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Cash and Short Duration Strategies: Driving with Caution on the Road to 2010



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The weeks preceding year-end can be a daunting period for any investor, including those at the short end of the fixed income markets. Balance sheet pressures from dealers and investors alike, sporadic issuance of new investment alternatives into the marketplace, and last-minute changes to the regulatory landscape have dotted the fourth quarter landscape in years past and usually lead to lower yields as we approach year-end. This year-end promises to be no different. As investors maneuver among these obstacles while planning their strategies for the changing market and regulatory environments in 2010, they may find that a combination of money market and short duration strategies can be the optimal approach both to managing principal preservation and to providing sufficient liquidity at a reasonable cost.

Driving with Rumble Strips

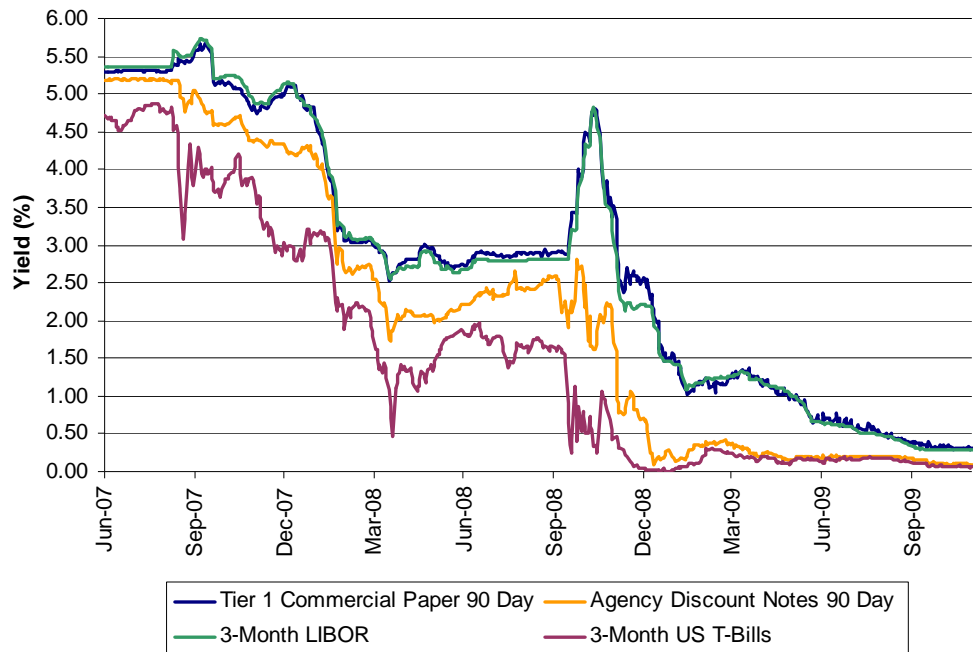
To navigate the current markets and the ever-changing regulatory environment, investors must find – or create – a road that will lead them in the right direction. Good roads are equipped with rumble strips: perhaps one of the most understated inventions of the 20th century, they have probably prevented countless accidents and saved many lives. Rumble strips? Yes, you know, the plastic bumps or textured sections of pavement alongside each lane and shoulder on the highway. They keep you in your lane and on the road and sometimes warn of hazards ahead, and they make that sound similar to a drumbeat of a bad 1980's song when you drive over them.

Prudent cash investment strategies also come equipped with rumble strips. As mentioned in our [June Viewpoints: "The CFO's Cash Dilemma,"](#) we believe that all types of "CFOs" – whether individuals managing their own cash flow and investment portfolios, or treasurers managing liquidity for multi-billion-dollar corporations – should create strategies that will allow them to maximise the risk/return and liquidity on their cash investments. As they plan their cash management strategies, they should keep these two rumble strips in mind: 1) their real need for liquidity within their portfolios, and 2) the price/cost implied in the performance of the portfolio in order to achieve that liquidity. Liquidity has been expensive to obtain since late 2008. Most investors felt safer investing in cash than in risk assets; however, since March there have been opportunity costs as yields have fallen and risk assets have rallied (see Chart 1).

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Money Market Strategy Yields, June 2007 – October 2009



Source: Bloomberg

Chart 1

As a result of this increased demand for short duration assets coupled with the reduction in supply as year-end approaches, the yields available in many short-end strategies are noticeably less than they were only a few weeks ago in October. Consequently, outflows from money market strategies have increased over the past quarter as more investors recognise the inherent cost of liquidity. The question now is not only about determining the need for liquidity, but deciding whether the risk and reward payoffs available in the marketplace are compelling enough to motivate you, the CFO, to invest in other short duration cash alternatives.

Additional Considerations for Cash and Short Duration Investing in 2010

Short duration strategies could potentially help cash investors navigate the highway ahead and balance the cost of low cash yields with the potential risks of investing in the current environment. However, before we ring in 2010, CFOs should consider some additional rumble strips as they develop their investment strategies.

- **Federal Reserve Policy** – The impact of quantitative easing is a focus of vigorous debates around treasury departments and trading floors, and perhaps around your dinner table at home. While we believe the Fed will be on hold for a reasonable period, we understand that any change in policy, when it occurs, will affect performance of risk assets differently.
- **Changes in Money Market Regulations** – The expected changes in 2a-7 money market regulations suggested by the Investment Company Institute, the President's Working Group on Financial Markets and the SEC will likely have an

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impact on the weighted average maturity, liquidity and credit quality of money market strategies. This may not occur before year-end, but it may keep money market rates low.

- Changes in Treasury Issuance – Increased issuance of US Treasuries will likely affect the shape of the yield curve, particularly on the front end as the Treasury adjusts T-bill issuance in an effort to extend the average duration of their paper and to address their periodic cash management requirements. More issuance means more collateral for the repo markets, and that could push overnight rates a little bit higher. However, the Treasury's timing is uncertain and unlikely to affect rates before year-end.
- Excess Reserves – Once again, timing is the key question: When will the Fed begin to change the level of excess reserves in the marketplace? Given the Fed's recent preparations to conduct reserve repo operations with the primary dealers (and perhaps subsequently with other parties, including the Agencies and money market strategies), it appears that the potential for activity on this front is growing.
- Valuations of Risk Assets – The tightening in credit spreads and rise in equity valuations over the past six months has been an unbelievable opportunity for investors. The question remains how long this trend might continue, and more importantly for CFOs, what motivates it (is it based on the strength of economic activity, or continued risk appetite from investors?).
- FDIC Assessments – With the FDIC continuing to assess a special fee of 10 basis points on demand deposits, investors will most likely look for any means to avoid being charged this punitive fee on their excess cash over year-end.
- Dealer Balance Sheet over Year-end – As usual, dealers will likely look to shed aged inventory and reduce funding commitments preceding and over the year-end period. As a result, investors may suffer from paltry yields as available investment options become sparse, particularly overnight repurchase agreements.

These could all be considered rumble strips that alert drivers to intersections and forks in the road, and CFOs need to plan ahead so that they can adeptly navigate the liquidity landscape. As the markets have moved from a dearth of liquidity during the crisis to a deluge, the theoretical task at hand is fairly simple: Stay on the road. However, the means of staying on that road is not so simple.

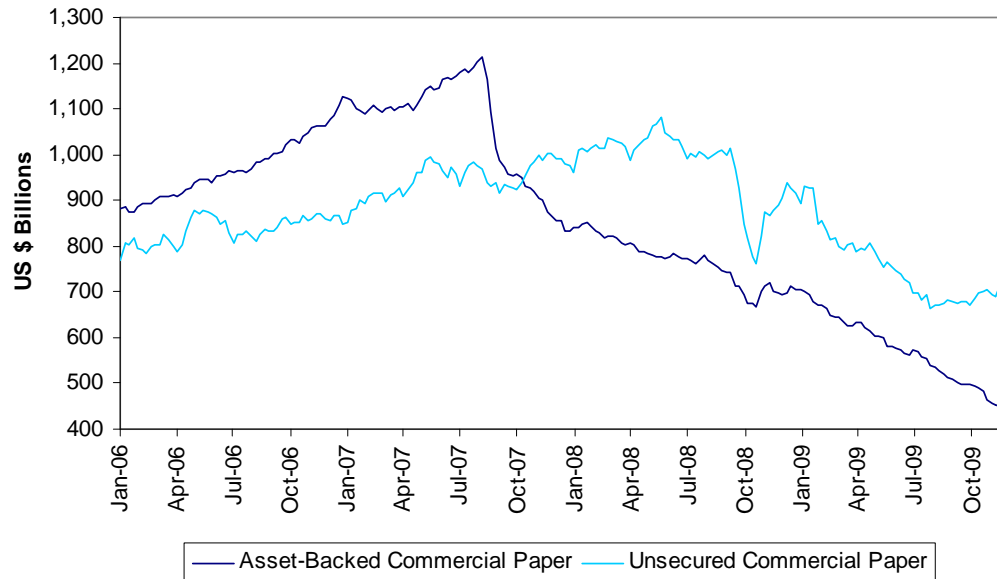
Managing Cash Beyond the Crisis

Surviving the past twelve months has taught many CFOs about various strategies that focus on creating and protecting liquidity. Many corporations did this in two ways: 1) debt issuance was termed out to raise longer-term funds, and 2) capital investments and expenditures were cut to save on planned expenses. While the economic future is a bit less cloudy today than it was a year ago, there still remain questions about how much growth there will be in the business sector over the next one to two years. Traditionally, corporations who had the means raised funds for interim cash management purposes (capital expenditures, pending receivables) via the commercial paper (CP) market. And while that market is coming back into its old form, the need to tap its resources (funding) is much smaller today than it was 12–24 months ago. Consequently, there is limited issuance of non-financial CP into the marketplace (see Chart 2).

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Commercial Paper Issuance, January 2006 – October 2009



Source: Federal Reserve

Chart 2

If CFOs continue to invest a large portion of their cash in money market strategies in efforts to protect principal and maintain liquidity, then they will likely pay for it with lower yields. Considering the impact that regulation, government policy and central bank policy may have on keeping interest rates low during 2010, investors may start to formulate a plan for navigating the highway without hitting too many rumble strips. Many CFOs are starting to move out the risk spectrum into short duration cash strategies that provide a limited degree of liquidity coupled with more attractive yields than a typical money market strategy would offer. CFOs are looking to optimise their objectives of maintaining principal, assuring liquidity and targeting an attractive return, and some are beginning to do so through a combination of money market and short duration strategies.

Cash mandates continue to offer potential yields that are more appealing than money market yields, and in the current environment, we are able to find securities that offer attractive relative value, good liquidity and competitive spreads for the risk obtained. We are managing many portfolios conservatively as we navigate through year-end uncertainty, with an emphasis on the Treasury and Agency sectors. We also remain opportunistic: we look to invest in high-quality credit with maturities outside of the money market spectrum, particularly in financial credits and non-cyclical sectors, non-U.S. government-guaranteed obligations and select short-dated prime asset-backed securities (via the TALF, or Term Asset-Backed Securities Loan Facility). CP issuance for financials and non-financials alike has become more sparse as the need for funding has diminished. This in turn has led to a collapse in LIBOR spreads

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versus CP offering levels, and as a result we remain highly selective when investing in the commercial paper space.

Changing Lanes Between Money Markets and Short Duration Strategies

Some CFOs are starting to think about short duration strategies slightly outside of money markets as the rumble strip of investing. Short duration strategies give them enough latitude to switch lanes on the highway, without being forced to jump the guardrail entirely into another strategy that is too volatile. Similarly, enhanced cash strategies may provide CFOs with attractive liquidity options and flexibility. Given how poor liquidity was during the crisis (as bad as being on the 405 freeway in Los Angeles at rush hour), and given the current expectations for the global markets, a short duration, enhanced cash strategy is one of the recommendations we would make as we transition to the New Normal financial environment.

We recommend investors use the next few weeks to position portfolios into an optimal liquidity position, not only for year-end but for well into 2010, without overpaying for that liquidity. While the direction of the road will likely become clearer over the next few quarters, the key at the moment is staying on the road, even with the help of a rumble strip from time to time.

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