IN BRIEF

At a pivotal moment on a number of fronts—regulatory, interest rate and economic—around the globe, more investors are reassessing their short-term fixed income investment policy statement (cash IPS) and putting into place the strategies and solutions that can best help them navigate a changing environment. A cash IPS lets an organization define its short-term investment objectives and the strategies for achieving them. It creates a sound foundation and promotes consistent, long-term discipline in decision-making through all market conditions, so that crucial liquidity and investment goals may be met.

CRITICAL COMPONENTS OF A CASH IPS

- Risk tolerances
- Portfolio benchmarks
- Permissible investments
- Treatment of realized gains/ losses
- ESG requirements, if any

3 The components of a cash investment policy statement: Building out the policy

Instituting a cash IPS begins with inventorying cash flows, defining liquidity targets and determining short-term fixed income investment objectives for your organization's cash that will guide cash segmentation. From those foundations, the IPS becomes more detailed, specifying acceptable levels of the many types of risk—for and within each segment. An organization can choose to have a higher-return strategic cash allocation; however, because higher returns come with a higher level of risk, this decision and its trade-offs should be well understood (even if quantifying the risk is difficult), agreed upon and documented within the IPS.

Begin with a cash flow inventory

From that fundamental premise, we expand below on the variety of important risk factors to consider as critical components when building out a cash IPS. In addition, we explore five related components: permissible investments, benchmarks, realized gain/loss treatment, duration strategies and sustainability (ESG) parameters, if any.

Risk tolerance is the most important issue. To examine various risks, which we enumerate below, we recommend considering these questions to clarify the organization's tolerance for various types of risk and volatility:

Constraints What is the organization's tolerance for the possibility it could be unable to raise cash for a chosen purpose—that its liquidity could be constrained?

Fees How does it view the prospect of having to pay a liquidity fee in times of market stress?

Interest rate volatility How sensitive is the organization to unrealized portfolio losses due to interest rate volatility?

MAJOR TYPES OF RISK

INTEREST RATE RISK: This is the risk a security's value will change because of a change in prevailing interest rates. The operating, reserve and strategic segments may each have distinct tolerances; of the three, operating cash is likely to have the lowest interest rate risk tolerance, making it the least able to generate a high yield. The reserve segment generally has more flexibility and duration appetite. **The strategic segment offers the most flexibility and assumes the highest level of tolerance for interest rate risk.**

LIQUIDITY RISK: This is the inability to raise cash for any purpose—in an extreme case, possibly requiring sales of illiquid assets or even making it impossible to meet a debt payment (leading to default). A cash IPS will stipulate ample liquidity, through investing in short-dated maturities, so an organization won't be forced to sell longer-dated securities to meet cash needs. In considering liquidity risk tolerance, think about how the organization views the prospect of a money market fund imposing a liquidity fee, or "redemption gate," in a time of market stress.

CREDIT RISK: This is the risk that a fixed income security's value will change due to a rating downgrade or because of a credit risk default. Credit quality is central to all fixed income investing. A security with a lower credit rating typically adds yield to the portfolio, but it also adds an element of risk. The IPS defines the minimum credit quality of individual securities; however, **having an average credit quality limit on the portfolio as a whole may be just as important, to ensure credit quality diversification.**

LOSS OF PRINCIPAL RISK: If an organization invests in a longer-duration cash product and an event provokes a major downturn, perhaps volatility in floating NAV, loss of principal is possible. The cash IPS should define whether the organization can accept some level of short-term volatility, and the degree to which it requires steady dividend income and wants to diversify its investments.

Negative returns Could it tolerate negative total returns over the short term to achieve potentially higher returns longer term?

Realized gains/losses What is the "bandwidth" for acceptable net realized gains/losses in a given period? An effective IPS considers these matters, defining acceptance levels for, among others, three major types of risk in a portfolio: interest rate risk, credit risk and liquidity risk.

Several further components of the IPS related to risk tolerance should also be factored in:

1 PERMISSIBLE INVESTMENTS

While different countries will have different investment options, the "permissible investments" section of a cash IPS defines the types of securities allowed, along with parameters for credit quality, maturity and diversification. It should be updated periodically to reflect market changes and the organization's evolving investment philosophy. Along with permissible investments, the IPS should specify the course of action if a security or issuer is downgraded or has different ratings from rating agencies.

2 BENCHMARKS

Portfolio benchmarks express the organization's goals for its cash portfolios, providing mechanisms to track performance, define risk limits and communicate clearly to, for example, an advisory committee, senior management and external asset managers. Choose transparent benchmarks that are easy to understand, clear in their composition, publicly available and, most important, that mirror the investment strategy for which they will serve as yardsticks.

3 REALIZED GAIN/LOSS TOLERANCE

An IPS should define an organization's tolerance (if any) for realized portfolio gains or losses, on a net or absolute basis, on a per-month or per-quarter basis. This will provide clear internal parameters for acceptable performance and may give the investment manager more flexibility to help enhance return. As there are no set standards, the definition of realized gain/loss tolerance should evolve to reflect an organization's circumstances, drawing on input from finance and accounting departments.

4 DURATION STRATEGIES

An IPS should articulate duration strategies (which will differ for each cash segment). It should delineate whether the approach in each case will be a target duration or a buy-and-hold strategy. A target can create more active trading, triggering higher costs, as well as higher levels of interest rate risk during a rate-hiking cycle. Buy-and-hold strategies are more appropriate for capital preservation, a short-duration portfolio and when liquidity is the key objective.

5 SUSTAINABILITY (ESG) PARAMETERS

Some organizations will factor in values-based screening or "impact" investing themes—also called sustainability or environmental, social and governance (ESG) parameters. A cash IPS might, for example, restrict the purchase of securities because of an issuer's energy use.

BUILD STRONGER LIQUIDITY STRATEGIES WITH J.P. MORGAN

Rigorous credit and risk management, combined with access to J.P. Morgan's global resources and expertise, help us to deliver the most effective short-term fixed income solutions for our clients.

Global coordination, lasting partnerships

- Harness the power of our research-driven, globally coordinated investment process, led by our dedicated team of liquidity professionals.
- Make investment decisions based on actionable insights from our senior investors, and build portfolios based on the output of proprietary benchmarking tools.
- Select from a breadth of outcome-oriented solutions designed to help you build the most effective liquidity strategy.
- Tap into the award-winning innovation and success of one of the world's top liquidity fund managers, with over 30 years of demonstrated results across market cycles.

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