

Grow or Die?

The Debate Continues on the Future of Money Funds

Confession: This eye-catching title is not our invention. It is borrowed from a panel discussion on money market fund distribution strategies held at the Crane Data Money Fund Symposium in Providence, RI in late August. We, however, think it brings out a salient point - growth for growth's sake can be a recipe for disaster. The truism manifested itself when unsustainable growth strategies at certain leading fund companies contributed to the irrational investor behaviors that ultimately resulted in runs on money funds after the Reserve Primary broke the dollar last fall.

On the anniversary of the spectacular events of September 2008, the future of money funds undoubtedly dominates boardroom discussions at many fund companies, especially with the revised SEC 2a-7 regulations on money funds hanging in the balance. We wanted to take this opportunity to reflect on the presentations at the money fund symposium, hosted by Crane Data on August 23rd - 25th, that may influence whether the industry will grow, die, or end up somewhere in between. In the end, we believe it will take a sensible approach and a concerted effort from fund companies, regulators and institutional investors to preserve the sanctity, and ensure the survival, of a product treasured by many.

PAST, PRESENT & FUTURE – YOU ARE WHAT YOU INVEST IN

The portfolio managers' panel discussion caught our attention in tracing the genesis of money funds. One manager reviewed the industry's 40 years of history by the types of investments money funds bought. In the 1970s, fund portfolios consisted primarily of bank deposits and bank notes (94%). At this stage, the funds were lenders to banks, which then lent to business and individuals.

Then the 1980s ushered in innovations such as commercial paper and variable rate products. With commercial paper, which made up 30% of the portfolios, money funds allowed banks to help their most creditworthy business customers to borrow directly in the capital markets. The variable rate debt, which comprised of 15% of money fund portfolios, allowed issuers to pay short-term interest rates on long-term debt. Asset-backed Commercial Paper (ABCP) also was invented in the 1980s, although its popularity didn't rise until later.

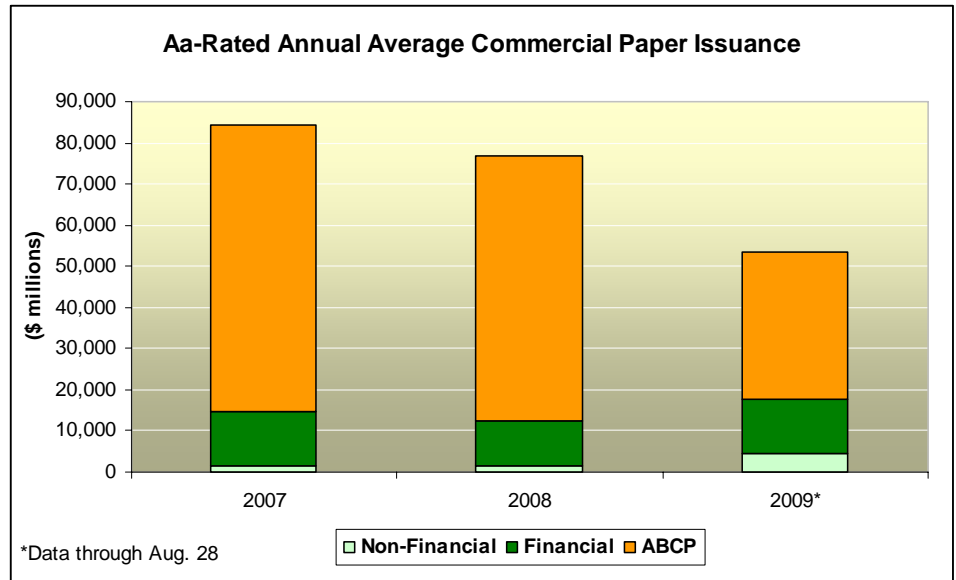
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The 1990s continued with more innovations in financial CP, ABCP and non-traditional repurchase agreements. Towards the end of the decade, issuance of CP debt from industrial firms dwindled. Overtaking it was financial institution CP debt, which eventually became indistinguishable from bank deposits as funding instruments. ABCP programs (15% of fund holdings) also morphed from short-term financing solutions for bank customers to becoming the banks' own off-balance-sheet vehicles for an assortment of bank loans. Repurchase agreements (25%) backed by Treasury obligations traditionally provided overnight funding to broker-dealers. In the late 1990s, they also started to morph with mortgage and corporate loans as collateral and lending terms were extended to as long as a year.

The trajectory of product innovations in the 2000s followed the 1990s, although portfolio holdings after the Reserve Primary debacle started to resemble the nascent stage of the fund industry. The portfolio manager noted that bank paper again became dominant in portfolio holdings at 50%, followed by government repos at 20%. Concentration in financial CP and ABCP dropped off precipitously from the pre-crisis levels.

This walk down memory lane helped us understand the important role of money funds in the credit creation process of the banking industry. The future of the industry, thus, is rooted in the economy's demand for credit and the banking industry's response to that demand. There exists a growing sentiment that the deleveraging of balance sheets at businesses and in households is likely to continue for several more years. This view is supported by the recent reduction of ABCP issuance and the moderation in financial CP.



Source: Federal Reserve

Based on the macro supply of credit, we think the growth of money fund assets is likely to stagnate until the economy can absorb the losses of the previous cycle and credit creation resumes.

SAFETY AND YIELD – AN EQUILIBRIUM COMPLICATED BY THE ZIRP AND SEC RULE CHANGES

Throughout the conference, we felt a clear sense of concern that the future of the industry may be threatened by two things: the Federal Reserve’s zero interest rate policy (ZIRP) and the SEC’s proposed 2a-7 rule amendments. In the current interest rate environment, some funds literally pay zero percent yield, which undoubtedly reduces their attractiveness. The SEC’s proposed changes, especially the impact of stricter liquidity requirements, may result in safer funds, but also would reduce the upside in yield potential.

The delicate balance of paying attractive yield at acceptable risk levels can be a high-wire act for all money managers, but money fund investors’ non-negotiable demand for principal preservation clearly sets the product apart from other investments. Since the recent crisis, investors’ emphasis has shifted from yield to safety. In prime money funds, this means lower concentration in ABCP, floating rate notes and financial CP, resulting in lower yield. With the Fed’s playbook glued to the ZIRP for the foreseeable future, the challenge to achieve asset growth at current yield levels was widely voiced by conference presenters.

Participants further expressed that the proposed SEC rules could further depress the yield potential. Most believed that the SEC's rules on overnight and seven-day liquidity could be the greatest hinderance to yield. One presenter's analysis indicated that to satisfy the requirement of 30% portfolio liquidity within seven days, the maximum attainable weighted average maturity (WAM) of a laddered portfolio would be 26 days, far short of the agency's new mandate of 60 days.

Our assessment of the impact of the ZIRP and SEC rule changes is that money funds, under the revised SEC rules, should continue to provide adequate risk-adjusted yield advantage over bank products and other cash vehicles. In their current format, the rules allow the funds to lend directly to borrowers. The agency also did not impose capital reserves against fund assets. These two factors mean that funds will continue to be competitive with bank products, all else being equal. The challenge is to retain assets long enough for the interest rate environment to return to more normal function. We think the argument for money funds in today's environment should be focused on factors other than yield, such as sweep functions, diversification benefits, and ease of accounting. Some drop-offs in asset size also should be expected given that some recent investors were not core cash management investors, but pension funds, hedge funds, and opportunistic investors that would eventually leave as capital markets improve.

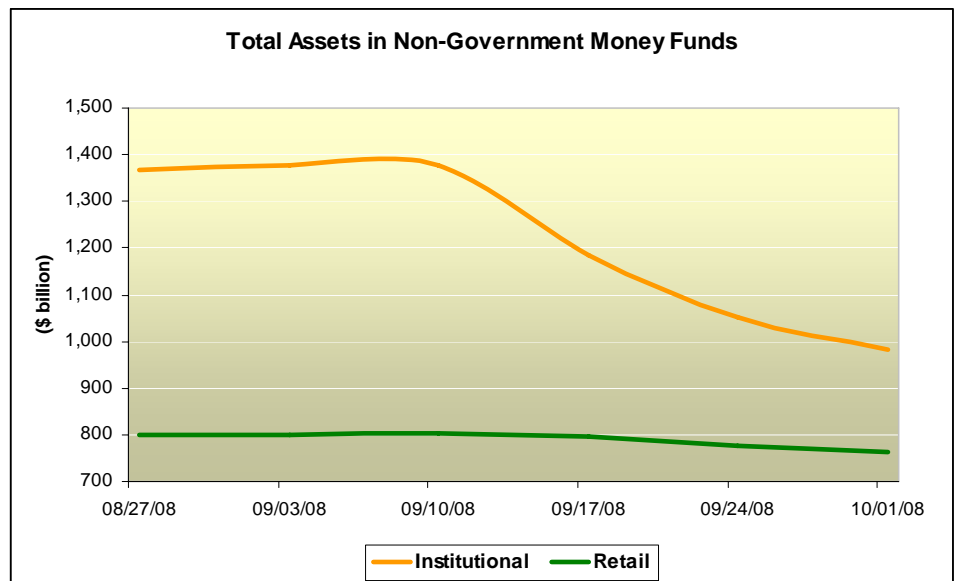
MANAGING THE RUN RISK - THE MOUSETRAP THAT MATTERS

One bit of feedback we consistently heard from conference participants was their new appreciation for managing liquidity risk in money market funds; or more specifically, the issue of run risk.

A seasoned portfolio manager poignantly pointed out that, historically, the main focus of the SEC 2a-7 rule had been the control of interest rate risk and credit risk, not run risk. We concur with this assessment, and believe the oversight was the result of overconfidence in credit ratings and in the short maturities of the underlying securities. We think that the existing 2a-7 rules primarily address the left side of a money fund's balance sheet. The bigger threat, however, lies on the right side, namely the shareholder risk. Setting new rules to address the run risk represents a new direction in the 2a-7 regulation and potentially could improve its protection against such risk.

Robert Plaze, the SEC official in charge of reviewing comment letters to the proposed rules, opened his session with the remark that money funds “essentially lend long and borrow short,” Therefore a key objective of the new rules would be to remove the incentives for investors to race for redemptions at the first sign of trouble. Stress testing the net asset values (NAVs), adopting a floating NAV approach, putting in place procedures for redemptions in kind (RIK) and suspending rapid redemptions were some of the measures being considered by the SEC, but not all are part of the new proposal.

There also was consensus that institutional investors participated in the runs at a much higher rate than retail investors.



Source: Investment Company Institute

The concentration of institutional assets, the use of anonymous fund portals, and institutional investors’ higher sensitivity to credit events may have explained why institutional assets were more volatile. Resolving the issue, however, is no easy task. Recognizing that it is difficult to define and pinpoint “institutional” assets, we feel there needs to be costs associated with different levels of fund availability, so that “retail” and stable asset investors will not be disadvantaged by the actions of “hot money” institutional investors.

We are unequivocal advocates for an external liquidity option as a remedy for run risk, and thus were pleased to find an ally in a lead portfolio manager of a major fund family who proposed one such plan. His proposal, which is in

essence, a Federal Reserve discount window for money market funds, is similar to a solution we've suggested in the past. Given the size of the money fund industry (close to \$4 trillion at its peak), few private external liquidity sources exist that could even begin to address the run risk. The haircut on borrowing and the stigma associated with discount window borrowing from the Fed should address a number of systemic issues related to borrowing from the government.

These run risk issues can also be tied directly to growth. The recent credit crisis showed us that unsustainable growth strategies exacerbated the runs at firms that accumulated assets quickly through riskier investments, aggressive fee waivers and wholesale distribution channels. In fact, the larger a fund was, the more difficult it was to remedy the run risk. The ultimate proof of the size threat was the Federal Reserve's decision to open its balance sheet to lend to the funds after private solutions failed.

MEDICATION OR THE PUBLIC RELATIONS MACHINE – WHAT THE INDUSTRY NEEDS

To conclude, we were struck by the sharp divide between two camps of money market professionals - those who thought that the industry went through a near-death experience and needed some tough medicine to become well again; and those who believed the industry was fundamentally sound and would get back on its feet once the market recovers.

To the former, of which we belong, the task to rebuild investor trust is daunting, especially in the current yield environment. It will take concerted efforts from fund managers, broker-dealers, regulators, service providers and investors to reach a new equilibrium of safety, liquidity, and yield. In the future, the industry may not grow as fast as it once did, and the product may not be as profitable as it once was, but to preserve the longevity of a great product is, in itself, a just reward.

For those who refuse to think that the industry needs major restoration and rehabilitation, we have only one phrase for them - "those who cannot learn from history are doomed to repeat it." Buyers beware.

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