ADDEPAR

Cash

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Ron Akke, Dan Golosovker, Ashby Monk, Amar Patel, Dane Rook

An excerpt from a recent Addepar research report.

Key Takeaways:

- Clients hold 9% of their portfolio in cash in a variety of cash instruments, with significant dispersion in cash returns
- Even as the year-long sell-off steadied in Q4, clients derisked their portfolios, moving capital into cash and particularly short-duration Treasuries[1]

Cash management is a topic of increasing importance to investment managers. **Across the Addepar client base, approximately 9% of holdings are in cash instruments, and — as interest rates are now substantially above zero — having a suitable cash management strategy can have a substantial impact on performance.** Typical clients that use the Addepar platform hold a significant portion of their portfolios in private capital, which strengthens the importance of liquidity management where "cash drag" is becoming an increasingly visible component of private equity performance. Finally, in a high-inflation economy, there is the additional hurdle of high opportunity costs from holding any cash at all.

While the range of possible cash investments is vast, the most common of these opportunities are outlined below. As Exhibit 7 shows, aggregate cash holdings peaked during the start of the pandemic (in part due to a sharp fall in asset prices) and declined to more historic levels in 2021, as asset prices bounced back and subsequently increased in 2022. **Of particular note, we've seen a significant uptick in relative holdings of short-term Treasuries (particularly bills and off-the-run[2] Treasuries with less than one year to maturity)** over money market funds, presumably due to increasingly competitive yield.

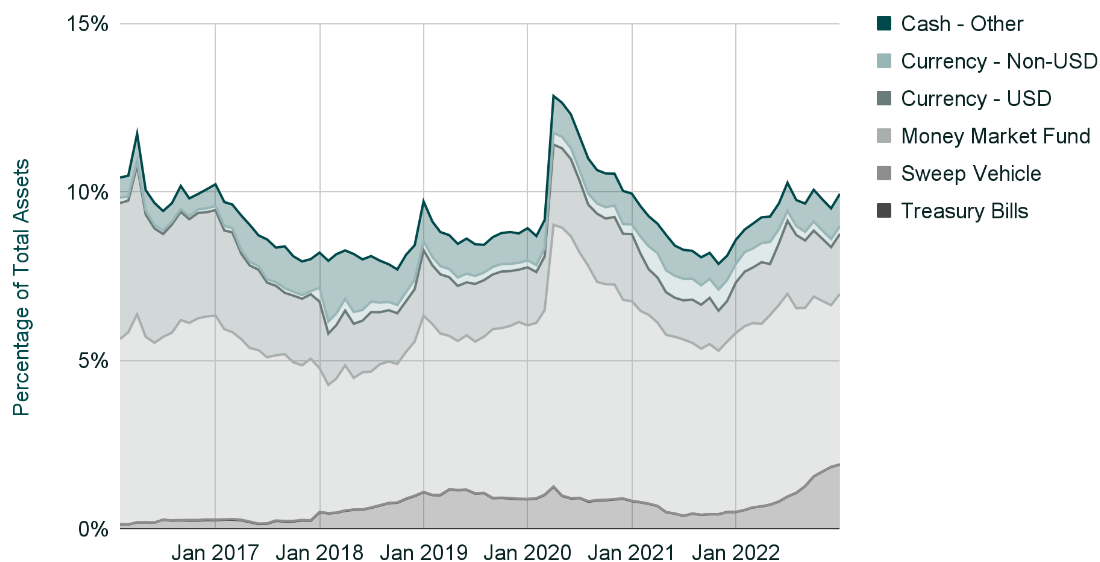
[1] Short-term Treasuries consist of Treasury bills and off-the-run Treasury securities which are set to mature within one year.

[2] Not of the latest issuance, trading in secondary markets.

Exhibit 7

Short-duration Treasury holdings increased nearly 4x in 2022.

Cash holdings by investment type, % of total assets, Jan 2016 to Dec 2022



Source: Addepar

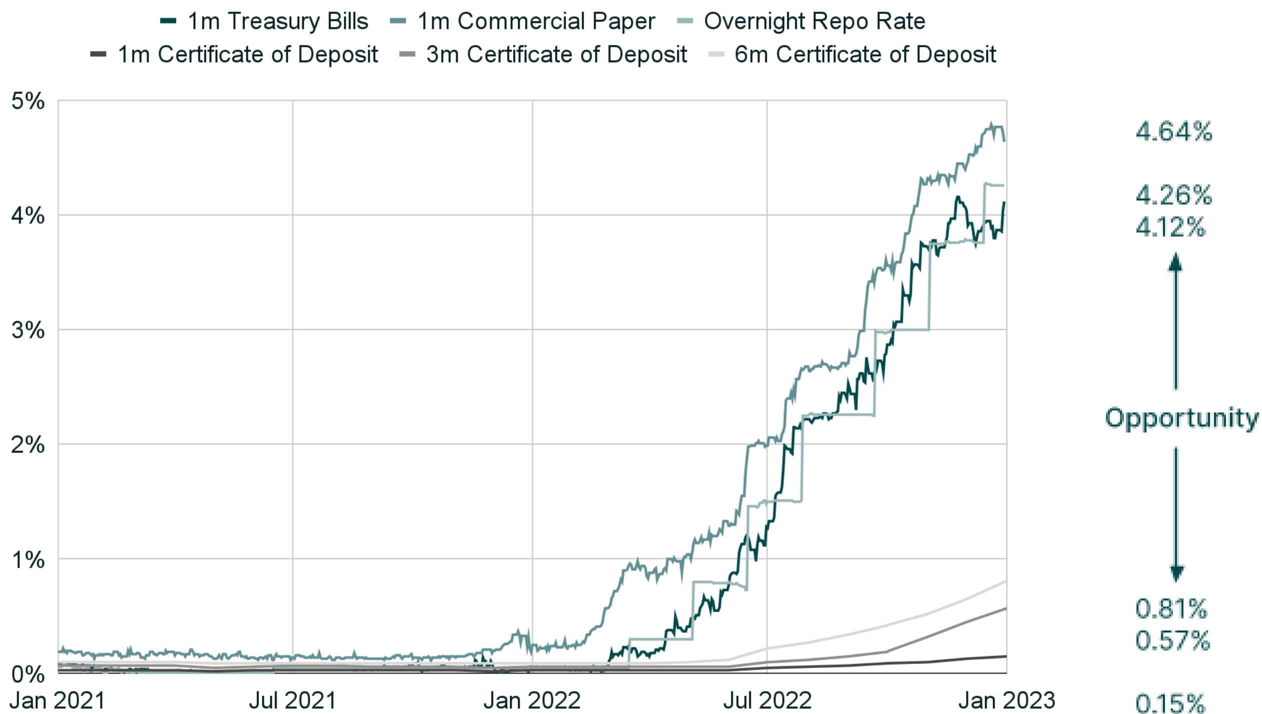
Currency is defined as paper money and cash held at banks. Sweep vehicles are programs that automatically invest end-of-day capital held at custodians into higher earning instruments. Money market funds are ETFs and mutual funds that invest in safe fixed income instruments with maturities of one year or less. Treasuries are Treasury bills and off-the-run Treasury securities set to mature in one year or less.

As Exhibit 8 shows, **over the last year, yield differentials between cash instruments have skyrocketed as the Fed increased interest rates.** In earlier years, many investors prioritized operational ease by holding cash in depository products — ignoring cash as an asset class that can move the needle for investors — when yields were broadly low and therefore held significant allocations to bank deposits. Today, that trade-off looks increasingly less appropriate, with spreads between Treasury bills and deposit rates in the hundreds of basis points in some cases. Yet, **for some investors, allocations to bank deposits remain stubbornly high.**

Exhibit 8

Yields on depository instruments have barely moved despite the Fed raising interest rates in 2022.

Daily yields of cash instruments during 2022



Source: Thomson Reuters, Federal Reserve Bank of New York

Once a sleepy corner of the investment industry, cash is quickly becoming a strategic portfolio management tool, particularly as inflation is now high and investors have materially increased their allocations to private equity over the last decade. It is a best practice to both monitor returns across the zoo of cash instruments and perform portfolio optimizations that take into account hard-to-predict future cash flow needs due to private capital. A number of clients are benefiting from Addepar's cash market monitoring and optimization tool[3]. We may even see investors (re)building capabilities around Treasuries, agency debt and other traditionally "boring" assets. Because alternative investments draw commitments over time — sometimes over as long as five years — the importance of sound cash management will increase along with the size of allocations to alternatives.

[3] Learn more about cash market monitoring and optimization by connecting with your Addepar team.

Asset allocations change over time based on a combination of (1) investment flows into and out of individual assets (e.g., buying, selling) and (2) the investment performance of individual assets. Here, we examine investment flows to cash in isolation. Investment flows are highly informative due to the fact that they are an outcome of the investor decision-making process. Flows are an "over-time" concept; we explore them at a quarterly resolution because this is the smallest scale at which (statistically) meaningful inferences can be drawn. Unlike other data sources, Addepar isolates the behavior of private wealth investors.

For context on recent trends, you should be made aware of several broad conclusions that have been drawn from long-term analysis of flows. First, the flows to cash and liquid risky assets are strongly negatively correlated (p = -0.63 since 2016). This implies that cash is an important substitute for liquid risky assets. Second, the flow to liquid risky assets falls during times of financial market turmoil, such as the first quarter of 2020, while the flow to cash picks up during those same periods. This highlights the role that cash plays as a safe asset in investors' portfolios[4].

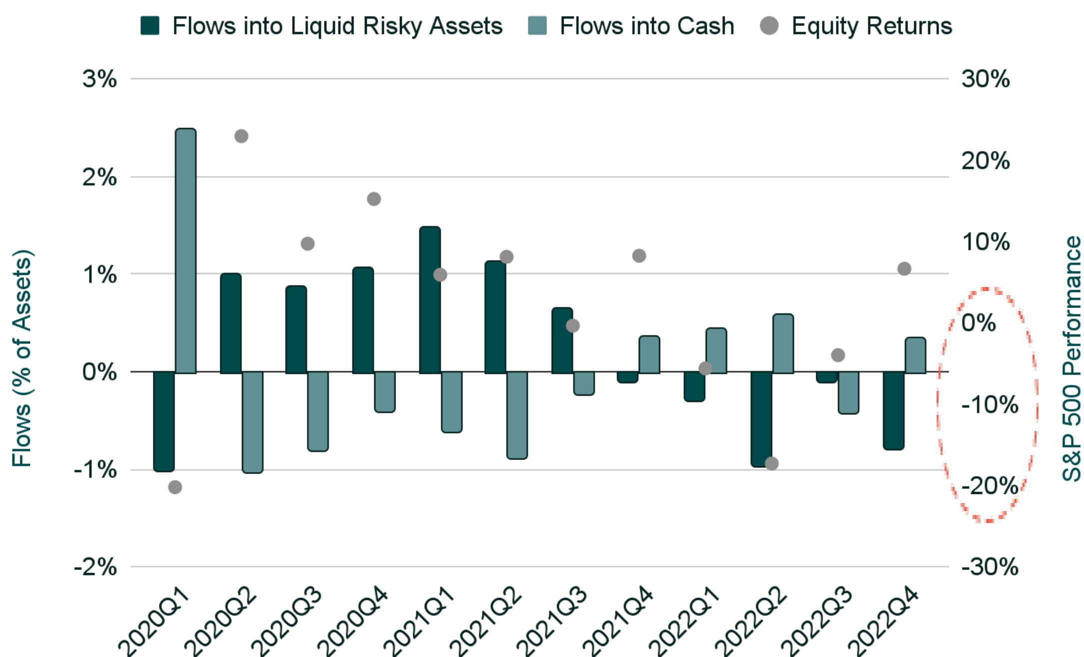
Flows into cash (see Exhibit 9) corroborate the cash allocation picture in Exhibit 7. We saw significant flows out of liquid risky assets[5] and into cash in Q4 of 2022, despite an upturn in equity market performance. Flows into liquid risky assets tend to track equity market performance[6] closely, which makes Q4 2022 a surprising outcome. **Despite the Q4 rally in the markets, this derisking may indicate a pessimistic forward view on equity and fixed income markets in 2023.** We will continue to monitor this signal very closely.

[4] This is discussed further in Ralph Koijen and Xavier Gabaix's paper *Asset Demand of U.S. Households*.
[5] Risky assets include equities and fixed income.
[6] The correlation between equity market returns and risky asset flows is +0.6 since 2016.

Exhibit 9

Investors derisked in Q42022, despite a rally in equities.

Flows as a percentage of overall assets, quarterly, 2020 - 2022



Source: S&P 500 returns from FRED, flows from Addepar

Note that to rule out seasonality, an F-test was completed on quarterly dummy variables that did not return statistically significant results (e.g., there was not statistically significant seasonality in our sample).

While no one really knows what will happen in 2023, the easy part is to comment on what is priced into assets or future expectations and describe the implications if things were to play out that way. As of the writing of this piece, markets are pricing in that short rates will rise to 5.0% in June 2023, followed by a rapid easing to 4.5% in August 2023. **The implication for cash is that rates should continue to rise for some time and dynamics that arose in 2022, such as rate dispersion, cash drag and inflation hurdles, will persist and may get further magnified. Investment managers who focus on cash management have the potential to demonstrate value to clients and outperform their peers.**

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