
Evaluating credit as part of a cash management strategy

Considerations for expected returns of credit in cash markets

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1. Introduction

The fundamental question of any investment is how the return compares to the risk. Investing in cash is no exception to this rule, although cash is special in that it's often considered riskless.¹ Investors who think that cash is riskless naturally gravitate toward cash instruments with the highest yields. This is understandable, as yield represents the expected return if nothing goes awry. If cash had no risk, you wouldn't need to look beyond the yield to compare different strategies.

However, things aren't quite that simple. Yields of different cash strategies need to be interpreted in light of their risks. As a best practice, investors should discount the yield from a best case scenario to an expected return. We use 'expected' here in a mathematical sense; it represents the probability-weighted mean of returns across a range of outcomes.

Many cash instruments carry credit risk². While most cash strategies tend to invest in instruments that are comparatively safe and short in duration (which limits the period over which an issuer may decline in credit quality before an investment is due), they nonetheless carry a degree of *credit risk*. Credit risk is a key differentiator between higher- and lower-yielding cash strategies.

¹ We strenuously disagree with the idea that cash investments are riskless, but would concede that a short term U.S. Treasury bill, for a USD-denominated investor, probably is — or is comparable in risk to — the lowest risk instrument in their universe.

² Credit risk is the probability of a financial loss resulting from a borrower's failure to repay a loan.



2. Takeaways

- Credit risk premia have historically been outsized compared to credit risk, presenting opportunities for investors with a broad basket of securities to earn risk premium over time.
- Commercial paper tends to have less credit risk than longer-duration corporate bonds. The short-term nature of commercial paper allows investors to more frequently reassess credit quality upon maturity and protects against general declines in credit quality over time.

3. Context

Cash investments span a wide range, but the major category with substantial credit risk is corporate liabilities.³ Credit risk is also notably present in asset-backed commercial paper and agency and municipal debt. All instruments with credit risk trade at some spread (difference in yield) to duration-matched Treasuries. In general, the instruments' spread is proportional to the credit risk they carry.⁴

For corporate bonds and commercial paper, the credit spread is generally thought to be outsized relative to the credit risk. Issuers of corporate debt are largely price takers, as they need to issue debt or equity to fund their operations. Corporate bond returns are correlated to other risk assets. **Equilibrium models suggest that the market tends to discount such securities, and that investors who hold a broad basket of such securities can expect to earn a risk premium over time.**

The historical data for corporate credit in the U.S. is consistent with this theoretical framework. Long-run analysis of corporate bond returns and default intensities suggest that credit spreads have compensated investors approximately twice as much as the default intensity (or approximately half the credit spread is earned in expected return).^{5,6}

³ This includes commercial paper, short-term corporate bonds and bank deposits in excess of the \$250,000 FDIC insurance threshold.

⁴ This is not the case for bank deposits, which typically offer negative spreads to Treasuries despite having substantially more risk (when held above the FDIC insurance threshold).

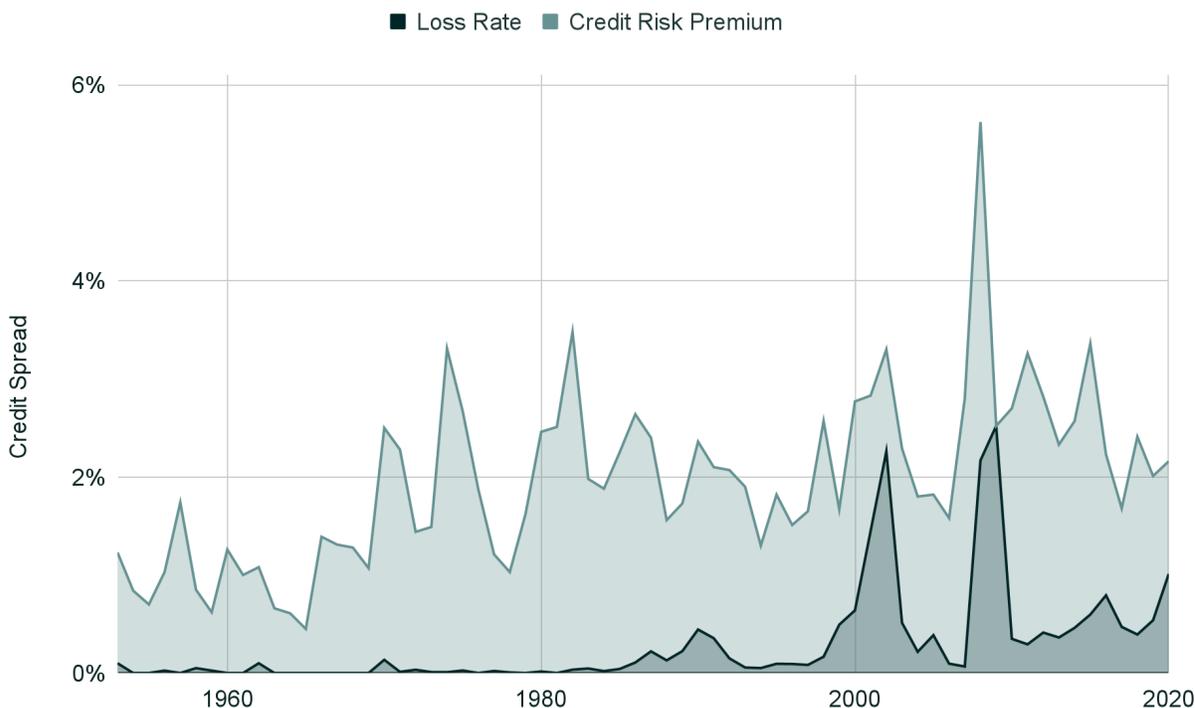
⁵ https://www.anderson.ucla.edu/documents/areas/fac/finance/longstaff_corporate3.10.pdf

⁶ <https://www.moodys.com/sites/products/DefaultResearch/2006400000429618.pdf>

Exhibit 1

Credit risk premiums have been captured as a persistently large part of credit spreads

Credit spreads against proportion of losses (\$) due to defaults



Source: Moody's, FRED, "Corporate Bond Default Risk: 150 Year Perspective," Giesecke & Schaefer, 2011

Commercial paper is generally a smaller market than corporate bonds and differs in a few ways. First, it includes only short-term paper (typically 9 months or less). This means investors are able to reassess their investment upon maturity much more frequently and are less susceptible to a general decline in credit quality over time. It's not uncommon for issuers to be shut out of the commercial paper market as their credit quality deteriorates into eventual default.

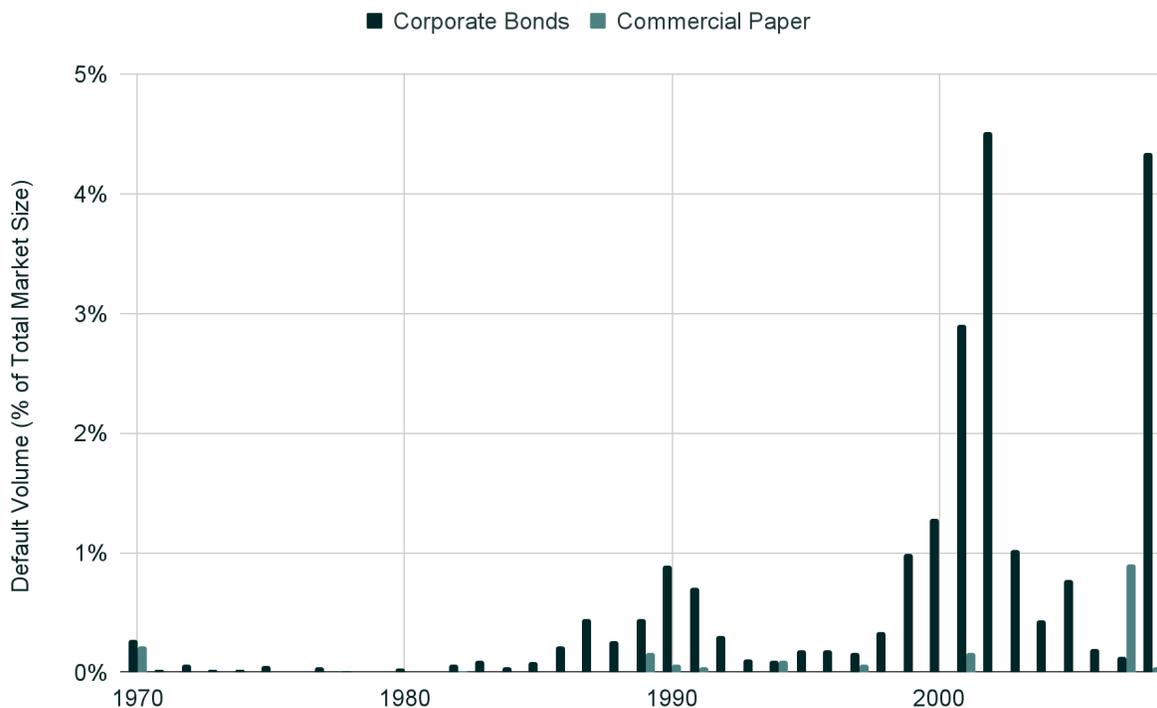
Second, commercial paper is more often dominated by financials than the broader corporate bond market, and is a critical near-term funding source. Given these characteristics, central banks tend to prioritize its liquidity and smooth operation in times of stress. While commercial paper does default from time to time (see Exhibit 2), the likelihood of incurring substantial losses from a diversified portfolio of commercial paper is probably quite low. Indeed, the risks are significantly lower than a portfolio of corporate bonds of comparable credit quality.



Exhibit 2

Corporate bond defaults are historically far more common than commercial paper defaults

Value-weighted defaults in corporate bond and commercial paper markets, 1970–2008



Source: Moody's

4. Conclusion

Effective cash management requires investors to evaluate the expected return of competing strategies. Credit premium is a critical component of cash expected return, and credit risk can be a source of significant differentiation. While estimating the credit premium with precision is a challenge, we believe there is potential meaningful, positive premium based off of our analysis. Investors who have the mandate flexibility should consider credit.

Please review our companion pieces on cash or contact the research team at research@addepar.com to learn more about how to evaluate the expected return of cash.



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Asset Classifications

Asset class	Sub-asset class
Cash	Cash Cash equivalents
Fixed income	U.S. Treasuries and Agencies U.S. TIPS U.S. investment-grade credit U.S. high yield U.S. bank loans International developed markets Emerging markets Opportunistic Other fixed income Unknown fixed income U.S. municipals/tax exempt
Equities	U.S. equities Global equities Developed markets–Americas Developed markets–EMEA Developed markets–Asia Pacific Emerging & frontier markets Other equities Concentrated equity positions Unknown equities
Mixed allocation	Asset allocation vehicles Held-away accounts
Alternatives	Hedge funds Concentrated alts positions Private equity & venture Real estate funds Other alts Unknown alts
Private business	Direct private companies
Direct real estate	Direct real estate
Other	Collectibles Direct loans Unknown Liability



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