Money market funds can help the treasurer to enhance liquidity, security and yield, and reduce operational costs within a well balanced portfolio.

The treasurer's view

THERE IS, of course, no single view of money market funds (MMFs) among European-based treasurers. There are also typically no long-established European views, because MMFs are still relatively new to the European market. However, according to recent estimates, MMFs are now actively used by roughly half of large European corporate treasury departments and their usage is growing rapidly.

The largest funds continue to be in US dollars. Since the advent of the euro, the use of euro and sterling MMFs has also developed, and there are smaller MMFs in Canadian dollars. Increasing numbers of treasurers have begun to use MMFs to invest the majority of their overnight cash and liquid investments. The reason for this is primarily a combination of strong security and liquidity, enhanced yield and the opportunity MMFs provide to reduce workloads and potentially staff numbers and systems costs within treasury departments.

At the time of writing, uncertainties are high, including the consequences of the current war in Iraq. European and US markets look poised to enter their fourth consecutive year of bear markets – the longest period of sustained downward equity price movements for almost 70 years. Many companies and pension funds have reduced their exposures to equity markets, by selling equities, contributing to bear markets but increasing the size of funds held in cash, deposits, money market and fixed income funds and securities. Pressure on share prices and corporate profitability have put increased pressure on treasury departments to reduce costs and/or increase the value they add through their cash and investment portfolio management activities. In this environment, there could be increased benefits available from using or expanding usage of MMFs.

Which treasurers will be interested in using MMFs? Benefits are often available from using MMFs in treasuries of all sizes and should be considered, in particular by those who wish to hold funds in very liquid form (that is, available on the same day). The only treasurers likely not to be interested in using MMFs will generally be either those who work in smaller companies with less than $1m of overnight/investment balances in any major currency or those who opt for the sometimes more dangerous strategy of carrying no significant cash, liquid funds or deposit balances at all, relying instead upon borrowing and overdraft facilities to provide liquidity.

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Treasurers with very large sums to invest beyond the very short term are likely to decide not to use MMFs exclusively, although they will still often view MMFs as the best place to hold short-term balances. Depending upon their yield curve view, they may also wish to use MMFs substantially to invest longer term surplus balances. The treasurer will probably wish to invest longer-term funds in a range of other instruments such as bank deposits (relatively illiquid), commercial paper (CP), certificates of deposit (CDs), floating rate notes (FRNs), medium term notes (MTNs) and other longer-term money market/fixed income instruments/funds (typically redeemable at three days' notice).

Decisions on the appropriate size of investment portfolios, the mixture of instruments to be used and the amounts that should be invested in each type of instrument require skilled judgment and will vary enormously, depending on personal preferences, the characteristics of the organisations concerned, and the general business environment in which they are trading. I would like to consider the perspectives of:

- a large treasury department, managing a substantial investment portfolio, which is used partly to generate investment income and partly to provide liquidity to finance variable and often volatile and unpredictable multi-currency cashflows (see box below); and
- a small treasury department, managing primarily cash and short-term deposits, which are used to service more predictable cashflows in a smaller range of currencies (below).

The treasurer managing smaller balances

The yield benefits of MMFs, in percentage terms, are typically much greater to smaller wholesale investors. MMFs typically accept deposits of $1m or more, whereas the rates offered by banks to smaller investors (smaller companies with, say, £10m or less to invest) will commonly average well below the near Libid rates available to larger investors. Withdrawal/subscription of MMFs can be in relatively small amounts, for example, $50,000. The small investor will gain the same liquidity/security/yield as a larger investor, and will also often have opportunities to benefit from savings in staff time and information systems costs.

HOW TO CHOOSE AN MMF FUND?

The Institutional Money Market Funds Association (IMMFA) website, www.immfa.org, provides an excellent summary of recent performance (seven-day and one-year) of major funds. However, other AAA-rated MMFs are available from major banks and fund managers that do not belong to the IMMFA. The IMMFA website can be used to assess yield and rating performance records, and trading deadline of any IMMFA fund in which the treasurer may have an interest.

The view of the treasurer of a larger treasury department

LIQUIDITY While money market fund (MMF) liquidity is extremely good, if the treasurer wishes to invest or withdraw more than a small percentage of the fund (2% to 3%), it is advisable to give the investment manager as much notice as possible. Very large withdrawals at short notice can require the fund manager to liquidate investments or borrow in the markets, which can negatively impact the overall yield of the fund, and late unadvised investments can be harder to place at satisfactory yields. Same day availability, in US dollar funds up to 8pm to 10pm, provides liquidity that is almost as good as an overdraft, and more reliable, as overdraft facilities can generally be cancelled without notice. Reliance on making late deposits in the overnight money markets provides a precarious alternative, where on days when there are large market surpluses the banks can offer little or no interest on late overnight deposits.

SECURITY MMF credit ratings measure the perceived likelihood of loss of principal and are comparable to the rating scales used by rating agencies to rate long-term debt. MMFs are typically rated AAA and therefore generally offer a more secure alternative to bank deposits. This is because, increasingly, fewer banks have AAA or even AA ratings, whereas AAA-rated MMFs are widely available. It is almost unknown for investors in AAA-rated MMFs to lose principal. Also, ratings of MMFs are generally easier to monitor than bank ratings (you can use one website), and the AAA ratings of MMFs reduce diversification requirements.

YIELD Over time, few, if any, well rated banks' LIBID rates have matched the rates available from the better performing MMFs.

COST SAVINGS Staff and information technology savings may be available. Essentially, the manager of the MMF is seeking opportunities to increase yield through timely extension of the average duration of the fund that previously a treasurer's interest rate management team would seek to secure. A treasurer may choose to use MMFs instead of active short-term yield curve management, perhaps sacrificing one interesting aspect of their (or their team's) job and offering the potential for a large coup if they get their investment timing to coincide with a yield curve peak, instead securing a steadier return and often significantly reducing staff time, as well as costs incurred on information systems.

TAXATION

A treasurer should consider the characteristics of the fund from a tax perspective and take tax advice, as they deem appropriate, before investing. Generally, MMFs are structured so that shareholders (investors) receive income, at their option, either as 'distributing' (interest paying) shares or as 'accumulating' shares. This choice is to provide increased flexibility to enable investors to select the most tax-efficient form of investment. Treasurers of companies resident in the UK and a variety of other jurisdictions have usually been able to conclude quite easily that MMF investments would deliver yields which are free from withholding tax and stamp duty, and are subject to taxation on their income and capital gains.

INTERNAL PROCEEDURES

A treasurer should ensure that parameters for investing in MMFs are already included within or added to its board approved business risk management policies. They also need to arrange for their department's procedures manual(s) to be appropriately amended to prescribe appropriate reporting, monitoring and oversight procedures for investments in MMFs.

Why can treasurers find it difficult to justify use of MMFs?

A treasurer who is considering using MMFs may have many concerns, some of which may be more well founded than others.

- What will the balance sheet treatment be? An investment in MMFs may appear within 'securities available for sale' on a corporate's balance sheet, instead of 'cash and deposits'. The treasurer may worry about whether investors/analysts may view investments in securities available for sale as riskier than cash and deposits. But they should not, provided the AAA-rated nature of the MMFs, and their same day availability, can be clearly explained.
- Similarly, will investment impact his or her financial covenants, or (for regulated entities) attract more onerous treatment than cash and deposits? These issues should be considered but are unlikely to be relevant to many corporate treasurers and, if they are, will generally reflect issues of form rather than substance.
- A treasurer may be advised by their bank to keep funds in cash and deposits. Increasing numbers of banks are making their own MMFs available to clients, although some do not go out of their way to publicise the fact. Banks can be faced with dilemmas on how to advise their clients, and also of where their own best interests lie. Bank deposits will be less liquid and may appear to the customer to offer lower or higher yields, depending upon maturity and the like, and will typically offer higher margins to the banks. Their level of security will typically reflect the bank's credit rating, whereas MMFs are AAA-rated. They will appear on a bank's balance sheets, whereas customer funds invested in banks' MMFs typically do not and so allow banks to present better capital ratios.
- While MMFs are typically rated AAA, treasurers may be less certain of the true nature of the counterparty risk than when investing in a bank with whom they feel more familiar.
- The staff and IT savings that can result from the use of MMFs can be unpopular within corporate treasury departments.
- Settlement between a treasurer's bank and their MMF can be slightly more complex than simply placing the money on deposit or in a call account with a clearing bank. MMFs are often very security conscious, however, and it is fairly common for MMFs to insist, as a money laundering prevention measure, that all MMF investors should be able to withdraw funds only to the pre-designated account for the currency concerned. Such an arrangement can also have internal control benefits for the treasurer.
- Treasurers can have concerns about documentation, although this is generally straightforward. The treasurer should read the prospectus of the fund, which will explain the fund's investment policy, administration procedures, including subscription and redemption requirements and confirmation procedures, and other details relating to its constitution, management, taxation and charging structure. The treasurer should also read rating agency and fund manager reports. Account opening documentation is generally also fairly standard and straightforward.
- MMF depositor protection will generally be limited to recourse to the fund, with less implicit and no explicit protection from a bank's regulator than might be available from a bank deposit.

Having looked at these issues carefully, most treasurers can overcome these concerns, reducing their decision to one of yield, security, liquidity and assessment of staff/cost/administrative consequences.

The Institutional Money Markets Funds Association

The Institutional Money Market Funds Association (IMMFA) is a highly reputable European institution representing most of the largest and best AAA-rated MMFs. Treasurers involved or interested in investing in MMFs should become well acquainted with the contents of IMMFA's website, www.immfa.com. It lists all major IMMFA members' MMFs, their size, recent seven-day and one-year yields, source of AAA-ratings and same-day trading deadlines. These include a large number of well-established AAA-rated MMFs provided by immediately recognisable investment managers and banks, including, in early March 2003:

- 24 US dollar MMFs with a combined $80bn of assets under management (AUM) mostly offering average yields, during the past seven days, of between 1.25% and 1.30% (versus the current Federal Reserve fund rate of 1.25%);
- 21 euro MMFs with combined €20bn AUM, mostly offering average yields, during the past seven days, of between 2.70% and 2.85%, (versus the European Central Bank (ECB) rate of 2.75%);
- 18 sterling funds with £27bn AUM, mostly offering average yields, during the past seven days, of between 3.85% and 3.95% (versus the Bank of England (BoE) rate of 3.75%).

Dealing/confirmation procedures are usually by phone and fax (with the ability to deal by internet in some MMFs), with proceeds, on redemption, being paid to pre-designated accounts.

An increased MMF presence

Although MMFs have only become available to corporate treasurers in Europe during the past few years (see article on pI of this feature), they have 'come of age' as an investment product for liquid funds, with very strong security and yield performance and the potential to provide cost savings. Their rapid growth can reasonably be expected to continue, and in a few years it seems likely that most treasurers will be using them to manage a substantial proportion of their short-term liquid funds. Also, more extended maturity/'enhanced' MMFs are likely to develop, both as general funds and as segregated funds, for investors willing to accept increased short-term yield volatility in order to seek enhanced yields associated with accepting longer-term yield curve exposure.

THE AUTHOR

Jon Boyle is Chairman of the ACT's Technical Committee and Director of Treasury of Fidelity International Limited (which, together with its affiliate FMR Corp, forms what is commonly known as Fidelity Investments, one of the world's largest independent fund management organisations. Fidelity was a founder member of IMMFA.).

As a practicing treasurer for the past 16 years, Jon has been treasurer of several different types of organisations, each having multi-billion pound investment portfolios (mostly multi-currency) and cashflow and liquidity demands.

Case study

The author's recent experience, as a corporate treasurer, of using MMFs within a high-quality investment grade portfolio.

Within Fidelity International's (FIL) corporate treasury, active management of sums invested within MMFs has, during the past two years, become a fundamental part of its daily cash management routines. Our goal is, generally, to maximise the net cash balances in dollars, sterling and euros held within our MMFs. Yields measured through active cash management are measured daily and compared with those which would have been generated by following our previous cash management procedures, net of fees paid to the fund. This provided a measure of incremental value added, which in 2002 comfortably exceeded $1m. This did not take account of any yields generated from investment of our group's parent company's funds, which include the proceeds of our recent bond issue.

FIL manages potentially volatile movements in all major currencies, but the advent of the euro simplified this, enhancing the potential value of MMFs considerably.

The first quarter of 2002 was an extremely busy period for FIL's corporate treasury, with FIL obtaining its first long-term credit ratings and launching a €500m bond issue. All the proceeds needed to be invested initially in highly secure, liquid and high yielding form, and AAA-rated MMFs provided the ideal solution. We simply increased the balance in our euro MMF. Shortly afterwards, €400m of the proceeds were transferred to a segregated short-duration fixed income portfolio, managed by Fidelity's fixed income team, which is tailored to our own pre-authorised investment parameters and invested mostly in euro-denominated securities (with some investments made in dollar securities for which FX flows are swapped into euros).

During the period of about nine months to the end of 2002, the annualised average return on our euro MMFs was 3.21%. The high-investment grade, short-duration fixed income portfolio performed considerably better and during the same period, yielded an annualised average return of 5.85% (4.62% from interest income and 1.23% from realised and unrealised gains). The euro MMF predictably generated a very steady return, averaging about 1/8% above seven-day Libid, whereas the returns on the fixed income portfolio, while generally substantially higher, varied considerably, given that the average duration of the underlying fixed rate instruments was roughly 18 months, reflecting movements in the short-term yield curves and credit spreads of corporate fixed income securities over government securities.

Our investment in euro MMF provides the greater short-term liquidity, being available for same day withdrawal up to 1.30pm GMT, whereas our fixed income portfolio would take approximately three days to liquidate. Also, our MMF investments are more secure, being AAA-rated, whereas our fixed income portfolio, while also of good quality and well diversified, is fairly evenly divided along the credit spectrum from single A to AAA-rated securities. I am able to monitor the market value of the €500m portfolio practically on a real-time basis and receive an email summary of the closing market value of the portfolio each evening, which is helpful to keep track of performance and to monitor the cost of carry of our bond issue.