Alternative investment options to increase yield

Background

1. Owing to a flood of government money into the banking sector as a result of the Funding For Lending scheme, there has been a downward trend in investment rates over the last few months. We previously had significant sums invested in the one year period at various rates in excess of 1% and up to 3%. These investments have started to mature and the equivalent 1 year rates are now at or below 1%.
2. In order to maintain the interest receipts budget at its existing level going forward, consideration needs to be given to alternative options to increase yield.
3. The consideration of risk is important in local authority investment decisions and the overriding principles are security and liquidity before yield.
4. In considering the alternative options, it must be realised that additional risk will be inherent.
5. Our treasury management advisors (Capita Asset Services) produce a matrix of recommended counterparties and duration limits on a weekly basis. Whilst it is for the authority to make its own investment decisions, it should be recognised that some of the options would fall outside their recommended guidance.
6. Our current investment strategy is very cautious and largely follows the Capita model. Most changes put forward here would not be compatible and would hence require approval by Full Council.

Options

A. Increase limits to existing counterparties

Currently, the limits are £8m for Lloyds and RBS, £5m (or £6m including call accounts) for others and £2m for the top five building societies (with the exception of Nationwide).

The value of the portfolio averages about £30m and there is a current limit of 25% of the total fund to any counterparty.

By increasing the limits, there would be scope to concentrate more money in the institutions paying better rates (mainly Lloyds & RBS). However, it should be recognised that there is increased risk in the event of the institution's failure.

B. Add new counterparties

At present, the policy is to only lend to UK based institutions. The use of foreign banks could be considered as some are paying better rates. Examples are Santander (who were removed from the lending list because of perceived issues with its Spanish parent) and Svenska Handelsbanken who will shortly be opening a branch in Sevenoaks and whose offerings for instant access accounts at least match or even better those on offer from Barclays and RBS.

The Bank of China (London branch) is new into the sterling market. It is paying above the usual levels (3 months @ 0.55%, 1 year @ 0.95%)

C. Extend the duration of investments

The maximum duration currently allowed in our strategy is one year. Depending on the assessment in Capita's colour coding matrix, some counterparties have a maximum of 3 or 6 months duration imposed. These limits severely restrict potential yield, but are there to mitigate against the security and liquidity risks. We also have a self-imposed 3 month limit on Building Societies other than the Nationwide.

There is no doubt that an improvement in yield could be obtained by committing to longer dated investments. An analysis of the need to use reserves over the coming years would be needed before tying up money long term.

Other authorities already use longer dated investments, so we would not be unique here. Some examples of the rates available at 10/9/13 are:-

Lloyds – 2 years @ 1.10%, 3 years @ 1.45%, 4 years @ 1.96% and 5 years @ 2.30%

RBS – 18 mths @ 0.85%, 2 years @ 1.27%, 3 years @1.74%, 4 years @ 2.08% and 5 years @ 2.37%

Barclays – 2 years @ 1.03%, 3 years @ 1.46%, 4 years @ 1.94% and 5 years @ 2.39%

These rates are dependent on gilt yields which have been on the increase recently owing to so much good news on the UK economy. Swap rates are moving up, so cash rates have been improving all the time. However, they can be very volatile and decisions to place money need to be timed carefully in reaction to rapidly changing market conditions. The market thinks that base rates will need to rise before Mark Carney's goal of a reduction in unemployment to 7% is reached.

As far as the Building Societies are concerned, by extending the duration to 1 year, rates in the region of 0.85% to 0.87% can be achieved, compared with 0.45% to 0.50% in the 3 month period to which we are limited at the present time.

D. Enhanced Money Market Funds

These are becoming a popular alternative for many authorities as they struggle with shrinking counterparty lists and ever reducing yields. However, these funds operate in a very different way to the standard MMFs, even though both types have AAA ratings. EMMFs have a variable NAV and therefore a greater market risk exposure. There is a potential for loss of capital. They achieve better returns because they have a wider credit appetite and increased durational limits.

EMMFs are usually viewed with a minimum of a 6 months holding in order to even out potentially volatile month on month returns. However, should access to cash be required, it is usually on a T+2 or T+3 basis (i.e. a redemption requested on Monday would be received on Wednesday or Thursday).

An example of an EMMF from one of our existing MMF providers, based on a 1 month annualised gross return and on T+5 access, is:

August 2013: 1.05%

July 2013: 0.54%

June 2013: 0.50%

May 2013: 0.93%

This compares with an almost static 0.43% to 0.44% return over the same period on their standard MMF.

E. Property Funds

These are pooled investment vehicles, investing in all types of commercial/industrial property. They have entry and exit fees and are typically viewed as long term investments over 5 years or more. They give indirect access to the property market, can be seen as another means of diversification and can provide stable returns and capital appreciation.

On the downside, they are illiquid and have inherent price volatility (whether due to a property market collapse or quality of tenants). Hence the need to take a longer term view. Additionally, exit timings can be difficult resulting in a long term lag on redemption.