Cash offers both a shield and a sword in investing

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 less.

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There are, however, various types of instruments that could be regarded as cash and it's important to understand just what these are, as well as the risks cash holds in the investment process.

Consider, in essence, that 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, such as 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 if the unit trust manager finds a willing buyer he can exchange the loan for, in return for immediate cash. 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, followed by corporate instruments.

Treasury bills

These are often considered 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 it is unlikely. These instruments do, however, have maturity risk and to a lesser extent, liquidity risk.

Bank deposits

- ### Call accounts

These have the lowest yields and 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 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

Otherwise known as negotiable certificates of deposit (NCDs), these hold 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. 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

Also known as promissory notes, these are legal agreements 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 three and 12 months. These instruments generally hold greater credit and liquidity risk than NCDs and should compensate investors accordingly.

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 will depend on their interest rate view. For example, investors who believe interest rates will rise sharply may rather opt for a floating rate instrument and vice versa.
Cash is a critical part of a manager's arsenal as it offers both a shield and a sword. 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.

ABOUT THE AUTHOR

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