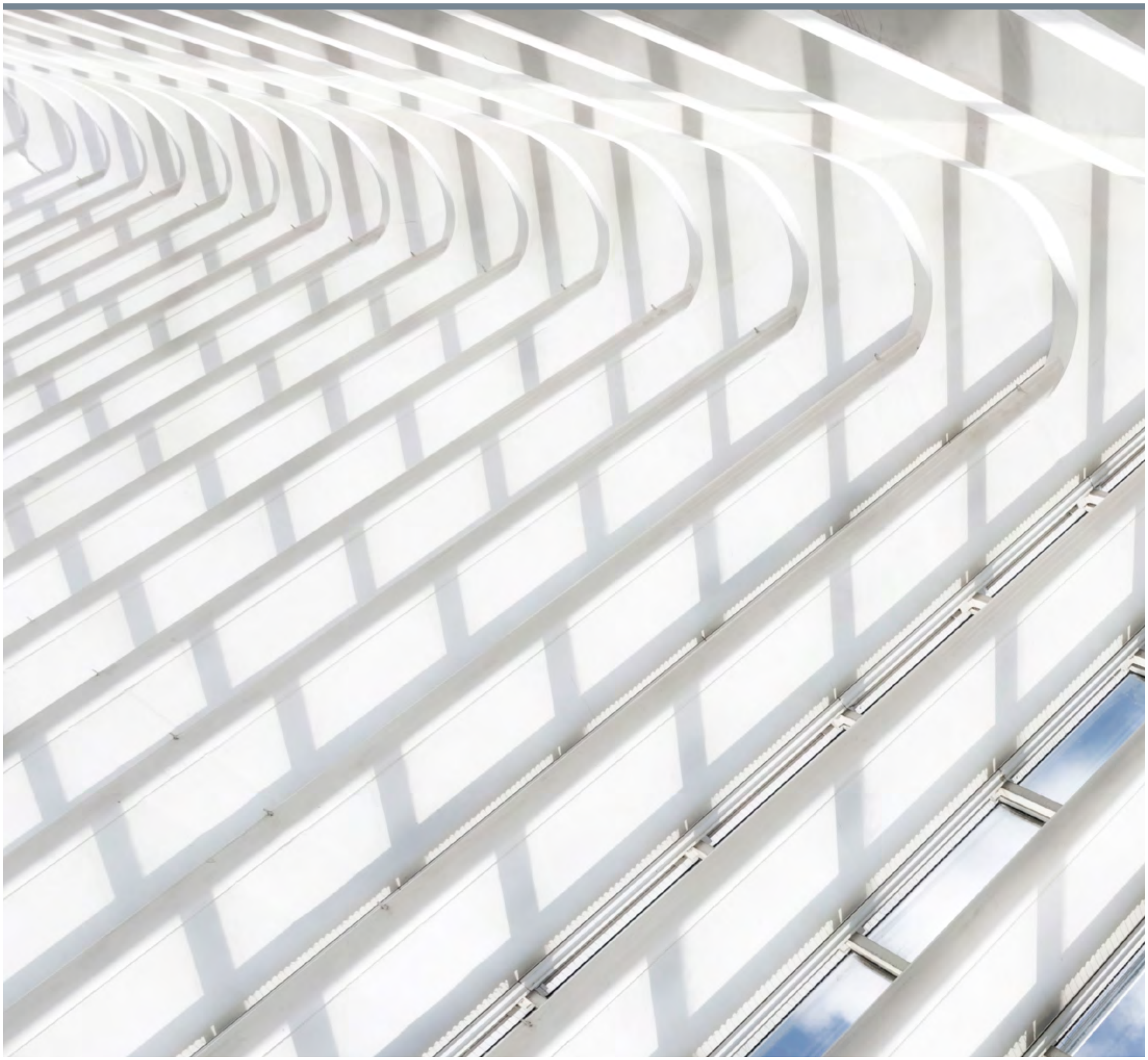
Global. Liquidity. Management.

Prime Funds: Is the Income Advantage Gone?



Global Asset Management

Prime Funds

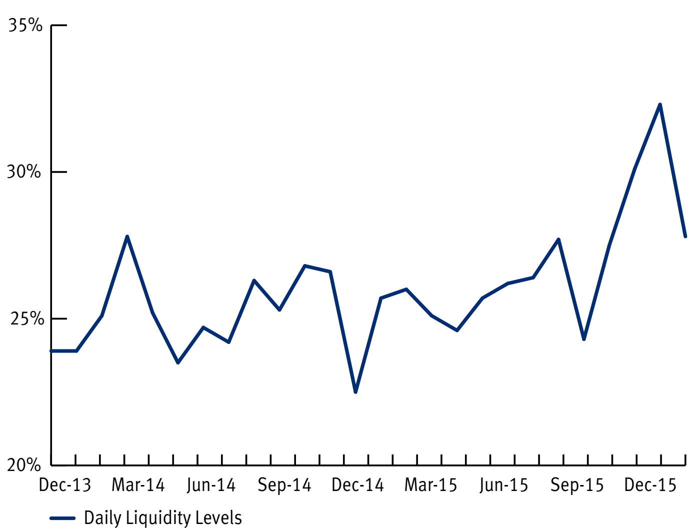
Is the Income Advantage Gone?

We believe the regulatory changes coming in the fall of 2016 will cause prime money market funds to become unsuitable for daily liquidity management. Gates and fees will structurally weaken the funds, effectively eliminating their usability as a liquidity product. (Read more on money market reform in our paper: The New Cash Paradigm) Prime funds will also be forced to maintain such high levels of liquidity that the income advantage they have offered in the past will drop significantly and may become negligible compared to government money funds.

Prime money market funds are required to maintain 10% in overnight liquidity and 30% in weekly liquidity. Under the new rules, funds that breach the 10% and 30% thresholds will require board action. Boards will be required to consider imposing gates and fees for funds without sufficient liquidity.

Fund management will become highly motivated to avoid board involvement. Managers realize that the mere consideration of gates and fees could cause a run on a fund and lead to its demise. To avoid board scrutiny, the daily and weekly liquidity levels will be kept well above the minimum requirements (Exhibit 1).

Exhibit 1
Prime Funds Liquidity Trend



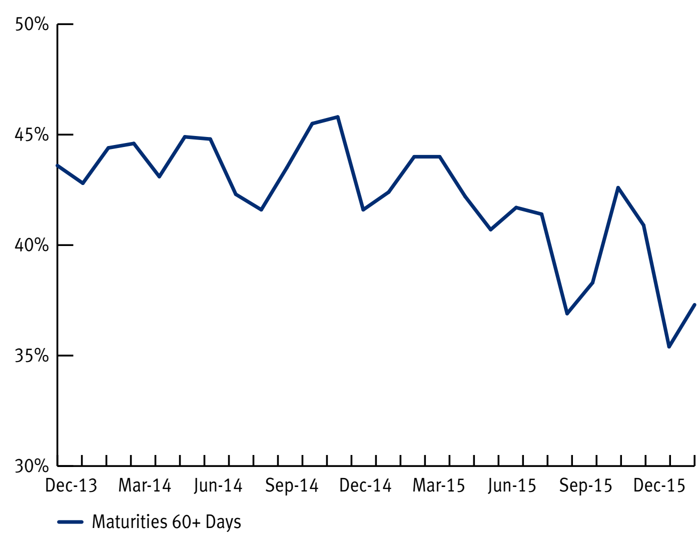
Source: SEC as of January 2016

Institutional investors, whose cash needs mandate zero tolerance for potential impairment of their cash, will also be monitoring liquidity levels. Fund managers are aware that the sophisticated, risk averse investors will be quick to exit funds with perceived liquidity issues. The conservative, nervous, investor base is another reason funds will maintain liquidity levels well above the minimum requirements.

In addition to the scrutiny of liquidity positioning, variable net asset value (NAV) of prime funds will also be under a new microscope by boards and investors. These funds, in an effort to achieve steadiness, will naturally seek to reduce the volatility of the new four decimal NAV.

Longer-maturity securities have higher price volatility and will be less attractive to funds trying to stabilize variable NAVs (Exhibit 2). Instead, prime funds will be forced to focus on shorter-maturity, lower yielding securities.

Exhibit 2
Longer-Maturity Securities in Prime Funds



Source: SEC as of January 2016

Government funds, which will not have additional liquidity or NAV rules, remain unchanged compared to newly regulated prime funds, that may be inclined to buffer liquidity levels even further in an effort to maintain a margin above the requirements (Exhibit 3). As liquidity buffers increase, fund yields drop. Government funds without gates, fees or variable NAV issues, may continue to hold smaller liquidity buffers and take full advantage of the higher yields typically offered by longer weighted average maturity (WAM) securities.

Exhibit 3

Portfolio	Gross Yield	WAM	Daily Liquidity	Weekly Liquidity*
Money Market, 2010 2a7	0.69%	65 days	10%	15%
Money Market, Current 2a7	0.64%	45 days	15%	21%
Money Market, 2016 2a7	0.51%	31 days	25%	36%
Government Money Market, Current 2a7	0.49%	51 days	15%	18%

As of 10.8.15

*Weekly liquidity numbers are not intended to reflect "Weekly Liquidity Assets" as defined by 2a-7.

The above information is provided for discussion purposes only as a model of how portfolios with the above variables may be constructed. Information presented is not representative of any account managed by RBC GAM-US or performance that will be achieved by investing in these types of portfolios. Securities are subject to availability and may change at any time. Weighted average maturity is the weighted average of the time until all securities in the portfolio mature.

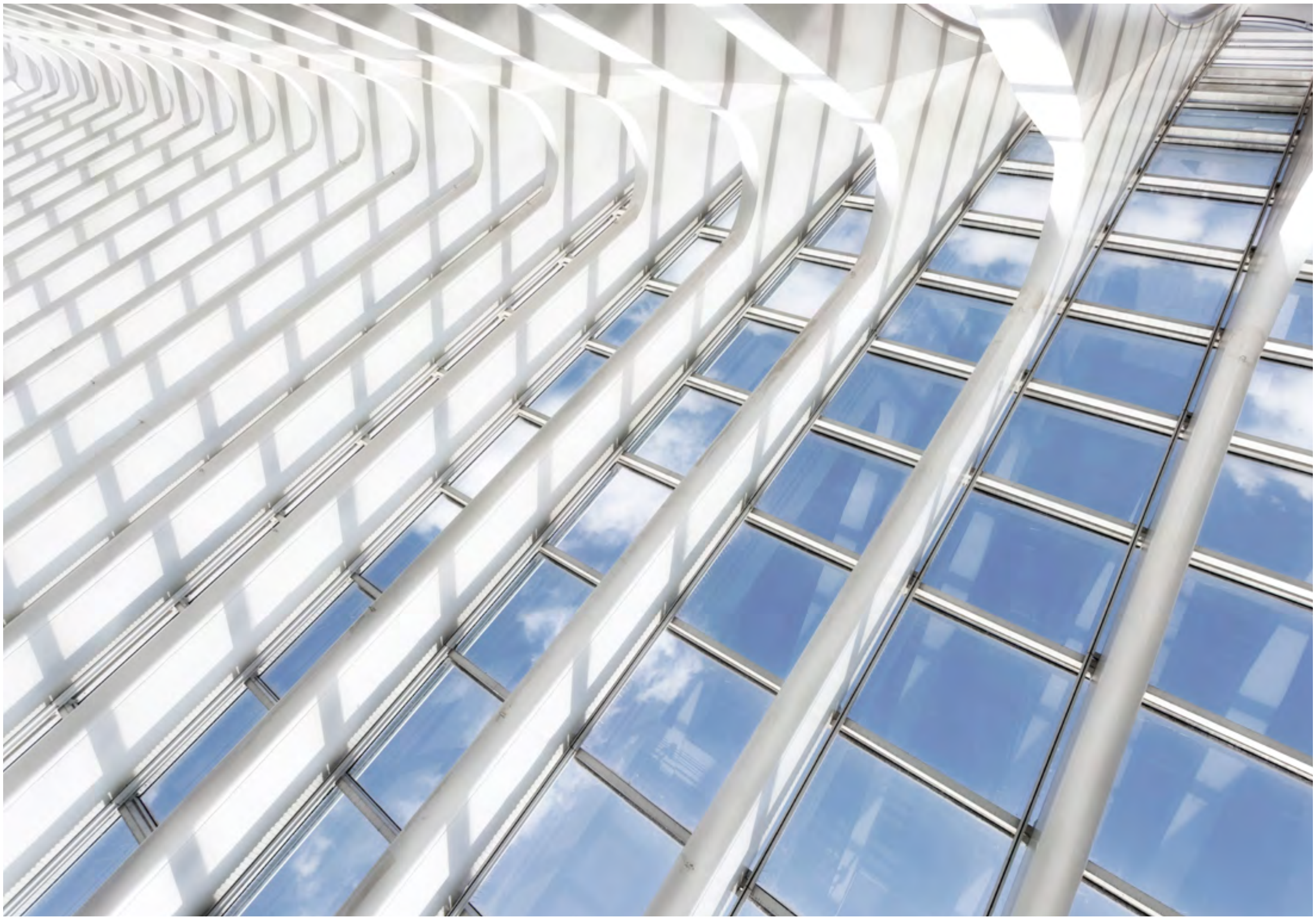
Conclusion

There is an explicit cost to a very conservative portfolio. In line with regulators' goals, post-reform prime funds will be forced to have shorter WAMs and hold more liquidity than government funds. Both of these factors will significantly narrow the gap in yield between prime funds and government funds. Government funds can take full advantage of traditional sources of yield in money markets by having more flexibility to invest in longer securities and hold relatively less in overnight and weekly liquidity. The absence of gates and fees may also make them less vulnerable to runs.

Government money market funds will be optimal for investors seeking a true liquidity vehicle. Those investors currently using prime funds for liquidity should begin moving their assets to government money market funds before reform is implemented in fall 2016.

New Alternative Money Market Strategies

New strategies have been designed to avoid the new regulations including "seven day funds" and "less than 60 day funds." Yet these new strategies will have to adhere to floating NAV and fee/gate requirements in much the same way as post-reform prime funds. Given these new vehicles have small amounts of underlying assets and as such, we are unable to determine a track record of performance. We believe these funds will suffer even more from the same pitfalls as prime funds. Their shorter nature will leave even less opportunity to offer attractive yields to investors.



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