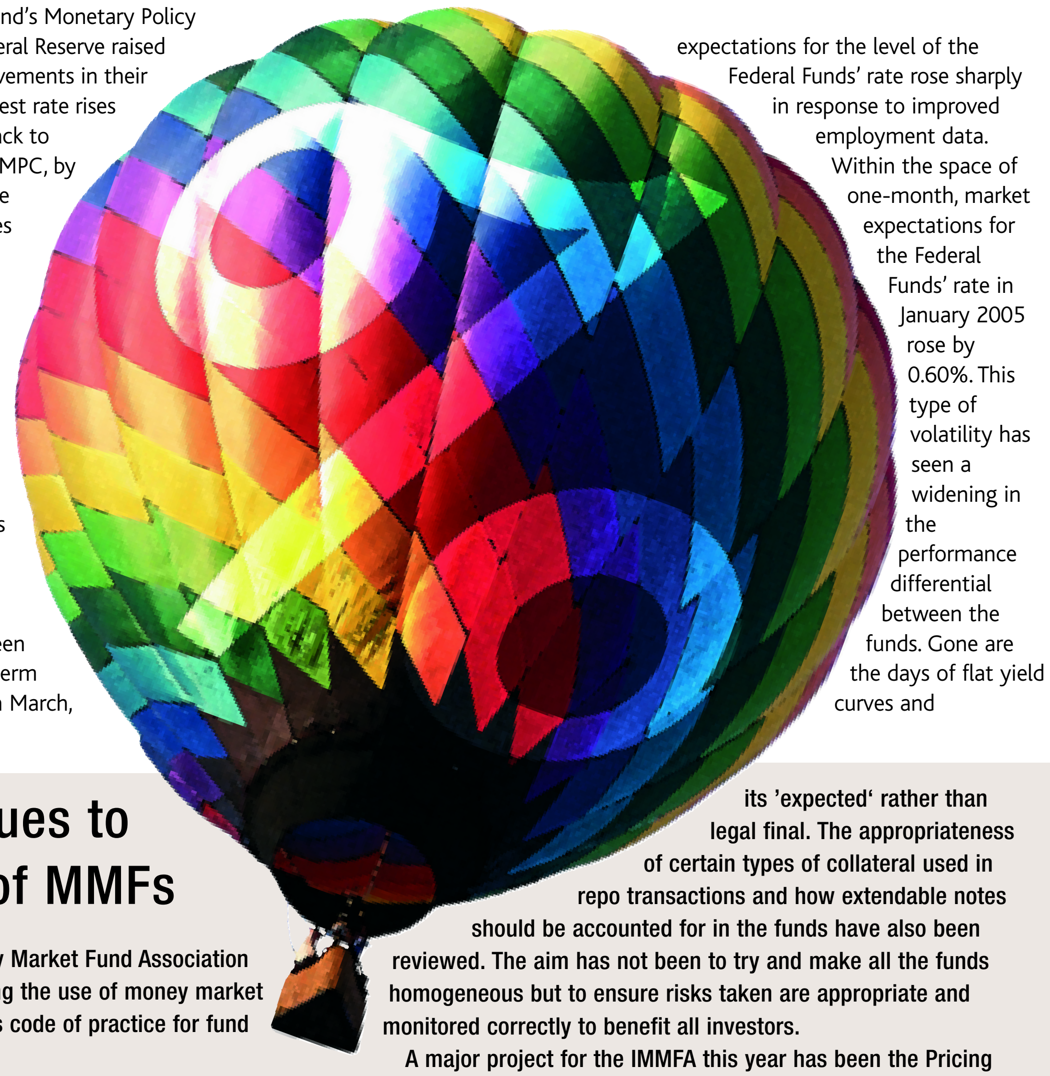
Up, up and away

RISING INTEREST RATES HAVE BROUGHT MANY NEW CHALLENGES TO TREASURERS AND OTHER MONEY MARKET INVESTORS DURING 2004. **JONATHAN CURRY** EXAMINES THE INVESTMENT OPTIONS THAT MADE GOOD AND WHY.

The interest rate environment this year has been testing for treasurers and other investors looking for a safe and profitable haven for their cash. Until this year, the markets had not experienced a sharp rise in interest rates for 10 years which meant most money market funds (MMFs) had not been managed through a period of rising interest rates. Interestingly, there was a widening of the performance differential between the funds offering the highest and lowest returns in 2004.

> 'THE MONEY MARKETS HAVE SEEN A NUMBER OF DEVELOPMENTS THIS YEAR, CENTRED AROUND THE COMMERCIAL PAPER MARKET AND THE ASSET-BACKED MARKET'

This year both the Bank of England's Monetary Policy Committee (MPC) and the US Federal Reserve raised interest rates in response to improvements in their economies. The magnitude of interest rate rises required to bring the economies back to trend growth is still uncertain. The MPC, by not being as accommodating as the Federal Reserve when reducing rates and by raising them earlier, has brought interest rates close to 'neutral'. The US Federal Reserve may be required to raise interest rates still further to reach a 'neutral' level for the US economy.



FINDING THE RIGHT PROVIDER. This year has highlighted the importance of using fund providers that offer consistent performance over time, with low volatility of returns across the US, UK and eurozone currencies. There have been periods of high volatility in short-term term interest rates. For example, in March, expectations for the level of the Federal Funds' rate rose sharply in response to improved employment data. Within the space of one-month, market expectations for the Federal Funds' rate in January 2005 rose by 0.60%. This type of volatility has seen a widening in the performance differential between the funds. Gone are the days of flat yield curves and contracting performance differentials seen in 2003. During the middle of 2003 the spread between the GBP fund with the highest and lowest yield was typically around 0.11%. By the beginning of the fourth quarter this year, this spread had widened to around 0.30%.

This year, the turn in the interest rate cycle has brought with it another phenomenon – a period of lag between the yield offered by funds and yields available in the market. It is common for this to occur during periods of rising interest rates and is most pronounced when market expectations of interest rate rises have not kept pace with the actual rise in official rates. However, these lags do not appear to have been wide enough to justify investors redeeming money from funds to invest the proceeds directly in the marketplace. By the middle of 2004, the total assets under management in AAA-rated MMFs, across the three main currencies, totalled more than US$200bn, up from around US$100bn only three years ago.

Surprisingly, the rise in interest rates has not impacted risk premiums or liquidity. Risk premiums are at or close to historic lows as evidenced by the low spread levels in the high-yield, corporate and asset-backed markets. The financial system is also still awash with liquidity and real interest rates in the US and eurozone are still close to their all-time lows.

However, the risk of a sharp correction remains, but that may be next year's story.

Executive summary

- Money market funds (MMFs) are an attractive solution for treasurers looking for a safe haven for their organisations' cash.
- The interest rate environment in 2004 has led to greater performance differentials, with a widening gap between the highest and lowest returns on offer.
- It is important for investors to use fund providers that will offer consistent performance over time and a low volatility of returns.
- This year the money markets have seen a number of developments, especially in the commercial paper market and the asset-backed market.
- The rise in interest rates has not had any impact on risk premiums or the liquidity of MMFs, with premiums still close to historic lows as evidenced by low spread levels in the high-yield, corporate and asset-backed markets.
- By mid-2004, the total assets under management in AAA-rated MMFs totalled US$200bn, an increase of nearly US$100bn in just three years.
- The IMMFA is promoting the use of MMFs as a cash management solution and is fleshing out its guidelines on asset types used in AAA-rated MMFs.

MONEY MARKET DEVELOPMENTS. The money markets have seen a number of developments this year, centred around the commercial paper market and the asset-backed market.

The euro commercial paper market (ECP) has continued to grow this year with outstandings rising by around 6% to over US$435bn. Two segments in particular have experienced growth, notably asset-backed commercial paper and overnight commercial paper.

Asset-backed commercial paper has grown to represent 25% of outstandings in the euro commercial paper market, growing from only 7% in 2000. Outstandings are now larger than those of the corporate sector. This gives investors in money market assets the opportunity to diversify risk away from bank and corporate issuance. Some of the programmes also offer a yield premium over traditional bank and corporate ECP. Any yield premium available is typically due to the structural and liquidity risk in the product.

The money markets have also seen the emergence of an overnight market in commercial paper. Historically, this market has not developed because security references were not available in time to allow same-day settlement. Due to improvements in the process of getting asset identifiers to investors and issuers, settlement with same-day value is now possible. This offers money market investors an alternative to the overnight interbank deposit market, and allows them to achieve a yield premium and issuer diversification.

Another trend this year has been the growth in money market tranches of asset-backed securities (ABS) as issuers of ABS have begun to tap the demand from money market investors. Tranches have been structured to meet investors' typical criterion of a short maturity (the tranches typically have a 12-month or shorter expected maturity) and high credit quality (the tranches are typically AAA-rated). They hence offer a yield premium and issuer diversification. However, owing to the complex structures inherent in this product, relying on a rating alone is not sufficient to understand the risks involved.

Jonathan Curry is Head of European Cash Management at Barclays Global Investors.
jonathan.curry@barclaysglobal.com
www.barclaysglobal.com

IMMFA continues to promote use of MMFs

This year the Institutional Money Market Fund Association (IMMFA) has continued promoting the use of money market funds (MMFs) and developing its code of practice for fund providers.

It has focused on fleshing out guidelines around certain asset types used in AAA-rated MMFs. Floating rate notes, and particularly asset-backed floating rate notes, have been reviewed to discuss the issue of maturity extension if the asset is booked to its 'expected' rather than legal final. The appropriateness of certain types of collateral used in repo transactions and how extendable notes should be accounted for in the funds have also been reviewed. The aim has not been to try and make all the funds homogeneous but to ensure risks taken are appropriate and monitored correctly to benefit all investors.

A major project for the IMMFA this year has been the Pricing Methodology Project which aims to review existing policies across IMMFA members in areas such as pricing, gain/loss smoothing and the monitoring of the mark-to-market price of the funds, and to recommend prudent policies for the industry. It is important both for the protection of investors in the funds and the industry as a whole, that all providers of AAA-rated MMFs are using consistent and prudent policies in all these areas.

The IMMFA has also played an important role in a number of regulatory areas this year, the aim being to ensure that any new regulation, or changes to existing regulation, considers the implications on AAA-rated MMFs. As the MMFs are relatively new, on occasion, regulators can overlook them. The IMMFA wants to ensure that existing investors are still able to use the funds and it is working to broaden the range of investors that are allowed to invest in the product.

A number of new pieces of regulation this year would have inadvertently prohibited certain investors from continuing to use AAA-rated MMFs if the IMMFA had not lobbied for changes. For example, the Financial Services Authority (FSA) was successfully lobbied to change regulations that would have required life and non-life insurers and Lloyd's syndicates to hold 16% capital against their investments in AAA-rated MMFs. This meant the funds would have been treated in the same way as equity or bond funds and would have made the use of AAA-rated MMFs uneconomic. The IMMFA has also been lobbying the FSA to find a solution to allow insurance brokers to continue to use AAA-rated MMFs for clients' monies. Insurance brokers risk being prevented from using the funds by a change in regulation. Clearly, there is an incentive for the industry to prevent this but also, from an investor perspective, this would reduce the scale of the funds and hence liquidity.