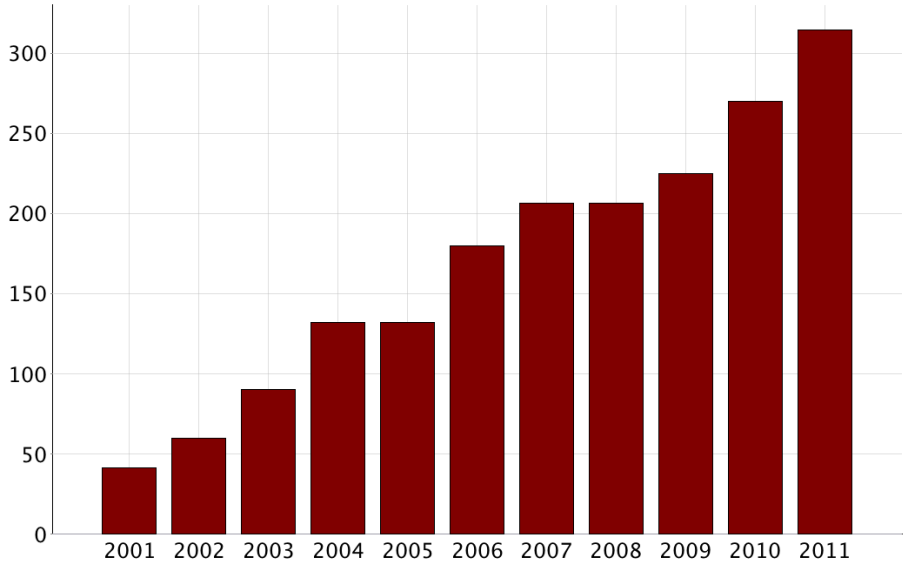
The importance of CTA cash management

Between March and June 2012, Autumn Capital conducted a survey of more than 70 CTA managers, investors and service providers in relation to cash management practices and processes across the industry. This paper provides a summary of the results of that survey, offering an insight into the ways that managers invest their cash, market views on the appropriate balance of risk and return and the differences between investor expectations and manager delivery.

According to data provided by BarclayHedge, at the end of Q1 2012, total assets in the CTA industry were estimated at approximately $328.3bn. If we assume that the average margin to equity ratio across the industry is approximately 15%, CTAs manage (or could manage, if their investors were to fund the full notional amount of the underlying positions) in excess of $275bn of cash. That's a lot of money, by any standards.



Total CTA industry assets ($Billion) - BarclayHedge

As such, the management of cash and cash equivalents by CTAs presents significant risk as well significant opportunity, In that vein, it is crucial for CTA investors to examine whether those managing these large fixed income portfolios are doing a good job. And if they are not, investors should consider only funding the necessary margin and hiring somebody else to manage the cash. The truth is that most CTA managers are probably not very good fixed income managers. Worse still, a large proportion of them continue to view the management of cash as incidental, as opposed to integral, to their business.

The good news for investors is that this is changing, slowly. The largest and most sophisticated CTAs understand that investing their non-margin cash in a way that ensures its safekeeping is as important as any other aspect of their business and that this doesn't mean leaving it in an unsecured bank deposit. In a world where investors are increasingly struggling to differentiate between CTAs, the smarter managers are also starting to realise that good cash management can be a point of differentiation, not only from a risk perspective, but also in terms of risk-adjusted return.

It is estimated that the CTA industry managed approximately $338bn at the end of Q1 2012

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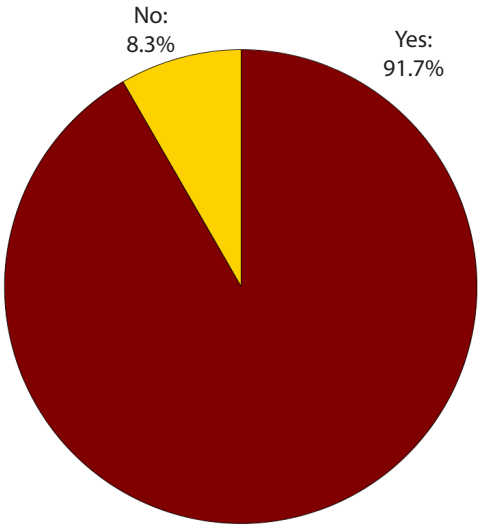
In response to the question: Is effective cash management an important part of being a good CTA manager? 83% of CTA investors responded in the affirmative with 94% of managers considering this an important part of their business and the overall results confirming that the overwhelming majority of industry participants regard cash management as a business critical issue.

83% of CTA investors surveyed believe that effective cash management is an important part of being a good CTA manager



All respondents: Is effective cash management an important part of being a good CTA manager?

Investors, in particular, are starting to take a much greater interest in CTA cash management policies, procedures and investments, post-crisis. Words such as "segregation", "client money" and "re-hypothecation" are now part of every investor's lexicon and operational due diligence has steadily risen in importance since 2008.

This is a relatively recent phenomenon however. Pre-crisis, against the back-drop of 5% risk-free rates, a generally "risk-on" market and little contemplation of the potential effects of a bankruptcy of a major bank or broker, cash management would likely have been the last box on a due diligence checklist, if it made it on at all. Five years later, there is much debate as to which assets, if any, are truly risk-free, we are in a zero-interest rate environment and we have seen five of the six largest financial bankruptcies in history in the last four years. In this context, it is hardly surprisingly that cash management is coming under the microscope.

We have seen five of the six largest financial bankruptcies in history in the last four years

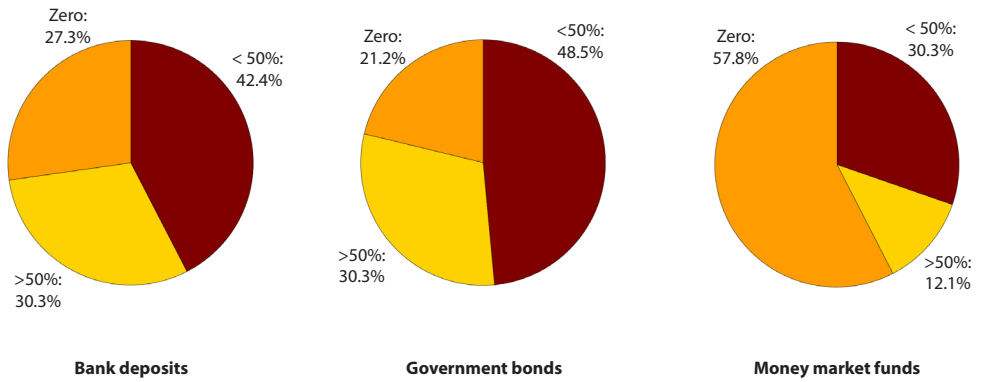
CTA cash management overview

Generally, managers seem to be on top of most of the legal issues related to effective cash management but the question of how cash should actually be invested is not a straightforward one, particularly in 2012. Treasuries are over-bought. Unsecured loans to a bank, in the form of a close to zero interest deposit, represent a poor choice on any risk-adjusted metric. And money-market funds charging fees that are typically at least double the investor return, with commingling risk and limited transparency, are probably the least attractive of the traditional cash management tools.

However, it is these three asset classes that still make up the majority of CTA cash holdings, with government bonds and bank deposits attracting the largest proportions. More than three in ten CTA managers have more than 50% of their funds' cash invested in bank deposits, with another three in ten investing more than 50% in Government bonds. Only 12% of managers listed money market funds as their largest cash holdings, while 45% of managers stated that they believed that money market funds' fees were too high.

It is interesting to contrast the actual manager allocations with investor's views as to how they would like their CTA managers to invest their cash.

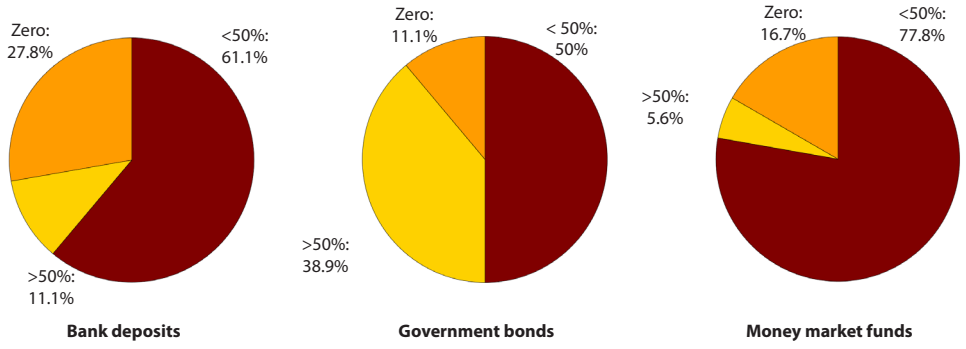
To managers: What proportion (%) of your cash and cash equivalents portfolio is held in the following asset classes?



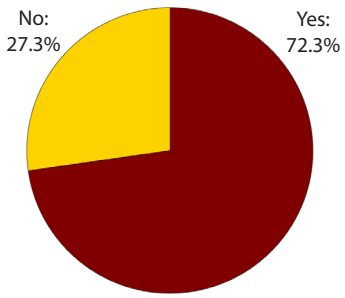
In each case, investor preference is for lower allocations than those that persist, particularly in the case of bank deposits. It seems, for the most part, that investors have a keen desire for managers to diversify their cash holdings across asset classes and to challenge the notion that unsecured bank deposits should be considered as "cash".

More than 3 in 10 CTA managers have more than 50% of their clients' cash invested in unsecured bank deposits

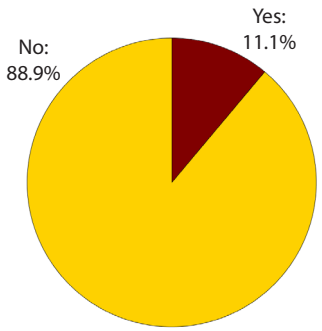
To investors: What proportion of a well managed cash and cash equivalents portfolio should be comprised of the following asset classes?



A starker illustration of the divide between investor expectations and the realities of CTA cash management can be seen in the contrasting responses to the question of whether CTAs (or, in the case of managers, their particular fund) have impressive cash management processes, systems and protocols.



To managers: Do you think that an institutional investor would be impressed by your cash management, practices, protocols and systems?



To investors: Do you think that most CTA managers that you see have impressive cash management, protocols and systems?

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It is clear that, post-crisis, investor expectations for CTA cash management have increased dramatically but the practices of all but a few CTAs have not kept pace with this change. All the while that poor or mediocre cash management is the norm, managers who have the foresight to take steps to improve this part of their business can differentiate themselves from their peers. In turn, as the industry in general takes a more robust approach to the management of its fixed income assets, as it surely will, those that do not improve will find themselves struggling to justify their inaction.

72% of CTA's think that their cash management processes are effective

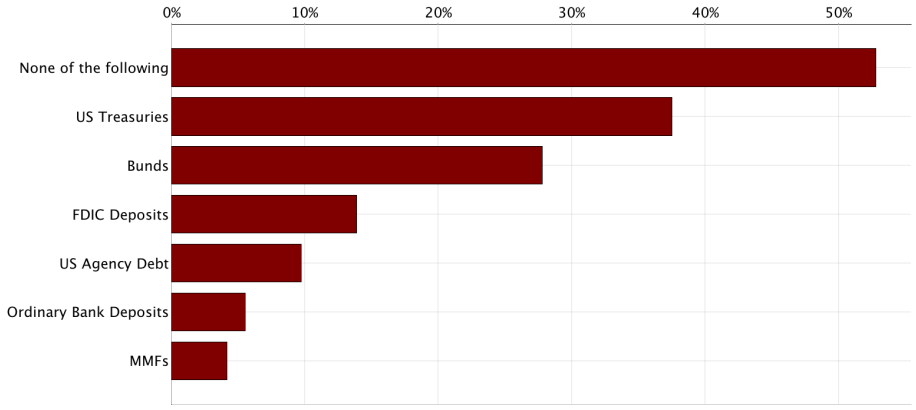
It is not surprising that CTA cash management practices to do not accurately match investor desires, or that they are relatively rudimentary when compared with the level of sophistication in other areas of the business. This is an issue that has, until recently, been largely overlooked by CTA investors and managers alike. Without proper consideration being given to cash management and an intelligent dialogue between managers and investors, a sensible solution can't be reached and the gap between industry practices and investor expectations cannot be bridged.

11% of investors think that CTAs have effective cash management processes

Risk and return

When evaluating risk-adjusted return, it is necessary to consider the excess return that a given asset offers over the risk-free rate. This, of course, requires a reliable risk-free rate to use as a benchmark which, in turn, requires the identification of a risk-free asset. In 2012, the first question that must be asked is which assets, if any, are risk-free?

More than 50% of respondents considered that there is currently no such thing as a risk free asset



All respondents: Which assets do you consider to be risk-free?

There was considerable disagreement amongst survey respondents as to which assets constituted risk-free investments with more than half taking the view that, in this environment, the term is a misnomer. Such disagreement illustrates the current difficulties facing treasury departments and cash managers. Without a true risk-free alternative, surely managers have an obligation to properly evaluate their cash management options with the same rigour that they would apply to any other investment.

A primary driver of a manager's investment strategy, whether in cash or futures trading, should be investor preference. Interestingly, in response to the question of whether CTA investors would prefer their managers to focus on taking as close to zero risk as possible or maximising risk-adjusted return within a low risk framework, investors were equally divided.

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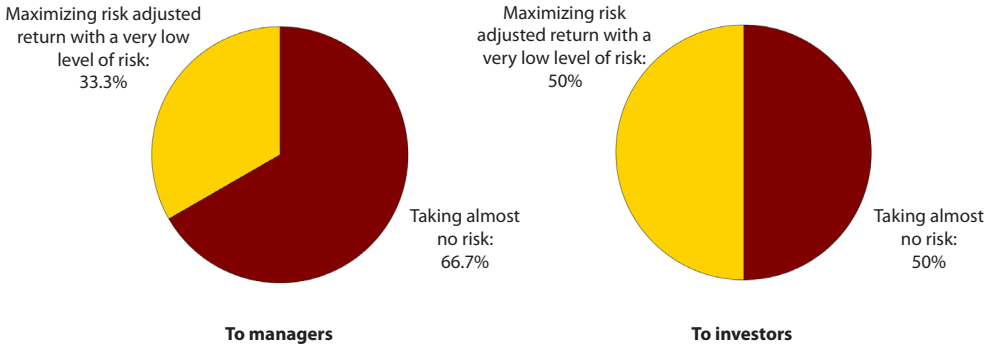
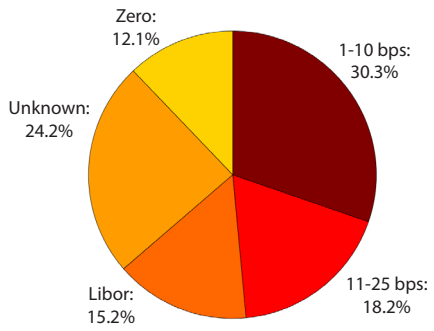
Managers, by contrast had a stated preference for taking as little risk as possible. This is illustrated by the fact that only 27% of managers were of the opinion that the yield on a 1 year US T-Bill represented an attractive risk-adjusted return. Given that almost 50% of managers invest more than 50% of their cash allocations in government bonds, it appears that managers are favouring investments that they understand offer poor risk-adjusted returns in exchange for a perceived guarantee of principal protection. In the context of the earlier findings that a third of managers invested more than 30% of their portfolio in bank deposits, it is not clear that managers preferences and actions are necessarily well aligned, however.

What is more important when managing cash and cash equivalent portfolios within a CTA?

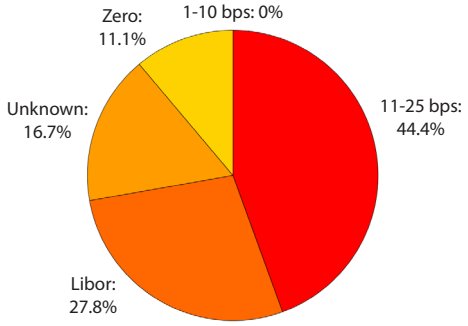


Considering that the stated preference of half of the investors surveyed was to take as little risk as possible when dealing with cash and cash equivalents, one might expect that their return expectations for these portfolios would be zero, or close to zero. However, the results do not bear this out, with only 12% of investors expecting a return on cash of less than 10bps. 44% of investors expected cash returns to be between 11-25bps, with 28% expecting returns in excess of this. With the 3 month T-bill currently yielding approximately 8 basis points, returns above this level would imply some risk, at least to duration.

Actual returns from underlying cash portfolios were more closely aligned with risk perspectives of managers with more than 40% of portfolios yielding 10bps or less. Only 15% of managers were able to generate more than 25bps from their cash holdings. Never-the-less, in absolute terms, the disparity between zero and 25bps is quite significant, particularly in an environment where investors are struggling to differentiate between managers operating similar strategies.



To managers: What is the current level of returns on the cash and cash equivalents held in your portfolio?



To investors: What level of return do you think that it is reasonable to expect your managers to achieve on the cash and cash equivalents portion of their portfolio in the current environment?

Investors are equally divided as to whether cash management should focus purely on minimizing risk or on generating appropriate risk-adjusted returns

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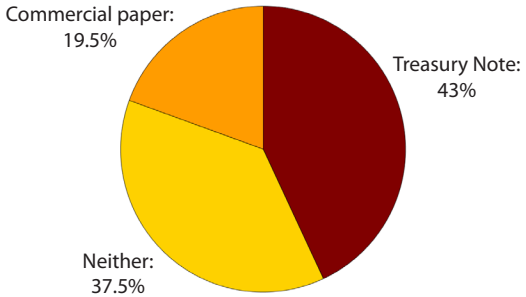
In terms of risk preferences, both investors and managers showed a clear preference for duration as opposed to credit with 43% of respondents preferring to invest in a 5 year Treasury Note than Commercial Paper issued by an A1-P1 rated company from a peripheral Eurozone country. More than a third of respondents indicated that they did not think that either investment was appropriate for a cash portfolio.

More than 40% of managers surveyed indicated that they earned less than 10bps on their cash portfolios



All respondents: From a risk perspective, would you rather invest in commercial paper issued by an A1-P1 company in a peripheral Eurozone country or a 5 year Treasury Note?

The mystery of secured lending

If you were to ask most people, financially educated or otherwise, whether they would prefer to lend money to someone on a secured or unsecured basis, the overwhelming majority would surely indicate that they preferred the secured trade. If you were to then tell them that they would be paid more for offering the secured loan than the unsecured, any remaining doubters would hopefully stop scratching their heads and tick the secured box. In certain circumstances this is exactly the choice that is offered to cash investors when considering whether to place money on deposit with a bank (unsecured loan) or to enter into a reverse repo trade with that bank (secured loan). For various structural, operational and economic reasons, it is currently possible to earn a greater return by lending to a large number of highly rated banks on a secured basis through reverse repo transactions than by placing a deposit with the same bank for a commensurate term.

Only 55% of respondents had any familiarity with the repo market with only 15% believing that it offered good risk-adjusted returns

It is true that repo transactions, particularly in the tri-party market require significant operational infrastructure in terms of legal agreements, market contacts and clearing relationships in order to implement them, which means that it would rarely make sense for smaller funds to participate directly. However, many larger funds have some or all of this infrastructure in place already. Additionally, there are a number of ways to access the reverse repo market without expending the time and money necessary to participate directly, either through conduits or platforms. It was surprising therefore that the survey results indicated that only 15% of managers and 11% of investors had ever invested in reverse repo and approximately 20%, in both camps, were completely unaware of the reverse repo market.

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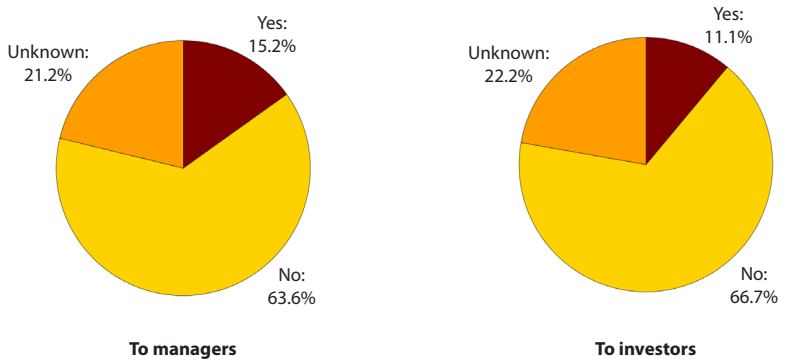
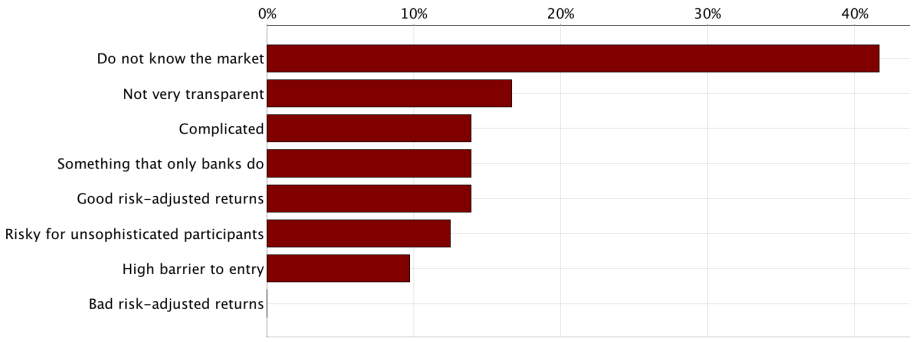
Have you ever invested in reverse-repo transactions either directly or indirectly through a platform, conduit, money market fund or money market managed account?



When asked to pick characteristics to describe the repo market, the response was equally unenthusiastic with only 65% of the respondents having any familiarity and only 11% taking the view that it offered good risk-adjusted returns.



All respondents: What is your impression of the repo market?

Summary

Perhaps the key takeaway form this survey is that the overwhelming majority of CTA investors surveyed believe that cash management is a business critical issue and, perhaps more importantly, they are not impressed with the way that managers currently conduct this part of their business. Unsurprisingly, given the economic backdrop, risk and capital preservation are the key concerns but satisfying those concerns is not easy in an environment where risk free assets are exceptionally difficult, or arguably impossible, to identify.

Achieving an acceptable risk-adjusted return is also an important factor for at least of 50% of investors. Everybody seems to agree that bank deposits, government bonds and money market funds do not fare well on this criterion. Yet they continue to be the instruments of choice for most managers.

Up to this point, we can only point to a handful of managers that are giving this area the attention that it deserves in order to diversify and reduce risk while searching for some incidental yield pick-up. Investor demand and evolving best practices from those at the top of the industry are driving change but many managers still fail to grasp the potential peer group differentiation that high quality cash management can offer.

The overwhelming majority of those surveyed regarded cash management as a business critical issue

Autumn Capital Partners LLP is a financial consultancy firm offering services primarily to the hedge fund community. Autumn currently advises on in excess of $8bn of cash and cash equivalents.

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