Money Market Mutual Funds

An Update: Money Market Fund Rule Changes, Industry Reaction and Options for Investors

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Changes impacting the stability and liquidity of money market funds are coming. In October of 2016, the Securities and Exchange Commission (SEC) rules, under which money market funds can operate, will officially change. When implemented, institutional prime money market funds will be forced to post a nightly floating Net Asset Value (NAV), and both institutional and retail investors will be subject to withdrawal limitations and penalties in times of market stress. As a result of this new legislation, we believe that investors' perceptions will change. Money market funds will likely be viewed as higher-risk investments with increased volatility and decreased liquidity, without any improvement in yield.

The "one-size-fits-all" approach to cash money management is changing.

The SEC rule changes are reshaping the money market industry, as shown in Exhibit 1.[1] In response to the new SEC rules, many of the world's largest money management firms are replacing and rebranding their institutional prime money market fund offerings.[2] One major money manager announced that rather than have a floating NAV and potentially gate investors during times of market stress, the company is converting the world's largest prime money market fund to a government-only money market fund.[3] Other firms have instead elected to float their institutional prime money market funds' NAV and subject clients to gating restrictions in times of market stress.[4] As shown by these actions, the "one-size-fits-all approach" to cash money management through traditional prime money market funds is changing. Money market investors will have to choose between zero-yielding but stable NAV government-only money market funds, or take the risk that their funds could be locked up during market stress if they instead choose to invest in prime money market funds with a floating NAV.

Exhibit 1: SEC Rule Changes by Investor and Fund Type

	Investor Type			
	Institutional		Retail	
FUND TYPE ▶	PRIME	GOVERNMENT	PRIME	GOVERNMENT
Net asset value	Floating	Fixed	Fixed	Fixed
Suspension of redemptions	Yes	No	Yes	No
Fee on redemptions	Yes, up to 2%	No	Yes, up to 2%	No

Source: Lockton Retirement Services, *The Wall Street Journal*.

What is an investor to do? Just keep excess cash in...cash?

The expression "cash is king" has been around for decades. In theory, cash does not go down in value. What the expression fails to acknowledge is that there are costs to holding cash. The current environment is a prime example: holding too much cash or earning zero percent in a government-only money market fund costs investors potential future returns. When factoring in the effect of inflation, the purchasing power of cash can actually decline.

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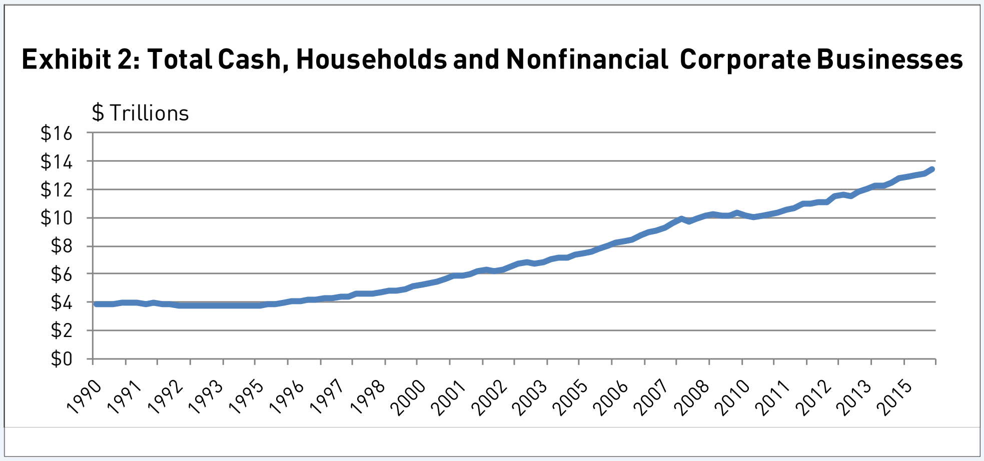
[1] For additional information, please see "Money Market Mutual Funds: A Report on the History and Potential Implications of Recent SEC Rule Amendments," which we published in September 2014. The paper is available at https://www.sbhic.com/media-center/insights/

[2] Source: Katy Burne, "BlackRock to Shift Funds to Comply With New Rules." *The Wall Street Journal*. Available at http://www.wsj.com/articles/blackrock-to-close-consolidate-some-money-market-funds-1428346823

[3] Source: Sabrina Willmer, "Fidelity to Change Largest Money Fund to Buy Government Debt." Available at http://www.bloomberg.com/news/articles/2015-02-03/fidelity-to-change-largest-money-fund-to-buy-government-debt

[4] Source: PR Newswire, "Federated Investors Inc. announces first phase of adjustments to money market fund lineup." Available at http://www.prnewswire.com/news-releases/federated-investors-inc-announces-first-phase-of-adjustments-to-money-market-fund-lineup-300038411.html



Note: Data as of December 31, 2015
Source: U.S. Federal Reserve. Z.1: Financial Accounts of the United States. Released March 10, 2016.

Yet, as Exhibit 2 shows, cash held by investors is at an all-time high, more than double what was held in 2000. Why? Many investors have been reluctant to invest in the markets because of fears that their investment will decline in value. This is understandable considering the volatile nature of today's markets. In the first quarter of 2016, investors have already witnessed crude oil prices drop to $26 a barrel, seen a 10% drop in the S&P 500 Index and subsequent full recovery, and watched global negative economic headlines from China to Brazil. If this isn't enough, investors can barely open a financial publication or turn on a news program without hearing about the prospect of further short-term interest rate increases by the U.S. Federal Reserve.

As previously mentioned, money managers are reacting to the new SEC money market regulations and either changing their money market fund offerings or electing to keep their institutional prime funds with liquidity restrictions. Come October 2016, investors will need to decide between liquidity and yield for their "cash" portfolio. They can maintain liquidity in a zero percent yielding government money market fund, or earn a slightly higher yield and take the risk of zero liquidity during periods of market stress if they choose to invest in an institutional prime money market fund. Fortunately for investors that still want a return from their "cash" portfolio, there is another overlooked option—invest in liquid, high-quality, higher-yielding short-duration fixed income securities. We believe that it is possible for money managers to select high-quality short-maturity securities that can offer higher yields than short-term government-only securities, while maintaining appropriate liquidity and without significant interest rate risk.

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