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## Revisiting Cash Management: Strategies for Capturing Incremental Yield in the Current Environment

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Cash is an unglamorous – but critical – element of portfolio management. For the past couple of years, yields on cash-like investments were negligible, leading endowments to take the simplest and most convenient approach to cash management: Holding cash in bank accounts bearing little to no interest. This year's increases in short-term interest rates, driven by the Federal Reserve, have changed this calculus. For example, 1-year Treasury yields were close to 0% in early November 2021, compared to more than 4.7% in early November 2022. Non-profits able to explore more active approaches to cash management have the potential to realize some additional return in a market environment that has been challenging for all asset classes.

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### Defining Cash Needs

How should an organization approach a possible shift in cash management strategy? The first step is to evaluate and define cash operating needs. It can be useful to group cash needs into four categories, defined predominantly by timing of expected need:

1. **Immediate:** funds required to clear an issued check or another imminent expense
2. **Near Term:** cash needs that can be foreseen by at least a few days
3. **Medium Term:** a known amount of cash needed at a defined time that is at least one or more months in the future
4. **Reserves:** cash without an earmarked use or anticipated timing

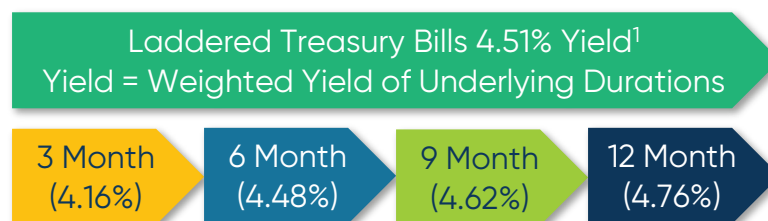
The greater the uncertainty around cash needs, the more conservative an organization may want to be when classifying cash needs.



## Mapping Cash Needs to a Cash Management Strategy

The appropriate cash management strategy will be driven by when an institution expects to access the cash being held. Potential cash management strategies by horizon are:

- **Immediate**
  - Typically should be held in a checking or other demand-deposit account
    - Yields are usually close to zero, and the amount held should be minimized
- **Near Term**
  - Cash required in a few days or more should be held in a money market
    - Money market sales settle in one day, and cash is generally available to wire or otherwise move from the brokerage a day or two after the sale
- **Medium Term**
  - Cash needed in 1 to 12 months can be held in a Treasury Bill maturing shortly before the required date
    - Once a bill is purchased, its yield to maturity is locked in, as are both the timing and the exact amount of cash available at maturity
- **Reserves**
  - Cash with an unknown use or horizon can be invested in a *rolling* ladder of Treasury Bills, providing improved yield for an indefinite period, while still allowing ready access to cash
    - A typical strategy could be to put 25% of the reserve into each of the current 3-, 6-, 9- and 12-month bills
      - » When the shortest bill matures in 3 months, reinvest the proceeds in the then-current 12-month bill
    - If a cash need arises, all bills can be readily sold with one day settlement
    - Bill prices - and thus the proceeds received upon any sale before maturity - do change with short-term yields, but this ladder is built with short duration to minimize this risk



<sup>1</sup> Note: As of November 7, 2022 closing mid yields. Laddered Treasury Bills assumes 25% weight each to 3-, 6-, 9-, and 12-months bills. Source: Bloomberg.



- » For example, at an average laddered duration of 6 months, even a very large, sudden 2% increase in yields would only reduce the value of the bills by about 1%
- » If the bills are held to maturity, there is no such interest rate risk, since the exact proceeds upon maturity are locked in (but see “Opportunity Cost” below)

A cash management strategy should be unique to the institution. It is important that you consider your organizational needs before implementing a strategy.

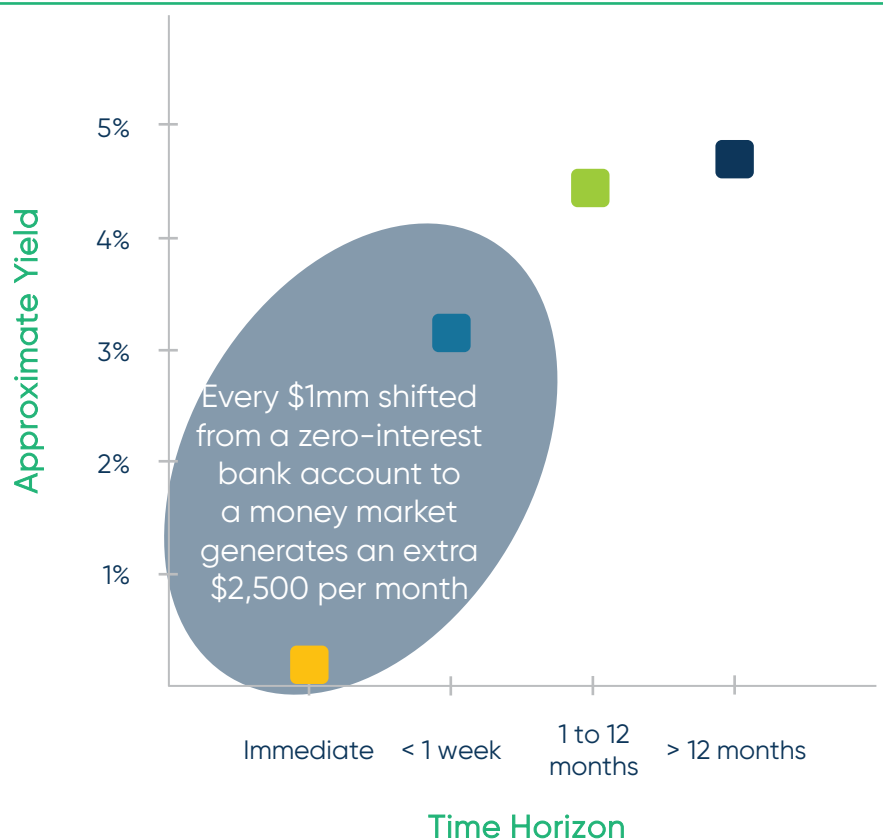
### Measuring the Tradeoff of Convenience for Return

At time of writing, competitive money markets are yielding more than 3%, and a bill ladder as described above yields about 4.5%. For every \$1 million that an organization shifts from a zero-interest bank account to a money market, it can expect to earn an extra \$2,500 per month; with laddered treasuries, an institution could earn additional \$3,750 per month per \$1 million.

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## Cash Management Strategy and Prospective Yields by Time Horizon

- Checking Account 0%
- Money Market >3%
- 6-Month T-Bill 4.48%
- Laddered T-Bills 4.51%





## Considering Risks

- **Credit:** The credit risk facing a reputable money market provider or the US Treasury is low and generally not higher than that facing a bank
- **Interest Rate Risk:** Money market rates can change at any time but, as in a bank account, changes in their rates do not impact their asset value
  - Bills do have some sensitivity to interest rates and can lose value when rates rise as noted above, but the sensitivity is small
  - In the example above, even a very large, sudden 2% increase in rates costs the bill ladder only about 1%
    - At a 4.5% yield, this 1% would be recouped in less than 3 months
- **Opportunity Cost:** The outlook for yields can be a perceived risk, and it is important to keep in mind that opportunity cost cuts both ways
  - An investor must ask, "Will rates go up further if we wait?"
    - Every month waiting for (impossible-to-identify) peak rates may cost a typical portfolio thousands of dollars or more

## Ease of Implementation

Implementation can be straightforward, regardless of which of these strategies an organization may choose.

Money markets are very competitive:

- Focus on a money market's "SEC yield" which shows apples-to-apples effective yield after all fees and subsidies
- If investing a larger balance, look for a money market with a higher minimum as headline fees on these funds are often subsidized to result in better SEC yields
- The biggest pricing risks are transaction and other fees imposed by the brokerage platform you select

Treasury Bills trade in an extremely liquid and transparent market:

- There is only one bill at each maturity, so no need to "shop around"
- The "bid/ask" for bills – the effective cost of buying and, if necessary, selling before maturity – is small, and typically measured in single-digit basis points
- There may be brokerage fees and commissions



Assessment of cash needs can be simple and quick. A conservative analysis and an equally conservative, simple strategy realizing 80% of the potential gains will generally be of meaningful value.

## Conclusion

While the inflation outlook remains unclear, the Federal Reserve's monetary policy approach and the resulting improvement in short-term yields have given non-profits the opportunity to replace close-to-zero yields on their cash with meaningful positive nominal returns.

We encourage you to reach out to us about this note and your organization's cash needs and to your banker or other financial institution to discuss an appropriate cash management strategy for your organization.

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