INTRODUCTION

CLEARING UP THE CASH DEBATE

Cash may have been viewed as a simple solution to market volatility, but an abundance of new products to choose from has led to an increasing sophistication in the asset class, as Elisa Trovato reports

When market volatility increases, there seems to be only one asset class regarded as secure haven and this is cash. But what exactly is cash? With such an abundance of products with the 'cash' label available, distributors need to find their way through an ever-growing jungle of equity, bond and alternative funds. What they usually find is that cash is not just the simple option it may initially seem.

"There are the traditional money market funds and, of course, the fiduciary deposits, but also structured products like stability notes or protected range notes, range podium notes or finers," says Michael Krinner, head of private client sales at Credit Suisse Asset Management in Zurich. "Moreover, what Credit Suisse may sell as a range podium note, a similar or even the same structure may be sold by another bank with a completely different name."

In Europe there appears to be a complete lack of transparency and regulation in this, further complicated by the fact that so-called money market funds are not homogeneous and can also include anything from equity to property and can have different durations, although typically they have a three-month benchmark.

In France, for example, and to an extent in Germany and Luxembourg, absolute return products tend to be referred to as money markets funds, says Mark Allen, head of cash sales, UK and Ireland at Goldman Sachs Asset Management.

One of the areas that have experienced significant growth in the past few years is the credit derivative market. As a consequence, asset-backed securities (ABS) and mortgage-backed securities (MBS) are now widely employed in money market funds.

PRODUCTS IN DEMAND

Fiduciary deposits are certainly the most traditional products banks can offer. And they are still very much in demand among end-clients. "We do see a lot of demand for deposits. We are very competitive on our deposits and a lot of cash is placed with us for this reason," says

Lescure: two techniques for the short term

Philip Watson, head of analysis and advisory at Citigroup in London.

Credit Suisse estimates that two thirds of cash in continental Europe is still in deposits compared to 15 per cent in the United States.

Rated money market funds, or liquidity funds, which started to take off in Europe in the late-1990s, offer constant liquidity, unlike fixed-term deposits, and may be preferred over the latter also because they invest in a variety of instruments.

Liquidity funds have grown significantly in the last 10 years in Europe, from €7bn in 1997 to around €300bn today. In the United States, where these funds predominantly originated back in the 1980s, they represent 50 per cent of the cash market.

"Rated money market funds are typically triple-A rated. They are highly regulated, highly liquid and you can trade in and out on a daily basis," says Mr Allen.

Triple-A rated funds provide a 'libid' rate of return,

which is 12.5 per cent basis points lower than 'libor' after fees. Unlike absolute return products, they are constant net asset value products. "In a rated money market fund, capital preservation is the absolute priority," says Mr Allen.

On the other hand, continues Mr Allen, there are so-called enhanced cash funds, which seek to provide a higher rate of return, for example by taking greater credit risk. This is why some of the enhanced cash funds will be double-A rated or single-A rated, with some of them being unrated altogether. Also, enhanced cash funds might seek to take advantage of the yield curve by offering a longer weighted-average maturity.

Mr Allen believes that although these enhanced products have a role to play in investors' portfolios, triple-A rated money market funds will account for the majority of cash. GSAM manages around $120bn (€94bn) of assets in rated money market funds and £20bn (€29bn) in enhanced cash globally.

Cash is a consistent asset class in major fund houses. For example, liquidity and enhanced cash funds represent around 13 per cent of Credit Suisse's assets under management, with a value of $60bn out of the $474bn total managed globally.

Yves van Langenhove, Brussels-based head of institutional business for Western Europe at Invesco elaborates on the benefits of investing in enhanced cash funds against "plain vanilla" money market funds.

"The problem with plain vanilla money market funds, which have cash as benchmark, is that they also have some operating costs. People say that they need cash on a daily basis, but if they look at it historically, they could see that a certain percentage, say 30-40 per cent of cash, has been left unused for a long time".

Figure one: number of domestic money market funds in Europe

In descending order by domestic money market funds	Domestic No. of money market funds	Total AUM (€m)
French Registered	575	363,240
Luxembourg Domestic	316	182,226
Spanish Registered	293	93,067
Ireland (Eire) Domestic	73	45,165
German Registered	51	32,802
Italian Registered	39	63,207
UK Registered Investment	35	3,048
Austrian Registered	33	6,113
Belgian Registered	23	2,381
Swiss Registered	23	10,086
Portuguese Registered	22	8,395
Liechtenstein Registered	13	2,489
Netherlands Registered	2	194.53

Source: Standard and Poor's

Enhanced cash funds can prove to be a valid alternative, says Mr van Langenhove.

Invesco's enhanced fund targets 60 basis points above cash and invests in securitised debt, in ABS and MBS in the US, hedging away dollar risk completely.

Another related fund, called 'bond return plus', was launched by Invesco in 2005, and has already gathered €3bn this year. It targets 150-160 basis points net above cash and uses only fixed income alpha sources. "The question is where we draw the line between enhanced cash and absolute return. If you ask 10 different people you might get 10 different answers. The volatility of our bond return plus fund is so low, just 120 basis points since inception, that you could call the fund 'enhanced cash'. On the other hand, the fund is targeting quite a high alpha above cash and therefore should be classified as absolute return." Mr van Langenhove's personal definition of enhanced cash is "a fund having volatility below one per cent".

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PHILIP WATSON, CITIGROUP

Roland Lescure, deputy chief investment officer at Natexis Asset Management, adds the French prospective. The traditional money market area, in which Natexis runs €40bn out of its €110bn in total assets, has a target return of libor up to libor + 10 basis points. Another range of enhanced cash funds deliver libor +30, up to libor +200, but "this is where we are moving towards the absolute return strategy," says Mr Lescure.

Natexis employs two different techniques for managing enhanced money market funds, particularly for "shortish" time horizons, explains Mr Lescure. These are tactical asset allocation overlay and multi-management, which leverages the investment expertise of Natexis Asset Square, the French group's multi-management arm.

In May 2005, Natexis launched the MG (multigestion) Natexis Dinamique 18 open-ended fund aiming at out-performing libor by one per cent over 18 months.

In the second half of 2006, the French fund house is planning to launch another "multigestion" fund, Natexis MG Dynamique 24, which will target libor +2 per cent over a period of 24 months.

Natexis currently manages €2bn of assets in enhanced money market funds, which include tactical overlay and multi-management, where the target performance is libor +10 basis points upwards.

OPTIMAL CASH ALLOCATION

The steep of the yield curve is an important factor in determining cash exposition, says Mr Lescure. "Three years ago, the yield curve was very steep and there was not much point in investing in money markets. Today, the risk-return profile of a money market investment is much better that that of a fixed income, if you have three years in front of you," says Mr Lescure.

Natexis runs €2.5bn of assets in its global balanced flagship retail funds. In the three-year horizon fund, 30 per cent of total assets are in cash, money market and enhanced money market. All of these investments have zero downside risk, explains Mr Lescure.

The optimal allocation depends very much on the client liquidity needs and risk tolerance, says Mr Watson at Citigroup.

"In terms of framework, we have five different prescribed asset allocations based upon investors' objectives, although in practice, we would design the portfolio to meet the client's specific requirements. For a client who seeks liquidity management and capital preservation, we would typically recommend an allocation of at least 20 percent into cash or equivalent."

As they move up the risk spectrum, where the amount of cash or equivalent can be reduced quite significantly, explains Mr Watson, the high level of liquidity associated with short-term bonds and investment grade bonds becomes important, so that clients still have the ability to extract liquidity at short notice.

ROLE OF CASH

The low-yield environment of the past few years has generally led to a "global hunt" for return that has affected cash too.

The function itself of the cash, traditionally a "liquidity cushion" says Mr Krinner, has changed. "In the past, if the equity markets were shaky, and you were not sure about bonds, like in late 1993 and 1994 when interest rates rose quite substantially, the only (financial asset) alternative as a private investor was to invest in cash. Hedge funds were not as established and accessible as they are today."

Today, the amount of money that investors place in cash depends mainly on the relative attractiveness, return-wise, of the other asset classes, explains Mr Krinner.

Van Langenhove: a percentage of cash goes unused

"In times of uncertainty, people flee to the most secure asset class and this is cash," he says.

There are also considerations to take into account, such as the changing dynamism of asset allocation, says Mr Watson.

"The increasing level of interest in private equity that we have seen recently, for example, has created a need for liquidity, out of the fact that your capital will be called, sometimes at quite short notice." This means the rest of the portfolio has to be sufficiently liquid to be able to support the future capital calls.

Looking at the disadvantages of investing in cash, Mr Watson comments: "I think the great disadvantage is that over the long term you are forgoing additional return associated with more aggressive asset classes.

"But then, that is not necessarily a disadvantage, it comes down to the profile of the clients. Whether they have a tolerance for the volatility generated on their portfolios by including other asset classes and other type of investable solutions," he says.

French domination of money market funds

It is estimated that France is the European country with the highest value of assets in money market funds. "This is because, historically, French investors, and especially private investors, have been very risk averse," explains Mr Lescure, deputy chief investment officer at Natexis Asset Management. "Also, the equity culture has developed to a greater extent only in the last 10 years in France."

Another important reason is that fund managers and banks had to develop money market products able to compete with the very popular subsidised public saving schemes, explains Mr Lescure.

Moreover, deposits do not represent an attractive alternative in France. Unlike their counterparts elsewhere in Europe, until recently French banks were not allowed by regulation to give yields on their deposits. "Now this is allowed and some banks have started giving yields on their deposits but yields are still very low," says Mr Lescure.