Shining light on MMFs

IMPROVED STANDARDS FOR DISCLOSURE MEAN MONEY MARKET FUNDS ARE MORE TRANSPARENT THAN YOU MAY REALISE, SAYS MARK STOCKLEY OF BLACKROCK

Transparency and risk have become increasingly important themes in the global money market fund (MMF) industry over recent years due to new and improved standards for disclosure. Following the financial crisis of 2006-2009, MMF reporting has improved, enabling investors to easily understand, manage and act on risks within their MMF portfolio holdings. This new landscape helps to increase stability for the MMF industry and supports deeper ongoing partnership and dialogue between investors and fund sponsors.

Most, if not all, market participants are focusing on transparency in one way or another. Regulators have demanded increased disclosure to investors across almost all sectors of the financial markets, including the banking, insurance and asset management industries. In the financial crisis, lack of transparency was blamed for investors having an inadequate appreciation of the risks inherent in many financial instruments as well as unfamiliarity with associated funding structures of leading issuers and participants in the capital markets.

The financial crisis created a new paradigm for the MMF industry: investors became highly curious and sensitised to the different approaches taken by fund sponsors. As a result, the concept of transparency has evolved since then. Regulators, fund sponsors and technology platform providers have all taken steps to build rules, processes and tools to enhance disclosure, analysis and calibration of risks.

In 2010, the US Securities and Exchange Commission (SEC) amended Rule 2a-7 of the 1940 Investment Company Act to introduce tightened regulations around credit, liquidity and portfolio maturity. New rules also meant increased transparency and investor understanding in the risks associated with investing in MMFs.

UNDERSTANDING MMF INVESTMENTS

◆ MMFs typically invest in securities that are considered to have minimal credit risk and short maturities. Investments held by an MMF vary and may include treasury securities repurchase agreements, commercial paper issued by financial and non-financial institutions, federal agency securities, short-term debt obligations and deposits of financial institutions, and debt obligations of states, cities or other forms of municipal agency, such as variable rate demand notes (VRDNs).

◆ Transparency is key to helping investors get the information they need to make sound investment decisions. Digging deeper into the eligible securities that MMFs can hold will help an investor to understand their investment and the relative risks that different fund sponsors take when managing MMF portfolios within similar investing parameters.

◆ Investors should talk to their fund sponsor if they see securities in an MMF portfolio they aren't able to easily identify. For instance, some securities, such as those issued by an ABCP programme or VRDNs, may have multiple levels of credit exposure. ABCP is often issued by a financial entity or sponsor on behalf of its clients and backed by the latter's trade receivables; but an ABCP programme may or may not also have credit support from the sponsor. VRDNs issued by US municipal entities represent credit exposure to the municipal issuer, but are also often backed by external credit enhancement and liquidity support from a financial institution.

◆ When reviewing an MMF's holdings it may be important, particularly at times of market stress, for an investor to understand its credit profile and portfolio strategy in some detail. Usually, the best way to do this is to speak to the fund sponsor.

These changes mean US MMFs now have to send a detailed schedule of portfolio holdings and associated data as well as the mark-to-market or 'shadow' net asset value (NAV) pricing to the SEC on a monthly basis. The SEC publishes this information for investors to review 60 days after month end. Additionally, fund sponsors now have to publish their portfolio holdings on their website within five business days after each month end.

Meanwhile, the European Commission has created new rules around MMFs, which categorise them into 'money market funds' and 'short-term money market funds'. This has increased the understanding of investors who invest in MMFs sold as undertakings for collective investment in transferable securities (UCITS) under EU law.

International industry association the Institutional Money Market Funds Association (IMMFA) has also published best practice guidance for members within its Code of Conduct. The guidance aims to ensure that members take a consistent approach to valuing their funds and freely disclose their funds' liquidity profile on a monthly basis.

Before 2006, MMF investors would rarely contact a fund sponsor to discuss portfolio strategy and individual holdings, while regulators provided sparse rules to investment managers around transparency and disclosure. As the crisis evolved, culminating in a run on prime MMFs in September 2008, discussions between shareholders and fund sponsors increasingly focused on instrument types and credit exposures held within portfolios.

In the early days of the crisis, as the housing market progressively deteriorated, the spotlight shone on security types held by a number of US-based MMFs. Two notable instances were linked to the asset-backed commercial paper (ABCP) market: extendible ABCP conduits and structured investment vehicles (SIVs). Some of these securities suffered from a lack of liquidity in their underlying investments, often linked to the housing market. This caused them to take measures to extend, restructure and, in a number of highly publicised instances, default on their debt.

In the early stages of the crisis, there was less concern around the creditworthiness of institutions than the structural flaws and poor underlying credit quality inherent in particular forms of short-term debt issuance. But, in March 2008, this situation changed markedly. Bear Stearns nearly went bankrupt, brought down by its reliance on wholesale funding in an increasingly nervous market, and was sold to JPMorgan Chase & Co, following intervention by the Federal Reserve Bank of New York.

As the crisis spread from one leading institution to the next, fund sponsors frequently fielded questions from institutional investors around their MMF holdings. Questions had spread beyond specific instrument types to fundamental concerns around the creditworthiness of major institutions.

Since then, regulators have demanded a greater level of disclosure by MMF sponsors. But many, if not most, sponsors have taken additional steps to publish their holdings more frequently. Combined with this greater level of reporting, fund sponsors have consistently encouraged more dialogue with their investors.

Many institutional investors diversify their cash across multiple fund families. But evaluating the overall risk exposures within an aggregate portfolio of MMFs can be challenging without the tools to do so efficiently and accurately. As code and market practice has evolved and moved towards greater transparency, firms associated with the MMF industry, including asset managers and technology providers, have developed analytics tools that allow investors to combine, analyse and interpret holdings within multiple MMF portfolios. These 'aggregation' or 'transparency' tools now provide investors with the means to efficiently investigate and assess their exposures to individual counterparties, instrument types and geographies. Such tools should also have both a robust quality control and data integrity process to calibrate and maintain data from multiple fund families.

For investors, these new tools will be most powerful when combined with an ongoing dialogue with their fund sponsors. The investor should seek to understand a fund sponsor's investment philosophy and the rationale behind their portfolio strategy. The fund sponsor has a fiduciary responsibility to its investors to ensure that the highest level of due diligence and research takes place when making investment decisions.

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TOOLS FOR INVESTORS

New tools help investors answer questions such as:

- **What is my exposure to a particular country across my MMF holdings?**
- **Which of my funds has the highest exposure to a particular counterparty?**
- **What are the top 10 issuers within my aggregate portfolio?**

An effective tool will do the following:

- **Provide a complete picture of fund holdings across multiple MMFs;**
- **Identify exposure to specific metrics (country, issuer, sector) across MMFs; and**
- **Permit user-entered changes to allow investors to model 'what-if' scenarios based on the levels of assets held within various funds.**

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