

(MORE) REFLECTIONS ON THE MONEY MARKET FUND DEBACLE: Parallels to Auction-Rate Securities?

EXECUTIVE SUMMARY:

Prior to the recent credit crisis, strong criticism of money market funds taking on too much risk could easily have been dismissed as fear mongering. With strong (but now dubious) triple-A credit ratings, constant \$1 per share prices, daily liquidity, strong brand recognition, and deep-pocketed parents, what was not to like about money funds?

In fact, a large segment of the cash market still agrees with this notion even after recent credit events. The latest ICI industry data shows that money market fund assets grew from some \$2.5 trillion in June 2007 to \$3.1 trillion in December 2007, and again to \$3.4 trillion on April 23. After all, where can one put large sums of cash if not in money funds?

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MONEY MARKET FUND REPORT CARD

If one pauses to think about what money market funds are, it is not difficult to see the irony in the behavior of some cash investors: those worried about troubled financial firms, obscure foreign names, and complicated asset-backed commercial paper choose instead to leave their cash in money funds that invest in exactly the same types of investments these investors have been trying to avoid. Investors who no longer wish to manage cash in-house because of credit risks may think that their money is better managed in the hands of capable institutional money market fund managers. The fair question is how did the money market fund industry do in averting the credit crisis?

In August 2007, several of the largest money market funds began battling their exposure to asset-backed commercial paper (ABCP) and collateralized debt obligations (CDOs) backed by subprime mortgage loans. During this time, most of the top 15 money markets funds tracked by Moody's Investor Services had holdings in structured investment vehicles (SIVs) that faced the risk of credit downgrades, liquidation, and default. By our own count, at least 17 fund sponsors absorbed the losses related to these securities themselves in order to shore up confidence in their money funds. By any measure, this is not what one would consider a great report card. If corporate treasurers are relying on money funds to diversify their credit risk, then the recent actions of the fund industry have likely provided little assurance.

THE AUCTION-RATE SECURITIES MARKET PARALLEL

With the failed auctions debacle fresh in our memory, let's think for a moment about what parallels we can draw to the money funds. Note that auction-rate securities (ARS) are not money-market eligible investments, so money market funds do not hold these investments.

Systemic Risk: Remember that not too long ago many investors were bombarded by brokerage representatives who claimed that there never had been a failed auction or that the dealers would not let an auction fail. The tune from money market fund representatives that no fund family will likely let a money market fund break the buck sounds eerily familiar. On both counts, the proponents fail to point out that the systemic risk of these investments may be beyond their sponsors' willingness or ability to lend support.

When a few auctions began to fail in August 2007, major broker-dealers stepped up their bidding to prevent additional failed auctions. In fact, Merrill Lynch, UBS, and Citigroup

took into their own inventory \$18 billion, \$11 billion and \$8 billion, respectively, in par value of auction-rates, according to company documents released in early 2008. Relative to the \$330 billion market, these sand bags could not hold back the tidal wave that was coming. As more people lost confidence in the auctions and stepped away from the auction market, the tide turned and eventually morphed into the classic “bank-run” situation and dealers could not support the auctions.

For money market funds, SEC rule 2a-7 helps to limit credit risk and reduce the likelihood of a bank-run scenario, but it may have little effect on investor behavior, which can be influenced by negative news headlines. A large unexpected withdrawal from a money market fund can force the fund manager to sell securities to satisfy redemptions. Potential losses from such security sales can cause the fund’s price to drop below \$0.995, at which point its price would round down to \$.99, not \$1.00. The systemic risk here is that news of a poorly managed fund about to break the buck may cause investors in other money market funds to request redemptions. This is where same-day liquidity may become a double-edged sword to fund investors.

Another factor that may contribute to the systemic risk of money market funds is the growth and concentration of large money market funds. According to Crane Data, total assets in the 10 largest taxable money funds (\$547 billion as of March 2008) accounted for 29% of all taxable fund assets. The sheer size of some of the large funds, a positive liquidity consideration under normal market conditions, may pose a risk to market liquidity if they are to sell even small percentages of their holdings to raise cash.

Sponsor Risk: While we consider the strength of a financial sponsor to be an important factor in investor confidence, we think the support becomes less effective when a problem goes beyond the idiosyncratic risk of an isolated investment or is limited to one fund.

Money market funds’ large sizes also make it more difficult for sponsors to lend any significant credit or liquidity support without triggering serious regulatory challenges to their other fiduciary responsibilities. Although we welcomed the moves by major banks to purchase the troubled SIV investments from money funds, we think the assumption that these financial sponsors will always pick up the tab is ill advised. The decision by major auction dealers to stop supporting their auctions in February 2008 should serve as a reminder that all investments should be evaluated based on their own merit, not on uncommitted external support.

An interesting trend that emerged recently also deserves notice. While many money funds sponsored by strong, highly-rated banks and broker-dealers received credit support, several funds run by independent fund families did not have investments in SIVs or CDOs that required “bailouts”. Is it possible that the presence of a strong financial parent encouraged more risk taking - a phenomenon known as moral hazard? We think that industry practitioners should think critically about the fact that fund sponsorship may invite, rather than discourage, risk taking.

MORE REFLECTIONS

Let's now turn our attention to the current market environment. As the SIV crisis winds down, as bond insurers temporarily avert ratings downgrades, and as major financial firms shore up depleted capital, we think the risk of a bank-run scenario has subsided somewhat. However, the U.S. economy is by no means out of the woods, which means credit issues will continue to plague names owned by money market funds. Evolving credit cycles in other developed markets also will have a strong impact on non-U.S. financial issuers. Distressed student loan pools are finding their way into ABCP programs. Active proposals are in the works for money funds to buy restructured auction-rate securities. In short, there are still plenty of risks for investors of money market funds, and corporate cash investors should be selective in their fund choices.

In our November 2007 newsletter, we proposed an alternative to money market funds in the current credit environment. We submitted that investors may benefit from separately managed cash accounts that include tailored risk management, transparency of holdings and flexible yield strategies. Separately managed accounts are also free from "hot money." Establishing a separate account relationship takes more steps than a mere mouse click on a money market fund portal, but investments in time and research may bring just rewards in these times of uncertainty. We invite you to read more on this topic in our November newsletter.

In summary, the safety and convenience of institutional money market funds have brought so many benefits to corporate treasury functions that life without money funds is unimaginable. Fund investing, however, has drawbacks that have been brought to the surface by the recent credit turmoil. **Treasury professionals must be aware of the risks of money funds and treat them as credit investments, not as commodities differentiated only by yield.** Credit diversification may not remedy systemic risk such as that which recently occurred in the auction-rate securities market.

In the end, money market funds should be an important part of a treasury portfolio, but for the portion that does not require immediate liquidity, investors should consider having more control of their cash by investing in individual securities that are consistent with their own risk and return objectives, not those mandated by money funds.

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