Strategy

February 13, 2017

Contacts

Lance Pan, CFA®
Director of Investment Research and Strategy
Main: 617.630.8100
Research: 617.244.9466
lpan@capitaladvisors.com

Using Separately Managed Accounts (SMAs) to Ride the Tides of Uncertainty

Abstract

Recent events serve as a prelude to what is to come from the new administration. Active cash portfolio management with a separate account solution helps manage policy uncertainty, market volatility, headline and geopolitical risk. Fiscal and monetary policies, international relations and political conflicts may bring more uncertainty in 2017 than in other recent years. SMAs deserve a closer examination as active risk management tool in this age of uncertainty.

Introduction

Financial markets, along with the rest of the world, witnessed the eventful first two weeks of a new administration. President Donald Trump swiftly signed a number of executive orders that affect healthcare, trade, hiring, energy, education, border security and national defense, among others. Despite controversies, financial markets largely remained calm with equity prices and bond yields marginally higher.

These recent events serve as a prelude to what is to come, when a full slate of policies and initiatives from the new administration are in full swing. Despite the pro-growth, inflationary and deregulatory undertone to Trumponomics, many market observers acknowledge looming uncertainties ahead and wonder how to react to the new president's moves.

Coupling fiscal policy uncertainty with the Fed's path towards higher interest rates and large sums of corporate cash parked in government money market funds, corporate treasury professionals have a tough task ahead. We advocate for a well-structured separately managed account (SMA) solution to help weather the stormy seas of policy uncertainty, market volatility, headline and geopolitical risk.

What Lies Ahead

Without repeating too much from our recent commentaries, we are mindful of a number of sources of uncertainty that may impact cash investment decisions:

Interest Rates and Yield Curve Effect: While the general market consensus is for interest rates to move higher, we do not know how soon or how much federal infrastructure spending and tax cuts will work their way through interest rates. The pace of rate hikes by the federal open market committee (FOMC), consisting of a fresh set of voting members and the administration's appointments to the two vacant seats, remains an open question. We cannot quantify how much monetary tightening may counteract fiscal stimulus. In the event of policy failures, or successes for those impeding growth, interest rates could reverse directions. In short, uncertainty exists for both short and long term rates and anywhere along the yield curve.

Stimulus, Deregulation, Twitter, and Credit Implications: Both fundamental and technical factors can influence how credit instruments perform. Uncertainties exist on a variety of fronts that could help or hurt credit spreads and liquidity of corporate securities. Tax and spending policies, a changing regulatory framework, trade and immigration policies could all have profound impacts on corporate profits, consumer credit, and ultimately the credit metrics of eligible securities. The president's penchant for governing by twitter also raises uncertainty for companies in his crosshairs.

Geopolitics, Power Brokering and Market Reactions: Adding to the aforementioned uncertainties, geopolitics and current events could move markets in unexpected ways. 2017 is a big election year for Germany, France and the Netherlands. The U.K. is set to start Brexit negotiations. The US is adjusting its strategic relations with Russia and China and changing courses in its Middle East policies. These events, individually or together or as catalysts for other events, may bring unwelcome market volatility and liquidity effects not seen since 2008.

SMAs for Uncertain Times

As a separate account manager of institutional cash for more than two decades, it has been our philosophy that SMAs are appropriate for institutional treasury organizations primarily as a risk management tool. Besides higher income potential over money funds and bank deposits, it is portfolio customization that makes them a valuable cash alternative. With the passing of prime money market funds as the predominant institutional cash vehicle of choice, SMAs deserve a closer examination for the following reasons:

Total Return vs. Liquidity SMAs: There exists an erroneous conception in the cash management world that separate accounts actively trade securities beyond traditional money market credits with substantially longer portfolio duration and total return objectives. While these products can prove valuable for a segment of the market, SMAs also can exist as liquidity vehicles constructed primarily with money market securities, with minimal trading and with income objectives. We speak of managing uncertainty in the liquidity SMA context more so than the total return SMA context.

Laddered Structure Minimizes Interest Rate Volatility: A portfolio of securities with laddered maturities provides higher income potential in an upwardly sloping yield curve environment than government money market funds confined by maturity restrictions. A laddered structure allows reinvestment opportunities to adjust for unanticipated interest rate movements. One may adjust the "ladder", meaning maturity distribution and weighted average maturity (WAM), as growth, inflation or Fed policy outlook changes throughout the year.

Coupon Income Cushions Market Volatility: Relative to government money market funds, a portfolio of carefully selected corporate and asset backed securities provides additional coupon interest as cushion against potential market value declines from higher interest rates or credit spread widening. Prime money market funds may achieve similar effects, but at the cost of liquidity fees and gates and net asset value fluctuations.

Fewer Loss and Tax Implications: Uncertainty could result in gains and losses in investments and prompt related tax implications. Other than for issues related to weakening credit quality, separate accounts with a buy-and-hold bias are not overly concerned with market value fluctuations unless securities must be sold prior to maturity. By contrast, ultra-short bond funds (USBFs), a competitor of prime money funds assets, must trade frequently to process shareholder activities. As a result, SMA investors face tax implications only when they sell something. USBF shareholders, on the other hand, receive pass-through gain and loss distributions at the end of each year regardless of their own activities.

Oversight and Flexibility on Credit Exposures: We think the biggest advantage of SMAs over commingled cash vehicles in times of uncertainty is the investor's ability to limit exposures to certain sectors, asset classes and securities with additional layers of maturity and ratings restrictions. In comingled products, these decisions are left to the portfolio managers where shareholders play only a limited and indirect role. However, investors with convictions that certain securities will do better or worse may direct their SMA managers to add or reduce exposure accordingly.

Preparing for Uncertainties

Uncertainties are by definition difficult to forecast. Without a crystal ball to tell which and how a number of risk factors may affect financial markets, we as liquidity managers will want to be mindful of evaporating market liquidity in uncertain times and equip ourselves with a high quality, diversified portfolio of assets.

Liquidity Crunch and Contagion Effect: Liquidity risk often arises from one of two sources – perceived credit problems with specific issuers or asset classes and the reluctance to trade by nervous market participants for fear of disappearing liquidity. For example, the Federal Reserve pointed out the risk in the repurchase agreement (repo) market when bond dealers or investors may be forced to sell asset collateral either before or after their counterparties experience liquidity problems. Commingled investments such as prime money market funds and ultra-short bond funds may experience liquidity crunches and contagion trying to satisfy waves of sell orders. SMA investors may set aside a portion of their portfolios in highly liquid government securities as backup liquidity.

Diversify, Diversify, and Diversify: Regardless of objectives or asset choices, diversification remains a key risk management tool for uncertain times. A sufficiently diversified portfolio among asset types, industry sectors, and geographical locations may greatly reduce the impact from a specific unexpected event. For example, high-grade sovereign and supranational securities may be viable supplemental investments in a corporate bond portfolio. Similarly, a portfolio of unsecured bonds may weather risk better with asset-backed securities, which offer the double benefits of instant diversification and asset collateral.

Maintain a High Credit Quality Bias: Born out of investment policy requirements, most liquidity portfolios justifiably have a high credit quality bias to provide a ratings cushion against negative credit events. Recent credit market performance, we think, anticipates the implementation of Trump's economic policies that suggest more down side risk from policy disappointments. The additional yield benefit from lower quality bonds in the current environment may not justify the added credit and liquidity risks.

A Vehicle for Active Management in Times of Uncertainty

Financial markets awaited the new administration with cautious optimism. After successive rallies, equity valuation is consolidated at a level close to that of inauguration day. Bond yields are moderately higher by 0.05% to 0.08% between 2- to 10-year maturities. While there remains much debate on the net effect of Trumponomics on risk assets, many stock and bond strategists urge caution and recommend active portfolio management to cope with policy and event uncertainties and steer clear of looming risks. We recommend the same for short-duration cash portfolios.

We should note that this year's landscape is not all about the new administration's policies. One needs to keep an open eye on the Federal Reserve and interest rates, post-money market fund reform asset movements, the states of the European Union and China and their respective financial institutions, property markets in Australia, Canada and the UK and their banks, credit performance of energy portfolios in distress…the list goes on. While dealing with uncertainty is nothing new in treasury investment management, this year may bring more surprises than in recent memory. For investors switching out of prime money market funds and unsure about the alternative liquidity vehicles, SMAs deserve a closer examination as an active risk management tool in an age of uncertainty.

About Us

Capital Advisors Group, Inc. is an independent SEC-registered investment advisor specializing in institutional cash investments, risk management, and debt finance consulting. Our clients range from venture capital-funded startups and emerging growth companies to Fortune 100 companies.

Drawing upon more than a quarter of a century of experience through varied interest rate cycles, the firm has built its reputation upon deep, research-driven investment strategies and solutions for its clientele.

Capital Advisors Group manages customized separately managed accounts (SMAs) that seek to protect principal and maximize risk-adjusted returns within the context of each client's investment guidelines and specific liquidity needs. Capital Advisors Group also provides FundIQ® money market fund research; CounterpartyIQ® aggregation and credit analysis of counterparty exposures; risk assessment on short-term fixed income securities and portfolios; and independent debt finance consulting services.

Headquartered in metropolitan Boston, Capital Advisors Group maintains multiple U.S. regional offices.

CAPITAL ADVISORS GROUP
Capital Advisors Group, Inc.
29 Crafts Street, Suite 270, Newton, MA 02458
Tel: 617.630.8100 ~ Fax: 617.630.0023
www.capitaladvisors.com
info@capitaladvisors.com