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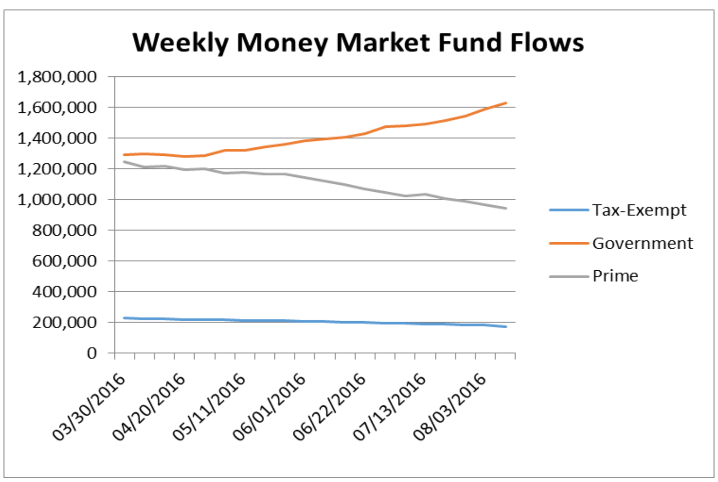
Money Market Funds and LIBOR Update

August 2016

By October 14, 2016, money market funds must be in compliance with the reformed money market requirements issued by the SEC in July 2014[1]. The major shift in this reform requires prime and tax-exempt money market funds to be priced at a floating net asset value (NAV). Prime, or general purpose, funds hold securities such as certificates of deposit (CDs), commercial paper (CP) and other non-U.S. government instruments. A floating NAV introduces the possibility of realizing losses or holding securities that have an unrealized loss in a "cash" alternative. In addition, holders of these funds will now also be subject to gates and redemption fees.

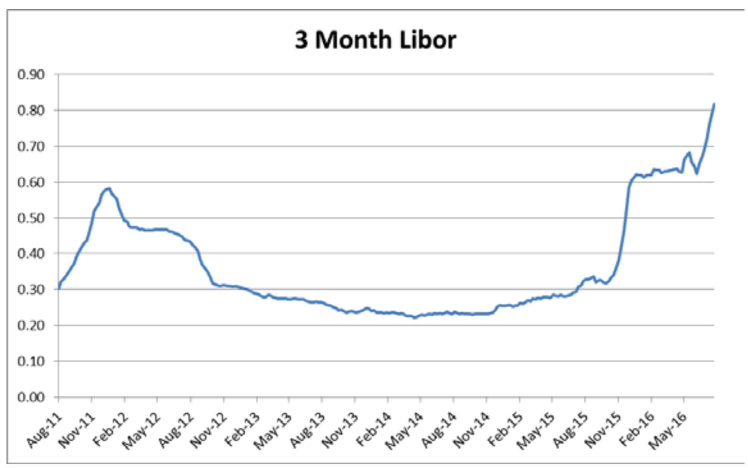
Government money market funds are exempt from the floating NAV requirement as well as from gates and fees, and they will continue to have a stable NAV. As a result, many prime funds have closed, while others are seeing significant redemptions. Since the fourth quarter of 2015, prime fund assets are down 34% while government money market assets are up 57% (www.ici.org). This trend has continued, as can be seen in the graph below, which shows the weekly net assets of money market mutual funds from March 30, 2016 to August, 3, 2016.



Source: Investment Company Institute (in millions of dollars)

Historically, prime funds provided financial institutions with an efficient and consistent buyer for their short-term funding needs. However, with the migration of assets out of prime and tax-exempt funds and the anticipation that this trend will continue, fund managers have positioned their portfolios to be more defensive in nature. For example, fund managers have decreased the average maturities of their funds to meet current and anticipated outflows. If funds don't have adequate liquidity to meet future outflows, fund managers may be forced to sell securities at a loss and that could pressure the NAV to fall below $1.00.

Conversely, new Basel III Liquidity Coverage Ratio (LCR) requirements force banks to increase the term on their liabilities, such as CP and CDs, beyond 30 days to avoid the outflow surcharge. This supply/demand mismatch has caused LIBOR to reset to higher levels. In addition, non-US banks (namely Japanese and European) have limited short-term funding alternatives. Therefore, they will be forced to issue CP and CDs, resulting in additional pressure on LIBOR. Three-month LIBOR is at the highest level since the European debt crisis of 2011-2012, as shown in the graph below.



Source: Bloomberg

This anomaly could present an opportunity to invest in stable to improving credits with floating rate securities at attractive valuations compared to fixed rate securities. The majority of floating rate bonds reset off of 1-month or 3-month LIBOR. In addition, if the Fed does increase rates, then additional upward pressure on LIBOR could offer even more attractive yields.

As we enter this period of money market fund reform and higher LIBOR rates, it is worth considering how a separately managed account could reduce risks and enhance returns on the cash holdings within your portfolio. Enhanced cash portfolios are managed with an eye towards preserving capital, providing liquidity and minimizing volatility. Maturity exposure can be customized with a typical average of 12 to 18 months. The benefits of using a separate account include a yield advantage over money markets, diversification of holdings and the control available when the portfolio is managed to client-specific guidelines. While the liquidity profile is not the same as a money market fund, securities selected for these short-term portfolios are purchased with an understanding that access to cash and principal stability are of the utmost importance.

We recognize that each client's situation is unique and would be happy to discuss the reform or possible solutions to your liquidity management challenges. Please feel free to contact John Villela or Corinne Larson at 617-695-3504 or JEV@LongfellowIM.com or CL@LongfellowIM.com.

[1] Longfellow Investment Management published a white paper, "Money Market Reform," in August 2014. The white paper provides background on the reforms and can be found on LIM's website at http://www.longfellowim.com/insights/sec-releases-money-market-reform-rules.

Disclosures