NORTHERN TRUST
ASSET MANAGEMENT

CASE STUDY

THINKING OUTSIDE THE BOX MAXIMIZES LIQUIDITY MANAGEMENT YIELDS

"How can we optimize our liquidity management product for retail investors, so that we deliver a higher yield without taking too much interest rate risk?"

The Client

An RIA with $12 billion in assets under management.

With $12 billion in assets under management, this registered investment advisor focuses on high-net-worth and mass affluent investors. It specializes in managing model-driven portfolios, constructed with ETFs and mutual funds.

The Challenge

Increasing yields in a strict regulatory environment.

How to generate yield after the SEC's Money Market Fund Reforms

After the 2008–2009 global financial crisis, managing short-term financial liquidity became far less straightforward. Until the crisis, the conventional solution was to invest in money market funds that delivered a decent return. But the crisis "broke the buck," meaning that it drove the net asset values of some money market funds below $1, resulting in investors losing money.

To protect investors, the Securities and Exchange Commission (SEC) introduced reforms in 2010, restricting funds' underlying investments to very-high-quality securities with a maximum duration of three months. That left this RIA and investors generally facing the challenge of how to generate yield in liquidity management. The RIA's high-net-worth investors were disappointed with the yield on its standard money market fund. Failing to offer a competitive liquidity management strategy could result in its investors choosing to place their money elsewhere.

Our Approach

Develop liquidity portfolios based on desired outcomes.

Segmenting liquidity portfolios according to goals

We worked with the RIA to better understand their needs and ultimately those of their high-net-worth and mass affluent investors. We then proposed a new approach, which is now known as "segmentation." This operated on the principle that a liquidity portfolio could be split into different elements with different goals. Doing so would lift aggregate yield.

The key was to segment liquidity portfolios according to three priorities: principal preservation, liquidity and yield. For instance, if a client needed liquidity for day-to-day spending that would need to be invested in a money market fund with principal preservation, while capital not needed so urgently might be left in reserve in a fund with slightly reduced liquidity. Finally, if the investor intends to keep a part of the liquidity portfolio invested for over a year, then it is likely possible to invest that part strategically in a way that would seek to generate a higher yield. Consequently, a liquidity solution could be customized for each client by splitting the portfolio across three corresponding strategies or products (see segmentation illustration).

THE THREE PILLARS OF CASH SEGMENTATION

Changes in the global liquidity market require investors to adopt a more strategic and focused approach to liquidity management — moving beyond a one-size-fits-all approach.

Operational (1- to 30-day maturities)	Reserve (1- to 90-day maturities)	Strategic (6- to 18-month maturities)
Day-to-day spending needs Highly liquid, invested conservatively	Intermediate or uncertain spending needs Slightly reduced liquidity	Long-term spending needs Reduced liquidity Seeks highest possible yield while preserving principal
PRODUCT TYPE: Money market fund	**PRODUCT TYPE:** Money market fund Custom strategy	**PRODUCT TYPE:** Ultra-short Custom strategy

In particular, investments with a time horizon of a year or more tend to earn a higher yield than shorter term investments, while only modestly increasing risk. Described as ultra-short-term, these slightly longer-term investments do not fall under the SEC's Money Market Fund Reforms, freeing them to invest in a wider range of securities and durations that offer higher yields (see analysis below).

RETURN AND RISK: THE LONGER THE TERM, THE GREATER THE RETURN

Index Return and Risk Analysis (01/1990–03/31/22)	3-Month T-Bill[1]	50% 3-Month T-Bill + 50% 1–3 Year Government/Credit[2]	1–3 Year Government/Credit[3]
Yield	0.24	1.33	2.41
Duration	0.17	1.00	1.84
Frequency of Loss			
Rolling 12-Mo. Periods (376 observed)			
# of Negative Periods	0	5	10
Minimum Return	0.01	-1.46	-2.98
Frequency of Loss (%)	0.0%	1.3%	2.7%
Rolling 3-Mo. Periods (385 observed)			
# of Negative Periods	4	24	39
Minimum Return	-0.11	-1.50	-3.04
Frequency of Loss (%)	1.0%	6.2%	10.1%

[1] Bloomberg U.S. 3-Month Treasury Bill. [2] Bloomberg 50% 3-Month Treasury Bill/50% 1–3 Year Government/Credit Bond Index. [3] U.S. 1–3 Year Government/Credit Bond Index.

Source: Bloomberg and Northern Trust. Data period: January 1990 through March 2022.

Past performance does not guarantee future results. Index returns do no reflect the deduction of any fees, trading costs or other expenses. Direct investment in an index is not possible

Our Solution

Segment portfolios to take advantage of optimal allocations.

A three-way split across immediate liquidity, principal preservation and yield

After balancing the RIA's overall needs for principal preservation and liquidity, while increasing the yield of their cash portfolio, we determined what we believe to be the optimum allocation. The liquidity portfolio was split three ways: 33% money market for immediate liquidity, 33% 1–3 month T-bills for principal preservation and 33% ultra-short for maximizing yield.

After deciding to allocate their liquidity investment among three different managers, the RIA chose different asset managers' products for each allocation, investing $12 million with Northern Trust Asset Management's ultra-short funds to generate yield. Specifically, the products chosen were the Northern Ultra Short Fund (ticker: NUSFX) and FlexShares Ultra-Short Income Fund (ticker: RAVI). Both are actively managed and invest in agency debt, mortgage-backed/asset-backed securities, commercial paper, corporate debt, government debt and third-party repos.

The Benefits

Client retention and AUM growth.

Higher yields and satisfied investors

This RIA now has a competitive liquidity management solution, with an attractive yield, helping it to retain investors. Not only has this deepened the RIA's relationships with its investors, but also it has added the benefit of drawing further assets as these individuals have moved assets from their banks.

The Benefits

Cash segmentation allows for flexibility as interest rates change.

Competitive fund performance

The Northern Ultra Short Fixed Income Fund and FlexShares Ultra-Short Income Fund have contributed to the RIA's differentiated liquidity offering. The move from using primarily money market funds to cash segmentation allows the RIA added flexibility as interest rates fluctuate.

How helpful was this?

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An investment in FlexShares is subject to numerous risks, including possible loss of principal. Fund returns may not match the return of the respective indexes. A full description of risks is in the prospectus.

FlexShares Ultra-Short Income Fund (RAVI) is actively managed and does not seek to replicate a specified index. Additionally, the Fund may invest without limitation in the fixed income and debt securities of foreign issuers in both developed and emerging markets. The Fund is at increased credit and default risk, where there is an inability or unwillingness by the issuer of a fixed income security to meet its financial obligations, debt extension risk, where an issuer may exercise its right to pay principal on an obligation later than expected, as well as interest rate/maturity risk, where the value of the Fund's fixed income assets will decline because of rising interest rates. The Fund may also be subject to increased concentration risk as it may invest more than 25% of its assets into the securities of a single developed market. Additionally, the Fund may invest without limitation in mortgage or asset-backed securities, which puts it at increased risk for interest rate/maturity risk, debt extension risk, and prepayment (or call) risk. Also, the Fund is "non-diversified" under the Investment Company Act of 1940, and may invest more of its assets in fewer issuers than diversified funds.

FlexShares ETFs are managed by Northern Trust.

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Index performance is not indicative of the Funds' performance. For Fund performance, please call 1-800-595-9111.

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