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Understanding Money Market Mutual Fund

Money Market Mutual Fund

Money market mutual funds (usually referred to as money market funds or money funds) invest in short-term, fixed-income securities, otherwise known as money market investments. By definition, money market investments mature in less than one year.

Like other mutual funds, money market funds are pooled investments that allow investors to participate in a diversified portfolio managed by professionals to meet certain goals, which are stated in the fund's prospectus.

There are several types of money market funds, each with different underlying investments.

- Prime funds invest in riskier short-term corporate and bank debt
- Government funds must have 99.5% of total assets invested in cash, U.S. Treasury securities, other government securities, and repurchase agreements collateralized by government securities
- Tax-exempt (municipal) funds invest primarily in securities issued by state and local governments

Reforms addressed risks

Money market funds have traditionally traded at a $1-per-share net asset value (NAV), even though the underlying holdings might be worth slightly more or less. In the fall of 2008, a long-established institutional money fund "broke the buck" after suffering investment losses that caused its shares to fall to 97 cents. Investors fled from money market funds in a panic that threatened to freeze corporate lending markets. To help reassure the public, the U.S. Treasury intervened by providing a temporary guarantee for all publicly offered money market funds. This program was allowed to expire as scheduled on September 18, 2009. However, the Securities and Exchange Commission (SEC) adopted a series of new regulations over the following years.

Rules implemented in 2010 require money market funds to hold a greater percentage of their assets in higher quality, more liquid assets to facilitate shareholder redemptions. The regulations also limit the amount of lower-quality securities a fund may hold; shorten the average maturity limits for a fund's overall portfolio; require a fund to identify investors whose redemption requests could pose a risk to the fund, and stress-test its ability to maintain a stable share value; require funds to independently analyze all holdings rather than relying solely on credit ratings; and enable a fund's board of directors to suspend redemptions if the fund is about to "break the buck."

After further review, the SEC adopted more fundamental structural changes to money market fund regulations. These changes were announced in 2014 and took effect on October 14, 2016. The SEC rules now distinguish between retail and institutional money market funds. Retail investors are defined as "natural persons," such as individuals who can be identified by a Social Security number. Financial institutions, governments, defined benefit plans (pensions), corporations, endowments, and other accounts that are not owned by natural persons are allowed to invest only in institutional money market funds.

Only institutional prime funds will be required to float in value like other mutual funds, and investors who pursue their higher yields will be expected to accept the additional risk. Government and retail funds should continue to trade at a stable $1 share price.

All prime and tax-exempt money market funds (for institutional and retail investors) will be capable of placing restrictions on redemptions in times of stress. If weekly liquid assets fall below 10% of total assets, the fund's board could impose a liquidity fee of up to 2% on shareholders who sell their shares. Below 30%, a "gate" could be used (in addition to fees) to prevent investors from withdrawing money altogether for as many as 10 business days in a 90-day period.

Government money funds, which hold instruments backed by the full faith and credit of the United States, are not required to implement fees or gates.

Taxable money market funds

The yield on money market funds generally falls somewhere between those of FDIC-insured money market deposit accounts or short-term certificates of deposit (CDs), and those offered by longer-term CDs, which generally offer higher returns in exchange for tying up your money for periods in excess of one year.

The yields on conservative government funds are likely to be lower than the yields on riskier prime money market funds and Eurodollar certificates of deposit (which involve risks associated with foreign investing). Yields on money market funds vary over time, and some funds may pay a higher rate than others either because they are designed to take higher risks or because they charge lower fees. You should review these policies and fee structures as they are described in each fund's prospectus to determine a fund's true yield over time.

For tax planning purposes, you should know that earnings from money market funds occur in three ways: interest and dividend distributions, capital gain distributions, and profits from selling fund shares.

Tax-exempt money market funds

Tax-exempt money market funds invest primarily in short-term obligations of tax-exempt entities, such as state and municipal authorities. The interest on these instruments is not subject to federal income tax, but may be subject to state and/or local income taxes. And, for certain investors, a portion may be subject to the alternative minimum tax.

Generally, income generated from U.S. Treasuries is exempt from state income tax (the tax-exempt benefit generated by U.S. government agency obligations, such as Ginnie Maes, usually does not pass through to shareholders).

There are also state-specific tax-exempt money market funds that concentrate in short-term securities issued within a particular state, providing residents of that state with income that is exempt from state and local taxes as well as federal tax. Some tax-free funds diversify their investments throughout the United States and U.S. territories, such as Puerto Rico and Guam. Since some states have higher credit ratings than others, interest rates vary on these funds. A geographically diversified portfolio of municipal securities spreads out risks among states with varying credit strength.

Caution: *Any capital gain distribution from a tax-exempt money market fund will generally be subject to tax, as will any capital gain that results from the sale or exchange of the fund shares.*

Caution: *Tax-exempt income from a tax-exempt money market fund is generally included when calculating modified adjusted gross income (MAGI) for purposes of determining the taxable portion of any Social Security retirement benefits.*

Caution: *A money market fund may advertise that it invests in government or municipal securities. However, this does not necessarily mean that the income you would receive is tax free. Check the fund's prospectus to determine whether income will be taxable or tax free.*

Calculating after-tax returns

Depending on your tax bracket, you may find that your returns are actually better with tax-free investments, even though they pay a lower rate, because on an after-tax basis you get to keep more of the money you earn. To determine which makes more sense for you, you need to compare the tax-equivalent yields of both funds. To do this, compare the yield of a tax-free fund to the after-tax yield of a taxable fund. To determine after-tax yield, multiply the rate of return by 100 percent minus your tax rate. For example:

Pretax return X (100% - tax rate) = after-tax rate of return

For example: Assume you are in the 25 percent tax bracket and you earn a pretax return of 10 percent.

10% x (1 - 0.25) = 0.075 or 7.5% after-tax rate of return

Money market funds differ from money market deposit accounts

The main difference between money market funds and money market deposit accounts is that money market funds are not insured or guaranteed by the FDIC or any other government agency. Although money market funds seek to preserve the value of your investment at a constant value of $1 per share, it is possible to lose money in a money market fund. However, some money market funds may have arranged for private insurance. Because insurance always comes at a cost, insured accounts generally offer lower yields than uninsured funds.

Caution: *Changing regulations have allowed some banks to offer their own mutual fund products, including money market funds. Although offered by banks, these funds are not FDIC insured. When opening a money market account through a bank, be clear about whether you are establishing a money market deposit account or money market mutual fund.*

Strengths

Liquidity and flexibility

It's easy to invest in a money market account. You can open an account, and make deposits and withdrawals virtually any time you want. Your money is not tied up for any specific time period.

Higher interest rates

Money market funds usually offer higher rates than traditional savings accounts.

Check writing and other privileges

Money market funds typically offer such services as check-writing privileges and/or the ability to transfer funds by telephone or the Internet from your money market fund to another mutual fund in the same family or to your checking account. There are usually restrictions on minimum check amounts and service fees may apply. These are described in each fund's prospectus.

Many fund families allow you to establish a periodic investment plan, drawing as little as $25 a month from your regular checking account to invest in your money market fund. This can be a relatively painless way to accumulate assets.

Convenience for active investors

Because money market funds are offered by both brokerage houses and mutual fund companies, they can be convenient places to hold your cash while you look for other investment opportunities. Most large brokerage houses provide their own money market funds and, with your authorization, they will automatically invest any money that you receive from buying and selling other investments in a money market fund. Likewise, when you want to make an investment, the broker will take the funds needed for the purchase out of your money market fund account.

Caution: *Most large mutual fund families offer an exchange privilege that allows you to transfer assets from your money market fund to other funds in the family. But, if you do so, you may incur an exchange fee and/or sales charge. In addition, the transaction may result in a capital gain or loss that will affect your taxes.*

Tradeoffs

Money market funds are not required to maintain a $1 per share price

Money market funds are not bank accounts, and as noted above, they are not FDIC insured. However, fund companies will go to great lengths to avoid "breaking the buck." On some occasions, if a money market fund's income fell below the level required to maintain a $1 per-share value, the investment companies that sponsored the funds voluntarily made up the difference to fund shareholders. However, the sponsoring companies are not obligated to do so, and there is no guarantee that they will always do so.

Technical Note: *If a mutual fund company or brokerage firm offers its own private insurance for a money market fund, the fund deducts a fee from its total return in order to pay for the insurance. If the fund does not generate a return, the fee is paid out of fund assets.*

Restrictions may apply

Although it is usually easy to make deposits and withdrawals from money market funds, the fund sponsor may impose certain restrictions on the account. For example, initial requirements to establish a money market fund can range from $25 to establish a monthly investment plan to initial deposits of $25,000 or more. Subsequent deposits may also have minimums.

In addition, the companies offering money market funds may give shareholders check-writing, Internet or electronic transfer, or ATM privileges. However, the companies may impose restrictions on such withdrawals or charge fees for these services. Restrictions and fees are described in each fund's prospectus.

Shareholders pay the fund's expenses

Mutual funds operate by pooling investors' money and paying a professional money manager to invest it. The manager charges the fund a fee. In addition, the fund will charge fees for servicing shareholder accounts; some may also charge marketing fees.

Mutual fund fees are usually calculated as a percentage of the fund's assets. All fees are deducted before any distributions are made to shareholders.

Tip: *Mutual funds issue annual and semiannual reports that disclose in detail a fund's income and expenses for the reporting* *period. Also, regulations implemented by the SEC after the 2008 financial crisis require money market mutual funds to report their holdings to the SEC monthly. Those reports include the "mark-to-market" value of the fund's net assets (as opposed to the fund's NAV at which shareholder transactions occur). The reports are available to the public 60 days later, and a fund's holdings must be posted monthly on the fund's web site.*

How to invest

Money market funds are available from mutual fund companies directly as well as from banks and brokers. Application forms to establish an account are usually included in the fund's prospectus.

The terms and conditions of each money market fund vary considerably. For this reason, it is important to shop around for a fund that meets your needs for current income and convenience. Be aware that the returns listed in the prospectus are past returns and do not guarantee future returns. Before investing in any mutual fund, carefully consider its investment objectives, risks, charges, and expenses, which can be found in the prospectus available from the fund. Read it carefully before investing.

To schedule an appointment with Faye Sykes, click here .

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