Money market funds – a corporate perspective

Carlton Communications' financing policy has resulted in a surplus cash position. Charles van der Welle explains how money market funds have been utilised.

Carlton Communications Plc is the largest commercial terrestrial broadcaster in the UK and the world's largest producer of pre-recorded video cassettes and motion picture film. The company has a very conservative financial profile for a media company; its major acquisitions were financed through a mixture of equity and long-term debt. This financing policy, together with cash-generative businesses, has meant that the company has had surplus cash to manage during most of the 1990s. The cash has been predominantly in sterling and dollars concentrated in the UK and US and at times has totalled hundreds of millions.

Cash management

Carlton's cash has been managed in-house by treasury. The company's attitude to risk is that security is of paramount importance followed by liquidity then yield. As a result some yield is sacrificed for higher security/liquidity. The company's investment guidelines are approved at board level with short-term investments (of less than one year) requiring A1 or P1 ratings and long-term investments (more than one year) requiring AA ratings. There are counterparty limits and restrictions on type of instrument, country risk, portfolio duration and use of derivatives. Investment strategy is kept simple, the majority of investments being in bank deposits, commercial paper and, in the last 18 months, money market funds (MMFs).

MMFs

MMFs were first marketed to Carlton about two years ago. To consider investing cash in a fund, Carlton needed to be satisfied that security and liquidity at least matched existing investments and then that the funds could be competitive on yield. The prime objective of MMFs is to preserve principal. They achieve this by investing in a diversified portfolio of high-grade (A1/P1 or better) short-term money market instruments (Repos, CP, CDs, MTNs, FRNs and bank deposits). The assets are ring-fenced by an independent custodian; as a result, the day-to-day management and dealing functions are separated from settlement and custody. Also, credit decisions are segregated from investment and dealing. An investor in the fund is effectively investing in the portfolio. Liquidity is very high, with immediate access to cash up to the fund's cut-off time which typically is between 12.00pm and 2.00pm.

To provide investors with immediate access the fund itself keeps 40–50% of its investments on an overnight basis. MMF yields are net of fees and are attractive compared with overnight bank deposit rates, particularly when the short-term yield curve slopes sharply upward or when short-term interest rates are cut more aggressively than the market had anticipated, as we have seen over the past nine months. In each case the investor is benefiting from the longer duration of the fund.

The majority of MMFs that have been marketed to Carlton carry an AAA credit rating, well above Carlton's hurdle. To achieve this rating the fund would normally require an average maturity of less than or equal to 60 days and compliance with minimum diversification limits. Carlton also considers the financial strength and reputation of the fund sponsor even though there is no legal recourse. Each MMF is separately approved by the finance director under powers delegated within the group's treasury authorities which, in turn, have been approved by the board.

MMFs are usually based offshore for tax reasons and operate in a similar way to unit trusts, interest being earned through additional shares in the fund. The funds Carlton has used seek to maintain a stable net asset value (NAV) – an important concept since the assets of the fund are valued on an accruals rather than market-to-market basis. As a result, principal invested is maintained and there are no capital gains/losses. The fund manager controls the stable NAV in the worst-case scenario of a sharp increase in short-term interest rates by reducing the average life of the portfolio if its market value moves below book value by certain predetermined trigger levels. When considering an MMF it is sensible to ask the sponsor how it maintains stable NAVs.

Carlton has found MMFs to be a very useful alternative to bank deposits and commercial paper and currently has accounts with Aim Global and Fidelity Investments. The funds are very easy to use and the level of utilisation depends on return, like any other investment that has met the investment guidelines.

Advantages of outsourcing

Carlton has allocated a limit to each fund it utilises, just as with any other counterparty and this is partly a function of the size of the fund. Carlton does not see any disadvantage in outsourcing and views investment in a fund rather like an overnight deposit. There is some time-saving on dealing and processing but this should not be overstated. The funds are available in major currencies and minimum investment sizes are very small. Since the funds closely replicate the investment guidelines that Carlton has for its own direct investments they have been useful for benchmarking in-house performance. The only minor disadvantages with MMFs is that there are no industry standards (eg, quoting returns or payment of interest) and with most funds the rate achieved is not known until the following day. However, these disadvantages are strongly outweighed by the advantages. ■

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