AN INCREASING NUMBER OF ENHANCED CASH FUNDS HAVE COME TO THE MARKET PLACE OVER THE LAST FEW YEARS. THE OBJECTIVE HAS BEEN TO OFFER CLIENTS WITH MORE STABLE CASH BALANCES THE OPPORTUNITY TO INCREASE RETURNS. AS **JONATHAN CURRY** MAKES CLEAR THE QUESTIONS FOR INVESTORS ARE WHAT RISKS ARE BEING TAKEN TO ACHIEVE HIGHER RETURNS AND WHAT ISSUES NEED TO BE CONSIDERED WHEN COMPARING THE PRODUCTS AVAILABLE

Best of the bunch enhanced cash funds

Executive summary

- Enhanced cash funds differ from traditional AAA-rated liquidity funds through greater interest rate risk, greater credit risk and by offering less liquidity.
- Enhanced cash funds are less homogeneous than traditional AAA-rated liquidity funds and their risk profiles are more diverse.
- While enhanced cash funds offer increased returns on cash balances all the issues should be considered before investing.

Most enhanced cash funds differ from traditional AAA-rated liquidity funds in a number of ways. They may take more interest rate risk by running the portfolio with a longer average maturity profile, they may take greater credit risk by running the fund at a AA or single-A level and will typically offer less liquidity. This increase in risk offers the opportunity to enhance returns.

Increasing interest rate, credit and liquidity risk are the most common methods used to enhance cash returns. Another option is to increase structured risk in a portfolio and investors can use money market, rather than fixed income assets to do this. It is not necessary to take additional duration risk as they are buying floating-rate notes. Nor is it necessary to take additional credit risk as there is a large universe of highly-rated issuers in the sector. The investor is giving up a degree of liquidity and taking structural risk to enhance returns instead.

Asset-backed securities are the most common asset type in the market that allows investors to take on structural risk. Asset-backed securities are a form of debt financing that involves the sale of specified assets, known as the collateral, into a bankruptcy remote vehicle or trust. The trust issues notes to investors to finance the purchase of the assets. The cash flows associated with the collateral, which may be mortgage payments, credit card or auto loan payments, and/or sale of the collateral are used to pay interest and principal back to investors.

Using asset-backed securities in enhanced cash funds has a number of advantages. The interest rate risk or duration is the same as a money market instrument, the volatility of returns is lower, but a yield premium is available over money market assets. Rating agency data shows that the rating volatility of asset-backed securities is lower than bank or corporate credit ratings. This typically means that the credit spreads on asset-backed securities are less volatile than spreads on bank or corporate assets. This will in turn reduce the volatility of returns of a fund that uses asset-backed securities as part or all of its investment strategy. Low volatility of returns is important for cash investors.

Most enhanced cash funds are less homogeneous than the traditional AAA-rated liquidity funds and their risk profiles much more diverse. *Table 1* shows some typical key characteristics of examples of enhanced cash strategies.

The table clearly demonstrates the higher risk profile in terms of interest rate risk, credit and liquidity of the enhanced cash funds compared to a typical AAA-rated liquidity fund.

Whilst demonstrating the similarities between enhanced cash funds *Table 1* also highlights some key differences. In the example, all the enhanced cash funds have the same minimum investment horizon and similar return targets and fees. However, the liquidity profiles are different, ranging from a fund trading daily with next day settlement to a fund trading only twice a month with T+5 settlement. The maximum average maturity profiles also differ, demonstrating differences in interest rate risk. Both the AAA and AA-rated funds can have a maximum average maturity of 365 days, whilst the AAA asset-backed fund has a maximum average maturity of 180 days. The AAA and AA-rated enhanced cash funds can therefore take significantly more duration risk. Although the three enhanced cash funds have similar minimum credit ratings for both

short-term and long-term assets, their credit profiles will be very different. The AA-rated fund will be able to invest a greater percentage in lower-rated credits and be able to invest in assets with longer maturities issued by these lower-rated credits. It is clearly important for investors to consider carefully the risk profiles of any enhanced cash fund to ensure they are comfortable with the risks being taken.

So, what are the risk factors that investors need to consider when investing in this type of fund?

An increase in interest rate risk is likely to lead to an increase in the volatility of returns. This can clearly be seen from figure 1 showing the monthly returns of 3-month LIBID, a 0-1 year Gilt index and a 1-3 year Gilt index. The volatility of returns of the 1-3 year Gilt index, which has a duration of around 1.7 years, is greater than the volatility of the 0-1 year index which has a lower duration of around 0.5 years. In turn, the 0-1 year Gilt index has a greater volatility of returns than the 3-month LIBID index, which has a duration of around 0.25 years. The greater the duration of a fund, the greater the potential for negative monthly and quarterly returns.

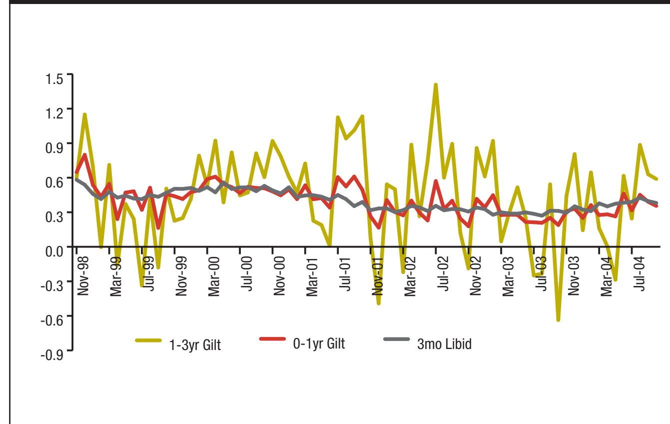
Therefore, it can be seen that risk and volatility of returns are greater with added duration but, over time, returns are likely to be higher. This can be seen from *Table 2*. It should also be noted that during periods of rising interest rates the longer duration indices produce lower returns and the opposite during periods of falling interest rates.

Credit risk is a further important factor to consider. Moving down the credit spectrum will also increase the likelihood of a default. Although this risk is low in single A-rated credits, the probability of default is greater. Moving down the credit spectrum and out the maturity curve is also likely to increase the volatility of returns. Previous credit cycles have demonstrated greater credit rating volatility in lower-rated credits and hence greater credit spread volatility. This will feed through into greater volatility of fund returns. It is also important to consider liquidity risk when moving down the credit spectrum. Typically lower-rated and longer maturity assets will be less liquid than an equivalent maturity government security.

Adding credit risk will add risk to a portfolio but over time returns are also likely to be higher. Comparing the returns of a 1-3 year broad index that includes issuers from AAA to BBB with the same maturity Gilt index demonstrates this (see *Table 3*).

When considering funds that use asset-backed securities for all or part of their strategy, there are some important risks to consider.

Figure 1. Monthly Returns



Source: BGI and Merrill Lynch

Firstly, liquidity risk may be greater. The cost of raising liquidity will be greater as the bid/offer spread of asset-backed securities is typically greater. However, this has narrowed in recent years as more investors have entered the marketplace. Secondly, there is structural risk in asset-backed securities. Asset-backed securities may cross a number of legal jurisdictions and a change in a law for example may lead to a wholesale revaluation of the sector.

Another factor for investors to consider is the length of any performance track record to demonstrate that a fund has met its return targets over time. The majority of enhanced cash funds have been launched in the last couple of years which therefore means it is not possible to see a track record over different interest rate and credit cycles. A small number of funds however do have longer track records dating back to the mid to late nineties. A related issue is that of scale. As the majority of funds were only launched over the last few years, few funds yet have significant scale. The majority of funds' assets under management are in the £100-500 million range, and only a handful have scale over £1 billion. Although these funds are not designed for regular redemptions, it is still important to consider whether a fund offers next day value, for example.

As we have seen, the risk profiles of the various enhanced cash funds can be quite different and therefore simply comparing net or gross returns between providers is not a satisfactory method to determine investment performance. It is more appropriate to

Table 1. Typical key characteristics of examples of enhanced cash strategies

	AAA liquidity fund	AA-rated enhanced cash fund with duration	AAA-rated enhanced cash fund with duration	Asset-backed AAA enhanced cash fund
Maximum average maturity	60 days	365 days	365 days	180 days
Minimum credit rating	Short-term A-1/P-1	Short-term A-1/P-1 Long-term A-/A3	Short-term A-1/P-1 Long-term A/A2	Short-term A-1/P-1 Long-term A/A2
Minimum investment horizon	Daily	9-months	9-months	9-months
Liquidity	Daily	Daily T+1	Daily T+7	Twice monthly T+5
Return target after fees	7-day LIBID	3-month LIBOR +0.05%	3-month LIBOR	3-month LIBOR
Fees	0.15% pa	0.20% pa	0.15% pa	0.15% pa

Source: BGI

Table 2. Annual returns of the 1-3 year Gilt index, the 0-1 year Gilt index and 3-month LIBOR

	1999	2000	2001	2002	2003	2004
1-3yr Gilt Index	2.77	8.195	6.176	6.593	3.356	4.636
0-1yr Gilt index	5.138	6.34	5.418	4.12	3.391	4.229
3-month LIBOR	5.494	6.206	5.502	4.016	3.687	4.642

Source: BGI and Merrill Lynch

Table 3. Returns of the 1-3 year broad index and 1-3 year Gilt index

	1999	2000	2001	2002	2003	2004
1-3yr broad index	3.088	8544	6.509	6.832	3.932	4.895
1-3yr Gilt index	2.77	8.195	6.176	6.593	3.356	4.636

Source: Merrill Lynch

compare risk-adjusted returns and the volatility of returns. This will give an investor a better indication of the performance of the manager.

It is also necessary to consider the experience of the provider in managing this type of fund. For example, has the manager managed this type of fund through different interest rate and credit cycles, what investment process is used and what systems does the manager have to manage the risks inherent in enhanced cash funds?

To conclude, enhanced cash funds can offer the opportunity for investors to enhance returns on their cash balances but it is important to consider all the issues before investing.

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