HIGHLAND

# INSIGHT
FEBRUARY 2017

## IS CASH KING? OPTIMIZING LIQUIDITY IN A LOWER-RETURNING ENVIRONMENT

### HIGHLIGHTS:

- Short-term cash pools are vital to the success of not-for-profit (NFP) healthcare organizations. In an environment of low yields and low growth, they are forced to balance having the required amount of cash available to meet the organization's needs without sacrificing the opportunity for additional returns.
- Currently, many NFP healthcare systems hold their short-term cash pools in traditional instruments such as demand deposit accounts and money market funds. Even after recent interest rate increases, these investments offer minimal yields. Regulations have also transformed the prime money market industry.
- Highland believes there is a better solution that involves structuring the program to the specific liquidity needs of the organization. Based on a cash analysis, NFP investors are able to tier their cash program based on time horizon, and significantly increase potential returns, without sacrificing liquidity.

"Cash is king"—a favorite expression heard most often after a financial crisis. Although the origin of the phrase is not known, many attribute it to Pehr G. Gyllenhammar, who was the CEO of Volvo from 1970 to 1994. After the stock market crash of 1987, he was often known to use the phrase. The expression once again gained traction during the Global Financial Crisis of 2008 describing companies that could avoid financial distress or bankruptcy. "Cash is king" was relevant also to households who struggled to avoid foreclosures, and investors who had significant amounts of cash to invest at market bottoms.

For not-for-profit (NFP) healthcare organizations, the idea that cash is king is a way of life. These organizations face challenges across multiple pools of capital. These varying pools include longer-term operating portfolios, retirement plans (defined contribution and defined benefit), and shorter-term cash pools. Liquidity demands, lower longer-term return expectations, and funding status are just some of the challenges facing the more prominent pools of capital such as NFP operating portfolios and retirement plans. While short-term cash pools are not typically at the forefront of investment media, they are not immune to the challenging capital market environment of today.

Short-term cash pools are vital to the success of NFP healthcare organizations. The purpose of this capital is to provide the organization with enough cash to meet the day-to-day needs of running a hospital. These daily needs are exceedingly erratic given the difficult operating environment with which hospitals must contend. Declining reimbursement rates and uncertainty regarding the future of the Affordable Care Act increase the pressure for hospitals to maintain adequate short-term cash pools. Operating margins, as depicted in **Figure 1**, have historically been lean for the NFP

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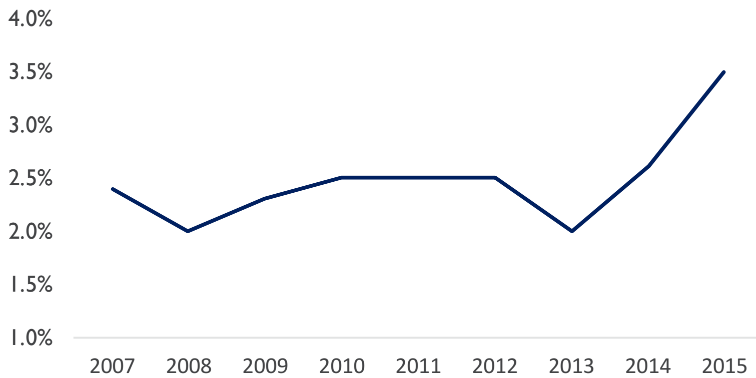
Highland Associates, Inc. is an independent institutional investment advisor headquartered in Birmingham, Alabama. Highland was founded specifically to help develop, implement and maintain investment management programs for institutions. We serve a national client base of investors including not-for-profit healthcare organizations, foundations, endowments, defined benefit plans, defined contribution plans, and high-net worth individuals. As of December 31, 2016, we serve as investment consultant on approximately $20 billion in assets. Please visit the website at www.highlandassoc.com to learn more.

healthcare industry, which makes these portfolios even more vital to the mission of the organization. Notwithstanding, M&A activity has increased immensely in recent years, leading organizations to increase the size of their cash investments.

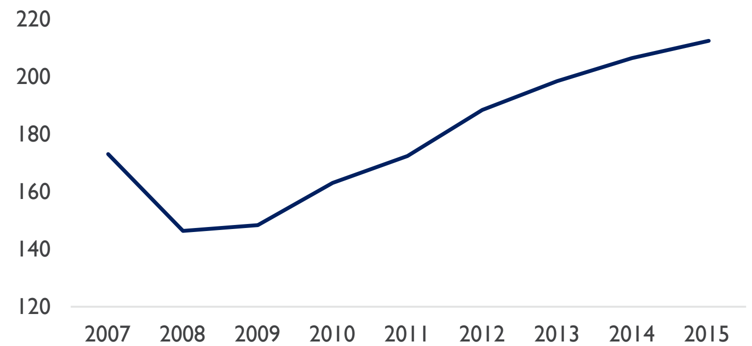
*FIGURE 1*




SOURCE: MOODY'S, HIGHLAND ASSOCIATES. INCLUDES ALL RATED NFP SYSTEMS.

Following the 2008 financial crisis, many organizations worked hard to strengthen and repair their balance sheets. As discussed in Catch 22: Balancing Portfolio Liquidity in a Low Returning World, during the 2008-2009 period, more than 100 NFP healthcare systems were downgraded by Moody's as a result of deteriorating balance sheet liquidity. This "perfect storm" environment created an extreme mismatch between assets and liabilities. This also came at a time when operating performance for healthcare systems declined immensely and most investment portfolios saw significant drawdowns. Consequently, they built up sizable cash reserves to bolster their balance sheets. As shown in **Figure 2**, days cash on hand for NFP healthcare systems has increased by 45% since the lows of 2008. Unfortunately, these higher balances post-2008 came at a time when the Federal Reserve enacted ZIRP (zero interest rate policy) along with quantitative easing, which pushed short-term interest rates to near zero. While the Federal Reserve has recently enacted two rate increases, short-term interest rates remain very low and well below pre-crisis levels (see **Figure 3**).

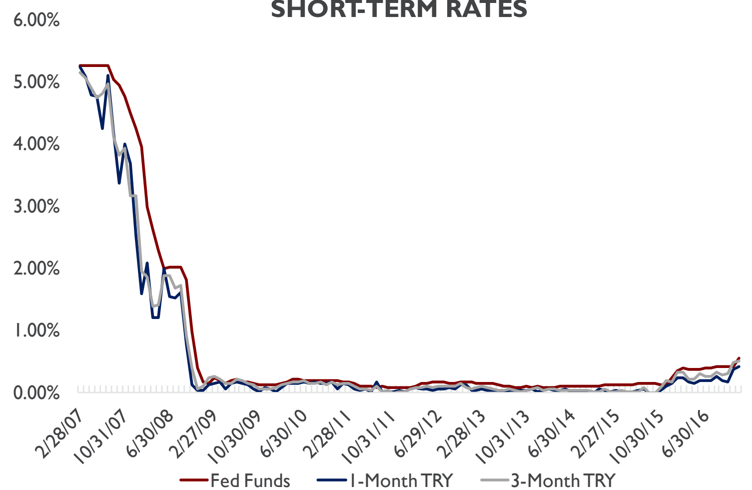
*FIGURE 2*




*SOURCES:* MOODY'S, HIGHLAND ASSOCIATES. INCLUDES ALL RATED NFP SYSTEMS.

In this challenging environment, NFP healthcare systems are forced to balance having the required amount of cash available to meet the organizations' needs without sacrificing the opportunity for additional returns.

*FIGURE 3*




SOURCES: FACTSET, HIGHLAND ASSOCIATES

## CHALLENGES

### Banking Deposits

Many NFP healthcare systems hold their short-term cash pools with banking institutions in the form of demand deposit accounts (DDA). These forms of cash currently offer very modest yields (in the range of 0.20% to 0.30% from our discussions with clients). Oftentimes, these are not true "yields" per se, but are "earnings crediting rates." For example, if a customer currently receives an earnings crediting rate of 0.20%, this amount of interest is not

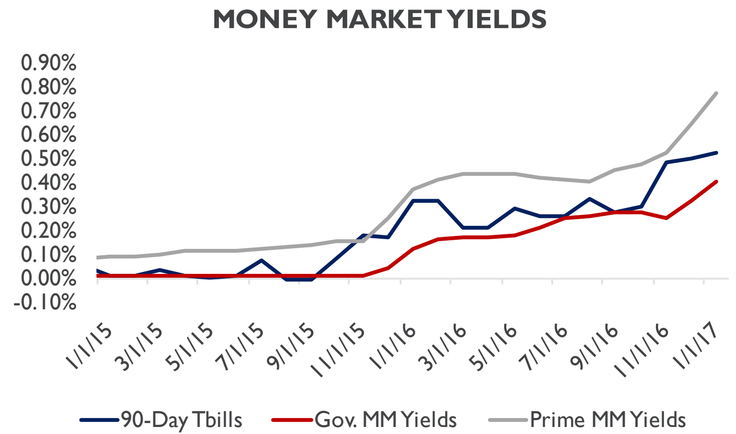
added to his/her account balance, but is deducted from fees they pay for services provided by the bank (such as cash management services). This differs from a traditional sweep account, where excess cash is swept into a DDA and interest is credited to the balance. Another option is to buy banking certificates of deposit (CDs). There is not much improvement in yield, however, as the Bankrate National Average 6-month CD rate[1] is currently 0.36%. Investors are also subject to the credit risk of the banking institution, in addition to the illiquidity associated with varying maturities.

Not only are yields at very depressed levels, but many banks are also seeking to reduce the level to which they accommodate deposits given new regulations. In fact, many large banks recently announced they would begin to charge large institutional customers for some deposits. These factors have made bank deposit accounts an unattractive option for short-term cash pools.

### Money Market Funds

Another widely used option for housing short-term cash reserves is traditional institutional money market funds. Like bank deposits, these vehicles have faced similar headwinds associated with low yields and regulatory changes. On the regulatory front, changes went into effect in October 2016 that impacted institutional prime money market funds. As discussed in Money Market Reform, these changes instituted a floating net asset value (NAV) (rather than the traditional fixed NAV), possible liquidity fees, and potential redemption gates for institutional prime and tax-exempt funds. Government money market funds were excluded from the aforementioned changes. This has led to meaningful redemptions from institutional prime money market funds as investors prefer the safety and stability of government money market funds. This has also put pressure on government money market yields, in an environment where yields are already at depressed levels. At the date of this piece, average government money market yields were approximately 40 basis points. For investors willing to eschew the safety and stability of government money market funds, yields are currently higher at approximately 70 basis points for prime funds (see **Figure 4**).

*FIGURE 4*




SOURCES: WELLS CAPITAL MANAGEMENT GOVERNMENT AND HERITAGE SELECT MONEY MARKET FUNDS, HIGHLAND ASSOCIATES

Based on the two options listed above, NFP short-term cash pools are currently earning anywhere from 0-70 basis points depending upon the product utilized. While prime money market funds offer higher yields, Highland does not feel that the structures compensate investors for the potential changes that could occur in value (floating NAV) in addition to potential illiquidity. Our view is that NFP investors can establish a strategic framework for managing short-term cash pools that allows them to navigate the current landscape and add incremental value above and beyond the options previously discussed.

## HIGHLAND'S SOLUTION: "REIGNING" IN CASH NEEDS

Highland's solution for short-term cash pools involves structuring the program to evaluate the specific liquidity needs of an organization and tailor a program that capitalizes on the dynamic opportunities and risks in the market. A cash tiering approach that matches differing strategies to an organization's liquidity needs can add significant value to the overall organization. Capital preservation is still sustained for daily cash needs, but with potentially higher yield across the portfolio.

The initial step of this process involves evaluating the liquidity needs of an organization through a detailed cash balance analysis. We review the organization's total cash position to determine operating cash flow needs, net flows, and any anticipated needs (capital outlays). Based on the cash balance analysis, we can determine the minimum working capital needs (i.e., cash needed on a daily basis within a 30-day period) and begin to tier the organization's cash based on time horizon (see **Figure 5**).

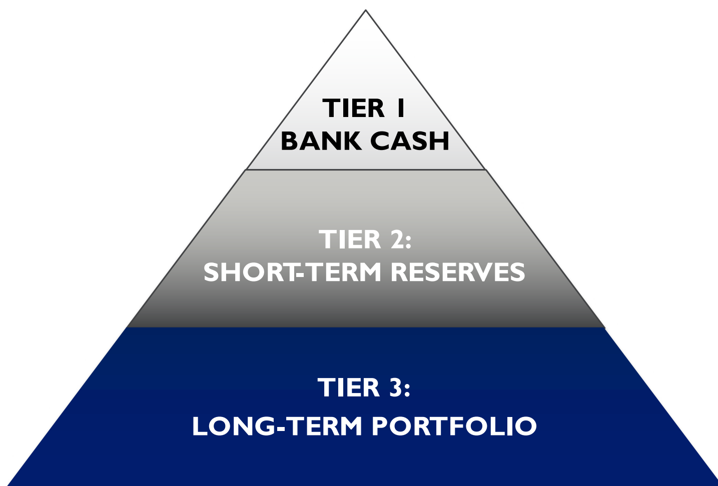
[1] SOURCE: FACTSET

**Tier I** is traditional "bank cash" and represents the most liquid tier of a cash portfolio. The primary objective here is capital preservation and liquidity, rather than yield. These funds are typically held at banks in the form of bank deposits or money market funds (both discussed earlier). This tier should contain enough cash to cover any expected flows within a typical month.

**Tier II** represents a still liquid portion of the short-term cash pool, but for less immediate cash needs (beyond 30 days). Alternatives to traditional safe havens such as bank deposits and money market funds that can produce additional yield is the motivation within this tier. However, liquidity is still a focus as this level should be sufficient to cover any seasonal spikes in cash, which would be swept into Tier 1 as needed. Liquid ultra-short and short-duration cash strategies are often utilized. These strategies typically have maturities within 1 year. Currently, utilizing various ultra-short and short duration strategies can provide investors with returns of approximately 1.1% (net of fees), with duration well under 1 year.

**Tier III** represents the traditional long-term operating portfolio of the organization. While the primary objective here is growth, organizations should maintain sufficient liquidity to fulfill strategic needs (for example capital outlays above and beyond 1 year). As these funds are subject to market risk, they should not be used for routine cash needs if possible.

*FIGURE 5*




*SOURCE: HIGHLAND ASSOCIATES*

***ILLUSTRATION***

*Assume an NFP healthcare system has $100 million in short-term operating cash on its balance sheet that is currently at various banks in deposit accounts and government money market funds and is earning a generous 20 basis points on these balances. After a cash balance analysis, it is determined that the organization needs 25% of its short-term cash pool in Tier I investments to cover daily cash needs within a month. Additionally, 55% of the balance can be moved to Tier II reserves, while 20% can be shifted to the longer-term operating portfolio.*

*Prior to utilizing the tier structure, the organization would earn approximately $200,000 (20 basis points) on its short-term cash pool investments. By utilizing the new tier structure, it can increase its earnings to $1.9 million[2], which is a significant value add proposition.*

## HIGHLAND'S VIEW:

NFP healthcare investors are facing continuing challenges across their multiple pools of capital. Short-term cash pools, perhaps the most critical to the day-to-day operations of healthcare organization are not immune to these challenges. While there is no one-size-fits-all approach here, Highland believes that a strategy that accounts for the organizational needs first, then seeks to maximize return through a tiered approach, is an optimal solution for short-term cash pools. Cash continues to be king for short-term needs, but NFP investors shouldn't let low returns rule the kingdom.

[2] SOURCE: ASSUMES THE INVESTOR EARNS 20 BASIS POINTS ON TIER 1 INVESTMENTS, 1.1% ON TIER 2, AND A LONG-TERM EXPECTED RATE OF RETURN OF 6% ON ITS OPERATING PORTFOLIO.

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