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Portfolios: Horizon Cash Management Eyes Structured Agencies Beyond 1 Year; SEC MMF Reform Could Bring Opportunities in Short-term Agencies, CP

By Yali N'Diaye, March 15, 2010

WASHINGTON (MNI) - Against a background of ongoing low interest rates and an uncertain timing of the Federal Reserve monetary policy tightening, adding a moderate percentage of maturities beyond one year might be the way to enhance the return on cash, a Horizon Cash Management portfolio manager told Market News International.

In fact, VP and Senior Portfolio Manager Jill King is looking at structured agency securities with maturities longer than one year, "as a way to add alpha in the low rate environment".

While looking to pick up some yield in longer dated paper, she warned against getting "greedy" by trying to reach for returns that are not provided by the market.

King also hopes the Securities and Exchange Commission's money market fund reforms will generate opportunities for her firm -- which manages short-term cash for institutional investors outside the constraints of money market fund regulation.

"We can take advantage of the little intricacies and changes of rules and regulations that create pockets of opportunity," she said, that have nothing to do with a deterioration of credit quality or another negative development in the market or related to the issuer.

Noting the recent increase in the discount rate to 75 basis points from 50 basis points, King said the Fed has been very "clear and transparent" about removing the extraordinary liquidity programs and facilities, which have no impact on the Fed's monetary policy.

And going forward, "We're probably going to get through 2010 without the Fed being in a position to make a change" given the ongoing weakness of the economy -- including the housing sector, she said.

During another year of low fed funds rates, there is going to be "very little differentiation" between short term assets, whether they are T-Bills, discount notes, commercial paper or short term corporate notes, King commented.

Therefore, it might prove relevant to go a little bit longer than a year to find yield.

And while keeping a "requisite amount of liquidity" as dictated by the client, King is particularly looking at structured agency securities, that include Fannie Mae, Freddie Mac as well as Federal Home Loan Bank or Federal Fund Credit Bank.

Given her short-term investment horizon, she is "not concerned" about the future of Fannie Mae and Freddie Mac.

She reminded that the U.S. Treasury said on December 24 it was giving an unlimited line of credit to Fannie Mae and Freddie Mac for the next three years -- through the end of December 2012.

"The long-term structure and role of Fannie Mae and Freddie Mac remains unclear, but in the short run they have unlimited access to funding from the Treasury and are instrumental to recovery in the U.S. housing market," King said.

Last week, House Financial Services Committee chairman Barney Frank said bondholders of the two mortgage giants should not assume the federal government will guarantee the debt of these government-sponsored enterprises at 100 cents on the dollar. He added bondholders could suffer losses.

However, a spokesman for the U.S. Treasury responded right after that "there should be no uncertainty about Treasury's commitment to support Fannie Mae and Freddie Mac as they continue to play a vital role in the housing market during this current crisis."

Frank then back-pedaled, saying he supports "the intention of the Treasury to stand fully behind the terms of its December 24 statement."

The future of the GSEs will be more and more debated as Treasury Secretary Tim Geithner has said its Department would come up with proposals in 2011.

On March 23, the House Financial Services Committee is scheduled to hold a hearing on the future of housing finance.

There is no doubt there will be substantial changes going forward in the housing finance area, King said.

Whatever option the Treasury decides, "There has to be something that does serve the purpose" that Fannie Mae and Freddie Mac serve, as they underwrite 90% of all mortgages in the U.S., with the private-label mortgage market "very depleted," King said.

Freddie Mac and Fannie Mae are "instrumental" to the return of "normalcy" in the housing market, she added.

So "I think right now they are off the table for discussion," and combined with the short-term investment horizon of her mandates, there is no need to be concerned about buying agency paper, she said.

Yet "I don't think short agencies are overly attractive if they don't pay any spread to Treasuries," King said, which is the case for maturities that are lower than one year.

Looking beyond one year, however, "we like some 18-month paper," she said, citing structured agency securities, which "offer a lot of value relative to what else is available in the market."

She especially takes advantage of some structures such as callable agencies with step up features "because they provide upside potential" while offering downside protection.

"I think that's a prudent investment in the changing interest rate environment," King commented.

That said, "you could only get what the markets give," and in the very short maturities, there is just not much differentiation at this point between the different asset classes, she added.

King is also hoping to benefit from new regulations about money market funds adopted by the Securities and Exchange Commission.

The new regulations in particular require higher credit quality for securities held in portfolios and a reduced ability to invest in lower quality (second tier) securities.

In particular, funds cannot invest more than 3% of their assets in second-tier securities and more than 1/2 percent in a single second-tier issuer. Their second-tier holdings must not mature in more than 45 days, a limit that has been sharply reduced from 397 days.

The regulations also reduce the "maximum weighted average maturity of a fund's portfolio to 60 days" from 90 days, while limiting the funds' ability to invest in long-term floating rate securities.

The SEC registered the final rule on March 4, so the rules will become effective 60 days after that date, which is from May 5.

King especially sees potential opportunities from the restrictions on credit quality, which will mostly affect short-term commercial paper.

"We like tier two commercial paper," she said, adding "we buy quite a bit of that."

With money market funds having to lower their holdings in second tier paper, competition among issuers could increase, leading to a cheapening of the paper, she said.

The new restrictions on credit quality could also encourage issuers to entice other types of investors to buy their paper.

So "that might be a positive for us," King said, since she usually buys that kind of paper.

And with the 60-day maturity limit on cash and cash equivalent holdings -- which include mortgages and agency securities -- that "could create some opportunities longer than two months" that the agencies' natural buyers won't be able to buy as much.

If money market funds, natural buyers of such paper, have to dispose of the assets, that could "cheapen up that part of the agency curve, which for us would be a positive," King said.

"I would love to see that," as it would provide short-dated securities offering a better yield than Treasuries, she concluded.

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