Cynthia Sweeney Barnes looks at why and how treasurers can use MMFs as part of their yield strategy.

Yield and performance

WE HAVE ALL READ MUCH about the growth of Money Market Funds (MMFs) and their various characteristics, but why have MMFs become so popular with corporate treasurers and how do treasurers compare the various MMFs with direct market instruments?

MMFs are highly liquid, conservative, short maturity mutual funds that invest in a range of money market instruments which fall within well defined investment parameters including credit, diversification and individual security and average fund maturity limits. The most popular and successful of these funds are officially rated by at least one of the major rating agencies. MMFs are aimed at the retail and institutional investor but in many cases, the minimum investment requirements exclude all but the very top of the retail investor segment and, in some cases, even exclude treasury balances at the lower end of the institutional market.

There are various means by which the performance of MMFs can be tracked. They provide daily liquidity and as such have a daily, published yield which is calculated by the fund administrator and which can also be obtained from the fund provider. Yields are often published in the major financial journals and sourced through market data systems such as Reuters and Bloomberg. The most comprehensive data source is the Money Fund Report published by the Institutional Money Market Fund Association (IMMFA) and iMoneynet which records, amongst other features, gross and net yields; the fund's broad sector exposure; weighted average maturity (WAM); size of fund and cut-off times. For the majority of funds, the target is to maintain a stable net asset value (NAV), with the yield providing the main source of absolute and relative return measurement. However, the 'industry norm' is for the net yields to be used in comparative analysis (see side box) since all the funds have a variety of embedded costs and expenses that are offset against the daily gross yield that the fund earns from its investments. It is the net yield that end investors will earn on their investment in a particular MMF.

All funds have total expense ratios (TERs) which have a direct impact on the yield (and therefore performance) of the fund. Typical TERs range between 15bp and 20bp for institutional share classes and are made up of the following elements:

- Administration/custody;
- Investment management; and
- Distribution and support.

The TERs tend to be a key selection factor considered by would-be investors as they have a direct impact on the yield earned by the investor. In examining the relative attractiveness of funds, the treasurer should base comparisons on the full TER to ensure like-for-like analysis.

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However, irrespective of the TER level, the first consideration should not be fees but net return. Although there is a correlation between fee level and return, it is not unusual for a MMF with a higher TER to outperform a MMF with a lower one owing to better gross investment performance.

In cases when all the funds that a treasurer is examining prior to investment are giving the same or very similar yields net of TER, there are other considerations that should be taken into account. Some of these have direct performance effects and others may simply increase the usefulness of the fund. The usefulness of a fund may be impacted by the minimum size of contribution (although this is unlikely to be a factor for the larger treasury investors) and the total size of the MMF, particularly when a specific investor is not permitted to hold more than 10% of the fund's net assets. Other factors include the dealer's cut off time or the time by which all subscriptions/redemptions for that day must be notified by investors. For example, if a treasurer is unable to identify surplus funds for investment, or the amount of monies required back from the MMF, before midday on a particular dealing day owing to outstanding items or the particular treasurer's in-house systems, then a MMF with a 'cut-off' time of 10am is of little use. This may exclude several MMFs and make yield and return criteria secondary to the treasurer's needs. In this example, the MMFs with late cut-off times are even more valuable since the treasurer would have very limited choice when dealing directly in particular money markets since the best rates may no longer exist and it may not be possible to settle individual trades. MMFs that have late cut off times are able to settle transactions due to efficient trading practices and settlement procedures. Therefore, it may be that the major criteria for choice are neither historic nor actual yields, but the mechanics and value added features of the fund.

Turning to investment returns, one could ask whether there are periods when MMF returns are going to beat money market returns for a period of time such that they will represent an obvious alternative for treasurers? Much depends upon the benchmark that the treasurer uses. In purely theoretical terms, the comparison should be against overnight interbank funds as, with daily liquidity, the investment nearest in behaviour to the MMF is the interbank overnight rate, which can be highly volatile, particularly in a currency such as sterling. If this benchmark rate is used, the MMF will obviously offer higher returns during periods of declining interest rates, provided the managers have invested longer and the yield curve has not overly discounted the speed at which rates will fall. Most dedicated MMF managers allocate strategy to optimise the fund's position relative to internal investment strategies and to allow for interest rate moves that the market has already discounted. One useful instrument available to MMF managers is the floating rate note (FRN) which allows the fund to benefit from higher yields in a market where yields are falling over a period of time. The rate applied to the FRN (possibly the three-month Libor less a margin) may initially be lower than very short rates (overnight or one month) but will still exist as rates decline, until the refixing date. The reverse is true in a rising market-rate environment as the refix rate due to the FRN will lag the market's rate increase. It is observed over time that few overnight Libid rates available have matched the rates that have been available on the better performing MMFs, but this is because of a mismatch in timeframes.

Many of the managers notionally benchmark themselves to either seven day or one month rates as a means to control risk and as a reflection of what they believe to be the marketplace's view of the MMF's horizon. This reflects in part the fact that whilst these funds offer daily liquidity, the investors they hope to attract are there for the 'longer' term and that the returns should reflect their investment timeframe. Investors that use MMFs for interest-rate 'arbitrage' purposes, only to reverse the flow the next day are really helping no one as they dilute the yield that day for all holders, not just themselves, and in the longer term, may alienate themselves from the funds. Whilst the MMF industry is very large, the number of major MMF managers is far smaller and such 'arbitrage' of funds is unpopular with many of the managers, many of which will actively track the investments of 'suspect' investors.

In conclusion, MMFs offer treasurers a very useful alternative to direct money market investments, providing diversification, additional yields and ease of access. The need to provide daily liquidity and compliance with rating agency guidelines requires the investments to be of the highest quality. The additional yield available (net of TERs) means that they are a very convenient and effective additional tool for institutional investors and especially for treasurers whose cashflow, even if predictable, may be liable to timing and size variations.

PERFORMANCE ANALYSIS

Major treasury investors, who use the funds as an alternative to direct money market investments, are likely to have detailed historic databases for comparing the major MMF returns against each other in terms of net yields. The major comparisons centre around seven-day and 30-day simple net yields (defined by IMMFA as the annualised net yield which assumes that income earned over the past seven days/30 days is not reinvested in the funds and excludes capital gains). These seven and 30-day net yields are the true reflection of yield available to the end investor over that specific time frame. These databases will allow for direct comparisons with money market deposit rates for overnight, seven-day, and possibly one-month periods, as a way of comparing the funds to the basic market instruments in which the treasurer could invest directly. There will also be the direct comparison with bank deposit rates and/or rates quoted by liquidity custodians on call, as a way for the treasurer to decide whether to leave monies on a call account rather than switching into MMFs. In fact, an increasing number of banks and financial institutions are offering a 'sweep' mechanism to transfer clients monies to that firm's proprietary MMF which can help the client earn higher returns than typically available on deposit accounts. Clients wishing to use this facility would have to give authority for the 'sweeps' to occur and thereafter it would become an automated procedure.