Fund IQ

A research product of Capital Advisors Group

New Research Sheds Light on Money Fund Risk Factors

Background

Money fund due diligence is among several topics du jour with corporate investors. Prior to the Reserve Primary Fund "breaking the buck" in September 2008, loss of principal and liquidity in a money market fund was barely a concern for most corporate cash investors. Much has occurred in the fund industry since then, and the investing public should no longer count on the government to be the knight in shining armor. We believe, it is now crucial that investors have due diligence methods to critically evaluate the risks of money fund investing.

Unfortunately, few options are available for the typical corporate investor. In retrospect, few, if any, of the traditional measures, from credit ratings to portal reports to fund commentaries, proved completely effective in avoiding funds like Reserve Primary. The knowledge of a particular fund's characteristics such as its weighted average maturity (WAM), average credit rating, and exposure to specific asset classes seems no more helpful, since funds with a few similar characteristics may still have significantly different risk profiles.

As a regular part of the investment process at Capital Advisors Group, we evaluate the creditworthiness of money funds in our portfolios routinely, and often are faced with the same challenge. Due to our liquidity mandate for cash portfolios, prime money funds often represent our largest credit concern. With no suitable off-the-shelf solutions, we set out to several years ago to develop a practical, intuitive and effective fund evaluation tool for ourselves.

What Does "Risk" Mean in a Money Fund?

First, it is important to understand exactly what risks we are trying to identify, avoid or minimize. In simple terms, the myriad of risks associated with a typical fund can be reduced to two items: the loss of principal when a fund breaks the constant dollar share price and the loss of liquidity when fund management decides to halt redemptions. While credit risk is generally well understood and feared, liquidity risk often can be a larger threat to investors – and may be too often overlooked. Furthermore, these two risk factors can often be intricately related.

It is not difficult to argue why liquidity risk management is more critical than managing credit risk, although both are important. We think the previous version of SEC Rule 2a-7 already did a reasonably good job in limiting portfolio credit risk, so much so that shareholders of the Reserve fund are now expected to lose no more than 1.25% of principal*. On the other hand, having lost access to an asset pool designed for day-to-day usage can be devastating and potentially deadly to a company if alternative liquidity is not readily available. History shows that when a fund is forced to halt redemptions, it often ceases to be a going concern and enters into an unwinding process that may take weeks or months. It is for this reason that our own money fund due diligence process focuses heavily on several liquidity risk factors.

Specific Risk Monitoring

Liquidity risk can come in many forms. Through our methodology, we find it useful to isolate two major types of forces that may bring such stress onto a fund: internal and external.

Internal stress may come from the makeup of a fund's investment portfolio and through the strength of the fund sponsor and management team. Among factors unique to a fund portfolio are its weighted average life (WAL), how maturities are laddered, diversification of non-government securities by sector, industry and issuers, the

*Source: *Bloomberg Businessweek, Reserve Got $170 Million for $785 Million Lehman Debt (Update2), April 14, 2010* use of complex securities, and the risk of repurchase agreement (repo) dealers. Additionally, a mismanaged fund is a direct source of risk to shareholders. In our fund assessment, we look closely at the funds' sponsors and their management teams using fundamental techniques to evaluate the manager's resourcefulness and the sponsor's willingness to step in for contingency support.

External stress may come in the form of systemic/macro events or shareholder risk. Such external factors can play a major role in a fund's risk characteristics. A run on a single fund may result in a "contagion" of runs on the entire family of funds due to their interconnectedness of the securities held and of the shareholders. In our research, we work to identify tell-tale signs that help to reveal when there is market risk.

Putting the Factors Together

To conclude, we think our methodology presents a unique way of evaluating prime money fund risk. While ratings agencies reviews of money market funds typically reflect current facts, our research offers a more forward looking assessment. For instance, of the 169 domestic prime funds that are rated by Moody's, all but two are rated AAA**. We think it's important to look deeper. Our credit scores, while derived from a rigorous process of converting various factors into scores, convey our relative view and offer the investor a clearer and more convenient means to compare funds.

*Source: **As of 1/1/10, as presented on Moody's Global Managed Investments Ratings List*

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