Putnam INVESTMENTS

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Changing currents: The money market since reform

Key takeaways

New regulations for money market funds implemented in 2016 caused a major change in asset flows at the short end of the yield curve.

Low volatility in financial markets, relative value, and supply/demand dynamics combined to create some offsetting effects.

To this point, reforms such as the floating NAV, redemption gates, and liquidity fees have had little impact.

Stay informed on the evolving ultra-short-term bond investment landscape

Putnam offers three commentaries to keep you updated on changes to investing at the short end of the yield curve.

1 **CHANGING CURRENTS: THE MONEY MARKET SINCE REFORM**

Discusses the impact of the SEC reform on the behavior of industry participants.

2 **THE NEW TERRAIN OF THE ULTRA-SHORT MARKET**

Describes the decline of prime money market funds, the increase in commercial paper, and T-bill demand as the market reacted to reforms.

3 **THE FORCES SHAPING THE ULTRA-SHORT MARKET**

Addresses tax reform, Fed policy, and potential for future regulatory reforms and LIBOR replacement.

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The impact of regulatory reform

In October 2016, the U.S. Securities and Exchange Commission completed implementation of reforms to regulations of registered money market mutual funds, spurring a tectonic shift in assets away from prime money market funds and into government money market funds. Approximately 18 months later, it is worth reviewing the rule changes and the downstream impacts, both those directly associated with the reform itself and the second-order consequences within the ultra-short market. Beyond the current state, the ultra-short landscape for 2018 will also likely continue to transform as it absorbs the aftereffects of U.S. policy and regulatory change.

A look back at what changed

The U.S. Securities and Exchange Commission (SEC) changes to Rule 2a-7 (effective October 14, 2016) were intended to make registered money market funds even safer, building upon initial changes the SEC implemented in 2010.* The 2016 rule changes required a number of new disclosures and reporting requirements, among other provisions. The most important new requirements created distinct categories of money market funds, prescribed the use of a floating net asset value (NAV) for some of the new categories, and allowed for implementation of liquidity fees and redemption gates should a money market fund's liquid assets fall below the designated 10% and 30% thresholds as described in Figure 1.

Prior to the October 2016 effective date of the reform, and in anticipation of the upcoming changes, investors began moving their assets out of prime money market funds and into different types of money funds. Government money market funds became the primary beneficiary, along with collective trust funds and ultra-short investments. The asset move began around April 2016. The migration picked up steam through the summer and, by the October implementation date, over $1 trillion in assets had moved into government money market funds. The ultra-short bond fund category, a fraction of the size of the larger money market fund categories, also experienced an increase

FIGURE 1

The regulatory transformation of money market funds

	Prime institutional	Prime retail	Government (retail or institutional)	Tax exempt (retail or institutional)
Definition	Designed for institutions only and not "natural persons," although retail clients are allowed to invest	Beneficial owners limited to "natural persons"	99.5% invested in cash, government securities; 100% government- or cash-collateralized repo	Institutional and retail definitions apply
NAV	Floating	$1.00	$1.00	Institutional and retail definitions apply
Liquidity fees	**Based on weekly liquidity:** If <30%, max 2% fee at board discretion If <10%, 1% fee required, unless board increases, decreases or removes; up to 2%	**Based on weekly liquidity:** If <30%, max 2% fee at board discretion If <10%, 1% fee required, unless board increases, decreases, or removes; up to 2%	May opt in with prior prospectus disclosure	**Based on weekly liquid assets:** If <30%, max 2% fee at board discretion If <10%, 1% fee required, unless board increases, decreases, or removes; up to 2%
Redemption gates	**Based on weekly liquidity:** If <30%, board may suspend up to 10 days in a rolling 90-day period	**Based on weekly liquidity:** If <30%, board may suspend up to 10 days in a rolling 90-day period	May opt in with prior prospectus disclosure	**Based on weekly liquidity:** If <30%, board may suspend up to 10 days in a rolling 90-day period

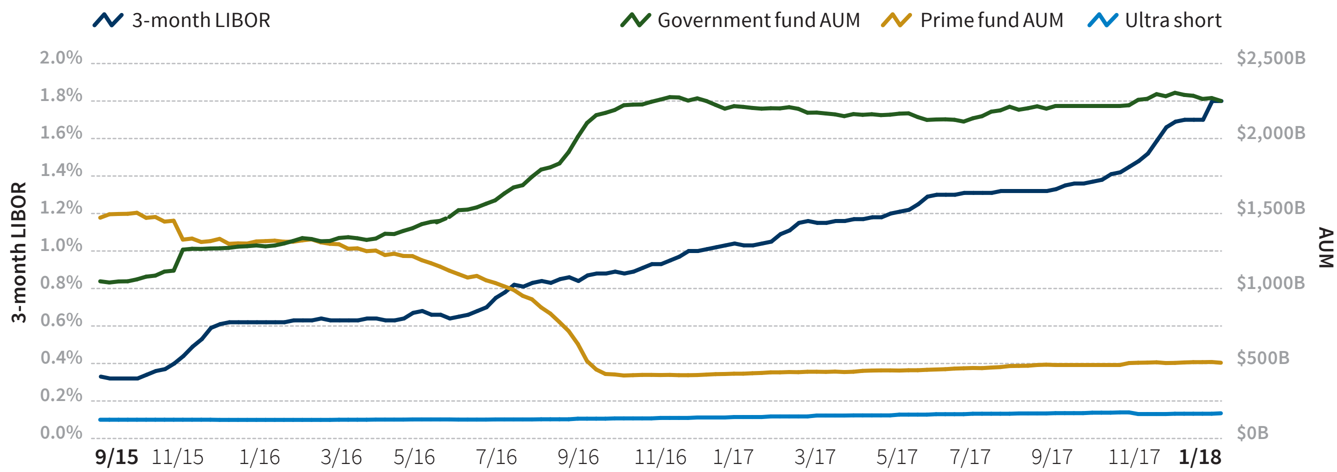
All funds are required to comply with new disclosure and reporting, diversification, and stress-testing requirements.

Source: Putnam.

* In 2010, the SEC made its first round of changes to Rule 2a-7 in response to events of the credit crisis. The SEC wanted to make registered money market funds safer for the investor by increasing liquidity. Among other refinements, the SEC required four significant changes that began the reformation of money market funds. The four key modifications are 1) the reduction in the maximum weighted average maturity ("WAM") of money market funds from 90 to 60 days, 2) the requirement for money market funds to maintain a minimum of 10% in daily liquidity with 30% of the fund liquid within seven days, 3) the reduction in the allowable Tier 2 or A-2/P-2 rated securities (roughly BBB) to 3% from 5% of net assets, and 4) the requirement for stress testing the market value ("shadow") NAV of money market funds.

FIGURE 2

Changes in LIBOR and in asset flows to money market funds



Sources: Investment Company Institute, Putnam.

in total category assets under management. Figure 2 illustrates the asset shifts that occurred in 2016.

Key reform elements: No unpleasant effects, thus far

Now that the dust has settled in terms of this major asset transition and the implementation of all aspects of the reform, it is possible to assess the initial impact on the overall short end market. In our view, the move to a floating NAV and the addition of liquidity fees and redemption gates were the major changes in this set of reform measures. The results from implementing these measures are mixed: A low volatility market, relative value, and supply/demand dynamics combined to create some offsetting effects. As it relates specifically to the reform elements, we think the jury is still out.

The change that had the least impact, which we identified in our initial writings on this topic, involved the floating NAV for institutional money market funds (excluding government money market funds). Given how short the weighted average maturity of money funds must be — 60 days — and the very small amount (3%) of potentially more volatile Tier 2 instruments that are allowed to be purchased, we believed there was little chance of a money fund's floating NAV moving enough to be noticeable in normal market conditions. As we expected, the floating NAV has not been a major concern under every day circumstances.

The liquidity fees and redemption gates have also proven to be a non-event thus far. Fund managers have been doing a good job of maintaining their 10% and 30% liquidity requirements, so there has not been an instance of either the fees or gates being imposed. Nor do we expect these measures to be imposed in normal market conditions. There has been no impetus in the form of disorderly market conditions for implementing fees or gates since the effective date of the rule changes.

The potential for dislocation

All that being said, it is difficult for us to regard either fees or gates as complete non-issues. There simply has not been a major market event or dislocation in the past year to spur any extreme changes in valuation or significant withdrawals. In our view, neither the floating NAV nor the liquidity fee/redemption gate rules have yet to be really tested. If market conditions continue to be relatively benign and any bouts of volatility short-lived rather than extreme, these rules will likely remain untested. Over time, investors may cease to expect material market value fluctuations in the floating NAV, and the potential for liquidity fees and redemption gates will likely be forgotten or dismissed as a concern.

Eventually, when there is a major market dislocation and a material decline in NAV, or when fund managers enact the fee/gate provisions, it is a strong possibility that some investors will be unpleasantly surprised and dismayed at:

1. losing more than they anticipated in their "safe" option,
2. their inability to redeem at the time they desire, and/or
3. the cost to be paid in order to redeem. If and when this happens, we may see another major shift in allocations to money market funds.

Consider these risks before investing: *You can lose money by investing in the fund. Although the fund seeks to preserve the value of your investment at $1.00 per share, it cannot guarantee it will do so. The fund may impose a fee upon the sale of your shares or may temporarily suspend your ability to sell shares if the fund's liquidity falls below certain required minimums because of market conditions or other factors. An investment in the fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The fund's sponsor has no legal obligation to provide financial support to the fund, and you should not expect that the sponsor will provide financial support to the fund at any time.*

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