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SOLUTIONS FOR EUROPEAN DISTRIBUTORS

LIQUIDITY FUNDS

# SO MUCH BETTER THAN A PLAIN OLD DEPOSIT

**Secure and simple, liquidity funds are a useful way to take care of excess cash and a must-have product for asset managers and distributors**

The way organisations invest their cash is changing. Companies require a vehicle that provides exceptional levels of security and liquidity combined with competitive levels of return.

Mindful of counterparty risk, they have become more concerned about placing their balances with individual deposit-takers. But faced with increasing time pressures and greater cash management complexity, few want the burden of managing multiple deposit relationships. This is why many investors are looking to liquidity funds to give them the security, flexibility as well as the integrated global support they require.

In the US, investors have been able to access liquidity funds for more than 30 years, creating a market that's now worth US$2000bn (€1635bn). In Europe, that growth is only just beginning – but demand is formidable. Since the mid-1990s, the European liquidity fund market has grown on average by 50 per cent a year as countries open up to these vehicles and an increasing number of investors discover how these funds can deliver the security, liquidity, and performance they need. In less than a decade, the European liquidity market has grown from nothing to now stand at US$200bn.

## RAPID GROWTH

Given this rapid growth, it's worth looking again at the reasons for the trend away from deposits and into liquidity funds. Many commentators have highlighted key factors ranging from falling credit ratings amongst deposit-takers, volatile yields and the time and resources required to diversify effectively. In addition it is important to highlight that deposits are, by their very nature, a passive investment, whereas liquidity funds actively manage credit quality and duration on a daily and even intra-day basis, giving them the potential to achieve a more attractive risk/reward profile.

In short, the key advantages of liquidity funds over conventional deposits can be summarised as follows:

- **Security**

Unlike single bank deposits, money market funds diversify risk across their underlying assets, allowing investors to achieve a spread of counter-party risk through a single investment. In the current environment, investors take comfort from the knowledge that the vehicle they are using to manage their cash will almost certainly have a superior rating than the banks with which they may currently be placing deposits. There are few AAA-rated banks today and those that remain are heavily targeted by investors – resulting in less competitive rates.

- **Simplicity**

One of the benefits of these types of funds for investors is the simplicity they bring to the cash investment process. Investors often spend much of their time (and associated cost) managing counter-parties,

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**James Finch, JPMorgan Fleming**

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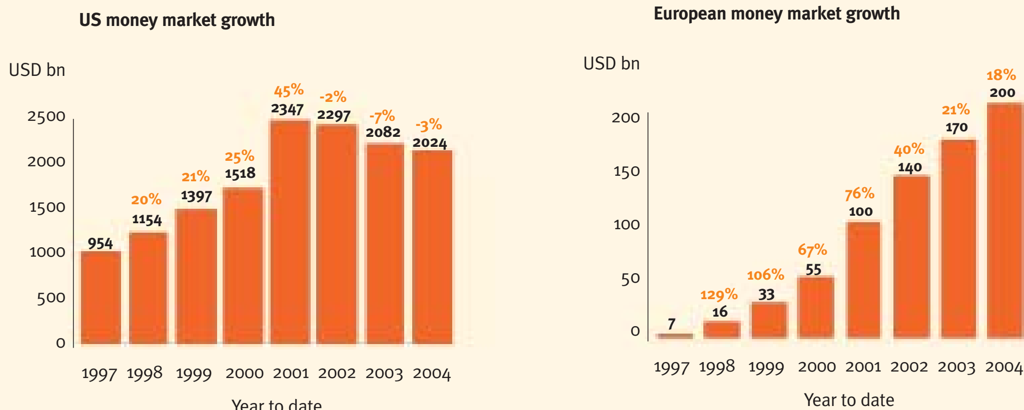
**Europe: following the US into a trillion-dollar market**




*Source: iMoneynet*

placing and rolling deposits, while often still failing to achieve the levels of security, liquidity and yield offered by liquidity funds.

Liquidity funds offer the opportunity to outsource these responsibilities to a professional investment manager, freeing up investors' time for more value added responsibilities. In addition, the availability of dedicated client service desks, on-line trading capabilities, two-way sweeps and automated debiting from clients underlying bank accounts has made access to liquidity funds more straightforward than ever before.

**Liquidity**

Late cut-off times, the size of the fund, and diversity of investors and investments all work together to provide investors in liquidity funds with unrivalled levels of access to their cash. Investors switching to liquidity funds from deposits will be able to benefit from the added security and simplicity these funds offer, whilst maintaining the accessibility they enjoyed with deposits.

## SUFFICIENT SCALE

From a fund provider's viewpoint, scale and resource are essential to a liquidity fund's success. Low margins and high fixed costs mean that in order to generate viable revenue, a liquidity fund should have a minimum of approximately $2bn in assets. In addition, the need for AAA-rated funds to maintain a stable net asset value presents unique business and reputational considerations.

Fund size is also critical for investors. Most clients maintain investment guidelines restricting them from holding more than 5 or 10 per cent of a fund's total assets. This will restrict smaller funds from accepting larger deals and means that building viable fund scale will be a prolonged process.

Asset volatility is another key point to consider. The nature of liquidity funds means that there are regular inflows and outflows and the fund must be large enough to accommodate these without affecting the underlying holdings or the level of liquidity for other investors.

In order to do this, it is vital that there is a diversified client base investing into the fund. A small liquidity fund built on a small number of investors will not provide the expected benefits for investors and fund sponsors alike.

Service is another key differentiator – and the liquidity fund manager must look to this area to provide added value. In this context , managers must ask themselves if they can answer the questions posed in Chart 3.

All of this means that it's a tough market for newcomers. Today, 36 out of the 50 liquidity funds available in Europe still have less than $5bn in assets under management (source: iMoneyNet). Sixteen providers have experienced no growth in the last three years.

But for established liquidity managers, high barriers to entry have created a virtuous circle. Of the $115bn

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**Why deposits are losing out...**

- **Falling credit ratings among deposit-takers**
- **Low, volatile yields**
- **Time- and cost-intensive to diversify**

**And liquidity funds are winning**

- **Competitive yield with low volatility**
- **High security and diversification**
- **Ease of use**

that has flowed into the international liquidity market in the last three years, $55bn has gone to the five largest providers, and that momentum shows no sign of slowing.

Because of these considerations many financial institutions look to established liquidity fund managers to provide third-party solutions which can help them access this market in the short or long term.

## THIRD PARTY WAY

For example, an asset manager may be looking to expand its own liquidity fund offering, but is unable to achieve the sufficient scale needed in a particular currency. Equally, not all asset management houses have the capability, or the desire, to provide liquidity funds. In these cases, third party liquidity fund providers can offer a safe and flexible home for excess client and portfolio cash.

Below are additional examples of the third-party solutions that liquidity fund managers may be able to provide to other financial institutions:

- **Distribution of third-party funds**

This solution offers a quick, low cost means for an asset manager to add liquidity funds to its product offering, or to expand the existing liquidity fund range. The asset manager can retain full marketing and distribution control and nominee accounts can be used to retain discretion over its client base.

- **Building in-house capability through a third-party**

If an asset manager wants to set up its own liquidity fund platform, a feeder fund structure can provide the support it needs to build up assets gradually, without compromising on deal size. Investments into the asset manager's funds would initially feed into a third-party manager's AAA liquidity funds. As the asset manager's capabilities grow, the volume diverted to the third-party funds can be reduced.

- **Sub-advisory – leveraging a third-party's investment process**

A sub-advised relationship allows an asset manager to take full advantage of a third-party's investment process and research capabilities. While the third-party would handle the investment management of assets, the asset manager would retain all control over operations, marketing and sales. Support for these services can also be outsourced to the third-party.

In short, liquidity funds are a fast growing market that investors need to understand in order to invest their cash balances effectively, and one that asset managers cannot afford to leave out of their product offering.

By approaching experienced and established liquidity fund managers, both these parties can achieve cash management solutions that go far beyond what can normally be achieved with conventional deposits.

*James Finch, vice-president, Institutional Liquidity Funds, Financial Institutions Team, JPMorgan Fleming*

### Questions of liquidity 3

**Ten questions investors should ask about liquidity funds:**

- **Will you let me reduce to a zero balance without penalty?**
- **Do any investors account for more than 10 per cent of the fund?**
- **How late in the day can I redeem?**
- **Which currencies do you offer?**
- **How large are your internal credit research teams?**
- **How much can you invest with a single issuer?**
- **Do you provide a dedicated client service team, online access and sweeping capabilities?**
- **Are funds AAA-rated? By which agencies?**
- **Do you offer enhanced yield funds?**
- **What are the size of the individual funds?**

'Not all asset management houses have the capability, or the desire, to provide liquidity funds. In these cases, third party liquidity fund providers can offer a safe and flexible home for excess client and portfolio cash'


## CORPORATE STATEMENT

**JPMorgan Fleming is the asset management arm of JPMorgan Chase, the global financial services provider. It manages assets of more than US$750bn for institutional and private investors around the world. Assets under management include more than US$34bn (source: iMoneyNet as at 30/06/04) in its AAA-rated offshore liquidity funds, making JPMorgan Fleming the largest international (ie non-US) provider of AAA-rated liquidity funds in the world.**

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