Comprehensive Cash Investment Strategies

Comparing Three Major Types of Investment Vehicles

Abstract

The challenging environment for treasury cash investments has prompted many practitioners to look for alternative options in managing their excess cash. We address this topic in a generalized manner, summarizing three major categories of available cash investment vehicles: deposits, pooled assets and direct purchases. The pros and cons of each vehicle type are discussed. Corporate cash investors may benefit from this analysis as they discuss their options internally and with their investment managers.

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Introduction

To say that a lot has changed in the last five years with respect to corporate cash investments is a great understatement. We witnessed the failure of several popular investment vehicles in 2007. We saw formidable financial issuers falling on hard times in 2008 and beyond. We've endured a prolonged low yield environment since early 2009. The Eurozone debt crisis is in its third or fourth phase. World economies remain sluggish and the future of financial regulations remains uncertain. In short, it is no small feat to ensure return ***of*** investments, let alone return ***on*** them.

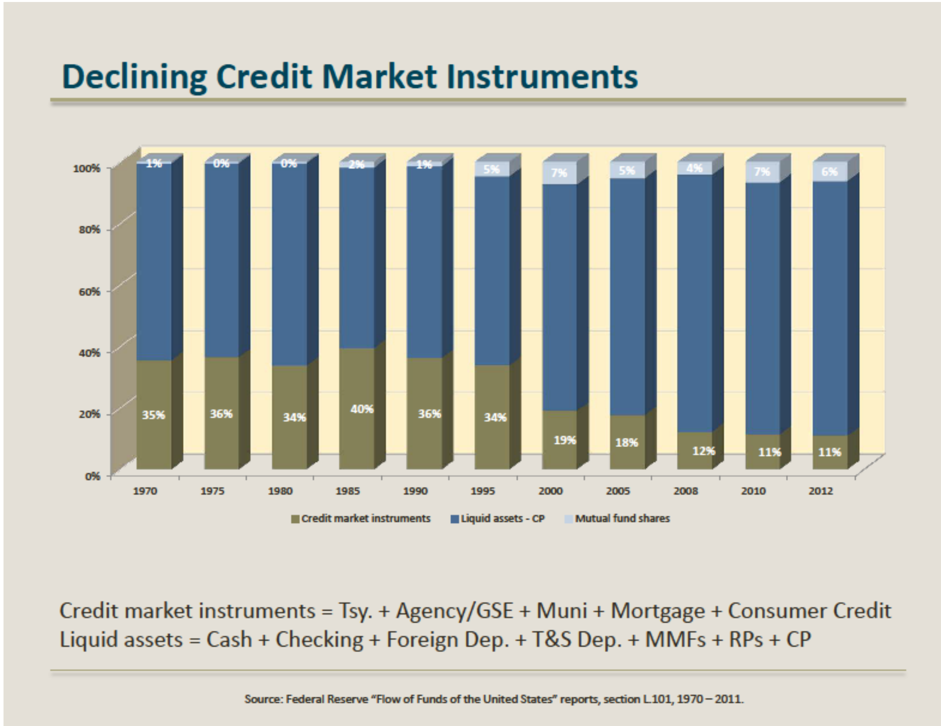
With the unlimited FDIC insurance coverage on transactional accounts set to expire soon and the future of money market mutual funds uncertain, many corporate treasury professionals have asked us for a more comprehensive approach to managing their excess cash. They want to know all the reasonable options for their principal investments before they decide on specific strategies. Rather than making specific references to eligible investments, we wanted to address this topic in a more generalized fashion.

Corporate Cash Over 40 Years

To many corporate treasury practitioners, today's cash management options are fairly limited: bank deposits and money market funds. As the number of creditworthy banks dwindles and the fate of money market funds remains uncertain, it may help to have a historical perspective of cash management before the hay day of money market funds, which may cause us rethink our cash management opportunities.

Figure 1 shows financial balance sheets of non-financial businesses on the aggregate in the United States since 1970, according to the Federal Reserve's Flow of Funds reports. It shows that corporate balance sheets became increasingly more liquid. Liquid assets include cash, checking accounts, time and savings deposits, foreign deposits, money market funds, security repurchase agreements and commercial paper.

Figure 1: How Liquid Balances at Non-Financial Firms Evolved



The graph also shows that, prior to the introduction of money market funds in the 1970s, firms held significant portions of their balance sheets in "credit market instruments" that included government and agency securities, municipal bonds, mutual fund shares, mortgages and consumer credit. The proliferation of money market funds since the late 1990s coincided with the progressive drop of credit market instruments.

This illustration of non-financial business balance sheets suggests that, as one thinks about the total opportunity set in cash investments, it may pay to look outside the limitations of deposits and money market funds. Other options may include credit market instruments that were popular in past decades and vehicles introduced in recent decades.

Cash Vehicles At-A-Glance

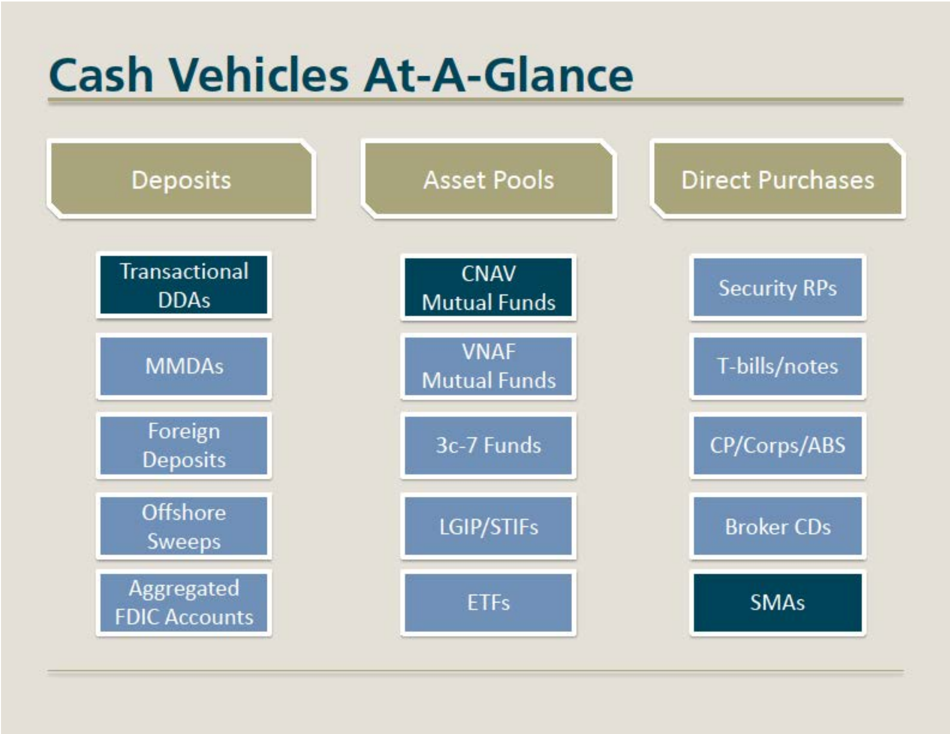
In our opinion, the types of instruments suitable for corporate cash management invariably fall into three categories: deposits, asset pools and direct purchases.

Deposits may include insured and uninsured bank balances. They can be transactional (demand deposit) accounts or time and savings accounts that are issued by U.S. banks, foreign banks, U.S. branches of foreign banks (Yankee deposits) or foreign branches of U.S. banks (offshore deposits).

Asset Pools refer to commingled investments where investors have prorated ownership in professionally managed cash-like instruments. Money market mutual funds are a subset of mutual funds with a goal of achieving a stable net asset value and providing daily liquidity. Other short-duration asset pools may include ultra-short-term bond mutual funds, bank short-term investment funds, local government investment pools, lightly regulated private investment pools (3c-7 funds) and exchange-traded funds.

Direct Purchases are individual securities purchased and held in the name of the investor. Common investments in corporate cash accounts may include security repurchase agreements (repos), U.S. government and agency bills and notes, commercial paper, corporate notes or asset-backed securities. Broker-sold certificates of deposit also may fall into this category. In some instances, investors may choose to hire external managers to look after their investments in separately managed accounts (SMAs).

Figure 2: Cash Vehicles At-A-Glance



Comparing Vehicle Types

Understandably, each of the three types of cash vehicles comes with advantages and disadvantages. Timing of cash needs, risk tolerance and yield expectations, among other factors, may influence the adoption of one or several of these strategies.

1. Deposits

Deposits form the basis of most treasury organizations' cash strategies. In most cases, demand deposit accounts are the default cash management vehicle because they are readily available and are part of the organization's overall banking relationship. In addition to the demand feature of deposits, U.S. depositors enjoy a depositor-friendly banking regulatory framework under the supervision of the Federal Reserve Board and the Federal Deposit Insurance Corporation (FDIC).

In the current low yield environment, deposits come with a sweetener in the form of earnings credit rates (ECRs) for many institutional investors. These fee rebates against other banking services, which are typically low in a normal yield environment, became competitive as yields on other cash instruments dropped.

The main risk in bank deposits is the credit risk of uninsured deposits. The temporary transactional account guarantee (TAG), in place as part of the Dodd-Frank Act of 2009 for unlimited non-interest bearing balances, is set to expire at the end of 2012. For many institutional depositors, it is impractical to maintain balances below $250,000 to enjoy full FDIC insurance. Uninsured deposits are unsecured loans to the issuing banks, so sophisticated credit analysis on bank credit is paramount. The challenging credit environment, impact of the Eurozone sovereign credit crisis and the reduced assumption of government support for banks create new challenges to conducting bank credit analyses. For many practitioners, a related risk is concentration risk to a few relationship banks, as the operational burden increases with the addition of new banks.

Under normal circumstances, yield on bank deposits may be less competitive than market rates for money market securities. Depositors desiring higher yield may opt for longer fixed-term certificates of deposits with prepayment penalties, reducing liquidity of the portfolio.

Also noteworthy is the fact that many institutions use foreign deposits. While U.S. branches of foreign banks are under the supervision of U.S. regulators, deposits issued in foreign markets or by offshore branches of U.S. banks carry the risk of cross-border transactions and involve different supervisory jurisdictions. Depositors need to assess each situation carefully and not rely on the perceived links of their deposits to foreign governments or the U.S. parents of foreign branches.

2. Asset Pools

In general, the biggest advantage of asset pools is the professional management of risk assets, which also brings the benefit of instant risk diversification to individual issuers. Shared liquidity, especially in the case of money market funds, also can be beneficial to investors under normal market conditions. The $1.00 net asset value and daily liquidity of money market funds offer the convenience of simple accounting and tax reporting. Asset pools may allow managers to purchase securities with better trade execution. Under normal circumstances, yield on assets pools may be higher than bank products because rates are determined by market factors.

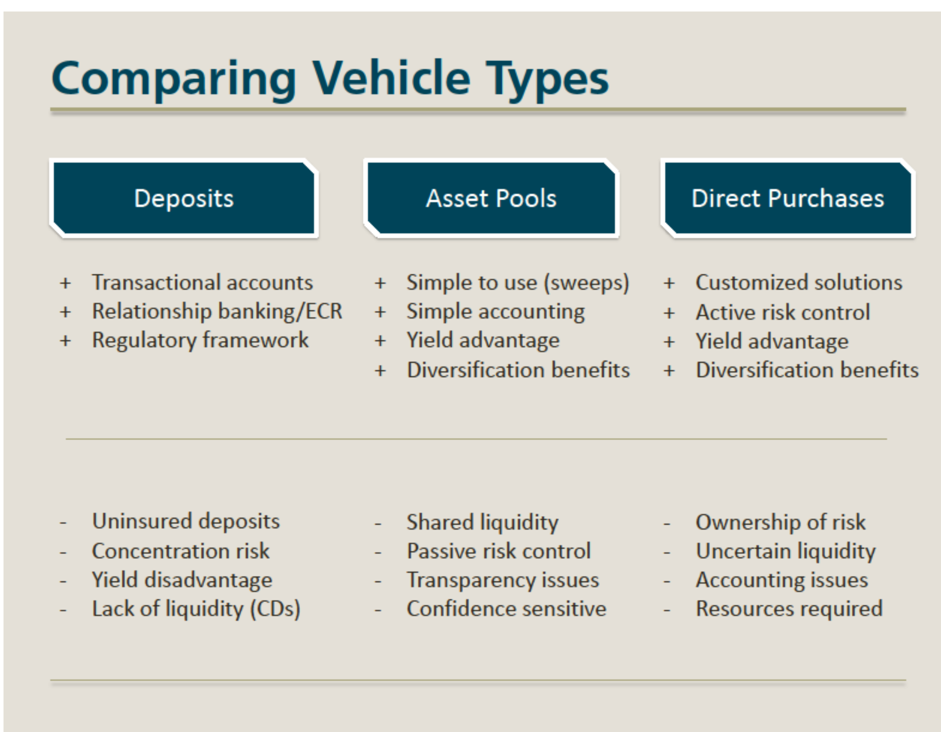
On the other hand, the shared nature of pooled investments means that investors also share the downside risk, chief among which is the shared liquidity during market disruptions. The vulnerability of money market funds to shareholder runs was magnified in recent years and remains a contentious issue for further money market fund reforms. Also, transparency of investments is somewhat limited to a fund manager’s/sponsor’s willingness to share all pertinent information. In that regard, shareholders’ risk management role in their investments is a passive one in which they can either voice their concerns or vote with their feet.

3. Direct Purchases

As intimidating as they sound to some cash investors, direct purchases represent a back-to-basics approach to cash management. The advantages of direct purchases include the ability to customize investments to suit specific needs, risk tolerances and return expectations of the institutional investor. A separate account solution strengthens the investor's role in active risk management, which is even more important in today's environment. A separate account also receives risk diversification benefits similar to pooled assets, but with more precision when stipulated by specific investment guidelines. Because direct purchases are not bound by restrictions imposed on pooled assets, including money market funds, separate account strategies may take advantage of market inefficiencies and may produce higher yield opportunities than both deposits and pooled vehicles.

Of course, owning securities outright also has its downside. A separate account cements the ownership of risk, a downside to investors who are less experienced in investment products. While the investment tasks may be delegated to outside managers, investment policy construction, manager selection and portfolio monitoring may involve additional time and effort. Separate accounts also may require more accurate projections of cash flows to maximize yield potential. Selling securities prior to maturity, even when done prudently, may result in unwanted gain or loss recognition and create the need for investment accounting entries. The size of the cash portfolio also may determine the applicability of a separate account solution, as smaller lots of securities may be difficult to find.

Figure 3: Comparing Types of Cash Vehicles



Conclusion

The challenging environment for treasury cash investments may cause anxiety among practitioners who are looking for safe havens in light of the expiration of FDIC insurance, uncertainty with money market fund reforms, the threat of negative yield and rekindled Eurozone debt crisis fires. We hope our analysis of these three types of cash vehicles will facilitate further dialog internally and with investment managers on the feasibility of each option. We also welcome our readers to reach out to us discuss specific strategies.
