DEPTH AND BREADTH IN £££

WHAT SHOULD TREASURERS CONSIDER WHEN OUTSOURCING STERLING CASH MANAGEMENT TO INVESTMENT MANAGERS? JIM FUELL AND OLIVIA MAGUIRE EXPLAIN

For corporate treasurers with sterling cash investment requirements, short-term investment products, such as money market funds (MMFs), short-term fixed income funds and separately managed accounts, can offer a flexible, convenient and cost-effective solution, as well as diversification benefits and attractive opportunities to improve returns.

But continued economic uncertainty means that the wrong decision could expose the treasurer to unnecessary counterparty and liquidity risk. Treasurers can reduce this risk by outsourcing sterling cash management to investment managers with proven credit and risk-management capabilities. By carrying out thorough due diligence on an investment manager, treasurers can establish if it has the size, experience and resources to fulfil their investment goal, which is often demonstrated by a manager's product and strategy range.

MMFs in Europe must meet the regulatory guidelines set out by the European Securities and Markets Authority (ESMA). In 2012, ESMA introduced two definitions: 1) "short-term money market fund" and 2) "money market fund". This two-tiered, harmonised classification clarifies what constitutes an MMF and distinguishes between funds that are tightly constrained to holding short-dated investments and those that can hold longer-dated instruments, therefore affording a greater level of investor protection and understanding in choosing between investments. Funds can also be regulated by the Undertakings for Collective Investment in Transferable Securities (UCITS) that aim to allow collective investment schemes to operate freely throughout the EU.

In addition to regulatory guidelines, funds may choose to adopt and follow additional external criteria as set out by industry bodies such as the Institutional Money Market Funds Association (IMMFA) or the rating agencies. The three big rating agencies – Standard & Poor's, Moody's and Fitch – set very stringent conditions in the way AAA-rated MMFs should be managed in terms of credit quality; duration, liquidity and concentration limits; and other restrictions.

Not all MMFs will choose to adopt the IMMFA *Code of Practice* or look to have their funds AAA rated by one or all agencies, so it is important that corporate treasurers understand all the guidelines that a fund is following to allow them to properly compare funds against each other.

How to distinguish the best sterling provider

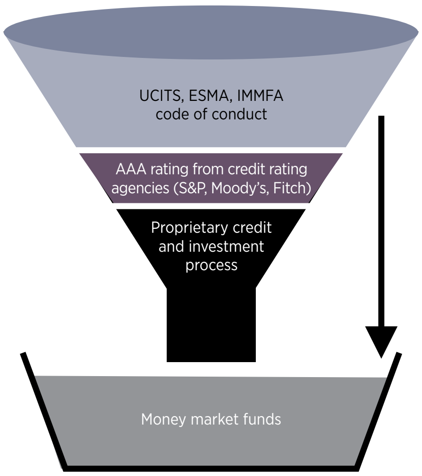
With regulators and other bodies obliging MMFs to have varying attributes depending on the guidelines adopted, treasurers have to look for other factors that help them to differentiate the best funds. One of the most important distinguishing factors is a well-resourced and proven proprietary credit research team. Rather than relying on external credit ratings, fund managers should be performing in-house credit analysis and devising internal credit ratings. The credit department should also be separate from the portfolio management and/or trading function to ensure independence.

Another crucial factor in distinguishing MMFs is the portfolio management style. Not all AAA-rated MMFs are the same, and drilling down to portfolio holdings is the best method to determine the manager's attitude to risk. Due diligence should be carried out across the fund range, looking at the nominal limits on issuers, the size of positions across maturities and instruments, and the diversification of positions within the portfolio.

One investment style is to ladder maturities in individual issuers, which permits the fund manager to be more flexible if a credit view fluctuates. Another style is to take full exposure at a single tenor, which can bring enhanced yield, depending on the yield curve, but can add additional risks where the large position is placed in a longer maturity. Treasurers should question whether the investment manager would face any difficulties in the event of needing to unwind large

ELIGIBLE SECURITIES

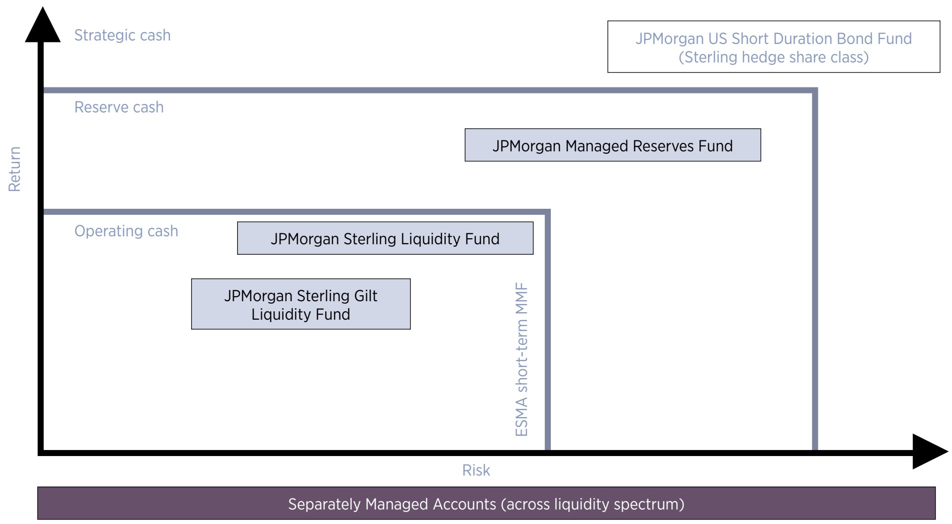
MONEY MARKET FUND OVERSIGHT



Minimum portfolio requirements for a typical fund

Maximum maturity (per security) – 397 days
Maximum maturity (per portfolio) – 60 days
Minimum credit quality (A-1/P-1)
Maximum issuer concentration – 5%
Minimum liquidity – 10% overnight/25% <7 days

AN EXAMPLE OF A LIQUIDITY FUND RANGE: JPMORGAN GLOBAL LIQUIDITY FUND RANGE



positions in specific credits and tenors.

Treasurers should also look at the commitment of the financial institution to the success of its liquidity fund business. This may be difficult to assess, but innovation is a key indicator of commitment: does the manager have a broad fund range and do they launch new products and strategies? Other considerations include how well resourced the business is; how long it has been running; the number of personnel; the global reach of the manager; and also the size and importance of the liquidity funds business compared with the size of the broader asset management business.

A broad fund range is particularly important as it provides the potential to switch products within the same investment manager when attitudes to risk evolve. Treasurers should look for a manager that has successfully navigated previous and current periods of credit market turmoil, such as the collapse of Lehman Brothers and the European sovereign and banking crisis.

Sterling cash investment solutions for varying investment objectives

Sterling government liquidity funds: the safest home for your cash
Sterling government liquidity funds typically invest in short-term gilts and reverse repurchase agreements backed by UK government-issued collateral and so contain minimal credit risk. These pure government funds typically have the highest money fund rating of AAA from the major credit rating agencies, and offer a high level of liquidity and easy access.

Client profile: For investors who only want exposure to government securities in their sterling portfolio, and do not want to sacrifice liquidity or yield. Ideal for operating cash allocations that seek to preserve principal daily.

Sterling liquidity funds: stability and potential for returns from low-risk securities
Sterling liquidity funds offer same-day liquidity, a stable net asset value and late dealing cut-off times. These funds invest in a diversified pool of low-risk money market securities, with a minimum credit quality of A-1 or P-1. These funds typically have a AAA rating – the highest money market rating from the major credit agencies.

Client profile: Ideal for operating cash allocations that seek to preserve principal daily and want the potential for a higher return on cash than is available from UK gilts or a government liquidity fund.

Short-term fixed income funds: higher returns for additional risk
Short-term fixed income funds invest in a diversified pool of assets, with the aim of providing an incremental return over cash and AAA-rated MMFs, while retaining a focus on the preservation of principal and seeking to maintain a low level of volatility.

Client profile: Suited to treasurers looking for potentially greater returns on their cash investment, and who are prepared to incur a higher level of risk in order to achieve this. Best used for reserve cash allocations with an investment horizon longer than three months.

Separately managed accounts: a bespoke investment solution
A separately managed account is an individual portfolio of securities invested on behalf of a corporation. As these accounts are tailored to meet an investor's risk appetite, yield target and liquidity needs, the expected investment return can be larger when compared with other short-term investments, such as MMFs or bank deposits. Compared with a fund structure, separately managed accounts provide a corporate treasurer with greater flexibility to more closely align the company's investments with its formal investment policy.

Client profile: Aiming for higher returns requires investors to assume additional risk, therefore making separate accounts suitable for sterling cash balances that are not needed for at least six months. The cash amount invested should also be higher compared with an MMF investment, to ensure adequate diversification is achieved in the underlying securities.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