ENHANCED CASH FUNDS

A market that continues to grow and innovate

More and varied enhanced cash funds have come to the marketplace in recent years, aiming to offer clients with more stable cash balances the opportunity to increase returns. Investors must consider the risks being taken to achieve higher returns and the current issues when comparing available products

Most enhanced cash funds differ from traditional AAA rated liquidity funds in a number of ways. They may take more interest rate risk by managing the portfolio with a longer duration, they may take greater credit risk by managing the fund at a AA or single-A level, or they may take structural risk through the use of asset-backed securities and will typically offer less liquidity. This increase in risk and reduction of liquidity offers investors the opportunity to enhance returns.

Asset-backed securities are an ideal asset type for enhanced cash funds. Asset backed securities are a form of debt financing that involves the sale of specified assets, known as the collateral, into a bankruptcy remote vehicle or trust. The trust issues notes to investors to finance the purchase of the assets. The cash flows associated with the collateral, which may be mortgage payments, credit card or auto loan payments, are used to pay interest and principal back to investors.

SECURE ADVANTAGE

Using asset-backed securities in enhanced cash funds has a number of advantages. The interest rate risk or duration is similar to a money market instrument. The volatility of returns from interest rate moves should be fairly low, but a yield premium is available over money market assets. Rating agency data shows that the rating volatility of asset-backed securities is lower than bank or corporate credit ratings across the rating spectrum. This typically means that the credit spreads on asset-backed securities are less volatile than spreads on bank or corporate assets. This will again reduce the volatility of returns for a fund that uses asset-backed securities as part or all of its investment strategy. Low volatility of returns is important for cash investors. Asset backed deals typically have "tranches" across the rating spectrum from AAA to BBB and beyond. This means the asset class is very flexible allowing investors to take structural risk and credit risk in one investment.

Table One: Enhanced products key characteristics

	AAA Liquidity Funds	Cash Plus Funds	Enhanced Cash Funds	Ultra short bond funds
Typical duration range	<60 days	<180 days	<1 year Usually 0.5-1 yr	<2 years Usually 0.5-2 yr
Minimum credit rating	Short-term A-1/P-1	Short-term A-1/P-1 Long-term A-	Short-term A-1/P-1 Long-term BBB	Short-term A-1/P-1 Long-term BBB
Minimum investment horizon	Daily	3-6 months	>6 months	>6 months
Active duration management	Very limited	Limited	Active	Active
NAV volatility	Stable NAV	Stable NAV or floating NAV	Floating NAV Range 0.5-1.0% change over 12 months	Floating NAV Range 2-3% change over 12 months

Source: iMoneyNet and BGI, 30/09/06

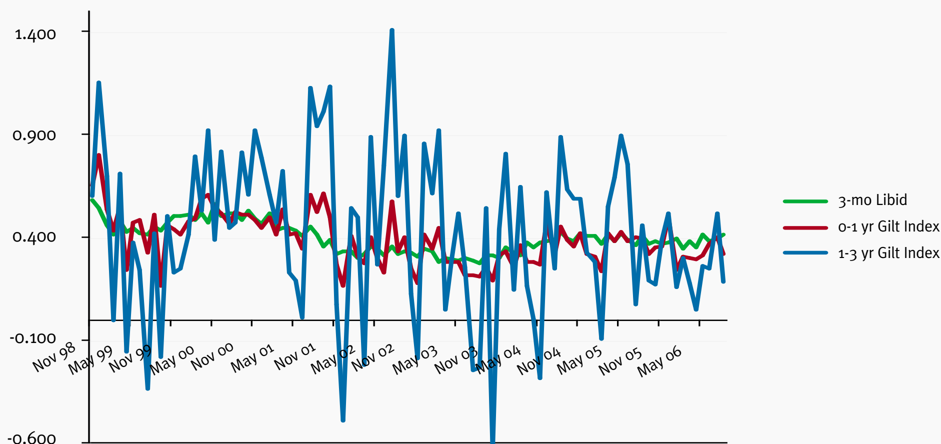
Most enhanced cash funds are less homogeneous than the traditional AAA rated liquidity funds and their risk profiles much more diverse. This means defining an "enhanced cash" fund is challenging. This in turn can cause confusion for potential investors in these products. iMoneyNet Inc, an independent provider of data and research for money market funds, has researched the enhanced cash sector and segmented it into three buckets. Table One shows the buckets and some key characteristics of each category.

Compared to a typical AAA rated liquidity fund, Table One clearly demonstrates the enhanced products' more aggressive investment strategy in terms of interest rate and credit risks as well as the reduced liquidity.

So, what risk factors do investors need to consider when investing in this type of fund?

An increase in interest rate risk is likely to lead to an increase in the volatility of returns. This can clearly be seen from the graph, that shows the monthly returns of 3-month Libid, a 0-1 year Gilt index and a 1-3 year Gilt index. The volatility of returns for the 1-3 year Gilt index, which has a duration of around 1.7 years, is greater than the volatility of the 0-1 year index which has a lower duration of around 0.5 years.

Analysis of monthly returns



Source: BGI and Merrill Lynch. For illustrative purposes only.

In turn, the 0-1 year Gilt index has a greater volatility of returns than the three-month LIBID index, which has a duration of around 0.25 years. The greater the duration of a fund, the greater the potential for negative monthly and quarterly returns.

TIME FACTOR

It can therefore be noted that risk and volatility of returns are greater with added duration but, over time, returns are likely to be higher. This can be seen from Table Two: annual returns of the 1-3 year Gilt index, the 0-1 year Gilt index and 3-month Libor (London Interbank Offered Rate). It should also be observed that during periods of rising interest rates the longer duration indices produce lower returns and vice versa during periods of falling interest rates.

Credit risk is also an important factor to consider. Moving down the credit spectrum and out the maturity curve is likely to increase the volatility of returns. Previous credit cycles have demonstrated greater credit rating volatility in lower-rated credits and hence greater credit spread volatility. This will feed through into greater volatility of fund returns. It is also important to consider liquidity risk when moving down the credit spectrum to issuers with lower ratings. Typically, lower-rated and longer maturity assets will be less liquid than an equivalent maturity government security.

Investing in issuers of lower credit quality will add risk to a portfolio but over time returns are likely to be higher. Comparing the returns of a one to three-year broad index that includes issuers from AAA to BBB with the same maturity Gilt index demonstrates this (see table three).

When considering funds that use asset-backed securities for all or part of their strategy, there are some important risks to consider. Firstly, liquidity risk may be greater. The cost of raising liquidity will be greater as the bid/offer spread of asset-backed securities is typically greater. However, this has narrowed in recent years as more investors have entered the marketplace. Secondly, there is structural risk in asset-backed securities. Asset-backed securities may cross a number of legal jurisdictions and a change in a law for example may lead to a wholesale revaluation of the sector.

As the universe of enhanced cash funds continues to expand, there are a number of interesting developments taking place in the market.

USEFUL TOOLS

Derivatives are beginning to be used in the more sophisticated products. Recent changes to the Ucits (Undertaking for Collective Investment in Transferable Securities) regulations now allow the use of derivatives in Ucits regulated funds. It is common for the use of derivatives to raise concern among investors. In many cases, however, derivatives are simply a different way of implementing an investment strategy. As long as the manager has experience in using derivatives and the necessary risk controls in place, they can be very useful tools for implementing portfolio strategies efficiently, hedging risk as well as taking active positions.

Table Two: Annual returns

	2000	2001	2002	2003	2004	2005
1-3yr Gilt index return	8.195	6.176	6.593	3.356	4.636	4.983
0-1yr Gilt index return	6.34	5.418	4.12	3.391	4.229	4.566
3-month LIBOR	6.206	5.502	4.016	3.687	4.642	4.757

Source: BGI and Merrill Lynch, 31/12/05

Table Three: Comparing returns

	2000	2001	2002	2003	2004	2005
1-3yr Broad index return	8.544	6.509	6.832	3.932	4.895	5.086
1-3yr Gilt index return	8.195	6.176	6.593	3.356	4.636	4.983

Source: Merrill Lynch, 31/12/05

Leading asset managers including Barclays Global Investors is looking to develop further its range of enhanced cash strategies by seeking to employ a number of different types of derivatives such as interest rate swaps, exchange traded futures, total return swaps and credit default swaps, as additional sources of return.

For example, interest rate swaps and exchange traded futures may be used to implement a quantitatively based interest rate overlay strategy.

Using these derivative instruments is more efficient and cost effective than using the physical bonds. Total return swaps would be used to gain immediate exposure to the asset backed market rather than purchasing the physical assets, which could take longer to gain similar exposure.

This would help to avoid "cash drag" in the fund. Cash drag is the name given to the phenomenon whereby cash is invested in money market instruments that offer a lower premium than asset backed securities as the portfolio of physicals is built up over time, thus creating a "drag" on the funds performance.

SYSTEMS IN PLACE

Credit default swaps might also be used, for example, to hedge assets if our opinion on the credit quality of the asset changed. As liquidity improves in the asset backed credit default swap market, it is expected that CDSs will be cheaper to use than selling the asset outright. However, derivatives are not without their specific risks. Controls and systems must be in place to manage counterparty and correlation risk inherent in the use of these instruments.

John Curry, Barclays Global Investors

Traditionally, a simple average of overnight, 1-month or 3-month Libor rates have been used as benchmarks. However, a recent development, and one we expect to gather momentum, is the use of total return indices, rather than simple average numbers as the standard benchmark for enhanced cash funds.

There are a number of different total return indices available that are suitable for enhanced cash funds. The best index to use will depend on the investment strategy of the fund. For example, JP Morgan, Citigroup and Merrill Lynch all produce short-term, total return cash indices. The advantage of these is that, unlike a Libor benchmark, they use mark-to-market accounting which mirrors the accounting of the majority of enhanced cash funds. Having a fund and benchmark that use different accounting methodologies can mask the skill, or lack of skill, of the manager. Using these indices overcomes this major issue with using Libor benchmarks.

A basic requirement of a good benchmark is that it should be investable.

It is not possible to replicate the "neutral" position of a Libor based benchmark as there are no underlying assets making up the benchmark (as there are with a traditional equity or bond index).

This problem can be overcome by using one of the asset-backed security indices that have been recently launched by Lehman Brothers and Deutsche Bank. These indices overcome the traditional problems with Libor benchmarks as mentioned above, but are only appropriate for a fund that uses asset backed securities as a core part of its investment strategy.

The different indices discussed above are not ideal but they are more appropriate, in many cases, than using a simple Libor benchmark. Anything that increases transparency of investment manager performance has to be positive for both managers and investors.

To conclude, enhanced cash funds offer investors the opportunity to enhance returns on their cash balances, but it is important to consider all the risks when using these vehicles. It is also encouraging to see continued innovation in the market. Long may it continue.

CORPORATE STATEMENT

Established over 30 years ago, Barclays Global Investors Limited (BGI) is the world's largest fund manager with over £877bn (€1,269bn) in assets under management as at 30 June 2006.
Through continual innovation, we have delivered an unparalleled range of investment products and services. Our comprehensive cash offering aims to provide clients with the liquidity, risk control and returns they require for effective cash investment, whether for day-to-day or longer term needs and as at 30 June 2006 our cash assets totalled £89 billion (€128bn).

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