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The New Frontier: Managing Cash Investments

For almost 40 years, money market funds have offered a comprehensive solution for cash investors by providing three main benefits—preservation of capital, liquidity and yield—all with a simple structure that has provided ease of use. However, in the years since the financial crisis, regulators have focused on ways in which they could avert a future financial crisis. As a result, stricter banking regulations and new money market fund rules were introduced. The new regulatory regime coupled with an environment of unprecedented low interest rates has fundamentally changed the dynamics of the short-term markets. Consequently, investors may find it increasingly challenging to capture all of the traditional benefits of money market funds. We believe these challenges have created opportunities for cash investors to take a more proactive and dynamic approach to their cash management strategies.

Banking Regulations and Money Market Reforms

After the financial crisis, regulators determined that it was essential for them to design a more robust regulatory framework that could be utilized to prevent a similar global crisis from ever occurring again. To this end, they have initiated both stricter and more encompassing regulations for financial institutions and money market funds.

The Basel Committee on Banking Supervision instituted a new standard for international banking, the Basel III framework. The center of this integrated capital, funding and liquidity framework lies within two key measures: the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). These ratios were designed to mitigate banks' liquidity risk by ensuring that financial institutions maintain adequate amounts of assets that can be easily sold. With the emphasis of this new regulatory framework on funding efficiencies, banks will likely increase their purchases of high-quality assets while becoming less competitive with respect to yield on certain deposits and other sources of short-term financing.

The Securities and Exchange Commission (SEC) implemented reforms that seek to make money market funds more resilient. The first round of reforms occurred in 2010 when the SEC mandated that funds hold minimum percentages in daily liquid assets and weekly liquid assets while maintaining shorter portfolio-weighted average maturities. However, the SEC resolved that it had not done enough to address the potential vulnerabilities of money market funds. Consequently in 2014, it adopted the most fundamental changes for money market funds, which have a multi-year implementation period. The amendments contain structural changes as well as enhancements to disclosure, portfolio construction and stress testing requirements for money market funds.

	Institutional Prime and Institutional Municipal MMFs	Government MMFs	Retail MMFs
Floating Net Asset Value (Required)	Yes	No	No
Constant Net Asset Value (Permitted)	No	Yes	Yes
Liquidity Fees	At board discretion	Voluntary option	At board discretion
Redemption Gates	At board discretion	Voluntary option	At board discretion
Enhanced Disclosure	Yes	Yes	Yes

Further details are contained in our paper published in July 2014, “Money Market Funds: The SEC’s Long-Awaited Rulemaking.”

As these post-crisis regulatory policies take effect, the collective consequences will take form and will be broadly felt throughout the market. To date, the market has experienced a reduction in the supply of short-dated bank debt since the NSFR encourages banks to hold longer duration funding, thereby reducing banks’ reliance on short-term funding. Additionally, requiring banks to hold higher quality assets with the intent of reducing risk should they need to generate cash by liquidating assets at “fire sale” prices, has created increased demand for high-quality assets. As mandated by the 2010 SEC reforms, the requirement for money market funds to maintain a minimum amount of liquid assets coupled with their overall shorter maturity profile has caused funds to increase their demand for shorter dated assets. At the same time that money market funds are required to hold a higher percentage in short-term debt, banks are being penalized for issuing debt with maturities of less than 30 days. These reforms have essentially created a supply/demand mismatch between the banks and money market funds, fundamentally changing the dynamics of the short-end of the market. We believe these market dynamics have created an opportunity for investors to revisit their cash management strategies and to explore the many alternatives for cash investors.

Alternatives for Cash Investors

Between the regulatory overhaul and the unprecedented market conditions of today’s environment, a fundamental shift has occurred in the way investors think of “cash.” The historical approach of utilizing money market funds to provide a simple cash alternative by providing preservation of capital, liquidity and yield will be transformed in the near future. And while we still believe that money market funds will continue to provide investors many benefits, we think that cash investors should view this as an opportunity to take a more dynamic approach to their cash management strategies. By adopting a more efficient approach to managing risk and liquidity, cash investors can realign their cash needs to better meet their strategic objectives.

One of the initial steps in this process is to establish or carefully review existing investment policies. Investment policies create a roadmap for cash investors by containing specific information about risk tolerances and liquidity needs, as well as identifying parameters for achieving investment goals. Investment policies should be designed to be dynamic and broad in scope so that cash investors can have the flexibility to respond to market fluidity and changing cash needs.

To ensure preservation of capital while achieving optimal returns within a cash portfolio, it is important to conduct a thorough evaluation of future liquidity needs. Once this analysis is complete, cash investors may consider segmentation or cash bucketing. To clarify, cash can fall into a minimum of three distinct categories: operating cash, core cash and strategic cash. By allocating cash investments over multiple time horizons, investors may be able to achieve optimal returns by separating operational cash needs from longer horizon strategic needs. In the coming months, this simplistic approach may require additional precision as multiple strategies may need to be utilized for the deployment of operating cash. As a result of this thorough analysis, cash investors may be able to more efficiently allocate their short-term investments to better meet strategic objectives.

Historically, money market funds have been categorized as a single type of account. However, the SEC regulatory reforms have made this single categorization more complicated for cash investors. While Treasury and government money market funds are exempt from the structural reforms, institutional prime money market funds and institutional municipal money market funds will be fundamentally transformed. As the October 2016 implementation date for these structural reforms approaches, cash investors will need to recalibrate their approach to money market fund investing. Additional factors that will require evaluation include floating net asset valuation (NAV) versus constant NAV, same day settlement versus next day settlement, and the potential for liquidity fees and redemption gates.

Summary of Cash Alternatives for Institutional Investors

	Operating Cash		Core Cash	Strategic Cash
	Government	Non-Government		
Investment Horizon	0 – 6 months	0 – 6 months	6 – 12 months	>12 months
Objective	Liquidity and preservation of capital	Liquidity and preservation of capital	Enhanced return	Maximize total return potential
Strategy	Treasury Money Market Funds Government Money Market Funds	Prime Money Market Funds Municipal Money Market Funds	Ultra Short Bond Funds Separate accounts	Short Term Bond Funds Short Duration Municipal Bond Funds Separate accounts
Settlement	Same day settlement (T+0)	Same day settlement (T+0)	Next day settlement (T+1)	Next day settlement (T+1)
NAV	Constant NAV	Floating NAV	Floating NAV	Floating NAV
Liquidity Fees/ Redemption Gates	Voluntary option	At board discretion	None	None
Rating	AAA rating	AAA rating	Funds may be rated	Funds may be rated

Conclusion

With the imminent structural changes to money market funds and the market-based consequences of regulatory reform, investors need to prepare for the future and rethink their cash management strategies. As investors gain a better understanding of the dynamics of this new environment, they will be better equipped to meet its challenges. Western Asset is committed to working with our clients to help them navigate this new frontier, helping to ensure that they are prepared to optimize their liquidity management strategies.

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