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Identifying The Shifting Sands For Money Market Funds In 2016

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Years ago, the advantage of operating in the short-term, money market fund (MMF) industry was that negative events could be fleeting. A credit event or change in monetary policy would seemingly hit the short-duration markets quicker than expected and then was gone, sometimes leaving a mark but generally not staying long enough to cause permanent pain.

In the past several years, we've seen significant changes in the MMF industry. Prior to 2007, most MMFs and local government investment pools had sporadic fire drills. They made the occasional misstep, an inverse floater here, a toggle bond there, and even, perhaps, a funding agreement lurking behind a closed door. But these are different times. Shifts in the operating conditions for MMFs seem to have more staying power and certainly are proving to shape the industry more than ever before.

Overview

- Shifts in the operating conditions for money market funds (MMFs) will shape the industry in 2016 more than ever before.
- We expect that the main issues MMFs will face next year are liquidity, fee waivers, and credit risks.
- On the other hand, some funds could benefit from the possible U.S. interest rate hike in the near term.

Indeed, in Standard & Poor's Ratings Services' opinion, 2016 promises to be an eventful year for short-duration investors. Some of the industrywide issues, such as implementation of regulatory reform, may cause a shudder of dread, while others promise some hope--such as a possible U.S. interest rate hike in the near term. We expect such issues as liquidity, fee waivers, and looming credit events to not only keep investment managers on their toes, but to also make the upcoming year a memorable one for the industry. Each of these could pressure how these funds operate, and while managers in this space have historically shown an ability to properly balance themselves in the midst of shifting sands, that's not to say that will be the case this time.

Liquidity Remains At The Forefront

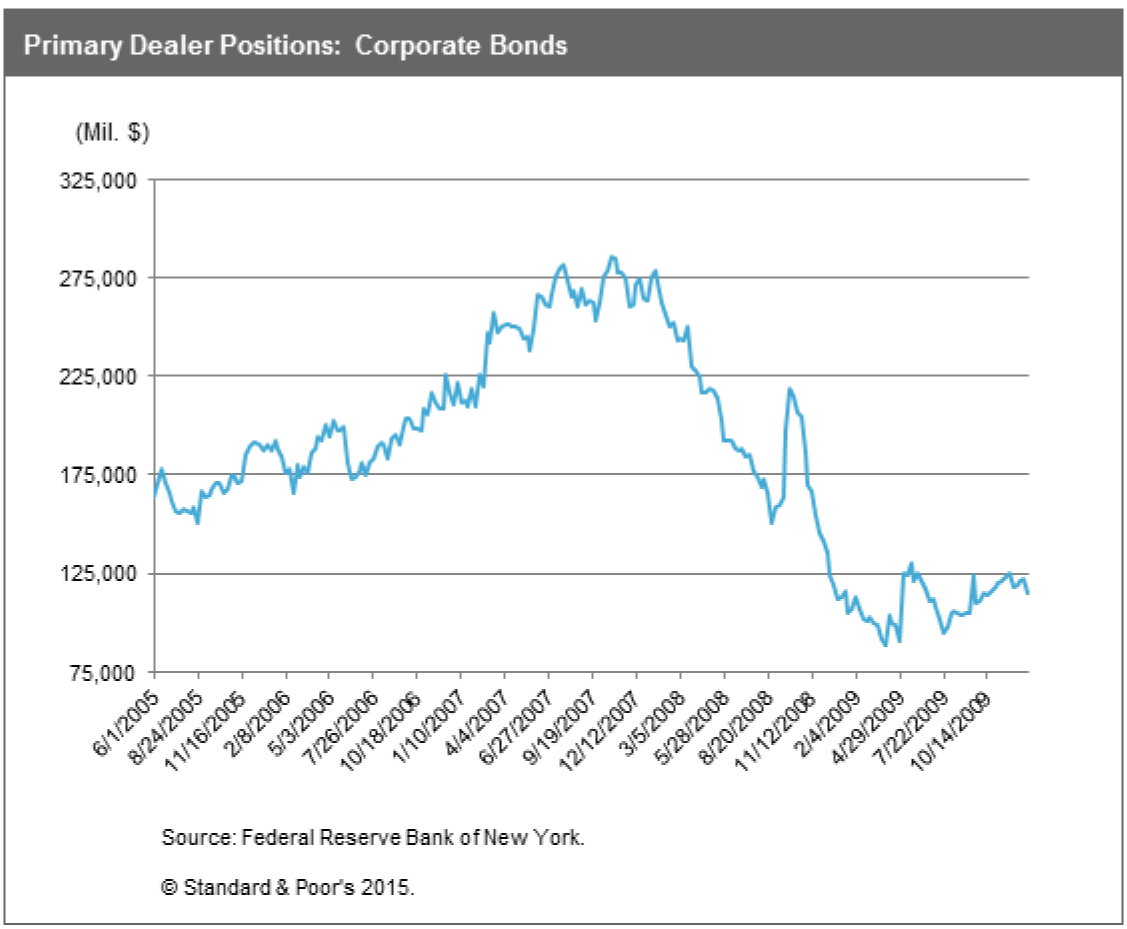
Liquidity (often described as the "oxygen" of the market) is an important topic for fixed-income markets, and the issue of what is and isn't liquid is often debated. How market participants define it depends on what side of the fence you are standing. How a buy-side analyst and sell-side professional assess it can be strikingly dissimilar. Because measures of what is liquid in primary markets and what is liquid in secondary markets tend to cloud the issue even more, mutual bond and money funds have typically found themselves at the forefront of this issue, either negatively or positively affected by the actions of others.

As the financial landscape has shifted, fixed-income funds have become a focal point of this issue, but in a manner they perhaps were not accustomed to. Historically, banks and other financial institutions were counted on to fill the role of market maker in the fixed-income market. Their participation was a given and considered an important part of how markets were expected to function. As a market maker, banks and dealers were expected to step up--provide liquidity and keep markets functioning smoothly. As we have seen over time, participation for these entities had limits, and their ability and willingness to fill that void has waned with the same perceived risks of stressed markets that drove investors to seek that liquidity in the first place.

Primary dealers and market making

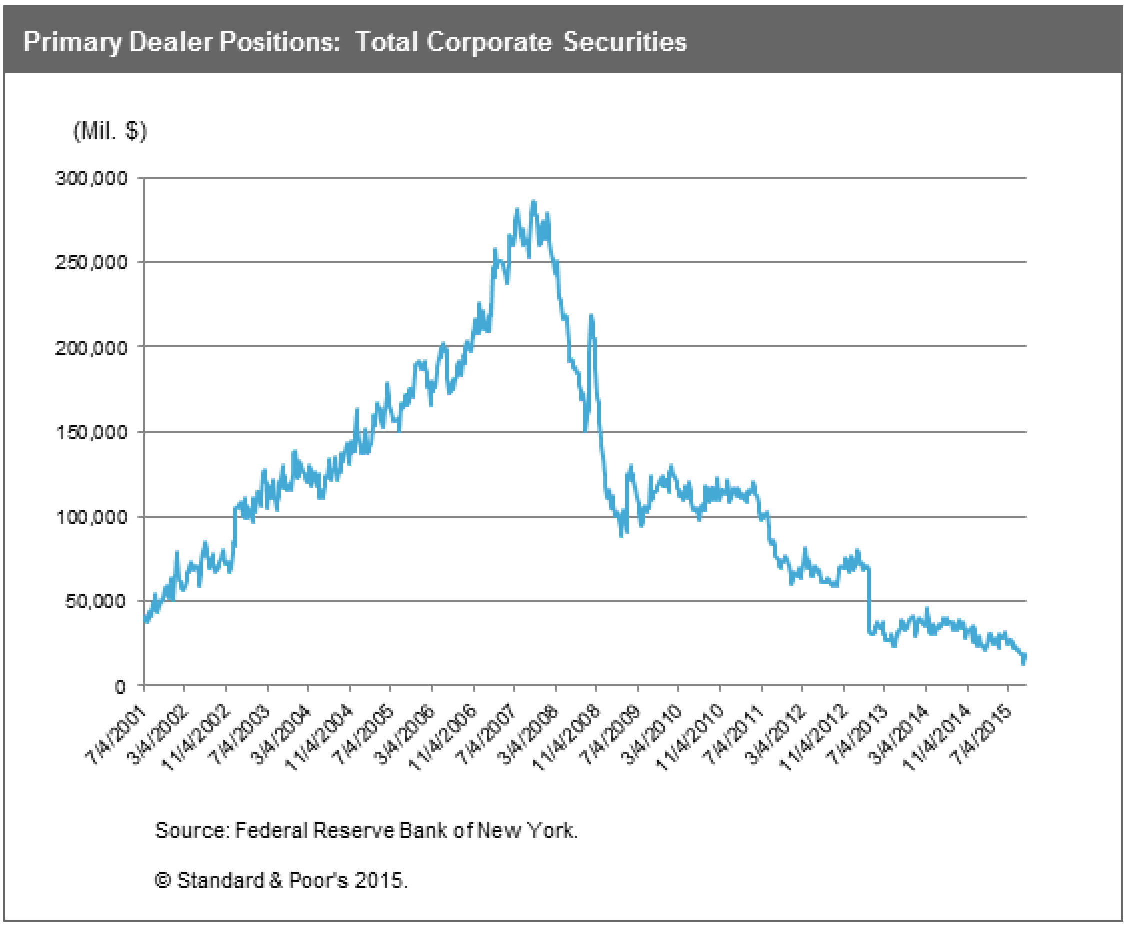
This was illustrated quite clearly during the 2007–2009 financial crisis. Dealers' willingness and ability to position corporate debt on their balance sheets was uncertain--it fell as headlines emerged about credit meltdowns and it rose with government initiatives meant to calm market concerns. Primary dealers' peak net positions of corporate debt occurred during late October 2007 (see chart 1) as structured investment vehicles (SIVs) caused stress in the short-duration market, and, in response, the Treasury Department began considering a proposed $80 billion liquidity facility, headed by four large U.S. domestic banks, to purchase those tarnished securities. From that point, as the flow of worrisome headlines continued, dealers' holdings of corporate debt declined steadily. The only respite to the downturn of dealer interaction was in October 2008, when a litany of government programs and initiatives intended to stabilize the markets was announced, including the Troubled Asset Relief Program, the Commercial Paper Funding Facility, the Temporary Liquidity Guarantee Program, and the Money Market Investor Funding Facility.

Chart 1



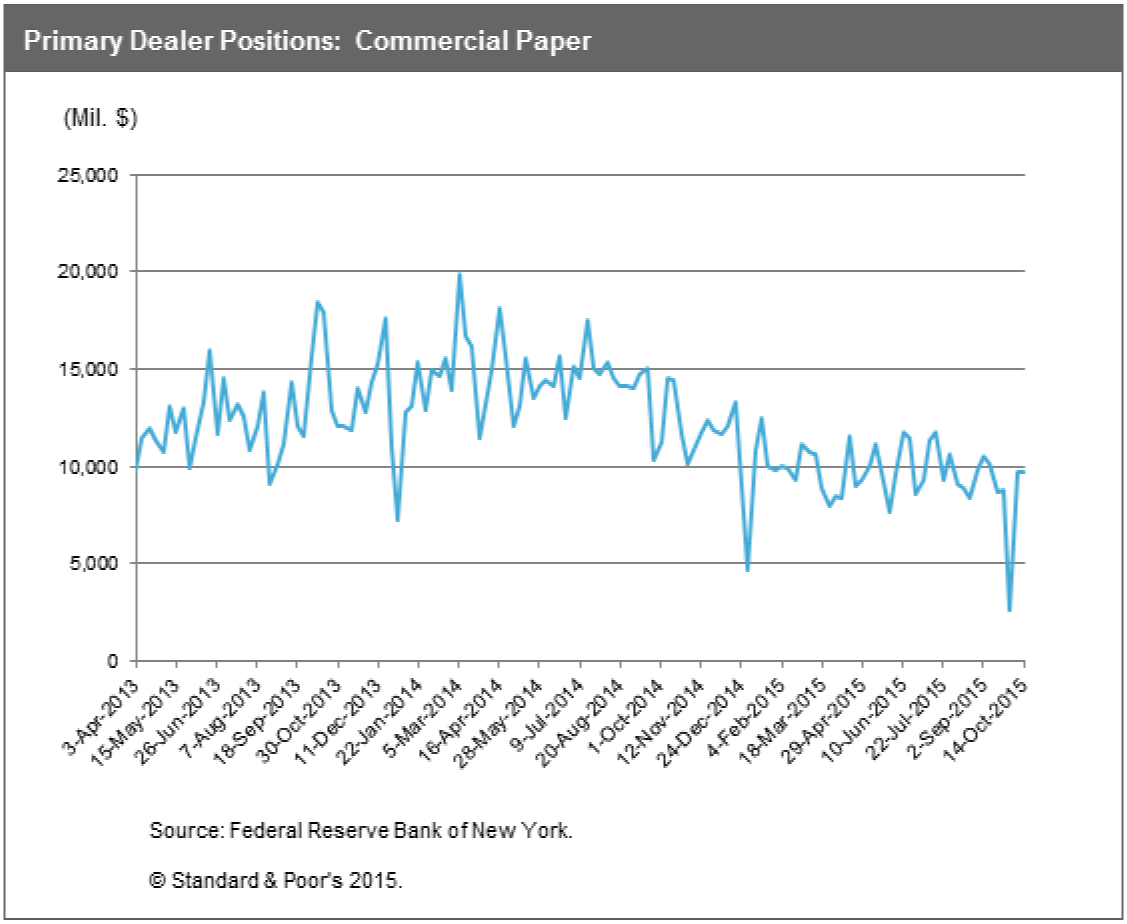
Prior to the 2007-2009 financial crisis, when markets rebounded and the smoke had cleared, dealers would return to their role of market maker and once again provide liquidity to the primary and secondary markets. That could well now be considered a distant memory--in the sense that financial markets forget anything greater than five years ago and that it happened in a world where banks didn't fail regularly. In today's world, the banks and dealers previously engaged in market making are now preoccupied with a swathe of regulatory reform requiring them to shrink their balance sheets, improve capital buffers, and strengthen liquidity profiles. The effects of this include the shedding of trading desks (proprietary trading), resulting in dealers' corporate bond positions shrinking further (see chart 2). This all seems a bit counterintuitive to the "strengthening" economy and rosier credit environment.

Chart 2



As frightening as that may seem for the overall bond market, it may be even more pronounced for short-duration and money market investors. Over the past two years, dealers' positions of commercial paper (CP), in absolute dollars, have fallen steadily. Worse, sharp drops (in terms of dealer positioning and, therefore, liquidity) seem to be especially acute during quarter-end and year-end time frames (see chart 3). This type of activity means in a moment of unexpected redemptions, when redemptions may be larger, the banks and dealers that fixed-income funds rely on to provide liquidity to shareholders are not willing to play their role, exacerbating secondary market liquidity stress.

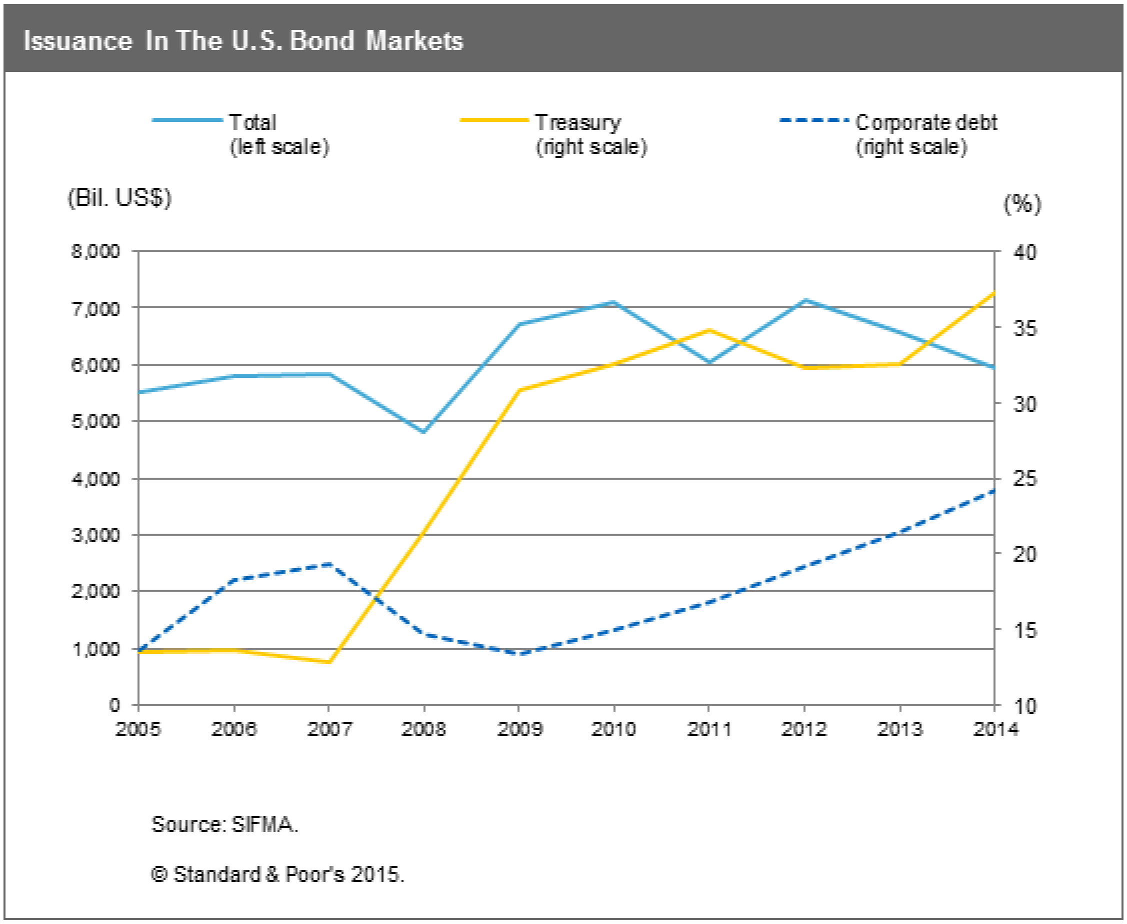
Chart 3



Issuance: Another side of the coin

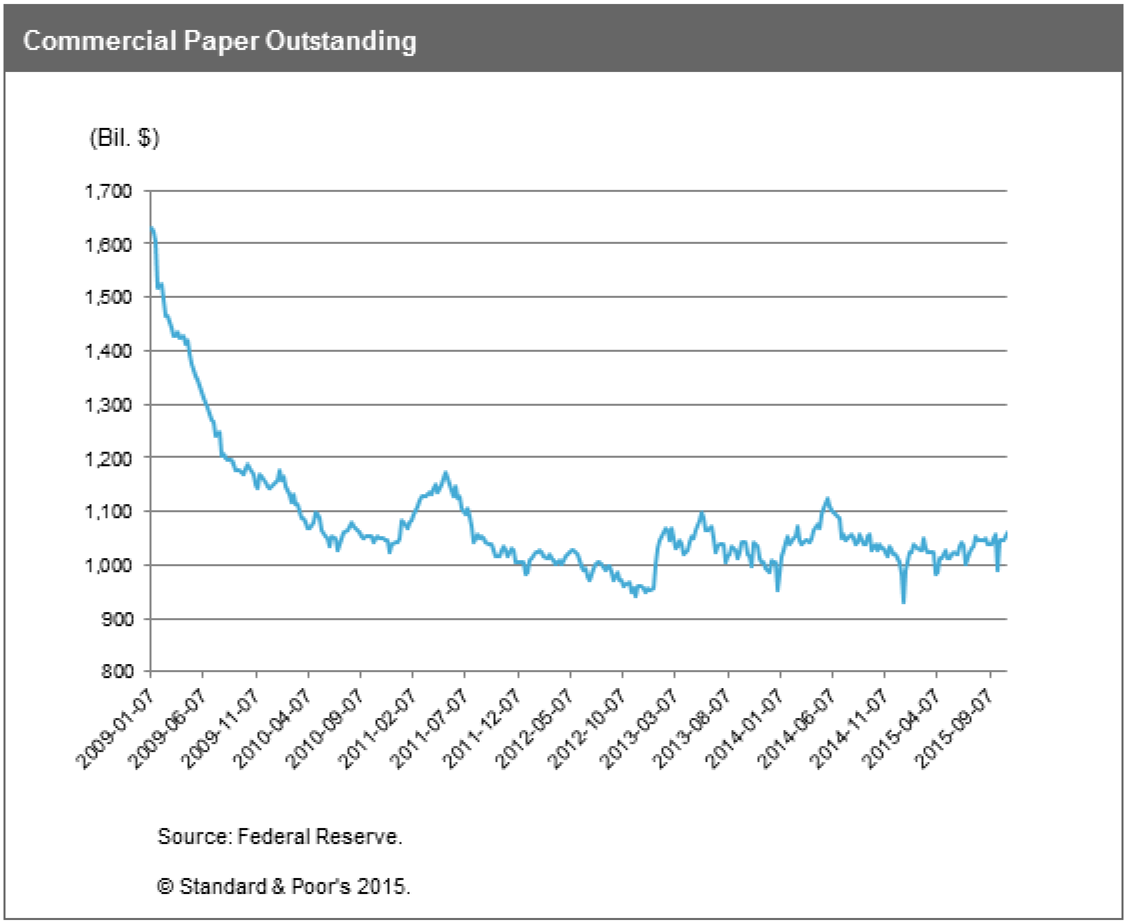
All of this is occurring at a time when overall issuance volume has been near historical highs. To astute observers, this is especially true for government debt: The U.S. continues to push its debt ceiling higher, and across the pond, negative interest rates are promoting favorable conditions for increased issuance from European governments. Additionally, the low interest rates in the U.S. have led to unprecedented growth of credit, in the form of corporate debt, as firms race to refinance while funding is cheap.

Chart 4



For the short-duration investor looking for returns of more than zero (0.00%), the current low interest rate has been undesirable, but for issuers it has encouraged them to seize the moment--capitalizing on low rates to issue longer-term debt rather than short-dated CP that MMFs rely on. Even after the precipitous fall from the heights of 2007, however, CP outstandings are beginning to recover from historical lows (see chart 5), giving some hope that even this type of issuance will start to grow.

Chart 5



What is a fund's appetite to provide liquidity?

So, with climbing issuance, who will take the place of banks and dealers in the role of market maker? The expectation is that fixed-income mutual funds could well step into this role.

One could view this as a natural progression of the mutual fund industry, considering its asset accumulation and specifically the expected growth of fixed-income funds as baby boomers move from equity-based funds and into the theoretically safer, coupon-producing world of fixed income. In sanguine times, that may be a perfectly fine expectation. But concerns about stability, in terms of liquidity, don't typically focus on times when the markets are calm, but rather when those waters are choppy. So, the real question is: Will fixed-income mutual funds be able to help stabilize markets during a turbulent period, when that liquidity is needed the most?

Fixed-income funds and MMFs are simply not immune to market conditions. Take a fallen angel, which is a credit that has moved to speculative-grade from investment-grade. Given shareholder flows in high yield, there would seem to be ample evidence that funds operating in that space would be able to provide liquidity to investment-grade funds that suddenly wanted to or needed to sell that security. One would expect high-yield funds that focus on that area of the credit curve to be more than eager to provide liquidity at stressed times and lay a ground floor for impressive future returns. Yet typically what happens is almost the exact opposite.

Historically, we have seen the managers we rate under our fund credit quality rating criteria (which cover a broad variety of fixed-income funds) become defensive in this situation. Some of that reaction has to do with managers abiding by investment guidelines that make investing in falling credits difficult, if not impossible. Certainly, MMFs would not be making these types of investments, and the majority of investment-grade funds are simply not allowed to because of limitations outlined in the prospectus. In stressful times they typically move to higher-quality securities. Even for investment-grade funds that can buy a smaller percentage of high-yield bonds, those managers cite regularly to Standard & Poor's a lack of familiarity with these fallen angel securities.

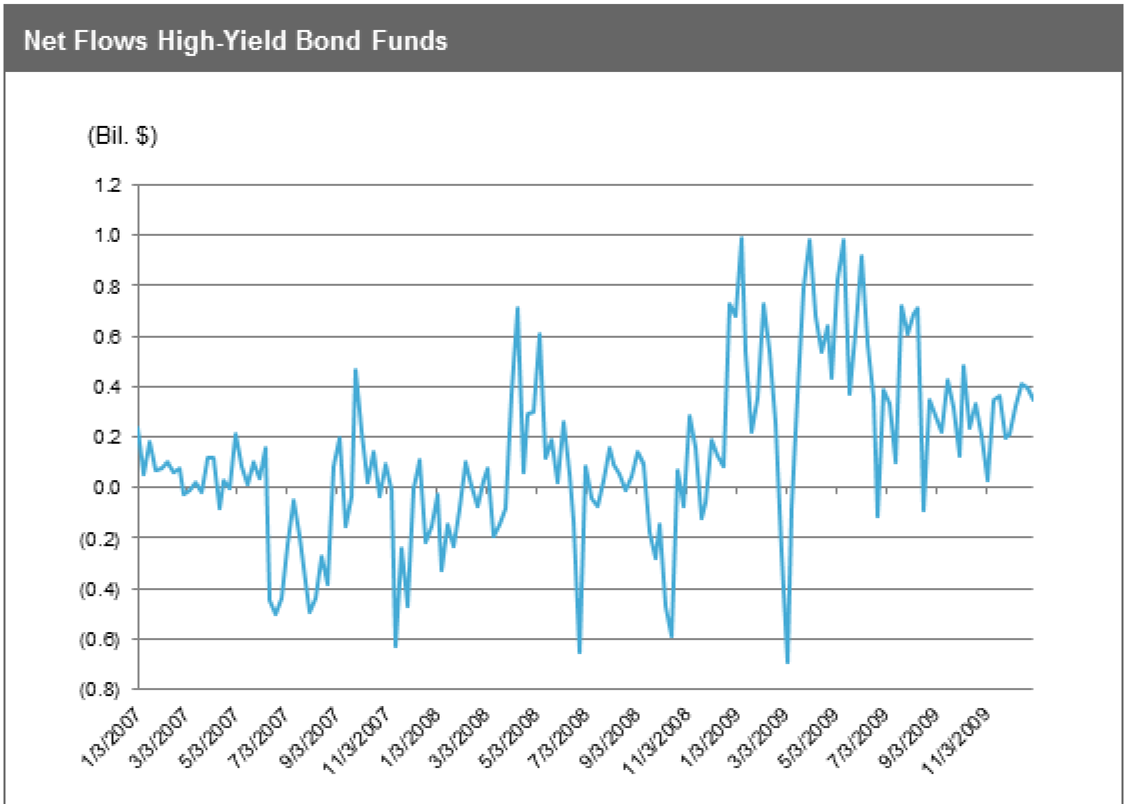
While we have seen during this period of low interest rates and higher levels of assets under management managers taking on more credit risk by adding unfamiliar asset types, we have also observed that dipping their toes into unfamiliar waters during a period of stress will most likely lead to more liquidity pressure. As a result, managers of these funds are more likely to walk away from sectors they're unfamiliar with quicker than they might have for sectors they are more familiar with. This lack of asset class historical experience could lead to a further deterioration of liquidity as fixed-income funds that had been buyers of the product increase liquidity pressures by becoming sellers. For funds that are index-based and passively managed, they have limited options to begin with, and if those impaired credits are removed from indices they track, they have little choice but to remove them from their portfolios or ignore those opportunities as they occur.

Even funds that theoretically can, by prospectus, participate in markets where investment-grade credits are falling into speculative grade tend to shy away. Part of this reluctance is based on the fear of the unknown and part is based on prudence. Catching a falling knife is far different than picking it up off the floor. Managers that focus on high-yield securities are most likely looking for relative value and quality. They are not typically opportunistic liquidity providers, but rather are investment teams that pride themselves on finding relative value through solid fundamental analysis built on historical performance and not simply running in to provide liquidity to a broken market, hoping for an upswing in prices. Ultimately, managers of these funds are focused on returns. Providing strong, steady returns is important to these managers. Indeed, historical returns with a high degree of volatility (i.e., being a top performer one year and a laggard the next) are not typically enticing for institutional clients and the advisers helping to identify suitable managers.

This is ultimately the largest issue for managers of fixed-income funds. They manage other people's money and their shareholders have the ability to ask for weekly liquidity or even daily liquidity. Shareholders watch television reports, read newspaper articles, and sometimes irrationally respond to headlines at times when credit markets are under siege. Their inclination is to withdraw money from those funds and do so at moments when headline risk is high. Thus, fund managers must be prepared for a "run" on their funds as redemptions come in faster. At a time like this, even if the managers saw extreme value in providing liquidity to secondary offerings, their own funds would most likely be experiencing a higher redemption rate and would be forced to defensively move into higher-quality assets in anticipation of the higher redemptions. The unfortunate flip side to this is that market conditions and higher redemptions turn them into sellers in a market they'd rather be buying in.

This is especially true when looking at high-yield funds. During the Great Recession (2007–2009), liquidity sometimes vanished, and credit was under pressure--theoretically a great buying opportunity. And yet, high-yield funds suffered large outflows as shareholders reacted to negative headlines and moved to higher-quality securities (see chart 6).

Chart 6



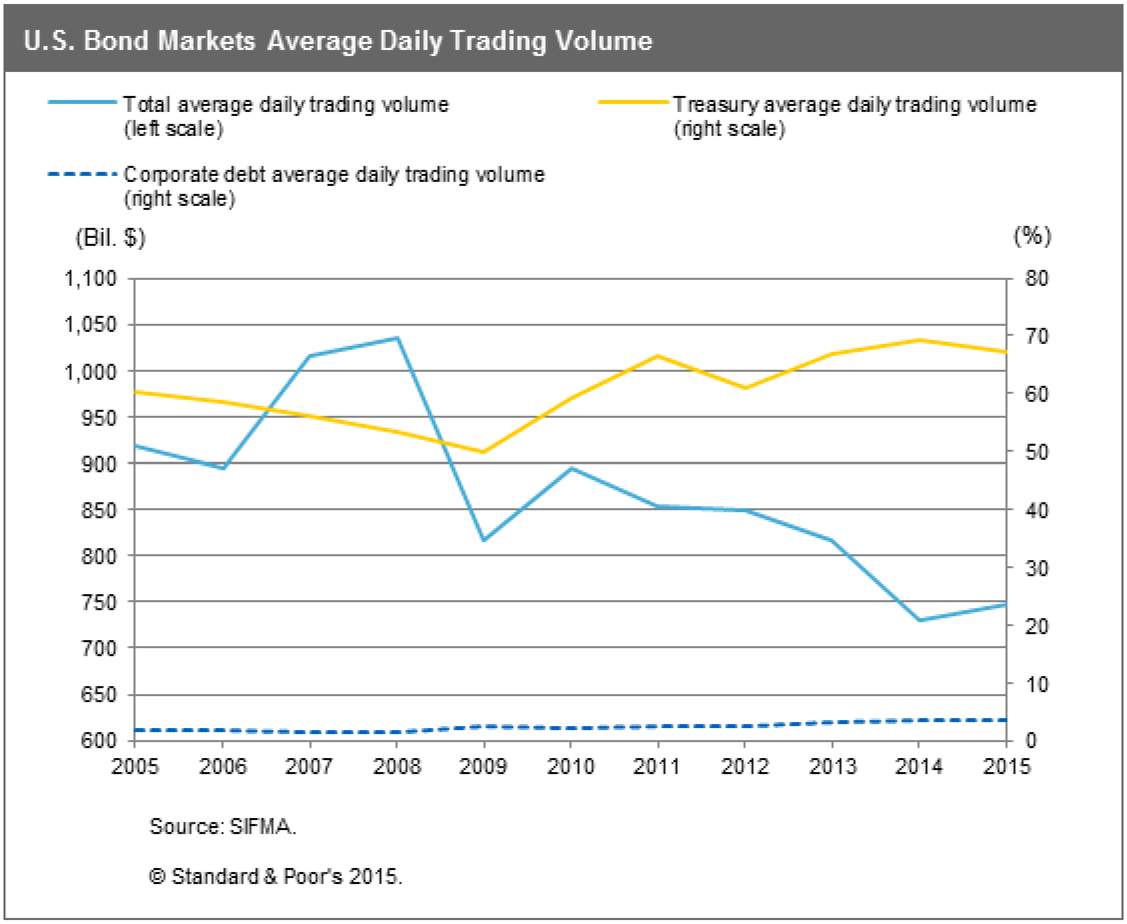
Source: Lipper.

Four large negative movements occurred during this time. The first in October 2007 coincided with the lack of liquidity in short-duration markets, specifically around SIV exposures, but also with the negative market sentiment toward several large banks. The second large negative change occurred in early June 2008, around the time Wachovia's CEO retired and questions arose about that entity's ability to survive. The third large drop began in early September 2008 when investor confidence in Lehman Brothers began to plummet. The last, and no doubt largest, negative movement was in February 2009, when international banks such as UBS, RBS, and Lloyds were reporting devastating losses combined with the stock market suffering historic falls: the S&P 500 dropped some 18% during January and February. Even after the majority of those drops, while some recovery was witnessed in flows, the majority of that recovery was not necessarily positive net flows, but rather a continuation of negative flows, just less negative than the week prior. Thus, at a moment of crisis, when assets were theoretically cheap, or at least cheaper, high-yield funds were in defense mode, having to battle their own liquidity problems.

Trading activity: Lack of investor participation

So, the fixed-income markets are now at a point where primary dealer holdings are falling and issuance is climbing. Furthermore, this is taking place within a financial marketplace being pushed toward a model in which fixed-income funds themselves are being counted on to help markets function smoothly by providing their own liquidity to one another. How does that look so far? The recent trading volume is occurring during what has been, for the most part, a benign credit environment (see chart 7). Yet daily trading volume continues to fall, especially compared with the 2008 peak.

Chart 7



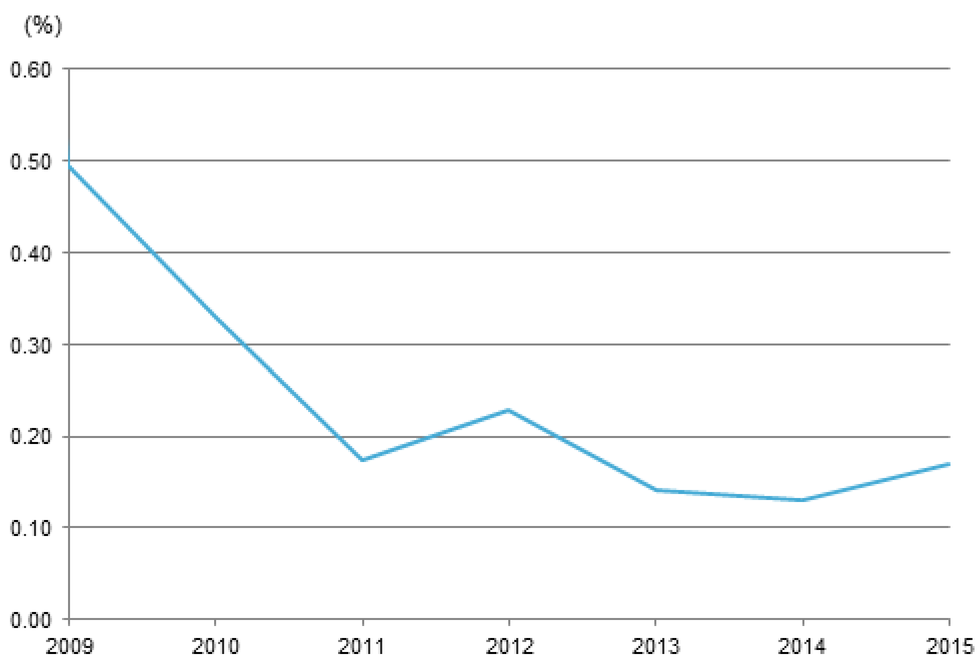
How liquid is the current bond market? It is hard to say. The reason is that with a flood of money into it, investors and mutual funds have not been heavy users of secondary market liquidity. The heavy inflow of money has meant primary liquidity is still in place because investors are hungry for the product. And the lack of secondary activity is due to a need to hold onto what was so hard to come by in the first place. But equating primary liquidity as a proxy for how things will shake out when the market deteriorates and secondary liquidity is needed or wanted seems to be a misguided effort. When markets are stressed, the liquidity everyone truly cares about is secondary liquidity. Right now, without dealer or bank participation in large sizes, there would be an expectation that funds would provide that needed service to one another. And that may be misjudging not only the mechanics of fund prospectuses but also the psychology of how those very funds operate.

Saying Goodbye To Fee Waivers

After nearly a decade of coping with low rates of return, there appears to be a light at the end of the tunnel. After years of waiving fees and adjusting expense ratios so that their MMFs return something, anything, to shareholders, U.S. MMFs are finally seeing some movement in longer-term rates, buttressing their hopes for growth in gross yields.

Chart 8

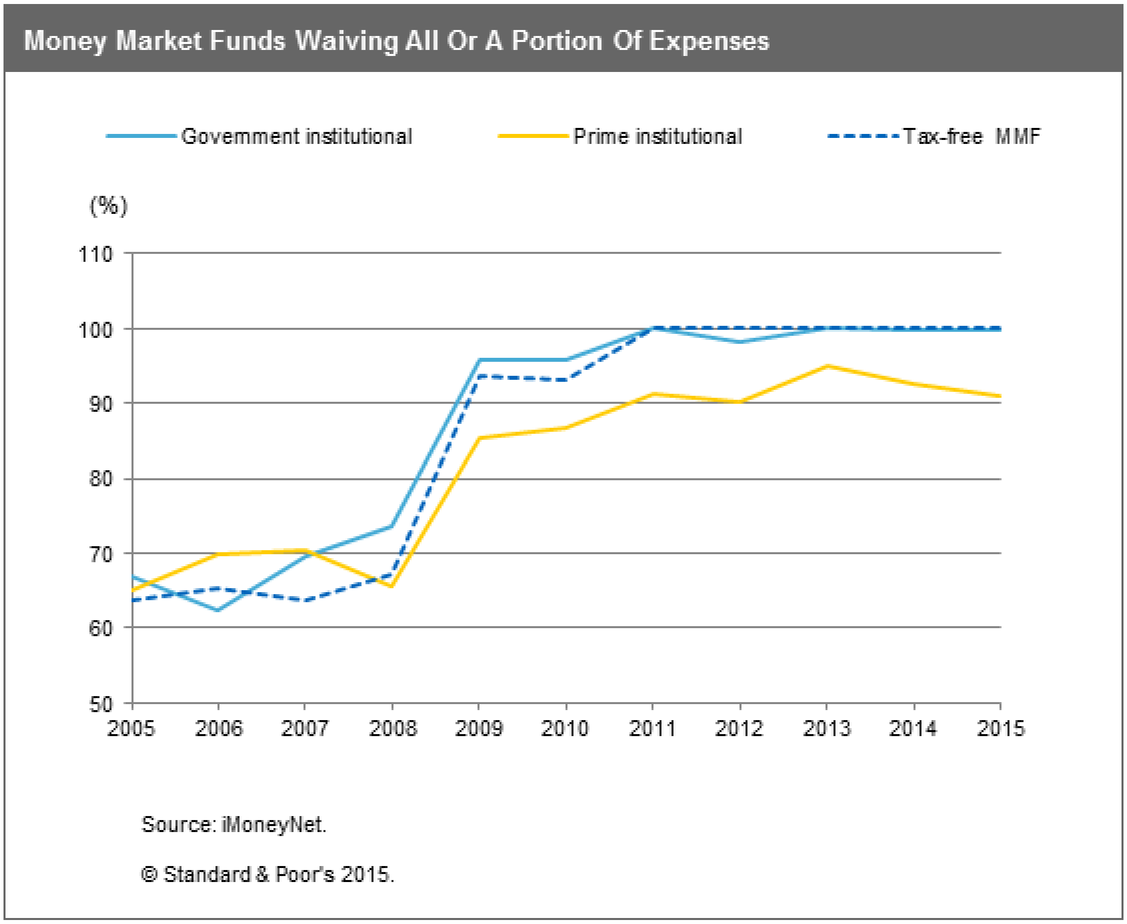
Crane Money Fund Average Gross Returns



Source: Crane.

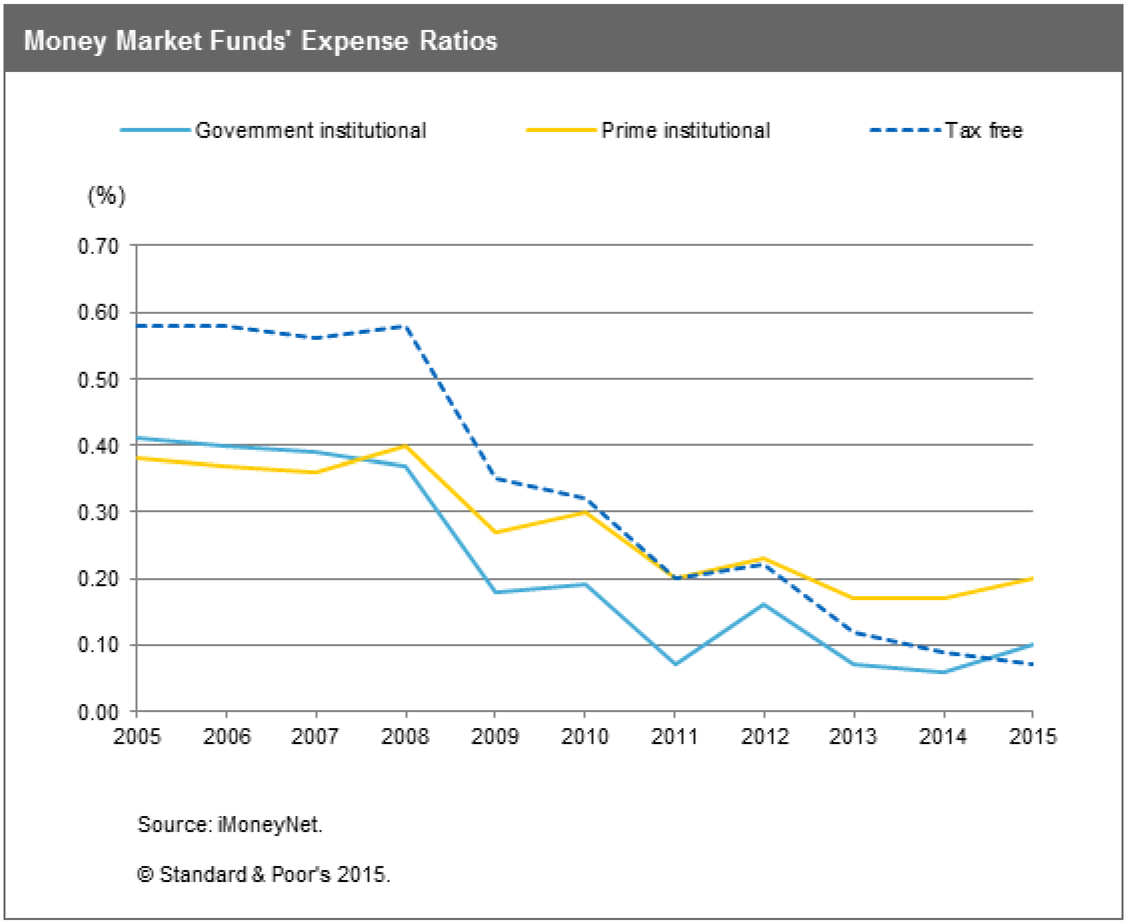
Certainly, the rise in gross returns is nothing dramatic, but when discussing the difference between 1 basis point and 3 basis points, well, everything is truly relative. If nothing else, it is providing a ray of hope to what has otherwise been a dreary operating environment. The number of firms over the past decade waiving a portion of their fees had risen to the point that by 2011, it was virtually 100% of those operating government institutional, prime institutional, and tax-free MMFs (see chart 9).

Chart 9



Worse for these firms wasn't just that they needed to waive fees, but how much they needed to waive just to provide a small return, no matter how paltry, to shareholders. In almost direct contrast, as the number of funds that were waiving fees grew, the amount being waived, illustrated by falling expense ratios, also rose (see chart 10).

Chart 10



The bump in gross returns is being muted somewhat as investment managers purposefully keep maturities of portfolio holdings short so as to be in the appropriate position for the ever-promised Fed rate hikes. Thus, one could argue that the turn to higher yields is actually even more positive than what has actually manifested itself so far in fund returns.

With growing positive gross yields and the expectation that as yields rise and expense ratios return to more normal levels, MMF operators could once again exhibit the stronger, more positive returns their firms have come to expect.

Across The Pond

To be sure, it has been tough going for U.S. MMFs, especially while operating with the interest rate near zero. So then, what has it been like for euro-denominated funds, which have been subjected to a sub-zero interest rate over the past two years? If it was difficult, in the U.S. for MMFs, to earn any amount of fees with the interest rate near zero, the assumption would be that those operating in a negative yield environment would most certainly be suffering a great deal more. However, that isn't exactly the case.

One large multinational MMF sponsor once told Standard & Poor's that "you never make any money in euros," and "asset size is the only thing that matters." Now it appears that fund sponsors can not only make money in euros, but

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also can do so in a negative yield environment. How? Well, simply by extending the use of share cancellation.

Share cancellation is a method that constant net asset value MMFs use to stabilize the NAV at €1 per share when a fund is encountering negative yields. The European industrywide rollout of share cancellations over the past two years to combat negative yields can also be used as a mechanism to reintroduce fees on a larger scale. The average margin (the difference between net and gross seven-day yields reported to Standard & Poor's) is 4 basis points (0.04%) for euro-denominated funds, 12 basis points (0.12%) for U.S.-dollar denominated, and 14 basis points (0.14%) for pound-sterling MMFs.

Focusing on euros and the idea that asset size matters, 4 basis points (0.04%) of fees on €1 billion is revenue of €400,000. Boost that MMF asset base to €10 billion, and the addition to an asset manager's bottom line is significant (up to €4 million). Improve the margin by 2 basis points, and again there's improvement. Further industry consolidation will only see fund sizes get larger, leading to reduced competition, but ultimately a greater slice of the pie to a select few.

Of course, the industry is a little sheepish in admitting this, but after years of investment--boosting capabilities across technology, risk and compliance, and credit research--it does come with an associated cost, and investors are accepting that cash may no longer be king. And accept it they have. Each fund using this mechanism previously had received approval from shareholders to update their prospectuses for the allowance of this tool. It may be surprising that despite shares being canceled every day and investors' principal being eroded, MMFs are still incredibly popular, not only because of the lack of alternative choices, but also because of their ability to focus on safety and liquidity through portfolio diversification.

With the advent of share cancellation, MMFs have the neatest avenue to end low revenues and reestablish fees at an appropriate (yet larger profitable margin). In our forecast, despite negative yields and investment returns being a pittance, margins for MMF asset managers in Europe can, and most likely will, increase in 2016, albeit a few steps behind those of U.S. domestic managers operating in a so-far more forgiving yield environment.

How is share cancellation applied to MMFs?

Here's an example of share cancellation and its method. This example represents the loss of an investor's shares over a holding period of one day. It is pretty vanilla in its application, but when the method is stressed by including fund fees and charges, plus a much longer holding period--let's say one year (see table)--and a greater negative yield, the impact is more dramatic.

Share Cancellation And Its Method

Example 1: MMF - One-day holding period with a negative yield

Activity	**Method**
Subscription	€1,000,000 @ €1.00 NAV per share
# of shares owned	€1,000,000 / €1.00 = 1,000,000 shares
Fund yield (annualized)	-0.07%
# of shares cancelled (after one day)	1,000,000 x (-0.07% / 365) = -1.92
# of shares after cancellation	999,998.08
Value of shares	€ 999,998.08

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Share Cancellation And Its Method (cont.)

Example 2: MMF - One-year holding period with a negative yield

Activity	**Method**
Subscription	€1,000,000 @ €1.00 NAV per share
# of shares owned	€1,000,000 / €1.00 = 1,000,000 shares
Fund yield (annualized)	-0.12% (annualized)
Fund fees and charges	-0.06% per annum
# of shares cancelled after one year	1,000,000 x 0.18% = 1,800 shares
# of shares after cancellation	998,200.00
Value of shares	€ 998,200.00
Equivalent loss over one-year holding period	0.18% or 18 basis points

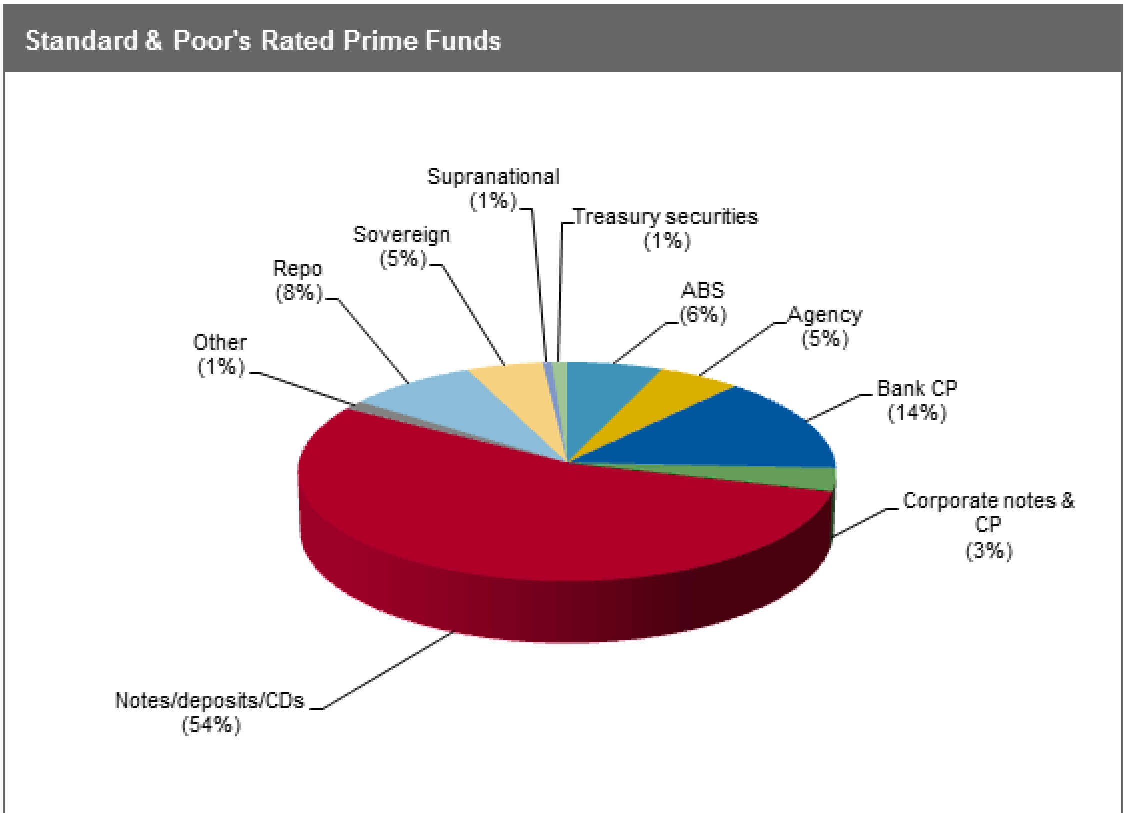
Considering a longer holding period (most prospectuses listing share cancellation have only a one-day holding period), as well as fund charges more reflective of current conditions, it is apparent that upon the investor redeeming its shares, the number of shares will be less than when the investor first entered. This is despite a €1 NAV on the accounting statement. In this second example, the loss over the one-year holding period is 18 basis points, or €1,800 less than the original principal investment of €1 million.

Credit Risks: One Last Cloud In The Outlook

In 2016, we see rising rates in the U.S. benefiting MMFs, euro-denominated funds being able to make money without any yield, and mutual funds riding to the liquidity rescue. Despite that, MMF funds are facing one more issue: credit risk. Credit risk always seems to be in the way, and nowhere is that more obvious than what we see transpiring in the banking sector.

Historically, bank risk in the form of CP, certificates of deposit, time deposits, bank deposits, repurchase agreements (repo), and asset-backed CP have been a large and important component of MMF portfolios. Indeed, funds' investments in this sector are typically 60%–80% of their portfolios. And while those holdings sometimes come in different forms, the overall investments can be large. Thus, their importance cannot be understated to the short-duration investor (see chart 11).

Chart 11



ABS--Asset-backed securities. CP--Commercial paper. CDs--Certificates of deposit.

Pre-2008, the credit health of banks, especially those that were seemingly permanent residents of the Tier 1 space, was not truly a concern. Prior to 2008, the Tier 1 institutions that issued debt, coveted by MMFs, were some of the largest in the world, boasting impressively large balance sheets, well-known brands, and diverse business platforms. The majority of those institutions were of such high credit quality that they were safely within the Tier 1 credit rating bandwidth (short term ratings 'A-1' or better). But that was then, and this is now.

Since 2008, banks have found themselves squarely in the sights of regulators. After watching the solvency of so many banks come into question, they began demanding changes--pushing for a strengthening of balance sheets and proof of that through newly created liquidity ratio requirements. This led to a reshaping of the industry and those who were left to populate it. There were many fabled names that simply did not make it out of the Great Recession and were either swallowed by competitors, or worse, left on a symbolic piece of ice and pushed out to sea, like Lehman Brothers.

Banks are now in a relatively new age. Those still operating and needing funding from MMFs have undergone significant changes. And the MMFs still have worries as the remaining banks continue to navigate through regulatory changes and, separately are learning how to operate in this low-rate environment with smaller staffs and fewer resources. How banks are responding to these operating conditions, as well as their own pared-down structures, has caused rating actions and will, in the future, potentially be the source or cause for more.

For the past year, bank rating changes have been muted domestically and globally, but changes have occurred. Year to date, there have been some noteworthy rating actions, including the downgrades of large European banks such as Barclays Bank and Deutsche Bank. While MMFs' exposures to these banks were certainly worth noting at the time of the downgrades, the majority of MMFs that did have investments in these entities prior to rating agency actions mostly reduced any long-duration holdings. However, what seemed especially painful at the time was the MMFs' inability to continue using these firms as counterparties for repos. With MMFs having so many kinds of investments with banks, and with Rule 2(a)7, part of the Investment Company Act of 1940, requiring a great deal of upfront liquidity for the funds, many had turned to repos as a means for managing that requirement.

Nevertheless, while the downgrades are worth noting, the real focus here is on where we are and where we are going. MMFs do rely a great deal on this sector for investment products. Recently, as the industry well knows, overall supply of any type of investment has been constrained. In June 2015, The Banker published a list of the top 100 global banks--by amount of Tier 1 capital--which consists of some of the larger issuers and exposures as counterparties within MMF portfolios. Based on their current long-term ratings (see chart 12), approximately 74 of the top 100 banks are seemingly within rating levels that MMFs typically require for short-term issuers that populate their investment space. But, as the outlook distribution shows, there is a great deal of potential change on the horizon for the sector (see chart 12). Outlooks of positive or negative are an indication the rating can change in the intermediate term, which is typically a period of six months to two years.

Chart 12

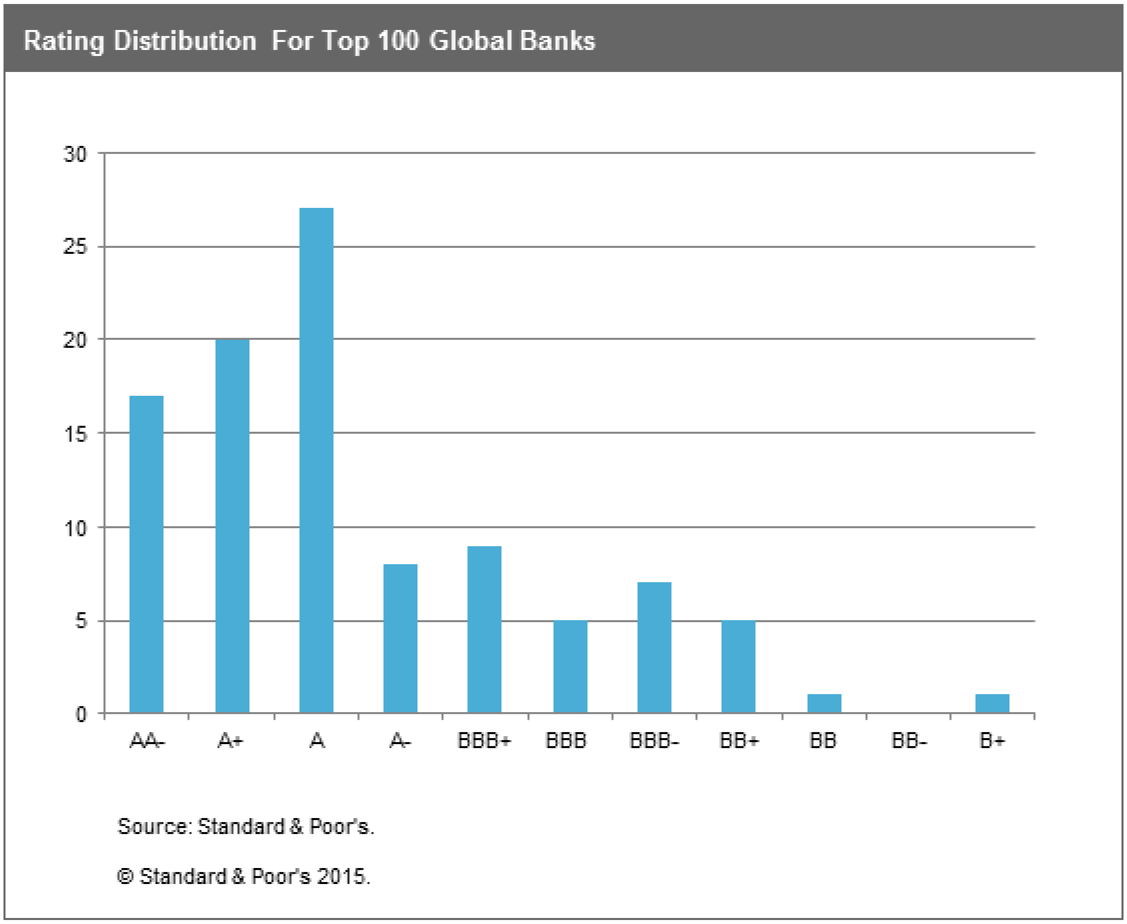

Rating Distribution For Top 100 Global Banks
30
25
20
15
10
5
0
AA-
A+
A
A-
BBB+
BBB
BBB-
BB+
BB
BB-
B+
Source: Standard & Poor's.
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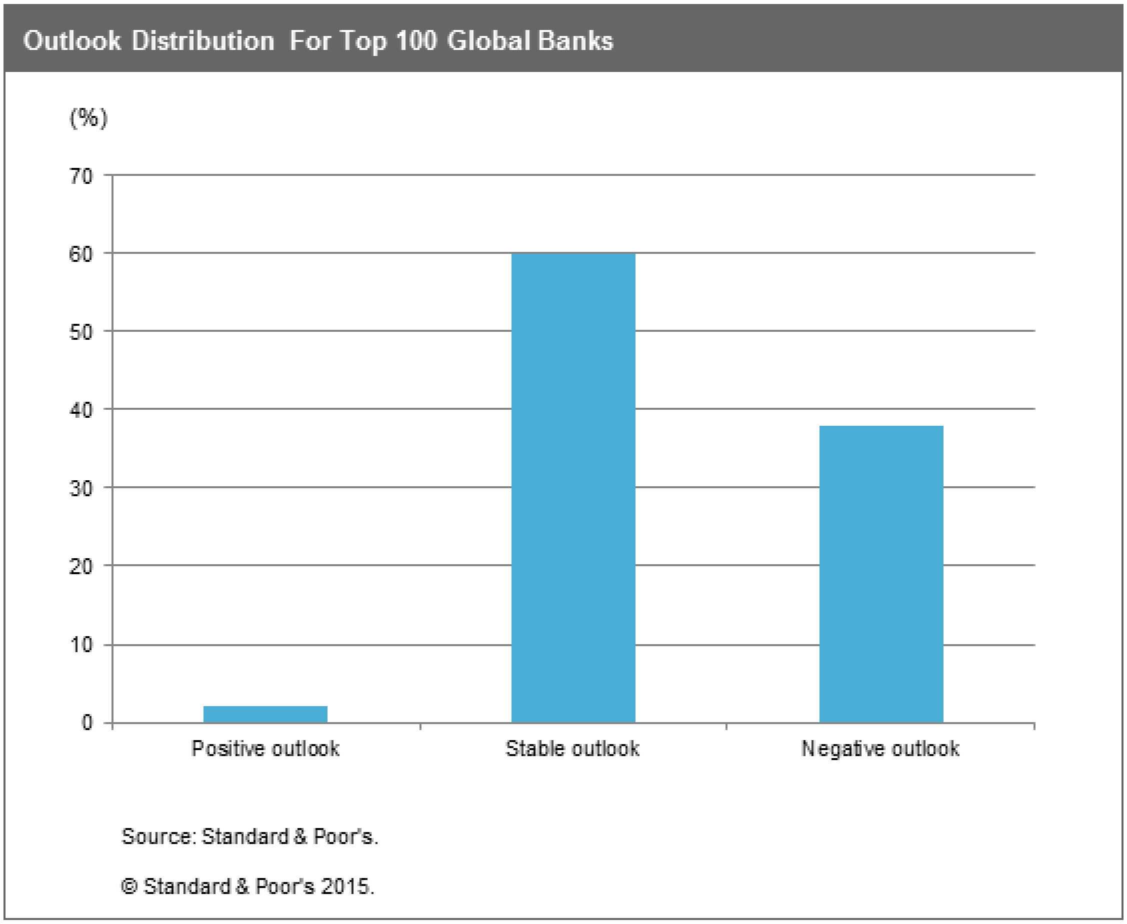
Chart 13



To allay concerns for the MMF (Tier 1 focused) sector, not all the entities listed in the chart are Tier 1 issuers or are even relied-upon counterparties. But, the global banking sector still seems to be in a state of change, and for MMFs, that certainly is something to focus on in 2016.

Related Criteria And Research

Related Criteria

- Methodology: Principal Stability Fund Ratings, June 8, 2011
- Fund Credit Quality Rating Criteria, Feb. 2, 2007

We have determined, based solely on the developments described herein, that no rating actions are currently warranted. Only a rating committee may determine a rating action and, as these developments were not viewed as material to the ratings, neither they nor this report were reviewed by a rating committee.