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FROM BUSINESS FINANCIAL SERVICES AT MERRILL LYNCH

Short-Term Investing of Your Working Capital

Investing your company's operating cash can make a bottom-line difference.

With a challenging business climate and rising interest rates, business owners should consider the management of working capital a top priority. Yet many neglect to focus on analyzing their cash flows, forecasting their cash positions and developing short-term investment guidelines that will help them improve the return on their idle funds. Sound investment guidelines coupled with effective cash management can, for even short time horizons, generate interest income that contributes to a company's bottom line.

In the "2004 U.S. Corporate Liquidity Survey" by Treasury Strategies Inc., 32% of the companies responding had no investment policy. For every $1 in a non-interest-bearing bank account, the companies held an additional $9 in an account that allowed them to earn interest. Interestingly, 51% of these companies keep their money in low-yielding instruments with maturities of 1 month or less.

Anthony Carfang, co-founder and partner of Treasury Strategies Inc., suggests that good cash-flow forecasting is important if a company wishes to improve interest income. In his company's survey, businesses who forecast cash out at least 30 days saw an average 30-basis-point yield improvement on investments with maturities of 3 months over those who forecast one week or less. While cash-flow forecasting cannot guarantee future performance or success, it is a sound cash management practice.

Online banking services are increasingly helping businesses monitor their cash positions in real time. Fifty-five percent of the companies surveyed use the Internet for liquidity management—from making payments to viewing their account balances and investment portfolios. "Companies would be wise to use online services daily to monitor positions and use sweep investment accounts," Carfang said.

He added, "First, organize your system so all your money winds up in one place. Second, use a sweep account to keep money invested. Third, practice cash-flow forecasting with an eye on achieving a higher yield consistent with your risk tolerance and investment policies."

ESTABLISH INVESTMENT GUIDELINES

A company's investment guidelines serve as a "road map" for selecting appropriate investment alternatives. This policy should state acceptable investment vehicles, outline acceptable risk parameters (security and interest rate), and provide guidelines for the investment's maturity (overnight out to 2 to 5 years).

Most business investors have 3 primary objectives:

- Preserve Principal—loss of principal is unacceptable
- Maintain Liquidity—cash must be available when needed
- Achieve Highest Yield—while complying with safety and liquidity requirements

In conjunction with these objectives, a policy should account for risk tolerance.

ANALYZE CASH FLOW

Historical sales patterns can provide the trends for future cash flows. Cash-flow forecasting may also come from the field sales staff, especially for manufacturers or wholesalers. These projections, whether weekly, monthly or quarterly, help the company project account balances and develop a short-term cash-flow forecast. This analysis helps ensure that they have funding for daily operations while allowing them to project the balances that may be invested out over a longer term and potentially increase the yield on the portfolio.

PLAN YOUR INVESTMENTS

As you consider investment options, you should answer four basic questions:

1. *How much cash is available for investing and for how long?* This is where short-term cash-flow forecasting is essential. Based on this analysis, you will determine the duration of your investment pool:
   A. Operating Cash—Very short term, up to 30 days
   B. Short-term Cash—30 days to 1 year
   C. Intermediate Cash—1 to 7 years
2. *What securities may be invested in and what is an acceptable credit rating?* Short-term investment guidelines should clarify what instruments you are allowed to invest in and the safety rating of the investment.
3. *How is the business organized?* Your business structure along with your current tax rate will help an advisor determine whether tax-exempt investment alternatives are appropriate.
4. *What is the company's tax bracket?* Your accountant or tax advisor can provide you with this important information.

IMPROVE INVESTMENT YIELDS

Four basic ways to improve investment yields include:

Improve after-tax returns: Companies in higher federal tax brackets may see better after-tax returns by investing in federally tax-exempt securities. Compare yields on tax-free obligations to those on their fully taxed equivalents to determine which may give a better return. For example, to equal a yield of 4% on a tax-exempt municipal note, a corporation in the 34% tax bracket would need to earn a yield of 6.06% on a fully taxable instrument.

For some tax benefits, the company's business structure may be a determining factor. A C corporation, for example, can use the Dividends-Received Deduction (DRD) to improve returns. Subject to certain restrictions, federal law allows regular C corporations to deduct from taxable income 70% of the dividends they receive from stock they hold in other U.S. corporations.

Extend maturities of investments: Your investment guidelines should account for your liquidity needs, so you should be able to determine how much cash you can commit for terms of 90 days or more. Consider what amounts would be reasonable for intermediate-term investments that mature in one to three years. If you are building cash reserves for planned expansions, acquisitions or equipment purchases, consider holding these reserves in an investment for a year or two.

Diversify credit quality: Your risk tolerance should also be assessed as part of your investment guidelines. As such, you should determine which potentially higher yields might fit that risk. A conservative approach would limit you to choosing only obligations backed by the U.S. government. While this choice is low risk, its yields are correspondingly low as well. You give up the potentially higher yields of investment-grade corporate obligations that have a relatively high-degree of safety.

Determine choices based on cash available for investment: As your business builds stronger cash reserves, you can choose from a wider array of investment alternatives. You might consider offerings that provide potentially better rates than those with lower-minimum requirements. Treasury bills, for example, with a required minimum investment of $10,000, are available in multiples of $1,000. But if you have $100,000 or more to invest, you might seek investments with higher minimums and potentially superior yields.

CHARACTERISTICS OF INVESTMENT INSTRUMENTS

Instruments differ in their timelines to maturity, their potential yields, their liquidity and their safety.

Income. Short-term cash management seeks to improve the income stream from available cash while preserving the principal. The objective is to generate the highest level of income after federal and state taxes, where applicable, are paid.

Safety. Any investment poses some degree of risk.

1. Credit risk: The risk that an issuer will not repay a promised obligation. This is greater for longer-term securities and for those from lesser-quality issuers.
2. Interest-rate risk: The risk that a fixed-income investment will decline in value if interest rates increase. This risk may be minimized by matching your investment maturities to your cash flow and holding the investments through to full maturity. The risk is only present if you sell an investment before it matures.

Maturity. The date when the principal of a debt instrument becomes due and payable is its maturity date. As indicated above, there are various ranges of maturities, from short- to intermediate-term, for business investments. Some investment types, such as mutual funds, have no stated maturity.

Liquidity. When you need to convert assets into cash quickly without a significant loss, there are investments with high liquidity, such as money market instruments. Although they are not obligated to do so, and while no assurances can be made with respect to future performance, investment dealers usually provide secondary markets for working capital investments. These secondary markets increase the liquidity of an asset.

WORKING CAPITAL INVESTMENT ALTERNATIVES

Merrill Lynch offers a very broad array of working capital investments from which to choose. The short-term taxable and tax-advantaged investments can provide a basis for effective cash management, in conjunction with sound cash-flow analysis.

SHORT-TERM TAXABLE INVESTMENTS

Money Market Funds. These are mutual funds that seek current income, preservation of capital and liquidity. They invest in a diversified portfolio of short-term money market securities, usually including short-term U.S. government instruments, bank certificates of deposit, commercial paper and repurchase agreements. These funds are not insured or guaranteed by the U.S. government or any other entity.

Treasury Bills (T-bills). T-bills, the most widely used federal debt securities, are short-term debt obligations of the U.S. government with maturities up to a year.

Federal Agency Securities. Federal agencies offer two types of short-term debt issues:

1. Discount notes—issued by the Federal Home Loan Bank, the Federal National Mortgage Association, the Federal Home Loan Mortgage and the Student Loan Marketing Association.
2. Interest-bearing notes—sold by the Federal Farm Credit Banks (which also sell discount notes), and backed by the assets of the Federal Intermediate Credit Banks, the Banks for Cooperatives and the Federal Land Banks.

Certificates of Deposit (CDs). A negotiable CD is a marketable receipt for funds deposited in a bank or thrift institution for a specific period at a stated rate of interest or yield. The three types of CDs are Insured CDs, issued generally in minimum denominations of $1000; Jumbo CDs, issued generally in minimum denominations of $100,000; and Institutional CDs, generally issued in denominations of $1 million.

Variable-Rate Preferred Stock (VRP). This stock pays dividends at rates fixed for a specified number of days. At the start of a new period, rates are reset in auctions or remarketings that reflect current market conditions. Depending on supply and demand, the liquidity from this auction or remarketing process can vary. Dividend rates generally adjust every 7, 28 or 49 days (depending on the type of VRP). The frequent resetting of rates allows dividends to stay aligned with market conditions. As with all securities, credit quality variation may affect the price and liquidity of VRP shares. Other reset period options, such as 52 weeks or more, may help investors match their cash-flow needs. VRP shares have priority over common stock in the payment of dividend income and liquidation preference in case of an issuer's dissolution.

Commercial Paper (CP). CPs, generally issued by major domestic or foreign utilities, financial and industrial companies, are negotiable unsecured promissory notes issued for a specific face amount that matures on a specified future date. The maturity can be as short as a single day or as long as 270 days.

Banker's Acceptances (BAs). BAs, essentially short-term loans to importers and exporters, are used to finance trade transactions. For example, a U.S. importer who wants to buy TV sets from a Korean company may ask a New York bank to guarantee the importer's promise to pay that company. The bank "accepts," or guarantees to pay, a time draft at maturity. On the due date, the bank debits the importer's account. If that account lacks sufficient funds to cover the draft, the bank is obligated to pay the full face value. There are domestic BAs,

issued through U.S. banks, and foreign BAs, issued by U.S. branches and agencies of foreign banks.

Repurchase Agreements (RPs, or Repos). In their simplest form, repos are essentially collateralized loans, where one party sells securities to another and agrees to buy them back at a later date. There are various investment options of repos:

1. Overnight repo—this is the most common and liquid form.
2. Term repo—the difference is only in the longer maturity.
3. Reverse repo—this allows an investor to put down collateral and borrow funds.
4. Tri-party repo—the collateral is held by a third-party bank for added security.
5. Variable repo—A tri-party, term repo whose rates are set weekly or monthly, with the flexibility of changing the principal daily.

Money Market Deposit Accounts (MMDAs). MMDAs are of several types, from banks' savings accounts to money market accounts. The accounts are an obligation of the banks and are covered by the Federal Deposit Insurance Corporation (FDIC), which insures total deposits there up to $100,000 per depositor. The offering financial institution sets and manages the rates.

SHORT-TERM TAX-ADVANTAGED INVESTMENTS

Tax-Exempt Money Market Funds. These are mutual funds that invest in a diversified portfolio of short-term municipal securities issued by state and local governments. These funds are exempt from federal and, in some case, state taxes. They may offer short-term investors in higher tax brackets higher after-tax returns than they might earn on taxable instruments.

Variable-Rate Demand Obligations (VRDOs). These are bonds with nominal long-term maturity and interest rates set daily, weekly or monthly by a remarketing agent, based on market conditions. The investor buys and holds the bonds, earning interest at the set rate, but retains the flexibility of being able to "put back" or return the bonds with specified notice and receiving payment at par with accrued interest. VRDOs are generally supported by letters or lines of credit, insurance and/or company guarantees to ensure timely payment of principal and interest. The remarketing agent generally makes the best possible effort to resell the bonds to other investors.

VRPs. These are also available in tax-advantaged instruments:

1. Tax-Exempt Closed-End Fund VRP—VRP shares that are issued by a closed-end municipal bond fund.
2. Dividends-Received Deduction-Eligible VRP—allows eligible corporate investors to take advantage of the 70% corporate Dividends-Received Deduction on federal taxes (explained above), provided the stock is held for at least 46 days. The tax savings are considerable to companies in the highest tax brackets.

WORK WITH YOUR FINANCIAL ADVISOR

Short-term investing of working capital is a prudent strategy for businesses. A Merrill Lynch Financial Advisor can help you:

- Evaluate your needs and set suitable goals.
- Make available information that will help you devise your investment strategy and evaluate investments appropriate to your company.
- Implement your investment plan.

This brochure discusses various tax and legal considerations affecting personal financial strategies. Neither Merrill Lynch nor its Financial Advisors provide individual tax or legal advice. Clients should review any planned financial transactions that may have tax implications with their tax advisors and attorneys. The content about investments in this paper is for information only, and does not constitute an offer by Merrill Lynch to buy or sell any securities or financial instruments and is not intended to provide any investment advice. All investments have risks, including possible loss of principal. Clients should review with their Financial Advisors the terms, conditions and risks involved with specific investments.

For a current prospectus of Merrill Lynch money funds, which contains more complete information, please call a Financial Advisor. Before investing, consider the investment objectives, risks and charges, and expenses of the fund. Investments in the money market funds are not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the funds seek to preserve the value of your investment at $1 per share, it is possible to lose money by investing in the funds.

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