By Doug Wells

Cash Management Strategies

Understand Your Choices to Avoid Costly Mistakes

Many people and corporations want guaranteed access to funds with little or no notice—cash on hand. But an ongoing challenge is investing funds that are set aside as cash. Interest rates are dismally low, and many people are seeking safe ways to achieve higher yields.

"Safe" is the operative word; and as you move away from short-term government securities, the risks associated with such investments increase—sometimes substantially.

Wall Street offers an abundance of investment products that look almost as safe as the money market deposit accounts offered at the local bank. However, "almost as safe" is very different than "as safe as" cash.

A Spectrum of Choices

Few people know that they can purchase U.S. Treasury securities directly from the United States government at www.TreasuryDirect.gov. Unlike bank accounts and FDIC insurance, there is no limit to the amount of capital that is insured; all invested funds are backed by the full faith of the U.S. government.

Moving a bit up the risk spectrum are money market deposit accounts (MMDAs) offered by the local bank. These are traditional cash accounts and, within limits, are backed by the FDIC. Investors should know that, above FDIC limits, they become general creditors of the issuing bank. Funds above the FDIC limit are subject to potential losses.

Next on the risk spectrum are money market mutual funds (MMMFs). It is imperative to understand that money market mutual funds are not backed by the U.S. government. They are essentially mutual funds that invest in traditionally low-risk investments such as government securities, bank CDs and commercial paper.

Within limits, MMMF rules permit the fund to keep the net asset value (NAV) at $1. A money market is said to "break the buck" when its NAV drops below $1. In their 40-year history, only two funds have ultimately broken the dollar. One lost 3 cents in 1994, the other lost 4 cents in 2008.

Ultra-short bond funds are a bit further up the risk spectrum. These funds invest in a wide range of securities, including corporate debt, government securities, mortgage-backed securities and other asset-backed securities. Rates on these funds vary depending on the risks of the fund. The price of the fund will not likely fluctuate much if interest rates rise, as their holdings are relatively short term. However, credit risk can be material and investors should seek diversification by issuer, industry, duration and credit rating.

Much further up the risk spectrum are auction rate preferreds (ARPs). ARPs refer to a debt instrument with a long-term maturity but whose interest rate resets each week or month via a Dutch auction. The structure is attractive to the issuer as they can sell long-term debt but pay the short-term interest rate, which is typically lower. An auction "fails" when there are more shares offered for sale then the number of shares being sought by buyers.

In 2008, auctions for these securities began to fail as investors declined to bid on ARPs. The investment banks that underwrote these offerings declined to act as bidders of last resort, as they had in the past. Some investors waited six months for an exit and some continue to wait as of this writing. Ultimately, many, but not all, of the larger underwriters agreed to repurchase ARPs at par.

The Bottom Line

There are many risks to consider when seeking to get a yield slightly higher than a U.S. Treasury or bank money deposit account. Oftentimes, these risks relate to liquidity. Yes, you may be paid in full eventually, but can you afford to be without your funds for six months or longer? I counsel clients to avoid the temptation of stretching for yield in their cash account. It simply is not worth the risks. Instead, accept the fact that risk-free investments are benchmarked off short-term U.S. Treasuries, which right now pay essentially nothing.

Do money markets make sense for your cash account? Probably. Do auction rate preferreds? Not in my account and likely not in yours either. **UB**

Doug Wells is a partner at Albion Financial Group. Mr. Wells earned his MBA from Stanford University and is a CFA and CFP. He can be reached at 801-487-3700 or at dwells@albionfinancial.com.