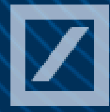
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The New Paradigm in Liquidity Management: Continuous Risk Analysis, Recalibration

With financial markets turned upside down, treasurers who had once trusted their ability to identify safe investments may be less confident. Treasurers can no longer rely fully on a rating agency's assessment of a particular investment, and alternatives are so convoluted it is difficult to pinpoint even one characteristic upon which to judge the safety of an investment.

"We've entered a new era where nothing is safe," says Lee Epstein, CEO of Decision Analytics, an institutional investment consulting firm providing services to publicly traded companies. "Corporates used to be able to distinguish among investments and place their working capital in options that fit their tolerance for risk. Today's treasurers, however, must continually recalibrate their risk tolerance levels. Risk analysis and risk-based investing is the new paradigm."

Epstein says treasurers must acknowledge that every investment has some degree of risk. Regarding each potential investment, they must ask: What types of risk are involved? How can we quantify the risks? Are the risks acceptable? Also, investors must update their policies to protect their businesses and formalize procedures that clearly demonstrate how they will manage this new paradigm.

Start by examining the risks associated with each investment category and know what risks your business can tolerate, Epstein advises. For example, asset-backed securities are heavily dependent on hierarchical cash flows, and an investor should completely understand how their investment fits in relation to the entire trust.

Other tips from Epstein include:

1. *Don't think you're protected just because you have an investment policy.* Policies are designed to outline eligible investments, maximum loss constraints and more. Some treasurers may think such policies insulate them from making bad investments because the individuals doing the investing are required to follow the policy rules. But that's not the case, Epstein says. "Policies provide guidance, but may require interpretation. They're no longer enough. Now you must also concentrate on procedures."

2. *Institute clear procedures.* Create some procedures to complement your investment policy. For example, list the exact steps one must go through in order to make an investment that meets your risk tolerance. Also, outline the process for handling policy exceptions and credit downgrades.

3. *Read. Better information = better decisions.* Someone has to do the due diligence, and unless you are paying someone for that service, that someone should be you. Don't expect that the people selling you investments will do this work for you. While it's not practical to research every industry and every fund or expect to become an expert, it's incumbent upon you to have a level of understanding about particular investments. A prospectus can tell you what you need to know.

4. *Get a competent investment adviser.* "Most investments are delineated in a somewhat unintelligible book the size of an encyclopedia," Epstein says. "The reason you have an investment adviser is to have someone who can explain, in language you can understand and base prudent decisions on, what it all means."

   If you have hired a registered investment adviser, know their depth of expertise and investment style, and what operational support or conflicts of interest they may have. Evaluate their performance with a fair and neutral benchmark, risk/return analyses and quarterly reviews.

5. *Know how your investments are being handled and how much you're being charged for that management.* Rule 2-a7 (Investment Company Act of 1940) allows a money market fund to have a maximum exposure of up to 5% to any issuer, but perhaps you would feel safer limiting your exposure to 3%. Know what your managers are doing and how they're managing your funds.

6. *Recognize signs of portfolio trouble.* Potential red flags include drastic changes in portfolio quality, increased concentrations by issuer, making exceptions to your policy and high transaction volume.

7. *Be aggressive.* Demand high-caliber service for those dollars you're spending for investment services. "We need aggressive treasurers who demand information from those making money off their working capital," Epstein says. "Treasurers are already smart. Now they have to continue to pay attention and stay assertive."

At the end of the day, the risks associated with a particular investment can't be measured in black and white, but rather along a sliding scale in varying shades of gray.

"Risks are all around us and this is no time to be using old techniques to manage new market conditions," Epstein warns. "There's nothing ‘safe' about that approach."