All Pain, No Gain?

On Improving the Risk/Reward Profile of a Corporate Cash Portfolio

Abstract

Recent developments in corporate cash investments resulted in portfolios of different risk characteristics having little yield differentiation. Popular cash vehicles, including prime money market funds, FDIC-insured transactional accounts and all-Treasury portfolios, require a fresh look in this new environment. Improving a portfolio's risk/reward profile may involve diversification among cash vehicles, liquidity and maturity structures, as well as fee considerations. 2012 may be a crucial year for investors to rebalance their risk/reward tradeoffs thanks to a number of current events. A multi-pronged approach, including separately managed account solutions, may help. The window of opportunity may be closing for treasury organizations still without a long-term plan.

Introduction

The financial debacle of 2008 gave birth to a popular catch phrase, "a crisis is a terrible thing to waste." Yet, few people were prepared for the game of "whack-a-mole" that would plague the world's debt markets for the next three years. These events taught us to stay on the conservative side of investing cash assets and worry less about yield. But did we calibrate our risk and reward tradeoffs just right? Do we have a Plan B if situations continue to deteriorate in Europe? What can we do to improve our risk/reward profile?

Tales of Four Cash Investors

To illustrate our point of risk/reward tradeoffs, let's consider four hypothetical investors:

Investor	Profile	Instrument	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	0.01% (high fee class)
D	High risk, High reward	Total return portfolio	631	1.09%

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Investor A: Balances are entirely in U.S. Treasury bills, with an average maturity of 99 days, according to the Merrill Lynch U.S. Treasury Index. As of 1/31/2012, the portfolio yield was 0.06%.

Investor B: Balances are entirely in an FDIC-insured, non-interest bearing transactional account. The depositor earns an estimated effective rate (earnings credit rate) of 0.10% to 0.30% (no industry information is available). The FDIC program expires at the end of 2012.

Investor C: Balances are entirely in a non-bank affiliated U.S. institutional prime money market fund. As of 12/31/2011, 76% of the fund holdings are non-U.S., 44% of which are European sovereign and bank borrowers. The investor has an effective overnight maturity and earns 0.01% (the institutional share class of the fund pays 0.20%)[1].

Investor D: Balances are entirely in an index-tracking account consisting of government, corporate, financial and mortgage-backed securities. As of 1/31/2012, its effective maturity is 631 days and has a yield of 1.09%, according to the Merrill Lynch 1-3 Year U.S. Domestic Master Index.

This stylized table may cover a wide spectrum of investors among us. Investors A and D represent the two opposite ends of the risk/reward spectrum, but the majority of corporate cash investors may identify more closely with Investors B and C. Note that although Investors A and C both are in the "no gain" camp, the "pain" quotient for the fund investor may be significantly higher than the Treasury investor. The depositor (Investor B) derives a meaningful "gain" from the FDIC guarantee program, but the good days are numbered before the "pain" may set in. Lastly, the short-duration, total-return style used by Investor D may be beyond the "pain" threshold of some, if not most, corporate investors in a practical and psychological sense.

The Need to Improve the Risk/Reward Profile

The modern day corporate cash investor is challenged on multiple fronts – limited yield opportunity, developing credit risks and a long list of regulations. Staying ultra-conservative is sensible for the time being, however, not all investors' risk/reward profiles are optimized to improve returns or reduce risk. Understanding recent developments among different corporate cash investment options may help treasurers appreciate the need to improve their profiles.

A. **All-Treasury:** Moving into a 100% Treasury portfolio with essentially zero yield may make sense when an investor needs time to assess the current situation and

develop a long-term plan. Firms with significant cash balances forgo significant income opportunities over time. A new approach may be needed.

B. **FDIC Program:** Transactional account guarantees and ECRs currently present the best-of-both-worlds solution relative to other cash vehicles. Yet, as this option will expire on 12/31/2012, sensible corporate treasurers need to look for ways to fill this void.

C. **Money Market Funds:** The risk of a classic "run" in fixed net asset value pooled investments calls into question the reliability of money market funds as the main solution to outsource corporate cash. From the enhanced cash funds in 2007, to the Reserve Primary in 2008 and the mini-runs in 2011, this structural vulnerability is present regardless of the underlying credit investments or manager capabilities. This risk should compel corporate treasurers to reevaluate their outsourced models and risk/reward profiles.

D. **Total Return Strategies:** Although not all corporate treasury portfolios can implement portfolio strategies with a 600^{+} day average maturity, they may be equally saturated with securities that have good credit ratings but carry high prepayment or liquidity risk. As an example, portfolios using variable rate demand notes to add yield often are exposed to the same financial credits (as liquidity backstops) that they are unwilling to own outright.

E. **Challenges in Financials:** Lastly, turmoil continues in the financial markets at home and abroad that requires us to reevaluate our risk profile. Reduced government support assumptions, capital inadequacies, difficulties in funding, business model validity and ratings downgrades are but a few reasons that force us to reappraise the creditworthiness of the same names we have used for decades.

In short, developments in all modes of outsourced investment solutions face changes that will require corporate investors to improve their risk/reward profiles.

Ways to Improve Profile

Simply put, improving one's risk/reward profile requires pulling one or both of the two risk/return levers: reduce risk and/or improve return potential. Although there is no quantitative model to do that job for us, a combination of the following steps may help:

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 simply securities diversification.

1. **Types of Instruments:** Because of their convenience and cost considerations, money market funds have replaced other investment choices in the cash portfolios of many treasury organizations. Reintroducing some of these instruments, such as deposit accounts, separately managed accounts, repurchase agreements and some direct purchases, may improve one's profile.

2. **Types of Liquidity:** Likewise, treasurers no longer may rely exclusively on the promised daily liquidity delivered by pooled vehicles, including 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 (losses of up to 100%) by marginal issuers far outweighs their incremental yield pickup (often less than 0.10%).

B. Fee Considerations

Fees reduce a portfolio's return potential, leading to a less desirable profile. On a relative basis, they become an even bigger factor in a low yield environment.

1. **Share Class Based Fees:** Our example of Investor C illustrates the need to pay attention to fees because the investor is in a share class of higher fees, although they may qualify for a lower fee class. Thus, investors need to always inquire

with their investment managers or fund distributors whether they are in the lowest fee share class possible, all else being equal.

2. **Comparison Shopping:** Regardless of investment choices, expenses often are a negotiable item. In a low yield environment, fund sponsors and money managers often accommodate investors by instituting partial fee waivers. While expenses never should be the primary reason in evaluating an investment option, comparison shopping helps improve the reward side of the profile.

3. **Net of Fees Performance:** Notwithstanding many nuances involving expenses, we believe investors' ultimate interest is in the long-term net of fees performance of their portfolios. Thus, their decision should focus on the manager's satisfactory gross return performance as well as the manager's ability to control costs.

C. Alpha or Beta

Lastly, 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.

Time to Act

Improving one's risk/reward profile ought to be an ongoing task, but the urgency to act takes on a new dimension in 2012 as corporate treasurers seek alternatives to their current deposit accounts and money market funds before time runs out.

A. End of the FDIC Program: The FDIC guarantee for non-interest bearing transactional accounts will end at the end of 2012. Corporations with large sums of cash but no executable plans to diversify their cash holdings may be at a disadvantage. They may be forced to accept single credit risks in uninsured bank deposits or face the risks of financial concentration and runs in money market funds.

B. **Uncertainty with Fund Regulations:** It is widely expected that the SEC will introduce proposals in 2012 to further regulate the money market fund industry. Floating net asset values, capital buffers and redemption restrictions are the three leading options discussed thus far. Unprepared corporate treasurers may be caught by surprise if an option is adopted that is incompatible with their cash management mandate.

C. **Developing Sovereign Debt Crisis:** Despite some signs of life in U.S. economic data, a long-lasting solution to the Eurozone debt crisis continues to be elusive. Below-trend growth, mortgage market headwinds, and liquidity and capital issues facing banks suggest another difficult year for financial credits. Corporations exposed to these credits, either through prime funds or other vehicles, need alternative means to limit or eliminate such exposures.

D. **Time Needed to Ramp-Up SMA:** Treasury organizations interested in starting a separately management account (SMA) mandate will need a ramp-up period, including initial assessments and internal debates, management and board level approvals, advisor searches, account openings and tactical investment decisions. This process may take four to six months to complete. We believe an SMA relationship may help resolve the issues discussed thus far, and may be a worthy exercise even as a contingent plan.

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

For most institutional cash investors, surviving the current environment requires patience, tenacity and a forward looking attitude. Historically popular cash vehicles, including prime money market funds, FDIC-insured transactional accounts and all-Treasury portfolios, worked well at one point or another, but new circumstances and challenges require a fresh look at one's risk/reward profile. Improved diversification among cash vehicles, liquidity and maturity structures may help improve this profile. Important considerations also include fees and sources of return. 2012 may be a crucial year for investors to rebalance their risk/reward tradeoffs thanks to changing regulations, the end of certain government guarantee programs and the current economic environment. A multi-pronged approach that includes the use of separately managed accounts may help improve one's risk/reward profile. More importantly, the window of opportunity may be closing for treasury organizations still without a long-term plan.

[1] Information about the fund used by hypothetical Investor C is based on information compiled by Capital Advisors Group for its FundIQ® research database. FundIQ® offers in-depth research and ongoing analysis of more than 50 elements within five risk categories of 15 of the largest AAA-rated prime money market funds. For more information about FundIQ®, please visit http://www.capitaladvisors.com/fund_iq/index.html.

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