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Let's Talk About Cash: It's Time to Ask the Right Questions about Liquidity Strategy

With the Fed halting interest rate hikes, the party is over when it comes to increased yield in the near-term. That means that for many companies, the time is right to revisit cash management strategies and investment policies. While each company's liquidity needs are unique to its business plan, industry, and even season, one thing is universal: the need to have a balanced strategy that optimizes near-term goals with long-term risk and returns.

Taking stock of the economic environment

Macroeconomic factors such as interest rate and monetary policy set the stage for what businesses need to consider when developing their working capital management strategies. Expressing caution over global developments and muted inflation pressures, the Federal Open Market Committee voted to cut the Fed Funds rate at the end of July. In addition, the flattening yield curve does not incent treasury staff to place funds in longer-term instruments.

Now that the Fed Funds rate was cut for the first time since the end of 2008 and market expectations call for 1 to 2 more cuts before year-end, should practitioners think differently about investing excess cash? The answer is yes. According to George Mohan, Managing Director of Fixed Income Sales for KeyBanc Capital Markets,® the bond market is anticipating lower yields, as evidenced by the inverted yield curve.

Based upon the current market conditions, clients that are sitting on excess cash should consider laddering funds into fixed income instruments that match their investment policies, including U.S. Treasury securities, commercial paper, and CDs, for example.

Key takeaways

Macroeconomic factors, including a halt to interest rate increases and a slowdown in growth and inflation, make this a good time to revisit your capital management practices.

The types of cash a business needs to manage are operational cash, reserve cash and strategic cash, and they fall on a continuum of risk, yield, and availability or term.

To optimize liquidity, businesses must balance their liquidity needs with their needs for return.

If rates continue to fall, keeping cash in indexed solutions may not result in increased return. If a company is looking for yield but also wants to keep some funds liquid for near-term needs, it may require practitioners to reevaluate their investment policy, risk tolerance, and mix of liquidity vehicles.

Economists surveyed by Bloomberg are predicting a 93.3% chance of a Fed cut in rates over the next year.

Understanding the cash continuum

As your business decides a balance of liquid and longer-term investments, you need to take stock of what needs you may have for your cash. Additionally, understanding where each investment falls on a continuum of availability, duration, and yield can help you achieve a healthy balance of operational, reserve, and strategic cash strategies.

Cash Strategy	Description	Duration	Objective
Operational cash	Funds required for day-to-day operations, such as monthly lease payments, payroll, and recurring vendor payments. Your business needs to be able to access operational cash at all times and assurance that these accounts are secure and not being put at risk. Most operational cash tends to be placed in a Demand Deposit Account (DDA) or a sweep structure, which is an account that automatically transfers amounts that exceed a certain level into a higher interest-earning investment option.	Overnight to 1 month	Safety
Reserve cash	Excess cash set aside for unexpected events, for example, a major repair to a facility. If business owners need to access these funds, they don't want it to be tied up in an account that has a set duration. Reserve cash may be kept in an interest-earning account, such as a money market deposit account (MMDA).	3–12 months	Liquidity
Strategic cash	Reserved for particular purpose and duration, for example, a plant purchase, major expansion, or equipment replacement. In this instance, business owners may be willing to put maturity terms around these funds, and their risk tolerance will be higher. One option for this type of cash is a structured deposit agreement with a bank, in which the account holder agrees to keep the assets on deposit for a certain duration to receive a contractual yield.	1–2 years	Yield

Ask and answer: How to evaluate your cash management

It's time to take stock of your company's working capital strategy to evaluate whether it's optimized for the current economic environment. Start by asking these questions:

- ☐ Is your firm's short-term investment approach active or passive? Optimizing your accounts doesn't necessarily mean an active approach, in which your financial officers track the market and accounts and make daily trades. Today, liquidity strategies that employ automation make it possible to be less hands-on and still maximize yield.
- ☐ Do you have the in-house expertise to manage your liquidity?
- ☐ Does your company have an investment policy that prescribes your risk tolerance and diversification requirements? If not, what is your risk tolerance and need for diversification? If you do have a policy, does it need to be amended?
- ☐ What are your business's unique needs for liquidity in the next several months, year or two years? Are you planning to expand to new locations, hire more employees, be active in mergers or acquisitions? Is your organization's liquidity need seasonal or cyclical—are there certain times of year when you make more capital expenditures, for example, to improve facilities or increase staffing?
- ☐ Are you using the right liquidity solutions? New hybrid products make it possible to structure your deposit accounts in more optimal ways, for example, automatically calculating how much balance is needed to offset fees while earning interest on the excess funds. Various sweep account options, including bank deposit sweep, credit sweep, and money market fund sweep, can be another way to optimize return on idle cash.
- ☐ Are you making the most of your bank relationships? Your commercial bank should have a holistic view of your business, understanding your cash flow, need for liquidity, and how best to achieve your overall financial goals.
- ☐ Does your investment policy address market risk? Can the liquidity you have tied to corporate debt withstand market uncertainty and volatility?

In today's rate environment, the benefits of active liquidity management are more apparent than ever. KeyBank offers liquidity management solutions that efficiently manage your short-term cash and deliver optimized results.

To learn more, **visit key.com/payments**

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