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Building a liquidity ladder

Craig Inches
Head of Rates & Cash

Royal London Asset Management's Head of Rates & Cash, Craig Inches, discusses the importance of security and diversification in the current market, and explains why liquidity and short term fixed income investors should aim to build a 'liquidity ladder'.

From soaring inflation to high-profile bank failures, the last couple of years have brought no shortage of challenges for corporate investors – but recent interest rate hikes have brought opportunities for yield that have been unavailable since the global financial crisis. So, what should investors be focusing on in 2024? And how can fund managers best meet their continuing requirements for security and capital preservation?

Diversification and security

For one thing, current market conditions make it particularly important for asset managers to maximise diversification within a portfolio, while building in as much security as possible, says Craig Inches, Head of Rates and Cash at Royal London Asset Management, who recently celebrated his 15-year anniversary at the investment management firm.

"We focus a lot on things like secured lending against government bonds (reverse repo), and we invest quite a lot into the covered bond market," he explains. "Where we are investing on an unsecured basis, we try to look for a few quirks in the market, where the assets are exempt from bail-in rules introduced after the financial crisis."

Another major focus for Royal London Asset Management is on building security within its portfolios. "If you look at our corporate bond funds, you'll find that probably in excess of 20% of most of the portfolios have security backing the assets," comments Inches. "We're either backing our positions with government debt, or we're backing them with covered bonds, which are AAA-rated assets that are exempt from bail-in rules."

At the same time, they are increasingly building ESG analysis into their funds. "Credit analysis has always been important when you're analysing financial institutions, and you generally look at the corporate structure of the institution and the financial viability," Inches says. "But now, looking at ESG is very important."

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He comments that when an institution experiences a negative event relating to ESG, the liquidity of that asset completely disappears – "so doing your homework on ESG, and constructing your portfolio so that you're less exposed to institutions that have a poor track record in this space, is key."

A question of duration

In 2023, the firm's RL Sterling Liquidity Fund was the joint top performing Sterling money market fund*. According to Inches, one reason for this success is that the firm "had a good call on the interest rate outlook for the UK in 2023."

In 2022, he explains, it was clear that interest rates needed to rise in the UK, "and we thought they needed to rise much more significantly than most of the market expected." Consequently, the firm opted to keep the profile of its fund very short, in contrast to many peers who opted to extend the duration of their portfolios early.

"We then started increasing the duration of our portfolio in the mid part of 2023," he adds, "so as interest rate expectations started to fall in the second half of 2023, we'd locked in some of those higher rates."

In 2024, Inches says there is an argument that investors should be looking at a wider subset of funds. "We run liquidity funds, but we also run other short-term fixed income funds, which are still in that liquidity solution space but invest in slightly longer dated assets," he explains. "I think that if your view is that interest rates have peaked, and credit spreads will continue to remain tight or contract further, you probably want to consider slightly longer-dated cash funds."

Prospects for 2024

So, what is the rest of 2024 likely to bring? "Our central case scenario is that after you've raised rates globally by 5%, which is what more central banks have done, you would expect to see things starting to slow down," says Inches.

"We've seen that initially, with global inflation rates starting to come back down towards the 2% target rate for most major central banks."

Nevertheless, he says that wages will be an important factor to watch in 2024. "As we move into the second half of 2024, if you've got strong real average earnings and tight labour markets, that could still cause some problems for central banks, because it is likely to bolster reasonably robust domestic inflation," he comments.

"However, if current trends continue around declining vacancies and unemployment rates drifting a little higher, that could lead to some economic slowdown, which justifies central banks cutting interest rates."

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Against this backdrop, Inches emphasises the importance of segmenting cash into different buckets.

"One of the reasons why we launched four funds in this space was not to give people a choice of funds at different points of time, but to give them a ladder of funds," he notes.

"If treasurers have got a pot of money, they can look at how much they need for day-to-day expenses, and place that portion into liquidity-type funds.

Money that might be needed in three months' time can go into medium-dated funds – and longer-term cash can go into enhanced products, which aim to capitalise on higher potential returns."

By using this liquidity ladder approach to diversify cash, Inches says treasurers can maintain liquidity, invest in products that offer strong security, and try to enhance yield – "rather than having to just choose a fund for a season."

*Based on IMoneyNet data with restricted/internal share classes removed.

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