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Low Yields Are Just One of Money Markets' Woes

By TOM SULLIVAN

With interest rates so low, investors can do nearly as well keeping the money under their mattresses. The immediate future doesn't look a whole lot more promising.

A 30-DAY TAXABLE money-market fund offers an average yield of 0.04%. Little wonder then that investors on balance have pulled $1 trillion out of them since the beginning of 2009.

As tough as that is on shareholders, it's more brutal on the business. To charge any fee means the funds are offering their customers a losing proposition from the start—a good chance to lose some of their money. As a result, retail-oriented firms have waived all or a portion of their fees in the second quarter, and 94% of all taxable funds, including institutional funds, waived all or a portion of their fees, up from 85.5% in the second quarter of last year, 63.08% in 2008 and 65.8% in 2007.

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Elwood Smith for Barron's

The best money markets can offer these days is a good chance to get virtually all of your money back.

As of the end of the second quarter, the average unweighted charged expense ratio stood at 0.27%, 18 hundredths of a percentage point lower than the ratio a year earlier. The average on an asset-weighted basis was 0.23%, down from 0.33% a year earlier.

There are other challenges as well for the business, which still oversees about $3.1 trillion in assets, according to fund-flow tracker EPFR Global. Portfolio managers are still struggling to find investments that provide as much yield as possible without taking undue risks, while coping with new regulations designed to prevent a repeat of fund failures that were a highlight in the financial crisis. This environment contributed to the more than $40 billion of money-market funds that have been sold, traded or closed so far this year.

Money-market funds "face some pretty meaningful headwinds," says Nathan Flanders, a member of Fitch's funds and asset-management team. "The low-yield environment, the search for suitable assets and more conservative changes to the regulatory environment" are among them.

Cheap Money

Although they popped up slightly in the second-quarter expense ratios for money market funds have been in a steady decline over the past year.

	Unweighted Expense Ratios					Expense Ratio	
	2Q '09	3Q'09	4Q '09	1Q '10	2Q '10	Range for Unweighted	Asset Weighted
TAXABLE MMF							
Government Retail	0.38%	0.29%	0.21%	0.17%	0.20%	0.05 - 0.333%	0.20%
Prime Retail	0.60	0.47	0.34	0.27	0.29	0.01 - 0.74	0.31
All Taxable*	0.41	0.33	0.25	0.21	0.24	0.01 - 0.74	0.22
TAX-FREE MMF							
National Retail	0.60	0.49	0.38	0.31	0.37	0.17 - 0.62	0.32
State Retail	0.62	0.47	0.36	0.30	0.36	0.17 - 0.59	0.31
All Tax Free*	0.53	0.44	0.35	0.29	0.34	0.14 - 0.62	0.29
All MMFs*	0.45	0.36	0.28	0.23	0.27	0.01 - 0.74	0.23

*Includes Institutional.

Source: iMoneyNet

The constraints were due in part to the $63 billion Reserve Primary Fund breaking the buck, or having its net asset value fall below $1 a share, in late 2008 because it owned bankrupt Lehman Brothers debt. (It was one of only two money-market funds to have broken the buck since 1971). A general panic by investors ensued, as they sought billions in dollars in redemptions.

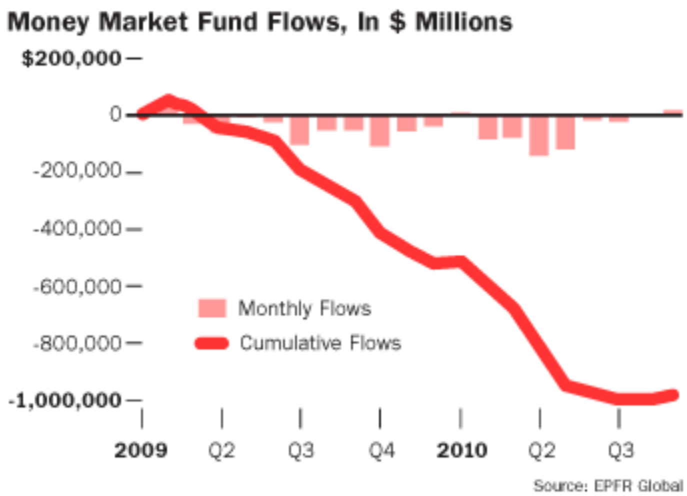
Under new Securities and Exchange Commission rules, money funds will still be only "as good as cash," as the saying goes, until they're not. In May, funds' boards of directors were authorized to bar investors from redeeming their shares when the net asset value falls below $1 and it decides to liquidate. Money-market funds now must be at least 10% liquid within one day and 30% within one week. There were no liquidity requirements previously.

A fund can have only 3% of its portfolio in second-tier securities, not 5% as previously. It must also have one of the four nationally recognized statistical rating organizations, such as Fitch or Standard & Poor's, do a credit analysis of holdings once a year, and must do its own stress test before the next scheduled meeting of its board. That could force some banks out of the business because Moody's is requesting market comment on a new rating scale that would require parent companies to guarantee a subsidiary's holdings to get its highest, MF1, rating.

"The higher cost of compliance, fewer issuers of suitable assets and more intensive competition" are scaring some funds out, says Mike Krasner, managing editor of iMoneynet.com, which recently co-hosted a money-market forum in New York. "But many survived, they're resilient, they're hard to kill and they're a value proposition," he says.

Funds Flow in One Direction -- Out

Since the beginning of last year, investors have been pulling money out of low-yielding assets and searching for better rates elsewhere.



INDEED, MONEY-MARKET FUNDS still offer investors diversification, liquidity, credit analysis and scale, even if they're not offering yield at the moment.

"Pricing power will come back after consolidation, when costs come down. It will take a year or two of sorting out," says Anthony Carfang, a partner at Treasury Strategies, a consulting firm for corporations and financial institutions. A corporate treasurer can't put $25 million into commercial paper because he might need the money tomorrow.

Right now, corporations are sitting on mounds of cash. The Federal Reserve this month reported that corporate cash was at record high levels of $1.84 trillion, almost identical to the previous quarter. The Fed also reported that total corporate borrowing rose by $50.4 billion in the second quarter, but that was more than offset by $75.5 billion in new direct investment abroad.

Many funds waive fees and take a hit to their bottom lines because the vehicles are loss leaders that their customers want within a large suite of other funds that offer better margins.

Money-market funds are "an extraordinary vehicle for cash management, with daily liquidity at par," says Christopher Donahue, chief executive officer at Federated Investors, one of the biggest money-fund operators. He doesn't expect the Fed to raise its historically low rates until the middle of next year and says it may be on the verge of another "quantitative easing," or printing new money, to goose the anemic economic recovery, further pressuring yields.

Donahue is an unabashed bull on the business. "The future is strong, even robust. We continue to buy other mutual funds' money markets," he says. That includes its purchase of RidgeWorth money-market funds from Sun Trust, which is expected to close by year end. Federated has lost $100 billion in money-market assets since the credit crisis began in late 2008, but it enjoyed $175 billion in inflows beforehand. Its share price has fallen by about a third in that time to 23.

No Fee For All

More than 90% of retail money-market funds now waive part or all of their fees.

	Second Quarter 2007	2008	2009	2010
TAXABLE MMF				
Government Retail	67.8%	64.4%	93.9%	99.0%
Prime Retail	57.0	53.9	83.9	97.5
All Taxable*	65.8	63.0	85.5	94.0
TAX-FREE MMF				
National Retail	62.6	58.3	84.1	94.2
State Retail	54.8	51.7	80.9	94.9
All Tax Free*	63.9	63.9	82.5	91.9
All MMFs*	65.2	63.3	84.6	93.4

*Includes Institutional. Source: iMoneyNet

Federated needs a repurchase, or repo, rate—the discount rate at which a central bank repurchases government securities from commercial banks—of 0.25 of a percentage point to pay core expenses. "We don't collect an advisory fee but we're not subsidizing" the funds, says Donahue.

There's little suggestion that this low-yield world is going to change right away. Two-year Treasury notes ended at record 0.335% Friday, while the five-year note set a record low yield of 1.070%. There's not much yield anywhere in the developed world,.

Of course, it may be that yields just aren't important in this economic environment. "Yields used to be the first question asked of a money manager, and the second question, and third question," says Krasner of iMoneyNet.com. "Now it's the last question," after an investor gets information on the fund's stability, assets and liquidity, he says.

The Bottom Line

Even if they can't offer yield, money funds provide liquidity, diversity and safety. Alternatives for investors would include higher-yielding instruments like bank loans.

And if you can't accept money-market yields, there are alternatives, including bank loan funds (Up and Down Wall Street: **The Search for Intelligent Yields**).

"Roughly 20% of the so-called [secured] leveraged loans in the widely followed indexes and many newly issued loans have minimum income payouts to help compensate for the currently low level of short rates, and the average loan in Barclay's high-yield loan index is still priced at roughly 90 cents on the dollar. As long as defaults remain at or drift down from their current rate of 5%, that could mean some additional, eventual price appreciation as well," wrote Morningstar's Eric Jacobson this past summer.

That's after a strong 2009, when the median offering in the loan category surged 41%. Either give them a look or be content with the assurance that you'll get virtually all of your money back from a money-market fund.

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