Retrofitting Money Market Funds for Treasury Risk Management

A Treasurer's Roadmap to Money Market Fund Selection

Abstract

For four decades, many corporate treasurers successfully employed a hands-off approach to managing the money market funds in their portfolios. However, recent market events revealed the danger in this approach. Like other investments, money market funds must be evaluated to determine how they fit into a firm's overall risk management strategy.

A money market fund evaluation may include an assessment of a corporation's needs and risk tolerances, the design of an investment policy, the monitoring of money market fund characteristics, as well as periodic re-evaluation and rebalancing of the firm's portfolio. In the evaluation process, investors should make good use of the money market fund transparency initiatives recently adopted by the SEC and use holdings information to derive a credit opinion. Further, a user-defined system of reports and alerts may be aided by independent credit research in uncovering potential sources of risk. Finally, investors should view all money market funds to which they have exposure as part of a single portfolio that fits their needs and risk tolerances. In uncertain times, failure to consider a suite of cash investment solutions in addition to money market funds may have adverse consequences, which may include delayed redemptions or, in a worst-case scenario, loss of principal.

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Introduction

Money market mutual funds became a principal institutional cash investment vehicle without many treasury managers giving serious consideration to the risk profiles of the individual funds. Immediately following the Lehman Brothers bankruptcy in 2008, some corporate practitioners admitted that they did not know why they were invested in certain money market funds, and that they needed help scrutinizing their money market fund holdings. A cottage industry of transparency services soon flourished.

We think the most basic question about money market funds is not whether they bring benefits to institutional cash management – they do, in most cases; rather, the question is how can an investor use and benefit from money market funds. For institutions that skipped a step or two in the evaluation process before plunging into money market funds, now may be a good time to rethink this question in the framework of the firms' overall risk management strategy. One then may adjust money market fund usage to the right risk/return fulcrum point. We call it a "retrofitting" process since most organizations already use money market funds in one way or another.

In this article, we hope to help practitioners identify their needs and risk tolerances, establish investment policy guidelines, identify the key characteristics of money market funds, implement a money market fund monitoring system, and optimize

money market fund selection. The specific funds investors choose and the tools they use to make such decisions are choices they will have to make on their own. However, we hope this article will provide food for thought, even if not all readers agree with our philosophy and approach.

Why Self-examination is Necessary

Money market funds became the cash vehicle of choice for institutions largely as a result of apathy. The perception of principal safety, daily liquidity and little to no investment accounting make money market funds an attractive candidate for a resource-constrained treasury staff. Instant risk diversification, daily sweep availability and portal technology make money market fund transactions a breeze and a higher yield potential than that offered by bank deposits is icing on the cake. This semi-autopilot style of cash investing is hard to resist.

But therein lies the risk. Money market funds have embedded credit and liquidity risks that are hard to detect in relatively calm markets. During periods when markets are unsettled, investors' decisions to immediately cash out of money market funds invested in longer-term assets could create and exacerbate credit and liquidity problems. As we wrote in previous white papers, the AAA credit ratings given to money market funds were not particularly helpful in alerting investors of looming threats.

Recent regulatory overhaul has resulted in more detailed and timely money market fund holding disclosures. The money market fund industry and service providers made great progress improving transparency to inform investors of what they own. Still, better disclosure and easier access to the information does not tell us why we should invest in certain money market funds or whether they are right for us.

Instead, a reverse process is needed. We think money market fund selection should start from the investor, not from a universe of money market funds and money market fund holdings. The starting point is no different from other investment analysis – an assessment of needs, risk tolerance and return expectations.

1. Conduct Needs, Tolerance and Expectations Assessment

In our 20 years of managing cash investments for institutions, we found that almost all investors put principal protection and liquidity needs ahead of yield as investment objectives. Yet, in practice, objectives differ greatly based on needs, risk appetite and expectations. We encourage investors to re-assess their objectives through these prisms:

Needs: The utility of a money market fund as a liquidity vehicle is to hold cash for near-term needs. Investors who face more urgent cash needs, cyclical balances or uncertain cash flows should consider money market funds with higher liquidity attributes, such as daily and weekly liquidity allocations. Those with lower liquidity needs may gravitate towards money market funds with higher yield objectives, such as a longer weighted average maturity and more credit investments.

Risk Tolerance: Investors with a higher risk tolerance may feel comfortable with strategies deemed too risky by others. Beneath the accounting treatment that allows money market funds to be priced at $1.00, money market funds invest in securities of different credit, maturity and liquidity attributes. It is helpful to think of risk appetite in both normal and extreme scenarios, paying particular attention to the likelihood of the latter occurring and how one should respond. We believe risk appetite should reflect the corporate culture of an organization, not that of the individuals managing the firm's cash assets.

Expectations: In a competitive and transparent market, yield should be the derivative product of an investor's needs and risk appetite. Those with greater liquidity needs and a lower risk threshold should expect their money market fund(s) of choice to provide lower yield. Prevailing interest rates and credit conditions, in addition to the short-maturity and limited supply of money market instruments, further limits yield potential. We state the obvious here to alert investors not to put expectations ahead of need and risk analysis in selecting money market funds.

2. Formulate Investment Policies

We suggest that corporations consider developing or revising formal investment guidelines for money market funds, either as a standalone investment policy or as part of an overall treasury investment policy. Many existing policies often only require that money market funds be regulated under SEC Rule 2a-7, maintain a stable net asset value of $1.00 and have a AAA rating. These policies may be inadequate, in certain instances, thanks to recent credit events and the availability of more complete holdings information.

In developing a money market fund investment policy, investors should incorporate their needs and risk tolerances and set broad guidelines that are measureable and consistent through market cycles. For example, the policy may allow for rated or unrated prime money market funds, government money market funds or Treasury-only money market funds. Setting a minimum money market fund size requirement may enhance liquidity, while stating a maximum percentage allocation in any one money market fund may reduce redemption risk.

A policy also should set tolerance levels for portfolio and non-portfolio related attributes. The following lists provide some examples. These tolerance levels should reflect a through-the-cycle view after careful analysis of each attribute's potential impact on a money market fund's credit and liquidity strength.

Sample Portfolio Characteristics (legal requirement):

- Minimum daily liquidity (10%) and weekly liquidity (30%)
- Maximum weighted average maturity (60 days) and weighted average life (120 days)
- Maximum issuer exposure on an individual (5%) and affiliated basis (Not Specified)
- Maximum exposure financial issuers (Not Specified)
- Maximum non-U.S. exposure (Not Specified)

- Maximum exposure to asset-backed commercial paper, time deposits or repurchase agreements, etc. (Not Specified)

Sample Non-portfolio Characteristics (legal requirement):

- Minimum credit ratings of the money market fund sponsor (Not Specified)
- Minimum tenure of money market fund manager(s) (Not Specified)
- Maximum portfolio outflows over a period of time (Not Specified)
- Money market fund families' overall assets under management standing in the industry (Not Specified)

It is important to set parameters that may be monitored and controlled across money market funds, money market fund groups and money market fund families. Investors may choose to tighten up some parameters from time-to-time, through an investment policy addendum or verbal instruction, but should establish broad guidelines that will remain applicable through all market cycles.

3. Monitor Performance with Reports and Alerts

Once the key attributes are identified, the next step is to devise a monitoring system of reports and alerts to provide input for decision making. Monitoring, at a minimum, should ensure money market funds are in compliance with investment policy guidelines. More complex monitoring systems may help identify emerging trends before problems develop. Once the risks are well understood, focus then may be turned to performance.

Well-designed reports and alerts may help the investor in the decision-making process when they:

a) use independently calculated and verified data to obtain better accuracy and objectivity, as opposed to using self-reported data from the money market fund companies;
b) use standardized holdings data across money market fund companies to make an apples-to-apples comparison;
c) combine direct and indirect credit exposure to provide aggregate issuer, industry and country concentration information;
d) track money market fund characteristics over time to provide insight into money market fund managers' shifting strategies;
e) track money market fund characteristics relative to money market funds with comparable objectives (peer group) to provide insight into managers' risk behaviors relative to their peers;
f) provide tools to track overall risk exposures across a portfolio of money market funds held by the investor; and

g) provide user-defined alerts to inform investors through email or other electronic means when a threshold is breached or when a target value is reached on any of the money market fund attributes.

We are aware of the difficulty in developing an effective and dependable monitoring system because of the short-duration and non-standard nature of many money market securities, such as non-marketable deposits and repurchase agreements. Data providers have made progress in recent months, but most continue to rely on self-reported data from money market fund companies.

4. Supplement Monitoring with an Independent Credit Opinion

All money market funds, other than those invested in *direct* US Treasury obligations, are credit investments that carry the risk of default and/or other credit losses. To help mitigate this risk, government regulations stipulate that to be classified as a money market fund, a security must be of high quality and low maturity. Unfortunately, the market practice of circumventing these regulations has resulted in some money market funds buying nominally compliant securities that carry unforeseen risks. Investors typically have relied on money market fund managers to make the key credit decisions in the past, but lessons learned from the recent financial crisis have brought this process into question. These lessons also speak to the need for subjective credit evaluation of money market funds.

Unlike current transparency initiatives, which attempt to obtain accurate and detailed information quickly and conveniently, money market fund research evaluates the credit implications of the information unveiled by these initiatives. Is a certain type of investment appropriate for a money market fund? Is a money market fund overly exposed to certain markets? Does the manager repeat the same mistakes? These subjective opinions from independent sources may corroborate or contradict the money market fund managers' own claims of money market fund performance and help investors gain more insight. We think investors may benefit from subjective credit research from independent cash managers for the following reasons:

a) The manager is unaffiliated with money market fund companies to provide independence and objectivity;

b) The manager has expertise in short-maturity, high-grade credit investments, especially in financial names widely used by money market funds;

c) The manager has experience in individual credits as well as commingled vehicles, including money market funds;

d) The manager has the ability to integrate opinions on money market funds with their other cash investments;

e) The manager provides on-going evaluation of covered money market funds.

5. Customize and Optimize

Few things in life are one-size-fits-all and money market fund investing is no exception. If, after careful examination, no perfect money market fund exists to satisfy all of the firm's requirements, the investor may hold several money market funds to achieve their goals. For example, if a chosen money market fund has too much concentration in a given issuer, there may be a money market fund with less exposure, such that the overall issuer concentration is reduced. Conversely, if a desirable attribute is lacking in a chosen money market fund, a portion of cash may be allocated to other money market funds to gain the desired results.

This customized, or portfolio, approach to money market fund selection is different from the traditional way of simply holding multiple money market funds at a time, since it involves planning ahead, accurate reporting and periodic rebalancing of money market funds. This approach may place more demand on a system that tracks investor positions and money market fund characteristics, but the benefit of having a portfolio of money market funds customized to the needs of the investor may make the effort worthwhile.

Even if investors do not always think of optimizing their overall money market fund holdings, they should always view them in two ways:

a) All money market funds should be considered part of a single portfolio of cash investments, with each investment below the tolerance threshold allowed by the corporate risk culture; and
b) Each money market fund serves a unique purpose within the portfolio; for example money market fund A improves safety, money market fund B bolsters liquidity, and money market fund C enhances yield potential.

Conclusion: Money Market Funds in Total Risk Management

Despite daunting credit, yield and regulatory challenges, institutional money market funds continue to offer safety, stability and risk diversification benefits few other cash alternatives can. However, many assumptions about money market funds' safety and liquidity have turned out to be false. Today's treasurers should overhaul the practice of vetting money market funds solely for liquidity investment needs and retrofit money market funds as part of their total treasury risk management endeavors.

Evaluating money market funds for corporate use should be no different than the evaluation of other investment vehicles. The process involves a risk tolerance assessment, the design of an investment policy, the monitoring of money market fund performance and periodic re-evaluation and rebalancing of money market funds. The presumed zero-loss expectations for money market funds and their susceptibility to shareholder runs make the task unique for money market fund investors. The right forward-looking tools and techniques may help investors better assess the underlying causes of a shareholder run – some are portfolio-related, others not. A user defined monitoring system of reports and alerts may be aided by an independent credit opinion. Investors also should view the money market funds in which they are invested as part of a single portfolio customized to fit their needs.

As companies continue to use money market funds to manage their near-term cash needs, we think money market funds should fit a firm's overall risk management culture. Even with limited organizational and financial resources, treasury organizations should actively consider money market funds as part of a suite of cash investment solutions, not as the only choice. In the uncertain times the industry is facing today, failure to recognize the urgency of proper money market fund due diligence may have adverse consequences, which may include delayed redemptions or, in a worst case scenario, loss of principal.

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