A Floating Net Asset Value Substitute

Reintroducing the Dual-NAV Proposal with Shadow NAVs

Executive Summary

We believe that mandatory disclosure of daily market value NAVs will be a significant step toward better risk transparency in money market funds. It is functionally equivalent to the FSOC/SEC's floating NAV proposal without the unnecessary operational, accounting and tax complexities. When applied along with objective liquidity gates and/or reasonable NAV buffers, the approach should sufficiently reduce systemic concerns with money market funds and address major issues from key constituents.

We are opposed to resetting the unit NAVs to $100.00; however, we believe more work is needed for market value NAVs to be truly useful. We think shareholders could further benefit from analytical research that incorporates market value NAVs, but, at the same time, we urge regulators to address shareholder risk by enforcing more look-through shareholder concentration and asset flow disclosure.

Introduction

Back in April 2012, we proposed to the Securities and Exchange Commission (SEC) a floating Net Asset Value (NAV) recommendation that requires money market mutual funds to report daily market value-based NAVs up to the 4th decimal place, but allows shares to be traded at NAVs rounded to the 2nd decimal place. The premise is to preserve the transactional utility of the $1.00 NAV while making share value volatility fully transparent. In essence, we believe in NAV stability through market disciplines and sound risk management rather than through amortized cost accounting or sponsor capital support. Forcing NAVs to change every day not only is cumbersome, but also ineffective, in our opinion.

Recognizing floating NAVs as one of the alternatives proposed by the Financial Stability Oversight Council (FSOC), we encourage the council to reconsider our dual-NAV approach in bridging the gap between systemic concerns and transactional utility. We are encouraged by several fund sponsors' initiatives in publishing daily market value NAVs[1], more commonly known as shadow NAVs. We think these announcements signify a major step toward a workable resolution similar to the one we proposed.

In the rest of the commentary, we discuss the incorporation of shadow NAVs in our dual-NAV proposal, present our argument that floating NAVs should not preclude

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NAV stability, and, finally, we conclude with our ongoing advocacy for enhanced shareholder transparency that, we believe, should go hand-in-hand with our modified NAV proposal.

Floating NAVs do not have to lead to changes in transactional NAVs

Dual-NAV: Without ambiguity, we support the floating NAV alternative over capital buffers or redemption holdbacks. However, we do not see the necessity of converting NAVs from a base unit value of a $1.00 to $100.00 to magnify daily share value volatility. Rather, we support doing away with the amortized cost method of calculating the NAV, with limited exemptions. The daily (no longer shadow) NAVs can be rounded to the nearest penny for share transactions, while the "official" NAV is fully reported for accounting purposes.

With the availability of a daily reported NAV, transactional NAV fluctuations become unnecessarily redundant. In other words, we do not see any additional benefits in floating NAVs that are not already apparent in the daily reported NAVs. Forced floating NAVs also will render money market funds irrelevant within the mutual fund category, since ultra-short bond mutual funds can achieve most of their functions with far fewer restrictions, in our opinion.

NAV Stability Promotes Market Disciplines: The purpose of a floating NAV is to lift the veil of perceived safety in money market funds and promote more risk transparency. A stable $1.00 NAV achieved through prudent portfolio decisions (as opposed to accounting treatment or sponsor capital support) not only is consistent with the spirit of a floating NAV, but it also promotes market disciplines that reward conservatively managed portfolios. As an aside, we are not opposed to economically feasible, fully disclosed NAV buffers as contingent shock absorbers or liquidity gates that regulate share activities based on reported NAV volatility.

We do not think that a floating NAV will solve all the systemic concerns with money market funds. Instead, the purpose of floating NAVs should be to reinforce disciplines in managing funds such that, within the confines of the revised Rule 2a-7 of 2010, the $1.00 NAV may be maintained without the assistance of amortized cost accounting. Poorly managed funds should be allowed to break the "constant" dollar and bear the economic consequences. Strong managers should have plenty of evidence to show why their portfolios are more resilient.

Use Reported NAVs as Buffer Triggers or Redemption Gates: Instead of automatic redemption holdbacks, which we believe are fundamentally incompatible with institutional cash management, NAV perimeters can be used to apply NAV buffers and/or institute liquidity gates.

While well-informed investors can make their rational share of decisions based on the NAV's proximity to \$0.995 (and \$1.005), regulators and fund sponsors can use the same information to apply NAV buffers or institute liquidity gates. Therefore, if the daily changes are within pre-determined perimeters (for example \$0.9975 to \$1.0025), no decision is required. As the NAVs move outside the perimeters, increasingly larger buffers and more severe redemption restrictions may be applied.

Disclosure of a daily shadow NAV is a major step forward

In our view, the voluntary disclosure of daily market value NAVs represents the industry's conciliatory step toward resolving systemic concerns that still remain. If adopted and standardized, it may serve as the floating part of our dual-NAV proposal.

Immediate Risk Transparency: Compared to the current requirement of providing month-end NAVs on a 60-day lag, daily NAVs become part of current affairs rather than historical events. Shareholders may use daily NAVs to gauge the impact of market events on their portfolios as they occur. The first wave of panic selling need not form if shareholders can ascertain that their funds are not exposed to material negative events.

Less Prone to Window Dressing: We dislike the month-end NAV disclosure because of its vulnerability to "window dressing." The short-term nature of money market investments makes it easy to de-risk a portfolio by reducing compliant but riskier names before month-end and buying them back on the calendar switch. Managers also have more time to execute capital support to smooth out month-end NAVs. We often chuckle at so-called market value NAVs in funds that never deviate from \$1.0000. Daily disclosure of NAVs as they become available should significantly cut down the window dressing element and make the data more trustworthy, in our opinion.

Natural Deterrent to Risk Appetite: The benefit to shareholders from the daily shadow NAV is not in the often negligible day-to-day changes, but rather a new reality that a fund advisor must hold itself responsible for its management decisions every day. We believe daily NAVs will serve as natural deterrents to large "bets" on portfolio decisions to avoid NAV volatility spikes. The reduced risk appetite helps to reinforce the conservative principles in money market funds.

Useful Risk Barometer: We believe that the lack of knowledge of proximity to the danger zone is a major factor causing a shareholder run. Instead of assurances from fund sponsors in the depths of a crisis, which are often ineffective, daily NAV disclosure can offer a heads-up before a fund goes beyond the breaking point. We suspect that, back in September 2008, the values in many prime fund holdings, at the Reserve Company and elsewhere, were far below their amortized costs before the Lehman Brothers default. Daily available NAVs would have alerted constituents to the stressed environment earlier.

More work is needed on shadow NAVs

We applaud the fund sponsors' initiatives of disclosing market value NAVs daily; however, we think more work is needed on enhanced disclosure.

Lack of Secondary Market Prices: Market value NAVs supposedly reflect the market values of the underlying securities. This is problematic because money market securities are, by design, meant to be held to maturity, so the "bid" prices to re-sell them are not always known. Instead, pricing services often determine the values based on the "offered" prices from bond dealers on the primary market. Sometimes, pricing based on other securities of comparable credit ratings and maturities are used, which may have very different risk attributes. This is an essential distinction due to the importance given to the funds' ability to sell securities to meet redemptions in the floating NAV narrative.

Stale Prices and Firm's Discretion: Besides the marketable securities discussed above, many fund holdings are private securities that never trade. These securities may include all sorts of repurchase agreements, master demand notes and non-brokered certificates of deposit. Thus, some of them are always presumed to be at par ($100.00) while the fund advisor has the discretion to determine the values on others. We think a more objective pricing mechanism is needed on these instruments.

The Market Value of Size: One of the lessons we learned from the structured investment vehicle (SIV) debacle in 2007 is that, in a market dominated by a few very large buyers and sellers, the "market" value of a security became meaningless when no buyers emerged. In the concentrated market of prime money market funds, NAVs can be misleading indicators of valuation if size concentration is not taken into consideration.

In short, we do not mean to criticize the fund sponsors move to disclose market value NAVs. Rather, we think if we were to use the NAVs as proxies for the floating NAVs favored by the regulators, more work would be needed to ensure their true representation of a portfolio's worth in an orderly liquidation scenario.

How market value NAVs can be important risk monitoring tools
In support of the floating NAV alternative, we believe that the actual economic benefit of a fluctuating NAV is minimal due to the small band of movement. Its real benefit is derived from the informational value that reflects portfolio risk characteristics. Consequently, we think that more tools may be developed to help shareholders gain more insight.

Stress Tests: In addition to money market fund companies, independent research firms, including our own FundIQ® research engine, also perform stress tests that may benefit from what is revealed by daily NAVs. Without daily market value information, our tests assume the value declines from a base price of $1.0000. With daily NAVs, independent sensitivity analysis can be more accurate, especially intra-month, when cumulative losses in the portfolio may be substantial.

Sensitivity Attribution: The day-to-day changes in NAVs, along with daily weighted average maturity data and period-end holdings, may allow shareholders to back test a fund for certain exposures. For example, analysts may be able to piece together a hidden cause for a sudden NAV reduction by isolating other factors in relation to its peer group.

Risk Forecasting: While trend monitoring of daily NAVs may not necessarily detect the next Lehman bankruptcy, shareholders could, however, incorporate NAV trends into their forward-looking risk projections, especially in relation to shareholder activities.

Summary Conclusions and Recommendations
We think that mandatory disclosure of daily market value NAVs will represent a significant step toward better risk transparency. It is functionally equivalent to the FSOC/SEC's floating NAV proposal without the unnecessary operational, accounting and tax complexities. When applied along with objective liquidity gates and/or reasonable NAV buffers, the approach should sufficiently reduce the systemic concerns with money market funds while addressing many of the issues of major constituents.

We are opposed to resetting the unit NAVs to $100.00, because the main benefit of a floating NAV lies in its informational value, not in the economic substance of miniscule daily changes. However, we believe more work is needed for market value NAVs to truly reflect the values of the underlying securities and their responsiveness to market events. Lastly, we think shareholders can further benefit from thoughtful analytical research that incorporates market value NAVs in back testing and in forecasting models.

We again urge regulators to find ways to address shareholder risk. This risk stems from the indirect, and thus anonymous, participation of many institutional shareholders in money market funds and the large pools of cash they control. Look-through shareholder concentration and fund flow data should be available to the public so that regulators and shareholders can ascertain which funds are more prone to runs. We believe that segmental concentration data may be obtained without revealing the ultimate identify of shareholders. Because of the existence of multiple money market fund distribution channels, this issue cannot be resolved within the fund management firms, but should involve the larger fund eco-system.

[1] Since Goldman Sachs Asset Management announced that it would begin disclosing a daily market value NAV for its U.S.-domiciled commercial paper money market funds on January 9, at least five other U.S. based fund sponsors (J.P.Morgan Chase, BNY Mellon, BlackRock, Fidelity and Invesco) have announced plans to release similar information by the end of January 2013. http://professional.wsj.com/article/PR-CO-20130109-904893.html?mg=reno64-wsj

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