# REAP THE REWARDS

**SEEKING OUT BETTER RETURNS FOR YOUR COMPANY'S CASH DOESN'T HAVE TO BE A HIGH-RISK STRATEGY. DOMINIC JAQUES EXPLAINS**

It is not the destination that matters; it is how you get there safely. In today's low-interest-rate environment, investing surplus cash to maximise returns is a significant challenge. Research shows that European corporates have accumulated significant cash balances (an estimated £750bn has been hoarded in the UK alone), suggesting that security and protection from the unexpected still take priority.

Opting for higher returns involves greater risk, the assessment of which is no longer straightforward. Recent events in the eurozone demonstrate that risks can appear from the least-expected quarter. As a result, stakeholders need to consciously quantify the acceptable level of risk and types of investment that their business can accommodate.

On the other hand, the opportunity cost of accepting low yields and prioritising security and liquidity also needs to be calculated. There is the value of income being given up to consider, the investments that could be achieved and the chance to make more efficient use of cash. From a shareholder perspective, the aim should be to achieve a balance between risk and return.

The ability to take an independent approach to risk is a vital component of avoiding herd-like trends when making investment decisions. Remember the Icelandic banking collapse in 2008? It caught out many private and public-sector organisations that were chasing higher, ultimately unsustainable, yields – albeit from deposit-taking banks approved by UK regulators.

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While there are no guarantees, if you carefully select counterparty limits and balances, you should still be able to diversify risk and seek enhanced returns. Investing in higher-risk countries such as Greece or Spain does not require a lengthy debate, just common sense and a regular review process. Similarly, placing deposits with counterparties that have a high exposure to the euro – if known – may not be deemed appropriate.

The ability to match cash requirements to liquidity, and thus the maturity of investments, is an integral part of creating a portfolio. The quest for higher yields often leads to a longer maturity profile that requires cash to be classified into operational short-term cash and surplus long-term cash.

Given all the factors involved in accurately forecasting cash, the ability to define the surplus cash available for longer-term investment will be important in achieving higher yields. The assessment of true liquidity (when a financial shock occurs) is very subjective and is best approached through assessing the counterparty and underlying investments.

### A choice of investment strategies

At the time of writing, yields on overnight deposits are in the order of 0.5%, with money market rates at 0.6%. Money market funds (MMFs) are widely used, but offer only marginally better cash returns and may well have hidden counterparty risks.

The treasurer has a number of investment choices to assess for better returns:

- Time deposits offered by banks can be structured as revolving fixed-term deposits. By staggering a series of deposits with different maturity periods and larger balances at the longer end, an effective rate is created that gives an enhanced return. This will still allow access to funds on a weekly basis, but with better returns. The downside is that rates can fluctuate considerably, depending on the counterparty, and breakage fees should not be forgotten.
- Deposit rates can be improved for larger corporates by using swaps. With the changes in the yield curve and increased volatility as maturity increases, it is possible to use swaps to manage the time periods and thus better returns. This requires good relationship banking and larger balances to be cost-effective.
- Commercial paper is an actively traded market, but the returns and risk are very much linked to the issuer and care is needed on the level of bid/offer spreads in the market.
- Asset managers have a range of funds to enhance cash returns while still providing the security and liquidity associated with an MMF. This is achieved by investing in a focused number of government and high-quality corporate bonds that are structured to provide higher yields, but also

## SEVEN STEPS TO EFFECTIVE CASH MANAGEMENT

should provide comfort in that the underlying securities will not disappear overnight. Rates are likely to be 50-75bp higher than an MMF in the range of 1.0-2.0%.

◆ Corporate bonds can be used to achieve higher returns in the order of 1.5-2.5%. The key here is assessing individual risk and corporates need to have the resources to be able to assess and monitor individual bonds. Multinationals with strong track records may offer a better alternative to the banks and have less exposure to the euro. The downside is that when interest rates start to move upwards (which will happen eventually), a sharp sell-off in bonds cannot be ruled out.

### An alternative approach

There are alternative methods of generating higher yields without using specific treasury instruments. These are indirect methods that achieve the same result:

◆ The use of supplier finance with key suppliers can create the ability to make upfront payments in return for a cost discount. With internal yields being low, it is possible to provide the business with an improved financial position by effectively lowering the cost base. Suppliers will typically agree to discounts in a range of 0.5-2.0% for prompt payment that provides them with working capital that may not be available from their normal sources. The discount is therefore worth more than holding the cash.

◆ Large corporates may be able to benefit from and pass better yields down to their supply chain by using their higher credit ratings to their advantage. The benefits of a higher rating and thus improved margins can be shared with suppliers by a price adjustment in a win-win scenario. Banks now have specialised teams dedicated to working on supply chain finance options, ensuring the financial benefits can be shared among the participants.

◆ The cost of carry is an important measure for corporates that maintain both debt portfolios and cash investments. The spread between the cost of debt, which might be Libor plus a 150bp margin, versus the bank deposit or money market rates for cash at 50-70bp may be a significant cost to the business. The business must decide whether it is better to be more efficient and use the cash to repay some or all of the debt, evaluating any repayment clauses in the loan documentation, or if cash is still required for other strategic reasons (capital expenditure or an acquisition). As a result of quantitive easing policies depressing yields on cash, the current carry spread is particularly wide and a conscious choice needs to be made.

### Review cash investment policies

Investment rates on cash will vary with the market and counterparty circumstances. The ability to use treasury management systems to report and review holdings and returns is key. This enables monitoring of risk and highlights when yields are falling or trends are developing. Greater transparency and online reporting enables treasurers to change or amend investments and react quickly to adverse movements.

The solution to risk is knowledge and corporates are realising they need to evaluate the use of cash in more detail and update their cash investment policies. An assessment has to be made as to the purpose of holding cash, and then match that to an objective in terms of both return and risk. The trend in Europe for investing cash is conservative at present and corporates should, in our view, be actively working to achieve greater returns on their growing cash balances. While balance sheet strength is clearly important, so is the threat of inflation, and with the current low-interest-rate environment, the value of cash is being eroded every day. Treasurers should not be afraid to cross the bridge and seek higher yields. ◆

**Coming soon to www.treasurers.org/thetreasurer: seven steps to effective cash management**

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## COMPARISON OF SHORT-TERM INVESTMENT RETURNS

| SHORT-TERM RATES | SEPT 2012 |
|---|---|
| BANK OF ENGLAND BASE RATE | 0.50% |
| OVERNIGHT – GBP LIBOR | 0.51% |
| OVERNIGHT – MONEY MARKET FUNDS | 0.60% |
| ONE MONTH – GBP LIBOR | 0.53% |
| THREE MONTH – GBP LIBOR | 0.68% |

| ONE-YEAR BENCHMARKS | SEPT 2012 |
|---|---|
| ONE YEAR – GBP LIBOR | 1.40% |
| ONE YEAR – GBP INTEREST RATE SWAP | 0.60% |
| ONE YEAR – GILTS | 0.13% |
| YIELD – INSTITUTIONAL CASH FUNDS | 1.0-1.5% |
| YIELD – BONDS (GLOBAL INVESTMENT GRADE) | 1.5-2.5% |
| YIELD – FTSE 100 | 3.50% |