Many investors are attracted to money market funds because of their daily liquidity. But just how liquid are they really?

Going with the flow

MONEY MARKET FUNDS (MMFs) are regularly referred to as liquidity funds and many of the firms that manage them cite daily liquidity as one of their key selling points. But how liquid are they in practice? And how can a treasurer assess whether the fund they are using will be able to cope with their liquidity requirements?

In this article, I will look at the four main factors that determine the amount of liquidity a money market fund has and set out some of the questions a treasurer should ask their money market fund manager to evaluate the quality of the vehicle's liquidity.

I will focus solely on the AAA-rated MMFs that are represented by the Institutional Money Market Association (IMMFA). Readers can discover more about the IMMFA and its membership at www.immfa.org.

Size does matter

Small is definitely not always beautiful when it comes to MMFs. Generally speaking, the bigger the fund, the bigger the potential pool of liquidity and the more attractive the fund becomes for the investor. Larger MMF investors in particular will therefore seek to invest in larger funds where their holdings will not represent a substantial percentage of the overall fund.

A quick look at the 19 sterling funds currently offered by IMMFA members (see Figure 1) shows that funds range in size dramatically from about £6bn to as little as £40m. The average size is about £1.4bn, but the three largest funds manage half of the £27bn of assets, and the top six funds manage 75% of the assets. In other words, there is significant concentration in the market and only the larger funds will be able to provide good liquidity to the largest investors.

Managing daily flows

The fund's mix of investments is also an important indication of its liquidity. It will also determine the potential costs of creating liquidity if the manager has to sell assets to meet redemption requests.

Treasurers would therefore be well advised not just to check how big a fund is but also to check what the typical asset allocation looks like, prior to making an investment. There is some publicly available data on asset allocation, which gives a general idea of a fund's liquidity. However, more detailed information would normally be required to make a firm judgement. Taking the sample of 19 sterling funds mentioned before, the average asset allocation among the main asset classes is shown in Figure 2.

Assuming that most deposits and repo trades are for short maturities (say, one week or less), these, together with the certificates of deposit (which can be sold for same day value)

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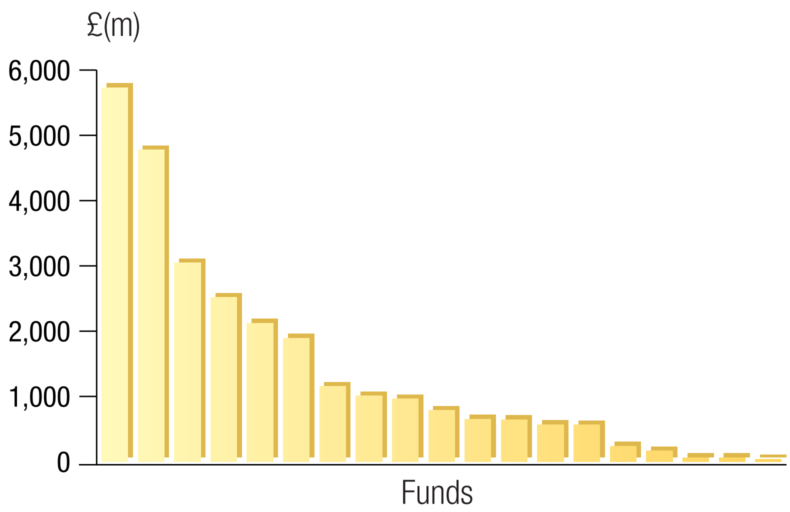
■ **Figure 1** Assets under management of 19 IMMFA member sterling funds



■ **Figure 2** Asset allocation of 19 IMMFA member sterling funds

Time deposits and repo	19%
Certificates of deposit	16%
Commercial paper	51%
Floating rate notes	14%

Source: *iMoneyNet, IMMFA Money Fund Report, 2 May 2003*

represent the prime liquidity of the funds. On average, funds hold around 35% of assets in these instruments, which suggests a fair degree of liquidity. However, the range between funds can be wide: some funds have well over 45% of their funds in these assets types and other as little at 12%.

Commercial paper (CP) can sometimes be traded for same-day value, although T+1 or T+2 is more normal. However, the secondary market in sterling CP is not particularly deep and spreads can be quite wide. This means that the fund manager may incur costs (which impact on fund performance) if they are forced to sell paper to generate liquidity. Likewise, floating rate notes (FRNs) normally trade on a T+3 basis and with fairly wide bid-offer spreads, which makes them unsuitable for liquidity management.

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What about the other investors?

One problem that all investors face is a lack of knowledge about the other investors in the fund and what use they might want to make of the fund. A treasurer will want to be comfortable that their returns are not being disadvantaged by the 'bad behaviour' of other investors in the fund. Investor diversification is generally a benefit, so funds with a wide cross-section of investors are preferable to those in which a small number of investors own a large proportion of the fund.

There are two reasons for this. First, not all investors are likely to be doing the same thing on the same day, so in-flows and out-flows are likely to net off to some extent.

This is particularly so when the investors are not just different clients but different types of client – for example, not just corporate treasurers but pension funds, local authorities, insurance companies, hedge funds and so forth.

Second, if the fund has a wide range of investors, the fund manager is less likely to be over-dependent upon any of the individual investors. This lowers the risk of the fund manager running the fund to suit the needs of one investor at the expense of the other investors. In other words, the absence of a dominant investor, or a small group of dominant investors, makes it more likely that all investors will be treated equally.

Treasurers can establish the investor base of a fund by asking for information both on the number of other investors and on the concentration of their holdings. For example, it is always useful to know what proportion of the fund is accounted for by the largest five investors. It is also useful to find out from the manager how actively the other investors use the fund – in particular whether the largest investor(s) behave any differently from the others.

When does the fund trade?

Cut-off times are a matter of lively debate between fund managers and fund investors. Understandably, many investors want cut-off times to be as late as possible, to allow plenty of time for the treasurer to establish their cash position for the day and to accommodate any late flows. However, a later cut-off may influence returns and liquidity in the fund.

The sterling money market is most active between 8am and 11.30am and starts to wind down by midday. At this time the rates available for overnight balances start to fall and the range (and quality) of counterparts in the market also starts to decline. Funds which offer late cut-offs and that also experience high dealing movements in the fund (past noon, for sterling MMFs, for example) are therefore forced to trade when the market is rapidly becoming illiquid.

So, from the point of view of liquidity, it is better to use a fund with an early rather than late cut off time. The quality of the liquidity is better because the fund is trading when the market is still liquid. In addition, other things being equal, a fund with an early cut off time might produce slightly higher returns.

For those treasurers who are not able to meet the earlier cut-off deadline, or for those who prefer to wait until later in the day to make their investment decisions, there are sterling funds with cut-offs as late as 1.30pm.

So treasurers can still access MMFs even when the sterling money markets are more or less closing for the day. However, if an investor is planning to use a fund with a late cut-off, it might be worth checking with the fund manager how they would fund a late redemption request.

Real liquidity

Not all investors care about liquidity. Some investors choose MMFs because of their AAA-ratings and their ability to diversify credit risk, some choose them for their ease of use and some because the returns they offer are better than those offered directly by banks.

To the extent that liquidity is a major concern it is important for investors to appreciate that not all MMFs are the same. In general, the best liquidity is available from the bigger funds, whose asset allocation includes a large proportion of liquid assets, with a wide and highly diversified client base, and a cut-off time that allows the fund to be managed during the market's peak liquidity.

Treasurers should check each of these four issues with their fund providers to ensure they understand how much liquidity is going to be available if an unexpected cashflow need arises. If liquidity is a real issue, it makes sense to pick a fund that provides real liquidity.

TREASURER'S CHECKLIST

So what questions should a corporate treasurer ask about asset allocation, prior to investing in a fund?

- **FIRST** What is the average daily net flow in or out of the fund, as a proportion of the overall fund's size? This will be a good sign of normal investor activity and will also indicate how accustomed the fund manager is to meeting significant liquidity fluctuations.
- **SECOND** What is the average amount available in the fund to deal with daily liquidity flows? This figure should be comfortably larger than the answer to question one. If not, the fund manager has little safety margin to protect against a large redemption request.
- **THIRD** What percentage of the fund is invested in less liquid assets, such as floating rate notes (FRNs) or short-term corporate bonds? If this is a large number (say, more than 30%), it suggests that the manager may have to incur trading costs to restructure the portfolio after a large redemption, which may impact the performance of the fund for the remaining investors.
- **LAST, BUT NOT LEAST** How much money can I redeem without notice? Some funds may set a limit – either a nominal amount, a percentage of the fund size, or a percentage of the investor's holding – to what can be withdrawn without notice. It is important to establish what limits, if any, of this nature apply, whether they have ever been imposed and, if so, how frequently, at the time the investment is made rather than the day a redemption request is made.