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Cash Management:

Positioning for the Next Phase of the Rate Cycle

Authored by: Oliver Bardon, Head of Risk

Executive Summary

Last year, we advised members on how to take advantage of rising short-term rates and harvest yield on cash holdings. Now, as this period of rapid and frequent rate hikes may be ending, we offer our guidance on how to navigate a phase of stable and possibly declining interest rates. Specifically, we share views on:

- Adding duration to lock in yield
- Mitigating the duration risk that comes with longer-term rates

We also review the four categories we use to group cash, determined by timing of expected need.

- Reserve funds provide the greatest opportunity to extend duration and lock in yield

We recommend a strategy to take advantage of the current rate environment using Reserve funds – even as we caution that members must have some degree of confidence that those funds will not need to be accessed prior to maturity of the recommended investments.

The interest rate movements of the past 18 months have made the usually staid world of cash management an interesting – and increasingly important – component of portfolio construction. Last fall, in [Strategies for Capturing Incremental Yield in the Current Market](#), we wrote about this dynamic as short-term rates were in the midst of an unprecedented rapid rise. We may now be entering a



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[Strategies for Capturing Incremental Yield in the Current Market](#)



next phase in this interest rate cycle: It seems increasingly likely that short-term rates, driven by the Federal Reserve, have substantially peaked. We anticipate a period of more stable rates and the prospect of a decline in rates, an almost inevitable next phase in the rate cycle. This new phase of potentially peaking and ultimately declining rates causes us to revisit our analysis and to consider adding duration to our cash-like holdings.

Duration is a measure of the sensitivity of a fixed income investment's present value to changes in prevailing interest rates.¹ It is a function of both prevailing rates and of how long it takes to receive the principal and interest accruing from a fixed income investment. Generally, the longer a bond's principal is outstanding and it is paying its coupon, the greater its duration. From a cash-management perspective, duration indicates how long an investor locks in a yield. Duration carries risk: For fixed coupon bonds, the present value of a locked-in yield decreases as prevailing rates increase – that is, as the market offers a higher yield than the one the investor has locked in. This risk increases with greater duration. The longer the lock-up period, the greater the sensitivity of the bond's present value to changing rates. This risk works both ways, as a bond's present value will increase if rates decline, as may be the case in a recession.

A thoughtful cash-management strategy can mitigate this risk and allow the investor to take advantage of attractive longer-term rates. The key is simply to make as certain as possible that one never has to sell a bond for liquidity needs. No matter the path of interest rates during the life of a bond, its purchase yield is guaranteed as long as it is held to maturity, assuming the bond does not default – which Treasuries historically have not. The hold-to-maturity investor is thus effectively immunized from duration risk and can more safely lock in longer attractive yields.

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The key to not having to sell is asset-liability matching: making the maturity of each cash-management investment line up closely with the time when that cash will be

¹ Duration is usually expressed in terms of the sensitivity of the present value of an investment to a 1% parallel move in interest rates, i.e. a 1% move in all rates along the maturity curve. If a bond's value changes by 7% when prevailing rates change by 1%, the bond is said to have a duration of 7 years.



needed. Asset-liability matching is always an important element of cash management no matter the interest rate environment, and we reiterate the 4-tier approach we laid out last fall.

Members should 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

Strategies for first three categories are largely independent of interest rate environment:

Immediate	Near Term	Medium Term
<ul style="list-style-type: none"> ▪ Typically should be held in a checking or other demand-deposit account (DDA) that facilitates payments ▪ Yields on business DDAs are usually close to zero – even in today’s higher rate environment ▪ The amount held in DDAs should always be minimized 	<ul style="list-style-type: none"> ▪ Cash required in a few days or more should be held in a money market ▪ Money market sales settle in one day <ul style="list-style-type: none"> ▪ Cash is generally available to wire or otherwise move from the brokerage a day or two after the sale ▪ At the time of our paper about 9 months ago, money market rates were already greater than 3% ▪ Today money markets are available yielding more than 5%, making the need to minimize low-yielding bank holdings and keep near-term funds in money markets even more important 	<ul style="list-style-type: none"> ▪ Cash needed at a known future date can be held in a Treasury bill or note maturing shortly before the required date ▪ Once a bill or note is purchased, its yield to maturity is locked in, as are the timing and the exact amount of cash available at maturity ▪ Nine months ago, Treasury bills locking in rates and cash flows for 3 to 12 months averaged around 4.5% ▪ Today they are closer to 5.5%



The fourth category of **Reserves**, cash with no specific uses or horizons, is where we suggest you consider increasing duration. As we did last year, we recommend a rolling ladder of Treasury instruments, extending it to a longer duration. A reasonable strategy could be to put 25% of the reserve in each of 1-, 2-, 3-, and 4-year notes. At the time of writing, a typical shorter ladder of 3-, 6-, 9- and 12-month bills – one that we illustrated in our last cash-management paper – yields just over 5.5% with a duration, or effective rate lock-in period, of about 7.5 months. The longer ladder yields about 5.1%, with a duration of a little under 30 months. We effectively trade about 0.4% of yield over the first 7.5 months for the certainty of 5.1% yield over the subsequent 20+ months. Why would we knowingly make this tradeoff? Because we believe in the current potentially peaking rate environment that the risk to short-term yields is asymmetrically to the downside. If rates decline and we were to roll the shorter ladder, its yield is likely to drop below that of the longer ladder.

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Current short-term futures markets suggest that short-term rates may be slightly above 4% in 2025 and 2026. Illustratively, in round figures, the longer ladder could give up 0.5% yield over its first year, break even the second year, and add 1% in years 3 and 4. Versus the shorter ladder, the longer ladder could add around 0.4% on average per annum, or an additional ~\$15,000 for every \$1mm invested over the 4-year period.

We also take advantage of the cash-management strategy's built-in "risk management option": If rates do instead go up, we are happy to receive the yield to maturity of the first leg of the ladder and roll the proceeds into a new longer, higher-yielding bond, never having to sell notes at a loss. Of course, all the laddered funds still serve their fundamental purpose as a reserve. If any reserve cash is needed, the extremely liquid notes can be immediately sold. If prevailing rates have gone up, the sale would be at a modest loss. For example, if rates have gone up a very significant 1% immediately after implementing this strategy, the approximately 2.5-year-duration ladder would have lost about 2.5% in present value, and the shortest 1-year note in the ladder would only have lost about 1%. Reserve funds should be unlikely enough to be needed that this modest duration risk is worth the reward of locking in attractive yields for an extended period.



As always, a cash-management strategy should be unique to the institution. It is important that you consider your organizational needs before implementing a strategy, carefully considering the asset-liability management that is the foundation of good cash management. TIFF has begun extending the duration of our members' fixed income holdings, the degree of extension varying with the specific needs of the individual members and of the specific TIFF commingled funds.

Conclusion

As the inflation outlook has begun to stabilize and the Federal Reserve's monetary policy actions may have peaked, the opportunity may be ripe for institutions to secure their cash management situation by locking in longer-term yields.

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

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