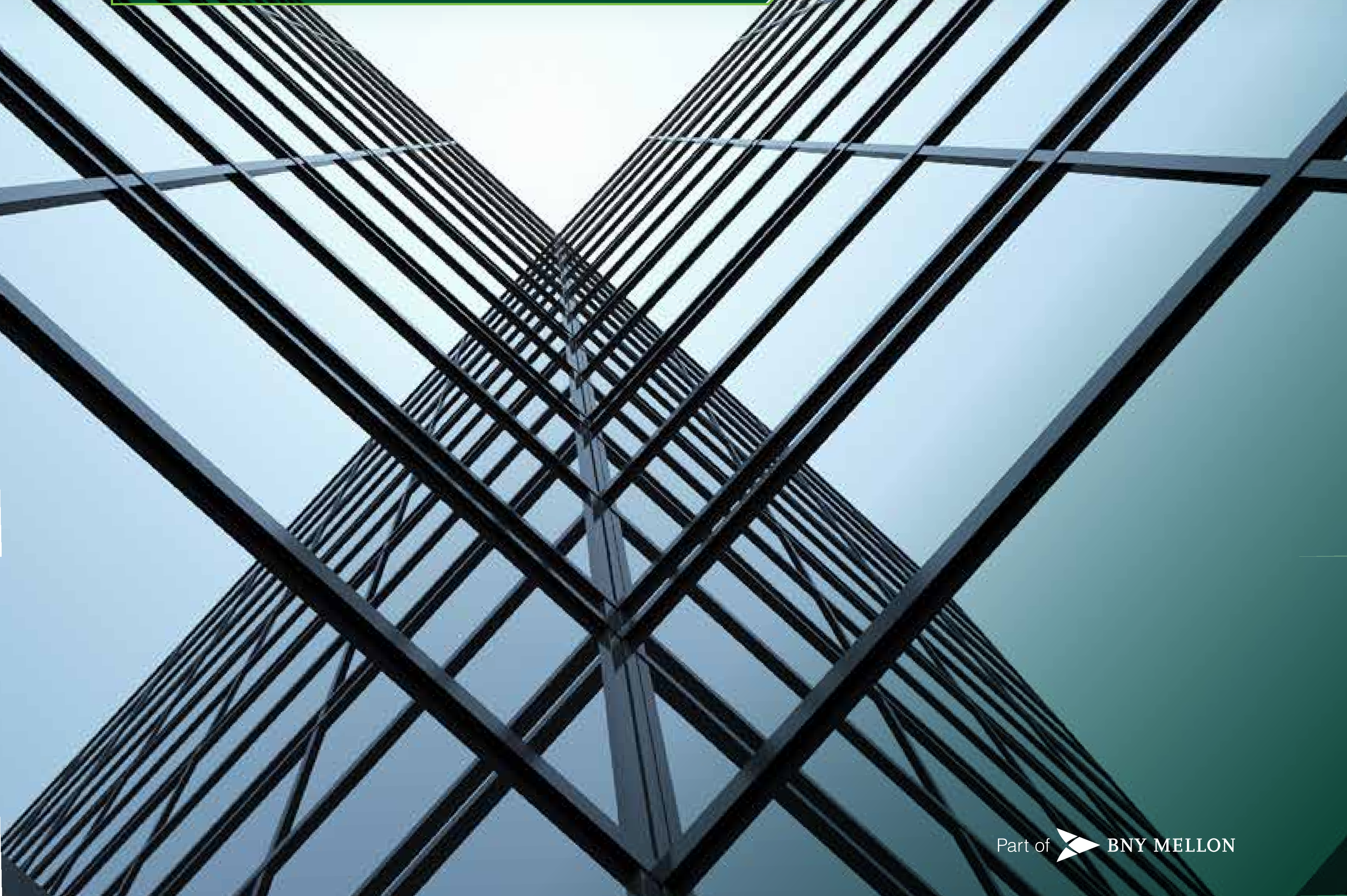
Insight INVESTMENT

CASH VALUE

ULTRA-SHORT DURATION PORTFOLIOS CAN AIM TO HELP SOLVE TREASURERS' CASH CONUNDRUM

MAY 2019

> Insight believes it could be time for corporate treasurers to seriously consider allowing assets like structured credit to play a greater role in cash management.



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EXECUTIVE SUMMARY

Delivering safety, liquidity and yield through cash management has become increasingly challenging for corporate treasurers since the global financial crisis. In our view, investors may be over-invested in unsecured bank deposits and under-invested in secured ultra-short duration assets like structured credit.

We believe that a AAA rated ultra-short structured credit portfolio has the potential to offer:

- investments **secured against collateral** with credit enhancement and structural protections
- a **high degree of liquidity** and **relatively stable capital values**
- a **50bp premium above Libor**[1], reflecting a complexity premium rather than additional credit risk

To achieve comparable yields to structured credit, investors would normally have to consider increasing maturity or credit risk exposure. Structured credit may therefore provide a defensive source of value for cash investors at a time in which the economic and credit cycles are showing signs of maturing.

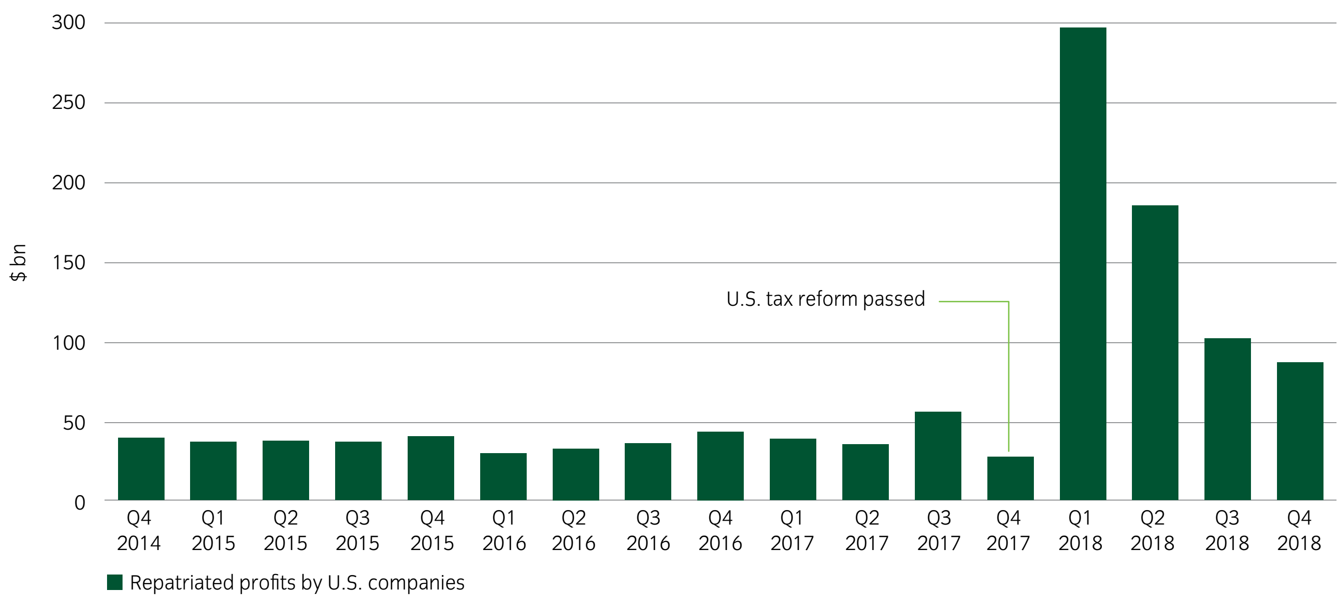
Insight believes it could be time for treasurers to consider allowing ultra-short duration assets, like structured credit, to play a greater role in cash management as part of a 'liquidity waterfall' approach.

[1]Manager makes no assurances that premiums will be achieved.

THE CHALLENGE FOR CASH INVESTORS

Following the passage of US tax reform in December 2017, corporates repatriated $665bn of profits held overseas in 2018 (Figure 1). This has increased the need for efficient cash management solutions. However, since the global financial crisis it has become trickier for treasurers to abide by their 'SLY' principle (safety first, liquidity second and yield third).

Figure 1: Corporate cash management on the rise following US tax reform[2]



Surveys indicate that 68% of US corporate treasurers say they use unsecured bank deposits for short-term investments[3]. The downside is that bank credit risk has not been considered 'near risk-free' since the 2008 crisis. Deposits have also become more expensive for banks, given liquidity coverage requirements introduced under the 'Basel III' capital accords.

Concerns have also been raised over prime money market funds, which often provide more diversified exposure to bank risk, after one 'broke the buck' following the Lehman Brothers collapse.

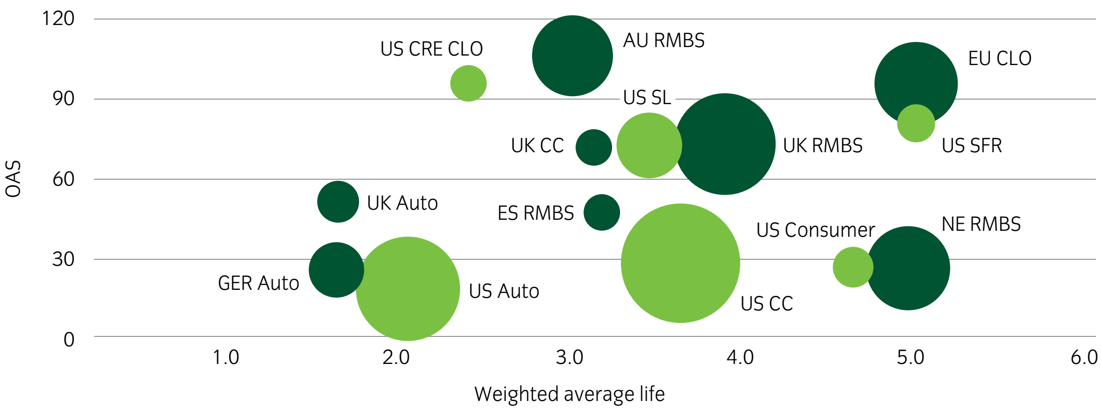
At a time in which the safety has become tougher to secure, investors have also had to contend with a low-yield world, which raises the risk of cash being eroded by inflation. Unsecured commercial paper, for example, currently yields only c.10bp above LIBOR[4].

[2] Bureau of Economic Analysis, US Department of Commerce, December 2018.
[3] 2018 Liquidity Risk Survey, Strategic Treasurer and Capital Advisors Group, June 2018.
[4] Bloomberg, February 2019.

STRUCTURED CREDIT MAY BE AN UNTAPPED OPPORTUNITY

Only 5%[5] of treasurers say they invest in asset-backed securities (ABS). The global ABS market is a global opportunity set of over $1trn in nominal value (Figure 2). Given the size and diversification available within global markets, together with the safety and spread premia, ABS may present a compelling and overlooked opportunity.

Figure 2: Structured credit is a large, deep and largely untapped $1trn+ market for treasurers[6]



Sector	Outstanding ($bn)
US Auto	$130.0
US Credit Card	$119.0
UK RMBS	$89.0

U.S. opportunities
Non-U.S. opportunities

Investors can target either a conservative AAA portfolio focusing on deeply liquid domestic ABS markets such as autos or credit card ABS, or they could expand their approach to encompass valuable global ABS sectors such as UK residential mortgage-backed securities (provided they have the tools to hedge currency risk and manage cross-currency basis risks).

A global approach can offer the greatest depth and diversification. Access to the widest opportunity set also allows managers the greatest potential to benefit from relative value opportunities across markets.

Structured credit in a 'liquidity waterfall': Investing cash assets in a 'waterfall' structure has become commonplace among Insight's institutional clients. This involves a tiered structure, in which 'top tier' liquidity assets are concentrated on the most liquid and secured assets. Lower tiers seek higher yields but offer lower liquidity.

We believe that structured credit will best work as 'tier 2' assets, just below assets such as repurchase agreements and money market instruments (Figure 3). If needed, frequent cash flows from principal and interest can be used to replenish tier 1 holdings.

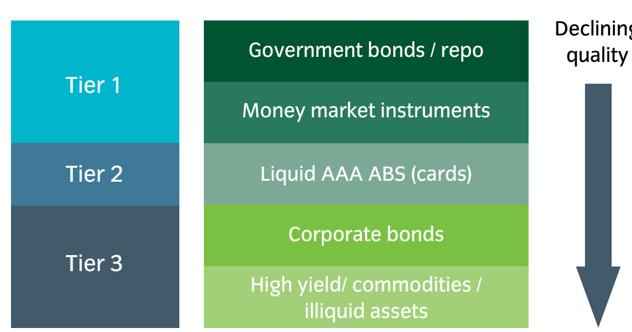
Figure 3: How a liquidity 'waterfall' structure could help optimize corporates' cash investments[7]

Treasury reverse repo – Tier 1

- Enhance repo program with secured Treasury reverse repo
- Ultra-liquid, huge capacity market
- Potentially benefit from 'super-normal' returns

Ultra-short ABS – Tier 2

- Diversify credit card exposure across the high capacity global ultra-short ABS universe
- Consumer, residential and commercial sectors
- Structurally robust, very limited credit risk, highly liquid, yield additive



[5] 2018 Liquidity Risk Survey, Strategic Treasurer and Capital Advisors Group, June 2018.
[6] JP Morgan, September 2017. [7] Insight, for illustrative purposes only.

STRUCTURED CREDIT CAN EFFICIENTLY TARGET SAFETY, LIQUIDITY AND YIELD

1: SAFETY

We believe that ABS investments can offer a high degree of safety as they are often secured against hard assets with substantial credit enhancement. High quality portfolios can be managed with average AAA ratings.

An index, maintained by S&P, of US ABS sectors including student loans, auto loans and credit cards has seen a 0.4% pa average default rate since 2001. The trailing 12-month default rate was less than 1% through the global financial crisis[8]. US collateralized loan obligations have seen a 0.1% pa default for US collateralized loan obligations since 2001[9].

Outside the US, no losses have been recorded in the largest European sectors such as French, German or UK prime and buy-to-let (Figure 4). According to FitchRatings[10], only 0.25% of losses have been cumulatively realized on €3.23trn of European structured finance assets between 2000 and 2016, which equates to around 2bp per year[11].

According to analysis from JP Morgan[12], the UK would require a housing crisis that inflicts 56 times the default losses experienced than during the 1990s (the largest crisis on record) before senior investors risk an irrecoverable loss.

Figure 4: Many areas of senior structured credit have an excellent fundamental track record[13]

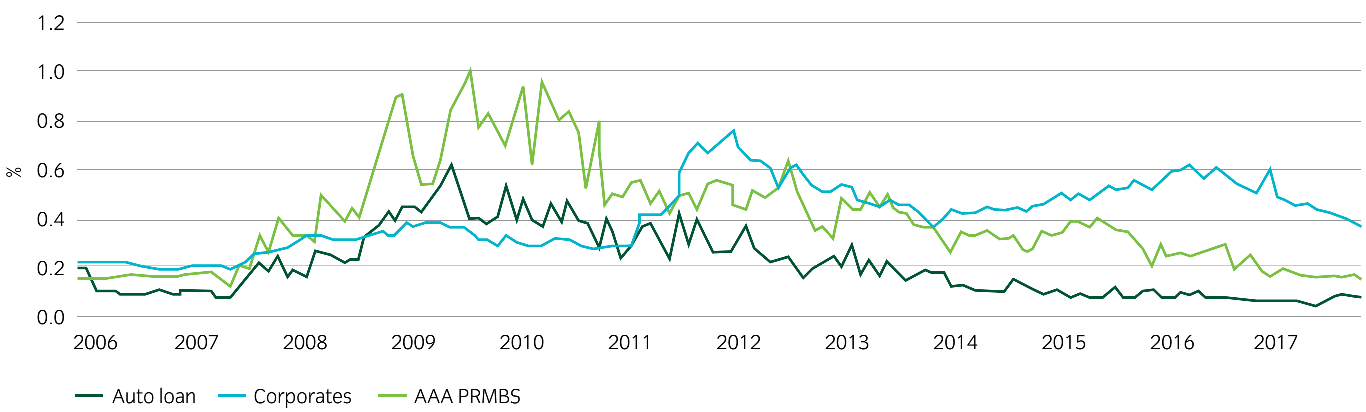
	Default rates	Recovery rate	Loss rate
UK Prime RMBS (AAA / AA)	0%	n/a	n/a
UK buy-to-let (AAA / AA)	0%	n/a	n/a
Dutch/Italian/Spanish RMBS	0%	n/a	n/a
European CLO (AAA / BBB)	0%	n/a	n/a
European auto/credit cards	0%	n/a	n/a
US buy-to-let (AAA / AA)	0%	n/a	n/a
US auto/credit cards (AAA / AA)	0%	n/a	n/a
Where it went wrong:			
US subprime RMBS	15.86%	50%	7.93%
CDO of US subprime RMBS	21.30%	50%	10.65%
European CMBS	2.52%	50%	1.26%

8 S&P Global Ratings, "2017 Annual Global Structured Finance Default Study And Rating Transitions", March 2018.
9 S&P Global Ratings, "2017 Annual Global Structured Finance Default Study And Rating Transitions", March 2018.
10 Fitch, "Structured Finance Losses: EMEA 2000-2016 Issuance", July 2017.
11 Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.
12 JP Morgan, April 2017.
13 Insight, S&P and Moody's as at February 2018. Default rates since market inception.

2: LIQUIDITY

Short-dated structured credit portfolios are typically highly liquid given short weighted average life, frequent maturities and amortizing underlying loan structures. Bid / offer spreads tend to be tighter than in corporate bond markets (Figure 5).

Figure 5: Average bid / offer spreads tend to indicate superior liquidity in structured credit versus corporate credits[14]



In our experience managers can achieve same-day or next-day liquidity when executing trades in short-dated ABS. Also, ultra-short ABS strategies are able to transact at market prices at scale even during difficult market conditions, such as those experienced in December 2018. One factor is market relationships. When managers submit BWICs (bids wanted in competition), they can aim to benefit from a breadth of counterparty relationships. Insight maintains relationships with 20 dealers in the US alone.

A further potential benefit for cash investors is that capital values tend to be relatively stable, as ABS is mostly floating rate, eliminating interest rate risks.

3: YIELD

In our experience (over 10 years) of managing ultra-short duration portfolios, investors can target 50bp[15] pa over Libor in a portfolio with the following characteristics:

- Majority AAA
- 1-year weighted average life
- Close to zero interest rate duration

Figure 6: Summary of safety and yield characteristics of cash investments[16]

	Ultra-short structured credit strategy[17]	Cash	T-bills	Ultra-short corporate credit
Credit risk	Low (AAA)	Low (FDIC)	Low (AAA)	High (BBB exposure)
Interest rate risk	Low	None	Low	Medium
Mark-to-market risk	Low	None	Low	High
Yield	3.15%	0.00-0.50%	2.50%	3.00%

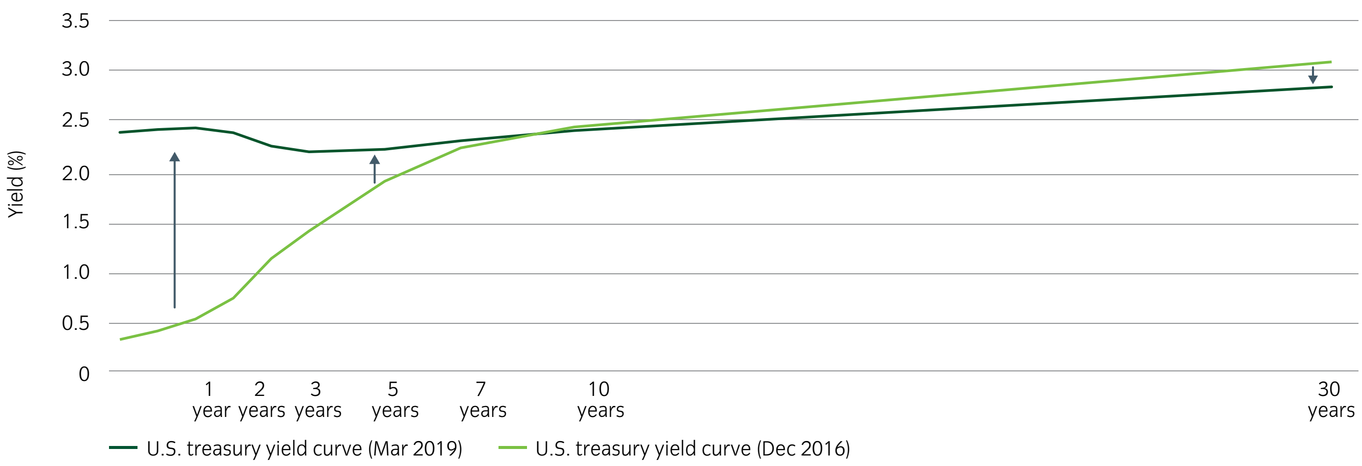
[14] Bank of America Merrill Lynch Global Research as of October 31, 2018. [15] No assurance can be given that the performance objectives of a given strategy will be achieved. Portfolio characteristics are for illustration purposes only and subject to change without notice. [16] Insight, Bloomberg. [17] Information as of March 31, 2019. Yield and risk characteristics for the ultra-short structured credit are based on a representative account. Yield and risk calculations are calculated based on weighted average market yields of the portfolio's holdings (predominately asset-backed securities). Yield is calculated by adding LIBOR and portfolio discount margin of 63bp as of March 31, 2019. Past performance is not indicative of future results. Each account is individually managed and could vary from the information shown herein. An account may have different holdings and investment objectives which could produce lower yields or higher risks.

SHORT-DATED STRUCTURED CREDIT VERSUS OTHER FIXED INCOME ASSET CLASSES

SHORT-DATED STRUCTURED CREDIT VS LONGER-DURATION FIXED INCOME

The flattening of the Treasury curve over the last few years has eroded much of the premium available further out the curve. We see greater tactical value in shorter-dated assets, which also have higher liquidity and less interest rate risk exposure (Figure 7).

Figure 7: The flattening of the yield curve may mean more value in shorter-dated assets[18]



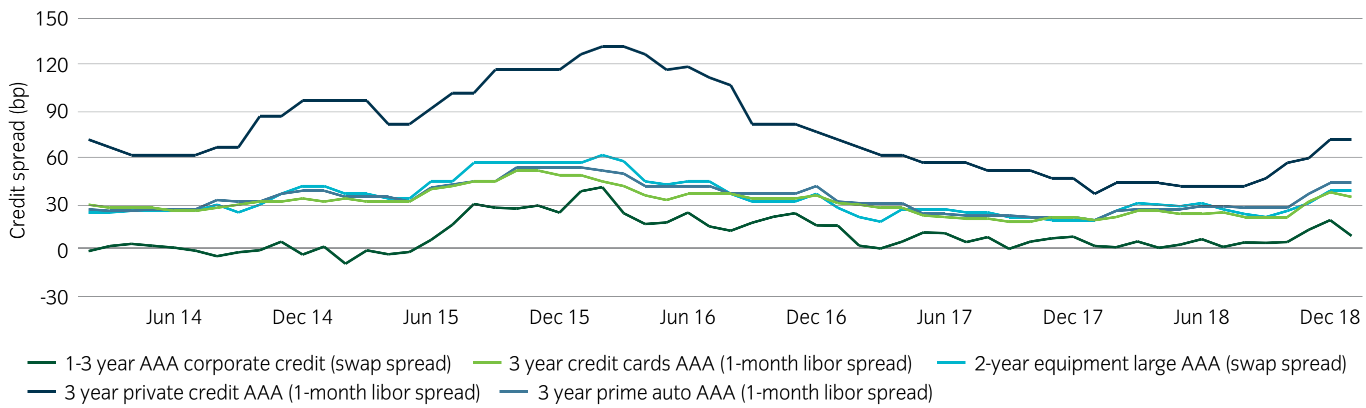
[18] Bloomberg, February 2019.

As both the current economic and credit cycles mature, the defensive characteristics of structured credit may offer additional comfort.

STRUCTURED CREDIT VS CORPORATE CREDIT

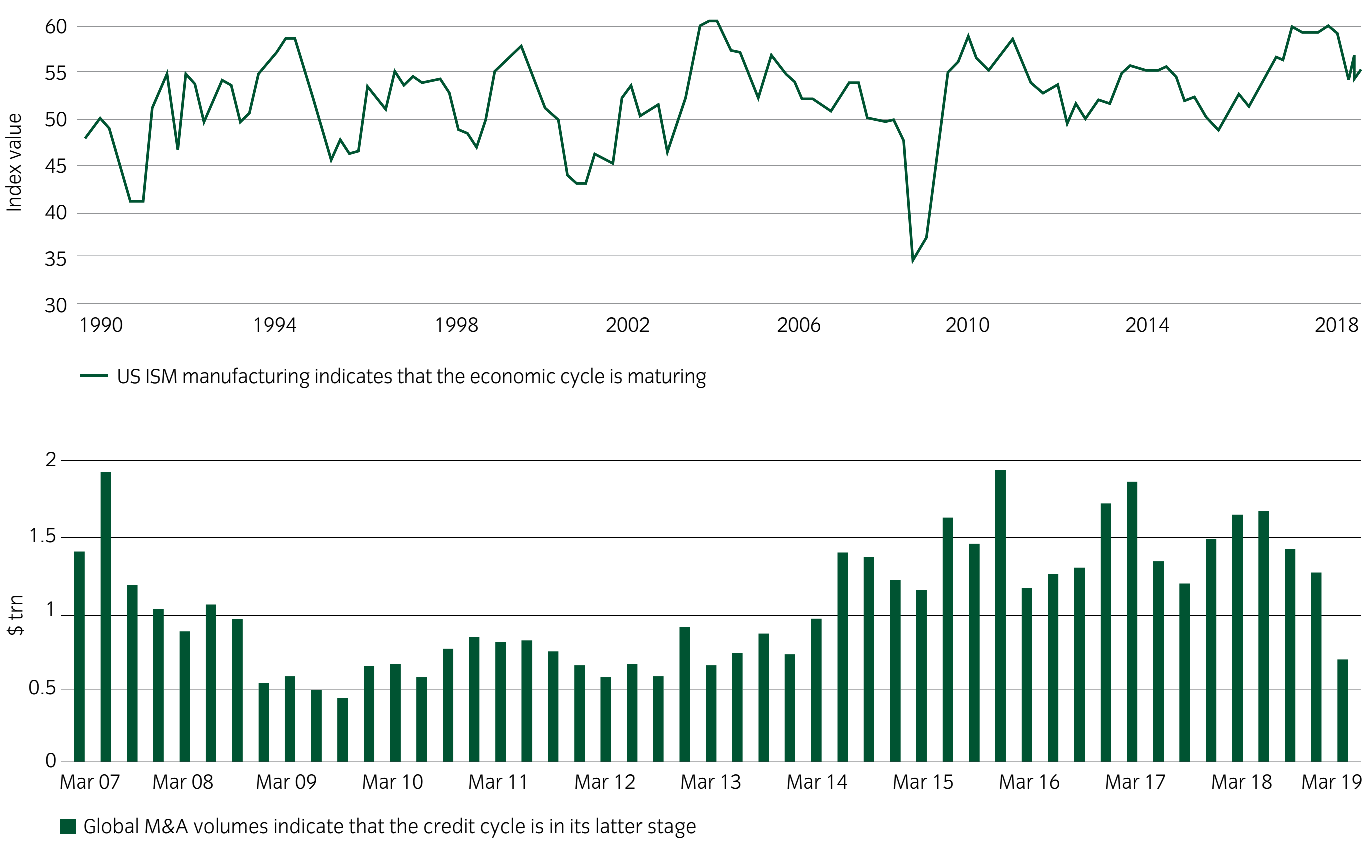
The potential returns available in structured credit reflect a complexity premium (rather than a premium for additional credit risk) owing to the specialist expertise required to model and analyze asset-backed securities. We believe that this results in higher spreads than comparatively-rated investment grade credit (which is predominately unsecured).

Figure 8: AAA structured credit offers a premium over unsecured AAA corporate credit[19]



Importantly, as both the current economic and credit cycles mature, the defensive characteristics of structured credit may offer additional comfort.

Figure 9: Structured credit may be a defensive option as the economic and credit cycles each show signs of maturing[20]



[19] JP Morgan, Bank of America Merrill Lynch, February 2019.
[20] Bloomberg, February 2019.

EXTRACTING MORE FROM LIQUID ASSETS

Insight believes that corporate treasurers are potentially underinvested in structured credit assets and may find compelling opportunities in allowing the assets to play a key role in cash management.

Investors can access ultra-short duration structured credit investments in pooled fund format but they may find greater flexibility investing in a segregated structure.

It is crucial that investors have access to suitable expertise to unlock the market's complexity premium. Managers need to analyze the many loans that underlie a single security, model and stress test the structure and accessing relative and absolute value.

Structured credit can, in our view, help cash investors target security, liquidity and yield more effectively through defensive investments.

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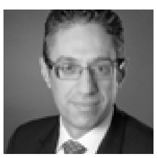

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