For global professional / qualified / institutional clients and investors and US retail clients and investors

Liquidity Perspectives—3Q19

Investors are looking to "prime" money market funds to pick up yield

Overview

- After initial resistance, investors are embracing floating net asset value (F-NAV) prime money market funds
- Higher interest rates compared to the zero-bound levels following the Global Financial Crisis have made net yields on prime money market funds more attractive
- Prime money market funds offer investors an opportunity to pick up additional yield relative to government/Treasury-only money market funds

The calm before the storm

Money market mutual funds (MMFs) have long been a key tool used by individuals as well as institutional investors (corporations, colleges, hospitals, state and local governments, etc.) for managing their cash balances. These funds have historically provided an attractive return over cash by investing in high quality, short term securities, while also providing a high degree of liquidity, and adhering to the primary goal of seeking to preserve capital.

Within the taxable money market mutual fund space, there have historically been three types of funds: US Treasury, US government, and prime. US Treasury funds invest in US Treasury securities or repurchase agreements collateralized by US Treasuries. US government funds may invest in the same opportunity set as US Treasury funds, but can also invest in securities issued by US Government Sponsored Agencies, such as Fannie Mae and Freddie Mac, and repurchase agreements collateralized by these securities. Finally, prime money market funds can also invest in short-term, highly-rated asset-backed commercial paper, commercial paper, certificates of deposit and time deposits. These securities typically offer yield spreads over Treasuries and Agencies, and so prime money market funds generally offer a return premium vs. other money market funds in terms of higher interest rates. As a result of this, before the financial crisis, prime money market funds were a popular vehicle for those in pursuit of the highest net yield while still maintaining a constant net asset value. They were, in fact, so popular that the total money market fund industry grew to over USD 3 trillion in assets, dominated by investors utilizing prime money market funds.

However, in the aftermath of the 2008 financial crisis, and the impact that the crisis had on several prime money market mutual funds, the Securities and Exchange Commission (SEC) set out to reform the US money market industry to make it more resilient to potential future shocks.

Brave new world

In 2010 the first set of amendments to SEC Rule 2a-7 were published and were aimed at mitigating risk to money market fund investors by imposing stricter limitations around the maximum weighted average maturity (WAM—60 days) and weighted average life (WAL—120 days) of the MMFs, as well as instituting minimum daily (10%) and weekly (30%) liquidity levels.

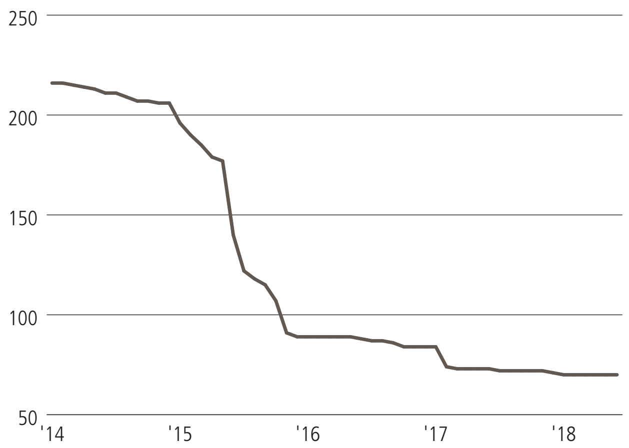
However, the ink was not yet dry on the new rules when the SEC announced there were going to be additional regulations in the near future.

Left pocket, right pocket

In 2014, these additional regulations were instituted with an effective date of October 14, 2016 with the intention of further mitigating money market fund risk and enhancing regulation along with increased transparency for investors. One of the most impactful amendments was the mandate that all prime and tax free money market funds be classified as either "institutional" (meaning open to "all" investors) or "retail" (meaning open to "natural persons," or individual investors only) and the requirement for institutional prime and tax free funds to price their shares using a floating net asset value, or an F-NAV, expressed with four places to the right of the decimal, i.e., USD 1.0000. This price could move higher or lower, essentially doing away with the concept of penny rounding to a constant USD 1.00 net asset value (C-NAV) that had, in concert with amortized cost, been in effect since the early 1970s. This change was meant to allow the NAV to fluctuate and potentially better reflect any potential risks associated with these investments. F-NAV also created accounting issues (gain/loss, wash sales, mark to market, etc.) and operational challenges to fund sponsors and investors.

This was a massive deviation to money market fund share pricing that investors had been accustomed to for over 40 years, and many institutional investors flocked to US Treasury and US government money market funds (which were allowed to continue using penny rounding, and therefore could maintain a C-NAV of USD 1.00).

Exhibit 1: Number of US Prime Money Market Funds



Source: Bloomberg, Investment Company Institute, as of 4/30/2019

The report of my death was an exaggeration— Mark Twain

The shift to F-NAV for institutional prime funds—and its related operational requirements—caused several fund companies to abandon the prime fund business altogether and transition their current prime funds to C-NAV Treasury or Government funds or completely liquidate their prime funds and exit the money market mutual fund business entirely.

After the regulations went into effect, many corporate treasurers elected to sit on the sidelines and invest in C-NAV Treasury and Government funds. However, as the US Federal Reserve began raising the federal funds from its previous zero-bound target rate institutional prime funds became more attractive to many of those investors because they generally offered more attractive yields than bank deposits and Treasury and government money market funds. The fund complexes that decided to stay in the F-NAV prime fund business have seen flows into those funds.

Exhibit 2: ICI US Institutional Prime Money Market Funds Growth (indexed 100 = 11/1/14)

Source: Bloomberg, Investment Company Institute, as of 4/30/2019

Elevated rates are making money market funds more attractive

In the current interest rate environment, the yields on prime money market funds look compelling relative to other alternatives within fixed income and also relative to other assets classes as well. To put this in context, the yield, is now higher than the average dividend yield on the S&P 500. Figure 3 shows the spread between US Treasury three-month bill yield and average S&P 500 dividend yield.

Exhibit 3: Cash equivalents yield as much as the average S&P 500 dividend

Source: Bloomberg, as of 9/12/2019

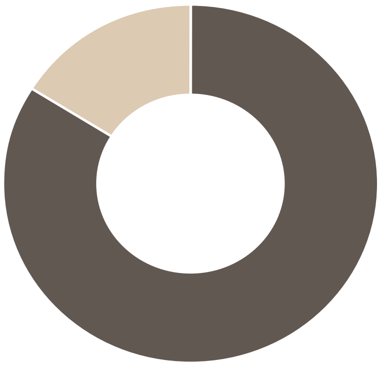
More investors are finding money market fund rates a more attractive place to keep their cash. It may well be a good time for investors to take a second look at floating net asset value prime money market funds.

Breaking down floating net asset value pricing
With a floating NAV, the share price fluctuates to reflect the daily market value of the underlying investments the fund owns.

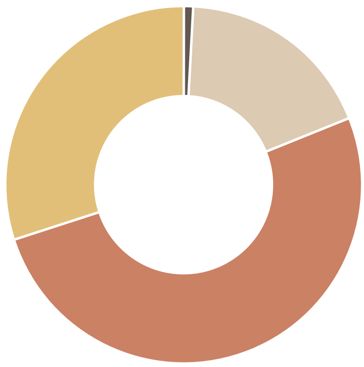
As investors saw the value of their FNAV money fund investments move minimally to prices of USD 1.0002 or USD 1.0001, and seeing the additional daily accrued income—the anecdotal analysis of NAV movements prompted many investors of all types to migrate to the now better understood FNAV prime funds.

Looking at the NAV price movements and dividend distributions for the UBS Select Prime Preferred Fund, which has a floating net asset value, may be useful. For example, from January 1, 2018 through May 31, 2019, at each of the intraday and end of day NAV calculations for the fund, the NAV only changed 16% of the time, and was constant 84% of the time. And, 51% of those price changes were to USD 1.0001, 30% were to USD 1.0002, while only 1% were to USD 0.9999.

NAV movement at each strike time



Distribution of NAV prices



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