Professionals, Bethesda, MD.

Customization – Potential Advantages

Many of the potential and obvious advantages of SMAs reflect their trait of individuality. Because assets and investment preferences are not commingled with those of others, individual investors are able to work with their investment manager to customize investment strategies and construct a portfolio catering to their own risk tolerance, return expectations and specific operating cash needs.

1. Tailored Risk Management: Every investor faces unique circumstances that impact income, growth, safety and liquidity considerations. Understandably, a commingled vehicle rarely satisfies the preferences of all investors in the fund. For example, certain corporate investors would not permit mortgage-backed securities (MBS), asset-backed securities (ABS) and collateralized debt obligations (CDOs) in their portfolios. During the financial crisis, some of the more exotic forms of asset-backed commercial paper (ABCP) ran into credit and liquidity problems and many investors were surprised to discover such exposures in the money market and yield plus funds they owned.

In a separate account relationship, an investor may set specific guidelines on some of the key risk control metrics such as maturities, concentration limits, ratings and liquidity requirements. Another effective risk control mechanism may be a list of prohibited transactions including the use of financial leverage, derivatives and/or specific security types to be excluded.

Figure 2: Sample Restrictions in Investment Guidelines

ITEM	LIMITS
Maximum issuer maturity	24 months
Maximum portfolio maturity	12 months
Minimum credit ratings	A3/A- (A-1/P-1)
Issuer concentration	5%
Industry diversification	20%
Overnight liquidity	10%
Benchmark selection	3-month T-bill
Prohibited transactions	Leverage, derivatives, extendible CPs, CDOs

2. Transparency: Another potential advantage related to risk control is the level of disclosure of investment activities. In addition to periodic statements, reports and expenses, an investor is entitled to all relevant portfolio information on demand. Equipped with the right data, the investor may address and deal with credit issues in a relatively timely fashion.

In contrast, money market funds currently release information on a monthly basis with several days of lag time. Even in the more transparent environment under upcoming rule 2a-7 requirements, for competitive reasons fund companies are unlikely to volunteer more information than is necessary. Fair Disclosure regulation requiring funds to disseminate new information to all shareholders at the same time also presents operational challenges that make timely identification of specific exposures cumbersome.

3. Higher Return Potential: When comparing and contrasting commingled and separate account investments, one cannot dismiss the potential return aspect. Under certain conditions, a separate account may provide higher yield potential than a typical money market fund. There are two reasons that may contribute to this.

a) Exemption from Rule 2a-7: The governing SEC regulation for money funds includes Rule 2a-7 which limits investments to well-diversified short-term securities with high credit ratings. The revised rule, in place since 2010, further restricts liquidity and maturities and reduces yield potential. As such funds make up a major part of the short-term credit market, securities not eligible for the 2a-7 parameters, such as those with maturities slightly longer than 13 months, may be less popular and subsequently higher-yielding. Come October 2016, yield potential in institutional prime funds is expected to decline further as fund managers become more conservative to avoid potential fees and gates. Some of the yield-plus funds exploited income opportunity with overly aggressive strategies and suffered the consequences. A separate account may avoid some of these pitfalls and achieve higher income potential by adhering to measured parameters beyond 2a-7 without violating the investor's risk tolerance.

b) Yield curve positioning: Another higher yield potential for separate accounts is related to the levels of interest rates. Generally speaking, investors may expect investments with longer maturities to outperform money market funds in a normal interest rate environment, since the higher risk of longer-term securities demands higher yield to compensate for owning such securities.

4. Free from "Hot Money": One of the difficult realities a commingled fund manager faces is the movement of "hot money" from fund to fund by certain investors. This movement could be to take advantage of favorable yield or to escape a fund if one suspects that a run might occur. The 2014 SEC rule revision makes this risk more pronounced as institutional shareholders, which tend to represent "hot money", are separated from retail investors. Volatile cash flows can force managers to either leave too much idle cash in the portfolio or to sell securities at a loss to satisfy redemptions, both of which may have serious long-term implications on fund performance.

The development of web-based portal technologies and the increasing commoditization of money market funds may have exacerbated the volatility of fund flows. At its extreme, a large number of yield-chasing investors simultaneously moving out of underperforming funds could threaten the stability of the money market fund product.

On the other hand, separate account investing is not affected by cash flows from other investors. SMA investors can and often do work with managers in response to upcoming cash flow changes weeks or months ahead. Such information becomes a valuable tool in helping to improve the account's investment performance.

5. Income & Capital Gains Management: Practically speaking, few corporate cash management accounts focus on total return initiatives. Instead, most focus on income potential and accounting gains. The advantage of a separate account that allows an investor to work with an investment manager on certain yield targets, income recognition and capital gain/loss management can be significant. This is especially true for some publicly traded companies where investment income is a meaningful contributor to the firms' bottom-lines. Income forecasting, gains recognition and loss-harboring for tax purposes are some of the tools not offered by commingled vehicles.

6. Versatile Reporting: In addition to risk and return considerations, the separate account setup allows an investor to receive customized reporting unavailable from commingled vehicles. For investors concerned with specific credit, industry and country exposure, performance measurement, corporate governance, audit oversight and operational efficiency, the number and details of reports are limited only by the investor's preferences and the manager's technological capabilities. Compliance reports that detail all portfolio activities and current holdings on demand may be included among these reports.

Conclusion

The process required to establish a separate account relationship may take more steps than a mere mouse click on a fund portal, but investments in time and research may bring just rewards during times of uncertainty. There is no question that an advisory relationship should be a long-term partnership that requires considerable trust and scrutiny.

It also is important to point out that separate account relationships are not without their drawbacks. Less public and comprehensive information is available from outside managers on separate accounts in aggregate and return performance may not be directly comparable among managers. Such difficulties place more due diligence requirements on the investor before and after establishing an advisory relationship. Ongoing dialog, performance appraisal and manager evaluation should be integral to a separate account management process.

These six potential advantages of separate account management are not meant to be exhaustive, but are intended to stimulate discussion on this topic. Using a commingled

vehicle or a separate account manager should not be mutually exclusive. In addition to the convenience and daily liquidity of a money market fund, corporate cash investors may look to separate account management to enhance investment return potential and to improve risk management.

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