Strategy
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The Paths Forward

Nine Things We Learned from Recent Money Market Fund Announcements

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Abstract

As large money market fund sponsors begin to release their new fund directions, the wait may be over for cash investors to get their own strategies in place. The recent announcements allow us to gauge different paths forward for the industry and help investors gain insight into what to expect. Among a lineup of alternatives options, separately managed accounts may provide investors the necessary supplemental capacity to both satisfy liquidity needs and opportunistically take advantage of market dislocations. Nine things we learned from the recent announcements include:

1. *The most direct route to stable NAVs with no "fees and gates" is through a government fund.*
2. *All existing funds and shareholders must reconfirm their identities.*
3. *Look out for government funds that may opt in to "fees and gates".*
4. *A 60-day maximum maturity "stable NAV" fund is still a floating NAV fund.*
5. *Fund sponsors go their separate ways in retaining existing institutional shareholders.*
6. *Fund choices will be more limited, especially for municipal fund shareholders.*
7. *Executing structural changes is time consuming.*
8. *Changes may come several months before October 14, 2016.*
9. *There are many choices, but no clear winners.*

Introduction

Structural reforms on money market funds adopted by the SEC in July 2014 were widely expected to bring about comprehensive changes to the popular savings vehicle. Cash investors, especially shareholders of institutional prime funds, were anxious about a world of floating net asset values (NAVs), liquidity fees and redemption gates (fees & gates). For much of the last six months, they sat and waited for some information upon which they could act.

Now, the wait may be over.

Over the last month or so, three fund companies provided significant fund updates that may lay paths to a new world of liquidity investments effective October 14, 2016. Fidelity, JPMorgan, and Federated together manage $884 billion, or one third of the $2.7 trillion of U.S. money market fund assets, and rank as the 1st, 2nd and 4th largest managers by assets, respectively, as of January 31, 2015[1]. Thanks to their dominant market.

[1] iMoneyNet Domestic MarketShare data as of January 31, 2015.

positions, we expect other major fund companies to soon make public their road maps to compliance

The companies were careful in handling their announcements: information disclosed thus far remains preliminary; changes will come in phases; some actions require shareholders' approval; major changes will not happen until the second half of 2016, just to name a few. Reading between the lines, we observed similarities as well as differences to their paths forward regarding future fund strategies[2].

We plan to discuss the similarities and implied disparities from institutional cash investors' perspectives. We hope to provide some insight into possible paths fund sponsors may take and how investors may prepare their own liquidity management plans. Shareholders of affected funds may engage their managers in fruitful discussions. Others may benefit from an early heads-up on possible changes to their funds. Without further ado, here are the nine things we learned from the recent announcements.

Nine Notable Things We Learned

1. The most direct route to stable NAVs with no "fees and gates" is through a government fund: Fidelity, as an industry leader and pioneer, made this statement unambiguous by converting the Cash Reserves fund, the largest fund in its complex, from prime to government. Currently a retail prime fund, Cash Reserves is not required to float its NAV, but will be subject to fees and gates come next October. The firm made the decision after feedback from its shareholder community revealed strong opposition to fees and gates. As Exhibit 1 illustrates, the quickest solution to remove shareholder uncertainty regarding NAV stability or fees and gates is a government fund. This announcement offers a safe haven to shareholders, retail or institutional, who require stable NAV and daily liquidity assurance.

Exhibit 1: Post-2016 Money Market Fund Requirements

	Retail		Institutional	
	NAV	Fees & Gates	NAV	Fees & Gates
Government	Stable	No	Stable	No
Prime & Municipal	Stable	Yes	Floating	Yes

The move from prime to government for a fund this size may introduce supply dislocations in the short-term market, although Fidelity plans to spread implementation over several months. If other funds follow suit, the impact on the yield and availability of eligible instruments may be greater. Shareholders should be mindful that some government funds may refuse new investments. Should the Federal Reserve delay its interest rate normalization timetable, negative yield on government funds may be another possibility.

2. All existing funds and shareholders must reconfirm their identities: The new SEC rule requires explicit designation of all existing funds as either retail or institutional, prime or government, regardless of what their names may suggest. Recall that the new government fund definition requires that at least 99.5% of fund assets be government securities (as opposed to 80% now). Likewise, a retail fund will only accept money from natural persons as opposed to organizations. The current rule has no such definition.

There might be smart operational and business reasons behind fund companies claiming their government funds' compliance, or converting prime funds into government funds as a first step. Combing through identities of

[2] For information on the companies' recent announcements, please refer to Fidelity's supplements to select money market fund prospectuses on January 29, 2014, Federated's press release on February 19, 2015, and JPMorgan's money market fund announcement on February 20, 2015.

thousands or millions of shareholders is time consuming. Early designation of funds as government exempts the fund companies and their business partners from this lengthy process, freeing up valuable resources to tackle other implementation challenges.

Shareholders should gain knowledge of their funds' new designation as soon as possible. If, for example, their fund will survive as an institutional prime fund but they do not want a floating NAV fund, this knowledge will allow them to start looking for other alternatives sooner.

3. Look out for government funds that may opt in to "fees and gates": The new rule does not require government funds to impose these restrictions, but it does allow boards of directors the discretion to opt-in. Companies providing their government fund updates have been proactive in explicitly excluding the possibility of imposing fees and gates. Shareholders who want to avoid fees and gates should follow a similar approach in ensuring the exclusion language is included in the funds' revised prospectuses.

4. A 60-day maximum maturity "stable NAV" fund is still a floating NAV fund: One of the more notable announcements came from Federated, which plans to convert "certain existing" prime funds to 60-day maximum maturity funds. SEC rules allow all mutual funds to value securities maturing within 60 days at their amortized costs, thus preserving the $1.0000 stable NAV if none of the securities in a portfolio is subject to market price fluctuations. Such treatment must satisfy the conditions that "no market quotations are available, and each such security's amortized cost approximates the security's fair value," according to Federated.

Although the innovative approach to a stable NAV may work under most market conditions, it is not without some drawbacks. The funds still file under the floating NAV fund category for classification purposes. Shareholders and intermediaries, while not expecting the NAV to deviate, must have operational preparedness to deal with a NAV other than $1.0000. In addition, sales of securities below cost or ratings downgrades may force a fund to revert to market pricing and make a small but notable dent in the stable NAV. On top of these challenges, these funds still face the "fees and gates" issue.

We admit to not know much about the operational viability of a 60-day max prime fund category. We do suspect, however, that such a vehicle is not a suitable sweep candidate due to a number of factors that could knock the NAV off of the perfect dollar mark. Shorter expected portfolio maturities also limit the funds' yield potential relative to other cash vehicles.

5. Fund sponsors go their separate ways in retaining existing institutional shareholders: It is likely that larger fund companies will offer a full suite of products to investors of different preferences. Based on press reports and recent announcements, we sensed divided firm strategies in retaining existing institutional prime assets. Shareholders can take cues from these approaches in planning their own strategies.

For example, leadership at Federated publicly questioned the viability of floating NAV prime funds with fees and gates restrictions[3]. The 60-day maximum maturity fund offering may serve as a leading product to retain its institutional prime business. Fidelity's conversion of a large retail prime fund into a government designation insinuates its priority of covering a large cross section of shareholders desiring stability and liquidity under the government umbrella. JPMorgan's designation of the $112 billion Prime Money Market Fund, the largest among its peer group, as a floating NAV prime fund communicates the firm's confidence that a majority of its existing shareholders will stay put when the new rule takes effect.

[3] On the third quarter 2014 earnings call on October 17, 2014 and in reference to floating NAV prime funds, Federated CEO Chris Donahue noted that "those kinds of funds aren't going to be viable at all", as reported by Crane Data.

While expecting more firms to announce their plans shortly, we think the aforementioned varieties represent the main money fund alternatives for institutional shareholders – government, floating NAV prime and 60-day max "stable NAV" prime funds. It is worth reiterating that, although many larger fund sponsors will offer a full suite of choices for competitive reasons, commitment and expertise will vary. It is up to the shareholders to choose their preferred paths forward and select the most capable managers in the respective products.

6. Fund choices will be more limited, especially for municipal fund shareholders: A common theme from the recent announcements is the merging of funds with similar objectives. Higher operating and distribution costs post-2016 may be behind some of these consolidations. We also expect a few smaller fund companies to exit part or all of their fund business, a recent trend that may accelerate due to higher costs, more complex operations, and comparatively lower demand for prime products. This means fewer choices for shareholders, especially municipal fund investors.

The SEC places municipal funds in the prime category and subjects them to fees and gates. If a fund allows non-natural persons as shareholders, it is also subject to floating NAVs. Higher costs and lower expected demand may have contributed to the firms' decisions to combine municipal funds and reduce or eliminate state-specific and AMT tax-free fund offerings.

For smaller fund companies, offering government only or retail only funds may make more sense operationally. Finding out where their fund sponsors are headed is a critical task for institutional investors today.

7. Executing structural changes is time consuming: Some investors may be curious why these companies made plans many months before the new SEC rules take effect. In reality, structural changes of this magnitude require significant lead time for fund sponsors, service providers, intermediaries and shareholders. Approval proceedings by boards of directors, shareholders and, in some cases, regulatory authorities can be quite time consuming. Implementation, testing and communication may take up to a year after a plan is approved. For this reason, we expect other fund companies to publicize their planned changes in the first half of 2015 in order to be fully compliant by October 2016.

Likewise, cash investors should be cognizant of the time consuming process of amending their own cash investment practices, including strategy decisions, investment policy revisions, board approvals, procedural changes, system enhancements, intermediary coordination, and custody and accounting considerations. For example, the simple amendment to an existing investment policy from funds with a fixed $1.00 NAV to government funds alone may take several months to approve by a busy corporate board of directors.

We think 2015 should be the year for institutional investors to begin to prepare for these changes. Assuming that fund sponsors plan on becoming fully compliant by June 2016, or three months before the deadline, many of their operational changes may start getting in gear by September of this year. Conversely, if it takes six to nine months for investors to implement their corresponding strategies, a concrete plan should be in place by the end of this year.

8. Changes may come several months before October 14, 2016: This one is for the procrastinators among us. At least two of the three firms hinted that their changes will be effective sometime in the second half of 2016 before the October 14th deadline. This makes sense as structural changes of this magnitude will require some time for delays, reporting and testing before the deadline. This may mean that some funds may start floating their NAVs and become subject to fees and gates as early as July 1, 2016.

We do not point this out because we think there will be unpleasant surprises. Fund boards of directors will have their operational date known months in advance. However for investors who require a long lead to respond to

policy changes it may be a good idea to think of their target date as being early July so as not to fall behind schedule.

9. There are many choices, but no clear winners: We are pleased that major fund sponsors are taking concrete steps towards rule compliance in a proactive, responsive and transparent fashion. Although the announcements specifically address money market funds, we think changes also will occur in other alternative instruments for cash investors. Such instruments may include, but are not limited to, transactional deposit accounts, stable NAV privately registered funds, floating NAV ultra-short mutual funds and separately managed accounts. These are vastly different products which offer clear choices for institutional investors.

Our August 2014 newsletter article provides a comparative analysis on alternative cash instruments among three categories of deposits, commingled funds and direct purchases (including separately managed accounts). Suffice it to say that among the many choices, none seems to hold a clear advantage in terms of safety, liquidity, simplicity and income potential. We encourage investors to closely examine all possible options, actively engage internal decision makers, asset managers and service providers, and select a plan with a combination of choices most appropriate for them.

Conclusion: Separating Liquidity Needs from Savings Objectives

In the final analysis, the decision as to the correct cash management strategy may come down to the tradeoff of liquidity versus investment, a point we often make. Supply and demand dynamics will compel true liquidity products (namely stable NAVs absent of liquidity restrictions) to offer yield potential close to or below transactional deposit accounts. Higher tolerance for principal variability and relaxed demand for liquidity may provide higher income potential.

It seems clear that there will not be enough stable NAV, full liquidity vehicles to accommodate all existing demand in the near term. Market forces such as yield differentials and human interventions including restricted entry or balance caps may help regulate some fund flows. During this adjustment period, separately managed accounts may provide the necessary supplemental capacity for the right investors to both satisfy their liquidity needs and opportunistically take advantage of market dislocations. Time will tell whether any of the newer money market offerings have staying power, but ultra-short separate account strategies that stand the test of time deserve their own place in an institutional cash investor’s tool chest.

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