Survival of the fittest

TREASURERS NEED TO ADAPT TO THIS CHALLENGING INVESTMENT ENVIRONMENT AND NOT JUST RELY ON CREDIT RATING AGENCIES, SAYS MARK STOCKLEY

The credit crisis of 2007-2009 brought about fundamental changes in the landscape for money market funds (MMFs). Not least of these was the impact on the role and importance of credit rating agencies. Regulators responded to what they perceived as an over-reliance on credit rating agencies by the securities industry and investors in the pre-crisis days by proposing laws that would specifically prohibit reference to issuer ratings. In turn, the agencies amended their credit matrices, or the scoring process they used to gauge the credit strength of issuers and their various instruments, often resulting in a downward shift in their credit assessments of specific counterparties.

As a result of the credit crisis, it is arguably less likely that credit rating agencies will continue to play as significant a role for the money market industry as they have done up till now. In our view, rating agencies are important as a source of information in the investment process for both asset managers and clients. But they should be viewed as just one component in a process that should also include dialogue and partnership between an asset manager and an MMF investor.

A confluence of factors have led to a difficult investing environment as cash investors seek to find balance between their quest for stability, liquidity and yield. In this article, we explore what the impact has been on MMFs and the options that may help cash investors to find relief in this challenging environment.

Current market and background

The current economic climate has made investing in the short-term markets increasingly challenging. Whether you are an MMF portfolio manager or a corporate treasurer investing directly in the markets, it has never been harder to invest cash assets while aiming to achieve flat or positive yields. This situation has arisen for a number of reasons:

◆ Diminishing supply
Over the past year there has been a decreasing supply of eligible money market instruments, particularly from the banking sector, most notably in maturities under one year. This is primarily due to the European Central Bank's (ECB) two long-term refinancing operations, which have funded the banks for three years and decreased their appetite for cash balances. In addition, there are pending regulatory changes, such as Basel III, that incentivise banks to term out their funding.

◆ Credit deterioration
It would be hard not to have noticed the plethora of rating downgrades that have taken place in the past year. In fact, there is no longer a bank in the UK that carries an AAA rating, which has led to a single-A banking universe. In 2012, Moody's downgraded Western European banks and financial institutions in the investment-grade space at a rate of 22 to 1. For Standard & Poor's this figure stands at 10 to 1 over the same period. Many treasurers and MMFs have had to amend their investment guidelines either by reducing their percentage allocation to lower-rated counterparties or by removing some counterparties from their approved lists. Credit deterioration further exacerbates the supply challenges due to these requirements.

◆ Prolonged low interest rates
In July 2012, the ECB cut the deposit rate to an unprecedented level of 0.00%, while the UK still has its lowest central bank base rate since records began at 0.50%. Market indicators tell us that this yield environment is expected to continue, impacting investors in the short-term markets.

Outlook for AAA-rated MMFs

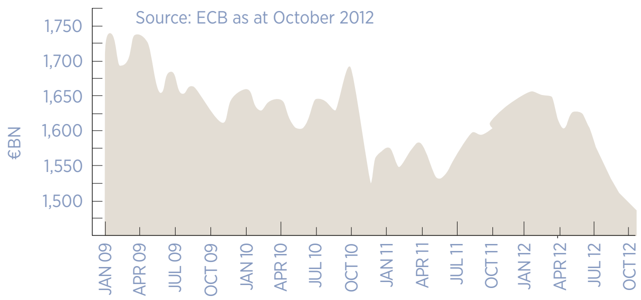
What does the current economic climate mean for AAA-rated MMFs? A combination of low yields, the Basel III directive, banks' preference for term funding and the volatility of government bonds in the eurozone meant that the supply of high-quality, short-dated assets declined in 2012 and will be limited in 2013. Running an AAA-rated prime MMF is prohibitively more difficult in this environment because the metrics used to evaluate and rate funds do not keep pace with the rate of downgrades. Because fund providers acted unilaterally to re-benchmark the banking sector, the overlap between rated funds and eligible supply is disappearing. In order to be compliant, AAA-rated MMFs are being led into a smaller eligible universe.

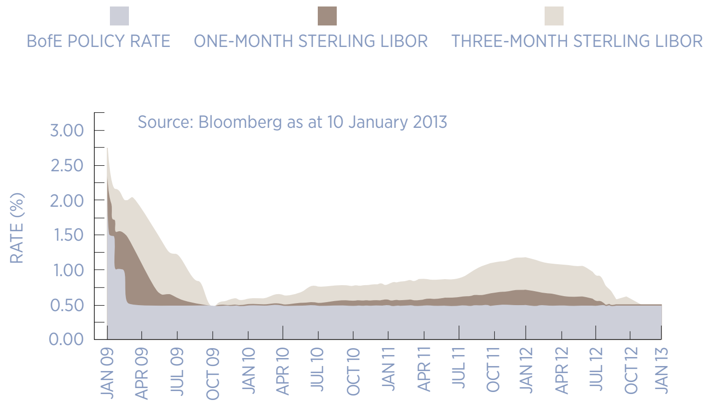
With the number of non-governmental eligible securities significantly reduced, sovereign debt is one alternative. But as the amount of highly rated treasury debt reduces further, and sovereign ratings continue to be challenged with regions such as the UK being put on negative outlook, it makes getting invested even harder. There is also the opportunity cost that comes with investing in sovereign bonds in terms of yield sacrifice.

So portfolio managers need to be creative and employ all of their resources in order to search for additional options and yield.

Credit rating agencies somewhat constrain investment decisions due to the methodology that they employ. Ratings provide a great benchmark or reference point that investors can use to evaluate a fund's potential eligibility for inclusion in their guidelines. Furthermore,

OUTSTANDING AMOUNTS OF SHORT-TERM SECURITIES IN THE EUROZONE





without globally recognised standards, uncertainty about the credit quality of the investment could undermine the confidence of investors. But the financial crisis highlighted a number of weaknesses in the rating agency model. Regulators globally have sought to address these weaknesses and to modify investor behaviour by discouraging an over-reliance on ratings.

In the past, credit rating agencies have been proactive about changing their methodology to allow for changing conditions. But they often take a significant amount of time to implement changes and so lag behind market movements. Additionally, rating agencies have tended to use a fairly mechanistic relationship between long-term and short-term ratings rather than provide standalone analysis for short-term ratings, which would be decoupled from their long-term counterparts. We believe this would be a more productive outcome for short-term investors.

It is prudent to think about funds that are not externally rated in these current market conditions. Without the constraints of a rating, MMFs can deliver potential yield pick-up over funds constrained by rating agencies' guidelines while also relying on their internal extensive credit management process.

What about unrated alternatives?

We believe it is time to reassess and update investment policies in order to take advantage of new investment solutions. After carefully considering risk tolerance, portfolio objectives and benchmarks, you can determine whether alternative solutions (ie unrated funds) in the cash management space might work.

In this constantly changing environment, treasurers are going to have to alter how they think about cash investing. Regulatory change is looming along with fundamental differences to the way MMFs are operationally run. For cash investors, the past few years have seemed like a fight for survival. But there are ways to adapt to the new world, to make the shift from survival to revival. To thrive in this challenging environment, the fittest investors will be more nimble in their approach, more adaptive in their thinking and more flexible in their search for opportunities.

CHECKLIST FOR TREASURERS

- **Has the company's approach to credit assessment changed in the past three to four years?**
- **Do we look at other parameters in addition to credit ratings? How prepared are we for future shocks?**
- **Do we have sufficient resources to undertake a thorough credit assessment internally?**
- **What's more important – extra yield or security of cash?**
- **What are our views on diversifying credit risk and how do we achieve it?**
- **How frequently do we conduct due diligence on our MMF providers?**

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