Strategy

December 1, 2015

Maintaining Liquidity after Rule 2a-7 Implementation of "Floating NAV" Prime Money Market Funds

Capital Advisors Group Liquidity Accounts[SM]

Contacts

Marc St. André
Senior Portfolio Manager
Main: 617.630.8100
mstandre@capitaladvisors.com

Abstract

Institutional prime money market fund investors may face a number of liquidity challenges after October 2016. Floating net asset values, potential fees and gates on redemptions and unpredictable institutional shareholder behavior during times of stress all present potential obstacles. Cash investors may be able to avoid these difficulties with direct investments in cash equivalent securities in a Capital Advisors Group Liquidity Account™.

Introduction

In the fall of 2016, when institutional prime money market funds will be required to adopt floating net asset values (NAVs) as well as provisions for fees and gates on redemptions, investors who remain in the funds will face a number of challenges. In previous papers we have addressed a few concerns resulting from the forthcoming amendments to U.S. Securities and Exchange Commission (SEC) Rule 2a-7; in this paper, we will briefly revisit them and highlight a potential solution.

Lack of Control in Prime Funds

Individual shareholders in prime funds have always lacked the ability to control specific credit exposures in money market funds. In the past, this may have been less problematic for investors, as they could look through to the credit strength of the fund's sponsor bank as an unofficial backstop in the event of any trouble with individual credits. However, the new SEC rules make sponsor support far less likely, magnifying the significance of individual credit decisions – and making investors' lack of control over the fund's credit selections more troublesome.

Complexities of New Structures

Prime fund investors may also face challenges with daily liquidity. When NAVs were fixed at $1.00 per share, investors enjoyed same-day access to their fund investment throughout the business day. Without the fixed NAV, some floating NAV funds may not offer same-day access, and thus may not function as daily sweep vehicles. Next-day trade settlement would make prime funds unsuitable for unplanned same-day cash needs. Some floating NAV funds plan to offer same-day access, with NAV pricing at multiple times throughout the day – but fund managers haven't yet disclosed how certain operational difficulties will be resolved.

Shareholder Risk

Perhaps the most significant liquidity challenge fund investors face is the potential for a shareholder run. Just as banks cannot accommodate all depositors if they request their deposits back all at once, neither can a money market fund. In September 2008 and throughout the successive months, institutional money market funds shed assets quickly as investors headed for the exits. Retail money fund investors, on the other hand, hardly blinked.

The new SEC rules segregate institutional and retail investors in separate funds, instead of just separate share classes of the same fund as in the past. A certain population of fund shareholders with low cash flow volatility, like retirement and wealth management accounts, will benefit from investing in retail prime funds with stable shareholders that are exempt from the requirements for institutional prime funds. Conversely, investors remaining in all-institutional prime funds will tend to be more sophisticated and have larger balances, on average. History tells us that these shareholder pools will likely be comprised of faster money with the potential to erode liquid reserves more quickly, weakening other shareholders' daily access.

Before the rule amendments, savvy investors could reduce shareholder fund flow volatility by selecting prime funds that included large retail and trust account share classes. After 2016 though, the new structures may increase the likelihood of herd mentality and exacerbate liquidity challenges. Institutional investors may only be able to limit exposure to hotter money in comingled funds by reducing or eliminating such investments.

Weekly Liquidity

To help resist potentially higher volatility in fund flows, the SEC requires prime funds to maintain at least 30% liquidity within 7 days. More sophisticated institutional investors are likely to monitor these liquidity levels carefully, and may react swiftly to downward shifts in weekly liquidity positions to avoid the possible imposition of fees and gates on redemptions that would be intended to halt a run. Liquidity monitoring is a useful tool, but doesn't by itself prevent large swings in liquid balances. After all, one's peers in a prime fund are also likely to be paying much closer attention to a fund's liquidity characteristics and individual holdings than in the past.

The SEC definition of "weekly liquidity" includes Treasury debt without maturity restrictions and agency debt maturing in up to *60 days*, which could also present liquidity challenges at times. While government securities with short maturities are typically very liquid, rising interest rates can cause market value declines and impact the fund's share price – an unappealing result for an investment whose highest objective is typically capital preservation. It's not unlikely that during a period of rising rates a 60-day maturity could provide materially less liquidity than one actually maturing within a week.

Seeking Liquidity Solutions

In light of the challenges prime fund investors will face under the new rules, we recommend a diversified liquidity strategy to provide liquidity on a same-day basis and during times of stress when prime money market funds may experience greater volatility. While prime funds can offer next-day liquidity, and may even offer same-day liquidity in some cases, the challenges associated with less predictable institutional fund flows should make the addition of alternate liquidity products a priority. Direct investments, in addition to money market fund holdings, can augment the liquidity provided by prime funds and give the investor direct control, without having to share liquidity benefits with other investors.

Resolving Risk & Control Issues

Government money market funds are exempt from floating NAV requirements and from provisions for fees and gates; therefore, government funds can continue to accommodate same-day liquidity needs going forward and represent a logical choice to augment or replace the liquidity formerly provided by prime funds. However, they also come with reduced yield potential.

To complement a portion of a cash portfolio held in government funds and prime funds, we suggest a diversified portfolio, laddered with cash-equivalent securities and using a government money market fund for same-day liquidity. Such a structure can mitigate challenges associated with the new amendments to Rule 2a-7, as well as help provide planned liquidity, emergency liquidity, direct control over credit exposures, and yield enhancement. Capital Advisors Group Liquidity Accounts℠ are a recently launched investment product designed to help investors mitigate the risks we've identified in prime money market funds without sacrificing the potential yield advantages offered by the high quality paper found in most prime funds.

Liquidity & Credit Risk Control

A Capital Advisors Group Liquidity Account℠ is a separately managed portfolio with assets held in a segregated bank custody account in the investor's name. By limiting maturities to 90 days, all investments in a Liquidity Account℠ are cash equivalents and can be booked at amortized cost instead of being marked to market. With no commingling of assets with other shareholders—except in government money market funds used for daily liquidity—direct ownership mitigates the risk of a shareholder run interrupting access through fees or gates. To provide liquidity, the accounts target the same daily and weekly liquidity requirements mandated in Rule 2a-7 – 10% daily and 30% weekly. The accounts also observe the 5% issuer concentration limits in the SEC rule, but with increased conservatism

While investors in each separately managed Liquidity Accounts℠ benefit from a dedicated credit research team working on their behalf, as they would in a money market fund, the addition of direct influence over investment decisions allows a Liquidity Account™ investor to avoid specific credits and sectors at their discretion. An investor may have existing exposures to a financial institution through credit facilities or other banking services, for example, which could make any additional exposure inappropriate. While an investor can't instruct a money market fund to limit investments in that bank, it is simple to avoid that issuer in a Liquidity Account™.

Direct control also allows investors to manage liquidity characteristics to suit their needs. In a fund, liquidity targets may be fairly constant over time, and be driven by regulatory limits – such as the 30% minimum on 7-day liquidity. Portfolios of direct investments in cash-equivalent securities can adjust liquidity based on expected cash needs and the credit environment.

Conclusion

Institutional prime money market fund investors may face a number of liquidity challenges after Rule 2a-7 amendments go into effect in October 2016. With Capital Advisors Group Liquidity Accounts^{SM}, we believe investors can mitigate potentially undesirable characteristics of floating NAV prime funds without having to limit income potential to lower yielding government funds. The comparison table below summarizes a few key characteristics of prime funds and Capital Advisors Group Liquidity Accounts^{SM}:

Table 1: Prime Funds and Capital Advisors Group Liquidity Accounts^{SM}

	Prime MMF	Liquidity Accounts^{SM}
Cash Equivalent Treatment	Individual holdings may mature in as many as 13 months, but FASB permits cash equivalent treatment for all MMF shares	Every individual holding is a cash equivalent maturing in 90 days or less
Access Restrictions	Fees and gates can be implemented if weekly liquidity falls below the 30% regulatory threshold	No fees or gates for access to liquidity.
Shareholder Composition	Floating NAV funds will be comprised entirely of institutional shareholders. With larger balances and increased sophistication, fund flows are likely to be more volatile than retail share classes	No commingling of assets with other shareholders, except for government money market funds used for daily liquidity.
Liquidity	SEC regulations require 10% liquid overnight and 30% weekly (including longer-dated U.S. Government maturities)	Liquidity Accounts^{SM} also target a minimum of 10% overnight and 30% weekly
Custody	Assets held in bank custody accounts in the fund's name	Assets held in a segregated bank custody account in each investor's name
Risk Control	Fund is managed by investment advisors, with no control at the investor level	Each account is managed by Capital Advisors Group, a registered investment advisor , with additional credit controls available to individual investors
Issuer Concentration	5% issuer limit, but total exposure can exceed 5% when counterparty exposures or other bank liquidity support mechanisms are included	Strict 5% limit on non-governmental issuers
Sector Exposure	Neither the SEC nor individual prime funds have published limits on sector or industry exposures	Liquidity Accounts^{SM} limit exposure to finance and bank issuers to 60% - and limit further during times of stress (or upon investor's request)

About Us

Capital Advisors Group, Inc. is an independent investment advisor specializing in institutional cash investments, risk management, and debt financing.

Drawing upon almost a quarter of a century of experience through varied interest rate cycles, the firm has built its reputation upon deep, research-driven investment strategies and solutions for its clientele.

Capital Advisors Group manages customized separate accounts that seek to protect principal and maximize risk adjusted returns within the context of each client's investment guidelines and specific liquidity needs. Capital Advisors Group also provides FundIQ® money market fund research, CounterpartyIQ® aggregation and credit analysis of counterparty exposures, risk assessment on short-term fixed income securities and portfolios, and independent debt financing consulting services.

Headquartered in metropolitan Boston, Capital Advisors Group maintains multiple U.S. regional offices.

Capital Advisors Group, Inc.
29 Crafts Street, Suite 270, Newton, MA 02458
Tel: 617.630.8100 ~ Fax: 617.630.0023
www.capitaladvisors.com
info@capitaladvisors.com