Cash Drag or Collateral-Derived Alpha: The Choice Is Yours

Generating alpha is hard enough, so why let cash drag stifle returns? With derivative-laden portfolios in a high-interest rate environment, collateral presents opportunity to improve returns. The decade-long period of low-interest rates created detrimental habits with a default cash collateral model. Asset owners face challenges in diversifying collateral beyond cash due to existing infrastructure that often lacks the sophistication necessary to efficiently handle alternative collateral types and their respective operational challenges. Don't let cash be a drag; overcome constraints to enable use of non-cash collateral.

ARE YOU MISSING OUT ON ALPHA BECAUSE OF SUB-OPTIMALLY ALLOCATED COLLATERAL?

Historically, asset managers often used cash as collateral due to its availability and simplicity. However, with the current Fed Funds rate ranging between 5.25% and 5.5% as of Q1 2024, the landscape has shifted. With opportunity costs increasing, optimally allocated collateral could yield several percentage points of alpha (on posted collateral) relative to sub-optimal allocations. With significant return differences at stake, asset managers should reconsider their collateral allocation strategy.

Optimal collateral allocation involves several factors: portfolio strategy, eligible collateral, regulatory requirements, technological capabilities, and securities lending opportunity costs. These factors determine the advantages and disadvantages of using various assets as collateral.

CASH & CASH EQUIVALENTS

Cash is often viewed as the go-to collateral option for portfolio managers due to its operational ease, availability, and absence of haircuts. However, it comes with drawbacks, notably cash drag. The minimal interest earned in FCM, tri-party, or third-party accounts make it the lowest yielding option. As interest rates rise, the opportunity cost of holding cash increases, potentially impacting fund performance and its ability to track or beat the index. Most money market funds (MMFs) cannot currently be used for collateral for uncleared margin rules (UMR) as they contain REPOs, but certain asset managers have rolled out MMFs without REPOs to bridge this gap.

FIXED INCOME SECURITIES

Pledging government debt as collateral is another popular option, especially among fixed-income portfolio managers. US treasuries offer generous haircuts ranging from around 0.5% to 10% (or more), depending on factors like tenor, credit rating, and country. With current treasury yields ranging from 4% to 5.5%, they present an attractive alternative to cash and are generally accepted by most counterparties. Drawbacks include the need to monitor treasury rolls and manage substitutions. While government debt is ideal for fixed-income portfolio managers, equity or multi-asset funds can also benefit from incorporating treasuries to optimize collateral.

Using Corporate bonds as collateral offers higher yield (and volatility) compared to treasuries but comes with a greater haircut to account for the increased risk. Challenges include managing fund and enterprise size limits, bond rolls, and smaller position sizes. Effective collateral management requires sophistical monitoring across ratings, sectors, industries, and countries at both fund and enterprise level. This approach is best suited for fixed-income portfolio managers with diverse bond portfolios and advanced collateral management systems capable of monitoring and recalling eligible collateral effectively.

Cash Drag or Collateral-Derived Alpha: The Choice Is Yours

EQUITIES

Equities are seldom used as collateral due to their high volatility and risk, as most counterparties do not accept them. Broker-imposed restrictions often require collateral to be unrelated to the underlying security, with contribution limits to spread risk. Additionally, equities incur the largest haircut percentage among collateral types and pose monitoring challenges due to corporate actions necessitating substitutions. While equities are commonly used for securities lending to generate extra revenue, integrating them into collateral management systems requires real-time communication between systems, which is often lacking. Nonetheless, with the right infrastructure and accepting counterparties, equities can be a lucrative option for equity portfolio managers aiming to minimize cash drag and tracking errors.

CONCLUSION

There's no universal recommendation due to various factors such as fund holdings, mandates, broker limitations, and monitoring capabilities. During high-interest rate periods, posting cash collateral is discouraged due to the opportunity cost (cash drag). A practical approach involves assessing fund holdings and broker allowances, then weighing the pros and cons of each option. For instance, a balanced portfolio manager with a robust collateral management system trading equities, treasuries, and corporate bonds may opt for treasuries and corporate bonds. On the other hand, an equity portfolio manager without integrated equity collateral management faces tough decisions: invest in infrastructure and push brokers to let them post equities, learn to trade T-bills and post them, or post cash and accept the opportunity costs.

Finding the optimal solution requires weighing all the available options and deciding upon the best outcome.

As firms have become accustomed to low interest rates, now is an opportune moment to reassess the role of collateral in enhancing fund performance. With management fees decreasing and competition rising, it is crucial for managers to utilize every available tool to maximize fund performance. Overlooked areas should be re-evaluated as they could be the deciding factor in fund outperformance.

HOW MERADIA CAN HELP

Meradia offers the expertise to evaluate collateral maturity models, suggest adjustments, and implement systems and processes for optimal collateral management. Regardless of your firm's derivative exposure or collateral model, Meradia understands the challenges involved. Our consulting team utilizes best practices to maximize vendor capabilities and enhance performance and operations across front, middle, and back offices.

Ryan Bond, PMP, CFA brings over 10 years of front, middle, and back-office experience to address challenges for Meradia's clients. With extensive digital transformation experience, he enables asset managers to maximize their operational efficiency with many of the industry's leading platforms and products. He has led all stages of multiple implementations, ranging from design all the way through conversion in both middle-office and back-office applications. Additionally, Ryan specializes in the outsourcing of key operational capabilities to external service providers to achieve cost savings for the client. He has worked closely with fixed income, equity, and derivative instruments throughout his career and has substantial expertise in both middle and back offices.

Meradia
119 North High Street
West Chester, PA 19380
Phone: 610-738-7787

© 2024 Meradia. All rights reserved.