PIMCO

STRATEGY SPOTLIGHT

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Giving Cash Its Due

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Short-term bond markets are in the spotlight as the Federal Reserve normalizes interest rates and the implementation of money market reform is set to begin later this year. Recent market volatility further underlines the importance of taking a thoughtful approach to cash allocation. Jerome Schneider, head of PIMCO's short-term investing and recently named Morningstar 2015 Fixed-Income Fund Manager of the Year (U.S.) along with his team on the PIMCO Short-Term Fund, and Andrew Wittkop, portfolio manager, explain the dynamics of the short-term market and discuss PIMCO's approach to managing cash and short-term investments.

Q: It has been over a month since the Federal Reserve's first rate hike in nine years. How have cash markets performed and what is the takeaway for cash investors as they look ahead in 2016?

Schneider: In the cash markets, the reaction to the Fed's first 25-basis-point increase in December was very subdued. Treasury bill yields have lagged due to strong demand, and money market government fund yields on a net basis are basically still around zero, since some management fees have ticked up. Further, not only have bank deposit rates generally stayed put, even though many investors had expected banks to raise them, but some major banks have said they will start to charge fees on deposits for certain customers. As these trends continue, we do not expect any meaningful increase in cash yields from the Fed's next rate hike either.

More broadly, one of the most important takeaways for cash investors is that there is now a global divergence in monetary policy: While the Fed raised rates in December, the European Central Bank, the Bank of Japan and the People's Bank of China are all still engaged in monetary easing. Even if the Fed moderates its policy ambitions, the effects of global policy divergence are going to be profound for all fixed income investors and especially for those focused on the front end of the yield curve, which is the most affected by central bank policy and can be the most volatile part of the curve.

Cash has become a structural allocation – an integral part of the investment portfolio – for many investors over the past few years. So the impact of these macroeconomic developments is important for cash and short-term investors.

Q: With the volatility in global markets so far in 2016, do you now expect a slower path for rate increases from the Fed?

Schneider: We are anticipating a slower trajectory than the Fed's own projection for four hikes in 2016. It is clear that the Fed will remain focused on the economic data: There will be some disappointing and some reassuring economic numbers in the months ahead, and the Fed is going to take each data point into consideration, projecting and revising outcomes.

For investors, this type of data-dependence is going to make the markets more volatile. In the previous rate hike cycle, the Fed raised rates at regular intervals, typically by 25 basis points at each meeting, so the market could anticipate and prepare for the rate increases.

Going forward, we expect that the Fed will raise rates as economic conditions improve, and yields on the front end of the curve should increase gently. But that doesn't mean that all yields will rise. Investors should be aware that some asset classes, including money market funds and the instruments they invest in, predominantly T-bills, will continue to be structurally restrained in terms of yield. Money market reform and bank capital requirements have increased demand for these securities, which is likely to keep yields low. T-bill and agency debenture issuance is also lower than historical levels, which may put further pressure on yields.

Q: Why is active management so important for short-term investing?

Wittkop: It is more important than ever for investors to actively pivot around changing market conditions. Whether we experience slowing global growth, diverging monetary policies or even increasing employment in the U.S., these developments – positive and negative – when combined create a more volatile market. As an active investor in the short-term market, we are focused on finding ways to dampen volatility, preserve capital, manage liquidity and ultimately produce income.

Many investors rely on their cash and short-term allocations for liquidity, but market liquidity has dropped significantly over the past several years, with fewer banks and brokers willing to take positions. In this environment, active management can aim to ensure that a short-term portfolio remains liquid through careful security selection. And a large active manager can even become a provider of liquidity to the markets, earning premiums for buying or selling less liquid securities and potentially increasing portfolio returns.

Capital preservation generally is also crucial for short-term investors, and therefore it is important to note that in this environment, passive investing could increase the chance of negative returns and even capital loss. With passive investing, an investor holds the securities that make up an index, allocating among them as the index does, based on the amount of bonds outstanding from each issuer. For short-term investors, this may result in high exposure to Treasuries and other instruments that are very sensitive to interest rates, which increases the potential for negative absolute returns in a rising interest rate environment. Passive investing also entails owning all of the credit names in the index regardless of credit quality. So passive investing can increase exposure to credits that may default. This is an especially important consideration as the drop in oil prices roils the energy sector and possibly has knock-on effects elsewhere. Finally, passive investing forces the investor to invest only in index securities, which are in high demand and often expensive.

By contrast, an active manager has greater latitude to select the securities in a portfolio based on research, analysis and market valuation, and can aim to identify attractive opportunities, adjust exposure to specific securities or sectors as needed and potentially avoid pockets of risk.

Q: Can you discuss your team's approach to managing short-term strategies?

Schneider: What differentiates us from many other short-term funds is our investment process. We are fully integrated into the larger investment process at PIMCO, from the Investment Committee that sets the firmwide guidelines to the regional portfolio committees that research, monitor and generate ideas for specific geographic areas, to our quarterly economic forums in which we formulate our outlook for economies and markets. We provide the firm with insight into the short-term sector, and we in turn have access to the expertise around PIMCO globally, which helps us find opportunities that many other managers with a more singular focus might miss.

On the short-term desk, we have 10 portfolio managers, including Andrew and myself, with a broad range of sector expertise and deep knowledge of the various sub-sectors of the short-term market – government securities, credit, interest rate exposure, global sovereigns, structured products and collateral trading, to name a few. While we do trade traditional money market instruments like Treasury bills and repurchase agreements (repos), our bandwidth is much greater, and that, along with PIMCO's global reach and depth, is central to uncovering opportunities with higher risk-adjusted yields than those on typical U.S. dollar-denominated cash investments.

Having expertise across a wide range of sectors has also helped us sidestep risk. We have a long track record of managing short-term portfolios through many interest rate cycles and through the financial crisis in 2008. That expertise enables us to identify opportunities, and more important, to manage portfolios defensively by avoiding sectors embedded with potential volatility. PIMCO has also managed capital through all types of liquidity environments over more than 40 years, and we can draw on this experience to navigate the structural changes now underway in the cash and short-term markets.

Q: What else should investors consider as they make their cash allocations in 2016?

Wittkop: As Jerome alluded to earlier, we believe it is important to acknowledge that macroeconomic developments, especially central bank actions, are having outsized effects on the short-term markets. After many years of focusing almost exclusively on the search for yield, cash investors will need to contend with higher risk. As the Fed takes away the punch bowl, volatility is increasing, interest rates are likely to fluctuate in a wider band and defaults are starting to rise. To take advantage of Fed rate increases, investors may need to think more holistically about how to manage their cash – their liquidity – in an active way, diversifying exposure while minimizing duration, or interest rate exposure, over the foreseeable future.

Schneider: Structural changes are also underway this year: Money market reform is set for the third quarter, and ongoing bank regulations will continue to limit market liquidity and the availability of high quality, short-term assets.

In the past, cash allocations were sometimes an afterthought for investors. But today, as more investors make cash and short-term investments an integral part of the portfolio, these allocations matter. As a result, investors need to be prepared for the changes that are underway and be proactive so they can meet their needs for both return and liquidity in the year ahead.

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