ADVISER INVESTMENTS

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

September 12, 2014

How Safe is Your Money Fund?

Money market fund regulation was in the financial news over the summer, so it's a good time to cover the basics, explain the new Securities and Exchange Commission (SEC) regulations and discuss the role of this asset class for investors today.

The Basics

Money market funds—comprised of short-term IOUs issued by the federal government, municipalities, corporations and financial institutions, among others—are generally considered a convenient safe haven for cash that also produces some interest (right now, it's a *very* small amount of interest, which we'll revisit below).

In addition to the benefit of easy access to your cash, money market funds offer a degree of stability that other mutual funds do not, by maintaining a constant net asset value (NAV) of $1 a share. That stable $1 NAV eliminates tax implications for writing checks on your account or selling shares, making it a great money management tool within a portfolio and a good place to keep emergency funds or spending money.

While money funds are perhaps the lowest-risk mutual funds available to individual investors, there are a couple of risks worth discussing. The first is the possibility that the fund provider won't be able to maintain a $1 NAV at the end of the day, closing somewhere below that value. This is known as "breaking the buck." A second risk is the impact of inflation. A third consideration is "recoupment risk," created by the sustained low yields we've experienced over the last several years.

Breaking the Buck

There have only been a few instances of money market funds breaking the buck since they were first offered in 1971, most recently in 2008, when the now-defunct Reserve Primary fund had to write off debt as a result of the Lehman Brothers bankruptcy and closed at 97 cents. The event led to heavy redemptions at other money market funds, none of which fell below a $1 NAV, however. The fund's collapse is what prompted the SEC to probe deeper into the asset class and question whether money funds should begin reporting floating (or variable) NAVs rather than

In This Issue

their traditional, steady $1 per share.

What many money market shareholders do not know is that apart from the $1 NAV reported in their statements, money funds actually record a "shadow" NAV daily, an estimation of the current market value of their portfolios that fluctuate thousandths of a dollar above or below $1. History has shown that money fund managers, with very few exceptions, have been extremely successful at keeping these shadow NAVs in the dark and maintaining a stable $1 NAV. We see no reason to expect this to change for the individual investor going forward, although institutional investors will be subject to new SEC regulations in the coming years, which we'll get to below.

Inflation Can Take a Toll

Inflation is always a consideration for income-focused investors, as rising costs of food, energy and other products can erode your spending power. For a money market fund, where yields are typically lower than other bond investments, inflation can take even more of a toll—in the current environment, with interest rates and yields at historic lows, cash can be costly.

For example, Vanguard's Prime Money Market fund has had a yield of 0.01% for over a year now. If you had invested $10,000 in the fund 12 months ago, you would have earned $1 in income before taxes. Meanwhile, inflation (based on the core consumer price index) is running at 1.9%, meaning that it costs $10,190 today to buy $10,000 of goods in last year's dollars, a shortfall of $189 for money fund investors earning that 0.01% yield. That's the impact of inflation, and why a money market fund is a losing investment right now.

Fee Waivers and Recoupment Risk

When yields on money funds began to decline as interest rates were lowered during the financial crisis, many fund providers began to offer temporary "fee waivers" or voluntary reductions to the expenses charged on their offerings to help keep yields competitive, and, more recently, in positive territory.

While it has certainly been to investors' benefit that fund providers have taken a smaller cut on expenses (the Investment Company Institute estimates that $10.6 billion in fees were waived on money market funds during the course of 2012 and 2013), when interest rates begin to rise, those same fund providers will find themselves facing a dilemma, one which will likely spark a giant game of chicken all throughout the industry. As rates go up, the questions for each fund provider will be, "Should we continue to waive our fees and boost yields? Or should we begin reducing or eliminating those waivers at the expense of the yield we can offer?"

Fund providers will have to balance the need to collect fees with the desire to keep investors in their funds—if Fund Company A cuts its fee waiver and offers a lower yield, investors may flee to Fund Company B, which is offering a better yield at the expense of revenue. It will be very interesting to see who blinks first and to what result.

Another wrinkle money market fund shareholders should be aware of is that some fund companies have given themselves the ability to recoup a portion of waived fees. So once rates rise and yields follow, not only will certain funds be eliminating their waivers, they may also be taking a little extra to make up for the shortfall created by those waivers in the first place. It's definitely worth checking your money fund's fine print to see if you might end up reimbursing it for the fees it once waived.

Vanguard has no such language in its funds' prospectuses, but Fidelity gives itself the limited ability to recoup waived fees over the course of a fund's fiscal year. That doesn't mean the company will do it, but the option exists.

New Regulations

In July, the SEC announced new rules that seek to reduce the risk of runs on money market funds without reducing their utility for individual investors. The new rules come atop amendments adopted in March 2010 intended to minimize interest rate, liquidity and credit risk for these funds.

Floating NAVs

Perhaps the most controversial measure adopted by the SEC this summer was the requirement that institutional money funds begin reporting floating NAVs out to four decimal places at the end of a two-year transitional period. Instead of maintaining a stable $1 NAV, the affected money market funds will see their share prices vary day to day like any other mutual fund, although likely by only fractions of a penny. This fundamental alteration to money funds is designed to keep investors from panicking about the possibility of a fund breaking the buck during periods of stress in the markets. But this change also introduces tax implications for the buying and selling of shares, eliminating one of the more attractive features of money funds in a taxable account.

For the individual investor, one place this change may be felt is in 401(k) and other retirement plans, which often offer lower-cost institutional share classes of funds. The transition from stable to floating NAV may not be that noticeable, but it's better to be prepared than surprised.

For a while, floating NAVs were being considered across the board, but the SEC (wisely, in our opinion) opted to exempt funds geared toward individual retail investors as well as those primarily invested in government securities from the rule. This is good news for investors like us, who can continue to write checks on and transfer cash out of money funds without creating taxable events.

Other New Rules

In addition to introducing variable share prices for some money funds, the SEC also will require money fund providers to be more transparent about what their funds own, run regular stress tests and diversify holdings more broadly, all of which can be considered safety measures for investors.

Another controversial rule will allow money funds to impose optional "fees and gates"—withdrawal fees and the ability to temporarily block redemptions—to guard against heavy selling or a lack of liquidity. The fees can be up to 2% of the withdrawal amount if the fund provider is worried about its ability to meet redemptions, and the gates could block all withdrawals for a period of up to 10 days in times of extreme duress. These fees and gates will be applicable to both institutional and retail investor share classes of money funds starting in 2016, although the boards of government money market funds can opt out.

Our Take

While it's still too early to say how the SEC's new rules will play out, we would be surprised to notice much, if any, change in the way Fidelity and Vanguard manage their money market offerings —whether their NAVs begin to float or not.

As we mentioned above, money market funds might not be great investments at the moment due to rock-bottom yields and inflation, but they remain a fine place to stash money for emergencies or when saving for a big purchase. They certainly can remove volatility from a portfolio. And a little further down the line, when we inevitably enter a rising-rate environment, money market funds should benefit—either immediately if the fund company continues waiving fees, or sometime after if fee waivers are dropped. Either way, we think brighter days lie ahead for money funds.