The Risks Associated with Money Market Investing

‘To make money, you will have to take risks, even if it’s just your time on the line. The key to risk-taking is knowledge.’
Stuart Wilde

‘I learned to embrace risk, as long as it was well thought out and, in a worst-case scenario, I’d still land on my feet.’
Eli Broad

‘When everyone feels that risks are at their minimum, over-confidence can take over and elementary precautions start to get watered down.’
Ian Macfarlane

Money market investments are considered to be a low-risk investment asset class compared to equities, bonds and property. This is because its main constituents – cash, bank deposits and short-term debt instruments – are perceived to be relatively low risk in nature. However, this does not mean these investments are risk free.

In this article we discuss the nature of the risks associated with money market investing and how we deal with these. We specifically:

- define the different types of money market investments risks, namely reinvestment risk, counterparty risk, instrument risk, and liquidity risk;
- explain how we at RE:CM manage these risks; and
- explain how we focus on preserving our clients’ capital while offering them liquidity and ensuring they earn a low-risk income.

1. Reinvestment risk

Reinvestment risk is the risk of investing maturing funds at a lower interest rate and getting a lower yield than on the maturing investment

Conversely, money market funds tend to benefit from an ‘interest rate opportunity’ when interest rates increase. The South African Reserve Bank through the Monetary Policy Committee (MPC) has the sole responsibility of managing monetary policy by raising or lowering short-term interest rates. The MPC periodically decides on the level of short-term interest rates based mainly on inflation. If inflation is rising, the MPC will raise short-term rates and vice versa. Although inflation has been rising in the past year the MPC has kept interest rates unchanged. This has affected interest rate expectations, resulting in uncertainty and volatility in short-term interest rates. To money market fund managers, the task of managing reinvestment risk can be cumbersome if short-term interest rates are highly volatile.

We do our own economic and yield curve analysis to manage interest rate risk

To manage reinvestment risk, we do our own economic analysis combined with interest rate or yield-curve analysis. We aim to take advantage of low reinvestment risk opportunities presented by the yield curve, even in times of uncertainty. We do this by investing in short-dated instruments when the yield curve is flat, or lengthening our duration when the yield-curve is steep. A steep yield curve means longer-dated deposits offer higher yields than short-dated deposits. Our discipline is focused on allocating capital where money market instruments offer value relative to our base-case interest rate scenario. We are not yield seekers but value seekers. Focusing on value enables us to manage reinvestment risk even when there is volatility in the market.

2. Counterparty risk

Counterparty risk is the risk of the borrower not making payments as promised

Counterparty risk (credit risk) is the risk that the counterparty or issuer of the debt will fail to fulfil its obligations to pay the borrowed amount or the promised interest amount. The banks and
corporates that issue deposits and commercial paper are examples of money market fund counterparties. Counterparties with poor or weak balance sheets pose a high risk to money market assets when they default on their borrowed funds.

During the global financial crisis in 2008, foreign money market funds lost capital because of counterparty defaults. The reason for this was that there was a lack of liquidity in the global money market space. Banks and corporates that depended on short-term funding were exposed to a funding or liquidity crisis, resulting in multiple counterparty defaults. This funding crisis led to a systemic risk in the global financial market. The lesson from this is that understanding and managing counterparty risk is vital to avoid capital losses.

**We manage counterparty risk by investing only in counterparties with strong balance sheets**

Our money market fund only invests in counterparties with strong balance sheets, such as the big four banks (Absa, Nedbank, First National Bank and Standard Bank), National Treasury and the South African Reserve Bank. We don’t simply take comfort in allocating capital to the big banks or only rely on the ‘too big to fail’ belief. Instead, we analyse their prudential liquidity requirements as required by the Reserve Bank. We do this to identify banks that are facing potential liquidity pressure before it becomes a liquidity or credit event in the market.

Even though poor quality counterparties generally pay higher yields, we generally avoid them. Our goal is to generate steady interest income at low risk rather than the highest possible income. Managing counterparty risk exposure will remain a cornerstone of our capital allocation on a continuous basis.

3. Instrument risk

**Instrument risk is the risk that is specific to a particular debt instrument**

Instrument risk arises when a particular money market instrument does not perform as promised due to adverse events in the market. These events could include the counterparty defaulting on its commitments or the underlying credit risk of the instrument (or counterparty) increasing dramatically.

Deposit or short-term debt instruments is the source of income yield for money market funds. Money market instruments comprise a variety of instruments, including plain fixed deposits, tradable certificates of deposit, treasury bills, asset-backed securities and commercial paper. These instruments have different risk characteristics, depending on the issuer and term.

Treasury bills and bank deposits have the least risk due to security in the capital structure and the quality of the issuer. On the other hand commercial paper borrowers and asset-backed issuers have been known to fail.

Although money market instruments are typically a source of income yield in an investor’s portfolio, it is important to balance yield and risk and to know the nature of the underlying instruments. Managers that seek higher yields could be lured into investing in high-yielding unsecured instruments where the yield does not compensate for the risk.

**We manage instrument risk by investing in high quality money market instruments like bank deposits**

RE:CM’s mantra is ‘Your capital first’ and this is core to our investment process. The RE:CM Money Market Fund only invests in high quality money market instruments like bank deposits, which offer capital safety, albeit at slightly lower yields. We focus on investing in deposits that we understand and avoid instruments that offer limited security such as poor quality commercial paper or asset-backed securities.

4. Liquidity risk

**Liquidity risk is the risk of being unable to sell an asset at the desired time or at fair value**

Liquidity risk arises when a money market fund experiences unexpected large cash outflows and is forced to sell because it has insufficient liquid assets to fund the outflows.

During the global financial crisis investors in asset-backed securities and commercial paper lost capital because these instruments were sold at a discount to their face value as investors in funds sought immediate liquidity. Generally money market instruments such as fixed deposits or asset-backed securities are not easily tradable in the secondary market. Selling illiquid instruments before their maturity usually results in an
additional cost to the fund, which reduces the fund’s income. The poor tradability means that a fund should have limited exposure to instruments that are unsecured so as to avoid becoming a forced seller.

**We manage liquidity risk by maintaining 5% exposure in overnight deposits**

One of our key objectives in setting up the Fund was to offer liquidity to our clients. Liquidity determines our duration exposure across the money market yield curve. We maintain a minimum liquidity level of 5% exposure in overnight deposits. Additionally the step-up deposits (in which the fund is significantly invested) offer us the opportunity to liquidate every one or three months at no cost when we need the cash.

**Our priority is to preserve your capital and offer you liquidity while earning you an income at low risk**

Although the money market asset class generally preserves capital when compared to equities and bonds, it is important that investors are familiar with the risks of investing in this asset class. At RE:CM our priority is to preserve capital, offer liquidity and then generate incremental income at the lowest risk possible. It is not our objective to generate high yields by investing in risky counterparties and dubious instruments. With every decision we make when we allocate clients’ assets, we carefully consider our ability to manage reinvestment risk, counterparty risk, instrument risk and liquidity risks. Ultimately, we believe that to be better at managing these risks we should be consistent and disciplined when we invest in low-risk income opportunities.

Thompson Ganyeka