

Schroders

Alternatives to cash

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Thinking about the performance of markets over the last 12-18 months, I think the biggest surprise for investors has been the relatively and absolutely poor performance of the more defensive parts of their portfolio.

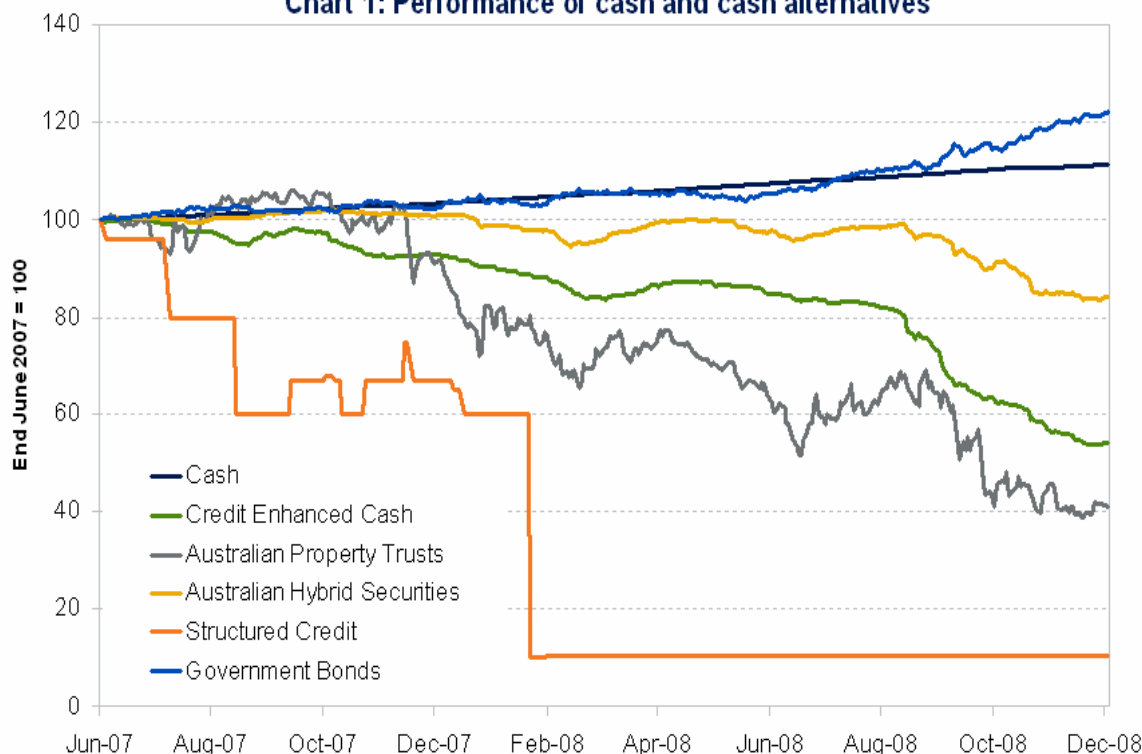
Selecting defensive instruments for a portfolio

Until credit markets collapsed in 2007 most investors and advisers tended to avoid holding pure cash because a range of investment products including mortgage funds, credit enhanced strategies and even LPTs were considered low risk but higher yielding alternatives. In other words, many believed they were proxies for cash. However, the onset of a challenging environment has reminded investors of the fundamental law of investment - the prospect of higher returns involves higher risk and once you start to move away from pure cash (ie the risk free investment) you are adding risk to your portfolio.

Cash has a number of important characteristics:

- Cash is completely liquid, which means it is very easily and quickly convertible into notes and coins if required without incurring big transaction costs.
- Cash is transparent. That is, it's not locked away behind some complex structure and its simple and easy to understand.
- Cash is low risk which means a very low risk of loss of capital.
- Cash diversifies against equity risk and should always produce a positive return.

Chart 1: Performance of cash and cash alternatives



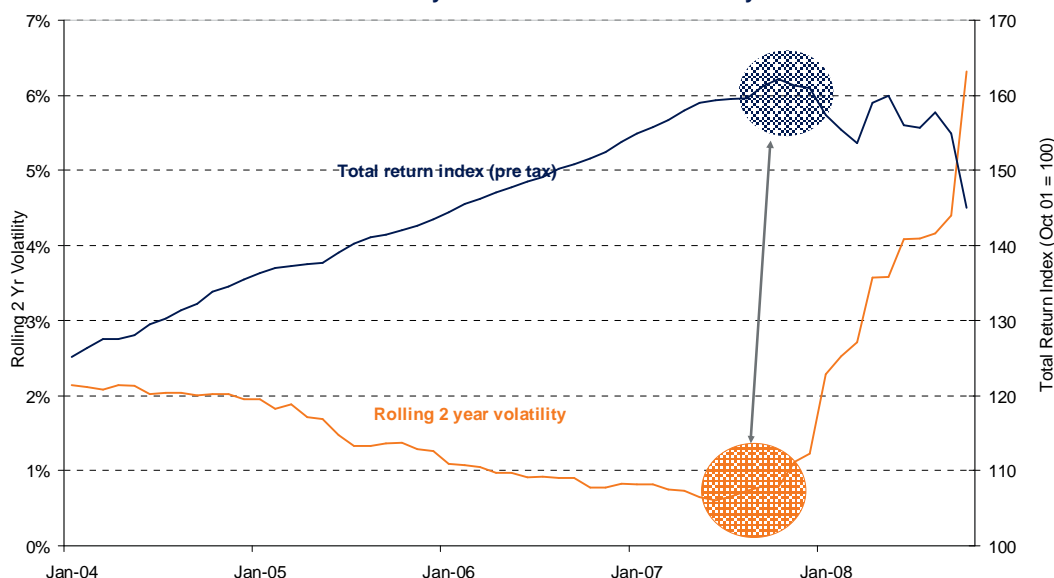
Source: Schroders, Datastream. Cash = UBS Bank Bill Index. Credit Enhanced = Blackrock Monthly Income Fund. LPTs = ASX/S&P 300 Property Trusts. Hybrids = Schroder Hybrid Securities Pool. Structured credit = Macquarie Fortress Investments Ltd. Government

While there has been a proliferation of so-called 'cash' alternatives the reality is that these products have not satisfied many of the cash criteria detailed above. Largely, that's why investors have been so disappointed with the supposed cash or defensive parts of their portfolio.

Not all defensive financial instruments have been a complete disaster in the last 18 months. As can be seen in chart 1, pure cash has been slow but steadily positive and Government bonds, so often shunned by investors, have returned in excess of 20% since the beginning of last year. Government bonds tick most of the 'cash' boxes even though they aren't deemed to be pure cash. It also shows the further out the risk curve you've been the more painful the experience has been. Hybrids, LPTs, enhanced cash and structured credit have all lost capital. While investors knew these instruments could change in value they didn't appreciate the tail risk associated with these instruments.

Volatility is actually a very poor measure of risk

Chart 2: Schroder Hybrid Securities Pool - Volatility v Return



Volatility is often used as a measure or predictor of risk. In fact, volatility is a poor measure of risk and this is evidenced in chart 2. Using the performance of the Schroder Hybrid Securities Fund as an example you can see that returns peaked when volatility was at its lowest. The low volatility in late 2007 gave investors no indication it was imminent that credit markets were about to collapse. Since late 2008/2009 returns have been negative on risk assets while volatility has exploded.

Assessing 'cash proxies'

Table 1 assesses a range of cash proxies against the features of cash as outlined above. It's a useful framework against which to measure products on a structural basis and determine whether to include them in the cash part of a portfolio. The top half are structurally attractive for a defensive or cash part of a portfolio while the lower half typically don't, in our view, qualify as defensive.

	Table 1	Liquidity	Transparency	Low risk	Diversifies equity risk
Structurally attractive	Cash	Very high	Yes	Yes	Yes
	Enhanced cash	Varies	Varies	Yes	Depends
	Bank debt	High	Yes	Yes	Yes
	Pure credit/hybrids	Varies	Varies	Varies	Yes
	Government bonds	Very high	Yes	Yes	Yes
Structurally unattractive	Mortgages	Illiquid	Varies	No	Yes
	Structured Credit	Illiquid	No	No	No
	Listed Property Trusts	High	Varies	No	No
	Dividends	Very high	Yes	Maybe	No

- Pure cash is the default and purest in form. It has very high liquidity, its very transparent, risk is virtually non-existent and it diversifies equity risk because the return will always be positive.
- Enhanced Cash. Assessment of this product depends on the degree of enhancement. Some products have a high degree of enhancement which makes them almost pure credit type strategies. Liquidity and risk

qualities can be high or low depending on the enhancements. We note a number of enhanced cash products had liquidity issues and were frozen in 2008.

- Bank debt is a security issued by a bank and includes bank guaranteed and non-bank guaranteed. It is a purer defensive component of a portfolio than the credit enhanced type strategies.
- Pure credit/hybrids. Pure credit's assessment varies largely according to where on the credit curve you are and the degree of risk in the underlying securities. Like Enhanced Cash, liquidity has varied significantly recently.
- Government bonds. Government bonds are one of the few assets that actually go up when markets are going down in terms of returns. The Schroder Fixed Income Fund has a Government bond core and that's a large part of why this fund has had double digit returns over the last year. Government bonds perform very differently to credit and work very well in a defensive asset structure.
- Mortgages. Mortgages are a structured vehicle so transparency varies. In the last year they have been really disappointing in terms of liquidity with many investors struggling to get their money back
- Structured credit may have had good ratings in the past however the reality is it is typically illiquid, lacking in transparency and higher risk.
- Listed property trusts. While there is a reasonable degree of liquidity and transparency in LPTs they are effectively equity proxies and considered neither low risk or a diversifier of equity risk.
- Dividends. A dividend stream is highly liquid however in the current environment dividends are being cut and of course they don't diversify equity risk.

Where to from here?

Table 2	Risk premium	Invest now?	Comment
Cash	Nil	P	Still has a role though!
Enhanced cash	Improving	P	Attractive risk premium in credit enhanced returns
Bank debt	High	P	Especially bank guaranteed paper
Pure credit/hybrids	High	P	Attractive risk premium
Government bonds	Positive – normal yield curve	P	But will provide further protection to downside...a good diversifier
Mortgages	Adequate	U	Uncertainty, liquidity issues
Structured Credit	No	U	Leveraged into the default cycle, liquidity issues
Listed Property Trusts	Low	U	Sector remains under pressure. Concerns over business model and ability to de-lever.
Dividends	Adequate	U	High risk of dividends cut

To identify which products make sense to own going forward it is important to consider structural criteria as well as cyclical conditions and valuations. Table 2 provides a summary of our current views on various strategies which is also reflected in the composition of the Schroder Fixed Income Fund. We believe it's important to remain well diversified and not rely on any one theme to drive returns. In the Schroder Fixed Income Fund we retain a pure cash component to help manage liquidity and certainty of returns. Recently we have started to increase our credit positioning as risk premiums are now very attractive.

Conclusion

As inflation pressures have abated it seems cash rates are likely to remain low for some time. Alternatives to cash present challenges for advisers and their clients. There are many so called 'cash proxies' available but not all are suitable for clients. At Schroders we believe alternatives to cash should be defensive, transparent and liquid. We position the Schroder Fixed Income Fund in this space with investments currently focussed on government debt, cash and increasingly credit, bank debt and hybrids to supplement returns and diversify risk.

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