The Changing Dynamics of Quarter-End Investing for Money Market Funds

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If you are a frequent investor in money market funds, you may have noticed that making large deposits over quarter-end periods can be a challenge. That challenge is a result of decreased supply from broker / dealers and issuers of overnight investment products, combined with increased demand from money market fund managers and short-term investors for those same investments. Those dynamics still exist and continue to increase in the face of an increasingly stringent regulatory environment and the Federal Reserve's (Fed's) large balance sheet position accumulated through quantitative easing.

Quarter-end continues to be a key financial reporting date for broker / dealers and issuers of overnight investment products. Reported financial statements represent an overview of a company's financial health at quarter-end. Firms reduce their balance sheets to enhance certain capital / leverage ratios or other key financial metrics the regulators and general public analyze to determine their financial strength. Ultimately, the exercise of balance sheet reduction / management limits the short-term investment options that money market fund managers utilize on a day-to-day basis. The quarter-ends that are significant for money market fund investing are the last business days of March, June, September and December, with June and December being the most challenging.

Fed's Reverse Repo Program – A Big Influence on Quarter-end Dynamics

In the second half of 2013, the Fed started to meaningfully test its Reverse Repurchase Agreement (Repo) Program operations. Since that time the Fed has implemented a combination of tests, changing the various inputs to observe the different results on market rates. For March of 2015, the Fed will provide collateral relief much like they did in December of 2014.

The most recent revision to the Fed's Reverse Repo Program added $200 billion in term repo maturing on either April 2nd or April 6th, 2015. There will be a $75 billion two-week term auction on March 19th and a $125 billion one-week term auction on March 30th. The total Fed repo available to the market over the March 2015 quarter-end will be $500 billion. This $200 billion in additional supply will provide welcome relief to the typical quarter-end product shortage.

The $200 billion in term Fed repo being offered is in addition to the daily $300 billion auction. The basic terms of the $300 billion daily Fed Reverse Repo auction remain the same as they were in January and February. There is a daily Dutch auction with a $30 billion dollar limit per counterparty. On days when market demand is less than $300 billion, all bidders will have their orders filled at the current five basis point clearing rate. If the total bids exceed $300 billion, the auction will then convert to a Dutch auction and repo will be allocated to the lowest bidders and divided pro-rata at the stop-out rate, up to the $300 billion limit. If a fund manager's conditional bid rate is too high, it is possible they could end up with a much lower allocation than expected, or even no allocation. This presents the fund manager with the risk of large amounts of un-invested cash on the last day of the quarter when there are very little in the way of investment options. Typically daily Fed Reverse Repo auctions end at 12:15 p.m. central time (CT), however, on quarter-ends they typically run the auctions at 9:00 a.m. CT. The additional term Fed repo maturing in April will likely provide supply relief as we approach quarter-end. However, as is typical with all quarter-ends, we expect investment options to be scarce, so getting large unexpected deposits invested after the Fed Reverse Repo auction could be challenging. Quarter-end supply across all asset classes diminishes in the face of stringent and increasing financial industry regulation. In the face of reduced supply we expect that the market's dependency on the Fed Reverse Repo Program will rise, which will then increase the probability that a fund manager could be allocated less than was requested during the Fed Reverse Repo auction.

Early Investor Notification of Large Purchases Essential

It is critical for investors to understand that early notification of large purchases is essential for fund managers to make attempts to invest those funds. Money fund investment such as Discount Notes, T-bills, Commercial paper, CD's and time deposits are scarce on the last day of the quarter. Money market fund managers are very reluctant to purchase securities with negative yields or longer-dated securities at artificially low levels, which could negatively impact portfolio yield and other portfolio metrics – specifically weighted average maturity (WAM), weighted average life (WAL) and liquidity measures – well beyond quarter-end.

Although the Fed has significantly increased the amount of repo it supplies to the market, the early 9:00 a.m. CT quarter-end auction closing time leaves managers at risk for larger deposits occurring after the auction has occurred. Although it is every fund manager's goal to accommodate all purchase requests, there could be situations in which late or large deposit requests cannot be accepted. We expect this to be a largely quarter-end phenomenon. However, the supply dynamics are in place to potentially make late and large deposits an investment challenge at any time.

It is important to remember that un-invested cash in money market funds ultimately means undesirable short-term deposits for custodial banks. Money market fund custodians are now required to comply with more stringent and costly regulatory requirements and are hesitant to house un-invested cash. In some instances, money market funds may be charged penalty fees for un-invested balances ending up on the balance sheets of their custodial banks. At best in the current environment, money market funds will earn a 0.0% yield on the un-invested balances. Ultimately, un-invested cash balances in a money market fund are detrimental to the fund's existing shareholders and this can make money market fund managers apprehensive about accepting large late-day deposits they are not certain can be fully invested.

Conclusion

In summary, even though the Fed has supplied the market with additional supply, traditional quarter-end supply pressures still exist and a more stringent regulatory environment has non-government investment options largely non-existent over key reporting periods. With the Fed auction ending at 9:00 a.m. CT, any unexpected large inflows or an unexpected low allocation at the Fed auction could put fund managers in the difficult position of trying to invest the remaining cash with little or no available supply. With the cooperation of fund investors and early notification, fund managers will do their best to accommodate every purchase request. However, the new market supply dynamics increase the possibility that late and / or large deposits may not get invested. It is still important to understand that each money market fund is impacted differently by large quarter-end deposits based on size, type, prospectus guidelines, rating agency requirements and eligible investments.

Source

Federal Reserve Bank of New York website, "FAQs: Overnight Reverse Repurchase Agreement Operational Exercise," 2 September 2014, (http://newyorkfed.org/markets/rrp_faq.html).

Federal Reserve Bank of New York website - Operating Policy "Statement Regarding Term Reverse Repurchase Agreements", March 2, 2015. (http://www.newyorkfed.org/markets/opolicy/operating_policy).

Definitions

Balance sheet is a detailed listing of assets, liabilities and capital accounts (net worth), showing the financial condition of a bank or company as of a given date.

Basis Point (bps) is one one-hundredths of a percentage point. This term is often used in describing changes in interest rates. For example, if a bond yield increases from 7.50% to 7.88%, it has moved up 38 basis points.
Capital/leverage ratios measure a company's profitability.
Certificate of deposit (CD) is a formal receipt issued by a bank for a specified amount of money left with the bank. CDs commonly bear interest, in which case they are payable at a specified future date or after a specified minimum notice of intent to withdraw. Some CDs are noninterest-bearing.
Commercial Paper refers to short-term obligations with maturities ranging from 2 to 270 days issued by banks, corporations, and other borrowers.
Counterparty is the other party that participates in a financial transaction. Every transaction must have a counterparty in order for the transaction to go through. More specifically, every buyer of an asset must be paired up with a seller that is willing to sell and vice versa.
Discount Note is a short-term debt obligation issued at a discount to par. Discount notes are similar to zero-coupon bonds and Treasury bills and are typically issued by government-sponsored agencies or highly rated corporate borrowers. Discount notes do not make interest payments; instead the bond is matured at a par value above the purchase price, and the price appreciation is used to calculate the investment's yield.
Dutch Auction is a public offering auction structure in which the price of the offering is set after taking in all bids and determining the highest price at which the total offering can be sold. In this type of auction, investors place a bid for the amount they are willing to buy in terms of quantity and price.
Fed Reverse Repo Facility is a transaction whereby the Fed sells Treasury or agency securities to an approved counterparty with an agreement to purchase them back from the same counterparty at a specified price and date in the future.
Federal Reserve is the central banking system of the U.S. Its primary purpose is to regulate the flow of money and credit in the country.
Quantitative Easing 3 (QE3) is a government monetary policy in which the total money supply is increased through the Federal Reserve purchasing its own Treasury bonds from banks on the open market. This policy is intended to get money into the banking system so banks have more money to lend to businesses and consumers.
Repurchase agreement (Repo) is an agreement between two parties whereby one party sells the other a security at a specified price with a commitment to buy the security back at a later date for another specified price. Most Repos are overnight transactions.
Stop-out rate is the highest yield or the lowest price that the U.S. Treasury will accept when conducting an auction of Treasury securities.
Time deposit is an account which carries a specific maturity date, with limitations on withdrawals before that date.
Treasury Bill (T-Bill) is a short-term debt obligation backed by the U.S. government with a maturity of less than one year, commonly one month, three months, or six months.
Weighted Average Life, also known as Weighted Average Final Maturity, (WAL) is the average time to maturity of all the securities held in the portfolio, weighted by each security's percentage of total investments. Unlike WAM, the WAL calculation takes into account the final maturity date for each security held in the portfolio. WAL measures a fund's sensitivity to potential credit spread changes.
Weighted Average Maturity (WAM) is the average time to maturity of all the securities held in the portfolio, weighted by each security's percentage of total investments. This calculation takes into account the final maturity date for a fixed income security and the interest rate reset date for a floating rate security, which is allowed by Rule 2a-7 provisions. WAM measures a fund's sensitivity to interest rate changes.

Investors should carefully consider the fund's investment objectives, risks, charges, and expenses before investing. The prospectus contains this and other information; call 800.677.3863 or visit FirstAmericanFunds.com for a copy. Please read it carefully before investing.

An investment in money market funds is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other governmental agency. Although these funds seek to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in these funds.

The information and views expressed are provided by the funds' portfolio manager(s) and are current only through the date on this report. They are not intended to provide specific advice or to be construed as an offering of securities or a recommendation to invest. One cannot invest directly in an index. This information is subject to change at any time based on upon market or other conditions and may not be relied on as a forecast of future events or a guarantee of future results. Fund holdings, sector and portfolio allocations are subject to change at any time and are not recommendations to buy or sell any security.

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