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WHAT INVESTORS LEARNED FROM THE 2019 REPO MARKET EXPERIENCE: STRATEGIES FOR INSURANCE COMPANIES SEEKING TO OPTIMIZE CASH

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Yields may potentially be enhanced through structures that can invest further out on the yield curve while also adding modest credit risk.

Executive summary

- In September 2019, the repo market experienced a supply/demand imbalance, resulting in turbulence and a rise in financing rates. In response, the Fed introduced a new purchase program of $75 billion in overnight repo with another $30 billion in two-week repo. In October, the Fed executed another program to gain even further control of financing rates. Under this operation—currently projected to last six months—the Fed will purchase approximately $60 billion in Treasury bills per month.
- In this current low-rate environment, traditional money market funds might be inadequate as a sole solution for cash optimization, and currently tend to be even more biased toward the shortest maturities. Over the past decade, cash managers increasingly have been segmenting their cash according to their three-,six-, and nine-month liquidity needs.
- With segmentation, managers can make allocations to other vehicles that invest in asset classes and maturities that offer higher yields. For longer term liquidity needs, insurance companies may want to consider purchasing securities directly or opting for separately managed accounts (SMA).
- In an attempt to generate additional yield, a viable strategy could be taking on limited duration risk as well as investing in a range of asset classes, including floating-rate notes, asset-backed commercial paper, and medium-term notes.

The global economy weakens

In 2019, the global economy continued to slow, prompting central banks around the world to cut interest rates. The United States has not been immune to this trend, and the Fed cut the Fed funds target rate by a quarter point in the past three meetings. In September, the ISM Manufacturing Index fell to a 10-year low, and consumer sentiment has weakened. Job growth has also declined over the last few months.

Given the trade concerns and broader global weakness, the Fed sees significant downside risks to the economy and has begun what they've called a mid-cycle adjustment, cutting rates three times so far in the second half of 2019.

FIGURE 1: CENTRAL BANKS—ANOTHER 25 BPS RATE CUT BY THE FED

Institution	Current policy rate	Next meeting	Expectation	Comment
Fed	1.75-2.00	Oct 30	No change	Delivered a "neutral" 25bps cut
ECB	0.0	Oct 24	No change	Waiting for input from the new president
BoE	0.75	Nov 7	No change	Unchanged monetary stance
BoJ	0.0	Oct 31	No change	On hold for now, but signals change of easing at next meeting

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Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 9/20/19.

Trouble in the repo market

In September, a supply/demand imbalance in the repo market resulted in some significant turbulence. In response, the Fed executed a number of open market repo operations to bring some stability to financing rates; the following month it executed another purchase program. Through mid- November, the Fed has injected approximately $200 billion into the market, with its action appearing to have had a significant effect and serving to "clear the pipes."

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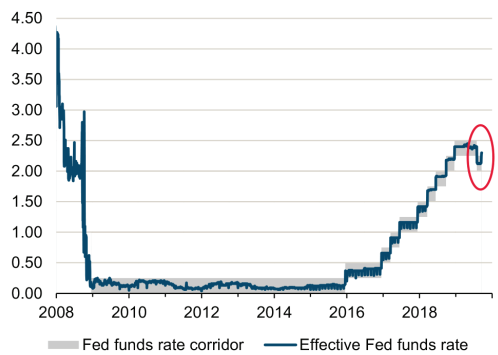
The turbulence in the repo market generated significant upward pressure on financing rates and on the Fed funds rate. And for the first time since 2008, the effective Fed funds rate traded above the upper target rate (See Figure 2). To some degree, this has signaled a loss of control by the Fed and a decline in its ability to manage interest rates lower.

FIGURE 2: U.S. POLICY RATE—FED FUNDS EFFECTIVE RATE VS. CORRIDOR (%)



Source: Bloomberg Finance L.P., DWS Investment GmbH; as of September 2019.

With the injection of liquidity by the Fed, they have appeared to have successfully anchored rates at the lower end of its target range and normalized the yield curve. But given the long-term expectation that interest rates are likely to remain lower for longer, what are the options available to insurance companies for optimizing their cash holdings?

Ways to optimize cash

Previously, cash management consisted of merely putting available cash into a money market vehicle. But over the past 10 years, this practice has changed, and today, other strategies are being employed as well. It is now common to set aside operational cash and segment the remainder by liquidity needs into three-, six-, and nine-month timeframes.

Money market funds still have a role to play in holding operational cash. But while they are currently offering attractive yields relative to the rest of the curve, they tend to be biased toward the shortest maturities because they're required to maintain daily and weekly liquidity. In addition, because of the switch from the LIBOR index to SOFR index, many of these funds are holding on to more SOFR related securities that are reset on a daily basis. Therefore, these funds are now even more biased towards shorter average maturities than they have been traditionally.

One alternative for potentially optimizing cash is to invest directly. A one-month U.S. Treasury bill, for example, pays a yield of 1.86% (as of September 30, 2019). Commercial paper (CP) provides a higher yield; highly rated one-month CP offers 1.91%, and six-month CP pays 1.99% (as of September 30, 2019). There are some risks to direct ownership, however, including access to a research team to analyze the unexpected market dynamics, access to a diversified pool of fundamentals, access to a team to monitor disruptions/ volatilities due to headline noise or investment vehicles that could be limited, and better price due to purchasing power.

On the other hand, separately managed accounts (SMA) may be used not only to meet liquidity needs but also to take advantage of other potential market opportunities. SMAs have the ability to be tailored to more customized investor guidelines, which could allow for greater flexibility than traditional money market funds. Generally speaking, for example, an SMA can be managed with a more aggressive tilt, identifying instruments that can deliver higher yields—sometimes amounting to between 5 and 12 basis points on average when compared to traditional money market funds, as well as differing levels of capital preservation and liquidity.

Another example of how a SMA can capture market opportunity was at the end of September, when the yield curve was flat-to-inverted in the Treasury market, it remained positively sloped in the corporate market. Attractive yields are available further out on this curve, and cash managers who have the ability to take on some credit risk and move out on the yield curve can take advantage of those higher yields as well as duration risk.

Emerging option: applying ESG filter to a cash program

Investors who seek to purchase instruments directly may find themselves constrained by environmental, social, and governance (ESG) considerations. In fact, a neutral or modest positive impact by ESG on performance exists between credit quality and ESG quality. More than 2,000 academic studies on the link between ESG and corporate financial performance have been published since the early 1970s and have been summarized in a joint meta study conducted by DWS and the University of Hamburg. This study revealed that companies with high ratings for ESG and Corporate Financial Performance historically demonstrated better performance over time. So, in some cases, perhaps on a short-term basis, the more attractive yields might be offered by issuers with poor ESG ratings. If you are operating with ESG constraints, you may have to forgo some yield. (Source: DWS and University of Hamburg, December 2015, and Robeco, 2016).

Through yield curve positioning and credit analysis, an actively managed strategy may be able to mitigate the effect of excluding higher yielding, low ESG credits, and at times even outperform funds that do not take ESG into account. Of course, this requires a capable team and strong credit research. Also, we consider ESG analysis to be a way to go beyond financial metrics and determine whether issuers will be healthy over the longer term.

Corporate enhanced cash strategy

One strategy that has the potential to assist you in optimizing your cash holdings is a Corporate Enhanced Cash Model. Figure 3 shows that, while a LIBOR-based portfolio produces a gross yield of 2.09%, the enhanced portfolio generates 2.16% while adding duration and extending the effective maturity (as of September 30, 2019). A portion of this enhanced yield comes from the allocation to higher risk asset classes; for example, the largest share in this hypothetical would go to floating-rate notes, with an average yield of 2.48%.

FIGURE 3: A COMPARISON—LIBOR VS. THE CORPORATE ENHANCED CASH MODEL

An example based on market levels as a way to demonstrate yield enhancement when comparing allocations.

INVESTMENT SUMMARY		
Asset Class	Allocation	Average Yield
Asset-Backed Commercial Paper	10%	2.09%
Certificate of Deposit	5%	1.96%
Commercial Paper	24%	2.03%
Floating Rate Note	30%	2.48%
Government Supported Programs	8%	1.95%
Medium Term Note	23%	2.01%

MODEL PORTFOLIO PERFORMANCE	
Estimated Gross Yield	**2.16%**
Avg. Duration (Year)	0.60
Avg. Effective Maturity (Year)	1.20
BENCHMARK PERFORMANCE SUMMARY	
Estimated Gross Yield	**2.09%**
Avg. Duration (Year)	0.25
Avg. Effective Maturity (Year)	0.25

The described model portfolio is hypothetical and based on the following assumptions

1. *Short term securities with minimum A-1/P-1 rating*
2. *Long term securities with minimum A rating*
3. *Effective duration calculation is based on the lower of the stated maturity date, next interest rate reset date or call/put date*
4. *The average duration of the portfolio shall not exceed 1 years*
5. *Average effective maturity calculation is based on the stated final maturity date*
6. *No more than 5% can be invested in any single issuer*
7. *The benchmark for this model is 3-Month Libor*
8. *Data as of 9/30/2019*

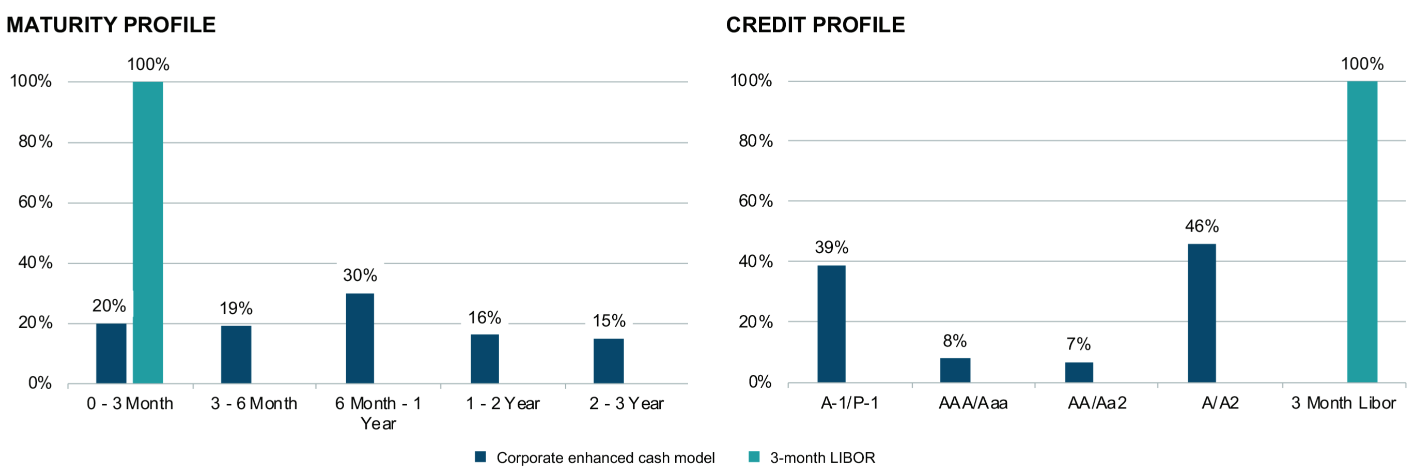
Source: DWS, Bloomberg. Note: This model portfolio and percentage allocations are shown for illustrative purposes only and reflect hypothetical performance results. Please note there are many inherent limitations in the use of hypothetical performance results, such as they are generally prepared with the benefit of hindsight, they do not involve financial risk, and no hypothetical trading record can completely account for the impact of financial risk in actual trading. There are numerous other factors related to the markets in general or to the implementation of any specific trading program which cannot be fully accounted for in the preparation of hypothetical performance results and all of which can adversely affect actual trading results. The hypothetical returns shown do not reflect the deduction of investment advisory fees. A clients return will be reduced by advisory fees and any other expenses that may be incurred in the management of its investment advisory account. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Performance is shown gross of fees and does not reflect investment advisory fees. Had such fees been deducted, returns would have been lower.

Through yield curve positioning and credit analysis, an actively managed strategy may be able to mitigate the effect of excluding higher yielding, low ESG credits, and at times even outperform funds that do not take ESG into account.

Figure 4 illustrates how the Corporate Enhanced Cash Model generates the additional yield from a longer average maturity and a range of credit quality. For example, 30% of the portfolio is in the six-month to one-year maturities, and 46% is in instruments rated A/A2.

Figure 5 illustrates the yields resulting from the Enhanced Cash Model's duration, sector, and credit quality allocations. For example, of the 2.16% yield generated by the model, 1.15 percentage points come from instruments with a 0 to 3-month duration, 1.11 percentage points come from the financial sector, and 1.03 percentage points originated with securities rated A/A2.

FIGURE 4: A HYPOTHETICAL COMPARISON—MATURITY AND CREDIT QUALITY



For discussion and illustrative purposes only. | Source: DWS, State street, and Bloomberg | Data as of September 30, 2019. Allocations are subject to change without notice.

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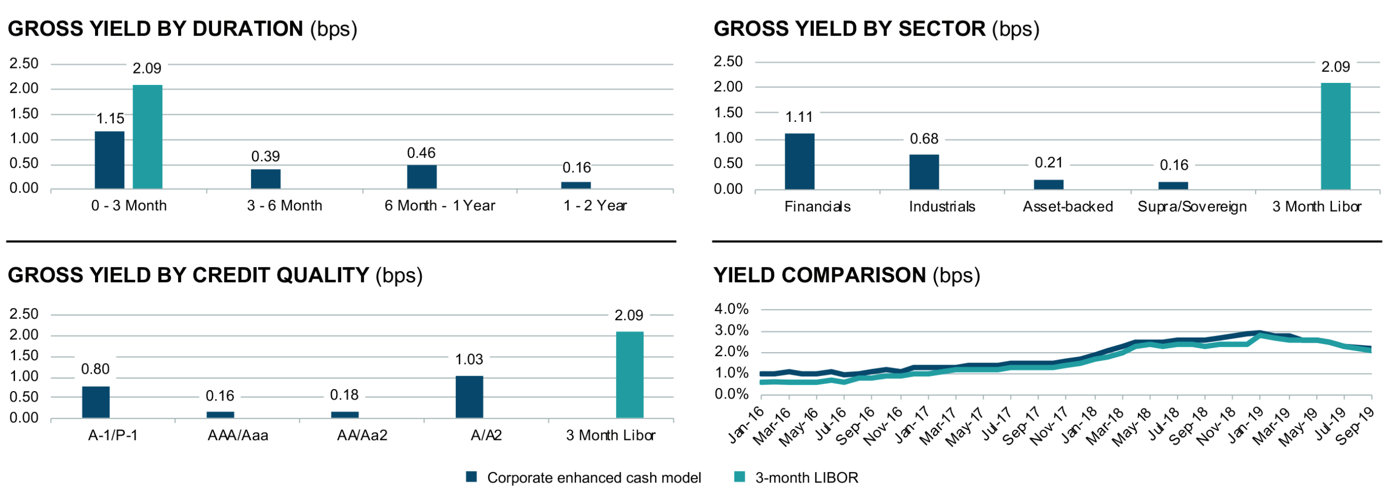
FIGURE 5: A HYPOTHETICAL PERFORMANCE ATTRIBUTION COMPARISON—DURATION, SECTOR, AND CREDIT QUALITY



For discussion and illustrative purposes only. | Source: DWS, State street, and Bloomberg | Data as of Sep 30, 2019. Allocations are subject to change without notice.

Hypothetical performance results and all of which can adversely affect actual trading results. The hypothetical returns shown do not reflect the deduction of investment advisory fees. A clients return will be reduced by advisory fees and any other expenses that may be incurred in the management of its investment advisory account. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown.

Conclusion

Given that the current low interest rate environment is likely to persist, insurance companies should consider looking beyond traditional money market funds if they want to truly optimize their cash holdings. Segmenting cash by liquidity needs can allow them to allocate a portion to SMA strategies. Via modest duration and credit risk, these vehicles can offer enhanced yields while potentially also providing liquidity and preserving capital.