The Top 3 Credit Deficiencies in Corporate Cash Portfolios (And How to Avoid Them)

Now into our 18th year of working with treasury managers across the country, it's as clear as ever that managing risk remains one of the least understood and most challenging areas of corporate cash management. The treasury landscape is littered with painful examples of write-downs from highly rated securities whose risk was miscalculated, misunderstood, or misrepresented. Corporate treasury functions can certainly improve their effectiveness in this environment through a better understanding of the pitfalls associated with managing credit risk.

With 17+ years of hindsight, we summarize the three most common credit-related deficiencies in today's corporate cash portfolios: 1) overconfidence in credit ratings; 2) falling victim to non-traditional investments; and 3) insufficiency or misinterpretation of investment policies.

1. Overconfidence in Credit Ratings

Ratings assigned by Nationally Recognized Statistical Rating Organizations (NRSROs), such as Moody's Investors Service and Standard & Poor's, provide valuable information on an investment's creditworthiness. However, ratings alone almost never adequately address the pertinent credit risks of a given investment.

First, ratings tend to be "sticky" since the rating process requires ratings to be "through the cycle", meaning that ratings take into consideration a credit's ability to weather a down business cycle marked by higher interest rates, reduced demand, and slower profit growth. Ratings change only when a NRSRO determines that a company's credit deterioration is the result of a long-term trend, by which time bond prices may have already reflected that fact.

In addition, many large user groups of bond ratings appreciate rating stability over time. For example, credit ratings are widely used as credit measures of bank and insurance company capital adequacy, as well as in company debt covenants. Rapid rating changes may cause significant problems throughout the financial system. Rating agencies have proposed to have ratings reflect faster changes in business and market environments, but most user groups, including investors, have opposed such initiatives.

Finally, the credit rating agencies have recently faced harsh criticism resulting from the fact that they have not incorporated multiple forms of risk (liquidity or structure) into their ratings. For example, virtually all outstanding auction rate securities continue to maintain the highest credit ratings while the market remains almost entirely illiquid with very limited trading activity.

Remedy: Investors should only use ratings as a starting point in the credit screening process, and should periodically review current operating and market conditions that may affect a company's business activities, financial leverage, cash flow behavior, and its ability to access the capital markets.

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2. Falling Victim to Non-traditional Investments
Today, corporate cash managers are faced with the problem of low portfolio yields due to historically low short-term interest rates and tight credit spreads. The yearning for extra yield sometimes lures investors to depart from established investment vehicles into the uncharted area of non-traditional, “financially engineered” products.

Non-traditional investments generally offer higher yields than comparably rated “plain vanilla” bonds of similar maturities, because their embedded risks are more difficult to analyze. Products, such as the now infamous auction rate securities, “engineered” specifically for cash investors, had recently gained popularity in today’s low interest rate environment. These non-traditional securities, which also include extendible commercial paper, secured liquidity notes, and CDO money market tranches, serve to transfer credit, liquidity, or pre-payment risk from other parties to cash investors for an incremental yield over traditional investments.

Many financially engineered products are inconsistent with the risk tolerances and liquidity mandates of corporate cash accounts. These products typically have wider bid-ask spreads than traditional products. They often carry esoteric “option” risk that requires sophisticated statistical models to analyze and track. And, few have gone through a “seasoning” process under adverse market conditions.

Reaching for yield by way of exotic products has a chilling effect on those who still recall the havoc wreaked by range floaters and putable funding agreements in the previous decade and who may now be battling auction rate security losses.

Remedy: Corporate cash investors should be conservative when the market’s risk tolerance is high and should patiently let new products go through a credit/interest rate seasoning cycle prior to purchasing. When investors decide to buy non-traditional securities, they should perform rigorous collateral evaluation and maintain ongoing surveillance of asset quality and optionality.

3. Insufficiencies or Misinterpretation of Investment Policies
An investment policy is an important document that lays the groundwork for a corporate cash portfolio. Sometimes investors misunderstand the purpose of this document and make it either too vague, so that it does not adequately address credit risk, or too rigid, so that it impairs effective management of the portfolio.

Some investment guidelines we have reviewed have been as brief as one page and addressed little more than minimum credit ratings and eligible investment classes. Even though most cash accounts subscribe to the objectives of capital preservation, liquidity, and competitive returns, not all prescribe specific measures to accomplish such goals.

Effective investment guidelines should not only provide parameters for eligible investments and ratings, but also state specific steps to address out-of-compliance issues, such as reaching a “sell” or “hold” decision within a set number of trading days after a credit is downgraded.

As investment policies do not, and cannot, anticipate daily market and economic conditions, additional credit restrictions may be necessary to address day-to-day investment activities. For example, even though most guidelines would allow investments in Fannie Mae debt, in the past, regulatory investigations and the lack of audited financial statements of the company may have caused a portfolio manager to reduce the holdings of the credit to limit marked-to-market losses.

Vague investment guidelines can be hazardous, especially in a direct-purchase relationship, where a securities broker acts as an agent for the investor in making investment decisions. Sometimes, securities may satisfy the credit rating and portfolio concentration requirements, but still be undesirable by other investors or have downgrade risk in the near future. For example, back in 2005, some investors found themselves holding Southern California Edison, PG&E, and WorldCom bonds that were in compliance with investment guidelines just days prior to the rapid deterioration of those credits.

The lessons of that credit cycle and subsequent difficult cycles may cause some investors to go to the other extreme and write investment guidelines that are too rigid for the portfolio manager to effectively take advantage of market inefficiencies and new opportunities. As a rule of thumb, an effective investment policy should adequately address downside risk without hindering the portfolio manager's investment flexibility.

Remedy: Investors should develop investment policies that clearly satisfy the risk tolerances and return expectations of their corporations. For example, investment policies may specify the use of a formal list of approved credits and internal watch lists for developing credits, concentration limits by ratings and maturities, and periodic credit review of portfolio holdings. Corporate treasurers often find that outsourcing these credit review procedures to an institutional money manager provides an added layer of fiduciary control for their cash assets.

If you'd like to read more about our thoughts on how to better secure cash portfolios, please click here for an additional whitepaper on the subject.

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