Investment (Income) Matters

The nuts and bolts of investments, inflation, and cash flow in today's economy.

By Rajesh Chainani

TIPPAPATT/STOCK.ADOBE.COM

It's fair to say that 2022 was an interesting year with regard to the financial climate. What the Federal Open Market Committee, or FOMC, described as "transitory inflation" at the beginning of the year soon became the catalyst for the fastest interest rate hikes in recent history. The increase from 0.25% to 4.50% in less than 12 months was significantly faster than the last two tightening cycles (2004 and 2015).

The actions by the FOMC, which reviews economic and financial conditions and determines monetary policy that affects interests rates, slowed inflation to 6.5% to begin 2023, from its peak of around 9% in June 2022. While this is progress, inflation is still much higher than the 2% target the Federal Reserve Board, often referred to as "the Fed," would like to achieve.

Bright Spots in Investments

The bright spots here are that the Fed is still committed to fighting inflation and that many of the increases from the fourth quarter of 2022 have not had the full effect on the economy yet, as there is typically a lag of three to six months.

While each situation is unique, for the most part, fixed (locked-in) rates typically provide a higher return than liquid rates.

While the increase in rates can significantly impact the cost of borrowing, for example for capital projects, school districts can earn additional revenues on their investments, which is a positive development. Consider this comparison:

- $10 million invested for 30 days at 0.25% = $2,054.79
- $10 million invested for 30 days at 4.00% = $32,876.71

It is important to evaluate your school district's individual situation to ensure that you are optimizing your interest earnings potential. While each situation is unique, for the most part, fixed (locked-in) rates typically provide a higher return than liquid rates.

Investing based on rates alone is not a prudent strategy, however, as districts must consider their individual needs prior to developing an investment plan. And that is where a good cash flow comes into the picture.

The Importance of Good Cash Flow

Cash flow is defined as the net amount of cash and cash equivalents being transferred in and out of an organization. A well-defined cash flow can help an organization identify where funds originate and on what they are spent. Doing so can help define an organization's liquidity, flexibility, and overall financial performance (Hayes 2022).

By extending investments by even a few months, finance managers typically are able to pick up some additional yield

One of the essential aspects of cash flow is timing. It is important to know how long after receipt certain funds will be spent. Companies use this information to analyze timing of negotiated payment periods for various expenditures and to determine if customers are paying invoices on time and how that impacts available funds. Similar analyses can be done in school districts to determine payment periods with vendors as well as when funds will need to be available for general operating expenses (American Express 2021).

School districts also have an advantage when it comes to planning cash flows, as inflows are typically well known and cyclical. While predicting all aspects of a cash flow may not be possible, comparing inflows to expected outflows such as payroll, debt service, and other well-defined expenditures is a great place to start.

A cash flow can help a business office evaluate potential investment options. Once a cash flow has been completed, an organization can build an investment schedule that optimizes its returns and helps extend maturity lengths to take advantage of higher yields that are generally available longer out on the yield curve.

It's Not Just About Yield Pickup

By extending investments by even a few months, finance managers typically are able to pick up some additional yield. This makes sense as we are "locking up the funds" for a period of time and do not have access to it, so for that reason we are being compensated with additional yield compared to a liquid product (yield pickup).

While that in itself should be good motivation to develop a cash flow and invest per the district's cash flow needs, another important factor to consider is that the Federal Reserve is likely getting close to the top of the rate hikes based on the most recent survey of economists. A January 20, 2023, Bloomberg article suggested the Fed was going to increase rates by 0.25% at the February 1, 2023, meeting and were considering a "pause" to gauge inflation, the labor market, and other important economic data (Torres 2023).

The Federal Reserve has typically lowered interest rates after periods of rapid hikes. While the goal of the Fed is to create a "soft landing" (slow the economy just the right amount to avoid a recession), they have never successfully accomplished that goal. That is not to say that 2023 would follow the same pattern—they may succeed this time.

By investing per their individual cash flow needs, school districts are locking the best rates that are available for the time frame they need. They are also limiting the potential reinvestment risk that may occur if the Fed starts to lower rates at some point in the future.

References

American Express. August 3, 2021. What Is Cash Flow: Why Is It Important? Business Class: Trends and Insights | American Express. www.americanexpress.com/en-gb/business/trends-and-insights/articles/why-is-cash-flow-important

Hayes A. October 8, 2022. Cash Flow: What It Is, How It Works, and How To Analyze It. Investopedia. www.investopedia.com/terms/c/cashflow.asp

Torres C. January 20, 2023. Fed Set to Slow Rate Hikes Again and Debate How Much Further to Go. Bloomberg. www.bloomberg.com/news/articles/2023-01-20/federal-reserve-to-slow-pace-of-interest-rate-hikes-and-debate-how-high-to-go?leadSource=uverify%20wall

Rajesh Chainani is senior vice president and director, PMA Financial Network, Lancaster, Pennsylvania. Email: rchainani@pmanetwork.com