

Inside money market funds

Money market funds can offer advantages over straight cash deposits provided you understand how they're structured

LEONORA WALTERS

“Cheques aren't money,” Andy Warhol famously remarked. And neither are money market funds. But they can still be a useful investment tool, so long as you pick the best of the bunch and remain aware of their risks and limitations.

However disillusioned you may be with low rates on bank deposits, you cannot avoid holding cash at various stages in your investment career. Holding cash is useful if you want to see how the market pans out before deciding on asset allocation, for example. In a bad market, cash is also a safe haven from falling prices, and means you can move quickly to take advantage of investment opportunities when they arise.

“You cannot dismiss cash just because it offers an unattractive rate,” says wealth adviser Jonathan Fry. “The world is very uncertain and avoiding volatility with part of your portfolio is important.” That's especially true if your main objective is preserving wealth. “The loss of wealth often causes significantly more concern than achieving above-average investment returns,” adds Mr Fry.

Money market funds

Despite what the name may imply, money market funds do not just hold cash. These funds invest in more complex and riskier money-market instruments and bonds. This can produce higher returns than bank deposits but incurs higher risk and can result in negative returns and volatility – a far cry from cash. During the credit crunch, some

funds even made substantial losses and were closed down.

Money market funds are less transparent than bank accounts because they can invest in a range of instruments. But you will not know about everything they hold, as they only have to declare their top 10 holdings or exposures, rather than their entire portfolio. “You should get a full breakdown of where the money is lent to, not just the top 10 exposures,” says Anna Sofat, founder of wealth adviser Addidi Wealth, who has not used money market funds for her clients since the problems encountered in 2008.

Although some money market funds offer higher total returns than cash, returns are still fairly low as these funds are also subject to low interest rates, and their short-term returns are not outpacing inflation.

Another downside is that money market funds levy charges while bank accounts tend to be free or have minimal charges. “If you are in near-cash investments the margin is small and the return will be negligible,” says Ms Sofat. “If you can get a tracker fund for a charge of around 0.25 per cent you should also be able to get money market funds at a small margin.”

Nevertheless, money market funds have much lower charges than the average equity unit trust, which typically has a 1.5 per cent annual management charge. Many money market funds charge 0.5 per cent or more. Exceptions include Fidelity Moneybuilder Cash, Fidelity Cash and Jupiter Cash which charge 0.4 per cent.

Cash plus

Despite their detractors – Mr Fry is not a great fan – there are some valid arguments in favour of money market funds. The financial crisis showed the dangers banks face, and how deposit holders could be seriously at risk, although the Financial Services Compensation Scheme will now refund up to £85,000 cash per person in the event of a bank going bust.

If you have more cash than this you should spread it around, and money market funds are instantly diversified investments as they typically have exposure to around 30 banks.

Diversification helps lower your risk, adds Paul Smith, fund manager of the Premier UK Money Market Fund. A money market fund can hold floating-rate notes as well as deposits to boost returns, but has the flexibility to move out of them to avoid risk when necessary. It can also hold investments of different maturities and change this accordingly to manage risk – just as bond funds do. “It is a mistake to assume

Take a look inside: money market funds do not just hold cash





Choosing a money market fund

The golden rule for choosing money market funds is not to look at performance. "The first thing to look at are the risk statistics, rather than the performance," says Paul Smith, manager of the Premier UK Money Market Fund. "Make sure it has never had negative periods and select your fund by looking for a stable net asset value and low volatility. If a fund is way above base rates over a shorter period, such as one year, it must be taking excessive risk."

A good way to do this is to look at the fund's annual returns rather than its cumulative returns to ensure they are always positive, especially during times of high market volatility, such as in 2008.

Also, you should know what kind of assets the fund is holding, and understand what they are, how they work and the risks involved.

Mark Osland, director at independent financial adviser Formula, suggests spreading your risk across more than one money market fund.

BlackRock Cash Fund (see profile on page 45) takes a lower-risk approach and has protected against downside, as has Premier UK Money Market Fund (see profile on page 45). Henderson Cash and Invesco Perpetual Money have also made reasonable returns and protected against downside.

M&G High Interest is the best performer over the past year, but this is one for higher risk appetites as it is more volatile due to a more aggressive asset allocation. In 2008, for example, this fund made a negative return of just over minus 1 per cent.

Money market funds

Fund	1-yr trailing annualised rtn (%)	3-yr trailing annualised rtn (%)	3-yr Volatility*	Total expense ratio (%)
Henderson Cash R Acc	0.57	1.62	0.1	0.37
Premier UK Money Market Acc	0.47	1.51	0.14	0.6
Invesco Perpetual Money 2	0.55	1.5	0.21	0.5
Aberdeen Cash A Acc	0.42	1.15	na	0.62
Henderson Money Market Unit Trust	0.35	1.09	na	0.56
Fidelity Gross Accumulating Cash	0.29	0.94	0.13	0.4
St James Place Cash Trust	0.34	0.86	na	0.4
Marlborough Cash Trust	0.71	0.85	0.11	0.53
Wesleyan Cash	0.36	0.84	0.1	0**
BlackRock Cash A Acc	0.17	0.82	na	0.57

Source: Morningstar, *Investors Chronicle**Temporary

IC ONLINE

You'll find comprehensive data on thousands of managed funds and ETFs at our funds data centre: <http://funds.investorschronicle.co.uk>. You can search for a fund by name or Mexid (the unique identifiers for funds, shown on all our fund profiles), or by management company (eg Fidelity, Invesco), or by sector (eg Asia ex-Japan, North America). Look out for funds with a full factsheet; this includes data on price performance, holdings, charges, risk and ratings – and you can download or print it as a PDF. All fund data is free to access.

that floating-rate notes and bonds are higher risk," says Mr Smith. "They can be lower risk, as it is the issuing bank or institution that is important. For example, at the moment a good bond is probably safer than a deposit in a Greek bank. During the financial crisis it was hard to trade deposits but you could trade bonds."

He also points out that to get higher rates on a bank deposit you may have to lock up your cash for a year or more. But you have instant access to a money market fund. If your money is invested via a fund platform you can easily move your money in and out of cash funds to other funds and, depending on your platform provider and the charging structure, it may be cheaper to move around funds on the platform than going in and out of funds and bank accounts. While some platforms and pensions offer the option of putting your assets into cash, some don't, so for short-term safety your best option may be a money market fund.

Money market funds do not make good returns relative to other fund sectors, but they are not meant to – their purpose is to preserve rather than grow your assets. As with other types of fund, it is not fair to tar them all with the same brush. There are currently 30 money market funds in the Investment Management Association's (IMA) Money Market sector and most did not experience severe problems in the financial crisis. While average sector returns are low, some funds have outperformed this, so even after charges you should get a positive return.

At the height of the financial crisis in 2008, 24 money market funds made positive returns, at a time when the FTSE All-Share plunged more than 30 per cent. During this year the Money Market sector average total return was 2.2 per cent, making it the fourth best-performing fund sector out of more than 30. By contrast, absolute-return funds, which are always meant to make positive returns, lost 3.6 per cent on average.

Last month, the UK fund industry trade body, the Investment Management Association, began consulting on a new definition for money market funds following the introduction of new rules by the Financial Services Authority (FSA). Fund providers have until 1 January 2012 to bring their funds into compliance with the regulations, and from then on the IMA will monitor money market funds to ensure they follow the rules.

These steps show that the sector has learned a lot since the problems incurred during the financial crisis. It has made fund managers sit up and take notice of how their funds are invested, and the monitoring should hopefully ensure this continues.

Alternatives to money market funds

What should you do if you've decided that money market funds aren't for you? For the short term, bank deposits give you flexibility and the ability to move quickly, but their returns are low and currently do not keep up with inflation. Whether the flexibility outweighs the value leakage is a personal decision. "The price you pay for having a reserve may be inflation erosion," says wealth planner Jonathan Fry. "It is better to get, say, 3 per cent growth than the promise of 4 per cent or 5 per cent and then lose it." However, Mr Fry adds that if you are prepared to take on a bit more risk and have more than a year or two to invest, rather than a money market fund, you should consider other assets, such as:

■ **Government bonds:** recent events in southern Europe mean that sovereign debt is no longer perceived as risk-free. But shorter-dated UK government bonds are still an option. A tracker fund or an exchange-traded fund (ETF) can give you exposure at a very low cost, which is a significant factor since the returns are likely to be quite low anyway. Vanguard UK Government Bond Index has a 0.15 per cent management fee and 10 per cent purchase fee, while the HSBC UK Gilt Index Fund charges 0.27 per cent.

■ **Index-linked investments:** if you want some inflation protection, you could opt for a fund investing in index-linked government bonds. The Vanguard UK Inflation-Linked Gilt Index has a 0.15 per cent management charge and 20 per cent purchase fee, while iShares offers a Barclays Capital Sterling Index-linked Gilts ETF with a 0.25 per cent total expense ratio. National Savings & Investments has recently issued a new tranche of its five-year Index-linked Savings Certificates, in which you can invest up to £15,000. Tax-free and guaranteed to beat retail prices index inflation, these have proved popular and are likely to sell out quite quickly.

Slightly further up the risk scale are Post

Office inflation-linked bonds, with the choice of a three- or five-year maturity. They offer a (taxable) return of retail prices inflation plus 1.5 per cent gross for the five-year term, and retail prices inflation plus 0.5 per cent gross for the three-year term. iShares Barclays Capital Global Inflation-Linked Bond ETF offers exposure to inflation-linked bonds globally, although this could incur foreign-exchange risk on top of government default risk. Its highest exposure is the US where there has also been some uncertainty – and Italy accounts for more than 8 per cent of assets.

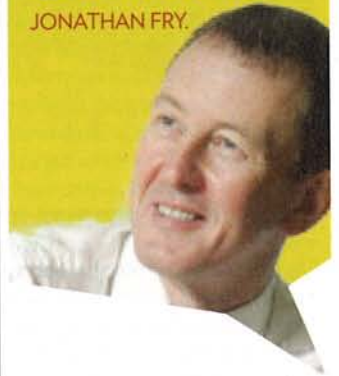
■ **Strategic bond funds:** a strategic bond fund has more flexibility than a plain-vanilla corporate bond fund. But while they may outpace inflation, their asset allocation and risk profiles change continually, so at times you could be in a fairly high-risk investment – and that will require a longer time horizon. For more cautious investors, funds with good returns include Fidelity Strategic Bond.

■ **Corporate bonds:** some corporate bond funds are fairly low risk, although at present the yields on some of these are below the inflation rate, especially if their allocation is more conservative. Options include M&G Corporate Bond and Henderson All Stocks Credit.

■ **Absolute return:** if you have a medium- to long-term time horizon some advisers, including Mr Fry, say you could consider absolute-return funds, which aim to make money in rising and falling markets. But it is difficult to compare these funds because the sector is very varied, and performance has been extremely mixed. For these reasons, Martin Bamford, managing director at Informed Choice, argues that absolute-return funds are not a suitable low-volatility option for low-risk investors. However, if you are tempted by absolute-return strategies, funds with good performance records include Standard Life Global Absolute Return Strategies, although this only has a three-year track record and a complicated underlying strategy.

"It is better to get, say, 3 per cent growth than the promise of 4 per cent or 5 per cent and then lose it"

JONATHAN FRY.



Money market meltdowns: two case studies

Standard Life's Pension Sterling fund diversified its investments out of bank deposits and very short-dated instruments and, by July 2007, most of it was invested in floating-rate notes. However, this resulted in losses and volatility, with the fund losing 4.8 per cent of its value (around £100m) on one day alone in January 2009. Standard Life had to

pay £103m into the fund to restore the value of the investors' holdings to the position they would have been in prior to the fall in the unit price.

Yet this fund was aimed at investors approaching retirement who needed something more stable than equities and bonds, and the factsheet for the fund indicated it was 100 per cent invested in cash until April 2008. The Financial

Services Authority (FSA) said marketing literature for this product did not meet its requirement of being "clear, fair and not misleading" and that this was inconsistent with the regulator's principle of treating customers fairly.

The FSA fined Standard Life £2.45m, on the grounds that the fund manager had breached the regulator's guidelines on management

and control, and communications with clients. The Pension Sterling Fund has now been closed. The Threadneedle UK Money Securities Fund was closed at the end of 2009 following massive losses and investor redemptions. Over the year to 2 October 2009 the fund lost 20 per cent, while its money market funds on average returned 0.7 per

cent. Threadneedle UK Money Securities Fund came under pressure when the market for mortgage-backed securities and asset-backed securities became illiquid and it was unable to trade them. These had been an integral part of the investment strategy of the fund. However, Threadneedle's fund literature did indicate that it held higher-risk assets.

MONEY MARKET FUNDS

MONEY MARKET UNIT TRUST

BLACKROCK CASH ACC (MYCA)

BlackRock Cash Fund breezes through crisis

BlackRock Cash Fund is not the top performer in the Investment Management Association's (IMA) Money Market fund sector in terms of cumulative returns, but it has done a tremendous job at protecting against losses.

Looking at returns on an annual basis, the fund has not made a negative return in the past five years, and in 2008, as the FTSE All-Share plunged more than 30 per cent and most other assets made losses, BlackRock Cash Fund returned 4 per cent.

The fund aims for a high rate of interest from cash, cash deposits and other money market instruments, but its choice of investments is more conservative than some money

market funds. Its core strategy is to maintain high levels of liquidity, while investing in top bank instruments from an approved list its management team draws up. Manager Stuart Niman prefers floating-rate securities with maturities under a year issued by very high-quality top-tier banks to enhance the fund's defensive qualities.

Due to the volatility in continental Europe, the fund has diversified its holdings by adding UK government guaranteed floating-rate debt, such that around 22 per cent of the fund's assets are now in this asset. The portfolio is positioned away from the sovereign and bank sectors of those eurozone countries with structural deficit problems.

BlackRock Cash Fund

Price: 236.7p

Yield: 0.23%

Size of fund: £592.7m

1-year performance: 0.2%*

3-year performance: 2.9%*

5-year performance: 11.2%*

Set-up date: 22 March 1990

Manager start date: 1 August 2006

Total expense ratio: 0.57%

3-year volatility: 0.4%*

3-year standard deviation: 0.38%

3-year beta: 0.17*

Minimum investment: £500

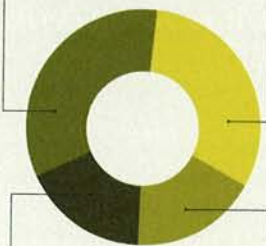
More details: blackrock.co.uk

Performance Data As At 30 June 2011

Source: Morningstar & *BlackRock

Security breakdown

33.7% Floating rate notes
31.3% Certificates of deposit



17.6% Commercial paper
17.4% Time deposits

Top 10 issuer exposure

Barclays 1.069 13 Jan 2012	6.0%	Bank of Tokyo Mitsubishi	
Citibank 0.650 1 Jul 2011	4.7%	0.000 20 Jul 2011	4.3%
FMS Wertmanagement		ING Bank 0.826 8 Sep 2011	4.3%
0.943 11 Apr 2012	4.7%	Lloyds 1.199 26 Jan 2012	4.3%
KBC 0.570 1 Jul 2011	4.6%	Lloyds 1.401 22 Dec 2011	4.3%
Soc Gen 0.550 1 Jul 2011	4.6%	Rabobank 0.000 1 Jul 2012	3.7%

As at 30 June 2011

MONEY MARKET UNIT TRUST

PREMIER UK MONEY MARKET ACC (PCUKMA)

Premier Money Market profits from low risks

Premier Money Market Fund is among the top five performing UK money market funds over three and five years, but it doesn't achieve this by taking excessive risks. This is evident in the fund's annual returns, which have been positive every year for the last five years. And it returned 4.5 per cent in 2008 when many other assets plunged more than 30 per cent.

Manager Paul Smith says he has generated positive returns amid historically low interest rates and after fund fees by "working his portfolio harder". This has included calling interest rates correctly and locking them in for a long time.

"It would be a mistake to take on more risk," says Mr Smith. "During the financial crisis some funds took excessive risk by

attempting to diversify too much. I keep my portfolio clean and plain-vanilla – I try and call interest rates. That is how a money market fund should work. For the last three years we've avoided riskier assets such as long-dated floating-rate notes and mortgage-backed securities, and for a few months during 2008, commercial paper."

Short-dated floating-rate notes now account for 35 per cent of the fund, but these are all issued by senior financial institutions. "I stick with financials to avoid corporate losses," adds Mr Smith.

The fund typically has exposure to between 20 and 30 financial institutions, although most of the assets are concentrated among the top 10 issuers, which account for more than 70 per cent.

Premier UK Money Market Fund

Price: 126.48p

Yield: 0.4%

Size of fund: £103.1m*

1-year performance: 0.47%

3-year performance: 4.58%

5-year performance: 13.47%

Set-up date: 1 August 1989

Manager Start Date:

10 September 2007*

Total expense ratio: 0.6%*

Volatility: 0.14

Tracking error: 0.1

Beta: 0.64

Minimum investment: £1,000

More details:

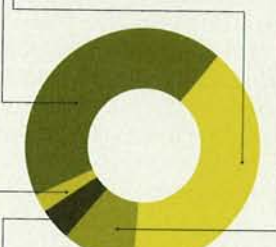
premierassetmanagement.co.uk

Performance data as at 2 August 2011

Source: Investors Chronicle & *Premier

Security breakdown

43.03% Floating rates notes (financials)
40.26% Certificates of deposit
9.85% Cash deposits



4.47% Bonds (financials)
2.39% Bonds (consumer, cyclical)

Top 10 issuer exposure

Citigroup	12.6%	Overseas Chinese Banking Corp (London)	5.8%
Rabobank Nederland	12.2%	ING Bank	5.8%
Credit Agricole	8.8%	Northern Trust	5.0%
Barclays	6.7%	General Electric	4.5%
Nordea	5.8%	BNP Paribas/Fortis	3.9%

As at July 2011