What is cash and why do we hold so much of it?

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As our clients are aware, our asset allocation funds currently hold very large amounts of cash – sufficiently large to justify a thorough explanation.

Understanding cash

Understanding the nature of cash

In the context of unit trusts, cash is a broad term referring to a large group of yielding instruments that provide short-term liquidity and have a maturity of 12 months or shorter. In Graph 1 we have plotted all the various types of securities that could be regarded as cash. This graph does not refer to specific securities but is a generic portrayal of the relative yields you can expect from the different security types. As a general principle, the yield offered by an instrument increases with its commensurate risk.

Understand the risks of cash

To understand the different risks of cash instruments, consider that in essence all of these instruments are short-term loans made by the unit trust to a third party. This loan earns interest and is repaid within 12 months. The obvious risk is credit risk, that is, the risk of the issuer not being able to repay the short-term loan. Another risk is the term to maturity – it is harder to predict the creditworthiness and the state of the world 12 months from now as opposed to three months from now. The issuer needs to compensate the lender for this. The third risk, liquidity, is less intuitive. These short-term loans are in many cases tradable, that is, if the unit trust manager finds a willing buyer he can exchange the loan for an immediate cash payment. The less likely such a trade, the greater the liquidity risk.

Instruments issued by the government tend to have the lowest risk, followed by deposits with well-capitalised banks and then corporate instruments. For this reason, we can distinguish between three different issuers of cash: government, banks and corporates.

Treasury bills

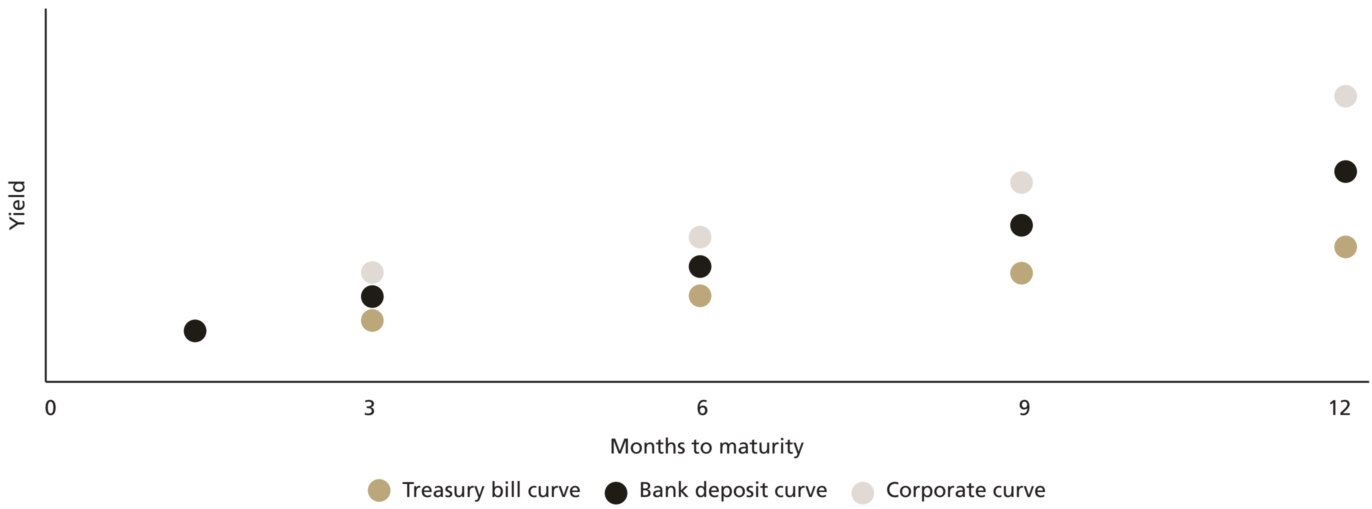
Treasury bills are usually regarded as risk free investments as they are issued in a weekly auction by the South African Reserve Bank and guaranteed by government. Naturally, even the state could default, but as a receiver of revenue who also has access to global bond markets, they would need to run their affairs decidedly poorly if they are not able to make good on 3- to 12-month debt. These instruments do however have maturity risk, and to a lesser extent, liquidity risk. They offer our funds very low risk liquidity.

Bank deposits

Call accounts

The cash instruments with the lowest yields are call account deposits. These deposits offer instant (same day) access to funds. Call accounts tend to yield slightly less than treasury bills because, while they lie on the balance sheet of the bank and

Graph 1: How yield varies by time and by type



Source: PSG Asset Management

therefore expose investors to a degree of credit risk, they offer the highest level of liquidity and do not have to compensate for any maturity risk. Due to the size of the deposits made by institutional investors, like a unit trust, the yield on a call account tends to be higher than the yield offered to individuals on their cheque accounts.

Tradable short-term loans to banks
The second kind of bank deposit is tradable fixed deposits termed negotiable certificates of deposit (NCDs). An NCD is a certificate of deposit holding a minimum face value that will be paid by the bank at the end of the term. A highly liquid secondary market exists for trading in these instruments as the banks create two-way pricing for the deposits they issue. These NCDs provide funds with higher yields than treasury bills due to increased credit risk. NCDs are issued with various maturity terms, from one month to five years. Strictly speaking, only instruments with a maturity of 12 months or shorter can be classified as cash.

Corporate paper

Tradable short-term loans to corporates
The third class of cash instruments is tradable short-term loans to corporates in the form of promissory notes or commercial paper. A promissory note is a legal agreement where the borrower agrees to repay the holder of the note a specified amount at a set date, or sometimes on demand. These are typically over the counter (unlisted) instruments and are therefore relatively illiquid. Commercial paper is a listed instrument similar to a corporate bond but with a shorter term, usually between 3 and 12 months. These instruments generally hold greater credit and liquidity risk than NCDs and should compensate investors accordingly.

Quasi-cash instruments

As mentioned above, banks also issue NCDs with a term longer than 12 months. We look at these instruments as quasi-cash as they are liquid and have minimal credit risk.

Distinguishing between fixed and floating instruments

All the above instruments can be issued as fixed or floating rate instruments, with the exception of cash on call, which is a floating rate facility. In the case of a fixed rate instrument, the exact interest offered by the issuer is agreed upon upfront. In the case of floating rate instruments, the actual payment varies in line with an agreed upon reference rate, generally Jibar (Johannesburg Inter-Bank Average Rate). An investor's decision to select a floating or a fixed rate instrument is a function of their interest rate view. For example, investors who believe interest rates will rise sharply, would rather opt for a floating rate instrument and vice versa.

How do we decide what kind of cash our clients should own?

At PSG Asset Management, we spend a significant amount of our time evaluating the riskiness of all the issuers of cash instruments in the South African market. We then determine which issuers are offering the most attractive yield given the commensurate risk. In some cases, the decision is not a matter of degree but entirely binary. For example, we did not invest in any African Bank cash instruments, regardless of the yield on offer.

How does cash fit into our asset allocation process?

We don't allocate to cash
At PSG Asset Management, we follow a bottom-up investment process. This entails evaluating individual investment opportunities on a case-by-case basis rather than making broad, bold calls on asset classes. For every potential investment, we determine a required real rate of return, with the return being greater for riskier investments. We would allocate from our cash resources when we find opportunities offering sufficient real return – the more compelling the opportunity, the greater the allocation. The amount of cash held in the funds is the end result of this process, not a strategic safe harbour allocation. In a nutshell, we hunt for quality asset trading below fair value and do not time markets.

'Clever cash': If you're going to hold cash, you might as well think about it
The nature of our process is such that we could sit on large amounts of cash for extended periods of time. For this reason, we spend a significant amount of time and research to ensure we are optimising our cash yield on a risk/return basis. In short, we hold 'clever cash' rather than just parking it on call. We allocate between the different cash instruments, maximising yield per unit of risk while taking into account the respective funds' liquidity requirements.

Cash on the defence and the offence
Understandably, some investors may feel frustrated with their portfolio manager holding significant amounts of cash at times. However, it is important to remember how critical cash is to a portfolio manager's armory when there is blood on the streets. Cash offers both a shield and a sword. Due to the nature of our process, we tend to hold more cash when more assets are overvalued. Our clients will therefore not fully participate in the correction in prices as they return to fairer levels. Markets tend not to correct in an orderly fashion – a sell-off is generally accompanied by a fair amount of panic, with the result that prices far overshoot fair values on the way down. This is when investors holding cash become spoilt for choice and can buy exceptional securities at below regular prices.

Unfortunately, cash doesn't offer a real yield throughout the interest rate cycle, but when it does, it's a sought after weapon with benefits. This is currently the case.

We currently have significant cash holdings

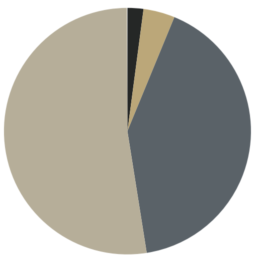
As shown in Graph 2, we are holding significant cash across all our domestic asset allocation funds.

It is clear that we are not currently finding that many opportunities in the domestic equity and bond markets and, as a result, have large exposure to cash. Remember that this is ‘clever’ rather than ‘lazy’ cash. Let’s look at the PSG Balanced Fund as a case study: 27% of the fund is invested in 'clever cash'. Of this 27%, 66% is invested in instruments with maturity terms of longer than 12 months, as we believe issuers are currently rewarding this extra duration more than fairly. In fact, the yield on the portfolio’s cash is currently 7.8%, which is 3.2% above last printed inflation.

This means that, at the moment, our clients are being paid a real yield by the banks while they wait until other investors start selling their racing horses at donkey prices – which is when we suit up.

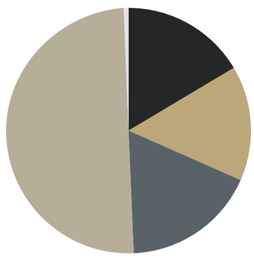
Graph 2: Cash holdings in our domestic asset allocation funds as at 30 June 2015

PSG Diversified Income Fund



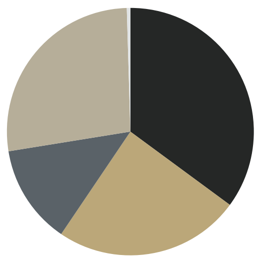
Domestic equity	2%
Global equity	4%
Domestic bonds	41%
Domestic cash	53%
Global cash	0%

PSG Stable Fund



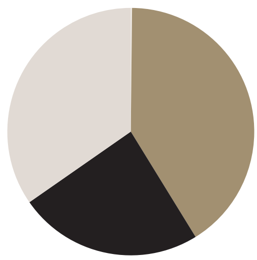
Domestic equity	16%
Global equity	15%
Domestic bonds	18%
Domestic cash	50%
Global cash	1%

PSG Balanced Fund



Domestic equity	35%
Global equity	24%
Domestic bonds	13%
Domestic cash	27%
Global cash	1%

PSG Flexible Fund



Domestic equity	35%
Global equity	24%
Domestic cash	41%
Global cash	0%