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Turmoil in the Cash Markets: Did Enhanced Cash and Money Market Strategies Overdo Risk?

By Paul Reisz

Before the summer of 2007, most cash investors felt little need to ask questions about the specific holdings within their money market and enhanced cash investments. Money market and enhanced cash strategies were generally doing what was expected of them: money markets provided liquidity and principal preservation with consistent returns, and enhanced cash strategies had moderate price volatility and offered stable returns over money markets.

Over the past year, however, there have been ongoing challenges for many money market and enhanced cash strategies, stemming from significant volatility in short-term securities. The credit crisis has had painful consequences for many investors. Many funds experienced significant volatility and some of their presumably safest investments declined in value. As the credit crisis progressed, many investors in enhanced cash strategies experienced capital losses, and several managers and sponsors had to provide capital infusions or purchase illiquid assets from their portfolios because there was potential for the net asset values of their money market portfolios to fall below \$1.

Investors thought they were taking little risk in their money market and enhanced cash strategies. These strategies generally had high average credit quality, and yields were at reasonable levels compared to Treasuries and LIBOR rates. Money market and short-term bond investments were a stable corner of the fixed income universe, and investors presumed it would remain that way. Unfortunately for many, that perception turned out to be an illusion.

What Happened and Why?

In recent months, some enhanced cash strategies have experienced significant volatility and a decline in value, even those with an average credit rating as high as AAA. While money market sponsors have stepped in to prevent similar declines in value, uncertainty about money market investments has increased.

It's important to note that enhanced cash (or short-term) strategies are not the same as money market strategies. Because enhanced cash strategies may hold slightly longer-term and modestly higher-risk securities, investors should generally expect a degree of volatility in net asset value (NAV) over time. Money market strategies, meanwhile, are expected to hold only the safest and shortest-term investments, and investors expect that the NAV will not fall below \$1.

In either case, investors now realise there is the potential for a loss of principal even in strategies where the primary objectives are preservation of capital and a reasonable level of liquidity.

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How did this happen? Over the past few years, the securities that money market and enhanced cash strategies traditionally hold were providing low yields and low risk premiums compared to historical levels. This led many managers to search for alternative sources of high-quality yield in cash portfolios. Asset-backed commercial paper (ABCP) offered just that: higher yields with AAA credit ratings. Until recently, ABCP routinely yielded 1–2 basis points more than traditional commercial paper, a staple of money market and enhanced cash portfolios. ABCP is a classic case of borrowing short to lend long – in essence, arbitraging the investment time horizon but outside of the banking system. Although the underlying assets in ABCP were not transparent, their high credit ratings meant that investors did not scrutinise them. And while the underlying assets were presumably diversified, about 12%–15% of the ABCP market was backed by subprime debt in structured investment vehicles (SIVs) or collateralised debt obligations (CDOs).

When rising concerns about subprime loans prompted a liquidity crunch in the summer of 2007, the ABCP market stopped dead. Investors didn't care if the ABCP was rated AAA; if there was an association to SIVs or CDOs, investors did not want to extend credit. As a result, ABCP spreads have widened to historical levels and some money market and enhanced cash strategies have been forced to write down the value of their assets. As of December, most of the problematic ABCP has already matured, rolled off or been refinanced, but the losses that many money managers incurred are still fresh in the minds of investors.

The recent event that had the greatest impact was the Lehman Brothers bankruptcy on September 15. Most financial markets experienced a tremendous shock and it had a profound ripple effect on money markets as well: it indirectly drove a very large money market fund to “break the buck.” The Reserve Primary Fund held over one percent in Lehman commercial paper and when investors got wind of it, they decided to redeem en masse. That same week, AIG, a major international insurance company, ran into trouble and was bailed out by the government.

Following these historic events, corporate spreads widened dramatically, especially in the financial and banking sector. The commercial paper issued by many large, high-quality issuers traded as though every financial was going out of business. Banks stopped lending to each other and the cash markets were frozen. Before this crisis, prime money market funds, which held mostly commercial paper, were thought to be just about the safest investments in the market. But investors quickly understood that prime funds were no longer immune to the credit crunch because of their corporate exposure, and they fled to only the safest assets – Treasuries.

Government Takes Action to Assist Money Markets

The U.S. government had to take dramatic steps to address the problems in the money market arena:

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- First, they needed to stop the run on the bank. Too many redemptions in prime money market funds would cause a feedback loop and more prime funds might break the buck. Therefore, the Treasury established a temporary money market guaranty program recently extended until April 30, 2009, and eligible to holdings held as of September 19 to stop the run. This program insures money market assets of those funds that enrol and pay a small premium of assets.
- The next step was to create liquidity in the commercial paper markets: the Federal Reserve established the AMLF, or Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, which gives banks financing to buy high-quality ABCP from money market funds through January 2009.
- Another step was needed to create liquidity in the unsecured commercial paper market. The New York Fed launched the Commercial Paper Funding Facility (CPFF), a special purpose vehicle funded by the Fed which will buy highly rated asset-backed and unsecured commercial paper directly from U.S. issuers. So far, this facility has helped add liquidity for direct issuers and reduce the LIBOR-OIS spread.
- These steps still hadn't addressed the sale of commercial paper in the secondary market, so the Fed also agreed to provide up to \$540 billion in loans to money market funds beset by redemptions. This program, the Money Market Investor Funding Facility (MMIFF), launched in late November and helps mutual funds sell term commercial paper on the secondary market. We expect this to free up more liquidity.

While these measures have begun to thaw the frozen short-term credit markets, they have not completely solved all of the issues. Outside of these government programs, there is still a lack of liquidity. It's not as bad as before, but it could be much better.

Is Your Manager Taking Excessive Risk With Your Cash?

For many investors, the unexpected volatility that some money market and enhanced cash strategies have experienced has brought the realisation that managing cash is not as simple as it may seem, and they are spending significantly more time evaluating managers. At PIMCO, we believe this is a very positive development. Investors should review their investments and make sure their managers can answer some fundamental questions about philosophy and process to determine whether the managers are taking excessive risks in investments that should be stable. Key questions include:

- What is your philosophy for managing cash?
- What is the investment process?
- How have your portfolios been impacted by recent market events?
- How do you analyse, select and monitor credits?

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- Do you own ABCP? How secure do you feel the program is, and how much credit support is there?

How would PIMCO respond to these questions?

Our philosophy is that money market investments are the equivalent of cash, which means that protecting principal is paramount and it does not make sense to take on risk. Enhanced cash strategies, as a substitute for cash, differ from money markets since investors expect the manager to take on some risk in order to generate a return. Nevertheless, even in these strategies, our philosophy is that liquidity and principal preservation are extremely important objectives, so significant risk-taking is not prudent.

PIMCO's investment process emphasises risk management; one way we manage risk in money market and enhanced cash strategies is to employ a senior team of portfolio managers who have experienced many market cycles and who understand cash-equivalent instruments and securities and the risks associated with them. These seasoned portfolio managers adhere to the firm's longstanding philosophy: focus on the long term, strive to produce consistent results and do not allow market changes to influence our belief that investors should always be fairly compensated for the risk embedded in securities, even those in the money markets. Securities that pay a higher yield of one or two basis points may not be worth buying when the downside risk is a price markdown of 20% – or potentially even more.

A second way we manage risk is to employ an internal team of credit analysts so that we don't have to rely on the rating agencies. Our analysts recognised early on the risks involved in ABCP due to the lack of transparency in the underlying assets, and we avoided the sector because we could not quantify those risks. In fact, our risk management process led us to make a policy decision years ago to avoid any meaningful exposure to ABCP or debt associated with SIVs.

A third way we manage risk is to employ a broad opportunity set, which allows us to diversify our portfolios and helps us avoid excessive exposure to any one sector or issuer. Our philosophy and process have helped us avoid any meaningful exposure to ABCP, SIVs or CDOs.

That said, there are opportunities that prudent managers of enhanced cash strategies can explore even amid the current extreme volatility. While we do view the short-term strategy as a cash strategy where we do not want to take on excess risk, market volatility has led to some interesting opportunities that may deliver attractive returns to investors. In addition, debt reduction and balance sheet realignment, and the resulting dearth of liquidity, have contributed to a dramatic increase in risk premiums across a variety of fixed income assets. We rarely see such favourable environments of historically wide spreads, competitive yields, and a steep yield curve that may offer the potential for gains as bonds "roll down," or mature, along the curve over time.

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Conclusion

As investors continue to realise that managing cash is no simple task, we expect that they will take less risk in these portfolios and increase their level of scrutiny. At PIMCO, we welcome this development. Cash management is not an area where investors ought to take on significant risk. Investors should take risk in other portfolios and keep their cash portfolios focused on the key objectives of liquidity and principal preservation.

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supported by some form of government or private guarantee there is no assurance that private guarantors will meet their obligations. The credit quality of a particular security or group of securities does not ensure the stability or safety of the overall portfolio.

Collateralized Debt Obligations (CDO) are an investment grade security backed by a pool of bonds, loans, or other assets. Structured Investment Vehicles (SIVS) are a pool of investment assets that attempts to profit from credit spreads between short-term debt and long-term structured finance products such as asset-backed securities (ABS). LIBOR (London Interbank Offered Rate) is the rate banks charge each other for short-term Eurodollar loans. The LIBOR/OIS (Overnight Index Swaps) spread measures the amount of cash available for interbank lending and is used by banks to determine interest rates.

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