

Quantifying Liquidity Premium of Money Market Funds in the Low Yield Environment, Part II

How to Put Excess Cash to Work without Increasing Credit Risk

Abstract:

This paper attempts to quantify the impact of a liquidity premium in money market funds by modeling three hypothetical portfolios of 29, 60, and 121-day weighted average maturities (WAM). Through our modeling process, we found the WAM extensions would have resulted in 0.11% and 0.31%, respectively, of additional annual yield potential over the 29-day WAM portfolio. The premise of the exercise is that by using separately managed accounts of custom maturities, investors may be able to recuperate part of the reduced yield caused by the more stringent liquidity requirements of the revised 2a-7 rule.

Introduction:

In our May 2010 newsletter, we estimated the typical U.S. prime money market fund would relinquish approximately eight basis points (0.08%) due to the recent SEC 2a-7 rule changes. This simulated “liquidity premium” was computed on a hypothetical prime fund with actual industry data for the previous 110 months.

Since the publication of that article, we received requests to test the methodology in the current low yield environment instead of looking at an historical average. We felt this was a reasonable request as more investors are seeking new ways to improve their