

All par one

DIVERSIFICATION, EASY OPERATION AND DECENT RATES – **CHRIS OULTON** EXPLAINS THE ATTRACTIONS OF CONSTANT NET ASSET VALUE FUNDS FOR MONEY MARKET INVESTORS.

Constant net asset value (CNAV) money market funds, also referred to as liquidity funds, have become widely used by treasurers over the last 10 years. They provide a useful home for short-term cash, offering treasurers the benefits of diversification while also providing the ease of operation of a bank deposit. As Andrew Koss, treasurer of Drax Group, says: "We find AAA-rated funds currently pay rates at or close to six month LIBID, while giving us instant liquidity. Money market funds are also transparent in terms of investments and liquidity."

Constant net asset value means that the price of a share in the fund is always £1.00 (or €1.00 or \$1.00) and the income earned is paid to the investor as a dividend. As a result the product looks like a deposit, where principal is invested, and principal plus interest is returned or reinvested monthly. The constant price of £1.00 is achieved by using amortised cost accounting instead of mark to market accounting.

Nicholas Hayland, treasury operations manager of Colt Technology

Services, says: "CNAV pricing allows us to monitor our investments in money funds in the same way as our investments in bank deposits."

AMORTISED COST ACCOUNTING However, the fallout from the banking crisis of 2008 has resulted in regulators looking more closely at the arguments for CNAV funds and in particular the use of amortised cost accounting. The justification for using amortised cost accounting relies on the key assumption that the portfolio valuation will never materially deviate from its original acquisition value. The convention of what constitutes a material change has been "penny rounding" to two decimal places. So a fund priced at 1.00 must not reach a revaluation level of 99.50% or 100.50% without having to abandon the 1.00 price in favour of the revalued level. The point of reverting to market values is to ensure that there is no dilution or subsidy of one investor's return to or from another investor. Clearly the key must be to maintain the real value of the portfolio at very close to par value. Where the last line in the sand was drawn at 0.50%, before the financial crisis, there are now moves to restrict this to a difference of 0.25%.

In order to maintain their mark to market price so close to par, money market funds adopt conservative risk limits. These include limits on final maturity and weighted average maturity, diversification, asset type and minimum credit ratings. Funds are marked to market at least weekly with the results scrutinised by the rating agencies. They also have escalation procedures in place to ensure that any necessary action is taken to rectify the situation if the price begins to move appreciably away from par towards 99.75%.

The industry, through the Institutional Money Market Funds Association, has additionally agreed to include stress-testing as part of its risk management. This is designed to forecast possible revaluation losses given worst-case market scenarios. Clearly there is no secret formula to ensure that a credit loss will not occur, but that is as true for direct investments as it is for those made by a fund. The variables used in this stress test will typically include credit downgrades, interest rate changes, changes in the shape of the yield curve, and redemptions by a number of the largest investors. Funds should be run to ensure that these possible outcomes do not challenge the 99.50% level. In practice variances from 1.00 should never come anywhere close to these worst-case outcomes.

Despite all these safeguards around the use of amortised cost accounting the banking crisis has caused regulators and rating agencies to call this convention into question. The regulators are



Box: The small print

UCITS money market funds are, subject to applicable national law, permitted to use an amortised cost method of valuation under the EU Commission's Eligible Assets Directive 2007/16/EC and the related CESR guidelines concerning eligible assets for investment by UCITS (Ref CESR/07-044b).

concerned that the "promise" of a constant net asset value in some way suggests that the principal invested is almost guaranteed. This has been described in some places as "shadow banking" and has resulted in calls for funds or their sponsors to be regulated and indeed capitalised as if they were banks.

The rating agencies have differed from each other in their position with regard to CNAV funds. Fitch has stressed that portfolio integrity is its main focus. Standard and Poor's has said this is also the case unless valuations touch the 99.75% level, at which point it will look at the extent to which a sponsor might support its fund. Moody's is consulting on using possible sponsor support as one of its assessments in determining fund ratings.

NO GUARANTEE However the funds do not offer a "guarantee" of principal protection, any more than a bank deposit does. They are of course managed with the aim of protecting capital while earning a money market rate of return – a key factor for treasurers such as Koss. Nevertheless the constant NAV is not meant to be a claim of guaranteed capital, but to offer treasurers a convenient way to transact. If the valuation were to move significantly from 1.00, then clearly this should be reflected in the price. So long as underlying portfolios are managed in such a way that there is negligible market risk, money market funds should be able to maintain a CNAV of 1.00 without running the risks of either causing or incurring dilution of return for investors.

The advantages for the investor of CNAV administration and dealing, the protection against possible dilution provided by the stress-testing and the escalation procedures should reassure regulators and rating agencies that this convenient convention is just that, not an attempt to obscure appropriate pricing.



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23 November 2010, London

Sponsored by RBS

This breakfast briefing will get you up to speed on Basel III and what it means for your funding and risk management strategy. Key topics include:

- what do treasurers need to know about the new rules?
- understanding the impact on the cost of borrowing and banks' willingness to lend
- wider implications for financial services – from money market funds to the loan market.

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Sponsored by MetLife

This breakfast briefing will offer practical guidance for anyone considering the US private placement market. Key topics include:

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- practical insight into going through the PP process
- key benefits for the borrower and common problems to avoid.

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