Treasury Trends

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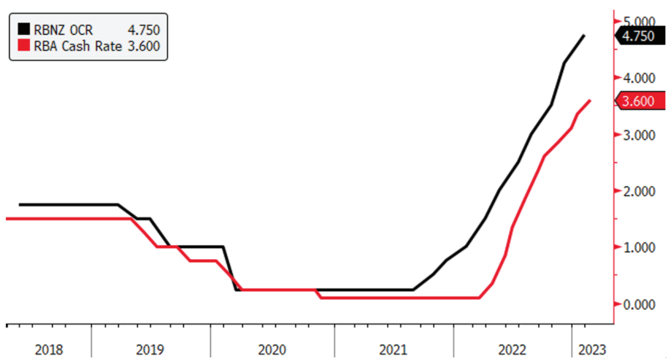
HIGHER INTEREST IN AND ON INVESTMENTS

In work with clients across a range of sectors, the need for visibility of and access to cash balances to support ongoing liquidity needs has never been higher. "*If cash is King, cashflow is Queen*" the saying goes.

Improved cashflow forecasting systems, fine-tuned supply chain management, education of key internal stakeholders and more sophisticated bank account and auto-sweep functionality have all been deployed to varying degrees in pursuit of maximising cash balances and enhancing their visibility.

Until recently, and in a global interest rate regime that has seen rates fall to historic lows for an extended period, many organisations viewed cash balances purely as a liquidity buffer - since any interest earned on such balances was sufficiently 'close to zero' as to not warrant a good deal of investment attention.



The world is now a very different place financially and geopolitically, and there has been a step change in mindset about the increasingly critical dual-role cash balances serve as both a liquidity buffer and an important source of interest income.

Zero interest rates confined to history

Ten consecutive increases in the cash rate by the Reserve Bank of Australia, from the emergency level of 0.10% in April last year, has provided relief to savers and cash managers.

Key Points:

- **Cash to serve as both a liquidity buffer and a source of income**
- **Zero interest rates a thing of the past**
- **Risk : Reward**
- **Prudent to refresh investment governance**
- **Ensure good cash visibility**

NZ investors have seen an equally dramatic increase in interest earning opportunity with the OCR rate now at 4.75%, from a 0.25% low. It is hard to believe that speculation on cash rates going negative dominated financial market thinking not that long ago.

The rapid rise in official and related bank deposit rates as central banks look to suppress the inflationary surge seen across the globe has been a boon for organisations with material cash balances that may sit on balance sheets for extended periods – sometimes years. Cash is not just the bit "left over", it is now a financial asset to be managed carefully. For both liquidity and interest income purposes.

Balancing risk and reward

Investing in high-credit quality bonds as opposed to cash will generally earn a higher yield due to the increased duration, albeit with the risk of capital gains or losses if it is not held to maturity. The expected longevity of the invested cash surplus would be a key consideration before locking in funds via a bond investment, as well as ongoing valuation volatility, depending on interest rate changes over the life of the investment.

An example is the recent issue by Telstra, which is A- rated. It issued a 5-year bond at a yield of 4.90% and while this looks attractive compared to cash linked investments and has very low credit risk, if it was sold before maturity and interest rates had increased there would be a capital loss. Conversely, if rates fell there would be a capital gain. Of course, if held to maturity the full principal is returned with a guaranteed 4.90% earned over the life of the investment.

Some long-term investments, such as Floating Rate Notes ("FRN"s), are linked to short-term rates which makes them less sensitive to market volatility. But, as with a fixed rate bond of a similar maturity, FRN's are sensitive to credit spread changes and these could impact on the face value received if they were sold before maturity.

An alternative approach is to invest via a fund or an ETF in the cash space. This approach avoids the opportunity cost of always going to preferred banks and provides diversification. However, at least in theory, liquidity could become an issue and of course there are fees with these vehicles.

Investment governance review

If organisations are going to have significant cash surpluses and a core positive balance over the long run, an investment strategy that includes cash, bank deposits, highly rated bond and/or FRN's may be appropriate. Needless to say, as with any treasury activity, this would need to be supported by a clear understanding of the risk tolerances acceptable to the organisation, the accuracy of cash surplus projections and, a formal, Board/Council approved investment policy.

The dramatic change of interest rates and CPI provides a timely reminder if your organisation hasn't done so recently, to review your investment policies and strategies to ensure they are optimal for the period ahead. Getting to agreement as to an organisation's objectives of investment is a fundamental starting point in our Investment Governance Review workshops.

Most organisations describe themselves as conservative – an admirable business sentiment – but we are constantly surprised just how far apart conservative clients can be when they are invited to elaborate on exactly what it means. Is a term deposit portfolio with very high capital security but that delivers insufficient real returns to fund/offset future liabilities conservative?

The list is long

Investors may be surprised to find that there are in fact 88 Australian-owned authorised deposit-taking institutions ("ADI") on the APRA website. In New Zealand there are 27 registered banks with credit ratings ranging from long term AA to BBB. In addition to the registered banks there are 16 licensed non-bank deposit takers with one rated 'BBB-' and seven between BB- and BB+, i.e. 'speculative grade'.

There are a number of cash management funds in New Zealand with many of the larger sharebrokers offering this type of product. However even though the deposits may be with a registered bank, it pays to check actual counterparty details.

Avoid the steak knives

Investors should always be wary of investment offers that appear too good to be true. A recent high-profile case hit the media where senior industry professionals invested in a scheme that 'guaranteed' a return approaching 40% for a six-month term, but which subsequently failed. This highlights the ever present need for caution, research and transparency. Earning double-digit returns on the way to losing your capital is not likely to meet many tests of 'conservative' risk management policy.

Prompt to review policy and strategy

Does your investment policy statement or governing act allow for deposits with 'any ADI or registered bank'? Have you considered what this means for the placement of funds with counterparties outside of those you have traditionally dealt with or are familiar with? It's worth asking the question of your treasury team.

Recent events at Silicon Valley and Signature Banks in the US have highlighted once again, that it is buyer (or investor) beware – a reminder that the basics of treasury still apply: know how much cash you have, where it is and who controls it.

WHERE WE AND OUR PARTNERS OPERATE

BANCORP TREASURY & BARRINGTON TREASURY NZ
* Auckland * Wellington * Christchurch
Phone: +64 9 912 7600

BARRINGTON TREASURY
* Sydney * Melbourne * Brisbane
* Sunshine Coast * Perth * Adelaide
Phone: 1800 425 079

BARRINGTON ASSET CONSULTING
* Sydney
Phone: 1800 425 079

PMC TREASURY
* London * New York * Singapore
Phone: +64 9 912 7600

BANCORP TREASURY SERVICES LIMITED

Barrington TREASURY SERVICES

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