Think About It

Can a stable $1.00 NAV U.S. Treasury Money Market Fund yield the same as a floating NAV Prime Money Market Fund?

By Lewis Goldman

State and local government finance officers would be thrilled if a $1.00 stable net asset value (NAV) U.S. Treasury Money Market Fund, was able to yield as much as a floating NAV Prime Money Market Fund. Recent money market reforms to SEC Rule 2a-7 in 2010 and 2014 were meant to protect investors and hopefully provide market stability in instances of market disruptions. However, because many corporations, as well as state and local governments, are required to follow mandates to invest their cash holdings in stable NAV money market funds, floating NAV Prime Funds are no longer the fund of choice for many finance officers. This brings me back to my initial question: Can a stable $1.00 NAV U.S. Treasury Money Market Fund yield the same as a floating NAV Prime Money Market Fund or possibly more?

Let's explore why a Prime Money Market Fund currently yields more than a Treasury Money Market Fund and then let's explore what it would take to have a Treasury Money Market Fund achieve similar returns. If a finance officer was to construct two portfolios, with identical maturity schedules and dollar distributions, the only difference between the two portfolios would be the underlying credit quality of the securities in the portfolio. Portfolio A is comprised of government debt (U.S. Treasuries and U.S. Agencies) and Portfolio B is comprised of Commercial Paper, Corporate Bonds, and other Non-government securities. It is safe to conclude Portfolio B would yield more than Portfolio A because of credit risk. Is there a means by which a Treasury or Government Money Market Fund can recoup the additional yield without taking the additional credit risk?

This writer believes there is, and believes portfolio managers of Treasury securities have an advantage over Prime Money Market Fund portfolio managers if they consider active portfolio management. First and foremost the U.S. Treasury market is the most liquid market in the world. Second, supply and demand factors cause pricing anomalies that allow astute managers to capture market inefficiencies. In addition to the above mentioned advantages of managing treasuries rather than other esoteric securities (since the Treasury market is so much bigger and actively traded than all others), a portfolio manager looking to add active management to their daily activities will find this area of the market much easier to navigate. One other issue to consider when deciding to invest in a Prime Fund or a Treasury or Government Fund: What happens when

there is a disruption in the markets due to a financial or political "Black Swan Event"? During turbulent times created by such an event, history has proven that spreads between treasuries and all other securities widen drastically and therefore a Prime Fund is not the most favorable place to be. Under this scenario a U.S. Treasury Money Market Fund would be the money market fund of choice.

The money market fund industry is forty plus years young, and over that time period has offered investors a short term investment vehicle with safety, liquidity, and a stable $1.00 NAV. "Keep it safe" and "keep it simple" is the conventional wisdom administered by money management firms and this is exactly what money managers should do and have been doing for decades. While doing this, the Money Fund industry has continued to keep trading volume low, portfolio turnover low, and accounting events to a minimum. By following this logic, opportunities to generate yield enhancement within a U.S. Treasury Money Market Fund are usually missed. However, modern portfolio management, which utilizes data analytics, electronic trading platforms, and portfolio managers who have mastered U.S. Treasury supply and demand intricacies, and can use the Repo market to their advantage, should be able to generate alpha which can be applied to narrow the credit spread gap between the two types of funds. How much alpha can be captured? That will depend on the portfolio manager and the systems that support their trading efforts. Modern money market portfolio management is synonymous with active portfolio management. Portfolio managers of U.S. Treasuries and Repurchase Agreements (collateralized by U.S. Treasuries) currently attempt to minimize accounting events, maintain high liquidity levels, and maintain a stable NAV of $1.00. Investors should consider reallocating their investment dollars towards those U.S. Treasury Money Market Funds who practice active portfolio management while keeping accounting events to a minimum, maintaining high liquidity levels, and are able to maintain a stable NAV of $1.00.

Prior to October 2016 when the new money market reforms were to begin, the twenty year historical spread relationship between Institutional Prime Money Market Funds and Institutional Government Money Market Funds was 12 basis points. The 12 basis point spread was inclusive of the market disruptions witnessed during the credit crisis. Leading up to October 2016, and shortly thereafter, corporate and government Treasurers began shifting their cash holdings away from Prime Funds into Treasury or Government/Agency Funds with stable NAV's of $1.00. According to iMoneyNet the shifting of assets from Prime Money Market Funds into Government Money Market Funds, by the end of fourth quarter 2017, had expanded to approximately 21 basis points.

Ignoring modern portfolio management would be a mistake. Sometimes the market hands us an opportunity we should not ignore. Portfolio managers who capitalize on these opportunities will be rewarded with better performance. The more the market gives the more the portfolio manager should take. There can be several reasons why portfolio managers might not choose to take advantage of these opportunities. Conventional wisdom says active management causes accounting events, changes the makeup of the portfolios holdings, has transactional costs, changes the portfolios WAM, and introduces operational friction. However, if active management was considered it would be one way to narrow the gap between a Prime Fund's yield and a U.S. Treasury or Government Money Market Funds yield. The more active management is used the narrower the gap becomes.

Finance officers can no longer afford to blindly accept increased risk for increased alpha just to keep volume, trading, and accounting events to a minimum. The world is very different today than

it was four decades ago, and even different than it was two weeks ago. The landscape for liquidity is not so simple anymore. Investors today realize the risk is just too great when you consider the requirements for liquidity.

In conclusion, the author believes the day of active management of U.S. Treasury portfolios is upon us. Rising rates, increasing government debt, and market volatility, will lead to yield enhancement opportunities which should be captured. Portfolio managers who strive to narrow the gap by looking for yield enhancement opportunities, within the rules of SEC Rule 2a-7, should seriously consider active management. The increased yield, without increased risk, should make these managers your fund of choice. It's time to close the gap!

About the Author: Lew Goldman, Founder and CEO of Goldman Landow Capital, LLC, works with beneficial owners of U.S. Treasuries to construct yield enhancement strategies using U.S. Treasuries. Goldman Landow Capital is not a money manager. Goldman Landow Capital created "The Black Swan Option" and "U.S. Treasury Alpha PLUS", two strategies which generate yield enhancement for beneficial owners of U.S. Treasuries using SIFMA Master Repurchase Agreements. Prior to starting Goldman Landow Capital, he was a money market and U.S. Treasury Salesman at Citibank and Swiss Bank Corporation (now UBS). Throughout the 90's he became a derivatives structurer and marketer at firms such as Nomura and FIMAT (Societe Generale) creating numerous first time structures and products. Thereafter, he built and ran a number of fixed income sales, trading, and origination platforms such as Pali Capital before launching Goldman Landow Capital in 2013.