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THE CASH INVESTMENT POLICY STATEMENT

DEVELOPING, DOCUMENTING AND MAINTAINING A
CASH MANAGEMENT PLAN

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The Cash Investment Policy Statement (IPS)

The face of the cash management industry is changing. Once thought of as a homogeneous, no-risk asset class, the cash market is now recognised as multi-faceted, complex and, to be sure, subject to risk. Many cash investors are evolving their portfolios to be more dynamic and more flexible to adapt to these changing markets and to embrace new opportunities. For corporate treasury groups who have yet to establish or have not recently evaluated their existing cash investment policies, now is the time. In the following pages, we examine the issues surrounding the cash investment policy statement and offer institutional investors some suggestions and best practices for establishing, updating and maintaining this important roadmap for managing their company's cash.

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What is an IPS?

An IPS is a document designed to ensure that the goals and objectives for a company's investment portfolio(s) are met. The document generally contains specific information about a company's risk tolerance and liquidity needs, as well as identifying allowable parameters for achieving stated goals. The IPS should be broad, yet explicit in terms of interpretation.

Generally speaking, an IPS also should be:

- ▶ Specific to each company's situation,
- ▶ Dynamic and flexible to leverage current market and firm needs,
- ▶ Able to adapt to changing needs, but reflect total risk tolerance, and
- ▶ Easily modified (with proper analysis and approvals).

Having a documented policy for the administration of the company's cash is among the most effective means of risk management, serving as a clear and constant reminder of the firm's goals and ability to tolerate risk. We believe the IPS should be part of every firm's risk management protocol, incorporated into an annual board review process (typically by the audit committee) and updated on a regular basis.

It will be important to determine:

- ▶ How the policy will be reviewed and modified on an ongoing basis,
- ▶ Who should be involved in that review process (internal or external),
- ▶ Who has ultimate decision-making authority, and
- ▶ The frequency and timeframe for such a review (annually, semiannually).

In short, an effective IPS provides a means for communicating the objectives for and permitted level of risk in a company's cash portfolio. The IPS should provide guidelines for those responsible for management of the company's cash, whether that be an internal or external manager. Typically, these parameters should be reviewed in detail with potential managers as part of the due diligence process to ensure that the company and the party(ies) responsible for the management of its cash share mutual philosophies and assumptions, particularly where interpretive language may exist.

ACCORDING TO THE CFA INSTITUTE

An IPS "addresses the client's risk tolerance, return requirements and all investment constraints (including time horizon, liquidity needs, tax concerns, legal and regulatory factors, and unique circumstances).

...The IPS also should identify and describe the roles and responsibilities of the parties to the advisory relationship and investment process, as well as schedules for review and evaluation."

Getting started

Before developing an IPS, it is important to conduct a thorough evaluation of the company's cash needs and to pinpoint its risk profile. Effective forecasting of liquidity needs and assessment of risk tolerance allows for the best opportunity to ensure preservation of capital, while achieving excess returns within a cash portfolio.

As an initial step, the appropriate staff should inventory the company's cash flow forecasts, including payroll, buyback plans and shareholder dividend payments, as well as any other data that could affect the level of cash on the balance sheet, to quantify how much cash is available for strategic investment. Additionally, staff should consider whether there are any company-specific or unique restrictions to be factored into the cash IPS. These might include covenants or bond indentures that may govern permissible investments.

Second, it is important to assess company priorities. To that end, ask the questions: What is the general course of the company and where is cash likely to be deployed (e.g., toward acquisitions, to fund operations or more likely toward capital expenditures)? Answering these questions can help to ensure that the company's treasury staff, are sharply attuned to the broader objectives of the firm. Of equal importance is obtaining a good understanding of the company's outlook, taking into account the organisation's view of the economy and the industry in which it functions. When constructing a cash portfolio, it is important to understand how and when the company may potentially need cash. Forward knowledge of a cash need – be it months, weeks or just days ahead – can have a beneficial impact on expected returns. Having a thorough grasp of expected liquidity needs often can provide more opportunity for excess returns with less risk than a broader set of allowable investments in longer or lower-rated securities, but with uncertain needs.

From there, treasury and finance staff are better equipped to judge the overall make-up of the company's cash, a central concept when developing an IPS. In fairly simplistic terms, a company's cash can fall into three distinct categories:

- ▶ **Operating cash**, working capital required to meet daily needs of the business.
- ▶ **Core cash**, which is generally earmarked for unknown future needs of the company.
- ▶ **Strategic cash**, the stable balance sheet assets not intended for specific expenditures. While still 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.

CATEGORIES OF CASH

	Operating cash	Core cash	Strategic cash
Investment horizon	0–6 months	6–12 months	12–24 months
Categories of cash	Regular access to cash	Occasional access to a portion of cash	Varies; accessibility determined prior to investment
Investment focus	Liquidity	Regular liquidity, incremental return	Optimisation of returns

There are many questions to be answered when developing an IPS.

Among them:

- ▶ How does the company identify and measure risk in cash investing?
- ▶ How much risk is the company willing to take in its cash accounts?
- ▶ What is the company's cash investment objective?
- ▶ What is the appropriate benchmark for the company's cash portfolio?
- ▶ Should the assets be managed internally or by an external manager?

Important considerations

Each company's cash investment policy will be as unique as the company itself, factoring in the firm's liquidity needs, the general state of the industry in which it operates, broader economic trends and the size of the cash pool. The firm'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 several important factors that all corporations should take into account when developing a policy. Each of them – risk tolerance, portfolio objective, benchmark and investment manager – is described here.

RISK TOLERANCE

Risk tolerance is arguably the most important criterion upon which to begin building a cash investment policy. As a first step, company management must determine if the key priority is preservation of capital or maximisation of returns. This determination may be made for cash as an asset class or for each category of cash the company maintains (i.e., operating, core and strategic). As a next step, consider whether, within each category, there is an ability to weather any deterioration in liquidity.

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

TYPES OF RISK

Primary Risks	Definition	Factors
Credit Risk	Risk that a security's value will change due to a ratings downgrade or, in the case of a distressed security, default	<ul style="list-style-type: none">▶ Rating downgrade▶ Default
Interest Rate Risk	Risk that a security's value will change due to a change in interest rates or the shape of the yield curve	<ul style="list-style-type: none">▶ Change in the level of interest rates▶ Change in the shape of the yield curve
Liquidity Risk	Risk that arises from the difficulty of selling an asset; security cannot be bought or sold quickly enough to prevent or minimize a loss	<ul style="list-style-type: none">▶ Secondary market bid availability
Spread Risk	Risk of change in value of a security due to a change in the relative spreads in the market	<ul style="list-style-type: none">▶ Hybrid of credit and liquidity risk

Conventional investment wisdom suggests that higher returns are accompanied by higher levels of risk. However, as noted above, there are different types of risk to consider, some of which may be more tolerable than others given the potential reward. Quantifying such variables can be a difficult task, but considering these questions can help corporate treasury groups frame their company's risk tolerance:

- ▶ What types of risk are acceptable? Can the company cope with lack of liquidity for a short or extended period of time? Is there ever a circumstance where loss of principal is acceptable?
- ▶ Is the company prepared to weather volatility in returns? If so, how much is acceptable – monthly, quarterly or only annual bouts of volatility?
- ▶ How does the business perform in different market cycles? And, to what extent is this correlated to the investment markets?
- ▶ How much diversification of investments is desired? It is not uncommon for a policy to incorporate parameters that do little to contain risk-taking, but do limit the portfolio in terms of diversification. Does the company have the means to access and manage a diverse mix of investments?

The dialogue surrounding these questions can help ensure that company management is aware of the risks associated with their cash investment policies and the potential consequences of market or industry events.

PORTFOLIO OBJECTIVE

Based on the company's risk tolerance, market views and liquidity needs, corporate treasury groups are faced with the task of establishing objectives for their companies' cash portfolios. A portfolio objective can be quantitative (e.g., seek returns that exceed a defined market hurdle) or qualitative (e.g., focus on safety and liquidity). In either case, the objective should be specific enough to guide the company's choice of investments, but flexible enough to allow the company to take advantage of tactical opportunities that the cash and fixed income markets might present.

This is not to say that a corporation must establish a single objective for the management of its cash. In fact, as stated earlier, multiple objectives are often warranted. Ultimately, these objectives will guide portfolio construction and help the company to appropriately divide its cash assets into operating, core and strategic buckets.

Importantly, any given corporation might have multiple cash pools, each with a distinct purpose, such as those noted to the right. It is possible, and often more efficient, to manage multiple pools within a single portfolio; however, it is necessary to identify the purpose of and to establish an appropriate investment objective and risk profile for each pool within the context of the overall portfolio.

Ideally, the portfolio objective(s) also should address the question of 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. There are ramifications to either approach, as outlined in 'The Question of Duration' on the following page.

ACCORDING TO THE CFA INSTITUTE

"The investment profession has long recognised that the combination of several investments is likely to provide a more acceptable level of risk exposure than having all assets in a single investment. The unique characteristics (or risks) of an individual investment may be partially or entirely neutralised when combined with other investments within a portfolio. Some reasonable amount of diversification is the norm for many portfolios, especially those managed by individuals or institutions that have some degree of fiduciary responsibility."

Common examples of cash portfolio objectives:

- ▶ Preserve principle
- ▶ Meet forecasted cash flow needs
- ▶ Provide income/yield
- ▶ Provide tax-advantaged returns
- ▶ Deliver prudent, risk-managed total return
- ▶ Seek above-benchmark returns
- ▶ Provide increased levels of diversification

Of final note, when establishing an objective for cash balances, consider the accounting associated with capital gains and losses and the tax implications when gains are realised. In most cases, a total return strategy will require more frequent portfolio turnover. This will equate to more accounting entries and the realisation of capital gains that can affect a company's reported profitability. In addition, if the company is working with a broker who is paid on a per-trade basis, higher turnover will result in an incremental increase in management costs.

BENCHMARK

A benchmark offers a means for comparing and measuring portfolio performance and risk. Importantly, 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 alone does not constitute a benchmark. Generally speaking, every benchmark should be transparent and measurable, meaning it should be comprised of well-defined securities with readily available prices quoted on a daily basis. By definition, a benchmark must exhibit a certain 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.

When choosing a benchmark, consider the impact of your decision on future performance comparisons. Because of the custom constraints and guidelines typically imposed on a corporate cash portfolio, most will often sacrifice yield-enhancement opportunities in favor of ensuring that the company's larger goals of capital preservation and liquidity are maintained. In contrast, most fixed income credit indices are total return-oriented and may have components that would be inappropriate for a cash portfolio. For that reason, the indices will often generate returns that exceed those of a more conservative cash portfolio. Considering the impact of your 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 you to better match those portions of the portfolio that are intended to be more liquid.

THE QUESTION OF DURATION

Every IPS should factor in the desired duration strategy for the company's cash portfolio. Most often, this will be a choice between targeting a specific duration or a buy-and-hold approach:

Target duration. Making adjustments to target a specific duration can expose a portfolio to high turnover. This can be a concern if the company's management arrangement is such that costs are incurred per trade. In addition, trades to bring a portfolio in line with its benchmark could be subject to interest rate risk if the yield curve shifts up unexpectedly. That said, the effect of a change in interest rates or a shift in the yield curve should also be reflected in the composition of the portfolio's benchmark. For a longer-dated portfolio, a total return strategy measured against an appropriate benchmark is the best tool for measuring the effectiveness of the investment strategy, serving to accurately evaluate both the principal value and income portions of performance.

Buy and hold. A buy-and-hold strategy is usually more appropriate for a capital preservation or short-dated portfolio, or one that is subject to liquidity requirements. Buy-and-hold strategies traditionally are yield-focused and do not have the gain/loss considerations of an actively managed portfolio. This may preclude tactical opportunities that could enhance performance. The potential impact to yield is usually acceptable in buy-and-hold strategies given the portfolio objectives of capital preservation and liquidity.

INVESTMENT MANAGER

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

Given the resources and expertise required, internal management is most commonly seen with companies that manage very large, core cash portfolios over a long time horizon. Typically, in this model, internal staff work with a broker (or series of brokers in an effort to achieve more competitive pricing) to execute transactions.

An external management model generally involves a registered investment advisor (RIA), a professional investment manager who has the authority to participate in the creation, execution and maintenance of the company's cash investment policy. By definition, RIAs 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 may not be RIAs and are not required to act as a fiduciary for clients.

For many firms, hiring an investment advisor to manage some or all of their cash has become a logical move given the intricacy of today's fixed income markets and cost-conscious managements' focus on establishing key strategic partnerships. In any case, the same criteria should be applied whether considering an in-house or external management arrangement.

Questions to consider include:

- ▶ Is the chosen investment manager, whether internal or external, equipped to manage the company's expectations as well as the various degrees and types of risk, including credit risk, interest rate risk, liquidity risk and headline risk?
- ▶ Does the chosen investment manager have the 'proven' credit research and risk-management capabilities necessary to provide the level of security analysis required in today's increasingly complex marketplace?
- ▶ Does the investment manager have the ability to leverage size and scale to access a broad range of sectors or securities in order to ensure the level of portfolio diversification that your company desires?
- ▶ Does the investment manager have the trading experience necessary to build, oversee and maintain a portfolio (or multiple portfolios) of short-term fixed income assets?

INVESTMENT MANAGEMENT: MAKING THE RIGHT CHOICE FOR YOUR COMPANY

Corporate treasury groups might consider the following points to assist in making a well-informed decision regarding the most appropriate type of management for their company's cash accounts:

Goals. Is the company ready to move beyond money market mutual funds? Often these vehicles are the easiest way for treasury groups to invest excess cash while still maintaining daily access to their funds and achieving a competitive return. However, the ability to move beyond money funds offers the potential for excess returns for those institutions that are willing and able to take that next step.

Personnel considerations. 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 optimal results. Ensure that the company or the external cash manager has access to these capabilities.

Components of an IPS document

Each cash IPS will be unique in its details. However, the basic components are likely to be very similar across firms. It is important to carefully evaluate each component of the IPS to rule out the possibility that related guidelines may contradict one another. In addition, 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 IPS.

COMPONENTS OF A TYPICAL CASH INVESTMENT POLICY STATEMENT

1. Definition of portfolio

- ▶ Who is managing the portfolio

2. Investment objective

- ▶ Qualitative
- ▶ Quantitative

3. Benchmark

- ▶ Performance target
- ▶ Risk target

4. Maturity/duration guidelines

- ▶ Maximum maturity (may differ across sectors)
- ▶ Average duration for portfolio
- ▶ Weighted average life for asset- and mortgage-backed securities

5. Asset guidelines

- ▶ Specifically define allowable investment types and sectors

6. Asset allocation

- ▶ Define issuer and sector limitations

7. Credit criteria

- ▶ Short term vs. long term
- ▶ Quality (may differ by sector/asset class, e.g., only AAA-rated ABS, but A-rated corporates)

8. Other investment practices

- ▶ Repurchase agreement guidelines

9. Reinvestment of income

10. Custodian

- ▶ Determined by the company

11. Accounting agent

- ▶ Your investment manager's reports are to be used only for reconciliation and performance purposes
- ▶ Your custodian and/or accounting agent is the official record keeper for the portfolio

12. Other vendors

- ▶ Investment consultant
- ▶ Treasury consultant
- ▶ Compliance/reporting systems



The importance of a well-documented and up-to-date cash investment policy cannot be overstated. The IPS 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 IPS paves the way for successful administration of the company's cash. For assistance with your company's cash IPS or to learn more, contact your BlackRock® representative.