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Fine time to wade into money-market funds

Robert Pozen and Theresa Hamacher

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Money-market mutual funds are widely used, poorly understood - and suddenly much in the news.

After decades of quietly providing millions of investors with relatively safe places to put their cash, money-market funds are getting a lot of attention in Washington. After one prominent money-market fund - the Reserve Primary Fund - lost money in the 2008 credit crisis, federal regulators have studied the risks these funds pose to their shareholders as well as the whole financial system. They have also looked at how the funds might be affected by the debt crisis in the euro zone, because some money-market funds have exposure to European banks.

It's a discussion focused on the potential downsides - without much consideration of money-market funds' substantial benefits. Overall, these funds have an attractive risk-return trade-off that should earn them a place in many portfolios.

They are are under scrutiny because they are an unusual type of mutual fund. Unlike bond or equity funds, the share price of a money-market fund does not fluctuate along with the value of its portfolio; instead, it is fixed at $1 per share.

To qualify for this special treatment, money-market funds must comply with regulations that limit their investments to very high-quality, very short-term bonds. These restrictions were recently tightened by the Securities and Exchange Commission.

The bonds held by money-market funds are highly likely to be repaid in full when they mature - and their prices normally don't fluctuate much before then. As a result, $1 per share is a reasonable representation of a fund's value in most circumstances.

Because of this stability, many people have come to think of investing in money-market funds as synonymous with putting money in the bank. There are, however, key differences between the two, with both pros and cons in investing in the funds vs. making a bank deposit.

On the plus side, money-market funds have traditionally paid higher interest rates than passbook savings accounts that provide the same ready access to funds. Investors can earn those higher rates at the bank only if they limit their ability to take money out of their account - by committing to a three-month **investment** in a certificate of deposit with early-withdrawal penalties, for example. Another bank alternative, the money-market account or deposit account, also has withdrawal restrictions, which are normally limited to six per month.

Investors also benefit from the wide range of choices offered by money-market funds. Consumers can usually choose among three types of money-market funds - government, general-purpose (or "prime") and tax-exempt.

Tax-exempt money-market funds in particular offer savers a feature they cannot get from any type of bank account: interest that is exempt from federal and local income taxes. These funds are quite attractive in states such as California and New York, which have high income tax rates.

On the other hand, money-market funds have a significant drawback compared with bank deposits. Although cash held in a

bank is insured by the U.S. government (for up to $250,000 in total), investors in money-market funds can lose money if there are large losses on the bonds owned by the fund.

That's happened only twice in the 40-plus-year history of money-market funds - most recently in the Reserve Primary Fund during the credit crisis. It's called "breaking the buck" because the fund is no longer able to maintain a steady $1-a-share price.

No one wants a third fund to break the buck, so regulators are considering changes to the rules that govern money-market funds to further reduce their risk. They're looking at two types of proposals: moving to a floating share price (no longer stable at $1 per share) or requiring that funds hold a cushion against losses.

Either of these could well hobble money-market funds to the point where they are no longer attractive to investors or borrowers. A floating share price would make money-market funds less attractive to conservative investors who want to earn interest on short-term cash without risking losses.

At the same time, requiring funds to hold some sort of a cushion against losses would increase the cost of managing them. Higher costs ultimately translate into lower yields, making the funds less appealing to all types of investors.

The yields are already under pressure because of the tighter **investment** restrictions the SEC imposed in 2010. The new rules lowered the limits on bonds' average maturity, raised liquidity requirements and upped quality standards - thereby reducing portfolio risk. But lower risk will also turn into lower yields, eroding one of the key advantages that money-market funds have over banks.

Rethinking redemptions

Rather than implementing a floating share price or establishing a loss cushion, money-market funds should change the way they handle large redemptions by institutional investors - redemptions that played a major role in the only two instances when a fund broke the buck.

Money-market funds usually wind up selling securities to pay out redemptions - shelling out $1 per share even when the value of the securities may be slightly less.

Sophisticated investors watch for this discrepancy and attempt to profit from it.

Instead, funds could make greater use of existing rules that allow them to meet redemptions "in kind," giving redeeming investors a proportional share of all the securities held by the fund. This approach would discourage large investors from making opportunistic redemptions, thereby reducing a fund's risk without reducing its yield.

It's critical for both investors and bond issuers that money-market funds remain a viable alternative to banks. The funds play an important role in the economy as a source of capital for businesses and governments; they own one-third of all U.S. commercial paper and $330 billion in obligations issued by states and cities. Issuers would surely face higher funding costs if money-market funds were no longer able to compete effectively.

Businesses also rely heavily on money-market funds as a tool for managing their cash. In 2010, 25 percent of cash balances at non-financial businesses was in money-market funds. Even small businesses can have more than $250,000 in cash on hand - which means they are not fully protected from a bank failure. Money-market funds allow them to diversify their risk without having to open accounts at multiple banks.

Yes, money-market funds have a modest degree of risk, but their advantages offset it. And remember that, in the worst case on record, when the Reserve Primary Fund broke the buck in 2008, shareholders lost only 3 cents on every dollar. Not bad for the most severe financial crisis since the Great Depression.

Pozen is chairman emeritus of **MFS Investment Management**. Hamacher is president of Nicsa. Together they wrote "The Fund Industry: How Your Money is Managed."

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