The Changing Tide in The Money Market Universe

In September 2008, amidst financial upheaval and bankruptcy headlines, the "breaking of the buck", or the scenario in which the net asset value (NAV) of a money market fund fell below $1, received surprisingly low billing. Specifically, the breaking of the buck by the Reserve Primary Fund, one of the oldest money market funds and assumed to be as safe as cash, lowered its share price below $1 in response to its Lehman Brothers exposure. Meanwhile, eight years later, that event has caused a chain reaction that is now creating turmoil within parts of the fixed income market, and causing new regulations that could significantly impact funding sources among many institutions.

Let's take a step back and review money market fund basics. The purpose of a money market fund is to provide investors with a safe place in which to put cash in exchange for a low interest rate, much like a checking account. The money market fund, in turn, invests in many supposedly safe short-term debt instruments, provides liquidity in the form of short term credit to many institutions and generates a small interest payment. There are three types of money market funds, Prime, Municipal, and US Government. The Primary Fund (originally the Prime Fund), was invested in asset backed securities and corporate short term debt deemed suitable by the SEC. Following the Lehman bankruptcy, the fund was forced to write down a significant portion of its assets, thereby dropping the NAV from $1 to $0.97. This caused mass withdrawals from similar money market funds as investors feared these instruments would collapse along with all the other investments in their portfolios. As a result, the Primary Fund halted redemptions, refusing to return investor capital; an unheard-of scenario given that these products were sold as a substitute for cash. Money fled from money market funds, which caused liquidity in the short-term debt market to dry up and exacerbated the financial crisis.

In the wake of this occurrence, the SEC passed a series of rules that went into effect October 14, 2016, ultimately mandating that all Primary and Municipal Money Market Funds' NAVs float just as traditional mutual funds do. It is important to note that this rule does not apply to US Government money market funds. In effect, the SEC's amendment removed part of the reason an investor uses a money market fund, the security of getting $1 back for every $1 you invest. Despite higher interest payments by Primary Funds (60bps compared to 6bp for US Government money market funds), money is pouring out of Primary Funds and into US Government Money Market Funds. The question is, why does this matter?

Prior to October 2016, Prime Money Market Fund assets ranged from $1.2 to $1.4 trillion and Government Money Market Fund assets ranged between $800 billion to $1 trillion. As of the end of October, Government Money Market assets were $2.1 trillion, while assets in Prime Funds were only $380 billion, or roughly one-fourth the average before the rule change. Investors in these Prime Funds used to be large US companies and banks, who held the Prime Funds to fund their day to day operations. Prime Funds provided the liquidity needed to meet the daily cash demands prior to the recognition of a company's revenue or provided extra cash to meet short term reserve requirements. The drastic fall in the assets available to replace the role of Prime Funds has caused a fight for what's left, resulting in a 3-month Libor Rate (the rate used when pricing short-term loans) that has "detached" from the Fed Funds Rate. The below chart shows how Libor followed the Fed until its last rise in December, then held steady until June when Prime Money Market assets began to fall as investors moved assets from the Prime Funds to the US Government Money Market Funds.

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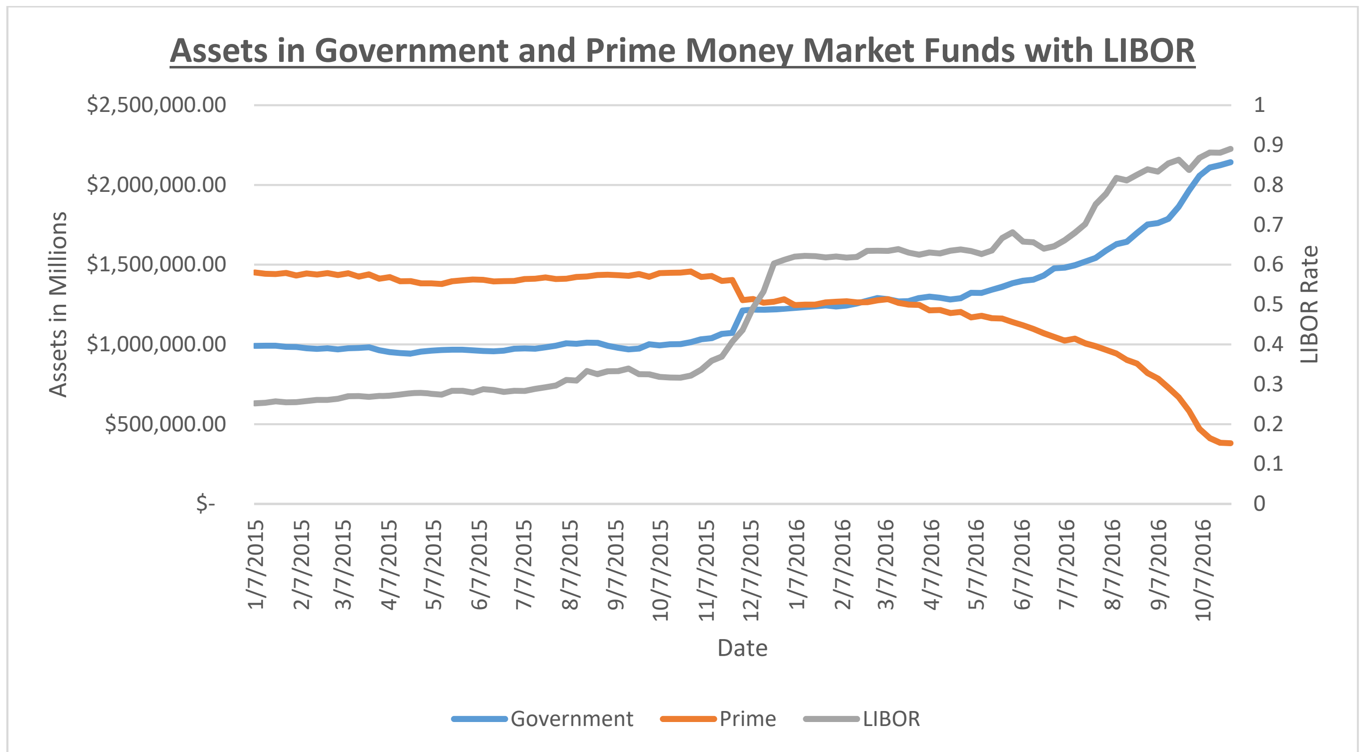

This is important for a few reasons. First, in essence, Libor has already priced in an additional 25 bps move by the Fed. Second, floating rate notes issued by many companies typically have 3-month LIBOR floors between 75bp and 1%. Until now these companies have gotten away with paying low rates on their debt, but now that Libor is rising, we may see increased fixed bond issuance and possible defaults from firms over exposed to the increase in interest on their floating rate debt. Goldman Sachs estimates that nonfinancial debt referencing LIBOR tops $28 trillion in the United States. This includes private student loans, mortgages, nonfinancial corporate borrowing, home equity loans, and many other liabilities.

Like many events in the market, an opportunity now exists with this recent development. Actively managed floating rate funds allow investors to invest in these instruments, utilizing managers' fundamental research capabilities to weed out firms that may struggle with increased payments. This provides a double benefit, not only does the investor benefit from increasing interest payments, but these funds can act as a key hedge against rising rates within the fixed income allocation of a balanced portfolio. Another way an investor could take advantage is through a security like Cohen and Steers Limited Duration Portfolio (LDP), which utilizes fixed to floating and floating to floating preferreds to control duration. This has the added benefit of providing extra upside as Libor continues to rise. Though we recommend utilizing active managers in this space, if an investor prefers to use an ETF vehicle there are several options. Three of the more common are the iShares Floating Rate Bond ETF (FLOT), the SPDR Barclays Investment Grade Floating Rate ETF (FLRN), and the PowerShares Senior Loan ETF (BKLN).

*Disclaimer: Some clients of Lynx Investment Advisory have current investments in LDP