LIQUIDITY MANAGEMENT

Divide and Rule

The Power of an Effective Cash Segmentation Strategy

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Cash segmentation is an essential liquidity optimisation process. The results can be compelling. In the company of Amundi's Stéphanie Akhal, Head of Liquidity Solutions Business Development, Europe, and Patrick Carletto, Head of Money Market Investment Strategy, we explore cash segmentation drivers, options and outcomes for money market investors.

In the investment world, cash segmentation refers to the practice of categorising cash into different 'buckets', based on the purpose and time horizon of the funds. It's an approach that enables investors to optimise their liquidity management by aligning their cash, through the lens of individual risk tolerances, with specific needs. These needs are commonly daily cash, operational cash, and strategic cash.

Daily cash is, as might be expected, used for day-to-day transactions and expenses. Operational cash is intended to fund key short-term activities such as acquisitions, and to provide a backstop for daily cash should it ever be needed. And the strategically defined cash element may be deemed either as investment or reserve cash, but either way is typically a resource held either for longer-term investment opportunities or to meet future obligations.

Optimising these is an essential part of effective treasury management. This is why, however cash is ultimately allocated, segmentation has "always been an important financial tool", states Akhal. Segmentation's proper execution ensures that funds are selected and allocated successfully to meet specific client needs. But in the current macroeconomic environment, characterised by heightened uncertainty and fluctuating interest rates, she observes that the importance of cash segmentation has "increased significantly".

Investors needs are typically guided by the four key investment drivers (see Figure 1). These drivers tend to be somewhat fluid, depending on variable inputs such as policy and, as we are seeing, economic environment. Indeed, comments Akhal: "Investors are now more focused on maintaining liquidity while also seeking yield, making it essential to have a clear strategy for managing cash effectively."

> *"Customers can define a target allocation and benefit from a range of products, from short-term MMFs to short-term bond funds."*

Products for all

Amundi's product set is guided by the needs of its clients, says Akhal. "Our offer covers the full range, guided by three fields of expertise. This enables us to answer very specific investor needs, as they emerge."

At a high level, Amundi today provides fund access within the short-term money market for daily cash needs, the standard money market for operational cash requirements, and beyond liquidity strategies (including ultra-short-term bond market, for example) which meets clients' strategic cash requests.

For Carletto, as a money market portfolio manager, it is extremely important to recognise and understand clients' differing needs. "The investment horizon determines our management," he explains. "Within the two categories of money market funds [MMFs] – short-term money market funds and standard money market funds – identifying each client's investment horizon will be crucial in guiding them towards the right product."

It's important to note that the European Money Market Regulation, which took effect in July 2018 for new funds, and in 2019 for existing ones, imposes specific liquidity criteria, adds Carletto. Here, for instance, he explains that Variable NAV funds, which are valued at full mark-to-market, must maintain 7.5% liquidity on a daily basis and 15% weekly. On the other hand, LVNAV funds, which value part of their portfolio at amortised cost, have different requirements—10% daily and 30% weekly.

The regulations also include a criterion for assessing credit risk, another requirement in terms of weighted average life (WAL) and weighted average maturity (WAM), and, of course, knowledge of liabilities, which determines liquidity buffers. With all Amundi MMFs offering day-value liquidity, without notice or penalty, "cash segmentation is now all the more important", states Carletto. And a deep knowledge of its outcomes enables the investment manager to adapt and optimise its portfolio, credit duration, and interest rate policy accordingly.

As an example, Carletto suggests that a client with a short time horizon – perhaps just a few days – will have "absolutely no interest" in a product that takes an interest rate risk, in that it is invested at a fixed rate in an inverted yield curve. "Such an investment would deliver a return below the overnight level," he cautions.

With Amundi clients "looking for liquidity at all times, and a recognised cash and cash equivalent investment", investing in a liquidity instrument that offers strong diversification is recommended. To achieve this, Carletto says that management must deliver a performance in line with market conditions, while offering the most stable performance possible. "This is why we spread our investments over all maturity segments in order to deliver regular performance and low volatility," he reveals.

Meeting ever-changing needs

But client requirements continuously evolve, and the investment offering must keep pace. For Akhal, these needs may be subject to several factors, including market volatility, interest rate changes, and regulatory pressures. "Larger institutional clients often require more sophisticated liquidity solutions and risk management strategies, while smaller clients may prioritise simplicity and ease of access," she notes. "However, all have in common the need for liquidity and security."

Since 2022, positive rates have been back on the table. Many investors will seek to ensure that the return on their cash is positive, with bank deposits and MMFs on the agenda once more. However, ongoing economic and geopolitical uncertainties play into the hands of MMF users.

Carletto explains that MMFs are products primarily used in two situations. The first is to generate cash flow, which is the most common use; the second is to offer investors a holding position. "The latter occurs when there is a crisis. In 2008, for example, MMFs were heavily subscribed. They acted as a safe haven for investors," he says.

Akhal too, mindful of 2008's global financial crisis, draws attention to how the MMF industry has been further stabilised with the introduction, for example, of the European

FIG 1 | THE FOUR KEY INVESTMENT DRIVERS

Safety and liquidity:
Clients prioritise investments that preserve capital and offer easy access to funds.

Yield:
While safety is paramount, clients may seek investments that generate some return, especially for excess cash.

Regulatory compliance:
Certain industries or individuals may have specific cash management requirements to adhere to regulations.

Risk tolerance:
Clients' comfort levels with market fluctuations vary, impacting their choice of cash investments.

Securities and Markets Authority (ESMA) in 2011, and the EU's MMF Regulation, which came into effect in 2019.

With fund investment limits and criteria, the aforementioned liquidity ratios, internal credit assessments, and increased transparency, she says the raft of rules and increased governance in recent years has sought to reassure investors not only that the quality of the assets is sufficient but also that their investments correspond with their needs.

A secure home

Of course, there are still banking bumps in the road to navigate. Here again MMFs have added value. The 2023 collapse of SVB, and later Credit Suisse, in particular drove investors towards so-called govies – MMFs invested in bonds issued or guaranteed by Eurozone governments – as they sought to decouple from perceived banking risk.

"As a fund manager, it is important to appreciate the context of investment on both sides," comments Carletto. "We also carry out the segmentation of cash in a similar same way to our clients. We allocate pockets of cash or short liquidity of varying sizes, depending on the market and our clients' expectations. For example, a few weeks before dividend payments, we will record large subscriptions. We then invest this surplus short-term liquidity, and monitor the liquidity profile of the funds, in order to be able to cope with the outflows that will occur at the time of payment."

The same approach applies in the event of a fall in interest rates, which is the current trend in many markets. Carletto explains that some clients, which had placed their strategic cash in the shortest asset class, in a holding position, can reallocate to higher-yielding solutions.

Stéphanie Akhal
Head of Liquidity Solutions Business Development, Europe, Amundi

"Our management adapts by modelling these future flows, and adapting the average life of the portfolios. At the same time, our sales teams provide a 'relay' by attracting new clients looking to invest their operating cash or daily cash."

As might be expected, variations in segmentation approach exist – across different geographical areas, for instance. "But that's exactly what we're looking for," states Carletto. "Liability management involves getting to know your customers and diversifying your investor base. In this way, we avoid being dependent on certain cycles (tax or indemnity payments, for example)."

Segment and succeed

There are several compelling reasons for clients to segment their cash, notes Akhal. These include:

- Enhanced liquidity management. By categorising cash in the ways discussed above, clients can ensure that they have immediate access to funds for operational needs while also setting aside reserves for longer-term investments.
- Risk mitigation. Segmentation enables clients to better manage risks associated with market fluctuations and interest rate changes by diversifying their cash holdings across different instruments.
- Yield optimisation. Clients can strategically allocate cash to different segments to take advantage of investment horizons, thereby maximising returns on their liquid assets.
- Regulatory compliance. For corporate investors, cash segmentation can help meet regulatory requirements related to liquidity and risk management.

"With visibility over their cash, through segmentation, customers can define a target allocation and benefit from a range of products, from short-term MMFs to short-term bond funds," says Carletto.

"It should also not be forgotten that by investing in an open-ended fund, clients immediately gain access to a very high

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level of risk diversification (MMFs may not hold more than 5% of any one issuing group – part of the EU 2019 regulation referred to above, covering investment limits)."

For Amundi, as a fund manager, client cash segmentation also enables it to spread its incoming investments over different maturity segments. "We stress the liabilities, monitor them by client-type and can ensure a permanent liquidity profile, while capturing credit premiums on maturities of up to two years," notes Carletto.

On trend

Segmenting the time horizon of their cash needs is always a valuable exercise for investors. It continues to enable them to manage their risk, and optimise their returns, in a dynamic and, at times, challenging environment. Within that scenario, Carletto contends that money market products "meet specific needs, so it is important for clients to be able to switch from a product that is 100% uncorrelated with banking risk, such as a short-term govies fund, to a more credit-based product".

Risk is not the only driver. Cash segmentation today includes a growing emphasis on operational and strategic cash management streams, notes Akhal. "Among the key segments, operational cash is increasingly being optimised for efficiency, as clients seek to streamline their day-to-day cash flows," she reports. "Strategic cash, on the other hand, is gaining attention as investors look for ways to deploy excess liquidity into higher-yielding opportunities.

Overall, she sees a trend towards a more dynamic approach to cash management, "where clients are actively managing their cash positions in response to market conditions". That core capability, she suggests, is facilitated in part by segmenting cash.

Patrick Carletto
Head of Money Market Investment Strategy, Amundi

A constant companion

The cash segmentation priority for most investors today, notes Carletto, is to ensure liquidity at any time, "without being subject to penalties nor notice periods". For fund managers, diversification and knowledge of liabilities are an essential component of client success. "They enable us to optimise each client's portfolio structure, and offer an attractive return without volatility, while maintaining daily liquidity, whatever the market environment."

The appetite for different fund types is, of course, shifting in response to the current interest rate environment. Akhal therefore observes that short-term funds are becoming more attractive as investors seek to maintain liquidity while earning competitive yields.

"Standard funds are also seeing more interest, particularly among clients looking for a balance between risk and return, while considering the cash & cash equivalence constraint", she reports, adding that ultra-short-term bonds are also gaining traction "as they offer a way to capture yield without locking in capital for extended periods".

As interest rates fluctuate, investors should continue reassessing their preferences according to their segmented cash drivers. With a potential increase in demand for funds that provide both safety and yield, Akhal says Amundi can be a "valued partner throughout the cash flow cycle".