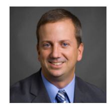
How a Tiered Strategy Can Help Meet Short-Term Cash Needs

Optimize short-term liquidity and yield by tiering investments.

April 2023

KEY INSIGHTS

- Our recommended approach to short-term liquidity management is to align, or tier, short-term allocation assets with the expected time frames for withdrawals.
- Investors should consider two key factors when structuring short-term allocations: anticipated cash needs time frames and risk tolerance.
- When determining short-term allocations, look for those that have relatively low fees, competitive yields, high liquidity, and limited interest rate risk.



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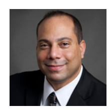

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For most investors, it makes sense to have a highly liquid short-term portfolio allocation to meet near-term cash needs, provide an "emergency fund" reserve against unexpected loss of income, or take advantage of attractively priced investment opportunities as they arise. There are a variety of ways to invest for short-term needs and goals, including bank savings accounts and certificates of deposit (CDs) or investment products such as money market mutual funds and low duration[1] bond funds.

It's important for individuals to periodically review their full portfolios—including any short-term allocations—to determine whether their investments are still aligned with their objectives. If not, they may be missing potential opportunities to improve yields or enhance liquidity.

We believe investors should consider two key factors when structuring short-term allocations: anticipated cash needs time frames and risk tolerance. Expected short-term cash needs or a desired buffer against unexpected financial setbacks should determine the amount of risk an investor is willing to take. If saving for a down payment on a first house, for example, one 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 the short-term allocation based on the anticipated time frames for future withdrawals.

Tier One: Emergency Funds

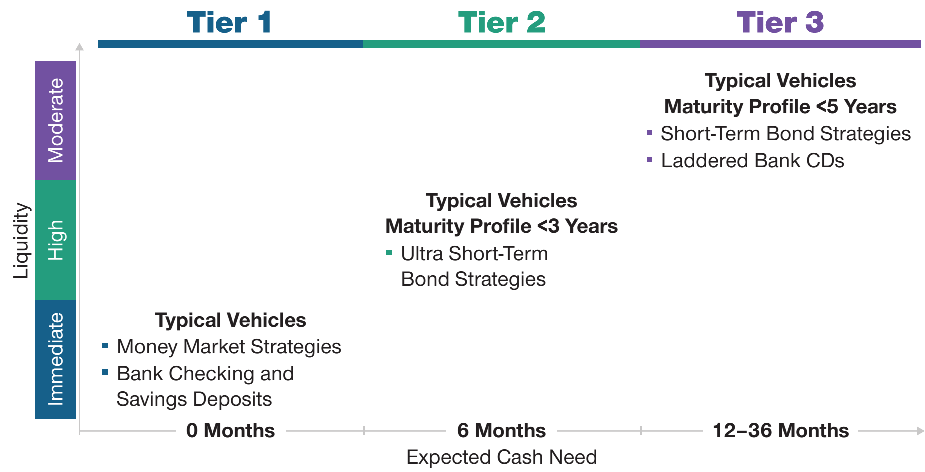
Funds to meet an investor's immediate cash needs would fall into tier one. This category should include the most liquid

[1] Duration measures a bond's sensitivity to changes in interest rates.

Money market mutual funds generally offer the greatest level of flexibility and liquidity along with the lowest risk of principal loss among the available short-term investment products.

Creating a Tiered Liquidity Structure

(Fig. 1) Investment tiering is a simple, yet powerful, concept



Source: T. Rowe Price
For illustrative purposes only.

vehicles—assets that an investor could reasonably expect to access at any time, potentially as an emergency fund.

Many investors rely on bank checking or savings accounts as well as bank money market deposit 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 CDs. Moreover, high minimum balances may be required to keep a bank account open.

Money market mutual funds are a popular alternative to bank accounts as vehicles for liquid cash reserves. Money market mutual funds generally offer the greatest level of flexibility and liquidity along with the lowest risk of principal loss among the available short-term investment products. In general, there are three types of money market mutual funds available:

- U.S. Treasury funds
- Government funds
- Retail prime funds

While money market mutual funds do not guarantee an investor's deposit like an FDIC-insured bank account or CD and it is possible to lose money, U.S. Treasury and government money market mutual 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. Retail prime money market mutual funds can invest in a broader range of short-term instruments, including commercial paper issued by corporations.

Tier Two: Cash Needed in the Next Six to 12 Months

Funds for near-term cash requirements—which we would define as cash needed within the next six to 12 months—make up tier two of a short-term allocation. This could include cash accumulated for a down payment on a home purchase intended to be made within that time frame. Tier two investments also may include money market mutual funds, but more typically they are low duration fixed income vehicles such as ultra short-term and short-term bond funds.

These funds are professionally managed fixed income portfolios that invest in a broadly diversified set of fixed rate and floating rate bonds that generally mature in three years or less. These holdings may include government debt, securitized debt, or corporate bonds. 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 returns with the addition of interest rate risk and credit risk.

Tier Three: Liquidity Needs Beyond 12 Months

Longer-term liquidity needs (cash required beyond the next 12 months but within the next 36 months)—which could include money for purchasing a home—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 that savings be set aside or locked up for a specified period. If the investor's cash needs change, early CD withdrawals typically are subject to a 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 could also reduce the average yield on 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.

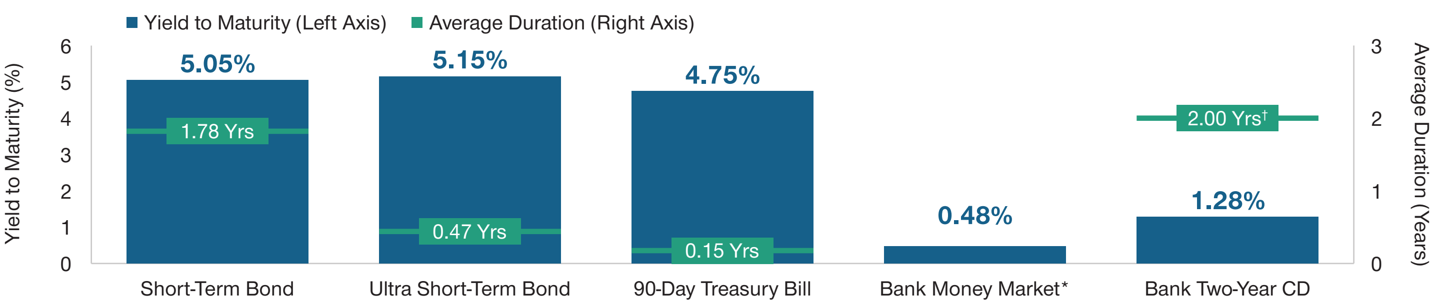
Laddered Portfolios

Some investors prefer to manage their fixed income investments by creating laddered portfolios of short-term securities, such as Treasury bills. As with bank CDs, investors can structure these portfolios to include a range of maturities, providing liquid access to cash over different time 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

Comparing Short-Term Investment Vehicles

(Fig. 2) Yield to maturity and duration, February 28, 2023



As of February 28, 2023.

Short-Term Bond: Bloomberg 1–3 Yr. U.S. Gov't./Credit Bond Index; Ultra Short-Term Bond: Bloomberg Short-Term Gov't./Corporate Index; 90-Day Treasury Bill: ICE BofA U.S. 3-Month Treasury Bill Index; Bank Money Market and Bank Two-Year CD: averages for non-jumbo accounts (<USD 100,000) as reported by the FDIC. Index data is for illustrative purposes only and is not indicative of any specific investment. Investors cannot invest directly in an index.

Sources: Bloomberg Index Services Limited (see Additional Disclosures); ICE BofA (see Additional Disclosures); S&P Capital IQ Pro; SNL Financial Data. Calculations: FDIC.

Savings and interest checking account rates are based on the USD 2,500 product tier, while money market and certificate of deposit rates represent an average of the USD 10,000 and USD 100,000 product tiers. Account types and maturities published in these tables are those most commonly offered by the banks and branches for which the providers have data (on-tenor maturities).

* Bank money market accounts have minimal duration.

† The duration of the bank CD is the lockup period.

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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 investors and their brokers. Constructing and maintaining laddered portfolios also may entail a significant time commitment to researching and monitoring securities.

Comparing Investment Options

Figure 2 compares average yield and duration for each of the short-term vehicles discussed above. As highlighted in the chart, money market bank 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 mutual funds, they also require investors to tie up their funds for those two years or face early withdrawal penalties.

Although three-month Treasury bills provided higher yields than money market bank accounts, directly investing in individual fixed income securities poses its own challenges, as noted above. We believe this strategy is best suited for more experienced investors. Ultra short-term bonds provided the most attractive yield and duration combination among the alternatives shown here as February 28, 2023.

Tiering Can Help Align Assets With Cash Needs

With short-term rates well above longer-term yields and the Federal Reserve (Fed) expected to keep hiking interest rates, this may be a good time for investors to review cash and short-term allocations to see if they are still appropriate given their 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, 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 those with lengthy lockup periods for short-term investments, especially if there is a significant possibility that your financial situation or cash needs may change in the near future.

WHAT WE'RE WATCHING NEXT

We are closely monitoring economic data for signs that inflation will continue to decelerate, which of course will determine when the Fed stops raising rates and the level of the terminal federal funds rate, or the highest point in this hiking cycle. Inflation erodes the value of savings in fixed rate instruments such as CDs, while short-term bond funds can reinvest maturing holdings and coupon payments in higher-rate securities.

Additional Disclosure

Risks—Retail Money Market Mutual Funds: You could lose money by investing in the Fund. Although the Fund seeks to preserve the value of your investment at USD 1.00 per share, it cannot guarantee it will do so. The Fund may impose a fee upon the sale of your shares or may temporarily suspend your ability to sell shares if the Fund's liquidity falls below required minimums because of market conditions or other factors. An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The Fund's sponsor has no legal obligation to provide financial support to the Fund, and you should not expect that the sponsor will provide financial support to the Fund at any time.

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While U.S. government-backed securities generally are considered to be among the highest credit quality, they are subject to market risk. The primary source of risk is the possibility of rising interest rates, which generally cause bond prices, and a bond fund's share price, to fall.

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 will fluctuate, and investing in these products could result in the loss of principal.

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