

Liquidity Perspectives—3Q16

Investment policy guidelines: Time for a review?

- Regulatory changes and the low rate environment are forcing many treasurers to rethink their cash management strategies and adjust their investment policy guidelines.
- Developing methods and guidelines for separating cash into operating, reserve and strategic buckets may help in crafting a sound investment policy. Doing so may help to mitigate many of the most pressing challenges facing corporate treasurers today, allowing them to seek to:
 - Maximize operating cash value
 - Broaden the investable universe
 - Reduce the potential impact of negative rates and provide flexibility in dealing with regulatory changes, especially those impacting money funds
- The level of investment policy changes required to adjust to US money fund reforms may largely depend on how strictly capital preservation is currently defined in institutional investment guidelines.

New environment may require a refresh

It has been an interesting year for cash management. Sweeping regulatory changes and uncertainty around the future direction of interest rates in the US are creating a challenging environment for corporate treasurers in managing liquidity.

The combination of market and regulatory factors is forcing many treasurers to look at their investment policy guidelines in ways they haven't done in years. Multinational corporations are especially under pressure. Not only do they have to adapt to the way banks are valuing deposits and address new considerations around money market funds, they also may need to reevaluate their investment policies and how they can be adjusted when traditional methods of capital preservation may not be effective. For example, negative-yielding overnight deposits and money market instruments denominated in certain non-US currencies can effectively erode the value of the very capital they are supposed to preserve.

The importance of cash segmentation

Many investment policy statements provide detailed guidelines on how to invest cash, but they rarely address specific cash buckets. The one-size-fits-all approach may have worked in a world when interest rates were at historically normal levels; the line between operating and non-operating deposits was blurred; and there was limited distinction between stable and variable net

asset value (NAV) short-duration products. However, today's challenges may call for a more customized approach. A clear delineation of cash may be critically important to achieving desired outcomes while also adapting investment policies to the new world.

• Seek to maximize returns on operating cash

Large corporations and financial institutions now face bank-mandated limits on what is considered an operating or non-operating deposit. Determining these limits, or "headroom," is often made by looking at the average daily debit activity registered through a Demand Deposit Account over a six-month period (updated quarterly). The fact that companies may have to cap their banking balances to a daily average (not a monthly average) makes it extremely challenging for treasurers to manage intra-month spikes in both payables and receivables. Failure to comply or going over the headroom can disrupt a firm's operations and negatively impact overall returns. Treasurers should consider incorporating methods of measuring "headroom" into their investment guidelines to differentiate between operating cash, which is linked to transactional activity, and excess operating cash, which may best be deployed in money market-type instruments that can provide daily liquidity and act as a complement to their bank accounts. Money market funds have to absorb spikes and enhance returns on overall operating cash balances.

- **Consider broadening the universe of investable securities**

Having a single set of guidelines for all types of cash may limit treasurers' ability to tap into the broader set of investment vehicles that have become more prominent in response to the new environment. A one-size-fits-all approach may be limiting because the universe of allowable investments is capped to the safest option. This creates an opportunity cost, because all cash is subject to guidelines applicable to working capital. However, banking and money fund reforms are ushering in alternative solutions, such as separately managed accounts and short-duration bond funds. Despite the diversification benefits and potential yield enhancements these solutions could offer, most policies do not account for them. By segmenting cash and assigning distinct guidelines for each bucket, treasurers can have access to additional cash-management tools. For example, a portion of cash balances that is considered "reserve" could be invested further out the yield curve to temper negative rates, such as in the case of the eurozone. A broader set of investable options including separate accounts and private placement funds could also mitigate the effects of regulatory changes affecting money funds (see Figure 1 for a sample list of investable options).

Adjusting investment policy to floating NAV

Upcoming money fund reforms will impose the potential for gates and fees on all prime and municipal money market funds, and floating NAV on institutional prime and institutional municipal money market funds. As a result, treasurers have important decisions to make when adjusting their investment policies. The magnitude of the changes and the process involved in getting these changes approved may largely depend on the following two variables:

- Capital preservation: Is it strictly or loosely defined? Strictly means zero tolerance for gains and losses.
- Cash segmentation: Is the policy cash-bucket specific or not?

Treasurers should also give careful consideration to the gates and fees that may be imposed on prime and municipal funds. Investment policies with separate guidelines for each cash bucket can provide more flexibility in dealing with gates and fees. For example, liquidity requirements on reserve cash are not as stringent as they are on operating cash, so with minimal changes to the policy, prime fund investments could simply be shifted from the operating cash bucket to the reserve cash bucket and still stay compliant with a given corporation's guidelines.

The following table provides an indication of the extent of changes required given the variables previously discussed:

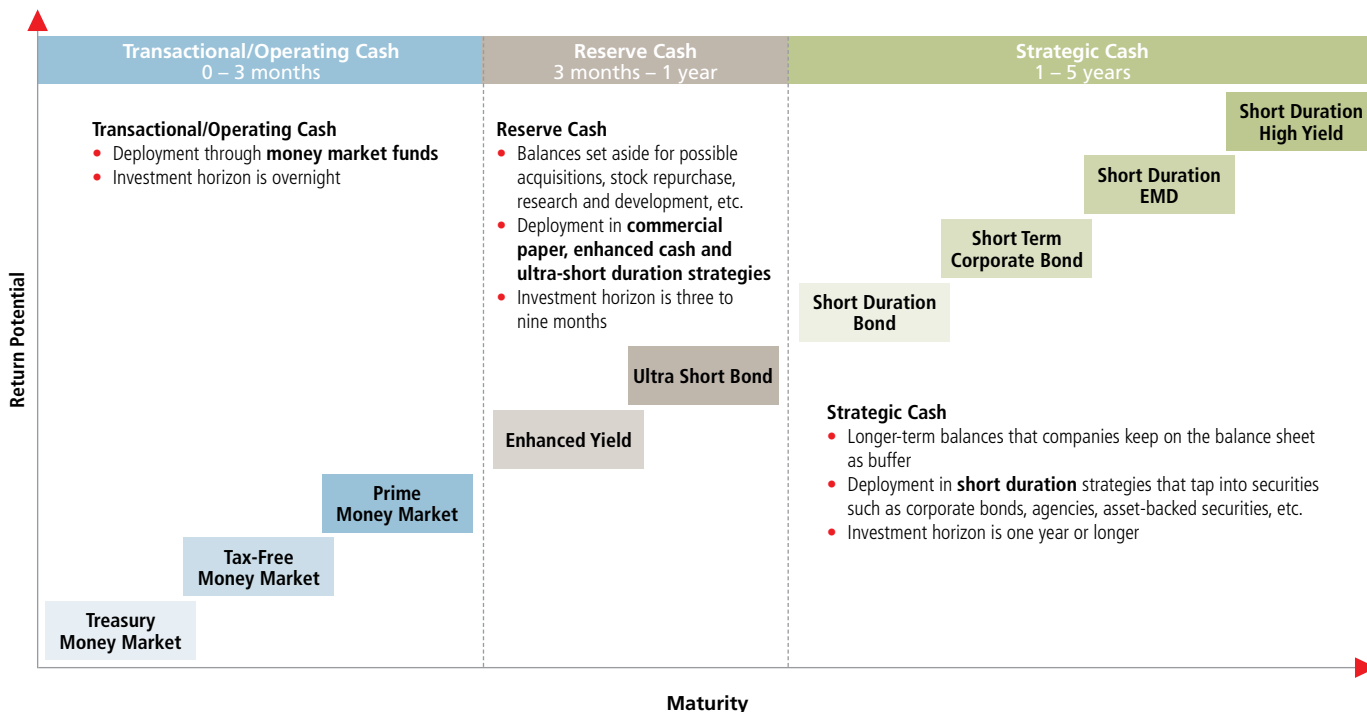
		Capital Preservation	
		Strictly defined	Loosely defined
Cash Segmentation	Not bucket-specific	<ul style="list-style-type: none"> • Amendment may be required to continue investing in prime funds • Board approval may be required 	<ul style="list-style-type: none"> • Amendment may not be required to continue investing in prime funds • Board approval may not be required
	Bucket-specific	<ul style="list-style-type: none"> • Amendment may be required to continue investing operating cash in prime funds. Alternatively, prime funds could be used only for reserve cash (in this case the only required adjustment would be shifting prime funds into the reserve cash bucket) • Board approval may be required 	<ul style="list-style-type: none"> • No adjustment required to continue investing operating cash in prime funds • Board approval may not be required

Figure 1. Sample investable securities

Security Type	Minimum Credit Rating	Maximum Maturity	Maximum Portfolio Exposure
US Treasuries	N/A	0–5 yrs	100%
US Agencies	N/A	0–5 yrs	100%
Certificate of Deposit/Time Deposit	A-1 to A-2	397 days	80%
Commercial Paper	A-1 to A-2	270 days	80%
Asset Backed Commercial Paper	A-1 to A-2	270 days	50%
Corporate Bonds	AAA to BBB-	0–5 yrs	50%
Asset-Backed Securities	AAA	0–5 yrs	30%
Mortgage-Backed Securities	N/A	0–5 yrs	30%
Commercial Mortgage-Backed Securities	AAA	0–5 yrs	20%
Variable Rate Demand Notes (VRDN)	A-1/P-1/F-1	397 days	50%

For illustrative purposes only. Not a comprehensive set of investable options.

Figure 2. Sample cash segmentation and possible investment considerations



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