Breaking the Buck – What Investors Can Learn From African Bank

‘One of the most useful things I’ve learnt over the years is to remember that if you don’t know what is going to happen, don’t structure your portfolio as though you do!’

James Montier

‘History doesn’t repeat itself, but it does rhyme.’

Mark Twain

‘If you got into a 747 today, and the pilot came aboard wearing a 50-mission hat with a long, white silk scarf around his neck, you’d get off. Those people do not belong in airplanes any longer because flying an airplane today is a Loser’s Game. Today, there’s only one way to fly an airplane. It’s simple: Don’t make any mistakes.’

Charlie Ellis, ‘The Loser’s Game’

Money market funds are generally used as ultra-safe vehicles for investors looking to temporarily park short term cash. As such, most investors would regard it as almost inconceivable that they could actually lose their money in money market funds. The exposure of some money market funds to African Bank (ABIL) debt at the time of its collapse holds important lessons for fund managers, regulators and investors alike.

Pricing discovery and liquidity is poor in the South African money market

In South Africa, money market funds are priced at a constant net asset value (NAV) per unit. The NAV per unit is usually R1 because the underlying investments aren’t expected to produce any capital gains or losses. Breaking the buck refers to a scenario where the fund NAV per unit drops below R1 due to the underlying pool of assets decreasing in value and investors’ units being impaired to the lower price. The disconnect between the constant R1 price of the funds’ units and the actual value of the underlying investments in the fund has sparked the debate around moving towards a more transparent mark to market (MTM) pricing model. Theoretically, this would improve transparency and more accurately reflect pricing between willing buyers and sellers in the market.

The problem in South Africa is that the secondary market is extremely illiquid for corporate bonds and almost non-existent for Commercial Paper (CP). Price discovery outside of primary banking instruments therefore tends to be especially poor. Banks are the primary market makers for short dated money market assets and provide what is termed ‘two way’ pricing. They provide a bid (buy) and an offer (sell) price at which they trade instruments. Corporates by contrast will typically use debt raised through the issue of bonds or CP to fund working capital or longer term capital expenditure. This lack of liquidity constrains efficient price discovery. The Johannesburg Stock Exchange (JSE) also has very specific rules as to what actually constitutes a viable trade and can ultimately affect the price of the instrument. These rules include factors like the total size of the trade, settlement period and the relationship between the two trading counterparties.

Some funds stretch for yield in lower quality credit

There are essentially two ways to increase or enhance yield in money market portfolios – investing in higher duration (longer maturity) instruments or searching for yield in lower quality credits. Longer maturity instruments typically carry higher rates as investors need to be compensated for effectively lending for longer. Lower quality credit needs to be priced at a premium to reward investors for lending to companies that have a higher probability of default. The opportunity set of investable credit in South Africa, especially in shorter-term money market assets, is relatively small. Demand for corporate debt is also particularly strong with issuance at primary auctions being regularly oversubscribed. The effect of limited supply and high demand is to inflate price and simultaneously depress yield. An additional concern is that the absence of a well-developed secondary market means fund
managers will ultimately be forced to hold the credit to maturity. Investors are therefore likely to remain exposed even if there’s a deterioration in the creditworthiness of a company.

The bailout of African Bank led to impairments on funds holding ABIL paper

Credit rating agencies assigned ABIL an A-rating (investment grade), which allowed the company to access the market at more attractive funding rates than if it wasn’t investment grade. The instruments ABIL issued that qualified for inclusion in money market funds were shorter-term bonds maturing in less than 13 months, fixed or floating rate wholesale deposits and CP. All were tranché as senior unsecured credits. At the time the bank was placed under curatorship, no CP was in the market. ABIL repaid a CP issue in February 2014 after successfully raising a 175 million Swiss Franc Eurobond. All ABIL debt was extremely illiquid. There was no secondary market for Rand denominated corporate bonds. Trading in wholesale deposits was constrained by the bank not being able – or willing – to buy back its own paper. The South African Reserve Bank’s announcement that all senior debt would be impaired by 10% meant that local money market funds effectively had to write down the income accruing under ABIL by the same amount.

Important lessons learnt

1. There’s no such thing as a risk-free asset. Money market funds are a relatively lower risk asset class, but the underlying pool of assets still carries both credit and liquidity risk. In the RECM Money Market Fund we mitigate these risks by having a strong preference for investing in high quality issuers like the primary banks and government, and avoiding exposure to less creditworthy corporates or any credit structured through special purpose vehicles (SPVs).

2. Focus on return of capital. The higher yields on ABIL credit were primarily due to the bank being less creditworthy than the primary banks. Most funds with ABIL exposure were attempting to enhance fund yields. To stretch for yield in a lower risk asset class like a money market fund is bound to end unfavourably. To paraphrase Charlie Ellis – managing a money market fund is a ‘loser’s game’. The most positive outcome is determined by making fewer mistakes as opposed to trying to beat the market by taking on undue credit risk. The RECM Money Market Fund currently has no exposure to corporate credit – primarily because higher quality credit is particularly expensive and we don’t put our clients’ capital at risk in lower quality alternatives.

3. Only invest in companies, securities or funds you fully understand. To suggest that money market funds should avoid investing in corporate bonds altogether would be a hasty and ultimately incorrect conclusion. Money market funds have an important role to play in providing more efficient credit markets by disintermediating banks and allowing companies to diversify funding. Well priced, higher quality corporate credit has a place in money market funds, but the primary goal should however always be to preserve capital. AtRECM we only invest in assets we understand and if we can’t properly assess credit risk and aren’t adequately compensated for investing in illiquid assets, we simply don’t put our client’s capital at risk. We therefore don’t invest in conduits or SPVs where we can’t look through into the underlying asset pool.

4. Distinguish between price and value. As custodians of other people’s money, fund managers are paid to assess risk and return and to think independently about which opportunities to allocate clients’ capital to. They also need to apply their minds to determine what price to pay for those assets. MTM prices mean absolutely nothing if assets don’t trade. The industry as a whole is better off if the price of an asset is determined by willing buyers and sellers. This avoids the obvious dangers of anchoring price off stale MTM pricing or allowing credit rating agencies or regulators to frame your estimate of fair value. If you don’t know what an asset is worth it shouldn’t be part of your portfolio.

Pay attention to fees.

Distinguishing between luck and skill especially over short periods is tremendously difficult in investing in general. The RECM Money Market Fund has been a leading performer since its inception in 2010 not necessarily because of either attribute. There certainly are elements of both luck and skill in constructing money market portfolios, but the outperformance of the RECM Money Market Fund is primarily due to the relatively low fees charged. It’s highly unlikely that a fund manager can consistently be correct in their views of macroeconomic factors like inflation and interest rates. Thus, we spend no time trying to forecast the size and timing of prospective changes in any economic variable. Instead, given
that we are not professing to have more skill – or luck – than our competitors, we simply charge our clients lower fees. The benefit to our investors is a layer of additional yield, with no commensurate increase in risk.

The bottom line is that all market participants – fund managers, clients and regulators – can learn from the events at African bank. Defaults are a normal part of any credit cycle. There’s no such thing as a risk free asset and the industry is better off if all participants act accordingly. The ultimate goal for a credit investor is first and foremost to ensure they get their capital back. The important thing is not to focus on the specifics of the ABIL fallout but to consider in general more prudent reforms to protect clients’ capital better. It isn’t as simple as changing to a MTM pricing system – there are structural and behavioural challenges to address in the secondary market for corporate debt in South Africa. The RECM Money Market Fund had no exposure to ABIL at the time it was placed under curatorship. The Fund prioritises capital preservation and generates competitive yields for our clients by charging low fees, not by stretching for yield in lower quality credit.

Sean Neethling

References: