Four Steps to Prudently Pursue Yield

Abstract:
With the Fed on hold for an extended period, institutional cash investors need a new perspective on dealing with the prolonged low yield reality. Our four-step guide reminds investors to expect lower yields in the new environment, increase exposure only to securities supported by strong fundamentals, improve yield potential with moderate maturity extension, and be mindful of the downside risk of over-extending oneself.

Introduction:
The Federal Reserve's August 10th decision to reinvest proceeds from its mortgage-backed securities holdings sent an important signal that the near zero (0.00% to 0.25%) interest rate policy will likely linger longer than previously expected. With the futures market predicting the Fed funds rate stuck on zero through much of 2011, institutional cash investors need a new perspective on how to deal with this prolonged low yield reality.

Given these assumptions, it is possible that the moderate yield increases in money market funds and other cash portfolios in recent months will reverse course in coming weeks. Should one be content with the meager yield, if any, from these commingled vehicles? What are some of the feasible yield opportunities? Should one consider increasing portfolio risk when a double-dip recession may cause new credit concerns? We hope our four-step guide provides a helpful perspective to the institutional cash and short-duration community.

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Exhibit 1: Futures Market's Expectation of Fed Funds Rate

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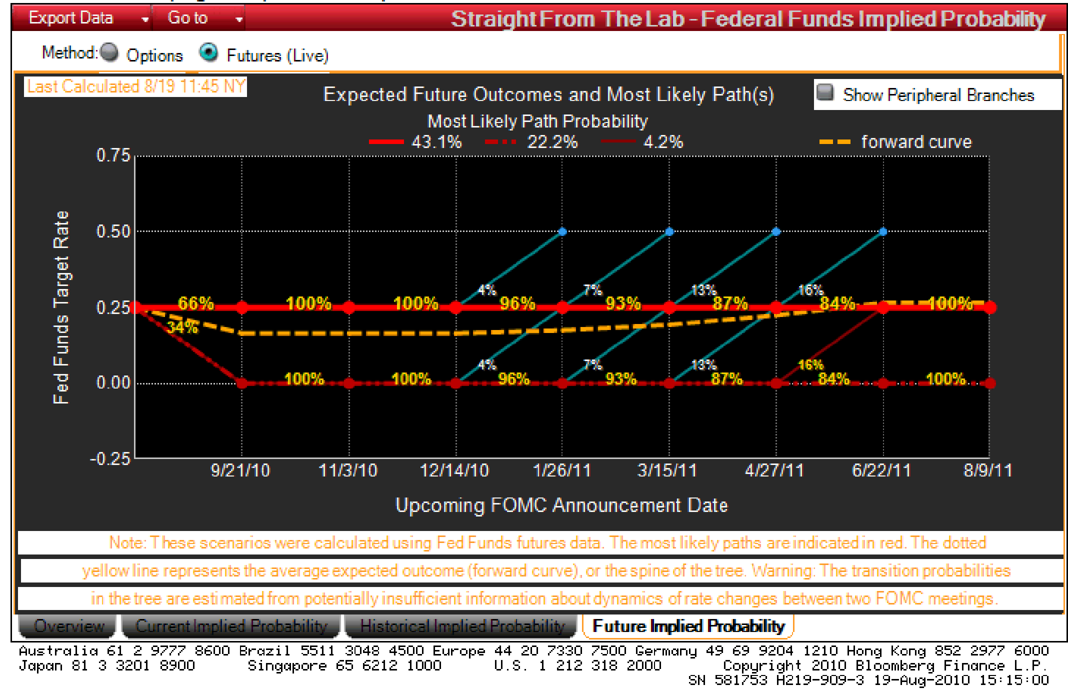


Source: Bloomberg. See footnote 1.

Step 1: Recognize the New Normal

As we pointed out in several of our previous research pieces, the landscape of liquidity investing was permanently altered by regulatory changes after the financial crisis of 2008. Money market funds are required to hold more liquid investments in shorter maturities. Banks must bring off-balance sheet vehicles such as asset-backed commercial paper programs back on balance sheets. Financial firms are told to hold more capital and reduce risky activities. All of these measures resulted in the disappearance of certain higher yielding securities and lower yield on those securities that survived. Thus, investors should reset their yield expectations in this post crisis era.

The "lowered yield expectation" paradigm is especially true in today's yield environment, where yield spreads among different investment choices have compressed to historic lows. The incremental risk in achieving an extra 0.20% in yield today may be greater than those fetching 1% or 2% in the past. In short, historical yield expectations are no longer relevant reference points for today's investors.

Step 2: Do No Harm

Known as *primum non nocere* in Latin, the "do no harm" phrase is one of the principal precepts of ethics taught to all medical students around the world. In our survival guide, this phrase means any additional yield opportunities should not come at the expense of the first two principles of liquidity investments: the protection of principal and adequate liquidity. Most of us know that, of course; but in practice, it is easier said than done. The fact that prime money market funds have increased their exposure to Southern European financial issuers since May 2010 is a good example of failure to do just that.

One should not criticize prime money market funds for investing in non-government securities, as that is what they are designed to do. We, however, thought it was inappropriate to boost yield by increasing exposures to a region when headline risk is running high, something we noticed some money funds were doing. Rather, we suggest investors consider increasing exposure to issuers supported by strong credit and economic fundamentals. These credits may include strong financial issuers in growing markets such as Canada and Australia, companies benefiting from strong exports and the cheap dollar, and mispriced asset-backed programs supported by top notch financial sponsors. If one does not simply take what the market has to offer but instead focuses on strong credit characteristics, one may find a few diamonds in the rough and manage to avoid the perils of chasing yield.

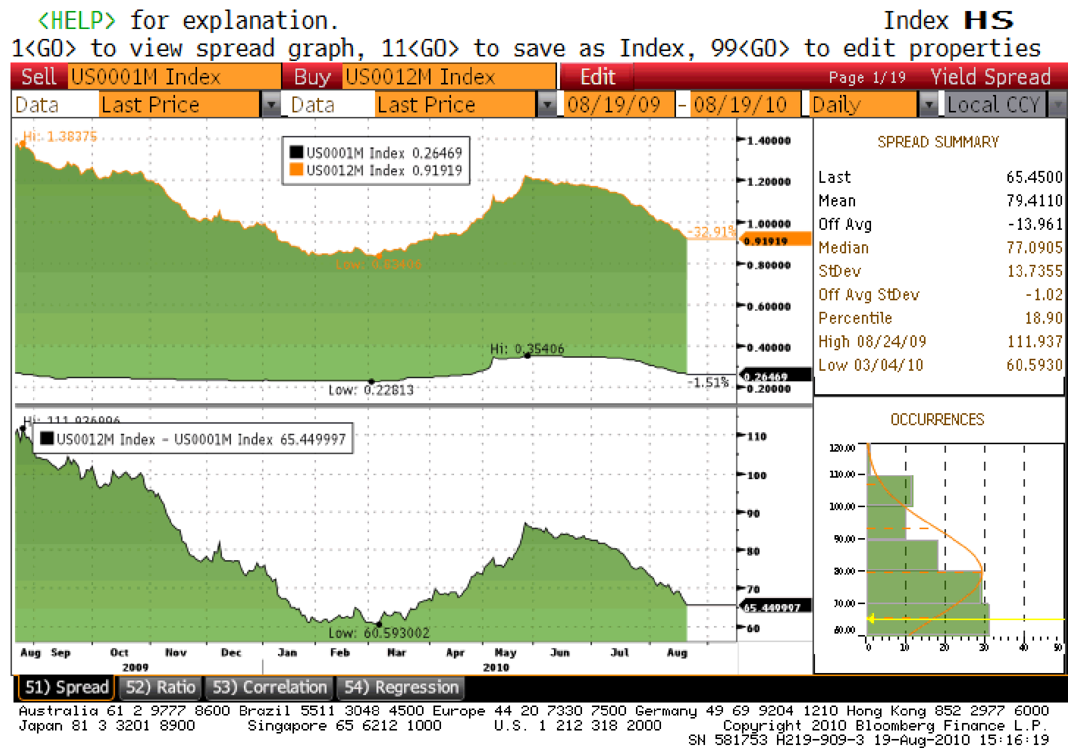
Step 3: Make Liquidity Pay

Several of our past articles attempted to measure the cost of idle cash in money market funds. While uncertainty requires most investors to keep some balances in overnight vehicles in excess of their daily cash needs, a large balance in money funds without an apparent need is akin to lending money to other fund investors at no cost, in our opinion. Extending maturities on suitable investments to match target expenditures may be a more preferred liquidity management tool.

As reiterated by the Fed, short-term interest rates will likely stay range bound for an extended period. Buying a security with a slightly longer maturity may produce higher yield than rolling bonds from the same issuer in shorter maturities. Exhibit 2 shows that the current yield spread of the 12-month benchmark rate known as LIBOR over the 1-month LIBOR rate is 0.66%. If we assume the Fed is on hold and all market factors

remain unchanged, one would earn an annualized yield of 0.27% a month for the next year. Lending the money out for 12 months, investors may earn 0.93%. With the futures market not expecting any Fed action through at least September 2011, a maturity extension of 3, 6, or 9 months may be appropriate for an investor with no immediate cash needs.

Exhibit 2: Yield Spread History of 1-month and 12-month Benchmark Rates

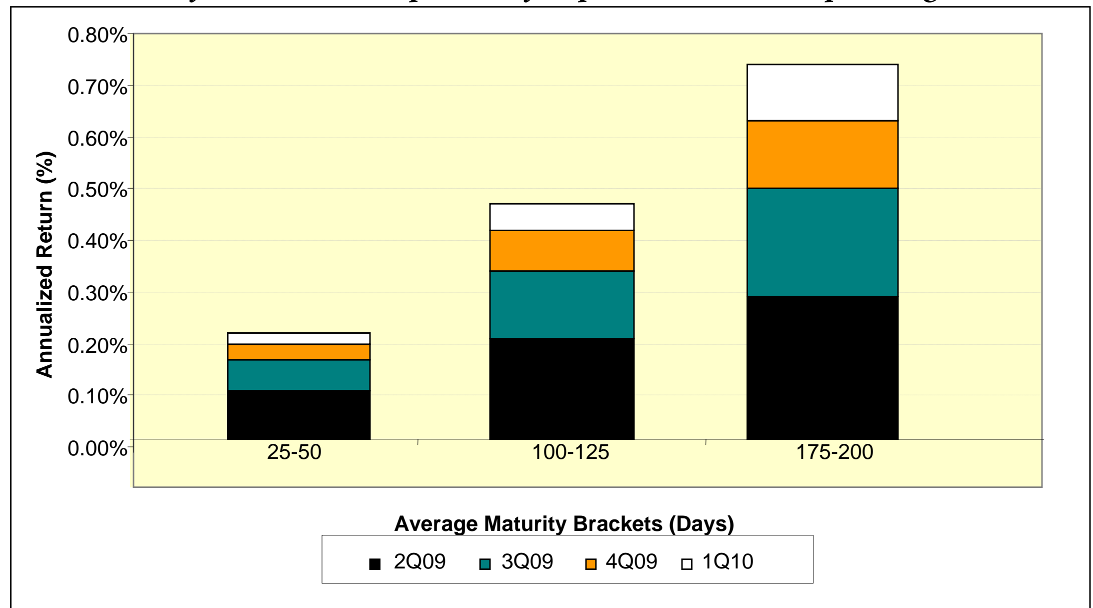


Source: Bloomberg

Exhibit 3 provides an example of the maturity extension strategy employed at Capital Advisors Group. In the four quarters through March 2010, accounts with average maturities between 100 and 125 days earned an average annualized return of 0.47%, which represents a pickup of 0.25% over portfolios running a 25-50-day average maturity. The 175-200-day average maturity bracket earned 0.73% over the same period, or 0.51% over the shortest bracket. We should note that there are other factors besides average maturity that may have caused the yield differences and that one cannot guarantee that the same yield advantage will hold going forward. While past performance is not indicative of future results, the purpose of this exhibit is to illustrate

that even in this near zero interest rate environment, it was possible to achieve higher yield potential without significantly increasing interest rate risk, which we will discuss next.

Exhibit 3: Portfolio Return Comparison of Capital Advisors Group Managed Accounts



Source: Capital Advisors Group Data[2]

Step 4: Watch for the Turn

Having made the case for extending maturities to improve yield opportunities, we cannot stress enough the downside risk of over-extension. In fact, one of the basic principles of fixed income investing is that higher interest rates almost always hurt investors more than help them. So what's a treasurer to do in this case?

We caution investors of the risks of higher interest rates for two reasons. First, history shows that when the Fed starts a tightening cycle, the pace may be faster than the market anticipated given the current low starting point. This means bonds with several months left to maturity may experience some unrealized losses. For this reason, we advise investors to refrain from investing beyond the time when the Fed is expected to start tightening. Note that in this cycle, the Fed may need to shrink its balance sheet before tightening rates, so we should have some early indications on the timing of its moves.

Another reason to watch for higher rates stems from the great debate of austerity vs. stimulus among investors of sovereign bonds. While the market's focus so far has been on the fiscal health of the U.K. and some Eurozone countries, the crosshairs may be on the U.S. if the government starts a new round of stimulus spending to help consumers or local governments. This means higher bond yields and unrealized losses, although the impact on short-duration investors may be less than on long-term investors.

Conclusion: Make the Most out of a Prolonged Low Yield Environment

It has been a long and painful stretch of low yields for the treasury community, which happens to be endowed with record levels of cash on its balance sheet. As the Eurozone sovereign debt crisis subsides and the Fed has made known its intention to engage in more quantitative easing, we expect the low yield environment to continue through 2010 and possibly into the middle of 2011. Yield enhancing opportunities, though available, are limited. Sifting through these opportunities, coupled with heightened sensitivity towards credit risk and the pressure to add yield, will be challenging for all.

In this paper, we advise the institutional investor to recognize the new reality of lower expected yield from cash instruments, to add credit exposures based on sound fundamentals, to sensibly invest in moderately longer maturities and to be vigilant of the risk of higher interest rates. While none of the suggestions sound earth shattering, we think it is helpful to be reminded of these tips. As we say goodbye to the long, hot summer, we wish investors better yield opportunities in the fall.

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[1] According to the Bloomberg "Straight from the Lab" (FFIP) analysis, there is no indication of greater than 50% probability of the Fed funds rate rising above 0.25% through the 8/9/2011 FOMC meeting. Data as of 8/18/10.

[2] Past performance is no guarantee of future results. Capital Advisors Group, Inc. claims compliance with the Global Investment Performance Standards (GIPS®). Capital Advisors Group, Inc. has been verified for the periods December 31, 2000 through March 31, 2010 by Beacon Verification Services. Capital Advisors Group, Inc. (CAG) is an independent investment advisor registered with the Securities and Exchange Commission under the Investment Advisors Act of 1940. CAG manages fixed income portfolios comprised mostly of cash and short-duration securities primarily for corporations, non-profit organizations, and other institutional investors. Accounts included in the Cash Management Composite are comprised of all actively managed US Dollar-denominated fixed income accounts. Investment objectives include investment return, principal preservation, and maintenance of liquidity. Accounts are not managed against market indices; but returns are compared to money market fund peer group performance and/or short-term market benchmarks for reference

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25-50 days	Supplemental Book Value	Market Value
2009 Q2	0.11%	0.03%
2009 Q3	0.06%	0.03%
2009 Q4	0.03%	0.00%
2010 Q1	0.02%	0.01%

100-125 days	Supplemental Book Value	Market Value
2009 Q2	0.21%	0.15%
2009 Q3	0.13%	0.07%
2009 Q4	0.08%	0.03%
2010 Q1	0.05%	0.03%

175-200 days	Supplemental Book Value	Market Value
2009 Q2	0.29%	0.18%
2009 Q3	0.21%	0.08%
2009 Q4	0.13%	0.10%
2010 Q1	0.10%	0.05%

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