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Money Market Reinvestment Risk

With net inflows of almost R14.4 billion for the quarter to end March 2009, the Domestic Money Market sector was the best supported sector in the unit trust industry for the fifth consecutive quarter; bringing rolling one year net inflows to almost R55 billion (source: ASISA quarterly statistics). The result being that money market unit trust fund assets, at almost R228 billion, now constitute more than one third (36.5%) of total unit trust industry assets. In the face of ongoing market volatility and weakness, local investors have continued to derisk their portfolios by switching into and remaining invested in the money market.

Many of these investors were attracted by the relative outperformance of cash (11.38%, as represented by 3 month treasury bills) in 2008 over equities (-23.23%, as represented by the All Share Index). Cash also outperformed inflation (9.5%, as represented by CPI) in 2008. In hindsight, it appears that the one year performance of Money Market unit trust funds peaked at the end of March 2009 – the average Money Market unit trust fund returned 12.01% for the one year (source: Morningstar); by comparison the average general equity fund returned -25.85% for the same period! Clearly then, following the collapse of the equity markets in May 2008, cash proved to be king. However, what new risk does this switch to cash introduce?

I believe the key risk is that of investor expectations being anchored in a similar return going forward; much like many were anchored in a return from equity investments of in excess of 30% following the five year bull market, which ended in May 2008. However, we know from studying financial markets over very long periods of time that one can expect a real return from equities of approximately 7% and from cash of approximately 1%. So, it is likely that many investors in money market funds will be disappointed by the return on their investment in the coming months, and this disappointment will manifest itself through reinvestment risk.

What do I mean by reinvestment risk? In terms of Notice 1503 to the Collective Investment Schemes Control Act, money market unit trust funds are restricted to investing in financial instruments with a term to maturity of not more than 365 days and the weighted average duration of all the financial instruments that make up the money market unit trust fund cannot exceed 90 days. This effectively means that on average the portfolio manager of a money market fund is required to reinvest the entire portfolio every 90 days.

Now in an increasing interest rate environment, as we experienced from May 2006 to May 2008 (over this period the repo rate increased by 500 basis points in ten fifty basis point increments, as demonstrated in the Bloomberg graph below), this allowed the portfolio manager to invest in financial instruments that gradually offered a higher yield (interest rate). Hence the return on money market unit trust funds increased significantly over this period – the one year return to 31 May 2006 was only 6.78% and, as stated above, this increased to a high of 12.01%!

Unfortunately we have already seen the repo rate, and consequently short term interest rates, come off by 450 basis points since December 2008 – note that it took approximately two years for interest rates to rise by 500 basis points and only six months for them to return to almost where they started! What this effectively means is that when reinvesting matured financial instruments the portfolio manager is now getting a yield significantly lower than what he / she was receiving six months ago – by way of example Negotiable Certificates of Deposit that were yielding 14% late last year are now only yielding 7.6%! Investors can therefore expect to see the one year return on their money market unit trust fund reduce commensurately.

With inflation fairly sticky at the current level of just over 8%, there is the very real risk that investors that remain in cash will see a decrease in the real value of their investment.

But what then are the alternatives for the conservative investor? Certainly investors should consider flexible fixed interest funds such as the Cadiz Absolute Yield Fund, where the portfolio manager has a far broader investment universe from which to select in order to diversify risk and enhance the yield of a portfolio. In a decreasing interest rate environment the mandate of these funds also allows the portfolio manager to hold financial instruments with a term to maturity of longer than one year. By way of example, the weighted average duration of the Cadiz Absolute Yield Fund is now 1.44 years, which far exceeds the 89 days of the Cadiz Money Market Fund. The flexible fixed interest portfolio manager is therefore able to lock in higher yielding assets and hold them for longer than money market portfolio managers are able to. This should reflect in flexible fixed interest funds outperforming money market funds in the months ahead.

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