Goldman Sachs Asset Management

From Stable to Floating NAV: Implications for Prime and Municipal Money Market Funds

Starting on October 14, 2016, the U.S. Securities and Exchange Commission (SEC) rules will require institutional prime and municipal money market funds to migrate from a stable $1.00 price per share to a floating net asset value (NAV). The new rules allow all prime and municipal money market funds to temporarily prevent investors from making withdrawals or to impose fees for investors who redeem shares under certain extraordinary circumstances. The changes were proposed after the financial crisis of 2007–08, when the Reserve Primary Fund dropped below a $1.00 NAV price and "broke the buck," prompting a run of redemptions from institutional prime money market funds.

The new rules will have implications for how institutional investors use and evaluate money market funds, and have therefore raised a number of questions in advance of the rule change later this year.

What is a floating NAV and how are such funds priced?

A floating NAV is calculated using market value—or mark-to-market—accounting rather than the amortized cost accounting that money market funds have historically used. This means that floating NAV funds have to calculate and transact at the underlying value of all of the securities in the fund on an ongoing basis and publish the corresponding price out to four decimal places.

Pricing services determine the NAV based on how like securities are trading in the market, and will adjust the price as needed to reflect credit events or other market developments impacting prices. As such, the NAV can fluctuate, or float, whereas stable NAV funds are able to round up to $1.00 so long as the amortized cost per share is $0.9950.

Could changes in the NAV be material?

In most cases, we believe changes to the NAV will likely be immaterial, as the value of the underlying securities in most prime and municipal money market funds rarely move. These funds are structurally designed to minimize risk and invest accordingly. When fluctuations occur in the NAV, they are typically confined to the fourth decimal place, or a ten-thousandth of a percent. Depending on prevailing interest rates and the length of time an investor holds a fund, the fund's daily dividend could be sufficient to compensate for any fluctuation in the NAV over the course of the day.

Nevertheless, there may be instances where the change in the NAV has a material impact on the underlying principal and investors in floating NAV funds should prepare for this possibility.

How is trading different with a floating NAV fund?

The biggest change is that liquidity will no longer be instantaneous, because it will take time for the fund to make the NAV calculation for each fund and release the wires.

Investors will need to consider the potential impact of a moving NAV on their available balance. With stable NAV funds, an investor can assume each money market fund share is $1. But with floating NAV funds, an investor doesn't know what the price will be before they trade since the NAV can move if the underlying value of one of the securities in the fund's portfolio increases or decreases. How often a floating NAV fund is priced will vary depending on the fund company and its pricing partners.

How early and late in the day will floating NAV funds offer liquidity?

Today, most fund providers can provide redemption wires on an hourly basis, as the NAV calculations are more straightforward under amortized cost accounting rules. The new rules will certainly add time to this process, as pricing services will need to mark the underlying securities to market before sending the NAV to the transfer agents who execute wire redemptions. The frequency at which a fund must calculate its NAV, and therefore provide liquidity, is not specified under the new rule. Therefore, each fund company may take a different approach. Fund companies have already started to address this, and early indications are that intraday liquidity may be available as often as three times a day—around 8 or 9 am, noon and 3 pm Eastern Standard Time.

What are the implications for using floating NAV funds?

Prime and municipal money market funds may still be an important primary liquidity option, but it's important to understand how a floating NAV may affect their use. First, institutional investors who rely on prime funds as a source of intraday liquidity may have more limited access to their cash. Second, because the NAV fluctuates, the cash redeemed may be less than expected. Finally, there is now the potential for the fund company to restrict redemptions or impose a redemption fee during periods of extreme volatility.

In cases where institutional investors have constant and specific intraday needs for their short-term cash holdings, a government money market fund may be a better alternative. But for those investors who have sophisticated cash forecasting capabilities or have a liquidity time horizon of one to 180 days, we believe prime and municipal money market funds will likely remain an attractive liquidity source given historically higher yields versus government money market funds.[1]

If a floating NAV fund is being used on an intraday basis, it will be important to allow for additional time to process redemptions, particularly toward the end of the day.

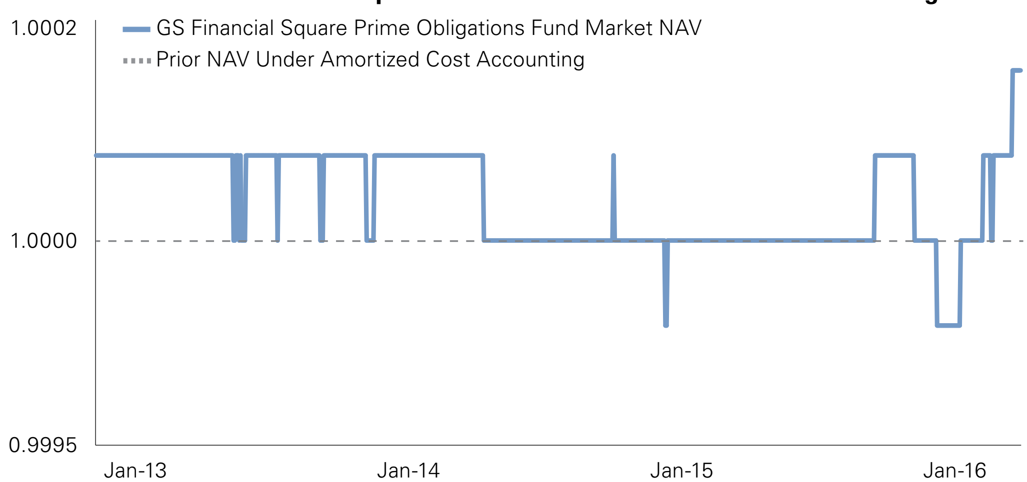
What tax and accounting requirements are there for floating NAV funds?

Floating NAV market funds will still be treated as cash and cash equivalents on the balance sheet, but those who use them will now have to recognize the gains and losses associated with their fluctuating prices. At the bare minimum, investors will need to do this once per year, though ultimately it may make sense to track gains and losses more frequently. Check with your auditors to determine the best course of action.

How will performance be assessed differently in a floating NAV fund?

Institutional investors will now need to evaluate prime and municipal money market funds based on their total return. In a stable NAV fund, the yield is the same as the return since the price doesn't change. But with a floating NAV fund, as with other income-producing assets, the yield moves in inversely to the price. The fund's total return—the combination of its price and income generated from dividends and other distributions—can therefore change with fluctuations in the NAV.

Market Value of GS Financial Square Prime NAV vs. Amortized Cost Accounting



Source: GSAM as of March 31, 2016.

[1] Source: iMoneyNet

Institutional investors who use money market funds primarily as a source of liquidity and capital preservation may want to examine how frequently a fund's NAV moves as part of their regular due diligence, in addition to assessing each fund's liquidity levels. Those investors who are more return-oriented should be less concerned about NAV changes and can therefore likely rely more on traditional evaluation measures for manager credit risk.

Why is GSAM only offering a select group of floating NAV funds?

Given the complexities involved with using floating NAV money market funds, we want to ensure that our clients have had time to digest these changes, explore the alternatives and analyze the impacts that the new features will have on their cash management. In addition, clients should be aware that in addition to their own product views, some money market intermediaries only have the operational infrastructure at this point to support one NAV calculation per day. Investors may need to make decisions based on both their product preferences as well as what money market intermediaries will support. As investors and intermediaries grow more familiar with the demands of floating NAV funds, we may look to expand our roster of floating NAV money market fund offerings to adapt to client demands and provide a product suite.

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Government Funds: You could 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. An investment in the Fund is not a deposit of the bank and 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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