CAPITAL ADVISORS GROUP
Independent Treasury and Debt Solutions

Controlling Hidden Exposures in Cash Portfolios

Dear Reader:

Recent credit market events have stress-tested corporate cash portfolios more than at any time I can recall in my 28-year investment career. These events are shocking in scope and have threatened our financial system in ways not seen since the Great Depression. Because it's so easy to "lose sight of the forest" in this unprecedented environment, I wanted to take a minute and discuss the macro environment of the current credit-driven housing cycle in historical context in hopes of getting a clearer view of what we may face in the future.

In the early 90s, Finland, Norway and Sweden endured major credit-driven housing down cycles, while Japan went through a significantly longer one from '91 to '02. The protracted length of Japan's troubles was caused by an extremely slow loss response and recapitalization process compared to the other three. Admittedly, these parallels to the current U.S. situation are only helpful if we first recognize the obvious differences.

Of course, the sheer dollar size of the U.S. mortgage market dwarfs that of the other countries'. And, as the largest economy in the world combined with the relatively recent engineering, packaging and distribution of Collateralized Debt Obligations, Structured Investment Vehicles, and other mortgage conduits, there is no doubt the U.S. cycle will have vastly greater global impact on foreign banks, equity markets and global growth. However, if we view the aforementioned parallels as a percent of real estate decline, percent of equity price decline and percent of recapitalization costs to GDP, they do provide interesting context to the current trajectory of the U.S. real estate credit bust.

In each of these housing credit cycles easy mortgage credit drove a self-reinforcing increase in home prices which subsequently reversed to the inevitable cycle of collateral impairment when the trend shifted. Declines in mortgage collateral devastated the banking sectors and required major government interventions. In Sweden the government guaranteed the assets of the entire banking system, while Finland and Norway's governments guaranteed a majority of their bank deposits.

Excluding Japan from the data set due to its extended 12-year recapitalization process, the U.S. still significantly lags the data declines from the Finland, Norway, and Sweden examples. So far the U.S. housing market has declined 24% from its high, versus an average decline of 39% for the other three. U.S. banking equities, as represented by the KBW bank index have declined 58% so far, while the financial stocks in the other three countries declined an average of 85%. Recapitalization costs for the group averaged a total of 7.6% of GDP while the U.S. is today roughly at 3% of GDP and climbing. Lastly, recovery to trend GDP took an average of 7.6 years for the set of countries.

The discouraging conclusion that can be drawn from these parallels is this: Even while the U.S. has been relatively quick to address the losses and worked to establish the Troubled Asset Relief Program, which would bring the U.S. recapitalization costs in line with that of averages from previous credit driven housing cycles, the fact remains that other U.S. housing and financial indices actually have additional room to decline.

What Does This Mean to Corporate Treasurers?

First on Treasurers' minds is how best to control risk exposures in this environment.

A large part of the answer lies in how effectively one's cash portfolio was preemptively positioned 6-12 months ago. To this end, while we always hope to avoid the sometimes less-than-rosy conclusions that can be found in our research papers, (link to More Reflections on the Money Market Fund Debacle), we have also learned to appreciate the discipline of taking a forward view and adjusting exposures for anticipated market conditions.

While the foresight of a year ago is the greatest determinate of the strength of a cash portfolio today, there are specific exposures that may still be reduced in many Treasury functions. CFOs, Treasurers and Audit Committees who were committed to reducing or eliminating financial/banking exposure in this environment may have done so effectively with individual portfolio holdings. What they may have overlooked however, were the financial/banking exposures in their corporate (2a-7) Money Market Funds and or Bank Money Market Deposit Accounts (MMDA). These financial/banking exposures can run as extreme as a BBB-rated, single-concentrated risk of a bank money market deposit account, with deposits that are fully exposed beyond the $100,000 FDIC insurance coverage (the FDIC insurance limit may increase to $250,000 if the current rescue bill before Congress is passed). They can also be as benign as a diversified (2a-7) corporate money fund, but one that maintains up to a 70% exposure to banking and finance names.

Note: It is important to understand the differences between a (2a-7) money market fund and a MMDA account. While they share similar names they work quite differently as financial instruments. At its most basic form, (2a-7) money funds are regulated by the SEC and, depending on their mandate, pool client cash to invest in diversified, highly- rated portfolios that target a constant dollar share price. On the other hand, the bank MMDA, often linked to corporate operating accounts, has FDIC oversight, is insured up to a $100,000 limit and provides a return set by the bank and backed by the bank's loan portfolio and other financial assets. Therefore, the bank credit rating plays a significant role if you place cash assets into an MMDA. A BBB-rated bank provides you the lowest rung of what is considered "investment grade," while a AAA-rated bank provides significantly greater credit worthiness.

In the wake of the Washington Mutual failure, the banking sector is and will remain under considerable stress for the foreseeable future. Corporate cash portfolios must be scrutinized for potential exposures to financial names in money funds and/or concentrated risk in bank accounts for balances beyond the $100,000 FDIC coverage. The good news is many of these exposures may be eliminated with a phone call as banks and money funds are less dependant on credit market liquidity.

Conclusion

In trying to control risk exposures in Corporate Treasury functions it is important to understand where the exposures exist. The trouble is that they may not be found in the traditional areas we've grown accustomed to and responsibility for bank deposits and money funds may fall beyond the purview of outside cash managers. Therefore, management must diligently review and modify these exposures as necessary.

All the signs point to a very high likelihood of a U.S. recession and below trend growth for several years to follow. Deleveraging of the U.S. economy will provide strong headwinds for GDP growth for some time to come. In this environment, financial exposure, whether through individual holdings, corporate money market funds or bank accounts, should be purposely limited and one should focus on counter cyclical non-financial credits that will provide stability in a recessionary low growth environment.

Regards,

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