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The 60-Day Prime Fund – A First Look

Abstract

As the money market fund industry moves to comply with the SEC Rule 2a-7 amendment, the 60-day maximum maturity prime fund concept has received much public attention. For institutional cash managers faced with a chasm between government and prime funds, the 60-day prime fund may represent a viable middle ground and a market-based solution to price the economic costs of stable NAVs and liquidity fees and gates.

While we like the concept in theory, a number of issues need clarification, among which is the challenge to the $1.0000 goal post with basis point rounding. Some of the other considerations include marketing challenges, the continued presence of liquidity fees and gates, supply constraints, yield trade-offs, intermediaries' participation and regulators' responses.

Introduction

With 18 months left before the 2014 money market fund reform takes full effect, a number of large fund sponsors have announced their fund lineups and follow-up strategies. In a February 19 press release, Federated Investors disclosed that it plans to convert "certain existing institutional prime funds to 60-day maximum maturity funds[1]." The main objective is to continue to offer a "stable" net asset value (NAV) product after institutional prime funds adopt market based NAVs come October 14, 2016.

We found this 60-day prime fund concept intriguing. As corporate treasury professionals start to look more closely at the various alternative liquidity solutions, we will attempt to shed some light on the features, potential applications and challenges of this new product. As the concept is still in development at a number of fund companies, there are more questions than answers today, in our opinion. We may return to the subject in a future installment.

The Magic of 60 Days

To understand the magic in the 60 days, let's review why NAVs for money market funds are fixed at $1.00 today and what will change when the new rule goes into effect.

The NAV of a mutual fund is simply the total portfolio value divided by the number of shares outstanding. Under most circumstances, the SEC's Rule 2a-7 allows money market funds to use amortized costs instead of market values as the numerator for NAV calculations. This allows the NAV to remain constant, as amortized costs are not influenced by market volatility.

The 2014 Rule 2a-7 amendment, of course, will require prime funds offered to institutional shareholders to calculate NAVs with market-based prices. It.

[1] PR Newswire – Federated Investors Inc. announces first phase of adjustments to money market fund lineup, February 19, 2015.

also requires that the NAVs be reported to the fourth decimal place, a method known as basis point rounding. These new requirements increase the chance of the NAV moving away from the $1 goal post

This is where "60 days" come into play. An SEC rule interpretation dating back to 1977 allows money market and bond mutual funds to substitute fair values with amortized costs for debt instruments with remaining maturities of 60 days or less[2]. The 2014 Rule 2a-7 amendment reaffirmed this allowance[3]. In essence, the SEC closes the door on amortized cost pricing on most money market assets, but leaves it ajar for instruments with really short remaining maturities.

The implication of this exemption is that a money market fund with all of its holdings maturing within 60 days may continue to have a stable NAV of $1.0000, or something close to it. In a floating NAV regulatory environment, the 60-day maximum maturity prime fund offers a credible alternative for shareholders who prefer NAV stability.

Potential Benefits – Thumbs Up to Stability

We should note that the 60-day prime fund likely will appeal only to institutional shareholders who desire prime funds but dislike the floating NAV requirements. Starting on October 2016, Treasury and government funds will continue to have a stable NAV of $1.0000, as will prime funds offered to retail investors.

NAV Stability: The apparent benefit of the 60-day prime fund is the stability of principal investments. While one may argue whether a particular fund can manage to keep its NAV at $1.0000 forever, there is no doubt that limiting maximum maturities of portfolio holdings reduces both interest rate and credit risks, all else being equal. For investors who want to minimize potential principal losses, the 60-day fund represents a more conservative choice than a general institutional prime fund.

Operational Simplicity: The NAV stability advantage provides a number of operational benefits for cash management professionals. For example, even though floating NAV funds may receive accounting and tax relief, share transactions and recordkeeping still may be cumbersome for people with day-to-day responsibilities. With the 60-day prime fund, projections of cash movement may be more efficient. Approval of a new fund may be easier than a floating NAV fund on the basis of principal stability.

Yield, Supply, and Availability: The prevailing preference for stable NAV funds may cause swift migration by prime fund shareholders to the government space, exacerbating the already severe supply constraints in government securities. It may be necessary, at least for a brief transitional period, for some government funds to refuse new shareholders or new investments. The 60-day prime funds may offer capacity relief, as credit instruments are more plentiful. The inclusion of non-government instruments and the potentially wider credit-to-government yield spreads may create attractive yield opportunities.

Potential Concerns – Identity Confusion

Is the 60-day prime fund a stable or floating NAV fund? The best answer may be that it is a floating NAV fund that acts like a stable NAV fund. This vague characterization may present a number of challenges.

Longevity of the $1.0000 NAV: At the moment, we are unsure how fortified the $1 NAV will remain before the fund "breaks the buck". Today's rounding convention allows the market-based (or shadow) NAV to fluctuate by up to $0.005 from the dollar mark before the NAV goes up or down by a penny. In the basis point rounding convention, a $0.0001 move may knock the NAV off of the round dollar. A number of possibilities, such as

[2] "Valuating of debt instruments by money market funds and certain other open-end investment companies", Federal Register, Vol. 42, No. 109, June 7, 1977

[3] See note 453 of the SEC's 2014 amendment to Rule 2a-7 final rule document (RIN 3235-AK61).

changes in interest rates, deterioration in market liquidity, or sales of holdings to meet redemption requests may all present challenges. The same SEC rule interpretation mentioned earlier also requires that, if market prices are readily available, all debt securities must use market prices accordingly regardless of remaining maturities. While we wait for clarification from the industry (and perhaps the SEC), we like to think of the 60-day funds as NAV-stabilizing funds, as opposed to stable NAV funds.

Legally Floating NAV: The 60-day prime funds are a subset of institutional prime funds, but with self-limiting portfolio characteristics. They resemble neither the stable NAV funds of today, nor the stable NAV government funds of the future. This peculiar distinction of a stable NAV fund wrapped in a floating NAV label may present marketing challenges for fund sponsors and affect its popularity among potential shareholders.

Liquidity Fees and Gates: For shareholders who value no-strings-attached daily liquidity, stable NAV alone may not persuade them to remain in the prime fund space. The 60-day prime funds, along with all institutional and retail prime funds, are subject to liquidity fees and gates when portfolio liquidity falls under certain thresholds.

Supply Constraints: Although the 60-day prime funds may provide shareholders some supply relief from the government fund space, they are not immune from supply constraints in the general short-term funding market. The 60-day portfolio weighted average maturity (WAM) and the 30% weekly portfolio liquidity requirements for all funds subject to Rule 2a-7 mean that most funds will keep a big chunk of their portfolio holdings in maturities inside of 60 days. Meanwhile, recent financial regulations encourage financial issuers to reduce debt issuance of very short maturities. The voluntary hand-binding inside 60 days may limit portfolio flexibility.

Yield Trade-offs: To government fund shareholders, the 60-day prime fund represents a better yield opportunity in exchange for the fees and gates liquidity concession. To prime fund shareholders, the 60-day fund's lower yield potential represents the cost of NAV stability. The product's popularity rests on how much the cash management community is willing pay for liquidity and NAV stability, respectively. We suspect that the respective yield spreads need to be substantially wide (say 0.25% each in a 3% yield environment) to attract either group of investors.

Intermediary Participation: The popularity of share transactions through fund portals, trading platforms and omnibus relationships leads to the important question of intermediary participation. Recent press reports seem to suggest that new systems costs and potential liabilities at fund intermediaries may encourage them to favor government funds over prime funds. Since the 60-day fund falls in the prime fund category, intermediary participation may influence its popularity and growth unless shareholders opt to buy shares from the fund companies directly.

Regulators' Response: Since the SEC, as the main regulator of money market funds, included the relevant language in its rule amendment, we assume that the agency does not object to the concept of the 60-day prime fund at this time. However, should the product become so popular as to represent a substantial part of the wholesale funding market, the concern of a large fund "breaking the buck" may resurface. While this may not be a front burner issue for most of us, the regulators may take a long-term view and preemptively intervene. We may hear more on that shortly.

Conclusion – A Liquidity Alternative Worth Further Exploration

The 60-day prime fund represents a novel attempt to preserve some essential operational utility of money market funds. The 2014 SEC Rule 2a-7 amendment resulted in a chasm between government and prime funds for institutional cash management professionals. Faced with the difficult choice of stable vs. floating NAVs and threatened by prime fund liquidity restrictions, many, if not most, practitioners may decide to abandon prime funds for the extremely crowded space of government funds. The 60-day prime funds may serve as the viable middle ground to alleviate potential destructive migration and offer a market-based solution to price the economic costs of stable NAVs, fees and gates.

While we like the concept in theory, there are number of issues yet to be clarified. We need to hear more about the conditions under which the use of amortized costs may be restricted. Anticipation of market volatility from liquidity events also may present challenges to the $1.0000 goal post with the basis point rounding convention.

Some of the other considerations we discussed include marketing challenges of fund classifications, the continued presence of liquidity fees and gates, supply constraints, yield trade-offs, intermediaries' participation and regulators' responses. As we are in the early stages of discussions and development, we hope more clarity will arrive in the next few months in order for institutional cash investors to seriously consider this fund category as a viable alternative.

About Us

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