For Professional Advisers Only

Money Market Funds

Why to Hold Them

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Introduction

Money market funds have been accessible to investors since 1971 and are structured to replicate the traditional investment features of cash deposits, i.e. to be highly liquid and generate returns equivalent to or potentially greater than those of deposits whilst taking on a similar degree of risk. They do this through a combination of placing deposits at commercial banks and buying tradable short term money market instruments, such as certificates of deposits. In doing so, money market funds provide short-term financing in the economy for banks, non-financial corporates and governments alike.

Investor Need

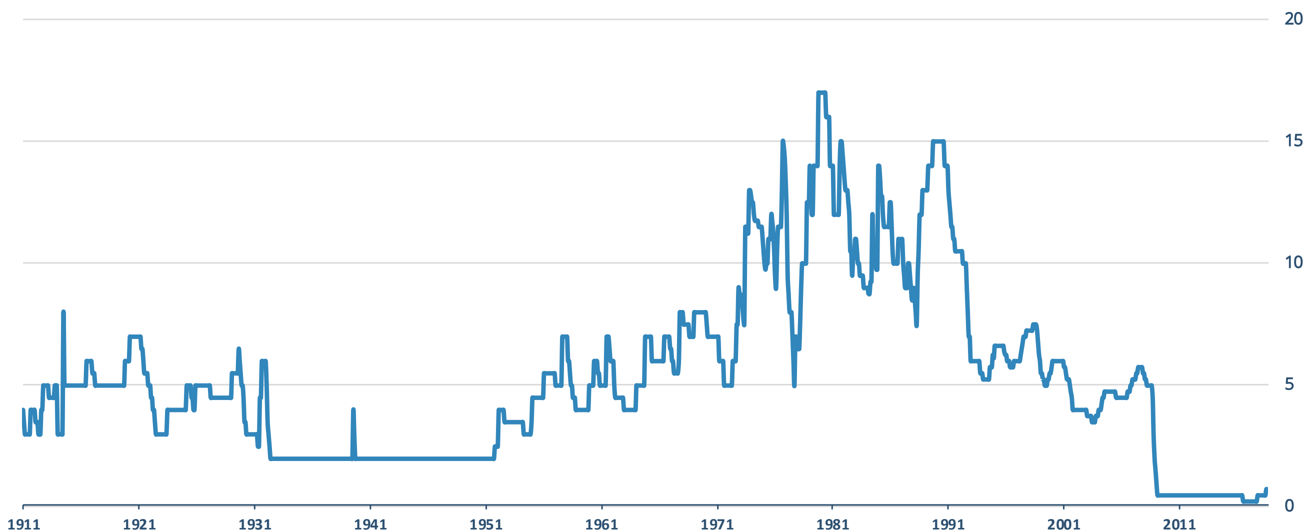
Given all time highs in equity markets and near record low yields in bond markets, many investors are understandably cautious on the upcoming prospects for global markets and this is driving significant cash balances in many client portfolios. Understandably perhaps, clients who are paying fees to investment professionals for their investment expertise, frequently question both the necessity and the 'expertise' involved in allocating to cash as an asset class within an investment portfolio. This is particularly true given that clients themselves could hold deposits, free of charge, with any combination of their local high street banks.

The minuscule returns of portfolio cash balances are further stressing these client concerns. The days when a high street savings account would generate a 5% annual return just by sitting untouched at the bank are a distant memory. Current Bank of England base rates represent an 85% decline from those heady heights of 5% back in 2008.

Such relatively low returns on cash balances will likely continue for some time to come, given that the Bank of England shows little sign of undertaking a meaningful shift higher in UK interest rates. There is however clearly a transmission problem between the interest rate set by the Bank of England, currently 0.75%, and the meagre returns generated on cash deposits, wherever they are held.

For money managers and investors who hold such concerns and find themselves increasing their cash holdings, they could certainly do worse than considering how, and with whom, they want to deploy these balances. If a return can be generated without meaningfully increasing the risk of the holding, investors should take it. Short term money market funds, that are well run, provide such an opportunity.

Figure 1: UK Interest Rates



Source: Tradingeconomics.com | Bank of England

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Strengths of Market

In short, money market funds are able to generate a return gross of fees broadly in line with the Bank of England's short term interest rate. They do this by investing in money market instruments (less than 397 days in term) that trade around the markets' expectations for short term interest rates over their term. Understandably this is often very close to the current Bank of England short term interest rate. Net returns are then, as usual, passed on to investors.

The funds also enable holders to diversify their credit risk. As, rather than placing all deposits with one bank, the managers diversify holdings across instruments and institutions, thereby spreading the inherent credit risk of the fund.

Cost and compensation

If set on selecting a money market fund, investors should be particularly careful not to over-pay for money market expertise. Fees in the sector often exceed 0.25% which can substantially erode any positive return, particularly given the multi-year period of very low interest rates that we have recently experienced in the UK.

No solution is without its drawbacks and a consideration might be that, contrary to the first £85,000 of an individual's bank deposits, when investing in money market funds, individuals are only insured up to £50,000 under the Financial Services Compensation Scheme. An individual would therefore be taking on an unsecured risk, albeit small, in a money market fund that they are not taking in a traditional bank account.

Risks

Many would consider a money market fund as the lowest risk possible deployment of client assets. Investors however, should be aware of some, albeit small, risks. We see these as fourfold; credit risk, liquidity risk, market risk and interest rate risk.

Liquidity risk

As with any open ended investment vehicle, investors are exposed to the risk of either being unable to sell their holding at a fair price (in the instance of elevated investor redemption requests) or being unable to sell their holding at all (in the case of a gated/closed fund).

Given this risk, most money market funds now have liquidity built into their official objectives alongside capital preservation. Additionally, European regulators have acted to try and minimise the risk of liquidity events occurring. First, most money market funds must now be priced with a variable rather than a constant price, so that the price of the fund reacts to real time market movements. Second, the daily and weekly liquidity requirements of all money market funds have been increased. These measures should further reduce the chances of a fund becoming gated.

Credit risk

The other main risk to money market funds is credit risk, i.e. the risk that the issuing institutions of the certificates of deposit they hold are unable to return investors' capital due to insolvency. This would result in the real loss of capital for investors to the extent of the exposure the fund had in the now insolvent company. Some of this cash may eventually be recovered, of course, subject to the appointed liquidators' deliberations.

Well-run money market funds, however, will have considerable credit analysis capabilities. This may be in the form of a standalone credit analysis team or, more likely, a credit analyst team shared with an asset manager's credit research function. Regulation around credit analysis in these funds has also been bolstered in recent years.

Market risk

In practice, outside of a major credit event, the risk of a large market move in the price of an underlying money market instrument is negligible due to their extremely short dated nature. Investments are frequently held to maturity and also tend to trade near par throughout their investment life.

The most evident period of considerable market risk was during the global financial crisis in 2008, following the 'run' on the Primary Reserve Fund in the U.S. However, regulatory developments around liquidity requirements, as well as fund pricing, have been designed to reduce the future likelihood of such a 'run'. Whilst we anticipate this to be the case, only time will tell if such regulatory developments will prove successful in the instance that sentiment turns quickly against the sector again.

Whilst these risks should not be ignored, we believe that both regulators and the money market industry itself have taken significant steps in recent years to reduce liquidity, credit, and market risk in the money market sector to very low levels.

Interest rate risk

Given money market instruments have short time to maturity, interest rate moves are likely to have a very small impact on the price of existing securities. Interest rate risk can therefore be better interpreted for money market funds as the risk that base interest rates are reduced to, or below, 0%. This would then almost certainly result in negative returns for the funds, regardless of how well they are managed and how frugally they are priced. A fate that has overcome equivalent funds in both Europe and Japan in recent years.

Current market expectations are for interest rates to rise in the UK in the coming years. Given their short dated nature of the holdings in money market funds, this would soon result in an equivalent increase in the returns of the funds. That said, the risk of further interest rate cuts to the money market sector should not be ignored.

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Available UK funds

The IA Short Term Money Market and Money Market sectors each have ~c.£20-25 billion invested in them across 9 and 10 funds respectively. The table below shows the funds that sit within both these sectors:

Figure 2: IA Money Market funds

IA Money Market Funds	Sector	Fund Size (£m)	OCF
JPM Liq Sterling Liquidity Agency Dis NAV GBP TR in GB*	IA Short Term Money Market	9,891	0.25
Royal London Short Term Money Market Y Acc TR in GB	IA Short Term Money Market	3,264	0.09
BlackRock Cash D Acc in GB	IA Short Term Money Market	2,410	0.32
L&G Cash Trust I Acc in GB**	IA Short Term Money Market	1,704	0.15
Fidelity Cash Y Acc GBP in GB	IA Short Term Money Market	846	0.15
Scottish Widows Cash A Acc in GB	IA Short Term Money Market	89	0.62
Baillie Gifford Cash A Inc TR in GB	IA Short Term Money Market	81	0.12
Standard Life Investments Short Term Money Market Ret Acc in GB	IA Short Term Money Market	6	0.45
Wesleyan Risk Averse A Acc in GB	IA Short Term Money Market	3	0.00
Insight ILF GBP Liquidity C4 in GB**	IA Money Market	23,472	0.25
Aberdeen Sterling Money Market I Acc in GB	IA Money Market	309	0.15
LF Canlife Sterling Liquidity I Acc in GB	IA Money Market	265	0.15
Premier UK Money Market B Inc TR in GB	IA Money Market	257	0.28
Janus Henderson Inst Cash Ret Acc in GB	IA Money Market	207	0.36
Invesco Money Z Acc in GB	IA Money Market	179	0.25
Janus Henderson Money Market Acc in GB	IA Money Market	143	0.31
Aviva Inv Cash 1 Acc in GB	IA Money Market	92	0.20
NFU Mutual Deposit C TR in GB	IA Money Market	59	0.55
F&C Short Duration Bond 4 Acc in GB	IA Money Market	34	0.12

* The history of this unit/share class has been extended, at FE's discretion, to give a sense of a longer track record of the fund as a whole.
Source: FE, 20th September 2018.

As the table shows, the JPM Sterling Liquidity fund and the Insight ILF GBP Liquidity fund are by far the biggest funds in the sectors, with £9.9 billion and £23.5 billion assets respectively. However, the Insight ILF GBP Liquidity fund is not currently accessible to retail clients.

There is also £180 billion invested in the FCA recognised FO- Sterling Liquidity sector (non IA), across 43 funds; however very few of these funds are accessible to retail clients.

Fees on money market funds in the UK start at just 9 basis points as an ongoing charge figure (OCF) and rise up to c.60 basis points.

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From an outcome perspective, most of the funds aim to preserve investor capital. In addition, they want to preserve the liquidity of the fund. From a performance perspective, most of the funds aim to generate returns broadly in line with returns available in money markets.

Given the importance of capital preservation in these funds, we prefer funds within the shorter maturity/ lower risk IA Short Term Money Market sector to those in the IA Money Market sector.

A number of IA Short Term Money Market funds have extremely impressive performance histories from a capital preservation perspective. The table below shows the downside performance history of these funds.

Figure 3: Performance of IA Short Term Money Market funds for 15 years to 31st August 2018

IA Short Term Money Market Funds	Max Drawdown	Negative Periods	Return (p.a.)	Volatility
JPM Liq Sterling Liquidity Agency Dis NAV GBP TR in GB**	0.00	0	0.9	0.48
Royal London Short Term Money Market Y Acc TR in GB	-0.19	28	1.37	0.48
BlackRock Cash D Acc in GB	-0.04	2	1.4	0.47
L&G Cash Trust I Acc in GB**	0.00	0	1.5	0.47
Fidelity Cash Y Acc GBP in GB	0.00	0	1.41	0.48
Scottish Widows Cash A Acc in GB	-0.79	15	1.12	0.47
Baillie Gifford Cash A Inc TR in GB	-0.01	6	1.38	0.48

** The history of this unit/share class has been extended, at FE's discretion, to give a sense of a longer track record of the fund as a whole.

Source: FE Analytics. Data to 31st August 2018, returns net of income re-invested.

It is not unheard of for funds to have negative periods on a monthly basis due to small movements in the prices of traded securities. JPM Sterling Liquidity, L&G Cash Trust and Fidelity Cash funds all impress from a limited drawdown perspective.

Fund that stands out

Whilst we are impressed by the drawdown stats of both the JPM Sterling Liquidity fund and the Fidelity Cash fund, the L&G Cash Trust fund is the fund that stands out most to us in the sector. This fund has an excellent long term track record of never having a negative monthly return, a strong credit analyst team and that the fund is part of a much larger cash franchise. It also has low fees and aligns client interests with those of L&G itself, in that the company holds its own cash balances in a sister fund to the unit trust available for the retail market.

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