Rated, overlooked and over here…

The US money market fund and its growing presence in Europe is still a bit of a puzzle to treasurers. Ashley Meek explains the concept.

Two years ago, travelling home from a continental shin-dig on fund management, I found myself exchanging pleasantries with the passenger next to me, who turned out to be a corporate treasurer. His curiosity over my role within a leading US rating agency turned the conversation to common ground that made for an interesting and, in places, quite heated exchange for the duration of the flight.

We discussed a variety of issues that make up the general rating agency concept and he extolled the virtues of the increased fiduciary responsibility afforded by ratings. One point he dwelled on was the fact that some traditional operations – such as cash management – were restricted by in-house guidelines, causing additional or alternative avenues to be explored to address any imbalances in counter-party or instrument exposure. I questioned his usage of rated, offshore, institutional money market funds as a means of outsourcing part or all of the cash management process and at the same time, freeing up resources to pursue 'higher margin' activities…

For a moment he contemplated my enquiry (and probably my sanity) and proceeded to dismiss the concept citing the differences between fund management and the need for planned cash flow, the fact that the funds were 'American', domiciled way off his 'patch', and probably just another gimmick to attract institutional or questionable money. I retorted with facts and figures, rules and regulations (albeit American) and a detailed breakdown of the rating process designed specifically for users of these funds. My aim overall was to outline the growth of 'cash' as a distinct and important asset class that now had access to increasingly specialised management in Europe – with all its implications to corporate treasury.

Unimpressed by the end of the flight, my acquaintance suggested we agree to differ on the subject and referred to the fund concept by way of a slightly distorted version of the old World War II line, "overrated and over here"…

I generally try to avoid anecdotal introductions, however, on this occasion I feel justified. The above recollection is by no means representative of current corporate treasury in Europe but, two years on from that encounter, a number of myths or misconceptions still lurk around treasury desks concerning the US money market fund and its growing presence within European cash management.

My aim in this article, then, is to shed some light on three areas of the fund concept:

- its origins;
- its operating principles; and
- its role within treasury management.

US money market funds

The US money fund industry was born in the 1970s and early 1980s. Initially the industry was driven by the financial and political turbulence that swept through the US. In a period that witnessed the aftermath of Vietnam, the oil price explosion, the S&L crises, two major CPI peaks and a series of punitive banking regulations, investors desperately sought stability and the protection of purchasing power. In 1974, the pooling of short-dated money market instruments into funds was offered to provide an effective solution to capital preservation, liquidity and relatively competitive returns. The concept was very well received, and it spread so much that by 1980 there was close to $100bn under management.

Ashley Meek

New fund launches kept pace with the demand and the competition to attract assets intensified. The marketing bonanza focused on returns, causing yield-hungry investors to purchase and liquidate so aggressively that the industry became suspicious of certain claims and practices. The Securities and Exchange Commission (SEC) was approached to mediate in an attempt to establish a standard framework around the concept, particularly in the areas of fund construction, instrument eligibility and the calculation of yields, to enable product comparison. In 1983, the SEC published a series of extensive regulations within the *Investment Company Act 1940* to address these issues, as well as all matters legal and fiscal, and these regulations remain the industry bedrock to this day.

Labelled Rule 2a-7, the primary section of the regulations sets out detailed checks and balances governing credit, market and operating risk, which effectively limited what risks money market funds (adopting the rule) could take to protect investors seeking safety of principal and liquidity through money fund investing. This served to ring-fence the 'specific purpose vehicles' from the rest of the crowd and thus achieve product clarity.

With new regulations and hence a degree of transparency in place (and not to mention three years of high inflation), growth of the industry accelerated

to new heights, with assets under management doubling to $200bn by 1984. That same year, two noteworthy events occurred that initiated the shape of the industry as it stands at present.

First, the market embarked on product fragmentation and investor differentiation, a move designed to separate (and service accordingly) the institutional and retail investor bases. Second, rising concerns were voiced (primarily from the institutional camp) over just how closely funds were adhering to the rule. Due to the complexities and extremely low margin of error stipulated by the latter, investors demanded confirmation that funds were maintaining their stated investment parameters at all times and that this clearly required a mechanism above and beyond marketing information or indeed relationship management. Both investors and fund providers sought the involvement of a respected third-party 'watchdog' and logically gravitated towards nationally recognised statistical rating organisations (NRSROs) or the leading credit rating agencies.

NRSROs were asked if a clear, consistent rating process could be developed to calibrate money funds, on a continuous basis, within the confines of the rule. Due to the nature of active fund management, this clearly required new analytical skills beyond those of traditional credit analysis. In due course they responded by publishing a rating process, criteria and accompanying rating categories, which expressed their opinion on funds' capacities to maintain principal value and limit exposure to loss. Funds were also now contractually obliged to submit full portfolios on a weekly basis for inspection. This way the agencies could ensure both their own integrity and that of the rating. Rated funds, on the other hand, were lifted into a new level of transparency; suddenly investors knew exactly what they were getting for their money.

Once the regulatory and rating foundations had been established, the concept of pooled cash management became firmly embedded in all walks of financial life. Indeed, today, its success as a multifaceted delivery mechanism has enabled its growth to transcend all manner of market developments, including shifts in inflation and the explosion in the number of financial instruments over the past ten years. With nearly 1,400 funds – of which 500 are institutional – reporting into IBC (the leading US money fund data house), the product has grown to constitute a substantial asset class in the US investment spectrum. Assets under management are now circling the $1.3trn mark, accounting for a quarter of the country's mutual fund industry.

TABLE 1

Key benefits of money market funds

- Security
- Liquidity
- Yield
- Costs
- Simplicity

Europe and the rated 2a-7 clone

Despite the existence of money market funds in Europe since the 1980s, there is at present no Rule 2a-7 equivalent. A number of regulations exist that focus on prudence and best practice, but formal regulation for the asset class as a whole has been slow to materialise. One could argue that regulators have had bigger fish to fry (the UCITS directive?) or that money market funds, broadly speaking, have 'quietly' served to encapsulate the more conservative, shorter duration end of the managed fund spectrum. There is little doubt about the product's success (witness France, Germany, Luxembourg, Spain and the UK/Ireland), but there is no home-grown fund structure that compares directly with the specific service provided by the US concept.

In response to shifts in the investment panorama and investor practices over recent years, an increasing number of leading US and European institutions have identified the need to augment specialised cash management services as a natural extension of expertise and product line. Through direct participation in, or more recent assimilation of, the US experience, both sets of institutions are striding forwards with the offshore, European replication of the US concept as a logical, ready-made and certainly well-tested solution. To boot, they are attaining the highest rating awards as introductory credentials.

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Fund operating principles

A closer inspection of a '2a-7'-style money fund is best achieved by highlighting the broad thrust of the rating process. Leading agency criteria has not only kept pace with regulatory and market evolution but it is available on request. As such, the key features driving the fund's safety and liquidity can be examined without the need to get bogged down in 16 years of US regulatory metamorphosis.

In straightforward terms, the fund is a diversified pool of high-grade, short-dated money market assets, actively managed within strict guidelines to ensure that the 'pound in today is the pound out tomorrow', with a day's accrued competitive interest – net of management fees.

The achievement of the above within a fluid market environment is clearly the fund's hallmark. Indeed, the combination of capital preservation, liquidity and return, implies the convergence of numerous variables, in a state of flux, to produce comprehensive and dynamic insulation from the plethora of known and anticipated market risks. It is the methodical identification, assessment and weighting of these that make up a large element of the rating process and by extension, the final rating award.

Rating criteria broadly comprises three main areas of analysis and evaluation that systematically address the fund's operating principles: credit quality, portfolio construction and its management. Each is subjected to specific guidelines that equate to the fund's rating category and, of course, the higher the award, the more stringent the guidelines become.

Credit quality

A fund's credit quality encompasses what the fund can buy, who it can do

business with (including the exact nature of the business) and who it can appoint to 'safekeep' all its assets. By way of explicit delineation, the fund's every move is therefore predicated on a rigid operating 'template' that, in turn, has material investor connotations. The template provides investors with a clear view of the fund's asset eligibility and restrictions, eg, quality, type and currency, its counterparty risk (transactionally based investments) and custodian services (asset segregation).

Portfolio construction

By far the most complex part of money fund analysis is judging a fund's sensitivity to changing market conditions. All fixed-income securities, rated or otherwise, are subject to price fluctuations based on interest rate movements, maturity, liquidity and the supply and demand for each type of security. These factors are just as true for money funds as they are for longer-term fixed-income mutual funds.

Capital preservation is expressed in terms of the stability or constant accumulation of the fund's net asset value (NAV) per share (dealing price). Although the latter pricing format is traditionally European and thus not strictly recognised under Rule 2a-7, both formats are scrutinised for the same potential deviation in the fund's market value and hence in its ability to insulate investors from adverse market moves. The determination of market value, or portfolio price exposure, begins with the examination of a fund's susceptibility to rising interest rates. One critical component of this is the fund's weighted average portfolio maturity (WAM), a factor that is specifically restricted by rating category.

At the triple-A level, funds are required to stay within a 60-day limit, an optimal level derived from portfolio stress testing analysis. Other variables evaluated include: instrument liquidity, index and spread risk (factors affecting the value of variable rate instruments), portfolio diversification, potential dilution of investor holdings and portfolio valuation (the accurate verification of the fund's continuous NAV status).

Fund management

Essential to any analysis of managed portfolios is an understanding of the strengths and weaknesses of management. This effectively entails an assessment of all the working parts that make up the manager's front, middle and back offices. Key areas of evaluation focus on fund manager experience, investment objectives, portfolio management techniques, risk aversion strategies, operating procedures and internal controls. Due to the precision necessary in running a money fund successfully, every aspect of the fund's operation must be able to withstand close scrutiny and emerge with its integrity intact.

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Implications and applications

At the risk of sounding flippant, the rated 2a-7 style institutional money fund – in both its US and European incarnations – constitutes a highly viable one-stop solution for the partial or total outsourcing of corporate liquidity management. As a constantly monitored, comprehensive delivery mechanism, with a transparent design and operating principals, the concept tables a number of material efficiencies. The following considerations seek to extract or distill the salient features and benefits of the product.

Security

- The primary concerns over the risk of outsourcing are allayed by the fact that the fund contains built-in fiduciary due diligence that is corroborated by a respected, independent third party. As specific 'comfort levels', the fund has legal council in place, a custodian appointed where assets are explicitly ring-fenced and operating parameters that are transparent, facilitating comparison with individual risk profiles; and
- the rating award communicates an agency's opinion of the fund's ability to maintain its stated goals of capital preservation and liquidity. This affords the conversion of all holdings into a single rated investment of specified restriction on duration and type of instrument. In addition, weekly surveillance ensures the ongoing integrity of the rating award and thus investment safety.

Liquidity

- By virtue of the fund's maturity profile and construction dynamics, access is instant and redemption offered on a penalty-free, same-day settlement basis.

Yield

- The fund effectively emulates an overnight investment, however, beneficial returns are derived from its longer duration profile; and
- the fund can be used to consolidate all balances into one account giving smaller amounts of cash access to the same beneficial returns as above.

Costs

- As mentioned above, the fund appoints (and pays for) legal and custodian services;
- account consolidation impacts the total expense ratio (TER) of cash holdings;
- the efficiencies gained through asset pooling means relatively low fund management charges;
- the rigorous credit parameters maintained by the fund, as part of its rating award requirements, implies the need for less time to be spent by financial professionals in fulfilling this duty; and
- the fund's liquidity cycle conveys its ease of use and hence the lower administrative resources required to oversee the investment process.

Finally, the fund's applications emerge as a result of its 'simplicity' of concept. As a bullet investment, the fund can prove useful for benchmarking treasury performance. As an international, actively and specifically managed 'bank account', its uses are unlimited where the storage or movement of cash is concerned, ie, a stepping stone between equity investments, the control of cash management in a remote subsidiary, or indeed, single account for Europe… ■

Ashley Meek is currently forming an association of cash management fund providers.