GMO Fixed Income Insights

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Cash: More Than What's In Your Wallet?

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The GMO Asset Allocation team is widely known for holding large amounts of cash during periods of extraordinary valuations. This approach enables us to deploy capital during market corrections and times of mean reversion. Cash allocations also help us absorb the career risk that exists in many facets of the investment management industry where managers are often forced to purchase assets that are priced to produce low expected returns. Recently, our colleague Rick Friedman eloquently stated the purpose and use of cash in our asset allocation process.[1] However, we do think that there is a bit of a misunderstanding about the term "cash." While not comprehensive in examining the cash and liquidity world, this paper will elucidate a number of types of liquidity instruments, including cash, and strategies that GMO employs or may employ in the future.[2]

It is important to note that we at GMO are not doing this:

In reality, cash is a poorly defined subject within our industry. Simply depositing cash at a bank in a quantity above the threshold limits of the Federal Deposit Insurance Corporation (FDIC) is bringing

[1] Rick Friedman, "Cash: One Investor's Trash Is Another Investor's Treasure," April 2017. This Asset Allocation Insights piece is available with registration at www.gmo.com or by request from your GMO relationship manager.
[2] Not all strategies mentioned in this paper are used by all investment teams at GMO. Certain investment teams may manage cash in a manner different than to those described in this paper. Furthermore, we focus in this paper on US liquidity instruments, as we manage our Asset Allocation portfolios using the US dollar as the base currency, hedging returns into other currencies as needed. Non-US investors have other instruments available to them for liquidity management that are not mentioned here.

unsecured counterparty risk to a depositor. For those of us who have lived and worked through the Global Financial Crisis (GFC), this is simply no longer an option. The market itself has any number of cash-oriented rates: Effective Fed Funds, LIBOR, Treasury repos, and Treasury bill rates are a few that are used on a daily basis by Short-Term Interest Rate (STIR) participants. We use high-quality liquid assets and collateral as our favored investments. A deeper look at these critical characteristics follows.

High quality

- Assets that are secured or have the credit risk of an underlying government balance sheet or system that the government depends on for its policymaking objective.
- Assets that have short or *de minimis* spread and interest rate duration.
  - There are plenty of assets in the world that meet the first condition of having little exposure to non-governmental credit risk ranking. But, the second issue, that of minimal duration, is important because a cash portfolio needs to have little or no price volatility.
  - Additionally, the more that duration impacts an asset's volatility, the less liquid it becomes with financial intermediaries. So an asset with more duration will have less liquidity and capacity for financial intermediation than one with similar credit quality but shorter duration. Thus, the holder will not only have more price shocks, but will also be able to have less dependence on market participants purchasing the security at exactly the time when the seller needs the liquidity.

Liquidity

- These are assets whose values we are able to assess with a high degree of confidence. These include instruments that we believe we will be able to liquidate at a price near our expectations, regardless of our trading size, as well as assets that will mature at their stated legal date of maturity.
- If securities markets cease to function, we should feel confident that the final maturities of our securities will be a self-liquidating feature.

This should be a "no-brainer," but markets have evolved in the aftermath of the GFC. With the advent of regulatory reform, higher capital requirements, and less delineation between risky and riskless goods, bond market liquidity has become the hottest, most boring, topic in fixed income markets.

The traditional opportunity set

Treasury notes/bills are securities issued by the United States Treasury Department. They have the full faith and credit of the United States behind them. They are fixed rate securities with maturities ranging from 1 month to 30 years. GMO's cash strategy broadly employs or may employ securities with maturities of less than 2 years. Like all Treasury securities, the interest income is exempt from state and local taxes.

Treasury Floating Rate Notes (FRNs) are fairly new Treasury notes, introduced by the Treasury Department in 2014. FRNs have a maturity of 2 years, with weekly index resets on the results of the 3-month bill auction. FRNs are useful tools in a cash management portfolio because they tend to have a spread above their Treasury bill reference index rate. In addition, because they have maturities up to 2 years, they allow us to purchase collateral and not be subject to the issuance seasonality that is described below.

While the Treasury Department has been one of the largest suppliers of short-term collateral in the world, this comes with the following two problems. First, there is seasonality to the supply of short-term collateral. For example, we see increased bills issuance during the days leading up to the fall "back to school" season, as the Treasury begins financing itself for new student loans. Likewise, we see a reduction in Treasury supply during the April tax season, as the Treasury becomes flush with cash from tax receipts. At other times, the months leading up to reaching a debt ceiling also cause a shortage of collateral.

Second, short-duration Treasury securities can be incredibly expensive. Not only had the Federal Reserve lowered its effective Fed Funds target rate, but regulatory reform following Dodd-Frank and 2a-7 money market reform made certain short-dated maturities of Treasuries, generally those held 365 days or less, expensive to own.[3]

The new opportunity set

"In the midst of chaos, there is opportunity." – Sun Tzu

The radical change to cash markets during the post-GFC regulatory era (i.e., banks needed to hold more Treasuries and capital, and money markets were reformed significantly in response to the Reserve Fund "breaking the buck") provided a significant opportunity set to market participants who were unlevered, cash-rich, and patient. The key driver was that banks no longer enjoyed a good return on capital via many of their traditional liquidity provision services, leaving liquidity provisioning available to the cash-heavy investor. As a result, a variety of interesting investments now exist for the thoughtful investor who is willing to adhere to the liquidity and quality standards noted above while venturing beyond the more traditional forms of cash. These opportunities include:

The Federal Home Loan Bank System (FHLB) is a commercial bank mortgage financing system that has survived intact through the Great Depression and the Great Recession. FHLB borrowings are senior to FDIC deposit claims during the resolution of a member commercial bank. Additionally, similar to Treasuries, interest on FHLB issuances is exempt from state and local taxes.

2-year Treasuries are short-term notes and bills that are part of traditional cash management. We will selectively add 18-month and/or 24-month Treasuries to our cash portfolio. We find that this particular point on the curve has been orphaned to some degree because it is too long for 2a-7 money market funds, and too short for traditional core fixed income portfolios. Our market microstructure research (how trading mechanisms affect price, transaction costs, etc.) has helped us to benefit from this reality. We are able to selectively utilize the 2-year point on the curve to take advantage of the maturity gap that exists for the investment management community.

Treasury Reverse Repos offer overnight and term cash lending that is fully collateralized against Treasury securities. Repos provide a pick-up in yield, as well as the ability to smooth a cash flow profile in between Treasury auctions or during securities liquidation. Term repos, at times, can be particularly cheap as the dealer community is penalized for short-term funding of their securities' books, requiring more term funding. This is noted in Exhibit 1, which shows overnight General Collateral Financing (GCF) repo levels versus 1-month T-bills.[4] Repos have the added benefit of being

[3] Indeed, a number of scholars and market participants have strongly encouraged Treasury to add additional bills supply into the market in order to meet the needs of the financial markets in the post-GFC world.

[4] There are a number of different types of repos, including Triparty and DVP. The exhibit is meant merely to illustrate the spread between one type of repo – GCF – versus UST 1-month bills. A GCF trade is a repo that is executed in the interdealer market. Its pricing and levels serve as a proxy, albeit an imperfect one, for understanding pricing in the overall repo market.

exempt from traditional bankruptcy laws, affording the cash lender additional security. Exhibit 1 shows that repos can often trade above the yields of 1-month T-bills.

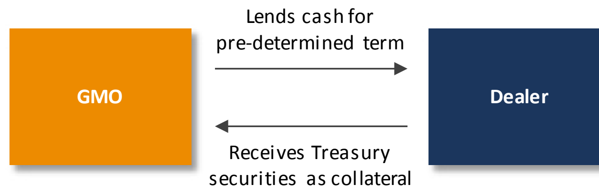
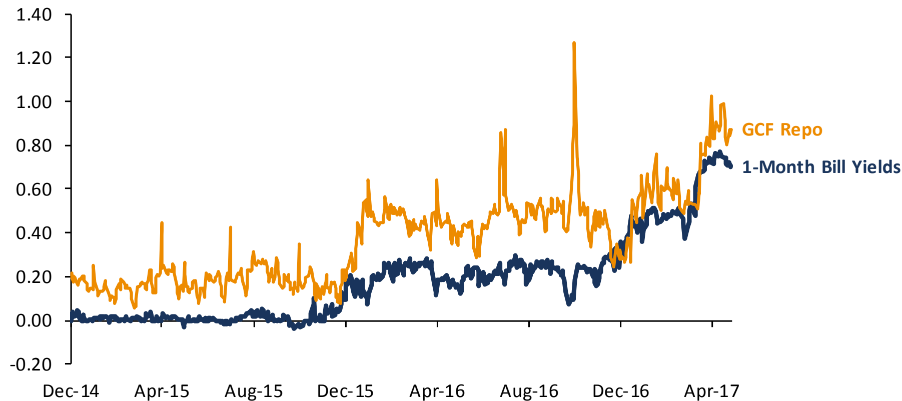


Exhibit 1: GCF Repo vs. 1-Month T-Bill



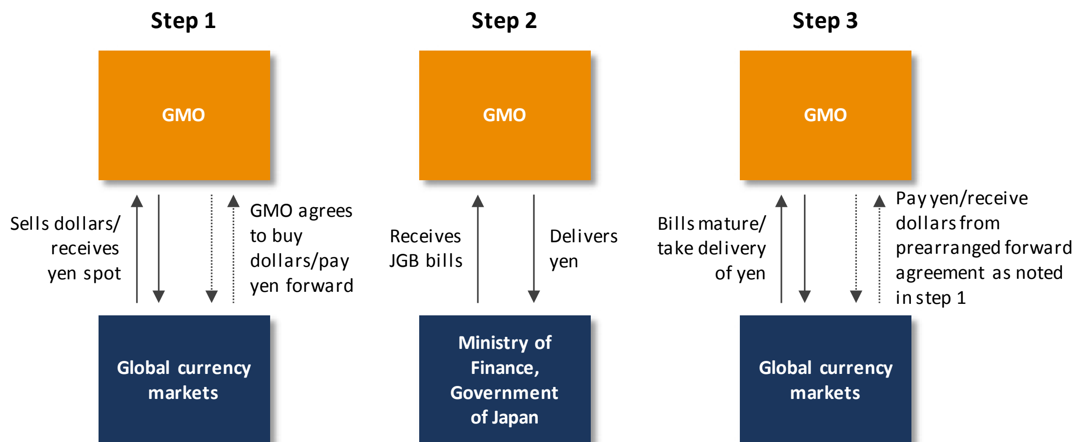
Source: Bloomberg

The FX Forward/Cross-Currency Basis swap trade, at its simplest level, is currency lending. Often described as the "shadow demand for dollars," these markets allow GMO to lend its dollars for a fixed period of time and earn a pick-up to similarly-termed short-term government securities. In the following example of a yen FX forward trade, Steps 1 through 3 are usually initiated on the same day, though Step 3 is not fully completed until the maturity of the trade.

Step 1: GMO sells dollars spot and receives yen. GMO buys dollars at a predetermined forward maturity.

Step 2: GMO invests the yen in Japanese government securities.

Step 3: The securities mature, and GMO delivers the yen currency and receives dollars in return as per the forward agreement in Step 1.



Short-dated TIPS Asset Swaps enable us to purchase short-dated TIPS, pay the cash flows of the security to a dealer, and receive LIBOR +/- a spread component.

Step 1: GMO purchases a short-dated TIPS bond.

Step 2: GMO agrees to pay the principal and interest to a dealer and receive LIBOR +/- a spread in return. In effect, GMO is offering financing of the TIPS bond to the dealer at the pre-agreed LIBOR spread.

Short Duration Structured Products. We respect the capriciousness of the structured product market. The market offers less liquid instruments than those we've discussed earlier in this paper and we do not use it as a liquidity resource. Rather, these securities have short weighted average life, high credit quality, no structural leverage, and a greater than LIBOR return. As they mature, GMO determines the reinvestments of the cash flows depending on broader asset valuations. These securities make up a relatively small portion of GMO's investment assets, and should securities markets cease to function, we have a high degree of confidence in the self-liquidating features of these securities.

Putting it all together

Our cash and liquidity strategies are dynamic, and will be dependent upon the seasonality of collateral, the relative pricing of various securities, the cyclical balance sheet needs of the dealer community, and the global demand for dollars. Cash is always rolling in as securities mature, and rolling out as reinvestments into liquid strategies continue. The size of our overall cash allocation is, in part, a key determiner of how diversified our short duration and liquidity management strategies are likely to be over a given period of time. The most important aspect to note is that cash is critical to our asset allocation process, and making the best use of it during times of rich valuations is critical. Importantly, aside from our modest allocation to short-durations ABS, we are focused on executing this strategy in a manner in which our goal is to not impair our freedom to act or expose us to uncollateralized counterparty or credit risk. A multi-faceted approach to cash and liquidity minimizes our opportunity cost and allows us to meet our goal of being able to purchase cheap assets during periods of mean reversion.

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