

How liquidity funds provide a safe haven for institutional investors during turbulent times

Ongoing financial market volatility, falling interest rates and concerns over the safety of bank deposits following the collapse of Northern Rock have focused institutional investors' attention on their cash investments. In this volatile environment, liquidity funds have proved to be the investment of choice.

Many institutional investors no longer feel safe leaving all their cash tied up in bank deposit accounts as the credit crunch continues to hit the banking sector. But at the same time as the security of bank accounts are perceived to be falling, the returns available are also being hit by lower official interest rates.

So, what can institutional investors do to maintain the highest level of security and liquidity for their cash investments, while also maximising potential returns? Increasingly liquidity funds are providing an answer to this question, thanks to their focus on optimising security, liquidity and yield, while offering a more sophisticated solution to bank deposits.

Because liquidity funds are pooled investment vehicles, with underlying investments in many different securities from many different issuers, counterparty risk is well diversified, unlike in a bank account where all the risk is focused on just one counterparty. If the bank runs into financial difficulties, you face a battle to reclaim your money.

Also, the fact that liquidity funds are actively managed means they can potentially outperform bank deposits when interest rates fall. This is because the fund manager can increase the average maturity of the underlying securities in the fund's portfolio, so that the fund can hold onto the higher available yields for longer. Bank accounts usually pass on interest rate cuts to their account holders immediately.

In essence liquidity funds enable investors to make their cash work harder using the skills and expertise of professional portfolio managers, rather than simply leaving money to sit passively in a bank account.

What are the advantages to investing in liquidity funds?

Liquidity funds provide institutional investors with a strong alternative to bank deposits for investing cash and as a home for working capital. They allow cash to be highly accessible at all times and large liquidity fund providers, such as JPMorgan Asset Management, even offer online services that are very similar to normal online banking sites, where investors can see their balances on screen and execute transactions.

The benefits of liquidity funds include:

1. Risk limitation

Unlike bank deposits, the risk to money invested in liquidity funds is spread across hundreds of different securities. Credit is diversified and volatility reduced through a broad portfolio mix, with a maximum of 5% of the fund placed with any one issuer and with diversification achieved across both industries and maturity profiles.

2. AAA ratings

The weighted average maturity of a liquidity fund portfolio is less than 60 days. The securities in which liquidity funds are invested enable many funds obtain the top credit rating of 'AAA' from Moody's, Standard and Poor's and Fitch. Contrast this with banks, whose own ratings are typically 'AA' or lower (and deteriorating in the current poor credit conditions).

3. Potentially higher returns

The return on cash investments may be higher in liquidity funds than for many bank deposits. The yield potential for bank deposits is extremely limited but, in contrast, liquidity funds are designed to maximise returns. Liquidity funds take advantage of their economies of scale to minimise costs and enhance yield through a larger asset pool. In standard market conditions, when the yield curve is not flat, fund managers can invest in underlying securities with longer durations to increase a portfolio's yield.

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4. Lower charges

In addition, liquidity fund investments do not incur the custody and settlement expenses or rolling and breakage costs that are associated with bank deposits. Instead, once a month, investors receive a dividend that has accrued over the month, net of a small published management fee, with no further subscription or redemption fees.

5. Active management

Finally, while money on deposit must be reinvested daily to retain short term liquidity, liquidity funds are spared this laborious task. Instead liquidity funds are actively managed based on credit and macro research, so investors can leave their cash to grow in the fund until it is required.

How popular are liquidity funds?

US investors have been able to access liquidity funds for over 30 years, creating a market that is now worth around USD 3.39 trillion*. North American treasurers are far more likely than their European counterparts to use pooled investments for their cash deposits.

The liquidity fund market is much newer in Europe, but it has been growing at roughly 50% a year (much quicker still since the credit crunch hit last August as investors seek the extra security that liquidity funds offer). Demand in recent years has also led to the creation of many other markets, particularly in Asia and South America, with the development of local currency liquidity funds.

The core fund denominations in Europe remain euros, US dollars and sterling. In Europe the single largest liquidity fund provider is JPMorgan Asset Management. They have been in the European liquidity funds market since its inception and have over 30 years of experience in the US. Unlike some other investment vehicles, fund size is very important for liquidity funds. Large funds provide the huge benefit that they can absorb very large fund flows without liquidity concerns.

Put liquidity funds at the top of your cash investment decision process?

Liquidity funds definitely earned their place in the investment armoury of institutional investors as a secure, liquid and return maximising strategy. Investment decision making is performed by a specialist liquidity fund manager, who uses all of the information at their disposal to create a fund that is most suited to the clients' needs.

The increasing popularity of these funds, particularly in Europe, is testament to the growing belief among investors that liquidity funds can provide a safe, secure and potentially higher yielding home for their money, particularly during the current uncertainty surrounding the international banking sector.

* Source: iMoneyNet as of 30 April 2008

For further information please contact your usual
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