

Investing Through the Liquidity Crisis

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Short-term investing is a critical function of most treasury departments. Investors work to preserve principal and maintain liquidity as their primary goals while also attempting to maximize returns generated on their excess cash as a secondary goal. Historically, treasury and other short-term investors have viewed money market mutual funds as safe havens to invest their excess liquidity. The 2008 liquidity crisis has tested historical norms around short-term investing. Investors are witnessing the sub-prime mortgage debacle and resulting ripple effects throughout the short-term fixed income markets. One well known money fund 'broke the buck' in September 2008 and several others experienced liquidity difficulties. Are money market investments really safe and exactly what does the future hold?

Let's begin with a look at a historical perspective on money market funds. Money funds are governed by SEC rule 2a-7 which provides guidelines for the type of instruments money funds can invest in, concentration of any one issuer, average maturity and other restrictions all aimed at safely maintaining the fund's liquidity and preserving principal at a Net Asset Value (NAV) of \$1. As another layer of perceived protection, S&P and Moody's rate some of the money funds as a service to the fund applying even more stringent guidelines than SEC Rule 2a-7. Funds that choose to pay for this rating and meet all applicable guidelines are designated 'AAA' by one or both agencies historically providing some investors more comfort around the safety of a respective fund. This formula has worked well over the past decade for money funds. Until late 2007 investors would routinely look to the 'AAA' rating as a sign of safety and sometimes merely pick the fund with the highest yield. Seldom did investors perform due diligence on the specific holdings of money funds.

Beginning in August 2007, the first signs of trouble emerged in the capital markets. Several well known extendible note programs exercised their extension features implying they may not be able to fund their obligations upon maturity. Before long, widespread illiquidity emerged with asset backed commercial paper issuers and problems with structured investment vehicles (SIVs) surfaced. Around the same time, there were several instances of auction failure within the auction rate securities (ARS) market. In response to mounting liquidity concerns in the capital markets, the Fed moved to lower the target rate, commencing an easing of monetary policy.

By the end of 2007 moving into the first quarter of 2008, the liquidity predicament intensified. Certain enhanced cash funds, which had been gaining popularity among corporate treasury and other short-term investors, found themselves in trouble. Stressed with declining short-term rates and liquidity concerns, some of these funds' NAVs dropped below a dollar.

Institutional investors were quick to exit enhanced cash funds with large redemptions. One well known fund with approximately forty billion in assets lost over half of its value in a matter of days. The large redemptions of enhanced cash investments continued the chain effect in the short-term fixed income markets. Some of these enhanced funds held a high percentage of ARS. The redemptions, along with other market forces, pressured the ARS market and auctions began to fail. Large dealers, who formerly would have stepped in and supported auctions when backup liquidity needed, refused to do so as they were already flushed with portfolios of illiquid securities and couldn't afford to take on more exposure. As a result of lack of dealer support and other factors, auctions failed across the board and the ARS market became largely illiquid. Many market experts feel the ARS market will never come back as a viable investment alternative and these programs are currently being refinanced into variable rate demand notes and other obligations.

Widespread confusion cast itself into the financial press as there were several erroneous accounts of money funds breaking their dollar NAV and enhanced cash funds incorrectly referenced as

money funds. In addition, there were several highly publicized bailouts of money market funds where financial firms actually purchased troubled securities out of the fund portfolios to preserve the NAV of these funds at \$1. There have been approximately a dozen such fund bailouts noted in the market recently. Finally, in September 2008 the crisis grew more dire when a well known fund provider, Reserve, announced their Primary Fund actually broke the buck as a result of Lehman bond exposure and several other funds froze activity because of liquidity concerns.

Where does all of this market chaos leave the treasury investor holding a portfolio of money funds? No longer is it good enough for most investors to view a AAA rating on a money fund as a sole means of assurance. Management of many treasury departments has mandated the performance of in-depth due diligence and monitoring of specific money fund holdings. Fund families and other intermediaries are being flooded with inquiries around the safety of money funds and the specific holdings of these vehicles.

Noting there are high quality prime money funds in the market with little or no exposure to troubled securities, some investors are able to achieve comfort with the prime money market funds of several families and choose to continue their investment in prime funds. Others are taking the approach of exiting prime funds altogether moving into government and treasury money funds or treasury bills. As a result of the liquidity crunch and flight to quality, treasury prices have spiked dramatically, dropping the yields of

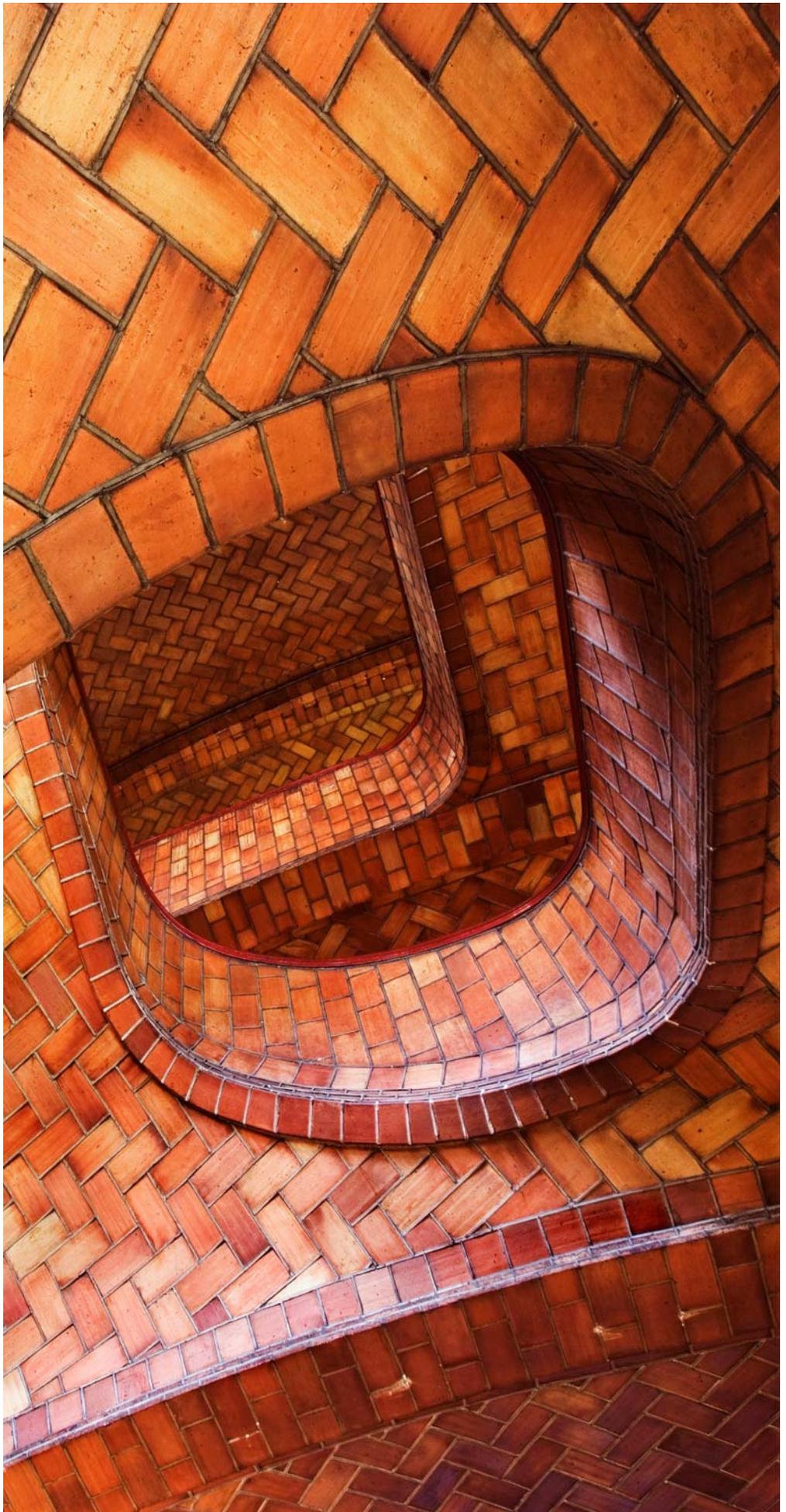
treasury only funds and treasury bills. Treasury yields were pushed to nearly zero at one point in September 2008.

Over the past decade, many treasury investors have turned to web-based investment portals to conduct investments in money funds and other instruments such as commercial paper. Portal investors have enjoyed the benefits of time savings, enhanced compliance, and earning competitive returns all on one consolidated web-based platform. The market's liquidity predicament further illustrates the power of an investment portal offering information on demand and a wide selection of investment choices. Some investment portals have proven very useful in facilitating investors' research by posting recent fund holdings, sub-prime/ SIV statements, fact sheets, prospectuses and other useful information directly on the portal. In addition to online information, investment professionals, who are assigned to clients by some portal providers, continue to prove instrumental in assisting clients with due diligence around sub-prime/ SIV exposure and general information regarding the liquidity crisis and how it's impacting the financial markets. For investors choosing to change their fund investments as a result of the liquidity crisis, an investment portal executes the move between funds in seamless fashion with a few clicks of the mouse.

The fed had launched a campaign of easing through early 2008, dropping the target rate significantly. Given Fed easing, money funds generally outperform most short-term issuers of commercial paper and certain other

corporate discount notes and government securities. As a result, many investors choose to shift their portfolios from individual security issuers into heavier concentrations of money funds during an easing campaign. An investment portal allows the investor to efficiently purchase a market of money funds, taking advantage of out-performance opportunities. Should the Fed pause easing for an extended period or reverse course into a tightening posture, portal users can easily redeem their money fund positions and reenter securities markets on the portal, purchasing instruments such as commercial paper and other discount notes. The portal arms the client with a tool that is useful in an array of prevailing market conditions.

The current market turmoil has caused a great deal of apprehension and uncertainty among short-term investors. Such difficulties in the short-term markets aren't historically unprecedented—in 1994, mostly because of exposure to Orange County debt, twenty fund families bailed out their money funds by purchasing troubled securities from their portfolios. It's difficult to predict when all of the liquidity issues will work themselves through the short-term capital markets during this current predicament. Now more than ever, investors are relying on the timely information available on their investment portals, access to a wide selection of investment possibilities, and their consultative relationship with investment professionals assigned to their accounts by portal providers to guide them through the turbulent market.





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Money Markets Funds: Money market fund 7-day yield performance represents past performance, which is no guarantee of future results. Yields may fluctuate. Although a money market fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in a money market fund, so shares may be worth more or less than original cost upon redemption. Investors should consider the investment objectives, risks, charges, and expenses of the fund carefully before investing. Investors should receive a prospectus that contains this and other information about the fund, and are advised to read it carefully before investing. The following factors, among many, could reduce any one fund's income level and/or share price: interest rates could rise sharply, causing the value of the fund's investments and its share price to drop; interest rates could drop, thereby reducing the fund's yield; any of the fund's holdings could have its credit rating downgraded or could default; there are risks generally associated with concentrating investments in any one industry; and the risk that a counterparty in any agreement could fail to honor the terms of its agreement. A fund's yield will fluctuate as the short-term securities in its portfolio mature and the proceeds are reinvested in securities with different interest rates.

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T Bills and Discount Notes: Not all obligations of the U.S. government or its agencies and instrumentalities are backed by the full faith and credit of the U.S. Treasury. Some obligations, such as those issued by the Student Loan Marketing Association and the Federal Home Loan Banks, are backed only by the credit of the issuing agency or instrumentality, and in some cases there may be some risk of default by the issuer. In addition, because many types of U.S. government securities trade actively outside the US, their prices may rise and fall as changes in global economic conditions affect the demand for these securities.