InvestmentNews
The Leading News Source for Financial Advisers

Say goodbye to money funds

By Robert N. Gordon

February 15, 2009

We're on the brink of seeing a profound change in the way we invest. In fact, the upcoming change is so great that I'd like to put aside my usual focus on taxes to make an observation.

From the signs that are emerging, I predict that the $3-trillion-plus money market fund business will disappear in its present form and that existing funds either will come under banklike regulation or become ultrashort-term-bond funds with fluctuating net asset values.

My conclusions stem from several observations. First is that the Department of the Treasury's temporary guarantee of money funds is scheduled to expire April 30, although the guarantee may be extended to Sept. 18 at the latest.

Second, since banks need deposits, it would be politically attractive to do away with money market funds, which would cause money to flow back to the banks from whence it came.

Another driver is the mood of the nation's top financial regulators. The Group of 30, an influential international economic-policy body led by Paul Volcker that often shapes public policy, described money market mutual funds in a recent report as "institutions with no capital, no supervision and no safety net."

The report merits close attention, considering that he is also chairman of the President's Economic Recovery Advisory Board and that Treasury Secretary Timothy Geithner and Lawrence Summers, President Obama's chief economic adviser, also are members of the Group of 30. The report states that "a regulatory distinction should be drawn between those services that are most appropriately housed in regulated and supervised banks, particularly the right to withdraw funds on demand at par, and those that can reasonably be provided by mutual funds focused on short-term fixed-rate credit instruments."

The group recommends that money funds either "be required to reorganize as special-purpose banks" or become an ultrashort-term-bond fund. Such funds probably would have fluctuating net asset values since there also would be a ban on using amortized accounting to achieve NAV stability as money funds do now.

If the group's recommendations are accepted by U.S. policymakers, there's likely to be a negative reaction from the mutual fund industry's trade group, the Washington-based
Investment Company Institute, although that isn't a certainty.

The money fund business is hurting. Money fund sponsors aren't making any money now with interest rates this low; most need to waive fees to keep the returns to investors from going negative.

Until the impending failure of New York-based Lehman Brothers Holdings Inc. in September led the Reserve Fund — offered by Reserve Management Co. Inc. of New York — to "break the buck," investors had thought there always had been an implied promise on the part of fund sponsors that the net asset value of money market funds would not fall below $1 per share. Historically, sponsors have backed up that promise by digging into their own pockets. One such break occurred in 1990 when a commercial-paper default caused 10 fund sponsors to pony up. The Securities and Exchange Commission responded in 1991 by tightening the quality and composition of acceptable money fund assets. In 1992, some fund executives were reported to be exploring the creation of an industrywide insurance pool or requiring a sponsor's capital to equal some minimum percentage of its money fund assets.

Despite those efforts, 1993 and 1994 saw 15 more near-failures. These cost sponsors about $600 million. Some fund sponsors arranged letters of credit with banks, calling the backup facility "NAV protection" or "isolated default insurance" to shore up investor confidence.

Currently, many fund companies are propping up money market funds — or closing them to new investors because the economics are just so awful.

Many could believe that all this "patching" activity has just papered over the fundamental flaws, and possible dangers, of money market funds. At the recent meeting of the Geneva-based World Economic Forum, for example, the chief executive of New York-based JPMorgan Asset Management, James Staley, observed that money funds pose the "greatest systemic risk" that hasn't yet been adequately addressed. He seems ready to accept the need for money funds to put aside reserves.

If the risks of money market funds are deemed too great by the nation's new economic leaders, and if the economics of the funds in today's low-interest-rate environment don't change, don't be surprised if money market funds as we know them fade into financial history.

Robert N. Gordon is chief executive of Twenty-First Securities Corp., a New York-based brokerage firm, and writes the monthly Tax-Conscious Adviser column. He can be reached at bob@twenty-first.com.