Why a cash ladder may be worth climbing

We explain how this solution can move up and down the risk and return spectrum according to charities' individual liquidity and timing requirements.

Richard Lubbock
Charities Client Director

Central banks in developed markets around the world are tightening monetary policy, trying to rein in rampant inflation and prompting volatility among financial markets. Against this complex backdrop, charities and trusts are likely to be thinking about their organisation's cash positions, wanting to ensure sufficient funds are on hand for grant-making and operational expenses. However, inflation will erode the value of cash at hand over time. (For more on this, see our article: Inflation, the unseen robber of investment returns?)

What's in your inflation-fighting toolkit?

Just as a good old-fashioned ladder is a staple for DIYers, a cash ladder may be just the right addition to the inflation-fighter's toolkit. This is a tiered system of investments in strategies such as money market and absolute return bond funds.

We believe an efficient cash-laddering solution, taking into account different return and liquidity requirements, has the potential to improve real returns on cash portfolios whilst seeking to mitigate risk.

Cash laddering may put cash at hand to work by:

- Increasing the expected return on liquidity portfolios
- Seeking to safeguard against rate volatility and cash drags
- Offering the benefits of counterparty and issuer diversification
- Providing daily liquidity no matter which laddering strategy is employed

By combining a selection of money market, short-term alternative finance and absolute return bond strategies in a cash ladder, we believe it is possible to increase the expected return of a portfolio, while retaining sufficient stability and liquidity for clients who need to keep a pot of money readily available.

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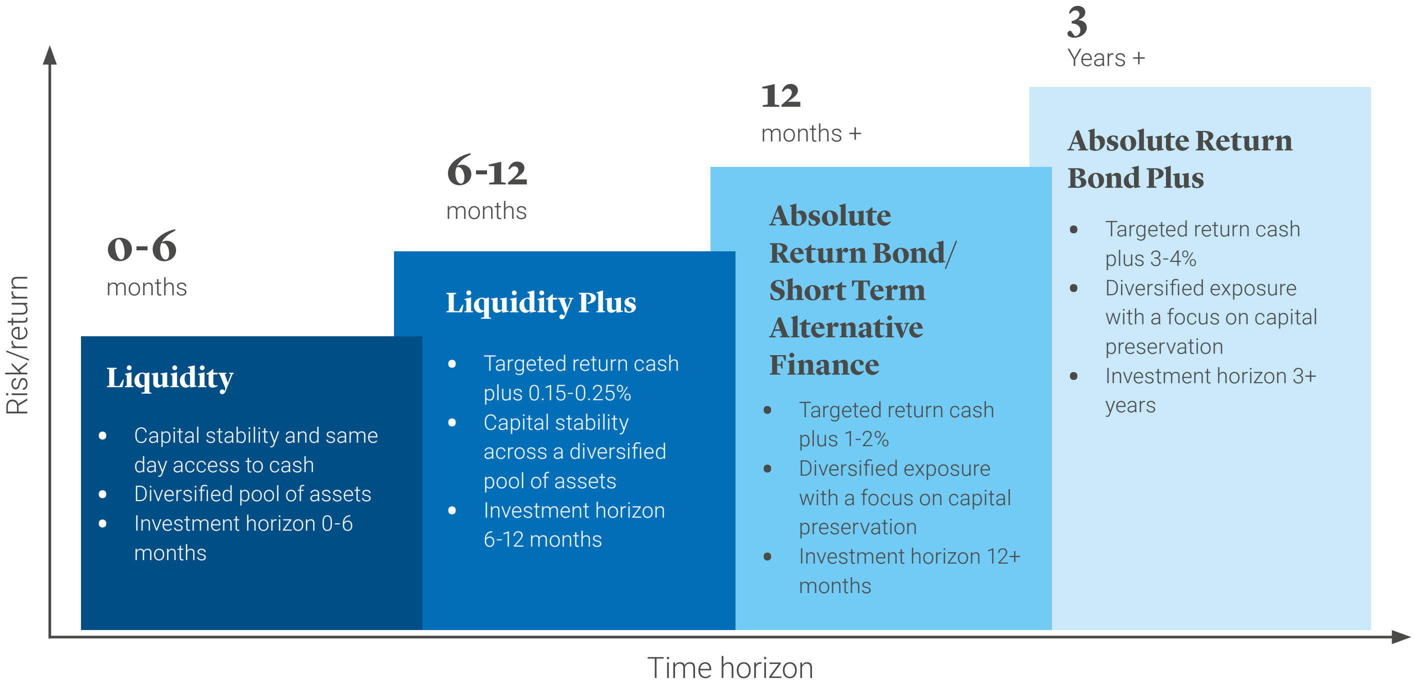
Here is an illustration of the typical features that money market, short-term alternative finance and absolute return bond strategies may deliver. They can provide varying levels of expected return for a given level of risk over different investment horizons (Figure 1).

Figure 1: Optimising cash allocations[1]



Source: LGIM

All performance objectives and limits are for information purposes only and subject to change. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

Step by step – the cash ladder explained

On the first rung of the cash ladder are money market funds, which aim to offer investors capital stability and daily access to operational cash. They seek to achieve this by actively investing in a diverse pool of ultra-short-term assets issued by governments, high- quality banks and financials. Money market funds are designed for investors looking for low volatility and high liquidity, with a typical investment horizon of 0-6 months. The flexibility, daily access and diversification on offer can make money market funds a good alternative to term bank deposits and bank accounts, in our view.

The next rung comprises liquidity plus funds. Like money market funds, liquidity plus funds can offer investors capital stability to operational cash, but with the added benefit of enhanced potential returns. This is achieved by investing in the same diverse pool of issuance as money market funds but over a slightly longer time horizon, with extended duration limits. Liquidity plus strategies are designed specifically for investors who have expected known cashflows over an investment horizon of 6-12 months. These can also offer flexibility and diversification benefits, making liquidity plus strategies a potential alternative to term bank deposits.

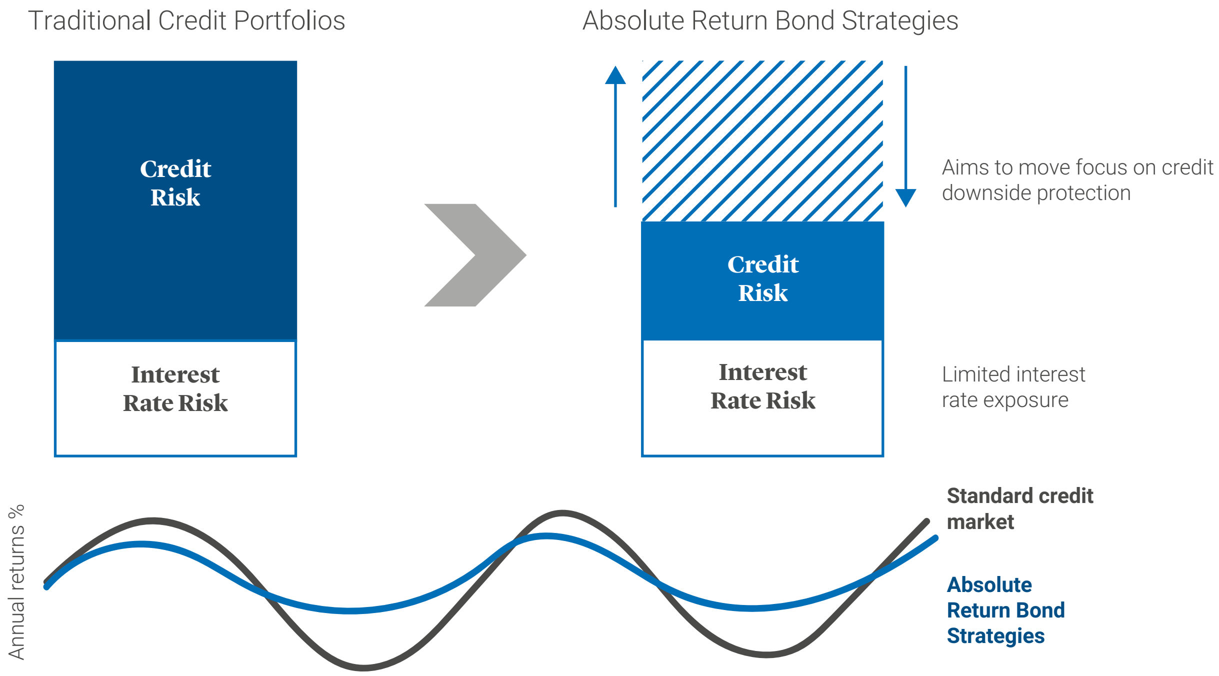
Further up the ladder are absolute return bond and absolute return bond plus strategies. These generally invest in investment grade credit securities and have flexibility to invest smaller amounts in high yield bonds, currencies, emerging market bonds and asset-backed securities to increase the portfolio yield.

Given the greater exposure to risk assets, emphasis is placed on risk management to minimise drawdown and preserve capital; to this end, interest rate risk is actively managed (Figure 2). We believe these funds are suitable for investors looking for additional returns on cash that is not necessarily needed over at least a 12-month horizon.

There are various flavours of these strategies, targeting different levels of return and risk. As an investor looks to increase returns further, greater flexibility to invest in different, higher-yielding instruments may be necessary. Of course, every effort is made to ensure that the strategies do not take on undue risk. It is important to note that these strategies are usually daily dealing, so swift access to capital is also a feature.

1. Methodology: SONIA + percentage. Targets and limits are for illustrative purposes and subject to change

Figure 2: Aiming for more downside mitigation, limited interest rate exposure and lower volatility than traditional credit portfolios



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What is short-term alternative finance?

Short-term alternative finance covers a multitude of opportunities. Examples include:

Capital call facilities: short-term funding to private investment funds to bridge the time between when an investment is made by the fund and when capital contributions are received from investors to finance that investment. The loans, which help private funds smooth their drawdown process, are secured against the legally binding LP commitments and fund assets.

Supply chain finance: whereby a supplier of goods sells its invoices at a discount in order to receive immediate payment and thus optimise their working capital position. Supply chain financing allows the supplier to secure lower cost financing based on the credit rating of the buyer, which is typically a larger investment grade corporate, while the buyer is able to negotiate better terms from the seller, such as extended payment terms.

Asset-backed financing: Funding provided to a company backed by their balance sheet assets, including short-term investments, inventory and accounts receivable. Asset financing is most often used when a borrower needs a short-term cash loan or working capital to purchase assets and/or enter into leases.

Diversification can make all the difference

At a similar point on the cash ladder to absolute return bond strategies comes short-term alternative finance, which we believe can play an important role in the ladder given its liquidity and return profile. It can be uncorrelated with the broader financial market, providing the potential for valuable diversification.
The short-term nature of the underlying loans (typically less than one year) means that cash can be typically returned to the investor over a short period.

This is an area historically dominated by banks but bank retrenchment over recent years as a result of regulatory pressure has enabled other investors to fill the void.
The underlying borrowers are generally investment-grade companies and often global in nature which limits credit risk, while the complexity and illiquidity allow investors to seek a meaningful premium and reduced volatility over similar public assets. More broadly, we believe diversification through investment solutions like cash ladders can be key to achieving more reliable returns while seeking to mitigate risks. Banking with one institution could potentially be risky if that bank defaults on its contractual obligations. In our view, investing in a multi-investor pooled fund, however, can spread out counterparty risk as investment managers trade with multiple counterparties on your behalf.

Investing in funds can also limit issuer risk and provide exposure to underlying instruments that are issued by companies and governments across many sectors and regions. This could reduce the negative impacts on the overall portfolio in case an issuer defaults on its coupon and/or principal repayment.

Another important aspect of investing in funds is that investment managers can engage with or exclude issuers, in order to help achieve environment, social and governance (ESG) outcomes and limit or curtail risks. Responsible investing can also provide a positive point of interest when discussing charitable investments with beneficiaries and donors.

Tailoring solutions

For investors seeking a potential new home for cash in this inflationary environment, one possible option is to consider a cash ladder framework.

Structuring such arrangements can be flexible and in line with individual risk appeitite can be customised to target bespoke return and stability requirements. We would be happy to perform modelling and to tailor solutions for investors who are interested in knowing how laddering might look based on their specific cash and return requirements.

It should be noted that diversification is no guarantee against a loss in a declining market. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

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Key Risks
The value of investments and the income from them can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance.

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