*Credit risk and the yields offered are two of the key criteria by which treasurers should judge the liquidity funds in which they invest their short-term cash surpluses. But the size of the fund is equally important, says **Kathleen Hughes**.*

Sizing up liquidity funds

IT IS A CHALLENGING TIME FOR CORPORATE TREASURERS. Credit rating downgrades are driving the need for more in-depth credit analysis and they are also faced with a rising interest rate environment and the opportunity to access enhanced yields. Given this, and the need for effective cash management in terms of security, liquidity and the efficient use of cash balances, the media they invest in must be given serious consideration.

Executive summary

- Credit rating downgrades have placed more pressure on treasurers to diversify their investments and spread counterparty risk.
- Liquidity funds can satisfy many requirements – providing security, liquidity and the potential to enhance yields.
- A number of factors must be considered when selecting a liquidity fund provider such as credit quality, the size of the fund and the solution's position along the yield curve.
- Enhanced yield funds diversify outside of traditional instruments and offer durations of 90 to 365 days, providing a home for cash balances with a 6-12 month horizon.
- Liquidity funds also offer a variety of services and options such as same-day settlement and late dealing deadlines.
- Other benefits include instant liquidity without penalty and automatic sweeping of uninvested cash. Some providers also offer online services.

CREDIT RISK INCREASES

The task of selecting a secure home for cash has become more difficult with the deterioration of the credit environment in recent years. Since 1998, the number of organisations receiving a credit downgrade has persistently outstripped those that were upgraded. This trend peaked in 2002 when downgrades outnumbered upgrades by almost five to one. The decline in credit ratings is putting greater pressure on treasurers to diversify their investments to spread counterparty risk. But managing multiple positions is resource-intensive and – without dedicated credit research resources to support them – treasurers can be exposed to re-ratings shocks among their chosen counterparties.

German depositors face the additional blow that the 12 state-backed Landesbanks are to lose their state guarantee in July 2005 (see *Exports bolster German recovery*, page 48, *The Treasurer,* September). When this happens, investors will have to look much harder to find a deposit-taker offering AAA-rated security.

INTEREST RATES ARE RISING

Recent economic data indicates that the world economy is growing, and with diminishing spare capacity, there have been tentative signs of inflation. Federal Reserve Chairman, Alan Greenspan, continues to acknowledge that economic growth is robust and, as a result, has begun to implement an interest rate tightening policy. As such, the forward market is already forecasting a number of interest rate rises in the US and UK.

CASH BALANCES ARE BUILDING

Meanwhile, corporate treasurers' cash balances continue to be robust. Having previously pre-funded debt in order to take advantage of historically low interest rates, treasurers have yet to use these funds to any great extent. Therefore, while considering potential areas of capital expenditure, liquidity funds may offer an ideal home for their cash balances.

Given this challenging environment, treasurers have to address three key requirements:

- How to maintain capital security and diversify counterparty risk;
- how to achieve meaningful yield without comprising liquidity; and
- how to ensure surplus cash balances are being managed efficiently.

THE RESPONSE

These challenges have led more and more treasurers to look beyond conventional deposits and direct investment in commercial paper and certificates of deposit. They are now looking to liquidity funds and enhanced yield funds to deliver higher rates of return, plus counterparty diversification and capital security.

Liquidity funds satisfy the two key requirements of effective cash management – security and liquidity – while offering the potential to enhance the yields offered by time deposits. Although enhanced yields might not be their long-term aim, they can smooth the volatile path that bank deposit rates tend to offer, notably in Europe and the UK. In fact, with the declining interest rate environment of previous years, liquidity funds actually offer investors enhanced yields, compared to banks' time deposits.

When interest rates are rising, liquidity fund managers tend to reduce the Weighted Average Maturity (WAM) of their portfolios – that is, the average maturity of the instruments invested in.

They may, for example, reduce maturities from around 60 days to 30 days in order to ensure adequate liquidity to invest in progressively higher yields.

Given that fund managers must wait for instruments to mature before accumulating the cash for investment in higher yields, a time lag occurs and, as a result, the funds may periodically underperform short-dated cash deposits. However, given time, the superior returns of liquidity funds show that it is not necessary to mitigate these short periods of underperformance.

The main contributor to this lag is change to the expected magnitude of interest rate increases. At present, much of the interest rate rises have been priced into the market. Money market curves have become very steep and, therefore, short-term deposits are not offering higher yields when compared against liquidity funds.

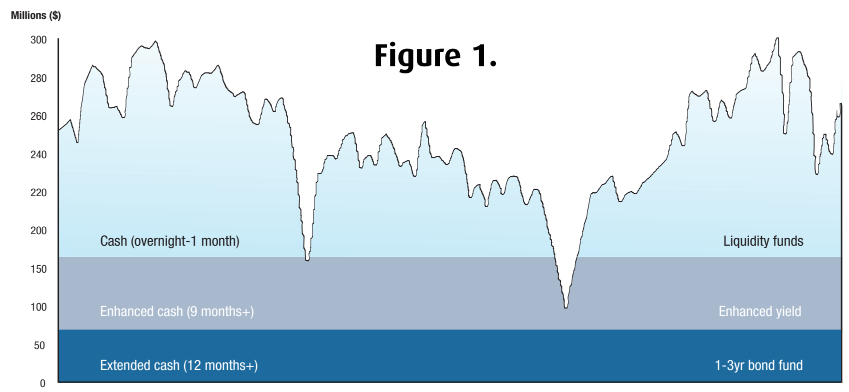

Figure 1.

'Liquidity funds satisfy the two key requirements of effective cash management – security and liquidity'

special report MONEY MARKET FUNDS

‘To effectively manage risk and enhance returns in a liquidity fund, considerable resources are needed for credit analysis’

WHAT TO LOOK FOR

Major distinctions can be made between the offerings available from different liquidity fund providers and, if capitalised on, these can further enhance the contribution made to your cash management activities.

To effectively manage risk and enhance returns in a liquidity fund, considerable resources are needed for credit analysis. Security is one of the most important criteria of liquidity funds and it is important that your fund manager is confident that the proprietary risk analysis and credit ratings of instruments invested in have been thoroughly researched. The sustainability of potential consistent outperfomance is hence aided.

The size of the fund itself is also important, particularly when it comes to weathering high levels of volatility. To ensure that liquidity is not compromised, your holding should not account for more than 10% of the fund. This, however, is unlikely to be an issue that arses if you invest in larger funds. The latter also offer the benefit of economies of scale.

Another key differentiating factor is the extent to which providers offer solutions further along the yield curve. Liquidity funds form the bread and butter of basic cash management needs. They provide a valuable safe-haven for short-term investments, earning competitive returns while offering daily liquidity. To achieve these objectives, they usually invest in highly-rated money market securities, maintain an average maturity of less than 60 days and carry an AAA-rating from Moody’s and Standard & Poor’s.

But some providers go beyond simply providing a short-term investment medium and provide a home for funds that require longer durations and are not suitable for investment in the short duration bond market. If you leave excess cash (over and above your short-term liquidity needs) in liquidity funds, it will not be used to its full potential. Cash with a longer time horizon seeking a higher level of current return, consistent with principal preservation is most suited to enhanced yield funds.

Enhanced yield funds diversify outside of traditional money market instruments, offering durations of between 90 days and 365 days, and invest in instruments such as commercial paper, floating-rate notes, asset-backed securities and short-duration corporate bonds. These funds can provide a good home for cash balances with a 6-12 month plus horizon.

Used together, liquidity funds and enhanced yield funds can provide a more complete and more effective cash management solution, with cash being made to work hard along the yield curve to achieve the return, risk and liquidity profile desired. Figure 1 illustrates how a tailored cash management solution can be achieved by combining liquidity funds and enhanced yield funds.

Liquidity fund providers also offer different services and options to enhance the attractiveness of their funds. For example, they can offer same-day settlement and late dealing deadlines so that investors can gain access to their cash when they need it. Shares are often priced at ‘constant net asset value’, meaning that the funds operate in the same way as bank deposits. Income is compounded daily and paid monthly (or on exit), and can be taken as cash dividends or reinvested in new shares. Alternatively, some liquidity funds offer accumulation, or ‘roll up’, shares, where income is accrued daily but not distributed. This provides added flexibility for investors in different tax positions.

Instant liquidity without penalty and the automatic sweeping of uninvited cash to ensure that all money is optimally invested at the end of each business day are further important enhancements. Some providers also offer investors access to their accounts using the internet, including the ability to transact online.

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‘Together, liquidity funds and enhanced yield funds can provide a more complete and more effective cash management solution’

Cash management at Hewlett Packard

Liquidity funds play a vital role in Hewlett-Packard’s (HP) cash investment strategy. A multi-national IT company, HP manages billions of dollars of cashflows every year. Its European treasury centre alone handles over 120,000 transactions each year, worth in excess of US$1tn, covering operations in 26 countries as it also covers various worldwide activities such as HP’s monthly multi-lateral netting process, a Belgium Co-ordination Centre structure for managing HP’s global US dollar, euro and sterling funding needs and a fully licensed bank in Ireland for HP’s pan-European leasing activities.

Operations on this scale can generate significant cash holdings. The offshore cash portfolio currently exceeds US$13bn, and all of this cash needs to be invested securely and profitably whilst ensuring adequate liquidity.

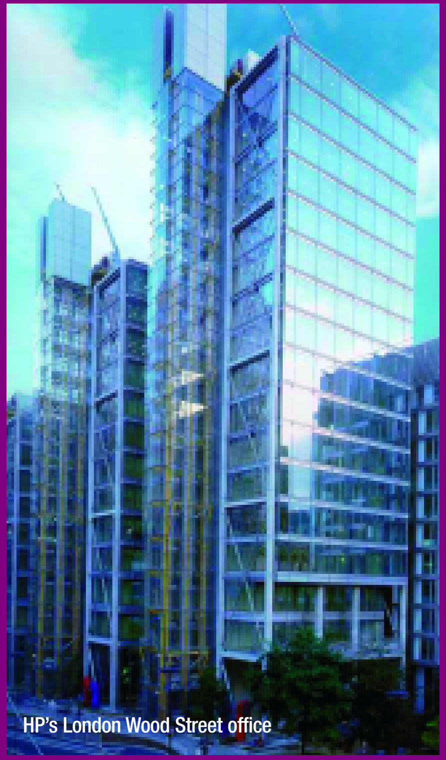
With operations in more than 170 countries worldwide, HP is exposed to considerable business risks – not least the cyclical nature of the global IT industry, foreign exchange movements and sovereign risk within its emerging market operations. Liquidity funds, with their high levels of security and portfolio diversification, offer an ideal solution as part of a broader investment strategy.

As well as security, liquidity is an equally important factor for HP. Cashflow forecasting is a big challenge for a business that is as complex as HP’s and it is vital for the company to react quickly and efficiently to changing circumstances. In addition to its daily liquidity needs, HP also has to plan for other activities such as strategic acquisitions and tax planning initiatives which often require cash availability at relatively short notice. Again, liquidity funds offer an ideal solution.

Liquidity funds also provide HP with competitive yields, enabling it to maximise cash returns through a diversified portfolio. Such levels of diversification are more difficult to achieve in-house, given the administrative effort associated with time deposits, commercial paper and other investment products, as the treasury centre only employs eight people. With liquidity funds, HP not only gets a spread of investments via one medium, but also leverages the expertise and credit research capabilities offered by large fund management groups to achieve the levels of yield and portfolio diversification required.

To further limit risks, HP ensures that no more than 10% of the value of a fund or US$250m is invested in liquidity funds that are smaller than US$5bn. For larger funds, the limit is set at no more than of 5% of the fund or US$1bn. Additional investment limits are used for the largest offshore funds. HP also does not consider any fund unless it holds the highest credit rating (AAAm).

HP considers the development of liquidity fund internet portals as a welcome step forwards and is pursuing greater levels of front office automation. Portals allow the company to trade online and provide easy access to its cash investment positions whenever needed. The company is also supporting the development of multi-fund portals which will allow it to maintain just one interface with various liquidity fund providers. A multi-fund portal needs to be based on open standards to facilitate linkages not only amongst the various liquidity providers themselves, but also their custodians and the treasury platforms used by corporates, to ensure Straight-through processing.



HP’s London Wood Street office

When this is achieved, the use of liquidity funds will become even more attractive as not only will they provide an efficient cash management solution, but they will also be fully integrated into the global treasury function.