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CASH

THE BEAUTY OF MONEY MARKET FUND HIDEAWAYS

Liquidity investment may be the poor cousin of glamorous equities and bonds, but investing in cash is becoming an involved and serious discipline

It may be all about the money. But what does cash actually mean to the wealthy investor? Liquidity? Or a safe but unexciting harbour in which to store assets while markets look dangerous – as equity markets so flamboyantly did at the start of the millennium?

Probably both. But too often, high net worth individuals (HNWIs) forget that cash is also an asset class in its own right, and one which can be made more of than three months sitting in a bank deposit account. Certain cash funds have seen the likes of average current day returns of 2.9 per cent gross since the start of 2002. This compares with 2.68 per cent for the seven-day London Interbank Bid Rate (Libid), which private investors would struggle to obtain.

Yes, equities, bonds and, more recently, alternatives are the so-called big three – the products over which commentators argue and between which investors jump as markets throw their judgments one way or the other.

But every portfolio is going to have an element of liquidity, of cash, underpinning every asset class, which provides the ability to easily switch between strategies and products. It is high time European HNWIs followed the example of their institutional – and transatlantic – counterparts, and thought seriously about the benefits provided by money market funds.

'So far Europe's mass affluent have barely dipped their toes into the money market waters, unlike their American counterparts'
Mark Stockley, JPMorgan Fleming

CREDIT RISK

Traditionally, cash has been placed in deposit accounts with banks. However, a turbulent economic climate for the first few years of the millennium left investors holding high levels of cash. Under such circumstances, and particularly with yields low, sophisticated investors have realised they might be putting too many eggs in one basket. Looking at their exposure to individual banks, they ask: what credit risk am I taking? Am I adequately paid for it?

Even as the economic cycle can be expected to normalise cash holdings again, the issues remain. Cash will always be a part of a portfolio. And, with term deposits thus questioned, the range of money market funds becomes an attractive alternative.

These products give clients both diversification and the ability to access cash on a daily basis. With a three or one-month deposit, if you need your money out sooner then you can expect to pay for the privilege. But investors in money market or liquidity funds can move in or out without any penalty for changing their plans. They are not left stranded by finding themselves unexpectedly shorter or longer in liquidity.

These funds, which as an asset class have grown to $165bn (€130bn) internationally, also boast typically higher credit quality than banks. The only AAA-rated bank in Europe is Rabobank. No wonder, then, that Continental and UK HNWIs are set to follow this trend.

EUROPEAN TRENDS

As ever, the US market is ahead. How many retail banks in the UK offer access to money market funds as standard or core offerings?

At the very top end of the wealth management

‘Germany is a market to watch. The current reform of the banking system there means that banks will have to get independent ratings’

market, sophisticated investors who use private banks are starting to use money market funds. But so far the mass affluent have barely dipped their toes into the water. Yet in the US it is standard practice to sweep surplus liquidity into a money market fund.

The market is ready to take off in Europe. France, with interest unavailable on current accounts, already has a well-established money market fund industry or be it a largely unrated one. Germany is a key market to watch. The current reform of the banking system there means that landesbanks will have to get independent ratings. Corporates and individuals who would previously have kept cash on deposit will face lower rates as banks, losing their quasi government backing, have to borrow at commercial rates. With better yields, as well as reduced credit risk and diversification benefits, money market funds are an obvious alternative.

BROAD SPECTRUM

So, practically speaking, what are the choices faced by the HNWI sitting with his pile of cash? In a low yield environment, he needs to look even more carefully at every basis point of return.

At one end of the spectrum, there is the non-management approach of a current account, or perhaps Internet banks such as Cahoot or ING with higher levels of return. (The HNWI has, of course, to be aware of his single counterparty risk here.)

Then there are traditional bank deposit products – 30-day accounts (which, they must remember, tie their money up for a month), rolling deposit accounts, and more sophisticated products with better key features in terms of security, yield and diversification.

Then the money market funds, for those investors too shrewd to leave cash unattended in a bank account, but who still need instant or near-instant access to their liquid funds. Highly sophisticated in terms of management and research, these funds invest in a pool of underlying money market instruments. The instruments picked do not go beyond a maturity of one year and the average maturity of the overall product is maintained at under 60 days.

The instruments are typically invested in commercial paper, certificates of deposit, repurchase agreements or floating rate notes, with a minimum credit quality of A-1/P-1. With a wide variety of investments and a large asset base, money market funds are very liquid products. An AAA-rated fund combines diversification of the portfolio in terms of instruments and high credit quality of instruments with an actively managed maturity profile.

MID-TERM VIEW

Moving one level up, there are also enhanced cash products. Typically AA-rated these allow an investor with cash he doesn’t mind tying up for, say, six months to remain conservative but reap the benefits of extra

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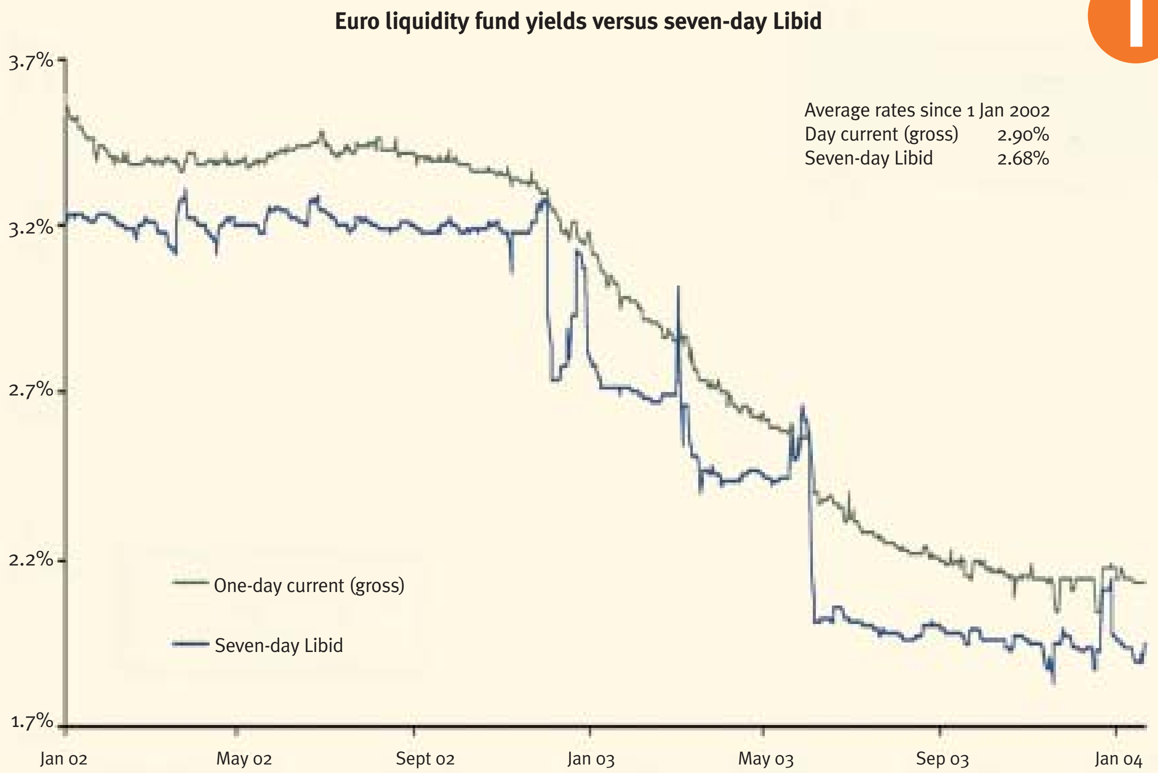

Data: 1 Jan 02 – 22 Jan 04

Source: JPMorgan Fleming internal reporting

returns without incurring much more credit risk. They are run in a manner that is highly correlated to the AAA-rated money market fund. However, a slight increase in duration and credit risk serves to broaden the spectrum of underlying investments and target higher returns.

Rather than an average maturity of less than 60-days, the enhanced fund average will be actively managed between 60 and 365 days. Instead of targeting one-week Libid returns, it aims to beat the three-month London Interbank Offered Rates (Libor). Capital preservation remains high on managers' priorities. Enhanced funds may have an individual month's performance below a liquidity fund, therefore a longer investment horizon is recommended, typically nine months or longer.

The next step up takes our HNWI into the fixed income market, with one to three-year short duration bond funds.

PICKING A FUND

Once a HNWI has decided to invest in a money market fund, he has to make his choice from the proliferation available on the market. So how does he compare them and make an informed selection?

First, how large in asset terms is the fund? If it is small, it may be illiquid, and there is the danger that too many people wanting their money out at the same time will jeopardise the whole pool. The HNWI wants to be a small fish, here, in a big pond. The last thing he should do is own a large proportion of a small fund. Then there is the question of when he is allowed to withdraw funds. What are the cut off times? How late in the day can he get same day access to cleared cash?

Third, he has to consider the quality of the management team – its history and experience of running this type of fund. Do the fund managers have the right resources in terms of credit research? What is the return for the product and how is it priced?

The right fund, on top of all its more tangible security and return benefits, will make it as easy as possible for the investor to know exactly what is going on with their money and to get hold of it however they like. They won't even have to go to the hole in the wall.

Mark Stockley, head of institutional liquidity sales, JPMorgan Fleming Asset Management