

2011 Special Report Series of Common Client Questions and Investor Education

Money Funds – Lessons from the 2008 Crisis New Requirement to Reveal "Shadow Prices" & Other New Regulations: Over- Regulation or Investor Protection?

The SEC is concerned about the "break the buck" risk if we have another crisis in the commercial paper market. In 2008 we almost had massive losses - more than the Primary Reserve Funds loss that started a run on money market funds until the Treasury stepped in to guarantee them.

In June 2010 to make money funds safer the SEC required a higher percentage in shorter maturity commercial paper and higher ratios in assets of higher quality. This made it even harder to have any return since short term rates have been so low on 30-60 day commercial paper, a common investment. Many money funds are waiving fees to keep expenses low enough to still be price at \$1.

Shadow Pricing New Disclosure Rules

As of 1/31/2011 the SEC shows the actual "shadow" price, not the rounded to \$1 price. Wall Street Journal (WSJ) 1/30/2011: "The new data will help investors still shaken by the financial crisis to gauge the true risks of money funds - and see why these conservative investments aren't quite the same as cash."

The shadow price is to 4 decimals and is shown at www.sec.gov. The data released 1/31/2011 are the shadow prices as of 11/30/2010. Money funds can quote \$1 as long as the shadow price is between \$0.995 and \$1.005.

It appears some funds pumped in extra money, as the first report shows out of the 236 largest funds, only 30 were below \$0.9999.

WSJ points out if the shadow price of a fund is \$0.996 and someone cashes in at \$1, they are getting slightly more than their fair share at the expense of other shareholders. If lots of people sell and the fund sponsor does not prop up the fund, it could force the shadow price to below \$0.995 and "break the buck."

As with all fixed income investments the value decreases if interest rates rise and the longer the duration the greater the risk. Because money market funds are required to own mostly short term paper the risk is far less than in bonds. The WSJ points out in the unlikely event of a 1% increase in interest rates,

the average money fund shadow price would drop to \$0.9983 if it had been shown as \$1

A bigger problem would be if a holding defaulted (like Lehman). If the average money market fund had 1.25% of its assets in a security that lost 40% in value that would be enough to "break the buck."

This added disclosure is to inform the investor of the risk because the Lehman crisis money fund guarantee by the Treasury has expired and it does not want to have to rescue the industry again.

The fund industry has a proposal under discussion to create an industry funded insurance fund to avoid further regulation.

[In 2011 FINRA was concerned about the risk of municipal bonds. FINRA now required brokers to provide more detailed disclosures of all the risks of the municipality when selling muni bonds.]

Many believe these new rules are excess government regulation. Others believe these actions are needed to inform and disclose the risks to investors.

History of Commercial Paper/ Debt Crisis That Put Money Markets at Risk

Back on September 16, 2008 the Primary Reserve Fund (the oldest money market fund in America) dropped in value to 97 cents due to losses on worthless Lehman commercial paper. More than a dozen money fund sponsors spent tens of millions to keep their funds from breaking a buck.

When Primary broke the buck, hurting many pension plans, the panic hit its zenith a few days later. The U.S. Treasury stepped in to guarantee retail and institutional money market funds, similar to FDIC insurance for banks.

The risk to money markets was far wider than just Lehman. Money funds hold mostly commercial paper, but the market was frozen in fear and trading stopped at the height of the Lehman crisis.

The commercial paper/money market crisis was on top of the mortgage crisis. As of August 2008, financial firms around the globe had written down their holdings of subprime-related securities by US

\$501 billion. These losses wiped out much of the capital of the world banking system.

After the Barclay takeover of Lehman option was not approved by British regulators, on Sunday, 9/14/2008 Treasury Secretary Hank Paulson was in meetings at the NY Fed with the heads of banks, the Fed, and in phone contact with the heads of Central banks around the world,

In his book he describes the call to his wife from the Fed meeting: "What if the system collapses? I asked her. Everybody is looking to me, and I don't have the answer. I am really scared. I asked her to pray for me, and for the country, and to help me cope with this sudden onslaught of fear."

Lehman with their derivatives was a huge risk to the worldwide financial system. Most money market funds would not even have had a price on that Monday morning since there was no market in commercial paper - the lifeblood of large companies and money funds a prime source of funding.

Paulson says, "A jolt of fear suddenly overcame me as I thought of what lay ahead of us. Lehman was as good as dead, and AIG's problems were spiraling out of control."

Marketwatch.com reported the frozen commercial paper market, the fear of a Lehman bankruptcy filing Monday morning and the fear of a collapse of major banks in the U.S. and Europe if their debts and credit default swaps with Lehman were worthless. The) futures markets around the world were plunging, setting up what could have been the largest stock decline in history with money markets frozen. It was critical to act fast, before the Asian markets opened late night in the U.S.

Late Sunday night the Fed took historic dramatic actions: it poured a huge amount of reserves into the U.S credit markets and doubled swap lines with the European Central Bank and other central banks to address the liquidity crisis in commercial paper and other Lehman related debts. Markets stabilized.

Lehman was the biggest bankruptcy in history—\$660 billion—bigger than Enron, Worldcom, Adelphia, Chrysler, and General Motors combined.

Then AIG faced bankruptcy, triggered by Lehman's demise. A bankrupt AIG could have been far worse than even Lehman! The Fed felt that AIG had enough collateral to justify being saved, whereas Lehman didn't.

During the last quarter of 2008, worldwide central banks carried out the largest liquidity injections into the credit markets, and the largest monetary policy actions, in world history.

To save U.S. banks there was a fight between President Bush who pushed the "TARP" plan and

some other Republicans. "I've abandoned free-market principles to save the free market," Bush said.

TARP was very successful in saving banks from the risk of bankruptcy and massive taxpayer losses via FDIC insured deposits.

Most TARP funds have now been repaid, with a huge profit to the Treasury in stock values, fees, and interest, and probably saved the U.S. auto industry and millions of related jobs from various "bailouts."

The political battle continues related to regulations to protect taxpayers. The effective repeal of Glass-Steagall by The Gramm-Leach-Bliley Act in 1999 allowed banks to take on highly leveraged risky investments while at the same time removing any requirements to maintain enough equity, and exposing the assets of banking customers and taxpayers via FDIC insured deposits. In the view of many, repeal of Glass-Steagall resulted in the bank crisis in 2008. Both major political parties were to blame.

Greenspan said there was "no need for government oversight, because the derivatives market involved Wall Street professionals who could patrol themselves."

1/28/2011 - Bank of America bankers and traders making more than \$5M may be paid up to 30% of compensation in cash, instead of stock. This is an example of compensation for trading profits but with taxpayers at risk for losses as in 2008. Even though the bank lost \$2.2bn in 2010, its investment banking and trading units earned \$6.3bn.

To try and avoid future taxpayer bailouts, the Obama administration made a series of regulatory proposals in June 2009. These addressed consumer protection, capital requirements, derivatives, expanded regulation of the banking system, and enhanced authority for the Fed to safely wind down systemically important financial institutions. Most ideas were blocked by Republicans who consider them too much interference with private business.

Some protective features are in the Dodd-Frank Act of July 2010, but many believe it did not go far enough, being far less comprehensive than the original attempts for regulation to protect the taxpayer.

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