DAVID WENDELL ASSOCIATES, INC.
INVESTMENT COUNSEL

P.O. Box 21980
325 Corporate Drive
Portsmouth, N.H. 03802
(603) 427-0200
www.davidwendell.com

February 2012

Update on Money Market Funds

For many investors, money market funds are little more than an afterthought. But with $2.7 trillion in assets, they are actually an important part of the economy. Created in 1971, money market funds now hold more than one-third of the commercial paper float and over half of the short-term municipal debt market. Businesses as well as state and local governments depend on them for cash flow and financing needs and investors rely on them for the convenience of readily accessible funds and, until recently, attractive yields.

Up until the financial crisis, money market funds were widely viewed as essentially risk-free, almost the same as cash. But when the 2008 bankruptcy of Lehman Brothers caused a well-known fund to "break the buck," investors across the industry panicked and headed for the exits -- no longer certain that a dollar would be received for each dollar invested. The redemption stampede abated only when the U.S. government and the Federal Reserve issued a guarantee for all money market fund deposits.

Two years later, the Securities and Exchange Commission ("SEC") implemented sweeping changes designed to make the money market fund industry more resilient. For example, there are now tighter credit standards on the types of securities that funds may hold and a requirement that enough cash be kept on hand to meet "reasonably foreseeable redemption requests." There is also more transparency in the industry than in the days leading up to the crisis.

In the next few weeks, the SEC is expected to propose additional rules and regulations. After a period for comments by the public, the changes may be finalized later in the year. While the details have yet to be announced, it appears the new rules will be aimed at preventing future stampedes and further strengthening the industry.

For example, instead of requiring that money market funds hold at least $1 in assets for each dollar invested, fund managers may be given leeway for temporary fluctuations. In other words, the net asset value of the fund may "float" around the dollar-for-dollar level. This means that when the financial markets are stressed, investors might have to absorb modest losses while in good times they might have modest gains. The industry is opposed to such a "float," stating the dollar-for-dollar expectation is what attracts investors to the funds in the first place. Also, the accounting and tax implications are unclear and may be cumbersome.

\- - - - -

Another rule may require money market funds to maintain capital cushions similar to the banking industry. This would ensure that funds always have adequate cash on hand to meet redemption requests on demand. However, the amount to be held in reserve is unknown and it is not clear where the money will come from or for how long the funds will have to accumulate the reserve.

Furthermore, the average yield in the money market fund industry is currently 0.02%, or $2 a year for every $10,000 invested. There are concerns that carving out funds for a required capital cushion will further reduce yields and send investors in search of other, perhaps riskier, non-money market fund alternatives, further impacting the industry. Since 2008, the number of money market funds has dropped by almost 40%.

Finally, there may be a "hold-back" rule that would prevent investors from quickly withdrawing all of their assets from a fund. For example, investors may be allowed to initially withdraw 95% of their funds but a 30-day waiting period would be required for the remaining 5% portion. The money market fund industry is strongly opposed to this rule also, pointing out that compliance with redemption freezes will impose additional costs on funds as well as investors and will impair the features that investors demand, such as check writing, debit-card access and sweep accounts.

It is not at all certain that these new rules and regulations actually will be implemented. There are five SEC commissioners and three of the five must vote in favor to propose the regulations. Then there is a 60-day public comment period after which the SEC will decide how it wishes to proceed.

From the SEC's point of view, these changes should help protect investors from another money market fund panic and address the industry's susceptibility to "fund runs" while providing a buffer against losses. They are also a planned follow-up to the changes implemented in 2010.

The money market fund industry, however, points out that it weathered the challenges of 2011 "with nary a hiccup" and that with the success of the 2010 reforms no further regulatory changes are needed. From June through August last summer, about $170 billion (roughly 10% of prime fund assets) was redeemed and the industry met the redemptions, maintained liquidity in excess of the new standards and saw no change in the mark-to-market value of fund portfolios.

In light of these possible changes, it makes sense for investors to first review how they are using their money market fund. Ideally, the purpose of a money market fund is to allow investors easily to purchase or sell securities in their investment portfolio. Investors using a money market fund as a checking account may be better served by other options, such as checking, savings and money-market deposit accounts which are insured by the Federal Deposit Insurance Corporation.

Finally, as we have recommended in the past, money market funds -- like all securities -- should be selected based on the quality of the underlying investments. Funds offered by large, established firms consisting of U.S. Treasury or government securities should fare better in these challenging times than funds from smaller firms, which may be impacted more by possible regulatory changes.