Putting Cash to Work

Eight Strategies to Weather Falling Interest Rates for Separately Managed Accounts

By Lance Pan, CFA®
Director of Investment Research and Strategy
lpan@capitaladvisors.com

Introduction: Higher Rates are Coming to An End

Recent comments by Federal Reserve officials indicate that monetary policymakers may soon start lowering short-term rates as inflation and employment data continue to moderate. This shift comes after a period of keeping interest rates more elevated than initially thought. Meanwhile, stockpiles of cash from Covid-era policies continue to sit idle in bank deposits and money markets funds.

Liquidity investors now have an opportunity to capture relatively high yields by owning longer-maturity instruments before rates start to drop. Separately managed accounts (SMAs) may help investors accomplish this goal more effectively than other cash vehicles.

A Recap on Common Cash Vehicles

Typical institutional treasury functions use various cash vehicles for liquidity and principal preservation. We believe that a portfolio of government and credit instruments with laddered maturities in an SMA is the optimal solution to help maintain high yields for an extended period while preserving organic liquidity and allowing for reinvestments to address the uncertainty of future Fed actions.

1. Checking and MMDAs: Bank checking accounts and money market deposit accounts (MMDAs) offer daily liquidity and deposit guarantees from the FDIC up to $250,000 per taxpayer identification number. Banks and brokerage firms provide sweep features that automatically move unused cash into these accounts at the end of the day. Interest rates are set by the banks based on their liquidity and funding needs but are often lower than short-term market rates, which are linked to the federal funds rate (FFR). Balances that exceed the FDIC limit expose depositors to the banks' credit risk, potentially resulting in delayed access to funds or principal losses in the event of a bank failure.

   Defense Against Rate Cuts: Checking accounts typically offer minimal protection against falling rates, as they often pay little to no interest. MMDA yields generally decline rapidly in response to rate cuts, providing limited defense against a falling rate environment.

2. Money Market Funds: MMFs are mutual funds that invest in short-term debt securities with low credit risk, such as overnight repurchase agreements, Treasury bills, and agency discount notes. These funds offer market-level yields that closely track the Fed funds target range and short-term debt instruments. Following recent regulatory changes, most institutional cash investors have moved into government or Treasury funds, as regulations have eroded prime funds' liquidity and yield advantages. Government and Treasury funds primarily invest in debt from the U.S. Treasury or federal agencies, which have

implicit government support. Daily liquidity and a stable $1.00 net asset value (NAV) make them functionally equivalent to bank Savings/MMDAs.

Defense Against Rate Cuts: Yields on MMFs will start coming down after a Fed rate cut with a time lag determined by the funds' weighted average maturity (WAM), which is held to a maximum of 60 days by SEC regulations. The shorter the WAM, the faster the fund's yield will drop after a Fed action.

3. Certificates of Deposit (CDs): Banks offer CDs with maturities from one month to five years or longer, typically at a fixed rate for the entire term. Depositors agree to keep their funds in the CD for the specified period or face penalties for early withdrawals. Like checking accounts and MMDAs, CDs are FDIC-insured up to $250,000 per taxpayer ID. Balances exceeding this limit expose the depositor to principal and liquidity risks. CD rates are set by the issuing banks and are often lower than market rates on bonds with comparable maturities. If a depositor requests a partial withdrawal with a penalty, they may need to liquidate the entire CD, losing the "locked-in" yield on the full balance.

   Defense Against Rate Cuts: CDs offer better protection against lower rates compared to checking accounts and MMDAs. However, they are less suitable as liquidity vehicles because of early withdrawal penalties. Managing a large portfolio with CDs from multiple banks can be operationally challenging. Additionally, CDs with call options diminish the benefit of maturity extensions, as the issuing bank can close the CD when rates drop.

4. Individual Bonds through SMAs: Cash investors can purchase individual short-maturity bonds with fixed coupon rates to secure higher yields before rate cuts. These instruments may include Treasury bills and notes, agency discount notes, coupon bonds, commercial paper, or corporate bonds. Investors often engage professional investment managers to oversee these portfolios through SMA relationships, where a manager advises on bond allocation to meet the client's maturity and liquidity objectives while providing expertise in credit selection, portfolio reporting, and compliance matters.

   Defense Against Rate Cuts: A portfolio of short-term bonds maintains its yield until the bonds mature. An SMA relationship offers several advantages: A) Flexibility and control in portfolio construction; B) Ability to balance expected portfolio yield against risk preferences; C) Customization based on investment horizon and cash flow needs; and D) Capacity to meet unexpected liquidity requirements by selling well-bid securities. This approach helps minimize tax implications and disruptions to the overall portfolio while providing a robust defense against falling interest rates.

5. Short-Duration Bond Funds: In response to recent MMF regulations, a new class of bond mutual funds emerged: ultrashort bond funds (USBFs). They invest in short-maturity and low-volatility bonds and serve as an alternative cash vehicle to institutional prime MMFs. USBFs typically have longer WAMs than MMFs (e.g., 270 days vs. 45 days). This characteristic allows them to maintain higher yields for some time in a falling rate environment. However, USBFs have two key limitations: A) They cannot "lock in" yields for existing shareholders; B) They offer less predictability of future income potential. As shared liquidity funds, USBFs are not subject to the same level of regulatory scrutiny from the SEC as MMFs. These differences present unique challenges for their adoption by institutional cash accounts. More on USBFs here.

   Defense Against Rate Cuts: USBFs may offer better yield protection than MMFs against declining yields due to higher WAMs. However, their effectiveness depends on future shareholder activities, making them less efficient than a portfolio of fixed-maturity bonds managed through an SMA relationship.

Factors to Consider When Putting Cash to Work

Choosing the right cash vehicles to defend against falling rates is just one aspect of a comprehensive strategy. Investors should consider several factors before implementation. Rather than focusing on precise timing, we recommend gradually building a defensive portfolio as the Federal Reserve's stance shifts towards an easing bias. These considerations are typically more effectively managed in an SMA context compared to other cash options.

The Cost of Staying in Cash: Holding significant cash reserves may provide peace of mind during uncertain times, especially for companies in transition. Current high yields on cash instruments, following a decade of low returns, have made some cash managers complacent. However, in the long run, returns on cash in overnight instruments rarely outpace inflation. Over a business cycle, investors are generally rewarded for extending investments beyond overnight instruments, including lending to non-government borrowers for additional yield.

The "Curse" of an Inverted Yield Curve: The yield curve graphically depicts interest rates across maturities. Normally, investors demand higher rates on longer bonds to compensate for future uncertainty. An inverted yield curve, where short-term rates exceed long-term rates, is often seen as signaling potential Federal Reserve rate cuts to stimulate economic growth and financial market stability. This inversion creates a psychological challenge: buying less liquid instruments for lower yields. Many investors find it easier to maintain the status quo, hence the "curse" of an inverted yield curve. The yield curve has been inverted since 2022, with the inversion deepening over time. As of July 31, 2024, the 3-month Treasury bills yield 5.30%, while 2-year and 10-year Treasury yields are 4.35% and 4.10%, respectively. The 3-month to 10-year yield spread has become more inverted, going from -0.66% a year ago to -1.20% currently.

The Risk of Mistiming Peak Yields: Investors must balance the risk of staying in cash too long against extending too early and locking in yields below current MMF rates. We advise against waiting for clear signals before extending, and instead recommend using conflicting signals as opportunities for gradual portfolio transition. Conversely, portfolio lengthening should not be rushed, as premature actions may limit cash on hand for extension if economic data delays the easing cycle.

No "Right" Maturity Targets: Determining the optimal duration extension for a cash portfolio in a falling rate environment is complex. Investors with high interest rate volatility tolerance and no near-term cash needs can extend as far as their investment policies allow. However, this may expose the portfolio to risks beyond the current interest rate cycle. A balanced approach involves adding longer-term bonds in a laddered fashion through an SMA, creating future reinvestment opportunities as the yield curve shape changes.

The Use of Fixed Rate Bonds (Not Bond Funds): Only fixed-rate bonds with moderate maturities offer protection against falling interest rates. Floating rate notes (FRNs) and callable bonds do not protect against lower rates as their yields tend to move in tandem with short-term benchmark rates or allow issuers to call them at par value when rates drop. Bond funds are suboptimal as new cash can dilute existing shareholders' earnings from previously purchased higher-yielding bonds. An SMA relationship can help provide safeguards against these less effective investment choices.

Eight Strategies to Weather Falling Interest Rates

To defend against falling interest rates, institutional cash investors may employ eight strategies using separately managed accounts.

1. Extend Portfolio Duration: They should consider extending portfolio duration by investing in longer-term bonds across the yield curve. This approach allows investors to "lock in" higher yields before rates decline in line with the Federal Reserve's decision to lower short-term rates.

2. Ladder Your Portfolio: Create a bond ladder by allocating cash in equal parts across various segments of the yield curve with staggered maturities. As rates fall, investors can reinvest maturing bonds into new, longer-term bonds. This strategy not only generates organic liquidity at regular intervals but also reduces the need to time the Federal Reserve's ongoing interest rate moves.

3. Target Yield Curve Positioning: The shape of the yield curve may change during different phases of the easing cycle, meaning yields along the curve may not move by the same amount. A manager can adjust the laddered strategy to take advantage of these shifts while maintaining the overall WAM target and ladder spacing.

4. Adjust Credit Quality: While extending portfolio duration, it is crucial to also adjust credit quality. Falling rates can present conflicting signals. Lower rates generally indicate improved credit conditions and reduced borrowing costs, which may encourage investment in higher-yielding, lower-quality credits. However, they may also suggest that some borrowers are struggling to service their debt due to high current rates, making it wiser to focus on stronger, lower-yielding credits. An SMA manager can assist in making the right risk-reward credit decisions at this time.

5. Rotate Sector Exposures: Rotating sector exposures is important, as different credit sectors perform differently in varying interest rate environments. For instance, banks may benefit from early cuts in the cycle, which can reduce unrealized losses in their government and mortgage portfolios, but their interest margins may be squeezed as the easing cycle continues. If lower rates do not stabilize an economic slowdown, it may be prudent to invest in bonds from more recession-resistant sectors, such as consumer staples.

6. Diversify: Maintaining a diversified portfolio can help mitigate risks and seize opportunities that arise from falling rates. This diversification may encompass different asset classes, maturities, cash flow features, credit qualities, and liquidity characteristics across the investment-grade bond spectrum.

7. Monitor and Rebalance: Regularly monitoring and rebalancing of the portfolio ensures alignment with safety and liquidity objectives in a changing interest rate environment.

8. Hedge Your Bets: It is advisable to hedge bets, as making large market bets can be risky. Even though the Fed appears poised to lower rates, the timing and trajectory of these cuts can be highly uncertain, particularly in a volatile economic climate influenced by both inflationary and disinflationary forces. Therefore, investors should balance their strategies with their risk tolerance, investment goals, and, most importantly, contingent liquidity plans.

Conclusion

In conclusion, the Federal Reserve's impending decrease in short-term interest rates presents a unique opportunity for liquidity investors to secure high yields by investing in longer-maturity instruments. While various cash vehicles are available, Separately Managed Accounts (SMAs) offer unparalleled benefits, including flexibility, control, and organic liquidity. By employing eight strategic approaches, SMA investors may be well positioned to effectively navigate the challenges of a falling interest rate environment, optimize their portfolios, and achieve their investment objectives. As the interest rate landscape continues to evolve, adopting a proactive and informed investment strategy will be crucial for liquidity investors seeking to maximize returns while preserving principal.

About Us

Capital Advisors Group, Inc. is an independent SEC-registered investment advisor specializing in institutional cash investments, risk management, and debt finance consulting. Our clients range from venture capital-funded startups and emerging growth companies to Fortune 100 companies.

Drawing upon more than a quarter of a century of experience through varied interest rate cycles, the firm has built its reputation upon deep, research-driven investment strategies and solutions for its clientele.

Capital Advisors Group manages customized separately managed accounts (SMAs) that seek to protect principal and maximize risk-adjusted returns within the context of each client's investment guidelines and specific liquidity needs. Capital Advisors Group also provides FundIQ® money market fund research; CounterpartyIQ® aggregation and credit analysis of counterparty exposures; risk assessment on short-term fixed income securities and portfolios; and independent debt finance consulting services.

Headquartered in metropolitan Boston, Capital Advisors Group maintains multiple U.S. regional offices.

Disclosure Information

Any projections, forecasts and estimates, including without limitation any statement using "expect" or "believe" or any variation of either term or a similar term, contained herein are forward-looking statements and are based upon certain current assumptions, beliefs and expectations that Capital Advisors Group, Inc. ("CAG", "we" or "us") considers reasonable. Forward-looking statements are necessarily speculative in nature, and it can be expected that some or all of the assumptions or beliefs underlying the forward-looking statements will not materialize or will vary significantly from actual results or outcomes. Some important factors that could cause actual results or outcomes to differ materially from those in any forward-looking statements include, among others, changes in interest rates and general economic conditions in the U.S. and globally, changes in the liquidity available in the market, change and volatility in the value of the U.S. dollar, market volatility and distressed credit markets, and other market, financial or legal uncertainties. Consequently, the inclusion of forward-looking statements herein should not be regarded as a representation by CAG or any other person or entity of the outcomes or results that will be achieved by following any recommendations contained herein. While the forward-looking statements in this report reflect estimates, expectations and beliefs, they are not guarantees of future performance or outcomes. CAG has no obligation to update or otherwise revise any forward-looking statements, including any revisions to reflect changes in economic conditions or other circumstances arising after the date hereof or to reflect the occurrence of events (whether anticipated or unanticipated), even if the underlying assumptions do not come to fruition. Opinions expressed herein are subject to change without notice and do not necessarily take into account the particular investment objectives, financial situations, or particular needs of all investors. This report is intended for informational purposes only and should not be construed as a solicitation or offer with respect to the purchase or sale of any security. Further, certain information set forth above may be based upon one or more third-party sources. No assurance can be given as to the accuracy of such third-party information. CAG assumes no responsibility for investigating, verifying or updating any information reported from any source.

Please note: This report is for personal, non-commercial use only. You may not copy, distribute or modify this report without prior written authorization from Capital Advisors Group.

All contents © copyright 2024 Capital Advisors Group, Inc. All rights reserved.

Capital Advisors Group, Inc.
One Federal Street, Suite 2200
Boston, MA 02110
Tel: 617.630.8100 ~ Fax: 617.630.0023
www.capitaladvisors.com
info@capitaladvisors.com