

NEW TACTICS FOR INVESTORS OF BALANCE SHEET ASSET POOLS

Often found on an organization's balance sheet, taxable asset pools are being invested in innovative ways.

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Institutional investors responsible for pension plan assets are facing accounting changes, regulatory reform and the problem of too few assets backing liabilities. At the same time, investors responsible for the balance sheet assets of taxable and tax-exempt institutions are encountering record asset levels and under-invested cash. These taxable asset pools — typically found in the domain of corporate treasurers, captive insurance companies, settlement trusts and other nonqualified pools — seem to occupy a different universe from pension plan assets. However, both face similar challenges and investment goals. The difference lies in how they implement their chosen investment strategies and the investment solutions used to achieve their goals.

For corporate treasurers, special-purpose asset managers and investment directors at nonprofit institutions, identifying strategies designed to approach assets on either the balance sheet or income statement from a different perspective can be vital to their success. As shown in the chart “Strategies for Taxable Asset Pools” on page 10, this set of strategies can include money market, enhanced cash, short-duration taxable fixed income, municipal fixed income, crossover mandates and tax-advantaged equity strategies. Identifying the right strategy for a particular pool of assets depends upon that pool’s purpose and the risk exposure the institutional investor is willing to accept.



“As the need for more complex balance sheet programs grows, so too does the need for more sophisticated asset management strategies.”

— Steven R. Everett, director of balance sheet and operating assets for Northern Trust

For taxable assets, risk is not just volatility of returns but also the potential impact on the organization’s balance sheet, income statement and tax liability. The following examples provide some insight into how various strategies might be implemented.

Case Study I: Extending Out the Curve

Assets on the balance sheet typically are held in short-term securities to ensure liquidity. But taxable and tax-exempt institutions — both public and private — are looking beyond traditional solutions to seek the potential for greater returns. In many cases, the key may lie in extending the nominal duration of the investment strategy to match expected liabilities or meet cash flows.

A European subsidiary of a U.S. multinational firm recently reviewed its core operating assets and analyzed how the funds were being utilized.



The business experienced such significant growth in Europe that the revenue flow from European operations exceeded that from North America. In addition, that flow had become relatively stable and predictable. Historically, these core reserves had been invested in highly liquid cash instruments. However, it was determined that a significant portion of the assets could be invested for higher returns.

Repatriating the money to U.S. shores was less attractive than maintaining the pool as a strategic resource for further growth in Europe. With the cash representing a significant and growing portion of the firm's assets, it was paramount to invest resources more effectively. Within that mandate, several investing strategies were considered:

- An actively managed enhanced cash strategy, with an average duration of six months to one year, to provide liquidity but with an expected higher return;

- A high-quality, actively managed, short-duration fixed-income approach, maintaining an average portfolio duration of one to three years; and
- An intermediate fixed-income strategy with longer duration that could offer higher returns but introduces potential volatility as well.

The firm chose the enhanced cash strategy. Extending the duration slightly for these core balance sheet reserves achieved the desired result. They accepted a modest level of risk beyond money market funds, which allowed them to target a higher return within a risk-managed solution.

Over a full market cycle, an enhanced cash strategy has the potential to generate returns of 50 to 75 bps of return over a money fund before fees. The choice of when to implement an enhanced cash strategy hinges on the shape of the yield curve, the expectation of short rates and the spread environment.

Case Study II: More Money Doesn't Mean More of the Same

In other cases, extended duration or enhanced yield strategies may become appropriate as a company grows or as accounting or tax circumstances change. The Homeland Investment Act, a provision of the American Jobs Creation Act of 2004, created such a situation. Under provisions of the act, income generated from overseas operations would receive favorable tax treatment when assets were repatriated to U.S. shores by the end of a corporation's 2005 fiscal year.

A global manufacturing and distribution company recently implemented a strategy to better manage a sizable pool of assets that had accumulated on its balance sheet. The firm had little to no debt and significant balance sheet reserves that were invested in euros and other European currencies. After these assets were repatriated to the U.S. under the Homeland Investment Act, the company faced a question: What should it do with more than a billion new U.S. dollars in balance sheet reserves until the time came to invest further in the business?

Given that the firm already had a healthy traditional cash reserve, these new assets could have a longer investment horizon. Strategies considered included:

- A portfolio of taxable instruments, such as Treasuries, agencies and corporate or securitized debt, to extend the duration and enhance return;
- A straight municipal bond strategy, which could extend duration while staying within a targeted credit-risk and tax-sensitivity profile; and
- A crossover strategy, comprising core municipal bond holdings and opportunistic purchases of taxable securities.

All-Taxable Versus Municipal-Only

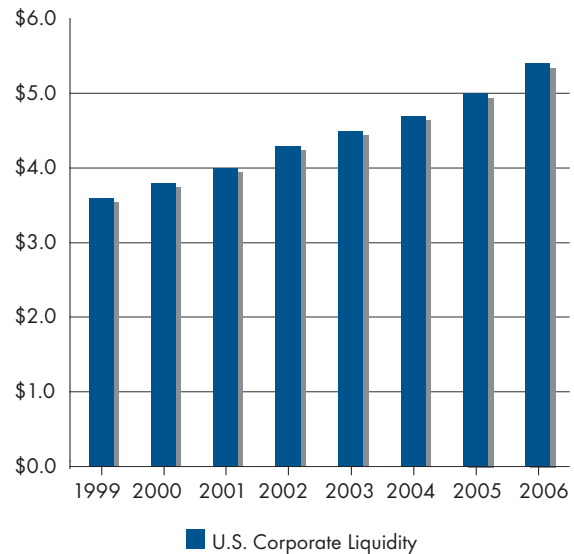
All-taxable options typically generate more pre-tax income, but corporate credit spreads were historically slim and the taxable yield curve was extremely flat. Municipal-only options maintain tax sensitivity but also involve a major commitment to a less transparent and more specialized asset class.

The corporation decided to implement a combined solution. It added a longer-duration tranche in the crossover strategy in an effort to achieve greater-than-cash returns and tax sensitivity while still retaining a focus on liquidity and risk management.

As the "Strategies for Taxable Asset Pools" chart on page 10 shows, the crossover approach includes maintaining a core municipal allocation while allocating between municipal bonds and taxable fixed-income securities as market opportunities suggest. The taxable and municipal yield curves are different, as spreads constantly fluctuate between municipal and taxable bonds. Corporate tax rates also can change, so capturing the

Corporate Liquidity Continues to Grow

U.S. corporations saw their cash and short-term investments climb 50% between 1999 and 2006, to US\$5.4 trillion. Meanwhile, European companies also hold an estimated €5 trillion* in cash and financial investments.



*European estimate based on 505 corporate treasury managers in the U.K. and Western Europe.

Note: U.S. dollars in trillions. Liquidity is defined as cash, deposits and short-term investments with maturities less than three years. Based on 652 U.S. corporate respondents.

Source: Treasury Strategies, 2006 U.S. Corporate Liquidity Research Program; 2005 European Treasury & Liquidity Research Program

various differentials can help add after-tax income and enable the firm to capitalize on gain or loss opportunities.

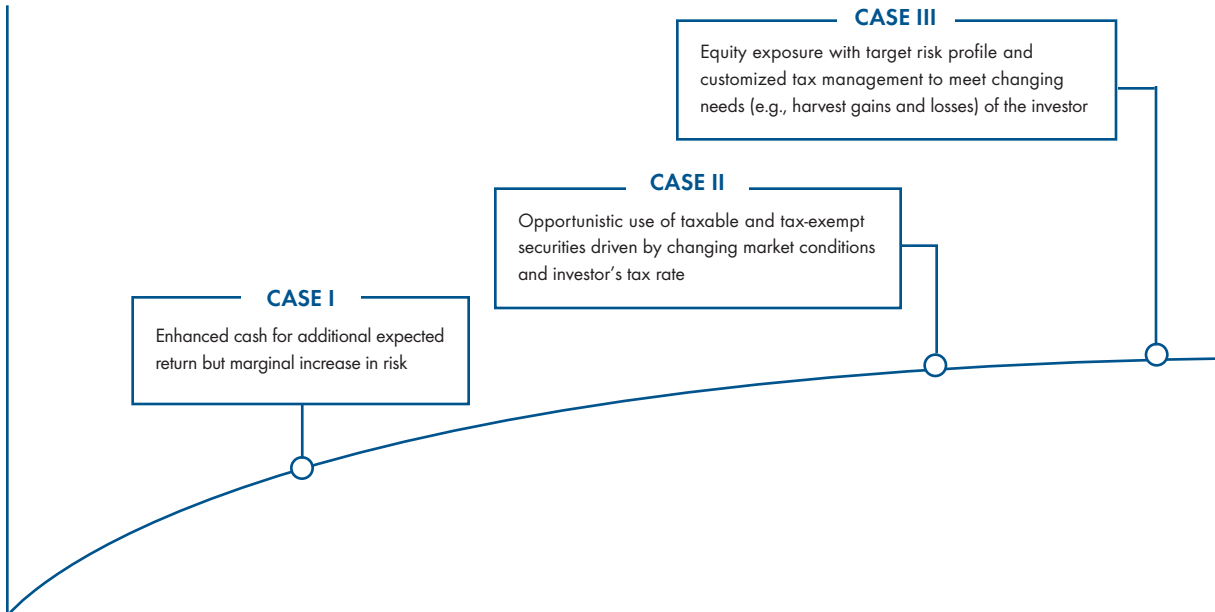
The asset manager achieves the desired balance by seeking investments expected to generate the most favorable after-tax return based upon the firm's particular tax rate, while offering an investment palette beyond municipal fixed income.

By their very nature, crossover mandates pose additional challenges for the asset manager. Emphasizing after-tax return requires strong management skills in the municipal market.

The key ingredients are an in-depth knowledge of regional municipal markets as well as national and international buying power. Nevertheless, the manager needs to remain cognizant of developments in taxable fixed-income sectors. In forming these comprehensive solutions, an investment manager should have well-developed expertise in straddling the two somewhat dissimilar fixed-income markets.

STRATEGIES FOR TAXABLE ASSET POOLS

Return



	MONEY MARKET	ENHANCED CASH	SHORT-DURATION TAXABLE FIXED INCOME	ACTIVE MUNICIPAL FIXED INCOME	CROSSOVER FIXED INCOME	TAX-ADVANTAGED EQUITY
Strategy	Invests in high quality, short-term securities with duration of less than 90 days. Seeks to maintain liquidity.	Invests in a high quality portfolio that is actively managed. Average portfolio duration of 6 months to 1 year. Seeks to enhance total return while maintaining liquidity.	Invests in a high quality portfolio, actively managed with a total return strategy. Average portfolio duration of 1.75 to 2 years.	Invests in a municipal bond portfolio. Supplements traditional duration and credit decisions with active sector allocation, security selection and trading expertise to maximize total return – both income and price appreciation – in a tax-efficient manner.	Invests primarily in a municipal bond portfolio; utilizes technical and fundamental analysis to opportunistically invest in taxable securities. Seeks to maximize after-tax total return.	Invests in a portfolio of individual securities to approximate the pre-tax return of an equity benchmark and add value on an after-tax basis. Uses a proprietary quantitative management approach with a disciplined tax management process.
Benefits	Provides investors with liquidity and principal protection.	Actively managed enhanced cash strategies have generated excess return of 50 to 75 bps relative to a money market fund over a market cycle.	Over a market cycle, short-duration fixed income strategies have generated excess return of 25 to 50 bps over a 1 to 3 years maturity fixed-income index (e.g., Lehman Brothers 1-3 Year U.S. Treasury Index).	Provides greater after-tax return potential. Due to market inefficiencies, experienced managers can add meaningful total return versus a ladder or buy-and-hold strategy. Over a market cycle, actively managed municipal strategies have generated excess return of 25 to 50 bps relative to a Lehman Brothers index.	By opening the eligible universe of securities to include taxable securities, the manager may increase the chance of improving performance within a similar risk framework. Typical crossover strategies have generated 50 bps of return over a straight municipal strategy and have added up to 25 bps in additional yield on an after-tax basis.	Precisely tailored to each investor's needs. Customization and controlled settings for: timing and amount of realization of gains and losses; active risk (expected tracking error) levels and specific benchmarks. Typical tax-advantaged strategies have generated 25 bps of expected annualized tracking error versus their benchmark and have provided up to 100 bps in annualized after-tax value added.

Source: Northern Trust

Case III: Equities Also Can Be in Play

Some investors are comfortable with (and may even need to use) equities as tools to help manage balance sheet assets. Many privately held firms, with their greater autonomy in executing investment strategies, find this to be an attractive approach. Captive insurers, insurance companies, nuclear decommissioning trusts, settlement trusts and nonqualified benefit plans often have obligations that stretch far into the future. For their needs, equity investments offer the opportunity for higher returns. The duration of their liabilities, meanwhile, allows for moving through the inevitable volatility of those returns. Yet taxes matter, so these investors must effectively manage the realization of gains and losses. They must also critically evaluate the flow-through effects to balance sheets and income statements that result from marking investments to market prices.

A diversified holding company undertook an equity offering for the express purpose of future merger-and-acquisition (M&A) activity. After the recent offering, however, the company was confronted with a lack of buying opportunities amid a slowing M&A market. As a result, the company faced two needs. First, it needed to maximize returns for the assets yet to be deployed, and second, avoid a drag on earnings as the assets from the equity offering's cash took up residence on the balance sheet. For corporations that have significant liquid assets, generating competitive returns on those assets can be vital to the overall valuation of the company.



"Implemented correctly, tax-advantaged strategies can produce investment returns with customized and controlled risk implications."

– Arch King, CFA, product manager for municipal fixed income and tax-advantaged equity at Northern Trust

with a precise level of customization and control. This allowed the investment manager to approximate the pre-tax return of an equity benchmark while adding value to the firm on an after-tax basis. (See "Strategies for Taxable Asset Pools," page 10.) Tax-advantaged equity management adds value by generating gains or capturing losses, which can be used to offset gains, on a per-holding basis, thus aiming to outperform the appropriate benchmark on an after-tax basis.

Implemented correctly, tax-advantaged strategies can produce investment returns with customized, controlled risk implications for the firm's balance sheet, income statement and tax bill. To do so, it is important for the investment manager to work closely with the firm's corporate treasury team and its tax manager to determine an effective and targeted approach to harvesting the gains and losses.

Although assets on the balance sheet are typically held in short-term securities to ensure liquidity, taxable and tax-exempt institutions – both public and private – are looking beyond traditional solutions for greater return potential.

The options considered for managing these assets included:

- Traditional active equity management, which focuses on stock selection and pre-tax returns;
- Exchange-traded funds (ETFs) to achieve market exposure while avoiding stock-specific risk; and
- A tax-advantaged equity strategy with a goal of pre-tax benchmark returns but with a controlled and customized after-tax value added.

Traditional active management was considered too risky, as stock-specific risk was not desirable. ETFs were eliminated due to embedded management expenses and because they also only allowed for tax management at the index level. A tax-advantaged equity strategy was chosen because it could be implemented

Identify the Necessary Expertise

As the need for more complex balance sheet programs grows, so too does the need for more sophisticated asset management strategies. At the end of the day, many investors are determining that balance sheet assets are being under-optimized when they produce cash-like returns. Today, a wider range of innovative solutions are available to taxable investors looking to achieve higher return objectives. Customized strategies consider multiple factors, including domestic and global tax consequences, cash flow, future liabilities, currency and global liquidity concerns. By analyzing the right strategies and developing partnerships with trusted advisors, institutional investors can employ more effective approaches to managing balance sheet assets. ❖