As seen in

Opalesque Exclusive: Ways to gain operational alpha in cash management as US interest rates may stay low over next 24 months

From Kirsten Bischoff, Opalesque New York (March 2, 2010):

A recently released Bank of America Merrill Lynch survey of hedge fund managers showed that most of the industry expects the US Fed to keep interest rates at very low levels through the end of 2010. Last week Fed Chairman Bernanke strengthened this supposition even further during his semi-annual testimony to the U.S. Congress when he said that although the Central Bank raised the discount rate (to banks), the federal funds rate would not necessarily rise anytime soon.

With hedge fund performance essentially flat through the end of February, and market volatility expected to continue through the foreseeable future, managers are on the hunt now more than ever for additional sources of alpha.

One area they are paying more attention to is the possible returns their cash portfolio can be gaining. “Depending on your performance, another point or two over a year can make the difference in passing your internal benchmarks,” says Jill King, VP and Senior Portfolio Manager at Horizon Cash Management. “That little bit extra can be instrumental in the way the year turns out.”

These incremental gains are more important than they ever were before, as many hedge funds are still a few percentage points away from previous highwater marks on investor assets, which keep a fund from collecting performance fees.

The combination of investor interest in all aspects of portfolio holdings, and manager drive to secure operational alpha to add to strategy gains has propelled cash management to the foreground. Prior to 2008, cash holdings tended to be something managers were more passive about; some handled them internally, others subcontract it out to firms like Horizon. In any case, it was an area rarely focused on.

These days, with some managers holding upwards of 80% of a portfolio in cash, investors want to know who is handling these funds, and what their parameters are. Cash management firms, are for the most part, subcontracted portfolio managers. Investors want to know exactly what is involved in this area of the portfolio. For managers that keep their cash management in-house, investors want to know how it is proactively being handled for gains. Whether internally or externally managed, hedge fund managers have – over the course of the past two years – become much more well-versed in their cash portfolios.

Where Horizon is looking for gains in the low interest rate environment

Management of a portfolio’s cash holdings is reliant on several factors, most of which is focused on anticipating any liquidity the fund manager may need (due to a myriad of reasons ranging from strategic investment needs to investor redemptions). Horizon holds all fund cash holdings in separately managed accounts and invests only into those securities that each fund manager has authorized the Horizon team to use.

“We always operate with a core philosophy of a conservative investment approach, but having said that, we do strive to provide yield enhancement,” says King.

Horizon invests in US Treasury securities, US Agency securities, CP, short corporate notes and repo. King explains that in the current interest environment the short end of the fixed income curve is going to stay very flat, so she and her team have to find ways to add value where they can.

“We’ve done a good job navigating the changes in the fixed income market due to the interest rate outlook, market volatility, and regulatory changes. We analyze different asset classes and structures to uncover attractive opportunities for our clients. We look for investments that don’t add any incremental risk per se, but do add some yield enhancements in a very, very low interest rate environment.”

The Horizon team has also focused on picking corporate credits they feel are recession resistant, or that are “shining stars” in their asset class. “We’ve managed to find some nice nuggets there as well,” says King.