Blogs
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Asset Management ADVocate

Why Tax Exempt Money Market Funds Should Make a Comeback

In a previous post, I noted that recent changes to Rule 2a-7 hit tax exempt money market funds hard, with the loss of half of their pre-reform assets. There are reasons to think these funds will recover, however. Foremost, prior to the post-election surge in interest rates, tax exempt funds were out-yielding every other type of money market fund. According Crane Data, tax exempt funds (which are nearly all retail) out-yielded both institutional and retail prime funds, to say nothing of government funds. These are pre-tax yields; on an after-tax basis, tax exempt funds offer very competitive yields.

No Substitutes for Tax Exempt Funds

Second, there are no substitutes for tax exempt money market funds. There are a variety of ways to earn taxable income on cash, such as bank deposits, repo and commercial paper. Only tax exempt money funds offer same-day cash redemptions with a stable value, diversification and tax-exempt yield.

No Realistic Risk of Fees or Gates

Finally, although tax exempt funds are permitted to impose liquidity fees and redemption gates, it should be practically impossible for them to do so. This is because the structure of the tax exempt market forces tax exempt funds to hold large amounts of weekly liquid assets. Most municipalities issue one-year notes to smooth over their lumpy cash flows. Only a handful of publicly utilities and similar enterprises issue tax-exempt commercial paper with shorter maturities. Long-term funding comprises the balance of the "short-term" market, which uses demand features (most commonly for seven days) to bring the bonds within the maturity limits of 2a-7. Rule 2a-7 requires money market funds to limit their dollar-weighted average maturity ("WAM") to no more than 60 days. One year notes quickly use up much of this WAM limit, with a 10% position adding 36.5 days to a fund's WAM. Tax exempt funds must invest most of the balance of their portfolio in seven-day instruments to stay well within the 60 day limitation. Investors can verify this using the daily website information now required by 2a-7. I found a representative fund that consistently maintained 75% of its assets in weekly liquid assets. Assuming all of these weekly liquid assets have a maturity for purposes of WAM of seven days (tax exempt funds don't invest in longer-dated treasuries or government notes), they contribute 5.25 days to the fund's WAM. The fund's current WAM is 38 days, which means that the remaining 25% of the portfolio has a WAM of 131 days. (38 days minus 5.25 days, divided by 25%). A fund's directors cannot impose a fee or gate until the fund's weekly liquid assets fall below 30%. If shareholders redeemed 45% of the shares, and the fund liquidated exclusively weekly liquid assets for the redemptions, we might think that this would reduce weekly liquid assets from 75% to 30%. But the redemptions make the fund smaller, and weekly liquid assets would remain nearly 55% of total assets. Hence, the fund could not impose a fee or gate. This level of redemptions would cause the fund to break a dollar, however, because the remaining portfolio would now comprise 45% of the assets and contribute 59 days to the fund's WAM. When added to the 4 days of WAM contributed by the weekly liquid assets, the fund's total WAM would exceed 2a-7's 60-day WAM limitation. Once the 60-day limit is breached, a fund may no longer use amortized cost to maintain a stable NAV. Absent other relief from the SEC, a fund that breaches the WAM limitation must either break a dollar or liquidate. This would moot the need for fees or gates before weekly liquid assets reached a level that would permit the fund to impose them.

Reconsidering Tax Exempt Funds

While the prospect of redemptions causing a fund to break a dollar may seem as alarming as the prospect of a fee or gate, this is not a new risk. 2a-7 has always imposed a WAM limit. Even during the financial crisis, tax exempt funds never experienced the combination of redemptions and illiquid market conditions required to cause them to breach the WAM limit. Investors who were comfortable with this risk before the current reforms may therefore want to reconsider the advantages of tax exempt funds.

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