



TREASURY Topics

How Money Market Funds Fail

As the credit crunch rippled into nearly every instrument in the debt market, investors wondered how purportedly “safe” securities (so classified based on high credit ratings, lack of default history or even common belief) came to suddenly be under unprecedented distress. For investors whose Investment Policies are primarily concerned with preservation of capital, liquidity and then return, 2a-7 Money Market Mutual Funds had been a trusted tool that abruptly failed and froze. To understand how these funds can falter, this article briefly explains the structure of comingled 2a-7 funds, their inherent abilities and shortcomings, and alternatives that can provide the necessary transparency, liquidity and control required by institutional investors.

What is a 2a-7 Fund?

The SEC website describes 2a-7 Money Market Funds as the following:

“A money market fund is a type of mutual fund that is required by law to invest in low-risk securities. These funds have relatively low risks compared to other mutual funds and pay dividends that generally reflect short-term interest rates. Unlike a “money market deposit account” at a bank, money market funds are not federally insured.

Money market funds typically invest in government securities, certificates of deposits, commercial paper of companies, and other highly liquid and low-risk securities. They attempt to keep their net asset value (NAV) at a constant \$1.00 per share—only the yield goes up and down. But a money market’s per share NAV may fall below \$1.00 if the investments perform poorly. While investor losses in money market funds have been rare, they are possible.

Before investing in a money market fund, you should carefully read all of the fund’s available information, including its prospectus, or profile if the fund has one, and its most recent shareholder report.

Money market funds are regulated primarily under the Investment Company Act of 1940 and the rules adopted under that Act, particularly Rule 2a-7 under the Act.”¹

Additional general investment guidelines found in Rule 2a-7 includeⁱⁱ:

- Use of the Amortized Cost Method - portfolio securities are valued at the fund's acquisition cost and are adjusted for amortization or accretion rather than adjusted to their current market value (meaning they are not marked-to-market unless the board of directors feels it does not accurately reflect the value).
- A Rated Security with a remaining maturity of 397 calendar days (~13 months) and a WAM of 90 days or less.
- Credit Ratings – 95% of the portfolio holdings have to be first tier (A1/P1) with a 5% allowance for second tier (A2/P2).
- Concentration Limits – no more than 5% per issuer (excluding governments) in first tier (A1/P1) securities and no more than the greater of 1% or \$1 million in second tier (A2/P2) securities.

How do Money Market Funds Fail?

There are many ways these funds fail: “breaking the buck,” forced liquidation, parent company bailout, frozen investments (illiquid), segregating bad assets, and failure to comply with investment policies are some of the main issues this paper will explore.

Systemic Issues

Investors utilize money market funds for many reasons including pooling and sweeping uninvested cash, collecting funds for stock repurchases or acquisitions, and as a short-duration portfolio management tool. Regardless of purpose, the reasons investors have been willing to pay 15 to 30 basis pointsⁱⁱⁱ in management fees for money market funds have traditionally been daily liquidity, reasonably attractive yields, and the security of a AAA-rated investment.

Due to the proliferation of access to money market funds through portals, attracting investments became purely a function of yield. Most investors usually chose the fund that tops the list when sorted by highest yield without regard for positions the fund actually held. This changed in late 2007 when a number of enhanced cash funds (non-2a-7 funds) experienced losses in the portfolio and broke the buck. Assets were frozen due to the large number of illiquid securities held and the high number of redemptions as the credit crisis picked up steam.

At the time, structured financial products were blamed (CDO, ABS, CLO, CMO, SIV, etc.) so auditors and investment managers began to demand to see the holdings of funds more often. Clearwater Analytics[®] began the Money Market Transparency[™] initiative and fund behavior began to change as funds declared they had no structured products and/or were unwilling to reinvest into them.

Unfortunately, even daily transparency cannot compensate for the lack of control an investor has over commingled funds. Investors cannot dictate security concentration or diversity, and are also punished when they ignore (or are unaware of) the “rush to the exit” or “liquidity squeeze.”

“Breaking the Buck”

From the time that Bruce Bent established the Reserve Fund (the first money market fund) in 1971 to 2008, there was only one recorded “break the buck” event in the history of 2a-7 Money Market Funds (Community Bankers Mutual Fund of Denver in 1994^{iv}).

For a fund’s NAV (Net Asset Value) to “break the buck” (drop below \$1) the value of the underlying securities needs to be permanently impaired. Ironically, this is what happened in Bruce Bent’s flagship Reserve Primary Fund on September 16, 2008, when the board of the fund decided that the Lehman debt the fund held was impaired and marked it as such. This dropped the fund’s NAV to \$0.97, causing a 3% loss to investors in the “low-risk” money market fund.

Worse still, investors representing 60% of the \$65 billion of fund somehow caught wind of, or suspected, that the fund held Lehman assets and were able to redeem at \$1 NAV up until Tuesday (9/16/08) at 3 pm EST (Lehman had announced bankruptcy on Sunday) when redemptions were frozen^v, leaving the remaining 40% of investors to absorb the entire loss.

Parent Company Bailout

Money Market Funds have been bailed out by parent companies on numerous occasions through the purchase and removal of problematic securities from the fund. The Lehman bankruptcy affected a number of funds including Evergreen’s (Wachovia), Russell Investments (Northwestern Mutual), and Ameriprise. These parent companies voluntarily purchased the problematic Lehman debt at par to keep the funds whole^{vi}.

Unfortunately, not every fund has a large parent company (The Reserve is privately held), and not every parent company has the stability or chooses to use its own capital to alleviate these types of burdens. Companies are not required to bail out their money market funds.

Forced Liquidation

When market or fund-specific pressures cause large, successive redemptions, the fund, which has likely been invested in securities with maturities out as far as 13 months to be yield competitive, is forced to sell the most liquid portions first. As redemption requests continue to pour in, the fund runs out of securities that are immediately sellable and freezes the fund to give itself time to try to find better pricing and get investors out at a \$1 NAV.

This was the scenario Putnam Investments' Putnam Prime Money Market Fund, a \$12.3 billion institutional fund, endured when it chose to liquidate rather than "break the buck" on the Thursday (9/19/08) after the Lehman bankruptcy.

Segregating Bad Assets

An alternative scenario transpired with Bank of New York Mellon's Institutional Cash Reserves. BNY Mellon initially chose to segregate the Lehman holdings into a new fund that had shares assigned pro rata to the shareholders of original fund, in addition to the fund shares that had officially broken the buck. BNY Mellon subsequently decided to purchase the segregated Lehman holdings from their clients at book value to make their clients whole. While these decisions were being made, clients' money fund investments were largely locked up and unavailable for withdrawal.

Failure to Comply

The simple fact is that "diversified" money market funds can, and most likely do, purchase securities outside of many investment policy mandates^{vii}. Funds are required to hold 95% in A1/P1 issuer quality (which translates roughly down to A/A2 long term ratings), but they are also allowed to hold 5% A2/P2 paper (which can translate to as low as BBB-/Baa3 in long term rating equivalents^{viii}). While many investment policies do allow for holdings of A-rated and even BBB-rated securities^{ix}, how may CDO, ABS, or SIV securities carried AAA ratings?

To understand why a money market fund could be holding securities not allowed in an investment policy, simply look to the economic forces driving their investment decisions. Until recently the highest yielding fund would earn the most inflows. In this environment, and given their fund management fees (15 to 30 basis points minimum^x), the managers really only have two options for showing up on the top of the yield sort: continue to reach for the highest yielding instruments (especially those with simultaneously high ratings), or temporarily lower their fees^{xi}. How many managers, do you think, choose to reduce their own paychecks?

It stands to reason that investors should examine when, and to what extent, money market funds

should be used in their cash management portfolios. Money market funds, like any other investment vehicle, have risks and specific purpose. While the possibility of a worst-case scenario should not be overstated, it should also not be ignored^{xii}. Accordingly, holding money market funds in small amounts, particularly when overnight liquidity is needed, should be acceptable. However, there are better alternatives when building large cash positions in anticipation of acquisitions, stock repurchases, or any other strategic pooling of cash.

What alternative investments exist?

Cash managers know that adherence to a board-mandated investment policy is not merely prudent, but absolutely required. To build up a large cash position (in excess approximately \$50 million) holding baskets of securities outside of the control or monitoring of those entrusted with that very task is strictly contrary to the treasurer's purpose. A money market fund is most effective as a tool to handle portfolio slippage (anything not fully invested), meet overnight liquidity requirements, and smooth temporary transactional aberrations. However, these funds are not optimal for larger, more strategic, cash positions.

A good investment manager should be able to structure a portfolio of \$50 million or more in adherence to the investment policy and match it to an appropriate benchmark (such as the ML 0-3 Month US Treasury Index [G0Q1]), adjusting the laddering of maturity dates in anticipation of any liquidity needs.

The challenge and key to successful implementation will always be communication, transparency, and transactional efficiency. Ensuring that the portfolio manager is regularly informed of shifting deadlines will minimize realized losses and facilitate yield curve adjustments for greater returns. These portfolios can regularly match or beat benchmarks and money market fund yields net of fees, adhere to investment policy guidelines, and, in conjunction with Clearwater Analytics[®], provide instant transparency into holdings, maturities, cash flows and risks.

Please contact us with any questions as we manage multiple mandates for this very purpose.

ⁱ <http://www.sec.gov/answers/mfmmkt.htm>

ⁱⁱ <http://www.law.uc.edu/CCL/InvCoRls/rule2a-7.html>

ⁱⁱⁱ Laura A. Bruce, "Finding the fees before funding a money market," Bankrate.com, November 6, 2000, http://www.bankrate.com/brm/news/money_market/20001106a.asp?prodtype=mut

^{iv} Henry Dubroff, "Mutual Fund's Failure Teaches a Lesson," *Denver Business Journal*, January 15, 1999, http://denver.bizjournals.com/denver/stories/1999/01/18/newscolu_mn1.html?jst=cn_cn_lk

^v Christopher Condon, "Reserve Money Fund Falls Below \$1, Delays Withdrawals," September 17, 2008, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aZQNFHdzabDY>

^{vi} Diya Gullapalli, Shefali Anand and Daisy Maxey, "Money Fund, Hurt by Debt Tied to Lehman, Breaks the Buck," September 17, 2008, <http://online.wsj.com/article/SB122160102128644897.html>

^{vii} Walter Updegrave, "Debunking Money Market Fears." CNNMoney.com, August 28, 2007,

http://money.cnn.com/2007/08/27/pf/expert/expert_tuesday.money_mag/index.htm?postversion=2007082818

^{viii} Chart

http://upload.wikimedia.org/wikipedia/commons/c/c3/Main_Credit_Ratings.png

^{ix} David Evans, "Subprime Infects \$300 Billion of Money Market Funds," *Bloomberg*, August 22, 2007,

http://www.bloomberg.com/apps/news?pid=20601109&refer=home&sid=aEUtlgwzL_qc

^x Laura A. Bruce, "Finding the fees before funding a money market," Bankrate.com, November 6, 2000,

http://www.bankrate.com/brm/news/money_market/20001106a.asp?prodtype=mut

^{xi} Megan Johnson, "Rising money-fund risks raise specter of default," *Financial Week*, May 21, 2007,

<http://www.financialweek.com/apps/pbcs.dll/article?AID=/20070521/REG/70518012>

^{xii} Jim Jubak, "The threat to your money-market fund," *Jubak's Journal: MSN Money*, November 14, 2007,

<http://articles.moneycentral.msn.com/Investing/JubaksJournal/HowSafeIsYourMoneyMarketFund.aspx?page=1>

Disclaimer

The information provided in this article is the result of experience with investment accounting issues and interaction with accountants and investment service providers. It is not intended to be relied upon substantively; rather, it is intended to inform and provide a discussion framework that treasury practitioners, internal management, and accounting and audit staff can use to discuss the impairment process.



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