Why a cash ladder may be worth climbing

We explain how this solution can move up and down the risk and return spectrum according to charities' individual liquidity and timing requirements.

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Central banks in developed markets around the world are tightening monetary policy, trying to rein in rampant inflation and prompting volatility among financial markets. Against this complex backdrop, charities and trusts are likely to be thinking about their organisation's cash positions, wanting to ensure sufficient funds are on hand for grant-making and operational expenses. However, inflation will erode the value of cash at hand over time. (For more on this, see our article: Inflation, the unseen robber of investment returns?)

What's in your inflation-fighting toolkit?

Just as a good old-fashioned ladder is a staple for DIYers, a cash ladder may be just the right addition to the inflation-fighter's toolkit. This is a tiered system of investments in strategies such as money market and absolute return bond funds.

We believe an efficient cash-laddering solution, taking into account different return and liquidity requirements, has the potential to improve real returns on cash portfolios whilst seeking to mitigate risk.

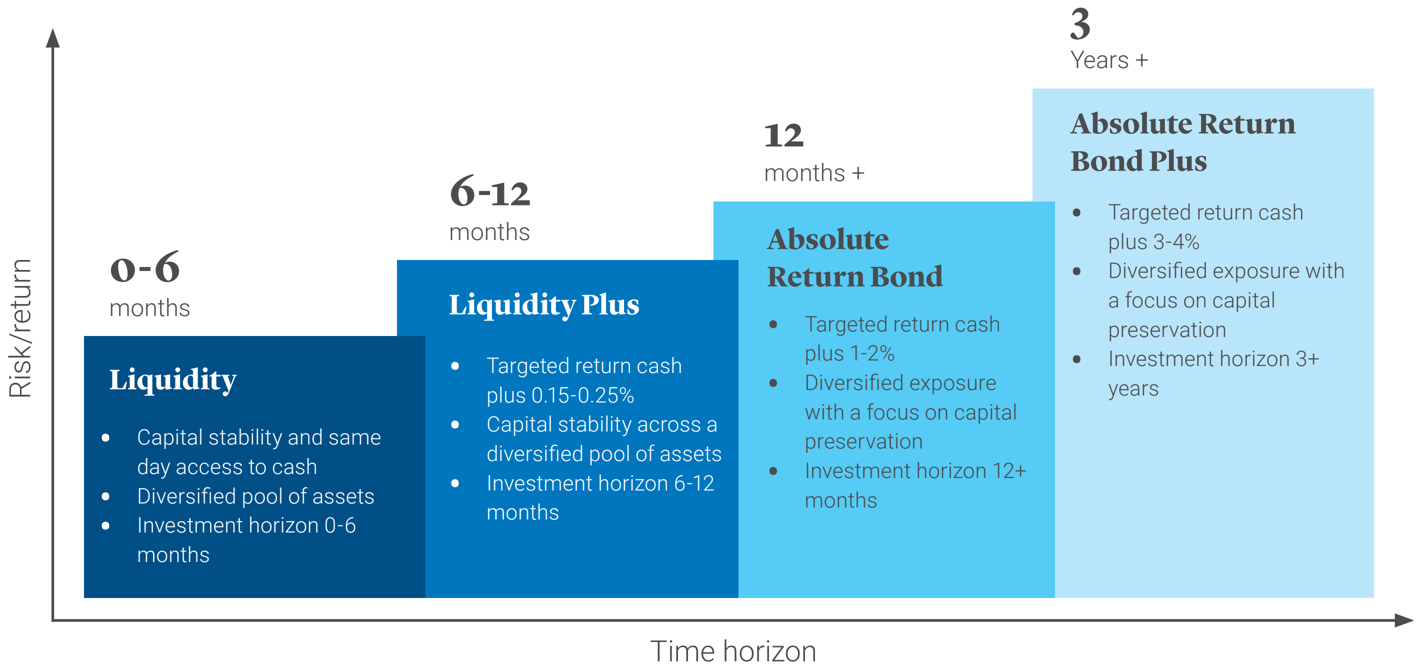
Cash laddering may put cash at hand to work by:

- Increasing the expected return on liquidity portfolios
- Seeking to safeguard against rate volatility and cash drags
- Offering the benefits of counterparty and issuer diversification
- Providing daily liquidity no matter which laddering strategy is employed

By combining a selection of money market and absolute return bond strategies in a cash ladder, we believe it is possible to increase the expected return of a portfolio, while retaining sufficient stability and liquidity for clients who need to keep a pot of money readily available.

Here is an illustration of the typical features that money market and absolute return bond strategies may deliver. They can provide varying levels of expected return for a given level of risk over different investment horizons (Figure 1).

Figure 1: Optimising cash allocations via money market and absolute return strategies[1]



Source: LGIM

Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

Step by step – the cash ladder explained

On the first rung of the cash ladder are money market funds, which aim to offer investors capital stability and daily access to operational cash. They seek to achieve this by actively investing in a diverse pool of ultra-short-term assets issued by governments, high- quality banks and financials. Money market funds are designed for investors looking for low volatility and high liquidity, with a typical investment horizon of 0-6 months. The flexibility, daily access and diversification on offer make money market funds a good alternative to term bank deposits and bank accounts, in our view.

The next rung comprises liquidity plus funds. Like money market funds, liquidity plus funds offer investors capital stability to operational cash, but with the added benefit of enhanced potential returns. This is achieved by investing in the same diverse pool of issuance as money market funds but over a slightly longer time horizon, with extended duration limits. Liquidity plus strategies are designed specifically for investors who have expected known cashflows over an investment horizon of 6-12 months. These also offer flexibility and diversification benefits, making liquidity plus strategies an alternative to term bank deposits.

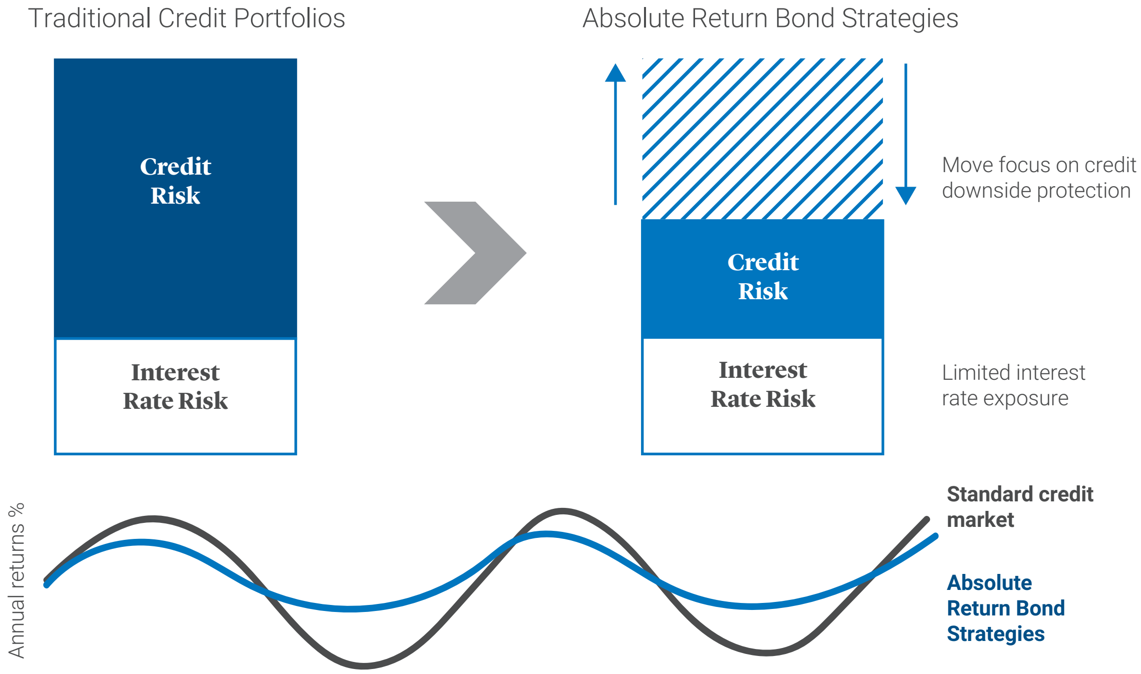
Further up the ladder are absolute return bond and absolute return bond plus strategies. These generally invest in investment grade credit securities and have flexibility to invest smaller amounts in high yield bonds, currencies, emerging market bonds and asset-backed securities to increase the portfolio yield.

Given the greater exposure to risk assets, emphasis is placed on risk management to minimise drawdown and preserve capital; to this end, interest rate risk is actively managed (Figure 2). We believe these funds are suitable for investors looking for additional returns on cash that is not necessarily needed over at least a 12-month horizon.

There are various flavours of these strategies, targeting different levels of return and risk. As an investor looks to increase returns further, greater flexibility to invest in different, higher-yielding instruments may be necessary. Of course, every effort is made to ensure that the strategies do not take on undue risk. It is important to note that these strategies are usually daily dealing, so swift access to capital is also a feature.

1. Methodology: SONIA + percentage. Targets and limits are for illustrative purposes and subject to change

Figure 2: Aiming for more downside mitigation, limited interest rate exposure and lower volatility than traditional credit portfolios



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Diversification can make all the difference

More broadly, we believe diversification through investment solutions like cash ladders can be key to achieving more reliable returns while seeking to mitigate risks. Banking with one institution could potentially be risky if that bank defaults on its contractual obligations. Investing in a multi-investor pooled fund, however, spreads out counterparty risk as investment managers trade with multiple counterparties on your behalf.

Investing in funds can also limit issuer risk and provide exposure to underlying instruments that are issued by companies and governments across many sectors and regions. This could reduce the negative impacts on the overall portfolio in case an issuer defaults on its coupon and/or principal repayment.

Another important aspect of investing in funds is that investment managers can engage with or exclude issuers, in order to achieve environment, social and governance (ESG) outcomes and limit or curtail risks. Responsible investing also provides a positive point of interest when discussing charitable investments with beneficiaries and donors.

Tailoring solutions

If you have excess cash and would like to capture higher potential returns in this inflationary environment, you may consider blending your assets using a cash ladder framework.

Structuring such arrangements is flexible and can be customised depending on individual needs to suit return and stability requirements. We would be happy to perform modelling and to tailor solutions for investors who are interested in knowing how laddering might look based on their specific cash and return requirements.

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative

Key risks

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