YOUR FLEXIBLE FRIEND?

EMMA BOWEN AND **CHRIS HALL** OF BFINANCE OUTLINE THE BENEFITS OF AAA-RATED INSTITUTIONAL MONEY MARKET FUNDS FOR CASH-POSITIVE TREASURERS LOOKING FOR HIGHER RETURNS.

If you are a treasurer of a FTSE 350 company, it is likely that a money market fund (MMF) salesman has already beat a path to your door in the past 18 months. First marketed in the UK by specialist providers looking to extend their US franchises, investment banks and commercial banks are now heavily promoting the benefits of MMFs, with the latter hoping to shore up long-exposed shortcomings in their cash deposit services. Despite first appearances, the market is far from homogeneous and it is perhaps time to take a step back to look at the basics of what MMFs can bring to the cash-positive treasurer.

In this article we will deal with only triple-A rated institutional money market funds, rather than lower-rated funds targeted at other investor groups.

FROM CASH DEPOSITS TO MMFs. Money market funds are essentially pooled investment vehicles which combine high security and liquidity with a better rate of return than that available from traditional bank deposits. They are able to offer better rates because they provide overnight or short-term investment in a range of liquid assets, including certificates of deposit, short-dated commercial paper and short-dated government paper. They also provide more flexibility because funds can be deposited or withdrawn on a daily basis.

Diversification into a wider range of instruments is an end in itself, but it also aids security of principal and higher returns. (Offshore money funds can typically provide yields that are 15bp-25bp higher than standard bank deposits rates). Moreover, investing in a MMF is less labour-intensive than calling round your counterparty banks to ensure you are getting the best current market rate.

Demand for MMFs stems largely from the poor returns that large UK banks have been able to offer corporates due to their policy of being 'long' of sterling for regulatory capital reasons. Although most UK institutions still accept deposits, rates become rapidly less competitive from 11am onward. Many banks are attempting to effect a quiet migration to MMFs without cannibalising their own deposit-taking business. Therefore, some treasurers may find they are able to obtain better returns from their own bank, simply by switching from one product to another.

With a majority of MMFs boasting a AAA-rating many analysts conclude that all funds have a similar profile in terms of risk and return. This is, of course, a gross over-simplification. Let's look at the differentiating factors further.

PERFORMANCE/RETURNS. MMFs can offer higher returns because they are able to 'invest along the yield curve'; the fund is free to invest in longer-dated higher-yielding investments because not all investors will withdraw their money at the same time. And although same day liquidity caps the potential yield on investments through MMFs, higher yield funds are already emerging for the less liquidity conscious. Some volatility is inevitable as the exact return on any one day cannot be known until the precise volume and proportion of investments bought is known. However, fund performance on any given day typically comes within a close margin of the previous day's return.

When analysing returns, historical comparison of fund performance is considered to provide limited clarity, because yields inevitably reflect short-term interest rates at the time. A closer comparison would be with an overnight bank deposit, or a seven-day LIBID. However, even this will not give actual 'after-expense' returns. One useful source is **www.imoneynet.com**, which provides averages available in seven- and 30-day yields as well as monthly, year-to-date, and one-year return periods.

INVESTMENT STYLE. This will inevitably differ from fund to fund and although most institutions provide details of investment parameters, they are nevertheless unlikely to share their secrets too willingly. However, it is still possible to probe differences in the way the fund is managed. Ask your MMF salesperson: What are the potential sources of under- and over-performance? What is your

'HISTORICAL COMPARISON OF FUND PERFORMANCE IS CONSIDERED TO PROVIDE LIMITED CLARITY' approach to choosing investment instruments? What are the market risks or credit risks? Is your investment style systematic or opportunistic? If there is a high volatility of returns, why?

STABLE & ACCUMULATING NAV. Although some experts recommend comparing fund performance based on either stable net asset value (SNAV) or accumulated net asset value (ANAV) the benefits of such distinctions are questionable.

With stable net asset value (NAV), investment income is accrued day by day during the month and then paid or added to the shareholding at the end of the month. For accumulating NAV, the income is reflected in a daily increase in the share price. Although it would appear that the ANAV investor benefits from compounding as the earnings are applied on a daily basis, analysis of performance for a given period shows that the outcome is much the same. Funds that offer both types of share in the same fund (about 50% of providers) have identical returns.

LIQUIDITY. The fact that a client can invest one day and leave the next provides a healthy level of liquidity for a treasurer who places funds with a MMF. Treasurers for whom liquidity is less important than investment returns, however, can take advantage of the increasing number of T+3 and T+5 funds.

The liquidity of the instruments in which MMFs invest can also be important. Only MMFs with a weighted average maturity (WAM – the average term to maturity of the instruments underlying the collateral pool at the date of issue) of up to 60 days can obtain a AAA credit rating.

Typically, a fund with a portfolio maturity of 80 days yields a single-A rating while a 90-day maturity is labelled with a BBB rating. Fitch, the ratings agency, recently warned against investments in securities regarded as too illiquid for a money fund portfolio, such as extendible commercial notes and exchangeable notes. Standard and Poor's guidelines state that 95% of a AAA-rated fund's investments must hold a P1 short-term rating.

Fitch noted that in several cases a combination of rising interest rate exposure, issuer defaults, and an over-concentration on illiquid investments has produced declines in the NAV of individual MMFs, resulting in investor losses or 'capital infusions' to restore the value of the fund.

CUT-OFF TIMES. To differentiate one fund from another, treasurers are looking increasingly to issues of access and ease of use to provide additional points of reference. Typically the cut-off times can play a key role – although some argue that suppliers with early cut-off times are notoriously inflexible when treasurers attempt to gain an extra minute here or there.

Most cut-off times currently range between 12 and 2pm, which may not be ideal from the point of view of treasurers attempting to concentrate funds from across Europe, but at least they can be more certain of a decent return at these times than in the cash deposit market.

MINIMUM INVESTMENT. Restrictions apply to how much cash can initially be placed; the current minimum is £50,000 but can be much higher for some funds. In addition, some funds impose ceilings on additional deposits and minimum balances.

In terms of performance, there should be no penalty for small investments. Unlike the market for deposits, where the larger investments attract the best rates, all investments earn the same return because money market funds operate in the same way as unit trusts, that is, they spread the investment among a range of instruments. However, differences in fees may ultimately reward larger investors.

'IN TERMS OF PERFORMANCE, THERE SHOULD BE NO PENALTY FOR SMALL INVESTMENTS'

SIZE AND STABILITY. The size and stability of a fund may have an impact on the level of operational liquidity the fund offers and will certainly influence investment strategy. Nevertheless, asset size is not necessarily reflected in how a fund performs. The track record of modestly-sized funds, such as ABN Amro's Global Liquidity Fund (£92.7m) and Deutsche's Sterling Managed Fund (£156m), demonstrates size may have little bearing on seven-day yields and can be superior to some of the bigger players.

Although flexibility potentially gives rise to problems for smaller funds, if a client decides to withdraw a large amount at short notice, most ensure that no more than 10% of the total value of the fund is invested by any one client and/or ensure that they keep in close contact with the plans of larger investors.

FEES. Management fees are converging on 12bp-15bp on an annual basis for the standard MMFs, but rise steeply above this level for the higher-return end of the market. In some cases, fees are negotiable downward depending on the size of the deposit invested by the treasurer. Some funds also claim to be willing to lower management fees in the event of lower-than-expected performance. Typically, entry and exit fees are rare, but smaller investors may be affected with additional fees, such as an intermediary fee for introducing the investor to the fund. These may add a further 2bp-3bp. More of concern are distribution fees which can penalise smaller placements to the tune of 35bp.

THE NEXT STEPS. If you are convinced that MMFs warrant a place in your investment policy, some internal changes may be required. Investment of surplus cash has three core aims:

- preservation of the capital value of cash;
- maintenance of a level of liquidity appropriate to the company's short term needs and longer term strategy; and
- optimisation of the return on the investment portfolio (bearing in mind these two constraints).

Thus most treasury departments will lay down guidelines which reflect the company's perception of: counterparty banks and limits; investment instruments used and limits; and bank/investment ratings.

If excess funds are only routinely invested in time deposits at A-rated banks a change of policy may be required to facilitate use of MMFs, not only in terms of counterparties and investment limits but also regarding the wider range of instruments.

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