KARPUS INVESTMENT MANAGEMENT

COMMENTARY

October 2024

Cash Management in a Low-Interest-Rate Environment

The federal funds rate has once again been a focal point in the news since the Federal Open Market Committee (FOMC) cut the key interest rate by 50 basis points (a basis point is 1/100th of 1 percent) on September 19th 2024.The federal funds rate is the interest rate range set by the FOMC that institutions, such as banks, charge each other for overnight loans. It is also one of the primary tools the FOMC has used to fight inflation. Prior to the cut in September, investors have been able to earn 5.25% in high yield savings accounts, CDs and money market funds since July 27th of 2023 when the FOMC last raised rates.The last time federal funds rates were this high was 2006. With the FOMC maintaining such a high federal funds rate, we believe an attractive investment option has presented itself for investors who had fears of possible recession and did not want to accept lower yields due to the yield curve being inverted since July of 2022.

With the September rate cut, the FOMC has signaled the end of 5% rate of return in cash investment products. The current money market rate is 4.8% and the Fed Funds futures market is pricing in another 150 basis points of cuts between now and the summer of 2026. The FOMC as indicted how many cuts are on the horizon will be largely dependent on inflation and jobs data. At the time of this writing the Fed Funds Futures market has swung back and forth; on 9/30/2024 the Fed Funds futures market was pricing in 200 basis points in cuts or an implied rate of 2.77% by 1/28/2026, but as of 10/7/2024 the Fed Funds future market was pricing in 150 basis points in cuts after a higher than expected jobs data report on 10/03/2024 and an implied rate of 3.3% as of 4/29/2024.

While the exact Fed Funds rate at the end of this interest rate cut cycle is unknown, the current look forward does imply a significantly better rate of return for investors than the period of March 2020 through March of 2022 when federal funds rate was targeted at 0-0.25%.It is important to realize that investing during periods of low interest rates every basis point matters.

We view that retail investors currently have several different investment options to maximize the return on cash. This cash could be set aside for a specific upcoming expense or perhaps the investor prioritizes preservation of capital above all else which would prevent them from investing in risker assets like equity or longer duration bonds. Below we highlight five options that we believe are readily available.

First, high-yield savings accounts are an option that ensure liquidity for an investor. The interest the investor earns on their high-yield savings account is the bank compensating them for borrowing their money to loan out to other customers at a higher rate. The bank has to offer a competitive savings rate or customers may take their business to other banks offering better rates of return. A high-yield savings account is a variable rate account. If the FOMC were to hike or cut the federal funds rate, the rate of return on an investor's high-yield savings account would also adjust accordingly.

Another option for investors is money market funds, which invest in high quality, short-term debt and earns a rate of return slightly better than high yield savings accounts for investors looking to invest substantial cash. Like high-yield savings accounts, money market funds offer liquidity and move in lock step with the federal funds rate. A money market fund's goal is to keep the net asset value of each share equal to one dollar and any additional earnings are paid out in the form of a dividend. There is no goal of capital appreciation for the shares.

A third option to consider is certificates of deposit (CDs). A CD is a savings product offered by financial institutions. An investor agrees to buy a CD with a guaranteed rate of return on the condition that they will not withdraw any money over an agreed upon length of time. The rates on CDs are closely tied to the federal funds rate and allow investors to lock in a rate of return they view as favorable with the trade-off being a lack of liquidity over a stated time frame. If interest rates were to move higher, the investor in the CD would miss out and not be able to reset until the CD matured without a penalty (if applicable). If interest rates moved down, then the investor would benefit because their rate of return would remain the same.

The fourth option is a short-term U.S. Treasury Bill that has 1-year or less until maturity. Compared to a CD or high-yield savings account, short-term U.S. Treasury Bills can offer a more competitive rate of return. Unlike CDs, which require a lock up of the money over a specific period of time, U.S. Treasury Bills can be sold in the secondary market easily if the need for cash arises since the Treasury market is one of the most liquid markets in the world. Short-term U.S. Treasury Bills are more sensitive to changes in interest rates and this is most evident if the investor has to sell before maturity. If rates move up or down, the price of the U.S. Treasury Bill would adjust accordingly, per industry practice, to match current interest rates if the investor had to sell.

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The last option is a less known alternative and a strategy we utilize, which is buying Special Purpose Acquisition Companies (SPACs) prior to their acquisition.

SPACs are blank check companies that raise cash through an initial public offering. Typically, each common share is backed by $10 per share, and that cash is set aside in a third-party trust that invests the cash in a money market fund or U.S. Treasury Bills extending out to 180 days. A SPAC usually has 12-24 months to find a deal or else they have to liquidate and return cash in trust to the investors. Ultimately, a SPAC's end goal is to raise capital and find a private company and bring them public through the SPAC.

In this particular strategy, the key is to invest only in pre-acquisition SPACs with the goal of buying the SPAC's common shares at a discount to their cash per share value. Then, if the SPAC decides to enter into a business combination with a private company, we would redeem our shares and get our cash back.

We believe that there are several benefits to SPACs, the first being that an investor can lock into a rate at or above the federal funds rate for 12-24 months depending on the length left on the SPAC.

Secondly, our view is that purchasing pre-acquisition SPACs has unlimited upside which we do not see with the other previously mentioned options discussed. This upside comes risk-free in that if the SPAC manager finds a deal that other investors want to invest in, the SPAC could start trading above its per share cash level. In this case, although rare in our experience, we would immediately sell and investors can have additional return on their SPAC investment (aside from their pro-rata share of the trust account).

The last benefit we see that SPACs can have is if their typical 12-24 timeline is shortened by finding a deal before the deadline. This enables investors to redeem early and recognize the full gain. For example, if an investor purchased a SPAC with 12 months left before liquidating and had a go-forward expected return of 5%. If this SPAC then entered into a business combination with a private company and the investor was able to redeem their shares for cash after only 6 months, they would get a 5% return in 6 months instead of waiting the full 12. This results in annualized rate of return of 10.25%.

To learn more about this option, please see our commentary piece titled "Our Approach to Investing in Special Purpose Acquisition Companies."

To summarize, the key things investors need to look at when considering cash management options are their risk tolerance and liquidity needs. We believe that investors will re-evaluate their cash management options as the FOMC continues to cut rates and find the rate of return on their current cash management investments insufficient. We suggest you re-evaluate to determine if you are maximizing your options and making your cash work for you. For more information, we suggest having an in-depth discussion with your tax and financial advisors.

Karpus Investment Management offers a Cash Management Strategy. Contact us to discuss further.

Sources: Blomberg Finance, L.P., The Board of Governors of the Federal Reserve System, Investopedia, PNC, Liberty Street Economics.

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