Tips For The Cautious Cash Investor

A Review of Two Emerging Cash Investment Trends

EXECUTIVE SUMMARY:

As risk averse cash investors slowly move away from an aggressively conservative strategy, we take a look at two developing trends that investors may be considering and some potential pitfalls.

Emerging Trends:

- Bank Deposit Accounts
- Prime Money Market Funds

We think that the credit market has probably exited the free-fall phase and has entered a phase of combating a recessionary economy. Investors must be mindful of some of the emerging cash management trends that represent giant leaps, rather than baby steps, back into credit risks. As we emphasized in previous communications, investments in government-backed debt, supplemented by strong individual credits appropriate for one's risk tolerance still offer better principal protection than some other options.

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Despite prolonged challenges to global economies, the fantastic collapse that began more than a year ago in the short-term credit market is showing definitive signs of improvement. Lower inter-bank lending rates, reduced use of the Federal Reserve emergency facilities, and increased money flows into prime money funds all seem to indicate that credit trends may have turned a critical corner. However, since the Federal Reserve's zero interest rate policy (ZIRP) came into effect last December we've seen two emerging strategies of cash management that appear to be getting ahead of our "cautiously optimistic" strategic outlook. One such practice involves small operating banks stepping up efforts to woo corporate clients into bank deposit accounts and the other is the gathering movement of cash away from treasury money market funds and into "prime" funds.

In light of such developing trends, risk averse corporate treasurers and CFOs must ask - Are bank deposits safe in today's environment? Are prime funds ready for prime time? Are there places where cash managers can park their cash and still get a good night's sleep?

BANK DEPOSIT ACCOUNTS

Why banks want your uninsured deposits and why you shouldn't hand them over: Of course you remember the not-so-distant days when liquidity was plentiful and banks were swimming with cash? These days, however, despite the U.S. Treasury and the Federal Reserve's unconventional measures of pumping cash into the financial system, banks are still short on deposits. Why so? In addition to the capital markets' shutout, mounting risks in the banking system have apparently reshaped depositor behavior.

Banks' deposit drive: According to FDIC data points from June 2007 and September 2008, uninsured deposits at banks with assets greater than $10 billion stayed consistent at 43% of total domestic deposits. But, uninsured deposits at banks with assets between $1 billion and $10 billion dropped from 39% to 33%. While total deposits grew 19% among the larger banks, deposits at the smaller banks grew by only 3%.

These comparative findings of uninsured deposits may suggest that, as the credit crisis deepened, smaller banks did not benefit from the Federal measures as much as their larger "systemically important" (translation - too big to fail) brethren due to credit concerns. Compounding this challenge for the smaller banks is the market shutdown of other funding channels, namely stock or bond issuance, mortgage or asset-backed securitization and private or venture placements. As the housing crisis deepened, borrowing from the Fed and the Federal Home Loan Banks also became more expensive due to larger haircuts on mortgage collateral. With all of these factors converging, it's no wonder why smaller banks are earnestly calling upon their corporate clients for additional deposits.

Uninsured deposits at greater risk: We think the risk of uninsured bank deposits today surpasses even the S&L crisis era of the 1980's. Macro economic challenges are having a severe impact on "Main Street," which in turn makes smaller banks more vulnerable. Regrettably, the second round of bailouts of Citigroup and Bank of America also resulted in investors' loss of confidence in the asset valuation on banks' balance sheets *and* on the credibility of bank management. Furthermore, the old FDIC model of having a failed bank taken over by a healthy one is much less likely nowadays, as few banks can be deemed healthy and strong enough to take on additional toxic assets. This means that there is a possibility that uninsured deposits at a failed bank may not be paid back in whole, especially now that taxpayer dollars are on the line in many of the bank takeovers.

Off-shore time deposits especially vulnerable: Off-shore sweep accounts and time deposits are even more vulnerable in the event of a bank failure. Off-shore deposits are typically overnight investments in a foreign tax haven such as the Cayman Islands. These foreign branches do not fall under Federal Reserve supervision and the deposits are not FDIC insured. The branches are wholly-owned and guaranteed by bank headquarters, but when the solvency of the bank itself is in jeopardy, depositors are on their own. U.S. federal authorities have no jurisdiction over, or obligation to, the off-shore deposits. Worse yet, in a bankruptcy proceeding, recovery of off-shore deposits is often complicated by legal entanglements involving local authorities and can be subject to delays, freezes or even seizures.

PRIME MONEY MARKET FUNDS

Prime funds - not ready for prime time…yet: Prime money market funds clearly have been major beneficiaries of ZIRP and global government support measures have also substantially improved the overall credit strength of fund holdings. After losing one third of their assets in the flight to quality to Treasury money market funds last September, prime funds are now slowly but surely increasing their sizes. This trend toward prime funds has gathered steam since the Fed December meeting, and has begun to erode Treasury fund balances. A recent Crane Data research report showed that between December 9, 2008 and January 14, 2009, Treasury fund assets dropped $75.8 billion, or 10.9%, while prime funds gained $110.8 billion, or $13.9%. While we welcome this improving trend, we remain mindful of a number of issues that still need to be resolved.

Prime ratings may be less than prime quality: Prime funds are so named because they can only purchase securities rated "prime" by major credit rating agencies. In the aftermath of prime-rated Lehman Brothers going bankrupt, the aura of prime ratings has somewhat faded. In a nutshell, prime money funds are short-term investment vehicles loaded with financial debt, namely bank CDs, holding company commercial paper (CP), or Asset Backed CP conduits. Note that CDs in money funds typically do not have FDIC insurance, holding company CP ranks inferior to depositors in credit protection, and some ABCP still has large unrealized losses. These credit challenges are somewhat offset by the Troubled Asset Relief Program and other Federal support measures, but the funds' concentration risk in financial debt remains an issue. Sufficient diversification into government and diversified industrial credits may be needed to further boost the underlying credit quality of prime funds.

New money may be hot money: Fund sponsors like to tout the increase in prime fund assets as the result of investors feeling more comfortable about investing. The irony is that the size increase may be the result of something quite the contrary – spooked equity investors switching money out of stocks and parking it in money funds. This is evidenced by the fact that money fund assets surpassed that of equity funds in December 2008 for the first time in history. What is relevant to cash investors is that this growth may not be sustainable and at some point could reverse direction. If sentiment suddenly shifts as stock investors rebalance portfolios, the whiplash effect to the funds may be quite painful, increasing duration and reinvestment risks and reducing fund liquidity.

Future is uncertain: For the past 17 months, the various government programs played no small part in stabilizing the prime fund industry. But without such programs, the ability of the industry to maintain the stable $1 share price may be in jeopardy. Most industry participants agree that the April 2009 deadline for many of these programs will likely be extended, but the only real test of the industry's health will be when these programs are no longer in effect. Additionally, failures in existing industry practices and the archaic 2a-7 rule have prompted calls for a major oversight overhauls and introduced other elements of uncertainty including the potential for asset runs. While we believe prime funds have made good progress and may once again be appropriate for corporate investors, it is still premature to move cash out of government funds into prime funds while many of these issues remain unresolved.

VIABLE OPTIONS

Government funds may be an acceptable compromise: In today's environment, we think investments in government-backed entities and strong industrial credits, as opposed to unsupported financial debt, provide a safeguard against capital erosion for most cash investors. However, the harsh reality is that supply is limited in industrial credits and ZIRP is presenting unique challenges to Treasury money funds. Faced with this predicament, we think funds invested in securities of federal agencies may be an acceptable substitute for treasury funds. The primary rationale for which is our sanguine view of government support for the underlying investments. The funds' relatively higher yield levels also may help to cushion risk of negative yield.

Not out of the woods yet, but opportunities exist: Finally, we think that the credit market has probably exited the free-fall phase and has entered a phase of combating a recessionary economy. Investors must be mindful of some of the emerging cash management trends that represent giant leaps, rather than baby steps, back into credit risks. As we emphasized in previous communications, investments in government-backed debt, supplemented by strong individual credits appropriate for one's risk tolerance, may offer better principal protection than high exposure to unsecured financial institution debt, either in uninsured bank deposits or commingled money funds.

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