

Three Challenges for Corporate Cash Investors in 2013

Abstract

We have identified the acceleration of money market fund reform, the scarcity of eligible investments and the threat of negative yield as three challenges facing corporate treasury professionals in 2013. Our recommendation remains the same as found in previous research – consider a separately managed account as a defensive measure against regulatory uncertainty, supply shortage and yield compression.

Introduction

In the January issue of our newsletters, we often discuss major challenges facing corporate cash investors in the upcoming New Year. First, congratulations are in order to all who successfully navigated through another difficult year of low yield, Eurozone credit crisis and regulatory uncertainty. Looking ahead, we find the landscape in 2013 remarkably familiar to the last. Perseverance is a virtue not to be overlooked.

Our 2012 challenges included the expiration of the FDIC's transaction account guarantee (TAG) program, less certainty regarding government support for the Government Sponsored Enterprises (GSEs) and a smaller market for financial issuers. This year, we see the acceleration of money market fund reform, the scarcity of eligible investments and the continuation of a low yield environment as three great challenges. While these subjects may not be entirely new to investors, we think the severity of their impact most likely will escalate in the upcoming year.

We continue to believe the confluence of persistent credit risk, the loss of safe havens and the threat to principal from potential negative yield call for strong in-house cash investment strategies, including separate account management.

Acceleration of Money Market Fund Reform

There never is a dull moment in the world of money market fund reform. Shortly after Securities and Exchange Commission (SEC) Chairman Mary Schapiro called off a critical vote by the agency's commissioners because of a lack of majority support, Treasury Secretary Timothy Geithner sprang to action and persuaded the Financial Stability Oversight Council (FSOC) to issue "proposed recommendations regarding money market mutual fund reform."¹

Public opinion remains divided over the merit of the FSOC proposal, which is similar to the one tabled by Chairman Schapiro. Momentum, nonetheless, seems to be building to have reforms passed in the near future, quite possibly before the end of

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2013. Of the set of alternatives that currently are proposed, floating the net asset value (NAV) appears to be the favored choice of regulators.

For starters, the FSOC probably will recommend the proposal to the SEC, the principal regulator of funds, after a 60-day comment period. By law, the SEC must impose standards similar to the recommendations or explain “in writing to the Council within 90 days why it has determined not to follow.”²

It is interesting that two of the three majority SEC commissioners opposed to Schapiro’s original proposal, Daniel Gallagher and Luis Aguilar, appear to have changed their positions on the floating NAV.³ As reference, floating the \$1.00 NAV has long been considered a “third rail” that many money fund industry participants fear could kill the product.

The SEC staff also released its money market fund study in response to questions posed by the majority commissioners.⁴ The study found that, as a result of the 2010 money market fund reforms, funds generally are more resilient to portfolio losses and investment redemptions than they were in 2008. However, the 2010 reforms would not have prevented a fund from owning Lehman Brothers debt nor would they have prevented the Reserve Primary fund from breaking its \$1.00 NAV back in 2008.⁵ The SEC staff study also provided evidence that a decline in money market demand for issuance may not substantially reduce funding sources for businesses and municipalities.

We believe that any new reforms likely will have a long implementation period, perhaps over several years, and this also is noted in the FSOC proposal. However, it looks increasingly possible that new rules will be here before 2013 comes to an end. The complexities involved with redemption holdbacks and prohibitively high capital buffers may mean that the floating NAV proposal is the most workable solution, whether it is adopted by a regulatory edict or from a reluctant business decision made by fund sponsors.

Money market funds are important to treasury organizations because many have transitioned much of their cash management functions from their internal staff to fund managers. Understandably, neither floating the NAV nor redemption holdbacks would be welcome or acceptable for many such organizations. With the expiration of the FDIC’s TAG program, institutional cash investors must look for alternative tools for liquidity management.

Scarcity of Eligible Investments

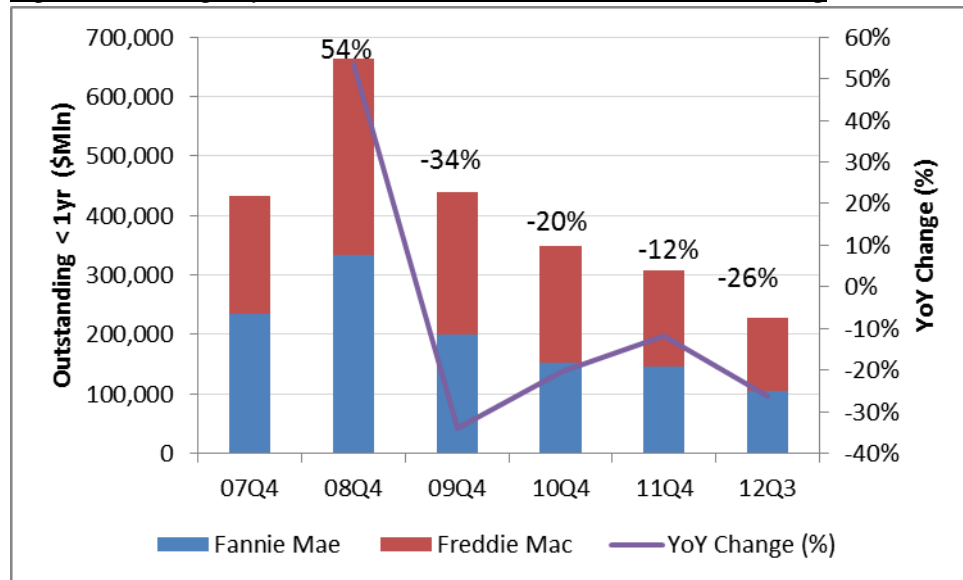
A year ago, we discussed the trend of declining financial institutions debt in the money markets due to the deleveraging of bank and household balance sheets. Despite some promising signs from the Eurozone banking sector, we still see supply scarcity continue because of a number of factors.

First, many financial institutions no longer can issue Top Tier (A-1/P-1) debt to the money markets due to recent credit ratings actions. In 2012, Moody's Investors Service downgraded several hundred banks throughout Europe, North America and the Asia Pacific region due to the worsening Eurozone debt crisis, reduced sovereign credit worthiness, reliance on wholesale funding and the agency's new risk philosophy regarding banks with capital markets operations.⁶

Other rating agencies, such as Standard & Poor's and Fitch Ratings, also took similar ratings actions and, as a result, many of the largest banks in the world, including Citigroup, Bank of America, Morgan Stanley and Royal Bank of Scotland, now have difficulty borrowing directly from money market funds. Eurozone banks with high credit ratings also became more wary of borrowing from money market funds, as fluctuating investor sentiment has turned the funds into a less reliable funding channel.

Another reason behind the scarcity of short-term debt relates to the acceleration of Fannie Mae and Freddie Mac's wind-down. In August 2012, the Treasury Department announced that the two GSEs would reduce their investment portfolios at an annual rate of 15%, up from 10%.⁷ This means that agency discount notes outstanding will shrink more quickly than previously anticipated.

Figure 1: U.S. Agency (Term Less than One Year) Debt Outstanding



Source: US Agency Debt Outstanding as of 11/16/2012, sifma.org.

Figure 1 shows the combined debt outstanding in maturities of less than one year from Fannie Mae and Freddie Mac, and we note that this outstanding debt has declined in each of the last four years. With the Treasury’s decision to further shrink mortgage portfolios, we think that the scarcity of high-quality, short-term debt will become even more severe in 2013 than in previous years.

We also think that the conclusion of the Federal Reserve’s “Operation Twist” open market operations will contribute to the reduction of the supply of short-term Treasury securities. Between September 2011 and December 2012, the Federal Reserve bought \$667 billion of long-maturity Treasury securities while simultaneously selling those maturing in less than three years.⁸ The end of Operation Twist in December 2012 also means the end of a steady supply of short-term Treasuries from the Fed’s balance sheet.

Continuation, and Possible Worsening, of the Low Yield Environment

As we near the fourth anniversary of the Federal Reserve’s zero interest rate policy, there does not seem to be relief in sight for money market investors. In fact, the situation may worsen in 2013, causing short-term yields to once again visit negative territory.

A number of factors may contribute to the persistent low yield environment in 2013. The Federal Reserve decided in December 2012 to peg any eventual increase in the Fed funds rate to a specific unemployment target rate of 6.5%. Compared to its previous

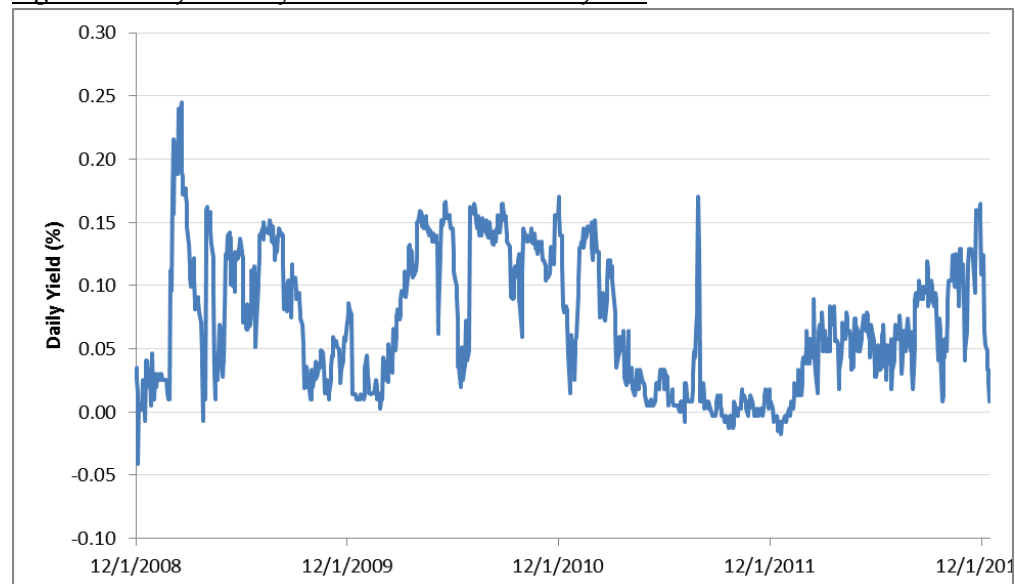
“mid-2015” timeframe, the new language may imply that zero interest rates may extend beyond 2015 if jobs numbers continue to disappoint.

Then, there is the disappearance of eligible investments discussed earlier that may result in more dollars chasing fewer assets, further lowering yield. The expiration of TAG on \$1.7 trillion of non-interest-bearing deposits also could mean that at least a portion of those deposits could become invested in money market funds and direct securities. Estimates of cash flow shifts associated with the TAG expiration range from \$100 billion to \$500 billion. Again, more dollars chasing fewer assets almost certainly means lower yield.

Additionally, the Fed’s open-ended purchases of mortgage and Treasury securities continue to inject \$85 billion of liquidity into the financial system every month. Much of that liquidity injection also may find its way into the cash market, further bringing down yield.

Across the Atlantic, the sovereign debt crisis in the Eurozone and the European Central Bank’s decision to lower deposit rates to zero caused short-term government bond yields in several countries to plunge to negative levels. At least one major Euro-denominated money market fund implemented a new cost structure in which they charge shareholders in zero-yield funds by reducing their shares.⁹ This invites the question: will the U.S. be seeing negative cash yields in the near future?

Figure 2: Daily Yield of the One Month Treasury Bill



Source: Daily closing yield of the generic 1-month Treasury bill, Bloomberg.

For now, Fed officials seem to agree that lowering the rate it pays on excess reserves (currently at 0.25%) to zero may cause more harm than benefit to the markets.¹⁰ However, even without the Fed making a move with respect to deposit rates, we still may face the threat of negative yield in 2013.

Since late 2008, yields on short-term Treasury bills have approached and dipped into negative territory on more than one occasion and almost every instance was related to the worsening of the Eurozone debt crisis. As indicated in [Figure 2](#), short rates again made a recent and sudden downturn.

We can envision a number of scenarios, including a failure to avert the “fiscal cliff,” a new credit event or geopolitical uncertainty, which could cause yields to plummet back into negative territory in 2013. Meanwhile, the Treasury Department continues to study “operational issues” related to possible negative-rate setting at future Treasury auctions.¹¹

Conclusion: Consider Separate Accounts As Defense

We identified the acceleration of money market fund reform, the scarcity of eligible investments and the threat of negative yields as three great challenges for corporate treasury professionals in 2013. This by no means is an exhaustive list nor should items on the list be a surprise to our regular readers. Our recommendation remains the same – consider a separately managed account as a defensive measure against regulatory uncertainty, supply shortage and yield compression.

Customized separate account strategies may allow cash investors to improve risk oversight and they may improve risk diversification by overweighing non-financial debt to counterbalance overexposure in money market funds. Separate account strategies also may help to enhance yield by steering investors away from the overcrowded space of “money market eligible” securities. The combined benefit from customized risk control, liquidity management and yield enhancement may outweigh the added legwork which sometimes is required when implementing a separate account strategy.

¹ See the FSOC proposal dated November 2012 at the Treasury Department website: <http://www.treasury.gov/initiatives/fsoc/Documents/Proposed%20Recommendations%20Regarding%20Money%20Market%20Mutual%20Fund%20Reform%20-%20November%2013,%202012.pdf>

² See End Note 1.

³ Joshua Gallu & Robert Schmidt, SEC's Gallagher calls for floating price for money funds, Bloomberg, September 27, 2012 <http://www.bloomberg.com/news/2012-09-27/sec-s-gallagher-calls-for-floating-price-for-money-market-funds.html>.

Jessica Holzer, SEC's Aguilar warms up to money-fund overhauls, the Wall Street Journal, December 7, 2012

http://professional.wsj.com/article/SB10001424127887324640104578165590981680774.html?mg=r_eno64-wsj

⁴ Division of Risk, Strategy, and Financial Innovation, U.S. Securities and Exchange Commission, Response to questions posted by Commissioners Aguilar, Paredes, and Gallagher, November 30, 2012. <http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf>

⁵ See the Executive Summary referenced in End Note 4.

⁶ Moody's Investors Service, Moody's reviews ratings for European banks, February 15, 2012.

http://www.moodys.com/research/Moodys-Reviews-Ratings-for-European-Banks--PR_237914.

Moody's reviews ratings for banks and securities firms with global capital markets, February 15, 2012. http://www.moodys.com/research/Moodys-Reviews-Ratings-for-Banks-and-Securities-Firms-with-Global--PR_238006.

⁷ See the Treasury Department's press release: Treasury Department announces further steps to expedite wind down of Fannie Mae and Freddie Mac, August 7, 2012.

<http://www.treasury.gov/press-center/press-releases/Pages/tg1684.aspx>

⁸ See the Federal Reserve's "frequently asked questions: what is the Federal Reserve's maturity extension program?" <http://www.federalreserve.gov/monetarypolicy/maturityextensionprogram-faqs.htm>

⁹ Vanessa Robert et al, Credit focus: JPMorgan liquidity funds: launch of share class aims to manage low/negative yields, Moody's Investors Service, November 16, 2012.

http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_147227

¹⁰ Gaetano Antinolfi & Todd Keister, Interest on excess reserves and cash "parked" at the Fed, Federal Reserve Bank of New York, August 27, 2012.

<http://libertystreeteconomics.newyorkfed.org/2012/08/interest-on-excess-reserves-and-cash-parked-at-the-fed.html>

¹¹ Ian Katz, U.S. Treasury says no decision on negative-rate bill auctions, Bloomberg, October 31, 2012.

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