RBC Global Asset Management

Cash and liquidity management: "This is a time to put money to work"

John Donohue, Head of Liquidity Management and RBC Banking Channel at RBC Global Asset Management, recently sat down with Institutional Investor to share his insights on the liquidity market in the current environment.

- The short-term investment world offers substantially more to investors willing to execute their strategies thoughtfully.
- There are interesting opportunities to maximize return, while preserving capital in a risk averse way, including: treasuries, agencies, corporate bonds, commercial paper, and asset backed securities.
- Investors stand at a crossroads where strategic planning, duration management, regulatory awareness, and technological acumen converge.

In the absence of a clear path from the U.S. Fed and high interest rates, investors and corporate treasurers face both challenges and opportunities in managing liquidity. The interplay of market forces, regulatory changes, and central bank policies has reshaped the contours of liquidity management. Despite a myriad of investment opportunities, investors and treasurers continue to sit on considerable amounts of cash. The question is, why?

The cash conundrum

While cash serves as a safe haven during times of uncertainty, it often remains an underutilized asset class and is usually placed in very low-risk investments. The inertia in deploying cash in an effort to generate higher yields has several origins, including the fear of market volatility, evolving central bank policies, and the perceived complexity of short-term investments. Recent memory of the pandemic and bank failures has also left investors and treasurers skittish about taking on liquidity risk.

This resistance has led to an enormous amount of money left on the sidelines. "Today there is $3.9 trillion in institutional money market funds, $1.9 trillion in treasury and agency, and $600 billion in prime funds. Ultimately, the world is a bigger place," says John Donohue, Head of Liquidity Management and RBC Banking Channel at RBC Global Asset Management.

This level of liquidity remains despite the rare market conditions that favor strategic liquid investments. "I've been in cash for 30 years, and there have been very few times that cash is actually performing beyond inflation expectations. Three years ago, if you had $100 million, you were earning .25% -- that's only $250,000. Today, that number is closer to $5 million. There are incredible opportunities to just provide returns beyond the risk-free rate," Donohue adds.

Despite today's higher interest rates, investors remain reluctant to invest in short-term liquid assets. Says Donohue, "I know there are many corporations that say, 'I cannot sacrifice liquidity as there could be a share buyback, an M&A opportunity.' Accordingly, their response here is to have a large operating cash position along with an extra cushion."

Donohue adds, "If there is an M&A transaction, you'll have a window to look at your upcoming maturities and then liquidate securities as needed. Although cash management is traditionally buy and hold, there is ability to trade in and out of things if you need to."

Opportunities for different cash strategies

With conditions ideal for rethinking liquidity management, the opportunity cost to institutional portfolios and corporate treasuries is too great for investment decision makers to not consider a shift in their cash strategies. Money market funds and deposits continue to be the traditional choice for most managers, but Donohue says the short-term investment world offers substantially more to investors willing to execute their strategies thoughtfully.

"There's a way for people to invest in treasury securities and agency securities that don't have such short maturity spectrums. Commercial paper and asset-backed commercial paper are also good options to enhance returns. Then you have corporate bonds that are a key ingredient to building a portfolio and adding return over time," he says, which may be well suited for larger, less risk-averse cash investors.

Donohue highlights the opportunities in asset backed securities, which have become a popular investment in recent years. They are generally thought to be highly liquid, and investors with a large enough pool of assets can benefit from the fluctuations in rates and central bank policy while investing in a highly liquid sector.

“We suggest investors look at the asset-backed market. You have AAA rated, three-year, prime auto deals that are presenting returns of about 95 basis points over the yield on three-year treasuries. And year-to-date, they’re setting records on issuance. Just because there’s a record in issuance doesn’t mean that’s the place to go. But if you have a pristine lender profile, great servicing, and names that you know, that’s something that we encourage people to look at as well.”

Amid the return of real yields on short-term investments, Donohue sees a bright outlook for return-seeking cash investments. “Unequivocally, this is a time to put money to work.”

Duration management

Navigating the duration landscape is particularly challenging given the uncertainty surrounding central bank movements. It would have been difficult for an investor to time their duration over that past two years with so many central bank movements. The Fed hiked interest rates four times in 2023, following a string of 11 prior hikes to round out the fastest pace of tightening since the early 1980s.

Investors lost out on potential returns by locking into a higher interest rate but missed out as central banks continued to hike, making some of their investments not as liquid as they might have anticipated.

As for the next Fed meeting, Donohue says “I think it’s pretty clear we don’t see an action here, so investors can capitalize on year-end pressures as issuers work through their year-end funding needs. I get excited about this as it provides an incremental 3, 5, or 7 basis points, but those basis points matter, and that’s where you can put money to work. One approach is to develop a dollar cost average approach to duration as you will have a longer term laddering of maturities that will capture the shape of the yield curve versus your overnight rate and will roll down quickly to reinvest as rates move higher.

Regulatory dynamics, partnerships, and technological advancements

The regulatory landscape, marked by changes such as the 2a-7 reforms, shapes the contours of cash-related investments. While certain reforms may impose constraints, they also create opportunities for astute investors. The emphasis on overnight liquidity and ready access to funds calls for a strategic evaluation of investment options within the defined regulatory framework.

Technology emerges as a game-changer in optimizing liquidity management processes. The evolution from manual processes to sophisticated risk management tools has empowered investors to navigate the complexities of the short-term investment landscape. Next generation trading platforms enable real-time visibility into market conditions, facilitating informed decision-making. Moreover, the integration of artificial intelligence and machine learning holds the potential to further enhance risk management capabilities. “I think technology has truly improved the ability to manage risk, to really stress test your portfolio. That puts a portfolio management team in a position to be well prepared for anything.”

Stress tests are particularly useful in liquidity management strategies. Stress tests reveal where and how a portfolio will shift under a myriad of market dynamics and conditions. “If you’re a cashflow positive company with limited debt obligations or anything of that nature, there’s no reason to have a billion dollars overnight. This overly conservative approach hinders returns as you could take $200 million and invest it a few additional months and pick up 40 or 50 basis points, and in fact, make a few million more on those assets in a very risk-averse way,” says Donohue.

Stress testing is an analytically intensive, often arduous process, but when completed, it can put investors in a position to pick up additional yield for their shareholders, pension beneficiaries, and other stakeholders. Companies also have the option to partner with firms and teams that specialize in liquidity management and stress testing to ensure specialized professionals assess a holistic view of what risks their funds can take.

Short-term investment offerings are currently robust, but they are not offered on a silver platter. Many investors remain concerned, and some simply do not know where and how to deploy their cash most effectively. Institutional investors and corporate treasurers stand at a crossroads where strategic planning, duration management, regulatory awareness, and technological acumen converge. By embracing a proactive approach, developing robust investment policies, and leveraging technology, investors can unlock the potential of their cash holdings. As the financial landscape continues to evolve, adaptability and a forward-looking mindset will be paramount in not missing valuable short-term opportunities.

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