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PWM

PROFESSIONAL WEALTH MANAGEMENT

SOLUTIONS FOR EUROPEAN DISTRIBUTORS

CASH PRODUCTS

EXCESS CASH NEED NOT BE A PROBLEM

No longer simply a safe haven to store money, cash products have a real role to play in an investor's portfolio, especially if that investor is risk-averse

During the 1990s, when investor expectations were for stock markets to regularly produce double-digit returns, the single-digit returns generated from cash were often overlooked. However, since the turn of the millennium, returns from cash have significantly exceeded those available from stock markets. For example, from 1 January 2000 until 30 June 2004, the DAX equity index fell by 41.7 per cent whilst cash averaged 16 per cent growth over the same period (source CSAM). This divergence of performance cannot be ignored and, while it is true that longer dated bonds have enjoyed an even higher return of around 30 per cent (as measured by the SSSB German Govt Bond Index), it remains a widely held view that the bull market in fixed income bonds is unlikely to be repeated over the short to medium term.

Central banks worldwide have already entered a cycle of higher interest rates, with the notable exception of the ECB. However, even in Europe, it is likely that interest rates will increase either during the latter half of this year or in the first quarter of 2005. The fact that rates are now on the rise has only served to further focus investors on the benefits offered by cash products.

'Cash products are an asset class in their own right, which are suitable for particularly risk averse investors who require a return that compares favourably to deposit rates'
Andrew Dickinson, CSAM

CATEGORIES

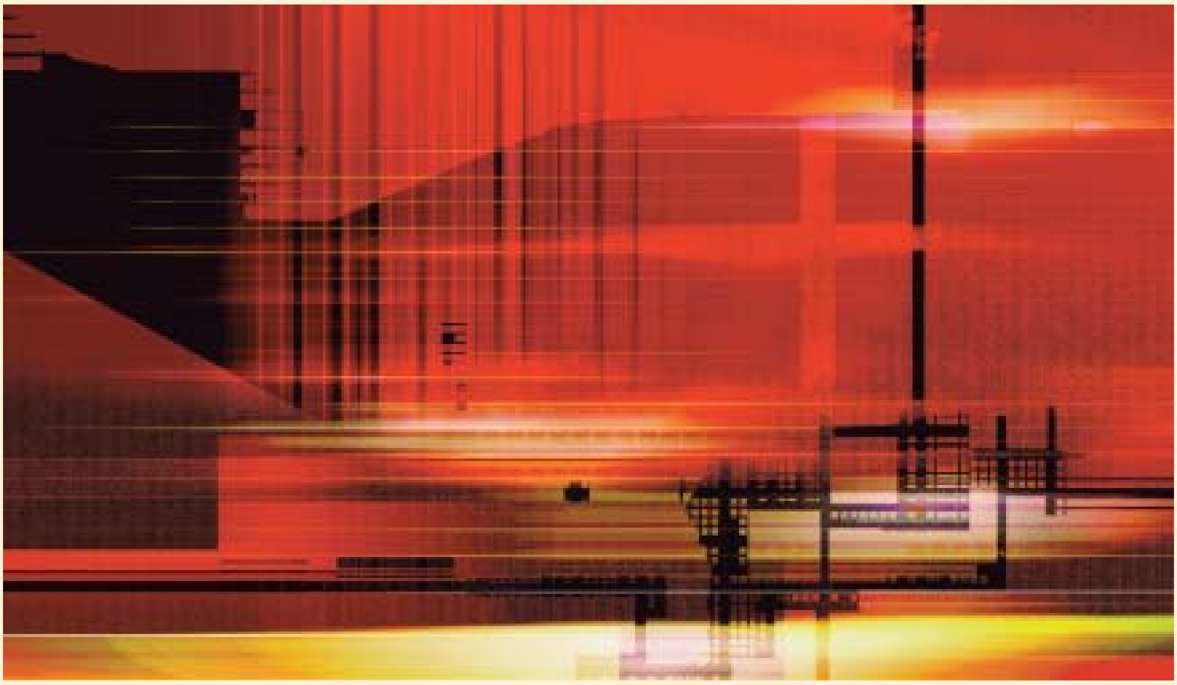
Cash products have traditionally been viewed in the context of tactical asset allocation or as a safe haven to park money in times of uncertainty whilst awaiting alternative investment opportunities.

However, cash products are an asset class in their own right, which are suitable for particularly risk averse investors who require a return that compares favourably to deposit rates.

There are many products available to retail and institutional investors that are covered by the 'cash management' label, but most will fit into four main

1 DIFFERENT CHARACTERISTICS OF CASH MANAGEMENT PRODUCTS

	Liquidity cash	Money market	Enhanced cash	Short duration
Investment horizon	< 1 month	> 1 month	> 1 year	> 1 year
Average rating	AAA	> AA	> AA	> A
Average maturity	30 days	90 days	180 days	1.5 years
Target return	< Libor	Libor + 025%	Libor + 0.40%	Libor + 0.75%



categories (see Chart 1). Chart 1 shows the different characteristics of cash management products with each vehicle representing a gradual increase in risk and return.

CONSIDERATION

When deciding upon a cash management strategy, investors must give careful consideration to their investment horizon and risk appetite.

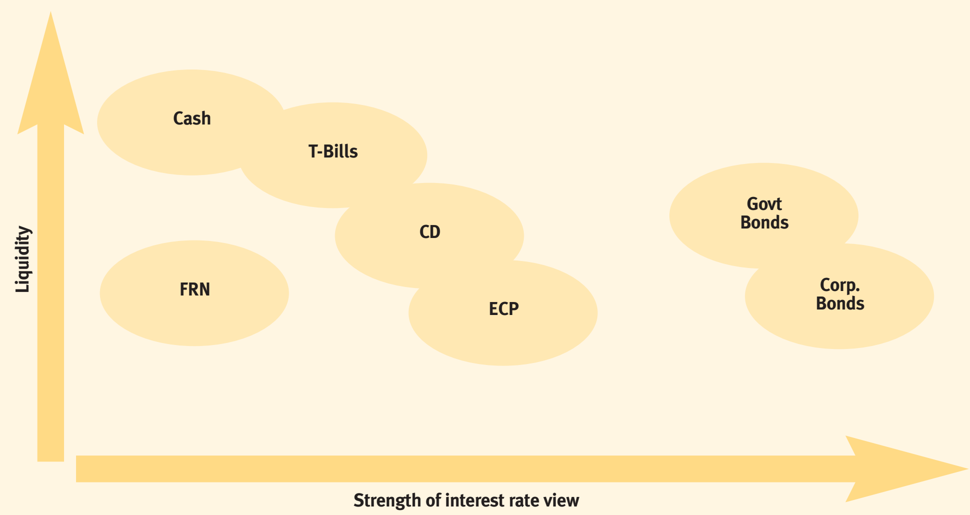
Liquidity cash accounts are designed with preservation of capital as the overriding objective; yield generation is a secondary concern. Their purpose is to provide high liquidity where investors can place large amounts of money for short time periods and enjoy safety of principal above that provided by simply placing money on deposit. As part of an overall investment strategy, these vehicles only serve as a parking facility for cash.

Capital preservation is also the overriding objective for money market funds. Yield enhancement is achieved by increasing both interest rate risk, with investment in fixed rate securities out to one year, as well as the credit risk by investing in FRNs (floating rate notes) with maturities of up to five years.

The purpose of these products is to provide a return above and beyond that available on deposit, whilst maintaining an overall credit quality that is equal to or better than bank risk.

2

How the strength of interest rate views helps determine asset allocation



Source: CSAM

Yield for all seasons

The key benefits of cash management products include:

- **Preservation of capital**
- **Excellent liquidity**
- **Yield enhancement**
- **Steady returns in all investment environments**

'The main difference between enhanced cash and money market funds is the interest rate risk, as illustrated by the longer investment horizon'

Money market funds can form part of an active asset allocation process as a yield enhancer on cash that would ordinarily be placed on deposit, whilst awaiting a tactical shift in asset allocation.

The purpose of enhanced cash products is to provide a pick-up in yield in excess of that available on deposit, as well as maintaining an overall credit quality equal to bank risk.

While the overarching aim of these products remains capital preservation, there is the possibility of absolute negative returns over a short time period (one month). This can occur in times of extreme volatility and low overall interest rates, which can have a negative impact on returns for short periods of time.

The main difference between enhanced cash and money market funds is the interest rate risk, as illustrated by the longer investment horizon, typically approaching one year, offered by enhanced cash vehicles.

Both products can form part of an active asset allocation strategy and are popular, for instance, with corporate treasury departments looking to increase the return on their cash assets by extending maturity. This is an expertise that may not generally be available to them in-house.

Finally, the furthest end of the cash spectrum embraces the very short end of the bond market. Here, short duration funds are designed for investors who are comfortable with the possibility of absolute negative returns for short periods but who have an investment horizon of three years or longer. Over such periods it has been shown that these funds can provide attractive levels of return for a modest increase in risk.

A further feature of cash management products is their use of derivatives, which is typically in the form of asset swaps. Such holdings are not made to leverage the portfolio but are purchased for risk management purposes to take advantage of arbitrage opportunities in the interest rate swap market.

This expertise is not readily available to retail investors or corporate treasury departments and is a further value-added benefit offered by asset managers well versed in running cash management products.

STRATEGIES

When looking at different cash allocation strategies, it is important to remember that the overriding emphasis remains on liquidity and capital preservation. Above this, the search for alpha will be driven by the strength of the portfolio manager's interest rate view against liquidity (see Chart 2).

For example, a strong interest rate view will see a greater focus on longer date fixed securities, such as governments and corporates, whilst a more uncertain outlook would dictate a higher allocation to FRNs and/or very short-term cash deposits.

An analysis of the asset allocation of euro cash funds over the last six months would typically have shown a focus away from longer dated fixed rate securities towards FRNs due to the significant increase in uncertainty over the timing of any potential ECB rate rise.

In summary, with global interest rates expected to rise further, cash products will form an increasingly important part of strategic asset allocation programmes. The view that double-digit stock market returns are a thing of the past may not ultimately turn out to be true but, for the time being, we continue to focus investors' minds on the non-equity alternatives.

Investors with a large risk appetite will undoubtedly continue to select equities, total return or hedge fund products, whilst bond markets will also continue to attract a large percentage of inflows. But for those investors that are primarily concerned with preservation of capital cash will remain king!

Andrew Dickinson, fixed income portfolio manager, Credit Suisse Asset Management