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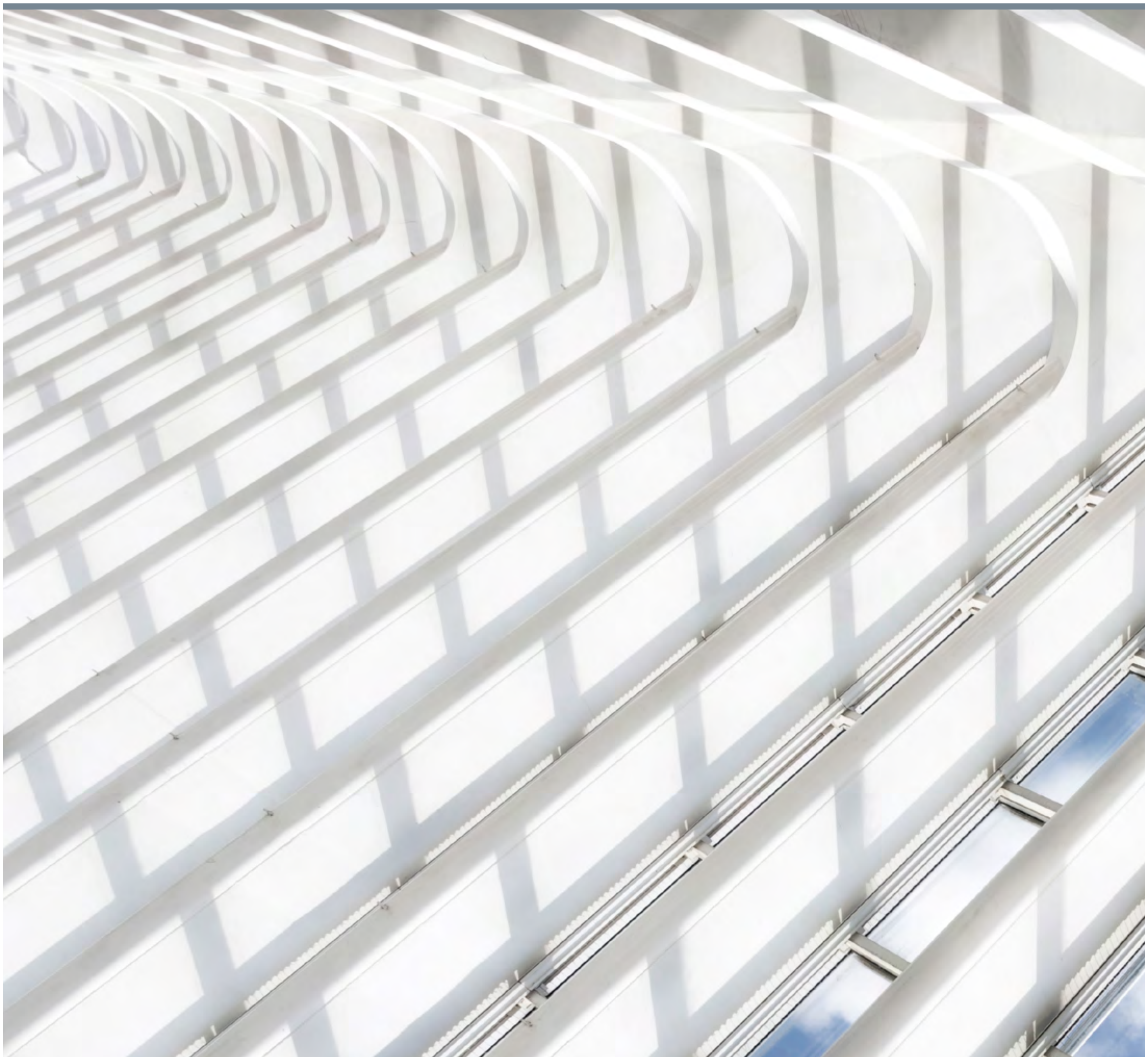
Short-Term Corporate Bonds: A Money Market Reform Opportunity



Global Asset Management

Short-Term Corporate Bonds

A Money Market Reform Opportunity

Money market fund reform is having a never-before-seen impact on the landscape for liquidity and short duration investors. Short-term corporate bonds are at the epicenter of this change. If prime fund assets decline, as we expect, so will an important source of demand for short-term corporate bonds. Less demand will occur as record-level corporate bond issuance is rolling down the curve. This changing dynamic may provide performance opportunities for investors who are positioned to benefit.

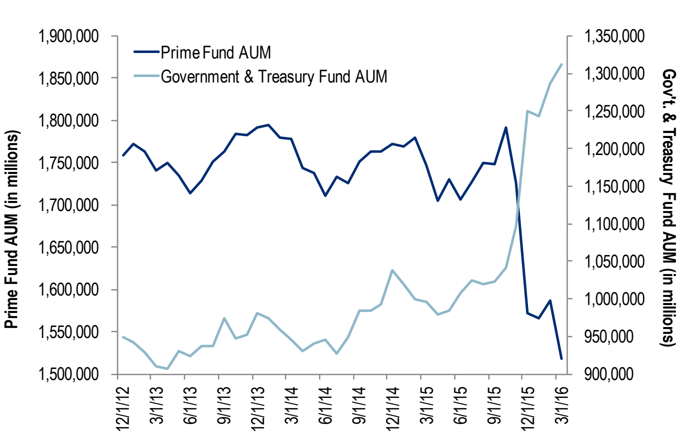
Historical Market Trends

Prime fund rules limit the maturity of individual securities to 397 days while also limiting the average life and average maturity of the overall fund. Seeking to maximize income, prime funds have historically been significant buyers of one-year corporate bonds given the extra income they provide over government securities and commercial paper.

Traditional benchmark-driven, longer-duration fixed income managers typically sell securities when they have maturities less than one year. The selling of these securities has been, and will continue to be, very consistent because most fixed income benchmarks exclude securities with maturities less than one year. For decades, prime funds were a reliable buyer of this supply of high-quality, short-term corporate bonds. The natural buyers and sellers for one-year corporate bonds formed a symbiotic and efficient market.

Exhibit 1

Decline in Prime Fund AUM



Source: U.S. Securities and Exchange Commission, “Money Market Fund Statistics Report” as of April 20, 2016

Shifting Trends in Demand

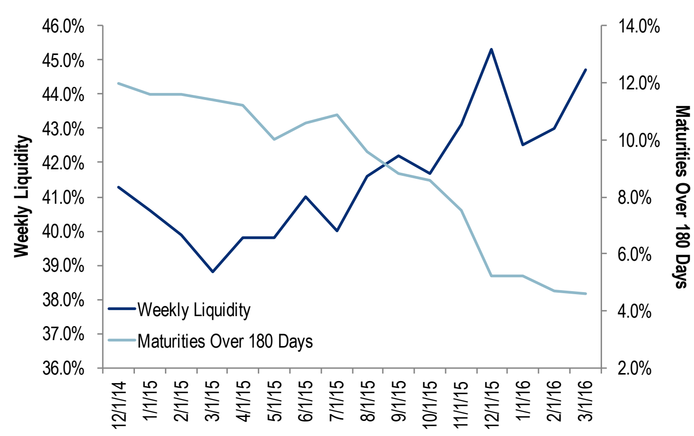
There are two fundamental reasons demand from prime funds for one-year corporate bonds will decline. First, prime fund assets under management are in decline and will continue to drop as we approach money market reform implementation in October (Exhibit 1). The majority of money moving out of prime funds has shifted to government money market funds, which cannot, by rule, purchase short-term corporate bonds.

Second, pending money market reform is forcing prime fund managers to position their funds more conservatively. These new draconian measures are driving prime funds to hold more liquidity and shorten their maturities. Under the new reform rules, funds are prioritizing liquidity, avoidance of gates and variable net asset value (NAV) volatility, rather than income maximization. The de-emphasis of income is sharply reducing demand for short-term corporate bonds.

Longer maturity securities have higher price volatility and will be less attractive to funds trying to stabilize variable NAVs. Instead, prime funds will be forced to focus on shorter-maturity, lower-yielding securities (Exhibit 2). We explore this more in our paper, “Prime Funds: Is the Income Advantage Gone?”

Exhibit 2

Prime Fund Managers Position Conservatively

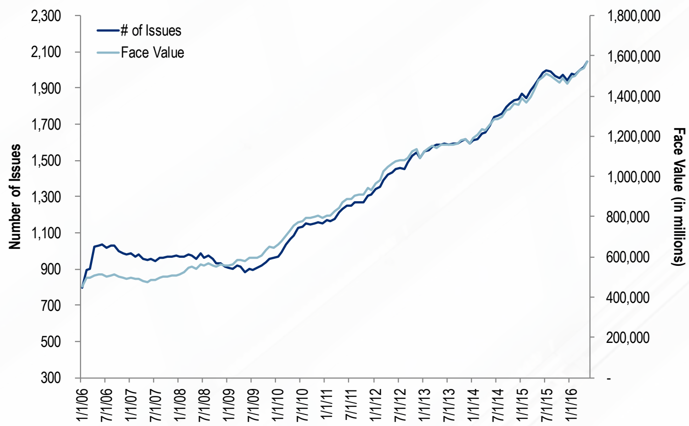


Source: U.S. Securities and Exchange Commission, “Money Market Fund Statistics Report” as of April 20, 2016

Corporate Supply Continues to Grow

Reduced demand for one-year corporate credit is coinciding with an increase in supply (Exhibit 3). The amount of corporate bonds outstanding has tripled over the past ten years reaching nearly $6 trillion, with over 25% maturing in the next three years. Supply for short-term corporate bonds will remain abundant as longer maturity bonds roll down the curve. We expect the consistent supply of short-term corporate bonds will provide attractive income for short duration investors for the foreseeable future.

Exhibit 3
Corporate Bond Supply Continues to Expand



Source: Bank of America Merrill Lynch, as of May 31, 2016

Opportunity for Investors

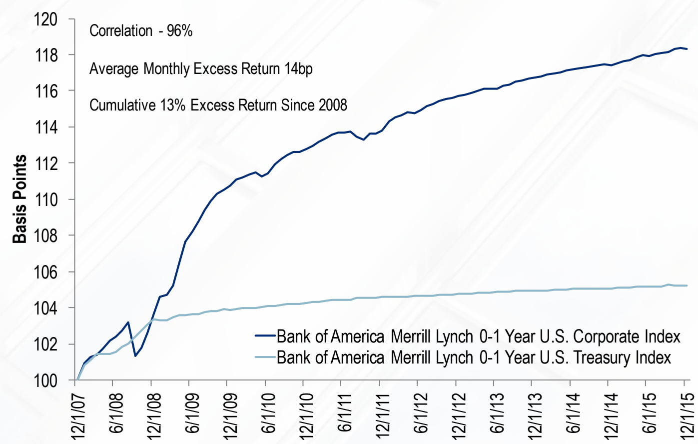
We believe investors have an opportunity to significantly improve return potential without a material increase in risk versus variable NAV prime funds. Exhibit 4a highlights the significant income advantage an investor achieves by employing a short credit strategy versus other short duration strategies. We believe the extra income short-term credit investors will earn is greater than that of prime money market funds or short government strategies. Short-term credit provides investors with a persistent income advantage as Exhibit 4b indicates.

Exhibit 4a
Corporate versus Treasury Duration and Yields
(as of March 31, 2016)

	Duration	Yield
Bank of America Merrill Lynch 0-1 Year U.S. Corporate Index	0.53 years	1.28%
Bank of America Merrill Lynch 0-1 Year U.S. Treasury Index	0.50 years	0.45%
Prime Money Market Funds	0.10 years	0.55%
Government & Treasury Money Market Funds	0.12 years	0.39%

Source: Bank of America Merrill Lynch and U.S. Securities and Exchange Commission, "Money Market Fund Statistics Report" as of April 20, 2016

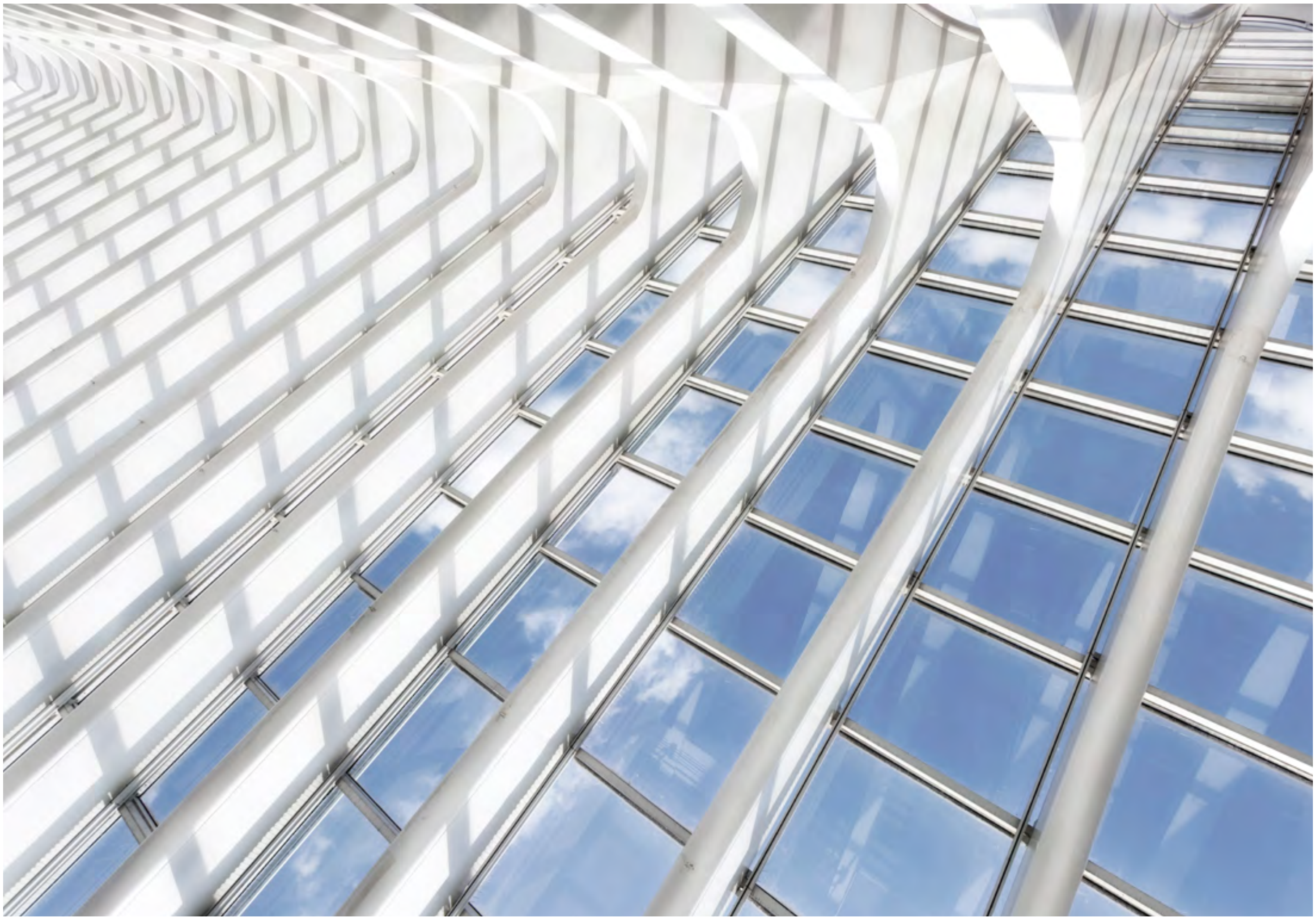
Exhibit 4b
Corporate versus Treasury Returns



Source: Bank of America Merrill Lynch as of May 31, 2016

Conclusion

Money market reform and record-level corporate bond issuances are altering the supply/demand dynamics of short-term bond markets. As prime money market funds lose assets, demand for short-term corporate bonds will decline at the same time supply is expanding. We believe investors able to purchase and hold securities that were once commonly held in prime money market funds can capture significant income with similar or less risk than a variable NAV prime fund. We believe the opportunity for investors to enhance income by buying short-term corporate bonds will be present for the foreseeable future.



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