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CAPITAL MANAGEMENT

INVESTMENT MEMO

Merganser Today

Merganser has extensive experience managing LIBOR-sensitive assets within both traditional fixed income mandates and a dedicated investment grade floating rate note strategy.

The cumulative result of these changes has caused a trillion dollar exodus out of prime money market funds.

The Sleepy Giant Awakens: LIBOR on the Move

For the last five years, investors have been sleeping on LIBOR. The 3 Month LIBOR rate, the most common benchmark of short term funding costs that is the reference rate for trillions of dollars of financial instruments, was within 10 basis points (bps) of 0.3% for the greater part of five years (64% of the last five years to be exact). The first meaningful increase in LIBOR since 2011 came when the Fed increased the policy rate in December 2015, but the market took little notice of the move. Since July, however, the market has become increasingly focused on LIBOR rates. So why the change of heart? To explain that, we must first delve into the underlying drivers of LIBOR.

Overview of LIBOR

LIBOR is set each day by a panel of 18 banks submitting an estimated borrowing cost for various currencies and tenors, the most commonly cited being the 3 Month US Dollar rate which will be the focus of this discussion. Three Month LIBOR is in theory a function of two factors: ultra-short government rates (in this case, the 3 Month T-Bill) and a credit risk premium to compensate for the higher risk of a bank creditor versus the United States Treasury. It stands to reason that if LIBOR increases, either credit risk in the market has increased or T-Bill rates have increased (likely in response to an expectation of higher Fed Funds rates). As we illustrate on the following page, the inefficiency of fixed income markets have again demonstrated that theory is just that, as neither of these indicators have explained the rise in LIBOR.

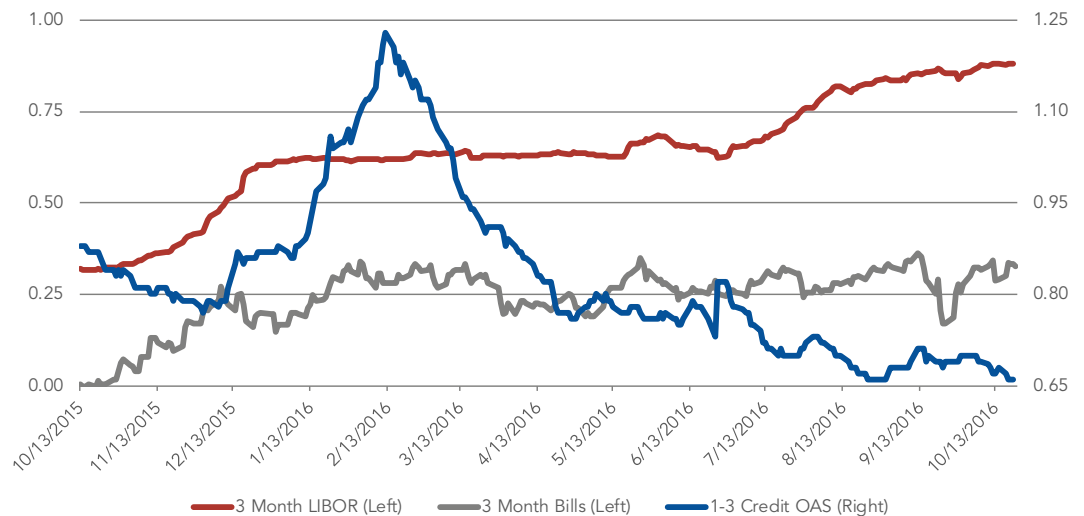
This past summer, expectations of a Fed rate increase and credit spreads both remained very low. However, LIBOR moved significantly higher over this period (see Figure 1, on the next page). Clearly the traditional relationship described above does not explain the move. So what happened? The answer lies in money market reform.

'How to Lose an Asset Class in 10 Days'

Following the financial crisis, the SEC sought to restrict the use of fixed NAVs and to provide mechanisms for reduced redemptions during a period of crisis in response to the issues at the Reserve Fund failing to preserve an NAV of \$1. The result of this effort, which took effect on October 14, brought restrictions primarily to institutional money market funds invested in securities not issued by the US Government. The cumulative

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Figure 1: Lower Rates, Lower Spreads, LIBOR...Higher?



Source: Bloomberg As of October 22, 2016

result of these changes was an exodus out of the asset class (see Figure 2, on the next page). With the traditional buyer of ultra-short securities rapidly shrinking, the market is unable to fully absorb the deluge of supply, causing interest rates to rise for commercial paper (CP), certificates of deposit (CDs) and traditional corporate bonds that have shortened to less than a year. As these ultra-short rates have risen, those higher funding costs are now being reflected in LIBOR submissions. In many cases, the spread between an ultra-short corporate bond and a similar duration Treasury is currently greater than that of a corporate bond maturing in 2019. Said another way, a company must pay more to finance itself for one year than three years in the current market.

Unintended Consequences

This inversion of credit spreads creates a ripple effect of market distortions and consequences. Beyond the increase in funding costs for companies attempting to raise short term funding, these market dynamics have affected numerous other areas of the market and economy.

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Structured Products: Distortions in the swap curve caused by the increase in LIBOR have skewed valuations, making shorter duration securities look attractive.

Floating Rate Corporate Bonds: The swap curve movement and the higher 3 Month LIBOR rate have resulted in five year corporate floating rate notes with attractive yields and total return profiles. While investor interest in the space has increased in recent months, we continue to regard corporate floaters as a compelling diversifier for many strategies.

Leveraged Finance: Leveraged bank loans, for which LIBOR determines interest rates, are nearly breaking through most interest rate floor levels, resulting in increased debt service costs for some of the most financially strained borrowers. We remain cautious that after years of cheap credit and even cheaper ultra-short rates, the junk rated companies that comprise the bank loan universe may be unable to fund themselves at even modestly higher LIBOR rates.

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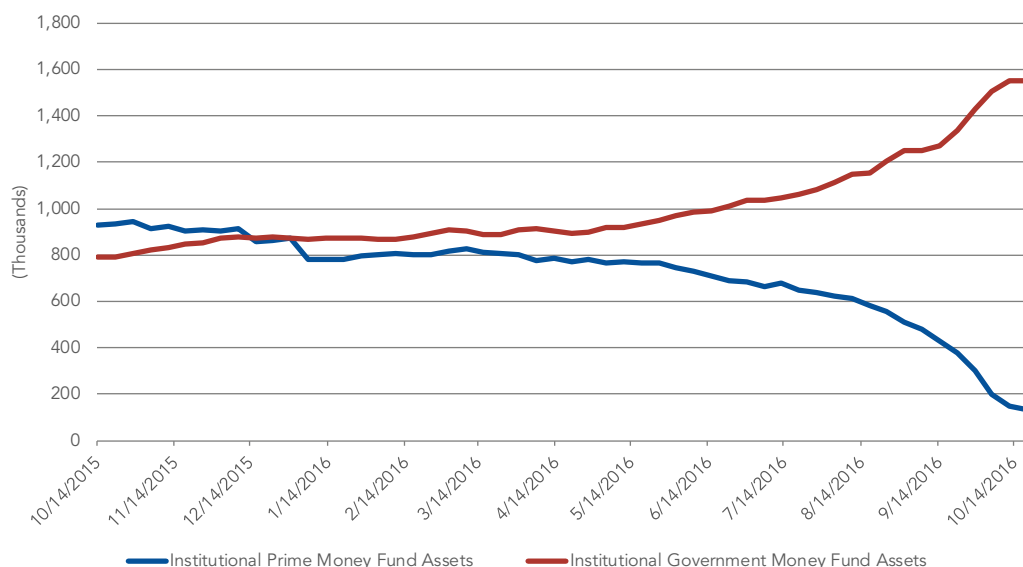
Consumer Balance Sheets: A meaningful percentage of consumer debt, most notably adjustable rate mortgages and private student loans, use LIBOR as a reference rate to determine the cost of interest. The increase in debt service costs could inhibit further recovery in consumer spending.

Corporate Bond Issuance: Within traditional fixed rate corporate bonds, the combination of upcoming capital rules for banks and the aforementioned weak demand for ultra-short corporates has resulted in increased investor appetite for securities that are designed to be called by the issuer prior to reduced liquidity and reduced capital credit. Additionally, we expect issuers to use a relatively higher mix of longer term funding due to the increase in the relative cost of shorter term funding. While this paradigm shift had already begun in response to persistently low interest rates over the last five years, we expect this dynamic to remain intact even as rates rise.

Some investors may return in part to the prime money market space, but more historical experience of a floating NAV and redemption gates is likely required.

The decrease in prime money market assets and increase in government money market assets has to date exhibited a nearly one-to-one relationship with overall institutional money market assets down less than 2% in the last 12 months. The prospect of near zero returns within the government money market space raises the question of whether pre-reform archetypes of liquidity management remain intact in this brave new world. Some investors may return in part to the prime money market space if the incremental returns relative to government money markets increase, but more historical experience of a floating NAV and redemption gates is likely required. Additionally, there remains a compelling argument that use of shorter duration traditional fixed income strategies (or an investment grade floating rate bond strategy) within a tiered portfolio of capital preservation, provides for a more diversified portfolio with more customizable liquidity and return profiles than what is available in the prime money market space going forward.

Figure 2: Institutional Money Market Trillion Dollar Rotation



Source: Bloomberg As of October 20, 2016

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By remaining agile in volatile and inefficient instances within the market, investors are rewarded with opportunities to outperform.

Conclusion

Within traditional fixed income mandates, the market conditions of 2Q and 3Q 2016 presented numerous opportunities to take advantage of some of the market inefficiencies highlighted above. As is consistent with our philosophy of fixed income markets exhibiting such inefficiencies, we found numerous relative value opportunities, particularly within corporate floating rate notes and short duration structured products. Within corporate floating rate bonds, many such securities outperformed similar-maturity fixed rate bonds in both total return and excess return. Short duration structured products offered strong capital preservation and high liquidity for future market opportunities with de minimis impact on overall portfolio yield. By remaining agile in volatile and inefficient instances within the market, investors are rewarded with opportunities to outperform. As with much of post-crisis financial regulation, we remain in the early innings and expect more experimentation and unintended consequences to present themselves in the future.

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