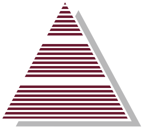

KARPUS
INVESTMENT
MANAGEMENT

COMMENTARY

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Options for Cash Management

The federal funds rate has been a focal point since the Federal Open Market Committee (FOMC) first began to raise this key interest rate in March 2022. It is the interest rate range set by the FOMC that institutions, such as banks, charge each other for overnight loans. It is also one of the primary tools the FOMC has used to fight inflation. In fact, since March 2022, the FOMC has raised the federal funds rate over 500 basis points (5%), for a total of 11 times, in a series of hikes ranging from 25 to 75 basis points (a basis point is 1/100th of 1 percent).

This has had a large impact on taxable and tax-sensitive fixed income markets, resulting in the Bloomberg U.S. Government/Credit Bond and Bloomberg Municipal Bond Market Indices being down by 13.57% and 8.53%, respectively, for calendar year 2022. Other interest rates on things such as mortgages, auto loans, and saving accounts are also influenced by the federal funds rate.

As of October 10, 2023, the average 30-year fixed mortgage rate was 7.83%, compared to the 3.27% average rate found at the end of 2021 (one quarter before the FOMC began hiking the federal funds rate). Put in nominal terms, homeowners today would have to pay an extra $4,560 in interest annually for every $100,000 they borrow, which is a substantial difference when buying a home.

While high interest rates have stifled borrowing, they have also revived cash management. Cash management all but went extinct as the federal funds rate was targeted at 0-0.25% from March 2020 through March of 2022.

Retail investors currently have several different investment options to maximize the return on cash. This cash could be set aside for a specific upcoming expense or perhaps the investor prioritizes preservation of capital above all else which would prevent them from investing in risker assets like equity or longer duration bonds. I will highlight five options that we believe are readily available.

First, high-yield savings accounts are an option that ensures liquidity for an investor. The interest the investor earns on their high-yield savings account is the bank compensating them for borrowing their money to loan out to other customers at a higher rate. The bank has to offer a competitive savings rate or customers will take their business to other banks offering better rates of return. A high-yield savings account is a variable rate account. If the FOMC were to hike or cut the federal funds rate, the rate of return on an investor's high-yield savings account would also adjust accordingly.

Another option for investors is money market funds, which invests in high quality, short-term debt and earns a rate of return slightly better than high yield savings accounts. Like high-yield savings accounts, money market funds offer liquidity and move in lock step with the federal funds rate. A money market fund's goal is to keep the net asset value of each share equal to one dollar and any additional earnings are paid out in the form of a dividend. There is no goal of capital appreciation for the shares.

A third option to consider are certificates of deposit (CDs). A CD is a savings product offered by financial institutions. An investor agrees to buy a CD with a guaranteed rate of return on the condition that they will not withdraw any money over an agreed upon length of time. The rates on CDs are closely tied to the federal funds rate and allows investors to lock in a favorable rate of return with the trade-off being a lack of liquidity over a stated time frame. If interest rates were to move higher, the investor in the CD would miss out and not be able to reset until the CD matured without a penalty. If interest rates moved down, then the investor would benefit because their rate of return would remain the same.

The fourth option is a short-term U.S. Treasury Bill that has 1-year or less until maturity. Compared to a CD or high-yield savings account, short-term U.S. Treasury Bills can offer a more competitive rate of return. Unlike CDs, which require a lock up of the money over a specific period of time, U.S. Treasury Bills can be sold in the secondary market easily if the need for cash arises since the Treasury market is one of the most liquid markets in the world. Short-term U.S. Treasury Bills are more sensitive to changes in interest rates and this is most evident if the investor has to sell before maturity. If rates move up or down, the price of the U.S. Treasury Bill would adjust accordingly to match current interest rates if the investor had to sell.

The last option is a less known alternative and a strategy we utilize, which is buying Special Purpose Acquisition Companies (SPACs) *prior to their acquisition*.

SPACs are blank check companies that raise cash through an initial public offering. Typically, each common share is backed by $10 per share, and that cash is set aside in a third-party trust that invests the cash in a money market fund or U.S. Treasury Bills extending out to 180 days. A SPAC usually has 12-24 months to find a deal or else they have to liquidate and return cash in trust to the investors. Ultimately, a SPAC's end goal is to raise capital and find a private company and bring them public through the SPAC.

In this particular strategy, the key is to invest only in pre-acquisition SPACs with the goal of buying the SPAC's common shares at a discount to their cash per share value. Then, if the SPAC decides to enter into a business combination with a private company, we would redeem our shares and get our cash back.

We believe that there are several benefits to SPACs, the first being that an investor can lock into a rate at or above the federal funds rate for 12-24 months depending on the length left on the SPAC.

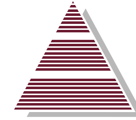
Secondly, our view is that purchasing pre-acquisition SPACs has unlimited upside which we do not see with the other previously mentioned options discussed. This upside comes risk-free in that if the SPAC manager finds a deal that other investors want to invest in, the SPAC could start trading above its per share cash level. In this case, although rare in our experience, we would immediately sell and investors can have additional return on their SPAC investment (aside from their pro-rata share of the trust account).

The last benefit we see that SPACs can have is if their typical 12-24 timeline is shortened by finding a deal before the deadline. This enables investors to redeem early and recognize the full gain. For example, if an investor purchased a SPAC with 12 months left before liquidating and had a go-forward expected return of 5%. If this SPAC then entered into a business combination with a private company and the investor was able to redeem their shares for cash after only 6 months, they would get a 5% return in 6 months instead of waiting the full 12. This results in annualized rate of return of 10.25%.

To learn more about this option, please see our commentary piece titled “Notes on our approach to investing in Special Purpose Acquisition Companies.”

To summarize, the key things investors need to look at when considering cash management options are their risk tolerance and liquidity needs. We believe that investors have become too comfortable accepting low returns on their cash investments due to an extended period of ultra-low interest rates. We suggest you re-evaluate and determine if you are maximizing your options and making your cash work for you. For more information, we suggest having an in-depth discussion with your tax and financial advisors.

Sources: Bankrate, Blomberg Finance, L.P., The Board of Governors of the Federal Reserve System, Federal Reserve Bank of St. Louis Investopedia, Liberty Street Economics.



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