Money Markets Under Siege

How Interest Rates, Lawsuits, and Regulations will Forever Change Money Market Funds

Agenda

- What are the New Money Market Regulations
- How will my Money Funds be Impacted
- What Risks Exist in the Money Market Arena
- What Role do Cash Equivalents Play in an Effective Defined Contribution Plan
- What are the Alternatives to Money Market
- What Steps Should I Take Next
- How do I Best Document my Decision Making Process

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Prior to founding the Multnomah Group in 2003, Erik served as a Vice President of Retirement Services and led the Portland, OR practice of a national retirement services firm. In that position Erik was a founding member of the firm's national Investment Committee and had oversight for business development in the western United States.

Erik is a member of the CFA Institute, the CFA Society of Portland, the CFA Society of Seattle, the American Society of Pension Professionals and Actuaries, the Portland Chapter of the Western Pension & Benefits Council, and the Society for Human Resource Management. Erik holds a B.B.A. from the University of Iowa.

Fixing the Gate Once the Horse Has Left the Barn

- September 16, 2008 the Reserve Primary Fund “broke the buck”
- September 29, 2008 the US Treasury Department established a Temporary Guarantee program for Money Market funds
- US Treasury assessed a fee of 0.01% on impacted funds
- September 18, 2009 Guarantee program expires
- US Treasury had no claims and earned approximately $1.2 B in participation fees
- June 5, 2013 SEC proposes Rule 2A-7 designed to limit money market investments in
  - the securities of any one issuer of a first tier security to no more than 5% of fund assets
  - the securities subject to a demand feature or a guarantee to no more than 10% of fund assets from any one provider
- On July 23, 2014 the SEC adopted final amendments to Rule 2A-7
- October 14, 2016 is the final effective date for changes in product structure

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Average Money Market Returns Since 2008

Year	Average Money Market Fund Return
2009	0.17%
2010	0.04%
2011	0.02%
2012	0.03%
2013	0.01%
2014	0.01%
2015	0.02%
2016 YTD (March 28, 2016)	0.02%

Money Market Fund Reforms

- Basic Reforms:
  - Floating NAV for Institutional MMFs
    - Retail and US Government Funds exempt
  - Liquidity fees and gates for all non-government MMFs
  - Increased diversification and stress testing
- Timeline
  - April 14, 2016 – Diversification, stress testing, additional disclosures, new SEC forms
  - October 14, 2016 – Conformance with FNAV, fees and gates

Examples of Types of Retail and Institutional Accounts

Examples of Types of Retail Accounts	Examples of Types of Institutional Accounts
Natural persons represent the beneficial ownership interest of these accounts	Natural persons do not represent the beneficial ownership of the accounts
• Individual accounts (brokerage or mutual fund) • Retirement accounts, including workplace defined contribution plans • College savings plans • Health savings plans • Ordinary trusts • Accounts sold through intermediaries with the underlying beneficial ownership being a natural person	• Accounts with registrations based on tax identification number with the beneficiary not being a natural person • Small business accounts • Defined benefit plans • Endowments

*Data from Fidelity Investments

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Structural Changes to MMFs in Final SEC Rules

Fund Type	SEC Classification	NAV	Redemption Fees and Gates
US Treasury	**N/A**	**Stable**	**No**
Government	**N/A**	**Stable**	**No**
Municipal Money Market Fund, with all natural person investors	Retail	Stable	Yes
Municipal Money Market Fund with Institutional Investors	Institutional	Floating	Yes
Prime Money Market with Institutional Investors	Institutional	Floating	Yes
Prime Money Market Fund with Only Natural Persons	Retail	Stable	Yes

*Data from [Fidelity Investments]

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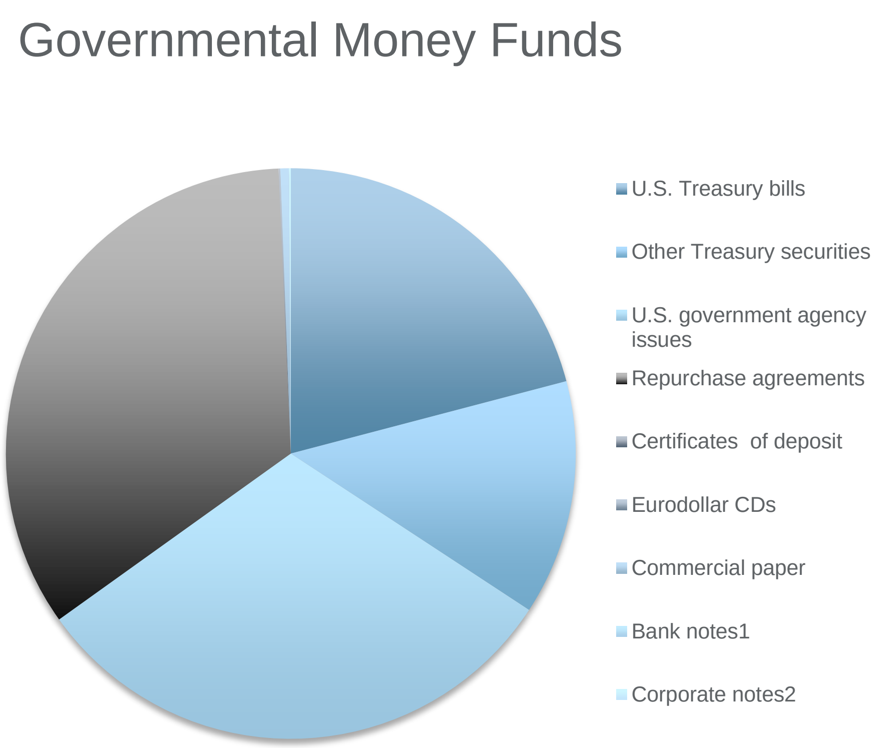
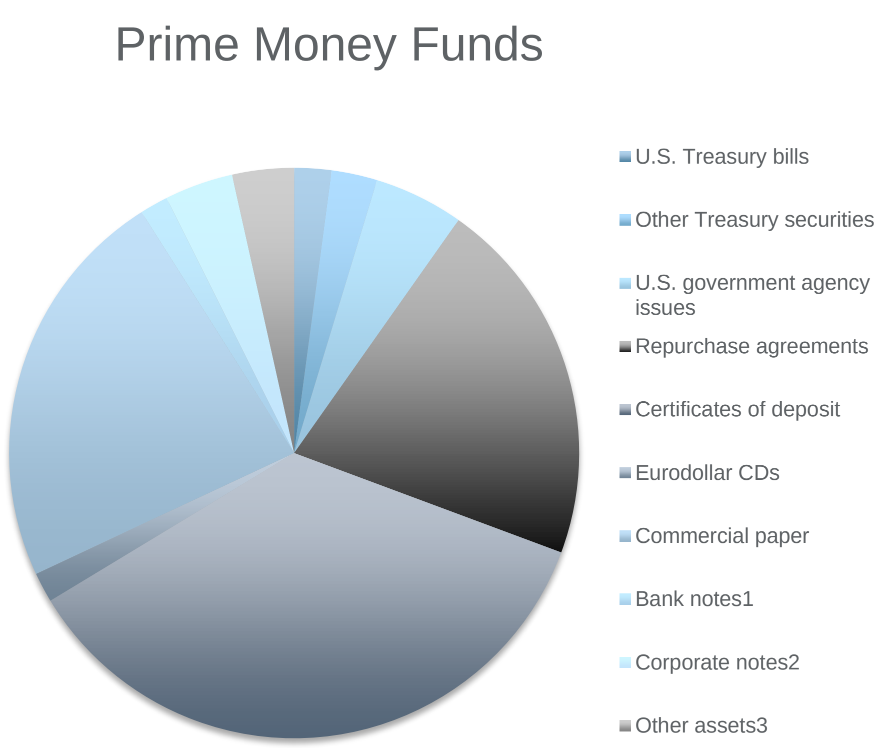
Final SEC Rules

Reform	Final SEC Rule	Implementation Date
Floating NAV	• Applicable funds will price and transact at a net asset value per share that can change, or “float” based on pricing the underlying fund holdings out to four decimal places	October 14, 2016
Liquidity Fee	• If a fund’s weekly liquid assets were to fall below 30%, fund’s board may impose a 2% fee on redemptions • If a fund’s weekly liquid assets were to fall below 10%, redemptions will be subject to a 1% fee, unless fund’s board determines otherwise	October 14, 2016
Redemption Gate	• If a fund’s weekly liquid assets were to fall below 30%, fund’s board may suspend redemptions for up to 10 days	October 14, 2016
Retail Fund Definition	• Retail fund limit shareholders to beneficial ownership by “natural persons” (individuals) • Institutional funds are open to any shareholders, including individuals, small businesses, and large corporations	October 14, 2016

*Data from Fidelity Investments

Governmental Funds vs. Prime Funds





*Data from [Investment Company Institute]

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Impact on Retirement Plans

- Move to higher quality government debt and shorter duration positions will likely reduce expected returns
  - Risk and return are correlated
- Ability to trigger fees and gates at the participant and plan sponsor level
- Disclosure responsibilities
  - 408(b)2
  - 404(a)5
- Closer examination of the "cash equivalent" strategy
- Plan sponsors are likely to move to government and treasury funds to avoid redemption gates, liquidity fees, and floating NAV
- Plan sponsors will need to evaluate the role of cash equivalents in a defined contribution plan

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Legal Risks to Money Market Funds

- Anthem Inc. – Offered the Vanguard Prime Money Market Fund as its sole capital preservation fund, which returned 6 BPs at its highest over 2010 to 2014
- Insperity Inc. – Used a money market fund that only returned 1 BP over the 2010 to 2014 period
- Chevron Corporation – Challenges the decision to use money market fund, rather than a lower-cost stable value fund and alleges that excessive fees were paid. Also alleges that Chevron should have considered separate accounts, collective trusts, and lower share class investments

"You could have had your money under the mattress that whole time. Inflation is greatly exceeding the amount of that return, which we allege is microscopically low." – Jerry Schlicter, Schlicter Bogard & Denton

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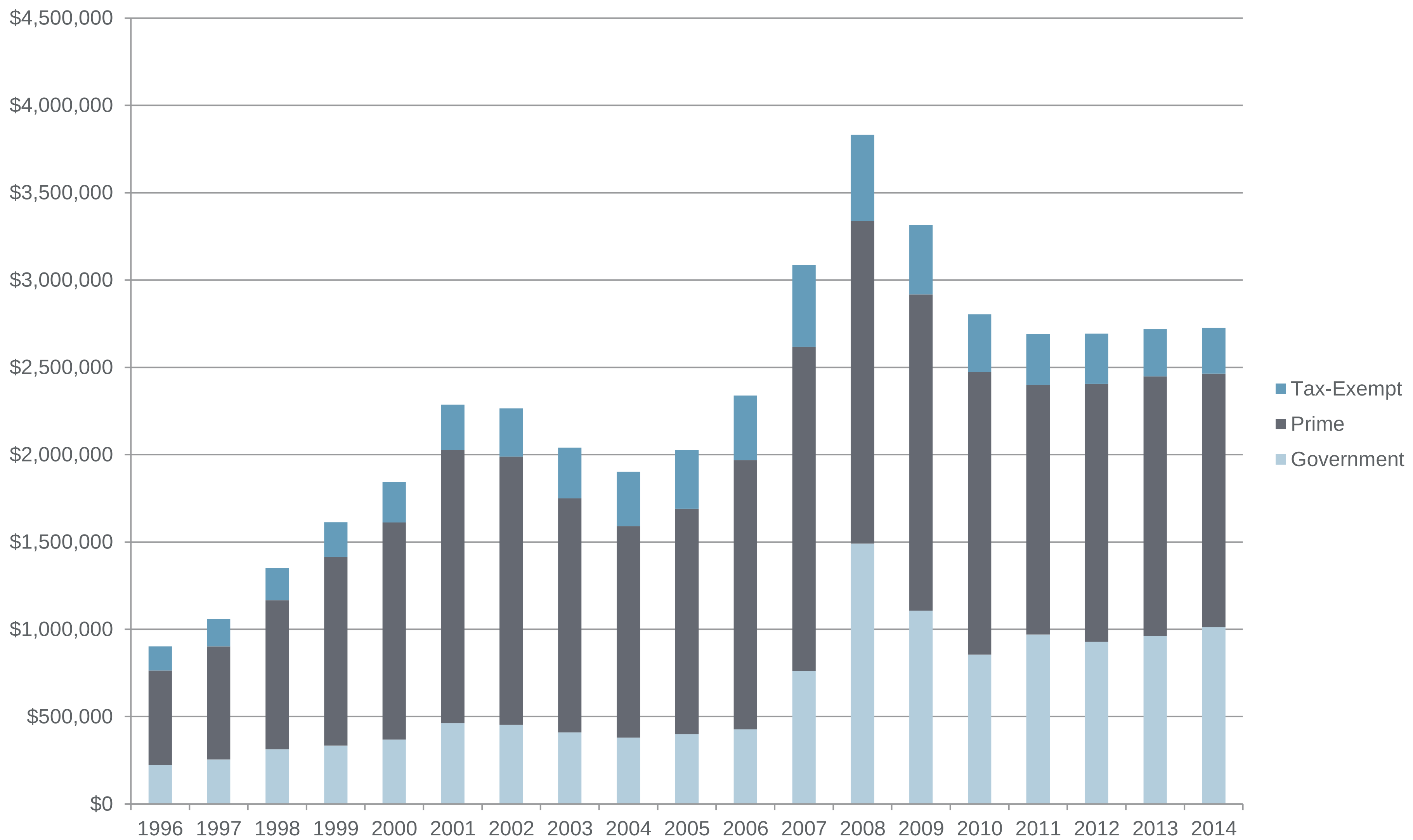
Size of the Money Market Industry Remains Strong



*Data from Investment Company Institute

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What Role Does Cash Equivalent Play in Defined Contribution Plans

- Roughly 50% of defined contribution plans still offer money market funds as an investment option
- Prior to the Pension Protection Act (PPA) many sponsors defaulted participants to money market funds
- While not legally required:
  - ERISA 404(c), referring to offering different asset classes and participant choice, encourages continuing use of cash equivalents

Cash Equivalents in the New Environment

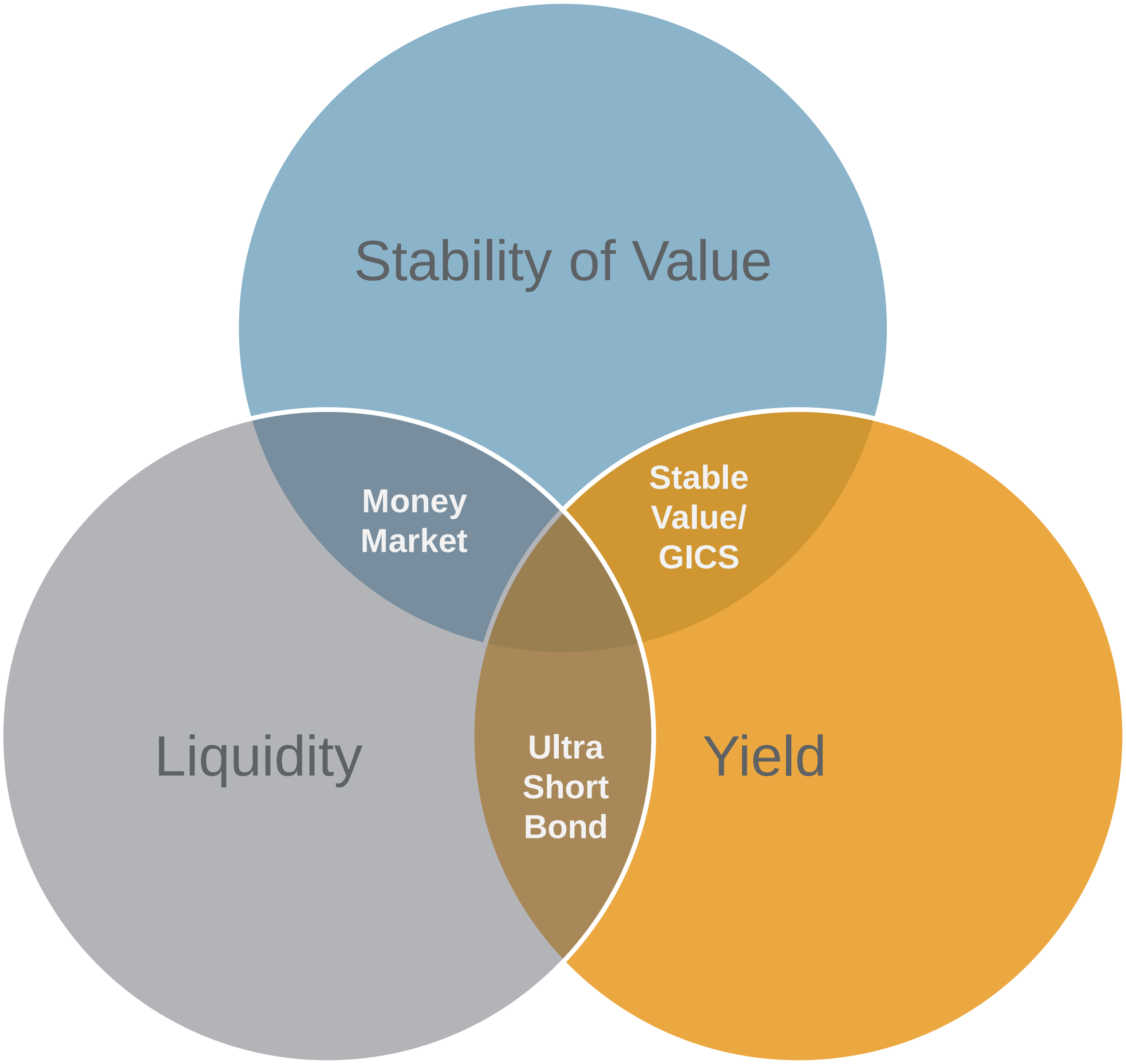
Stability of Value
- Long-term vs. Daily
- Significant impact when markets are their most volatile

Liquidity
- Participant vs. Plan level
- Impacts recordkeeping and pricing

Yield
- Short-term yield responsiveness vs. Long-term yield and performance
- Determinants of short-term yield

Sophie's Choice for Plan Sponsors

You can have any two of the above, but likely not all three


Stability of Value
Money Market
Stable Value/ GICS
Ultra Short Bond
Liquidity
Yield

Stable Value Structures

- Objective: Capital preservation coupled with steady, positive returns
- Expected to provide a return premium to money market funds because of the ability to accept greater interest rate and credit risk
- Synthetic GIC stable value funds consist of short / intermediate duration, high credit quality bond portfolio
- Bond portfolio is “wrapped” with contracts from wrap issuers (banks or insurance companies) that enable participants to transact at book value
- Wrap contracts do not protect against credit losses
- Investment returns and gains / losses are smoothed using a formula to maintain stable book value
- Structured as a separate or pooled account (collective investment trust)
- Separate accounts are for large plan sponsors (single plan)
- Pooled accounts consist of many (sometimes thousands) of smaller plan sponsors

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Fixed Annuity / GIC Structure

- Objective: Capital preservation coupled with steady, positive returns
- Expected to provide a return premium to money market funds because of the ability to accept greater interest rate and credit risk
- Generally fixed annuity and Guaranteed Interest Contracts (GICs) are promises to pay from insurance companies
- Assets are secured by the general account of the insurance company and crediting rates are declared by the insurance companies
- Health of a fixed annuity of GIC product is impacted by:
  - Credit quality of the insurance company making the guarantee
  - Current and historic crediting rates vs. peers
  - Participant and plan level liquidity
  - Minimum crediting rates

Ultra Short Term Bond

"Ultrashort-bond portfolios invest primarily in investment-grade U.S. fixed-income issues and have durations typically of less than one year. This category can include corporate or government ultrashort bond portfolios, but it excludes international, convertible, multisector, and high-yield bond portfolios. Because of their focus on bonds with very short durations, these portfolios offer minimum interest-rate sensitivity and therefore low risk and total return potential."
– Morningstar

- Category Average Statistics (Morningstar)
  - Average Effective Duration – 0.41
  - Average Effective Maturity – 0.94
  - Average Credit Quality - A

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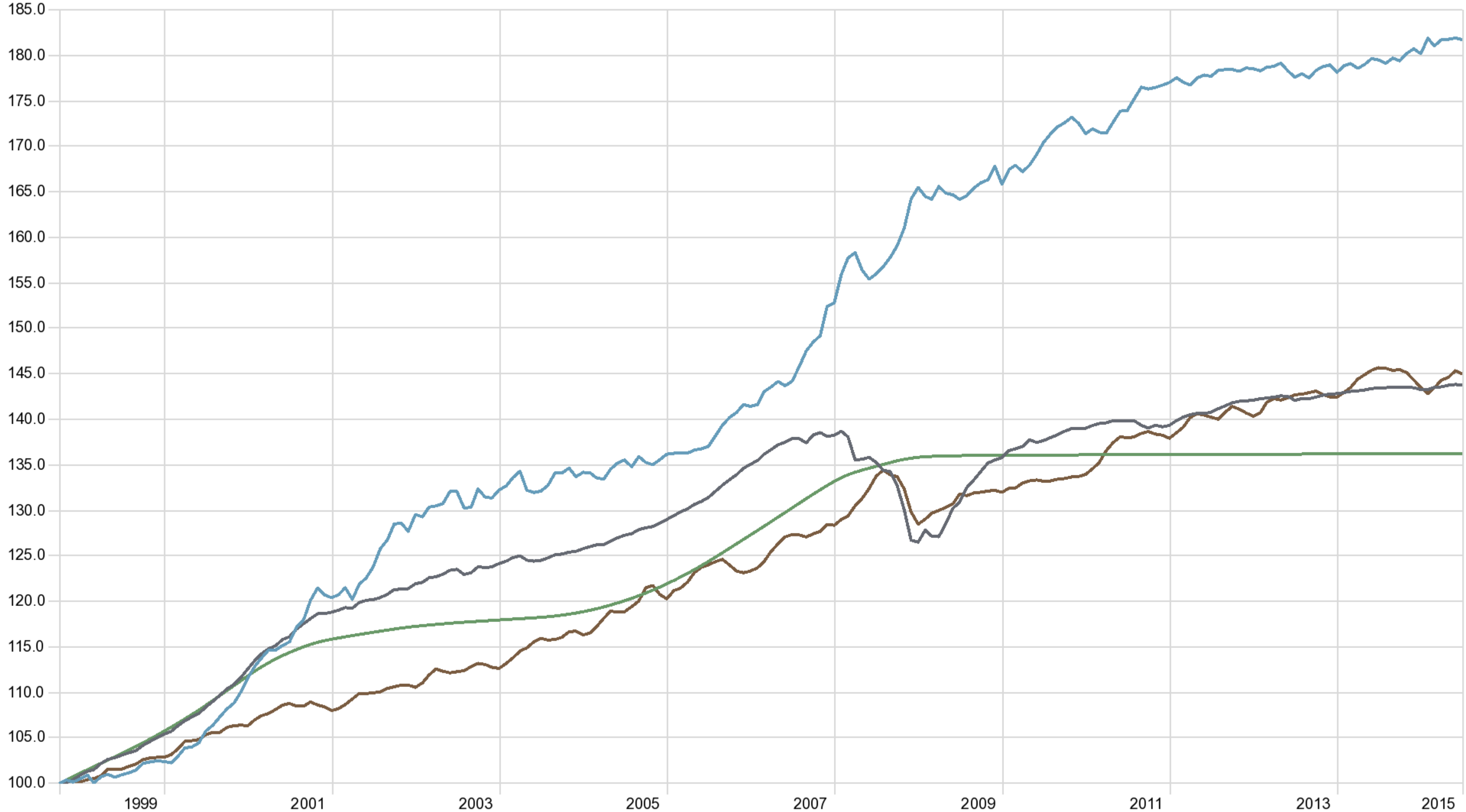
Growth of $100

Time Period: 10/1/1998 to 6/30/2015



Barclays Stable Value Benchmark TR USD	181.7	US OE Ultrashort Bond	143.8	US Money Market - Taxable	136.2
IA SBBI US Inflation	145.0				

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Considerations in Communicating Costs and Benefits to Participants

[1]Returns as of March 28, 2016

	Portfolio	Advantages	Disadvantages
Money Market	Ultra-short bonds, treasuries, and commercial paper. Money market holdings in mutual funds are subject to strict federal guidelines	• Generally, the most secure and liquid place to store assets • Short-term portfolio responds rapidly to changes in the interest rate	• Participant misuse • Low returns, potentially less than inflation
	US TREAS T-Bill Auction Ave 3 Mon 5-Year Return -0.03%[1]		
Fixed Annuity/GICS	Promise to pay from the issuing insurer backed by assets in the insurer's general account. Quality and security dictated by the state in which the insurer does business	• Should provide a higher crediting rate than money markets over full market cycles • Position is backed by the full faith and credit of the issuer • Future returns are generally announced in advance	• Participant misuse • Liquidity constraints • Difficult to analyze • Cost structure is generally not determinable
	Typical Fixed Annuity Return 1.5% – 3.5%[1]		
Ultra Short Bond	Short-term high-quality bonds, including asset-backed, government, and investment-grade corporate securities. The majority of securities in the fund will have an expected maturity of 0–3 years, and will generally be held until maturity.	• Should provide a higher crediting rate than money markets over full market cycles • Short-term portfolio responds rapidly to changes in the interest rate	• Floating NAV makes the portfolio appear more "risky" than alternative asset structures
	Barclays US Treas Bellwether 1 Year Index 5-Year Return 0.53%[1]		
Stable Value	Bond portfolio wrapped with insurance contracts to protect against changes in the yield curve impacting short-term redemptions	• Should provide a higher crediting rate than money markets over full market cycles • Insurance contracts protect against short-term rate changes	• Complex to analyze • Subject to insurance risk
	Hueler Stable Value Pooled Fund Avg 5-Year Return 2.46%[1]		

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Next Steps

1. Review the portfolio construction strategy
2. Adjust your Investment Policy Statement
3. Select your portfolio matrix
4. Communicate the product to participants
5. Reassess

Legal Risks to Money Market Funds

- Tibble v. Edison made similar assertions
  - District court ruled in favor of the defendants, saying that the fiduciaries considered using stable value, but decided in favor of a money market fund because it would “provide more consistent returns and have lower risk”

“In the Tibble case, the courts concluded there was full comparison [by fiduciaries] of money market funds to a stable value fund.” - Jerry Schlicter

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