

Seeking A Safe Haven? Not all Cash Is Safe

By Chidem Kurdas, New York Bureau Chief | Friday, August 03, 2007

NEW YORK (HedgeWorld.com)—There's a saying on Wall Street that when markets go down, the only thing that goes up is correlation. Turns out, even cash is not wholly immune to that hazard.

Markets have become more volatile. At times like this it makes sense to keep cash as a way of cushioning hedge fund portfolios. The money isn't kept under the mattress, of course. Managers, eager to boost their performance, are always on the lookout for better yield from their cash balances.

Enhanced cash funds, which promise higher returns than regular money market investments, have become popular in recent years. These get extra basis points by taking slightly more risk. Among the instruments they use are asset-backed securities—like mortgage-linked bonds.

Take a guess how the U.S. housing slump and mortgage meltdown is affecting certain "cash" investments. Some supposedly safe cash funds have closed down while others are showing strain in meeting redemptions. Hedge funds take enough risk with their own strategies, so they certainly don't need added risk from their cash balances.

This week Reuters reported that because of problems in the U.S. subprime mortgage market the French financial services company Oddo Asset Management closed several funds, including Oddo Cash Titrisation and Oddo Cash Arbitrages. Meanwhile, insurance company AXA took measures to provide sufficient liquidity to two funds with exposure to the subprime sector.

On the other hand, some cash funds are doing just fine. One example is The Reserve, a money market fund pioneer that managed \$62 billion as of May, including the cash balances of a number of hedge funds and funds of funds.

"Safety and liquidity are the most important components of our mandate," said Ryan Green, a vice president at The Reserve. "Safety is our first concern but liquidity is also important." So far that hasn't hurt returns: The firm's funds often outperform their counterparts.

Many managers simply put the cash into whatever venue their prime broker offers—banks typically run their own cash vehicles and a prime broker may offer the parent bank's money market funds. The mortgage debacle has affected some bank funds.

It may be that the \$2.4 trillion money market industry is becoming too big and crowded for its own good, increasing the demand for low-risk securities with acceptable yield. Hedge funds are one of the drivers of this growth.

The Reserve is getting three to five new hedge fund customers per quarter, ranging from startups to established large funds, according to Mr. Green. Hedge fund clients add as much as \$1 billion per quarter to the cash manager's assets.

But he said he does not see market crowding as an impediment. "We try to cherry-pick the best securities and balance safety, yield and liquidity," he said. He argued that the firm can create efficiencies to save costs because its core competence is cash management, so the enhanced cash fund makes a better return by keeping down expenses, not by trading securities of lesser quality.

Patrick Ledford, chief investment officer at The Reserve, has said that while he actively manages the portfolios' duration structure to get better yield and uses instruments like repurchase agreements, he emphasizes individual security selection.

Investors may need to pay more attention to who's managing the cash and how the cash manager keeps down the risk in selecting securities.

For more information about The Reserve's cash management capabilities, please contact a member of the Institutional Sales Team below:

Ryan Green 212-401-5737 rgreen@TheR.com	Brandon Semilof 212-401-5731 bsemilof@TheR.com	Zak Green 212-401-5755 zgreen@TheR.com
Elliott Goldstein 212-401-5842 egoldstein@TheR.com	Richard Delfino 212-401-5738 rdelfino@TheR.com	Cary Musser 212-401-5571 cmusser@TheR.com

You should carefully consider the investment objectives, risks and charges and expenses of a fund before investing. A fund's prospectus, which contains this and other information, may be obtained by writing to The Reserve, 1250 Broadway, New York, New York 10001-3701 or by calling 800-637-1700 and pressing "0." You should read the prospectus carefully before you invest.

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