

Enhanced Cash Investing: An Alternative to Money Market Funds

ALTHOUGH MONEY MARKET FUNDS HAVE TRADITIONALLY been the short-term product of choice for institutional investors, enhanced cash products are an attractive alternative — even during periods of rising interest rates. Investors willing to moderately increase risk exposure and extend the investment horizon to 12 months or more (foregoing daily liquidity) can realize substantially higher total returns with enhanced cash products.

What Is Enhanced Cash?

Typically, the primary investment objectives for short-term cash are capital preservation, liquidity and periodic income. As such, money funds offering a stable \$1 net asset value (NAV) and daily liquidity have appealed to cash investors. However, as money-market fund yields plummeted in 2003, enhanced cash investments began to gain popularity. When average net yields fell below 1%, investors began looking for short-term investment products that could provide better incremental returns.

To put these products in perspective, think of enhanced cash as an ultra-short-term bond product that is

one step away from money market funds. The key difference is that enhanced cash portfolios are actively managed products with the goal of generating higher total returns.

While enhanced cash products vary somewhat by investment manager, the investment objectives are sim-

Enhanced Cash is positioned between Money Market Funds and Total Return Short Duration Portfolios

RISK	Money Market	Enhanced Cash	Short Duration Bond
Target Portfolio Duration	90 Day Max	6 Months to 1 Year	1.75 to 2 Years
Average Portfolio Quality	AAA	AA	AA
Eligible Investments	2a-7	A or Better	BBB or Better
Maximum Maturity Per Issue	13 Months	2-3 Years	N/A
Benchmark	3 Month T-bill	1 Year Index	1-3 Year Government/Credit

SOURCE: NORTHERN TRUST



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ilar: outperform money funds on a total return basis by taking modest interest-rate risk, credit risk and liquidity risk. Whereas money funds operate with interest-rate duration of up to 3 months, enhanced cash products tend to have a duration of 6 months to 1 year. Enhanced cash products also invest in securities outside the traditional money fund opportunity set. Securities include longer-term fixed- and floating-rate agencies, corporates and asset-backed securities. Managers limit holdings to securities rated A or better, and the average portfolio quality has tended to be AA.

By constructing high-quality portfolios through an



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investment process that emphasizes thorough credit research, many managers of enhanced cash products have generated total returns of 50 to 100 basis points (bps) over money market funds.

Risk Profile of Enhanced Cash

Using total return data from various indices provides a reasonable proxy of the return and risk associated with enhanced cash products. The 3-month T-Bill approximates money funds while the 6-month T-Bill and 1-year index captures the added risk & return of enhanced cash products.

As the following chart shows, it doesn't require a significant adjustment to a client's risk tolerance to enjoy higher returns. Closer inspection of rolling 12-month time periods over the past 10 years reveals that enhanced cash strategies have delivered positive total returns without a single period of loss. For shorter investment horizons (e.g., rolling 3-month performance), negative returns occurred just four times during that same 10-year period.

One of the reasons for the moderate risk profile of enhanced

Index Return and Risk Analysis (as of 06/30/2005)			
	3 Month T-Bill	6 Month T-Bill	Custom 1 Year Index (50% 3 Month T-Bill & 50% 1-3 Year Gov/Corp)
Duration	0.25 years	0.50 years	1.00 year
Total Return (1)			
YTD	1.28%	1.33%	1.18%
1 Year	2.12%	2.15%	2.25%
3 Year	1.53%	1.64%	2.25%
5 Year	2.63%	2.94%	3.82%
Standard Deviation (2)			
3 Year	0.18	0.20	0.81
Probability of a Loss Rolling 12 Month Periods			
# of Negative Periods (140 Observations)	0	0	0
Maximum Return	6.43%	7.09%	8.50%
Minimum Return	0.97%	1.03%	0.80%

(1) Performance based on total return. Periods greater than one year are annualized.
(2) Standard deviation is an annualized figure based on monthly total return.

SOURCES: LEHMAN BROTHERS • NORTHERN TRUST

cash versus money funds is the active nature of the product. Most enhanced cash managers actively manage their duration position based on the prevailing interest rate environment. Also, many managers use a barbell approach to construct portfolios; holding a sizable allocation to securities maturing within 30 days as well as longer-dated bonds maturing in 2-3 years.

Rising Rate Environment Analysis

Several recent periods offer meaningful insight into the performance impact of rising interest rates on an enhanced cash portfolio. Rate increases came as a surprise in 1994 as the Federal Reserve hiked rates six times, including an unprecedented 75 bps move in November 1994. In total, rates increased by

250 bps to end the year at 5.5 percent. 1999 and 2000 saw rates increase by 175 bps. Finally, investors have experienced 250 bps of rate increase since June 2004.

Investors who are concerned about this risk and think it safer to stick to money market funds in a rising-rate environment may want to consider this data. In all rising-rate periods shown below, enhanced cash products have continued to generate a positive return.

Enhanced Cash Total Return Across Interest Rate Cycles			
	Change in Fed Funds Target Rate	Top Quartile Enhanced Cash Manager (1)	Median Enhanced Cash Manager (1)
1994	+2.50%	4.04%	3.64%
1995	+0.00%	7.87%	6.81%
1996	-0.25%	5.71%	5.59%
1997	+0.25%	6.01%	5.85%
1998	-0.75%	6.16%	5.95%
1999	+0.75%	5.33%	4.99%
2000	+1.00%	7.41%	6.98%
2001	-4.75%	6.73%	5.84%
2002	-0.50%	4.22%	3.47%
2003	-0.25%	2.12%	1.83%
2004	+1.25%	1.52%	1.39%
2005(2)	+1.00%	1.41%	1.36%

(1) Callan PEP Active Cash Style (Enhanced Cash) Universe Gross of Fees
(2) Through 6/30/05

SOURCES: FEDERAL RESERVE • CALLAN ASSOCIATES

Implementing an Effective Cash Strategy

Combining money funds, enhanced cash and other short-duration products can lead to an overall portfolio design that meets liquidity needs but also captures meaningful return, without undue risk. Investors should examine and segregate those balances that require immediate liquidity from those that are available for a longer investment horizon. Enhanced cash strategies typically require horizons of at least 12 months to fully generate the benefits that justify the additional risk.

Investors must realize that daily liquidity comes with an opportunity cost even in today's rate environment. Of the approximately \$2 trillion currently invested in money market funds (source: iMoneyNet), a good portion of those investments would offer better return potential if invested in an enhanced cash product. Although many investors are happy to accept a lower return for the peace of mind of knowing they can pull their money out at any time, for balances with a longer investment time horizon, modest exposure to interest-rate risk and credit risk can offer significant incremental returns over what investors can get from a money market fund.

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