Money Market Reform and Rising Rates

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Ready for Next

BACKGROUND

When the Reserve Primary Fund (Reserve Fund) broke the buck on September 16, 2008, most in the mutual fund industry had little idea what a profound effect the event would have on money market funds nearly a decade later. As a result of the Reserve Fund breaking the buck the SEC enacted reform to Rule 2a-7 of the Investment Company Act of 1940 (the 1940 Act). The largest portion of that reform went into effect on October 14, 2016, that, coupled with first historic low interest rates followed by rising rates, has created an unique situation for boards and management when benchmarking money market funds over the past year. The Fiduciary and Compliance Services team at Broadridge has spent significant time over the past year working with our 15(c) clients on the impact of these two forces. We have seen shifts in the number of funds, where they invest, who can invest in specific funds, as well as the impact of rising rates reducing the need to waive expenses all make benchmarking money market funds difficult. In this paper we attempt to highlight what all of these changes mean to the board with the optics of one year of data to further our knowledge.

Rule 2a-7 Reform

The two main components of money market reform are the enactment of liquidity gates for some products and the requirement that institutional prime money market funds must utilize a floating net asset value (NAV). All retail money market funds and institutional government funds can still have a constant NAV. While the liquidity gates offer funds an additional tool to control redemptions in stressed market conditions, this portion of the rule change has had less direct impact on fund expenses or classifications than the rules surrounding retail money markets and institutional government and prime funds.

In terms of retail money market funds, the SEC has said these products must be purchased by "natural persons", though this does include funds that are held by natural persons through retirement accounts. In contrast, the SEC does not specifically address what an institutional investor is and, interestingly, a family trust is considered an institutional investor. The intent of requiring a floating NAV for institutional investor is the belief that an institutional investor is more likely to move large amounts of money during stressed market conditions. In practical terms 2a-7 reform has shifted the overall landscape of money market funds with a number of institutional prime money market funds merging, liquidating, changing their investment mandate to institutional government securities, or in a few cases refining who can invest and becoming retail products. In Table 1, we have highlighted the changing landscape for money market funds. The most noticeable shift has been the decrease in funds and assets for institutional prime money market products and the increase in funds and assets for institutional governement money market products. While the changes related to classifications and the number of funds within a classification occurred prior to October of 2016, the result has had an effect on the 15(c) process throughout 2017 and will continue to impact boards over the next several years when reviewing historical expenses and performance due to the number of institutional prime funds that now have converted to institutional government products. In terms of peer groups for the 15(c) review, the decrease in the number of possible peers by nearly 50% for institutional prime money market funds, from 268 in early 2016 to 138 in 2017, provides an example of the new challenges to compiling peer groups, as well as indicating why peer groups have had significant shake-ups recently.

Table 1

Classification	Fund Count April 30, 2017	AUM ($Mil) April 30, 2017	Fund Count April 30, 2016	AUM ($Mil) April 30, 2016	Fund Count April 30, 2015	AUM ($Mil) April 30, 2015
Institutional Prime Money Market	138	430,646.70	268	818,491.60	263	796,571.10
Institutional US Government	230	734,517.50	191	388,582.80	183	352,477.70
Retail Money Market	119	300,315.90	189	497,818.50	190	509,199.10
Retail US Government	161	449,237.00	88	157,649.50	90	139,704.10

WHERE ARE WE TODAY

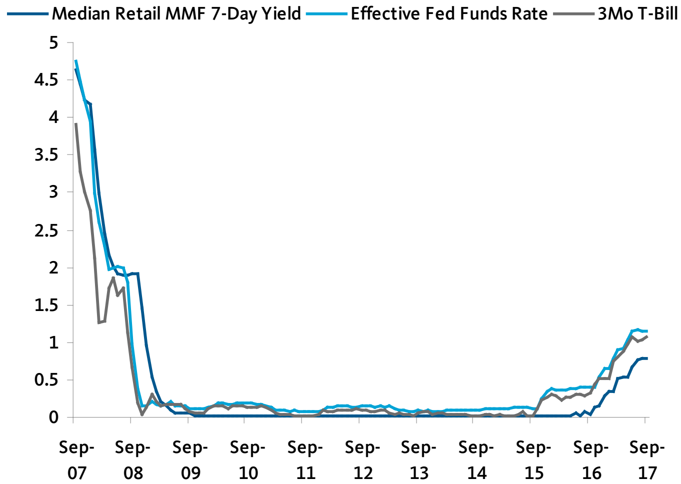
Rising Rates

The root of the low interest rate environment sprouted during the Great Recession, when the Fed lowered the overnight rate throughout 2008 from 4.25% at the beginning to 0.25% (which was actually a range of 0-0.25%) at the end. At the same time, bankers and investors were dealing with a phenomenal nationwide collapse in real estate values, the effects of which required the bailout of Bear Stearns and a lesson in moral hazard in the failure of Lehman Bros. Rates sat frozen for several years and during this time, money market funds had a difficult time paying out income: with fund expenses only slightly less than prevailing rates, there was very little left for investors and in some cases expenses were more than gross income, which necessitated an income subsidy for investors. Eventually, the U.S. economy recovered to a point where the Fed could consider raising rates and on December 17, 2015, it did exactly that, raising them one-fourth of one percent to 0.50% (again, it was actually a 25-50 basis point range but we'll settle at 0.50% for convenience). In October 2016, money market reforms further contributed to the late-year rise in money market yields, as a substantial amount of money (roughly $400 billion in just three months) was moved out of prime funds and into government funds, which caused issuers that relied on funding from prime funds to pay higher rates to attract new sources of funding.

At the end of 2016, the Fed raised the overnight rate again to 0.75% and in 2017 it was raised again, in March and June, to bring the Q3 rate to 1.25%. Money market fund sponsors at last had a rate environment that no longer required subsidizing fund expenses and investors had a yield that was no longer stuck to the floor.

Chart 1

Fed Rate Hikes and Yields



At the left of Chart 1 one can see that a consequence of falling Fed rates is a slight outperformance by money market funds. Initially, funds that encountered very little inflows were able to "hoard" the remaining higher interest and longer maturity portfolio securities. However, investors eventually sought out many of these funds and tried to work their way into these higher-yielding funds (especially so at the height of the financial crisis in the fall of 2008), perhaps not realizing that they were diluting the portfolio of what remained of those attractive yields (sensing this, some funds temporarily closed to new investors to avoid the dilution). But given their short maturities it wasn't long before they were gone, replaced by ever-lower yielding paper until April 2009 when the median yield, forever freighted with expenses, finally slipped beneath the Fed Funds rate. Yields have crept up (right side of chart) and still sit approximately 35 basis points below the Fed Funds Rate. Steadily increasing yields slowed in July, August, and September while the Fed paused its rate hike activity and was also partly due to stubbornly low inflation that has remained below the Fed's 2% target rate.

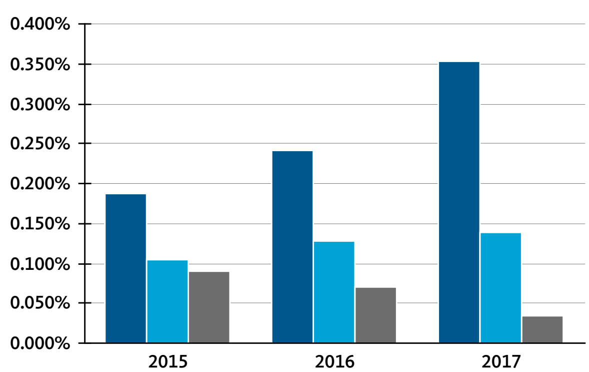
Looking ahead, the Fed intends to continue to raise rates gradually, with just one quarter-point hike likely coming in December 2017 and three more hikes likely in 2018. Also of note, in early September 2017 Congress agreed to extend the debt ceiling for 90 days, which removed a potential source of volatility for money markets until early 2018 (during a debt ceiling impasse in 2013 tens of billions of outflows hit government and Treasury money market funds).

BENCHMARKING CHANGES

Impact to Expenses and Yields

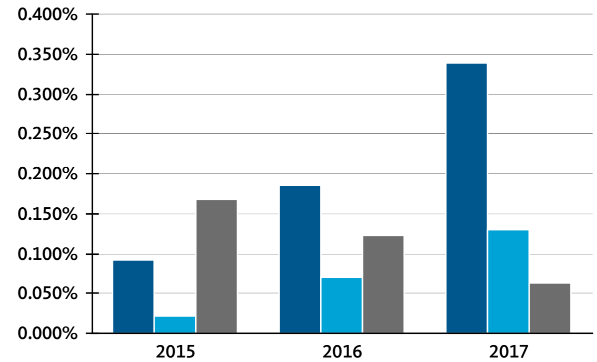
Mutual funds within the prime and government money market spaces have undergone significant change in not only total expense ratios, but how these expenses are being allocated across the fund. Whether institutional or retail, prime or government, three overarching expense trends have prevailed: total expense ratios are on the rise, the percentage of management fees retained is increasing, and total fund waivers have steadily dropped. Certainly all three of these data points are intertwined, and when comparing historical expenses the importance of the moving parts within the money market landscape must be noted. A more favorable yield environment has created a steady downward pressure on waivers in their entirety; the need for yield floor waivers across funds has all but dissipated with the increase in Fed rate setting over the last two years. Both the institutional and retail spaces have seen steady increases in total expenses and management fees over each of the last three years, but interestingly enough, the spread in expenses between prime and government has narrowed over each fiscal period. In 2015, prime funds were nearly double the TER from an asset-weighted average comparison than those of government, resulting in a 9 basis point difference between the two. That spread was cut in half in 2016 and has by and large disappeared within the most recent fiscal period. Continued demand for government funds has seen the number of products, as well as what expenses fund companies are willing to charge, increase steadily. Regardless of the investment mandate or intended investor, the amount of fees waived by companies continues to get slashed year over year. The vast majority of funds in each space continue to waive at least some portion of their fees, but on average government has seen larger percentages of fees waived over prime, which has led to lower retained management fees for these funds.

Chart 2
Institutional Prime MM



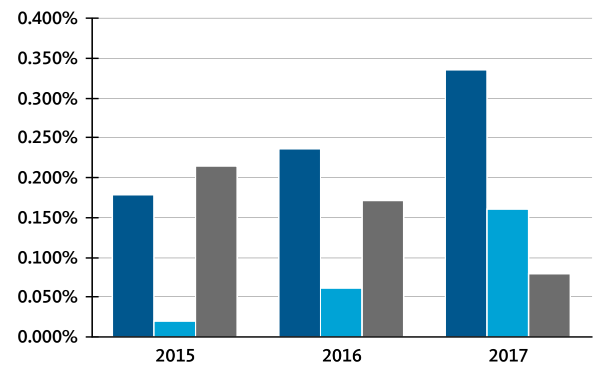
	2015	2016	2017
Total Expenses	0.188%	0.241%	0.354%
Management	0.105%	0.128%	0.138%
Waiver	0.090%	0.070%	0.034%

Chart 3
Institutional Government MM



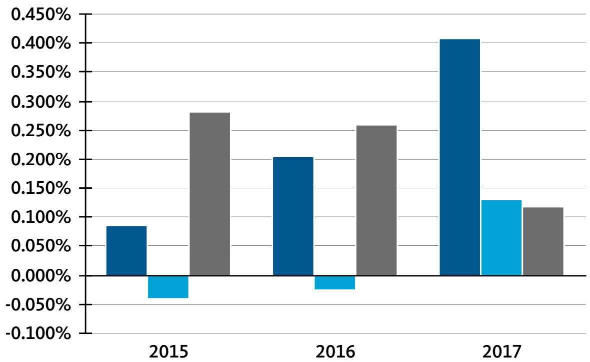
	2015	2016	2017
Total Expenses	0.091%	0.186%	0.338%
Management	0.021%	0.070%	0.129%
Waiver	0.167%	0.122%	0.063%

Chart 4
Retail Prime MM



	2015	2016	2017
Total Expenses	0.179%	0.236%	0.336%
Management	0.019%	0.062%	0.161%
Waiver	0.214%	0.171%	0.079%

Chart 5
Retail Government MM

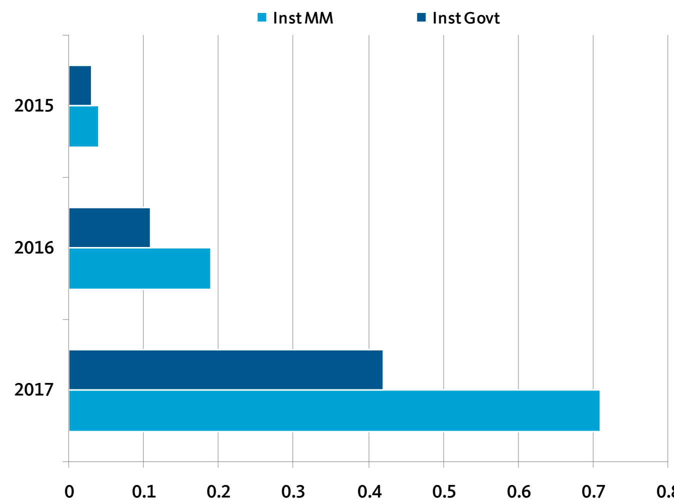


	2015	2016	2017
Total Expenses	0.086%	0.204%	0.407%
Management	-0.040%	-0.025%	0.130%
Waiver	0.281%	0.258%	0.118%

The exodus from prime money market into government money market began to take place in Q4 of 2015 and continued to gain steam throughout 2016 up to the October cutoff. The drastic change in the landscape is evident in Lipper's Institutional Government Money Market classification where roughly one-fourth of the current constituents were previously classified as Institutional Prime before the reformation period. The funds that have shifted investment mandates present an interesting challenge when used comparatively to their now-peer funds that have resided in the Institutional Government space without any type of investment strategy change. From an expense perspective, the full year since 2a-7 reform implementation has provided ample time for the formerly Institutional Prime funds to, for the most part, properly align themselves from an expense standpoint within the Institutional Government space. From a yield perspective, these reformed funds are still trying to play catch-up to their non-reformed Institutional Government counterparts for which the one-year (ended October 31) average is trailing by 8-9 basis points. The comparison of these two groups becomes more complex when analyzing historical expenses and performance beyond the most recent fiscal period. As one would expect, the reformed funds expenses in previous years more accurately represent the expenses of a prime money fund.

Between the SEC's mandate for floating NAVs of prime funds coupled with the Fed's zero interest rate period, the ideal environment for prime to government migration was created. As time has continued to distance the industry from the reformation enactment, the assessment of yield in the prime and government spaces has been placed under the microscope. During the one-year period since new regulations have governed the money market realm, prime funds have outyielded government funds by around 29 basis points in both the institutional and retail areas. Prior to 2017, the low interest rate environment made for a much narrower yield spread of 8 basis points in 2016 and 1 basis point in 2015. Has the value proposition of greater yields for prime money market over government outweighed the concerns of redemption gates and transacting at a floating NAV? Fund flow data would suggest that investors have shown a renewed interest in these prime money funds throughout the 2017 year-to-date. The Fed's intent to continue the rise of interest rates over the near future will also likely continue in fueling these prime money funds assets.

Chart 6
Institutional Prime vs Government One Year Yields



Minimum Initial Investments

The dispersity of minimum initial investment required across money market funds has become one of the increasing complexities for both boards and management alike when evaluating and selecting appropriate peer funds. How significant of an effect does minimum initial investment, and ultimately the asset base of the fund, have on expenses and the yield which it provides? In a simplistic approach to the idea, the Institutional Prime and Institutional Government classifications have been segmented into high minimum initial investment (greater than $1 mil) and low minimum initial investment ($1 mil and less), which splits each classification roughly into halves. In both spaces, the funds with higher minimums have generated greater one year yield averages by 9 basis points (Prime) and 6 basis points (Government), respectively. Total expense ratios also favored higher minimum funds where they were 15% less expensive than their low minimum counterparts in each of the two classifications.

Chart 7
High Minimum vs Low Minimum–Institutional Prime

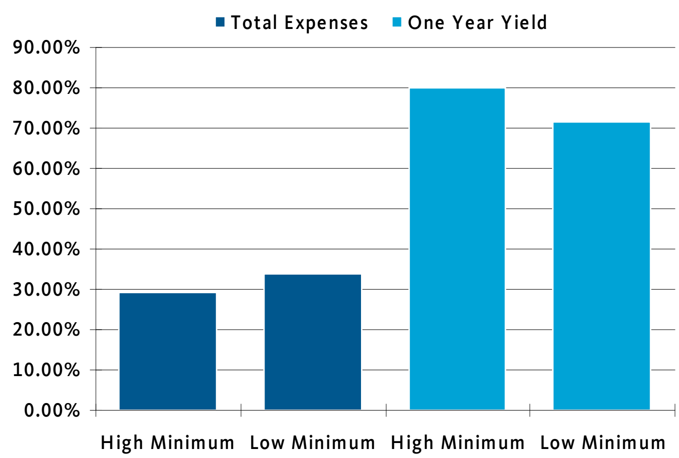
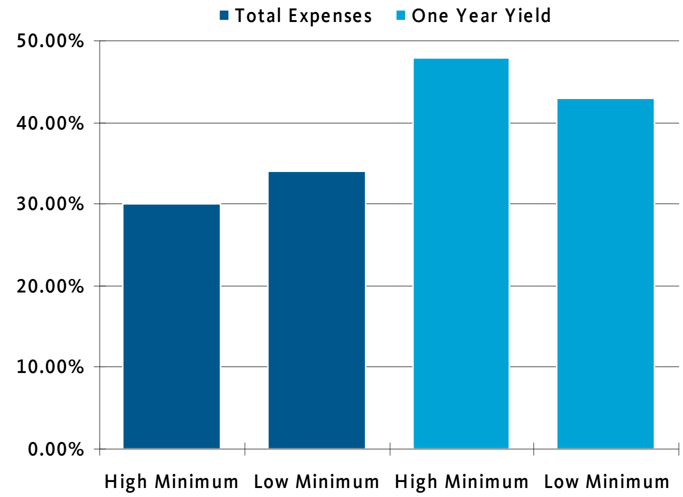


Chart 8
High Minimum vs Low Minimum–Institutional Government



Where We Are Today

What do all of these changes mean today, in a practical sense for boards and management when reviewing money market funds during the 15(c) process? For eight-plus years the review of money market funds consisted of reviewing how much management fee was waived to try to keep a positive yield and an understanding between the board and management that the products are a needed investment option and not a lot could be done to change the expense ranking or performance of a fund. That has now changed with 2a-7 reform and the rise of interest rates. In 2017, as well as going forward, peer groups have changed a great deal. On the institutional prime money market side, groups are typically smaller than they had been historically and some of the competitors boards grew used to seeing in reports are no longer there.

Broadridge expects peer groups to continue to change over the next few years as the dust continues to settle on changes related to 2a-7 reform. Fund companies are likely to continue to evaluate the success of products, as well as demand from investors when determining the need to keep existing products or potentially launch new products. The institutional prime space, which saw the greatest decrease in products may well receive new attention from investors as everyone learns about the practical impact of floating NAVs and the potential higher returns from investing in this space.

Takeaways For Directors

- As interest rates continue to rise directors should expect to see actual total expenses increase for money market funds, as well as a continued downward trend for waivers.
- Many funds, especially in the institutional government money market space, are new entrants that changed their investment strategy from prime to institutional as a result of 2a-7 reform. The historic data from these funds may not correlate as expected with those funds that have been in the government space all along.
- The comparison of historical expenses to current expenses in the 15(c) process will produce varied results. Until 2017, funds had to waive expenses to an artificially low level to keep positive yields, comparing historical expenses to current expenses will result in widely different stories.
- As with expenses, the review of historical performance data will produce ambiguous results. We believe looking at time periods in isolation, and putting greater focus on more recent performance periods, will give directors a more meaningful understanding of a fund.
- As interest rates continue to rise expect to see a wider performance range between funds. In the previous eight years a fund in the fifth quintile for performance could have been underperforming the universe by a basis point or two. That spread will continue to increase as interest rates increase and using a fund's ranking to identify where to dig deeper will become more relevant.
- Minimum initial investments will play a bigger role in peer selection. A "retail" money market fund used with a 401(k) plan will have different expense drivers than a retail fund with a $2,000 minimum. The same holds true on the institutional side of the coin, where we are seeing funds with relatively low minimum initial investments having higher total expenses than those with high minimum investments. This is also true on the performance piece of the review, where funds with a higher minimum initial investment have higher returns.

Comments and questions from readers of this white paper are welcome. Additionally, if you would like to have more detailed data presented related to your funds we can incorporate that into a study . Please direct any feedback to:

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