First rated in 1984, no investor has lost money in a Aaa-rated money market fund. But how has the market managed to perform such a feat?

A rating agency view

BEFORE discussing the process of rating a money market fund, we should first agree on the definition of a money market fund (MMF). Globally, money funds can take on a variety of guises; some look like deposits, others like short-term bond funds. In certain markets, such as the US, MMFs are clearly defined by regulation. In Europe, however, the UCITs directive does not define an MMF and the definition of a money fund falls into domestic regulation. The types of securities these funds may invest in can vary widely from jurisdiction to jurisdiction – for example, most domestic French MMFs hold a significant amount of synthetic floating rate notes (long bonds with matching fixed to floating swaps). Although the regulation is changing at the end of 2003, currently, neither the bond nor the swap needs to be marked to market, which is clearly a risk should the manager be forced to sell the security.

In looking at the rating agencies' approach to assessing risk in MMFs, this article will concentrate on stable or constant net asset value (CNAV) money market funds. These are funds that are structured to look like a deposit – that is, maintain a net asset value of $1, £1 or €1 and are a lookalike to the US domestic money fund structure.

Investors should look behind the rating to choose a fund

A commonly asked question is "are all Aaa-rated money market funds alike?" Simply stated, the answer is no. Rating agencies have standard guidelines for obtaining a Aaa rating. However, many factors can drive the agency to modify these guidelines. Let's take a look at the component parts of a rating and examine how they may differ from fund to fund.

Figure 1 identifies the primary risk parameters that are examined when rating a money market fund.

Asset management There are three major constituencies that can influence the rating of a fund: asset management, investor constituency and operational efficiency. Each of these component parts is inter-related and cannot be assessed in isolation. Examination of the asset management component comprises a review of the investment management process, including the manager's credit review policies, trade execution and compliance and oversight procedures.

▪ Credit quality risk is the first component part of portfolio construction evaluated by rating agencies. Highly-0rated MMFs must maintain minimum standards to obtain and keep their rating. For example, a Moody's Aaa-rated MMF may not purchase securities with a long-term rating lower than A2 or a short-term rating of lower than P-1. In addition, Aaa-rated portfolios are required to maintain a credit quality equivalent to a 13-month Aaa security. At Moody's, this is measured by calculating the expected loss (default probability) of the portfolio. An important aspect of the review process is an assessment of the manager's

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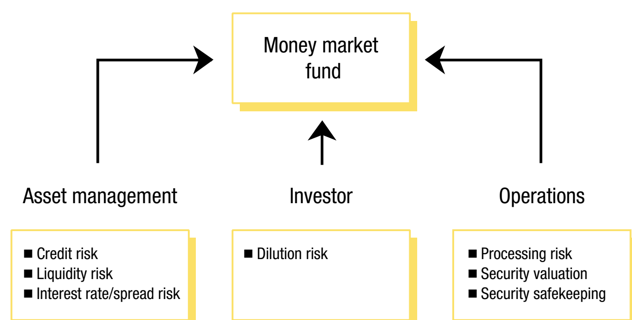
Figure 1 The primary risk parameters when rating an MMF



policies should a specific holding be downgraded below the acceptable rating level for a Aaa-rated portfolio. If a particular security in the portfolio is downgraded below A2/P1, the decision to hold or dispose of the security is driven by a number of different factors, the stability of the credit quality of the issuer, the final maturity of the security and the fund's liquidity needs.

Credit review process As such, the strength of an asset manager's credit review process plays an important role in assessing the quality of an MMF. Rating agencies prefer a strong credit culture, with a credit review process that is independent of ratings issued by the rating agencies. Asset management companies with strong credit groups, which are independent of the portfolio management process, may be held to a different standard than those groups that rely purely on rating agencies for their credit review process. For example, asset managers with a less developed credit expertise may be restricted in the amount of floating rate notes (FRNs) they may hold in a portfolio or may be restricted from investing in certain types of securities such as asset-backed securities (ABS). Therefore, although there are minimum credit guidelines to obtain a Aaa rating, in many cases the asset manager is constrained by tighter guidelines than the published guidelines.

Over the past 18 years that rating agencies have rated money funds, there have been a number of situations where funds have held securities that have encountered credit problems. The vast majority of cases are a simple downgrade below the A2/P1 threshold. In these cases, the asset manager presents a plan to the agency, usually letting short-term holdings mature and selling longer-term securities.

In a very few cases, there have been securities that slide down the credit scale very quickly – often unexpectedly. In these cases, it is important for management to make a move quickly. Assuming the fund is properly diversified and action is taken straightaway, potential losses to the fund can be minimised.

Interest rate and spread risks These also play an important role in portfolio construction. In the current low interest rate environment, the potential impact of interest rate spikes may have a significant effect on fixed income portfolios. Aaa-rated MMFs are restricted to maintaining a weighted average maturity of 60 days or less. However, this restriction alone cannot protect the fund. One only needs to look back to the US market in 1994 to see the potential impact a rising interest rate environment can play in the stability of CNAV MMFs. In 1994, many US MMFs were invested in FRNs that carried interest rate reset mechanisms that were not tied to the short-term interest rate market. As such, when both a spike in interest rates and a shift in the yield curve took place, many securities took severe hits in their market value. Many managers were forced to inject capital, or buy these securities out of the

RATING AGENCY SYMBOLS

S&P AAAm
Moody's Aaa/MR1+
Fitch AAA/V1+

WHAT DOES AN MMF RATING MEAN?

A mutual fund's credit rating, whether it be a constant net asset value (CNAV) money market fund (MMF) or a high-yield bond fund, does not have the same meaning as a debt rating. Mutual funds, unlike bonds or commercial paper (CP) are not debt instruments. As such, they carry only an obligation to pay the net asset value (NAV) per share of the fund.

A mutual fund credit rating addresses the concept of investment quality. For a CNAV MMF, the concept of investment quality implicitly means capital preservation, or as termed in the US, making sure the fund does not 'break the buck'. Therefore, a Aaa-rated CNAV money market fund provides investors with the highest level of capital preservation. The highest rating that can be assigned to a MMF is denoted in the box on above. Investors should look for the subscript 'm' with a Standard and Poor's rating, and an MR1+ or V1+ when looking at a Moody's or Fitch rating.

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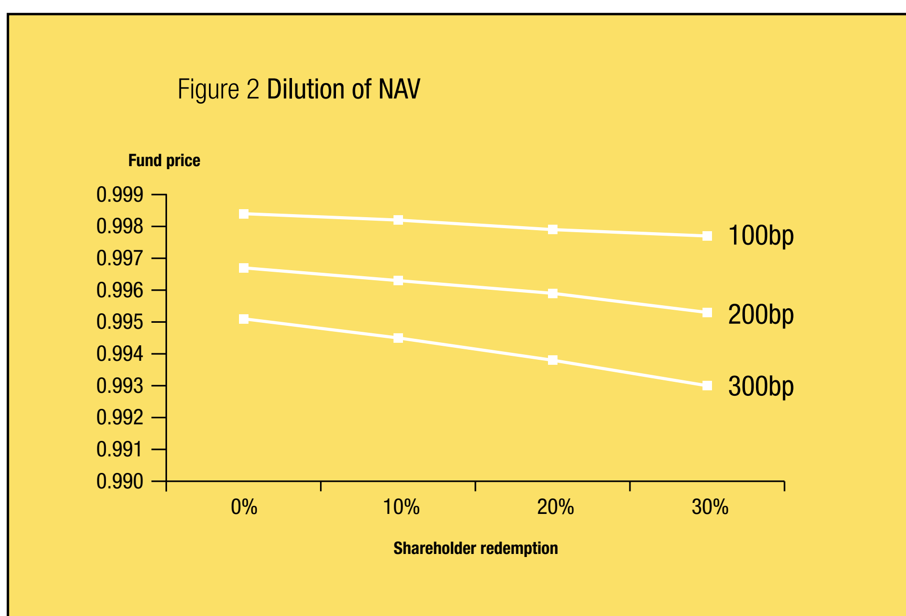
fund to avoid 'breaking the buck'. Both fund managers and investors learned an important lesson from this event – first, floating rate instruments in an MMF must be tied to an index relevant to the short-term market. Second, investors realised the need to invest in funds where the asset management company would have significant reputation risk if they let their fund fail.

Investor constituency Most investors perceive credit quality to be the predominate risk when looking for an MMF. However, of equal importance is the structure of the portfolio in relationship to the 'shareholder make-up' of the fund. The stickiness of a fund's shareholder base is extremely important to determine both the maturity structure of a fund and the types of securities a fund should invest in. A well-diversified shareholder base, by both type and size of client, provides the fund manager with investment opportunities not available to poorly diversified portfolios. Many institutional money funds have a core shareholder base consisting of internally controlled money or, in some cases, stickier retail investors. This allows the fund manager to invest in less liquid securities, such as ABS, as their liquidity needs are more predictable.

Predictability of investment flows is even more important in a rising interest rate environment. An MMF with a 30-day average maturity will generally take 30 days to adjust to market rate movements.

Experience in the US market has shown that there are certain shareholders that will move a portion of their investment into certificates of deposit or deposits until the fund has had a chance to reposition itself. If the portfolio is not structured to handle both the redemption activity and rising interest rates, there is a possibility that the fund, at least on a mark-to-market basis, could break the buck. As such, monitoring shareholder concentration and trends is a crucial part of the rating process. Figure 2 illustrates this concept. With no shareholder redemptions in the fund, it would take a one-day interest rate spike of nearly 300bp for a fund's price to fall by 50bp. However, combine an interest rate spike with an outflow of money, and the risk increases dramatically.

Operational efficiency In addition to managing processing and custodial risks, valuation of fund assets is a key consideration. To maintain a stable NAV per share, funds are valued using amortised, often referred to as 'linear', valuation. To assure the amortised value of the portfolio reflects true market value, funds are marked to market on at least a weekly basis. If the market value of the portfolio differs from the amortised cost of the portfolio by 50bp, the fund has effectively broken the buck. Rating agencies require the administrator to develop escalation procedures for addressing a market value drop in the portfolio. Typically, if the fund's market value price deviates from its amortised price by 20bp, action is required. Usually with a 25bp to 30bp differential, the fund's board of directors gets involved. The key here is to deal with a potential problem before it becomes a big problem.



The rated MMF track record

Currently, there are roughly 600 money funds rated worldwide. Institutional money funds were first rated in 1984 and therefore have endured many different economic and credit cycles. To date, no institutional investor has lost money in a Aaa-rated MMF.