The Ostrich Principle and Institutional Prime Money Market Funds

"To bury one's head in the sand" is a popular metaphor for ignoring uncomfortable situations in the hope that by simply denying their existence they will go away. It is believed this metaphor originated based on the wide-spread belief that ostriches bury their heads in the sand in the hope of avoiding predators.[1] If the ostrich ignores the predator, it will go away. Not surprisingly, the "Ostrich Principle" is not very effective. However, it is important to realize that the Ostrich Principle is not equivalent to evaluating a situation and then deciding not to make a change. This is simply decision making.

The Securities and Exchange Commission's (SEC) pending reform of prime money market funds (Reform) is a situation where, at first blush, many institutional investors wish the Ostrich Principle would work. However, after undertaking some evaluation of the Reform and one's risk tolerance and cash needs, institutional investors will soon realize the benefits institutional prime money market funds still offer post-Reform.

As has been widely reported and commented on, commencing October 14, 2016, the Reform will require prime money market funds in which institutions are eligible to invest (i) to have a floating net asset value ("NAV"), (ii) to transact at four decimals using market price, and (iii) to be subject to redemption fees and gates. Thus, institutional prime investors will be forced to decide whether to remain in prime money market funds or explore alternative cash investment options, of which many exist.

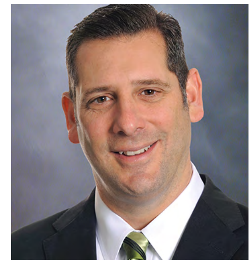
Government money market funds, which are able to maintain a stable NAV and opt out of liquidity fees and redemption gates, have proven to be a popular alternative. Many investment firms have announced plans to offer private prime funds to qualified investors. These private funds have the objective of maintaining a stable $1.00 NAV per share and offering same day liquidity, however they will not be registered with the SEC nor will they receive the accounting and tax treatment accorded Rule 2a-7 money market funds. In addition, there also exists a number of SEC-registered short-term and ultra-short term fixed income mutual funds, as well as separately managed accounts.

All the above investment vehicles may be viable options to prime money market funds given an investor's risk tolerance and liquidity needs. However, remaining invested in institutional prime funds is also a viable option. To do so does not mean adhering to the Ostrich Principle. It means following the wise adage that *sometimes no decision is the best decision.*

Reasons to Invest in Institutional Prime Funds Post-Reform

> **Reason 1:** Two of the SEC's stated goals in implementing Reform are to improve the money market fund industry's ability to perform in times of market stress and to increase transparency. Both of these goals benefit institutional prime money market fund investors, as well as all money market fund investors.

[1] In reality, ostriches do not bury their heads in the sand. However, ostriches do dig a hole in which to lay and incubate their eggs and, during incubation, rotate the eggs with their beaks. This obviously entails submerging their head in this underground nest. Hence, a metaphor is born.



Lou Martine
Senior Managing Director
Head of Distribution

Reason 2: It is our opinion that institutional prime funds may offer a yield spread over government money market funds of up to 20 to 40 basis points. While this in no way can be ascertained with any degree of certainty, it is logical to expect issuers of money market debt instruments to have to offer higher yields in response to less demand for their paper as assets migrate from prime money market funds to government money market funds. To date, prime money market funds totaling over $275 billion in assets under management have either converted, or declared their intention to convert, to government money market funds. In August 2016, government money market fund assets outstanding exceeded those in prime funds for the first time.

Reason 3: For investors concerned about the NAV variability, some solace may be offered through the understanding of total return. Historically, prime funds have been the best-yielding type of money market fund. As the holdings in money market fund portfolios generate income, those dollars are passed through to shareholders in the form of dividends. Moreover, should interest rates rise – therefore causing portfolio holdings to generate more income to distribute to shareholders – the income earned can quickly cover any losses due to a decrease in NAV, as evidenced in the table below:

Fund's NAV change is:	Number of days for income to overcome loss at various net yields:								
	0.10%	0.25%	0.50%	0.75%	1.00%	1.25%	1.50%	2.00%	2.50%
$0.0001	37	15	8	5	4	3	3	2	2
$0.0002	73	30	15	10	8	6	5	4	3
$0.0003	110	44	22	15	11	9	8	6	5
$0.0004	146	59	30	20	15	12	10	8	6
$0.0005	183	73	37	25	19	15	13	10	8

Reason 4: It is expected that the most common cause of deviation from a $1.0000 NAV per share for an institutional prime fund will be interest rate movement or an expectation of such, for various reasons including – but not limited to – an actual federal funds rate change. We believe such deviations will be relatively short lived before the fund's NAV migrates back to $1.0000. The shorter a fund's weighted average life and weighted average maturity (WAM) are, the quicker a portfolio will be to rebound. For example, a fund with a 15-day WAM would see its NAV rebound faster than one with a 30-day WAM. It is important to note that NAV variations as a result of widening and narrowing credit spreads, realized gains and losses and investor flows could last longer, although the liquidity requirements mandated by Rule 2a-7 mitigate this risk somewhat.

Reason 5: More and more institutional investors are focusing on cash flow forecasting and cash management. As a result, institutions are getting a better handle on their actual daily cash needs. Given their focus on principal stability and liquidity in conjunction with yield, money market funds have historically been utilized to invest operating cash. Institutional investors with strong cash flow forecasting could utilize stable NAV government money market funds, or other investments such as demand accounts, to meet daily cash needs while potentially benefitting from the safety, liquidity and expected higher yield of institutional prime money market funds for the remainder of their operating cash allocation. In essence, an institutional investor could utilize a prime money market fund to bifurcate its operating cash bucket to best position itself to maximize potential yield while maintaining safety and liquidity. Read the commentary on bifurcating cash written by my colleague, Tom Moore, here.

Conclusion

We feel the primary features investors want in money market funds – safety, liquidity and yield commensurate with risk – will remain intact for institutional prime money market funds post-Reform. Ultimately, however, an investor's cash flow needs and risk tolerance will determine its appetite for institutional prime money funds. For those investors currently invested in prime funds who determine to remain so invested after evaluating the situation, such a decision is not adherence to the Ostrich Principle. It is prudent cash management.

Author's Bio:

Lou Martine is the Head of Distribution and Marketing for U.S. Bancorp Asset Management. Lou has overall responsibility for sales, marketing, client services, communications and product research for U.S. Bancorp Asset Management and First American Funds. He is a member of the Investment Practices Committee and the Internal Compliance Controls Committee. Prior to joining U.S. Bancorp Asset Management in 2005, he served as managing director, investment banking for the debt capital markets group of Piper Jaffray. Prior to joining Piper Jaffray, Lou was an attorney for Barnes & Thornberg, an Indianapolis-based law firm. Lou earned a B.B.A in finance, with a second major in English from the University of Notre Dame, an M.B.A. from the J.L. Kellogg Graduate School of Management at Northwestern University and a J.D. from Northwestern University School of Law.

Sources:

Crane's Money Fund Intelligence, Volume 11, Issue 9, September 2016

"Exodus: Prime & Tax-Exempt MMFs Liquidate En Masse," Crane's Money Fund Intelligence, Volume 11, Issue 3, March 2016.

iMoneyNet Asset report, August 31, 2016.

Definitions:

Floating Net Asset Value (**NAV**) is the dollar value of a single mutual fund share, based on the value of the underlying assets of the fund minus its liabilities, divided by the number of shares outstanding. Calculated at the end of each business day.
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.
Securities and Exchange Commission (**SEC**) is the federal agency that regulates the registration and distribution of mutual funds.
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.

[See next page for important disclosure information.]

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