As the end of prime institutional money market funds becomes a reality, investors fleeing prime funds can seek higher yields in alternatives

From the Investment Team of PFM Asset Management LLC

The next phase of money market fund reform, effective October 14, 2016, is causing a shake-up in the money market fund industry and leading investors to seek alternatives, as the end of prime institutional money market funds becomes a reality.

In recent weeks:

- Investors have moved billions of dollars out of prime funds to avoid the new limitations;
- Most prime institutional money market funds and many retail funds have converted to government funds; and
- Yields of money market securities, including commercial paper and negotiable certificates of deposit (CDs), have risen as the demand for these securities by prime funds has diminished.

The Securities and Exchange Commission’s (SEC’s) reform of money market funds resulted from the 2008 financial crisis, when one large prime fund “broke the buck,” meaning its net asset value (NAV) fell below $1. This led to the unthinkable for investors: the loss of principal in money market funds, which were always counted on for their safety. In an effort to prevent a run on funds in the future, the SEC mandated that prime institutional funds make the following changes beginning October 14:

**Liquidity Fees** — All funds, except government funds, are required to impose a 1% liquidity fee on redemptions if a fund’s weekly liquid assets fall below 10% of its total assets. Liquidity fees may also be imposed if weekly liquid assets fall below 30%.

**Redemption Gates** — Funds other than government funds may use “redemption gates” to temporarily prevent investors from making withdrawals. If a fund’s weekly liquid assets fall below 30% of its total assets, redemption gates can be applied for up to 10 days.

**Floating NAV** — Prime institutional funds must move from the stable $1 share price to a “floating,” market-based NAV. This could mean a potential loss of principal for investors.

The characteristics of different types of money market funds are outlined in the table below:

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<th>Government Funds</th>
<th>Retail Funds</th>
<th>Prime &amp; Municipal Funds</th>
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<tr>
<td>Amendment</td>
<td>Money Funds</td>
<td>Money Funds</td>
<td>Institutional Funds</td>
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<tr>
<td></td>
<td>No</td>
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<tr>
<td>Floating NAV</td>
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<tr>
<td>Liquidity Fees</td>
<td>Not required</td>
<td>Yes</td>
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<td>Redemption Gates</td>
<td>Not required</td>
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Since the SEC adopted money market reform in July 2014, many sponsors of prime and tax-exempt funds have converted to government funds to avoid the new restrictions. In addition, there has been a shift from prime to government funds by investors seeking to avoid losing principal or immediate liquidity. As a result, government and prime assets have diverged by more than a trillion dollars, as illustrated in the chart on the next page.
The migration from prime to government fund assets has altered the yield relationship between both types of funds. The shift requires fund managers to increase their purchases of government securities and reduce holdings of short-term commercial paper and CDs. Yield spreads have widened dramatically leading up to money market reform, with most spreads doubling in the past six months. Some market participants believe the yield difference between prime and government funds may widen to 20 to 40 basis points, and could remain after October 14.

**Alternatives to Government Money Market Funds**

Institutional investors seeking to preserve yields have a number of principal-preservation options to choose from besides government funds. For investors seeking to maintain safety, liquidity, diversification and competitive yields, the primary options may be local government investment pools (LGIPs) and separately managed short-term accounts.

Because LGIPs are not 2a-7 funds, they are exempt from regulations regarding NAV, liquidity fees and redemption gates. Many LGIPs have the same objectives as prime funds and offer liquidity, competitive yields, diversification, credit quality and ease of use. LGIPs are designed for specific groups of investors (e.g. local governments in a single state or county); not all investors will be able to use an LGIP. Where their investment policies permit commercial paper and CDs, their yields should approximate those of prime money market funds.

Separately managed accounts, meanwhile, offer enhanced cash strategies, which are customizable, and can be managed to invest assets to match known or forecasted cash requirements. They may also permit investment in maturities that are somewhat longer than those that form the limits for money market funds and LGIPs.

Another advantage of these primary alternatives is the ability to combine options, such as pairing a government fund for daily liquidity with a separately managed account for both liquidity and access to additional investment opportunities. Although this approach requires a high level of coordination and oversight, it may offer many of the benefits of prime money market funds — minus the potential pitfalls of a floating NAV, liquidity fees and redemption gates.

Investors seeking alternatives should thoroughly consider the cost and operating efficiency of each.

**Market Reaction and Implications**

Fee waivers and ultra-low interest rates have compressed all money market yields, explaining why the full effects of money market reform have been avoided thus far. Recently, large prime funds have increased their liquidity by shortening the average maturity of securities they hold and avoiding all but the shortest maturities. This has pushed up yields on longer-term securities. As seen in the chart on the following page, yields on 6-month commercial paper and CDs and 6-month Treasury bills have widened, while the 3-month London Interbank Offered Rate (LIBOR) is elevated.
As money market reform continues to fundamentally alter the landscape of short-term investments, PFM Asset Management LLC is committed to evaluating the benefits, risks and costs of these options for our clients. Now more than ever, it is important to consider all available options when striving for safety, liquidity and competitive yields in an investment portfolio.

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