

Instituting a Cash Investment Policy Statement

In brief

At a pivotal moment on a number of fronts—regulatory, interest rate and economic—around the globe, more investors are reassessing their short-term fixed income investment policy statement (cash IPS) and putting into place the strategies and solutions that can best help them navigate a changing environment. A cash IPS lets an organization define its short-term investment objectives and the strategies for achieving them. It creates a sound foundation and promotes consistent, long-term discipline in decision-making through all market conditions, so that crucial liquidity and investment goals may be met.

The benefits of an IPS

- Provides greater clarity across the firm
- Defines short-term investing parameters
- Instills discipline and control
- Allows for optimizing cash
- Builds in governance
- Helps with navigating changing rates and regulations

1 What is a cash investment policy statement? A sound foundation for cash investment decisions

As investors continue to navigate a shifting interest rate environment globally and face reforms and new regulatory standards, a short-term fixed income investment policy statement—or cash IPS—offers clarity, giving everyone in an organization, from the investment team to the board of directors, a common understanding. A cash IPS provides financial transparency and a mechanism for internal control. It addresses the essential activity of cash segmentation—categorizing cash by liquidity needs (distinguishing among operating, reserve and strategic segments), enabling firms to seize the varied opportunities available and deploy a range of appropriate, optimal cash investment strategies.

A cash IPS defines an organization's:

- parameters for liquidity, quality and return
- risk tolerance
- return requirements
- permissible investments
- relevant constraints (tax considerations; environmental, social and governance [ESG] guidelines)

A cash IPS spells out the investment philosophy tailored to the organization's needs. And it should be flexible and dynamic. Many treasury teams continually update theirs to adjust to new cash management products and take advantage of opportunities in evolving global markets. For example, after 2016, the Securities and Exchange Commission (SEC) introduced new rules governing money market funds (MMFs) and many cash investors reconsidered the relative attractiveness of prime vs. government MMFs. In Europe, amid new MMF reform, investors will likely evaluate a range of new structures. And Basel III regulations redefining global standards for bank capital, liquidity and leverage will continue to drive non-operating deposits off bank balance sheets.

Why do you need a cash IPS?

A cash IPS can be used as a basis for discussing an organization's evolving investment management priorities. Every organization must find its own optimal balance—among capital preservation, yield generation and access to liquidity. Accordingly, the cash IPS serves as a necessary strategic guide in planning and implementing short-term investment. This has become especially important since liquidity investment has grown from a straightforward practice to a multi-faceted discipline with potentially greater risk.

A cash IPS is also a means for accountability. It builds in prudent governance, risk management and the monitoring and reporting of results. Organizations also need a cash IPS because it can provide the documentation required for Sarbanes-Oxley compliance, while serving as a mechanism for financial transparency and control. Consider writing an IPS if your corporate treasury group doesn't have one, or re-evaluating with your board and asset manager whether your existing IPS is up-to-date.

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When should you institute an IPS?

Your organization more than likely has a cash IPS in place already. More investors are updating theirs in this dynamic interest rate, regulatory and market environment. Less than a decade ago, an undifferentiated cash management industry offered a few no-risk asset classes. That has been transformed into a complex industry offering many products—3(c)(7)s, ETFs, separately managed accounts, money market mutual funds, ultra-short bond funds and short-duration bond funds. A new or changed cash IPS may be needed to take advantage of evolving market opportunities, but instituting one takes time and, often, considerable effort. It may be prudent to start the process sooner rather than later.



The steps to developing a cash IPS:

- 1. Define short-term fixed income investment objectives**
While these are unique to each company, they are typically some combination of maintaining necessary liquidity, maximizing total returns given risk tolerance, preserving capital, accommodating tax concerns and/or exceeding a particular benchmark.
- 2. Draw up cash forecast**
The finance team can generate this from an inventory of cash flows.
- 3. Organize cash segments into categories**
The short-term portfolio reflects several types of liquidity needs and risk profiles, designed to meet different investment goals. Segments typically cover operating cash, reserve cash and strategic cash.

Who supervises an IPS review?

Responsibility usually rests with the CFO, treasury managers and their team members. The CEO and/or board of directors may also be responsible for exceptions or updates. Final sign-off typically occurs at the most senior level of responsibility for investment activities. An IPS may be prepared by the CFO or treasurer and submitted to the board for final approval.

Whether the cash IPS will be implemented in-house or through an outside asset manager will depend on whether cash management resources—the knowledge, time and infrastructure—exist internally, such as portfolio management systems, technology and credit risk and risk control expertise.

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How to develop a cash IPS

- Clarify objectives for liquidity management
- Inventory expenditures to produce a detailed cash forecast
- Segment cash into pools to achieve different objectives

② How to develop a cash investment policy statement: Beginning the process

Clarifying cash investment objectives

An Objectives section of the cash IPS should define the organization's goals for its short-term investment strategy. It should provide a high-level framework that clearly explains how the organization will meet each objective. While affirming cash investment objectives, the IPS should also retain enough flexibility and adaptability to take advantage of new market opportunities that may present themselves.

The Objectives section may address:

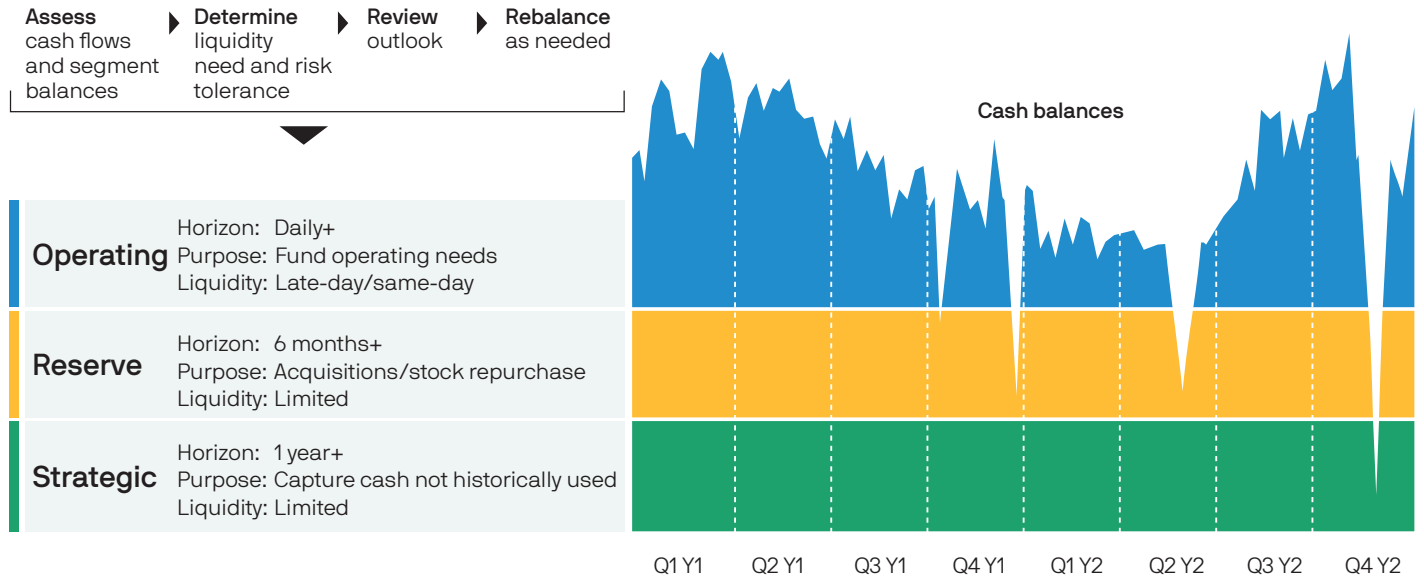
- **Capital preservation:** Protection of principal—the safety of cash investments—is likely to be a primary objective for many organizations.
- **Sufficient liquidity:** The treasury group or financial staff can ascertain the liquidity level appropriate to steer clear of avoidable risks—a crucial goal.
- **Yield/income:** Providing consistent current income may be another goal, which will, however, need to be balanced with a probable increase in the volatility of principal.
- **Tax-advantaged returns:** Tax-conscious liquidity management may be a goal, in which case tax-free short-term funds become an appropriate option.
- **Above-benchmark returns:** Exceeding a benchmark that mirrors the portfolio's underlying investments may be among the priority objectives.

Cash segmentation

The well-established discipline of cash segmentation is an especially useful tool for short-term fixed income investors. Once a cash forecast is in place, an organization can segment its liquidity portfolio into three categories, reflecting their different liquidity needs and risk profiles (**Exhibit 1**): operating cash (requiring same-day liquidity), reserve cash (with an investment horizon of six to 12 months); and strategic cash (with an investment horizon of one year or longer).

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Exhibit 1: Understanding your cash needs



Cash segmentation enables an organization to choose the most appropriate investment solution for each segment. For more details, see “Put cash in its place: Leveraging the power of cash segmentation,” jpmgloballiquidity.com.

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Critical components of a cash IPS

- Risk tolerances
- Portfolio benchmarks
- Permissible investments
- Treatment of realized gains/losses
- ESG requirements, if any

3 The components of a cash investment policy statement: Building out the policy

Instituting a cash IPS begins with inventorying cash flows, defining liquidity targets and determining short-term fixed income investment objectives for your organization’s cash that will guide cash segmentation. From those foundations, the IPS becomes more detailed, specifying acceptable levels of the many types of risk—for and within each segment. An organization can choose to have a higher-return strategic cash allocation; however, because higher returns come with a higher level of risk, this decision and its trade-offs should be well understood (even if quantifying the risk is difficult), agreed upon and documented within the IPS.

Begin with a cash flow inventory

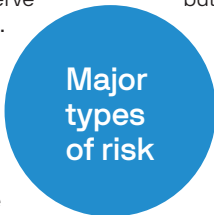
From that fundamental premise, we expand below on the variety of important risk factors to consider as critical components when building out a cash IPS. In addition, we explore five related components: permissible investments, benchmarks, realized gain/loss treatment, duration strategies and sustainability (ESG) parameters, if any.

Risk tolerance is the most important issue. To examine various risks, which we enumerate below, we recommend considering these questions to clarify the organization’s tolerance for various types of risk and volatility:

Constraints: What is the organization’s tolerance for the possibility it could be unable to raise cash for a chosen purpose—that its liquidity could be constrained?

Fees: How does it view the prospect of having to pay a liquidity fee in times of market stress?

Interest rate volatility: How sensitive is the organization to unrealized portfolio losses due to interest rate volatility?



Interest rate risk: This is the risk a security’s value will change because of a change in prevailing interest rates. The operating, reserve and strategic segments may each have distinct tolerances; of the three, operating cash is likely to have the lowest interest rate risk tolerance, making it the least able to generate a high yield. The reserve segment generally has more flexibility and duration appetite. **The strategic segment offers the most flexibility and assumes the highest level of tolerance for interest rate risk.**

Liquidity risk: This is the inability to raise cash for any purpose—in an extreme case, possibly requiring sales of illiquid assets or even making it impossible to meet a debt payment (leading to default). A cash IPS will stipulate ample liquidity, through investing in short-dated maturities, so an organization won’t be forced to sell longer-dated securities to meet cash needs. In considering liquidity risk tolerance, think about how the organization views the prospect of a money market fund imposing a liquidity fee, or “redemption gate,” in a time of market stress.

Credit risk: This is the risk that a fixed income security’s value will change due to a rating downgrade or because of a credit risk default. Credit quality is central to all fixed income investing. A security with a lower credit rating typically adds yield to the portfolio, but it also adds an element of risk. The IPS defines the minimum credit quality of individual securities; however, **having an average credit quality limit on the portfolio as a whole may be just as important, to ensure credit quality diversification.**

Loss of principal risk: If an organization invests in a longer-duration cash product and an event provokes a major downturn, perhaps volatility in floating NAV, loss of principal is possible. The cash IPS should define whether the organization can accept some level of short-term volatility, and the degree to which it requires steady dividend income and wants to diversify its investments.

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Negative returns

Could it tolerate negative total returns over the short term to achieve potentially higher returns longer term?

Realized gains/losses

What is the “bandwidth” for acceptable net realized gains/losses in a given period? An effective IPS considers these matters, defining acceptance levels for, among others, three major types of risk in a portfolio: interest rate risk, credit risk and liquidity risk.



Several further components of the IPS related to risk tolerance should also be factored in:

1. Permissible investments

While different countries will have different investment options, the “permissible investments” section of a cash IPS defines the types of securities allowed, along with parameters for credit quality, maturity and diversification. It should be updated periodically to reflect market changes and the organization’s evolving investment philosophy. Along with permissible investments, the IPS should specify the course of action if a security or issuer is downgraded or has different ratings from rating agencies.

2. Benchmarks

Portfolio benchmarks express the organization’s goals for its cash portfolios, providing mechanisms to track performance, define risk limits and communicate clearly to, for example, an advisory committee, senior management and external asset managers. Choose transparent benchmarks that are easy to understand, clear in their composition, publicly available and, most important, that mirror the investment strategy for which they will serve as yardsticks.

3. Realized gain/loss tolerance

An IPS should define an organization’s tolerance (if any) for realized portfolio gains or losses, on a net or absolute basis, on a per-month or per-quarter basis. This will provide clear internal parameters for acceptable performance and may give the investment manager more flexibility to help enhance return. As there are no set standards, the definition of realized gain/loss tolerance should evolve to reflect an organization’s circumstances, drawing on input from finance and accounting departments.

4. Duration strategies

An IPS should articulate duration strategies (which will differ for each cash segment). It should delineate whether the approach in each case will be a target duration or a buy-and-hold strategy. A target can create more active trading, triggering higher costs, as well as higher levels of interest risk during a rate-hiking cycle. Buy-and-hold strategies are more appropriate for capital preservation, a short-duration portfolio and when liquidity is the key objective.

5. Sustainability (ESG) parameters

Some organizations will factor in values-based screening or “impact” investing themes—also called sustainability or environmental, social and governance (ESG) parameters. A cash IPS might, for example, restrict the purchase of securities because of an issuer’s energy use.

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Governance—An IPS should:

- Specify who has authority over governance
- Build in provisions for reviewers to do so regularly
- Include procedures for review to accommodate exceptional circumstances
- Specify who has final sign-off and who is authorized to participate

4 Roles and responsibilities: Who institutes a cash investment policy statement?

Governance

While organizations vary, the cash IPS should identify responsibilities: how, when and by whom it will be approved, implemented and modified. The IPS should include provisions for ongoing evaluation: how the cash IPS will be evaluated on a regular basis and how compliance with its terms will be ensured over time.

In its Governance section, the IPS should also define how credit quality will be assessed and monitored, beyond agency ratings. As with asset management (see below), examine whether the organization has the ability and resources to do credit analysis in-house, or whether it should be outsourced.

Review, compliance, management:

Build in provisions for regular reviews and updates to keep the IPS current and flexible enough to allow, for example, a quick response to a significant cash inflow from a divestiture or bond issue, or a cash position reduced by an acquisition, share buyback or pension funding. Risk tolerance or investment philosophy may change, too. Cash management can also be affected by a regulatory event or the introduction of a new money market product. You may want to include:

- How frequently the IPS will be reviewed (quarterly, biennially or annually) and what types of events would activate an unscheduled review.
- Who is responsible for conducting the IPS review, and who is authorized to recommend modifications (generally, the list includes the chief financial officer and treasurer, assistant treasurers, treasury department managers and other members of the treasury group; the CEO and/or board of directors may also be responsible for exceptions or updates).
- The person with final sign-off authority (typically, someone at the most senior level of responsibility for investment activities: the board of directors, CEO or CFO). Often an IPS is prepared by the CFO or treasurer and submitted to the board for final approval. These roles should be clearly delineated in the IPS.

Compliance

During extraordinary market environments, exceptions to the investment policy may become necessary even with well-written policies. Procedures should be included to accommodate exceptions, along with a formal approval process that outlines responsibility for each step.

Asset management capabilities: Internal vs. external

Once you have developed a short-term IPS, how will your organization implement it? Examine whether the resources exist internally to manage short-term fixed income assets or whether an external asset manager should be hired. For internal management, consider whether your institution has:

- the resources in-house, such as the knowledge, time and infrastructure to manage all the aspects of short-term investing. These include portfolio management systems, operations, technology and credit risk and risk control expertise.
- a credit team and, if so, whether it is sector-specific (with different analysts covering asset-backed commercial paper, financials, utilities, etc.)
- a procedure for regular compliance-monitoring reporting to senior levels.



Some of the key criteria to consider when seeking an outside asset manager

- 1. Portfolio managers:** Look at the firm's tenure in the short-term fixed income business, whether its portfolio managers have invested through multiple credit cycles and market events, and whether they bring track records in credit and risk management.
- 2. Dedicated Credit team:** Think about its size, whether credit analysts serve both short-term and long-term fixed income portfolios, and team members' average years in the industry and with the asset manager. How has the team evolved in the past two to five years? Is the credit team separate from the portfolio managers—can portfolio managers override the credit team's recommendations or list of approved issuers?
- 3. Business and geographic breadth:** Does the asset manager reside within a diversified fixed income and asset management business? Does the asset manager have global presence and scale?
- 4. Diversity of client base:** How diverse is the fund sponsor's client base? And has it garnered assets during times of market instability?
- 5. Size, scale and market share:** What are the firm's total assets under management in short-term fixed income, including money market funds? What is its share of the money market business and how has this changed over time (in the U.S. and internationally)?

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Global coordination, lasting partnerships

- Harness the power of our research-driven, globally coordinated investment process, led by our dedicated team of liquidity professionals.
- Make investment decisions based on actionable insights from our senior investors, and build portfolios based on the output of proprietary benchmarking tools.
- Select from a breadth of outcome-oriented solutions designed to help you build the most effective liquidity strategy.
- Tap into the award-winning innovation and success of one of the world's top liquidity fund managers, with over 30 years of demonstrated results across market cycles.

Next steps

Please contact your J.P. Morgan Asset Management representative for more information.

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