

Jerome Schneider and Paul Reisz Discuss Investment Opportunities in the Changing Cash and Short Duration Markets

It's tough to be a cash investor these days: Market volatility is high, and the Federal Reserve, by announcing that it will keep policy on hold to 2014, likely has extended the horizon for zero bound interest rates. In this article, Jerome Schneider, head of PIMCO's short-term and funding desk, and Paul Reisz, money market and enhanced cash product manager, survey the current landscape for short-term investors and outline PIMCO's approach to this challenging environment.



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Q: Investors typically look to cash markets for safety, but lately volatility has soared. What's happening, and what lies ahead?

Schneider: A lot of the volatility comes down to this: Investors are spooked. From the U.S. debt ceiling debate last summer to the current eurozone crisis and other credit concerns, there's plenty to worry about. In 2011 investors pulled more than \$150 billion from so-called prime money-market funds. And these funds in turn have become more risk averse, avoiding securities from certain issuers, such as European banks, for instance. The banks then issue less debt, reducing market depth and liquidity. It's a vicious circle. In our view, this volatility isn't going away anytime soon.

Q: What should cash investors do now?

Reisz: As we've been telling clients, job number one is truly understanding your liquidity needs. We call this tiering your cash: How much liquidity do you need right now vs. how much of your short-term money can be put to work in different instruments that may have a better return profile? Cash for immediate needs would be the first tier. These funds should still be invested in traditional money market strategies or bank accounts to help ensure capital preservation and daily liquidity. Investors can then separate cash for intermediate needs into a second tier to invest in short-term bond strategies that can potentially enhance yield and better match intermediate cash liabilities. Finally, the third tier would consist of cash for longer term needs and would be invested in low duration bond strategies, which also offer potentially higher yields and better liability matching. Each tier is subject to additional risk and therefore may be less liquid.

Q: Can you offer more details about those better-yielding opportunities? What are they?

Schneider: In the current market, our focus is on short-dated, non-financial credits backed by solid balance sheets. In addition, as markets fluctuate, portfolios with an intermediate term holding period can benefit by becoming the liquidity provider to investors with immediate cash needs, thereby garnering liquidity premiums on their assets. We also see the potential for capital appreciation in “roll down” – buying and holding bonds for a period of time and then selling as they near maturity to capture any price gains. Finally, with the Federal Reserve’s recent announcement to keep interest rates steady into late 2014, adding duration tactically to increase potential yields will be important when the opportunity arises.

Again, we believe volatility is here to stay, but we feel we can use the volatility, as well as liquidity premiums present in the marketplace, as a catalyst to drive performance.

Q: How are changes to 2a-7 money market regulations affecting cash strategies?

Reisz: The Rule 2a-7 reforms that were implemented in 2010 have increased liquidity but pushed yields lower. In addition to increasing liquidity, the amendments were designed to improve credit quality, shorten maturity limits and trim risk in money market strategies, with the overall objective of preventing potential future losses and runs on the money markets. However, the regulations inherently limit yields that traditional money market funds can offer by confining them to very short or overnight maturities to meet the stringent liquidity requirements.

Additionally, the President’s Working Group on Financial Markets has suggested creating an emergency liquidity facility that, if implemented, would likely pile additional costs on the management of money market funds, which would likely further compress their yields for investors. Recently, both SEC and Fed officials have also expressed concern about money funds, and various proposals have been floated that are designed to protect investors’ assets but would increase fund company costs.

The upshot is that yields on money market investments – currently hovering just above zero – may remain painfully low for investors, and this is one major reason why many cash investors are looking for higher-yielding alternatives.

Q: How would you summarize PIMCO’s approach to the cash and short-term markets today?

Reisz: The past three years have taught us all to pay attention to our cash portfolios and focus on navigating safely through the cash markets. Before the financial crisis, the cash markets worked the way they should, with ample liquidity and securities with the highest credit ratings. Investors didn’t really think about cash. Today, we believe investors need to “look under the hood” in their cash portfolios and examine their security structures, credit and counterparty exposures. In other words, investors shouldn’t take cash management for granted.

Schneider: Cash investors are likely to face low yields for the foreseeable future. With a cocktail of low growth, high debt burdens, and questions around sovereign solvency in the developed world, we think the Fed and other central banks will continue to provide ample liquidity to the markets via low rates and funding facilities for years to come. We believe the most attractive risk-adjusted opportunities for investors lie just outside the traditional money market space where supply and regulatory constraints do not artificially alter the investment selection process. With the help of active portfolio management and credit selection, investors should benefit from managing their risk and liquidity metrics more efficiently and finding potentially better yields and capital appreciation as the dynamics continue to change in the world around us presenting opportunities to investors who have the ability to participate in the new realities before us.

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