Cash in the new world

During the last year cash has been increasingly under the spotlight, with trustees seeking to understand more about the different investment options, varying degrees of risk and return and in particular, counterparty risk. **David Rothon,** senior investment strategist at Northern Trust and member of Northern Trust's Retirement Solutions Practice, considers the role of cash and what it looks like in the new world.

In general, cash doesn't feature as part of a pension fund's overall asset allocation. However, it does play a large role when moving between managers where the scheme might be sitting on cash for a period of time. It is also generally held within the mandates assigned to a manager. For example, an equities manager might hold five percent cash in the course of running the mandate. So, trustees will indirectly allocate part of their portfolio to cash in that way.

During the financial crisis, there were mixed results for cash funds. Cash has been badly mis-labelled and all types of cash investment have been lumped together – and sometimes made out to be high risk investments. This mislabelling is partly due to the fact that a cash fund can mean all sorts of things – some have even had equities and emerging markets exposure as a part of the fund! We use the term to mean triple-A rated treasury style money market funds, with a focus on preserving the original investment and liquidity as a priority – and returns as a secondary consideration. Those types of fund have generally performed in line with expectations during the crisis.

Through this mis-labelling it comes as no surprise that trustees are really looking to understand the nuts and bolts of cash, no longer fully relying on the ratings agencies for validation of credit quality, portfolio construction and operational risk. In particular, trustees are much more concerned about counterparty risk. At Northern Trust we've recently had more questions about counterparty exposure, who the money is being invested with, how liquid it is (i.e. how easily it can be withdrawn from the fund) and what the risk parameters are. This growing emphasis on safety is also translating into different forms of cash products and how cash is being invested.

Cash still plays the role that it used to within a pension fund, but there are now much wider uses – for example, it might be used by overlay managers who generally hold high levels of cash. In the past, that cash might have been kept with a prime broker, but now the overlay manager might want to reduce counterparty risk by using a money market fund to distribute the risk more broadly.

New cash products are also emerging – we launched a range of government liquidity funds last year, for example. Investors wanted to improve the safety of their cash and be more thoughtful about how they were going to allocate it. One option might be putting some of it into a triple A-rated money market fund, and park cash with a longer time horizon into enhanced cash funds. The role of cash won't go away and the emphasis is now on education, transparency and disclosure.

This is a new world we're in now and governance will be of great importance – I don't think investors will expect a high rate of return from cash, as they would from equities, but they do expect their capital to be preserved. Also, cash may increase in popularity if you consider the demographics of many defined benefit pension funds. They have an ageing population and will want to allocate more to gilts and cash as their members get closer to retirement. But what are the main options for investing in cash?

I would say that there are four main types of cash funds, in increasing level of risk and return:

- The lowest risk are **government liquidity funds**. These are triple-A rated and the highest quality money funds from a safety aspect. They have government exposure without the volatility of holding government bonds.
- Traditional **Treasury-style triple-A rated funds** are still conservatively managed and focus on preservation and liquidity, but there is some financial risk. In the interbank market where these funds invest, in a sub-one year account there is 90 per cent exposure to financials and little diversification away from that.
- **Enhanced cash** products typically operate over a six month to one year timeframe. You expect risk and more volatility in a fund like this. In an enhanced cash fund, liquidity is lower, with more interest rate and credit risk.
- When you move beyond a year-long investment timeframe, you enter into the **short duration** cash space – these have similar levels of risk to traditional fixed income portfolios.

Accurate labelling is particularly important with short duration funds. Many of these products have been described as money market funds in the past, and people believed that type of lower risk product was what they were buying, whereas in fact the risk was much greater. On behalf of the money market fund industry the Institutional Money Market Funds Association (IMMFA) is working to improve labelling of money market funds. They have been working with many regulators, including EFAMA (European Fund and Asset Managers Association) to identify a common definition of what a money market fund is. Hopefully the days where you put your cash in something you thought was a cash fund only to find that there were less liquid investments involved should be gone in two to three years.

In the meantime it's up to the industry and its participants, such as Northern Trust and its Retirement Solutions Practice to support this new world of governance and assist pension schemes in navigating the complexities of the retirement industry. At the end of the day, cash will continue to play a role in pension's portfolios, it's really up to us to support trustees in any way we can to make their job that much easier. ■

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