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Corporate Cash: Putting it to Work

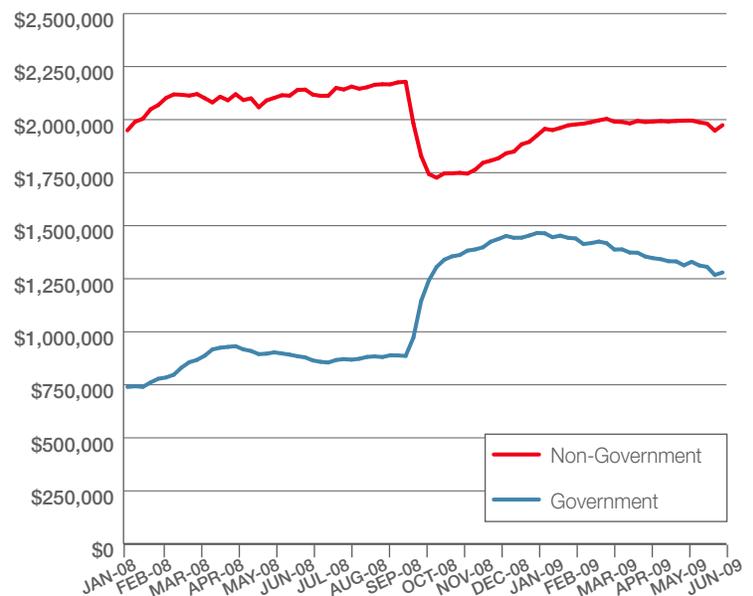
Short-term yields remain near historic lows, leaving corporate investors overly invested in cash investments earning near zero interest. Corporate CFOs are now wondering how to safely grow portfolio income without sacrificing liquidity. In this paper we will address this concern and re-evaluate the common approaches to managing corporate cash.

In the early phases of the credit crisis, investor confidence in [money market instruments](#) took a huge hit after asset classes such as extendible commercial paper, structured investment vehicles, and auction rate securities revealed their innate illiquidity under stressed conditions. To further complicate the already fractured market, the Reserve Primary Fund, a money market fund designed to achieve capital preservation and daily liquidity, “broke the buck” in September 2008.

These collective events caused a flight to the safest and most liquid investments and severely slashed the risk appetite of corporate cash investors. In response to the broken credit market, investors shortened their investment horizon considerably and limited their security type selection, creating a concentrated capital pool in the short end of the yield curve. The explosive growth of Treasury and government agency money market funds after the collapse of the Reserve fund is a perfect illustration of the high demand for safe and liquid products.

Against this backdrop, corporate CFOs are tasked with prudently investing excess cash while facing the dual challenge of maintaining liquidity and maximizing portfolio yield. Let’s begin our discussion by looking

Total Net Assets of Taxable Money Market Funds
(Millions of Dollars)



Source: Investment Company Institute

at the strengths and weaknesses of typical investment approaches.

Investment Approaches

Strategies for investing corporate cash have traditionally taken the form of: 1) a large allocation to SEC Rule 2a-7 money market funds, 2) a portfolio structure where investment maturities match expected cash needs, 3) laddering a portfolio across the yield curve, or 4) actively managing the portfolio with the goal of outperforming a representative index or benchmark. We will review each option highlighting the pros and cons of each and continue the discussion with an in-depth look at the active approach.

Large allocation to 2a-7 money market funds

Despite needing government intervention in the form of the Treasury Temporary Guarantee Program for Money Market Funds, this asset class has and will continue to be a viable option for investors seeking daily liquidity and capital preservation. This was once considered a no-brainer investment option for which many investors performed little analysis beyond yield comparison across funds. Now, investors in non-Treasury funds must take proactive measures to analyze the following factors before utilizing prime (underlying investments in prime funds typically include government agencies and corporate debt) money market funds in their overall portfolio.

- **Sponsor analysis** – How important is the money market fund business unit to the parent firm and what is the firm’s commitment level to supporting and growing this business?
- **Knowledge of the portfolio and credit management teams** – What is their interest rate and credit outlook? More importantly, what is their view on risk management?
- **Fund analysis** – What is the fund’s maturity schedule and credit strength of the underlying investments?
- **Shareholder base** – Is the fund unnecessarily exposed to a single group of investors, leaving it potentially vulnerable to a run on the fund?
- **Service level** – How responsive and proactive are team members in discussing market developments with investors? Furthermore, is information readily available to address auditor questions?

This strategy is ideal for investors with high liquidity needs and/or little visibility into their future cash needs. Investors in this strategy will forgo other higher yielding strategies in exchange for simplicity.

Investment maturities matched to expected cash needs

One of the most conservative methods for meeting a future cash need is constructing a bond portfolio with maturing principal payments that exactly match your liability schedule. To further simplify the approach, this passive portfolio can be constructed with zero-coupon bonds with maturity dates equaling expected cash needs. This portfolio does not require reinvestment as zero coupon bonds do not have coupon payments and maturity payments are used to pay out cash obligations.

For investors with a high degree of confidence in predicting their future cash needs, this approach is a relatively simple method to invest funds with little requirement to rebalance the portfolio — that is, assuming the initial cash projections do not change materially. While this is a slightly more proactive approach to money market fund investments, yields are mainly determined by the anticipated expenditures.

We believe this is a suitable approach for investors with high predictability of cash needs, but it places heavy pressure on the corporate finance team to accurately forecast future cash obligations.

Laddering a portfolio

This is a popular strategy often adopted by asset managers. Investments are evenly distributed across the yield curve and investment maturities are reinvested out to the investor’s maximum time horizon to maintain the even distribution.

Proponents of the laddered portfolio strategy stress that returns are consistent due to the even maturity distribution across the yield curve.

This autopilot reinvestment approach is attractive to investors with little to no outlook on the direction of interest rates. Should a large, unanticipated cash need occur, the portfolio could be stressed to generate cash

without incurring losses. In an environment where maintaining a highly liquid position is strongly desired, we believe the next approach is more suitable.

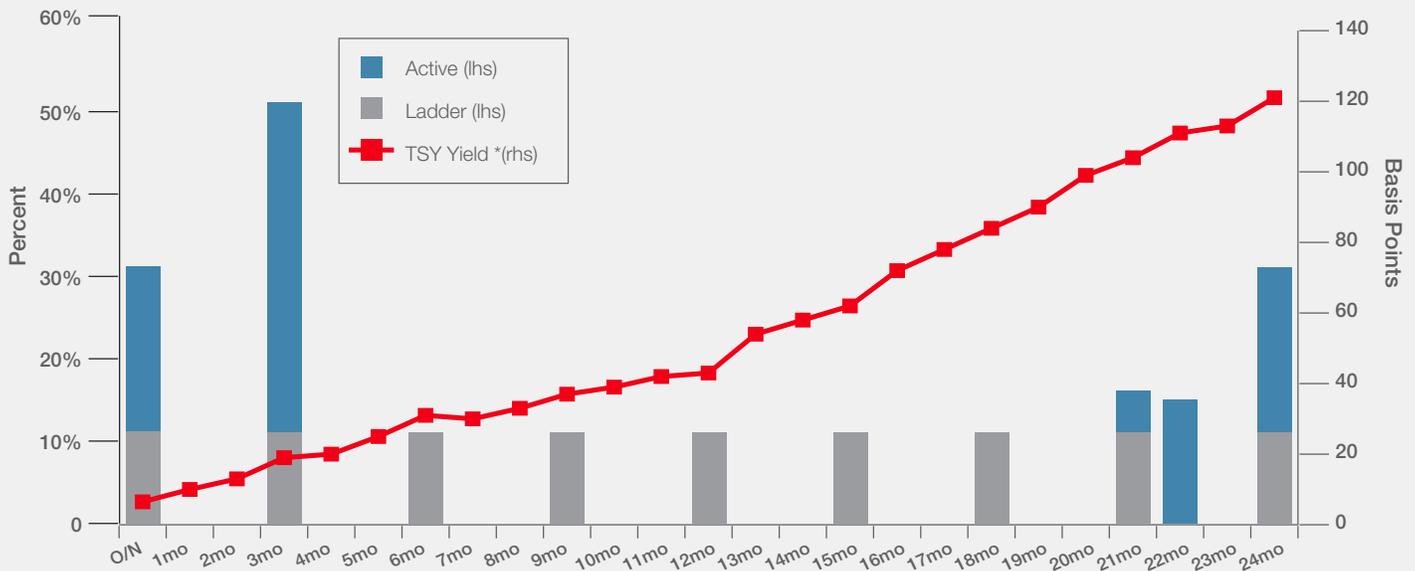
Actively managing the portfolio to outperform an index

The active management approach is a customized strategy that incorporates the investors’ specific investment objectives, risk tolerance, future capital use and special parameters in structuring the investment portfolio. Given today’s market conditions and corporations’ desire to maintain a high liquidity position, we believe a customized portfolio with a heavy emphasis on money market mutual

funds and selective allocations out across the yield curve is an optimal approach.

The following chart illustrates the superior liquidity position of the customized portfolio relative to the laddered portfolio without sacrificing yield. For the sake of simplicity, we assume both portfolios consist of only one asset class (Treasuries) and do not account for variances such as brokerage commissions or management fees. The laddered portfolio is invested evenly across the yield curve at three-month intervals, while the customized portfolio is distributed along both ends of the yield curve. The customized portfolio favors the extremely short end of the

Maturity Allocation



Strategy

	Ladder	Active
Weighted Average Maturity (WAM)	360 days	311 days
Yield	~ 56 bps	~55 bps

* Yields as of 6/24/09

Source: Bloomberg, SVB Asset Management

Capital Commitments (Assumes a \$20 MM Portfolio)

	Ladder	Active
Cash Equivalents	\$4.46 MM	\$12.0 MM
Short-term	\$6.66 MM	None
Long-term	\$8.88 MM	\$8.0 MM

curve (three months and in) with a 60-percent allocation, while 40 percent is deployed out to the long end.

By examining the cash equivalents allocation of both the laddered and active strategies, the previous chart illustrates that the active portfolio is approximately three times more liquid than the laddered portfolio while both portfolio yields are identical.

Implementing the Active Management Approach

Actively managing a portfolio begins with forecasting cash needs and incorporating credit analysis and selection as an integral part of the planning process.

Forecast excess cash

The excess cash your company generates through operations may be invested, set aside to pay back debt or used for strategic acquisitions. Regardless of the purpose, step one of the investment process is to revise cash forecasts using assumptions based on current business and market environment. If your clients are affected by the recession, it could adversely alter your forecasted plans, and previous assumptions should be revised to reflect these shocks. To prepare for future unexpected shocks, all forecasts should be stress-tested under abnormal assumptions.

Consider the implications of credit quality

In today's market environment, credit analysis of a corporate cash portfolio is one of the most significant risk mitigants. We currently recommend focusing on government-related investments, which consist of Treasury, agency and TLGP-backed securities. On a selective basis and after a rigorous and thorough credit analysis, investors should consider adding corporate debt obligations from strong businesses with sound financial bases that demonstrate robust capability and willingness to meet their obligations.

Ratings should not be the sole determining consideration for choosing investments. Instead, all factors, including headline risk, should be carefully evaluated. The recent credit crisis has proven that even the strongest corporate issuers can be strongly affected by loss of market confidence. Apart from evaluation of traditional credit factors, the issuers' financial flexibility and franchise value should be considered.

In addition, the credit process should be customized to the purpose on hand, which is the timely receipt of principal and interest (if any) of the debt obligation purchased. Events in the last two years have highlighted the vast differences among different classes of investors and how actions taken by issuers may favor one class of investors over another in the capital structure.

Take a proactive approach

While the extreme volatility in the credit markets has caused investors to have many sleepless nights, the combination of macroeconomic conditions and continued volatility also present trading opportunities for the actively managed style of investing. Traditional buy and hold investors should consider taking a more hands-on approach to their portfolio and seek opportune times to enter and perhaps exit investments across the yield curve.

For example, in two trading days (6/5/09 and 6/8/09) yields on 2-year Treasury notes surged more than 40 basis points to yield 1.40 percent. In the previous six months, the yield on this bond averaged only 89 basis points and did not close higher than 109 basis points. This yield volatility is an excellent trading opportunity for an actively managed portfolio to lock in yields at appropriate levels and exit when yields retract.

Corporations with ample liquidity and limited future cash commitments may consider taking a more proactive approach to their corporate cash portfolios. A small allocation to the 2-year Treasury note after a yield spike can add incremental return to the portfolio and decrease the income variability from an existing short-term strategy. Another benefit to this strategy is that the portfolio is adaptive to changing market conditions as yields, credit spreads and client-specific needs change over time.

Conclusion

The benefits of an actively managed portfolio are not limited to maturity distribution alone. Credit spread movement is another factor that can incrementally enhance the overall return of the portfolio, while the CFO prudently manages liquidity needs. To capture these opportunities, corporate CFOs must take a more proactive approach to their investment portfolio decisions and remove the autopilot program.

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