



Executive Summary

In the current environment of moderate market returns, institutional investors want to manage all of their assets — including cash inventories — as efficiently as possible. BNY Mellon’s Cash Investment Strategies discusses a strategic framework for balancing specific liquidity needs with risk and return objectives. The discussion below sets out a cash tiering approach aimed at helping investors to satisfy their short-term liquidity needs while allowing for the potential to enhance returns and better manage risk. The group also explores the potential benefits of going beyond pooled funds to manage cash in customized segregated accounts.

We believe the market events of the last decade have demonstrated a need for investors to take a more active role in reviewing and structuring their cash holdings to satisfy their liquidity requirements. In our view, investors have to ensure that they put their cash to work in an effective way. This involves knowing how much money will need to be drawn down within a given time frame to benefit from market opportunities as they arise.

Organizing the cash position depends on understanding the purpose of the cash and relevant constraints: is there enough cash for operating purposes? Is there surplus cash for potential investment in higher yielding/returning core alternatives? What is the tolerance for volatility? Is greater credit risk tolerable for additional yield? Is a longer maturity/duration an acceptable option? Other objectives might also affect cash management choices such as whether there is a need to provide income or yield, or whether the emphasis — shared by many market participants — is on preserving principal or seeking additional returns.

Generally there are three main facilities for managing cash inventories, segments of which may be required for distinct needs and at different points in time: bank deposits, triple-A liquidity funds, and separate accounts. These can vary according to credit ratings, maturities, fees and redemption costs, as well as legal structures. Settlement times can also vary. With regard to bank deposits, a single lending institution is often involved, diminishing diversification.

In our view, investors are increasingly looking beyond the pooled fund format to segregated accounts. They understand that cash inventories might be profitably invested in a customized segregated account, with immediate cash needs incorporated into such a structure. There is the potential to earn a higher return, while still catering to the investor’s liquidity requirements.

Managing Cash to Its Full Potential

By

*BNY Mellon Cash Investment Strategies*¹

BNY MELLON
CASH INVESTMENT
STRATEGIES

¹ BNY Mellon Cash Investment Strategies is a division of The Dreyfus Corporation. Please see disclosure at the end of this paper.

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Different Solutions for Different Risks

When considering short-term and long-term choices for cash, there are four primary risks to review: liquidity, interest rate, credit and spread.

- Liquidity risk is associated with the difficulty of selling an asset in a time of market stress. This was vividly demonstrated during the credit crunch of 2008/2009.
- Interest-rate risk encompasses the possibility that a security's value will vary due to a change in interest rates.
- Credit risk is the risk that a security's value will change due to a ratings downgrade or default. Although the default of an instrument owned in short duration markets is generally rare, it did occur during the financial crisis of 2008/2009.
- Spread risk might be involved when a floating-rate note or a short-term bond is used.

In seeking to mitigate risk, we believe diversification is one of the most important considerations. Compared with a bank deposit, a potential key benefit of a liquidity fund and separate account management is diversification with respect to credit exposure, instrument type and counterparties.

With liquidity funds, investors generally seek capital preservation through diversification, appropriate liquidity and yield. An advantage of liquidity funds is that they are separate legal entities ring-fenced from exposure to the sponsoring entity's balance sheet and subject to rigorous investment guidelines and reviews by the rating agencies. Diversification of the client base is also important to ensuring liquidity. (Fund managers typically impose a maximum shareholder concentration of assets under management from a single client.) Liquidity funds offer a measure of liquidity protection by generally having less than a 60-day weighted average maturity.

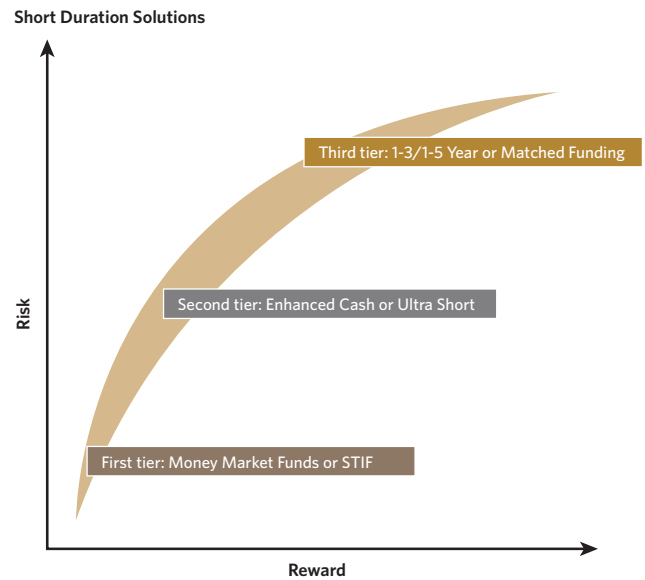
For an investor, we believe maintaining all of the money in deposits or even liquidity funds over an interest-rate cycle is unlikely to provide the best outcome for a pool of cash. Amid current low interest rates, it might be beneficial to move along the interest-rate curve. (Although the European Central Bank has been the first among the major central banks to raise interest rates, we believe it is unlikely others will follow suit until next year.) In our view, having a portion of money in a liquidity fund or bank deposit, and also a portion in a separately managed account might prove very beneficial.

While there is acute awareness of the pressure on yields and returns on short-term investments, we believe there is a way to offer a framework that may improve returns across the spectrum of cash pools. With a separate account, an investor typically enjoys bespoke guidelines and strategies along with customized reporting, powerful tools that we think are underutilized in the marketplace. In addition, we believe this can be achieved with a lower risk profile than might be expected.

The tiering of cash within a separate account — essentially dividing up the pool of cash into three tiers — can provide a flexible solution, segmenting the cash for additional yield or returns.

Three-Tier Strategy For Cash Management

Market events, particularly in the last decade, demonstrate that investors need to take a more active role in reviewing and structuring their cash holdings to meet their liquidity needs.



Source: BNY Mellon Cash Investment Strategies
Pictorial illustration reflects a view that inefficient markets may provide greater opportunity for total return.
Not reflective of any actual investments or historical activity.

The purpose of the first tier of a strategic liquidity position in the form of money market funds or short-term investment funds (STIF) is to provide for day-to-day cash flows, benefit payments or grant payments — payroll, for instance. A money market fund or a short-term, separately managed account with customized guidelines can provide this first tier of liquidity. We believe a yield above a comparable money market index can be expected.

The aim of the second tier is to provide for capital calls, benefit payments, grant payments, debt servicing, overlay or longer horizon cash needs. We believe this second tier is best constructed with maturities averaging between six months and one year. An enhanced cash or an ultra short (with an average maturity of one year) separately managed account with customized guidelines might provide a solution for this need. Tier-two objectives include tailored liquidity according to investor requirements, moderate maturity extension and focused credit guidelines ('A' or better). Higher yields (reflecting the higher risk) than the first tier are targeted.

The rationale of the third tier is for longer term cash funding: construction costs, matched funding, capital calls, a long-term horizon or a buy-and-hold strategy. We believe this third tier of liquidity is best provided by a portfolio of maturities in the range of one to three years or one to five years, or a matched funding, separately managed account with customized guidelines. Tier-three objectives entail tailored liquidity according to investor requirements, maturity extension to match liabilities or one to three year and one to five year index and investment-grade credit quality. Matched funding is tailored to an investor's specific risk tolerance and/or cashflows and allows flexibility for sector or yield curve positioning. It is anticipated that yields (and risk) will be higher than those of the second tier.

We believe one of the many current challenges of financial markets is managing cash reserves as efficiently as possible for institutional investors. In our view, investors should draw comfort from the fact that there are many more instruments and possibilities available than they may have considered to ensure their pool of cash works hard for them.

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