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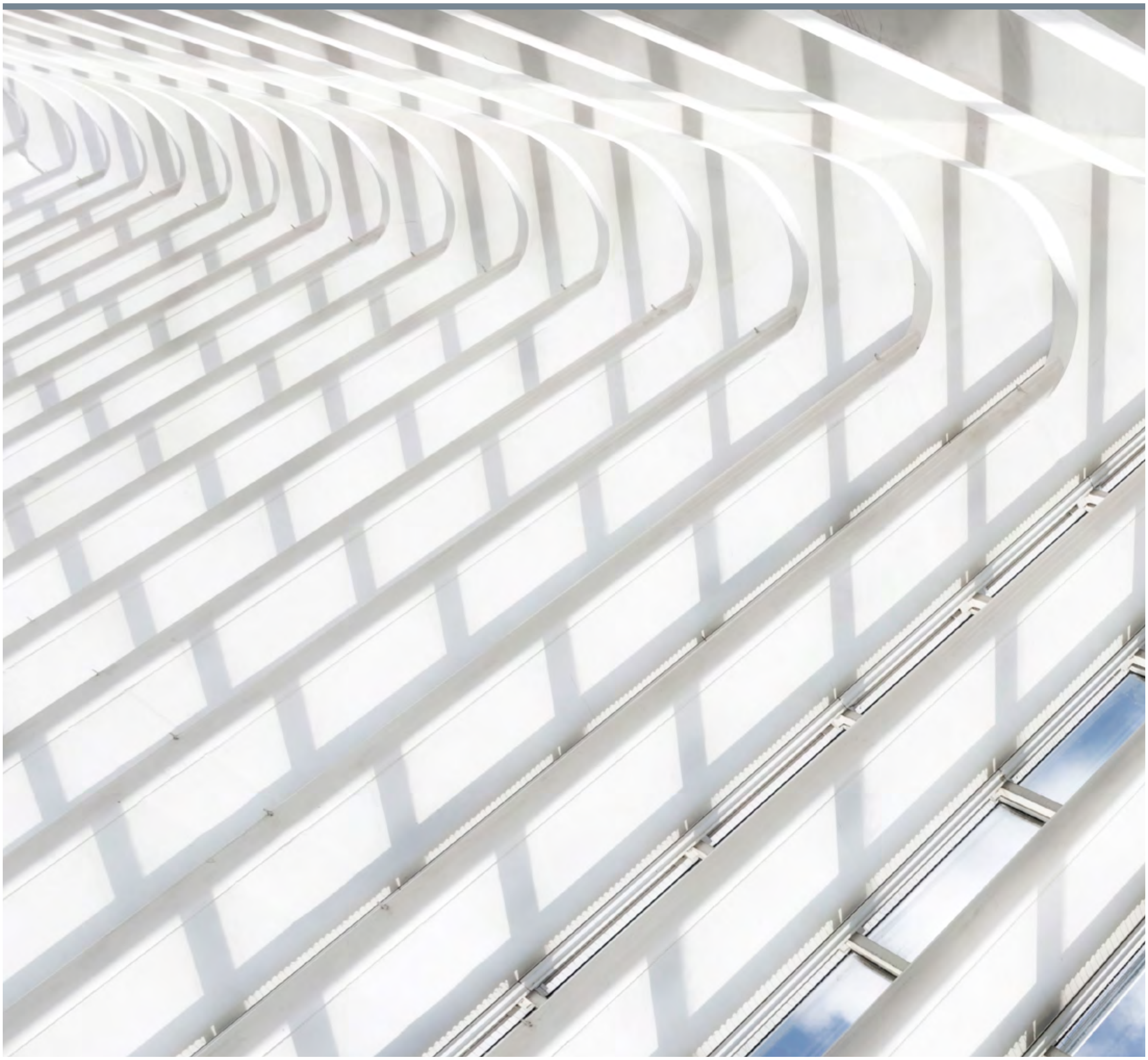
The New Cash Paradigm: Reform Changes Explained



Global Asset Management

The New Cash Paradigm

Reform Changes Explained

Prime Funds: Forever Changed

When the U.S. Securities and Exchange Commission's (SEC) money market fund reform is implemented in October 2016 (see Exhibit 1), prime money market funds will change dramatically. While the SEC intends to provide more market stability and address redemption risk, we believe these new regulations fundamentally change the utility of institutional prime funds. Prime money market funds will lose the important characteristics that mirror cash, and will diminish in availability. In our view, government money market funds, which are unaffected by reform, will become the clear choice for investors seeking safety, liquidity and a competitive yield.

Fundamental Changes: Fees, Gates and Variable Net Asset Value

Post-reform, institutional prime money market funds will be required to float their net asset value (NAV) and have new procedures to impose fees and gates. While variable NAV will be of little consequence (as we discuss below), fees and gates are major changes. The main use of current day prime money market funds is the unrestrained ability to convert an investment to cash. With the inclusion of fees and gates access to cash is now conditional. There is a low probability of fees and gates being implemented. Yet if this were to happen, just when investors most want their cash it may be inaccessible.

Prime money market funds will react to the new rules by positioning themselves more conservatively with a higher degree of liquidity. This more conservative profile will reduce the yield. The funds will be less risky from an investment perspective but, in turn, would be less desirable from a potential returns perspective.

Prime money market funds will be more risky from a structural perspective. Fees and gates are a draconian measure and intended to be imposed only in times of severe market stress, yet the mere existence of fees and gates potentially makes runs more likely. Even events that are considered smaller risks may cause investors to exit prime money market funds sooner than in a non-gated fund to avoid losing liquidity. As investors exit, the fund moves closer to the threshold of implementing fees and gates and potentially causes a preemptive run.[4]

Post-reform prime money market funds will also be less prominent in the market place. Providers have already begun to close or convert the funds. Prime money market funds' eligibility as a sweep vehicle at banks or brokerages has also been questioned as a viable future investment vehicle. Prime money market funds may have been, unfortunately, reformed to death.

Exhibit 1
Money Market Reform Rules

Fund Type	Net Asset Value Type	Liquidity Fee	Redemption Gate Per Fund's Board	Implementation Time Frame
Institutional[1] — Prime & Tax-Exempt	Variable (showing 4 decimals)	Up to 2% if fund's weekly liquidity falls below 30%[2]	Maximum of 10 days in a 90 day period	October 2016
Retail[1] — Prime & Tax-Exempt	Stable (at $1.00)	Up to 2% if fund's weekly liquidity falls below 30%[2]	Maximum of 10 days in a 90 day period	October 2016
Retail & Institutional — Government Only	Stable (at $1.00)	None[3]	None[3]	October 2016

[1]Institutional funds are owned by any investor, including 'natural persons.' Retail funds are owned only by investors deemed as 'natural persons.'
[2]And the Fund's Board determines a fee is in the Fund's best interest.
[3]Government funds are permitted, but not required to impose fees and gates.
[4]Marco Cipriani, Antoine Martin, Patrick McCabe and Bruno M. Parigi. "Gates, Fees, and Preemptive Runs." Liberty Street Economics (August 18, 2014): http://libertystreeteconomics.newyorkfed.org/2014/08/gates-fees-and-preemptive-runs.html

Variable NAV: Mostly Noise

Institutional prime money market funds will now be priced to four decimal places and the NAV will fluctuate with the value of fund holdings. While pricing will vary at the fourth decimal – equal to 1/100th of 1% or 1 basis point (bp) – most days will see no change in NAV. When the NAV does change it will likely be 1 bp per day (Exhibit 2). The sample prime money market fund's variable NAV changed 22% of the days as shown in Exhibit 3. The lower risk profile of prime money market funds will also reduce the amount of NAV variability.

A change of 1 bp could be meaningful in today's low rate environment if the holding period is short. The impact to the fund's total return is dampened over longer holding periods as income plays a larger role. The relative impact of the variable NAV will also be smaller should rates rise and income improves.

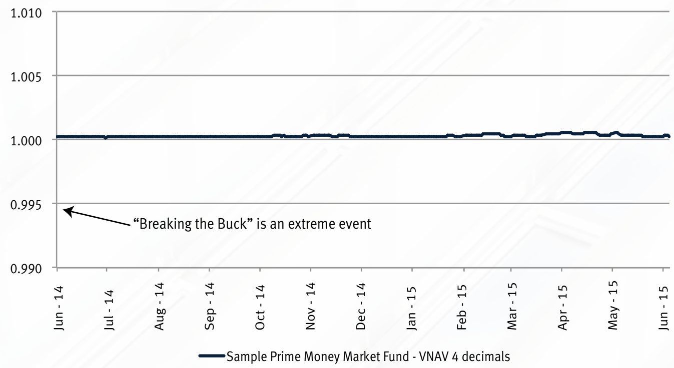
What Should Investors Do?

We believe institutional investors should be prepared to exit prime money market funds and switch to government money market funds as a first step. Government money market funds will retain the safety, liquidity and income investors seek, but without the added risks of fees and gates. Institutional investors should also explore the ability to buy securities on their own behalf through a broker or with the help of an asset manager via a customized separate account.

Fees and gates will place the cost of liquidity previously borne by central banks or financial institutions upon investors in institutional prime money market funds. These funds will now have gates, fees, variable NAVs, lower yields and be harder to find. In our view, government money market funds will become the clear choice for investors looking for a safe, consistent and transparent option for their liquidity needs.

Exhibit 2
Stable NAV

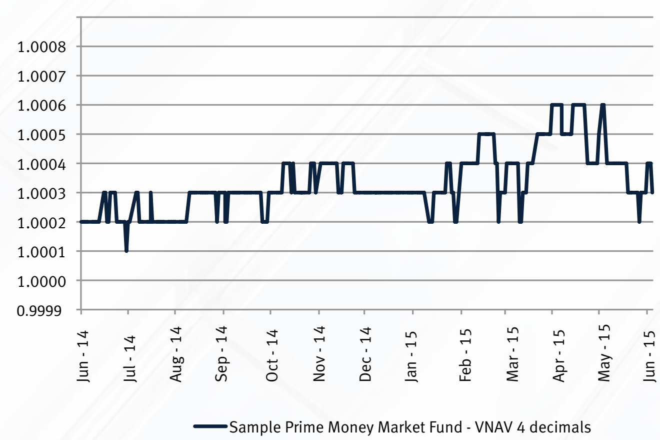
Under current rules the sample fund below will be priced at $1.00 unless the NAV drops below $0.995.



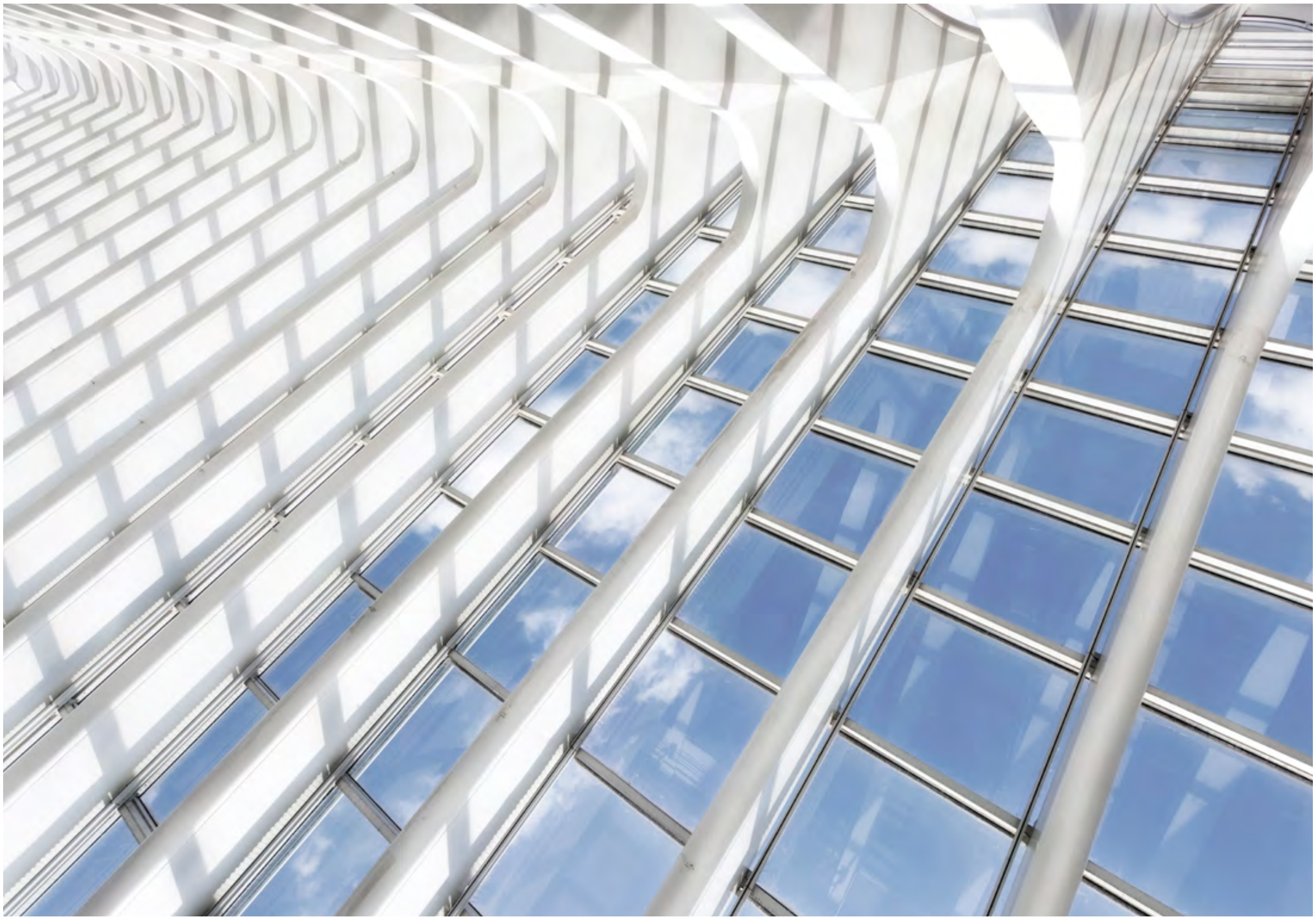
Souce: RBC GAM-US as of June 2015

Exhibit 3
Variable NAV

Under new rules the sample fund below saw its variable NAV change by 1bp 22% of trading days (and changed by 2bps 1% of the time.



Souce: RBC GAM-US as of June 2015



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