# The New Normal in the Cash Investment Landscape

As we enter the second decade of the new century, the world financial system has just emerged from a near death experience and embarked on a new journey of redefining itself. Having witnessed the subprime meltdown, the bankruptcy of Lehman Brothers, and the collapse of the Reserve Primary money market fund, corporate cash investment professionals are faced with the same task of redefining their investment choices, strategies and expectations. This paper attempts to point out several recent developments that will likely shape the new cash investment landscape for years to come.

**Old Myths about Cash Investing**

With recent events fresh in our memories, we will provide a recap of how a number of the old myths about cash investing were shattered.

**"Cash is cash. Anything that resembles cash with high credit ratings is safe and liquid."** The collapse of the auction rate securities market and several enhanced cash funds taught us that near-cash does not pass for cash. Credit ratings have little predictability for liquidity.

**"Cash is cash. You don't need an elaborate investment policy to manage something as simple as a cash portfolio."** Often cleverly disguised as high-grade asset-backed securities, some of the most offensive subprime loans turned up in portfolios designed specifically for cash investors. Outsized excess returns should have been red flags.

**"All money funds are the same. Why not invest in ones with the highest yield?"** A number of money fund mangers were quick to point out to us that the Reserve fund "breaking the buck" was no accident, rather the product of a sudden change of course in loading up on risky investments. Was the Reserve an outlier or was it a sign of the times? You be the judge, but money fund due diligence has evolved into a niche industry for financial professionals.

**"We use separately managed accounts for cash we don't need right now. We can tolerate the volatility in hopes for higher returns."** The average institutional investor reduced its maximum allocation to separately managed accounts from 27% to 18% between 2006 and 2009.[1] Anecdotally, we're aware of a few who liquidated their holdings at severely depressed valuations at the height of the credit crisis and went into money funds. Should they have done so? An interesting question, but our point is this: some investors might simply have overstated their risk tolerance. As a result, their portfolios either were too long in maturities or too risky in credit for them to stomach the volatility. The whiplash was painful.

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**The New Normal of Cash Investing**
With many of the conventional wisdoms of cash investing now in our past, what should we expect the new normal to look like?

**Lower Yield Expectation:** For starters, we should expect investors' loss aversion mindset (note: not risk aversion) to play out at least for a while. In addition, regulators will likely steer investments along this path (for example, the revised 2a-7 rules from the SEC). The flip side of the new philosophy, of course, is lower expected yield. When an investor resorts to a stricter investment policy, limits credit exposure, or invests with managers who employ conservative strategies, the expected yield inevitably comes down. The current ultra low yield environment may have masked this phenomenon. As yields start to increase, we do not expect the average cash investors to earn the same spread over riskless Treasury investments as they did in the past.

**The Liquidity Premium:** A byproduct of the recent credit crisis is a new appreciation for liquidity. Therefore, we expect that investment vehicles with better liquidity will hold a competitive advantage in attracting new investors. Liquidity comes in three forms: organic liquidity, market liquidity and contingent liquidity. Organic liquidity refers to cash proceeds from scheduled maturities. Market liquidity addresses the ability to convert securities into cash quickly and with minimum transaction costs. Contingent liquidity comes by way of a deep-pocketed parent or a contractual liquidity provider. An investment vehicle possessing one or more of these advantages will likely be more popular in the new environment.

**New Yield Opportunities:** The optimist in us says that every crisis is a new opportunity in disguise. The crisis, and more importantly investors' and regulators' response to the crisis, created a number of attractive yield opportunities for investors unwilling to conform to conventional thinking. For example, an asset-backed commercial paper (ABCP) program is no riskier than the bank that fully supports it. The irrational stigma towards ABCP immediately after the crisis created an opportunity to pick up the paper at a cheaper price than the bank debt - essentially a free dollar bill on the sidewalk. For the remainder of this paper, we will discuss a number of such opportunities brought on by the new normal environment.

**Corporate Credit, the New Safe Haven**
We wouldn't have expected that headline just a few years ago, but the brewing debt crisis in Europe introduces this interesting and relevant question: is sovereign debt really safer than corporate credit?

The credit worthiness of Greece and the solidarity of the European Monetary Union are beyond the scope of this paper. What we want to point out is that governments and corporations are moving in opposite directions in terms of fiscal health. If this trend

continues, corporate borrowers may well be more creditworthy than their sovereign governments, which supposedly have unlimited taxing authority and vast access to various resources.

It is rare for corporate bonds to be rated higher than those of their national governments. In recent years, however, the increased probability of default by government entities has opened the possibility for corporate issuers to receive higher ratings, in what is known as "piercing the country ceiling".[2] In a recent survey, Fitch Ratings noted that while European fixed income investors are more bearish on the prospects for sovereign debt, they are optimistic about corporate debt fundamentals.[3]

According to recent credit default swap data from index tracker Markit, the credit spreads of the composite 15 Western European governments were wider than the composite 125 investment-grade corporate bond issuers in those countries.[4] Simply put, investors believe lending to a diversified basket of corporate names in Europe is less risky than lending to their respective governments. This trend is not surprising to us.

In a non-scientific comparison summarized in the table below, we put government finances in the U.S., the U.K. and Greece up against those of a U.S. corporation, Procter & Gamble. The table shows that P&G has higher profitability, a lower debt burden, and lower debt servicing costs than all three sovereign borrowers. We are not, of course, implying that P&G is a better credit than the U.S. or the U.K., rather we are merely illustrating that technically P&G may be in better fiscal condition to weather a storm than the three sovereign borrowers.

| | **U.S.** | **U.K.** | **Greece** | **P&G** |
|---|---|---|---|---|
| **Ratings** | Aaa/AAA | Aaa/AAA | A2/BBB+ | Aa3/AA- |
| **GDP ($bln)** | 14,122 | 2,186 | 343 | 135 |
| **Gov. Revenue/GDP (%)** | 31 | 39 | 37 | 58 |
| **Gov. Surplus/GDP (%)** | (12.0) | (12.1) | (12.7) | 9.6 |
| **Gov. Debt/GDP (%)** | 87.0 | 68.6 | 112.6 | 22.5 |
| **Gov. Debt/Revenue (x)** | 2.8 | 1.8 | 3.0 | 0.4 |
| **Gov. Int./Revenue (%)** | 6.7 | 4.9 | 13.1 | 1.5 |

*Source: Sovereign ratios are from Moody's Sovereign Research statistics table as of 2009. Ratios for Procter & Gamble are from Capital IQ as of December 2009 with the following data conversions: GDP=Assets, Rev/GDP=Asset Turnover, Surplus/GDP=ROA, Debt/GDP=Debt/Assets.*

The sharp increases in government debt are not merely a European phenomenon. U.S. federal, state, and local governments are facing similar challenges. For the most part, however, defaults in the government sector are extremely low, but we expect more headline risk for government borrowers than in the corporate sector. Hence, corporate

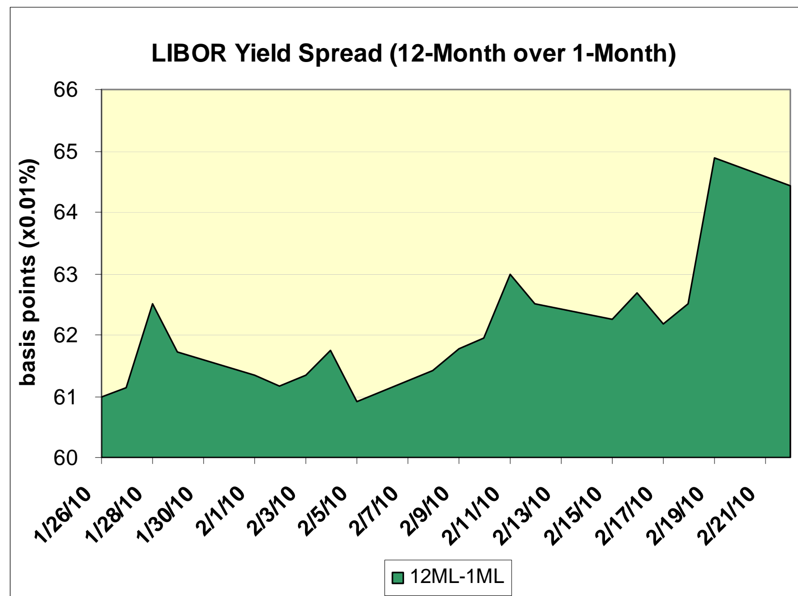
debt may be a relatively safe haven from headline risk. Moreover, we think yields on corporate debt will at times, be less volatile than government bonds. Therefore, corporate securities may be long-term safe bets against higher government debt leverage.

**The SEC Keeps on Giving**

We see a number of new opportunities created by the revised SEC 2a-7 rules governing money market funds. Just as the original 13-month maximum maturity rule caused yield to back up on securities with remaining maturities of 14 or 15 months, we think the new rules will have a similar effect of pushing up yields on a number of securities. That's good news to investors who are not restricted by the 2a-7 rules.

**Yield Curve Effect:** As we mentioned in an earlier article, the new 60-day weighted average maturity rule and the requirement to keep 30% of a portfolio maturing within seven days invariably will force money market funds to invest in securities with shorter maturities. The reduced demand for longer-maturity securities almost certainly will result in higher yields, hence a steeper yield curve in bond market terminology. In anticipation of that, the London Inter-Bank Offered Rate (LIBOR) market, a benchmark for short-term rates, already shows four basis points of wider yield spread between 12-month and one-month maturities since January 27, 2010 - the date of the SEC announcement [Please see Table 1 below]. We anticipate this trend to continue and create more yield opportunities for non-2a-7 investors. The difference between three- and one-month maturities, on the other hand, remains unchanged.

Table 1. Libor Yield Spread (12-Month over 1-Month)




*Source: Bloomberg. Data based on 1-month and 12-month U.S. LIBOR fixings between 1/26/10 and 2/22/10.*

**Floating rate notes (FRNs):** The SEC's new maximum weighted average life (WAL) rule of 120 days also means more limited use of FRNs, which have short reset dates but long legal final maturities. Similar to the ABCP example we highlighted earlier, there is nothing inherently wrong with FRNs when used appropriately. In fact, the prospect of an eventual interest rate tightening cycle makes floaters a more valuable investment choice. In the new 2a-7 environment, the use of FRNs penalizes a fund's WAL. What may be counted as a loss to money funds may be a gain to other cash investors.

**Agency Discount Notes:** Discount notes issued by Fannie Mae and Freddie Mac have always been a mainstay in cash portfolios. The new 2a-7 rules consider agency discount notes with remaining maturities of 60 days or less to be part of the 30% weekly liquidity bucket. This means that discount notes maturing within 60 days will become more valuable and thus yielding less. In anticipation of the new rules taking effect, discount notes maturing in six months have already experienced some yield spread compression. For non-2a-7 investors, buying ahead of money funds again may provide good relative value opportunities versus the funds.

**The Fed Holds the Key on Higher Rates**

With apologies to our readers, we need to come back for a second helping of the yield curve discussion. In addition to changes in 2a-7 rules, we think the Federal Reserve holds the keys to higher short-term interest rates, leading yields further up the yield curve to rise faster than the front end.

The Fed's decision to hike the discount rate to 0.75% on February 18th represents the central bank's latest move to remove the emergency liquidity it injected into the financial system, which flattened the front end of the yield curve. The reversal of that process, regardless of how carefully engineered, will likely have the effect of undoing the yield curve flattening. This may lead to higher yields further out on the yield curve. This should happen independent of the Fed's decision on the Fed funds rate.

Consider, for instance, that the Fed will use reverse repurchase agreements (repos) and pay interest on term deposits before raising the Fed funds rates. For operational efficiency, it likely will conduct term repos and/or offer term deposits of one-month maturities or longer. These moves could immediately increase the yield spread between overnight and 30-day yields. By ending its agency mortgage-backed securities purchases program, the Fed also may make it necessary for Fannie Mae and Freddie Mac to increase their discount note programs to subsidize the lost funding at the Fed, thus pushing up short term rates further. Lastly, the central bank and lawmakers are pressuring financial institutions to reduce their funding reliance on the short-term wholesale debt market. As banks refinance their debt with term deposits and intermediate term debt, one would expect yield on longer-maturity securities to rise even further, providing higher income opportunity for patient investors some time in the future.

**Learn, Adapt and Thrive**

Stanford economist Paul Romer coined the term, "A crisis is a terrible thing to waste."[5] In the world of liquidity investing, running to the proverbal mattress, aka U.S. Treasuries, after a crisis has come and gone, in our opinion, is the wrong lesson to learn. Rather, one needs to be a student of the market, evaluate the circumstances that led to the crisis, question the conventional wisdom, identify new risks and opportunities, and chart a new course incorporating new knowledge gained in hindsight.

In the two years since the onset of the subprime crisis, many of the so-called toxic assets have been cleansed by brutal market forces or by government regulation. Securities remaining in most cash portfolios are, for the most part, more credit worthy with better liquidity. The shrewd investor's job today is not to look out for the old "toxic waste" pitfalls but to watch out for new ones, and take advantage of the opportunities in this new environment. Conventional wisdom is a virtue; left unchecked, it runs the risk of becoming an outdated cliché.

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[1] AFP 2006 (2009) Liquidity Survey: Report of Survey Results, the Association for Financial Professionals, "Maximum Allowable Percentage of Short-Term Portfolio in Which the Organization Can Use Investment Vehicle per Short-term Investment Policy). page 7. (2006) and p. 11(2009).

[2] Rating Methodology: Piercing the Country Ceiling: An Update, Moody's Investors Service, January 2005.

[3] Press Release: Sovereign Outlook Weights on Improving European Investor Sentiment, Fitch Ratings, February 11, 2010.

[4] A Corporate/Government Conundrum, Paul Amery, IndexUniverse.eu, http://www.indexuniverse.com/blog/7132-a-corporategovernment-conundrum.html?Itemid=127

"According to data provider Markit's website, the Markit iTraxx SovX Western Europe index (an unweighted average of the credit default swap spreads of 15 European, primarily Eurozone, sovereign issuers) closed yesterday, Thursday 14 January, at 73.75 basis points, up 6.28% on the day. By comparison, Markit's iTraxx Europe index of 125 investment grade corporate bond issuers trades at 70 basis points."

[5] Jack Rosenthal, On Language: A Terrible Thing to Waste. The New York Times. July 31, 2009.

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