Aligning Allocations With Expected Cash Needs Is Critical

Investment tiering offers a simple but powerful approach.

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KEY INSIGHTS

- We believe many investors may be overlooking opportunities to improve yields and/or enhance liquidity in their cash or short-term allocations.
- In our view, investors should consider two key factors when structuring short-term allocations: their anticipated future cash needs and their tolerance for risk.
- Our recommended approach is for investors to tier or align their short-term allocations based on the expected time frames for their future cash withdrawals.

For most individual investors, it makes sense to include a highly liquid short-term allocation in their portfolio to meet near-term cash needs, provide a reserve against unexpected loss of income, or take advantage of attractively priced investment opportunities as they arise.

Highly liquid assets may be invested in a variety of short-term vehicles, including bank savings accounts and certificates of deposit or investment products such as money market mutual funds and low-duration fixed income funds.

While individuals should review their portfolios periodically to determine whether their longer-term allocations are still aligned with their objectives, we believe many investors may be overlooking their cash or short-term allocations. As a result, they may be missing potential opportunities to improve yields and/or enhance liquidity.

In our view, two key factors should be considered when structuring short-term allocations: anticipated cash needs and risk tolerance.

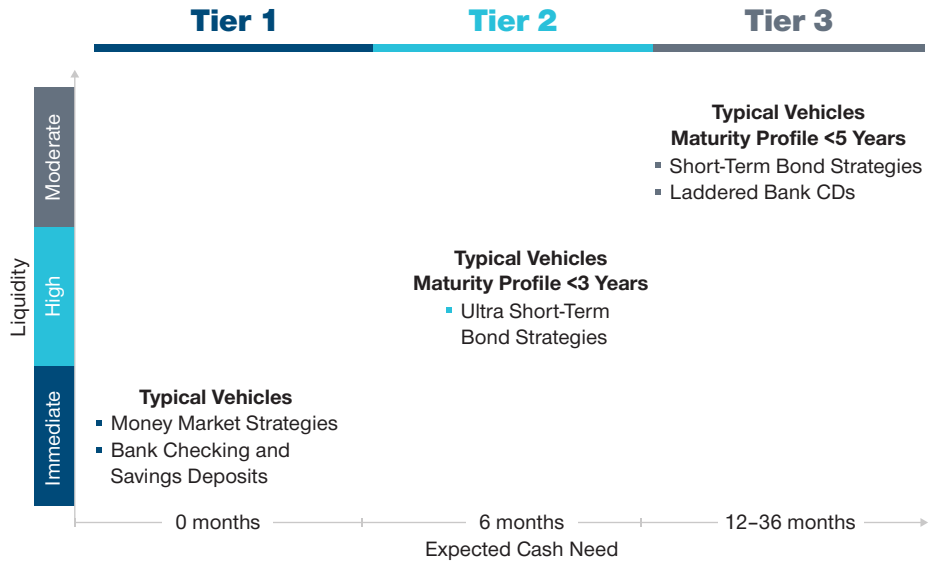
How much risk the investor is willing or able to take should be determined by their expected short-term cash needs or their desired buffer against unexpected financial setbacks. An investor saving for a down payment on their first house, for example, is likely to have a shorter time horizon and a lower tolerance for risk than an investor saving for retirement.

Creating a Tiered Liquidity Structure

Our recommended approach to short-term liquidity management is to tier or align the assets in your short-term allocation based on the anticipated time frames for future withdrawals. Investment tiering is a simple and yet powerful concept and can be applied to many different situations. Figure 1 outlines the basic concept as well as some of the investment vehicles typically used in each tier.

(Fig. 1) Creating a Tiered Liquidity Structure

Investment tiering is a simple yet powerful concept.



Source: T. Rowe Price.

> ...money market mutual funds offer the greatest level of flexibility and the highest level of principal protection and liquidity among the available investment products.

Tier One

As highlighted in Figure 1, funds to meet an investor's immediate cash needs would fall into tier one. This bucket should include an investor's most liquid vehicles, assets that he or she could reasonably expect to access at any time.

Many investors rely on bank checking, money market, or savings accounts to hold their most liquid funds. While these accounts are insured (up to USD 250,000) by the Federal Deposit Insurance Corporation (FDIC) against the risk of bank failure, and their principal values do not fluctuate as interest rates rise or fall, the interest they accrue typically is significantly lower than the yields on longer-term bank instruments such as certificates of deposit (CDs). Moreover, bank depositors may need to maintain high minimum balances to keep the account open.

Money market mutual funds are a popular alternative to bank accounts as vehicles for liquid cash reserves. In general, there are three types of money market mutual funds available to individual investors—U.S. Treasury, government, and retail prime funds. In our view, money market mutual funds offer the greatest level of flexibility and the highest level of principal protection and liquidity among the available short-term investment products.

While money market mutual funds do not guarantee an investor's deposit like an FDIC-insured bank account or CD, U.S. Treasury and government money market funds are required to invest at least 99.5% of their assets in fixed income securities backed by the full faith and credit of the U.S. government.

Tier Two

Funds for near-term cash requirements—which we would define as cash needed within the ensuing six to 12 months—make up tier two of a short-term allocation. Tier-two investments also may include money market mutual funds, but more typically they are invested in low-duration fixed income vehicles such as ultra-short-term and short-term bond funds.

> ...ultra-short-term bond funds provided the most attractive yield and duration combination among the alternatives shown here as of March 31, 2019.

Ultra-short-term and short-term bond funds are professionally managed fixed income portfolios that invest in a broadly diversified set of fixed and floating rate bonds. These holdings may include government debt, securitized debt, or corporate bonds. The T. Rowe Price Ultra Short-Term Bond Fund typically invests in securities with maturities of six months to one year, while the T. Rowe Price Short-Term Bond Fund typically invests in maturities between 1.5 and 2.3 years.

Compared with money market mutual funds, ultra-short-term and short-term bond funds offer investors high to moderate levels of liquidity, plus the potential to obtain higher yields and performance with the addition of interest rate risk and credit risk.

Tier Three

Longer-term liquidity needs (cash required beyond the next 12 months but before the end of the next 36 months) could be funded by assets in tier three. Typical tier-three vehicles could include bank CDs or short-term bond funds.

Bank CDs generally offer competitive rates, but they also require investors to set aside or lock up their savings for a specified period. If the investor's cash needs change, early withdrawals typically are subject to penalty. Investors can seek to reduce that risk by investing in multiple CDs with different maturities. "Laddering" CDs in this way may help improve liquidity but also could reduce the average yield on the investor's tier-three assets.

Like ultra-short-term bond funds, short-term bond funds can combine high to moderate levels of liquidity with moderate levels of principal risk. The somewhat longer duration of these funds potentially can improve yields while adding only a modest degree of additional interest rate risk to principal compared with ultra-short-term bond strategies.

Laddered Portfolios

Some investors prefer to manage and own their fixed income investments by creating laddered portfolios of short-term securities, such as Treasury bills. As with bank CDs, these portfolios can be structured to include different maturities, providing liquid access to cash over different periods. Funds not needed immediately can be rolled from maturing securities into newly purchased ones.

If done properly, investing directly in laddered fixed income assets can generate relatively attractive yields. However, like investing in individual stocks, investing in individual fixed income securities may require a degree of skill on the part of both individual investors and their brokers. Constructing and maintaining laddered portfolios also may require a significant time commitment to research and monitor securities.

Comparing Alternatives

Figure 2 compares average yield and duration (a measure of sensitivity to interest rate risk) for each of the short-term vehicles discussed above. As highlighted in the chart, money market accounts offer relatively high liquidity and typically provide higher yields than bank checking and savings accounts.

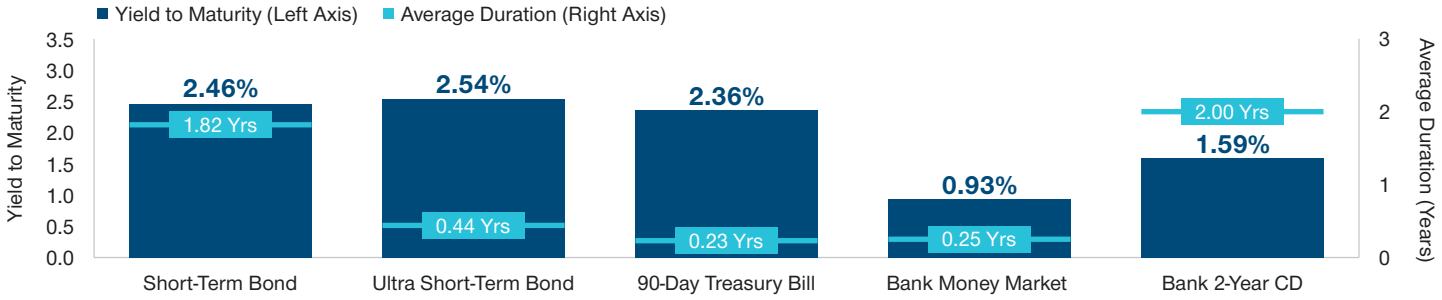
While two-year bank CDs typically feature competitive yields, on average, relative to low-duration vehicles such as money market funds, they also require investors to lock up their funds for those same two years or face early withdrawal penalties.

Although three-month Treasury bills provided somewhat higher yields compared with money market accounts, directly investing in individual fixed income securities poses its own challenges—as noted above—and we believe should be reserved for more experienced investors.

In our view, ultra-short-term bond funds provided the most attractive

(Fig. 2) Comparing Short-Term Investment Vehicles

Yield to Maturity and Duration[1], as of March 31, 2019



Short-Term Bond: Bloomberg Barclays 1-3Yr US Gov't\Credit Bond Index; Ultra Short-Term Bond: Bloomberg Barclays ST Gov't/ Corporate Index; 90-Day Treasury Bill: ICE BofAML US 3-Month Treasury Bill Index; Bank Money Market and Bank 2-Year CD: Averages for non-jumbo accounts (<$100,000) as reported by the FDIC.

Sources: Bloomberg Index Services Limited (see Additional Disclosures); ICE BofAML (see Additional Disclosures); FDIC.

[1] Duration measures sensitivity to interest rate changes. The duration of the bank CD is the lockup period.

yield and duration combination among the alternatives shown here as of March 31, 2019.

Conclusions

With the Federal Reserve indicating that it does not expect to raise interest rates for the remainder of 2019, and the Treasury yield curve (the spread between shorter- and longer-term interest rates) flat or even inverted out to five years, this may be a good time for individual investors to review their cash and short-term allocations to see if they are still appropriate given their financial needs and objectives. Investment tiering is a simple but powerful concept that investors can use to align their assets with their expected cash needs.

In our view, individual investors are most likely to benefit from short-term allocations that combine relatively low fees, competitive yields, high levels of liquidity, and limited exposure to interest rate risk. We believe most investors would do well to avoid illiquid vehicles or lengthy lockup periods, especially if there is a significant possibility that their financial situations and/or cash needs may change in the near future.

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Ultra short-term bond funds and short-term bond funds are subject to credit risk, liquidity risk, call risk, and interest-rate risk. As interest rates rise, bond prices generally fall. The funds involve more risk than a money market mutual fund and are not subject to the same diversification and maturity standards. The net asset value (NAV) will fluctuate, and investing in these products could result in the loss of principal.

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