Managing Cash to Meet Current and Long-term Needs

Creative, personalized strategies that clearly identify specific cash needs for the future may provide you with a better opportunity to maximize the value of your cash allocation.

Executive summary

Managing cash is a critical aspect of an overall financial strategy. Cash tends to become a more visible component in a portfolio during times of elevated market volatility and economic uncertainty. This explains why today many individuals are holding a substantial amount of funds in relatively liquid accounts. While this approach can help provide easy access to money and provide the potential to help maintain investment principal, one possible downside is that yields on very liquid assets are generally low, which can potentially erode purchasing power if the yield earned is lower than the current inflation rate.

Creative, personalized strategies that clearly identify specific cash needs for the future may provide you with a better opportunity to maximize the value of your cash allocation. These strategies may include a broad range of options, from FDIC-insured accounts with a modest current yield to mutual funds that may be subject to principal fluctuation but offer a higher yield potential. Other strategies, such as laddering of term deposits or bonds, may create a more consistent source of cash flow streams over the long term. A line of credit may be another way clients manage their cash-flow needs. Appropriate planning to identify 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 your long-term financial objectives.

Managing cash in a challenging market

Effective cash management is sometimes given a low priority by clients, 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 entirely justifiable, depending on liquidity requirements. But if not managed appropriately, the outcome can have an adverse impact on the client'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 should be considered when developing a cash-management strategy, including:

- The timing of cash needs, including when specific liabilities come due.
- The different options available to put the cash to work, including credit.
- The financial stability of the company entrusted to hold cash assets.
- 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, a new business venture or other committed expenses. A specific liquidity strategy should be established, with a focus on an asset and liability plan.

Assets

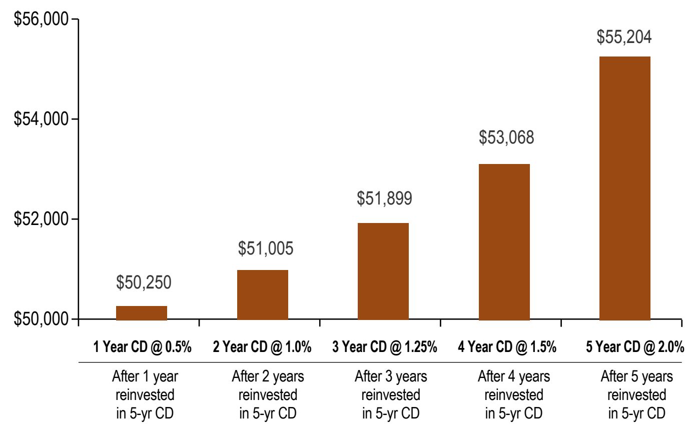
One of the first steps in creating an asset/liability plan is to identify available assets to help meet liquidity needs. Identify which assets are available to position in an appropriate manner to meet specific objectives.

Are there dollars accessible to the client 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 or re-positioned in another vehicle? Taking an inventory of all available assets is an important step in the process of determining opportune 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 (during the next 90 days) should be in the most accessible types of vehicles such as checking or savings accounts, money market mutual funds or other liquid investment alternatives. There may be greater flexibility in safely funding liabilities that are farther out (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.

Building a CD Ladder: $50,000 invested in each of 5 CDs



Example provided for illustrative purposes only; is not a guarantee of future results.

Laddering to potentially maximize returns while protecting long-term liquidity needs

One cash-management option called "laddering" is used to invest your money in securities such as CDs or bonds with different maturity dates. This approach can be very practical. If rates move up, as your shortest-term securities come due, the money can be reinvested at potentially higher levels.

For instance, building a short-term ladder with CDs can provide possible stability while providing the potential to generate increasing yields over time if rates move up. If interest rates are declining, future yields earned on reinvested dollars may be lower.

In this example, a total of $250,000 is invested equally among five CDs with short-term maturities of one, two, three, four and five 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 five-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 can be a more effective use of cash assets that provides the potential for greater flexibility since you invest cash for shorter time periods rather than committing all of your cash assets in a five-year investment. Depending on interest rates, you may also earn higher yields over the time period of the ladder as compared to holding only one- or two-year CDs.

Matching a full spectrum of opportunities to needs

Once specific cash flow needs (liabilities) are identified, it becomes easier to determine the appropriate 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 most suitable available options for those liabilities. Typical cash flow needs and the appropriate solutions generally 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 maintain principal. Some banking products offer FDIC insurance[1] to help assure the security of the investor's cash. Another important factor to consider is how easy an institution makes it to access cash, including a broad network of ATMs. Options include:

- Checking accounts (FDIC insured)[2]
- Money market savings accounts (FDIC insured)[2]
- Money market mutual funds
- Commercial paper
- U.S. Treasury and agency securities

Short-term needs

In some cases, expenses may be identified but cash will not be required to meet these liabilities for a period of time, beyond 90 days but within nine months. This allows the flexibility to seek higher yields without taking significant principal risk and still maintaining sufficient liquidity to meet specific future liabilities. Considerations include:

- Certificates of deposit
- Short-term U.S. Treasury and agency securities
- Commercial paper

Long-term cash needs

Some money should always be invested when 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. 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 identified as relatively stable investments. Considerations include:

- Short-term bond mutual funds
- Intermediate-term bond mutual funds
- Certificates of deposit

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

Conclusion

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

- The most appropriate role for cash in your financial strategy.
- A schedule of liabilities that will require access to funds in the short, intermediate and long term.

Because of frequent market changes and changes to your own objectives, it is important to review your financial strategy with a trusted advisor at least annually.

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

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 major risk of investing in commercial paper is the risk the issuer will not be able to pay the debt at maturity. Before purchase, investors should consider the characteristics of the issuing company, the business climate of the company and the economy.

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. Although a money market mutual fund seeks to preserve the value of an investment at $1.00 per share, it is possible to lose money by investing in these funds. 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.

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. Read the prospectus carefully before you invest. For certain funds, the fund manager may have elected to waive or absorb all or a portion of fees during a given period. This waiver or absorption would have the effect of increasing a fund's reported yields. Information about any waivers can be found in the fund's prospectus 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.