INTRODUCTION

Traditionally, money market funds have been a safe vehicle for investors to store money, and they have been a significant part of the economy in terms of generating short-term capital. Money market funds fell under scrutiny during the economic downturn when the Reserve Prime Money Fund “broke the buck” in 2008; net asset value (NAV) fell below $1.00. This breaking of the buck could have frightened investors into redeeming shares of money market funds, which would lead to a drop in demand for commercial papers. Firms would no longer be able to roll over short-term debt; thus, a liquidity crisis would have occurred. To help revive the market, the Federal Government took two steps. One, the Treasury announced a program guaranteeing money market fund assets for funds that enrolled in the program. Two, the Federal Reserve lowered the short-term interest rate, pulling down yields of money market funds. Recently money market fund yields have been low enough to discourage potential investors. This paper will determine how far money market fund yields have fallen and if the falling yields have affected money market fund expenses.

KEY POINTS:
1. Yields have decreased significantly in the past two years.
2. Total expenses have decreased slightly in the past two years.
3. Management fees have decreased, which is likely due to an increase in management fee waivers.
4. Over 90%, over $3 trillion, of money market fund assets were covered by the Treasury guarantee program. The program cost mutual funds one to two basis points in expenses. This program could explain why total expenses remained virtually the same while management fees decreased.

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YIELD CHANGES

Money market fund yields have fallen considerably from their 2007 high. In this paper, money market yields are defined as the average annual rate of return on an investment, as paid in dividends or interest per year. Figure 1 displays the average yield for money market funds for each calendar year compared to the year-end Federal Funds Rate. The Federal Funds Rate and money market fund yields have a correlation of 0.772, which indicates a strong, positive relationship: as the Federal Funds Rate increases, so do money market fund yields. The opposite is also true. In this decade, the Federal Funds Rate and money market fund yields increased dramatically in 2004 and 2005 and remained high in 2006 and 2007. They both decreased sharply in 2008 and 2009. Average yearly money market fund yields were at their high in 2007 at 4.36%, whereas, in 2009 they decreased to 0.12%. This is a decrease of 4.24% yield or 97.2% of the 2007 yield. A similar pattern is seen with the Federal Funds Rate. The Federal Funds Rate decreased 4.12% or 97.2% of the 2007 rate. A $1,000.00 investment with a 4% yield returns $40; whereas, a $1000.00 investment with a 0.4% yield returns $4. The current yields for money market funds are well below this.

Figure 2 shows the average annual yield for all money market funds as well as separate lines for institutional money market funds and retail money market funds. Institutional money market funds typically have a high minimum investment and are offered to corporations, governments, and fiduciaries. Retail money market funds are offered to individual investors and have relatively low minimum initial investments. For the most part, institutional and retail money market fund yields trend nearly identical; however, retail money market yields tend to be just below those of institutional money market yields. Institutional funds typically have higher yields than retail funds. This is likely due to retail fund’s higher expenses. In 2009, average money market yields are 0.170% for institutional money market funds, and 0.080% for retail money market funds.

EXPENSE CHANGES

In order to combat these historically low yields, one would expect money market funds to waive a high percent of management fees or decrease nonmanagement expenses. Lower expenses will allow investors to realize a positive return on their investment despite low yields. Figure 3 shows the asset-weighted average total expense ratios for both retail and institutional funds, as well as, aggregated ratios for all money market funds. Year over year, total expense ratios for money market funds have decreased, with one exception. Institutional money market funds asset-weighted average total expense ratios bounced around from 2003-2005 but have fallen in a consistent downward trend since then. On average, total expenses decreased 3% per year for money market funds, excluding the year 2001. There is no dramatic decline in total expenses in 2008 or 2009, as might have been expected considering the low yields. This may be due to the cost Treasury guarantee program. For the original program offering, the Treasury covered more than $3 trillion in money market fund assets, over 90% of money market fund assets. The program cost each fund between 1 and 2 bps. This could explain why there was not a dramatic decrease in the total expense ratios. Figures 4 and 5 look specifically at the management fee component of the total expense ratio.

Figure 4 displays asset-weighted average management fees for money market funds. Management fees have slowly declined since 2002. For both institutional and retail money market funds, the decrease in management fees year over year has been between 3% and 5%. There is a departure from the norm in 2009. The decrease in management fees from 2008 to 2009 was 14% for retail funds and 6% in institutional funds. The differences between retail money market fund expenses and institutional money market fund expenses are even more pronounced when examining asset-weighted average management fee waivers (Figure 5). In 2009, management fee waivers for retail money market funds were almost double the amount 2007; 7.5 basis points (bps) compared to 3.7 bps. Conversely, institutional money market funds have slightly decreased their management fee waiver moving from 4.9 bps to 4.4 bps.
“A $1000 investment with a 4% yield returns $40; whereas, a $1000 investment with a 0.4% yield returns $4.”
CONCLUSION

Yields for money market funds have decreased significantly in the past two years. To combat the decreasing yields, retail money market funds began waiving management fees. Total expense ratios, however, did not see a dramatic decreases. This may be due to the expense the Treasury Guarantee program that increased money market fund expenses. In addition to the aggregate expense changes, retail money market fund expenses have shifted closer to institutional money market fund expenses. The difference between retail and institutional money market funds is most pronounced when considering management fee waivers. The increase in the waiver amount indicates that the change in expenses is not permanent. Management fee waivers can be changed more easily than contractual management fees. We would expect, as the economy recovers and the Federal Funds Rate is increased along with the elimination of the Treasury Guarantee program, money market fund yields will also rise. At that point, retail money market funds are likely to stop waiving fees and resume regular expenses.