

SIX ADVANTAGES OF SEPARATELY MANAGED ACCOUNTS

Reflecting on the Recent Money Market Fund Crisis

EXECUTIVE SUMMARY:

The concurrent use of commingled and separate accounts may help in optimizing corporate cash management.

Among corporations, separate account management has a limited following - about 20% in separate account management vs. 76% in money funds and 22% in other funds.

Six Advantages of Separately Managed Accounts:

1. Tailored Risk Management
2. Transparency
3. Higher Return Potential
4. Free from “Hot Money”
5. Income and Capital Gains Management
6. Versatile Reporting

Investments in time and research in a separate account relationship may bring just rewards in times of uncertainty.

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INTRODUCTION

One of the lessons corporate treasurers may glean from the recent crisis of confidence in money market funds may be that pooled liquidity vehicles, despite their appearance of safety and liquidity, are in fact quite susceptible to severe credit risks that may lead to fund freezes. In 2007, after early blowups of supposedly conservative “yield-plus” and “ultra-short” funds, several state-owned local government investment pools (LGIPs) froze redemptions due to investments in troubled structured investment vehicles (SIVs). The Lehman Brothers bankruptcy in September 2008 forced the \$64 billion Reserve Primary money market fund to “break the dollar”, the second such instance in the history of money market funds. The U.S. Treasury had to institute an emergency guarantee program for money market funds to prevent widespread runs on money funds beyond the four fund families that already implemented fund freezes. The exclusion of the \$9.3 billion CommonFund Short-term Fund, a money market-like pooled vehicle, from the guarantee program forced its trustee to freeze redemptions and left thousands of colleges without access to their operating cash accounts. All of the recent events evoked more uneasiness among treasury professionals who routinely use such commingled investment vehicles as mainstay cash management tools.

Whether to use a commingled asset pool like a mutual fund or an investment manager in a separate account format is an age-old debate among investors in different disciplines. Few would dispute the benefits of a constant \$1 share price and the daily liquidity offered by an SEC-regulated money market fund today; however, an investor in a separate account with specific investment guidelines might have avoided the recent collateral damage from some of the poorly conceived investment strategies in commingled vehicles. Frustration from the inability to assess and remedy undesirable credit exposures in a fund by the individual investor was perhaps more agonizing than the severity of actual credit risks.

The recent growth of web-based portals took the popularity of fund investing to a new level. Credit events since August 2007, however, brought the argument for separate account management back to the front-burner for many corporate investors. In this paper, we point to a number of advantages of separately managed accounts (SMAs). We believe that the right answer is not an “either-or” decision, but rather the simultaneous use of both strategies in optimizing cash management solutions for the corporate investor.

SEPARATE ACCOUNT MANAGEMENT BASICS

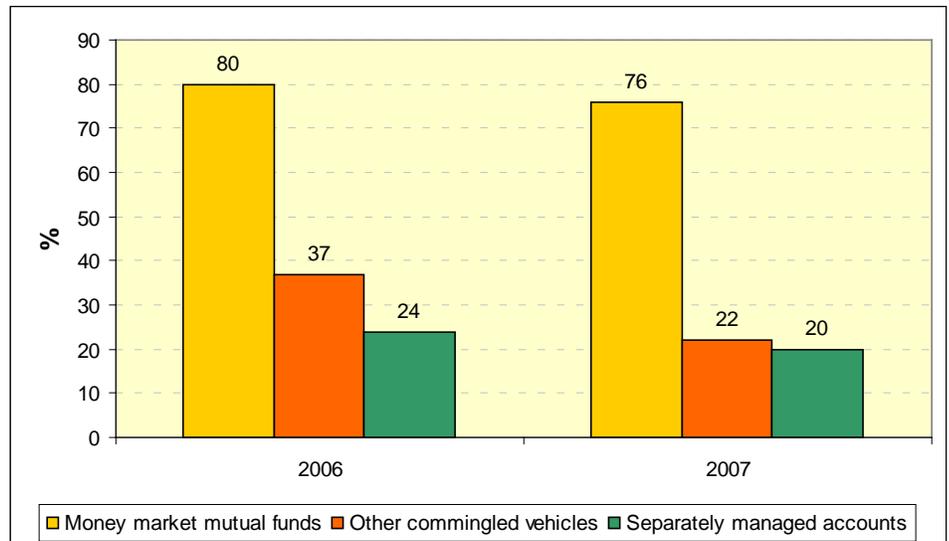
As the title indicates, investors of SMAs own their investments directly, often in a custodial investment account registered under the investor’s name. This is in contrast to investors owning shares of a mutual fund or another commingled investment vehicle that in turn owns individual securities, such as stocks, bonds, and/or derivatives. In both cases, investors use professional investment managers to make discretionary investment decisions. Typical SMA investors include educational endowments, charitable foundations, pension plans and private wealth trusts.

In the area of corporate cash management, the use of separate account management has a long tradition, but with a limited following. According to a recent industry survey by the Association for Financial Professionals, about 20% of U.S. corporations permit separate

A commingled vehicle rarely satisfies the preferences of all investors in the fund.

account investing in 2007. This compares to 76% allowing money market funds and another 22% in other forms of commingled vehicles. Some investors attribute to their net borrower status and the lengthier procedure of establishing an adviser relationship as the reasons for low separate account use rate. However, recent credit events affecting commingled investments may encourage more corporations to consider separate accounts to improve transparency and oversight. In fact, the potential advantages of a separate account does not stop at risk management concerns.

Figure 1: Permissible Investment Vehicles by Corporate Investors



Taken from table: Permissible Investment Vehicles per Organization's Short-term Investment Policy in Addition to Bank Deposits and Treasury Bills, 2006 & 2007 liquidity survey results, Association for Financial Professionals, Bethesda, MD.

CUSTOMIZATION - POTENTIAL ADVANTAGES

Many of the potential and obvious advantages of an SMA reflect its traits of individuality. As assets and investment preferences are not commingled with that of others, individual investors are able to work with their investment manager to customize investment strategies and construct a portfolio catering to their own risk tolerance, return expectations and specific operating cash needs.

1. Tailored Risk Management: Every investor faces unique circumstances that impact income, growth, safety, and liquidity considerations. Understandably, a commingled vehicle rarely satisfies the preferences of all investors in the fund. For example, certain corporate investors would not permit extendible commercial notes (ECNs), structured investment vehicles (SIVs) and collateralized debt obligations (CDOs) in their portfolios. Some of these exotic forms of asset-backed commercial paper have run into credit and liquidity problems recently and many investors were surprised to discover their exposure in the money market and yield plus funds they own.

In a separate account relationship, an investor may set specific guidelines on some of the key risk control metrics such as maturities, concentration limits, ratings and liquidity requirements. Another effective risk control mechanism may be a list of prohibited transactions including the use of financial leverage, derivatives and/or specific securities types to be excluded. For more information on investment policy formulation, you may visit our Web site at http://web.capitaladvisors.com/about_capital_advisors_group/

Fund companies rarely volunteer more information than necessary for competitive reasons.

Under certain conditions, a separate account may provide higher yield potential than a typical money market fund.

downloads/whitepapers.html and request our publication “*Shaping Investment Policies for a Safer Portfolio.*”

Figure 2: Sample Restrictions in Investment Guidelines

ITEM	LIMITS
Maximum issuer maturity	18 months
Maximum portfolio maturity	9 months
Minimum credit ratings	A3/A- (A-1/P-1)
Issuer concentration	5%
Industry diversification	20%
Overnight liquidity	10%
Benchmark selection	3-month T-bill
Prohibited transactions	Leverage, derivatives, extendible CPs, CDOs

When interest rates are falling, investors may invest in longer-term securities to “lock in” the higher yield.

2. Transparency: Another potential advantage related to risk control is the level of disclosure of investment activities. In addition to periodic statements, reports and expenses, an investor is entitled to all relevant portfolio information on demand. Equipped with the right data, the investor may address and deal with credit issues in a relatively timely fashion.

In contrast, money market and enhanced cash funds release information on a quarterly or semi-annual basis with a 45-day lag. Recent credit concerns forced several fund families to temporarily post such information on a monthly basis, but fund companies rarely volunteer more information than necessary for competitive reasons. Fair Disclosure regulation requiring funds to disseminate new information to all shareholders also presents operational challenges that become cumbersome for investors to quickly gain knowledge of specific exposure.

3. Higher Return Potential: When comparing and contrasting commingled and separate account investments, one cannot stress enough the potential return aspect. Under certain conditions, a separate account may provide higher yield potential than a typical money market fund. There are two reasons that may contribute to this.

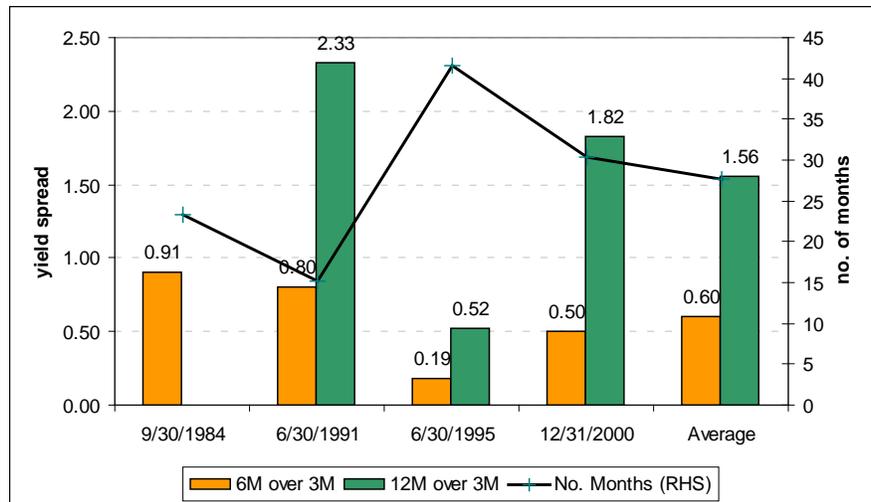
a) Exemption from the 2a-7 rule: The governing SEC regulation for money funds includes the 2a-7 rule which limits investments to well-diversified short-term securities with high credit ratings. As such funds make up a major part of the short-term credit market, securities not eligible for the 2a-7 perimeters, such as those with maturities slightly longer than 13 months, may be less popular and subsequently higher-yielding. Some of the yield-plus funds exploited this income opportunity with overly aggressive strategies and suffered the consequences. A separate account may avoid some of the pitfalls and achieve higher income potential by adhering to measured parameters beyond 2a-7 without violating the investor’s risk tolerance.

b) Yield curve positioning: Another higher yield potential for separate accounts is related to the levels of interest rates. Generally speaking, investors may expect investments with longer maturities to outperform money funds in a stable or falling interest rate environment.

When the levels of interest rates are relatively stable, there is a general belief among investors that the higher risk of longer-term securities demands higher yield to compensate for owning such securities. When interest rates are falling, investors may invest in securities with longer maturity dates to “lock in” the higher yield if they expect future interest rates to be lower than current levels.

A large number of investors simultaneously moving in and out of funds may threaten the very bedrock of money fund investing.

Figure 3: Return Differential of Treasury Securities in Falling Rate Periods



Annualized returns of 6 and 12-month Treasury securities over 3-month T-bills in periods (9/84-8/86, 6/91-9/92, 6/95-11/98, 12/00-6/03) when Fed funds rates fell. Data based on Merrill Lynch Treasury indices (G001, G002 & G003/GC03) on Bloomberg.

Figure 3 shows the annualized return differences between 3, 6 and 12-month Treasury securities in the last four falling interest rate periods. It shows extending maturity by 3 months and 9 months helped to pick up an average 0.60% and 1.56%, respectively, in return over the 3-month T-bill. Money fund returns are generally expected to be in line with the 3-month Treasury, adjusted for credit spreads, thanks to their maximum portfolio maturity of 90 days. These numbers indicate the potential benefit of moving up portfolio maturities when interest rates are falling.

4. Free from “Hot Money”: One of the difficult realities a commingled fund manager faces is the movement of “hot money” from fund to fund by certain investors to take advantage of favorable yield somewhere else. The constant \$1 share price and the convenience of daily liquidity make money market funds the obvious targets that present serious challenges to fund managers. Volatile cash flows can force managers to either leave too much idle cash in the portfolio or to sell securities at a loss to satisfy redemptions, both of which may have serious long-term implications on fund performance.

The recent development of web-based portal technologies and the increasing commoditization of money market funds may have exacerbated the volatility of fund flows. At its extreme, a large number of yield-chasing investors simultaneously moving out of underperforming funds into higher yielding ones may threaten the very bedrock of money fund investing – the confidence in the funds’ constant \$1 share price.

Investments in time and research in a separate account relationship may bring just rewards in times of uncertainty.

On the other hand, separate account investing is not affected by cash flows from other investors. SMA investors can and do often work with managers in response to upcoming cash flow changes weeks or months ahead. Such information becomes a valuable tool in helping to improve the account’s investment performance.

5. Income & Capital Gains Management: Practically speaking, few corporate cash management accounts focus on total return initiatives, most instead focus on income potential and accounting gains. The advantage of a separate account allowing an investor

to work with its investment manager on certain yield targets, income recognition and capital gain (loss) management cannot be overstated. This is especially true for some publicly-traded companies where investment income is a meaningful contributor to the firms' bottom-line. Income forecasting, gains recognition and loss-harboring for tax purposes are some of the tools unavailable from commingled vehicles.

6. Versatile Reporting: In addition to risk and return considerations, the separate account setup allows an investor to receive customized reporting unavailable from commingled vehicles. For investors concerned with performance measurement, corporate governance, audit oversight and operational efficiency, the number and details of reports are limited only by the investor's preferences and the manager's technological capabilities. Among these reports can be compliance reports that detail all portfolio activities and current holdings.

CONCLUSION

The process one goes through to establish a separate account relationship may take more steps than a mere mouse click on a fund portal, but investments in time and research may bring just rewards in times of uncertainty. There is no question that an advisory relationship should be a long-term partnership that requires considerable trust and scrutiny.

It is also important to point out that separate account relationships are not without their drawbacks. Less public and comprehensive information is available from outside managers on separate accounts in aggregate. Return performance may not be directly comparable among managers. Such difficulties place more due diligence requirement on the investor before and after establishing an advisory relationship. Ongoing dialog, performance appraisal and manager evaluation should be integral to a separate account management process.

The six potential advantages of separate account management are not meant to be exhaustive, but are intended to stimulate discussion on this topic. Using a commingled vehicle or a separate account manager should not be mutually exclusive choices. In addition to convenience and daily liquidity from a money market fund, corporate cash investors may look to separate account management to enhance investment return potential and as to improve risk management.