

# Cash and Money Markets

Recent market volatility has raised concerns over making an investment decision based on a prediction of future market movements or market timing. It has also made investors more aware of the importance of diversification, not only of manager investment styles but also in asset classes. More and more investors are looking to move into markets gradually. Many are choosing to start in cash funds and over time transfer into markets to take advantage of a form of pound cost averaging.

## What is 'the Money Market?'

Cash funds can contain many different forms of cash or cash equivalent investments. The key characteristic of these is that capital is not exposed to investment risk but can be exposed to default risk, the sole return is interest with no potential for capital growth and they are repaid in full at maturity. The money market is the market for these short-term investments. The investments traded are generally very safe but with a low interest rate. This makes them most appropriate for temporary cash storage or short-term investment periods.

## Deposit Accounts

Deposit Accounts are effectively current accounts held at a banking institution allowing money to be accessed at very short notice or on demand and paying interest. The money market generally uses cash equivalents or tradeable securities rather than deposit accounts.

## What are Cash equivalents?

Cash equivalents are assets that are highly liquid and can be easily converted into cash. Cash equivalents are distinguished from other investments by their typically short-term existence. Many of these cash equivalents mature within 3 months. They include the following investment instruments some of which are grouped under the collective term Commercial Paper.

## What is Commercial Paper?

Commercial paper is a system of IOUs used by banks and big companies to borrow money for short periods, usually 60 to 90 days. One of the main benefits is that issuing commercial paper is usually cheap. However a sub-sector of the Commercial Paper market known as asset-backed commercial paper (ABCP) has been instrumental in the recent credit crunch (see Investment Bulletin 5). ABCP involves loans backed by assets such as mortgages or credit-card debt, which in many cases have been dramatically impacted by interest rate rises, property devaluation and the ability of the borrowers to make repayments. Many cash and money market funds wishing to achieve a strong credit rating exclude the use of ABCPs.

As a relatively low-risk investment, Commercial Paper returns are not large. There are various forms of commercial paper but certificates of deposit are commonly used in cash funds.

## What are Certificates of deposit?

Certificates of deposit (CDs) or time deposits are financial products commonly offered by banks. The investment cannot be withdrawn for a certain “term” or period of time but the CD can be traded to realise assets. When the term is over it can be withdrawn or it can be held for another term. Generally speaking, the longer the term the better the yield on the investment. They can pay either a fixed or a floating rate of interest; coupons on floating rate CDs are fixed semi-annually against a reference rate such as LIBOR (London Inter Bank Overnight Rate). CDs are quoted according to their yield, and are priced similarly to bonds. They are issued in a wide range of currencies.

## What are Floating Rate Notes?

Floating Rate Notes (FRNs) can be considered to be similar to debt securities or bonds but are investments not debt. They can be of any currency. The holder is entitled to regular interest coupons. FRN coupons are reset periodically to match a chosen index, typically an interbank rate. Typically the rate agreed is the benchmark rate plus an additional amount and is reset every three to six months.

Some FRNs may have special characteristics defined by the issuer such as minimum or maximum coupons which provide certainty during times of interest rate changes.

## What are Sterling Treasury Bills? Are they like gilts?

A sterling treasury bill is a short-term (less than one year) UK government zero coupon bond. Treasury bills form an important constituent in the Debt Management Office's (DMO) cash management operations and an intrinsic component in the UK Government's stock of marketable debt instruments, alongside gilts.

As they are zero coupon bonds, treasury bills do not pay interest. They are instead issued at a discount to their face value with returns being made on maturity. Although not gilts there is very little risk attached to investing in treasury bills. Default risk on a government's borrowings in its own currency is low enough to be regarded as zero. Because of their short term, or duration, their price is not very sensitive to interest rate changes.

Treasury bills can be issued with maturities of 1 month, 3 months, 6 months or 12 months, although to date no 12 month tenders have been held.

**Treasury notes** and **Treasury bonds** are terms often used to indicate non-UK gilt equivalents issued by non-UK governments and do not feature in cash funds.

## What is a Repo?

A repo (or repurchase agreement) is an agreement between two parties under which the original owner agrees to sell government bonds to another for cash and then agrees to repurchase the same or equivalent bonds at a later date.

The repurchase price will normally be equal to the original sale price (which will be just below the market value of the bonds) plus an increment equivalent to interest on a loan of the same amount for the period of the repo.

## Do all cash and money market funds use these cash equivalents?

No. In many cases cash or money market funds will stipulate which instruments can and can't be used. This is usually due to whether or not the fund is seeking to secure a particular credit rating. A manager may only use instruments of a certain rating or above in order to gain a strong fund rating.

## Do cash funds have to be of a certain size to be efficiently managed?

Using Treasury Bills as an example, the minimum purchase size is £500,000 so in order to gain diversity within a cash fund there will need to be sizeable funds under management. Other considerations will include the general charges and expenses of running the fund, dealing efficiency and the economies of scale in purchasing large tranches of cash equivalents. UCITS restrictions which dictate other maxima which impact cash funds also need to be considered.

The larger the fund, the lower the charges will be in percentage terms. Ultimately, larger funds will have lower total expense ratios. This is very important when considering the returns available from cash and cash equivalents, which can be quickly eroded by higher charges.

The ability of a cash fund to obtain a strong money market fund rating will also be impacted by the efficiency with which the fund is run. In conclusion, a smaller fund is more likely not to be able to be run efficiently or be granted a strong rating.

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