CASH MANAGEMENT TRUSTS — THE FIRST THREE YEARS

by

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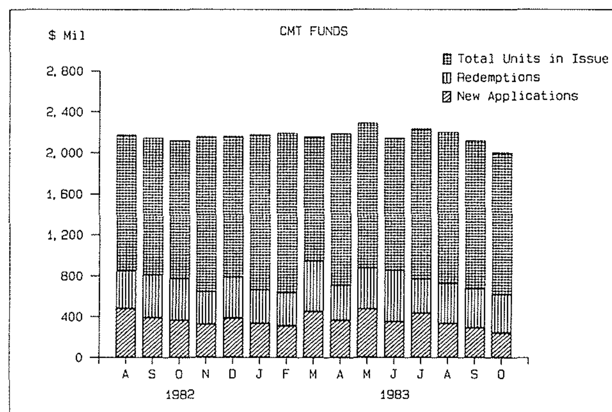
December 1983 sees the third anniversary of the Cash Management Trust Industry. The objective of this article is to review the past three years and comment on some of the issues that have been raised about the industry. The first two years saw a prodigious growth with over $2 billion in deposits. Hill Samuel, the first CMT in the market place, reported nearly $900M funds on deposit.

Nevertheless, the growth was not steady. The first major surge, in 1981, occurred when CMTs were criticised by the Prime Minister at the time, Malcolm Fraser, as being an almost unpatriotic form of investment. No advertising campaign could have been more successful, and money poured into the CMTs. The second major surge occurred in 1982 when money market rates reached 24 per cent and for the first time ever the household investor could obtain over 20 per cent for a $2,000 at call investment. Over the past six months, as Chart 1 clearly shows, funds growth stabilised and then declined. Hill Samuel's funds on deposit have now fallen to under $550 million.

Critics of CMTs, namely their competitors, are now predicting their demise. The first section of this analysis attempts to establish the validity of such claims.

Chart 1



It was Keynes who first suggested the three reasons for handling cash, namely the transactional, the precautionary and the investment.

Transactional cash balances are those that are held to effect the normal transactions that we all make in our normal day to day lives. Typically they would be represented by the physical coin and note and funds held in current accounts in Trading Banks (Ml in Australia).

Precautionary balances are those that are held for future emergencies. By their nature precautionary balances are seldom required but when wanted the need is often immediate. Precautionary funds may be held in current accounts where they earn no interest or placed with institutions that offer a return combined with instant or 24 hour availability. Typical repositories for precautionary balances have been the savings banks and building societies. Over the past 20 years the rise in interest rates has seen the shift of these precautionary balances from current accounts to interest bearing accounts.

Investment balances are those that are invested for some finite period of time. With these balances the investor is concerned more with risk and return and is willing to substitute marketability of the asset for liquidity. Indeed the effective working of a secondary market is a critical ingredient for success. The typical avenues for investment have been shares, property and fixed interest securities such as Commonwealth Bonds. Approximately $300 million is invested every week in Australia. The competition for these funds is fierce, and the relative merits of the various avenues of investment change over time.

Since 1965, a fourth avenue of investment in Australia, namely the short term money market, has been added to the shares and fixed interest. Originally restricted to the large institutions to balance flows of liquidity, the short term money market has shown explosive growth over the past 15 years.

Cash Management Trusts may thus be perceived as having two roles: a repository for precautionary balances and an alternative investment medium for the small investor into the short term money market. No additional surveys are publically available for Australia but a survey was carried out in the USA by the Investment Company Institute (the American association for all unit trusts and mutual funds) to try to find out why people invest in CMTs. The results were illuminating.

Purpose of Deposit

Long Term Savings	51 per cent
Short Term Cash — High Yield	24 per cent
Awaiting other Investment	21 per cent
Other	4 per cent

The amount of funds invested should not be confused with the number of investors. The majority of Cash Management Trusts have set a minimum of $2,000 and the majority of their investors have probably invested precautionary balances but of the total funds invested the majority (say 6 per cent) is probably for the longer term.

Cash Management Trusts are in fact poorly named. In the USA they are known as money market funds which reflects less the precautionary balance motive and more the investment motive. The CMTs have provided a mechanism whereby an investor gererally from the household sector may gain access to the money market. In the same way as property and equity trusts, CMTs offer the convenience and safety of becoming part of a portfolio.

What then of the future of CMTs? As a repository for precautionary balances their future is limited. The key to obtaining a precautionary balance is the link to a transactional account. In the USA the link has been achieved via the $500 minimum redemption cheque. In Australia, only the Australian Liquid Assets Trust via the link with the Australian Bank, has this ability and probably 10 per cent of the growth of ALAT is due to this automatic linkage. As the other trading banks begin to offer similar facilities in a more deregulated environment, particularly via the use of computers and automatic teller machines, the inflow of precautionary balances into CMTs will decline.

However, in the same way that a pension fund invests 5-15 per cent of its funds in the money market depending on the state of the various alternative investments, it is possible to envisage that a similar strategy of diversification of assets will occur in the household sector. Currently about 1.5 per cent of the investment dollar is held in CMTs so it is possible to envisage substantial future growth.

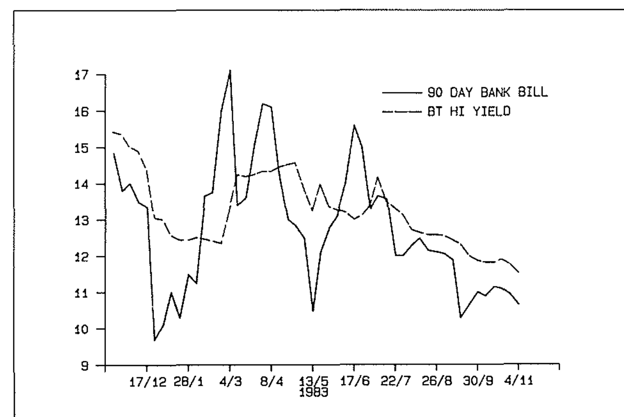
Nevertheless, this future growth will be cyclical in nature depending on the relative attractiveness of the various alternative investments. In the long term money market rates and hence CMT rate should be above those of other at call investments which traditionally work on fatter margins.

The other factor which will adversely influence the relative growth of CMTs is the difference in interest rate flexibility of the various competitive products.

The competitive products to such as ABSs, cashable semi-government bonds like those offered by Telecom and the West Australian Central Borrowing Authority, and six month Finance Company debentures, building society and bank call and term deposits all move in ratchet steps. The primary reason is all the competitive products have some degree of government regulation. For example, the prospectus provisions delay the finance companies, and ASBs are under a tap system which varies volume but not the rate.

In a climate of rising short term interest rates CMTs by following the money market on a daily basis are in a strong competitive position. In a declining market however, the CMTs are in an unfavourable position. The problem is further compounded in that the rates traditionally fall in a period of economic recession. This means that the traditional avenues of investment such as business loans, hire purchase for consumer durables, leases and mortgages all have low demand. In consequence all the institutions which service these areas are flush with cash and so invest on the short term money market. The result of this further supply on to the market is a further decline in money market yields, which leads to a vicious circle with even more outflow from CMTs.

Chart 2



A phenomenon that became particularly apparent over the past year was that of "hot money". As Chart 2 shows the CMT yield was a good approximation for the 90 day bank bill moving average. What happened to all CMTs, was that as bank bill rates rose above CMT yields larger investors would redeem funds and buy bank bills further widening the relativity. Then when bank bills rates fell below CMT yields the capital gain would be taken and the funds re-invested back into CMTs. Now that the rates have stabilised this effect has diminished.

The USA survey mentioned previously also asked investors to rank the important features in choosing a CMT. The results were as follows:

High Yield	79 per cent
Ease of Withdrawal	13 per cent
Safety	12 per cent
Low Initial Deposit	5 per cent
Other	15 per cent

As can be seen high yield is by far and away the most important factor in choosing a CMT. In Australia the high yield would probably be even more important as there are now only 15 CMTs and the results are published daily in many newspapers as a league table. No other product in Australia has the "price" of competitive products independently published in such a format. Even the Treasury supports the yield view. In November 1983, Rounding Up of Economic Statistics, the monthly take up of Australian Saving Bonds was demonstrated to be most sensitive to the competitiveness of the ASB rate and Jingoistic appeals to patriotism and peer-group pressure have little affect.

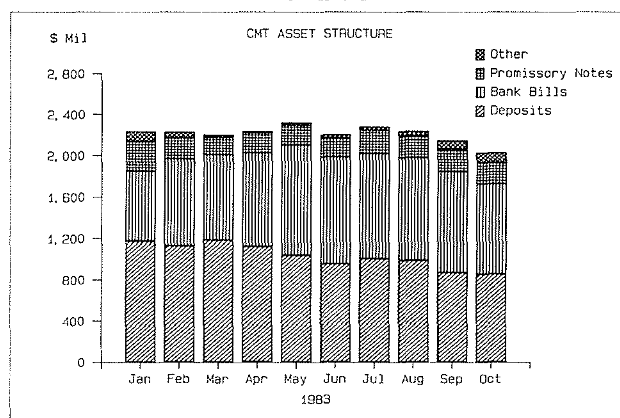
Over the past three years much time and effort has been spent by the medium and several CMT managers on the security and liquidity of CMTs. Now that the Australian Bureau of Statistics is publishing industry details it is worth passing comments on these two issues.

Security of CMTs

One of the big misconceptions about security of CMTs is that investing only in government and bank guaranteed securities has significantly reduced the risk to the investor. The validity of that argument is very weak. Most funds are of sufficient size that they can obtain wide diversification. A Bill of Exchange is theoretically less secure than a T-note but a portfolio of Bills is only slightly inferior in security than a portfolio of T-notes. As T-notes are deemed riskless, there is no diversification value in holding a portfolio of them while there is considerable diversification of risk in a portfolio of Bills. Bills are, of course, obligations of the Australian banking system and, therefore, one is easily tempted to take the supposed interest rate risk in these securities vis-a-vis T-notes.

In addition, history is replete with examples of governments and authorities defaulting. In the 1930s, the N.S.W. Government calmly reduced principal repayments on all outstanding bonds by 10 per cent and recently a USA municipal electrical authority, the Washington State Public Power Supply System, defaulted on $2.4 billion of bonds issued to the public. The only real protection that a management company has is to diversify its portfolio of securities.

Chart 3



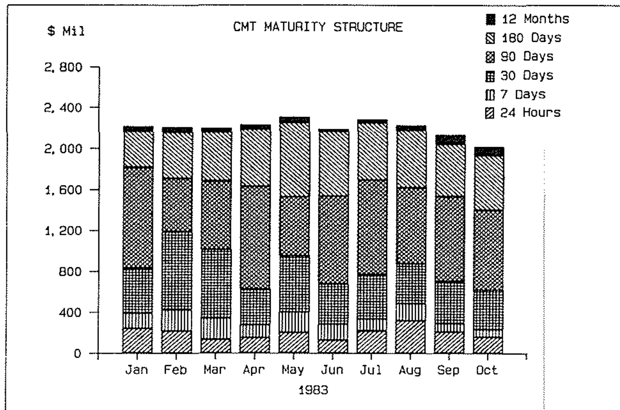
As can be seen in Chart 3 the asset structure is much as one would expect. In early 1982, CMTs stayed short and invested in short term price deposits, and then switched into bank bills in the second quarter. Promissory Notes stayed relatively stable throughout. Thus although there has been much posturing about investment in government backed securities, the investment has been minimal. Inspection of the prospectuses for the various CMTs that explicitly promote this viewpoint, and show that only up to 10 per cent of the total portfolio is invested in Commonwealth securities.

Liquidity of CMTs

Chart 4 showing the industry maturity structure is also revealing.

In the major business magazines such as BRW, Australian Business, Personal Investor, the CMT tables generally contain a column with average term to maturity. The average maturity indicates the degree of market risk involved in the portfolio. Market risk is the risk associated with interest rate rises which may result in an erosion of the value of the underlying securities previously purchased at lower interest rates. It was

Chart 4



often implied that "short" CMTs were *much* safer than "long" CMTs. This is because "short" CMTs turn over their investments more quickly and the effect of rate rises or falls is minimised. Another risk often quoted is that large depositors can quickly withdraw funds at any time and also the risk that many investors may wish to withdraw their funds on the same day.

It is true that interest rate changes may cause capital losses and for long dated securities such as 15 year bonds issued by semi-government authorities this is a considerable risk. A 1 per cent rise on a 20 year bond means a 10 per cent capital loss. However, for very short instruments such as money market bills the market risk is minimal. For example, a 45 day bill would lose 0.12 per cent of its value if interest rates went up by 1 per cent while for a 90 day bill the capital loss would only be 0.24 per cent. Such figures are negligible and in the case of any termination, a CMT would have sufficient time to mature all its investments. By their very nature, money market instruments are very liquid and not susceptible to capital loss if held to maturity; that is why they are so popular with professional investors.

It should also be remembered that the average term to maturity is just that — an average. It does not show the skew of the distribution. A small percentage of investments at one year can move up the average noticeably.

If we go back to the chart we can see this effect. In January CMTs had an average maturity of 45 days. 9 months later with an almost imperceptible increase in 6-12 months paper the ATM increased by 25 per cent to 60 days.

The Profitability and Breakeven Point of CMTs

Much comment has also been made in the media about the profitability of CMTs and estimates about breakeven points. Fortunately the answer to this question is provided in part by the CMT managers themselves. Most CMTs are managed by separate entities that need to disclose profits. A summary of those that reported on an individual basis are given below (relevant dates are in brackets).

Trust	Fund Size $ Million		Profit of Management Company	
AFT	$185.6	(30/6/82)	$ 39,201	(30/6/82)
ALAT	$236.5	(31/8/83)	NIL	(31/8/83)
BA	$139.1	(31/12/82)	($207,868)	(31/12/82)
BT Hi-Yield	$ 25.6	(31/12/82)	($311,875)	(31/12/82)
City Mutual	$103.6	(30/6/83)	($873,119)	(30/6/83)
Hill Samuel	$791.7	(30/3/82)	$527,560	(30/3/83)
RoyAust	$ 81.9	(30/4/83)	($ 1,500)	(30/9/81)
Potter Partners	$102.9	(30/6/82)	($ 5,309)	1982
Tricontinental	$145.0	(31/3/83)	$171,253	(30/6/83)
Were	$ 48.5	(30/6/83)	$ 4,688	(30/6/83)

The above results indicate that the profitability of a CMT is quite low and that for the usual structure of a $2,000 initial deposit and 0.75 per cent management fee and minimal advertising the breakeven point would be around $125 million. This is because the profitability of a CMT is mostly determined by the transaction costs wich are in turn determined by the average deposit size and transaction volume. In the case with which this writer is most familiar, the BT Hi-Yield Trust, the breakeven point is $52.5 million due to the fewer number of depositors — the minimum deposit is $10,000 and reduction in volatility caused by being the only CMT that charges a 0.25 per cent redemption fee on funds redeemed within 30 days of deposit. CMTs run by stockbrokers have a lower breakeven point probably because of lower administration costs and a smaller portion of the management fee is used up in commission.

Conclusion

The rationalisation of the industry will no doubt continue under the pressure of low profitability. In a climate of rising short term interest rates, CMTs by following the money market on a daily basis are in a strong competitive position as regulated rates rise more slowly, but in the current climate of declining interest rates, CMTs are in an unfavourable position. Nevertheless, flexible reaction to the market by CMTs make them intrinsically safer investments.

Thus over the next year one sees decline for the industry followed by another period of potential growth in 1985/86 if the next credit crunch eventuates.