Key Questions

Are Money Market Funds Safe?

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When choosing money market funds investors should focus on large well diversified funds, issued by respected companies, instead of chasing yield.

In response to the economic impact associated with the novel coronavirus and the related disease COVID-19, the Federal Reserve (Fed) not only reduced short-term interest rates to zero but instituted several programs to support financial markets. The Fed's aggressive actions have helped thaw frozen credit markets modestly, but — as is the case with other parts of the securities markets — these steps are making a profound and lasting impact on money market funds (MMFs).

Fed actions

The direct result of the reduction in interest rates by the Fed can best be seen on the yield of MMFs. At the end of February, the typical government MMF, the sweep vehicle of choice for most portfolios, reported a yield between 1.40-1.50%. That yield has since declined to under 0.50% and is expected to approach zero in the coming weeks.

Some key actions that the Fed has taken to help the broader economy and provide support to MMFs include:

- Unlimited quantitative easing by purchasing large quantities of US Treasuries and mortgage-backed securities (MBS), thus expanding the central bank's balance sheet.
- Introducing several programs, including the Money Market Mutual Fund Liquidity Facility, the Commercial Paper Funding Facility, the Primary Dealer Credit Facility, and the Primary Market Corporate Credit Facility.
- Reducing bank reserve requirements to zero and encouraging banks/financial institutions to use capital and liquidity buffers to increase lending.

Since these actions were first announced, the Fed has purchased some $1 trillion of assets, mostly Treasuries and MBS. As a result of these unprecedented actions, credit spreads have generally moved lower and prices of key short-term debt securities that MMFs invest in, such as commercial paper and repurchase agreements (repos), have gradually normalized.

Breaking the buck

Government MMFs, funds that can only invest in US government backed securities, have seen their coffers swell as fearful investors piled into the safety and security of US-backed cash-like assets. In contrast, prime MMFs are funds that primarily invest in short-term debt securities issued by corporations (e.g., commercial paper for taxable prime) or municipalities (e.g., variable rate demand notes for tax-exempt prime); these funds have experienced redemptions over concerns that they could be vulnerable to "breaking the buck," or redeeming at less than par.

Government and retail prime MMFs provide principal protection by maintaining a fixed net asset value (NAV) of $1 -– investors purchase at $1 NAV and redeem at $1 NAV. Institutions such as non-profits and corporations can only invest in either government MMFs (fixed $1 NAV) or institutional prime MMFs, which have floating rate NAVs.

While there is little chance of a government fund ever redeeming below $1 NAV (securities are issued by US Treasury and government backed institutions), investors have heightening concerns that credit/municipal defaults alongside large redemptions from prime funds could trigger such MMFs to break the buck.

As noted earlier, the Fed has implemented the Money Market Mutual Fund Liquidity Facility (MMLF) and other programs that are designed to provide support to MMFs and alleviate these fears. The MMLF has the ability to purchase assets directly from both taxable and municipal prime funds. The program is intended to provide MMFs with liquidity in times of market stress, when redemptions are running high and their investments could be difficult to sell at reasonable prices. Since the MMLF went into operation on March 23, the facility has purchased a whopping $31 billion in securities from prime funds and has helped restore confidence in the credit market. The impact of Fed actions has been strongly positive across the spectrum of assets with repos, commercial paper, municipals, etc., all catching a bid and generally observing rising prices.

Low, zero, or negative

Demand for high-quality assets such as US T-Bills has remained extraordinarily strong, with most of the front-end (up to 6 months) trading with a negative yield. In case of prime MMFs, the universe of investable securities is quite deep and vast. Although Fed actions have led to declining yields, prime funds still offer a considerable yield advantage (approximately 0.50%) over other cash-like instruments, including government funds. Similarly, government funds can invest in a diverse array of government-backed securities, which enables these funds to maintain a zero or slightly positive yield: Most government funds reduce their fees and do not pass negative rates to investors. Treasury-only MMFs, on the other hand, could be vulnerable to negative yields.

With T-Bills (6 month and less maturity) now trading at negative yields, Treasury-only MMFs could be forced to adjust their fund structures to accommodate negative yields if the current situation persists. In Europe, where negative yields have been the norm since at least 2014, fixed-NAV money market funds pass on negative yields by reducing investor shares. If negative rates in the US endure, we expect fixed-NAV money market funds to use a similar method.

Quality over yield

As a result of increased regulations and Fed's interventions, MMFs have become some of the most highly regulated funds in the market. At Key Private Bank our focus with internally managed strategies and our choice of external partners has always been safety of assets. Our internally managed fixed-NAV funds are managed to a higher liquidity and quality standard than traditional prime money market funds. Similarly, we have confidence in our third-party MMF partners: We monitor them constantly and are in close contact with them on an ongoing basis. Even in case of significant market stress or rising redemptions, we believe our internal and external funds are well placed to withstand significant periods of volatility and extended periods of low interest rates.

For more information, please contact your Key Private Bank Advisor.

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