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Making treasury cash work harder

By Craig Inches, Head of Rates and Cash

Most treasury investors aim to strike the right balance between liquidity and security, with investment return (yield) an important, but secondary consideration. However, security and liquidity on the one hand and yield on the other aren't mutually exclusive. We've had this conversation with many clients and helped them to optimise their treasury portfolios.

What's the portfolio for?

Let's consider some key questions. Is the money needed for day-to-day-expenditure? Is there a project or deadline for which these funds will be required? Are they currently unallocated, with their use to be defined at a later date? What is your attitude to risk? You may find that you can break down your treasury portfolio into different components, based on when each will be needed.

Let's look at an example. The University of Life (UL) has £50m invested in our Short Term Money Market Fund, which is for day-to-day liquidity and is our lowest risk fund. UL has been invested in the fund for 12 months and hasn't needed to draw on these funds on a regular basis. By considering the key questions, could this money be working harder for the benefit of the university?

- **Is the money needed for day-to-day-expenditure?** On current usage, the answer is no and, as long as this doesn't change, we can think slightly longer term about these funds.
- **Is there a project or deadline for which these funds will be required?** Most clients earmark treasury cash for certain needs. In our example, UL needs £15m for a capital project that is due to be paid in six months.
- **Are they currently unallocated, with their use to be defined at a later date?** Continuing our example, this leaves £35m currently unallocated; this might have built up from regular cash flows into the fund that can be put to good use until a future requirement is identified.
- **What is the attitude to risk?** The key question in developing a treasury strategy, which is often dictated by a treasury management policy or committee. But on what is the prevailing view based and has it been reviewed recently? Small incremental increases in risk can make a big difference to returns.

Let's talk about risks

Risk is a catch-all term that describes a range of different factors. In the last question, we're talking about two key risks – **interest rate risk** and **credit risk**. The first is the risk that if interest rates rise, this will erode the real value of investments that pay fixed coupons. The measure of interest rate risk is duration; the longer the duration, the more sensitive a fund is to interest rate increases. The second is the risk that companies that we lend to fail to repay.

Within pooled investment vehicles, liquidity risk and concentration are addressed through diversification. Clients can withdraw their money from any of our funds with either a two- or three-working day notice period. The well diversified portfolios help to mitigate the credit impact of any one holding on the fund. In fact, as you move up the range, the level of diversification increases. The Enhanced Cash Fund and Short Credit Fund have on average 150 to 200 issuers, compared with 50 or so in our Short Term Money Market Fund.

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Case study: University of Life

UL currently earns around 0.79% per annum gross of fees from its investment in the Short Term Money Market Fund:

Fund	Yield	Anticipated annual investment gain
Short Term Money Market	0.79%	£395,000

This is a reasonable return, particularly as yield is only a secondary consideration. After all, treasury managers are more concerned about security and liquidity than a few basis points of yield.

But let's look at what UL is leaving on the table. It could invest in different funds appropriate for the various components of its treasury portfolio and their time horizons. These funds could be:

- Short Term Money Market Fund – it's prudent to have some exposure to a very low risk fund in case it needs to redeem unexpectedly (the 'rainy day' fund). Yielding around 0.79% and with very short duration, this fund is appropriate for this purpose. **Allocation: 10%**
- Cash Plus Fund – taking slightly more interest rate and credit risk than the lower risk fund, this fund yields over 1% with duration of around three months. Historical volatility has been very low, so the increase in risk isn't large. This would be suitable for the funds earmarked for expenditure in six months, as well as some of the other capital. **Allocation: 50%**
- Enhanced Cash Plus Fund – by taking slightly more risk again, the portfolio has managed access to some higher yielding corporate bonds, earning an average yield of over 1.5%. There is reasonable confidence that these funds will be in the portfolio in 12 months, but the level of risk remains appropriate and offers materially higher returns than the lowest risk fund. **Allocation: 25%**
- Investment Grade Short Dated Credit Fund – the final component is the highest risk allocation, but also the best diversifier. When treasury portfolios invest in short dated credit funds, this gives exposure to non-bank/financial issuers, such as utilities and energy companies. This helps if there is a shock in the financial sector. However, while this fund only invests in highly rated companies, by taking more credit and interest rate risk, it yields over 2%. **Allocation: 15%**

This is the impact on UL's portfolio yield (gross of fees):

Fund	Yield	£ Invested	Anticipated annual investment gain
Short Term Money Market Fund	0.79%	£5,000,000	£39,500
Cash Plus Fund	1.15%	£25,000,000	£287,500
Enhanced Cash Plus Fund	1.51%	£12,500,000	£188,750
Investment Grade Short Dated Credit Fund	2.08%	£7,500,000	£156,000
Total		**£50,000,000**	**£671,750**

Conclusion

By managing the fund on a compartmentalised basis, taking account of time horizons, UL has achieved a 70% higher investment return, compared to leaving the portfolio in the lowest risk fund. While maintaining lower risk allocations for known redemptions and a potential 'rainy day', it has benefitted from the higher yields available to money which can be invested over a longer period. This would offset the effect of inflation and improve real returns. Furthermore, for clients seeking inflation protection, we offer specific short dated index-linked fund options.

We call this process laddering – funds with incrementally more risk can be seen as the rungs of a liquidity ladder. A key feature of laddering is the ability to create a bespoke portfolio using our well-established and diversified pooled funds, which can be quickly and very easily adjusted according to a client's individual needs. This can increase the client's control over their asset allocation, although equally we are happy to manage this on their behalf.

If you have any questions or you would like to discuss a laddering strategy for your treasury portfolio, please speak to your Royal London Asset Management contact.

Data correct at 30 April 2019 Source: RLAM

Contact us

For more information about our range of products and services, please contact us.

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For more information on the fund or the risks of investing, please refer to the fund factsheet, Prospectus or Key Investor Information Document (KIID), available via the relevant Fund Price page on www.rlam.co.uk

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