

## OPTIMIZING SHORT-TERM INVESTMENT ASSETS

### A BETTER APPROACH?

When building high net worth client portfolios, a great deal of attention is paid to asset allocation and manager selection. These decisions are often supported by risk-return frameworks aimed at maximizing portfolio efficiency. While metrics such as alpha, information ratio and correlation offer valuable historical context, this analysis is typically applied to longer term, risk-seeking investments. Less attention is arguably paid to short-term assets.

#### *We feel there is a better way.*

Changes in the municipal bond market over the past 18 months, coupled with rising short-term interest rates, have heightened the importance of cash alternative investment strategies.

**At Appleton, we work with advisors to craft high quality, liquid portfolios customized to meet a client's transitional, liability funding, and related short-term needs.**

Our investment approach strives to be flexible, goal-oriented, and cognizant of several fundamental needs: capital preservation, rising rate protection, income enhancement, customization flexibility, and asset-liability alignment.

While we are perhaps best known for intermediate and long duration municipal strategies, some clients are unwilling to extend duration, potentially given a desire to effectively immunize approaching liabilities. While money market funds, ETFs and bond funds have their merits, **it is our belief that utilizing VRDNs, complemented by high quality, short-term bonds, can present more attractive, personalized cash alternative solutions.**

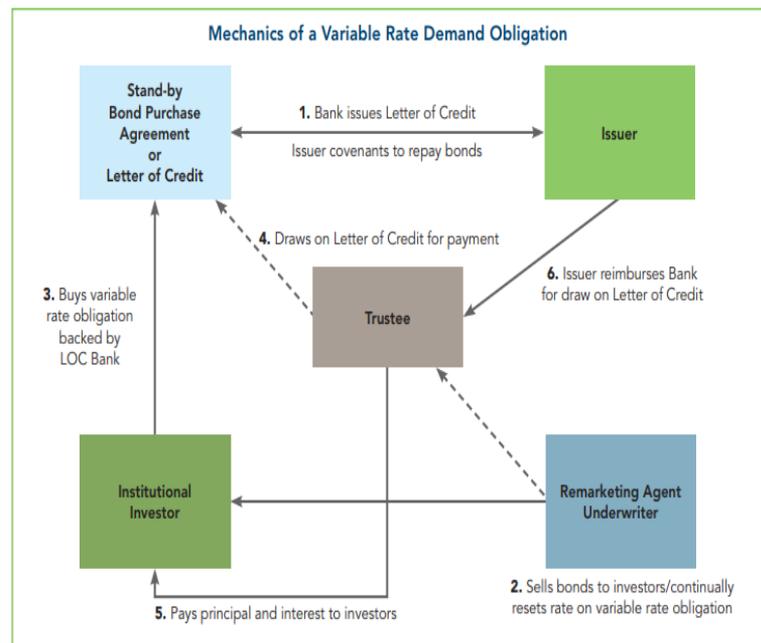
### VARIABLE RATE DEMAND NOTES

VRDNs are municipal instruments with a coupon that resets daily or weekly, and a put option allowing the investor to sell the asset back to the remarketing agent at par. The latter feature helps ensure price stability by anchoring issues to their par value. Despite a long-stated maturity, the put creates an effective maturity equal to the nearest put date.

Furthermore, VRDN credits are often backed by Letters of Credit or Standby Bond Purchase Agreements issued by highly rated liquidity providers. Given these characteristics, VRDNs are eligible for purchase by tax-exempt money market funds. The liquidity provider, and ultimately the obligor, would suffer an act of default should they fail to honor the put mechanism, thereby drawing a stark contrast with Auction Rate Securities that roiled the markets in 2007 and 2008.

With notes trading in minimum \$100,000 increments and a need to diversify maturities, retail managed account VRDN portfolios are generally only accessible to high net worth investors.

**Nonetheless, we feel the case for VRDNs is compelling given their significant yield premium to cash alternatives**



Source: Municipal Securities Rulemaking Board

### REGULATION CREATES A CHANGING LANDSCAPE

The aftermath of the Financial Crisis shook markets and the regulatory environment. **In our view, fallout from the SEC's money market reforms announced in 2014 and made effective in October 2016 has enhanced short-term tax-exempt investment opportunities**, perhaps most notably through a sharp spike in VRDN yields.

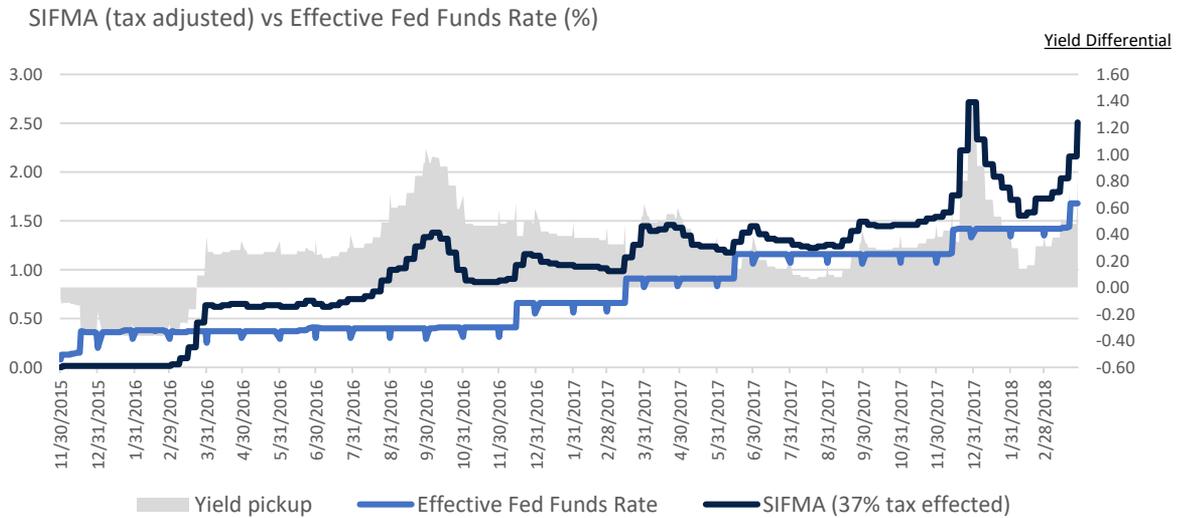
Requiring institutional prime and tax-exempt money market funds to price with floating NAVs rather than fixed \$1.00/share values,

and allowing for temporary liquidity restrictions during times of extreme volatility, greatly impacted investor behavior. According to iMoneyNet, over the period from 2014 through year-end 2016, government money market fund assets, which remain eligible for fixed \$1.00/share pricing, grew to \$2.2 trillion from \$924 billion. By contrast, institutional tax-exempt money market funds suffered sizeable outflows in anticipation of the regulation's effective date, thereby constraining a significant VRDN buyer.

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### REGULATION CREATES A CHANGING LANDSCAPE

VRDN clearing rates increased accordingly, rising from near zero in early 2016 to more than 1.30% ahead of the October 2016 rules implementation<sup>1</sup>. As the accompanying chart details, *the SIFMA Municipal Swap Index, a 7-day high grade market index comprised of tax-exempt VRDN reset rates, now maintains a considerable tax-adjusted yield advantage relative to Fed Funds.*



Source: Bloomberg

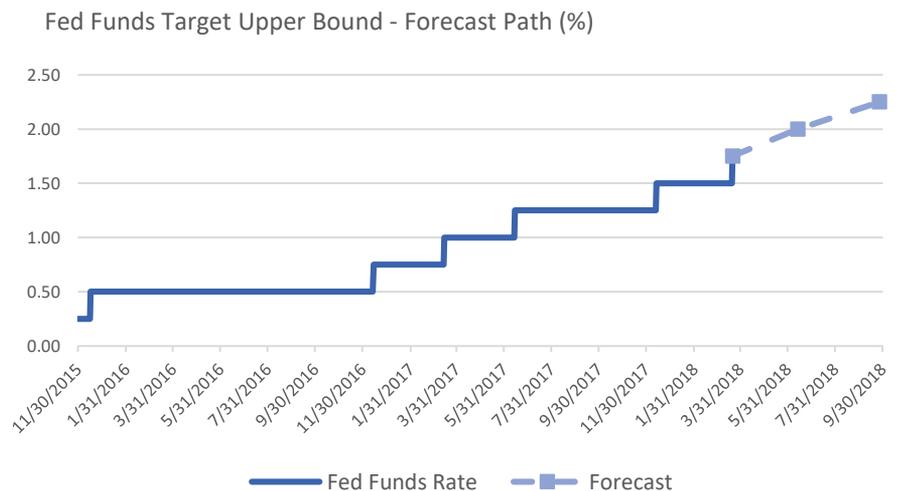
### CAPITAL PRESERVATION

Credit quality and price stability are paramount short-term investment concerns, particularly when a portfolio's cash flow is intended to align with pending liabilities. **A tangible advantage of pairing short-term bonds and VRDNs lies in avoiding the daily market price variability associated with non-money market mutual funds and ETFs.** Holding high quality bonds to maturity, coupled with VRDN's very short par put options, mitigates market value fluctuation risk. Furthermore, our proprietary credit assessment of VRDN liquidity providers offers added due diligence to issue selection.

### RISING RATE PROTECTION

**In an era of monetary tightening, term structure and interest rate risk are common concerns, even in the shorter maturity portions of the yield curve.**

Finding the right balance between price stability and yield can be challenging, and those unwilling to take duration or credit risk may end up foregoing considerable income. That is an understandable, but problematic trade-off. However, we feel that complementing VRDNs, whose coupons reset daily or weekly, with short-term bonds in an actively managed separate account, represents a potentially attractive option.



Source: Bloomberg

1. The yields quoted above are 37% tax-adjusted

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### INCOME ENHANCEMENT

**With Fed monetary policy normalization well underway, the opportunity cost of idle cash is steadily rising.** The recently concluded March Fed meeting bumped up the Fed Funds target rate to 1.50 – 1.75%, with an accelerated pace of increases anticipated. In fact, the median Fed governor’s expectations revealed at the last meeting call for a Fed Funds rate of 2.90% by the end of 2019 and 3.40% by 2020.

Short-term municipal rates have reacted largely in synch, with the SIFMA Muni Swap Yield Index (37% tax-adjusted) rising to 2.51% as of 3/28/18 vs. 0.63% roughly two years prior (3/31/16). The impact to a high net worth investor with sizeable short-term holdings can be considerable and speaks to the value of maximizing income consistent with credit, liquidity, maturity and other portfolio constraints.

### CUSTOMIZATION FLEXIBILITY

For high tax bracket investors, the ability of their investments to account for factors such as state preferences, tax circumstances, and risk profile can impact portfolio outcomes. **The control associated with managed accounts creates an ability to accommodate individual needs in our short-term, cash alternative portfolios,** characteristics unavailable through mutual funds or ETFs.

### ASSET-LIABILITY ALIGNMENT

Defined portions of high net worth portfolios may serve to fund near-term liabilities such as tax payments, pending investments, or other anticipated withdrawals. As with institutional LDI strategies, this requires proper calibration of assets and liabilities. **Managed accounts comprised of individually selected bonds and VRDNs can be customized to serve this purpose given the flexibility of these instruments.** By targeting bond maturities and call structure, while positioning a rolling portfolio of VRDNs, client cash flow can be closely aligned with anticipated withdrawals.

### CREATIVE APPROACHES CAN ADD VALUE

Optimizing short-term assets requires putting cash to work in a secure manner consistent with investor specifications. While this portion of a high net worth portfolio may at times be overlooked, this need not be the case. Appleton’s short-term solutions offer advisors options worth exploring within the context of an overall client asset allocation strategy.