Cash Alternatives in a Low Yield Environment

It seems as though we’ve been discussing the impact of very low interest rates on investors for many years now and the reality is we have – since at least 2009. Once again, market observers are opining about the possibility of the Federal Reserve increasing short-term rates next year. We’ve heard those calls before in the past few years, but each time conditions changed (or didn’t improve as expected) and as a result, short-term interest rates have remained extremely low for an extended period. Many investors with short-term reserves continue to face the challenge of earning higher returns than money market yields. What are the potential trade-offs for investors seeking higher returns?

When evaluating cash investment alternatives, at the outset it is important to thoroughly understand the tolerance for risk with these assets. Many institutions have their short-term cash assets specifically earmarked for a special purpose and may need to draw on these within a 12-month period, requiring a high degree of safety. Others may maintain short-term assets as “cushion” in the event severe adverse circumstances require them to tap into these assets as an emergency reserve; this scenario also often requires a high degree of safety. Still others may have excess reserves that are more mid-term in nature (2-3 years or longer) that they are willing to assume some small level of risk in pursuit of higher returns. This may involve moving beyond traditional money markets and bank certificates of deposit (CDs). In any event, higher returns almost always involve some sort of tradeoff, which often relates to the safety of the principal or liquidity of the investment. One of the key questions to address is if these assets experienced a loss in market value, even a relatively modest one, what would be the impact?

Money Market Funds

Money market funds are considered relatively low risk investments and while there were serious concerns about their safety in the depth of the credit crisis in 2008, newer regulations have sought to increase their safety. The rate of return and safety of principal are not guaranteed with money market mutual funds, however bank money markets accounts may provide FDIC insurance on the deposit amount up to the current limit of $250,000. Recent SEC changes to money market rules will now require that some funds, primarily institutional prime money market funds, report a floating net asset value (NAV) starting within the next two years. This means that depending on market conditions, those funds may not maintain a stable $1.00 per share NAV. Government and Treasury only money market funds, as well as retail money market funds, are not impacted by the new floating NAV rules and will continue to support a fixed $1.00 NAV.

Most money market funds currently yield in the range of 0.01%-0.05%, an amount that has been fairly consistent over the past few years. Funds with higher minimum investment amounts ($10 million or more), are likely to yield closer to 0.05% or perhaps slightly higher, while money market funds with lower minimums are likely to yield closer to 0.01%.

Certificates of Deposit (CDs)

CDs are issued by banks and are designed to deliver a stated yield over a set term. Bank CDs also may provide FDIC protection up to $250,000. Current CD rates are generally 0.30%-0.45% for a 12-month term and 0.75% to 1% for a 24-month term. For investors with large dollar amounts to invest that are concerned with safety, the lack of FDIC protection above $250,000 can be a concern. Fortunately, there are some programs that can provide FDIC protection above the common $250,000 threshold.

CD (Certificate of Deposit Account Registry Service)

The CD program allows investors to make larger CD investments and have those automatically spread among participating network banks so that FDIC insurance is maintained on the entire investment. Investors work directly with a CD network bank (over 3,000 institutions) and earn the
same rate for each of the CDs they purchase. Rates may not be quite as competitive as those of traditional CDs since the banks in the network pay transaction fees. However, for larger investors looking for safety, the program can provide FDIC insurance on deposits up to and exceeding $50,000,000.

There are usually costs to “break” (or redeem) a CD early so, as with all CDs, it’s important to be comfortable with the term and understand the potential costs associated with getting your money back sooner.

**Brokeded CDs**

Brokeded CDs are negotiable CDs offered and sold through branch networks of financial institutions. The issuing banks are often FDIC insured commercial banks and thrift institutions. The banks offer the CDs to investors and purchase them in the quantities desired (up to $250,000 per CD to maintain FDIC protection).

Some banks offer brokeded CD programs where they assess the relative health of the issuing financial institutions (using outside rating services) before purchasing CDs for investors. Investors can specify whether they want their CD investments to be spread among highly rated banks or less highly rated banks. As one can imagine, CDs from highly rated banks tend to pay less than those from lower rated banks.

With brokeded CDs, the final CD rates are not known until they are actually purchased and the rates of the underlying CDs will very likely vary. Understanding the strength of the underlying CD issuers is very important, particularly if an investor may need to sell in the secondary market prior to maturity.

**Community Bank Networks**

Some community bank networks offer programs similar to CD, where each of the individually chartered banks is wholly owned by a common parent corporation. This allows deposits to be spread among the subsidiaries to increase the total FDIC insurance coverage. Note that total FDIC coverage is likely to be capped somewhere under $3 million depending on the community bank network, so it may not be a viable solution where full FDIC coverage is desired on larger amounts.

As with any of the options discussed here, community bank networks require some research to determine relative strength of the institution and attractiveness of the terms. Depending on the dollar amount of investment, the money market and CD rates through this type of network may be compelling versus the alternative options while still providing FDIC insurance on larger balances.

**Short-Term Bond Portfolios**

As the name suggests, short-term bond portfolios invest in longer-dated maturities, generally with an average maturity of 1-3 years. Current yields on these portfolios range from 0.50% to 1.50% depending on the credit quality and the average maturity. These securities can and do fluctuate on a daily basis. They are subject to credit risk and interest rate risk. With short-term interest rates at historical lows, the impact of potentially higher rates on these portfolios should be fully understood. For instance, with a high quality short-term bond portfolio yielding 1%, it is entirely likely to expect a market value drop of 2.5% if short-term interest rates were to rise by 1% (assuming 2.5 year average portfolio duration). A 2% increase in interest rates would equate to a drop of approximately 5% in the market value for the same portfolio. Of course, the yield earned will modestly offset the loss in market value but an investor would likely still incur losses in this scenario. While there is certainly a yield advantage over money market funds and CDs, short-term bonds can lose value and the risks associated with the current rate environment should be strongly considered when contemplating this option.
Diversified Portfolios

For assets that are targeted for a longer term need of perhaps 3 years or greater with no immediate need for draw downs and a tolerance for some risk, investors should consider a broadly diversified approach. Constructing a portfolio with broad fixed income exposure and a small component of diversified equity exposure can actually have lower expected risk than a portfolio entirely composed of fixed income. This type of portfolio will experience volatility and can lose value in the short run, but it also would be expected to provide greater return potential over longer periods of time.

As you’ll hear us often recommend, periodically conducting the Three Levers exercise is vitally important. All investors need to understand the expected inflows, outflows and required return for their portfolio. Once those have been identified, only assume the risk that you must in order to achieve your goal.

With many options to consider, it’s important to understand the downside to whichever path you pursue. Keep in mind that a common thread exposed during the financial crisis was investors’ tendencies to take on risks that they did not fully understand in search of marginally higher returns. Consider the true purpose of the short-term cash and invest with a strategy that is best aligned with that purpose.

For further information and assistance with evaluating cash alternatives, please contact any of the professionals at MPS LORIA.