



Cash Management - The Quest for High-Yield, Secure Returns

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Our small company clients often ask us – “how should we considering investing on-hand cash for a year or two before as the company plans for critical working capital and capex requirements in the coming future?.”

“What is the best, entirely safe place to invest?”

Traditional Certificates of Deposit are one class of options, but offer limited liquidity to address the common corporate need to be flexible about spending and the timing of cash requirements as the business grows. CDs do not help with the frustration just about every holder of cash faces: *the quest for high, secure, federally-insured returns in relatively liquid instruments.*

Often, the first pass our clients think about is their local community bank. Savings accounts interest rates are usually not worth even bothering – especially if there are any fees or restrictions whatsoever. Candidly, leaving it in a checking account is usually more compelling. And again, CD rates at retail banking institutions are currently almost laughable given the time commitment and liquidity constraint.

For those comfortable with ranging beyond the local bank branch presence and transacting business online, high-yield savings accounts have typically been the best option for cash savings. At present, the highest liquid FDIC-insured savings account available as of this writing is 1.4% APR.

The next logical step to increase yields higher than 1.4% can be to entertain CD rates from high-yield direct banks. In this case, the top tier is roughly now 2.4% to 2.6% for 5 year CDs. Really, though – is a 5 year commitment worth 0.9% to 1.1% additional APR? Highly unlikely – especially when considering the noise of the Federal Reserve's voluminous money printing and anticipation of higher inflation rates sometime in the future. Middle-tier CD rates are usually no better – in fact, even worse when compared to the 1.4% floor of the savings account.

Typically, more creative small company investors will broaden consideration and start looking at Treasuries, municipal bond funds and other bond options. Inflation-linked bonds can be a popular choice. Caution is advised here as the desire for higher yield may lead to comparatively high risk amounts for minimal additional returns.

So, does a better option exist?

A Less Conventional Option

Again, consider our starting point – a small company looking for safe, secure, high yield investment earnings over the next year or two as management will likely need to deploy cash off the balance sheet on this timeline. Under the assumption that capital can be restricted, optionally, for a short period of time, then the company may be attracted to a somewhat less conventional option for interest earnings.

Let's step back to the 5-year CD concept. Maximum cash returns with, of course, maximum restriction. The loophole is that many of the high-yield options include an early withdrawal penalty that is relatively modest given the nearly doubled interest rates compared to the savings account option. So what are we getting at here? Simply put, one possibility is to park cash in a 5 year high-yield CD *with the presumption and anticipation of breaking the CD when interest rates rise or when capital is needed.* Here are some scenarios.

Shortest Liquidity

In any strategy, we don't want to reduce earnings by an errant set of circumstances. So, let's say that we are currently the high-yield saver at a primarily online bank. At what point could we put my money into this CD, withdraw it for some unpredictable need, and still maintain effective interest earnings of at least 1.4% (the highest savings account available in the US)? 5 months. This is based on a calculated effective APR (when factoring the time of the investment, higher 2.5% earnings less 2 months penalty). Essentially, the 3 months of interest that you are allowed to keep is enough to cover 5 months of high-yield savings account interest rates. For this example, we are basing our assumptions on Ally Bank's 5 year CD terms, but similar terms are available elsewhere.

At the one year point, if capital is withdrawn, the effective earnings translate into 1.99%. Certainly beating the 1.4% rate and also beating 12 month CD rates. Again, the basis is that 10 months of interest at 2.5% is enough to equal 1.99% over 12 months. From there, the rate rises in year 2 to 2.28% (by month 24) and slowly climbs up to the 5 year CD rate. So, in short, the 1-2 year timeframe we are speaking of returns almost a full 1% higher than the savings option.

The Interest Rate Step Up

Part of the whole strategy (aside from capital access) is the ability to step up interest rates as rates rise. Nobody wants to be stuck with a lower than market rate in the future just to get better rates now. Factoring a 2 month early withdrawal penalty, it is necessary for rates to rise 0.5% for the increased earnings to pay for the penalty *in one year*.

Logically, then, it makes little sense to keep doing this frequently – especially if the Federal Reserve starts stepping rates up more quickly as the recovery takes hold. Much like refinancing a mortgage, it is never smart to do it three times in a row and push out the ROI date three years due to recurrent transaction costs. Though there is no concrete requirement, it makes sense that if CD rates rise a full point, “refinancing” the CD (i.e. breaking it and re-entering into another 5 year CD) would make sense as it would take 6 months to earn back the withdrawal penalty with the higher earnings. Be careful. Make sure that the new CD still has a 2 month provision. If the banks do away with the 2 month provision at that time, wait until high yield savings rates increase enough to equal the present CD and consider getting out.

Additionally, be cautioned that, after the first “refinancing”, it is necessary to recalculate the necessary APR increase as it increases proportionally to the base CD rate. At 2.49% CD rates, it takes 0.5% APR increase for a one year return. If you refinance to 3.5%, it would take 0.54% to achieve a one year return on refinancing the CD for a second time.

Caveats

Caution is in order based on the bank chosen. For example, Stonebridge Bank in Pennsylvania appears to have the best 5 year rate at the time of this writing (2.65%). However, they have a staggered early withdrawal penalty – from 3 months increasing to one year. Obviously, meant to prevent this sort of strategy. Clearly, won't work with some institutions.

An additional concern is regarding partial withdrawals. Can you take *part* of the CD to cover an unanticipated need and then leave the rest in there without paying a full penalty on the entire balance? Bank policies are all over the map in this regard, so small companies have to do their homework.

Lastly, always maintain full sets of documentation around all CDs of course. We have experienced banks making errors on 2-year fee waivers and have had to show them copies of their website (glad that we printed it) when we signed up for various accounts to get the fee waived properly.

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