Morgan Stanley

INVESTMENT MANAGEMENT

Liquidity Darwinism

LIQUIDITY | GLOBAL LIQUIDITY TEAM | 2019

Darwin's Theory of Evolution is often applied to today's ever-changing business world: adapt and evolve. We believe this is particularly true for the modern treasury professional. In a liquidity investing landscape characterised by persistently low and negative rates, changing market forces, new regulations and product reform, the ability to adapt and evolve investment strategies has become ever more important.

Companies that have been willing and able to change their investment policy in the face of today's shifting environment can benefit from improved yield potential, diversification[1] and a greater set of investment opportunities.

CASH SEGMENTATION CAN IMPROVE INVESTMENT OPPORTUNITIES

Cash segmentation is a widely used strategy that many treasury teams have already successfully adopted over the past decade to help enhance their yields and gain better control and cost over their liquidity. The ability to reasonably forecast cash flows is critical for success, allowing the segmentation of liquidity into distinct pools, each with its own purpose and investment opportunity set. Investors have recognized that the cost of holding excess liquidity is extremely high and through liquidity optimization, they have reduced their opportunity costs. In order to make a segmentation process most effective, it is essential to ensure any investment policy is flexible enough to better align each pool's liquidity and return objectives.

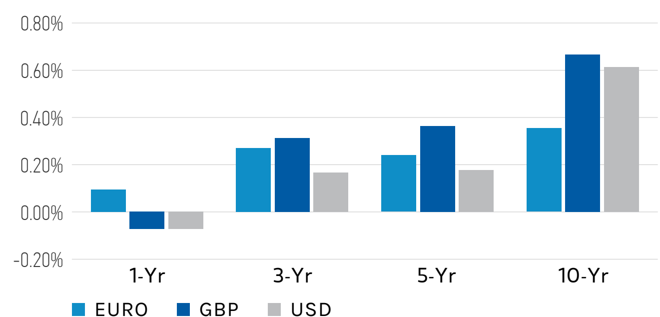
BUILDING FLEXIBILITY INTO INVESTMENT POLICIES

Many multinational corporations have deliberately implemented strategies that better align their cash investments with their expected cash flow needs, recognising that making their investment policies more flexible would allow them to capitalize on different market opportunities. The greater the flexibility of the investment policy, the easier it is for investors to take advantage of market dislocations and to pivot to strategies which may still emphasize principal protection or liquidity, but could offer better risk and/or return potential. In many cases, these companies have also added alternative investment strategies, such as money market funds, repurchase agreements, direct investments and separately managed accounts to seek to enhance their returns.

To illustrate how a more flexible investment policy statement can increase return, in *Display 1*, we show the excess returns of a hypothetical asset allocation versus 1M Libor across Euro, GBP, and USD for investors who have allocated 20 percent of the strategic or long-term cash into a one- to three- year corporate credit utilizing an index as a proxy. As shown, the excess returns have historically provided constructive benefits. These were realized without adding significant levels of interest rate risk to the overall portfolio. On average, the portfolio's added approximately four months of interest rate risk.

DISPLAY 1

Excess returns over 1M Libor by Currency



Source: MSIM and ICE BofA/ML Indices. From December 2008 to December 2018.

Past performance is no guarantee of future results. Hypothetical asset allocation results have inherent limitations. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. The chart compares a hypothetical portfolio that earns 1M Libor versus a blended portfolio of 20% 1-3 Year Corporate bonds and 80% 1M Libor. See Disclosure page for important information.

[1] Diversification does not eliminate the risk of loss.

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This hypothetical asset allocation has historically provided strong risk-adjusted returns, but, just as importantly, provided investors with the opportunity to improve diversification and gain access to market supply.

We believe that adapting and evolving is critical as new technologies and market dynamics change the treasury investing landscape. Today's treasurer usually benefits from improved visibility around cashflows, efficiency and control. We believe an investment policy that is flexible and adaptable will be better positioned for today's investment environment, as well as tomorrows. William Pollard, a 20th century physicist, may have summarized this best:

"Those who initiate change will have a better opportunity to manage the change that is inevitable."

At Morgan Stanley Investment Management, we are committed to working with our clients to help guide them through the changing market environment. For more information, please contact your Morgan Stanley Investment Management Relationship Manager.

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Indices are unmanaged and their returns do not include sales charges or fees, which would lower performance. It is not possible to invest directly in an index.

The value of the investments and the income from them can go down as well as up, and an investor may not get back the amount invested.

Hypothetical Asset Allocation: Hypothetical asset allocation blend results have inherent limitations. One of the limitations of a hypothetical blend is that decisions relating to asset allocation were made with the benefit of hindsight based upon the historical rates of return. Therefore, hypothetical blends often show positive rates of return. Another inherent limitation is that allocation decisions were not made under actual market conditions and, therefore, cannot completely account for the impact of financial risk in actual trading. Any changes to the assumptions included within the calculations could have a material impact to the results referenced. Additional information, including the basis and methodology for the information shown is available upon request.

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