Demystifying Separately Managed Accounts

Strategies for a Rising Rate Environment

Abstract

A well-structured separately managed account may serve liquidity investors better than money market funds, especially when faced with uncertain interest rate prospects and opportunity costs. Given historical fed funds and LIBOR rates, a moderately structured hypothetical SMA portfolio outperformed a hypothetical MMF in each of the last three rate tightening cycles. Today, SMAs may be more appealing than in the past due to a more transparent Fed, recent bank and MMF regulations, and potential spikes in overnight demand from long-term bond investors. When using SMAs during a rising rate environment, we advise our readers to keep portfolio duration moderate, maintain a laddered structure and higher quality credits, and consider floating rate notes.

Introduction

As the Federal Reserve's asset purchase program sailed into the sunset in October, some questions inevitably came to mind – when will the Fed start raising short-term interest rates? What will happen to my liquidity portfolio's income and expected returns? How do I manage it in the upcoming rising interest rate cycle?

A frequent response to these questions is to shorten one's portfolio duration to minimize interest rate risk. At an extreme, a liquidity account manager may be inclined to stay in money market funds (MMF) or transactional bank accounts to keep pace with rising rates.

While prudent strategies should anticipate a rising rate environment by making proactive duration and credit decisions, corporate treasury professionals today are faced with some unique challenges compared with previous rate cycles. We will show that, given historical evidence and in light of new challenges, separately managed accounts (SMAs) can be effective and advantageous in managing the rising rate environment.

LIQUIDITY SMAs

We should begin by noting that SMAs for liquidity portfolios may be different than some common perceptions. While portfolios with two-year or longer average maturities that follow active trading strategies for total return objectives are not uncommon, SMAs for liquidity accounts largely follow far more conservative principles with primary goals of preservation of principal and liquidity. Income is a secondary objective.

In the context of corporate treasury management, liquidity SMAs tend to value income more than capital gains as the main return driver. This results in the desire to hold securities until maturity and minimize active trading to reduce volatility. The income oriented, held-to-maturity preference also tends to reduce realized losses and gains,.

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SMA portfolio construction also tends to differ from commingled vehicles such as money market funds and bond funds. Liquidity is not maintained through pooling or through selling securities, but primarily through targeted maturities. Accordingly, SMAs tend to have fairly short average maturities, say three months to 1.5 years depending on one's risk tolerances. A laddered portfolio with securities of staggered maturities allows the manager to generate liquidity and decide on how to reinvest as securities mature, thus minimizing big interest rate bets.

WHY CONSIDER SMA

As all fixed income securities go, when market rates move higher, a fixed-rate coupon on an existing bond becomes less attractive and leads to a lower price. This forms the basis for a common argument to move money away from SMAs into MMFs or deposits. This line of thinking is myopic for several reasons.

a. It's all about the opportunity cost

The economic concept of opportunity cost is fairly easy to understand. It is the benefit of one object you give up by choosing another object. When one goes to college, the four years of income one could have earned right after high school is the opportunity cost.

In our context, if we buy a 6-month Treasury bill (T-bill) today, we are foregoing potentially higher income on another T-bill when interest rates rise before ours matures. Conversely, if we do not buy the T-bill, which earns more than money market funds or deposit rates, we are foregoing potentially higher income if market rates do not move higher. All else being equal, our decision boils down to our projection of whenrates will rise.

b. Forecasting interest rates is more art than science

The Federal Reserve as the central bank has the biggest influence on short-term interest rates in the U.S. It regulates the fed funds rate by buying or selling government securities through open market operations. Economic data that may cause the Fed to change the fed fund rate often cause the market to react before the Fed takes action.

Trying to forecast the changes in the fed funds rate is an imprecise science. Academic research and empirical evidence have shown that getting the timing and trajectory right is very hard. In a research note we published over a decade ago, we documented that neither consensus from economists nor the fed funds futures market did a particularly good job.

What's more, research found that the market is particularly bad at predicting the start of a new interest rate direction. The futures market often is premature in suggesting the first move the Fed will take. For our discussion, this could mean that the opportunity cost of not investing in an SMA with higher yielding instruments is greater than the opportunity cost of holding fixed-rate securities after interest rates increase.

c. Income vs. total return

Suppose that one has an SMA of longer-maturity instruments and the Fed raises interest rates too soon. Recall in our definition that liquidity SMAs tend to rely on income as the main return driver and do not incur gains or losses through trading. The portfolio may have a small unrealized loss in a total return sense, but not a realized loss in a practical sense because all securities(barring default or early sale at a loss) will be paid at par at maturity. Taken as a whole, the period-to-period fluctuations in unrealized gains and losses will net out to zero. Granted, unrealized losses will appear on account statements and may be subject to impairment tests, but the moderate maturity selection in our definition reduces that risk to a manageable dimension.

We make this point to show that the downside risk of SMAs before a higher rate cycle may not be as serious as some may fear. On balance, the locked-in higher income potential at the onset may outweigh the concern of lower income at the tail end. Plus, it really is the horizon return with which we ought to be concerned rather than the period return.

d. Horizon return vs. period return

Horizon return refers to income received over the entire period, or investment horizon, during which we own the security. We sometimes accept the outcome that an investment may be "underwater" for some latter part of our holding period – provided that the earnings from the earlier part more than compensate for the latter part.

For example, suppose we purchase a one-year instrument that pays 0.30% today. A deposit account pays 0.05% up until nine months from now, when it will pay 0.50% after the Fed has adjusted overnight rates. For the last quarter, we will own an investment yielding 0.20% less than the comparable bank instrument. In reality though, the horizon return for the deposit account over a one-year period is 0.16%, or about half the one-year instrument.

If we make decisions based on horizon return expectations, we may avoid the opportunity cost of focusing too much on the latter periods, and come out better off over the entire investment horizon.

EVIDENCE FROM THE PAST

Let's conduct an experiment from historical experience. Consider two portfolios: Portfolio FFR is a MMF that pays the fed funds rate. Portfolio LAD uses 12 securities with maturities spaced evenly between one and 12 months, their yield corresponding to the respective LIBOR levels; the maturity ladder is spaced this way to account for the inability to perfectly predict the timing of future Fed actions. In our historical experiment, we will consider a 12-month holding period, with the starting date six months before the first fed funds rate hike.

For simplicity's sake, the 12-month return on Portfolio FFR is the simple average of the fed funds rate in each month. Portfolio LAD uses the cash from the matured one-month paper to reinvest in a new 12-month paper at the new LIBOR rate. LAD's return will be the sum of the 12 monthly returns (see appendices). The three rising rate periods we

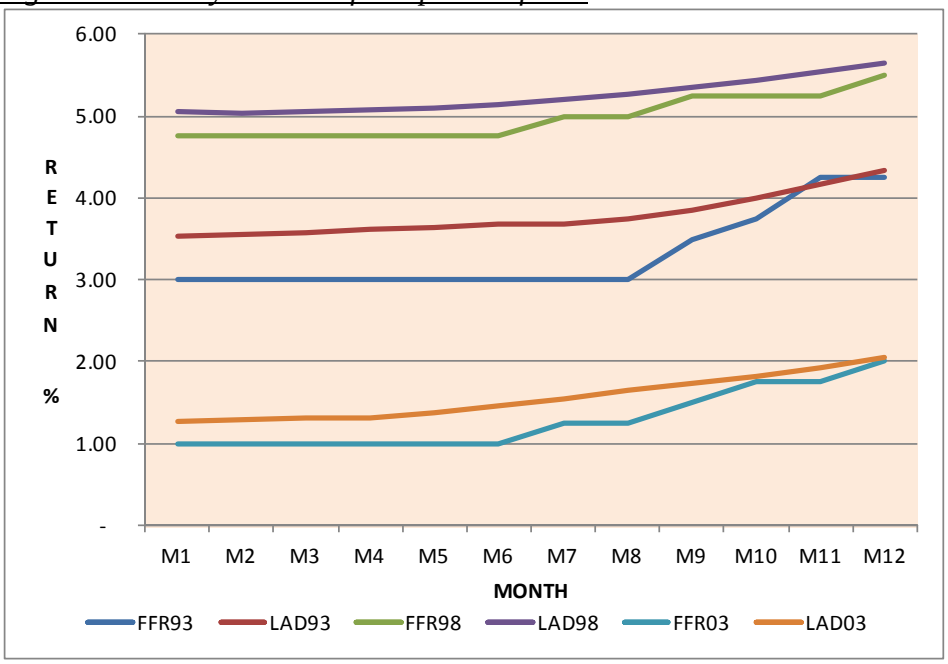
observed are: Feb-94 to Feb-95, Jun-99 to May-00, and Jun-04 to Jun-06. Our test holding periods are: Jul-93 to Jun-94, Dec-98 to Nov-99, and Dec-03 to Nov-04.

Table 1: 12-month Returns of Sample Portfolios during Fed Funds Rate Increases

	JUL93-JUN94	DEC-98-NOV99	DEC-03-NOV04
FFR	3.31	4.98	1.29
LAD	3.78	5.24	1.56
DIFF.	0.47 (14%)	0.26 (5%)	0.27 (21%)

Source: Fed funds and LIBOR rate history taken from Bloomberg

Figure 1: Monthly Returns of Sample Portfolios



Source: Fed funds and LIBOR rate history taken from Bloomberg

Table 1 shows that the SMA (LAD) outperformed the MMF (FFR) in each of the three periods, with the difference ranging from 0.26% to 0.47%. *Figure 1* shows further that, in all but one instance, the SMA outperformed the MMF in all 12 months during the three holding periods.

The Appendices also show that, towards the latter parts of the holding periods, some individual securities in LAD did have lower yield levels than FFR, but that LAD won out as a portfolio for all time periods. The experiment concludes that, as a portfolio, a moderately constructed SMA may outperform MMFs and bank deposits in a rising rate environment.

MORE COMPELLING TODAY

Historical performance, of course, does not guarantee future returns. In fact, the world is a very different place today from the last rate hikes, such that SMAs may be even more compelling today than previous rising rate periods.

a. More transparent and gradual Fed increases

Over the last decade or so, the Fed has told the market that it wants to be more transparent in communicating its interest rate decisions. It started releasing statements after each Federal Open Market Committee (FOMC) meeting, adding "easy" or "tightening" biases in the statements, setting inflation and labor market conditions targets, and publishing the now famed "dot plot" of FOMC members' projected future rate levels.

The changes to a more transparent Fed mean that the market will be less likely to be surprised by the Fed's rate moves, which in turns should lead to more confidence in investing further up the yield curve, capturing incremental yield.

We should also note that the world is not as healthy as the U.S. is today, and the Fed wants us to know that. Both market consensus and the Fed dot plot point to the first rate increase at some point in the second half of 2015. Economic drag from the Eurozone, Japan and China will likely keep the pace of the Fed's moves in check, leading to more gradual rate increases. A gradual pace of rate increases further diminishes the interest rate impact on a laddered portfolio.

b. Regulatory changes to bank deposits and MMFs

Much has been discussed on the impact of new banking regulations on the deposits market. With the implementation of the liquidity coverage ratio, banks generally have less use for overnight deposits, and even less interest in deposits deemed "non-operating" which are subject to higher haircuts against liquid assets. This means that the cash sitting in bank accounts waiting for rates to rise, though an ill-advised move compared to a liquidity SMA as we've demonstrated, may not as easily find a home.

Likewise, the new MMF regulation now requires institutional prime funds to adopt floating net asset values and to impose optional gates and fees as emergency measures. The new rule will not take effect until October 2016, but some shareholders may become uneasy towards the end of 2015 and try to find another home. One such destination may be government funds, which are not subject to the above mentioned rules. That space, however, may not be large enough to accommodate this flock of new investors, leading to depressed or even negative yield. Again, another viable option is exploring SMAs.

c. Potential bull market reversal in bonds

An often overlooked side effect of a rising rate environment is that the very short end of the yield curve gets crowded when pension and bond fund investors unload their holdings and leave cash in money market funds, Treasury bills and other vehicles. With several groups of investors looking for safety and liquidity, it is fair to say that the shorter the maturity, the more crowded the trade. The situation may be worse in this rate cycle, as the end of a long bull market in bonds from an unusually accommodating Fed may lead to even more outside cash chasing fewer short-term investments. The ability to stay slightly outside of this crowded ring is another SMA advantage.

CONCLUSION: SMA STRATEGIES FOR A RISING RATE ENVIRONMENT

We argued that while some people may prefer money market funds before interest rates rise, a well-structured separately managed account may serve them better. When faced with uncertain rate prospects, SMAs may be preferable in dealing with opportunity costs. With income as the primary objective and horizon return as the ultimate goal, SMAs are shown to outperform MMFs in a constructed example during the last three rate hiking cycles. The case for SMAs today is more compelling given a more transparent Fed, recent bank and MMF regulations, and potential overcrowding in the overnight space.

With respect to specific portfolio construction, we leave our readers with the following recommendations:

1. Keep portfolio duration moderate, consistent with one's risk tolerance and liquidity needs. For example, based on market expectations, allocate 50%-75% of the portfolio to maturities before the first forecasted rate hike to ensure adequate liquidity for reinvestment as rates rise.
2. Stay with a laddered portfolio, but moderately overweight certain steeper parts of the yield curve.
3. Stay with higher quality credits, as spreads of lower quality names compared to Treasuries tend to widen out more than stronger ones.
4. Consider floating rate notes when valuation is attractive to further minimize interest rate impact.

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