# Money market funds are here to stay

Nick Emmins and Avril Bullock of BNP look at the growth of money market funds in the UK and ask: can the growth in the UK emulate the US experience?

In recent years observers have increasingly identified cash as the under-managed asset class. In an ongoing climate of low inflation rates, the attention to, return on and management of cash, has gathered momentum. However, return is only part of the equation. Cash managers have to battle with issues of both the security of their capital and the liquidity their investment affords them. However, managing the balance between security, liquidity and return is proving an increasingly complex and time-consuming task for treasurers, trustees of pension funds and all those involved with the management of cash assets.

Traditionally, banks have been the major recipients of cash, the UK being dominated by high street clearers. However, with increasing concern over counterparty risk, resulting from the growing list of financial scandals, counterparty selection continues to prove a headache. Add to this the fundamental conflict of interest between banks looking to offer the lowest possible return and the investor looking for the highest, it is not surprising there is significant growth in alternative instruments such as money market funds.

### *Money market funds*

Simply speaking, money market funds are stand-alone pooled investment vehicles with certain characteristics:

- an open-ended mutual fund structure, typically domiciled in Dublin, Luxembourg or the Channel Islands;
- a diversified portfolio of high-grade short-term money market and fixed-income instruments; and
- AAA rated by the main credit rating agencies, (Standard & Poor's, Moody's, Fitch IBCA).

As such, these funds provide an additional product option to existing short-term money market instruments such as CPs, CDs and Repos, being suitable for most asset allocation strategies.

### *Background*

Money market funds grew out of the financial crisis and political upheavals that plagued the US during the 1970s. Initially these products were developed by asset management companies as a means of preserving capital, but it quickly became apparent that they also provided a competitive return and the required level of liquidity for cash managers.

Dramatic growth in the use of these funds led to the introduction of a series of extensive regulations by the Securities and Exchange Commission under the Investment Company Act of 1940, known as rule 2a-7. These regulations defined the structure of a money market fund, including the eligibility of certain instruments, as well as standardising yield calculations. This standardisation resulted in dramatic growth and by March 1999 total assets combining retail and institutional money market funds had reached $1,415.2bn.

During the 1980s there was significant growth in the use of money market funds across Europe, particularly in France, Germany and Luxembourg and more recently in the UK. Initially led by the big US fund managers, many players in Europe have realised the potential of these funds in the UK market and there are now over 20 managers looking to promote their funds here. The recent creation of the Institutional Money Market Funds Association (IMMFA) representing most of the managers promoting their funds in the UK has helped to raise the profile further.

Buyers of funds include corporates, local authorities and insurance companies and, increasingly, pension funds and charitable organisations.

The collapse of Barings highlighted the credit risk in using custodian banks for cash sweeping and acted as a catalyst for pension funds to seek alternatives. Using money market funds effectively subcontracts both the management of cash and the credit analysis to a third-party fund manager, typically the route chosen by the vast majority of pension funds for the other asset classes in their control. Over time, the cash manager can be assessed in the same way as all external fund managers. The attraction of money market funds also benefits smaller schemes. They can improve performance by pooling their

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cash assets with others, enabling the fund manager to obtain returns likely to be better than the scheme could have achieved through traditional methods.

In total, it is estimated that UK institutional liquidity is over £130bn, and, despite significant growth, the potential for the UK market remains huge.

***Advantages***

So why are these funds proving to be so popular? To answer this question one should simply re-visit the key considerations for any cash manager.

**Security** – Security of the principal remains of paramount importance to the cash manager. Institutional money market funds provide peace of mind, by the credit rating they achieve through the various rating agencies. In the case of Standard & Poor's this equates to a rating of AAAm. Such credit ratings place considerable constraints on the portfolio construction of the fund, which is monitored on a weekly basis. For example, no more than 5% of the fund can be invested in any one issuer ensuring the portfolio retains significant diversification of risk. Additionally, funds with an AAAm rating are restricted to a weighted average maturity of 60 days with minimum short-term rating of securities in the portfolio of A-1 and at least 50% held in AAA-rated securities.

Similarly, the regulatory authorities in the fund's domicile will apply stringent tests to ensure funds qualify as money market funds. With Luxembourg this means meeting the requirements of the undertaking for collective investment in transferable securities (UCITS), which is consistent with US SEC rule 2a-7. It is worth remembering that no UK bank has a higher credit rating than AA, and combined with the diversification that exists in the portfolio it would be virtually impossible for direct cash managers to replicate the level of capital security that money market funds exhibit. Though the risk of default is low, the specific risk of concentrating on a small number of banks as counterparties remains high. Money market funds provide a simple but effective answer to this problem of diversification and credit risk.

**Liquidity** – Achieving total daily liquidity can be cumbersome and expensive in terms of back office costs if the only solution is to use overnight money market deposits. UK clearing banks are awash with sterling and are unwilling to pay market rates in an effort to deter deposits. Money market funds offer daily dealing and same-day settlement, allowing investors to move money in and out of funds at a single NAV.

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This liquidity flexibility is achieved by the fund holding anything up to 50% of the portfolio in overnight cash instruments. As a result, funds are able to offer daily liquidity and still take advantage of yield curve opportunities. By using this approach it is possible for cash managers to use AAAf funds for deposits with a slightly longer time horizon. Funds with an AAAf rating are not technically money market funds, more short-term fixed income funds. As such they are restricted to a maximum weighted maturity of nine months and so enable the investor to take further advantages of yield curve opportunities.

**Return** – Many cash managers will be unable to achieve the same returns as can the diversified money market fund. Banks are keen to create downward pressure on their overnight deposit rates while for the investor managing a portfolio of better yielding instruments and securities is a resource-hungry and therefore costly activity. When comparing returns on cash management activities it is easy to forget the associated back-office costs. Though money market funds charge a management fee to investors, the return is net of fees and the economies of scale that can be achieved by the pooling of assets means money market funds are a very cost-efficient way of managing cash. For the corporate treasury function, a reduction in day-to-day cash management can enable valuable resources to be re-deployed to more profitable treasury activities.

Money market funds will typically generate a return net of fees close to or above the seven-day Libid rate, but may exhibit slight performance volatility in a changing interest rate environment. Typically a fund may provide superior returns in a period of falling interest rates – and vice versa. It is also important to remember that returns are the same for smaller investments – well above what a cash manager could normally achieve investing directly while maintaining sufficient liquidity and security. Furthermore, the return will directly reflect the duration of the fund's underlying portfolio rather than the period of investment. This further enhances potential returns over conventional cash management techniques.

Currently, fund comparisons across the market are incomplete. IMMFA is leading the way by planning to create a level playing field that will further improve visibility and transparency across the money market fund Industry.

***Why money market funds?***

As the quest for a competitive return on cash, combined with the need for liquidity flexibility, increases, the growth in the use of money market funds will likewise continue. Given that the vast majority of UK liquid assets currently remain on overnight deposit within banks, the return achieved by most investors must be increasingly disappointing. In addition to this growing conservatism to specific counterparty risk, money market funds could become the dominant force in the UK as they are in the US. For pension funds and charitable trusts the issues have become increasingly important as industry attention continues to focus on trustees' legal and fiduciary responsibilities.

Using these funds is as simple as making a bank deposit with same-day value and settlement. It reduces administrative costs and related risks, saves back-office processing costs, reduces transfer and counterparty risks and greatly simplifies account reconciliation.

Money market funds are here to stay. But will growth in the UK reflect the US experience? Only time will tell. ■

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