THE EIGHT SINS OF CASH INVESTMENT

MISALLOCATING RESOURCES CAN LEAD TO ALL KINDS OF TROUBLE BUT PLAN CAREFULLY AND YOU'LL SAVE THE DAY, AS **PETER KNIGHT** OF JPMORGAN FLEMING ASSET MANAGEMENT EXPLAINS.

Widely held assumptions about managing cash mean that many treasuries may be misallocating resources, achieving poor investment returns and taking on unnecessary risk. But it does not have to be like that. Below are eight common misconceptions that, if addressed, can lead to more efficient cash management.

1. INVESTMENT IS MORE IMPORTANT THAN CASH FORECASTING. It is widely believed that investment is the area of greatest added value in cash management. Consequently, this is the area on which treasurers are keen to focus.

But investment is only half the story. Experience shows that successful construction of a money market portfolio depends heavily on projected cashflow needs. Principally, this means understanding what is required as working capital with daily liquidity and what can be assigned as reserve and strategic capital, and allocated to longer-duration investments (see *Figure 1*).

Get your cash forecasting correct and the subsequent added value from investment increases considerably. For example, analysis of US dollar money market portfolios over the last three calendar years shows that – with the benefit of perfect hindsight – better cashflow knowledge would have added 4bp of extra return – exactly the same contribution as perfect market knowledge. Also, do not forget that this return is calculated without taking into account the effect of misforecasting cashflow, which can have a profoundly detrimental effect on overall return in terms of overdraft costs.

As a treasurer, it is therefore advisable to direct your finite resources towards cash forecasting – particularly as this is more within your control than market forecasting.

2. LONG-TERM INVESTING CAN ADD VALUE. It is a common misconception in the short-term money markets that if you passively tie up your money for a period of time in a term deposit, you will add value as a matter of course. But the difference in return between instant access and term deposits is marginal. Over the last three calendar years, the average yield difference between a one-week deposit and a three-month deposit was just 6bp. So, in relation to the flexibility you are sacrificing, there is negligible return advantage in tying up your money in term deposits. That said, the past three years also experienced periods when rates outperformed their mean level by as much as 80bp. It is therefore important to retain the flexibility to take advantage of these peaks, while minimising exposure to rate troughs. The only way to do that is through active investment management.

3. RATING AGENCIES ARE ALL I NEED TO MANAGE MY RISK. Although agencies provide a good indication of credit risk, they should not be relied upon exclusively – particularly in the present environment of severe credit downgrading.

Over the period 1990-2001 the percentage of bond issuers with an AAA credit rating dropped from more than 30% to less than 10%. And it is the big issuers which have been hit hardest, with the top 50 accounting for more than 60% of companies which were re-rated below investment grade in 2002.

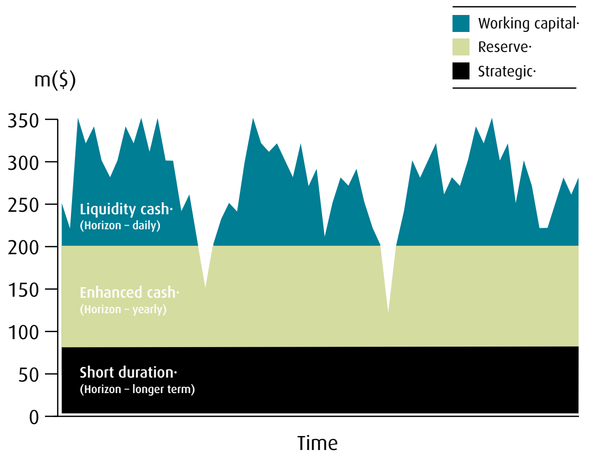
The key problem with rating agencies is that they tend to be reactive, not proactive. As commercial organisations, credit rating agencies need to be absolutely certain of their facts before they alter an institution's credit rating. Credit downgrades, therefore, tend to follow, rather than lead, events, leaving investors no time to act before the rest of the market responds to a downgrade.

In contrast, professional money market managers look proactively at credit quality and aim to act ahead of downgrades. Asset managers have a huge advantage in that, unlike a rating agency, they do not need to justify why they no longer favour a particular issuer – they can simply remove it from their portfolio as they wish.

The resources dedicated by professional asset managers to issuer analysis is comprehensive, with many investment houses dedicating separate teams of analysts to different parts of the yield curve. Asset managers can call upon the insights of their equity and fixed income teams and trading desks to build up a full picture of an issuer's credit quality. It is no surprise that rating agencies often consult money managers to augment their own credit analysis.

FIGURE 1

CONSTRUCTION OF A SHORT-TERM PORTFOLIO DEPENDS HEAVILY ON PROJECTED CASH NEEDS.



4. BANKS DO NOT GET INTO SERIOUS TROUBLE. Regardless of the downfall of Barings, BCCI and others, a curious view still persists that banks are somehow immune from the natural laws of corporate survival and that they do not get into so much trouble that they might actually lose your cash. But someplace, somewhere in the world, you can always rest assured that a banking crisis is in full flow.

While large retail banks in the developed world are not likely candidates for collapse, they can, and do, experience severe credit deterioration. Witness Japanese and German banks' recent woes. There are plenty of cases of failures among smaller banks and specialist niche institutions in the developed world. In addition, banks in the emerging markets and developing world have often experienced systemic banking crisis.

But even if an institution does not collapse it can still take time to retrieve your cash if it falls into difficulty. In the meantime, your cash management activities may be severely compromised.

The only way to guard against this risk – apart from active credit management – is through diversification. A money market portfolio should spread its assets across dozens, if not hundreds, of different institutions and apply exposure limits to each instrument and counterparty. Unless you employ a professional money market manager, a compromise, therefore, has to be struck between what is a sensible level of diversification and what is practical to achieve.

5. I ONLY NEED TO INVEST WITH MY RELATIONSHIP BANK. Leveraging off existing bank relationships can be beneficial in many ways, but using the same bank to handle both your deposits and your borrowings can be a risky pursuit.

If the bank goes out of business, you lose both your loan and your ability to deposit in one go. Plus, you cannot assume that, if the worst happens, you can simply offset your borrowings and your investments and walk away, as insolvency procedures will usually treat each separately.

The bank receiver will come after you for the debt it is owed and you still have to stand in line as a creditor for your deposits. If you are intent on using the same banking institutional for both these activities, you must be willing to keep a constant vigil on its creditworthiness.

It is also important to realise that many banks are trying to divest themselves of deposit and short-dated lending activities, which are high risk, low margin and contribute to balance sheet volatility. The rate of return being offered to companies is therefore becoming increasingly meagre – if the bank is willing to take your deposits at all.

Now, the role of 'intermediary' between investors and borrowers is increasingly being adopted by money market funds on the one side, and short dated capital market on the other. In turn, this is providing investors with better risk returns, better diversity and a better choice of instruments and investment options. At the same time, borrowers are benefiting from cheaper borrowings, a diversified lender basis and far more flexibility.

6. MY ONLY INVESTMENT RISK IS THE CREDIT RISK OF MY COUNTERPARTY. Not true – a far more injurious risk on a day-to-day basis is systemic risk, be it transaction error or intentional fraud. If you are carrying out investment transactions yourself, then the burden is on your department either to make good such errors or prove that they originated from a third party. Invest through a money market manager and this burden shifts to the asset manager.

Other risks include interest rate risk and the risk of breaching investment limits. All these elements require dedicated support and control systems and few organisations can compare with asset managers in terms of the technology and operations they can offer to monitor these risks.

7. I CAN MANAGE MY CASH PORTFOLIO MORE EFFICIENTLY MYSELF. Managing your cash portfolio in-house can only be more efficient if the allocated costs and opportunity costs are less than the cost of outsourcing.

Investing cash properly is expensive; in fact, do it on a piecemeal basis and it still does not come cheap.

Our research shows that managing $100m using using the bare minimum of personnel and systems can cost in excess of 20bp a year. To spend that amount and shoulder all the associated risks is clearly not an efficient use of resources.

As to opportunity cost, if you were not allocating personnel to managing the money, they could be allocated to other areas such as cash forecasting, which, as we have shown earlier, is an area where treasurers are in a far better position to add value.

8. INVESTING MONEY IS A VALUE-ADDED TASK. Investing money on an in-house basis is not a low-risk, high value-added task – it is a high-risk, low value-added task. It is high risk because getting it wrong can have a huge monetary and business impact. In terms of adding value, the most one can expect to add is 10bp to 20bp – and only then if using active management.

For these reasons, it makes more sense to outsource investment management to an external and accountable investment manager, thereby freeing up in-house resources to focus on more value-added activities.

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