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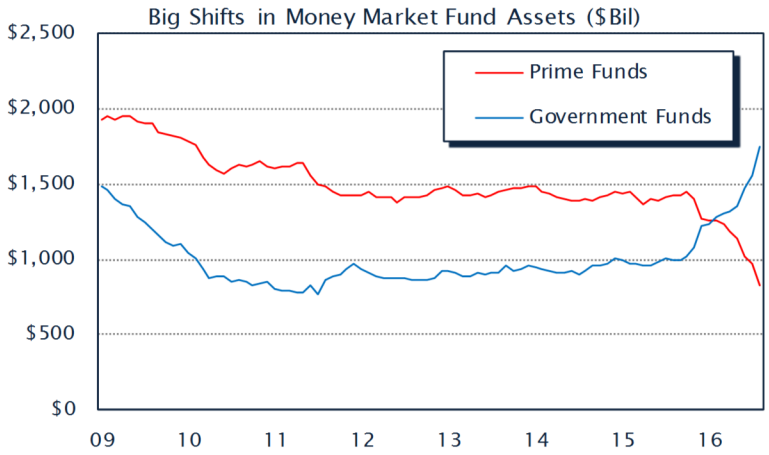
Agincourt Capital Management, LLC

INVESTMENT UPDATE

As we've documented in recent *Investment Updates*, there are plenty of explanations for historically low interest rates and soaring bond prices—central bank quantitative easing/asset purchase programs, a worldwide slowing of economic growth, aging populations, currency manipulation—you get the picture. But would you believe that in the midst of all this, there are interest rates that have been rising over the past few weeks?

Well, there are, and most of the causes are tied to new regulations that are going into effect in October for US money market funds (MMFs). These new rules are a result of events that took place during the financial crisis, when at least one high-profile money market fund "broke the buck"—that is, the net value of the assets in the fund dropped so low that the fund company was unable to supply daily liquidity to the funds' participants at 100 cents on the dollar. That's a bad thing, in case you were wondering, in a system that assumes that money market funds are the same thing as cash.



We will set aside for the time being the question of whether the impending regulations are the right ones to prevent a replay of the 2008 MMF debacle. Suffice to say that the SEC is designing these rules to reinforce investor confidence about the strength of money market funds. The US government doesn't want to have to step in, as they did in 2008, and guarantee the safety of funds that were touted by brokers and banks as "the safest of the safe." If investors don't have 100% confidence in the sanctity of their money funds, they will simply keep their money in their checking account; especially for institutional investors, preservation of principal is worth giving up a few basis points of return, at least when it comes to liquid funds.

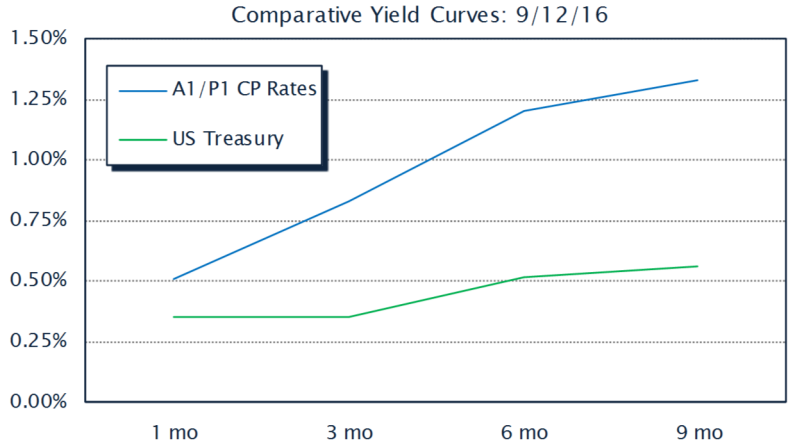
The new regulations take particular aim at non-government holdings in institutional MMFs—including short-term commercial paper (CP) issued by corporations, as well as bank repurchase agreements and non-insured certificates of deposit (CDs). You might recall that in the aftermath of the collapse of Lehman Brothers, prices tumbled for all types of corporate obligations, even those with ultra-short maturities favored by MMFs.

As a result, the SEC is placing restrictions both on what assets are allowed in certain MMFs and how they are accounted for. For funds that invest only in government securities there will be few changes, as the current regulations are sufficient to handle the limited price volatility and superior liquidity of these bonds. Government-only money market funds will continue to offer investors a stable net asset value (NAV) at $1.00. On the other hand, institutional "prime" money market funds, which have traditionally invested in a wide range of short-term instruments, will no longer have a stable NAV, but will be required to be marked to market just like any other short-maturity/short-duration bond fund. There will be other changes for these prime funds, including liquidity fees of up to 2% and "gates" to dissuade investors from pulling their money out if the fund's liquid assets fall below a certain threshold. Prime funds marketed to individual investors will be exempt from these new, tougher rules.

As shown on the chart above, these regulatory changes have led to huge shifts as investors are moving money from prime to government money market funds. Prime funds, which up until recently had roughly $1.5 trillion in assets (roughly 1.5 times the assets of government funds), have shrunk to less than $800 billion, their lowest market value in 20 years. A lot of this occurred earlier this summer as fund companies converted former prime funds to government-only, but over recent weeks the migration has been caused by institutional investors—many of whom demand a stable NAV from their money market fund—who are pulling the plug on prime funds.

Expectations are for these withdrawals to continue, as institutional investors shift into either government MMFs or alternative "semi-stable value" strategies further out the yield curve (more on this ahead).

Changing preferences in MMFs have, in turn, increased the demand for short-term government bonds while the demand for non-government short-maturity investment instruments has all but dried up. The once-robust market for commercial paper is in disarray, as is the CD market, as rates for these instruments have risen as institutions looking to borrow in the short-term markets have been forced to raise their rates in an increasingly-desperate attempt to attract buyers of their paper. As the chart on this page shows, in the short part of the yield curve CP rates are significantly higher than Treasuries. On average, the rate on six month term "A1/P1"-rated commercial paper is now roughly 70 basis points (0.70%) above the yield on similar-maturity Treasury bills; that's up from 35 basis points on January 1st and 44 basis points on June 30th.



Besides pushing up CD and CP rates, these regulatory changes are having an indirect impact on the banking system as well, pushing up short LIBOR rates. LIBOR, as you might recall, is an acronym for London Interbank Offering Rate, and is an important benchmark for short-term borrowing among banks. It's set daily, based on a survey of the costs of unsecured funding among a handful of mostly European (11 of 18 in the survey) contributing banks. With demand for CDs and CP drying up and pushing up short-term borrowing costs, the banking industry's cost of funds is rising, and that includes LIBOR funding.

LIBOR rates are also used as yield benchmarks for all kinds of instruments, much like the Treasury yield curve. But with short maturity Treasury rates still on the floor and LIBOR rates rising, the LIBOR curve has "flattened" much more than the Treasury curve, for all the reasons stated above, and that, in turn, is having an impact on the broader bond market. Investors who own either floating rate or short-maturity bonds whose yields are tied to LIBOR are experiencing a kind of windfall, simply from the knock-on effects of these regulatory changes; the opposite is true for those whose borrowing costs are tied to LIBOR.

While the world debates about when and (ultimately) how far the Federal Reserve will push up short-term rates, it's already happening in the corporate bond market, as well as the corporate loan market, including commercial real estate. Foreign banks, in particular, are feeling the pain, at least until the marketplace for short-maturity borrowing and savings moves back towards some sort of equilibrium; that could take a number of months, even after the new regulations come into full effect in October. In the meantime, yields are relatively attractive right now for buyers of low-risk, high quality short-term instruments that aren't issued by the US government or one of its agencies.

Institutions with short-term cash holdings are now faced with the unpleasant choice of near-zero yield on a government MMF (but with a stable NAV!) or a prime fund with no guarantee of price stability and a few basis points of extra yield. But there is a third option, and one that Agincourt has a long track record of managing successfully—namely, enhanced cash strategies. For investors who understand that earning something other than zero yield on their short-term holdings necessarily means giving up the certainty of stable NAV, we recommend "tiering out" their cash, and moving money that isn't needed for day-to-day operations into a short-duration strategy, investing in these suddenly-cheaper, higher-yielding, slightly longer instruments. We have the ability to tailor these funds to clients' specific needs. The advantages are obvious: Earn better returns by investing in high-quality, short-term non-government bonds where a yield of 1.0% to 1.5% is not unreasonable, while still maintaining excellent (if not total) price stability and liquidity. Funds needed for daily liquidity can be pared back to a minimum level and remain invested in a fund with a stable NAV, where necessary.

For clients who are invested in longer-duration strategies, these higher short term rates make a "barbelled" yield curve allocation more viable; a portfolio emphasizing short and long maturities (while underweighting intermediate bonds) looks much more attractive when yields on short-maturity bonds have risen. What's more, a barbelled strategy will generally outperform both neutral and "bulleted" yield curve allocations (i.e., holdings clustered around the middle of the maturity range) when the yield curve flattens, an increasingly likely scenario if the global economy picks up steam and the Fed begins pushing up the Fed funds rate.

Did the regulators at the SEC know that stiffening regulations for money market funds would create new investment opportunities? Probably not, but we're not complaining.