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Staying Afloat in a Floating Net Asset Value Money Market Fund

Managing Liquidity in a Reformed Liquidity Vehicle

Abstract

This commentary addresses a number of liquidity challenges concerning institutional prime money market funds after October 2016. The floating net asset values, the provision of fees and gates and the institutional shareholder syndrome each presents a unique set of challenges. The reformed institutional prime product can remain viable for a certain population of current institutional shareholders, but we suggest a more comprehensive lineup of liquidity vehicles that include government and prime funds as well as individual government and other liquid instruments of laddered maturities.

Introduction

It is fall of 2016. The dust has settled on money market fund reform. Institutional prime money market funds have adopted floating net asset values (NAVs) with optional liquidity fees and gates provisions. Institutional investors demanding NAV and liquidity certainty have eschewed the product for other liquidity options. Will floating NAV funds retain a critical mass to stay afloat as a viable cash management tool? How will fund dynamics be different? For remaining shareholders, what are the liquidity challenges?

Assets in institutional prime funds more than doubled in less than a decade after the start of the new millennium, from $496 billion in 2000 to $1.1 trillion in 2009. For the first six months of 2015, fund balances dropped from $1.0 trillion to $968 billion[1]. For a liquidity product that will undergo dramatic structural changes as prescribed by the 2014 SEC rule amendment, little is known about the liquidity characteristics of the institutional prime fund come October 2016.

Our baseline assumption is that there will be a meaningful core base of corporate cash investors who will continue to use institutional prime funds based on economic, relationship or risk management reasons. In this paper, we will address a few liquidity concerns resulting from the forthcoming changes to institutional prime funds.

First Look – Reasons to Remain Constructive

Assuming that fund sponsors are able to successfully accommodate outflows in the implementation phase, we think that the first few months after October 2016 may be less hectic than one might fear. There are reasons to remain positive on floating NAV funds as viable cash management tools.

[1] Source: iMoneyNet Analyzer historical Domestic Market Share table from total money market fund assets designated as "institutional" and "prime".

NAV Stability: With the SEC allowing fund advisors to "top off" on fund NAVs on Day One, one should expect the funds to start with a rounded $1.0000 NAV from the start. For the first few months at least, fund managers likely will manage their portfolios conservatively to keep the NAVs as close to $1.0000 for as long as possible. Strategies may include shorter portfolio weighted average maturity (WAM) and less use of credit instruments maturing beyond 60 days.

The Federal Reserve's steady and patient approach to interest rate normalization may help dampen, but not eliminate, NAV volatility in a rising rate environment. For a portfolio with a 45-day WAM, each 0.25% increase in the fed funds rate translates into a market value decline of $0.0003 ($1 * 45/365 * 0.25%). To avoid deviation of market-based NAVs (less than $0.00005 with rounding) from $1, the portfolio's WAM will need to be seven days or shorter ($1 * 7/365 * 0.25% = $0.0005). Stated differently, the smaller the fed fund increases, the longer time gaps between increases, and the shorter the portfolio WAM, the less NAV volatility.

Low Risk of Fees and Gates Becoming Reality: Despite the spotlight on potential liquidity fees and gates, the likelihood of such events occurring is quite low. For fees and gates to be triggered, the so-called seven-day liquidity level must be at 10% or less, or about one third of 30% as prescribed by the SEC in 2010. Even at this level, a fund's board of directors still has the discretion to withhold such measure if it is not in the best interest of all shareholders.

We think that, in the initial months after October 2016, funds have the incentive to keep the level of seven-day liquidity well in excess of 30%. As long as a fund's liquidity remains well above 10%, the issue of fees and gates is not a practical matter. In the example of a prime fund with no securities maturing beyond seven days, shareholders may be further assured of not having to worry about this threat, since the goal is to maintain liquidity as defined by the SEC at 100%.

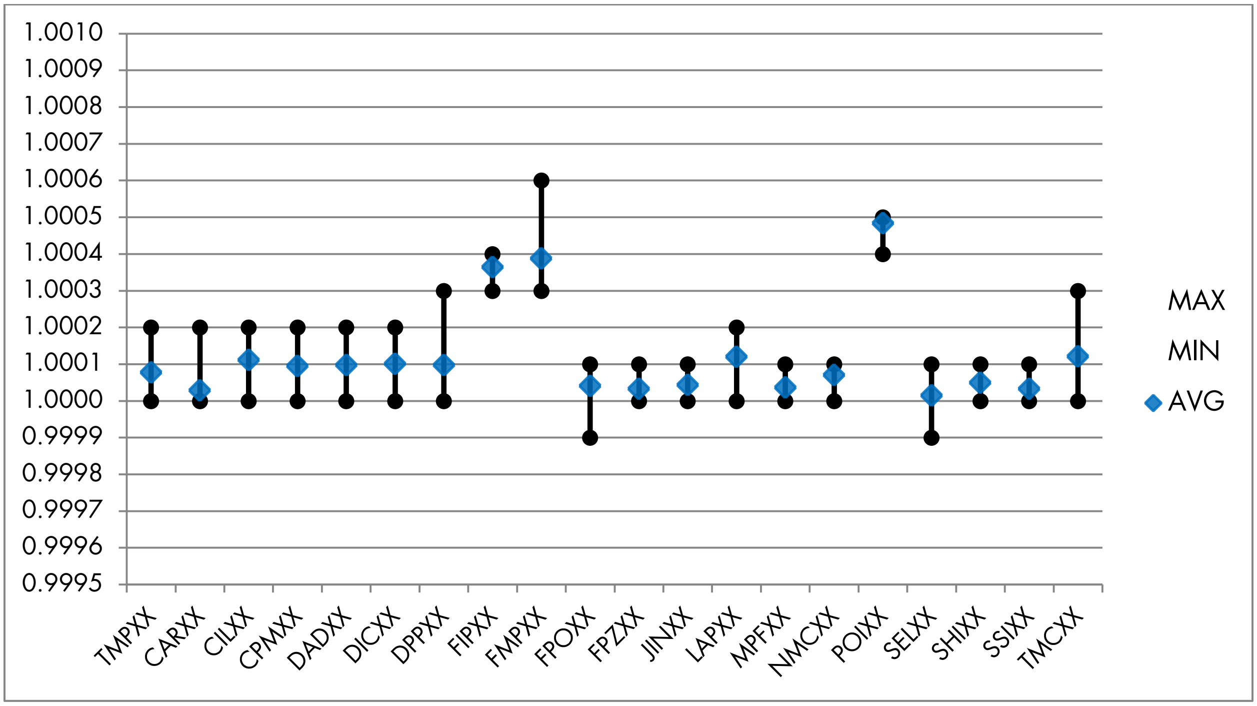
Accounting and Tax Relief: Two important relief measures concerning accounting and tax treatment came with the 2014 SEC rule amendment. First, the SEC will allow floating NAV funds to be treated as cash equivalents. Second, the Treasury Department and the Internal Revenue Service will allow simplified tax reporting by consolidating realized gains and losses within a year as a single net transaction and by exempting fund transactions from the so-called "wash sale" rules in short-term loss calculations. These measures addressed significant industry concerns regarding the operational complexity of implementing the new rules.

In short, shareholders need not worry about a doomsday scenario just yet. Barring major credit or interest rate events, risk limiting features in recent rule amendments have greatly minimized potential NAV volatility. Practically speaking, fees and gates are not a threat as long as funds keep liquidity levels sufficiently high. Although the new rule brings about major operational and technological headaches to service providers, the accounting and tax impact on the end shareholders does not appear onerous.

Managing Intra-Day Liquidity in Floating NAVs

While less desirable than the constant $1 NAV, floating NAVs are not necessarily a deal breaker from an investment viewpoint. As seen in Figure 1, historical market-based NAV data shows that NAVs have rarely deviated by more than $0.0002 per share under normal market conditions. For institutional shareholders, volatility of such magnitude rarely indicates economic significance. The issue is intra-day liquidity.

Figure 1: Market NAVs (2013-2015)



Source: Crane Data and other fund websites

As of this writing, there is no definitive industry answer as to whether floating NAV funds can function as sweep vehicles. As financial transactions happen throughout the day in an investor's account, sweeps automatically move funds to cover expenditures and invest excess balances at the end of a business day at a predicable $1.00 NAV. Without a stable NAV, shareholders may need to sell fund shares on one day and get their cash the next day.

Fund companies are actively working to solve the intra-day liquidity challenge, with proposals ranging from calculating intra-day NAVs twice a day to once per hour. While the technical details of these discussions are beyond our expertise, one may surmise that operational procedures may be too clumsy or costly to be practical.

With this intra-day liquidity challenge in mind, cash investors may need to think of institutional prime funds as de facto next day liquidity (T+1) vehicles much the same as overnight repurchase agreements today. In that regard, transactional deposit accounts and stable NAV government funds may be more suitable for unplanned same-day liquidity.

Managing Seven-Day Liquidity is Job One

With little doubt, institutional investors generally view the "fees and gates" provision as a bigger challenge than floating NAVs, as it cuts to the heart of the utility of money market funds. Although the provision is intended to protect all remaining shareholders, the notion of being denied liquidity when liquidity is most needed is a deal breaker for many treasury professionals. Those who can tolerate this low probability but high impact risk may continue to enjoy potential yield benefits provided by prime funds, as long as they can effectively track and forecast liquidity triggers.

Monitoring & Alerts: Effective October 2016, all prime funds are required to disclose the levels of seven-day liquidity daily. Shareholders should have procedures in place to monitor this key data point. They can look up the figures at the fund companies' websites or through a third-party data portal. There also may be services that allow investors to set automatic alerts based on liquidity levels. Note that 30% is the minimum required by the SEC, but funds are recommended but not required to make the fees and gates decision unless liquidity drops to 10%, when the decision becomes mandatory. Shareholders may set different priority levels of alerts based on liquidity levels, so that they can actively engage fund managers to correct liquidity deficiencies before fees and gates become necessary.

Understanding Liquidity Dynamics: The passive act of monitoring misses the point that liquidity could evaporate quickly due to the unrestricted daily redemption feature in money market funds. Comprehensive understanding of a fund's liquidity dynamics is needed for effective liquidity management. For example, any Treasury debt plus agency debt maturing within 60 days are part of the weekly liquidity figure. They are, however, not cash in a literal sense. In a rising interest rate environment, a fund selling these instruments to raise cash will inadvertently create realized losses, which may lead to NAV erosion. NAV deterioration may encourage more redemption, exacerbating liquidity shortage. Likewise, shareholders may simultaneously decide to redeem shares from funds with low liquidity levels in periods of market volatility, resulting in a self-perpetuating liquidity drain from these funds. Maturity and coupon structure of fund portfolios, shareholder concentration, and managers' ability to forecast liquidity needs also may affect liquidity dynamics.

In summary, a big challenge in an institutional prime fund is to understand its liquidity dynamics. Tracking liquidity levels regularly and frequently is important, but shareholders need to incorporate other important liquidity drivers to form more confident and forward-looking assessments in order to reduce liquidity risk imposed by fees and gates.

Beware of Shared Liquidity – the Institutional Shareholder Symptom

Easily overlooked, the biggest liquidity challenge in an institutional fund may come not from a floating NAV or fees and gates, but the separation of shareholder groups and fund types. High flow volatility and shareholder sophistication may cause institutional prime funds to be less stable or reliable sources of liquidity.

Institutional Designation Implies Faster Money: Attracted by stable NAVs offered by retail prime funds, a meaningful population of institutional prime shareholders, such as retirement savings and wealth management accounts, likely will exit. Remaining shareholders may be represented by cash management accounts with comparatively larger volatility in fund flows and higher sensitivity to liquidity shortages. The integration of fund trading platforms into treasury workstation technology also assists in faster funds transfers with a push of a button. Higher cash flow volatility, profit maximization motives and risk management objectives may subject institutional prime funds to higher run risk.

More Active Shareholders through Self Selection: Institutional shareholders who are extremely risk averse may gravitate towards Treasury or government funds. Those who remain in the prime space may be more risk tolerant, but also more sophisticated in understanding the shared liquidity dynamics and thus more active in managing their fund balances. This self-selection process adds to the characterization of faster money movement in institutional prime funds than in other fund types. When herd mentality and extreme market conditions are combined, active shareholders could lead to undesirable consequences for the funds and exacerbate liquidity situations.

Shared Liquidity Is an Example of Game Theory in Practice: Banks cannot accommodate all depositors who want their money back all at once. The same is true with money market funds. In extreme situations, demand to redeem shares may quickly drain a fund's available liquidity and force it to liquidate holdings to raise cash. While the collective rational thinking is to sit tight and not worsen the liquidity situation, individual rational thinking is exactly the opposite: to limit one's risk, especially if doing so does not have financial penalty. This game theory in practice is exactly what fees and gates are intended to address in protecting all shareholders. Being clear-minded about shared liquidity in a fund of highly sensitive institutional shareholders requires the sensible investor to exercise restraint, diversify sources of liquidity and keep a Plan B handy.

Conclusion - Managing Shared Liquidity in a Portfolio Context

Managing liquidity in a liquidity vehicle seems redundant in terms but is necessary because of scaled-back utility in the institutional prime fund. While it is not clear how well received it will be when the new rule takes effect, we raised related liquidity issues concerning the floating NAV, fees and gates, and the institutional shareholder syndrome. Of the three, we think the institutional shareholder syndrome in the context of a shared liquidity vehicle deserves the most attention.

In light of the challenges discussed thus far, we could foresee a portfolio approach with liquidity instruments that complement each other. The portfolio may consist of stable NAV government funds, floating NAV prime funds, and direct purchases of government and other highly liquid securities. Government fund shares may accommodate unforeseen intraday liquidity needs. Prime fund shares may provide extra yield potential and function as next-day source of liquidity. A laddered portfolio of government and other liquid securities may provide back-up liquidity through maturities or open market sales in the unlikely event of liquidity becoming inaccessible in prime funds. As government securities are expected to become scarcer with rising demand for government money market funds, procuring a sufficient stock of them in the months leading up to October 2016 may be necessary. Additionally, next day liquidity in prime funds could be impacted by the issues mentioned throughout this white paper.

This diversified liquidity approach may be the best compromise since many things remain unknown, including how other institutional shareholders will perceive and accept the reformed prime product, how effective liquidity monitoring tools will be, and whether intra-day liquidity is possible. While we think there may be room and potential for prime funds to belong in cash management accounts, managing liquidity risk through this period of its metamorphosis and beyond demands a lot of attention and caution from all stakeholders.

About Us

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