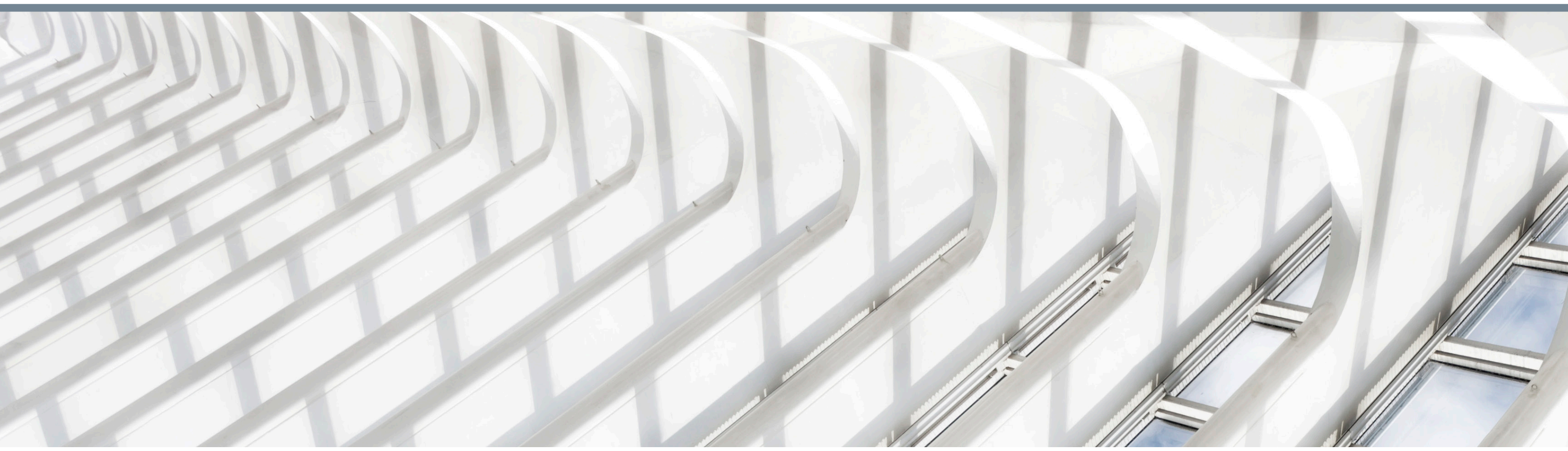
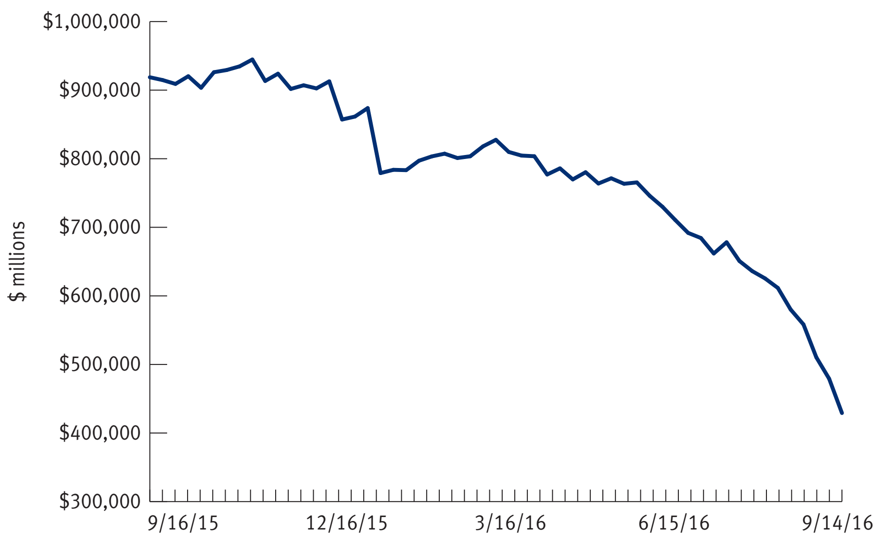
Global Asset Management



GLOBAL. LIQUIDITY. MANAGEMENT.

Prime Funds: The Great Separation

Exhibit 1
Institutional Prime Money Market AUM



Source: Bloomberg as of 9.14.16

Scale drives the asset management business. As funds grow, investors are drawn to deep pools of liquidity to invest their capital. This growth then starts a virtuous cycle in which scale becomes a great strength. But with pending money market reforms, we find this trend reversing. Prime funds are shrinking and this is causing problems for institutional investors. As the new rules take effect in October, it's important for institutional investors to understand the new realities of prime money market funds.

Floating net asset value (NAV), fees and gates have gotten the most coverage regarding money market fund reform. A less-examined issue is the separation of institutional and retail investors in prime money market funds, a result of institutions being pushed to floating NAV funds. In the past, it was common for prime money market funds to have a multi-share class structure that allowed for the commingling of retail and institutional investors. This benefited both parties. The retail investors contributed stable balances, as they typically require less liquidity. Simultaneously, institutional investors' larger balances increased scale and lowered cost for funds. The symbiotic relationship between stable and scalable capital will disappear with the separation of the two.

The first issue the separation creates for institutional investors is increased concentration. As institutional investors are moved to new funds with the absence of retail investors, concentrations in those funds immediately rise. Some investors, based on their investment policy, may be forced to sell if they exceed prescribed maximum concentration limits. This selling would further reduce the size of the fund, exacerbating the concentration issues, creating a spiral. Because there are no mandatory fund disclosures regarding investor concentrations, beyond disclosing 5% shareholders in the Statement of Additional Information, a few large investors may control a majority of assets in a fund unbeknownst to smaller investors. Sudden or unexpected redemptions by these large investors could quickly lead to shrinking fund size, and in turn the fund's liquidity. Thus requiring a fund to impose fees or gates as redemptions put stress on a fund's ability to maintain adequate liquidity.

The second issue the separation of retail and institutional investors creates is dramatically increased liquidity needs for institutional funds. Historically, the retail component of funds created a stable base that institutional investors depended on to meet liquidity targets. Without that stable investor base, institutional prime money market funds are now vulnerable to the frequent flows more typical of institutional investors. Funds will respond by holding significantly more liquidity than even the new 2a-7 rules require, for fear of tripping liquidity triggers, potentially leading to the ill-fated process of imposing gates and fees. Increased liquidity leads to lower yields, dampening overall returns.

The new reality of smaller, more concentrated funds increases the likelihood that fees and gates will at some point be used. It is widely agreed that if a fund ever had to enforce a fee or gate, it would be unlikely to survive. Given this, fund boards could face a difficult situation where redemptions are increasing, requiring securities to be liquidated. If this is done in a stressed market environment, it could cause the NAV to fall as securities are liquidated at wider spreads and lower prices. A fund board would have a difficult time explaining to the SEC why they did not think it was necessary to impose a fee or gate in a situation where remaining shareholders are harmed, at an increasing rate, by the redemptions of others. Just the fear of redemption gates might cause investors to sell first and ask questions later. (For more reading, see Federal Reserve Bank of New York Liberty Street Economics' blog, "Gates, Fees, and Preemptive Runs".)

Reforms to prime money market funds have rendered them unsuitable for liquidity investors. Whether it occurs slowly through the loss of scale, or quickly from a redemption run and fee or gate, prime money market funds may have been reformed to death. Under the new regulations some of them may eventually become nothing more than memories.

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