

Prime Time to Rethink Prime Funds

The world of money market funds is in a state of flux. Cash and liquidity investors are examining new regulations taking effect in October 2016 to see if their investment decisions and practices need rethinking. We believe the implications of regulatory reform for certain fund types—though widely discussed—ultimately depend on implementation details. As a result, we expect the impact on cash management practices may come as a surprise to some investors, since many of the details are only now being closely examined.

The biggest change, in our view, is a requirement that institutional prime and municipal money market funds adopt a floating net asset value (NAV). Prime funds are money market funds that primarily invest in corporate debt securities. Municipal money market funds are money market funds that primarily invest in municipal debt securities. This will transform institutional prime and municipal money market funds from a stable \$1 price per share to a floating net asset value. These funds will also be potentially subject to liquidity fees and redemption gates if needed to preserve value for all investors in the fund. (Government funds' features will remain unchanged.) The U.S. Securities and Exchange Commission's amendments to Rule 2a-7 will allow a money market fund to impose a liquidity fee of up to 2%, or temporarily suspend redemptions (also known as a "redemption gate") for up to 10 business days in a 90-day period, if the fund's weekly liquid assets fall below 30% of its total assets and the fund's board of directors (including a majority of its independent directors) determines that imposing a fee or gate is in the fund's best interests. Finally, many prime funds will introduce new, multiple intraday price points ("multiple NAVs") with associated redemption windows during which cash can be accessed by investors. This last change, in our view, will fundamentally alter the role of institutional prime funds to a "plan ahead" vehicle from a same-day liquidity vehicle.

The money market industry's turn to multiple NAVs reflects an effort to preserve the same-day liquidity benefits that prime funds have historically offered. But we think many investors will find multiple intraday price points and corresponding redemption windows too complex, and will opt instead for government money market funds for daily or unpredictable liquidity needs, since these funds will continue to offer their traditional liquidity features. Investors will need to choose between 1) rapid access to cash and stable NAVs or 2) a potentially more attractive yield with less frequent access to cash and higher principal risk due to potential volatility of NAVs.

Our view is that prime funds can continue to play a vital role serving many investors' cash and liquidity needs. Like money market funds more generally, prime funds time and again have adapted to new market environments, regulations, and fund features. This time, too, we believe the industry and investors will adapt, likely gravitating to prime funds that offer a single daily NAV, since the simplicity of this approach enables a focus on core features such as same-day liquidity and incremental return. What follows is our roadmap for rethinking the role of prime funds.

New Features, Additional Choices

Soon-to-be-implemented features such as multiple NAVs and multiple redemption windows are intended to help preserve prime funds' historically quick and convenient access to cash. Despite that intention, we believe that these new features have unnecessary complexity that some investors may not like, and offer questionable utility for them.

The variety of prime fund offerings is set to grow, as fund companies have reached differing conclusions over when and how frequently they will price prime funds. Besides multiple NAVs and associated redemption windows varying from provider to provider, the introduction of a redemption feature in certain funds which allows investors to access their money the following day ("T+1") expands prime funds substantially beyond their traditional features. Goldman Sachs Asset Management does not plan to offer this feature ("T+1") at this time due to concerns about shareholder fairness and input from clients about challenges associated with the implementation of this feature.

We believe the proliferation of prime-fund options creates a more complex and confusing set of products, replacing prime funds' historic simplicity and ease of use. Such a change is likely to prompt investors to reassess what they truly need in a money market fund. Against this backdrop, we believe that prime funds may no longer make sense for unpredictable daily liquidity needs, despite the fact that multiple price points were intended to serve just those needs.

We believe that the movement to floating NAV funds will likely be evolutionary—with investors adjusting over time to the new features and eventually adopting new cash management practices. We believe that as a practical matter, multiple-NAV functionality will not be used for certain types of cash investing at all, due to outsized complexity and additional market risk compared to its benefit to the investor. For example, institutional sweep accounts may be more easily implemented with funds with only one NAV—if not exclusively in government money market funds.

Even for investors who may prefer multiple NAVs, it is unlikely that this functionality will be needed by most investors on "day one" of the new regulatory requirements. Investors who are not planning on initially using funds for unpredictable cash flow may not need this intraday liquidity.

Prime money market funds will likely play an important role in what we call the "on-demand" liquidity bucket for many investors, potentially offering more attractive yields than government money market funds and different liquidity than bank deposits or other product structures such as private placements or separate accounts. The benefits of a more attractive yield of a prime fund comes with the sacrifice of adopting a floating NAV.

Simplicity Matters

Regulatory change will soon force investors to choose between 1) rapid access to cash and stable NAVs or 2) more attractive yield with less frequent access to cash and higher principal risk due to potential volatility of NAVs. In our experience, investors prefer simplicity. We believe many prime fund investors will move to government funds to meet intraday liquidity needs, since government funds give them the same experience they have enjoyed in the past.

Our institutional clients tell us that, generally, the following interrelated needs are likely to govern their use of prime funds:

- Attractiveness of yields, particularly versus \$1.00 stable NAV government MMFs;
- An understanding of the frequency and magnitude of the fluctuation of the floating NAV;
- A familiarity with fund liquidity and comfort with the probability of fees and gates;
- Ease of implementation from an operational and reporting standpoint (in particular, from a tax and accounting standpoint)

Heading into October 2016, the money market fund industry has viewed the introduction of multiple-NAV funds as a potential solution for some investors for the first three of these needs. At Goldman Sachs Asset Management, we, too, have seen merit in expanding the range of solutions in order to meet client demand. At the same time, we feel strongly that single-NAV solutions are likely to emerge as a preferred starting point for many investors who remain committed to using prime funds, while investors interested primarily in intraday liquidity are likely to consider moving to government funds, which will preserve their traditional liquidity features.

As we have explored the additional potential operational risks and legal requirements, particularly for intermediaries, we believe that certain investors will prefer one NAV per day for its relative simplicity and same-day liquidity feature.

Exhibit 1 presents an example of how multiple-NAV funds could be viewed as limiting access to cash when compared to government funds. Under the old money-market rules, investors generally could access money in prime funds on an hourly basis. In multiple-NAV prime funds, a need for precise timing of trade execution arises.

For instance, we expect situations in which a redemption request made at 8:05 a.m. may take more than three hours longer to receive proceeds when compared to a similar request made at 7:55 a.m. The difference results from the redemption window closing at 8:00 a.m. for the 7:55 request and at noon for the 8:05 request. This would be a departure from the past, when a difference of ten minutes was generally immaterial.

This example highlights one of the reasons we believe investors may need to change existing cash management or trade placement practices built around historically flexible timing requirements.

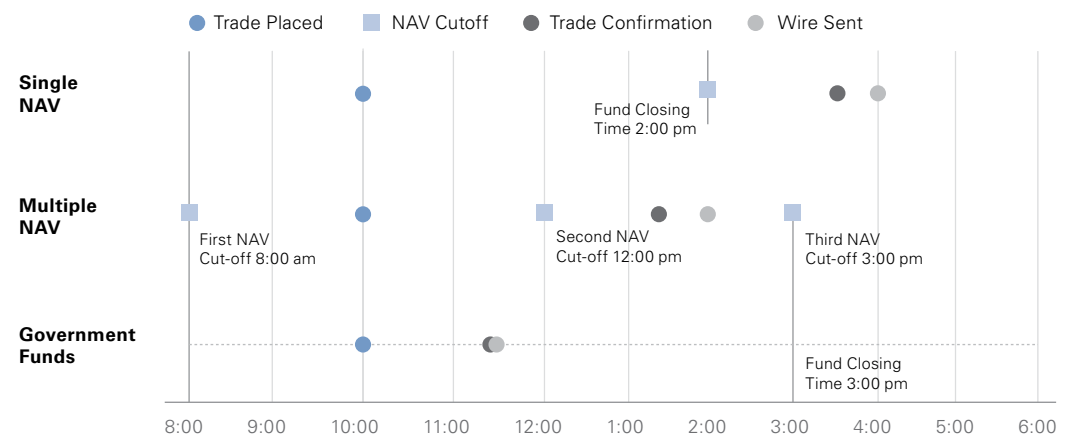
It may be simpler for investors to redeem prime-fund holdings ahead of the anticipated liquidity need, and invest in government funds to facilitate intraday liquidity when needed due to their ability to provide liquidity on an hourly basis.

We believe that institutional investors who come to view multiple NAVs as constraints on redemptions may perceive diminished utility of multiple NAV funds—increasing the relative attractiveness of government and single-NAV prime funds.

In turn, financial intermediaries may recognize that the relatively simple operational, legal, and reporting requirements of single-NAV funds may suffice for many investors.

Exhibit 1: Timing of Liquidity in a Hypothetical Multiple NAV Fund

Exhibit 1 shows the timing in liquidity across three product types. A redemption placed at 10 a.m. in a fund with a single NAV would mean cash is received around 5 p.m. In a multi-NAV fund, cash would be received around 2 p.m. For the same transaction in a government fund, cash would be received approximately 90 minutes later, around 11:30 a.m.



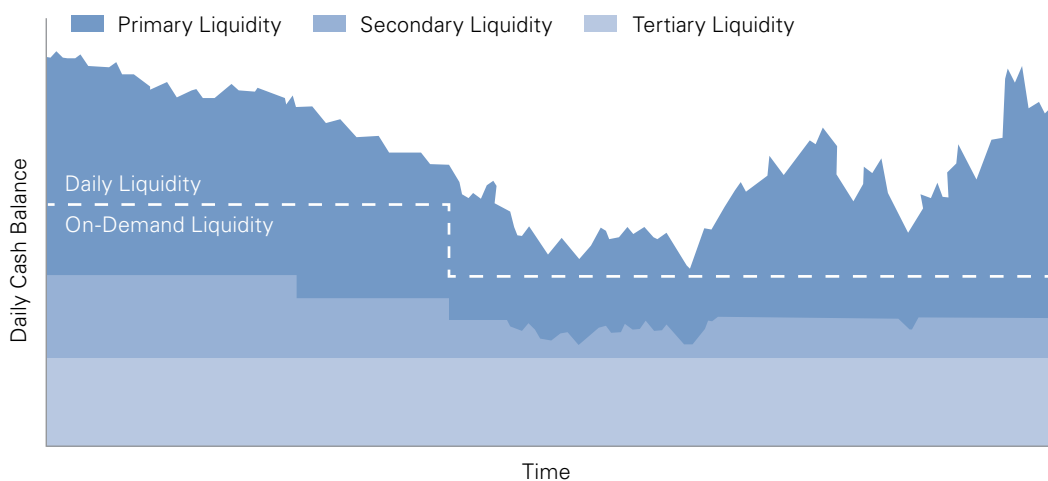
Source: GSAM. For Illustrative Purposes Only Timelines are for illustrative purposes only. All times shown in EST. GSAM Government Fund complex has fund closing times between 3:00 p.m. and 5:00 p.m.

Less May Be More

A focus on simplicity can also help investors adapt to the new world while still capturing the potential benefits of prime funds. We believe investors are likely to gravitate to prime funds that offer a single daily NAV, as the simplicity of this approach will allow them to continue to focus on core features including same-day liquidity and incremental return. We believe investors today should think of their liquidity needs across three buckets: primary liquidity, which consists of two types of cash needs (daily liquidity and on-demand liquidity), as well as the longer-term secondary and tertiary buckets. Secondary liquidity is defined as having an investment horizon of 12 months or longer and tertiary liquidity has an investment horizon longer than 12 months. Today, a fund serving an on-demand liquidity need may differ from one which serves longer-term needs.

We see prime funds today fitting into primary liquidity as an on-demand liquidity option, where cash is not needed every day, and there is desire for incremental return potential versus daily liquidity options.

Exhibit 2: Active Liquidity Management



	Primary Liquidity		Secondary Liquidity	Tertiary Liquidity
	Daily Liquidity	On-Demand Liquidity		
Investment Horizon	0-6 months	Less than 12 months	12 months or longer	Indefinite
Cash Flow Volatility	Very High	High	Low	Very Low
Objective	Preservation of capital and immediate liquidity	Preservation of capital and liquidity	Enhanced return and preservation of capital	Greater emphasis on maximizing return potential
Strategy	Money Market	Prime MMFs/ Ultrashort Duration Funds	Short Duration	Broad Fixed Income

Source: GSAM. For Illustrative Purposes Only Goldman Sachs does not provide accounting, tax or legal advice. The white line designates the new bifurcation of primary liquidity. Short duration bonds may invest in corporate and other investment-grade US fixed income issues that have a duration of one to 3.5 years. Please see additional disclosures at the end of this presentation. Investments in fixed income securities are subject to the risks associated with debt securities including credit, liquidity and interest rate risk. An investment in a money market portfolio is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although a money market portfolio seeks to preserve the value of an investment at \$1.00 per share, it is possible to lose money by investing in a money market portfolio. The Fund's sponsor has no legal obligation to provide financial support to a money market portfolio, and you should not expect that the sponsor will provide financial support to the money market portfolio at any time.

Conclusion

In our view, prime funds are and will remain an important investment vehicle for liquidity management needs. We believe a single-NAV prime fund, particularly at the inception of the new rules, may be the simplest way to invest in institutional prime funds. Prime funds have fundamentally changed as a result of the new rules. However, they will still be a viable option for “on-demand” primary liquidity—and are designed to offer many of the historical benefits of scaled, pooled liquidity investment vehicles.

General Disclosures

Views are as of May 18, 2016 and subject to change in the future.

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Date of First Use: October 11, 2016. Compliance code: 48442.

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