Five for Friday: Cash Surrogates

This week?s Five for Friday is a little different from prior ones. Instead of scanning for stocks that meet specific criteria, we address the growing demand for cash-like assets.

A few subscribers have asked us how to invest their excess cash sitting at a brokerage firm to earn more than the paltry sweep fund yields they offer. To help our readers understand the lay of the money market land, we critique cash alternatives.

Non-Sweep Money Market Funds

Cash at brokers is most often held in sweepable money market funds. This setup allows for the automatic transfer of cash to and from assets. Sweep money market funds frequently have well below market yields. However, few investors seemed to care over the last decade, with yields on alternatives equally low.

Alternatively, investors can buy a non-sweep money market fund. The benefit is the yields are more closely aligned with current money market rates. The downside is that if cash is needed to buy an asset or for a withdrawal, you must sell part or all of the fund first. Non-sweep money market funds can be very conservative or introduce some risk to boost the yield. Investors often opt for funds that hold U.S. Treasuries and or highly rated corporate or municipal bonds. In these cases, the maturities of the holdings tend to be very short-term.

Money market funds are governed by SEC Rule 2a-7. The rule helps ensure that money market funds are liquid and diversified in safe and short-term assets.

Treasury Securities

One-month Treasury bills yield 3%, while a 3-month bill yields 3.70%, and a 6-month bill is at 4.30%. Bills can easily be purchased from most brokers or directly from the U.S. Treasury. The bills can be sold before maturity if cash is needed.

Comparing bills with different maturities for potential investment is not as straightforward as assessing their yields. For example, assume you are weighing a one-month bill at 3% versus a two-month bill at 3.25%. The question to ask yourself is, what will the one-month bill yield be in one month? If the expected yield a month from now is 3.50%, then you are indifferent between buying a one or two-month bill. You weighted average yield over two months will be 3.25% in both cases.

If you think the Fed will raise rates by a full percent in a week, the one-month forward yield will be much more than 3.50%. In that case, you should prefer to buy the one-month bill and then reinvest in another one-month bill at maturity. Bill yields are highly correlated with Fed Funds and, therefore, monetary policy.

Corporate Securities

Instead of Treasury Bills, investors can earn more yield with short-term corporate bonds. For instance, a General Motors Finance Company bond maturing in three months offers a yield of 0.60% more than a Treasury bill. The obvious, albeit improbable risk, is that GM?s finance division defaults between now and January. The other risk is liquidity. The bid-offer spread on the GM bond is more than a Treasury security. Likely, selling it to raise cash would eat into any yield advantage. We only recommend a corporate note if you intend to hold it to maturity.

CDs

Bank CDs are an option, although they present a few drawbacks. FDIC-guaranteed CDs tend to yield the same or less than Treasury Bills. However, banks will often offer higher-yielding teaser-rate CDs to attract new clients. Many CDs automatically roll into a new CD at maturity unless you take action. There are typically fees or lost interest if you need to sell the CD before maturity. Lastly, finding a CD maturing in six months or less may be challenging.

The FDIC only guarantees CDs up to $250,000. Therefore if you have a large sum to invest in CDs, spread it out over multiple banks.

ETFs

Some bond ETFs are efficient alternatives to money market assets. For example, BIL holds U.S. Treasury Bills maturing within three months. The ETF can be easily purchased and sold by all brokers. BIL?s yield is commensurate with a portfolio of one to three-month Treasury bills less its 0.14% annualized expense ratio.

Disclosure