Fixed-Income Insights

Credit in Strategic Cash Management:
A Review of Performance and Applicability in the Pandemic Era

How would a tiered approach to cash management utilizing credit have weathered the Covid-led market volatility of 2020?

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For the last few years, we've discussed the advantages of using short term credit portfolios to meet institutional and HNW client cash management needs. Because the excess return available in high quality, short term credit is largely compensation for liquidity risk rather than principal risk due to default (as discussed here), institutions can use their privileged position of having insight into their own liquidity needs to earn that excess spread.

Review of Cash Tiering

How might institutions optimize the use of short-term credit in cash management? We've favored a tiering approach (Figure 1) which aligns portfolio weighted average life with expected liability timeframes. Focusing on the expected holding period of the portfolio allows an institution or HNW client to look past short term spread volatility and benefit from the "pull to par" as the portfolio holdings approach maturity.

Figure 1. An Approach to Cash Management Tiering

Operating Cash	Core Cash	Strategic Cash
▪ **Time Horizon:** 0-3 months	▪ **Time Horizon:** 3-12 months	▪ **Time Horizon:** Over 12 months
▪ **Use:** Unexpected cash needs, business operating expenses (e.g., payroll)	▪ **Use:** Periodic cash needs	▪ **Use:** Not intended for specific expenditures
▪ **Objective:** Capital preservation	▪ **Objective:** Capital preservation, incremental yield	▪ **Objective:** Total return, incremental yield
▪ **Risk:** Ultra Low Volatility	▪ **Risk:** Low Volatility	▪ **Risk:** Conservative
Money Market Funds Bank Deposits	Ultra Short Bond Strategies	Short Term Bond Strategies

Source: Lord Abbett. For illustrative purposes only.

March 2020:
A Test for Short-Term Credit

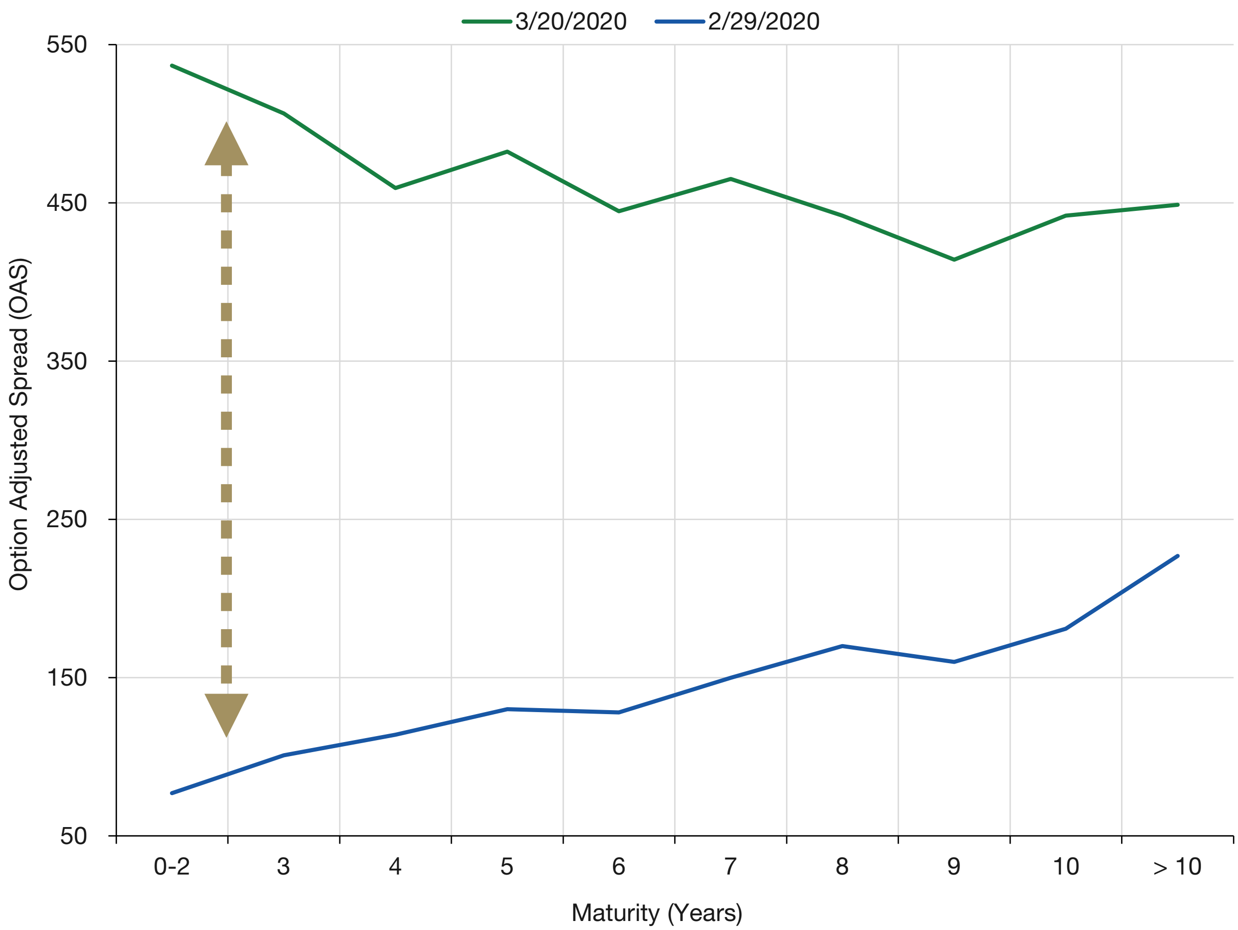
Many portfolio management strategies faced significant challenges during the onset of the COVID-19 pandemic in March 2020, but the crisis was especially acute in short term credit markets. While short term rates in government bonds dropped to near zero in response to policy measures, investor preference for cash and liquidity left credit curves much wider and inverted over time as investors sold short maturity bonds that were closest to par as shown in Figure 2.

This spread widening at the short end was exacerbated in March 2020 by several phenomena:

- **The inability of banks and dealers to take principal risk**. This has been limited since financial reforms after the 2008–09 credit crisis and the flare-ups in the repo market[1] that preceded the pandemic were signs of instability. In March, many markets turned "one way" as asset managers and cash bond holders all tried reducing risk at the same time.
- **The correlation of operating needs with financial markets.** Institutions such as hospitals and educational endowments that were previously thought to be relatively insulated from market events and even large economic events experienced an abrupt halt in cash flows from operations that, in some cases, needed to be funded with investment portfolios.
- **A re-rating of default probabilities.** This would not be considered unusual in times of great uncertainty, and the market action of March 2020 fit the pattern. As issuers' likelihood of default is re-rated by investors amid market turmoil, the normal dispersion in bond pricing over term begins to diminish because in a default, recoveries dictate fair price equally across the term spectrum.

Figure 2. Amid Pandemic-Led Volatility, the BBB Credit Curve Inverted in March 2020

Spread on the ICE BofA BBB U.S. Corporate Bond Index for the indicated dates



Source: Lord Abbett and Bloomberg. The **option-adjusted spread (OAS)** is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities yield for the risk-free rate.

Past performance is not a reliable indicator or guarantee of future results. Indexes are unmanaged, do not reflect the deduction of fees and expenses, and are not available for direct investment.

A Rapid Resolution

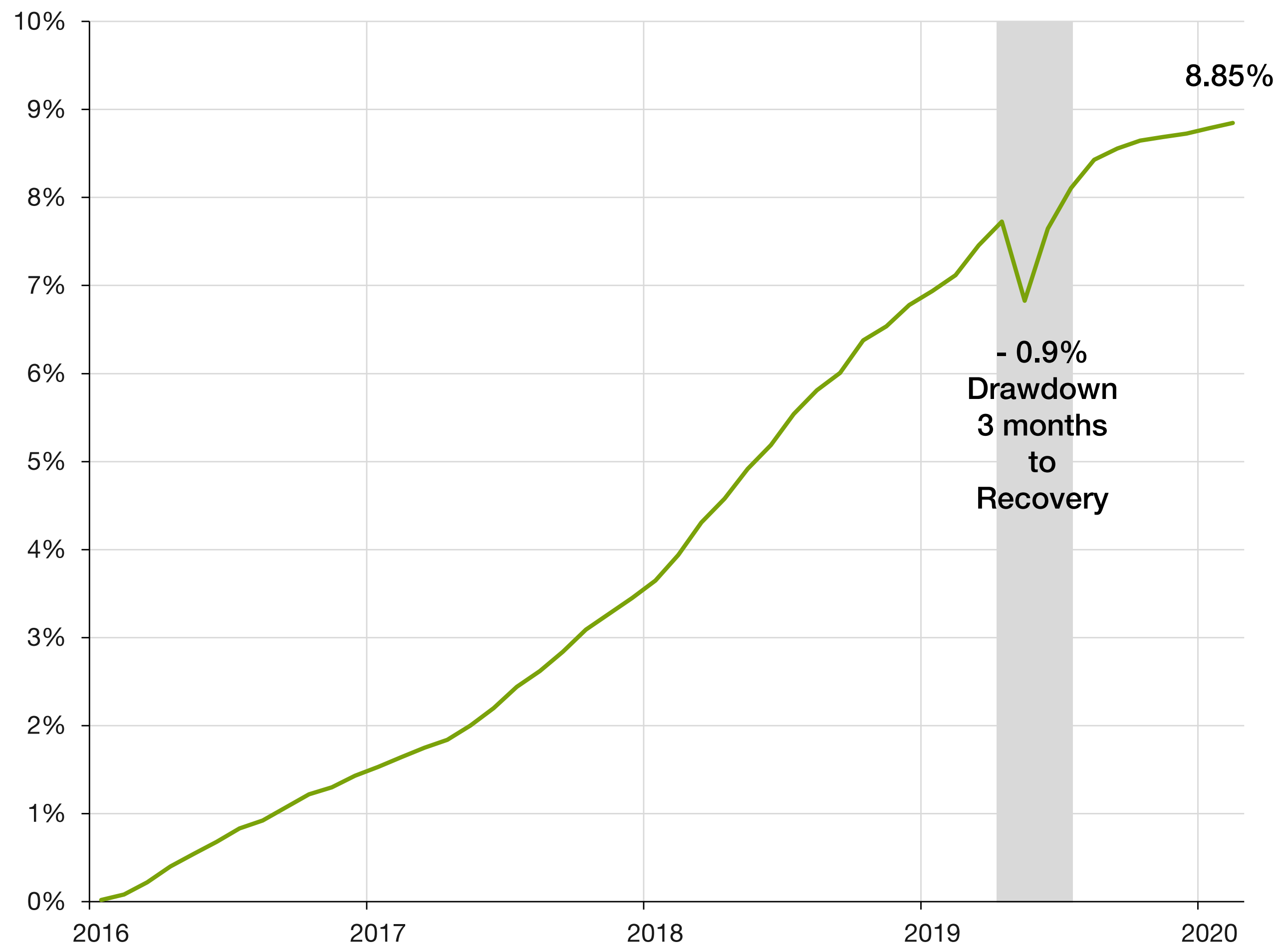
The rapidity with which the short-term credit crisis developed in March was matched by the speed with which it was resolved. The efforts of central banks to ease borrowing conditions and restore liquidity to markets were unprecedented in scale and scope but also unprecedented in the immediacy of their implementation. Combined with government spending programs to spur demand, these programs took many of the lessons of 2008-2009 and compressed the execution into weeks rather than months. Markets almost immediately responded with demand for credit compressing spreads in the secondary markets and fueling a record deluge of primary issuance totaling $1.5 trillion in the investment grade (IG) corporate market alone by the end of 2020.[2]

A cash management tiering strategy that focused on matching liability expectations and consequent holding periods with the life of assets in portfolios should have been able to weather this relatively brief crisis very well. Operating Cash portfolios of money market funds and bank deposits did their job of retaining value to meet operational needs. Core and Strategic Cash portfolios utilizing short term credit varied in time to full recovery but generally attained that recovery in less than a few months for even credit-sensitive portfolios with a weighted average life in excess of two years.

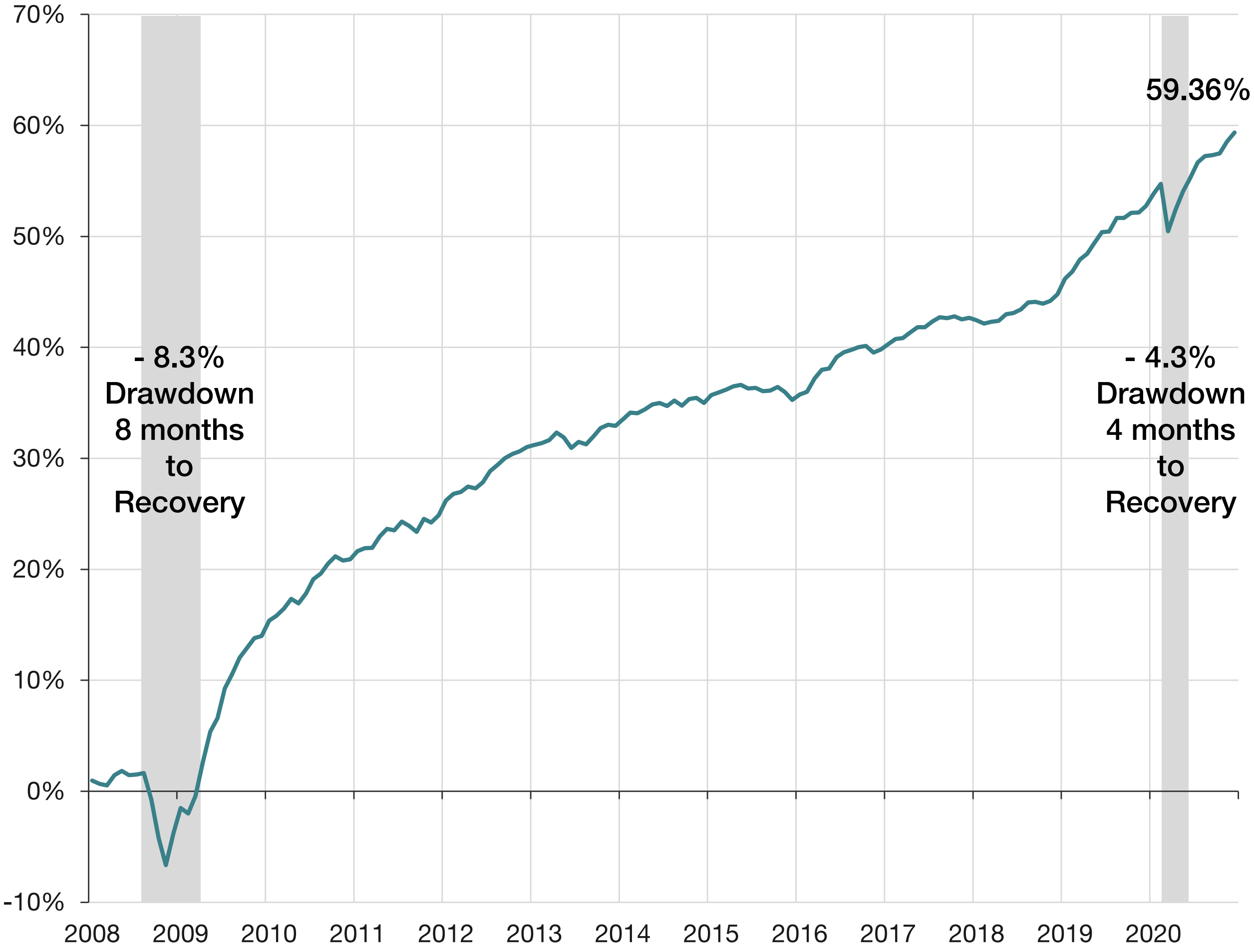
Figure 3. Short Credit Portfolios Recovered Quickly from March 2020 Stress

Cumulative gross returns for indicated strategies

Ultra Short Blend (November 1, 2016–December 31, 2020)



Short Duration Credit Blend (January 31, 2008–December 31, 2020)



Source: Lord Abbett and Bloomberg. Data as of December 31, 2020.

Ultra Short Blend: Hypothetical allocation (as of 12/31/20, not rebalanced) includes: 50% a subindex derived from the less than 1.5 year maturity, non-BBB rated (i.e., AAA to A3) segment of the Bloomberg Barclays U.S. Floating-Rate Note Index; 25% 90-Day A2/P2 nonfinancial commercial paper interest rate (as compiled by the U.S. Federal Reserve); 10% Bloomberg Barclays U.S. ABS Auto Aaa Total Return Index, 5% Bloomberg Barclays U.S. ABS Credit Card Aaa Index, 5% Bloomberg Barclays U.S. Treasury Bills: 1-3 Months Index, and 5% a subindex derived from the less than 1.5 year maturity, BBB-rated segment of the Bloomberg Barclays U.S. Floating-Rate Note Index.

Short Duration Credit Blend: Hypothetical allocation (as of 12/31/20, not rebalanced) includes 30% Bloomberg Barclays 1-3 Year U.S. Credit Index, 30% Bloomberg Barclays Non-Agency CMBS 1-3.5 Year Index, 15% Bloomberg Barclays Asset Backed Securities Index, 12.5% Bloomberg Barclays U.S. High Yield Index 1-5 Year, 7.5% Bloomberg Barclays U.S. Treasury 1-3 Year Index, 5% Bloomberg Barclays MBS 1-5 Year Index.

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Short Credit Portfolios Today

U.S. companies seized the opportunity to refinance their borrowings at low rates in 2020, which has left corporate balance sheets in good shape, in our opinion. Cash on balance sheets at U.S. companies is up over 30% from pre-pandemic levels.[3] The earnings recession that began in the first quarter of 2020 is likely to end with the release of first-quarter 2021 earnings, if not sooner, as big companies navigate the COVID era with surprising resiliency and flexibility. Default expectations early in the pandemic proved far too pessimistic and have been revised down repeatedly in the last few quarters. Demand stimulus measures and fiscal programs implemented by the U.S. government have left the consumer in good shape as well, with FICO scores up from pre-pandemic levels – something that has not happened in prior recessions. While short credit spreads are nearly back in most cases to levels seen prior to the emergence of COVID-19, we believe there are solid fundamentals to support these levels.

Further, the recovery in credit spreads has been uneven, leading to select opportunities in areas of the market that require extensive credit analysis and research capability. High yield issues that trade to a near term call currently offer significant spread pick-up relative to historical levels and, in our opinion, face limited refinancing risk in a market flush with liquidity. Commercial real estate continues to be an area that offers tremendous differentiation among property types and deal structures. While office properties and retail space are likely to remain stressed given the economic dislocation caused by the pandemic, we are optimistic about latent demand for destination hotels and leisure properties. Figure 4 uses index values and doesn't reveal idiosyncratic differences but shows the uneven nature of the spread recovery.

Finally, there is a strong argument to be made that short credit spreads may trade through their tightest historical levels. Just as these recent stimulus programs were built on the chassis of the 2008-2009 models that were much smaller in scale and slower

Figure 4. An Uneven Recovery in U.S. Fixed Income Presents Potential Opportunities

Spreads by index (in basis points), as of the indicated dates

Short Duration Sectors	Feb. 18, 2021	Dec. 31, 2019
ICE BofA US Corporates (1-3 Y) (BBB)	67	68
Bloomberg Barclays US High Yield (1-5 Y)	**392**	**377**
ICE BofA US Fixed Rate Asset Backed Securities (0-3 Y)	49	50
ICE BofA US Fixed Rate CMBS (0-3 Y)(AAA)	**89**	**71**
Bloomberg Barclays US CMBS 2.0 (1-3.5 Y)	**129**	**86**

Steepness in credit curves remains around cusp from IG to HY

CMBS has not fully recovered in most cases, particularly among lower-quality tranches and among property types that remain stressed

Source: Bloomberg. Data as of February 18, 2021. IG=investment grade. HY=high yield. CMBS=commercial mortgage-backed securities. The historical data are for illustrative purposes only, do not represent the performance of any specific portfolio managed by Lord Abbett or any particular investment, and are not intended to predict or depict future results. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment. **Past performance is not a reliable indicator or guarantee of future results**.

to take effect, it is likely that future U.S. monetary and fiscal policy activity will use 2020 as a guide. Though the pandemic-era programs themselves have ended, the approach of addressing dislocations in short term funding markets immediately and targeting primary and secondary markets in corporate credit—combined with demand stimulus from fiscal sources—is now an established, and effective, playbook. We expect that future liquidity crises may be met with similar tools.

Investor decisions are often based on "fighting the last war"–and the most recent skirmish involved a considerable, but brief, liquidity crisis. So very liquid instruments like on-the-run U.S. Treasury securities and cash are still held dear, leading to elevated levels of cash reserves at many institutions as they recover from the shock of last March. As those institutions explore ways to put that liquidity to work, we expect continued spread compression in short term credit.

After a challenging 2020, institutions are likely to rethink many things–capital market assumptions, asset allocation, traditional fixed income and cash management—in the current year. We believe cash tiering with short credit both weathered the recent crisis well and is likely to continue to offer opportunity as 2021 unfolds.

[1]Short-term borrowing costs in the so-called "repo" (repurchase agreement) market—a segment of the U.S. fixed income market that provides overnight funding for financial institutions—spiked on September 17, 2019, owing to a number of technical factors that created a supply/demand imbalance for the securities.

[2]Based on data from Bloomberg.

[3]Based on data from the U.S. Federal Reserve.

A Note about Risk: The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. High-yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Moreover, the specific collateral used to secure a loan may decline in value or become illiquid, which would adversely affect the loan's value. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price. Lower-rated bonds may be subject to greater risk than higher-rated bonds. No investing strategy can overcome all market volatility or guarantee future results. Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that markets will perform in a similar manner under similar conditions in the future.

Diversification does not guarantee a profit or protect against loss in declining markets.

Glossary

A **basis point** is equal to one-one hundredth of a percentage point.

A **callable bond** is a type of bond that allows the issuer of the bond to retain the privilege of redeeming the bond at some point before the bond reaches its date of maturity.

Asset-backed securities (ABS) are collateralized by a pool of assets such as loans, leases, credit card debt, royalties or receivables. An ABS is similar to a mortgage-backed security, except that the underlying securities are not mortgage-based.

Commercial mortgage-backed securities (CMBS) are secured by mortgages on commercial properties rather than residential real estate. The underlying loans that are securitized into CMBS include those for properties such as apartment buildings and complexes, factories, hotels, office buildings, office parks, and shopping malls.

Credit sensitive assets are financial products whose features and characteristics or their secondary market price are vulnerable to changes in economic fundamentals and therefore, underlying credit conditions. Interest sensitive assets are influenced by changes in interest rates.

Duration is a measure of the sensitivity of the price of a fixed-income asset to a change in interest rates and is expressed in years.

A **FICO score** is a credit score created by the Fair Isaac Corporation (FICO). Lenders use borrowers' FICO scores along with other details on borrowers' credit reports to assess credit risk and determine whether to extend credit.

HNW refers to high net worth investors.

On-the-run Treasuries are the most recently issued U.S. Treasury bonds or notes of a particular maturity. On-the-run Treasuries are the opposite of "off-the-run" Treasuries, which refer to Treasury securities that have been issued before the most recent issue and are still outstanding.

Pull to par is the effect in which the price of a bond converges to par value as time passes. At maturity the price of a debt instrument in good standing should equal its par (or face value).

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure.

Yield to maturity is the rate of return anticipated on a bond if held until it matures. Yield to maturity assumes all the coupon payments are reinvested at an interest rate that equals the yield-to-maturity. The yield to maturity is the long-term yield expressed as an annual rate.

Yield is the annual interest received from a bond and is typically expressed as a percentage of the bond's market price.

The **Bloomberg Barclays 1-3 Month U.S. Treasury Bill Inde**x is designed to measure the performance of public obligations of the U.S. Treasury that have a remaining maturity of greater than or equal to 1 month and less than 3 months.

The **Bloomberg Barclays Asset-Backed Securities (ABS) Inde**x is the ABS component of the Bloomberg Barclays U.S. Aggregate Bond Index. The ABS Index has three subsectors: credit and charge cards, autos and utility.

The **Bloomberg Barclays U.S. CMBS Investment Grade Index** measures the market of conduit and fusion commercial mortgage-backed securities (CMBS) deals with a minimum current deal size of $300 million. The index is divided into two subcomponents: the U.S. Aggregate-eligible component, which contains bonds that are ERISA eligible under the underwriter's exemption, and the non-U.S. Aggregate-eligible component, which consists of bonds that are not ERISA eligible. The U.S. CMBS Investment Grade Index was launched on January 1, 1997. The Bloomberg Barclays Non-Agency 1-3.5 Year CMBS Index and Bloomberg Barclays 1-3.5 Year Non-Agency CMBS Index are subsets of the broader index.

The **Bloomberg Barclays U.S. Credit Index** includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements. The Bloomberg Barclays 1-3 Year U.S. Credit Index is a maturity-specific subset of the Bloomberg Barclays U.S. Credit Index.

The **Bloomberg Barclays U.S. Floating-Rate Note (FRN) Index** measures the performance of USD denominated, investment-grade, floating-rate notes across corporate and government-related sectors.

The **Bloomberg Barclays U.S. High Yield Index** covers the universe of fixed rate, non-investment grade debt. The **Bloomberg Barclays 1-5 Year U.S. High Yield Index** is a maturity-specific subset.

The **Bloomberg Barclays U.S. Mortgage-Backed Securities (MBS) Index** is the a component of the Bloomberg Barclays U.S. Aggregate Bond index. The MBS Index covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The Bloomberg Barclays 1-5 Year U.S. MBS Index is a maturity-specific subset.

The **Bloomberg Barclays U.S. Treasury Index** is the U.S. Treasury component of the U.S. Government Index. The index includes public obligations of the U.S. Treasury with a remaining maturity of one year or more. The Bloomberg Barclays 1-3 Year U.S. Treasury Index is a maturity-specific subset.

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The **ICE BofA 1-3 Year BBB US Corporate Index** is an unmanaged index comprised of U.S. dollar denominated investment grade corporate debt securities publicly issued in the U.S. domestic market with between one and three year remaining to final maturity.

The **ICE BofA US Fixed Rate Asset Backed Securities Index** tracks the performance of fixed-rate U.S. dollar denominated investment grade asset backed securities publicly issued in the U.S. domestic market. The **ICE BofA 0-3 Year U.S. Fixed Rate Asset Backed Securities Index** is a maturity-specific subset.

The **ICE BofA US Fixed Rate CMBS Index** tracks the performance of fixed-rate U.S. dollar denominated investment grade commercial mortgage backed securities publicly issued in the U.S. domestic market. The **ICE BofA 0-3 Year U.S. Fixed Rate CMBS Index** is a maturity-specific subset.

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