Caution and crunch

DESPITE CONCERNS THAT SOME HAVE STRAYED OFF THE TRADITIONAL INVESTMENT PATH, DEMAND FOR MONEY MARKET FUNDS HAS BOOMED. GRAHAM BUCK REVIEWS HOW THEY HAVE FARED SINCE THE ONSET OF THE CREDIT CRUNCH.

Money market funds (MMFs) represent a cautious cash investment strategy with attractions when the outlook is hazardous. Bearing many of the characteristics of bank deposit accounts, MMFs have traditionally offered a high level of security, same-day access and the potential for higher returns. Volatility in global markets since the start of the decade has increased their appeal, a trend accelerated by the onset of the credit crunch. Corporate treasurers, traditionally the main users of MMFs, have now been joined by a wider range of investors including pension funds.

As Jason Singer, Head of Goldman Sachs Asset Management's international cash portfolio management team, summarised in *The Financial Times*: "MMFs are used for working capital, cyclical cash balances or potentially volatile cashflows with a degree of uncertainty. In addition, some investors may park their assets in MMFs to 'weather the storm' or during a 'flight to quality'."

Demand in Europe has risen to record levels. Members of the Institutional Money Market Funds Association (IMMFA) report that the figure for funds under management stood at $495bn on 28 December 2007, representing growth of 38% from a year earlier. The total assets of MMFs in the US rose by nearly 33% in 2007 as the Federal Reserve cut borrowing costs in response to spreading contagion from the sub-prime crisis. Investors added a net $764bn to MMFs, pushing total assets above the $3,000bn level for the first time, the fastest rate of growth since 1975.

In the US, MMFs have generally invested in the safest, most conservative of short-term investments and are regulated by the Securities and Exchange Commission. The permissible average maturities of their investments are subject to strict limits and 95% of their portfolio is in securities with investment-grade credit ratings. As a result MMFs pledge not to "break the buck" (that is, to allow the net asset value, the NAV, to fall below face value and result in losses for investors). There has been just one instance of a fund failing to meet this pledge; in 1994, the Community Bankers US Government Fund was only able to pay $0.96 per dollar after its assets in adjustable-rate securities lost value when interest rates increased.

In Europe, where funds are not subject to similar regulation, the term "money market fund" has been applied to a variety of products, ranging from top-grade AAA-rated institutional MMFs with stable NAV to others known as investment-style MMFs. To distinguish the former from the latter, which include short-term bond funds, the IMMFA was formed in 2000 to act as the trade association for European providers of AAA-rated institutional MMFs.

As IMMFA Chairman Donald Aiken observes, the credit crunch highlighted the differences between the various MMF products. Some fund structures are superior to others and not all attract a top rating. A fund with a AAA rating from more than one agency provides a further layer of reassurance, as the rating requires it to adhere to the individual guidelines of each agency – which differ slightly from one another and thereby impose a further restriction on the fund's investment options.

"The credit event over the last six months has shown the value of treasury-style money market funds in a stark light," says Kevin Thompson, Managing Director of Fidelity's Institutional Cash Fund.

He adds: "The bulk of money coming into MMFs is usually daily liquidity money, but recent months have witnessed the more unusual sight of strategic cash reserves flowing into the asset class. This is as sure a sign as any that corporate treasurers know the value of a fund that can offer the highest security possible – reflected by the fact that treasury-style funds attract the highest possible ratings.

"Funds with a more investment-led approach – so-called investment-style MMFs, which do not have a stable NAV and seek a slightly higher yield – have tended not to fare as well of late."

SUMMER CRISIS ON A GLOBAL SCALE When global financial markets first experienced turbulence last summer IMMFA said the asset composition and track record of the treasury-style MMFs would weather the storm, and continue to offer treasury managers a valuable component of their portfolio. IMMFA pointed out that:

- Its members' MMF products confine investing to high-quality, short-term money market instruments, and so are AAA-rated by the agencies. They are also structured to have only low susceptibility to market interest rate volatility and can provide investors with either same-day or next-day liquidity.

- Members' funds are the only type of European mutual funds permitted by the Eligible Assets Directive to value their assets on

Executive summary

■ The credit crisis of 2007 broadened into a liquidity issue which left no real pricing for even good-quality assets. With the secondary market for assets frozen, MMFs took a defensive stance with little room to go in and make buys. However, MMFs were relatively unaffected, maintaining their liquidity and holding onto maturity.

an amortised accounting basis. They are often referred to as "422 funds" to distinguish them from cash funds such as investment-style MMFs, liquidity-plus or enhanced-yield funds, which typically aim for an enhanced total investment return and may not always provide as high a level of liquidity or capital security.

- The underlying assets of members' funds must have a maximum fixed maturity, or maximum interest reset period, of 397 days maximum while the weighted average maturity (WAM) of any fund portfolio must not exceed 60 days. This reduces market risk from significant interest rate volatility and provides investors with same-day or next-day liquidity.

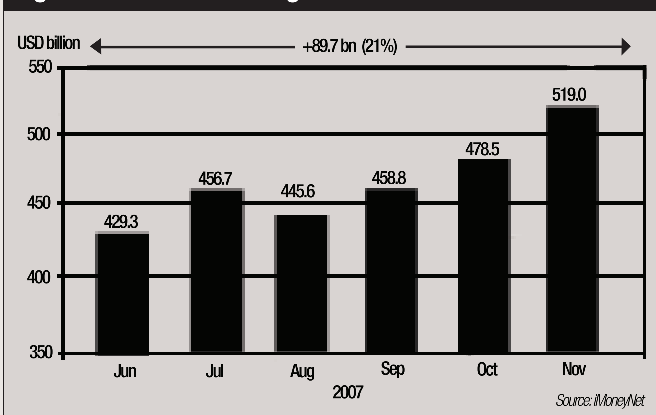
- Funds must also comply with an industry code of practice requiring that assets are regularly marked-to-market by an independent fund administrator. The code also applies standard escalation procedures so that any material variance between the amortised accounting value and the mark-to-market value of any individual asset or of a fund itself means the investment manager can act to maintain the fund's primary aim of preserving capital.

MMFS REMAIN STRONG The credit crisis broadened into a liquidity crisis affecting some non-422 funds with good underlying assets, which nonetheless found themselves unable to achieve liquidity

"The crisis meant there was no longer any real pricing out there even for good-quality assets, as the secondary market froze up," says Aiken. "Our members' funds were relatively unaffected by the crisis, however. As their main purpose is to maintain liquidity, rather than generate enhanced yield, their assets tend to be held to maturity and effectively ring-fenced."

But as the secondary market was effectively rendered illiquid it has been difficult for the funds to go in and make buys, so they have maintained a defensive stance. Conditions were at their worst

Figure 1: Growth during recent market turmoil



towards year-end when liquidity tends to be tight, so the crisis reinforced it further.

Aiken says the credit crunch brought some benefit as well as increasing demand for 422 funds. IMMFA has identified ways to improve the product further, and is focusing on the following areas:

- enhancing the liquidity provision of funds through use of repo;
- increasing the transparency of the portfolio, with many managers provided more frequent updates on the underlying assets of funds to reassure investors; and
- revising the code of practice, so that it is principles-based, with trustees policing the funds to ensure compliance.

Changes to Europe's regulatory environment have also helped MMFs. The EU's Capital Requirements Directive applies the same regulatory treatment to AAA-rated MMFs as it does to bank deposits, and since the introduction of the Markets in Financial Instruments Directive (MiFID) in November, custodians holding client money have been able to place it in certain MMFs in addition to bank deposits.

A growing demand for MMFs has, however, been accompanied by concerns over whether some US funds could incur capital losses, caused by problems from troubled structured investment vehicles (SIVs). In order to provide the returns expected by investors, some MMFs strayed from their traditional confine of plain vanilla investments and moved into SIVs, which in many cases lost their investment grade as the sub-prime crisis developed.

Alarm generally centred on funds that invest long-term and have a rating below AAA, but raised the possibility that a number of MMFs could actually break the buck by paying less than 100% of sums invested.

Although funds' exposure to SIVs may be more limited than some fear, a number of MMF sponsors such as Morgan Stanley, Bank of America and Credit Suisse stepped in to provide capital support to bail out those funds suffering SIV losses and protect their credit ratings. Reports suggest that not all of these rescues have been made public and losses will not be known until later this year.

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For more on cash management and money market funds, go to **www.treasurers.org/technical/cashsurvey.cfm**. And see *The Treasurer*, A Year of Twists and Turns, Jan/Feb 2008, page 44.