

November 2018

The Value of Active Treasury Management

HOW EFFICIENT CASH MANAGEMENT CAN ENHANCE YIELD

What Is Active Treasury Management?

Many asset managers consider treasury part of their operations unit and manage this function through manual, spreadsheet-oriented processes and support staff.

Forward-looking asset managers, however, have recognized the importance of treasury, not only in reducing operational risks and protecting assets but also in generating significant potential alpha — sometimes referred to as “treasury P&L”.

These firms have moved treasury to report to their front office and have made significant investments to streamline and automate this function.

Some organizations actively managing their treasury function have benefited from:

- Lower counterparty risk exposure
- Tighter operational controls
- Increased operational efficiencies
- Enhanced incremental return on assets

How Is Treasury Achieving This Alpha Generation?

At the simplest level, these asset managers are locating inefficiently allocated cash and collateral, either sitting idle or otherwise not being used optimally, and putting those balances to their best possible use to yield additional revenue.

Hazeltree has conducted a survey of more than 80 of the world’s leading hedge fund managers (with AUM ranging from \$2B to over \$50B).*

Based on its findings, Hazeltree has determined that most organizations are focused on treasury management to capitalize on the below benefits, in the following order:

- 1. Reducing counterparty risk** exposure with improved liquidity profiles
- 2. Improving operational efficiencies** with greater controls
- 3. Adding an incremental 30-100 basis points return** on their assets**

In this paper, we will explore these issues as we articulate a case for the costs and benefits of committing to active treasury management.

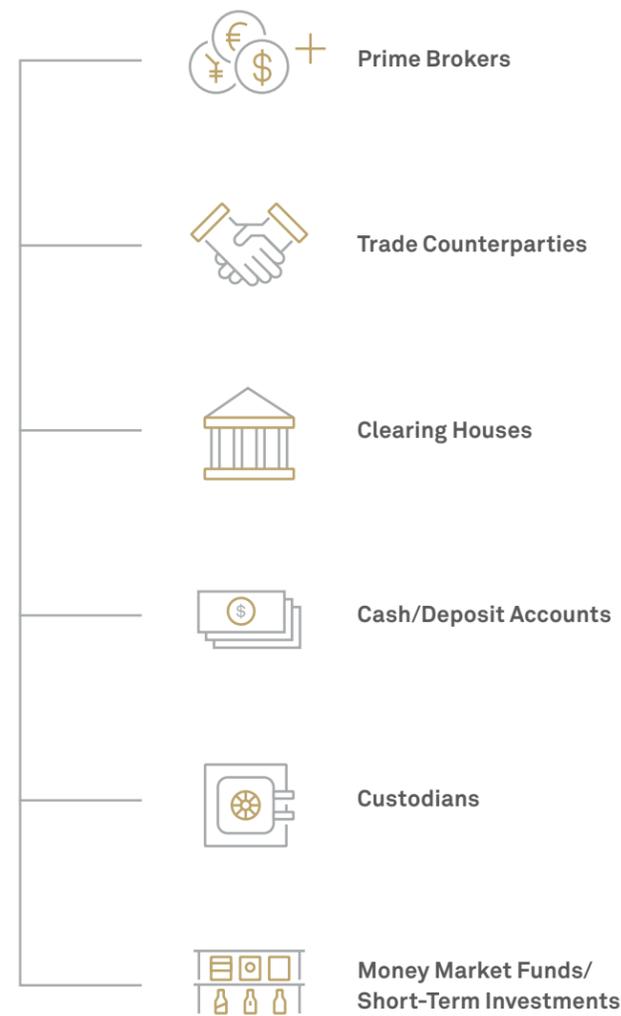
*To receive a copy of the Hazeltree hedge fund survey, please email info@hazeltree.com.

**Return estimate based on Hazeltree analysis. For more information, please contact Hazeltree at the address above.

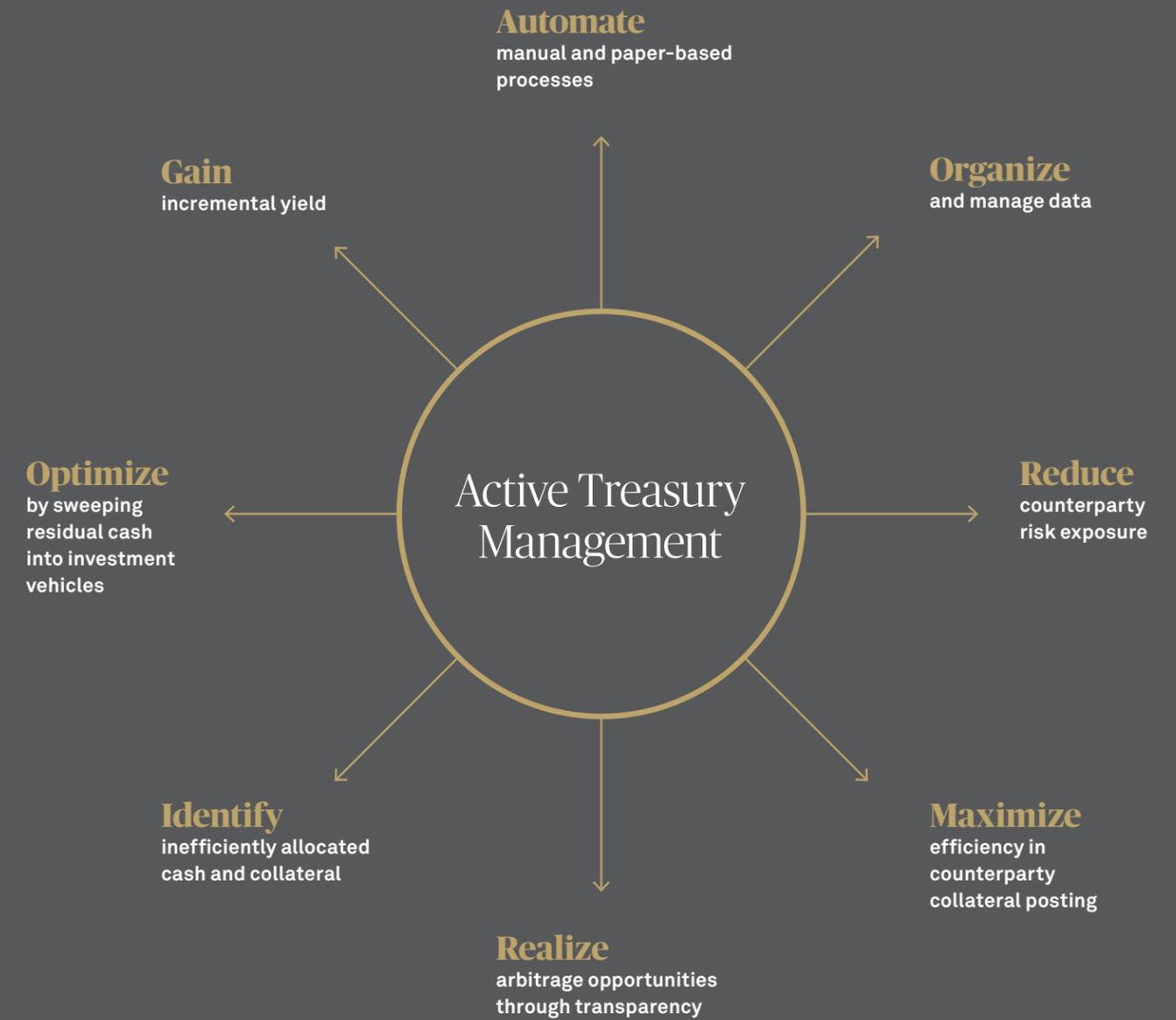
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Where Can Unallocated Cash Balances Reside?



How Can Active Treasury Management Generate Alpha?



Four Steps To Active Treasury Management

Realizing supplemental alpha, operational efficiencies and reduced counterparty risk is achievable for any asset manager willing to make the time and resource investment to optimize their treasury function. The path to active treasury management involves four essential steps.

1. Get Optimized
2. Organize Your Data
3. Locate Value Through Treasury Management
4. Identify Unallocated Balances

1 Get Optimized

Faced with a rising interest rate environment over the past two years, firms have been increasingly focused on the role played by the treasury function — and crucially, how it can be optimized.

In contrast to a post-crisis environment of near-zero interest rates and negligible spreads, the current climate means that increased attention to treasury analysis is becoming not just important, but necessary to remain competitive in today's changing markets.

With a fourth Fed rate hike expected for December 2018 and four more currently projected for 2019, that focus will only intensify.

As shown in the case studies cited in this paper, firms may be able to generate value and realize savings ranging anywhere from 30 to 100 basis points* by employing cash optimization processes to capture incremental spread as a result of exposing (or discovering through increased transparency) inefficiently deployed cash and collateral and rate variances.

In many cases, the optimization processes were simple in nature, and there are ample opportunities to refine these routines to extract increased savings. The chance to generate value and save is only amplified as interest rates rise and spreads widen.

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*Return estimate based on Hazeltree analysis.

2 Organize Your Data

The organization of your treasury function’s data is the foundation upon which every other element in the treasury optimization hierarchy is built.

This means that an intensive focus on data sourcing and data management is essential. Without such organization, investment managers will be unable to attain the enhanced transparency around cash management that they require to locate unallocated balances or to put those balances to work earning yield.

For treasurers, CFOs, operations heads, credit officers and other practitioners, a clearly defined data sourcing analysis and ongoing data management process is the necessary starting point for any treasury management effort.

Clean, normalized data allows for increasingly sophisticated analytic oversight. As such, true optimization of treasury management must be built on a bedrock of accurate data analysis.

In other words, get organized.

What matters most to institutional investors?

| | | | |
|---|---|--|---|
|  Liquidity Protection |  Risk Management |  Timely Asset Protection |  Performance |
|  Counterparty Exposure & Cost Metrics |  Transparency |  Regulatory Compliance |  Fee Structures |

3 Locate Value Through Treasury Management

Once you’ve put your data management in order, generating tangible and measurable alpha can be accomplished by implementing a handful of relatively straightforward optimization and efficiency initiatives within the treasury function. These include:

Cash Optimization – Optimize the utilization of your cash balances by resolving unintentional cash positions in non-interest bearing accounts, collapsing residual debits, sweeping excess cash into vehicles with higher returns such as money market funds, hedging currency risk, and managing foreign exchange settlement cycles. Collectively, these changes can add up to savings.

Rate Transparency – Identifying arbitrage opportunities from differences in financing spreads is an obvious area for potential cash savings. As transparency in financing and borrowing markets has increased, the opportunities for optimization have expanded.

Capital Efficiency – As markets for financing rates have become more transparent, it has not necessarily become easier to calculate, anticipate or optimize margin requirements with clearing houses and dealers. Depending on the cost of capital, the savings from freeing up excess collateral can be many times that of simple rate optimization.

What are the biggest challenges managers face?

| | | | |
|---|--|--|--|
| 1. Availability of Liquidity | 2. Cost of Liquidity & Balance Sheet | 3. Fee Compression | 4. Costs of Regulatory Compliance |
| 5. Asset Allocation & Optimization Among Counterparties | 6. Outdated Spreadsheet Methods | 7. One-to-One Transaction Management | 8. Lack of Integration Among Key Service Providers |

4 Identify Unallocated Balances

Once asset managers understand the potential value sitting within their firms' treasury function and recognize the possibilities to generate alpha by deploying unallocated cash and collateral more efficiently, the next step is to conduct the necessary diligence to locate and act on those balances.

Common methods to identify such assets include:

Cash Management

Compelled by the rising interest rate environment, treasurers are transitioning from simply monitoring payables and receivables into truly optimized cash-deployment routines. An optimal process can generate gains by rectifying rate differentials and spreads between debit and credit locations, as well as by sweeping excess cash to accounts with the best rates.

Securities Finance

Even before the financial crisis, a trend toward maintaining multiple financing counterparties, along with increased transparency in loan markets, made the economics of actively managing securities finance compelling. Simply by adding additional counterparties, data points can be gained, discrepancies can be analyzed, and actual borrow costs can be optimized. In recent years, independent third-party market data vendors have only increased transparency in the securities finance market.

OTC Collateral Management

Daily auditing of collateral posted to derivatives counterparties and actively disputing calls can free up excess or over-pledged collateral. Since this corresponds, dollar for dollar, to freeing up capital that would otherwise have been encumbered, the benefit can be readily measured.

Prime Broker Margin Management

Rules-based margin lending platforms have become far more sophisticated. Slippage in capital utilization due to inefficiently margined assets is not only difficult to measure but is an area of zero transparency in most cases. Auditing the daily calculations and outputs from counterparties is a good starting point, but actively managing margin requirements is a critical step toward optimization and true capital efficiency.

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Generating tangible and measurable alpha can be accomplished by implementing a handful of relatively straightforward optimization and efficiency initiatives within the treasury function.

The Hazeltree Treasury P&L Calculator

To help quantify the benefits of active treasury management, Hazeltree has developed a P&L Calculator to estimate the value of these functional areas, enabling you to enter variable inputs, assumptions and parameters.*

In the following two case studies, we include the Hazeltree P&L Calculator with the various input parameters according to each case.

Case Study 1. Long/Short Equity Manager

Case Study 2. Multi-strategy Hedge Fund

*For more details on the methodology of Hazeltree's P&L calculator, please contact info@hazeltree.com.

Case Study 1: Long/Short Equity Manager*

AUM: \$3 billion with six active prime broker relationships

The Problem

A large, levered long/short equity asset manager was operating with restricted transparency into its relationships with counterparties and with limited staff dedicated to the treasury function. Monitoring of counterparty costs and financing rates was only done periodically and performed manually on spreadsheets.

As a result of its complex account structures and decentralized relationship management, the firm was operating with an inefficient process for managing costs related to the use of leverage and short-selling and had inadequate capabilities for tracking rates from its brokers.

The Solution

The firm installed a treasury management platform to streamline processes and reduce cost, risk and inefficiency, which provided enhanced scalability to support future growth. An automated data aggregation and normalization process enabled the firm to gain visibility into counterparty-related costs, including financing, stock borrowing and transaction costs, and provided daily monitoring that delivered a way to analyze wallet spend with counterparties. As a result, the firm was able to transform its manual processes to establish the treasury function as a true cost-saving enterprise.

The Result

The firm's short exposure averaged approximately 35% of its total AUM. With its new transparency and analytic capabilities, the firm estimated that, on average, 20% of its short book was deemed hard to borrow due to the supply and demand of borrowing to support its short positions. Of the hard-to-borrow portion, the average differential between the most efficient and least efficient borrow rate was found to be 33 basis points. By enabling the asset manager to renegotiate or realign borrow rates, the process was able to generate savings of over \$2.6 million annualized, which the firm views as a direct enhancement to the performance of its funds.

About 10% of the overall AUM was posted as margin in the form of equity to brokers as collateral for leverage. With an automated audit process in place to give greater transparency, the firm could free up \$228 million of investment capital that would have otherwise been encumbered.

If reinvested at the expected rate of return for the strategy of 12%, the financial impact could be estimated at more than \$16 million of annualized benefit.

*Case study is based on a composite of actual active treasury management outcomes recorded by Hazeltree clients.

Long/Short Equity Manager – Potential Savings via Active Treasury Management

| P&L Inputs | | |
|---|---|--|
| Portfolio Input/ Assumptions | AUM | \$3,000,000,000 |
| | Annual Return Estimate | 12% |
| | Long Exposure | 100% |
| | Short Exposure | 35% |
| | Net Exposure | 65% |
| | Gross Exposure | 135% |
| | Equity | 76% |
| | OTC | 24% |
| | Total Stock Borrow/Loan Optimization | \$2,635,680 |
| | Stock Borrow | Avg. % of Short Market Value Considered Hard to Borrow |
| Short Market Value (SMV) | | \$798,000,000 |
| Hard to borrow (HTB) SMV | | \$159,600,000 |
| Typical Differential Between Most Efficient and Least Efficient Borrow Rate | | 0.33% |
| Stock Borrow Optimization | | \$526,680 |
| Stock Loan | Avg. % Longs That Are HTB | 5% |
| | Long Market Value (LMV) | \$2,280,000,000 |
| | Valuable Long Positions | \$114,000,000 |
| | Avg. Rate Paid on HTB Long | 1.85% |
| | Stock Loan Optimization | \$2,109,000 |
| Cash Management Inputs | Yield on Money Markets Funds | 1.85% |
| OTC Collateral Management Assumptions | Avg. Collateral Posted per OTC Amount of Fund | 25% |
| | Avg. % Amount of Excess Collateral (Over-Pledge) | 0% |
| | Excess Collateral to Invest | \$ - |
| PB Margin Management Assumptions | Avg. % Positions with Margin Overcharges | 10% |
| | Positions Renegotiated/Errors/Optimization | \$228,000,000 |
| | Total Excess Collateral/Margin | \$228,000,000 |
| | Avg. % to Invest Back into the Fund | 50% |

Benefit of Active Treasury Management

| Cash/Securities Finance | Annual Savings/Benefit | Basis Points |
|---|------------------------|--------------|
| Cash Management | \$ - | 0.0 |
| Stock Loan/Borrow Management | \$ 2,635,680 | 8.8 |
| Collateral/Margin Management | | |
| Excess Cash at MM Rates | \$4,218,000 | 14.1 |
| Excess Cash at Fund Returns | \$13,680,000 | 45.6 |
| Total Benefit at MM Rates | \$6,853,680 | 22.8 |
| Total Benefit at Fund Returns | \$16,315,680 | 54.4 |
| Active Treasury Benefit: 24-56 bps | | |

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If reinvested at the expected rate of return for the strategy of 12%, the financial impact could be estimated at more than \$56 million of annualized benefit.

Case Study 2: Multi-strategy Hedge Fund*

AUM: \$10 billion with seven active banking and broker relationships

The Problem

A multi-strategy diversified hedge fund was operating with an outdated and paper-based process to manage all cash and transactions. While the hedge fund had a full-time treasury staff and a well-established treasury function, cash monitoring was done manually through the creation and distribution of spreadsheets and was only performed periodically.

As a result of its globally disparate trading strategies and manual cash management processes, the firm experienced unnecessary and unintentional debit financing costs on a daily basis across multiple currencies. In addition, the firm maintained an average uninvested cash position of approximately 8.25% of AUM. The uninvested cash was seen as operational slippage and was driving substantial financing drag on a daily basis.

The Solution

By developing a dedicated cash management function with a fully automated daily data aggregation and normalization process, the firm was able to gain scale and control over all daily cash management and payments via a single-entry portal.

The firm found that it was unintentionally maintaining 1.5% of its AUM, on average, in offsetting debit and credit balances across many currencies. It also found that the differential in rates, between interest charges on debits and interest income on credits, was 75 basis points.

The Result

By capturing the spread differential in financing rates and the fund's uninvested cash the firm was able to generate an additional \$16.3 million.

On average, 25% of the firm's overall AUM was posted in the form of cash to counterparties as collateral required for derivatives trading. Of the amount posted, an average of 10% was found to be posted in excess, or over-pledged. With an optimized disputing and recall mechanism in place, the firm could free up \$60 million of investment capital that would have otherwise been encumbered.

Also, 8% of the overall AUM was posted as margin in the form of equity to brokers as collateral for margin leverage; the firm found it could free up approximately \$600 million of investment capital that would have otherwise been encumbered. If reinvested at the expected rate of return for the strategy of 15%, the financial impact could be estimated at more than \$50 million of annualized benefit.

*Case study is based on a composite of actual active treasury management outcomes recorded by Hazeltree clients.

Multi-strategy Hedge Fund – Potential Savings via Active Treasury Management

| P&L Inputs | | |
|---------------------------------------|---|----------------------|
| Portfolio Input/ Assumptions | AUM | \$10,000,000,000 |
| | Annual Return Estimate | 15% |
| | Long Exposure | 76% |
| | Short Exposure | 45% |
| | Net Exposure | 31% |
| | Gross Exposure | 121% |
| | Equity | 76% |
| | OTC | 24% |
| Cash Management Inputs | Avg. Credit Balance Size | 8.25% |
| | Differential Between Debit and Credit Rates | 0.75% |
| | Money Market Sweep of Excess Cash | \$150,000,000 |
| | Cash Management Optimization | \$16,387,500 |
| OTC Collateral Management Assumptions | Avg. Collateral Posted per OTC Amount of Fund | 25% |
| | Avg. % Amount of Excess Collateral (Over-Pledge) | 10% |
| | Excess Collateral to invest | \$60,000,000 |
| PB Margin Management Assumptions | Avg. % Positions with Margin overcharges | 8% |
| | Positions Renegotiated/Errors/Optimization | \$608,000,000 |
| | Total Excess Collateral/Margin | \$668,000,000 |
| | Avg. % to Invest Back into the Fund | 50% |

Benefit of Active Treasury Management

| Cash/Securities Finance | Annual Savings/Benefit | Basis Points |
|---|------------------------|--------------|
| Cash Management | \$16,387,500 | 16.4 |
| Collateral/Margin Management | | |
| Excess Cash at MM Rates | \$12,358,000 | 12.4 |
| Excess Cash at Fund Returns | \$50,100,000 | 50.1 |
| Total Benefit at MM Rates | \$28,745,500 | 28.7 |
| Total Benefit at Fund Returns | \$66,487,500 | 66.5 |
| Active Treasury Benefit: 28-65 bps | | |

Conclusion

Active Treasury Management — A Strategic Competitive Advantage

In this paper, we have argued that a robust, comprehensive treasury management function is a strategic necessity and a business imperative that delivers quantifiable value.

Given the demonstrable advantages of a dynamic approach to treasury management, it seems only a matter of time before a broader recognition of the value of these methods takes hold across capital markets.

Ultimately, active treasury management is about much more than simply achieving greater efficiency and superior yield, however.

A seamlessly integrated system capturing positions, rates and other key metrics provides detailed counterparty intelligence, a framework for analysis and a single point for executing transactions.

This ensures that risks are visible and minimized, that cash, collateral and securities are optimized, and that your investors can rest assured that their assets are in good hands, in both favorable and stressed markets.

Contact Us

To learn more about active treasury management and the benefits it can deliver to your portfolio, please contact:

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