Liquidity risk in a crisis

MARK ASHLEY DISCUSSES THE FUTURE OF MONEY MARKET FUNDS.

Executive summary

- Investors need to be satisfied that the security and liquidity of a portfolio is at the required level. Although the credit rating of the fund gives some reassurance, this is ultimately just the first part of due diligence.

Money market funds have become increasingly popular with UK corporate treasurers, pension funds and other institutional investors in recent years.

There are two basic types: standard liquidity funds with same day access and enhanced money market funds with, typically, a 4-four day notice period. Enhanced money market funds have a variable net asset value and a longer weighted average maturity of the underlying investments. They target a higher return for some reduction in liquidity. Income is accrued daily and is reflected by an increase in the value of the fund shares. These funds will have greater price volatility due to the mark to market of the underlying share values that will be reflected in the fund price. Standard liquidity funds generally have a constant net asset value issued with an unchanging face value of £1 per share; the amount invested is the amount received when the shares are sold plus the accrued daily income.

The investment guidelines that liquidity fund providers comply with involve a number of different factors, including the credit quality of individual holdings, their maturity and the diversification of fund holdings. Taking these three factors into consideration, fund managers can construct portfolios to preserve capital and protect income, and satisfy the strict criteria necessary to qualify for a AAA rating – specifically, AAA/V1 with Fitch Ratings, AAAm with Standard & Poor's and Aaa/MR1+ with Moody's Investors Service.

NAVIGATING THE CRISIS It was an extraordinary year in 2008 in financial markets for a variety of reasons: record levels of volatility; substantial losses for equity investors; the effective nationalisation of household names such as AIG, Fannie Mae, Freddie Mac, Bradford & Bingley, Northern Rock and the entire Icelandic banking system; as well as the collapse of Lehman Brothers. As a result, interbank markets, already struggling after the sub-prime crisis started to emerge in mid-2007, effectively closed. Institutional investors have not only increased their exposure to 'safer' assets, but have also looked for reassurance that their investments really are lower risk. AAA-rated liquidity funds have featured high on this list. Due to their diversification, security of capital and liquidity, constant NAV liquidity funds have been an increasingly attractive alternative to bank deposits.

There have been different approaches to managing liquidity funds during this crisis. Our own investment style has been very conservative and focuses on our clients' main objectives – namely security of capital and liquidity. Under FSA rules and regulations, assets invested by our clients in money market funds are held in segregated accounts to those assets of the fund providers. We aim to diversify the risk by looking at high-quality issuers and invest in a secure and diversified range of underlying assets that comply with market standards and rating agency requirements.

Currently, we are looking at certificates of deposit rather than commercial paper, reducing the average maturity of new holdings and only buying paper from banks that are seen as an essential part of their national financial system. The latter point is an interesting one – most EU governments guaranteed bank deposits, but the market has been sceptical that smaller countries such as Ireland or Belgium could honour these guarantees if required and hence remained reluctant to lend to their banks.

Many investors wish to understand the investment approach and potential risks of the money market fund provider that they are looking to invest with – we are frequently seeing requests for information on 'how conservative is our investment approach', 'what level of liquidity is provided within the fund' and 'what are the fund's full underlying investments'.

WHAT TO LOOK OUT FOR IN 2009 Anyone tasked with finding short-term, secure, liquid homes for cash has had a difficult time in 2008. Conditions in 2009 should not be as difficult, but the lessons are clear and regulatory bodies are calling for tighter liquidity fund regulations worldwide. At the end of January, the Group of Thirty, an independent US policy organisation whose members include the Treasury Secretary and the Head of the White House's National Economic Council proposed regulatory changes for the US money market fund industry. The recommendations, if adopted by US regulators, could force money funds to accept banking-industry controls.

In the UK, investing in constant NAV liquidity funds that are Moody's Aaa/MR1+ and S&P AAAm-rated provides further reassurance – as this reflects high credit quality, safety, diversity of debt, liquidity and maturity of the assets. This type of liquidity funds also avoids the mark to market volatility of variable net asset value funds that are also reflected in the underlying share value. Membership of the IMMFA provides an additional quality assurance framework as, in addition to gaining the highest external ratings members must comply with a code of practice that aims to ensure investors receive high quality products and services.

Ultimately, however, investors in the UK and elsewhere need to be aware that the credit rating of a fund is only the first part of their due diligence in order to be satisfied that the security and liquidity of the portfolio is of the required level.

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