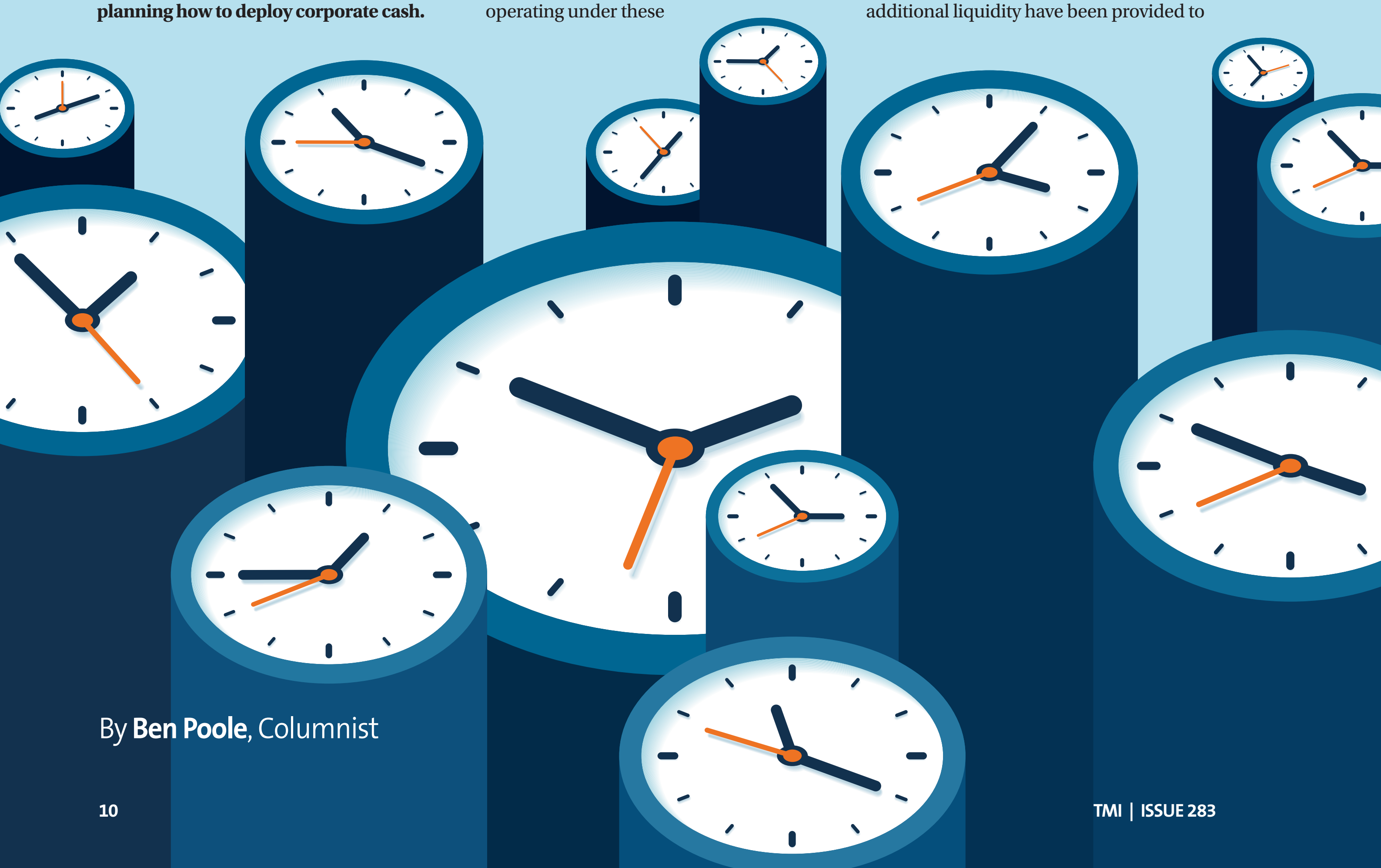
Finding Value for Corporate Cash

Short-term Investments Under the Microscope

A perfect storm of low interest rates, the pandemic, and potential regulation has put pressure on the short-term investment instruments that treasurers rely on for cash management. Add in trending topics such as environmental, social, and governance (ESG) and the role of technology in business, and it is clear there is plenty for treasurers to consider when planning how to deploy corporate cash.

The onset of the Covid-19 pandemic in 2020 triggered a massive increase in corporate cash balances. Treasurers built up liquidity buffers, drew down on credit facilities and were left managing unspent budgets from postponed or cancelled projects. By the end of 2020, US corporates held a record $2.5tr. in cash,[1] for example. In 2021, as businesses have become accustomed to operating under these pressures, the sense of panic may have dissipated, but excess liquidity across all currencies is still a significant factor.

Daniel Farrell, Director, International Short Duration Fixed Income, Northern Trust Asset Management, explains: "Investors, including corporate treasurers, are holding more liquidity, and we've seen record bond issuance levels this year. In addition to that, huge amounts of additional liquidity have been provided to



By **Ben Poole**, Columnist

the market this year through conventional and non-conventional monetary policy, causing that excess liquidity to increase."

For treasurers, a natural reaction to a high level of cash on the books is to look for short-term investment instruments in which to deploy at least some of that cash. However, both internal and external challenges are complicating matters, according to Jim Fuell, Head of Global Liquidity Sales, International, J.P. Morgan Asset Management.

"Challenges around cash flow forecasting have made it difficult for treasurers to do anything with cash other than keep it safe, keep it simple, keep it short, and keep it very liquid," Fuell says. "That's coincided with central banks attempting to address the pandemic, which has resulted in lower rates across the globe. Treasurers are wondering if they're fully maximising the returns they can have on that cash they've got, which may not be earning any yield or even negative yields. That's the challenge."

Poor rate environment drives innovative search for yield

Unquestionably, the low interest rate environment has hampered the ability of treasurers to maximise the yield from their short-term investments. And, despite inflationary trends towards the end of 2021 putting a certain amount of pressure on central banks to raise rates, they have not rushed to do so. Indeed, the Bank of England surprised markets in its November Monetary Policy Committee meeting when it opted not to make its first rate increase since August 2018, and following two consecutive decreases in March 2020.

"It is important for treasurers to take note that we are going to be anchored at these low rates for some time," says Farrell. "There are two ways you can safely earn additional yield – by taking either incremental credit risk or incremental duration risk. Greater yield is attainable for those who are able to move out along the curve and/or go down the credit spectrum."

The ability to invest cash in longer-term maturity instruments is somewhat dependent on how good a corporate's cash flow forecasting is, however. Treasurers need to be sure that they can invest non-operational cash for a more defined period to maximise investing in longer dated securities. This is the case even when those instruments offer good liquidity, but particularly when they might not.

"You could look at fixed deposits or call deposit accounts, but they commit you to locking up cash for a set period of time," explains Farrell. "You may achieve a little bit of extra yield that way, but you will sacrifice liquidity, meaning it may not be suitable. More so now than ever, treasurers must be thinking about those uses of cash and what their needs are, in order to allocate efficiently to achieve maximum yield while prioritising the preservation of capital."

Cash segmentation is one tactic that treasurers can apply to this circumstance, where accurate cash flow forecasting enables treasurers to split cash into

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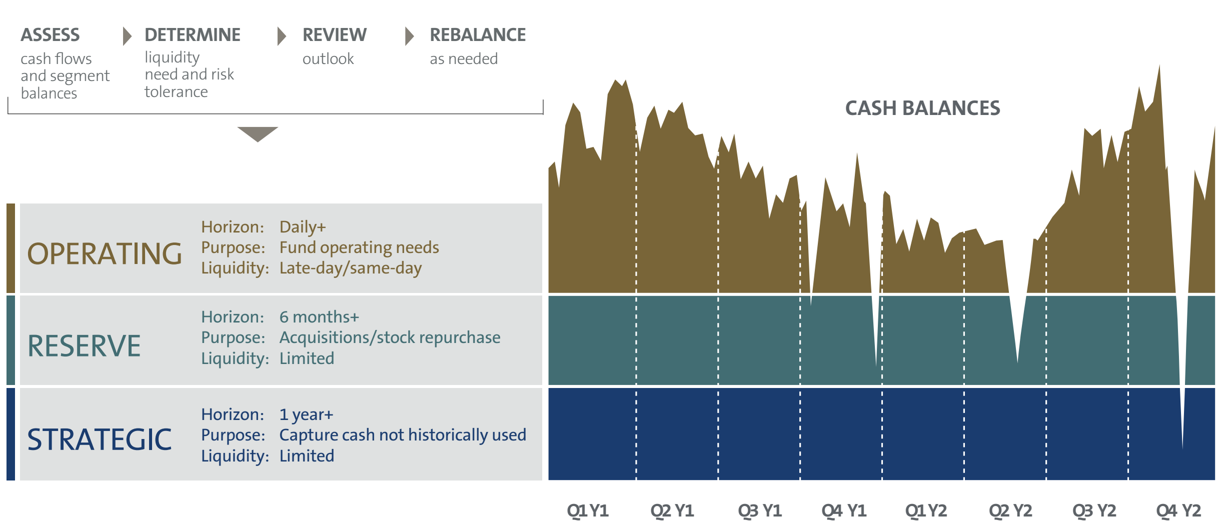
FIG 1 UNDERSTANDING YOUR CASH NEEDS



Source: J.P. Morgan Asset Management, as at December 2021
https://am.jpmorgan.com/gb/en/asset-management/liq/insights/liquidity-insights/leveraging-the-power-of-cash-segmentation/

different buckets, such as operating, reserve and strategic buckets, for example. Once you know you have enough in the operational bucket for day-to-day cash needs, you can build out other buckets of cash that can be specifically deployed in funds and strategies that offer better financial benefits if you can invest your cash in them for a more extended time.

"Cash segmentation is about understanding how long you have your cash and how much risk you can potentially take with that cash to generate returns," says Fuell. "This includes, within that risk, the sort of volatility that you have appetite for."

With corporates seeking to deploy some longer-term cash to improve returns, ultra-short duration bond strategies have come to the fore as a place where treasurers can invest that cash.

Ed Lopez, Chief Revenue Officer, Calastone, notes: "There's a move towards more bespoke cash management as opposed to a straight liquidity fund that's going to give you security, liquidity, and some yield. Ultimately, it's the move to separately managed accounts that leads into the ultra-short bond strategy. It's about getting the enhanced cash that we used to have, but doing it in a bespoke way where you've got a bit more visibility on it. Many asset managers have these initiatives, and we have seen much more activity in the past two years around separately managed accounts than ever before."

Ultra-short bond strategies tend to go beyond traditional money market funds (MMFs) in terms of duration and credit risk while still retaining a cash-like quality when it comes to liquidity. To obtain the real benefits of such a strategy, it is vital to keep the cash invested for the given duration if possible. Treasurers can typically expect a minimum of six months' investment horizon, so you shouldn't need to call on that cash within the next rolling six months, as products such as these can have an element of volatility in their returns.

Hugo Parry-Wingfield, EMEA Head of Liquidity Investment Specialists, HSBC Asset Management, comments: "Ultra-short strategies are something our corporate clients can benefit from if they can lock up cash for longer, where it meets their objectives and suits their cash operations. They are fundamentally different to MMFs, but we think there's an important place for them in that continuum of short-term cash products that a corporate might look at."

Aside from the incremental duration and credit risk, there are other challenges treasurers need to assess before going into the ultra-short bond market, according to NTAM's Farrell.

"Treasurers should spend time on their strategic cash allocation, splitting out its different needs and deciding whether allocations to strategies such as ultra-short bond funds are a viable option to solve for this low yielding environment," Farrell advises. "Additionally, there is the challenge of being able to address any questions their investment policy committees may have and making sure they are agreed on the acceptable uses of this cash. Both of these issues are not huge hurdles, but they do need to be addressed."

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DANIEL FARRELL

Director, International Short Duration Fixed Income, Northern Trust Asset Management

JIM FUELL

Head of Global Liquidity Sales, International, J.P. Morgan Asset Management

Leaning into liquidity

While yield in short-term investments has long been an issue for corporates, treasurers also faced a short, sharp shock on the liquidity side when the pandemic hit. With access to cash paramount at that time, treasurers raced to withdraw their investments from money market funds. As covered in TMI in October,[2] independent money fund portal ICD saw approximately 80% of its prime money fund assets in the US sold within a few days in March 2020 – and 30% of prime money fund assets in Europe.

Despite these initial outflows, however, MMFs proved up to the task of handling the surging liquidity demand, thanks in part to the regulatory changes put in place following the global financial crisis of 2008.

"The regulatory framework within which short-term MMFs operate does, and did, obligate us to carry a level of liquidity – 10% overnight liquidity and 30% weekly liquidity," says Fuell. "Despite a period of initial market distress, we didn't see anyone fail to deliver redemptions from clients in those funds. There is a level of robustness that exists in the product. There was an amount of stress in the marketplace but money market funds broadly operated as intended."

The liquidity event of March 2020 was over in just a few days, and more than 18 months later, liquidity in the market has loosened considerably. Banks can take more on their balance sheet, including commercial paper, certificates of deposit, and bonds. Having navigated last year's challenges, fund providers have been reflecting on what happened and adjusting accordingly.

"Corporate treasurers, as well as the wider investment community, have learnt lessons from the pandemic," says Farrell. "At Northern Trust Asset Management, we've adapted and made changes to our portfolio management strategy. We are naturally holding more liquidity than we were pre-pandemic, and holding even more high-quality, liquid assets too. We recognise that in the face of an unknown crisis there could again be liquidity constraints, so we've adjusted our strategy accordingly to ensure that we will be able to meet investor redemptions should such an unknown event occur."

Getting 'under the hood' of ESG

The trend towards environmental, social, and governance (ESG) seen in several areas of treasury is also present, increasingly, in the short-term investment space. A special report from Fitch Ratings[3] estimates that assets under management in ESG MMFs increased by around 50% by the end of 2020, far outpacing overall growth in MMFs in 2020 (20%).

"Before treasurers go out seeking a fund that is labelled 'ESG,' it is vital that they 'lift the hood' of the particular product or fund and understand what it is offering," cautions Fuell. "We launched a product in the US that is more specifically focused on social issues, addressing the presence of racial inequality across the country, so there's a product out there that enables corporates to address that particular issue. While it does fall under the umbrella term 'ESG,' it is specific. That's why I encourage treasurers to scrutinise any product with an ESG label, to ensure they are investing in something that complements their goals in this regard."

However, this can be a challenge, as the lack of rigorous standards surrounding ESG, and the ability to match data from the fund to any standard, is easier said than done.

"Getting ESG data is the issue for the industry," says Lopez. "There are some indices and analytics out there, but what is the standard? How do treasurers know they are meeting their corporate ESG goals with the investments that they are making, without having to dig down to see all the underlying investments? It isn't easy. That's an area of our industry that needs to be looked at."

Europe's Sustainable Finance Disclosure Regulation (SFDR) is perhaps the leading example globally of a regulator compelling asset managers to be more transparent about the make-up of their fund portfolios and sustainability-linked disclosures. Despite the benefits that SFDR might bring, the responsibility is still on treasurers to carry out their due diligence.

"SFDR is a focus for every asset manager, but how managers bring that to the fore is probably going to differ from manager to manager," comments Fuell. "In some respects, I'd compare it with how we approach credit and risk management – we all say we're doing it, but then we all seek to differentiate ourselves from one another. Perhaps, over time, ESG will present itself in a similar vein. But the onus is still going to be on the investor to understand what they're putting their money into."

As the SFDR classification is a broad set of disclosure requirements for asset managers, it's for each manager to define how they are setting their own sustainability definition, and HSBC's Parry-Wingfield points out that this is not necessarily a fix-all for treasurers.

"SFDR is not perhaps what an investor would like it to be, which would be to define what it is to be sustainably invested," he says. "I think it helps, and such disclosures are critical, but when you look at that classification across different funds, it doesn't necessarily give you the colour you need to understand how the manager of that fund defines sustainable investment. Hence the need for due diligence and for treasurers to look under the hood of any fund they might invest in."

ED LOPEZ

Chief Revenue Officer, Calastone

HUGO PARRY-WINGFIELD

EMEA Head of Liquidity Investment Specialists, HSBC Asset Management

No call for crypto... yet

While some leading-edge industry disruptors such as Tesla,[4] MicroStrategy[5] and even TMI[6] have added Bitcoin to the balance sheet in 2021 in longer-term positions, the consensus is that cryptocurrencies remain unsuitable for short-term treasury investments. This is partly due to the volatile nature of the value of cryptocurrencies over a short space of time.

"The volatility and the almost speculative nature of it seems incompatible for short-term treasury risk management, at least in its current form," says Parry-Wingfield. "More visible institutional and regulatory recognition will be required to see product development in this space."

That regulatory recognition might, perhaps, be slowly coming on. Bloomberg reported in July[7] that a new regulation passed in Germany allows institutional investors such as pension funds to access 'Spezialfonds,' which can put up to 20% of their holdings into cryptocurrency.

"If governments start to accept crypto as a valid or acceptable form of investment, such as the Spezialfonds example from Germany, things could develop," says Lopez. "If these things become more mainstream forms of investment, there will perhaps be crypto strategies that will be out there in the future. But for right now, crypto is too volatile for treasury short-term investment consideration."

Rate conversation to dominate early 2022

As 2021 draws to a close, the most significant talking point impacting the short-term investment space is how long rates can stay low and for how long central banks can resist the pressures from inflation. Treasurers need to prepare for a variety of outcomes regarding rates in 2022.

"There's been much speculation about central banks hiking rates in the near future, but our house view is that rates will remain lower for longer," says Farrell. "Any type of rate-hike cycles that may come in the next few years will remain very muted. So treasurers should be prepared that we're going to be in this lower-for-longer rate environment."

The risk case to this 'lower-for-longer' view is that the transitory inflationary pressures at the time of writing turn into sustained inflation pressures. Central banks will have to weigh up inflationary concerns versus the longer-term impact on economic growth that any rate rises may have. For treasurers, though, one benefit of rising rates could be the potential for greater yield from their short-term investments.

"There's the potential that treasurers might be managing short-term investments in a rising rate environment next year, depending on the currency," comments Parry-Wingfield. "They will need to ensure they are ready to manage that should it arise, as long as that is in line with their fundamental principles and objectives of managing liquidity."

Regulation will be another key theme for 2022, particularly in the MMF space, as Farrell outlines: "Next year, we should hear what the EU regulatory proposals may be for MMFs. Treasurers should start to think about what these could mean for their investments and what alternatives will be available to them. It's easy for treasurers to think that if MMFs become less attractive, they will move into bank deposits, but with the ongoing trend of surplus liquidity, banks are starting to turn away deposits. Preparing for those changes, and potentially working with their MMF providers to understand those changes and to get ahead of it, would be a prudent course of action."

Beyond that, in the short-term space, technology will continue to play a role in both how fund providers deliver products and how treasurers manage their investments.

"Providers are delivering things like straight-through connectivity, auto settlement with banking partners, banking platforms, and connectivity with treasury platforms so you can see your entire investment suite altogether," explains Fuell. "Then there is the enhanced risk analysis around those investments underpinned by technologies. Scenario analysis comes out of that, looking at your current portfolio and the potential implications of adding another type of investment alongside it, for example. This can highlight the returns that it might bring, as well as potential volatility and additional risk. That's all going to be further empowered by technology."

Automation through technology can also help corporates gain efficiencies and cut costs in their short-term investment plan, which is particularly important in a low-yield, low interest rate environment.

"It's all about reducing costs and increasing efficiencies," concludes Lopez. "Corporate treasurers can look internally at their short-term cash investment processes in terms of how they can make that more efficient. It opens up to additional options for investment as well, if they have fully automated solutions." ■

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Notes
1 https://www.spglobal.com/ratings/en/research/articles/201208-u-s-corporates-hold-record-2-5-trillion-cash-to-meet-pandemic-shock-debt-reaches-7-8-trillion-11762147
2 https://treasury-management.com/articles/mmf-reforms-risk-missing-the-point/
3 https://www.fitchratings.com/research/fund-asset-managers/global-esg-money-market-fund-dashboard-2020-10-03-2021
4 https://www.sec.gov/Archives/edgar/data/1318605/000156459021004599/tsla-10k_20201231.htm
5 https://www.microstrategy.com/en/investor-relations/press/microstrategy-acquires-additional-19452-bitcoins-for-1-026-billion_02-24-2021
6 https://treasury-management.com/news/treasury-management-international-engages-diginex-to-put-bitcoin-on-balance-sheet/
7 https://www.bloomberg.com/news/articles/2021-07-30/germany-to-allow-institutional-funds-to-hold-up-to-20-in-crypto