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A Modest Alternative for Your Cash

What is a corporate treasurer to do? The outlook for money market funds is uncertain due to a contentious regulatory environment. Also, the pool structure of money funds exposes investors' cash to the cash movements of other investors; and extremely low yields are likely to persist for the foreseeable future. Investors seeking a product that offers incremental return without significant incremental volatility, little to no redemption risk, and a limited regulatory profile may want to consider alternatives.

Regulatory Environment

Outside of the mortgage market, money market funds were the most closely scrutinized segment after the financial crisis of 2008. The once common notion of these instruments being simply a risk-free alternative to bank demand accounts, growing to $3.76 trillion[1] from their inception in 1983, collapsed overnight on September 16, 2008, with the announcement that the nation's oldest fund, the Reserve Primary Fund, would "break the buck." The Treasury and Federal Reserve rushed in with a guarantee against losses and an emergency backstop facility to prop them up, prompting both regulators and investors to ask: *just how safe are money market funds*?

In 2010, the SEC decided to make them safer. The agency amended Rule 2a-7 to restrict the investment options of these funds even more toward the shortest and safest securities. Additionally, Congress voted to prohibit the Treasury from guaranteeing the funds in the future as they did four days after the Reserve Primary Fund collapse. Taxpayers would no longer be put on the hook in the event of default.

However, it wasn't until this past year that the scope of default risk was revealed. According to a report by the Federal Reserve Bank of Boston, 21 funds received support from their parent companies to prevent share prices falling below the $0.995 standard. Additionally, this summer, the SEC produced a list to Congress of over 300 instances in the past 40 years where money market fund companies have sought permission from the SEC to support funds.

It is with this hindsight that regulators are moving forward. Despite the SEC's inability to reach consensus on a regulatory regime, the debate is ongoing. Proposals include requiring a capital backstop for funds to limit the depth of damage should a similar collapse occur, requiring a floating NAV to more accurately reflect the fluctuations

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intrinsic to the product, and building in redemption gates. Despite the stalemate among the SEC commissioners, with recommendations for further regulation coming from nearly every vantage point imaginable—the White House, Treasury officials, the Federal Reserve, the Bank of England and more— it's difficult to argue that change isn't coming.

Current State

Total money market fund assets (institutional and retail), after peaking at $3.76 trillion in 2008, have dropped over 34% and stands at $2.47 trillion at the end of the second quarter.[1] The number of total money market funds in the US topped off in early 2000 at around a thousand but has been on a steady decline since and currently stands at about 600.[2] Yields, averaging around 3.75% on an annual basis the year leading up to the crisis, now struggle to stay above 0.05%.[2] In the increasingly prolonged low interest-rate environment, fund companies have been forced to waive fees on their money market products more and more each year. Investment Company Institute and iMoneyNet data show that money funds waived some $5.2 billion in fees last year while collecting only $4.7 billion; this suggests that without these fee waivers, money fund yields may well have gone into negative territory.

As mentioned above, pressures persist from a variety of interested parties even after the damage done by 2010's amendment to Rule 2a-7. Money market funds have been forced to markedly shorten their portfolios and increase their concentration in the safest of products since this implementation. Some of the more significant mandated changes include:

- Taxable money market funds must hold at least 10% of total assets in cash, US Treasury securities and securities that mature within one day.
- All money market funds must hold at least 30% of total assets in cash, US Treasury securities, certain other government securities that mature in 60 days or less, and other securities maturing within one week.
- All money market funds are prohibited from purchasing illiquid securities if those securities would exceed 5% of the fund's portfolio (from 10%).
- All money market funds must limit their portfolio's dollar-weighted average maturity (WAM) to 60 days (from 90) and the weighted average life (WAL) of investments to 120 days.

As a result of these mandated changes, more funds are fighting for the same types of securities, with investor returns inevitably diminished.

Additionally, bank deposits aren't a particularly attractive alternative. Deposits yield even less than money-market funds, and for non-interest-bearing transaction accounts, the FDIC unlimited insurance coverage is set to expire on December 31, 2012. In short-term investments the theme is the same: increased regulation, lack of insurance and little-to-no yield.

An Alternative to Money Market Funds

While money market funds were once a mainstay product for investors looking for capital preservation, liquidity and stable NAVs (and a little bit of yield), the crisis of 2008 highlighted the vulnerability of achieving these objectives and altered the landscape. Pending regulatory changes, a further limited investment universe and a low-yield environment have combined to reduce the relative attractiveness of money market funds. Investors willing to modestly increase their interest-rate risk may wish to consider other short-term investment vehicles, such as the Merganser Cash

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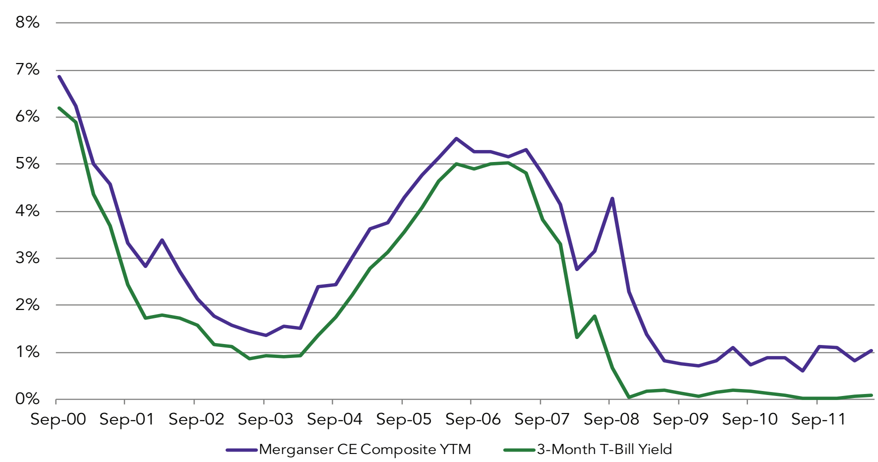
Enhancement Strategy for their second tier operating capital.

The advantages of the Merganser Cash Enhancement Strategy are numerous: diversification and an increased opportunity set of assets, yield advantage and a superior total return profile, segregated investments through separate account management, and portfolio customization – all while maintaining liquidity through Treasury and Agency securities and other securities paying monthly principal and interest, and with an average portfolio rating of AA.

The 2010 2a-7 amendment restricted the investment opportunities and as a result the increased competition among funds for 2a-7 eligible paper has reduced investment returns. In contrast, in addition to the 2a-7 universe, the Merganser Cash Enhancement Strategy incorporates high-grade corporate bonds, asset-backed securities, Agency residential mortgage-backed securities and commercial mortgage-backed securities. While money market funds achieve safety from their limitations, the cash enhancement strategy accomplishes much of the same goal through diversification.

Figure 1 displays the yield of the Merganser Cash Enhancement Composite versus Three Month Treasury Bills (a proxy for money market fund yields).

Figure 1: Merganser CE Composite vs. Three Month Treasury Bills



Source: Bloomberg, Merganser

Through diversification and an increased investment universe, the Merganser Cash Enhancement Strategy realizes a significant yield advantage over money market funds. Figure 1 displays the yield of the Merganser Cash Enhancement Composite versus Three Month Treasury Bills (a proxy for money market fund yields). The graph illustrates the substantial yield pickup that the Merganser Cash Enhancement Composite earns from a more diverse set of assets and extending out to the one-year area of the yield curve. As shown in Figure 2, this has resulted in the Merganser Cash Enhancement Composite earning superior total returns versus money market funds, as represented by the Crane 100 Money Market Fund Index. For the most recent quarter ending June 2012, the Merganser Cash Enhancement Composite earned 1.08% (Gross of Fees) for the trailing twelve month period.

As an example of the yield pickup through diversification, consider an asset-backed security that was recently issued by a top tier captive auto finance company. The A3 class of the security had an average life at issue of 2.25 years and is rated Aaa/AAA by Moody's and S&P, respectively. The collateral consists of prime auto loans on mostly new cars with a very high average FICO score on the obligors. The legal final maturity on the A3 class is 12/15/16, which is longer than the maximum maturity permitted in a 2a-7 fund.

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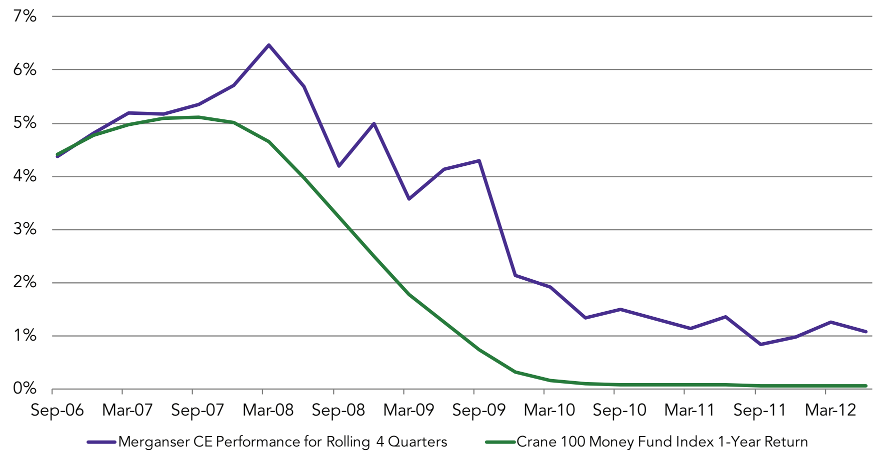
The tranche priced at a yield of 0.58% which is substantially higher than the available universe of money market eligible securities, all while maintaining little incremental risk and excellent liquidity.

Figure 2 shows the Merganser Cash Enhancement Composite's superior total return versus money market funds, as represented by the Crane 100 Money Market Fund Index.

Figure 2: Merganser CE Return vs. Money Fund Benchmark



Source: Bloomberg, Merganser

Account customization is a key characteristic of the separate account strategy. While money market funds are broken into broad fund-types, the Merganser Cash Enhancement Strategy provides a customized investment approach that utilizes client specific guidelines. For example, a client can choose to limit investments to particular sectors or ratings categories with a target portfolio duration. Such customization is simply not found in money market funds. In addition to the benefits of being able to customize your portfolio to meet capital preservation and liquidity needs, the separate account structure avoids the "run-for-the-exits" risk that is present in all pooled vehicles and particularly money funds. Additionally, during the financial crisis Merganser was able to provide liquidity when others could not.

The table below sets forth a summary product comparison.

Summary Product Comparison

	Typical Prime Money Market Fund	Merganser Cash Enhancement Strategy
Yield-to-Maturity	0.06%*	0.80% to 1.10%
Portfolio Average Maturity	46 Days*	0.75 to 1.25 Years
Maximum Maturity	397 Days	3 Years
Portfolio Duration	NA	6 Months to 1 Year
Liquidity	T+0	T+3
Average Portfolio Quality	A1+/P1	AA
Eligible Investments	2a-7 only	2a-7 plus BBB through AAA
Typical Investment Opportunity Set	Treasury, Agency, Commercial Paper, Certificates of Deposit, Repurchase Agreements, Municipal Bonds	Treasury, Agency, Domestic Corps, International Corps, Asset-Backed Securities, Agency Residential, Commercial MBS, Taxable Municipal Bonds
Mandate Customization	None	High

*Source: Crane Data

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Conclusion

Monetary policy and regulatory reform resulting from the financial crisis has had a plethora of unintended consequences, and the dearth of high quality, income-producing investment options is just one. Investors looking for high quality, incremental returns to Treasury bills should look beyond the money funds that suffer from these unintended consequences and instead seek to define risk based not just on broad categories and average maturities, but true market liquidity and the dependability of future cash flows. Those who do so will be rewarded with greater yield, higher average portfolio quality, greater diversification, and the ability to dynamically adjust the portfolio to the changing market opportunities and boardroom risk tolerances. For over 25 years, we at Merganser have worked closely with our clients to do just that.

For more information on the Merganser Cash Enhancement Strategy, please visit www.merganser.com.

[1] Federal Reserve Board

[2] Investment Company Institute

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