CASH PLUS SOLUTION

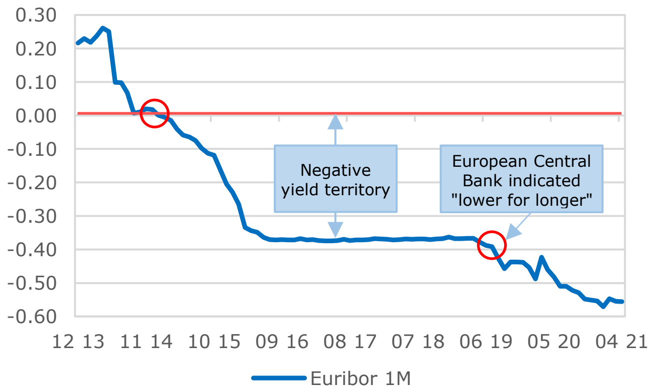
Investment Insight | Series VIII

In a series of articles, we discuss and present investment opportunities we actively use in our building blocks to form our absolute return portfolios. So far, we discussed various topics including "Structured Credit", "Direct Lending" or "Secured Lending". In series VIII we describe how we address the challenge faced by many investors: Cash balances that are subject to negative interest rates. For our clients we have established our "Cash Plus" solution, which combines the aspects of positive yielding assets, lowest risk and daily liquidity.

Bank accounts with negative interest rates

UBS announced that it will charge clients negative interest from July 2021 if cash balances exceed CHF 250'000. Many other banks have followed suit and are also charging negative interest on CHF and EUR cash balances. This measure is dictated by current money market rates, which are severely negative as demonstrated in Chart 1 for EUR rates.

Chart 1: Rates are negative since more than 5 years



Source: Bloomberg / Alpinum Investment Management

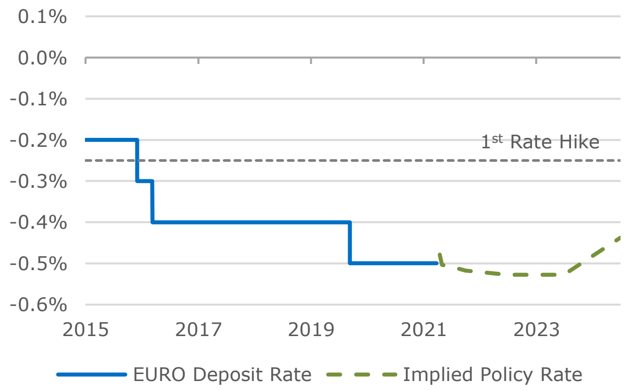
Institutional and corporate clients with cash deposits in Swiss francs have already been bearing the cost of negative interest rates for several years. Now, individual and business customers experience the same penalty. Credit Suisse, for example, charges its clients -0.75% p.a. on cash balances above CHF 2m.

Rates remain low for longer

Despite the recent steepening of the yield curve, short-term interest rates in Europe are expected to remain low for longer. The European Central Bank (ECB) is committed to keeping financial conditions extremely accommodative. In March, the ECB reiterated its stance and decided to leave its key refinancing rate at record low levels. It has even accelerated its emergency bond purchases to prevent a potential tightening of financing conditions.

The market is also pricing in a very dovish stance by the ECB for a multi-year period, as the implied policy rate in Chart 2 illustrates well.

Chart 2: No near-term rate hike in sight



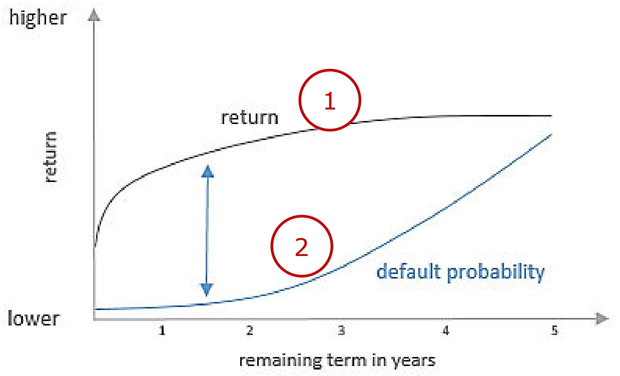
Source: Bloomberg / Alpinum Investment Management

Providing investors positive returns when interest rates are negative requires a well thought-through concept. Even more so if risk is minimized and liquidity maximized. We identified a practicable solution that combines additional yield income with an active and disciplined risk management approach.

Our approach to generate positive returns

Our approach is to focus on high-quality short-term bonds with a remaining maturity of 1-3 years. This characteristic offers two main advantages. First, interest rate sensitivity for early maturing bonds is minimal. This is very beneficial during times of rising rates as the portfolio is geared to benefit from climbing short-term rates. Second, shorter bond maturities mean less credit risk. Due to the short maturity, the bonds probability of default is on average lower. A third advantage of short-term bonds is the non-linear decline of the return, as the yield of a bond benefits from the "roll-down" effect, what results in an extra return.

Chart 3: Disproportional rise of default probability



Source: Alpinum Investment Management

Chart 3 illustrates the moderate yield increase for longer maturity bonds (1), while the probability of a bond default rises disproportionally over time (2), manifesting that short-term bonds provide a much better risk-/return relationship.

Chart 4: Cumulative default rates spike with time

	Time horizon in years						
Credit Rating	1	2	3	4	5	6	7
AAA	0.00	0.03	0.13	0.24	0.35	0.46	0.51
AA	0.02	0.03	0.08	0.22	0.36	0.48	0.61
A	0.06	0.15	0.24	0.36	0.49	0.68	0.86
BBB	0.17	0.43	0.68	1.05	1.42	1.80	2.15
BB	0.56	1.71	3.38	4.94	6.52	7.77	8.89
B	3.60	8.29	12.29	15.46	17.89	20.15	21.66
CCC	26.82	36.03	41.03	43.97	46.22	47.13	48.33

Source: Moody's (Global Corporate Bonds 1981-2017)

The behavior of return and default probability is best illustrated by historical data from Moody's (Chart 4). For instance, it exemplifies that an average AA-bond portfolio held over 6 years faces a similar default probability as compared to a BBB 2-year bond portfolio. At the same time, the compensation (credit spread) of a BBB 1-3 years bond index is much higher with currently 0.60% p.a. as compared to an AA 5-7 years bond index with only 0.36% p.a.

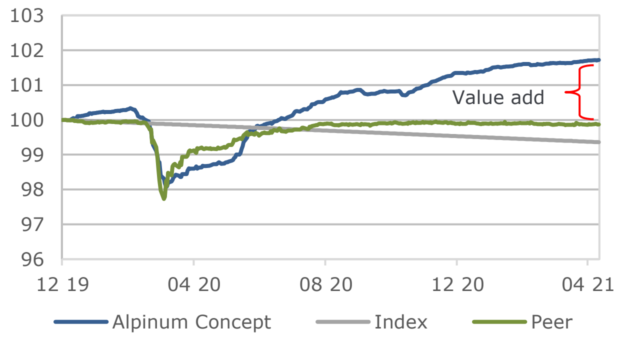
These "price anomalies" are caused in part by market segmentation and investor behavior. This offers tremendous alpha opportunities for credit and bond selection experts.

Reality check – We are live and tested

Putting theory into practice: We successfully run a portfolio taking advantage of these anomalies. It is the strategy's mandate to generate constant a positive absolute return over a 12-months rolling period, while putting highest emphasis on risk discipline via the implementation of a strict risk budgeting framework. Further key elements of our concept are:

1) Active allocation process through combining money market instruments and high-quality short-term bonds with low probability of default and minimal interest rate sensitivity.
2) Comprehensive bond selection with deep fundamental analysis. Taking advantage of mispriced bonds to build an efficient portfolio in terms of its risk-/return relationship.
3) No compromise on liquidity. All investments are highly liquid. Mandate provides daily liquidity.

Chart 5: Cash Plus Solution performed well (in EUR)



Index: EONIA Total Return Index
Peer: iShares Ultrashort Bond ETF (50%) & JPM Ultra-Short Income ETF (50%). No benchmark, serves only as a reference.

Source: Bloomberg / Alpinum Investment Management

We gain access to high quality bonds in established and liquid markets, which are often overlooked by a number of institutional investors in their search for market size combined with their rather passive investment style. This allows us to capture a structural inefficiency premium and enables us to generate an extra yield. Furthermore, our opportunistic investment style enables us to achieve higher "upside" participation during times of market strength.

Our tested "Cash Plus Solution" serves investors seeking a positive yielding substitute for cash or near-cash investments. If you like to learn more about our concept, please contact us under: info@alpinumim.com.

For more market insights and our monthly "Credit Letter" please reach out to our website on: www.alpinumim.com.

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