EXTRA VALUE WITHOUT MORE RISKS

JIM SARNI OF PAYDEN & RYGEL EXPLORES HOW IMPROVED FORECASTING PROVIDES THE PLATFORM FOR ENHANCED CASH MANAGEMENT THROUGH EXTENDING THEIR CASH INVESTMENT STRATEGY.

Two trends of recent years have been converging to provide the greatest impetus yet to improve active management of cash. The collapse in the returns on cash and margin pressures have driven companies to look for other ways to sweat their cash assets more productively. At the same time, the introduction of the euro has allowed treasurers to gather together formerly disparate, and sometimes small, pools of foreign currencies into single, larger amounts that make specialist active management economically feasible.

While the euro has provided an opportunity, the persistence of relatively low short-term global interest rates continues to make life challenging for treasurers and other investors. Although rates have rebounded this year, in response to more favourable economic news and credit markets, yield-seeking investors have continued to face difficulties in meeting earnings targets because of declining income streams.

WIDENING THE SEARCH. As companies search for a response to this pressure, we have seen growing interest in two complementary areas. The first involves improving knowledge and understanding of cash requirements, and opportunities through modelling and forecasting. The second involves exploiting this improved knowledge so a company is confident and able to deploy a more sophisticated cash management programme. Taken together, forecasting and enhanced management techniques can provide real opportunities for the enhanced returns firms are seeking.

Improved forecasting is the key starting point of this process. A growing number of US companies use sophisticated modelling to match much more closely the time horizons of company flows to assets and investments in a way that maximises returns. First, the historical balances of a cash pool should be analysed. Cash is then grouped as seen in *Figure 1* – cash portfolio breakdown: 'transactional' cash and 'permanent' cash. The transactional cash is used to meet expenses incurred in the course of business. The permanent cash tends to be the actual imbedded 'allocation' to cash by default. This cash allocation is not a deliberate choice, but rather a by-product of persistent cashflow timing differences. Investors should then adjust the historical analysis of their cash

'ACCESS TO A WIDER UNIVERSE OF SECURITIES, AND THEREFORE GREATER PORTFOLIO DIVERSIFICATION, IS ANOTHER IMPORTANT BENEFIT OF THE ENHANCED CASH STRATEGY'
JIM SARNI

balances to reflect their anticipated future cashflow needs. Enhanced cash portfolios can accommodate both transactional and permanent cash needs. Investors can buy highly-liquid money market and government securities for transactional cash, and higher-yielding asset-backed securities (ABS), mortgage-backed securities (MBS) and corporate securities for permanent cash.

GETTING THE BEST RESULTS. For optimal results, an active cash manager will establish a close, working relationship with their corporate client. Corporate spending plans can be accurately modelled, with probability weightings being attached to the likelihood of each outcome being achieved. A tolerance for unanticipated flows can then be built in, with contingency arrangements put in place and the trade-off between instant liquidity and higher yield being quantified. It is more often the case that liquidity requirements are overestimated and 'worst-case' scenarios rarely occur. Accurate forecasting exposes these inefficiencies and prevents the 'baby from being thrown out with the bath water', while still providing protection from the worst-case scenario.

But forecasting, however important, only provides the information platform for successful enhanced cash management. How that knowledge is then used, notably in underpinning the confidence to extend the universe of investable securities, is the second key to improved results. Short-term investors typically fall into two categories: those that are required to invest in short securities, such as money market mutual funds, and those that strategically choose to invest in short securities. Treasurers are likely to straddle both of these categories and are classic examples of investors needing to deal with uncertain portfolio time horizons. Investments of choice for them, regardless of category, have typically been bank time deposits, commercial paper (CP) and government securities such as one- to three-month maturity US Treasury bills. Money market mutual funds have also been popular short-term vehicles.

Principal stability (a constant net asset value) is the primary attraction of money market funds. This stability is derived from money market funds' stringent restrictions on the maximum maturity (397 days) of the securities in which they are allowed to invest. While money market funds have proven to be a good first step in improving cash management, they are little more than that. By limiting investments to money market funds, a treasurer is accepting both lower yields than necessary and restricted diversification. Money market funds are often a crude, one-size-fits-all solution that may not always meet the specific needs and unique requirements of a company.

By adopting a more active and sophisticated management of cash, investors can exploit a yield environment – as show in *Figure 2*: government yield curves – that is particularly attractive for those seeking ways to optimise yield and principal stability. An 'enhanced cash' investment strategy focuses on moderately extending maturity, and, in doing so, broadens the universe of investable securities. The result is a more diversified portfolio with a higher yield and credit quality comparable to a typical money market fund.

HIGHER YIELDS. Is this a 'free lunch'? The answer is yes and no. By slightly extending maturity (see *Figure 2*), US and European short-term investors can increase their annual portfolio yield by 0.3% to 0.5% without sacrificing credit quality. This certainly looks like a free lunch, at least from a credit quality perspective.

There is a cost, albeit a minor one, to the free lunch, however. While the enhanced cash portfolio's longer maturity provides a higher yield, it changes the degree of principal stability. As rates change, the portfolio's value will fluctuate inversely with the rate change. As rates rise, the portfolio value will fall, and vice versa. As with any bond portfolio, the longer the average maturity, the greater the principal fluctuation. There are, however, factors that mitigate this principal volatility, such as the slope of the yield curve, or the yield difference between maturities. Generally, the higher the yield differences, the less the fluctuation in principal. For example, in today's steeply sloped yield curve environment, yields can rise by 1% to 1.5% over a 12-month time period before the total return (interest plus price change) on the enhanced cash portfolio would fall below the money market fund return. In fact, for most categories of cash there need be no material change in

FIGURE 1
CASH PORTFOLIO BREAKDOWN

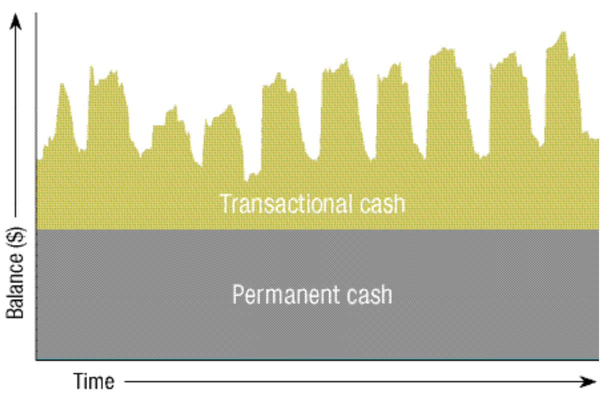
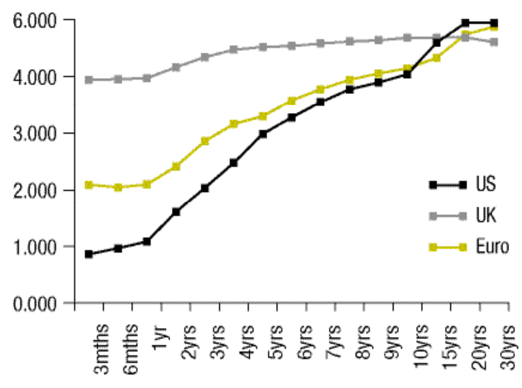


FIGURE 2
GOVERNMENT YIELD CURVES
(AS OF 31 DECEMBER 2003)



the risk profile, but a material improvement in yield can be achieved, providing the strategy is customised to the investor's requirements.

GREATER DIVERSIFICATION. Access to a wider universe of securities, and therefore greater portfolio diversification, is another important benefit of the enhanced cash strategy. While money market fund-eligible securities are limited, the universe of short-term securities with maturities of three years or less is broader. The universe includes high quality corporate notes, ABS and mortgage-backed securities, in addition to the traditional money market securities mentioned earlier. It is important to note that the breadth of short-term investments differs by geographic market. The US short-term market, for instance, is the broadest, with ample supply of short maturity ABS, while the short maturity UK and European asset-backed markets are still developing.

The key to achieving higher yield with greater diversification in today's environment is to invest with a global perspective. A UK- or European-based investor could take advantage of the higher yielding US ABS market, for example, by investing in these securities and hedging the currency exposure. Current interest rate differentials between the US and Europe make it possible for UK- and European-based investors to achieve higher yields by investing in selected currency hedged international securities, with identical credit quality (net of hedging costs). *Table 1* provides a current summary comparison of short-term portfolios and their currency hedged yields.

Cashflow forecasting can significantly augment short-term portfolio performance, while enhanced cash strategies present a compelling investment option to money market funds for short-term investors. By modestly extending the duration of a money market strategy, coupled with cashflow forecasting, a treasurer can take advantage of a broad universe of global securities to construct a high-quality portfolio that provides added yield without a commensurate increase in risk.

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TABLE 1
CASH PORTFOLIO BREAKDOWN
COMPARING PORTFOLIOS (31 DECEMBER 2003)

	Enhanced cash strategies			Typical money market funds		
Sector allocations	**$**	**£**	**€**	**$**	**£/€**	
Money market securities	10%	6%	6%	88%	81%	
Government securities (AAA-rated)	15%	12%	36%	4%	0%	
Asset-backed securities (AAA-rated)	28%	35%	20%	3%	0%	
Mortgage-backed securities (AAA-rated)	17%	12%	13%	0%	0%	
Corporate securities	30%	35%	25%	5%	19%	
Duration distribution						
0-6 months	59%	61%	65%	85%	99%	
6-12 months	25%	25%	18%	15%	1%	
12-18 months	6%	7%	7%	0%	0%	
18-24 months	7%	5%	8%	0%	0%	
24-36 months	3%	2%	2%	0%	0%	
	$	**£**	**€**	**$**	**£**	**€**
Weighted average yield	1.40%	4.40%*	2.50%*	0.90%	3.60%	1.90%
Weighted average credit quality	AAA	AAA	AAA	AA+	AA+	AA+
Weighted average duration	0.50	0.50	0.50	0.15	0.13	0.13

** Hedged yields using one-month currency forwards.*

Source: Payden & Rygel