Asset Class Investment Strategies

Cash

This is a financial promotion. Your capital is at risk, the value of investments may fall and rise and you may not get back the full amount you invested. Past performance is not indicative of future returns.

We continue to recommend keeping cash balances as low as operationally possible, with an allocation of just 1% in 2021. Cash offers near-zero to negative returns depending on the currency and is a poor use of capital in investment portfolios.

For portfolios with a small cash allocation of 2% or less, we continue to prefer the simplicity of investing in money market funds or bank accounts, although these options offer near-zero to negative returns depending on the currency. For larger cash allocations we recommend short duration investment grade corporate bonds as a risk-bearing cash substitute, but one with an acceptable level of risk for roughly 50 bps of additional yield and good liquidity. Investing in our preferred short duration high yield manager can add about 250-300 bps[1] over bank cash rates. Although this strategy comes with more credit risk than investment grade, the credit risk is diversified and has limited duration given the short average maturity of 12 to 18 months.

Asset Class Definition

We define 'cash' as deposits in bank accounts, certificates of deposit, daily-liquidity money market funds and short dated government bonds (2-year maturity or less). Cash solutions should be readily accessible at very short notice (<1 business day) and with minimal credit risk and duration risk.

Clients who are willing to take modest levels of credit or illiquidity risk can substitute cash with short duration investment grade or short duration high yield corporate bonds. These alternatives may offer reasonable liquidity and higher interest income, but should not be considered a true substitute for cash. In stressed market environments, in contrast to true cash solutions, these investments may require some modest impairment in order to generate liquidity.

Role in the Portfolio

Cash typically has no investment role in an optimised long-term portfolio as it offers no risk premium for which we expect to be compensated. Its role in our model portfolio is therefore operational, in that a cash allocation is typically structurally necessary in order to facilitate the implementation of a diversified multi-asset class portfolio, especially one where there are significant capital calls and capital distributions from private market commitments or where there are significant inflows and outflows from the portfolio.

[1] Hypothetical return expectations are based on simulations with forward looking assumptions, which have inherent limitations. Such forecasts are not a reliable indicator of future performance

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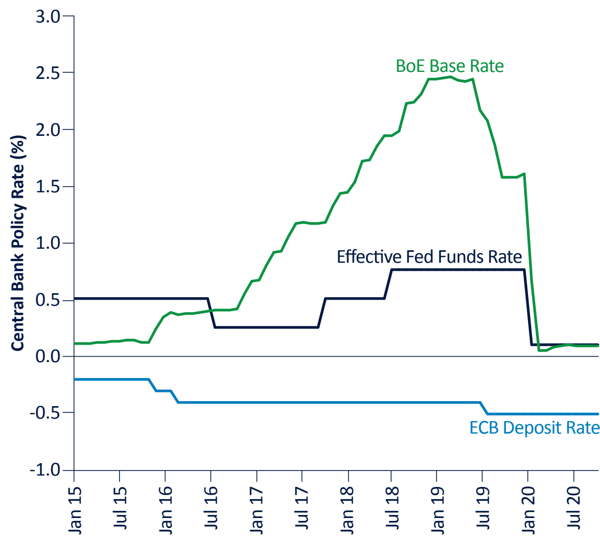
Market Overview

In response to the COVID-19 pandemic, the US Federal Reserve and Bank of England (BoE) brought short-rates down to virtually zero. The European Central Bank (ECB) has run a negative interest rate policy since 2014 and opted to leave the main policy rate at -0.5% (Exhibit 1). As a result, bank accounts, money market funds and short-term government securities all offer near-zero to negative returns. For example, as of 31 January the annualised yield on the 3-month government bonds of the US, UK and Germany was an underwhelming +0.06%, -0.06% and -0.83% respectively.

Exhibit 1

Short rates have been cut to zero in the US and UK, and remain negative in Europe



Source: *Bloomberg*

Duration extension does not provide meaningful yield pickup

Yield curves across developed markets are unusually flat, providing little additional yield for an extension in maturity. For example, the yield on the 5-year US Treasury was 0.4% as of 31 January 2021. The front end of the UK Gilt curve is nearly perfectly flat, with the 5-year Gilt providing the same near-zero return as the 3-month Gilt, while in Germany the 5-year Bund yield of -0.8% is very similar to that of the 3-month Bund. In short, there is no term premium to compensate investors for the higher interest rate risk of holding longer dated bonds.

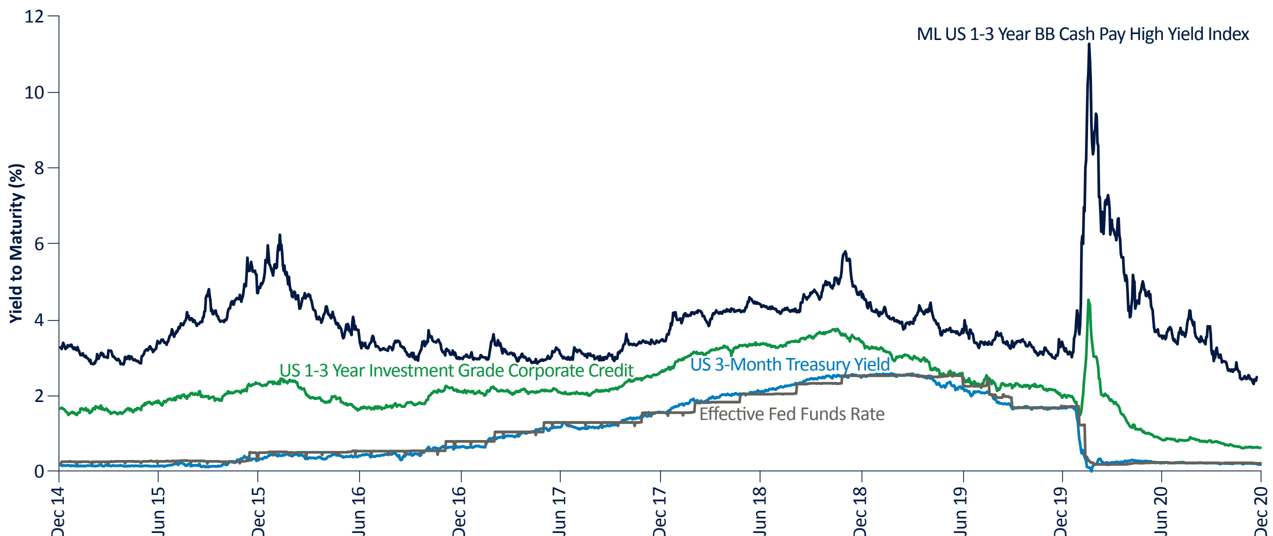
Investment Strategy for 2021

For clients who are able to accept modest credit risk, the best cash alternative remains short duration corporate bonds.

As per Exhibit 2, the Barclays 1-3 year US Investment Grade Index had an effective yield of 0.5% as of the end of January 2021. Lower quality credit options provide an additional yield pickup, with the Merrill Lynch US 1-3 year Cash High Yield Index offering an effective yield of 2.2% as of 31 January. However, Exhibit 2 also demonstrates the danger of adding credit risk in search for higher yield. During the large market sell-off of March 2020 the yield on the ML Cash High Yield Index spiked to 11.1%. The peak-to-trough price decline of the index over this period was -13.5%. The IG index also suffered A sell-off, with a peak-to-trough decline of -5.4%, briefly wiping out more than two years of prior gains. Both indices snapped back quickly on the back of central bank support and liquidity injections.

Exhibit 2

Short duration credit offers a higher yield, but with higher credit risk



Source: *Bloomberg, Merrill Lynch*

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Our preferred low duration high-yield manager attempts to limit the credit risk in high-yield bonds through fundamental credit analysis and careful assessment of the value of any underlying assets to be recovered in the event of default. This should provide a more stable total return over time, but unfortunately it offers little protection from bouts of sentiment-driven selling. The manager declined -13% peak-to-trough in March last year before ending the year +4% higher[2]. As of January 2021, this manager offered an aggregate yield-to-worst of 2.8% (most bonds in the portfolio were trading at yield to call given recent spread compression) and has low interest rate sensitivity with an effective duration of just 1.2 years. This is the preferred solution for those few occasions when a larger cash allocation is necessary. Again, where possible, we continue to advocate minimising cash allocations in investment portfolios.

Cash is sometimes argued to have “option value” to take advantage of investment opportunities that may require an immediate cash payment. Government bond funds or even equity funds with daily liquidity also provide the ability to respond to such opportunities. We have also established lending facilities for most of our clients, whereby the bank provides short-term loans collateralised against the portfolio or redemption proceeds pending settlement, minimising the need for cash on account. Too often we have watched opportunistic cash reserves sit idle for many years, creating a drag on overall portfolio returns that can exceed the excess return generated by the eventual opportune reinvestment. Our approach to opportunistic cash holdings is best summarised by Peter Lynch, who in 1995 noted that “far more money has been lost by investors in preparing for corrections, or anticipating corrections, than has been lost in corrections themselves.”

[2] Past performance is not indicative of future returns, your capital is at risk and you may not get back the full amount invested

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