The Top Three Risks in Money Fund Investing…
And How to Reduce Them

EXECUTIVE SUMMARY:

A. Recent market turmoil uncovered rising systemic risks among money market funds:
- Regulatory rules failed to adequately address investment risks
- Defending the constant $1 share value became more difficult
- Money funds as commingled vehicles have inherent drawbacks

B. Key factors in money market fund selections:
- Focus on the wherewithal of the funds' sponsors
- Shun funds overly exposed to derivatives and illiquid securities
- Focus on long-term fund performance
- Look beyond fund credit ratings

C. Decisions in the real world
- Risk of investing in Treasury money funds has increased
- Investors must be vigilant in money fund due diligence as in other investments
- Combining money fund and separate account investing may be prudent risk management

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INTRODUCTION

In early spring of 2008 we witnessed corporate treasurers stampede toward prime money market funds in the midst of accelerating credit concerns. Then, in May 2008, we issued a research paper mentioning that some funds, long proclaimed to be safe and stable investment vehicles, may not, in fact, live up to such a reputation. The premise was that the money fund industry was then (and remains today) rife with systemic risks not unlike that of the auction rate securities market.

The bankruptcy filings of Lehman Brothers and the resulting "buck-breaking" event of the Reserve Primary Fund kicked off a wave of swaps by cash investors from prime money funds to government funds and insured bank deposits. Prime funds saw a staggering outflow of $320 billion in the first four days after the Lehman bankruptcy alone. Investor retrenchment from prime funds, in turn, effectively shut down the commercial paper market and led to the unconventional liquidity measures by the Federal Reserve Board to prop up money markets.

What are the systemic risks in money funds? What are the factors that caused the mass reversal of public confidence? Are there risks present in the post-Treasury guarantee period? How does an institutional cash investor dissect the myriad of money fund offerings? Is investing in money funds really safe? What are the other viable options? Many of these questions are not only valid, but crucial for stakeholders in today's environment.

1. FUND ASSETS - STRUCTURAL DEFICIENCIES IN INVESTMENT QUALIFICATIONS

Money market funds were created with a noble goal in mind –low risk, yield-enhancing alternatives to bank savings accounts at a constant one dollar ($1.00) share price. Rule 2a-7 of the Investment Company Act of 1940, the main governing body of law for money funds, and the Securities and Exchange Commission, the main enforcement agency of money funds, aim to safeguard investors' interests by limiting certain credit and interest rate risks that may lead to large share value fluctuations. Those safeguards, however, became less effective when "innovative" structured securities were developed that circumvented the rules that were meant protect investors' interests.

Reliance on Short-term Ratings: Rule 2a-7 stipulates that the majority (typically 95%) of eligible securities in a regulated money fund must receive "top-tier" short-term credit ratings from major credit rating agencies (e.g. A-1 from Standard & Poor's, P-1 from Moody's Investor Services). This top-tier ratings category covers a wide spectrum of credit worthiness that does not adequately address the gradual decline of an asset's credit quality. For example, a P-1 Moody's short-term rating corresponds to seven steps of long-term credit ratings including Aaa, Aa1, Aa2, Aa3, A1, A2 and A3. The long-term ratings provide investors with up to six "warnings" to get out, while the short-term ratings do not provide such signaling.

Heavy Concentration in Financial Issuers: Rule 2a-7 sets a 5% concentration limit on individual non-government issuers, but it places no limit on the total amount a fund may own in securities issued, guaranteed, or supported by financial institutions. Since financial firms are more heavily levered, and inherently riskier, an explicit concentration limit to the whole sector may be appropriate. Furthermore, structural arrangements often mask the economic exposure to a single financial firm beyond the 5% concentration. For example, if a bank supports five asset-backed commercial paper (ABCP) programs, a regulated fund may purchase up to 5% of each of the programs bringing the effective exposure to the firm to 25%. It was no surprise that money funds felt the brunt of the credit assault as a result of their association with various financial issuers. The need for some risk rationing to financial issuers may be in order.

Lack of Provisions Against Structural Risk: Recognizing the explicit restrictions on ratings, issuer concentration, and the 397-day maximum maturity mandated by Rule 2a-7, Wall Street has a long history of "engineering" an array of otherwise ineligible securities specifically for money funds. One such instance was the creation of a commercial paper (CP) program to "warehouse" subprime mortgage loans before a bank sold them to other investors in bulk. Another was an extension program created to allow an issuer of a "nominal" five-year corporate note to roll over maturity each month. Yet another was a CP program that allows a distressed issuer to hold on to the money beyond the stated maturity date. Without delving into the specifics of these programs, in each instance, investors were exposed to an adverse event that triggered negative event shock and shareholder flight. In highly confidence-dependent products like the money funds, it seems odd that neither the rating agencies nor Rule 2a-7 enacted special provisions against such shock-prone deficiencies.

2. FUND LIABILITIES - HERCULEAN CHALLENGES TO PREVENT A FUND RUN

Money fund due diligence is not a recent phenomenon, but most investors' attention historically has focused on the left side of a fund's balance sheet – the underlying investment risk. What some investors and industry pundits overlooked, and continue to overlook, may be the right side of the balance sheet – the shareholder risk. As we learned from the Reserve Government Fund and the Putnam Prime Institutional Fund, neither of which were exposed to distressed credits at the time, investor flight may not necessarily be caused by actual credit exposure. While fund managers struggled for decades to anticipate shareholder redemptions in poor market environments, the recent success of mega fund mergers, increased popularity with institutional investors and the proliferation of portal technology only exacerbated the run risk.

Artificial Constant Dollar Value: To accommodate the funds' commitment to the constant $1.00 share value, a special exemption in Rule 2a-7 allows money funds to use the "amortized costs", rather than market values, of underlying securities to calculate the funds' share values. The method is based on a security's purchase price, adjusted for the daily income it earns, to arrive at an "artificial" price immune from the daily market price fluctuations. The caveat is that when an asset is deemed permanently impaired, such as in a payment default, its depressed market price may cause the share value of the fund to suddenly drop below $1. Such was the case with the Reserve Primary Fund when it valued its Lehman holdings as worthless on September 16. Although it is customary for funds to calculate "shadow" share prices that reflect market prices of securities, such figures are never disclosed to shareholders. The inability to know a fund's true share value contributes to investor speculation and unpredictable shareholder activity in volatile markets.

Reduced Market Liquidity from Fund Consolidations: The conventional thinking has been that larger funds generally offer superior liquidity to fund investors. However, in reality, recent mergers of financial institutions resulted in the rise of mega money fund families that actually reduced market liquidity. By some measures, the top 10 families comprised over 70% of the money fund industry assets. Since the onset of the current crisis a year ago, the lack of market liquidity has made it increasingly difficult for these funds to sell securities to satisfy investor redemptions. This was due to the majority of the market securities being held by the same small number of very large funds who tended to need liquidity at the same time. Even a small position that a very large fund needs to dispose of may place tremendous pricing pressure on that security that could result in a chain reaction that causes other funds to follow suit. It was, therefore, not surprising that when The Primary Fund, one of the largest in the industry, needed to sell close to 50% of its positions on September 16, market liquidity evaporated regardless of the credit quality of the securities.

The Rise of the Institutional Investor: The significant marketing success of money funds to institutional investors may have also introduced a hidden threat to their stability. Individual retail investors tend to view money funds as savings vehicles similar to bank deposits, and therefore, often keep relatively stable fund balances. In recent years, in order to cater to large corporate and institutional accounts, fund families began to create special niche classes with lower fees, later cut-off times, and more lenient withdrawal procedures. Shareholder risk thus increased as the investor makeup evolved from a large number of smaller investors to a small number of large investors. When the risk of a run on a fund starts to develop, it becomes more difficult to manage shareholder redemption when several "heavyweights" decide to exit en masse.

The Popularity of the Fund Portal: As with many technological innovations, fund portals can be a double-edged sword. While most fund families publicly denounce "hot money (large investors using portals to hop in and out of funds at lightening speed)," competitive reasons have led some fund families to actually waive fees, court fund portals and grow assets aggressively to achieve a critical mass. And, since fund portals were, in fact, designed specifically for large investors, the combination of these investors with fund portals could lead to some funds seeing unexpected large redemptions with little or no advance notice. Anonymity in shareholder redemptions also reduces the effectiveness of the funds' sales forces that had been effective in facilitating fund flows in the past. Since we could not independently verify through what channels the prime money funds lost $320 billion in four days, we suspect that portals played a meaningful role in the process.

3. SHORTCOMINGS OF COMMINGLED INVESTMENT STRATEGIES

Much evidence exists that speaks to the advantages of commingled investment strategies, money market funds included. Such advantages include professional asset management, reduced expenses, and daily liquidity access. Regrettably, the recent credit crisis also exposed the shortcomings of commingled vehicles. In December 2007, the $14 billion Florida Local Government Investment Pool (LGIP) was frozen due to investments in structured investment vehicles (SIVs). After money market fund freezes in the Reserve, Putnam and Utendahl funds last September, the $9.3 billion Commonfund Short Term Fund (STF) closed, forcing more than 1,000 colleges and other educational institutions to lose daily access to their operating cash.

In an article in our November 2007 newsletter "Reflecting on the 2007 Money Fund Debacle," we provided a list of shortcomings with commingled vehicles that may be remedied by direct investments made in-house or through separate account management. In addition to being susceptible to "hot money," fund runs and freezes, commingled vehicles present risk management challenges, including the lack of transparency of investment holdings and investors' inability to influence risk decisions made by fund managers.

Lack of transparency of holdings: Prior to the recent crisis, money funds were required to disclose investment holdings twice a year, although some funds reported supplemental holdings quarterly. The latest rapid-fire credit events forced many funds to disclose holdings monthly or more often to "clear up" their exposures, or the lack thereof. However, rarely would a fund make available its daily holdings to investors. The lag in disclosure and its infrequency may shield a fund's intra-month activities from investors' view and may allow a fund sponsor to "clean up" the fund before showing it to the public. Investor inquiries are often hindered by Regulation Fair Disclosure (Reg FD) that prevents fund families from selectively disclosing holdings to certain investors over others. This compares to a separately managed account where an investor may demand an-up-to-the minute review of holdings.

Inability over Funds' Risk Practices: Money fund portfolios are often complex investment portfolios with hundreds of securities and dozens of daily transactions. It is impossible and impractical for an individual investor to exert control over what securities to buy and which transactions are allowed in a fund. It is not uncommon for an investor with a conservative investment policy to be in a fund in which the risk profile is inconsistent with such a policy. While it may be difficult to force conformity of a large money fund to the policies of thousands of its shareholders, such an issue may be addressed by maintaining a portion of a cash portfolio in money funds adequate for on-demand liquidity. The rest may be in separate accounts invested in accordance with the investors' particular risk parameters in mind.

DIGGING THROUGH THE MONEY FUND HAYSTACK

The Treasury Department's temporary money fund guarantee program and the multiple Federal Reserve liquidity facilities have been successful in reducing the risk of large scale runs on prime funds for the time being. Meanwhile, Treasury funds saw sudden and large inflows that forced the funds to purchase Treasury securities at extremely low, even occasionally negative, yield levels that may serve to threaten the constant share price in those funds. How does an institutional cash investor sift through a myriad of money fund offerings in picking funds less susceptible to runs or freezes? In our June 2006 paper "How Safe Are Money Market Funds," we highlighted some of the most important fund selection criteria. Let's review them in today's context.

The Wherewithal of Fund Sponsors: We advocated that investors choose funds associated with strong financial parents that may be able to provide credit and liquidity support to avoid reputational risk. Shareholder activities since the Lehman bankruptcy show a strong correlation of large redemptions at funds associated with vulnerable financial firms and notable inflows at funds managed by subsidiaries of "white knights" (e.g. Bank of America, JPMorgan Chase) and survivors (e.g. USBancorp, Wells Fargo). Even though some of the funds benefiting from the inflows did not escape all of the credit "bombs", strong liquidity support from their parents by way of the Federal Reserve proved to be the single most important stabilizing factor.

Use of Derivatives and Illiquid Securities: Money funds that stumbled in August 2007 were exposed to extendible CP programs issued by mortgage companies. Later in 2007, SIVs were causing havoc in many prominent funds. Soon after, ABCPs and tender option bonds (TOBs) fell victim to the credit crisis. All of these previously popular money market securities have derivative qualities and are less liquid than plain vanilla short-term government and corporate debt. On the other hand, funds that managed to avoid or lessened such exposures tended to fair better in the aftermath. The old rule of thumb never ceases to make sense: “If you don’t know them, you don’t own them.”

Long-Term Fund Performance: Our 2006 research made an explicit point that picking a money fund based purely on the highest current yield generally is not good practice. In fact, the highest yielding money fund is almost *never* the right choice, since a fund with an outsized yield advantage over its peers may have taken on undue risk. Some funds were growing aggressively for growth’s sake. In retrospect, some of the funds that experienced the most outflows were the same ones offering the highest yields just prior to the credit crisis. This is also where fund portals may fail to protect investors who use yield as the primary selection criterion.

Beyond Fund Ratings: Money fund credit ratings exist for a practical reason so that certain regulated investors are allowed to invest in money funds and satisfy their regulatory requirements. Unfortunately, ratings did not offer investors meaningful insight as to money funds’ underlying risks. We pointed out in our April 2006 research that, out of the 165 U.S. funds rated by Moody’s all but two were rated Aaa at the time. On September 19, 2008, Moody’s downgraded a Utendahl money fund 10 notches from Aaa to B ***after*** the fund halted redemptions. This example shows that ratings may not be a good fund selection criterion.

FUND DECISIONS IN THE REAL WORLD

In a perfect world, money funds would hold only risk free securities, be available on demand, avoid all risks of runs and freezes, and offer competitive yield opportunities. Short of these utopian ideals, cash investors and treasurers must make prudent decisions that balance their goals of capital preservation, liquidity and return.

Caution on Treasury Money Funds: While we appreciate investors’ desire to be in Treasury money market funds today, as Capital Advisors Group currently recommends such a fund, this crowded space is not without its risk. Credit events can push Treasury yields down dramatically to the point that a fund’s expenses surpass its income. Recent Federal Reserve actions to lower the key Federal Funds Rate to 1% only increased such risk. Treasury securities purchased at extremely low yield levels also may lose value sharply when credit markets quickly return to normal. Such value depreciation may be exacerbated if investors run, en masse, in the opposite direction out of Treasury funds toward prime funds. We believe, therefore, that staying in treasury money funds without considering the market conditions is not a long-term solution.

Vigilance in Fund Investing: We further believe that risk analysis on money funds is as crucial as that on any other credit investments, perhaps even more so because assets in money funds often represent the most liquid and largest single portion of a cash portfolio. Overconfidence in fund managers' ability to manage risk resulted in regrettable results in some funds. Ongoing portfolio due diligence and constant dialog with fund management will be key risk management tools going forward.

Best of Both Worlds: For all the issues and potential risks we see in money fund investing, daily liquidity is an important benefit that cannot be overlooked. We believe that institutional funds as sweep vehicles remain very viable cash management tools. We do think, however, investors should actively consider taking risk management matters into their own hands by investing a portion of their portfolios themselves, either through an in-house staff or engaging outside managers in a separate account mandate. The heightened sensitivity to cash investment risks may elevate such a decision to the level of board governance. We believe that maintaining a proper balance between sufficient money fund due diligence and adequate direct risk control on the underlying securities is the most prudent risk management practice.