Money Market Reform And Opportunities

September 2016

In July 2014, the US Securities and Exchange Commission ("SEC") issued new rules pertaining to the regulation of money market funds which will go into effect October 14, 2016. We believe this change in regulation fundamentally changes front-end markets and presents new opportunities for client portfolios. New money market regulation is causing 12 month highly rated corporate debt to trade at attractive yields compared to yields on long maturity treasuries. Owning short-dated corporate debt vs long-term treasuries is a tradeoff between taking default risk vs taking the risk of government interest rates rising.

In the next few months it may make sense to reposition some portion of assets out of longer-dated treasuries and into short duration corporate debt. The extra yield on corporate paper is due largely to a change in regulation affecting the supply and demand and not a change in the underlying risk of default. This is a new choice that was not available a few months ago.

How is the money market changing?

Money market funds invest in short maturity debt instruments issued by the government and corporations. Investors buy money market funds as an alternative to cash.

The size of the entire money market industry is currently about $2.73 trillion, with $1.70 trillion of it in funds that invest only in government or government related securities, and $881 billion in prime funds that invest in credit instruments that have at least a small risk of default. A small amount also goes into tax-exempt funds. The industry peaked at $3.9 trillion before the financial crisis.

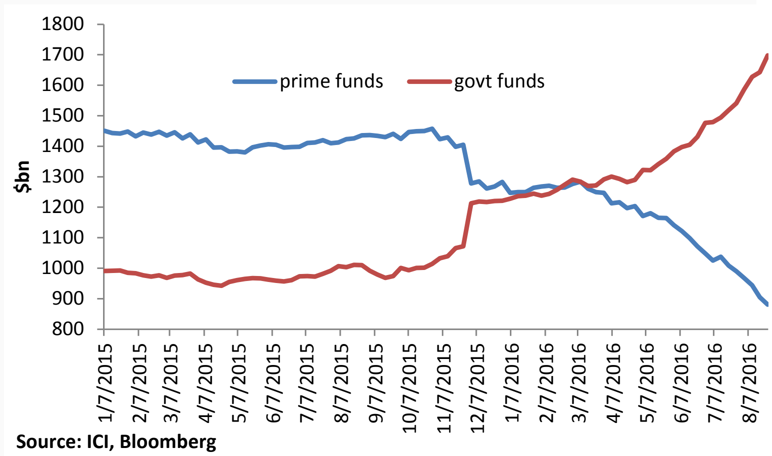
Investors view money market funds as cash equivalents, and expect to take their principal back, together with interest that has accumulated. As a consequence, industry practice evolved so that funds did not recognize mark-to-market losses on their investments and always reported a net asset value (NAV) of $1.00. With investors able to redeem at NAV regardless of the underlying market value of the investments, investors could be confident that their funds were effectively equivalent to cash.

During the financial crisis in 2008, a few money market funds were unable to keep up this practice. The value of their assets fell substantially due to the presence of commercial paper from a few issuers such as Lehman Brothers in their portfolios. This is called "breaking the buck", as each fund had to acknowledge that their NAV was genuinely below 1, and not a temporary mark-to-market problem. This led to a crisis in the industry, and created a run on money market funds, similar to a bank run. The Federal Reserve had to step in and bail out the funds that were under stress to contain the crisis.

As a result of the crisis, the SEC chose to regulate money-market funds which had operated hitherto with little regulation. Funds have to now choose to either be government funds or prime funds. Government funds can continue to report an NAV of 1. Prime funds, on the other hand, have to report an NAV that is based on the market value of their holdings. The idea behind a floating NAV is to make it clear to investors that some money market funds are not the equivalent of cash, and that there is genuine market risk embedded in them.

Separately, there are liquidity fees and exit gates imposed on prime funds. For example, a redemption gate of up to 10 days may be implemented by a fund's board in times of market stress to prevent a run on the fund. If a fund's liquidity drops below a threshold, the fund's board can impose a redemption fee of 1-2%. These tools are designed to help a fund navigate market stress without requiring the Fed to bail them out.

As we approach the October 14th implementation date, we find that many investors are moving a meaningful amount of money from prime to government funds.



Source: ICI, Bloomberg

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How are the changes affecting the market?

Many parts of the market are affected by this change, but we will focus on just the cash markets, as that is the market we invest in. One of the beneficiaries of prime fund investing was the commercial paper (CP) market. Of the various CP issuers, banks comprised a large part, and amongst the banks it is the non-US banks that have relied for more than half their dollar funding needs on US commercial paper. It is these issuers that are the most impacted by the industry's changes.

The best way to visualize the effect of legislation on front-end rates is to look at yields on highly-rated commercial paper with 360 days to maturity. These CP rates could either be financial or non-financial. For example, Deutsche Bank can currently fund itself in the CP market at 1.87%, for one-year. Similarly, Sumitomo Bank can fund itself at 1.45% for the same term.

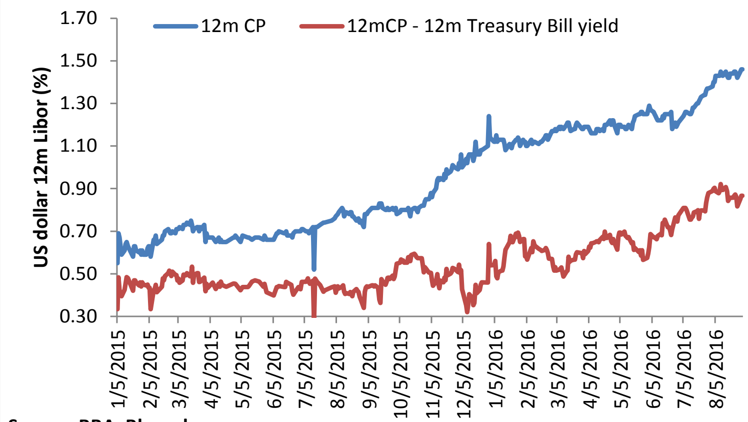
Over the period from January 2015, the 12m CP rate has risen by 0.94% (blue line below), about 0.56% (red line below) more than government borrowing rates for the same maturity. When the dust settles, some portion of this increase will be sticky, and some of it will come off.

In July, excess yield charged on CP vs rates on government borrowing was rising sharply. In August, this difference rose, and then fell slightly, suggesting that the move may be mostly done, even if the flows may not be fully done. In other words, the market has probably taken stock of the remaining flow into account and priced the market appropriately.

Some of the recent increase is precautionary as it reflects uncertainty about the total amount of flow expected to go through the market. We expect this component to go away once the market stabilizes. There are also reasons to believe that the borrowers/issuers have other means to reduce their dependence on the commercial paper market, thereby reducing yields modestly from peak levels.

Beyond this point, we think CP rates can still move around, but not probably due to money fund reform implementation. For example, when the Fed meets in late September, it will give more concrete guidance for policy both in the short term, as well as over the next several quarters. There has been discussion by the Fed recently that a near-term rate increase may be appropriate, but the longer term path of Fed Funds needs to be shallower as the neutral Fed Funds rate may have come down due to declining productivity. In short, if there are interesting surprises at the September Fed meeting, this will also impact CP rates.

As risk premium declines after mid-October, and if the Fed indicates a shallower hiking path in late September, there is actually room for some decline in 12m CP yields.



Source: BBA, Bloomberg

Why do we care about all of this?

The first thing we want to point out is that our goal with respect to managing cash is to have it be a risk-free asset, either keeping it as actual cash (in most cases), or using government money market funds. So any trades we will look at here will be in lieu of fixed income exposure rather than to take extra risk with cash.

Second, what is happening in markets as a result of these changes is a steepening of the very front-end of the credit curve, especially in money markets, out to the one-year point in maturity.

Some of the instruments we invest in have exposure to front-end credit. Therefore we do need to consider the impact of these changes on our portfolio. For example, Bloomberg reports that VCSH has the following exposure:

Bloomberg Composite Rating		Maturity Allocation	
BBB	43.18%	1 - 3 yrs	54.15%
A	42.93%	3 - 5 yrs	44.57%
AA	12.28%	0 - 1 yr	.91%
BB	.78%	+ 10 yrs	.21%
AAA	.51%	5 - 7 yrs	.17%
NR	.32%		

Source: Bloomberg

Despite the higher yields, investments in short-dated credit have outperformed a similar maturity government paper by 2% over the past 18 months and by 1.2% since the start of 2016.

Lastly, the front-end rise in credit yields offers opportunities to consider. As we mention above, there are some large bank 12 month commercial paper that is trading at yields as high as 1.87% — higher than 10y treasury yields. The tradeoffs are different. When investing in treasury bonds through a mutual fund or ETF, for instance, we face duration risk. When we invest in 12 month commercial paper directly, we are exposed to credit risk. When investing in bank CP, we think the credit risk is somewhat lower than it was during the previous banking crisis because bank balance sheets have improved since then — both in terms of capital, and in terms of liquidity buffers. Still, investors have continued concerns about the quality of assets on a bank balance sheet, and especially for some of the non-US banks, the price for protection has risen recently.

We view the increase in commercial paper yields as an opportunity because one set of investors have vacated that space, and therefore those assets have cheapened, and we have an opportunity to invest in them if we choose to. They make sense in some portfolios.

In our view, investing directly in commercial paper makes sense under the following conditions:

A) An investor thinks the long-term decline in yields is done and is looking to reduce interest rate exposure,

B) Other, non-fixed income portions of an investors portfolio are believed to be too rich which makes the 1.5-1.9% returns available in front-end credit for the next year look relatively attractive, or

C) An investor views bank balance sheets to be in relatively good shape

We are constantly evaluating various investment vehicles in the marketplace to judge options to express particular views at different points in the business cycle. We believe that the new regulation and the resulting market dislocation has provided us with another opportunity for generating benchmark outperformance.