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MARKET Commentary

Money Market Reform

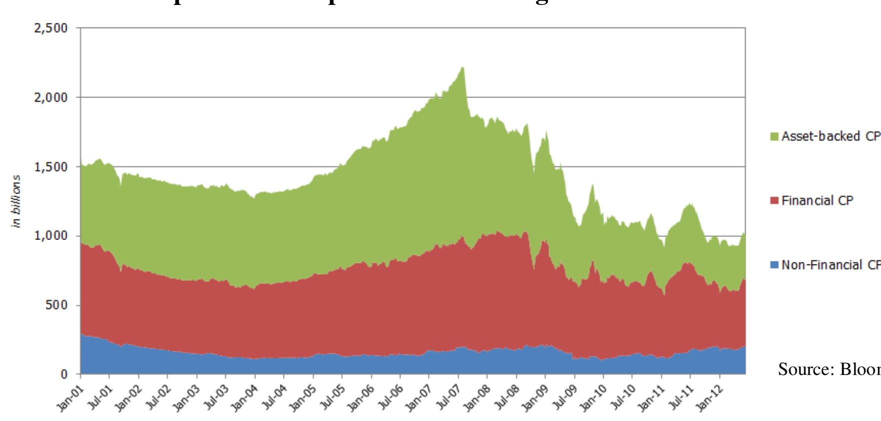
In the coming months, the money market fund (MMF) industry will likely face its toughest challenge in its already tumultuous history. SEC Chairman Mary Shapiro has shown a stout determination to revamp what she and many others consider the flawed structure of the MMF. The intended goal of Chairman Shapiro's efforts is to institute additional safeguards to protect fund investors and to prevent future industry turmoil from crippling the broader financial system as it once did in 2008. While the goal is commendable, Chairman Shapiro's efforts have been met with strong resistance. Prominent industry groups and investors contend that additional regulation in the MMF industry is unnecessary and could result in the decimation of a key source of funding and liquidity for millions of money market participants. Indeed, polls conducted by these groups indicate that several of the proposed reforms—such as mandatory holding periods, capital buffers and floating net asset fund values—would lead investors to seek alternative investment options.

Concern over the fate of the MMF, which once sat comfortably in the back of the mind of corporate practitioners, will soon be thrown very publicly into the forefront. As such, corporate practitioners should begin to formulate a plan to respond to potential changes that could potentially affect their investment strategy, funding requirements and liquidity profile.

A Brief History of Money Market Reform

In 2007, we composed a white paper outlining the flaws inherent in the MMF structure. Our report, "How Money Market Funds Fail," addressed the several ways—"breaking the buck," forced liquidation, parent company bailouts, frozen investments, investment policy breeches—that money market funds could fail their investors. The Credit Crisis of 2008 showed not only how each of these flaws can be exposed in a very short period of time, but also how a rapid loss of confidence in one fund or fund family can lead to a run on the entire asset class. Few imagined that a credit event at a single financial institution, Lehman Brothers, could cripple the $3.5 trillion money fund industry in a matter of days. After four years, it appears that many investors have forgotten—whether by choice or complacency—that it did.

Figure 1: Growth in Commercial Paper Borrowings by Foreign and Domestic Corporations Helped to Fuel MMF growth in the Previous Decade



Source: Bloomberg

June 2012

US Treasuries

As of 31-May

Benchmark	Yield
3 Month	0.07%
6 Month	0.12%
1 Year	0.18%
2 Year	0.26%
5 Year	0.66%
10 Year	1.56%
30 Year	2.63%

Bank of America/Merrill Lynch Indexes

30-Apr to 31-May

Index	Return
1-3 Yr Gov/Corp ≥ A	0.01%
1-3 Yr Municipals	0.07%
1-3 Yr Agencies	0.02%
0-3 Month UST	0.01%
S&P 500	-6.01%

Contact Us

www.ClearwaterAdvisors.com

Trading@ClearwaterAdvisors.com

Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan, The Economist, S&P and Center on Budget and Policy Priorities, Wall Street Journal

As a large lender of short-term credit to corporate borrowers, MMFs have a symbiotic relationship with money market borrowers and poses a systemic risk to financial markets that warrants additional regulation. The rapid growth of the MMF industry in the last decade was fueled by easy credit and the growth of short-term borrowing by domestic and foreign corporations. This "shadow banking system," where billions of dollars of lending and borrowing occurs daily, is not subject to the same amount of scrutiny and regulation as other institutions which the structure of the MMF closely resembles (i.e. depository institutions). While the structure of a MMF may resemble that of a bank, MMFs do not enjoy some of the key safeguards banks employ, such as deposit insurance or capital requirements, a fact which makes MMFs inherently more risky than they are marketed to clients.

When MMF investors ran for the exit en masse following the news that the Reserve Fund had "broken the buck," these investors inadvertently removed a key source of short-term liquidity for hundreds of corporate money market borrowers. The Federal Reserve, FDIC and Treasury were then forced to undertake a series of unprecedented steps to protect MMF investors and the integrity of the entire financial system. The Asset-backed Commercial Paper Money Market Mutual Fund Liquidity Facility, Money Market Investor Funding Facility, Commercial Paper Funding Facility, explicit MMF guarantees, and the Temporary Liquidity Guarantee Program which introduced both FDIC insurance on non-interest bearing accounts and FDIC-guaranteed debt of financial institutions, were just a few of the programs introduced to stabilize the short-term funding markets. In the darkest hours of the Credit Crisis of 2008, funds directly committed to bail out the MMF industry totaled over $1 trillion.

Figure 2: Government Rescue Programs Prevented the Total Collapse of the MMF Industry

Program	Description	Funds Committed
Asset-backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF)	Eligible borrowers may borrow funds from the AMLF in order to fund the purchase of eligible ABCP from a money market mutual fund (MMMF) under certain conditions.	$145 billion
Commercial Paper Funding Facility (CPFF)	The purpose of the CPFF is to enhance the liquidity of the commercial paper market by increasing the availability of term commercial paper funding to issuers and by providing greater assurance to both issuers and investors that firms will be able to roll over their maturing commercial paper.	$350 billion
Money Market Fund Guarantees	Guarantees investors on losses from money market funds. Participating funds pay a fee to qualify. The lesser balance of current balances or program.	Guarantees on $3.8 trillion of money fund assets
Temporary Liquidity Guarantee Program (TLGP)	The FDIC has created this program to strengthen confidence and encourage liquidity in the banking system by guaranteeing newly issued senior unsecured debt of banks, thrifts, and certain holding companies, and by providing full coverage of non-interest bearing deposit transaction accounts, regardless of dollar amount.	Guarantees on $360 billion of debt issued by various financial institutions, and all non-interest bearing transaction accounts
Money Market Investor Funding Facility (MMIFF)	The Money Market Investor Funding Facility (MMIFF) was designed to provide liquidity to U.S. money market investors. Under the MMIFF, the Federal Reserve Bank of New York could provide senior secured funding to a series of special-purpose vehicles to facilitate an industry-supported private-sector initiative to finance the purchase of eligible assets from eligible investors.	$540 billion

Source: Federal Reserve, Treasury, FDIC

The findings of Congressional post-crisis commissions indicate that the Reserve Fund was not an isolated event, and without bold actions on the part of policy makers, many more funds would have likely failed. In conjunction with the commission's findings, Moody's reported that 62 MMFs (including 30 of the 100 largest MMFs) needed extraordinary parental support in addition to a government bailout to avoid the same fate as the Reserve Fund following the Lehman default. The parental support may have provided the defibrillating shock to bring the industry back from death, but it was the $1 trillion government bailout that provided the crucial life support that kept the industry alive as market conditions continued to deteriorate. Many of these same MMFs, however, dubiously credit their survival during this trying time to their superior risk management practices, parental sponsorship, capital position or liquidity management. This revisionist history serves as the basis for the arguments currently used against the need for further industry regulation.

Money Market Fund Reform I & II

In the public uproar for stricter regulations of MMFs following the industry crisis in 2008, the SEC implemented several reforms to enhance the safety of MMFs and protect fund investors more fully. These reforms included higher liquidity requirements, limits on concentrations of lower-grade credit, required reporting on a delayed basis of a MMF's shadow NAV, and additional provisions for orderly fund liquidation in the case of a fund "breaking the buck." These reforms were a step in the right direction, but fell short in addressing the structural issues that make MMFs inherently risky investments.

The SEC has now embarked on a second round of MMF reform to finish what they started in 2010. Among the prominent proposals is a mandatory holding period for fund withdrawals, a required capital buffer to protect investors against unforeseen losses, and a floating net asset value to better reflect the true economic picture of a fund's underlying assets.

We view the required holding period as decidedly negative for MMF investors, and the capital buffer as decidedly positive. Preventing investors from withdrawing funds on-demand defeats the very purpose of utilizing MMFs as a vehicle for short-term liquidity. We feel investors would be better served utilizing alternative investment vehicles where they would have complete control over their invested funds. A capital buffer would reduce the attractiveness of an MMF as an investment vehicle, but provide an extra layer of protection against unforeseen credit events. In the hierarchy of importance, we feel investors place a greater emphasis on the safety of their cash over yield. In this light, a capital buffer is simply another cost investors will be forced to accept to maintain the preservation of their capital.

Figure 3: Rundown of SEC Proposed Changes with Likely Reaction from MMF Holders

Proposed Change	Description	Reaction
Holding Period	Investors who wish to liquidate entire holdings would only receive 95-97% of cash immediately and the rest in 30 days.	The holdback has the most negative perspective from money fund companies and investors. According to AFP, over 90% of current money fund holders would no longer use money funds if the hold-back provision is passed. ICD did a survey of clients using money funds and 88% of respondents would not invest in money funds due to holdback provision.
Capital Buffer	Money funds would be required to hold between 1-3% minimum in capital.	By far the least negative perception by practitioners. Only 46% of respondents to ICD survey say they will pull money fund investments due to capital buffers.
Floating NAV	Elimination of the $1 NAV would require fund companies to report the true asset values of the portfolio.	Investors are concerned with how the changes will affect how they account for money funds. Most practitioners agree that this adds to fund transparency. 80% of money fund holders will pull their holdings due to floating NAV.

Source: AFP, Wall Street Journal, Barclays, Clearwater Advisors

Of the three main proposals, the floating net asset value is the one that seems to get the most attention; it is also the most misunderstood. The stable net asset value (NAV) has been the hallmark of the MMF since its inception in 1971. MMFs seek to maintain a stable NAV for investors, allowing for convenience in accounting and the perception of preservation of capital. The way that MMFs accomplish this is through the use of amortized-cost accounting, an accounting method that ignores the impact of market fluctuations on asset prices and fails to paint a true economic picture of the underlying fund collateral.

The fallacy of the stable NAV is the primary reason why MMFs continue to be susceptible to runs. In a simple example, let's construct an MMF with two investors and one underlying security, a 3-month T-Bill, comprising the fund NAV. Both investors bought into the fund at the same time and each investor represents 50 percent of the fund. The same day that both investors bought into the fund, interest rates suddenly spike 100 basis points. A move of 100 basis points on a 0.25 year duration asset would result in an immediate loss of 0.25 percent of fund assets, bringing the fund's NAV to 99.75. This is decidedly below the 99.995 which is the statutory threshold for a fund "breaking the buck."

In this scenario, however, this market event would not result in a forced liquidation for the fund despite the fact that investors could only get 99.75 percent of their money back if they demanded it today. The wise investor would recognize the real impact of the interest rate movement and look to redeem at par, which is worth more than the intrinsic value of their portion of the fund. The investor who chose to stay in the fund is effectively subsidizing the investor who chose to take advantage of this accounting method. In our scenario, the value of the remaining investor's stake in the fund is now a dismal 99.50, 0.25 lost to the interest rate movement and 0.25 lost to making the other investor whole. In an environment where the real value of the fund assets is in question, it pays to be the first investor to the exit.

Floating Net Asset Values

Moving MMFs to a floating NAV has both advantages and disadvantages. On the positive side, a floating NAV solves for the fallacy of amortized-cost accounting and shadow NAVs. This would allow investors a better picture of the underlying value of fund assets in real time. A floating NAV would place more emphasis on investor education of fund holdings since investors will no longer be able to hide behind a stable NAV. The byproduct of the changes would be a more informed investor base and conservative management of fund assets by fund managers. Fund managers would have a strong incentive to keep the floating NAV as stable as possible, resulting in a safer, more liquid MMF. A floating NAV would also diminish the possibility of fund lock-ups, as investors would be able to liquidate their fund holdings at a clearing price, even in distressed markets, since fund assets would be marked-to-market daily.

The disadvantages of a floating NAV are the operational complexity and the potential for loss of principal for fund holders. For many investors, the idea that one could lose money on their cash allocation is unpalatable. For other investors, the change to a floating NAV would be less of an event, and in many ways would resemble a separately managed account. A floating NAV would introduce accounting and tax implications, introducing gains and losses on cash positions that investors did not have to worry about with stable NAV funds. The changes may seem radical, but for investors with the proper systems and flexibility, we believe they should be manageable and provide for greater transparency.

Looking Forward

Potential changes to the MMF industry in the coming months will have both positive and negative implications and should be viewed in the context of alternative investment options. Should investors find the proposed reforms unpalatable many would think the first replacements for MMFs would be non-interest bearing demand accounts or separately managed accounts. One problem, however, is that the FDIC insurance on non-interest bearing accounts is scheduled to end at the end of 2012. The expiration of this much-utilized investment vehicle, in addition to potential MMF reform, could create a perfect storm for money market investors who are unprepared to deal with the potential changes.

A separately managed account would require the operational and accounting flexibility that a floating NAV MMF would require, but would also provide other valuable benefits. Whereas a floating NAV would likely result in a gain or loss with every MMF sell transaction, a separately managed account can be structured to minimize account trading, limit the realization of gains or losses, and provide rolling liquidity. Relative to other investment options, an SMA would also be a more cost-efficient and attractive investment option, as the additional cost to maintain liquidity and preservation built into a MMF is unnecessary with SMAs.

For more additional color on alternative investment options and potential MMF reform, please feel free to contact the desk.

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