How Are Your Peers Managing Their Cash?

A look at the evolution of institutional cash investment strategies over the past three years

Introduction

Following the collapse of Lehman Brothers in 2008, the rapidly deteriorating economic environment in the U.S. and abroad caused most treasurers to reevaluate their cash investment strategies, with a specific focus on restricting investments in certain asset types. Some companies implemented these restrictions by changing their investment guidelines, while others simply gave instructions to limit investment activity to the most conservative corner of their existing guidelines. Across the board, we saw our clients "hunker down" in government-issued and government-backed debt during the height of the credit crisis. However, with a substantial improvement in the credit markets over the past three years, we have observed a considerable shift in clients' desire to pursue more yield by allowing investments in prime money market funds, corporate securities, foreign sovereign debt and even asset-backed securities.

When considering changes to their investment strategies, many treasurers are interested in understanding the decisions being made by their peers. This context not only helps to validate the recommendation that a treasurer may receive from an investment manager, but it also provides an invaluable reality check before a new cash management strategy is presented to an Audit Committee or Board of Directors. In this whitepaper, we will use Capital Advisors Group's client data to compare how investment strategies changed over the three years from March 31, 2009, to March 31, 2012. We hope that the results of our analysis will assist treasurers in evaluating their current investment strategies and determining whether to pursue additional yield in their cash portfolios.

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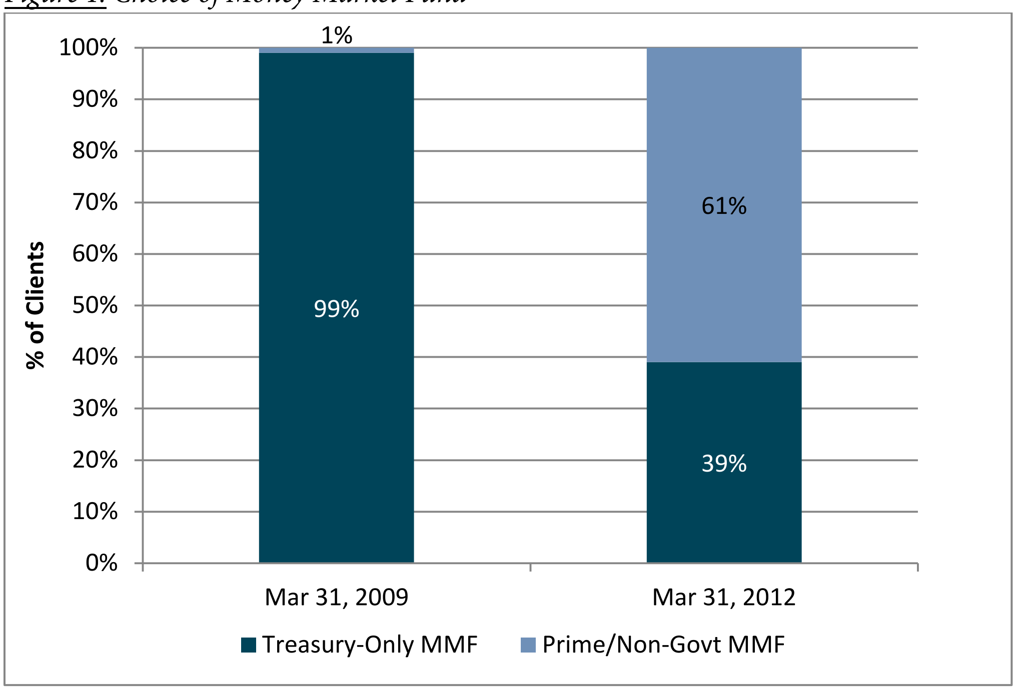
The Sample:

The sample of Capital Advisors Group's clients used in the analysis met the following criteria: i) they were clients throughout the three-year period of March 31, 2009, to March 31, 2012, and ii) they permitted investments outside of money market funds. For each client, we determined whether or not the permitted investments in prime money market funds, U.S. Government debt, industrial and financial corporate securities, foreign sovereign debt and asset-backed securities on March 31, 2009, and March 31, 2012. In determining if a client permitted investments in a particular asset class or industry, we considered the client's investment guidelines in combination with the client's instructions, if any, with respect to such asset class or industry. Our analysis did not take into account the maturities or ratings of securities.

Choice of Money Market Fund:

At the heart of most institutional cash portfolios are money market funds, which provide daily liquidity. As the potential for a credit crisis in the U.S. became increasingly apparent in 2008, we recommended that our clients move out of prime money market funds, and as of March 31, 2009, 99% of our data sample were invested in a Treasury money market fund (a money market fund which invests solely in Treasuries, federally-guaranteed agencies, or repurchase agreements collateralized by these assets). At that point in time, only one client was invested in a non-government money market fund and that decision was due to its custodian's lack of money market fund offerings. Three years later, attitudes regarding the overall risk of prime money market funds had shifted substantially, due in part to greater transparency throughout the industry and tighter regulatory oversight. As of March 31, 2012, only 39% of our clients continued to hold their overnight cash in Treasury money market funds, while 61% were invested in non-government "prime" money market funds. For additional information on selecting a money market fund please refer to our November 2011 publication Retrofitting Money Market Funds for Treasury Risk Management.

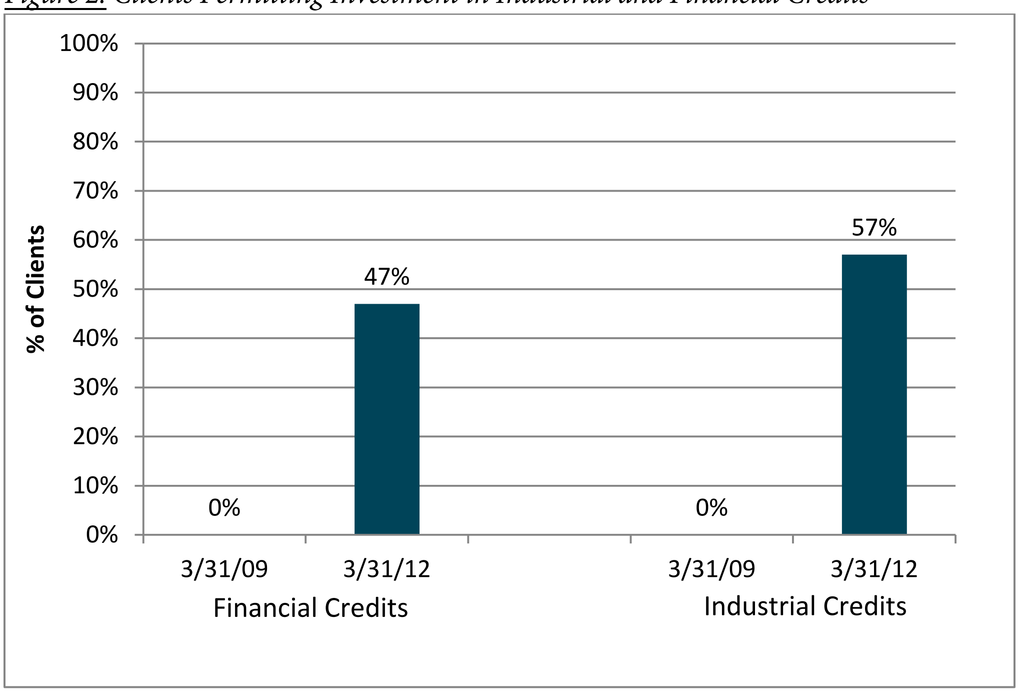
Figure 1: Choice of Money Market Fund



Government Debt:
As of March 31, 2009, 100% of the clients in our sample were comfortable with the purchase of securities issued by or guaranteed by the U.S. Government. These securities include U.S. Treasuries, government-sponsored enterprises (GSEs) and FDIC-insured securities issued under the Temporary Liquidity Guarantee Program (TLGP). Not surprisingly, three years later, all clients remained comfortable with debt issued by or guaranteed by the U.S. Government.

Industrial and Financial Corporate Debt:
As the credit markets deteriorated in 2007 and 2008, we sharply reduced our clients' exposure to potentially unstable issuers of industrial and financial corporate debt. Following the collapse of Lehman Brothers in September of 2008, we advised that clients invest solely in government-guaranteed securities. As a result, on March 31, 2009, none of our clients in the sample were invested or permitted investments in industrial or financial credits not guaranteed by the U.S. Government. However, as credit conditions improved, Capital Advisors Group gradually resumed investments in corporates, first purchasing select industrial credits in July 2009 and select financial credits in October 2009. By March 31, 2012, Capital Advisors Group was comfortable with the credit profiles of many industrial and financial issuers, and approximately half of the sample permitted investment in industrials and financials, as indicted in Figure 2 below.

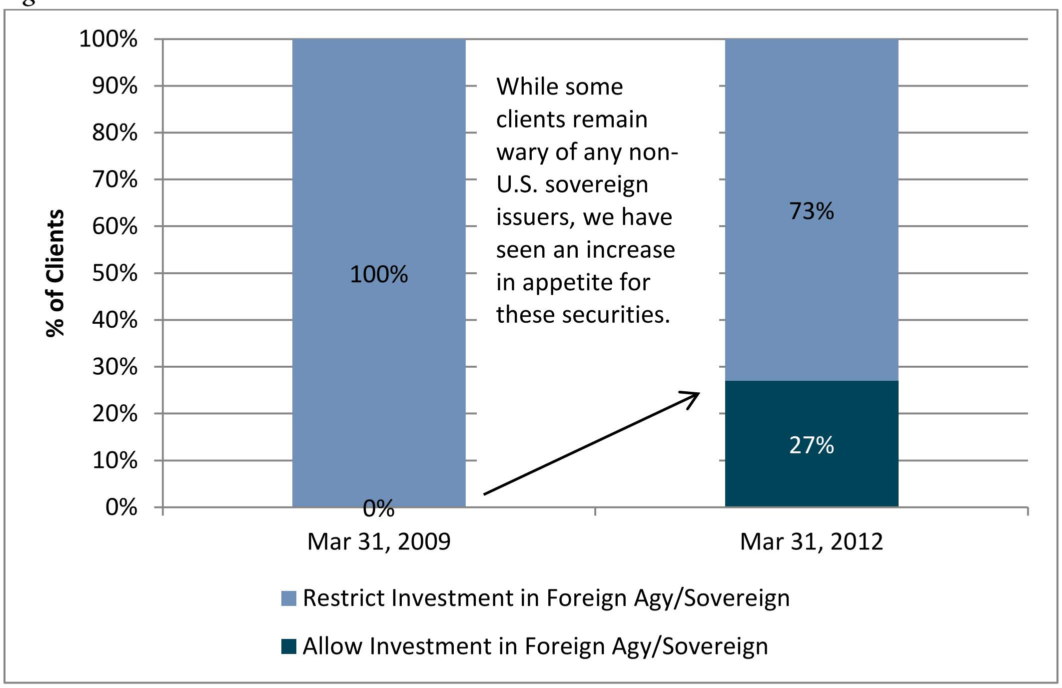
Figure 2: Clients Permitting Investment in Industrial and Financial Credits



Foreign Sovereign and Agency Debt:

Securities issued by sovereign governments other than the U.S. and by agencies guaranteed by these governments may be appropriate investments for cash portfolios. Many of the largest and most stable countries in the world issue debt denominated in U.S. dollars, and some of their risk profiles rival that of the most stable corporate issuers. Although the ongoing banking and sovereign debt crisis in Europe makes many investors wary of any investments outside of the U.S., a select number of Eurozone countries have avoided the pitfalls experienced by southern European economies, such as Greece and Spain, and remain in a position of financial and economic strength. As of March 31, 2012, 27% of our client sample allowed for investments in foreign sovereign and foreign sovereign agency debt, up from 0% on March 31, 2009.

Figure 3: Clients Permitting Investment in Securities Issued by Foreign Sovereigns and Agencies

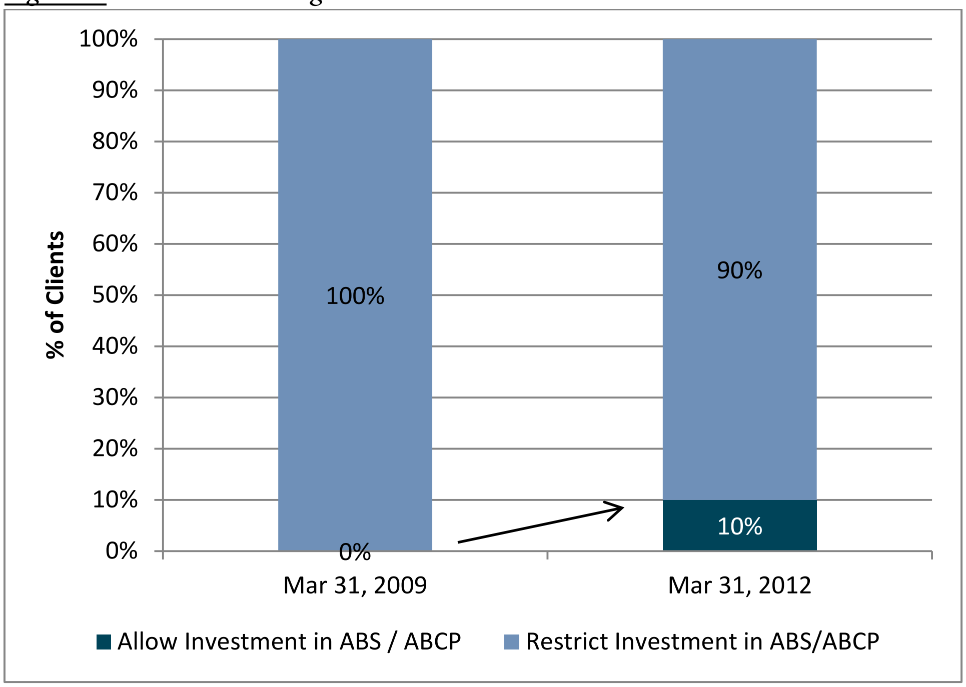


ABS and ABCP:

Many investors tend to associate all asset-backed securities (ABS) with mortgage-related securities; however, the ABS market consists of securities with many types of collateral. Capital Advisors Group believes that AAA-rated ABS backed by credit card receivables is again appropriate for certain clients. Overall credit card delinquencies have decreased since peaking in 2009, and AAA-rated credit card ABS may increase diversification and yield in cash portfolios (for additional information on ABS please see our March 2011 publication Asset-Backed Securities: Time to Reevaluate Their

Place in Corporate Accounts? Asset-backed commercial paper (ABCP) is backed by short-term receivables that do not include or include only a small percentage of mortgages. In the second quarter of 2010, Capital Advisors Group began adding ABS/ABCP issuers back to our approved list, and as of March 31, 2012, approximately 10% of the client sample permitted investments in ABS and ABCP.

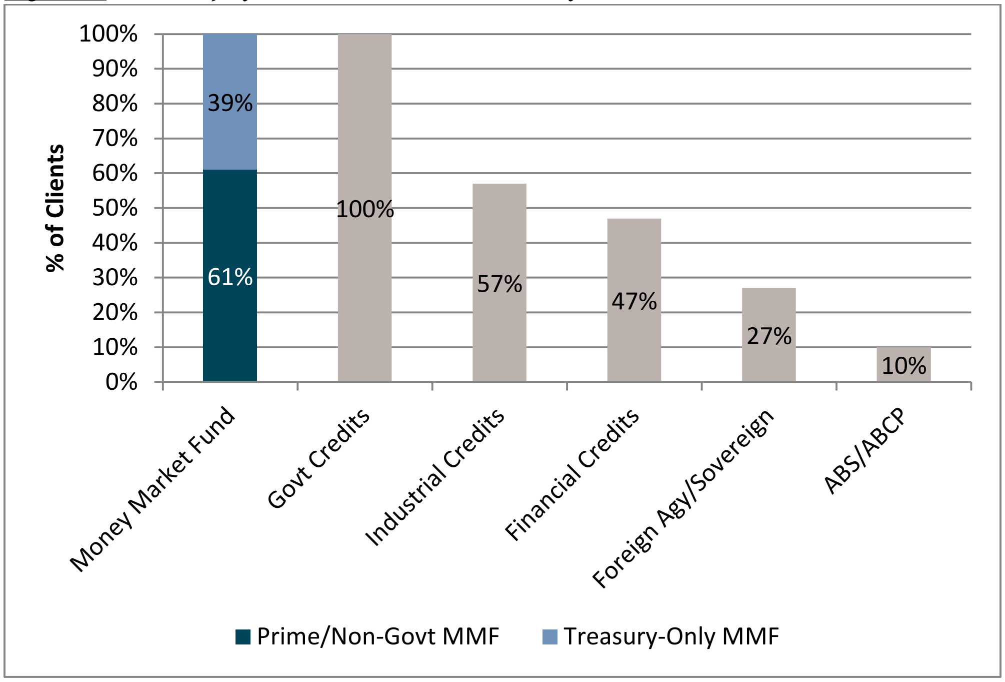
Figure 4: Clients Permitting Investment in ABS and ABCP



Conclusion:

Worries about new crises and fears of resulting contagion obscure the fact that the U.S. economy and world economy have recovered from the depths of the credit crisis. On March 31, 2009, 99% of clients in the sample were invested in Treasury money market funds and none of them permitted investments in corporates, foreign sovereign and foreign sovereign agency debt, or ABS and ABCP. On March 31, 2012, 61% of the clients in the sample were invested in prime money market funds and 57% permitted investment in industrials, 47% permitted investment in financials and 27% permitted investment in foreign sovereign and foreign sovereign agency debt. Please see Figure 5 below.

Figure 5: Summary of Permitted Investments as of March 31, 2012



Despite having recovered from the depths of the credit crisis, the U.S. economy and world economy still have not recovered fully and may not do so for years. The lack of a full recovery, memories of the near collapse of the financial markets in 2008 and continued fear are reflected in the fact that on March 31, 2012, 39% of clients in the sample remained invested in Treasury money market funds and approximately half of them did not permit investments in either industrial or financial corporates.

Since March 31, 2012, we have continued to see increased demand for yield via non-U.S. Government money market funds and securities. We expect that this trend will continue amid further improvements in economic fundamentals and as investors seek the potential incremental yield associated with non-U.S. Government assets. In fact, a few clients have even requested that we aggressively pursue yield. Of course, asset class selections must be considered within the context of the circumstances and preferences of each organization. We hope that this paper has provided a backdrop of institutional cash investment trends against which to make such selections.

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