Enhanced cash funds

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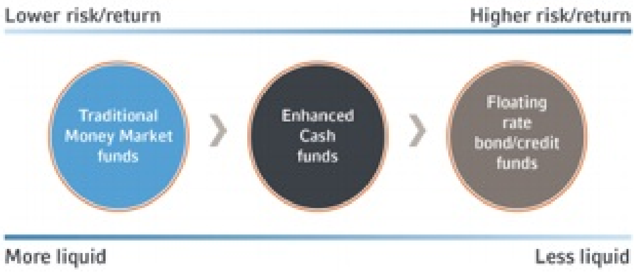
Given the global low yield environment, there is a rising demand from investors for enhanced cash investments. To generate enhanced returns compared to cash funds, enhanced cash products (sometimes referred to as money market funds) tend to carry greater risks. Figure 1 below illustrates the risk/return characters among cash funds, enhanced cash funds and bond funds.
Figure 1: Risk and return spectrum across various types of funds

Source: Russell Investments



Similar to any cash funds, enhanced cash funds are exposed to credit risk, term risk and liquidity risk. These generally imply the risk of losing capital from the default by security issuers, the changes in interest rates that adversely affect the price of the securities and the inability to convert the securities into cash without any loss of capital. Given these risk factors, the returns for enhanced cash are sourced from each of the risk accordingly (i.e. credit premium, term premium and liquidity premium) and among all the premiums, credit premium is typically the main contributor of enhanced returns.

A number of enhanced cash funds suffered material losses of capital in the depths of the GFC, with some being forced to freeze and return capital to investors. 11 am accounts, banks bills, promissory notes, asset-backed securities and floating rate notes are all common constituents of enhanced cash strategies. Subsequent to the GFC, ASIC prepared a review of the sector showing enhanced cash on average held approximately 50% of their assets in traditional cash assets and 50% in higher risk fixed income securities, of which asset-backed securities being the most common. This second category of assets is sensitive to price movements, which under the stressed credit and liquidity conditions of the GFC saw enhanced cash fund unit prices materially impacted. This caught many investors unaware and caused a number of enhanced cash funds to receive material redemption requests from unitholders, and ultimately caused the freezing of at least ten of these during 2008/2009.

It is noted that enhanced cash products typically invest in high quality securities with an average credit rating of A+ or A1, where the probability of losing capital or suffering delayed payments is very limited. However as seen by the experience of the GFC, the search for additional return beyond cash rates must be done cautiously.

Additional analysis has shown on average enhanced cash products have a longer weighted average life/maturity than traditional cash funds. As can be seen in figure 2 below, from all the surveyed funds by ASIC, cash funds have a weighted average life of 123 days, which is significantly shorter than that of enhanced cash funds (i.e. 629 days). This would expose enhanced cash funds to greater interest rate risks and as a consequence, expected higher term premium.

Figure 2: Maturities across various types of funds

Maturity matrices (days)	Money market funds	Enhanced money market funds	Fixed income funds
Weighted average life	123	629	1419

Source: Australian Securities and Investment Commissions

Overall, given elevated credit risks, longer durations and less liquidities compared to cash funds, higher returns are expected by investors in enhanced cash funds. However, given the similarities between cash funds and enhanced cash funds, it is critical for investors to understand the difference between the two. In addition, when it comes to product selection, as the main strategy for enhancing the return is credit, it is critical for investors to assess fund managers' abilities to manage credit spreads risks, especially during the downside scenarios.