A well-tended surplus

A COMPANY'S INVESTMENT POLICY STATEMENT IS THE KEY TOOL FOR MANAGING SURPLUS CORPORATE CASH. **MARK STOCKLEY** EXPLAINS ITS PURPOSE AND WORKINGS.

The management and control of surplus cash is a critical treasury department function. The cash investment policy statement allows a company's board of directors to understand and define how surplus cash is managed, and gives a treasury department written authority to invest the company's cash on a daily basis. For corporate treasurers who have yet to establish or have not recently evaluated their existing cash investment policies, now is the time.

WHAT IS AN INVESTMENT POLICY STATEMENT? An investment policy statement is a document that identifies the objectives for a company's investment portfolio and specifies the allowable parameters for achieving those goals. Having a documented policy for the administration of the company's cash is one of the most effective means of risk management, offering a clear and constant reminder of the business's goals and its ability to tolerate risk. The investment policy statement should be part of every company's risk management protocol, incorporated into an annual board review process (typically by the audit committee) and updated on a regular basis.

In short, an effective investment policy statement provides a means for communicating the objectives for and permitted level of risk in a company's cash portfolio. It should provide guidelines for those responsible for managing the company's cash, whether they are internal or external managers.

GETTING STARTED Before developing an investment policy statement, it is important to evaluate the company's cash needs thoroughly and to pinpoint its risk profile. Effective forecasting of liquidity needs and assessment of risk tolerance help achieve excess returns from a cash portfolio.

It is important to assess company priorities. To that end, you should determine what the general course of the company is and where cash is likely to be deployed (for acquisitions, operations or capital expenditure?). Of equal importance is obtaining a good understanding of the company's outlook, taking into account its view of the economy and its sector. When constructing a cash portfolio, it is important to understand how and when the company may need cash. Forward knowledge of a cash need – be it months, weeks or just days ahead – can have a beneficial impact on expected returns.

From there, treasury and finance staff are better equipped to judge the overall make-up of the company's cash, a central concept that every corporate treasurer needs to understand when developing an investment policy statement. In simplistic

EFFECTIVE FORECASTING OF LIQUIDITY NEEDS AND ASSESSMENT OF RISK TOLERANCE HELP ACHIEVE EXCESS RETURNS FROM A CASH PORTFOLIO.

terms, a company's cash falls into three distinct categories (see Box 1):

- operating cash (working capital required to meet the daily needs of the business);
- core cash, which is generally earmarked for unknown future needs of the company; and
- strategic cash, which is the stable balance sheet assets not intended for specific expenditures. While conservative by nature, strategic cash – which typically has a longer time horizon than operating cash or core cash – might have more of a total return objective.

MAJOR CONSIDERATIONS A company's cash investment policy will be unique to it, and a business's specific situation will dictate the policy constraints and benchmark for the cash portfolio. While a company's investment policy ultimately will be customised, there are important factors all corporations should take into account when developing a policy.

Risk tolerance Risk tolerance is arguably the most important criterion in a cash investment policy. Company management must first determine if the key priority is preservation of capital or maximisation of returns. As a next step, they should consider whether, within each of the three cash categories described, there is an ability to weather any deterioration in liquidity.

Risk can come in many forms as highlighted in Box 3 – short-term volatility, technical pressures (supply/demand) or headline risk, to name a few. The impact on the company's cash portfolio can differ based on the ability to navigate these variables.

Portfolio objectives Based on the company's risk tolerance, market views and liquidity needs, treasurers must establish objectives for the corporate cash portfolio. A portfolio objective can be quantitative (such as seeking returns that exceed a defined market hurdle) or qualitative (such as focusing on safety and liquidity).

This is not to say that a corporation has to establish a single objective for the management of its cash; multiple objectives are often warranted. Ultimately, these objectives will guide portfolio construction and help the company to divide its cash assets into operating, core and strategic buckets. Common examples of cash portfolio objectives include:

- preservation of principal;
- meeting forecasted cashflow needs;
- provision of income/yield;
- provision of tax-advantaged returns;
- delivery of prudent, risk-managed total return; and
- search for above-benchmark returns.

Ideally, the portfolio objective should also address duration, specifically indicating whether duration should be actively adjusted to remain within a stated range or whether a buy-and-hold strategy is preferred. Typically, targeting a specific duration is better suited to a total return objective, while buy and hold is more often associated with capital preservation, a short-dated portfolio, or one that is subject to liquidity requirements. Buy-and-hold strategies are usually yield-focused and do not have the gain/loss considerations of an actively managed portfolio.

Also, when establishing an objective for cash accounts, consider the accounting associated with capital gains and losses and the tax implications when gains are realised.

Benchmarking A benchmark offers a means for comparing and measuring portfolio performance and risk. It is important to realise that a performance target is not a benchmark. While a cash portfolio may seek to match the return of a specific industry or peer group average, such as those for money market mutual funds, that in itself does not constitute a benchmark. Generally speaking, every benchmark should be transparent and measurable, meaning it should consist of well-defined securities with readily available prices quoted on a daily basis. By definition, a benchmark must exhibit a level of comparability with the portfolio's makeup (in terms of type of securities held, asset allocation and duration) in order to effectively convey risk.

CONSIDERING THE IMPACT OF LIQUIDITY AND RISK OBJECTIVES RELATIVE TO THE BENCHMARK IS AN ESSENTIAL PART OF EVALUATING PERFORMANCE.

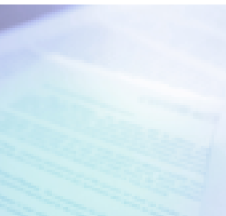
Considering the impact of liquidity and risk objectives relative to the benchmark is an essential part of evaluating performance. In most cases, a blended benchmark containing elements that closely resemble the cash portfolio's expected allocation may be beneficial. This allows treasurers to better match those portions of the portfolio that are intended to be more liquid.

Investment managers When it comes to choosing an investment manager for a company's cash accounts, there are generally two broad models: to manage the assets internally or to hire an external investment adviser. The level of service provided under each arrangement can be quite different, as can the costs.

External management generally involves engaging with a professional investment management firm. By definition, investment managers serve as fiduciaries for their corporate cash clients. While some brokers act as portfolio managers with discretionary trading authority over a company's cash accounts, they are not generally required to act as a fiduciary for clients in the same way as an investment manager whose sole purpose is to manage other people's money.

The following points should help decide the best type of management for a company's cash accounts:

- **Goals** The ability to move beyond money market mutual



funds offers the potential for excess returns for those institutions willing and able to take that step.

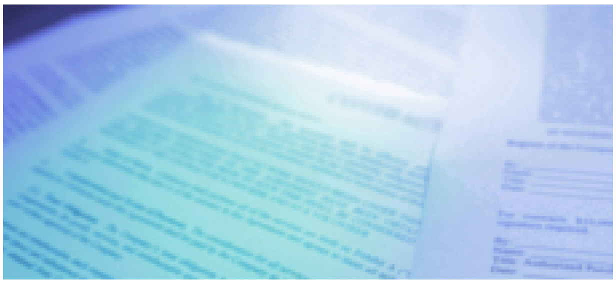
- **Personnel** Take stock of in-house expertise for cash management, including whether employees have experience managing cash assets, time to do so and what the opportunity costs might be.

- **Trading partnerships** Consider whether the company itself or an outside cash investment manager has trading relationships that will allow for diversified opportunities, and more bargaining power, in the cash space.

- **Support services** Managing cash is a multifaceted, complex activity that requires proper technology and support services (compliance, trading, valuation models, market data, accounting and reconciliation) to achieve best results. Ensure that the company or the external cash manager has access to these capabilities.

CRITICAL ROADMAP The importance of a well-documented and up-to-date cash investment policy cannot be overstated. The investment policy statement is a document that serves as a critical roadmap for companies and the investment managers charged with navigating today's increasingly complex cash and fixed income markets. By ensuring that all parties understand and observe the same objectives and guidelines, the investment policy statement paves the way for successful administration of the company's cash.

Mark Stockley is managing director and head of international sales at BlackRock.
Mark.stockley@blackrock.com
www2.blackrock.com



Box 1: Categories of cash

	Operating cash	Core cash	Strategic cash
Investment horizon	0-6 months	6-12 months	12-24 months
Liquidity needs	regular access to cash	occasional access to some cash	varies; accessibility determined prior to investment
Investment focus	liquidity	low-risk, incremental return	optimisation of returns

Box 2: What's in an investment policy statement?

Although every company's cash investment policy statement will be unique in its details, the basic components are likely to be very similar. Corporate treasurers should identify the particular risks they are seeking to control, and determine how to evaluate those risks, in constructing specific guidelines. The following is intended to illustrate the composition of a typical cash investment policy statement.

1. Definition of portfolio and who manages it
2. Investment objective: qualitative or quantitative?
3. Benchmarking: performance target and risk target
4. Maturity/duration guidelines: maximum maturity (may differ across sectors); average duration for portfolio; and weighted average life for asset and mortgage-backed securities
5. Asset guidelines: define allowable investment types/sectors
6. Asset allocation: define issuer and sector limitations
7. Credit criteria: short term versus long term; quality (may differ by sector/asset class – for example, only AAA rated asset-backed securities, but A rated corporates)
8. Other investment practices: repurchase agreement guidelines
9. Reinvestment of income
10. Custodian: determined by the company
11. Accounting agent: an investment manager's reports are to be used only for reconciliation and performance purposes; the custodian and/or accounting agent is the official record keeper for the portfolio
12. Other vendors: investment consultant; treasury consultant; compliance/reporting systems

Box 3: Types of risk

Primary risks	Definition	Factors
Credit risk	The risk that a security's value will change due to a ratings downgrade or, in the case of a distressed security, default	• rating downgrade • default
Interest rate risk	The risk that a security's value will change due to a change in interest rates or the shape of the yield curve	• change in the level of interest rates • change in the shape of the yield curve
Liquidity risk	The risk that arises from the difficulty of selling an asset; the security cannot be bought or sold quickly enough to prevent or minimise a loss	• secondary market bid availability
Spread risk	The risk of change in value of a security due to a change in the relative spreads in the market	• hybrid of credit and liquidity risk