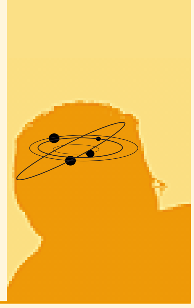

AN EVOLUTION OR RENAISSANCE?

By tracking the history of enhanced cash strategies and looking at the drivers of the current popularity, we can gain an insight into whether they have developed or interest has re-surfaced

Fact: Enhanced cash strategies are becoming more popular in Europe. Fact: These strategies are often characterised by the use of money market funds as alternatives to more traditional products. Yet what exactly has been driving this increase in popularity? What does liquidity management mean for European treasurers? And is the use of money market funds an evolution – or a renaissance?

OPPORTUNITIES

Before we look at the impetus behind the increasing use of money market products, let us take a look at where we are today. The mainland European short-term[1] cash market is estimated to be over €3,000bn[1] in size. Offshore stable net asset value (NAV) Euro-denominated money market funds equal around 1 per cent[2] of the Euro cash market.

To put this into perspective – in the United States, it is estimated that US$-denominated stable NAV money market funds represent approximately one quarter of the cash market.

There are quite large differences in the acceptance and use of money market products within Europe. The greatest growth has been in the UK and Ireland, where historically large US multi-nationals with offshore treasury centres channelled regular cash flows. We have even seen the pace of growth increase over the last few years, as British companies and financial institutions also began seeing the benefits that money market products could provide.

In comparison, the rest of Continental Europe has been a bit slower in implementing active liquidity management strategies. Yet change is inevitable, and the first signs are looming on the horizon.

What does liquidity management mean for the European institutions? Traditional cash investing in mainland Europe revolves around long-term relationships with domestic banks. Eager to keep cash business on the books, these are prepared to offer decent amounts of deposit interest.

> ‘Continental Europe has been a bit slower in implementing active liquidity management strategies. Yet change is inevitable, and the first signs are looming on the horizon’

In those situations where cash is periodically placed in investment funds, the investment objectives and potential returns of such vehicles are markedly different to those of the AAA-rated US-style money market funds. They have a broader exposure to both interest rate and credit risk and often incorporate elements designed to generate an even more dynamic return – thus bearing a much greater resemblance to what have become known as enhanced cash, or cash-plus, products.

Yet what are European institutions really looking for? A 2004 survey of 75 treasurers from 12 European countries showed that around 50 per cent were investing amounts greater than €50m in short-term cash products. More than 60 per cent indicated that they were investing this cash in short-term cash products with an investment horizon of one week or less.

'An evolution has certainly taken place: the demand for enhanced cash products – which swept through European distributors and fund of fund assemblers in the last two years – has been followed by a growing awareness and use of money market funds in portfolios'

But what about the benchmark? Nearly 50 per cent of treasurers polled also indicated that they used EONIA as their benchmark. This clearly shows us that the more traditional money market benchmark of 7-day Libid is not a suitable benchmark for European treasurers. With respect to actual returns, trends show that the majority of European treasurers receive returns in line with EONIA plus or minus a couple of basis points. This tells us that in order to be competitive in mainland Europe, cash management products must be able to, at a minimum, match EONIA over time.

DAILY LIQUIDITY

And here we return to the money market fund. In the light of the investment horizons and benchmark usage of European treasurers, it becomes clear that AAA-rated money market funds, with their inherent daily liquidity and flexibility, would be the ideal investment tool for most liquidity managers. A new generation of money market funds specifically designed for the mainland European treasurer's short-term cash needs are being sought after – and providers of such products are delivering. These new products should and can function as yield-driven complements to traditional overnight bank deposits, giving European treasurers an investment alternative with the benefits of a AAA rating, diversification and less work for them.

So we ask once again – has liquidity management in Europe been the result of evolution or the child of a renaissance? In our view, both.

Since money market funds made their way to Europe their use has mainly been confined to large multinational corporates and financial institutions. These entities quickly recognised the benefits of the ease of liquidity and the diversified range of instruments a money market fund could offer.

POOLS OF CASH

Recently, however, the alternative investment community has also started to use money market funds as a means of managing pools of cash. Specifically, we refer to private equity and hedge funds, both of which have large liquidity needs.

An evolution has certainly taken place: the demand for enhanced cash products – which swept through European distributors and fund of fund assemblers in the last two years – has been followed by a growing awareness and use of money market funds in portfolios. Money market funds have indeed grown into the backbone of any liquidity management strategy.

Yet, simultaneously, a renaissance has occurred. European treasurers, already looking for and receiving EONIA-like returns from overnight time deposits and familiar with enhanced cash products, are now taking a fresh look at money market funds and the benefits they offer.

Our view is that the growth in acceptance of AAA-rated, stable NAV money market funds as an alternative to traditional cash management tools will only continue.

[1]*All cash with a duration of one year or less, both retail and institutional.*
[2]*Source: ECB, Sep-04.*