

U.S. MMF Shadow NAV Volatility Declines Post-Crisis

Future Drivers Include Macro Events, Risk Appetite, Regulation
Special Report

Reduced NAV Volatility: The volatility of U.S. prime money market fund (MMF) “shadow” net asset values (NAVs) has declined significantly since the 2007-2009 financial crisis, driven by sustained demand for high quality MMF-eligible securities, heightened risk aversion of MMF managers, increased shareholder scrutiny and, importantly, the introduction of MMF regulatory reform by the Securities and Exchange Commission (SEC) in May 2010.

Permanent Change versus Temporary State: Future NAV volatility will be driven by competing factors including a conservative and well-defined regulatory regime supporting NAV stability, offset by the potential for increased risk appetite from fund managers as market conditions evolve and yield objectives return to focus.

Additional MMF reform, such as the introduction of subordinated capital or limitations on redemptions may serve to further support NAV stability, whereas other proposals, such as the move to a variable NAV, offer less certainty as to their impact on MMFs. The effects of any additional MMF reforms will also have to be weighed against their impact on the economics of the business and the incentives of fund managers.

Focus on Macro Factors: The outcome of the Eurozone crises, the evolving credit quality and liquidity of global financial institutions and the longer-term fiscal condition of developed sovereign nations, will all likely play prominent roles in determining the future stability of MMF NAVs. Sudden and unanticipated increases in market interest rates, while not currently expected by market participants or alluded to by Federal Reserve commentary, could also introduce increased NAV volatility.

Sponsor Support Also a Consideration: While fund sponsors have historically provided credit or liquidity support to MMFs during periods of extreme stress, sponsors’ willingness, financial capability, and regulatory authority to support fund NAVs may evolve over time. Factors that could influence future sponsor support include the profitability/viability of the business and its strategic importance as part of the sponsor’s broader suite of product offerings.

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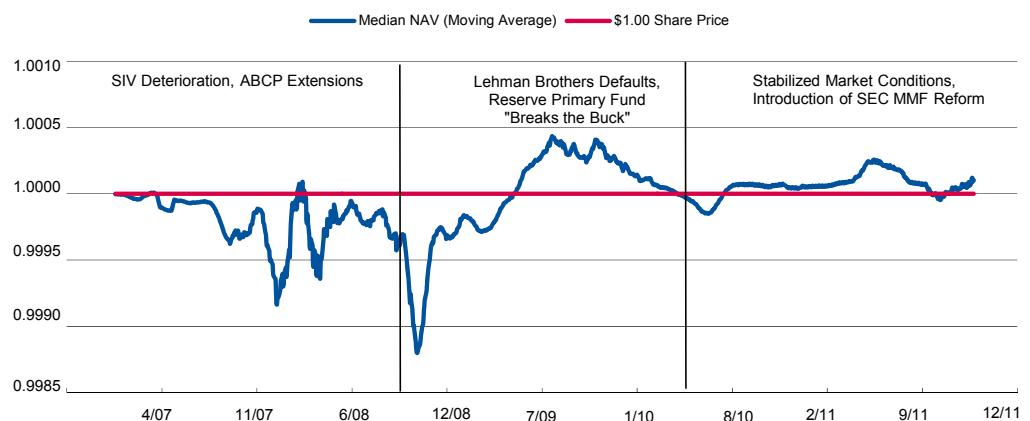
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Median NAV Volatility of Fitch-Rated U.S. Prime MMFs — 30-Day Moving Average (1/1/07–12/31/11)



Primary Drivers of Current NAV Stability

Changed Market Conditions

Current market conditions, while still extremely challenging, are in many ways less stressful than the 2007–2009 period. This has led to lower asset price volatility and moderated investor outflows relative to prior periods.

Post-crisis deleveraging of the banking system has decreased the supply of high quality, MMF-eligible securities, supporting current prices and limiting downside volatility. A future reversion of the bank deleveraging trend, however, may alter supply/demand dynamics and increase shadow NAV volatility. In addition, given that financial institutions remain a prominent component of MMF portfolios, credit or market deterioration at the individual issuer level could lead to increased market risk for MMFs.

Further supporting current NAV stability, several of the asset classes that previously introduced headline risk and asset price volatility to MMFs, such as extendible asset-backed commercial paper and structured investment vehicles, no longer exist or are avoided by rated MMFs.

Heightened Risk Aversion

MMF managers continue to exhibit significant risk aversion, given the ongoing Eurozone crisis and challenges facing global financial institutions. The result of these dynamics has been a move away from European financial institutions, and toward U.S. government securities or other shorter-dated instruments, which currently exhibit lower levels of price volatility. As of December 2011, prime MMFs averaged a 39-day weighted average maturity, whereas as recently as the beginning of 2011, prime MMFs were closer to a 50 day weighted average maturity.

Depending on the asset class, yields on longer-dated securities may offer little in terms of yield pick-up relative to shorter-dated securities from the same asset class. As such, fund managers may have limited incentive to invest further out the maturity spectrum.

Shareholder Scrutiny

Shareholder scrutiny of MMF manager activities, and conversely, MMF manager focus on the composition of their shareholder bases have combined to bring further conservatism to MMF portfolio composition while adding potential stability to fund flows.

Shareholders are more closely monitoring the activities of MMF managers, with particular focus at present on European sovereign/financial institution exposure. Shareholder's monitoring capabilities have been enhanced by MMF disclosure rules introduced in 2010 that require funds to provide more information about their portfolios, including monthly holdings, market-based pricing and shadow NAVs. In certain cases, increased shareholder monitoring has led MMF managers to avoid investments which they view as exhibiting stable credit fundamentals but which may otherwise raise investor concern.

MMF managers are also more closely scrutinizing the composition of their shareholder bases, as part of recent MMF reforms regarding "know your customer" requirements, in an attempt to minimize future redemption risk. In many cases, this has translated into increased investments from shareholders with stable/predictable flows, such as omnibus accounts, and reduced concentration in portal accounts with limited transparency regarding underlying investors, and less predictable flows.

Related Criteria

[Global Money Market Fund Rating Criteria, April 4, 2011](#)

Introduction of Regulatory Reform

More restrictive investment guidelines imposed by the SEC in May 2010 have served to enhance the stability of all MMFs regardless of the risk appetite of individual fund managers.

For example, minimum daily and weekly liquidity amounts for taxable funds of 10% and 30%, respectively, obligate fund managers to heavily weight their portfolios to shorter-dated assets (such as overnight repurchase agreements) and/or U.S. government securities, both of which exhibit lower price volatility and serve to stabilize fund NAVs. As of Dec. 31 2011, Fitch-rated U.S. prime MMFs averaged 26.1% and 40.9% of their assets in daily and weekly liquid assets, respectively.

Additional regulatory reform currently under discussion could bring further stability to fund NAVs. The introduction of subordinated capital, for example, would provide funds with the ability to absorb a small loss before impacting the NAV, while legal restrictions on redemptions (gating provisions) could reduce the reliance on secondary market asset liquidity which adversely impacted fund NAVs during previous periods of stress.

Background on MMF Shadow NAVs

Calculation and Impact on Share Price

A MMF's shadow NAV per share refers to the MMF share price calculated on the basis of mark-to-market valuation of the portfolio assets, which is typically conducted on a weekly basis. This is measured against the MMF's stable \$1.00 share price, which is calculated on the basis of an amortized cost valuation of the portfolio assets. MMFs calculate their amortized cost-based share price on a daily basis.

While the shadow NAV will almost always deviate slightly from the fund's stable \$1.00 share price, provided that the deviation is not greater than 50 basis points, the \$1.00 share price will be maintained due to penny rounding pricing convention. For example, a NAV of \$0.996 will be rounded up to \$1.00 whereas a NAV of \$0.994 will be rounded down to \$0.99. A deviation in excess of 50 basis points between the share price and the shadow NAV is commonly referred to as "breaking the buck".

Potential Leading Indicator

Monitoring the underlying shadow NAV is instructive as it indicates how volatile the fund's portfolio is, and by extension, how close a fund may be to honoring redemptions at a share price of less than \$1.00.

At a minimum, Fitch Ratings receives weekly reporting on MMF shadow NAVs, with more frequent reporting being instituted during periods of stress, as was the case in the fall of 2008. Following the MMF reform introduced in May 2010, U.S. MMFs are also obligated to report their shadow NAVs to the SEC on a monthly basis. The SEC publicly discloses such data via its filing database with a 60-day lag.

Periods of Fund-Specific NAV Dispersion

Certain periods of historical asset price volatility were driven by sector-specific events (such as those related to extendible asset-backed commercial paper, structured investment vehicles, or rapidly deteriorating financial institutions). In such instances, Fitch observed material differences in the NAVs of rated funds, depending on whether or not funds had exposure to affected sectors/issuers, as well as how quickly fund sponsors stepped in to immunize funds from credit or liquidity risks.

Data Sources

The data presented in the chart on page 1 reflects a 30-day moving average of the median observed NAV for 19 Fitch-rated U.S. prime MMFs for the period Jan. 1, 2007—Dec. 31, 2011. Given the historically observed dispersion of fund-specific NAVs, a median measurement of observed NAVs was chosen to reduce the effects of outlier data points.

Given that funds typically report to Fitch on a weekly basis, and report on different days of the week, observations were not available for all business days within the time period. In instances where there was no reported NAV on a given day, Fitch carried forward the prior day's median NAV.

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