



Fiduciary Alert: Cash Funds

The credit crisis of 2007-2009 generated a seismic shift of investment assets into “cash”. However, as the crisis induced panic fades, many corporate investors are deeply frustrated by the continuing low yields of cash. With the worst of the market conditions behind us, the great search for yield has begun. No doubt new products will appear to satisfy customer demand. This is a time for caution. The smart cash manager asks lots of questions.

Corporations typically conduct robust due diligence processes when hiring an external manager for a separate account; we would propose the same due diligence be performed when selecting cash vehicles or products. Pooled funds and vehicles present unquestionable benefits, yet, they can also raise some unique questions.



Due diligence for cash managers should include the following questions:

1) Is the fund a registered money market fund under Rule 2a-7?

Rule 2a-7, among other things, permits money market funds to maintain a stable net asset value per share through the use of the amortized cost method of valuation and the penny rounding method of pricing.

As we discovered in 2008, not all “cash” funds are 2a-7 registered mutual funds. Many financial institutions offer non-registered “constant dollar funds”. These funds may look like a registered fund, but only a rigorous due diligence process will determine if they afford the same protections with respect to maturity, credit quality and diversification mandated by 2a-7. An -unregulated cash product could be appropriate for your needs, but it is important to understand why this fund or product falls outside the regulations. Where is the manager assuming risks that wouldn’t be assumed in a registered fund?

2) What percentage interest in the Fund will your investment represent?

Investors commonly seek diversification when purchasing individual securities, funds or hiring managers. However, they rarely look to the “diversity” of investors in a fund.

The implications of holding a large proportion of the fund, or, alternatively, of a few investors holding large proportions of the same fund, is key. That’s because in the event of a rapid withdrawal of a large portion of a fund, the investment manager would need to sell a significant amount of the assets of the fund. In doing so, the fund could end up less diversified or holding a different mix of assets than before. More specifically, if you are a remaining investor you may end up with a less liquid, more volatile portfolio.

One way to evaluate whether you find yourself in this situation is to consider the amount you are likely to invest and calculate the percentage of the fund that investment would represent based on the average and lowest market value of the fund



over, say, 5 years. For example, a 3 percent investment today might have represented 20 percent of the fund a couple of years ago.

It's also a good idea to ask the manager to identify the percentage of the fund held by each of the five largest investors. If the fund is heavily weighted toward a few large investors it could mean that a decision by one or more of those large investors to withdraw from the fund could simultaneously shrink the size of the fund, while increasing your share of ownership.

If on the other hand the fund has a very large number of investors it is less likely that the impact of some investors leaving the fund would be as great for the remaining investors. Note that some funds have restrictions or transaction rules in place to dampen or eliminate the effect of such activity. (See Question 7, below.)

It is clear from the crisis of 2007-9 that counter-party creditworthiness can deteriorate very rapidly, leaving investors exposed and vulnerable to losses.

3) How is counter-party exposure managed?

It is important to ensure that the portfolio exposure is not heavily skewed toward a single counter-party, to review counter-parties frequently and to always know the total exposure you have to each counter-party. Managers should be able to aggregate risk by counter-party by summing all exposures, including repo, time deposits, commercial paper and any other assets. Investors should understand how the manager evaluates the creditworthiness or quality of the counter-party. We have all learned that blind dependence on ratings agencies can be dangerous. Does the manager have internal credit analysts or contract with other entities to supplement the credit analysis?

4) Has the Manager identified the correct-counter-party?

Financial institutions have many subsidiaries and the manager must both identify the subsidiary and assess its creditworthiness. In light of the recent Dodd-Frank financial reform act, many institutions will be restructuring their various trading activities.



Managers must keep an eye on their counter-parties and the capitalization of these entities.

REPO Investments raise many questions

5) What percentage of the fund is typically held in repo?

Most cash funds have significant investment in repurchase agreements (repo). Generally speaking, these transactions are rolled on an overnight basis and are collateralized by high- quality assets, but not always.

Repo collateral enables the repo investor to liquidate the collateral immediately in the case of default of the counter-party. For many years repo collateral was limited to US Treasuries and Agencies, which tend to be quite liquid. In recent years, many types of securities have come to be included as repo collateral, including equities, CDOs, “whole loan” mortgages and other types of securities.

It is important to evaluate the extent to which the fund permits this type of collateral and whether the manager has the ability to actually liquidate those securities quickly in the event of a default. Many of the current collateral types are thinly traded and would be susceptible to significant price declines in the case of forced sales.

6) What percentage of the repo is tri-party and bilateral?

In some cases a third-party bank, typically JPMorgan or BNY Mellon, stands in the middle of repo transactions, sending and receiving cash and collateral for both the buyer and the seller. This is called tri-party repo. Many find this arrangement to be both more efficient and less risky than bilateral repo (in which the buyer and the seller handle the settlement of cash and collateral). Tri-party repo reduces operational costs associated with processing collateral, substitutions and cash payment—plus the tri-party agent prices assets, calculates margin requirements and holds cash and assets in a separate custodial account.



7) Is repo executed with any parties that are not US entities?

In some jurisdictions repo assets are subject to the bankruptcy “automatic stay” (they are not subject to it in the US). That means that if the counter-party defaults, the repo collateral could be tied up in bankruptcy. For example Lehman repo that was conducted through a UK subsidiary (where the repo collateral is not exempt from the stay) was tied up and not available for investors to liquidate immediately.

Redemptions and Reporting

8) Are there limits on the percentage of the fund that can be withdrawn by a single party in one day or other period?

As an investor you want to be clear on both your ability to withdraw funds, and—just as importantly—the ability of others to force sales in the fund due to withdrawals during periods of market turmoil. Many funds have the ability to restrict transactions, although very few have done so. While limiting withdrawals may affect your liquidity, this mechanism could potentially protect the value of assets by insulating the fund from having to sell assets at distressed levels under adverse market conditions.

9) Have redemptions or withdrawals ever been suspended or restricted?

This provides insight as to whether the fund ever had a liquidity issue and how successful the fund or product was in navigating the credit crisis.

10) What type of reporting does the Manager provide?

Gone are the days of looking exclusively at yield, and some basis summary characteristics. Funds are providing more detailed portfolio characteristics and holdings. Some funds still provide holdings with a time delay, some funds offer more current holdings.

If the fund or product cannot produce timely holding reports to review, find a new fund. At the very least, a detailed summary report by instrument type should be reviewed. Similar to cash-like products, if the underlying assets are difficult to determine, find a new product.



The Old Questions Still Apply

Despite some of the new scenarios prompted by the crisis, it's still critical to keep in mind the basic, pre-crisis due diligence questions.

Risk controls, compliance, experience and relationship management are all important areas to investigate. Likewise, ask about the trading system which the traders use and the ability to catch pre-trade errors.

Also, how long has the investment team been in place? A newer team managing the fund could signal a change in management as a result of performance issues. Other good questions: How responsive is the relationship management team to questions? How proactive do you think the team would be if there were another liquidity crisis?

Safety in Details

The market is very quick to produce products to meet investor demand. Right now spectators on the sidelines are waiting to jump in.

The safest products to invest in are the products where you have asked the right questions and received answers to your satisfaction. If a product that you are reviewing offers an above-average yield, you must understand the sources of that yield -- traditionally it will come from either duration or credit quality.

Before making the investment, determine if it fits within your risk tolerance. The market turmoil of 2007-2009 served as a wake-up call for investors who didn't think it was necessary to dig into the details of cash funds. Many learned that our assumptions about liquidity and safety were inaccurate in the face of unexpected events. Liquidity reserves are invested in these funds primarily because they may be needed on very



short notice. By asking the questions we pose above, investors are able to make more informed decisions about which funds are best suited to their needs.



Contact **Harrison Fiduciary Group** for more information:

www.harrisonfiduciary.com | info@harrisonfiduciary.com

— COFOUNDERS —

BARBARA SHEGOG, CFA, CPA
bshegog@harrisonfiduciary.com

MITCHELL H. SHAMES, ESQ.
mshames@harrisonfiduciary.com