



The Role of Variable NAV Funds in Cash and Liquidity Management

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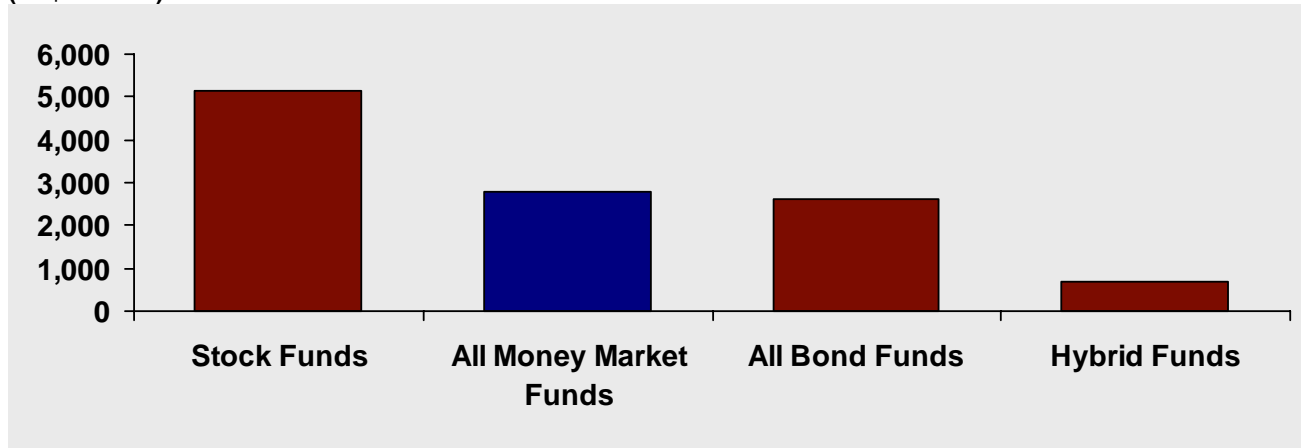
Variable Net Asset Value (VNAV) funds sound exotic, but their concepts have been around in one form or another for a long time: think 2a-7 funds with twists in transparency and accounting. The latest iteration of these funds comes as the US Securities and Exchange Commission has made major alterations to traditional money market (2a-7) funds, including mandating what liquidity buckets portfolio managers must use, introducing a weighted average portfolio life of 120 days, and mandating a new shadow NAV reporting system. Alongside the SEC's reporting for money market 2a-7 funds, new VNAV funds are offering benefits for the right kinds of investors in a more transparent and operationally efficient system that relies more on money manager performance and less on the trust of government mandates to ensure liquidity. While VNAV funds are not for everyone, investors should look closely at these products to see how they fit in their cash and liquidity management strategy.

The US money market industry has roughly US\$2.8 trillion in assets across taxable and tax-free funds, making it the second largest portion of assets in US mutual funds behind stock funds, according to the Investment Company Institute (see Exhibit 1). Institutional investors hold 2/3rds of these funds and over half the underlying assets held are from private companies. Any change for money market investors or the way that the funds themselves invest assets has immediate and large consequences for the US credit markets.

VNAV funds offer a unique alternative to the well-known US\$1 NAV funds. The US\$1 NAV money market fund, also called a Constant NAV or CNAV, almost always shows an accounting balance of US\$1 regardless of the value of underlying assets. On the other hand, the VNAV funds offer investors an actual price to buy in and sell out of the fund. The stable price of the US\$1 fund has been attractive to investors looking for simplified accounting and record keeping. However, this was also a contributing factor to the substantial market failure in 2008 as the value of these funds had fallen so far, and many of the positions became so illiquid that it was not possible to redeem at \$1.00 without realizing losses for the remaining shareholders. Once the first fund had fallen, investors ran for the exits leading to losses and substantial intervention by the US Department of the Treasury. While rare, breaking the buck happened before in 1994 and could happen again with

further turmoil in the short-term credit markets; when investing in cash products, investors need to be mindful of a world where large systemically important institutions can fail.

Exhibit 1:
Total Net Assets of US Mutual Funds, September 2010
(US\$ Billions)



Source: Investment Company Institute

A primary reason for the panic that occurred was the assumption of investors that their assets were safe at the US\$1 NAV mark. Some investors had thought that this US\$1 mark was a guarantee, although this was incorrect at the time and still is. As part of rebuilding the structure of money market funds, the SEC has mandated that money markets now publish a shadow NAV, which is the actual value of assets if the fund had to be liquidated immediately. This is in effect the true value of the fund. The SEC has allowed publishing a shadow NAV to occur with a two month lag both to ensure a smooth transition for fund operations and to protect investors, who might in fact be disturbed to suddenly see their funds with market values off of the US\$1 value. The SEC has initiated other reforms as well including promoting transparency of holdings and specifying liquidity buckets for investments.

Into this mix step the VNAV funds. While the investments of a VNAV and a US\$1 2a-7 money market fund can be nearly identical, there are important differences in transparency and accounting. The VNAV funds publish the mark to market value of some or all of their assets, depending on the rules they are following. This is a parallel to the shadow NAV prices being published by US\$1 NAV funds, although the VNAV funds make this information known to investors on a daily basis. In practice, the VNAV fund price should be exceptionally close to a stable value as well and will have close ranges to the base price. However, this new transparency has substantial benefits for both investors and the market.

Much has been made about the accounting impact on investors for VNAV funds. In fact, the accounting for VNAV funds is the same as for CNAV funds, although the implications for specific investors will vary. The US\$1, or CNAV, funds use amortized cost accounting to keep the value of

assets constant at US\$1. This allows investors to record no change to the value of their funds or the investment period. On the other hand, since VNAV funds use mark to market accounting with a price that changes daily, seeing the VNAV price takes out an extra step in identifying the variance between a US\$1 fund and the true value of its assets. It also means that investors will have additional accounting work to do on a periodic basis to account for gains and losses. This may create positive, negative or neutral implications for an investor's tax profile.

Some investors have noted concern about this accounting aspect of VNAV funds and believe that they might turn their attention towards other stable value products if US\$1 funds were no longer available. This has caused a backlash against VNAVs from sellers of commercial paper who worry that their products could lose their current natural buyers. These arguments have some merit, but there is no reason to think at this time that US\$1 NAV funds are going away; rather, VNAV funds are appearing as a supplement to this portion of the market. It is also important to note that VNAVs invest in the same products as US\$1 funds; a slow migration towards VNAVs will have no impact on the commercial paper market. Ironically, VNAV's may wind up being a major buyer of commercial paper, particularly as new Basel III capital rules for banks will discourage the issuance of short term paper in favor of longer term issues. As today's 2a-7 funds are limited in both their WAM and liquidity buckets, VNAV demand may step in to meet the new supply. The President's Working Group on Financial Markets has also suggested that VNAV funds might have some relief on certain accounting rules in order to strengthen the commercial paper market.¹

Although the SEC has made improvements, Constant NAV funds continue to have a fatal flaw that VNAV funds can help mitigate. As the SEC rules show, these funds are required to maintain a certain percentage of assets in the most liquid investments; this figure is not dissimilar from what portfolio managers held prior to 2008. The problem comes when large numbers of investors head for the exits at the same time. The earliest investors to leave will cause the fund to sell the most liquid assets leaving the remaining investors with losses as less liquid assets are sold off. It is uncertain how interested current money market investors would be to return to the market after another run; they may opt instead for Certificates of Deposit or other short term products.

On the other hand, the VNAV funds operate with a what-you-see-is-what-you-get policy. While the potential for loss exists, the daily publishing of an NAV can clearly inform investors that the price advertised is the price they would receive from a selloff. If a portfolio manager were to liquidate a fund overnight, the price on paper is the return that an investor would get regardless of if the investor were first to redeem shares or last. This is an important distinction: a VNAV fund can experience a run on the bank and still provide all investors with the advertised price without a government guarantee.

¹ Report of the President's Working Group on Financial Markets, Money Market Fund Reform Options, October 2010

The VNAV funds have additional benefits beyond the needs of safeguarding investors. For starters, the variance between a VNAV fund and a US\$1 NAV fund can be an early tipoff as to the security of assets in the US\$1 fund; the VNAV funds could serve as the canary in the coal mine for cash investors wanting to be sure that other assets are safe. The VNAV funds can enhance liquidity in commodities or other markets where investor cash margin must be held in specified products. VNAV funds can also serve the needs of mutual funds or other investors with a large number of shareholders looking to provide the most transparency back to their clients.

To be sure, there are investors who will continue to prefer the US\$1 NAV based on their accounting simplicity, and there is no harm to that. However for investors who either do not need the constant NAV or who are able to manage the slightly higher accounting requirements, the VNAV funds offer substantial improvements in transparency and safety. We recommend that cash investors take a serious look at VNAV funds as an opportunity for capturing greater transparency in their investments and security for their assets.

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