Money Market Reform Commentary

June 2016

Where Do We Go From Here?

Revisiting Money Market Funds

The final money market reform deliverable goes into effect October 14, 2016 and it disproportionately affects institutional investors in prime funds. If your organization hasn't yet spent time developing a game plan for cash investing, the time may be now.

Prime Funds Will Be Changing In October

Institutional cash investors will be faced with some new choices later this year on their short-term investment alternatives. Treasury professionals will be able to select from several investment options, each having distinct features and benefits for the investor. While some alternatives will remain the same as or similar to how we currently know them, some will be different in construction and operation. Some investors may be incented to look at new options altogether. One notable change set to occur in October – which will specifically affect institutional investors in prime money market funds – is the transition from a *constant* net asset value (NAV) pricing structure to a *floating* NAV pricing structure. Now, it should be noted that most observers are predicting minor NAV variances when institutional prime funds begin to float (a well-informed prediction if one were to review prime funds' enhanced disclosure reports), but it represents change nonetheless. Other impending changes come October include the allowance of liquidity fees and redemption gates if a fund's weekly liquid assets fall below 30% and it is deemed to be in the best interest of shareholders by a fund's board. Many institutional investors have utilized prime funds for many years as a good vehicle for achieving the common investment objectives of safety, liquidity and yield. The well-loved feature of a constant NAV pricing mechanism has also been a hallmark of these funds for most investors. At the peak of their popularity, it's been estimated that prime money market funds captured more than $1 trillion in assets under management from institutional investors. Given the aforementioned changes that are coming in October, institutional cash investors have a decision to make regarding prime fund investments: Where do we go from here?

As we contemplate the investing imperatives of the institutional cash investor and the related utility of his / her investment options, we can conclude that this revised investment landscape will offer something for everyone, albeit perhaps requiring some adjustment to what these investors have done in the past. No matter your risk tolerance in terms of NAV and portfolio market value, there remain cash management solutions. In addition, most of the factories (investment management firms) that manufacture these solutions are busy retooling their product lineups to potentially provide new solutions to meet the evolving needs of institutional cash investors.

Thinking Differently About "Cash"

It's useful to observe how other institutional investors choose to determine the appropriate investment vehicle for their short-term operating cash. In many instances, these investors will decide that a bifurcated approach best enables them to meet their operational objectives. That's because each available cash investment solution has its primary feature / benefit, but also a corresponding price to be paid for such benefits. Generally speaking, the price to be paid for overnight liquidity in the form of a constant NAV share price is a lower yield on the investment.

Tom Moore
Managing Director

Likewise, the price to be paid for a higher yielding investment is the ability to tolerate some fluctuation in the investment's value and perhaps additional risks as well (such as credit and spread risk). Since some investors will continue to require (or desire) a constant NAV pricing structure, those investors will have Government money market funds to consider, although they will have to accept the prevailing yields available on those funds. We anticipate yields on such funds will remain closely tied to the Federal Reserve's reverse repo rate, given expected supply and demand conditions on the limited universe of allowable Government securities. At the same time, institutional investors who are willing and able to absorb a floating NAV investment vehicle, may elect to consider prime funds, assuming other considerations (such as prevailing yields) are sufficiently attractive. Of course, what constitutes "sufficiently attractive" may vary by investor.

To begin developing a bifurcated approach, the treasury professional must try to ascertain his / her organization's ongoing operational characteristics. What are your historical cash flow tendencies and how predictable or seasonal are those flows? Are they expected to change over the course of the next 12 months or the next few years? Is the organization trending toward higher cash balances or lower cash balances and how much fluctuation can be anticipated? What strategic initiatives, such as share repurchase programs, acquisition / divestiture strategies or other capital allocation could alter the anticipated cash flow trends? While often very difficult to predict, every organization should attempt to quantify the amount and timing of these cash flows and the subsequent impact on the cash balance available for investments. While every organization is distinct and the complexities surrounding investable cash can vary, many entities find it useful to segregate their investable cash into several buckets in order to achieve an optimal blend of solutions to meet their investment objectives and constraints.

Next, the treasury professional can customize the number, size and specific parameters of each bucket, while maintaining compliance with the organization's overarching investment policy. Each bucket should be fairly well-defined in terms of strategic purpose (potential use of funds), time horizon (number of days / months / years that bucket can remain invested) and allowable investment vehicles or securities. These parameters can vary widely from one organization to the next and no one size fits all. That said, most organizations can broadly begin with a two- or three-tiered approach to bifurcating their cash investments, commonly labeled operating, core and strategic cash pools. Naturally, money can be shifted from one pool to another as priorities evolve.

	Operating Cash	Core Cash	Strategic Cash
Investment Horizon	Overnight to Six Months	Three Months to One Year	One Year or Longer
Likely Investments	• Government money market funds • Prime money market funds • Bank Deposits • Commercial Paper • Certificates of Deposit (CDs)	• Prime money market funds • Government money market funds • Separately Managed Accounts • CDs	• Separately Managed Accounts • Short-term bond funds

Operating cash is typically utilized as the first call for redemption when the organization needs money for operations. This can be general operational needs – either expected or unexpected – as well as planned expenditures that could be regular or irregular in nature. However defined, this pool's paramount investment objective is liquidity and, therefore, the prudent investment vehicle for this pool must provide minimal (if any) risk to principle and minimal (if any) risk to market value. The time horizon for an operating cash pool can vary slightly, but a good rule of thumb would be money that could be needed within six months. Appropriate investments for such a pool may include Government money market funds (which will continue to price at a constant NAV after money market reform), commercial paper, CDs and bank deposits. To the extent an investor can tolerate minor NAV fluctuations, prime funds may be a viable investment in operating pools. If no principal fluctuations can be tolerated at all, prime money market funds may be best suited for the core cash pool, which we discuss next.

The second pool is often considered core cash and the source of funds an organization will go to if / when the need for cash exceeds its operating pool. This pool is still considered highly liquid, albeit usually consisting of investment vehicles or securities that exhibit market value pricing (i.e. floating NAV), rather than amortized cost pricing (or constant NAV). The attraction of such investments is the expectation of relative safety, stability and liquidity, with an added yield boost to compensate for the risk of principal fluctuation. Core pool investments will have a time horizon suitable to the specific organization, but often found in the range of 90 days to 12 months. Given the shift to a floating NAV structure for institutional prime money market funds, cash investors may consider these funds to be appropriate for the core pool. Alternatively – and depending upon the specific investment policy goals and constraints – a separately managed account could be appropriate for core cash.

For organizations with substantial cash reserves and relatively identifiable cash needs, a third pool is often part of the plan. The strategic cash pool is customarily comprised of monies that the entity does not anticipate it will need within 12 months, perhaps even several years. It is the last source of funds for general operational needs and more likely the source of funds for longer-range strategic initiatives. Thus, strategic investing regularly considers several other vehicles, including separately managed accounts and short-term bond funds.

Staying the Course

So, as investors navigate the forthcoming changes to their money fund investment options, every institutional cash investor has the opportunity to revisit their objectives and constraints – as well as their organization's strategic plans – to help determine where money market funds best fit in the scheme of things. As always, we are here to help you consider the changing dynamics of money market funds to ensure you are invested in the right solution to meet your cash objectives. Where do we go from here? The answer depends on your specific circumstances and we believe there are compelling solutions for everyone.

Author's Bio:

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[See next page for definitions and important disclosure information.]

Source:

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Definitions:

Liquidity is a characteristic of a security or commodity with enough units outstanding to allow large transactions without a substantial drop in price.
Net Asset Value (NAV) is a mutual fund's price per share, calculated by dividing the total assets – less any liabilities – by the number of shares outstanding.

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