Quenching the Thirst for Yield

Is The Dry Season Over?

As signs of stability returned to capital markets in recent weeks, we've begun to hear investors inquire as to how to improve yield in their cash portfolios. We acknowledge that, first and foremost, the return of risk appetite is a welcome and healthy sign after a period of frozen credits and a crisis of confidence. We caution, however, that the quest for higher yield should not be influenced by the low yield on "risk-less" assets, but by the fundamental improvement in asset classes that carry greater risk. If the decision to improve portfolio yield is not based on sound principals, investors may face the consequences of potential bond yield *bear traps* or a credit risk *whiplash.*

Low Yield Is a Reality to Be Reckoned With

The pain felt by cash investors dealing with low returns is real. Recent excessive risk aversion has driven yields on Treasury bills and Treasury money market funds to near zero, and briefly to negative levels. In response to the housing market crisis, the Federal Reserve took the benchmark Federal Funds Rate from 5.25% in September 2007 all the way down to a range between zero and 0.25%. A number of government programs aimed bringing money markets back to normal after the 2008 freeze also resulted in the collapse of LIBOR rates, the global inter-bank lending rates upon which most non-government assets are based. For example, the 3-month LIBOR rate dropped from 4.82% on October 10, 2008 to 0.66% on May 22, 2009, representing a loss of 86% in interest income on a typical loan.

The collapse of yield potential in cash assets is also the result of the market-wide paradigm shift of "deleveraging" and "de-risking." Financial leverage allowed debt issuers and market intermediaries to enhance investment returns through high levels of borrowing. The burst of the credit bubble forced the reversal of this process. The impact on cash investors is that there are fewer borrowers willing to pay juicy yields as their own return opportunities dwindle due to deleveraging.

Now that the credit crisis has largely run its course, the de-risking process by cash investors is perhaps in full swing. Various proposals to eliminate certain asset classes, limit risk, and constrain ratings requirements only further serve to limit yield potential in cash portfolios. For example, the Investment Company Institute's Money Market Working Group has proposed a number of ways to limit the risk of money market funds. Such measures include shorter portfolio

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average maturity, higher allocation of securities to overnight and one-week maturities, and a new requirement of “spread WAM”, which is a measurement of sensitivity to credit risk. The designers of the proposal, who are CEOs of major money fund firms, acknowledged that these changes will result in lower yield potential, all else being equal.

In summary, the confluence of factors that contributed to lower yield in cash portfolios may not dissipate any time soon. Investors should not have unrealistic yield expectations in the near term. Stepping up interest rate risk or stepping down in credit quality to stretch for yield can ultimately have severe adverse effects on portfolio performance.

Beware of the Treasury Bear Trap

The interest rate risk of buying longer-term Treasury securities is apparent. With a paltry yield (0.13% on the 3-month T-bill as on June 1), these securities do not have much margin of safety as yields rise and put existing investments under water. The important question is whether short-term rates will rise quickly enough to pose that risk.

For all the recent discussions of the Treasury “bear trap,” that is, reaching for yield in a low rate environment and getting hurt when rates do rise, short-term rates have remained consistently low despite a creeping up in long-term Treasury securities. For example, the 10-year T-note yield has increased 1.26% to 3.48% since the beginning of the year, while the 3-month T-bill yield has risen only 0.09% to 0.18%. While the weakness in the 10-year note can be explained by investors’ concerns with a ballooning federal deficit and the weak dollar, many net exporting countries’, which need to keep their foreign exchange reserves in the U.S., moved their investments from long-term to short-term Treasuries. Safety-minded investors continue to have a larger-than-normal appetite for Treasury money market funds.

When there is no practical room for short-term interest rates to fall, they must rise at some point, for good or bad reasons. If cash investors hold securities with maturities longer than, say, a year, they can be painfully exposed when rates do rise quickly. A good reason for rates to rise could be a sustained economic recovery which compels the Federal Reserve to raise interest rates aggressively to “mop up” the excess liquidity that has been injected into the monetary system since late 2007. Bad reasons might be an overwhelming supply of Treasury securities, the further slippage of the dollar, and a sagging demand from foreign investors. We think that the presence of these risks make an argument for prudence in not overextending portfolio maturity when considering investment up the yield curve.

The most recent instance of Fed funds rate increases was between June 2004 and June 2006, when the rate rose from 1.00% to 5.25%. Some economists now argue that the Federal Reserve under former Chairman Alan Greenspan was partially responsible for the current credit crisis because it did not increase the rate soon or fast enough to curb the irresponsible lending practices that ensued. The implication of this reflection may mean much more aggressive interest rate increases when the Fed does begin to raise rates.

In short, we think this *bear trap* could affect ill-prepared investors more severely than when interest rates last rose.

Strong Credit Underpinning is Still Wishful Thinking

Since early March of 2009, credit spreads have followed equity indices in staging a spectacular rally. From February 27 through May 22 of this year, the yield spread on the Merrill Lynch 1- to 3-Year Corporate (A-rated and higher) Index dropped 2.64% to yield 4.78% over comparable Treasuries. A remarkable snap back indeed, although this is still a far cry from the level of 0.41% back at the end of 2006.

Interestingly, there has been little fundamental evidence to support this credit rally. One may point to the talk of "green shoots" by Fed Chairman Bernanke, the comments by President Obama about the administration's economic policy being effective, the Fed's disclosure that half of the 19 large U.S. banks do not need capital infusion, and recent reports of higher consumer confidence. However, nothing indicates that home sales and prices have stopped falling, that foreclosures and charge-offs have stopped climbing, that corporate profits have begun to rise and that the economy is again adding jobs. In other words, saying "the economy is falling at a lower rate of decline" does not indicate a turn in the credit environment nor does it provide a strong fundamental reason to take on credit risk, especially in lower-rated credit investments.

The data we observe from the Federal Reserve's regional activities, financial institutions' asset quality reports, ratings agencies stress tests, and international organizations' projections all seems to point to a worsening of fundamental credit trends including higher bankruptcy filings and loan losses, lower corporate profits and difficulty in accessing private capital. We expect that the recovery will favor certain sectors of the economy more than others as we emerge from the recession. Unless and until economic activities are broadly on an upswing, we believe investors would be ill advised to go down in credit quality to pick up yield.

The credit environment we are in is perhaps one of the most dichotomous we've experienced in recent history. With short-term yield dropping close to 4% (4.16% for the 3-month LIBOR as of May 29), one may find A-1/P-1 rated investments inside three months yielding anywhere between 2.25% (e.g. Amstel Funding) and 0% (yes, zero for European Investment Bank, or EIB) (both yields were taken from the Bloomberg dealer offering screen on May 26). Prior to the credit crisis, the difference may have been 0.02% or less. The challenge to today's cash investors is to discern whether this 2.25% in additional yield, which incidentally, represents nine times the interest income a bank earns on the Fed funds target rate (0%-0.25%), well enough compensates for the increase in credit risk.

To summarize, the recent positive trend in financial credits may present some opportunities in a few systemically important institutions. However, since we are still in the midst of a negative credit trend, a general bullish call on credit investments has not arrived.

Watch Out for the "Other" Moral Hazard

One final item of caution should resonate with investors who fell victim to exotic instruments popular in the low yield environment of 2003 -2004. In our opinion, this past period not only helped create the moral hazard of irresponsible lenders and overextended borrowers, but also encouraged, what we refer to as, a second moral hazard--the creation and marketing of risky securities to risk averse cash investors who were trying to make up for lost income.

Two of the more problematic security types that come to mind are auction rate securities (ARS) and asset-backed commercial paper programs issued by mortgage companies with maturity extension features (x-ABCP). The original version of ARS was developed in the mid-1980s and extendible corporate CP has been in existence since the late 1990s. Both remained in relative obscurity until the middle of this decade. The low yield environment helped create strong volume growth in consolidated student loans and refinanced mortgages, compelling lenders to cultivate new sources of funding. On the other hand, several years of strong retained earnings and a one-time reduced tax rate on repatriated foreign income resulted in large cash surpluses at many corporations.

At the time, the average money market fund was yielding less than the Fed funds rate of 1%. With yield spreads between 0.05% and 0.20% over traditional cash investments, Wall Street was able to convince cash investors that the student loan-backed ARS and the mortgage-backed x-ABCP programs were safe and sound cash vehicles. We saw the devastating effects of both products when their structural weaknesses were exposed.

One can clearly see the potential for the return of the moral hazard in today's environment, perhaps even worse than six years ago as the Fed funds rate was 0.75% to 1.00% higher – Treasury bills, government money market funds, and bank deposits all are earning close to nothing or even negative when maintenance and transaction costs are included. This means that the temptation can be greater to buy into new fangled "safe and liquid" assets to juice up yield.

In summary, the return of the low yield environment may coincide with tantalizing new offerings and seemingly attractive yield. As we often remind our readers, cash investors who are true to their conservative roots should be instinctively suspicious of all new and unproven investments despite the glossy brochures and low risk declarations. The real life stress test is the one test that counts.

Conclusion - Get Ready for the Point of Entry

With the economy in search of a firm footing and the fundamental credit outlook still cloudy, we think the low yield environment is a painful, logical, and transitory phase in a typical credit cycle. A low yielding portfolio itself should not be the catalyst for taking on more risk. The decision needs to be based on sound credit principles supported by evidence and conviction. From our vantage point, we are still not safe from false signals of recovery and premature rallies.

However, we do not suggest an ostrich strategy nor do we ignore market signals. On the contrary, the purpose of this commentary is to help our readers prepare for the most opportune point of entry when all the right pieces are in place. The classic building blocks of yield enhancing strategies will not change – yield curve positioning, credit selection and liquidity management. What has changed is that cash management has become an area of high scrutiny and high accountability. As the Chinese language combines the characters for "risk" and "opportunity" to spell the word "crisis," corporate cash investing, as a result of this current financial crisis, has become more challenging and more rewarding at the same time.