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Alternatives to the Mattress: A Review of Sound Cash Investment Options

Amidst the financial rubble brought on by the subprime crisis, might there be havens for cash (aside from under the mattress) for the corporate treasury investor? We think so.

First, let's review what led to the flurry of recent negative headlines. Since last August, there have been large write-downs by financial firms with credit exposure to complex securities linked to subprime mortgage loans. Fearing more bad news to come, bond investors held back their investments in all but U.S. Treasury securities. The short-duration credit market was the soft belly of this contagion as financial issuers tend to rely more heavily on short-term financing while cash investors tend to be more risk averse.

Surveying the bruised credit landscape, we think the pendulum of "irrational exuberance" has swung from excessive greed to extreme fear. Where there is fear, there lies opportunity. Let's look at three bond investment areas that may offer just rewards without comprising safety and liquidity.

1. Return to Basics - Diversified Non-financial Issuers:
The defensive corporate credits are those with stable cash flows, revenue diversification, low debt burden, and strong capital positions. Such marquee names as PepsiCo, Proctor & Gamble and Pfizer, which used to be prohibitively expensive, have now cheapened relative to Treasuries along with the entire market. Many of these issuers are not only recession-resilient, but are also internationally diversified which may allow them to benefit from economic growth in the non-US areas and from the weaker dollar.

2. Bedrock of Stability – Super-Regional U.S. Banks:
With multi-billion dollar write-downs by several large banks, this may sound counter-intuitive, but it's not. Banking corporations, especially the so-called "super-regionals" including Bank of America, Wachovia, and Wells Fargo, are the bedrock of financial system stability in the U.S. Strong and "sticky" core customer deposits put commercial banks in a better funding position than investment banks and finance companies. Mandatory capital ratio requirements for bank holding companies offer strong bondholder protection against excessive capital erosion. Even without the "too-big-to-fail" argument, many of the regional banks are in a much better position compared to the Savings & Loan crisis in the 1980s. They enjoy vastly improved operating efficiency, revenue diversification, risk pricing and management, and credit underwriting standards. Note that most of the subprime mortgage originations came not from regulated banking entities but from third-party mortgage companies.

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3. Diamonds in the Rough – Asset-backed Securities

As subprime continues to besiege the asset-backed markets, some investors have decided to pull out en mass from all things asset-backed. This creates good opportunities in strong commercial paper (CP) and term asset-backed securities (ABS) names without subprime association. For example, CP programs backed by short-term receivables with 100% AA-rated bank liquidity support are yielding 0.80% above the Fed funds rate and 0.40% above money fund yields. Such programs are, for practical purposes, equivalent to the sponsor banks' own credit with very short credit exposure in the collateral portfolio. In the term ABS market, AAA notes backed by credit card receivables, traditionally the most conservative ABS investments, are yielding 1.30% higher than comparable-maturity Treasury notes, compared to a spread of 0.30% a year ago. Unlike bonds backed by home equity loans and commercial properties, risks on these bonds are generally easier to assess as credit card receivables tend to have shorter payment cycles, longer loss history for analysis, and better information disclosure.*

As financial markets contemplate potential spillover effects of subprime mortgages and the state of the consumer economy, it's helpful to know that many businesses on Wall Street and Main Street are in a fine shape. Much of the write-downs by Wall Street firms constitute paper losses representing "front loading" of potential future losses with assumptions from the Great Depression era. The pains in the housing and stock markets may take some time to cure, but high-grade bond investors have firm ground to stand on in this crisis of confidence. Running for cover to the preverbal mattress – U.S. Treasury securities - is certainly an option, but savvy investors can find more prudent ways of investing without giving up safety and liquidity considerations.

* Data from Federal Reserve Web site (CP yield), Bloomberg Professional (Treasury yield), and Merrill Lynch Global Index System (ABS Credit Cards Fixed Rate AAA) as of November 29.

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