MONEY MARKET FUNDS UNDER THE CURRENT FINANCIAL CRISIS

FEI SUN
MENTOR: PRO. FELIX MESCHKE
DEPARTMENT OF FINANCE, UNIVERSITY OF MINNESOTA

Introduction

Money market funds are mutual funds regulated by SEC Investment Company Act of 1940. Rule 2a-7 requires money market funds to invest only in short-term, low-risk securities and to maintain a weighted average maturity of 90 days or less. As one of the investments with lowest risk, money market funds have been deemed and used almost equivalently as money market savings accounts with a bit higher return. However, money market funds are not insured by FDIC as are savings accounts. Last September, two money market funds went below the $1.00 net asset value, which is also know as “broke the buck”. Reserve Primary Fund, the oldest money fund, announced that it could only return 97 cents on a dollar. This resulted in many law suits filed against the failed fund management companies for misleading information and advertisement on its “low risk”. Many investors lost money from investing in these money market funds and some municipalities who invested tax payers’ money in them could not get their money out on time to pay for government daily function, due to liquidation of the fund.

Investigation

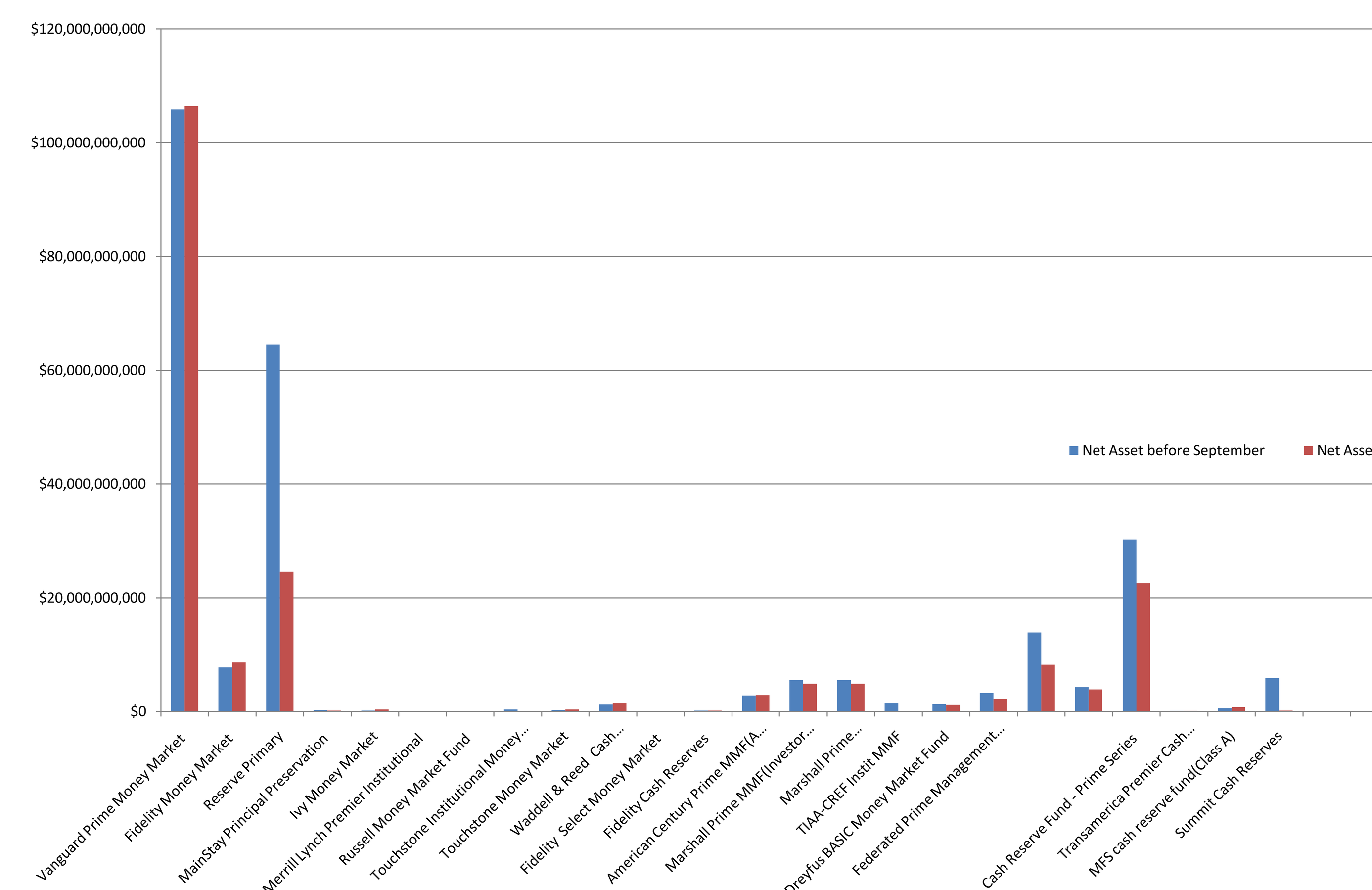
Almost all money market funds now have clear indication in their prospectuses and on their websites that they attempt to keep the net asset value at a constant $1.00 per share but they do not guarantee it. And money market funds are different from money market savings accounts in that savings accounts are FDIC insured while money market funds are not. However, there is no way to go back to see whether they had these statements before or they buried them in the footnotes.

Although Rule 2a-7 requires that all money market funds have to invest in short-term, low-risk securities, there really is not any clear definition of being “low-risk”. All money funds are doing a good job maintaining a weighted average maturity of 90 days or lower. But most of the money funds invest heavily in commercial paper, an unsecured promissory note with a fixed maturity of one to 270 days, which are usually issued by large corporations and banks with good credits. The funds usually maintain “low-risk” by keeping an average rating of portfolio above AA or A. However, Lehman Brothers, whose commercial was rated AAA, which means the lowest level of risk, defaulted on their debt. The Reserve Primary Fund had to write off their Lehman commercial paper from their portfolio which resulted in a net asset value below $1.00, which we mentioned before. Therefore, there really is no simple rule yet to say whether funds have or have not violated the rule of investing in low-risk securities.

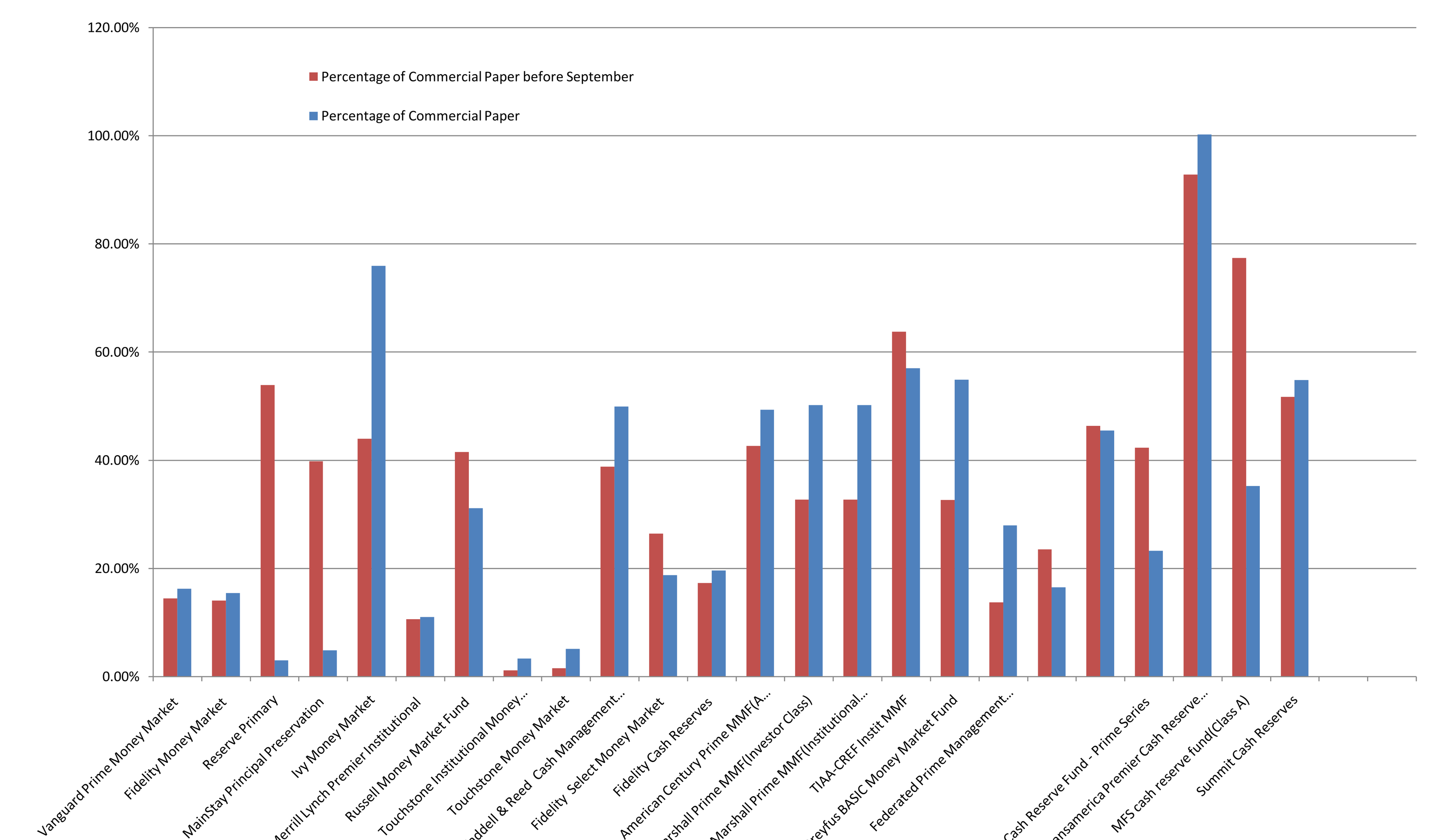
Research Method

I collected data of around 30 major money market funds from their prospectuses, annual/semi-annual reports and their SEC filings. Data are on funds’ one year return, net asset, percentage of commercial paper in their portfolio (representing risk), average maturity and expense ratio. I collected two sets of data: one from before September 2008 when money market funds started failing and one from afterward to make comparisons between the two. Thus, I can study the impact of the current financial crisis on money market funds.

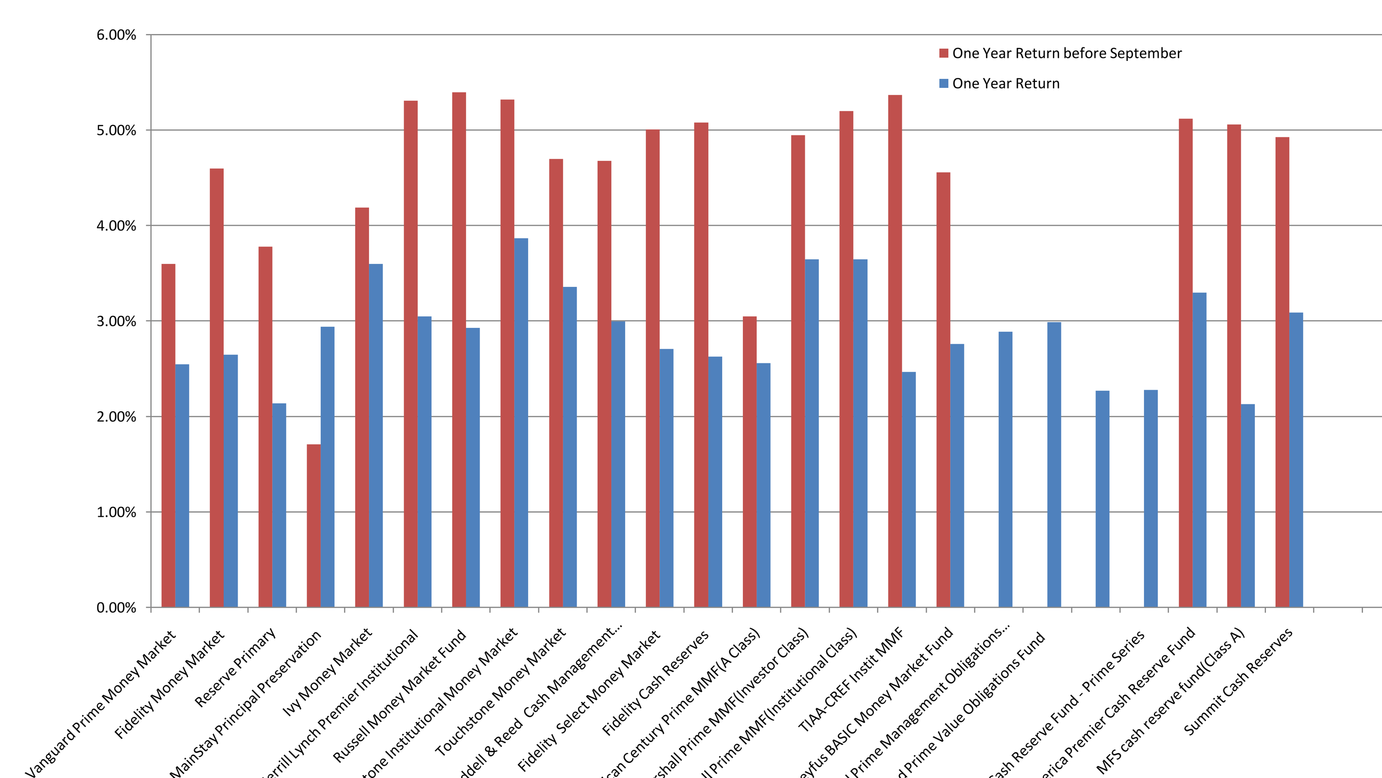
Results



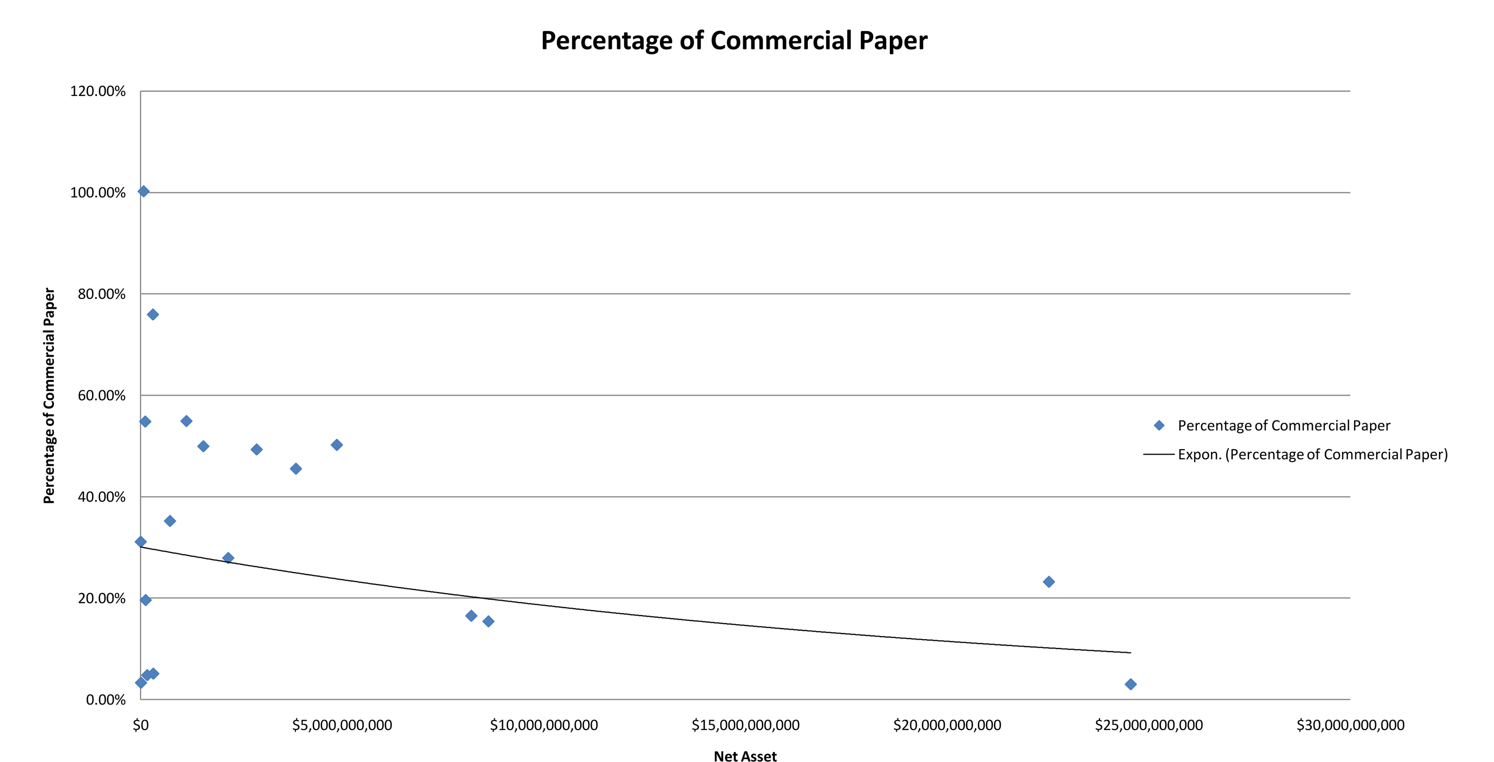
It is easy to see that net asset value of the money market funds declined after September mainly because investors were withdrawing their money from the funds, which caused a bank run. Many funds had to liquidate their portfolio to pay the investors.



Since commercial papers are the risky part in money market funds, after several funds “broke the buck” in September 2008, most money funds kept a lower percentage of commercial paper in their portfolio. Although some funds are having a higher percentage, the real value of commercial paper is lower because of lower net assets.



Money market funds are giving investors significantly less return on their investment. All funds I studied performed worse than last year. This is largely due to the current bad market condition. Also, fund managers are becoming more risk-averse and thus taking on lower return to get lower risk.



I found a negative correlation between the fund’s net asset or size and its percentage of commercial paper. It means that the bigger the fund is, the less it will invest in commercial papers. This is because large funds usually have more cost efficient management. It does not have to take on as much commercial paper to generate a satisfactory yield.

Conclusion

The on-going financial crisis has hurt money market funds badly. It caused lower net asset values of the funds and also resulted in significantly less return on investments. One thing investors have to notice is that although it is Lehman commercial that caused the failing of several money market funds, most money funds are still holding large amount of commercial paper issued by banks and other financial institutions.