Observation Deck

The Elephant in the Money Fund Room

Adam Dean, *CFA, President*

From the Cambridge Academic Content Dictionary comes a reasonably good definition for ***elephant in the room:*** "An obvious problem that nobody wants to discuss". It seems a near-perfect description of the situation facing money fund providers, and their investors, today. The elephant in question is the fundamental disconnect between the two major camps of money fund providers on how to ensure that money fund investors don't feel obligated to run for their exits when the next financial crisis hits.

The two camps in question are

1) The mainly stand-alone fund businesses that typically focus solely on money market mutual funds and other mutual funds

2) The much larger diversified financial services entities that also offer money funds

While the stand-alone providers represent the origins of this unique asset class, they face real structural and financial disadvantages not present for the providers with larger balance sheets. And when it comes to building investor assurances into their industry, such as those proposed by the **President's Working Group Report on Money Market Fund Reform*,** the large providers and the stand-alone providers find disturbingly little to agree on.

One proposal from the President's Working Group report is fund industry insurance. The large firms could afford it, but they probably don't need it. For the stand-alones, the opposite appears true. (Let's leave aside for now questions about anyone's desire to underwrite either camp.)

Another proposal is the creation of private emergency liquidity facilities, or a "liquidity bank," for the industry. Each of the stand-alones would readily join such a pool, but the large firms already have liquidity implicitly via the balance sheets of financial parents that can easily be 100 times greater than those of a stand-alone.

Implicit or not, this balance sheet access is invariably part of the evaluation process with SVB Asset Management's fund providers. We have a hard time dismissing its importance. Even from a somewhat subjective perspective, its value becomes clear: If the fund of a "too-big-to-fail' diversified financial services entity is under pressure, any decision that results in the fund halting redemptions would immediately be interpreted as proof that the entire entity was about to fail. It would instantly be a reputational hit to the whole brand. Given how relatively small the typical money fund division is within most major financial firms, proving unable to support a fund of their own would shock capital markets and shareholders equally.

On paper there is every reason for both sides to cooperate. By crafting a way to give the investor client confidence in the stability of money funds, they could grow their industry significantly over time, and both sides understand clearly that a reputation hit to one participant hurts all. In many respects, the money fund industry exists in 2011 because of the U.S. government's intervention in 2008 after one of the earliest fund providers, the Reserve, halted redemptions in the wake of the Lehman bankruptcy.

We all hope that a financial crisis that approaches the size and scope of the 2008 vintage is a long way off. But, regardless of when it might take place, both sides would probably agree that their money fund industry could not survive another reputational shellacking.

See comments to the S.E.C. on the **President's Working Group Report on Money Market Fund Reform**** at the link below or write to us directly.

* *http://www.treasury.gov/press-center/press-releases/Documents/10.21%20PWG%20Report%20Final.pdf*

** *http://www.sec.gov/comments/s7-11-09/s71109-123.pdf*

Markets

Treasury Rates	
3-Month	0.15%
6-Month	0.16%
1-Year	0.24%
2-Year	0.56%
3-Year	0.96%
5-Year	1.94%
7-Year	2.71%
10-Year	3.37%

January Total Returns	
ML 3-Month Treasury	0.01%
ML 6-Month Treasury	0.02%
ML 12-Month Treasury	0.09%
S&P 500	2.35%
Nasdaq	1.81%

Source: Bloomberg, as of 01/31/11

Economic Vista

Ninh Chung, *Head of Portfolio Management*

In the first Federal Reserve Open Market meeting of the year, the committee voted to keep the federal funds rate unchanged at zero to 0.25 percent, where it has been since December 2008. Policy makers reiterated their plan to purchase $600 billion of Treasury securities through June, signaling the economic recovery still needs stimulus to bring down the stubbornly high unemployment rate. They stated, "…the economic recovery is continuing, though at a rate that has been insufficient to bring about a significant improvement in labor market conditions. Growth in household spending picked up late last year, but remained constrained by high unemployment."

The jobless rate fell in December from 9.8 to 9.4 percent, but for the wrong reason, as the U.S. Labor Force Participation Rate decreased from 64.5 to 64.3. The disappointing non-farm payroll showed an increase of only 103,000 against expectations for 150,000 additional jobs. While retail sales and industrial production grew, faster job growth is required to extend the recovery momentum. Recent labor data does not support prolonged spending patterns by the consumer.

Excluding commodity-related items, inflationary data, and more importantly inflationary expectations, are currently muted. The core producer price index grew at a benign rate of 1.3 percent year-over-year and the inability of producers to pass this down to the consumer level has the Fed focusing its concerns on lowering the unemployment rate. The Fed will continue to focus on accommodating job growth policies while keeping a careful eye on inflationary readings.

Credit Vista

Melina Hadiwono, *CFA, Head of Credit Research*

On January 18, Moody's provided an update on its plans for revising its money market funds rating methodology, after considering a broad range of comments from market participants, including investors, sponsors, trade groups, regulators and consultants. The proposed changes are intended to capture the vulnerability of money market funds to market risk, liquidity risk, and credit risk. In addition, Moody's will assess the nature of the investor base regarding redemption risk and will continue to review the ability and willingness of sponsors to provide financial support to troubled funds.

The proposed revision reflects the experience from the financial crisis in late 2008, where disruptions in short-term funding markets caused record outflows from prime money market funds, a large fund "broke the buck," and many other funds suspended redemptions and/or received financial support from their sponsors. Ultimately, the introduction of a temporary guarantee from the U.S. Treasury managed to stem investor outflows and provide order.

The rating determination will be based on objective measures for two distinct assessments: the portfolio credit profile, and stability profile, including market and liquidity risks. In addition, Moody's will explicitly factor a sponsor's credit-worthiness into the ratings, especially for top-rated funds, to reflect the history of the sponsor's financial and operational support. In parallel, Moody's will introduce new rating symbols to highlight the distinct meanings of the fund ratings (Aaa-mf, Aa-mf, Baa-mf, B-mf, C-mf) while addressing one of the requirements from the Dodd-Frank Act that prohibits Nationally Recognized Statistical Rating Organizations from having multiple definition for the same rating symbol. Moody's expects to finalize and release the revised criteria by the end of March and will begin evaluating funds using the new approach. Moody's anticipates only a modest number of funds to receive lower ratings and is expected to release newly updated money market fund ratings in the second quarter of 2011.

Trading Vista

Hiroshi Ikemoto, *Money Market Trader*

U.S. bonds traded in a tight range in January as the markets were trying to find direction amid mixed economic data. The two-year Treasury note fluctuated from a yield of 0.57 percent to 0.64 percent. The one exception was a spike to 0.71 percent on January 5, when Automatic Data Processing, Inc.'s jobs report showed that companies added 297,000 workers to payrolls, tripling the median estimates by economists. That was short-lived, as the Labor Department then reported that private payrolls actually increased by only 113,000, much less than the 178,000 increase many analysts had expected. This sent Treasury yields back down, with the two-year note just below 60 basis points.

Corporate and agency spreads to Treasuries remained tight and unchanged. High-grade industrial issues traded plus 15 to 40 basis points in the 18-month to two-year maturity range, while financial names were trading at plus 30 to 80 basis points. Three-month commercial paper was yielding at 0.25 to 0.30 percent throughout the month.

SVB Asset Management
555 Mission Street, Suite 900
San Francisco, California 94105
866.719.9117
service@svbassetmanagement.com

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