The financial crisis and its aftermath significantly changed the landscape for liquidity investing. Over four years after Lehman’s bankruptcy, the business and market dynamics of liquidity investing remain unsettled. However, we believe there is no going back to the products and markets of old. It is time to prepare for a different future that includes new vehicles for managing liquidity assets.

The Old Paradigm:

Prior to the credit crisis, a confluence of favorable macro/market conditions, financial innovations, engaging Nationally Recognized Statistical Rating Organizations (NRSROs) and accommodating regulators resulted in an overabundance of AAA-rated securities being produced for the fast-growing business of fixed net asset value (NAV) money market funds.

These AAA-rated securities targeted a broad spectrum of fixed NAV product segments spread across taxable (financial, industrial, structured, asset-backed, mortgage-backed) and tax-exempt (insured municipal, VRDN, state-specific, auction rate) securities. Also, investors desiring “risk free” assets encountered an abundance of offerings issued or “guaranteed” by sovereign entities.

The widespread use and acceptance of interest rate swaps in tandem with a robust supply of short-term AAA-rated securities seemingly allowed both borrowers and investors to benefit from the situation. However, the unhelpful combination of mark-to-model or matrix-based pricing methodologies, overly generous credit ratings and relaxed oversight by regulators masked big problems lurking in the system. Post Lehman’s demise, the old paradigm imploded amid sinking issuer credit quality and frozen markets.

Investors in fixed NAV funds might have been lulled into believing that a single product could deliver attractive returns, high credit quality, daily liquidity and price stability. That paradigm started to wobble in 2006-07 and officially ended in September 2008.

The Current Environment – A Market In Transition:

The financial credit crisis challenged the belief that attractive yielding, high credit-quality assets supported by (seemingly) highly liquid secondary markets were sufficient to support the fixed-dollar NAV money market fund model. The AAA ratings on many insured and structured securities held by these funds (e.g. bond insurer wrapped, private label mortgages, home equity loans, structured investment vehicles, etc.) experienced quick and severe downgrades when the global economic and market environments became challenging.

The Great Recession likewise revealed fundamental weaknesses in many sovereign and guaranteed credits that depended on regular access to capital markets for debt refinancings. Also exposed were direct credit quality linkages between national banking systems and sovereign entities—and how each negatively fed upon the other when economic and financial stresses turned severe.
Credit Crisis Aftermath – Transparency:

The quasi-regulatory role of the NRSROs (Moody’s, S&P and others) was greatly undermined as the crisis revealed numerous conflicts of interest and the limits of their narrowly focused reviews and use of relative (versus absolute) criteria in assigning ratings. Both the NRSROs and regulators are still struggling to revamp how/whether the ratings process can best be used to serve investors in liquidity and related products.

Interest Rate Limbo – How Low Can You Go?

In the extended post-crisis period, the Federal Reserve and other central banks have aggressively lowered their policy rates and employed many non-standard techniques to facilitate balance sheet repair by financial institutions and individuals (but not sovereigns). They have also made efforts to create conditions that support a resumption of economic growth. The Fed’s actions have resulted in an extended period of record low policy and market interest rates. This has sent investors on a global hunt for yield.

Unfortunately, there is little yield-producing paper to be had, especially in the short fixed income space. The favorable mix of drivers that underpinned the “old paradigm” model of fixed-NAV investing no longer exists. Today’s investors are exhibiting strong demand for high-quality short-term paper but the “innovation factory” for new short-term issuance appears closed. Only one new offering type for short-term investors is on the docket: the U.S. Treasury’s plan to begin issuing floating rate notes in late 2013 or early 2014.

Unbundling the Management of Liquidity Assets:

Changing regulatory regimes is inherently a political process. Nearly five years after the financial crisis, the Securities and Exchange Commission (SEC) and other U.S. and global regulators continue to debate and evaluate key reforms. Even where new regulations and specific reforms have been enacted into law, the administrative process of writing implementation rules can take years to finalize. In this regard, the ultimate scope, direction and timing of many important rule changes still await clarification.

However, the short term fixed income market has moved forward. The old paradigm of managing liquidity assets is being pushed aside. In its place, many investors now recognize that a single product solution may no longer be viable. Today, liquidity management requires an articulation and prioritization among three distinct investment objectives: safety, yield and liquidity.

Shifting from old to new paradigms is typically slow and onerous. The instinct of many stakeholders is to do everything possible to hold onto “what was” by delaying, redirecting or limiting the forces of change. Others are more accepting of the change and work constructively to engage, acclimate and shape the new paradigm. Today, the liquidity investing space is at such a juncture.

The Future Environment:

Central Banks – Engaged, for Better or Worse

Central bankers (Federal Reserve, European Central Bank, People’s Bank of China, etc.) have all greatly expanded their balance sheets, driving down global interest rates (excepting certain
highly levered countries). These efforts seek to speed deleveraging activities and restart growth. Investors expect zero interest rate policies (ZIRP) to be maintained until the deleveraging has been completed and sustainable growth (i.e., trend-or-better pace) has returned. This will likely be years in the future.

Central banks will likely tolerate somewhat higher levels of inflation in order to speed achievement of deleveraging and growth objectives via the “easy money” channel. A risk to this strategy is that long-term inflation expectations become unmoored from current well-anchored levels. This could potentially force the Federal Reserve into earlier-than-expected policy tightening in order to prevent a negative feedback loop to its other objective of sustainable, low-inflation growth.

In the current environment, investors and central bankers have come to view negative yields (both real and nominal) on top-quality, short-dated fixed income paper as being the normal and appropriate valuation for an investment that provides absolute principal safety.

**Risk Analysis – More Guardrail Protections**

In the old paradigm, it was common to experience severe security/asset pricing dislocations as a result of ratings and maturity cliffs associated with SEC Rule 2a7 (pertaining to fixed NAV funds). These events should occur much less frequently now that revised Rule 2a7 incorporates more stringent quality and diversification criteria.

Similarly, instead of simply relying on AAA ratings from the NRSROs, investors will need to conduct more detailed analyses of each issuer’s credit quality, including risks tied to capital structures (in order to avoid those heavily exposed to short-term funding) and pension fund accounting (i.e., to fully understand unfunded liabilities and actuarial assumptions).

The NRSRO behaviors that enabled the proliferation of highly rated, relatively high-yielding short-term securities are unlikely to return. Instead, there will be demand among select investors and global financial institutions for the truly highest-quality credits. Such credits are likely to be quite scarce and very richly priced. In addition, secondary market trading liquidity might see both closer scrutiny and greater variability as regulators push for the dissolution of amortized cost accounting while investors demand valuation transparency (favoring market pricing over matrix pricing). Over time this trend will likely lead to more standardization of short-maturity debt offerings and, potentially, their migration to trading exchanges/platforms that facilitate greater market pricing transparency and liquidity.

Expect more robust practices vis-à-vis pricing, performance, liquidity and credit quality, including the introduction of new benchmark frameworks and index constructions.

**U.S. Money Market Funds – Change is the New Normal**

Regulators have made it clear that they will no longer tolerate systemic risks to the financial markets from money market funds. Quality and diversification requirements for investments in 2a7 money market funds have been significantly increased. Now, if investors seek absolute principal stability and daily liquidity they are likely to earn a low, zero or negative yield.

The development of structured securities specifically aimed at 2a7 money market investors is undergoing important changes as well. The risks associated with mismatched funding of assets and liabilities, combined with fallout from the recent LIBOR scandal, have forced regulators
and investors to increase disclosures around the funding transparency and capital structures of corporations, government entities and finance companies.

Should a “Lehman-like” crisis reoccur sometime in the future, a recently enacted U.S. law forbids any form of assistance (e.g. backstop guarantee) from the Federal Reserve or U.S. Treasury. Since regulators are prohibited from providing support in a future financial crisis, they are much more likely to coordinate robust anticipatory efforts, actions and rulings so as to prevent a crisis scenario from ever developing.

Despite the August 2012 cancelation by the SEC Chairwoman of a vote on proposed money market reforms, the SEC, various EU regulators, the U.S. Financial Stability Oversight Council, the Federal Reserve and the U.S. Treasury Department are all supporting new actions to protect against potential systemic risks to global capital markets caused by the legacy money market fund model. These actions are likely to range from further reductions in traditional money market funds’ investment flexibility (and thus ability to generate returns) to directing that all legacy money market funds move to a variable NAV pricing model.

**Investors - Adapting to the New Paradigm**

As investors become more aware of the causes and consequences of recent developments in liquidity investing, gradually and in some cases reluctantly, we expect they will seek more information about the richer menu of investment objectives, products and risks available in today’s marketplace.

In this regard, liquidity investors have started to sharpen their understanding of the tradeoffs between different investment objectives, like principal safety, income return and easy access to funds. As these investors begin to identify and prioritize their different objectives they likewise may choose to allocate these assets into distinct products that emphasize safety, yield or liquidity. As they embrace and evolve the new paradigm, investors may reconsider legacy beliefs about why they might (or might not) choose to invest in bank certificates of deposits, money market funds or other liquidity-focused assets.

While even the Federal Reserve does not know exactly when it will end its quantitative easing programs, investors shouldn’t expect the eventual normalization of policy and market interest rates to reverse the changes occurring in the liquidity investing space. We do not expect the short-term issuance or investing markets of the last few decades to stage a comeback.

**Issuers - Adapting to the New Paradigm**

Up until 2007-2008, the economics within the short-term debt and the interest rate swap markets allowed corporate or structured product issuers to fund themselves using short-term debt and then swap the short-term interest payments, extending the maturity of the liability (instead of just issuing longer maturity debt). All this was possible due to the exceptionally strong demand for “high-quality” assets from money market mutual fund investors. Today’s limited funding and swap options at the short end of the maturity curve should incentivize corporate borrowers to rely less on short-term funding and instead issue more debt with longer-term maturities. This may lessen CFOs’ flexibility to manage their capital structures and/or access low-cost funding for consumer credit and inventory management purposes.
Investment Options for the New Paradigm:

*Different Liquidity Investing Products Address Different Investor Needs*

Investors now face the task of deciding how to categorize their old-paradigm liquidity assets into distinct investment objectives of Preservation Liquidity and Investing Liquidity, and then matching these decisions with investment product options.

Preservation Liquidity represents short maturity fixed income investments which have no tolerance for transactional price variability in any context. This focus on stability of principal may mean no income return is generated. Investors seeking Preservation Liquidity are expected to gravitate towards federally insured bank deposits and short-term Treasuries. For investors desiring the transactional and tax convenience of fixed NAV pricing, 2a7 money market and other commingled (common/collective) funds are expected to still be available. These funds will likely offer slightly higher yields than principal-guaranteed products, but income levels will be very modest as regulators restrict investment options to a narrow slice of the investable universe in order to prevent runs on these funds during periods of extreme issuer stress. Under the Dodd-Frank legislation, neither the Federal Reserve nor U.S. Treasury can intercede to rescue these funds.

Investing Liquidity represents short maturity fixed income investments, positioned strategically or tactically with other risk-based asset classes, which can tolerate a modest degree of transactional price variability in order to earn an income return. For investors seeking ready liquidity and a more competitive yield, but with minimal principal volatility, the marketplace has developed a variable NAV (VNAV) alternative to the traditional 2a7 money market mutual fund. VNAV products may generate superior income versus Preservation Liquidity options, with the potential tradeoff of some minor principal volatility. VNAV ETFs and other non-2a7 money market products generate more competitive yields by investing in a diversified portfolio of investments options from a broad slice of the investable universe (i.e. securities having sector exposures and maturities that fall slightly outside the restrictions imposed by SEC Rule 2a7).

Today’s Liquidity Investing:

Change is coming to the management of liquidity objectives. Global regulators are determined to eliminate the systemic risks posed by the fixed NAV money fund model. Financial markets, investment managers and investors will all need to understand, shape and adapt to these changes. Although many legacy products will survive and thrive, there are also opportunities for new and different products that address the distinct objectives of Preservation Liquidity and Investing Liquidity investors.

**IMPORTANT INFORMATION**

*Before investing, carefully consider the FlexShares investment objectives, risks, charges and expenses. This and other information is in the prospectus, a copy of which may be obtained by visiting www.flexshares.com. Read the prospectus carefully before you invest.*
Foreside Fund Services, LLC, distributor.

An investment in FlexShares is subject to numerous risks, including possible loss of principal. Fund returns may not match the return of the respective indexes. The Fund is subject to the following principal risks: asset class; credit (or default) risk; concentration; currency; debt extension; derivatives; emerging markets; financial sector; foreign securities; interest rate/maturity risk; issuer; leveraging; liquidity; management; market; market trading; mortgage-related and other asset-backed risks; municipal market volatility; new fund; non-diversification; prepayment; and U.S. government securities risk. A full description of risks is in the prospectus.

Credit Quality, also referred to as a “bond rating,” is one of the principal criteria for judging the investment quality of a fixed income security. Credit quality informs investors of a security’s creditworthiness or risk of default. Different agencies employ different rating scales for credit quality. Standard & Poor’s (S&P), Fitch and Dominion all and use scales from AAA (highest) through AA, A, BBB, BB, B, CCC, CC, C to D (lowest). Moody’s uses a scale from Aaa (highest) through Aa, A, Baa, Ba, B, Caa, Ca to C (lowest).

Liquidity is the degree to which an asset or security can be bought or sold in the market without affecting the asset’s price. Assets that can be easily bought or sold are known as liquid assets.

Matrix-based pricing models generate an estimated price or value for a fixed-income security. Matrix prices are based on comparisons (a matrix) of quoted prices for securities with similar coupons, ratings, and maturities, rather than on specific bids and offers for the designated security.

A negative feedback loop relates to the self-correcting properties within a system. A negative feedback loop is designed to provide signals to help regulate the system, thereby avoiding a collapse through a mechanism that returns the system to some level of balance.