US-style AAA-rated stable net asset value money market funds are wooing investors from all sectors and parts of the world, says Andrew Ellis.

Glorious future

FACT: Predictions for the future are notoriously unreliable and difficult to frame with any degree of certainty, regardless of subject or walk of life; doubly so when the party forecasting the future has a vested interest in pressing for a specific sequence of events or championing a particular view. Would it not therefore be somewhat presumptuous for us to seek to put forward a balanced assessment of the future evolution of the European cash management business without some readers hinting at an element of bias?

Be that as it may, we are expected to put forward forthright views and to do so with a good deal of conviction. Our objective in this article is to make some predictions and remarks, with as much balance as possible, about future trends in the use of money market funds (MMFs) for short-term cash management in Europe. Readers' feedback on how successful we have been would be much appreciated.

Our prediction – based as much on clear market trends, as well as our own experiences – is that the marked growth in usage of US-style AAA-rated stable net asset value (NAV) MMFs for short-term cash management by (an increasingly wide variety of) European institutional investors and intermediaries will continue to escalate in the coming years.

A clear pattern

In terms of day-to-day cash investment strategy, if we split the European market, crudely, into two extremely broad spheres of influence and practice, we can begin to see a clearer pattern emerge. The extraordinarily high growth rate the non-US stable NAV money market industry has experienced over the past few years (the size of the market has increased by more than 40% year-on-year during the period in question) has been fuelled, in the main, by a steady take-up in usage by what I shall term as Anglo-Saxon institutional investors.

Initially, these were the larger US multinationals that would typically have established, often for tax reasons, an offshore treasury centre through which large and regular cashflows were channelled. For many US multinationals the advantages of keeping (often large) cash piles out of the hands of the US tax authorities still carry substantial fiscal benefits. For providers of MMFs, especially for those like Goldman Sachs with US parentage, it was natural that these entities would become a critical client base. After all, these same companies would often be users, and typically clients, of the corresponding domestic US MMF platform. For many fund companies, such opportunities are their raison d'etre – without recourse to their domestic US businesses, their ability to build a truly sustainable non-US MMF operation is likely to be fatally hampered in the medium term by a severe lack of distribution channels for their product. Nor should we forget that, stripped of their marketing spin, the products themselves, in their purest and simplest form, are commodity products. There may be nuances between offerings, but in the main potential buyers of a AAA-rated money fund would not expect there to be significant differences, in terms of structure and content, from one fund to the next.

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The other major plank in this Anglo-Saxon market for MMFs has been the considerable increase in their use by many British businesses. This can be seen by the steady growth in assets and new fund offerings within the sterling MMF segment. Reasons for this expansion are numerous (it is not my task or intention here to evaluate the specific benefits or advantages a MMF can bring to its users) and well documented. What is beyond doubt is that UK clearers have used their privileged position with corporate clients to promote a shift away from straightforward bank deposits for short-term cash investment into the alternative provided by their MMFs.

Golden opportunities

Turning to other channels of opportunity, it is their sheer versatility (among the other widely accepted benefits, chief of which are security, stability and overall risk enhancements) that have brought AAA-rated MMFs to the attention of a constantly growing number of 'alternative' users of cash investments over the past couple of years: hedge funds, collateral managers, synthetic investment structures and structured products, corporate trustees, custodians and pension funds. Growth in the usage of AAA-rated funds by such a wide variety of investor types has been no accident, and this despite recent difficult market conditions in short-term markets across most of the major currencies. Realistically, of course, the more forensic appreciation of cash investing in a deteriorating market has, in many ways, acted as a catalyst for these developments. It is probably fair to say that the main beneficiaries of these shifts in basic cash investing have been those providers whose business is truly global in reach. A quick glance at the evolution in size of the leading fund groups' assets would seem to bear out this assessment.

So the bigger funds have tended to get bigger – the maxim 'size begets size' seems to hold true in the MMF world. The winners appear to be those providers whose franchise provides multiple and varied distribution channels or, in the case of the bigger lending/clearing banks, a supply of willing customers beholden to their creditor banks. With this in mind, and reverting to my original theme, is it the case that bold predictions for the future can be made for this industry in the current environment? Based on the trends we have experienced over recent months, the answer would appear to suggest a cautious "yes."

The observant among you will have no doubt noticed that we have yet to make any further reference to the dichotomy in Europe, in terms of AAA-rated MMFs, between the Anglo-Saxon community and the rest.

Without any hint of disingenuity, cracking the rest of Europe, whatever the investor base, is the Holy Grail for the burgeoning offshore MMF industry. Put simply, there has been in no way the same degree of penetration by MMF providers across the continent as in the aforementioned Anglo-Saxon markets. Germany, France, Spain, Italy and beyond – the hinterland of continental Europe has remained determinedly, frustratingly aloof from the blatant overtures of the AAA-rated MMF community.

Statisticians among you should note that the growth in euro-denominated AAA-rated MMFs has been far less dramatic than hoped for following the launch of the single currency. Why is that?

Actually, the answer is not so controversial. Take a plane, train or boat to anywhere on the continent and head for the nearest large regional centre. Stand on a street corner and ask of the nearest passer-by their definition of a MMF. I am more than certain that the responses received, depending on locale, would be numerous and varied. More importantly, very few answers would involve descriptions of stable NAV MMFs.

'Cracking the rest of Europe is the Holy Grail for the burgeoning offshore money market fund industry... What remains problematic is the slew of fiscal and regulatory barriers to entry that adorn the continental European landscape.'

Enhanced offerings

Traditional cash investing outside the Anglo-Saxon sphere revolves round long-term relationships, with domestic banks eager to keep cash business on the books and prepared to offer decent amounts of deposit interest. Where cash is periodically placed in investment funds, the investment objectives and potential returns of such vehicles are markedly different to those of the AAA-rated US-style MMFs. In overall content and intent, with their broader exposure to both interest rate and credit risk, often incorporating elements designed to generate an even more dynamic return, the look and feel of these products bear a much greater resemblance to what, in our narrowly-defined Anglo-Saxon world, have become known as enhanced cash, or cash-plus, products.

Is it simple enough to suggest that the growth of the AAA-rated MMF industry will therefore founder on the rocks of local preference, custom and inertia? Tempting, but not true. What remains problematic is the slew of fiscal and regulatory barriers to entry that adorn the continental European landscape, to the extent that one reality for fund providers may be the need to explore hybrid product profiles for specific markets or clientele. The product incorporating BBB securities and a two-year average duration, which is potentially anathema to a more conservative-minded cash investor, may well jump off the shelves in downturn Madrid or Rome. Herein lies the dilemma.

On the other hand, there is enough evidence to suggest that the primary benefits of AAA-rated MMFs – stability, security, flexibility and operational simplicity – are now far more widely recognised than was previously the case, and can add significant value to the day-to-day management of cash by an ever-wider array of investors based on the continent. In addition, some fund groups have invested heavily to ensure that their product offering is made as convenient, efficient and relevant as possible.

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The right direction

Long recognised by our US colleagues, and eagerly adopted by the Anglo-Saxon investing community in Europe, it is clearly evident that as concerns over credit and individual counterparty exposure continue to proliferate (in particular in Germany, where worries about the credit-worthiness of traditional cash management counterparties are rife), the rationale for considering alternative cash investment strategies becomes ever clearer. For trend-setters as much as for the prudent, this has already occurred. As a result, we are confident that in terms of the likely direction and future development of the AAA-rated MMF industry outside the US, unlike other commentators who have predicted the beginning of the end, we have in truth only just about reached the end of the beginning.