



# RISK MANAGEMENT IN MONEY MARKETS

## ARE ALL CASH FUNDS CREATED EQUAL?

Prior to the events of August 2007, money market funds were generally perceived to be at the safer end of the risk / reward spectrum. Numerous products exist where traditional benefits are to provide capital preservation, high levels of liquidity and then to maximise the yield. For investors with differing risk appetites, the choice of strategy was ample and included everything from stable NAV money market funds to enhanced cash funds and short term bond funds. All were backed by high credit ratings and promised to add minimal risk to an overall asset allocation.

Recent distress in the financial markets has been widespread and the spotlight was focused on money market funds when concerns were raised over the degree of principal protection inherent in funds. The realisation that all money market funds are not the same has highlighted the importance of understanding the risk / return dynamics of differing types of money market funds.

## HOW DID WE GET HERE?

By taking a step back to understand how the money market universe has developed over the last decade it can be seen that ongoing regulatory changes in the US and Europe, as well as the increasing complexity of corporate cash management, have fuelled a dramatic growth in assets under management in the industry. Money market funds offered an attractive alternative to traditional bank deposits, providing diversification, off balance sheet exposure and access to active investment strategies without sacrificing liquidity.

As the demand for such products increased so did the variety. The result was an industry traditionally viewed as a conservative safe haven for cash actually became home to a multitude of disparate strategies ranging from very low risk government treasury funds to more volatile enhanced “cash +” vehicles and short duration bond funds. Yet in many ways this was a positive step for investors. It gave them the ability to parcel out their cash into buckets with different liquidity needs and therefore different risk profiles and allocate to the different strategies accordingly. As long as the risks underlying each type of strategy were clearly defined and monitored investors stood to gain significantly from this efficient re-allocation of capital.

An investor seeking the security of a short dated government fund would typically expect a lower yield relative to investing in a strategy which has a greater interest rate and credit exposure. However, the previously benign global economic environment spurred investor demand for higher yields from cash portfolios.



One avenue to increase yield undertaken by money managers was to increase exposure to securitised products. Securitisation implies there are underlying assets providing the necessary cash flows. Unfortunately several of these products' underlying investments included sub prime debt. Once the sub prime market collapsed the market for these related instruments froze irrespective of whether or not the program contained such exposures.

Crucially however, the market dislocations have resulted in a significant divergence in investment performance between the various strategies in the money market universe. It has served as a reminder that cash management involves active decision making and therefore robust risk management and a clear understanding of the underlying risks in any investment are critical factors in the potential success of a money market strategy.

### WHAT IS A MONEY MARKET FUND?

Where to begin defining a money market fund? A good place to start is with the definition provided by the Institutional Money Market Fund Association (IMMFA) which defines Money Market Funds (MMFs) as: "mutual funds that invest in short-term debt instruments. They provide the benefits of pooled investment, as investors can participate in a more diverse and high-quality portfolio than they otherwise could individually. Money market funds are actively managed within rigid and transparent guidelines to offer safety of principal, liquidity and competitive sector-related returns."

Moreover, IMMFA implicitly distinguishes between treasury-style products such as stable NAV MMFs and investment style funds with a variable NAV. In fact, IMMFA has worked hard to create a transparent code of practice for money market funds in Europe as a way of differentiating true Aaa rated funds from other money market vehicles. This has proved necessary due to the difference in the handling of money market vehicles in Europe relative to the US, which clearly delineates the expected practices for a Aaa rated money market fund. In Europe, no such legislation exists. Thus when a number of high profile European based short dated bond funds and enhanced cash vehicles suffered losses following the credit rout the perception of the money market universe as a whole was negatively impacted.

However, as previously mentioned, even Aaa rated funds have not been immune to the volatile market conditions. A reminder that even in such a constrained universe there can be important differences in investment style, with risk usage being the critical differentiating factor.

## WHAT ARE THE RISKS INVOLVED?

It is crucial to understand that stringent restrictions on the type and length of investments permitted by rating agencies and financial regulators in the Aaa universe have already been in place for a number of years. Indeed, the due diligence process involved in obtaining a Aaa rating itself requires the investment manager to demonstrate a robust investment philosophy and process encompassing a number of risk management techniques. To understand how an investment manager would manage a fund in a risk controlled environment we can look at three key areas of potential risk and return: Interest rates, liquidity and credit. Taking liquidity management as an example, two critical elements stand out:

- 1) Balancing client liquidity needs with the need to provide a competitive yield i.e. ensuring that liquidity is sufficient to allow flows in and out of fund without impacting incumbent investors while maintaining an efficient use of capital to provide the expected level of return.
- 2) Understanding the market environment and how cyclical events can impact on liquidity. The annual year end liquidity crunch is a good example of this, whereby the cost of funding around year end spikes higher affecting market participants who need to execute at that time. The credit crunch served to exacerbate this phenomenon and again put the spotlight on money managers' ability to adequately manage liquidity.

Credit management has of course come under particular scrutiny over the recent months yet this is one of the areas in which managers can truly differentiate themselves by virtue of a thorough process employed by an experienced, independent credit research team.

Managing interest rate risk within a fund can provide a meaningful impact on performance. It is important to ensure that risk controls are in place such that the level of risk is consistent with the stated objectives of the fund. Increased interest rate risk can benefit the fund during periods when interest rates are falling whilst reducing interest rate risk will benefit the fund when interest rates are rising.

When discussing risks, it is important to remember the reasons for using a AAA rated money market fund as well as the purpose of the cash investment in an overall asset allocation. Cash is the building block on which a solid investment platform is built and should not be vulnerable to the excessive or ill defined use of risk.

## WHAT DOES THIS MEAN FOR INVESTORS?

Recent events have reminded us that despite sitting at the conservative end of the risk / return spectrum money market funds are not risk free and active investment decisions do take place. It is equally important to remember that Aaa rated funds, as defined by IMMFA, have proven to be highly resilient to financial market volatility. It is key to understand the distinction between enhanced and short bond funds as they have a different risk profile to the aforementioned "treasury style" Aaa funds. Enhanced and short bond funds continue to be wholly appropriate as do money market funds as long as investors' risk appetite and objectives of a funds' strategy are in line with one another.

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