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The Honest Truth About Forcing Money Market Funds to Float

By Brian Reid

Advocates for further regulation of money market funds string together a loose chain of arguments to create the impression that money market funds are bank products, rather than investment securities. From this, they conclude that these funds need bank-like regulation. Sallie Krawcheck's commentary in today's *Wall Street Journal* is the latest effort in this campaign.

The reasoning usually goes like this: money market fund investors don't know what they're buying. Because the funds are managed to maintain a $1.00 share price, advocates of regulation argue that investors are lulled into believing that money market funds carry implicit guarantees. There's usually a reference to "honest accounting," with the implication that fund sponsors are hiding large fluctuations in the shares' "true prices." The solution, advocates say, is to "float" the share price, pass all those fluctuations on to investors, and thus demonstrate to investors that what they're holding is not a static bank account, but a security that carries risks.

There are flaws in every link of this chain—starting with the premise that investors are ignorant. Holders of institutional funds, which account for more than three-fifths of the $2.7 trillion invested in money market funds, certainly know the difference between a fund and a bank account. And retail investors are not ill-informed, either: in recent surveys by Fidelity Investments, 81 percent of retail investors said they understood that the securities held by money market funds had some small daily price fluctuations.

The notion that funds maintain their stable $1.00 price through implicit guarantees is also wrong. In truth, portfolio construction explains most of the stability: money market fund portfolios are designed to minimize risk and price fluctuations.

Money market funds invest in very short-term securities, and many of these securities have interest rates that reset frequently. That makes the value of these securities—and hence the funds' per-share portfolio value—extremely stable. As my colleagues and I wrote in a paper last year, interest rates would have to rise by 1 percentage point in a single day to reduce the portfolio value of the average $1.00 fund with a 45-day weighted average maturity by $0.0012 (about 0.1 cent). How often do such extreme interest rate changes occur? In the past 30 years, there has only been one day (February 1, 1982, to be specific) when three-month Treasury bill rates changed by more than 1 percentage point.

The stability of money market fund portfolios is demonstrated in historical data. For our paper, we collected mark-to-market prices from a sample of money market funds from 2000 to 2010. For prime funds (those that invest in commercial paper as well as government securities), the average "shadow price" never fell more than 0.1 cent below $1.00 until September 2008, when interest rates rose over several days. And even then—at the worst point in the worst financial crisis in 70 years—the average shadow price was only 0.2 cents below $1.00.

That record of stability was earned before the Securities and Exchange Commission (SEC) adopted amendments to money market fund regulation in 2010 that required funds to shorten the maturities and durations of their portfolios even further and to carry more liquid assets. Those rule amendments have made funds' mark-to-market share prices even more stable.

We've had a case study to prove that point. Last summer, three significant events rattled financial markets. The eurozone struggled to get ahead of the growing possibility of a Greek sovereign debt default. The U.S. Congress waited until the eleventh hour to increase the U.S. debt ceiling. And then, shortly afterward, Standard & Poor's downgraded the rating of U.S. government long-term debt.

What happened to money market funds' mark-to-market prices during the period from the end of May to the end of September? Very little. Using data that these funds provide to the SEC for public release, we can track the underlying prices of prime money market funds.

Among those funds that held the greatest share of their portfolios in dollar-denominated debt issued by the European-based financial institutions, the average share price of a fund with a $1.00 net asset value (NAV) fell by 0.9 basis points, or $0.00009. In other words, the price of a $1.00 fund slipped to $0.99991. For funds with the least exposure to European banks, the average mark to market share price rose by 0.3 basis points, or $0.00003, to $1.00003.

When a $1.00 fund moves by 1 cent, it's said to have "broken the dollar." In last summer's scenario, funds would have to have been priced at $100.00 a share for even a few funds to have moved one penny. (Maybe "break the Benjamin" would be the new term of art.) In any case, it's hard to argue that pricing a $0.99991 share at $1.00 is somehow not "honest accounting."

Some commentators believe that this type of fluctuation will convince investors that these funds contain assets that can lose value or provide more "honest accounting." False precision is not honest, and it is hard to imagine that investors would find these fluctuations to be meaningful. Floating the value of money market funds would create distinctions without a difference—an illusory benefit at best.

At the same time, the costs—in accounting, transactional, and tax hurdles for investors forced to track these minute changes in every transaction they make—will be very real, and very expensive. As we have said many times before, floating the price or imposing bank-like regulation will serve primarily to drive investors out of money market funds.

For more information, please visit ICI's Money Market Funds Resource Center.

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