HIGHLAND

INSIGHT
MARCH 2016

MONEY MARKET REFORM

In recent months, investors have been forced to contend with heightened volatility in the capital markets. Concerns over falling oil prices, divergent monetary policy, and weakening global growth have impacted a multitude of riskier assets, including real return, equity, and high yield bond markets. However, so-called "risk free" assets are not entirely immune to uncertainty either. In fact, money market fund investors are currently facing several unique challenges related to SEC-mandated reform initiatives and supply/demand imbalances in the short-term debt markets.

Significant rules changes in the $2.8 trillion money market industry have, and will continue to affect everything from fund manager behaviors to return expectations and yield spreads. Broader macroeconomic forces – including Federal Reserve policy and government bond issuance – will also impact risks and opportunities in the cash markets. To cope with these changes, investors must determine the role of cash in their portfolios, including its functions as both a source of liquidity and principal protection.

MONEY MARKET REFORM BACKGROUND

As noted in a previous *Highland Insight*, in 2014 the SEC approved several sweeping reforms designed to enhance transparency and stability in the money market fund industry. These reforms require different actions on the part of all types of money market funds. Prime institutional and tax-free municipal money market funds in particular will be forced to comply with several meaningful rules changes.

Beginning this October, these money market funds will be required to move to a floating net asset value. As a result, the practice of "penny rounding" will be replaced with "basis point rounding" in determining share prices going forward. Therefore, investors may see these funds occasionally deviating from the $1 per share target to which they've become accustomed. These funds have already begun reporting "shadow NAVs" in advance, and only a handful of funds have reported NAV below $1 per share. Importantly, fund boards have the option to provide cash infusions to restore NAV to $1 per share.

The new rules also allow prime institutional and tax-free municipal money market fund boards to impose liquidity fees and redemption gates under certain circumstances. Boards may impose a liquidity fee of up to 2% on all redemptions if the fund's "weekly liquid assets" drop below 30%. For reference, "weekly liquid assets" include cash, Treasury securities, other government securities with remaining maturities of less than 60 days, and securities that can be converted into cash within one week. The decision to charge a fee is at the discretion of the fund board, which should only impose a fee if doing so is determined to be "in the best interest of the fund." However, if a fund's "weekly liquid assets" drop below 10%, the fund would be

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required to impose a liquidity fee of 1% on all redemptions.

> *The new rules also allow prime institutional and tax-free municipal money market fund boards to impose liquidity fees and redemption gates under certain circumstances.*

Changes for government money market funds are much more limited. Specifically, government funds will now be required to invest at least 99.5% of assets in cash and cash equivalents, government securities, and repurchase agreements. Previously, these funds were only required to invest 80% of total assets in these categories. Government funds will not be subject to liquidity fees and redemption gates, although they are entitled to "opt in" if they provide full disclosure to clients.

A summary of the reform changes slated for implementation this fall are provided in Figure 1.

FIGURE 1

Money Market Reform Summary

	NAV		LIQUIDITY FEES		REDEMPTION GATES	
	CURRENT	REFORM	CURRENT	REFORM	CURRENT	REFORM
INSTITUTIONAL FUNDS						
PRIME	STABLE ($1.00)	FLOATING	NONE	0-2%	NONE	MAXIMUM 10 DAYS
MUNICIPAL (TAX EXEMPT)	STABLE ($1.00)	FLOATING	NONE	0-2%	NONE	MAXIMUM 10 DAYS
RETAIL FUNDS						
PRIME	STABLE ($1.00)	STABLE ($1.00)	NONE	0-2%	NONE	MAXIMUM 10 DAYS
MUNICIPAL (TAX EXEMPT)	STABLE ($1.00)	STABLE ($1.00)	NONE	0-2%	NONE	MAXIMUM 10 DAYS
GOVERNMENT FUNDS	STABLE ($1.00)	STABLE ($1.00)	NONE	NONE	NONE	NONE

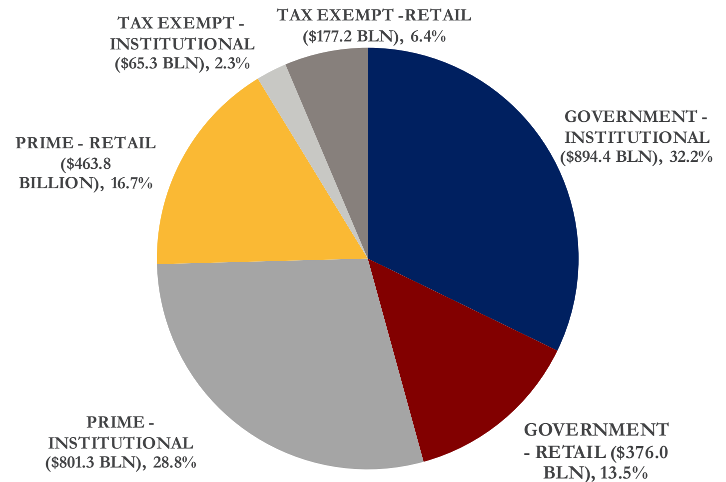
SOURCES: U.S. SECURITIES AND EXCHANGE COMMISSION ; HIGHLAND ASSOCIATES

MONEY MARKET FUND FLOWS

There has already been a substantial shift in assets from institutional prime money market funds to government money market funds in anticipation of these rules changes. Higher costs associated with reform implementation are cited as the primary driver of the shift. Crane Data, which publishes Money Fund Intelligence, estimates that roughly $272 billion in prime money market assets had either 1) liquidated, 2) converted to government money funds, or 3) planned to convert to government funds before October 2016. This accounts for nearly 10% of total money market assets. Roughly $100 billion of this $272 billion in prime assets had not converted as of the end of February, although Crane Data expects nearly half of this amount to convert by the end of May. In fact, the Investment Company Institute reported earlier this year that, for the first time ever, government money market funds collectively held more assets than prime institutional funds.

FIGURE 2

Money Market Assets by Fund Type



SOURCES: INVESTMENT COMPANY INSTITUTE; HIGHLAND ASSOCIATES

Some of the largest players in the industry are among those who have decided to shift assets out of prime and into government funds. Fidelity has already completed the conversion of its $116 billion Prime Cash Reserves Fund to its Government Cash Reserves Fund. The $24.5 billion Franklin Templeton Money Market Portfolio has also fully converted from prime to government. Other large funds in the process of conversion include Deutsche Money Market Series ($20.1 billion), American Funds Money Market Fund ($17.4 billion), BlackRock BIF Money Fund ($7.5 billion), and T. Rowe Price Prime Reserves Fund ($6.3 billion).

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INVESTMENT IMPLICATIONS

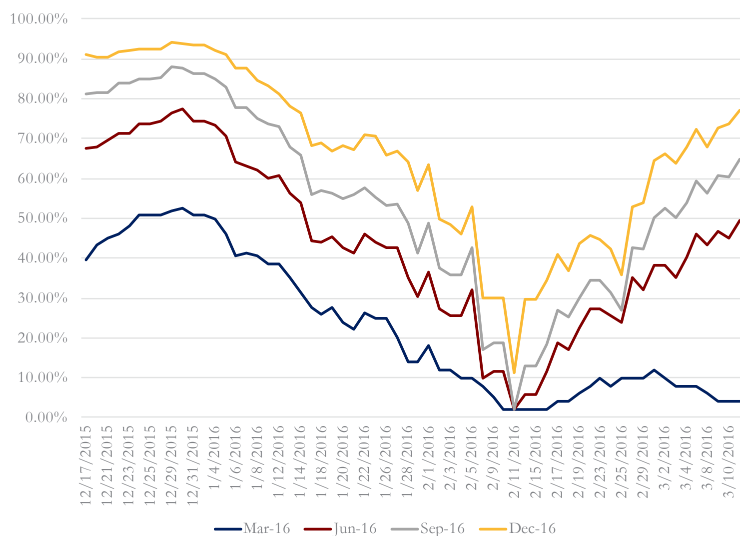
Money market fund investors should not expect meaningful increases in yield going forward for several reasons. The aforementioned conversion from prime to government funds is driving strong demand for government securities at a time when

supply is quite constrained. Demand may even accelerate as the October deadline for reform compliance nears, with hundreds of billions of dollars potentially moving into government securities. On the supply side, more restrictive regulations are curtailing issuance across short-term debt markets. Capital requirements have incentivized banks to stockpile government securities and limit short-term issuance of their own debt, further exacerbating the supply/demand imbalance. Anecdotally, the supply of Treasury bills, agency discount notes, and dealer repo balances have declined by $600 billion, $500 billion, and $300 billion since 2009. Treasury bills currently account for just 11% of total debt outstanding, a record low.

In addition, the pace of Fed rate hikes is likely to occur more gradually than originally anticipated. While the Fed has guided to four rate hikes in 2016, the futures market currently indicates that the Fed will only raise rates once or twice this year. While inflationary pressures appear to be mounting, continued slow economic growth seems unlikely to drive short-term rates substantially higher in the near future.

FIGURE 3

Probabilities of Future Fed Rate Hikes



SOURCES: UNITED STATES TREASURY; HIGHLAND ASSOCIATES

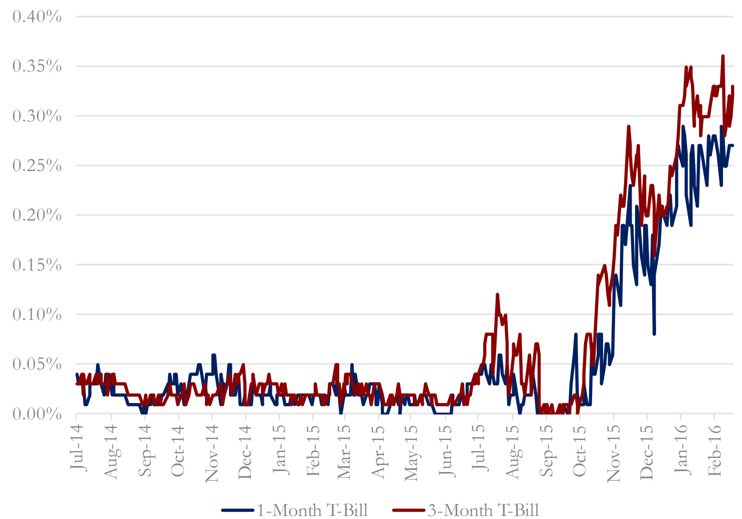
If and when the Fed does opt to further raise short-term rates, investors should not expect a one-for-one gain in yield. With short-terms rates hovering near zero, many money market funds have waived fees in order to provide a positive yield for clients. As rates rise, many of these funds could eliminate these fee waivers, erasing potential yield increases.

While inflationary pressures appear to be mounting, continued slow economic growth seems unlikely to drive short-term rates substantially higher in the near future.

Investors need only to look at recent history to see that rate hikes will not automatically drive higher yields in money market funds. As indicated in Figure 4, yields on one-month and three-month Treasury bills actually declined immediately following the Federal Reserve's rate hike in December.

FIGURE 4

Treasury Bill Rates Since Reforms Announced



SOURCES: UNITED STATES TREASURY; HIGHLAND ASSOCIATES

CLIENT POSITIONING

Investors must begin to consider all of the options available for their cash investments. Both prime and government funds will remain widely available and suitable for many investors, regardless of recent rules changes. Money market fund companies have also responded to reforms with new product offerings. Some investment firms have launched new "short maturity" prime institutional money market funds in order to limit NAV volatility, liquidity fees, and/or redemption gates. These funds will only hold securities with maturities of 60 days or less. BlackRock has actually launched a 7-day prime institutional fund that is expected to produce positive yield with de minimus interest rate risk or credit risk.

Investors should carefully consider the role of cash in their portfolios to be properly positioned amid these significant

changes in short-term debt markets. Highland believes that cash has historically served two distinct functions for investors: 1) liquidity and 2) principal preservation. Importantly, investors should not rely upon these investments to keep up with inflation.

Focusing strictly on liquidity and capital preservation, government money market funds represent an attractive option for investors looking to control risks at all costs. The tradeoff to lower risk is lower yield, and investors should not expect government fund yields to keep up with prime fund yields that can take more risk. Yield spreads between prime and government funds have widened in the last few months as conversions to government funds have depressed yields on those securities. While the yield advantage on prime funds is currently only 15 basis points, this spread could widen another 40-50 basis points by the October reform compliance deadline. Investors must decide if the incremental risk is worth the limited return advantage.

CONCLUSION

Investors with significant cash holdings may consider dividing their positions. Investments in government money market funds represent the best allocation for cash that must remain immediately accessible. For less immediate cash needs, yield-driven investments in enhanced cash or short-term debt portfolios should earn a higher yield, although the risk of small losses in principal must be noted. Highland looks forward to working with our clients to determine the proper mix for their portfolios as change continues to unfold around us.

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