Three Trends in 2010 that Changed the Cash Investments Landscape

Introduction:
As 2010 draws to a close, we cannot help but take note of the sea change in how corporate treasurers are managing their cash portfolios since the capitulation of the financial markets in September 2008. If we characterize 2008 as the year of "shellshock" and 2009 as one of "bunker mentality," 2010 clearly is the year of "transformation." As more treasury professionals came to recognize that the business of managing corporate cash investments has entered the age of the "new normal," we see the following three trends as having played pivotal roles in this transformation. We hope this insight will be useful as cash investors contemplate their year-end policy revisions and portfolio reallocations.

Sweeping regulations creating challenges, uncertainties and opportunities
Nearly two years after the quake that shook the foundation of the short-term debt market, aftershocks in the form of regulation finally arrived to address systemic vulnerabilities. As one of the epicenters of the financial crisis, this market was among the first market sectors to take the bitter regulatory medicine.

First arriving on the scene was the SEC's revised Rule 2a-7 for money market funds. The rule strengthened a number of credit and liquidity requirements for money market funds, a popular liquidity vehicle for treasury functions. Next came the sweeping Dodd-Frank Wall Street Reform and Consumer Protection Act that resulted in the creation of the Financial Stability Oversight Council to address systemic risk in the financial system. All told, the new legislation mandates 243 new rules to be implemented and 67 studies to be conducted by the 10 Federal regulatory agencies that make up the council and oversee much of the nation's financial systems[1]. Third to arrive was the proposed international bank capital adequacy standard, popularly known as the Basel III Accord, prescribing new capital, leverage and liquidity ratios for international banks. Additionally, the Federal Deposit Insurance Corp (FDIC) was the first among major U.S. Federal agencies in drafting new rules on deposits and asset-backed securities, altering the landscape of cash investments. Other regulations introduced in 2010 include those impacting repurchase agreements, asset-backed commercial paper programs and credit ratings, all of which may have a profound influence on cash investors.

There is little doubt that the intent of the new regulations is to repair the financial safety net so that a 2008-style crisis will not be repeated. However, their cumulative effect has been fewer investment opportunities, lower yield potential and higher compliance costs for the treasury community[2]. Adding to the challenges are the patchy details in most of the new rules and conflicting provisions among some. For example, the SEC's new credit ratings agency designation requirement for money market funds is directly contradicted by an instruction from the Dodd-Frank Act for the SEC to avoid reliance upon credit ratings as risk gauges. Additionally, reconciliation of the Dodd-Frank Act and Basel III capital rules may take months, if not years, to complete, pushing implementation even further into the future.

On the flip side, new regulations have also created opportunities for investors with higher risk tolerance and flexible investment strategies. As the demand for shorter, safer and more liquid assets increases, investors outside the regulatory framework may see more opportunities in some investments that have fallen out of favor.

Transparency 2.0 gathering steam

A pursuit that corporate treasurers picked up during the credit crisis was that of conducting periodic reviews of their money market fund portfolios. Although fund companies made efforts to provide more timely fund holdings in the past two years, 2010 seems to be the year of more advanced portfolio monitoring. This year's new SEC rule on uniform fund reporting made it easy to access fund records. Additionally, third-party providers finally caught up to investor demand in providing more frequent and granular fund data. For example, at the annual conference of the Association for Financial Professionals (AFP), we saw at least three fund portals launching their attempts at "enhanced" transparency products. 2010 marks a turning point for more enhanced reporting of portfolio risk exposure.

With the Reserve Fund fresh in our memory and the Eurozone debt crisis taking center stage, corporate treasurers are looking beyond periodic portfolio updates from money fund companies and industry data providers for more in-depth and contextualized data relevant to their risk exposures. Eroding confidence in fund credit ratings from rating agencies also seems to be playing a role. In retrospect, the ratings of many of the problem credits, include Lehman Brothers, AIG and BP plc, did not raise red flags before the crisis.

By the end of the year, all money market funds will be reporting monthly holdings to investors within five business days of the end of each month. A similar but more detailed holdings report will be reported to the SEC and become available to investors on a 60-day lagged basis. The latter report received particular market attention because

the funds will be disclosing their market-value based, or shadow, net asset value, which in most instances will not be $1.00 per share. How the public interprets this lagged information is a hotly debated issue, but should become clearer in the coming weeks.

Credit ratings agencies also tried to ride the wave of improved due diligence by revising their ratings methodologies. While Fitch's changes have been incremental, Moody's and S&P received criticism for being too draconian. Moody's proposal of introducing a "stability" component in its ratings and converting its ratings system to align with short-term investments has been confronted by resistance from the fund industry and certain lobby groups. S&P's requirement for explicit ratings for repurchase agreement counter-parties in money market funds received similar criticism from the fund industry as a result of difficulties in implementation. Meanwhile, some investors look to third-party research for credit opinions supplementing their own due diligence efforts. Against this backdrop, Capital Advisors Group introduced FundIQ, a research product designed to evaluate five unique risk factors within prime institutional money market funds (http://capitaladvisors.com/fundiq).

As the industry moves to comply with new SEC rules and as investors demand more transparency, we think the underlying holdings will become more transparent, which will allow investors to make more informed decisions about funds and lead to further differentiation of risk-reward profiles of different funds.

Increased recognition of money market funds as liquidity vehicles

Through the second week of November 2010, assets in money market funds had declined 28% to $2.8 trillion from $3.9 trillion in the first week of 2009[3]. Although some observers attributed the loss to asset reallocation to stocks and bonds during the recent market rallies, we believe a more fundamental change is taking place, namely institutional cash investors are undoing what they did early this decade by shifting liquidity balances away from money market funds into other vehicles. In addition to credit risk considerations, the recognition of money market funds as liquidity vehicles as opposed to investment vehicles is taking hold, in our opinion.

Figure 1: Current Allocation of Organization's Short-term Investments to Money Market Funds (%)[4]

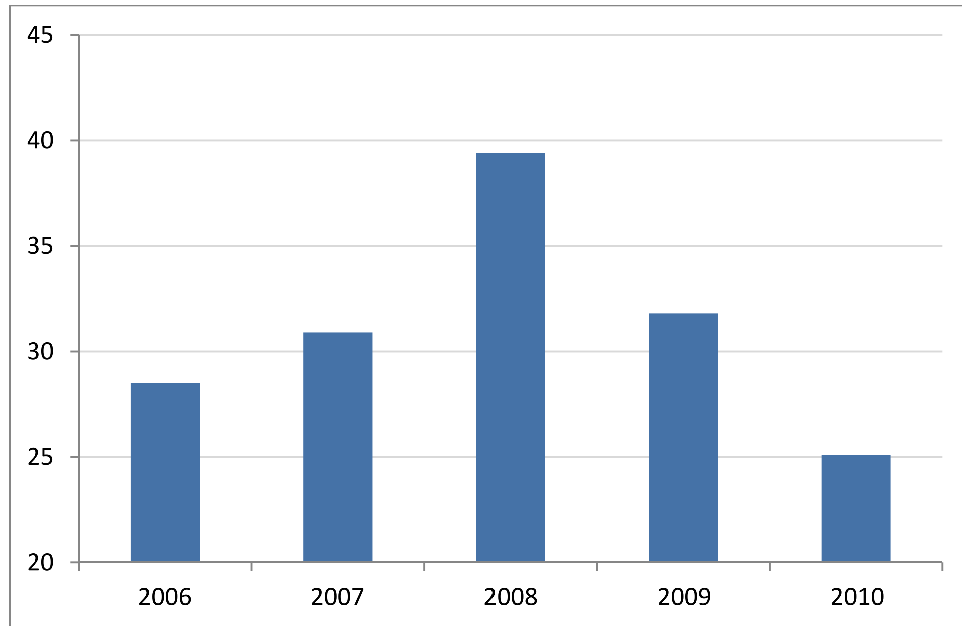

Figure 1 above shows the results of a survey by the Association for Financial Professionals of the current mean allocation of corporate treasury portfolios to money market funds. Compared to 39.4% in 2008, only 25.1% of the average treasury portfolio is in money market funds today. We think the days of relying solely on money market funds as a cheap and simple solution to treasury management without a committed staff or review process are numbered. Beyond the convenience of daily liquidity and a constant net asset value, treasury professionals are looking elsewhere for added performance.

The collapse of the Reserve Fund brought the recognition of credit risk in money market funds. Regulations bolstering the soundness of the funds came with a hefty price tag –lower yield potential due to shorter portfolio maturities, higher near-term liquidity parameters and reduced use of floating rate securities. The persistently ultra-low yield environment also forces investors to rethink the strategic use of money market funds in a portfolio.

We saw interest in separately managed accounts increase after the Reserve event, an interest which continues today. The crisis, new regulations, and a low yield environment seem to collectively reinforce a new school of thinking in which money market funds are used as the liquid portion of a treasury portfolio, rather than the entire portfolio.

In summary, we have identified tighter regulations, enhanced due diligence and the recognition of money funds as liquidity vehicles as the three prevailing treasury investment trends of 2010. In an environment of ultra-low interest rates and fiscal difficulties for sovereign and local government borrowers, the job of a corporate treasurer in managing a corporate cash portfolio will be no less challenging in 2011 than in 2010. Nonetheless, we wish our readers a happy holiday season and a fruitful new year.

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[1] Davis Polk, Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21, 2010. July 21, 2010. http://www.davispolk.com/files/Publication/7084f9fe-6580-413b-b870-b7c025ed2ecf/Presentation/PublicationAttachment/1d4495c7-0be0-4e9a-ba77-f786fb90464a/070910_Financial_Reform_Summary.pdf

[2] Please refer to our whitepaper in the October 2010 newsletter "Decoding the new regulatory blueprint: Ten ways corporate cash investors may feel the impact" for more details.

[3] "Historical weekly money market data" from Investment Company Institute's website: http://www.ici.org/research/stats/mmf.

[4] Taken from annual liquidity surveys results conducted by the Association for Financial Professionals in 2006 through 2010. Results shown are from "all responses."

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