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A Strategic Approach to Managing Cash in a Rising Rate Environment

Surging inflation, a hawkish Fed and talk of a recession are prompting corporate treasuries to reevaluate their cash investment strategies. While cash remains a massive – and often an underperforming – asset on corporate balance sheets, 70% of respondents to a NeuGroup survey, conducted in partnership with Clearwater Analytics, report they do not intend to extend duration in order to take advantage of the uptick in yield, and some are rolling off longer maturities.

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REPORT HIGHLIGHTS:

1. **Investible cash.** Corporate investors expect their significant, strategic cash balances to remain steady or grow this year as they monitor current events and evolving market conditions.
2. **Extending duration.** The most common response to recent shifts in the market has been to maintain - or slightly shorten - duration, reflecting concerns about market volatility and rising interest rates.
3. **External managers.** The amount of investible cash on the balance sheet continues to play a factor in offering economy of scale to corporates, driving those with smaller portfolios to seek the expertise of external managers.

"The yield curve is definitely signaling an inversion, particularly between the two- and 10-year rates and therefore an upcoming recession," said one of our survey respondents in a follow-up interview. "We are running scenario analysis using advanced analytics to determine our cash position given different recession scenarios." In addition, his company and others are stress-testing their portfolios against the potential fallout from the crisis in Ukraine. (See sidebar on p.2) Our survey, *Going Out the Yield Curve: Benchmarking Investment Strategies* closed on April 14 and was distributed to corporate institutional investors, including members of NeuGroup's two Cash Investment Management Peer Groups. The objective was to enable peer companies to compare and validate their asset management strategies.

SOLVING FOR THE CASH CONUNDRUM

US companies are sitting on nearly $2 trillion in cash, reflecting a period of frenzied debt issuance, healthy earnings going into the pandemic and over two years of defensive liquidity strategies. For cash-rich companies, realizing meaningful returns in a record-low interest rate environment has been a persistent challenge. With the Fed edging rates up one question facing treasury is whether it is time to extend duration to boost anemic yields. Our survey results indicate that adjacent risks are halting the move out the curve.

THE WAR IN UKRAINE: AN ADDED LAYER OF RISK

Inflationary pressures and economic uncertainty are the two major triggers of corporate investment portfolio reviews; however, the crisis in Ukraine has introduced an added layer of risk. As Fig. A illustrates, most treasury organizations are currently making marginal changes and watching the situation closely.

"The approach we've taken is to do additional analysis. Normally, we just follow our policy, which is very conservative to begin with. However, with the situation in Europe, we basically put a pause on new investments," one of our survey respondents said. "We didn't unwind anything, but we are doing more due diligence and adding some additional questions, for example, about our exposure and different possible outcomes." So far, the more deliberate monitoring has not led this company to make changes. "We just keep a closer eye on our allocations and our different partners, so if something happens, we will be able to unwind in time."

Concern about increased market risk topped the list of factors driving the change in mindset (Fig. B). "I think the war in Ukraine throws in some more uncertainty around the direction of interest rates," one member told us. "The impact of all these unprecedented economic sanctions is still unknown."

Focus group participants agreed that while things may change, for now the situation in Europe remains a localized issue, compared to the impact of the pandemic. "With the pandemic, we took a lot more action because it was so broad to the market. We asked our portfolio managers to stop all investments and just allow securities to mature and cash to build up. So, we actually took cash back because we were concerned about liquidity."

Figure A: Impact of crisis in Ukraine on cash investment strategy?

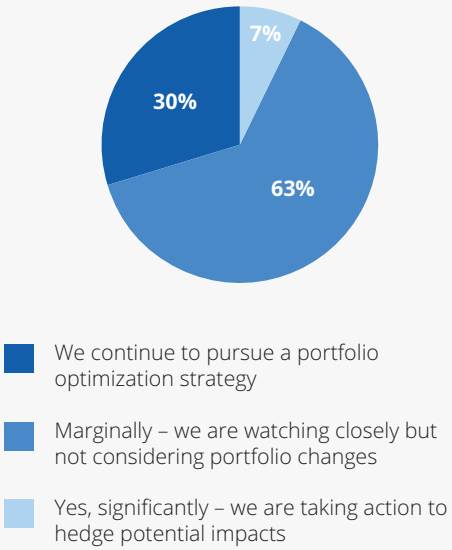


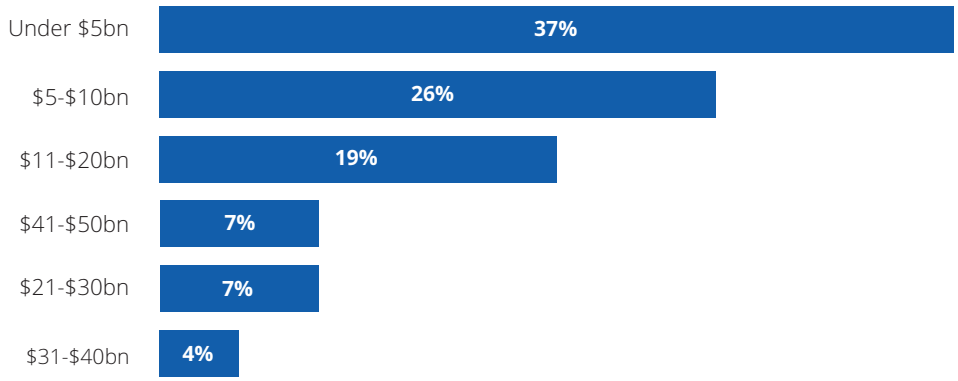
Figure B: The most important drivers of changes in policy

Source: Going Out the Curve: Benchmarking Investment Strategies, NeuGroup 2022

It is important to view these findings within the context of the demographics of the survey participants, who boast an average of $5.95 billion in cash on the balance sheet. However, as **Fig. 1** illustrates, there are some "fat tails" on this distribution, with a significant minority (18%) reporting that they have over $20 billion in cash on hand.

Not surprisingly, the larger the overall cash balance, the greater the share of corporate cash that can be allocated to longer-duration or more credit-sensitive assets. For example, 18% of companies with under $10 billion of balance sheet cash consider over 50% of their cash as investible, compared to 74% of organizations with cash balances of $11-$30 billion.

Figure 1: Cash on the balance sheet

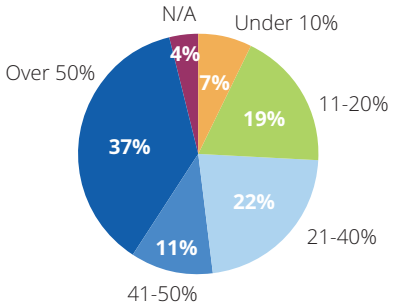


Our survey shows that investible cash balances are set to remain the same or even rise, with 40% and 44% choosing those respective categories.

However, there is more than absolute levels of cash that goes into the decision about what falls into the investible cash bucket. Corporate investors typically tier their cash by dividing it into three buckets: operational cash, cash reserve and strategic cash. By creating these separate categories, treasury is able to determine what share of corporate cash is available for investment in longer-duration or corporate fixed-income and other assets.

To get a more precise picture of how companies are managing their cash position, we asked our members to identify how much of their total cash fits within that strategic bucket, or their investible balances, i.e., cash exclusive of operational cash, e.g., overnights, repos, money market funds and CP. Given our member companies' over a third consider more than half their cash position as available for longer-duration investments (**Fig. 2**). Plus, our survey shows that investible cash balances are set to remain the same or even rise, with 40% and 44% choosing those respective categories.

Figure 2: Percentage of balance sheet considered investible*



*i.e., cash exclusive of operational cash, e.g., overnights, repos, money market funds and CP

Source: Going Out the Curve: Benchmarking Investment Strategies, NeuGroup 2022

We're narrowing the maturity horizon for our external managers, getting our duration level down to an area where it hasn't been for some time.

The two biggest factors affecting the amount of cash available for investing are operations and M&A activity expectations. The latter comes in two flavors: Companies that have completed major acquisitions in the past few years and are not currently planning significant additional ones are more likely to project flat or rising cash levels. In contrast, of companies forecasting declining balances, 33% cited M&A as a driving factor, i.e., these less acquisitive organizations may use some of their cash balance to execute M&A deals.

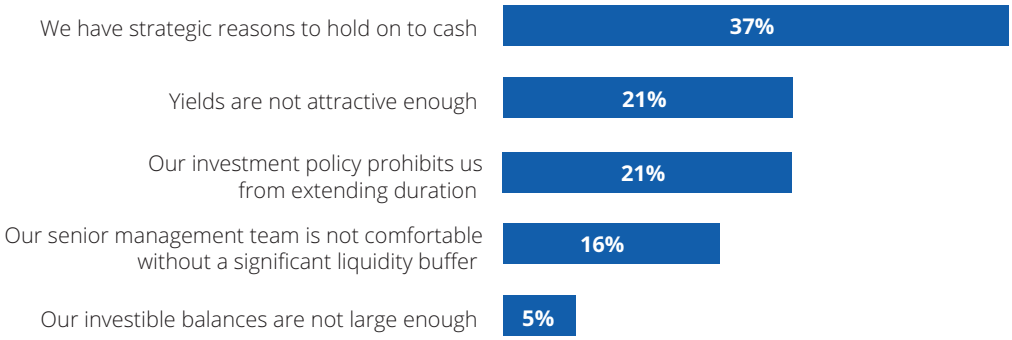
DURATION DECISIONS

Our survey found that 70% of respondents have no plans to extend duration at this point. On the contrary: "We are deliberately taking steps to take duration off the table," said one member who participated in a follow-up focus group. "We are cognizant of experts' message that the Fed is behind the curve, and inflation will be more persistent than many had expected." He added: "This does not mean we are selling off in any significant manner – no one wants to sell into a weak market." Instead, he said, "we're narrowing the maturity horizon for our external managers, getting our duration level down to an area where it hasn't been for some time."

Another participant noted that while treasury is not putting on interest rate hedges, "we are aggressively pulling funds back." Consequently, we see the beginning of a trend to pull more cash into internally managed portfolios with a renewed interest in money market funds. With short-duration assets, "we feel comfortable that we have the expertise," he said.

The decision to move out the curve starts with identifying the amount of cash in the strategic bucket. However, not having enough investible cash is the least important reason currently stopping investment managers from buying fixed-income instruments (**Fig. 3**). Other factors play a larger role in this decision: the company's strategic needs and the combination of investment policy and board and management comfort level. The three are interrelated, e.g., a significant liquidity buffer, or cash reserve, may be necessary to assuage board concerns.

Figure 3: Factors stopping companies from extending durations



Source: Going Out the Curve: Benchmarking Investment Strategies, NeuGroup 2022

According to our survey, the biggest obstacle to pushing forward with a longer-duration strategy is executive support, cited by 64% of members. Getting executives to become more comfortable depends primarily on economic conditions. **Fig. 4** shows the factors that would help garner greater support. Top among them are issues related to clarity of economic forecasts, which includes many of the "other" options, e.g., cooling inflationary pressures and less price volatility. Tellingly, 25% of respondents are looking to determine their direction through peer benchmarking (hence the survey). Changes in liabilities and visibility into business needs are also important considerations.

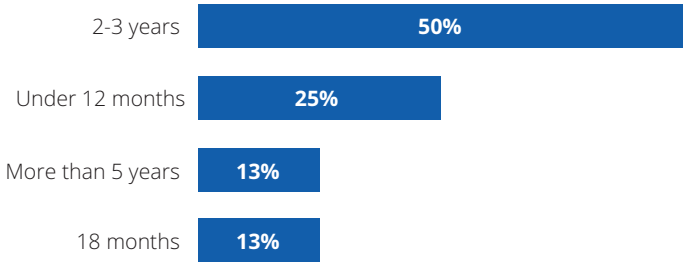
Figure 4: Factors that would increase level of comfort with extending duration

Source: Going Out the Curve: Benchmarking Investment Strategies, NeuGroup 2022

We've been busy buying bonds for the last month and a half, which is what we had planned. I'm actually looking at extending it a little bit further. Most of my duration is kept under two years, so I won't pick up 100% as we're going along. However, there's a lot of that expectation already priced in the issuances today.

It is important to note that not everyone is pulling back. Almost a third of our respondents are actively extending the duration of their portfolios. Among this cohort, the most popular range is 2-3 years (**Fig. 5**). "We've been busy buying bonds for the last month and a half, which is what we had planned. I'm actually looking at extending it a little bit further. Most of my duration is kept under two years, so I won't pick up 100% as we're going along. However, there's a lot of that expectation already priced in the issuances today." This member and another said they are also increasing their allocation for floating-rate notes.

Figure 5: Plans for extending duration



Source: Going Out the Curve: Benchmarking Investment Strategies, NeuGroup 2022

GETTING THE BOARD ON BOARD

Securing senior management approval is essential for allowing treasury greater flexibility around duration and credit exposures. However, getting approval has been a perennial issue for treasury professionals. As companies revisit their investment strategies, this may be an opportune time to consider whether it makes sense to try again.

Companies in our survey that have achieved board approval for extended duration and exposure to some corporate credit risk report that the key to their success was presenting the change in approach in a strategic context, using cash modeling. Instead of focusing on the absolute or relative size of the investible portfolio, they conducted analysis to determine how much cash is required in each of three categories: Operational cash, reserve cash and strategic cash.

"Getting management on board has been a big effort last year," according to one participant. "The way we got board approval was by talking about our uses of cash, how much was needed for operating purposes, and how much we should maintain for reserve purposes. This analysis gave us a firm understanding of how much of the cash was strategic, in other words not necessarily

required to maintain credit ratings. Once that amount got defined, it was easier to position strategic cash as cash that has no specific purpose in the next year; therefore, we could match the tenure of the investment with that amount of balance."

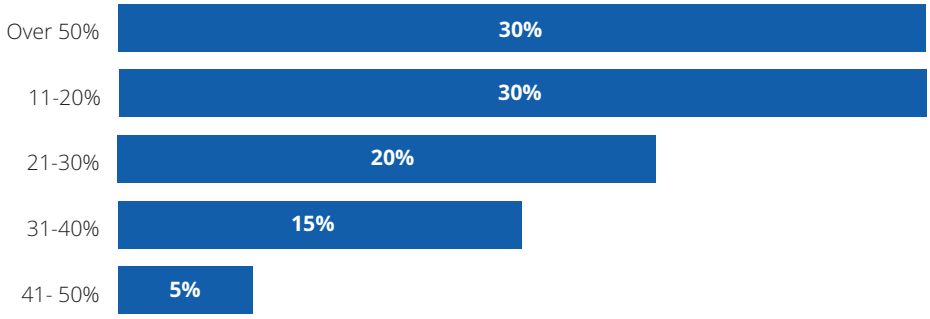
"This approach is in essence an asset/liability management strategy," another member added. "That's what helped get the approach sold. From there, we could ask more questions, for example what is the principal-preservation strategy and what investments do I want to go after?" he said. "When we got the green light to go from basically zero to two years, it got everybody excited."

LEVERGING EXTERNAL EXPERTISE

When the board approves a policy that allows duration extension, it raises questions about credit and interest-rate risk. We see this reflected in our members' choice to outsource a large portion of their portfolio to external managers. (**Fig. 6**).

Our view is that we can handle very short-term investments like our Treasuries buy-and-hold portfolio and save the cost on that. Where we look to use managers is when we seek out investments that are further out in duration, where they're going to inherently carry more risk.

Figure 6: Percentage of investible cash currently managed by external managers



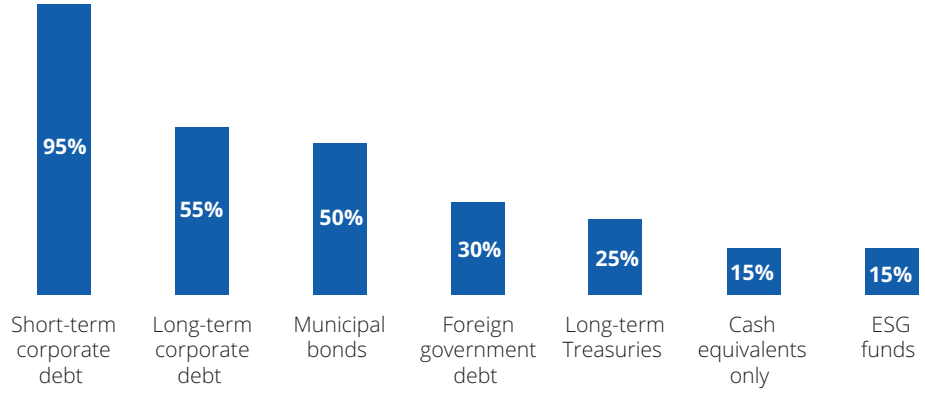
Source: Going Out the Curve: Benchmarking Investment Strategies, NeuGroup 2022

Conversations with our focus groups indicate that the primary rationales for outsourcing a significant portion of investible cash is outside managers' credit analysis and asset-specific expertise. "I cannot replicate the credit review support staff that portfolio managers offer; they get economies of scale by providing that service to a lot of customers. Generally speaking, they also have more industry knowledge, so I can stay more of a generalist as opposed to trying to specialize in corporate bond issuance," according to one member of the cash investment group. When credit and active trading are not an issue, this company manages its cash internally. "Our view is that we can handle very short-term investments like our Treasuries buy-and-hold portfolio and save the cost on that. Where we look to use managers is when we seek out investments that are further out in duration, where they're going to inherently carry more risk."

In addition, treasuries with separately managed accounts (SMAs) are also looking for managers for specialty skills, for example in asset-backed securities. As **Fig. 7** illustrates, almost all of our respondents have an allocation to short-term corporate bonds. However, long-term corporate debt and munis also rank highly. Macroeconomic research and credit analysis skills are especially important for the 30% of treasuries that invest in foreign-government debt.

Perhaps counterintuitively, companies with a higher percentage of investible cash are less likely to leverage external advisors. For example, 60% of respondents that count over 50% of their cash balances as investible utilize outside advisors, whereas companies with under $10 billion outsource 100%. That is because treasuries with more significant cash portfolios have the economies of scale to afford building internal market and credit expertise, purchase more sophisticated trading and accounting systems and hire the right talent.

Figure 7: Asset categories for cash managed externally



Source: Going Out the Curve: Benchmarking Investment Strategies, NeuGroup 2022

As events are unfolding at a rapid pace. Investment managers must monitor developments and market signals diligently and communicate with their managers to ensure they remain aligned.

CONCLUSION AND ACTION ITEMS

The environment for investing corporate cash will remain fluid, as inflationary and recessionary concerns play out, and until there is greater clarify about the global repercussions from the severe Western sanctions and Russian counter-sanctions. For corporate cash investors, there are five important implications:

1. **Continuous evaluation.** As our survey indicated, the prevailing response to the changes in the rate and economic environment have not led to significant alteration to investment strategies. However, this approach must be continuously reviewed, as events are unfolding at a rapid pace. Corporate managers must monitor developments and market signals diligently and communicate with their managers to ensure they remain aligned.
2. **Cash modeling and scenario analysis.** Another important action item for cash investment managers is to transition from the typical cadence of determining how much cash should be in each of their three liquidity buckets to a more frequent or even an event-triggered approach that is aligned with the company's sensitivity to rate hikes and an economic downturn. It's incumbent upon treasury to rerun its cash model to determine whether changing conditions must alter the distribution of cash along the operational, reserve and strategic categories.
3. **Cross-functional collaboration.** This is also the time to collaborate more closely with other parts of the finance organization, e.g., customer-to-cash and FP&A. Typical AR metrics like DSO and DPO can be an early warning sign of trouble ahead, and FP&A teams are looking at longer-term cash modeling and business scenarios.
4. **Increased communication with external managers.** Outside advisors' expertise in credit and duration are only more valuable now as is the need to align their specific mandates with treasury's view. Corporate cash investment managers should increase the frequency of discussions with external advisors to gain market intelligence, detect red flags and ensure mandates remain in sync with the results of their cash modeling and scenario analysis.
5. **Benchmarking with peers.** Finally, during times of volatility, it becomes essential to pressure test and validate investment strategies with peers inside and outside the industry. While market pros can provide expert advice, ultimately, the best insight comes from other corporates. Treasuries that are NeuGroup members are already leveraging our research, their groups' monthly sessions, semi-annual meetings, the communities page and our Connected by NeuGroup capability to find out what others are doing.

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