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Opportunities to Increase Yield by Moving from Cash to “Near Cash”

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With the federal funds rate close to zero and likely to stay there for some time, holding cash is currently painful, albeit essential for many investors. The cash reserves investors are holding in money market accounts are now the moral equivalent of the “dead presidents” people carry in their wallets. The fed funds rate is likely to stay low for some time because the Fed is hoping that if they keep rates low enough for long enough, the pain of such minimal yield will entice people to move out the risk spectrum.

How can investors effectively manage their cash in this environment? Until recently, investors relied without worry on money market strategies for daily liquidity and principal preservation, and enhanced cash strategies for potentially higher yields with minimal sacrifice of preservation or liquidity.

However, in the last 18–24 months, many things have changed in the cash management universe. After Lehman Brothers failed in September 2008 and the Reserve Primary money market fund subsequently “broke the buck,” money market investors panicked and fled to safer but low-yielding Treasuries.

The Cash Quandary

Cash market investors today face a dilemma: if they require principal preservation and liquidity, they must sacrifice yield. Investors feel the need to be extremely conservative, and to make sure they have access to the cash they need. And they should. But there are unprecedented opportunities to pick up additional yield by moving from money market strategies to short-term strategies for cash investments not earmarked for the “grocery bills next week.”

Investors should not let the tumultuous markets stop them from taking prudent advantage of the additional alpha potential that active management of mispriced short-term investment grade fixed income securities can provide. However, in the current environment it is more important than ever to evaluate fixed income managers. Investors

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should look for a proven track record of performance, careful risk controls and a dedicated and experienced cash management desk.

Investors should ask themselves if they really need the additional reserves, beyond the cash they will need in the near term, to trade “at the buck” every hour of every day. If they can potentially tolerate very modest price fluctuations around par, the pickup in yield from money market to enhanced cash investments is currently very large.

The deleveraging of the shadow banking system has set “pawn shop” prices on many otherwise high-quality securities. This is the result of the liquidity premium that is being demanded by buyers who have the available balance sheet to take on even the high-quality securities that deleveraging investors are forced to sell.

The prices in the market are not indicative of the long-term value of many of the high-quality securities in the market. We could call this the risk premium for a shortage of balance sheet in the market, or a liquidity premium.

Why Government Programs Matter

However, since the Treasury, the Fed and the FDIC (Federal Deposit Insurance Corporation) do not want securities to trade at the pawn shop bid level, they have developed programs intended to support prices, such as the Commercial Paper Funding Facility (CPFF) and the Term Asset-Backed Securities Loan Facility (TALF).

With the TALF, the Treasury and the Fed are effectively stepping around the banking system to create a sort of government shadow bank to provide financing for asset-backed securities (ABS).

The government is substituting its own balance sheet for the missing balance sheet on Wall Street, with the aim of supporting prices on ABS and incrementally nudging the prices up closer to their intrinsic value. This has created an opportunity to buy at attractive prices and potentially earn an attractive yield while also being in the position to potentially pick up capital gains if spreads tighten as the full force of Uncle Sam’s balance sheet comes into play.

Tiered Solution

Investors have a number of options: they can tailor cash management investment strategies to fit a broad spectrum of risk tolerances and liquidity and principal preservation needs.

The first tier of cash market investment strategies is designed to offer daily liquidity and the strictest degree of capital preservation, and is generally ideal for investors who have a very low risk tolerance, or for routine “grocery and utility bills” cash assets. A high-quality, short duration (90 days or less) money market strategy is suitable in this case.

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The second tier of cash market investment strategies are suitable for “semi-permanent” cash allocations – the emergency assets set aside for rainy days or for longer-term capital expenditures or planned disbursements, but not meant to be spent on frequent routine cash flows. For these assets, short-term (duration of up to 1 year) cash strategies still emphasize liquidity and principal preservation, but with greater flexibility, thus offering the potential for enhanced returns.

The third tier of cash market investment strategies are designed to enhance returns for long-term permanent cash allocations. Low duration (1–3 years) or even more intermediate strategies may be suitable for investors with greater risk tolerance and less need for liquidity.

Setting up an asset structure that matches liabilities and risk tolerances is becoming increasingly important for cash investors. The need to maintain a high level of liquidity in the current environment is keeping investors focused on principal preservation and ready access to their cash market investments. At the same time, investors may have return requirements that Treasury and Agency securities cannot generate. At PIMCO, we work closely with investors to help them understand the variety of options and structures available to them as they build a portfolio to meet their specific needs. In many cases, we help clients evaluate their liabilities and create a portfolio that matches their expected cash flows, and also takes into account subjective factors, such as risk tolerance, which are central to our analysis as we work to provide the best solution.

In today’s cash market environment, investment manager evaluation and due diligence are critical. Successful investment managers are structured with a focus on risk management. At PIMCO, the cash management team combines experience and dedicated expertise, bottom up credit research, analytics that underpin a risk-based approach to money management, and close attention to cash flows and efficient operations, all of which allow the portfolio managers to always be focused on principal preservation, liquidity, and the return potential on clients’ cash investments.

Past performance is not a guarantee or a reliable indicator of future results. Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk; investments may be worth more or less than the original cost when redeemed. Money Markets are not insured or guaranteed by the FDIC or any other government agency and although they seek to preserve the value of your investment at \$1.00 per share, it is possible to lose money. There is no guarantee that these investment strategies will work under all market conditions and each investor should evaluate their ability to invest for a long-term especially during periods of downturn in the market.

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