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The Great NAV Debate: Part I

Tune into the business news these days and you will hear about Presidential candidates' prescriptions for economic recovery, Medicare and Social Security, the latest developments in the Eurozone debt crisis and fears of a year-end "fiscal cliff" regarding domestic tax and spending policies. You also are likely to hear lots of talk of money market fund (MMF) reform; and more specifically, a proposal floated by Securities and Exchange Commission (SEC) Chair Mary Schapiro, to convert money market funds' share pricing from a "stable" net asset value (NAV) to a "floating" NAV.

The debate over this proposal has generated a great deal of discussion within the industry and among investors about the pros and cons of a stable vs floating NAV for MMFs. It also has prompted a number of inquiries from local agency investors about exactly what the NAV represents, and why MMFs are priced on a stable NAV while other funds have a floating NAV; and what difference it makes.

Given the high profile nature of the issue and its importance to local agency investors - including CalTRUST participants - discussion of the topic is particularly timely. In this first of two parts, we will look at SEC-registered MMFs, which play a critical role in today's capital markets and economy; and the benefits of a stable NAV pricing regimen for these cash-like instruments. In the second part, we will look at why a floating NAV is the most appropriate means of pricing shares of non-money market funds, such as the CalTRUST Short- and Medium-Term funds.

What is NAV Anyway?

Simply put, the "net asset value", or NAV, is the value of all of a fund's assets minus the value of its liabilities; literally the net value of the fund. More specifically, the NAV is the number (value) - calculated by the fund accountant based upon industry recognized pricing sources - that captures all activity within a fund, from the purchase and sale of securities, realized and unrealized gains/losses, amortization/accretion of bonds, income, expenses, and capital activity (purchases and sales of shares by investors in the fund). All of this data is captured each time a fund is valued to determine the net value of the assets of the fund.

Non-money market mutual funds (equity and bond funds) and many local government investment pools (LGIPs), such as the CalTRUST Short-Term and Medium-Term funds, determine their NAV based on the ***closing market prices*** of the securities in the fund's portfolio. MMFs, on the other hand, are permitted to value their holdings on an ***amortized cost basis***, rather than current market value (more on this below), although they are required to periodically calculate their per share market value, or "shadow NAV". Mutual funds and many LGIPs, including the CalTRUST funds, compute their NAV daily. This is the daily "mark-to-market". Many money funds compute their NAV several times a day; for instance, the CalTRUST Heritage MMF computes its NAV seven times each business day.

Quite commonly when people speak of a fund's NAV, they are really referring to the ***NAV per share***, or ***share price***. This is simply the NAV at any given valuation divided by the number of shares outstanding at that time, then rounded to the nearest whole cent.

Money Market Funds and A Stable NAV

Money market funds are a type of mutual fund, albeit a special type that plays a critical role in today's capital markets (see the box on page 2). Like other types of mutual funds, MMFs hold a portfolio of securities whose values fluctuate with changing market conditions. Unlike other mutual funds, however, MMFs strive to maintain - but do not guarantee - a stable $1.00 per share value.

The stable $1.00 NAV is a core feature of MMFs, providing investors with a number of benefits. For institutional investors MMFs are a preferred tool for cash management, providing a high degree of principal stability, liquidity, diversification, and a market-based yield. The stable $1.00 NAV also provides benefits in terms of tax and accounting convenience. For instance, because MMFs pay their return as a dividend to shareholders, there is no need to track capital gains and losses; and knowing the share price in advance permits MMFs to provide same-day liquidity, and other conveniences generally not available from floating NAV funds.

Since the early 1980s, MMFs have been subject to SEC Rule 2a-7, which places strict requirements on the types of securities which MMFs can hold, governing their credit quality, liquidity, diversification and maximum maturity. These restrictions are aimed at limiting money funds' exposure to credit, interest-rate and liquidity risk. Because of the short-term, high-quality nature of the securities they hold, fluctuations in their values generally are very minor.

In return for adhering to the restrictions of Rule 2a-7, SEC-registered MMFs are permitted to value their holdings on an "amortized cost" (or book value) basis, rather than a current market value basis. Amortized cost is the acquisition cost of the securities (rather than the current market value, which may be greater or lesser than the purchase price) held in the MMF, adjusted for any discounts or premiums reflected in the purchase prices. As mentioned above, MMFs are required to calculate their shadow NAV on a periodic basis.

So long as this shadow NAV tracks within plus or minus 0.5 cents of $1.00 ($0.995 to $1.0050) a MMF is permitted to maintain its amortized cost basis of pricing. If the shadow NAV moves outside this band (drops below the $0.995 cent level), the MMF sponsor must provide support, typically by buying distressed assets away from the MMF. If the fund sponsor is unable or

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unwilling to provide sufficient capital support to bring the shadow NAV back within the $.995 to $1.005 band, it must discontinue use of amortized cost valuation and re-price the fund's shares to their present market value. This is referred to as "breaking the buck". The short-term, high-quality nature of their holdings, along with the amortized cost basis of valuation has enabled ***most MMFs*** to maintain a stable $1.00 NAV through most market environments. ***Most; but not all*** (see the box below).

Second Round of Reforms Could Include Floating NAV

In the aftermath of the collapse of the Reserve Primary Fund and the 2008 financial crisis, the SEC adopted a number of revisions to Rule 2a-7, which further tightened the credit quality, maturity and liquidity requirements on MMFs. When these 2010 reforms were adopted, the SEC indicated that they were meant to be the first step in a more comprehensive effort to address what it saw as a false perception on the part of MMF investors that money funds are a risk-free vehicle. In the eyes of the SEC, investors, have not been adequately assessing the real risks inherent in MMFs, either because they have been lulled into a false sense of security or because they believe there is an implicit federal guarantee; in short, that MMFs are "systemically important" and "too big to fail". To drive home the point that MMFs are not risk-free, many, including SEC Chair Mary Schapiro, propose that MMFs should be required to abandon the stable $1.00 NAV in favor of the floating NAV used by other types of funds.

A recently-released 300+ page SEC staff proposal would require MMFs to either (a) move to a floating NAV, or (b) hold additional capital and impose redemption restrictions on shareholder redemptions. Supporters argue that, the 2010 reforms notwithstanding , money funds remain vulnerable to runs which, in a crisis, could cripple the financial system.

Opponents - including most of the MMF investor community - argue that reforms of this nature would effectively kill the MMF industry, with unknown but potentially dire consequences for large sectors of the economy. Investors utilize MMFs ***precisely because*** of the benefits and conveniences that follow from a stable NAV and same-day liquidity. In the absence of these features Investors would be forced to find alternative cash management tools, which may or may not provide the same combination of liquidity, diversification and ease of use. Investors will not migrate to floating NAV products, opponents argue, since they already have that option and "vote with their dollars" for MMFs, to the tune of $2.6 trillion.

Recently, Chairwoman Schapiro announced that the SEC staff proposal would not be released for public comment since a majority of the Commissioners is opposed. The venue for possible MMF reform now shifts to the Financial Stability Oversight Council (FSOC) created by the Dodd-Frank Act. The FSOC could (a) declare the ***MMF industry*** systemically important, and pressure the SEC to act; or (b) deem ***individual funds*** to be systemically important, and subject them to oversight by the Federal Reserve.

MMFs in Today's Capital Markets

To understand the importance of MMFs to our economy, consider that MMFs hold:

- nearly two-thirds of state and local government short-term debt;
- almost one-half of all the commercial paper that businesses issue to finance their payrolls and inventory; and
- over fifteen percent of all the short-term paper issued by the US Treasury.

Given the strategic importance of MMFs for the capital markets, there was grave concern in September of 2008, when the $60+ billion Reserve Primary Fund broke the buck, triggering a near run on money funds. Coming as it did in the midst of the financial crisis, uncertainty and anxiety prompted a flood of institutional investor redemptions, resulting in a net outflow of over $160 billion - 5 percent of all MMF assets - within the week.

The fear was that a full-fledged run on MMFs would threaten the liquidity of the markets, causing extensive damage to the real economy, in the same manner that bank runs did during the Great Depression. Of particular concern was the commercial paper market, the primary source of operating capital for businesses, since without the ability to rollover their existing short-term debt, firms without sufficient cash on hand to meet their obligations could be forced into bankruptcy

In response, within 3 days of the collapse of the Reserve Primary Fund, the US Treasury initiated a voluntary insurance program, backed by a small premium paid by the funds, for publicly offered MMFs. Virtually every MMF opted into the program, which stemmed the tide of redemptions and stabilized the market.

Given that Treasury Secretary Geithner chairs the FSOC and is a strong reform supporter, and that Schapiro and Federal Reserve Chairman Ben Bernanke (another reform supporter) are FSOC-members, it is quite likely that we have not heard the last of this issue.

Part II of this discussion of NAV will focus on non-money market bond funds; why a floating NAV is the most appropriate means of pricing shares of these funds; and why investors should focus on total return, rather than just the NAV when evaluating fund performance.

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