BOOST YOUR COFFERS

The financial markets may exist in a perpetual state of volatility, but treasurers can still manage counterparty risk without sacrificing yield. Jim Fuell explains how

In a world where markets are constantly changing, a well-structured investment policy can help treasurers achieve their corporate investment goals. But just as the investment landscape can swiftly change, so, too, can corporate cash objectives. That is why it is important for organisations to establish an investment policy that clearly states their objectives and permissible investments, while also promoting long-term discipline in establishing investment goals.

In this article, we outline a step-by-step approach that treasurers can take to make their surplus cash more effective, including an overview of the various cash investment options available.

Defining an effective liquidity strategy

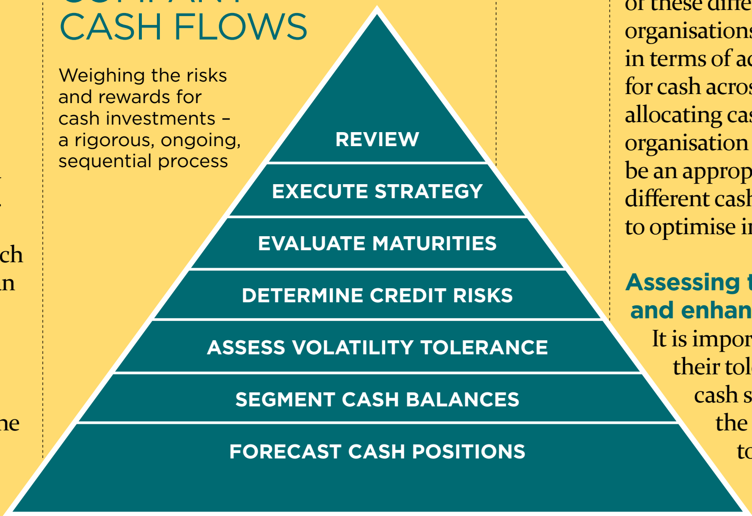
Effective liquidity management can increase cash efficiency by extracting the maximum value from cash resources and optimising working capital performance. The liquidity management process starts with a well-stated investment policy, which provides the guidelines that treasurers can follow to maximise their cash returns.

As shown in Exhibit 1, organisations must start the process by determining whether they have a robust and accurate cash flow forecasting process in place. The precise details of a forecast will depend on how much visibility a business has on its cash flows, for example, when and where surplus cash is in the organisation, how much of it is available and for how long.

It is important to get this forecasting process right. If an organisation underestimates the level of surplus cash, it could miss out on potential investment returns. But if the level of surplus cash is overestimated, treasurers may run into liquidity problems and be forced to pull money from investments at short notice, which could result in penalties or capital losses.

EXHIBIT 1: ASSESSING COMPANY CASH FLOWS

Weighing the risks and rewards for cash investments – a rigorous, ongoing, sequential process



SOURCE: JPMORGAN ASSET MANAGEMENT

Segmenting cash balances to maximise returns

If an organisation determines it has sufficient cash to invest, the next step is to segment that cash appropriately. Analysing an organisation's cash flow may reveal that surplus cash is available for investment, but for different time periods. For example, a company may choose to always hold some cash on its balance sheet, or may need the cash every six months, for example, to pay tax bills or dividends. Categorising each of these different pools of cash can help organisations to identify the priorities in terms of access, security and yield for cash across the business. Formally allocating cash in this way can help an organisation to determine what might be an appropriate investment strategy for different cash segments, thereby helping to optimise investment opportunities.

Assessing tolerance to volatility and enhancing the yield

It is important for treasurers to assess their tolerance to loss across each cash segment, taking into account the fact that strategies that aim to increase yield can potentially lead to greater fluctuations in the value of capital.

Once a tolerable level of volatility has been identified for each cash segment, organisations can assess how to enhance yield. Adding credit risk is one option. In that case, an organisation would have to determine if it has the resources to conduct in-house credit analysis or whether it would need to rely on a third-party investment manager. Alternatively, companies can invest further out on the yield curve. In a normal interest-rate environment, longer-maturity investments will pay higher yields to reward investors for committing their money for longer. While extending acceptable maturities will widen the universe of possible instruments available to an investment strategy, it may also reduce liquidity or increase portfolio volatility.

If increasing yield is viewed as a rational objective, treasurers would then have to decide how to implement and support the strategy. If an organisation decides it would like to revise its strategy to achieve a higher yield on its cash, then the change must be reflected in its formal investment policy and approved by senior management.

Once revised, the policy will need to be regularly reviewed to ensure it remains aligned with the objectives and risk requirements of the treasury department and broader business. It may also need to be reviewed on an ad hoc basis if extraordinary events occur.

Investment options for cash

As well as the typical bank solutions, such as interest-bearing accounts and time deposits, the following options are available:

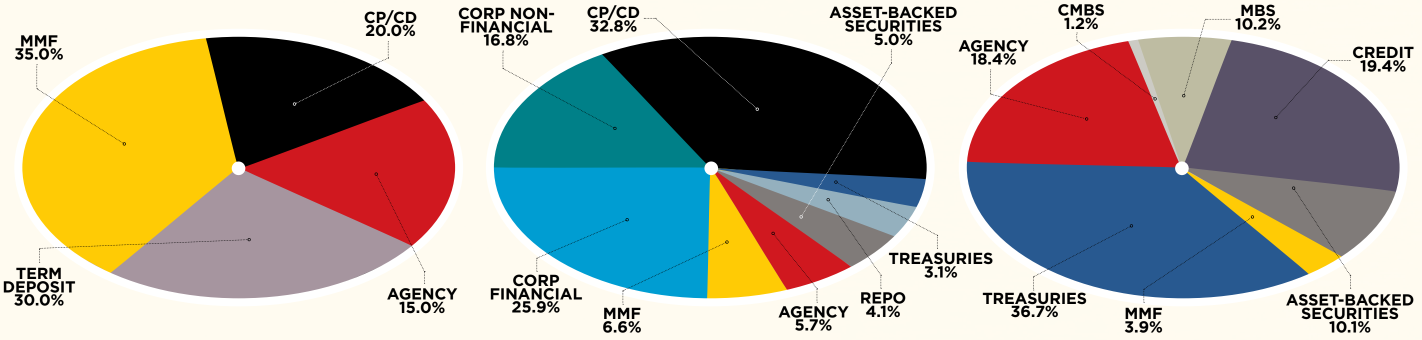
◆ Money market funds and liquidity funds

Money market funds (MMFs) are open-ended pooled investment vehicles that invest across many of the short-term and high-quality securities discussed earlier, with the aim of providing a secure and liquid home for investors' cash. Most MMFs are managed to maintain a stable net asset value (NAV) at a constant price per share, such as €1 or $1 – only the yield moves up and down. In order to be called an MMF certain criteria must be met as set out by the undertakings for collective investment in transferable securities and ESMA.

◆ Bond funds

There are various short-term bond fund options, primarily available for stable cash balances, which can provide a range of higher yields, depending on the client's appetite for risk. Some funds invest in very short-duration securities and, as a result, may have less volatility than most short-term bond funds, but still offer higher current income than MMFs. If interest rates rise sharply, however, the funds could lose money. The advantage >

EXHIBIT 2: CUSTOMISING AN INVESTMENT ACCOUNT TO OPTIMISE RETURNS



Objectives	Liquidity
Cash flow	Unpredictable and volatile
Investment horizon	90 days
Risk profile	Principal preservation is top priority
Policy parameters	Credit – less than six months Treasury and agency – one year

Objectives	Balance between liquidity and returns
Cash flow	Able to segment portion of cash that is not required near term
Investment horizon	Six months plus
Risk profile	Willing to accept low volatility, but not over a longer period
Policy parameters	Credit – two years Treasury and agency – three years

Objectives	Return
Cash flow	Strong cash flow with significant balances
Investment horizon	18 months plus
Risk profile	Developed risk budget and comfortable with volatility
Policy parameters	Credit – five years Treasury and agency – five years

SOURCE: JPMORGAN ASSET MANAGEMENT

is that if investors are comfortable with some volatility in NAV, they get the benefit of higher yields.

◆ Separately managed accounts

Separately managed accounts (SMAs) represent another option for treasurers who want more customised solutions or to spend more time on other core treasury functions. SMAs are customised portfolios of securities that meet specific investment needs with greater precision and flexibility.

Exhibit 2 illustrates sample portfolios that meet different objectives. The first portfolio, for example, has a mix of MMFs, commercial paper and certificates of deposit (CDs), agencies and time deposits, and offers a tailored solution for an investor whose primary objective is liquidity and for whom principal preservation is a top priority. The third portfolio, allocated across commercial mortgage-backed securities (CMBS), mortgage-backed securities (MBS) and credit, among other investments, is more suitable for an investor whose primary objective is returns, and who has a time horizon of at least 18 months, and is comfortable with volatility. The second portfolio, which includes a greater allocation to corporate bonds, may suit investors looking for a balance between liquidity and return.

Not only can SMAs deliver customised investment solutions, but they can also leverage the provider's global resources, in-depth research and risk management. From an investor perspective, one of the main advantages of SMAs is that they can offer investors direct ownership of securities in the portfolio, which permits greater customisation and control of tax liabilities. The provider may also be able to offer monthly US Financial Accounting Standards Board-compliant reporting, online web access to portfolio data, dedicated client portfolio and account managers, and access to economists, sector specialists and credit analysts.

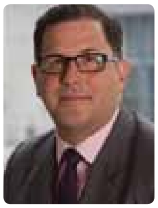
Conclusion

During the credit crisis, the priorities for many treasurers were to preserve capital and ensure significant liquidity to meet business needs. Today, a lot of companies are flush with cash and do not have the same liquidity requirements. As a result, they are looking to improve the return on their surplus cash. In order to choose from the various cash options available, companies should have a process to evaluate investments that meet their particular requirements for security, liquidity and yield.

Given the uncertain economic outlook, adding more interest rate or credit risk may be unsuitable for some investors, while timing the market over short periods can also be difficult, and the wrong decision could cost yield or expose the balance sheet to greater counterparty risks. Treasurers may, therefore, look to outsource their cash management or supplement their reliance on rating agencies with investment managers with strong credit and risk management capabilities.

Investment managers should be questioned on their ability and mechanisms to gauge and monitor interest rate expectations and risks across a full interest rate cycle. Treasurers with longer investment horizons may often work with an external manager to structure an investment portfolio appropriate for their risk tolerance and liquidity needs.

For detailed analysis on drawing up an investment policy, please see JPMorgan Asset Management's white paper, *Instituting an Investment Policy*



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