



Treasury Strategies[®]

The Power of Experience[®]

The Next Generation of Money Market Fund Investing

DEFINING A NEW APPROACH

INTRODUCTION

In 2008, the crisis in U.S. residential subprime loans spread into other securities. All investment classes were impacted. Even a few money market funds were contaminated by underlying holdings in risky investments. These events triggered a global financial crisis. Lehman Brothers, the nation's fourth largest investment bank, was forced into bankruptcy under the weight of its subprime mortgage portfolio and loss of liquidity from lenders. Lehman's troubles rippled through the financial markets, and the Reserve Primary Fund was one of its casualties.

The Reserve Fund "Broke the Buck" when its net asset value per share fell under \$1 due to considerable exposure to Lehman debt securities. This event, which happened to the nation's oldest money market fund, shook investor confidence in money market funds. As the financial crisis unfolded, investors in most types of investment asset classes experienced losses. Although the losses were small, it was an unsettling experience given that money market funds were historically highly-rated and conservative securities.



In the three years since the crisis, many articles and papers have been *written* about what investors *should* do to mitigate risk. During this time, Treasury Strategies has been engaged in work with many corporate clients globally, helping to assess and optimize their investment policies and practices. Drawing from our extensive client work and ongoing conversations with corporations and industry regulators, Treasury Strategies has defined a new approach for investing in money market funds that will help treasurers more prudently manage their holdings, while satisfying the increased risk scrutiny required in today's post-crisis investment climate.

CONVERSATIONS WITH CORPORATE TREASURERS

In this new approach:

FIRST: Treasury Strategies identifies a company's risk tolerance and investment objectives.

SECOND: Treasury Strategies determines which combination of the following seven parameters match a company's risk tolerance and investment objectives.

THIRD: Treasury Strategies sets limits on these recommended parameters.

- 1. Maximum investment in any single money market mutual fund as a percentage of total investment in money market mutual funds**
 - Just under half of corporations have a set limit.
 - In most cases, Treasury Strategies recommends 10% to 35%.
- 2. Maximum investment in any single money market mutual fund as a notional amount**
 - The notional amount varies by the size of the corporate's portfolio.
- 3. Maximum investment in a fund's total assets under management**
 - Treasury Strategies recommends setting a 5% maximum investment of a fund's total AUM.
- 4. Maximum investment in any single fund family as a percentage of total investment in money market mutual funds**
 - About one-third of corporations have a set limit.
 - Treasury Strategies recommends setting a maximum investment of 50% to 100% in a single fund family.
- 5. Maximum investment in any single fund holding issuer as a percentage of total investment in money market mutual funds**
 - Roughly one-quarter of corporations have a set limit.
 - Treasury Strategies advises most companies to set this limit between 3% to 5% for non-sovereign issues, again depending on the need for diversification. For sovereign issuers, the limit could be far beyond 5%.
- 6. Minimum investment in rated money market mutual funds**
 - Over three-quarters of corporations have a set limit.
 - In most cases, Treasury Strategies advises clients to have no less than 60% and upwards of 100% in rated funds.
- 7. Maximum investment in any single country as a percentage of total investment in money market mutual funds (based on the domicile of fund holding issuers)**
 - Only one-quarter of corporations have a set limit.
 - Treasury Strategies advises that most companies set a maximum investment level of 0% to 50% outside of the company's home country.



The vast majority of corporations **do not explicitly state MMF parameters in their investment policy**. The implication is that most corporations are relying on credit ratings to manage portfolio risk - investing in only the highest quality funds that, by definition, have to diversify risk to carry the rating. There is a weakness to this approach.

The lack of due diligence by credit rating agencies was one factor that led to the financial crisis and the instability experienced by money market funds. Additionally, limited transparency to specific assets held within funds made it difficult to determine whether proper diversification was being achieved.

The importance of reviewing investments in money market funds is vital – especially as corporate cash balances continue to grow. The Federal Reserve reported in early June 2011 that corporate cash balances climbed to \$1.91 trillion, representing a 36% increase since the first quarter of 2009.

A CALL TO ACTION

As a result of the troubling events over the past 3 years, in both sovereign and investment markets, coupled with the substantial increase of corporate cash balances, Treasury Strategies is sending a clear call to action for treasurers.

- Establish investment policies that clearly define and set acceptable investment and risk parameters.
- Integrate policies into the processes used to execute investments.
- Monitor policy compliance through systematic preventive controls.
- Review policies on a regular schedule and adjust as needed.



THE NEW APPROACH FOR MANAGING MMF INVESTMENT RISK

Treasury Strategies recommends the approach outlined below to manage MMF investment risk.

- Examine the company's current short-term investment policy. It should be updated annually to reflect changes in your company's risk profile and investment objectives.
- Identify specific parameters for your MMF investment policy:
 - Maximum holding limit in any single money market mutual fund as a percentage of total investment in money market mutual funds
 - Maximum holding limit in any single money market mutual fund as a notional amount of total investment in money market mutual funds
 - Maximum holding in any single fund family as a percentage of total investment in money market mutual funds
 - Maximum holding in any single fund holding issuer¹ as a percentage of total investment in money market mutual funds
 - Minimum investment in rated money market mutual funds
 - Maximum exposure to any single country (based on where the fund's holdings are held) as a percentage of total investment in money market mutual funds
- Diversify by asset class and set limits for each class based on risk appetite and investment objectives
- Have the investment policy approved by company's Board of Directors
- Automate compliance in investment execution and risk monitoring
- Regularly monitor performance and changes in underlying securities

We strongly assert that investment guidelines should not be considered a "one size fits all" exercise. The scope of guidelines should reflect the size of the company's portfolio and current financial market conditions. Additionally, investment guidelines should address three company-specific questions:

¹With recent amendments to SEC rule 2a-7, money market fund companies must now disclose fund holdings monthly.

- What is our company's appetite for risk?
 - Credit risk
 - Interest rate risk
- What are our investment objectives?
- What is our investment time horizon?

Aligning investment guidelines with the company's risk profile and investment objectives creates a framework that ensures proper controls are in place to counteract market fluctuations. Proactive monitoring of guidelines is required, and immediate action to correct guideline exceptions should be the norm. Increased regulatory and investor scrutiny over MMFs is not an excuse to let one's guard down.

Treasurers must answer this call to action for policies with clear investment parameters, processes that integrate those policies into daily activity, compliance monitoring, and periodic policy review. By answering this call to action, companies will be assured in the safety and preservation of their vital cash holdings.

ABOUT TREASURY STRATEGIES, INC.

Treasury Strategies, Inc. is the leading treasury consulting firm working with corporations and financial services providers. Our experience and thought leadership in treasury management, working capital management, liquidity and payments, combined with our comprehensive view of the market, rewards our clients with a unique perspective, unparalleled insights and actionable solutions. Visit www.TreasuryStrategies.com for more information.

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