NARROW ROAD
CAPITAL

What is “Cash” and Why it Matters

APRA’s letter to superannuation funds in June this year laid bare a concealed and often ignored risk being taken by some fund managers. Funds that are meant to be invested in low risk, highly liquid securities are being invested in medium and high risk securities with limited liquidity. Here’s the key paragraph from the APRA letter:

> *Assets that APRA has observed forming part of cash options’ underlying investments include asset-backed and mortgage-backed securities, commercial bonds and hybrid debt instruments, credit-default swaps, loans and other credit instruments. These assets do not typically exhibit the characteristics necessary to be considered as cash or cash equivalent. There were also exposures noted to cash enhanced vehicles without sufficient policy guidance as to the permitted holdings of these vehicles.*

It doesn’t help that that there are many different definitions of what constitutes a cash security and misunderstandings of the purpose for cash holdings. Terms like “cash”, “enhanced cash” and “investment grade” do have precise meanings to those who are working with the underlying securities on a day to day basis. However, these definitions can be blurred in sales pitches and as strategies work their way through an investment approval process. This article lays out the purpose of “cash”, “enhanced cash” and “investment grade” funds in a portfolio and the types of securities that are suitable for each of those funds. There’s also some commentary about the pitfalls of getting cash investments wrong, which is particularly pertinent now that we are ten years on from the failure of Lehman Brothers and the tumult that followed its failure for cash funds.

Cash Funds

Cash funds hold the operational cash of a portfolio and as such, funds can be called upon at any time. Publicly offered cash funds typically offer same day or next day liquidity. To match the potential liquidity requirements cash funds must only invest in short term securities (twelve months maturity or less), which also have the ability to be sold or redeemed quickly without substantial bid/offer spreads. Cash funds are likely to have a mixture of at-call accounts, bank bills, commercial paper and similar securities. Government, corporate and securitisation bonds that are highly liquid and have a firm maturity within twelve months may be considered for a small portion of the total portfolio. As term deposits now have restrictions on early redemptions, this limits their use in cash funds to a minimal portion.

As well as being highly liquid, the securities in a cash fund must also be extremely capital stable. In the balance between risk and return, cash funds must choose low risk securities that have almost no possibility of defaulting or suffering any meaningful mark to market loss. This limits investments to securities with short term credit ratings of A1+ and A1, and securities with long term credit ratings of AAA, AA and A.

Enhanced Cash Funds

The difference between enhanced cash funds and cash funds comes down to the expected use of the funds. Enhanced cash funds are used to hold capital that is expected to be invested in other asset classes in the medium term. This could be shares, property, infrastructure, private equity or other investments subject to capital calls. As these asset classes involve material mark to market volatility it is reasonable to invest in a fund that takes a small amount of capital risk whilst awaiting redeployment elsewhere. Enhanced cash funds may also be used as a long term allocation for very conservative investors who are uncomfortable with the risks of investment grade funds and other asset classes.

As the expected time horizon for enhanced cash funds is longer than cash funds it is reasonable for an enhanced cash fund to invest in some securities that have maturities beyond twelve months. Ideally this is limited to three years, but

there are examples of funds that cap at five years or (wrongly) have no maturity limit and include perpetual securities in their portfolios. The same credit rating restrictions should apply as for cash funds, though some managers will push into BBB rated securities, which carry an increased but still low risk of defaulting and suffering capital loss.

Investment Grade Funds

These funds differ from cash and enhanced cash in that the capital is a core and long term allocation within the portfolio. The fund manager is therefore able to invest with a three to five year outlook and a reduced focus on short term liquidity. To be true to label, credit ratings must be a minimum of BBB-. In some cases, managers will be allowed to invest in securities that do not have a public credit rating but where the debt has all of the underlying characteristics necessary for an investment grade rating. Hybrid and preference share instruments are not appropriate securities for an investment grade fund or any type of cash fund due to their inclusion of equity features.

Sub-investment grade buckets are an increasingly common inclusion, often with a limit of 5-10%. Including sub-investment grade securities in an investment grade fund is likely to substantially increase the potential for capital losses and mark to market volatility. They are also inconsistent with their label, something regulators are likely to take a dim view of even if they are clearly disclosed. Another risk is that managers focussed predominantly on investment grade securities may not have the credit skills and market knowledge to deliver good outcomes from sub-investment grade securities.

As well as additional yield gained from taking greater credit risk, investment grade funds can also take advantage of the illiquidity premium. In the Australian context, investing in low risk securities that are highly illiquid is the primary pathway to achieving substantial outperformance of an investment grade index. Some investment grade funds limit maturities to five or seven years but many do not have a stated maturity limit.

Lesson from the Financial Crisis

The financial crisis shook credit markets with two standout lessons for capital allocators and investors considering their cash fund options. First, some cash funds had lost their focus on capital preservation and were caught out when Lehman Brothers defaulted in September 2008. These funds should have sold out of Lehman Brothers securities long before the default as rumours of its demise increased. For the sake of a few extra basis points of yield these funds ended up losing millions.

The second key learning was the mismatch between the liquidity of the securities in some funds and the liquidity offered to investors in the fund. This problem has been likened to a fire in a theatre where patrons are hurt rushing for the exits and not from the fire itself. Open-ended enhanced cash and investment grade funds are particularly vulnerable to this risk. Once mark to market losses occur there will inevitably be redemptions. If the outflows are faster than the underlying investments can be sold, or if the buy/sell spread isn't a fair estimate of the cost of trading, investors that stay will suffer losses that should have been attributed to those who left early.

Conclusion

APRA's letter to superannuation funds was a timely reminder of the importance of cash funds restricting their holdings to highly liquid and very low risk securities. Cash, enhanced cash and investment grade funds each serve a different purpose within a superannuation fund or individual investor's overall portfolio. Capital allocators and investors should ensure that their cash funds are fit for purpose and their managers are investing in securities that reflect that purpose. Great care should be taken with open-ended funds that are investing in securities that are or could become highly illiquid when the next downturn occurs.

Written by Jonathan Rochford for Narrow Road Capital on September 19, 2018. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

Disclosure

This article has been prepared for educational purposes and is in no way meant to be a substitute for professional and tailored financial advice. It contains information derived and sourced from a broad list of third parties, and has been prepared on the basis that this third party information is accurate. This article expresses the views of the author at a point in time, and such views may change in the future with no obligation on Narrow Road Capital or the author to publicly update these views. Narrow Road Capital advises on and invests in a wide range of securities, including securities linked to the performance of various companies and financial institutions.