Rationalize Your Liquidity Premium

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Many will read the title above and feel the way some do when talking with a mechanic about what might be wrong with their automobile. The words are all used in the English language, but what do they actually mean when strung together? Much like changing the oil is beneficial in keeping a car from breaking down in the first place, establishing a regular habit of analyzing your investment opportunity cost (liquidity premium) will keep an investment portfolio out of trouble and optimized to the current market reality.

As shown in the process and example below, this rationalization can actually lower risk while simultaneously increasing liquidity and yield. Conversely, crossing your fingers and hoping the investment portfolio continues to function normally long after an oil change is due runs the risk of not only foregoing an increase in yield and lowering of risk, but could also leave a strategy in place that is actually working in opposition to your stated objectives. That is a situation that may be difficult to rationalize.

Introduction

The last few years have painfully exposed many investment strategy weaknesses. Largely in response to the hard lessons learned, treasury groups are now establishing a regular, documented process to compare their current investment strategy to their operational goals in light of preservation, liquidity and return.

This process has been refined to include three simple, but very important, steps:

1) Articulating the current strategic and operational liquidity goals.

2) Comparing the current strategy to what the Investment Policy allows to calculate the liquidity premium.

3) Considering alternatives to determine the best strategy to achieve stated goals.

When applied on an annual or (more effectively) semi-annual basis, this process will, at the very least, create new insight into the current assumptions and investment of cash. At best, it has the ability to uncover risks, improve liquidity and effectively increase return that would otherwise have been missed completely.

Articulating the current strategic and operational liquidity goals.

The liquidity needs of most entities are generally oversimplified: *cash investments must be available whenever needed.* Some have a very precise and reliable cash needs forecast or cyclicality. Some have wide variance in expectations and reality. All are tasked with the burden of preparing for what might be.

These examples may sound quite familiar:

- *We might need to liquidate everything for the right M&A opportunity.*
- *We might need to liquidate a portion of the investments if we don't meet sales goals.*
- *We might issue a special dividend.*
- *We might have an opportunity to retire debt.*
- *We need to keep our powder dry for what might come along.*

Whatever these needs and directives may be, they are rarely static. Updating, refining and clarifying these needs is key to rationalizing any investment strategy and is the main reason this type of analysis is best accomplished more frequently.

While it may be difficult to define liquidity needs succinctly, the simple exercise of attempting to do so will help to determine whether the current liquidity premium being paid is fully or partly rational.

Comparing the current strategy to what the Investment Policy allows to calculate the liquidity premium.

The treasury team, investment committee, or board has already delineated the level of risk deemed acceptable for cash investments in the Investment Policy. Once in place, this document should be periodically reviewed and updated to reflect the current markets.

Regularly comparing the limits of the Investment Policy to the current position of the portfolio is a critical exercise. There will likely always be a difference in what an Investment Policy allows for and how excess cash is actually invested. Whether due to capital needs, temporary liquidity crunches or simply market nervousness, it is rare to find an investment group with their pedal fully to the metal on yield maximization.

To calculate the liquidity premium, the difference between what is currently generated and what is possible within the constraints of the Investment Policy is multiplied by the size of the portfolio.

This dollar cost has been referred to more recently not only as opportunity cost, but as a “liquidity premium” because it is considered a real cost companies are paying to maintain a certain type of liquidity.

A “type” of liquidity because the relative liquidity of instruments can change dramatically over time (Auction Rate Securities, money funds and bank deposits). By translating the liquidity premium into real dollar terms, a team can compare their actual portfolio liquidity to its cost. This analysis can result in enlightenment or possible shock.

As an example, if a policy currently allows for a strategy that could earn 50 basis points more than is currently being earned, that equates to $500,000 per $100 million of investments. A total portfolio of $400 million would equate to a total liquidity premium of $2 million per year.

Whether that liquidity premium is truly shocking or enlightening depends on the subsequent steps and analysis. The rationalizing comes through ascertaining whether that cost is the right one based on current needs and market conditions.

Considering alternatives to determine the best strategy to achieve stated goals.

This is where most risks and flaws are discovered and is also where investment groups have the greatest difficulty assessing and updating the risks and educating their boards as to the current realities.

Once the liquidity premium is determined and the objectives are defined, this is the process of assessing how effectively the current investments are working to accomplish the stated goals. It’s where the rubber meets the road in thinking about whether paying the $2 million per year in the earlier example actually makes sense or if the right number is something different. The variable in this section is the investible market and all of its many facets.

It was not too long ago that Auction Rate Securities were considered short-term investments, money market funds were considered infallible, bank deposits went from not guaranteed to 100% guaranteed to not guaranteed, and AAA rated companies were far more plentiful than the three remaining in the category today.

The markets, the asset classes, the credit ratings, and the particular securities are constantly in flux. Some glacially and some explosively. That is the very nature of risk; nothing is truly guaranteed or static. It is the accurate and regular review of these factors that is necessary in determining the appropriate risk and return characteristics of any investment strategy – current or proposed.

Process Example

In order to illustrate how a company could apply this framework, the following is a hypothetical example using the market rates and conditions prevalent in the early part of 2014.

ABC Corporation, like many after the tumult of 2008 retreated into all government money funds in order to

maximize preservation and liquidity. Subsequently, this corporation took advantage of the US Treasury's TAG (Temporary Asset Guarantee) Program and expanded their investments into guaranteed bank deposits. As the markets calmed and the economy showed signs of recovery, the investments expanded to mix in some prime money funds and to continue to take advantage of the bank earnings credits after the TAG expired given the increased confidence in the banking system. At the outset of 2014, the board allowed the treasury group to selectively purchase commercial paper from A-1/P-1 rated corporations.

Now the three steps:

1) **Articulating the current strategic and operational liquidity goals.**

- Recently, ABC Corp.'s board and CFO have told the treasury group (and the public) that they are continuing to examine strategic moves (potential M&A), have approved a continuation of their stock repurchase program, and are hesitant to "lock money up" in longer term investments or separately managed accounts. Outside of the potential deal, the cash forecast is relatively stable with a 5-10% historic variance to projection.
- ABC Corp. has an operational cash budget of roughly $200 million and is planning on purchasing a previously issued convertible bond toward the end of the year for $100 million.

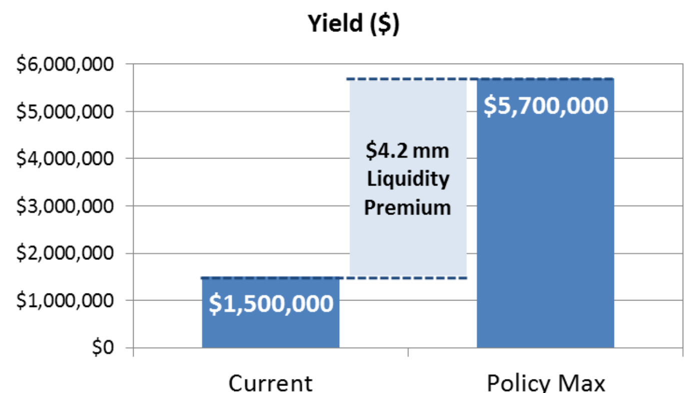
2) **Comparing the current strategy to what the Investment Policy allows to calculate the liquidity premium.**

As of May 2014, ABC Corp.'s aggregated investments are earning a weighted-average 25 basis points (including heavy usage of earnings credits).

- The US Govt. money market funds are earning close to 0 but are (outside of an unanticipated possibility of a run on the funds) same-day liquid.
- Prime funds currently hold European financial exposures between 40% and 60%. While the company has no control over what the funds invest in, the funds *should* be (outside of an unanticipated possibility of a run on the funds) same-day liquid and are earning 10 basis points.
- Bank earnings credits are still around 25-35 basis points but are no longer guaranteed and increased usage has required more regular and strenuous counterparty risk analysis. Despite straining the resources of the treasury group and concentrating investment risk well above the 5% maximum per issuer allowance in the Investment Policy, these deposits have been exempted due to the theoretical same-day liquidity.
- Commercial paper has been a recently approved welcome diversification but earns only 15 basis points on average while taking up a sizable amount of resource bandwidth to complete credit analysis that is periodic at best.

What does the current Investment Policy allow?

- ABC's approved Investment Policy allows for securities with a 3 year maximum maturity, 1.5 year weighted average maturity for the portfolio, a minimum credit rating of single A, AA weighted average credit rating and the usual priorities of preservation, liquidity and then return.
- If maxed out, this would allow for a portfolio earning 95 basis points. The 70 basis point spread from their current 25 basis point earnings equates to $700,000 per $100 million.



- *ABC Corp currently holds $600 million in cash meaning they are paying a liquidity premium of $4.2 million per year! Is that worth paying? If not, what is the right number? How will company and market conditions affect that expectation? The next two steps will help determine that answer.*

3) **Considering alternatives to determine the best strategy to achieve stated goals.**

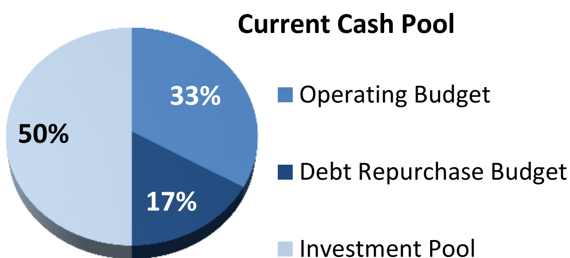
Regardless of the magnitude of the current liquidity premium, no treasury group would recommend allocating all of ABC Corp.'s $600 million to the maximum allowable duration.

That said, paying $700,000 per $100 million on even the $300 million outside of the operational budget and debt repurchase alone still equates to $2.1 million per year.

Is there a solution that can accomplish all of the stated goals that closes the gap while still providing for the potential total liquidation?

Potential Investment Strategy

Segregate the cash into buckets and invest according to each bucket's particular goals:



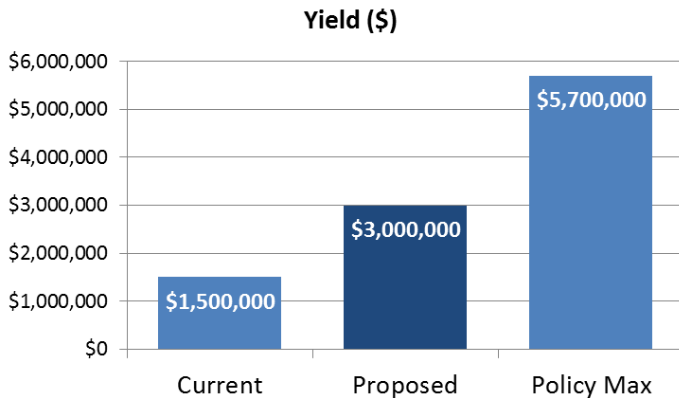
- $200 million Operating Budget: this can be kept in money funds and bank deposits (0-25 basis points) OR invested in securities matching the cash flow projections (also 15-30 basis points).
- $100 million Debt Repurchase Budget: this can be invested as a bullet maturity occurring before the actual debt repurchase date (20-40 basis points depending on security type).
- $300 million remaining Investment Pool: even a conservative 0-2 year strategy with a AA average containing minimal financial names should earn at least 50 basis points while still providing liquidity in less than one business week.

How does this potential strategy affect preservation, liquidity and return?

- Preservation: This strategy gives you more transparency and control of the specific credits and investments (relative to money funds) and is much more diversified than highly concentrated bank risk. Over time, curve-roll and seasoning will allow the portfolio to withstand yields spikes.
- Liquidity: Choosing conservative investments will allow the Investment Pool portfolio to be entirely liquidated in less than five days. Controlling and diversifying exposures into high-quality credits will result in a greater ability to liquidate positions in times of market stress.
- Return: The new portfolio could be earning a weighted average yield between 40 and 50 basis points ($400,000-$500,000 per $100 million).

How would this change the liquidity premium?

- The current portfolio is earning 25 basis points ($1.5 million on the $600 million total portfolio).
- The maximum possible is 95 basis points ($5.7 million on the $600 million total portfolio).
- The proposed portfolio is 50 basis points ($3 million on the $600 million total portfolio).



This new strategy would meet all of the proposed objectives while maintaining adequate liquidity and providing an additional $1.5 million per year.

Conclusion

When applied on an annual or (more effectively) semi-annual basis, this process will, at the very least, create new insight into the current assumptions and investment of cash. At best, it has the ability to uncover risks, improve liquidity and effectively increase return that would otherwise have been missed completely.

While there may not ever be one completely correct answer, some solutions will always be better than others.

Please contact us with questions or for help creating alternative scenarios or thinking through their risks/benefits.

Disclaimer

The information provided in this article is the result of experience with investment strategy planning. It is only intended to inform and provide a discussion framework that investment professionals can use to review their investment strategies. Hypothetical situations, including fees and returns, are purely for illustration purposes and not intended to be relied upon. Different market and economic conditions could have a material impact on performance. The risks inherent in any investments may lead to material loss of capital. The choice of index and investment strategy and objectives may have a material impact on performance results. Hypothetical results do not necessarily reflect returns that actual investors receive. This material is based upon information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon as such.