



## Cash Investing: Considerations for Investing in a Low Interest-Rate Environment

By Northern Trust Investments  
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The market events of 2008 and 2009 caused much investor angst, as investment portfolio values declined significantly during the market crises. Investors flocked to the safety of government securities, sending prices up and pushing yields down to historic levels, where they remain today. In addition, Federal bailouts, home price collapses and high unemployment continue to cause great concern around the globe. Central banks have eased monetary policies — to historic extremes in some cases-- in order to spur economic growth.

While the global economy struggles to regain its footing, investors are faced with the prospect of extremely low interest rates into the foreseeable future. While low rates are certainly positive for those issuing debt, for investors they mean challenges in generating the current income they seek.

Today, many investors are inquiring as to when interest rates might rise again. The response is that the market pundits, and the market itself, point to a period of low interest rates extending well into 2011. Additionally, investors also wonder how fast the subsequent rise will be, especially for money market instruments (less than one year to maturity) where a majority of liquid assets are invested. When rates do begin to rise, it's important to understand that the rebound will *start* from historic lows. If central banks—especially the U. S Federal Reserve--repeat their practice of recent rate cycles and enact slow, deliberate increases, rates will remain at absolute low levels for many months to come. Movements toward what many investors consider to be the norm for short term interest rates (perhaps 3-4%) will take a long time. The U. S. Treasury curve below (Chart #1), depicts the very low level of yields (especially those under one year) available in the market today:

### Money Fund Changes

Investors are currently in the midst of navigating a secular change surrounding the regulatory environment for money market funds. Recently the rules surrounding eligible securities for money market funds have been tightened to reduce the risk that a fund's net asset value (NAV) will fall below \$1.00. These changes will limit money market funds' ability to extend along the yield curve where returns are generally higher, and reduce the exposure to securities that proved to be especially illiquid in 2008-09. In essence, the opportunity set of investments for money market funds has been reduced. Subsequently, the return offered by money market funds is likely be lower than it would otherwise have been for a given market environment in exchange for the continued use of a constant \$1.00 NAV.

### Change to Fed policy in near term is unlikely

The level of uncertainty facing investors and the Federal Reserve regarding the future path of the Federal Funds rate is elevated. The Federal Reserve has many 'new' tools at its disposal to tighten policy without appearing to do so because they don't involve a change in the target for the Fed Funds rate, the most influential benchmark rate for money market funds.

One could argue the expiration of many of the non-traditional facilities the Federal Reserve used over the past two years to provide liquidity to the markets and calm worried investors are actually an 'unofficial' tightening of policy despite the current very low (and unchanged) settings on the Fed Funds rate.

Generally, the Federal Reserve and financial regulators seem to be pleased to see capital flow out of money market funds and into longer maturity, higher risk, investments which has been one of the primary tenets supporting the recovery in risk assets.

Unless the risk of higher inflation becomes elevated, and/or the Federal Reserve begins to notice a dangerous bubble occurring in other assets caused by the low Fed Funds rate monetary policy is expected to remain extraordinarily accommodative. Only once the economy is demonstrating organic growth consistent with stable employment is the Fed likely to take overt tightening steps.

CHART #1



Source: Bloomberg

With interest rates at historic lows, Federal Reserve Chairman Ben Bernanke continues to advocate keeping interest rates low because of his concern about a "nascent recovery", weak housing market, high unemployment and a frail lending environment. In his most recent semi-annual testimony to Congress, he stated short-term interest rates, near zero, were likely to remain there for several months<sup>1</sup>.

Northern Trust's Chief Economist Paul Kasriel has pushed his projection of the first Fed tightening of monetary policy out from August of 2010 to January of 2011. His reasoning is a bit different than Bernanke's, centered on the notion that the dollar will remain strong against the currencies of other countries that continue to work through their own financial crises. This will act as a moderating force on inflation and prevent the Fed from needing to raise rates in the United States anytime soon<sup>2</sup>.



Outside the U.S., the credit crisis has affected the market of developed economies as well, significantly impairing some Euro zone countries' ability to pay their debt, reign in high unemployment, and create meaningful GDP growth. Greece's sovereign debt problem, and contagion associated with other European countries debt issues, (namely Spain, Portugal and Italy) have forced those countries to accept austerity packages and focus intensely on debt reduction. In order to reduce their deficits, and encourage positive economic growth, the countries of Europe will most likely have to keep their interest rates low for a prolonged period.<sup>3</sup>

To get another perspective on the outlook for future interest rate levels, investors can look to the US futures market as a rational predictor of future interest rates. The Fed Fund Futures markets forecasts the probabilities of rate movements, and at least through September, 2010, reports the probability of the Fed keeping the target, or Fed Funds rate between 0.00% and 0.25%, at about 85%. In other words, the markets are forecasting only a 15% chance the Fed will raise rates above 0.25% through the end of summer 2010<sup>4</sup>. This, of course, has ramifications throughout the yield curve.

#### **ZERO INTEREST RATE ENVIRONMENT: NOW WHAT?**

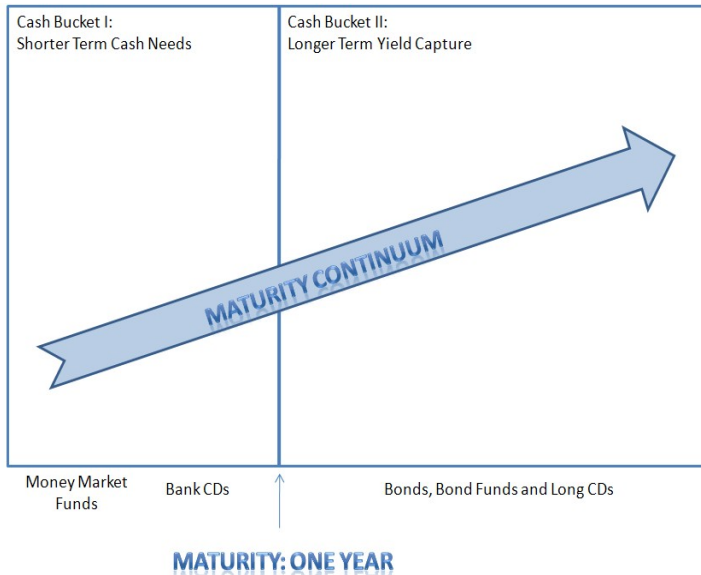
Since global markets expect interest rates to remain low for the remainder of 2010, investors are looking for guidance on how they should best position their cash and fixed income portfolios to take this environment into consideration.

Considerations in positioning portfolios include the conflicting demands of liquidity and yield. It is fundamental that one cannot have sufficient liquidity without giving up some yield, and one cannot obtain additional yield without giving up some liquidity. While this may seem obvious, investors sometimes want to have their cake and eat it too, but they need to reconcile their conflicting goals of the need for liquidity and the desire for yield. In addition, institutional investors have different needs than individual investors, so we will consider each segment separately in the context of managing short term investments in a zero rate environment.

#### **INDIVIDUAL INVESTORS**

Individual investors might consider dividing their cash allocation into two portions to manage the needs of liquidity and yield. One portion would serve as a liquidity vehicle in order to meet short term cash needs such as household expenses, medical expenses or immediate education expenses. This portion might make sense to be invested in vehicles such as bank deposits or money market funds, which have historically entailed less risk than other types of investments. The other allocation would potentially serve the need for higher yield, or total return with a goal towards growing cash for longer term needs, such as a home down payment, longer term educational expenses, or for a small number of individual investors, planning for private equity capital calls. An investor might consider investing this in short term

taxable or tax-exempt bonds or bond funds with maturities ranging from 1-3 years that offer somewhat higher yields. The graph below depicts the continuum of yield choices facing investors, and a suggestion as to where the two allocations might be segmented:



Source: Northern Trust

## INSTITUTIONAL INVESTORS

Institutional investors demand for cash varies greatly depending on the type of institution. Pension plans typically have to pay monthly benefit payments, and Foundations & Endowments make less frequent, but regular grant dispersals. Both types fund new investment options or make capital calls on private equity investments on an irregular basis. Corporations face regular operating expenses, plus the sporadic costs of R&D or mergers and acquisitions that require cash sourcing. Institutional investors usually plan for these cash flow needs well in advance. They typically engage in cash budgeting and often have more regular cash inflow than individual investors, so they don't typically view cash as a defensive holding. Rather, they are more targeted in their cash investing. Institutions, with professional management, make cash forecasting a significant planning activity that looks out one to three years. Expected cash inflows and outflows are typically managed in a way to optimize investments for yield and liquidity. This more sophisticated cash planning, allows institutional investors to be nimbler around matching timing with investment needs. When they face unexpected cash needs, institutions can move in and out of their investments, ignoring trading costs, a bit more aggressively as they usually aren't tax-sensitive, or they can more readily borrow cash for short term needs.

## SUMMARY

With money market yields remaining near zero, the cost, in terms of yield give up, is



high. Liquid cash yields are low and are expected to remain low, so investors need to consider the appropriate allocations to cash to meet the myriad of needs they face. The allocation to cash could potentially be bifurcated such that the first allocation considers liquidity, capital preservation and then yield in that order, while the second allocation would consider yield, liquidity and capital preservation in that order. As the markets recover slowly, investors may continue to operate in an environment of low interest rates that persist today. Considering how best to manage short and long term cash needs is an important focus today when not much yield is available. Investors, both individuals and institutions, need to focus on appropriately planning for their cash needs so as to potentially minimize surprises down the road.

1. The Wall Street Journal: February 25, 2010 P. A2
2. Northern Trust: US Economic and Interest Rate Outlook February 22, 2010
3. Global Investor Magazine: Greek tragedy forces policy rethink, April 2010, pp. 22-23.
4. Bloomberg

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**Money Market Risk:** An investment in a money market fund is not insured or guaranteed by the FDIC or any other governmental agency. Although a money market fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in a money market fund.

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