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Interview: Vanguard's Pam Tynan

With Treasury yields near their historical lows and investors bemoaning the minuscule yields on their money funds, we went searching for some insight into the fixed income and, specifically, the short-term cash markets. Our Chairman and CEO Dan Wiener had a chance to speak to Vanguard's Pam Tynan for some insights. Tynan, who has been managing Vanguard Tax-Exempt Money Market since 1988 and Vanguard Short-Term Tax-Exempt since 1996, joined the firm in 1982. She now serves as the head of the municipal money market group, overseeing all of Vanguard's tax-exempt money funds.

Here's an excerpt from their conversation.

Pam, let's get a little history. At almost 30 years, you're one of the longest-tenured Vanguard portfolio managers around.

Yes. It will be 30 years in January 2012. I joined Vanguard right out of college, undergrad, and worked as an accountant for a couple of years, moved into fixed income in 1984, then worked my way through trading and as an assistant portfolio manager and portfolio manager and now am head of the short-term muni desk.

Almost three years ago there was a tremendous spike in tax-exempt money fund yields. In some ways this set the stage for a lot of what's happened in the money fund world since, and in the tax-exempt money fund world in particular. Can you walk us through what was happening when yields spiked from about 1.5% to more than 5.8% in a matter of weeks?

The spike in yields occurred after the Lehman Bros. bankruptcy. It had a lot to do with the variable-rate demand note positions, which are a predominant holding in money market funds. The rates reset usually on a weekly basis (sometimes on a daily, but the preponderance on a weekly basis) and those securities are remarketed by the dealer community every week.

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They are the ones who set the rates.

With Wall Street in such disarray after the bankruptcy, no one wanted to hold inventory in this product, so they made it very, very attractive for the holders of this product to continue to hold it. That's when the rates moved higher and higher. It was just for a couple of months. The Treasury stepped in and provided support for money market funds, and things started to settle down again and those rates eventually came down. But for that time period, it was pretty attractive.

Explain these variable-rate demand notes (VRDNs) and variable-rate demand obligations (VRDOs), as I don't think most money market investors have a clue that's what they're buying.

A variable-rate demand note has become a mainstream way for municipal entities to finance their short-term needs and take advantage of the short-term market. Instead of issuing a longer bond, say, a 30-year bond or a serial bond, they may opt to issue this type of product, which means they have a longer-term security. Then we, as holders, are allowed to sell back the security at par (a dollar price of 100) within notice of seven days or less, depending on the structure.

It's good for money markets--we had the shorter maturity, because we always had that ability to sell them back at par upon notice. And it worked well for the issuer because they could take advantage of the short-end of the municipal yield curve, which, of course, had lower interest rates.

A lot of these municipal entities wouldn't necessarily be responsible for providing liquidity at the seven days; it was the banks that came in and they ultimately provide liquidity if I were to sell back a security within that timeframe. The bank would agree to give us the payment of principal and interest that's on that tender and not the municipal issuer--the municipal issuer actually paid a fee to the bank for that liquidity.

So, it would be accurate to say that money market funds actually hold longer-term bonds that have been guaranteed to have short-term characteristics?

Yes, that's essentially what a variable-rate is.

Money market funds overall, on the municipal side, probably have between 70% to 80% of their portfolios in this type of structure. It's a very, very highly liquid structure. That's why the money market fund average maturities tend to be pretty short. They're much shorter now, given the new regulatory amendments, but they're

shorter than our taxable counterparts because this product has been in existence for so long and has provided so much liquidity, even in the worst times.

We've often recommended using your other charge, Short-Term Tax-Exempt, as a money fund alternative, calling it a "money fund on steroids." At last report you personally had over \$1 million invested in Short-Term Tax-Exempt and somewhere between \$10,000 and \$50,000 in Tax-Exempt Money Market. Is this the right strategy for dealing with the super-low yields?

As an investor I look at going out a little bit on the curve. From a credit perspective I am very comfortable--I manage that fund, obviously. There is some volatility; it's not a stable net asset value.

Obviously you have to look at where you purchased it and when you sell shares, it's not always at par, so there are potential tax ramifications. These are the kinds of things that investors think about when they would like a shorter-term investment and not put so much risk on interest rates. They have that volatility around the NAV, but it's pretty low.

The money fund investor is really someone who clearly doesn't want any volatility at all around the price and is looking for the ability to raise cash pretty quickly and not have to pay or think about their cost basis.

What's the advice you give to folks who do want to have liquidity, but just can't abide the fact that with liquidity they are losing money every day to inflation?

At these levels a money fund investor is someone who is very, very risk averse. They absolutely are very uncomfortable with any kind of volatility. On the tax-exempt side, we know we have investors who do not want a floating NAV, regardless of whether or not it's just slightly out the curve. People do draw a line in the sand.

If you are willing to take a little bit more volatility--albeit very small--and you're willing to deal with that, I think there's a real benefit to being able to move out the curve ever so slightly. As the curve has been very steep, historically, for those who can stomach even a little more risk it would probably be best to move out even to the Limited-Term and Intermediate-Term funds. There are some real advantages in terms of yield pickup.

Thanks for your time, Pam.

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