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On a Path to Return on Investments

Revisiting the Risk/Reward Profile of a Corporate Cash Portfolio

Abstract

The return of yield opportunities presents institutional cash investors with fresh challenges. Higher rates have driven up the cost of staying with ultra conservative instruments. Money market fund reforms have left corporate cash managers with few clear choices to add yield. And historically popular cash vehicles that have undergone significant changes demand a fresh look. After revisiting several investment scenarios with updated income figures, we suggest that a multi-pronged investment strategy, including separately managed accounts (SMAs), may help improve one's risk/reward profile.

Introduction

In the years after the 2008 financial crisis, the Federal Reserve maintained a zero- interest-rate policy (ZIRP) to boost economic recovery until December 2015, when it slowly started to lift the short-term rates off the floor. When risks were plentiful and yield was nonexistent, institutional cash investors were concerned with the return of their investments, meaning principal preservation, than with traditional return on investments.

In February 2012, we published a whitepaper titled "All Pain, No Gain" that discussed several types of stylized cash vehicles with vastly different risk profiles but essentially the same return profile – zero. Now, with the Federal Reserve well on its way to interest rate normalization, we thought it appropriate to revisit the subject, identify changes in risk/reward characteristics of several sample portfolios, and discuss ways to improve their risk/reward balance.

Tales of Four Cash Investors

To illustrate the risk/reward tradeoffs, we presented four hypothetical investors' cash vehicles as of 1/31/2012 below (with edits):

Investor	Profile	Instrument	Effective Maturity (Days)	Yield
A	Low risk, Low reward	Treasury bills	99	0.06%
B	Low risk, Moderate reward	FDIC transactional account	1	0.00% (ECR 0.10% - 0.30%)
C	High risk, Low reward	Prime money market fund	1	0.08%
D	High risk, High reward	Total return portfolio	631	1.09%

Investor A: Balances were entirely in U.S. Treasury bills as represented by the BofA Merrill Lynch US Treasury Bill Index. The portfolio had an average maturity of 99 days and yielded 0.06%.

Investor B: Balances were entirely in an FDIC-insured, non-interest bearing transactional account. The depositor earned an estimated effective earnings credit rate (ECR) of 0.10% - 0.30%. No industry information is available on ECRs. The FDIC program expired at the end of 2012.

Investor C: Balances were entirely in an institutional prime money market fund represented by the Crane Data Prime Institutional MF Index with an effective overnight maturity that yielded 0.08%.

Investor D: Balances were entirely in an index-tracking account consisting of government, corporate, financial, mortgage-backed and asset-backed securities as represented by the BofA Merrill Lynch 1-3 Year US Broad Market Index yielding 1.09%. Its effective maturity was 631 days.

The stylized table covered a wide spectrum of cash investors. Except for D, real-world investors lay along different points of the "pain" scale, while the "gain" scale was almost indistinguishable from each other. We presented D to showcase a total return-oriented investor who assumed more risk to add yield.

Risk/Reward Profiles Then and Now

We reproduce the same four investors below with updated characteristics as of 6/26/2017. We also include their annualized year-to-date returns for comparison purposes:

Investor	Profile	Instrument	Effective Maturity (Days)	Yield
A	Low risk, Low reward	Treasury bills	88	0.93%
B	Low risk, Moderate reward	MMR	1	0.12% (ECR 0.25% - 0.40%)
C	High risk, Low reward	Prime money market fund	1	0.75%
D	High risk, High reward	Total return portfolio	661	1.57%

Differences are presented below:

Investor	Instrument	Effective Maturity (Days)	Yield	ANNU Return
A	Treasury bills	-11	+0.87%	0.59%
B	MMR	0	+0.01%	0.12%
C	Prime money market fund	0	+0.67%	0.66%
D	Total return portfolio	30	+0.48%	1.58%

The modern day corporate cash investor is challenged on multiple fronts, including compressed yield opportunity, looming credit risks and a long list of regulations. Staying ultra-conservative has been sensible for years, but the tables above indicate that as yield comes back to the market, it may be necessary to reassess risk/reward profiles.

A. All-Treasury: A portfolio of 100% Treasury bills represents the most conservative investor profile. This portfolio is generally an interim solution for investors who are developing long-term cash investment plans or who elect to step out of credit instruments for a period of time. Firms with significant cash balances tend to forgo meaningful income opportunities over time. In our example, Investor A currently earns 0.93% with a year-to-date annualized return of 0.59%

B. Transactional Deposits/MMR: The FDIC transactional account guarantee program expired on 12/31/2012. The published FDIC national average of money market rates (MMR) for jumbo (>$100,000) accounts held steady at 0.12%, unchanged from October 2014, despite the Federal Reserve's 1.00% cumulative interest rate increases since December 2015. Some corporate investors reported moderate increases in their ECRs (earnings credit rates, no published data available), although these fee rebates become less relevant as market rates rise above levels necessary to cover banking fees.

C. Money Market Funds: Institutional prime funds in 2017 are structurally different from 2012. The 2016 SEC reforms require the funds to float their net asset values and impose emergency redemption fees and gates. Collectively, the funds lost 92% of their assets before flows started to stabilize. From a yield perspective, the Crane institutional prime fund index gained 67 basis points to yield 0.75%, with a similar annualized return for the first half of 2017. The Crane index yield is 18 basis points shy of the Treasury index, although some of the larger prime funds are printing yield levels above 1.00%. Institutional cash investors should evaluate this yield opportunity in light of liquidity constraints and principal fluctuations.

D. Total Return Strategies: Not all corporate cash portfolios can implement portfolio strategies with a 600+ day average maturity. Those that could were rewarded by the market due to still-accommodative monetary policies and a benign credit environment. This investor is now earning 1.57% with an annualized first-half return of 1.58%. Note that the 0.48% yield pickup since 2012 is lower than the 0.87% pickup in Treasuries, an indication of a flatter short-term yield curve. This came as a result of bigger influences from Fed actions on front-end maturities than those further out. This portfolio, besides having a longer mandate, contains securities that may not be consistent with some cash investment policies.

Ways to Improve Profile

The three main investment objectives of Treasury organizations are generally capital preservation, liquidity and income opportunities. Improving a portfolio's profile requires pulling one or both of these levers: reduce risk and/or improve return potential. Yield generally receives lower priority than the other two, so more focus is needed on risk control. A combination of the following steps may help this process.

A. Improve Diversification: It should not come as a surprise that proper diversification can help improve one's risk/reward profile. We use this term in a broader sense than securities diversification.

    1. Types of Instruments: Recent money fund reforms have led most prime fund investors to switch to government funds, although some portions of the assets also went to deposits and separately

managed accounts (SMAs). These instruments, along with repurchase agreements and direct purchases, may improve one's profile.

2. Types of Liquidity: Treasurers no longer may rely exclusively on the promised daily liquidity delivered by pooled vehicles, including government money market funds. Instead, liquidity may be diversified through planned maturities and market liquidity (controlled sales) in addition to promised liquidity.

3. Laddered Maturities: Diversification among securities maturing at different times, otherwise known as laddered maturities, also may improve one's profile. In addition to liquidity benefits, a laddered-maturity portfolio may weather interest rate volatility better than a bullet or barbell portfolio strategy, two common styles of portfolio management.

4. Beware of Over-Diversification: In yield-oriented cash portfolios, we think over-diversification actually may lead to a worse-off profile in security selection. Highly correlated financial markets and a limited universe of debt issuers make owning a larger number of credits less desirable. The increased probability of defaults by a marginal issuer far outweighs its incremental yield pickup.

B. Alpha or Beta: Importantly, investors need to understand the factors contributing to returns. In financial jargon, alpha returns refer to extra returns over a benchmark without taking on extra risk. Beta returns are extra returns as the result of taking on additional risks. Although no standardized risk metrics exist for cash portfolios, we should be skeptical of investment managers delivering beta returns in the guise of alphas. For example, a fund with above-average returns during market turmoil may, in fact, be using lower quality, less liquid names.

A Sound Risk/Reward Profile Involves a Multi-Pronged Approach

For institutional cash investors, the return of yield opportunities presents fresh challenges. On the one hand, the cost of staying with ultra conservative instruments is increasing with higher rates. On the other hand, the 2016 money market fund reform left them with few clear choices to take advantages of the higher yield. Historically popular cash vehicles, including prime money market funds, FDIC-insured transactional accounts and all-Treasury portfolios, have all undergone significant changes and demand a fresh look. Improved diversification among cash vehicles, liquidity and maturity structures may help improve this profile. Understanding sources of excess returns may help locate sources of risk. A multi-pronged approach that includes SMAs may help improve one's risk/reward profile.

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