

Government Money Market Funds are Not All the Same

- Contrary to their reputation, government money market funds¹ are not all the same. These funds, which invest primarily in cash, government securities and/or repurchase agreements,² can offer a range of risks and returns.
- The view that all government money market funds are essentially alike is unfounded, as government fund managers have considerable discretion. Even considering these funds' relatively strict investment policies, active management matters.
- As a recent example of the differences, during both the October 2015 debt ceiling and the Federal Reserve December 2015 interest rate hike, funds that may have seemed alike on the surface delivered different risk and return characteristics.
- We think the differences among funds have been obscured by the low interest rate environment, but these differences matter over time—and are likely to draw more notice amid the implementation of money market fund reform.

As a manager of government funds, Goldman Sachs Asset Management espouses three principles: (1) We believe active management is central to government money market fund investing; (2) A combination of buy-and-hold and valued-based trading strategies leads to what we view as an optimal risk/return balance; (3) We believe government money market fund management should include credit risk oversight.

¹ Under Rule 2a-7 of the Investment Company Act of 1940, effective October 14, 2016 a government money market fund is a money market mutual fund with at least 99.5% of its underlying investments in government securities as required by the Securities and Exchange Commission.

² In a repurchase agreement, a dealer sells government securities to investors, usually on an overnight basis, and buys them back the following day.

Government Money Market Funds are Actively Managed Strategies, Too

In response to new money market regulations taking effect in October 2016, many investors are moving into government money market funds in search of simplicity, liquidity, and/or as a result of investment mandates that require stable net asset values (NAV).³ We think the view that all government money market funds are essentially the same—due in large part to their restrictive investment policies—is mistaken.

We see important differences within the category for investors who examine the topic closely. While it is true that, under the Securities and Exchange Commission's (SEC's) new rules, all government money market funds must invest at least 99.5 percent of their total assets in cash, government securities or government repurchase agreements (or "repos") that are collateralized by cash or government securities, even this seemingly restrictive investment universe can leave significant discretion in the hands of a fund manager.⁴ We view active management as an essential feature of government money market funds. Government money market funds are attractive for their diversified investment profile and the benefits of a manager trading and overseeing the portfolio. All funds have some component of active portfolio management. Accordingly, the fund manager's approach drives a government money market fund's risk profile and return potential.

All cash investments have some amount of risk, even if that risk is relatively small. We would argue that the safest, most conservative investments require more oversight and care, and we think the incorporation of more active management of a cash portfolio could result in a better risk / return profile over the long run. As is true in other areas of fixed income, government fund managers typically adopt a viewpoint about how to structure the portfolio from an asset mix—or investment type—and "term"—or maturity—standpoint, adjusting for the following factors:

- **Interest rates:** Managers take views about which part of the yield curve is likely to move and then position their portfolios accordingly. They establish an overall interest risk profile for the portfolio by blending maturities and fixed/ floating rate securities to achieve a certain weighted average maturity and a weighted average life.
- **Liquidity profile:** Managers must decide which types of investments to include by weighing faster access to cash (typically better liquidity) versus investing for return potential (typically poorer liquidity). Additionally, certain investments may be susceptible to short-term supply/ demand dynamics, creating periods of poorer liquidity.
- **Credit risk:** To the extent the portfolio includes repurchase agreements (or "repos"), managers might also evaluate any potential credit risk presented by the obligors to the agreements (or "repo counterparties"). Managers may take viewpoints on movements of LIBOR⁵ versus the Treasury curve, which can be a proxy for credit risk in the markets. Finally, if certain government entities may be subject to "headline risk," managers may evaluate those risks as well.

Disruptive Market Environments Can Illustrate Government Fund Differences

Many investors appropriately think of US government investments as among the most conservative investments in the world. It may therefore be easy to forget that all investments must still be managed for potential risks—particularly during periods of market disruption. Recent years have unfortunately given investors numerous examples of events that can impact short-term liquidity markets and the supply/demand dynamics for government assets, including: the downgrades of the US Government and several European sovereigns, the downgrade of several

³ Source: GSAM, Crane Data.

⁴ Source: Securities and Exchange Commission's Rule 2a-7.

⁵ **London Interbank Offered Rate** is a benchmark for short-term interest rates in the London interbank market and accepted as an indicator of overnight bank lending rates.

large banks globally; the Greek crisis, the US debt ceiling negotiations, the implementation of new bank regulation globally and, most recently, money market fund reforms in the United States.

Investors can examine government money market fund managers' differing approaches by reviewing the contrasting risk and return profiles they exhibit during volatile periods. Here, we examine the impact of two consecutive events at the end of 2015 that illustrated differences in liquidity, risk, and return profiles of government money market funds: the debt ceiling negotiations in October 2015 leading into the Federal Reserve interest rate hike in December 2015.

October 2015 Debt Ceiling

In the months before the October 2015 debt ceiling impasse, many investors—including government money market fund managers—were concerned about holding Treasuries if the government reached its borrowing capacity (i.e., “hit the debt ceiling”). For this reason, fund managers were forced to assess the likely market impact of this threat. At issue were potentially important decisions on how much to shorten maturities,⁶ which instruments to own, and how to assess the possibility of investor outflows and poorer market liquidity.

Viewpoints about the potential impact varied widely. Some market participants were concerned about an outright default on Treasury bills maturing at the debt ceiling. Others were less concerned about a Treasury default but nevertheless avoided certain maturities due to concerns over potential NAV risk if there were large market outflows from Treasuries. Coming into October, such differences in opinion led to fairly significant divergence in funds' positioning, maturity profiles, and yields.

December 2015 Rate Hike

Once the debt impasse was resolved, managers were immediately faced with a new challenge: the prospect of a potential Federal Reserve rate hike heading into year-end. Traditionally, money market fund rates move in relation to Fed rate increases,⁷ so managers began to take different views about when and how to take advantage of potential upside. In the case of December 2015 specifically, money market fund managers were concerned about the potential for unprecedented year-end inflows into government assets, as financial institutions began to comply with new regulatory bank capital requirements. The result was debate about how soon and how much to extend weighted average maturity⁸ or credit quality of the funds.

In the case of the December 2015 hike, short-term rates began to move higher in October due to a combination of bank balance sheet constriction, an increase in supply of Treasuries in the market and anticipation of the Fed's move. In this case, deploying liquidity, i.e. buying longer dated assets, prior to the December rate hike was a way to take advantage of the unique market opportunity, which resulted in a greater advantage than doing so after the rate hike, as supply spiked just before the Federal Open Market Committee meeting. Those who extended maturity profiles in advance of the Fed tightening were able to take advantage of yield increases, while those who waited could not. From a capacity standpoint, year-end flows were handled in an orderly fashion, as many funds increased exposure to the Fed's Reverse Repo Program to absorb excess demand.

We believe investors who perceive these differences as small should consider the effect of a low rate environment. Over long time periods, seemingly small differences can add up, both in terms of risk management and potential upside from certain strategies.

⁶ Shortening maturities is defined as buying investments, in this example Treasuries, that have a shorter maturity as those in the existing portfolio approach expiration.

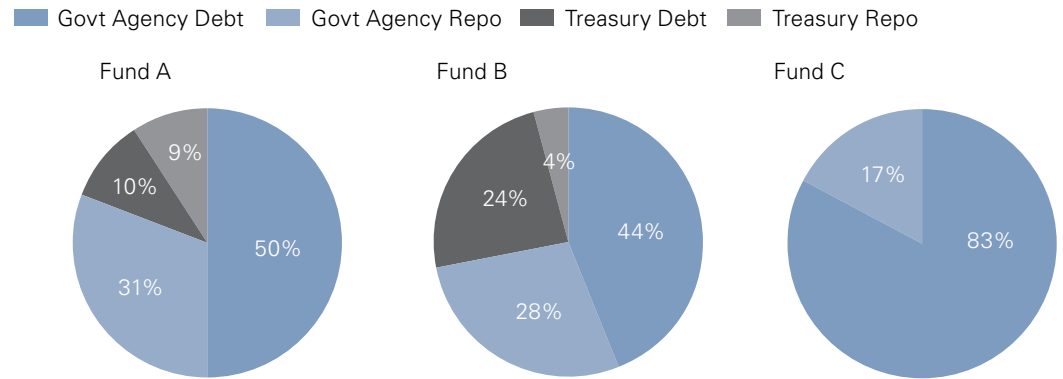
⁷ Source: GSAM.

⁸ **Weighted average maturity** is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates.

Exhibit 1: Fund Positioning At Rate Hike

The exhibit below illustrates the positioning differences among three illustrative funds heading into year-end. Each fund had different positioning from an asset mix (as illustrated by the different investment allocations).

While Fund A and Fund B had similar exposure to floating rate instruments (as illustrated by their similar WAL), Fund A extended further out the curve (as noted by its longer WAM), resulting in a slightly higher yield. Meanwhile, Fund B and Fund C had overall similar interest rate exposure (as exhibited by similar WAM), but Fund B had more floating rate instruments (as illustrated by its longer WAL), resulting in a meaningfully higher yield than Fund C.



	Fund A	Fund B	Fund C
Weighted Average Maturity	55	37	39
Weighted Average Life	113	107	81
Net Yield	0.19%	0.17%	0.04%

Source: iMoneyNet December 31, 2015 For Illustrative Purposes Only. Any mention of an investment decision is intended only to illustrate our investment approach and/or strategy, and is not indicative of the performance of our strategy as a whole. It should not be assumed that any investment decisions shown will prove to be profitable, or that any investment decisions made in the future will be profitable or will equal the performance of the investments discussed herein. A complete list of past recommendations is available upon request. Please see additional disclosures.

Manager Selection Matters with Government Money Market Funds

Even under the SEC's new rules, government money market fund managers retain significant leeway to differentiate their approaches, with potential ramifications for investors from a risk/return standpoint. As such, we believe due diligence around manager selection will remain vital to choosing government money market funds.

Exhibit 2 enumerates potential questions for investors evaluating different government money market fund managers

Exhibit 2: Government Money Market Fund Manager Evaluative Measures

Topics	Potential Questions
Interest Rate Risk	<ul style="list-style-type: none"> ■ How does the manager assess macroeconomic risks? ■ What are the inputs to the manager's interest rate viewpoints? How are those views formulated? ■ What are examples of times in the past when the funds have had significant duration repositioning? What were the drivers?
Liquidity Risk	<ul style="list-style-type: none"> ■ How does the manager define and identify liquidity risk in the fund? ■ How does the manager gauge investments' liquidity risk? ■ How does the manager take into account investor flows in assessing liquidity risk of the strategies? ■ What are examples of poorer liquidity markets in the past, and what was the manager's approach during those times?
Credit Risk	<ul style="list-style-type: none"> ■ What is the manager's philosophy about potential credit risk? ■ What is the credit process for evaluating counterparty exposure?
Portfolio Management Experience	<ul style="list-style-type: none"> ■ How long has the team been managing government strategies, and through what market cycles? ■ What is the scale and size of the manager's business, and what is the extent of their dealer relationships?
Return Profile	<ul style="list-style-type: none"> ■ How competitive have returns been versus peers? Why were returns higher or lower than peers? ■ How much of performance is a function of portfolio management approach vs. fees vs. a combination of both?

Source: Source: GSAM. For illustrative purposes only.

In our view, investors should look for government money market fund managers who are primarily focused on risk management and liquidity needs. Enhanced returns are what we view as a secondary goal, but still something investors should evaluate. We believe active management that combines disciplined buy-and-hold and opportunistic value-based trading is the best approach for achieving this balance. We believe that enough points of differentiation exist among government money market funds for investors to find a suitable fund for their risk/return objectives.

GSAM's Approach to Managing Government Money Market Funds

- GSAM has a long commitment to managing government money market funds. Our approach to managing government money market funds is built on three foundational beliefs: **Active management is central to government money market fund investing.** Our money market portfolio management team at GSAM works closely together as a global team covering government, prime and tax-exempt portfolios in multiple countries and currencies. We believe that all of our money market funds should be managed with the same stringent level of oversight. We prepare for the potential impacts of market forces, including central bank policy, supply demand dynamics, and risk sentiment to affect government and prime strategies alike. On an ongoing basis, our team incorporates insights from Goldman Sachs specialists around the globe to help frame our views on interest rates, liquidity and valuations.
- **A combination of buy-and-hold and valued-based trading strategies leads to what we view as an optimal risk/return balance.** Our approach is foremost focused on risk management. In all money market fund strategies, but in government strategies in particular, we believe that investors are principally concerned with minimizing portfolio risk. Historically, our team has achieved additional returns as a secondary goal, using an approach designed to minimize risk and provides liquidity. We balance these goals by taking a flexible approach to managing investments, deploying both a “buy-and-hold” strategy—in which investments are held to maturity—as well as a “value-based trading” strategy—in which investments are bought or sold based on price appreciation or liquidity opportunities.
- **Government money market fund management should include credit risk oversight.** Generally speaking, government money market funds have little credit risk exposure, by virtue of their focus on government securities. In the case of repurchase agreements, credit risk is minimized through the use of over-collateralization⁹ with government securities. Nevertheless, we believe it is still important to have a level of credit oversight in managing government money market funds.

Conclusion

Not all government money market funds are the same. Active managers play what we see as a decisive role in shaping the risk and return profiles of these funds, which are often mistaken as commoditized or essentially alike. For this reason, the reality is that investors who take a closer look can find important differences. As today's low interest rates give way to a more normalized rate environment in the coming years, we expect the differences between funds to become more recognizable—and we think that investors who understand the differences today may have a competitive advantage as they address their liquidity needs.

⁹ **Over-collateralization** is the process of posting more collateral than is needed to obtain or secure financing

Disclaimer

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Date of first use: October 11, 2016. Compliance Code: 43976-OTU-249109.