Effectively Managing Cash to Meet Current and Long-term Needs

Executive Summary
Access to cash has always been a critical aspect of an overall financial strategy. Cash tends to become a more visible component in a portfolio during times of equity market volatility and economic uncertainty. This explains why today, an above-average percentage of assets are held in fairly liquid accounts. While this approach assures easy access to money and potentially protects investment principal, the downside is that this money is earning almost no yield.

The need to effectively manage your cash investment portfolio has never been more important given our environment of consistently low interest rates. Creative, personalized solutions may give investors the greatest opportunity to maximize the value of the cash they have set aside. This includes clearly identifying specific cash needs for the future and investing assets accordingly.

If managed properly, there is the potential to take advantage of a broad range of options, from historically safe, FDIC-insured accounts with a modest current yield to mutual funds that may be subject to principal fluctuation, but may offer a higher yield potential. Other strategies, such as laddering of term deposits or bonds, may create a more reliable source of cash flow streams over the long term. Appropriate planning about the best ways to match available cash assets to scheduled liabilities and to potentially maximize returns on your cash investment portfolio may make a significant difference when it comes to achieving long-term financial success.
Managing cash in a challenging market

Effective cash management is sometimes given a low priority by investors, but its importance cannot be overlooked, particularly given today’s environment of consistently low interest rates. In a desire to find alternatives that can generate higher yields, some may become willing to accept more risk with their money. It is an understandable decision and may be fully justifiable, depending on liquidity requirements. But if not managed appropriately, the outcome can have a negative impact on the investor’s ultimate objectives. This is why it is important to put any decisions involving cash management issues in the context of a personal financial strategy.

Yield is not the only consideration when it comes to managing cash. A variety of other issues can come into play as well, including:

- The timing of cash needs including when specific liabilities come due.
- The amount of available assets required to meet short-term liabilities and other investable assets available.
- The different options available to put the cash to work.
- The role cash assets are required to play in the overall financial strategy.
- The financial stability of the company trusted to hold cash assets.
- Choice in ways to access cash via checks, ATMs and through online banking.
- The strength of the company issuing the investments.

Asset and liability planning

The importance of having sufficient liquidity can’t be understated, particularly for those who have specific liabilities to manage (such as funding retirement income or other committed expenses). A common mistake is to set aside too much cash in shorter-term vehicles than is necessary to meet liquidity requirements. A specific liquidity strategy should be established, centering on an asset and liability plan.

Assets

One of the first steps is to determine available assets to meet liquidity needs. Identify what assets are immediately available to position in an appropriate manner to meet specific objectives. In other words, are there dollars accessible to the investor that can be placed in cash-equivalent or similar accounts that are not subject to penalty or a significant tax liability if they are liquidated and re-positioned in another vehicle? Taking an inventory of all available assets is an important step in the process of determining the best ways to position cash investments.

Liabilities

The timing of liabilities is another significant factor in determining the most effective ways to manage cash. For example, money that is required to pay bills in the immediate future (over the next 90 days) needs to be in the most accessible types of vehicles such as checking or savings accounts, money market mutual funds, and other liquid investment alternatives. There may be greater flexibility in safely funding liabilities that are farther out on spectrum (120 days or more). Time deposits, individual debt securities (Treasury bills, and discount notes or commercial paper) and short- and intermediate-term bond funds may be a consideration for individuals seeking to generate a more competitive yield with money that will not require immediate liquidity.
A cash management concept that has worked for many investors over the years is called “laddering,” in which you spread your money across securities with different maturity dates, such as CDs, time deposits or bonds. This approach is very practical. As rates move up, your shortest-term securities come due and the money can be reinvested at higher levels.

For instance, building a short-term ladder with CDs allows the individual to access the stability and applicable guarantees associated with CDs while potentially generating increasing yields over time as rates move up. Note that in times when interest rates decline, yields earned on reinvested dollars could be lower than what would have been generated by investing in a longer-term security when rates were higher.

In this example, $250,000 is invested at once, but spread equally among five CDs with short-term maturities of 1, 2, 3, 4 and 5 years. In most environments, the longer the maturity, the higher the yield paid by the CD.

One CD matures each year. Each year, one of two options can be considered:

1. If cash is needed to pay current expenses, the assets are available for that purpose.
2. If cash is not needed, the assets can be reinvested in a 5-year CD. This is possible because one year later, another portion of the investment will become liquid as the next CD in the ladder matures.

The result of the strategy is more effective use of cash assets since you tie up less cash than you would putting everything into a five-year CD, and you may earn more than you would holding only one or two-year CDs.
Matching a full spectrum of options to needs

Once specific cash flow needs (liabilities) are identified, it becomes easier to determine the best options for investing available cash. In this way, cash does not have to be viewed as a category where all money is directed to the same vehicle. Greater efficiencies can be found by matching the timing of liabilities to the best available options for those liabilities. Typical cash flow needs and the appropriate solutions fall into three categories:

**Immediate cash**
Liabilities that must be met within 90 days, indicate a need to keep cash in an extremely liquid state. The primary focus is to protect principal. Some banking products offer an additional level of protection — FDIC insurance, to help assure the security of the investor’s cash. An important factor to consider is how easy an institution makes it to access cash, including a broad network of ATMs. Options to consider include:
- Checking accounts (FDIC insured)
- Money market savings accounts (FDIC insured)
- Money market mutual funds
- Puttable deposits
- Eurodollar deposits
- Commercial paper
- Repurchase agreements
- U.S. Treasury and agency securities
- Bankers’ acceptances

**Short-term needs**
In some cases, expenses may be identified but cash will not be needed to meet these liabilities for a period of time, beyond 90 days but within 9 months. This allows the flexibility to seek higher yields without taking significant principal risk and still maintaining sufficient liquidity to meet specific future liabilities. Options include:
- Certificates of deposit and Eurodollar time deposits
- Short-term U.S. Treasury and agency securities
- Commercial paper
- Bankers’ acceptances

**Long-term cash needs**
Some money should always be invested in ways where principal is relatively stable and assets can be liquidated to either meet emergency needs for unplanned expenses or as part of a broader asset allocation strategy for a portfolio of investments. Planned expenses such as the purchase of a vacation home, an upcoming tuition bill for college or funding for a small business are future liabilities that may be planned for well in advance. Alternatively, there may be a need to maintain a portion of a long-term portfolio in low-volatility investments. There is principal risk, but these are typically considered fairly stable investments. Options to consider include:
- Short-term bond funds
- Intermediate-term bond funds
- Certificates of deposit and Eurodollar time deposits
- Term commitment and puttable deposits

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1 FDIC insurance may not cover all investments.
2 FDIC insured to the maximum allowed by law.
Conclusion

There are no cookie cutter solutions when it comes to building a personalized strategy for effectively managing your cash. Investors are not well served by simply chasing yield or settling for a lower yield. In fact, the best approach is to take a holistic view of the entire financial situation to help determine:

- The most appropriate role for cash in your investment portfolio.
- A schedule of liabilities that will require access to funds in the short term.
- Other needs for cash such as meeting day-to-day expenses.
- Because of frequent market and regulatory changes it is important to review your investment strategy with a trusted advisor at least annually.

This is the kind of direction that can be provided by The Private Client Reserve of U.S. Bank. Our experienced investment professionals and private banking officers understand the wide array of options available in the marketplace and can help match your individual needs to the best the market has to offer to meet those needs.

Important Definitions and Disclosures

A bankers’ acceptance (BA) is a method of financing that a bank may provide to its customers to support the import, export or domestic shipment of goods or to finance the storage of properly titled goods. A bankers’ acceptance is a time draft drawn on, and stamped as “accepted” by a bank. Bankers’ acceptances are often issued in conjunction with Letters of Credit.

A commercial paper investment is a short-term unsecured promissory note issued by a corporation for a maturity specified by the issuer. Commercial paper is issued primarily by independent finance companies, finance subsidiaries of major corporations and asset-backed issuers. The issuing company can request a rating of its credit worthiness from national recognized rating organizations, such as Moody’s Investors Services, Standard & Poor’s and Fitch’s Rating Service.

A U.S. Bank Eurodollar Deposit consists of U.S. dollars deposited in a U.S. Bank branch located outside of the United States. Investments are in the form of a time deposit and remain a U.S. Bank liability. Eurodollar deposits issued through the U.S. Bank Grand Cayman Island Branch are subject to the laws of the Grand Cayman, British West Indies. FDIC insurance does not cover Eurodollar deposits.

A repurchase agreement (repo) is an agreement that involves the temporary sale of securities and a simultaneous commitment by the seller to repurchase the securities at a given date or upon notice by the buyer, in the case of an open repurchase agreement. The seller retains the securities, but designates the temporary owner on their books, according to the rules of the Government Securities Act.

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Investment products, including shares of mutual funds, are not deposits or obligations of, or guaranteed by U.S. Bank or any of its affiliates, nor are they insured by the Federal Deposit Insurance Corporation, or any other government agency. An investment in such products involves investment risk, including possible loss of principal. Mutual fund investing involves risk; principal loss is possible. Investing in certain funds involves special risk, such as those related to investment in small- and mid-capitalization stocks, foreign, debt and high-yield securities, and funds that focus their investments in a particular industry. Please refer to the fund prospectus for details pertaining to these risks.

Before purchasing a certificate of deposit (CD), investors should understand all terms and carefully read any disclosure statements. CDs have a maturity date and if money is withdrawn prior to this date, investors may be penalized with a fee. Investors should also confirm the interest rate that will be paid and at what interval payment will be made.

U.S. Bank may enter into agreements with non-proprietary mutual funds or their service providers whereby U.S. Bank provides shareholder services and/or sub-transfer agency, custodial and other administrative support services and receives compensation for these services. Compensation received by U.S. Bank directly or indirectly from mutual funds does not increase fund fees and expenses beyond what is disclosed in the prospectus. For more information, please review the fund’s prospectus. Fixed-income investments are subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications, and other factors. Investment in debt securities typically decrease in value when interest rates rise. The risk is usually greater for longer-term debt securities. Investments in lower-rated and non-rated securities present a greater risk of loss to principal and interest than higher-rated securities. Foreign investing entails additional risks, including currency fluctuations, political and economic instability, accounting changes, and foreign taxation. Securities may be less liquid and more volatile. An investment in money market funds is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although these funds seek to preserve the value of an investment at $1.00 per share, it is possible to lose money by investing in these funds.

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