DEVELOPING INVESTMENT STRATEGIES

TO MANAGE THE UNEXPECTED

In an effort to deal with the turmoil of the past few years, many companies invested and deployed excess cash so cautiously that their strategy may be counterproductive as the economy improves.

These companies now recognize the importance of having a deliberate and well-thought out investment policy that provides clear direction on how investments will be managed and how much risk is acceptable.

In addition to establishing boundaries for investing that will protect capital and provide liquidity when needed, a solid investment policy incorporates a number of important characteristics.

These include formalized forecasting and contingency plans to prepare key decision makers for unexpected events. Contingency plans should include a scenario analysis that details events of varying risk or magnitude and how the company will react. For example -- divest, stay the course, or become more conservative?

WHAT A GOOD INVESTMENT POLICY SHOULD INCLUDE

An investment policy that manages returns while preparing for contingencies should include:

- Statement of purpose. Then, for example "The purpose of this policy is to establish guidelines for the investment of corporate cash. The investment portfolio is to be a source of funds for the current and future operations of the company."
- Investment objectives. These might include preserving capital, maintaining liquidity, providing a market competitive rate of return and reducing tax liability; among the more obvious factors.
- A definition of responsibilities. Should clearly define roles and assign accountability for critical functions
- Definition of "prudence." This aspect begins to outline the company's risk tolerance.
- Policy details. The policy should include a list of approved investments, guidelines on the average maturity of the portfolio, concentration limits, denomination and securities ratings, and the priority of safety, liquidity, and return.
- Review and benchmarking. A well-structured investment policy should be reviewed at least annually to ensure that it meets current goals and objectives and should clearly define an appropriate benchmark against which investment performance can be measured.

Even companies willing to take on some additional risk in pursuit of better returns have limited options in today's environment.

- Low investment yields across all short-term investment options have minimized the value of active management vs. passive styles of investment.
- Money market mutual funds offer diversification and professional management, but recent changes to how they are structured will continue to put pressure on their yield.
- Low rates have made sweep investment options viable only for passive investors with significant amounts of excess cash.
- Given the lack of attractive alternatives for investing short term operating cash, companies are extracting value for their funds in this low rate environment by increasing bank deposits.
- Money in non-interest bearing bank deposit accounts can be used to reduce or eliminate bank fees while receiving earnings credits to offset fees.
- Interest bearing bank deposits are currently providing competitive returns compared to other money market instruments.

GOING FARTHER OUT ON THE CURVE

Companies with no immediate strategic plans to allocate cash buildup towards acquisition activity or capital expenditures may consider other options. With short term interest rates near record lows and money market instruments yielding less these options might include investing further out on the interest rate curve or increasing risk tolerance.

When trying to increase yield by going further out the curve, consider your risk tolerance, interest rate forecasts, and the purpose and time horizon for your cash. Short-term bond investment strategies are more susceptible to interest rate risk than overnight investments or interest-bearing bank accounts. However, companies that know that the cash will be around longer than one year and are willing to withstand possible temporary principle loss when interest rates rise might achieve a greater return in the long term.

In normal markets, corporate debt offers a higher yield than comparable maturity government bonds. However, to mitigate default risk, a strategy with investments in corporate bonds (credit risk) should be well diversified among many different issues. Companies should also consider the liquidity of the strategy in which they are investing.

Achieving a balance between optimizing return and mitigating risk can help businesses build a liquidity cushion that insulates them from the unexpected.

To learn more, contact your Treasury Management Officer or visit pnc.com/treasury.

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