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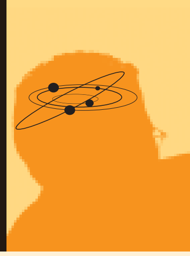
PWM

PROFESSIONAL WEALTH MANAGEMENT

SOLUTIONS FOR EUROPEAN DISTRIBUTORS



MONEY MARKET FUNDS

SAFE PATH TO MONEY MANAGEMENT

The greatest appeal of the AAA-rated money market fund lies in its simplicity and ease of use, plus it fits perfectly into the portfolios that are shifting away from high-risk investments

The unprecedented levels of volatility in stock markets since the turn of the millennium have had an understandably profound effect on the way investors think about their long-term investment goals and the correct portfolio allocations to achieve those goals. Cash management coffers have been swelled as many of the predominant players in the markets, in particular the hedge funds and private banks, have decided to steer clear of overt exposure to long equity positions while more definable patterns begin to re-emerge.

Cash, much misunderstood as an asset class when times are good, has been an obvious beneficiary of the wholesale shift away from risk within portfolios.

In addition, traditional cash managers, service providers and their products have found themselves to be under sustained scrutiny due to the marked deterioration in credit quality following the major corporate scandals of the past couple of years.

Bad loans and poor trading in core businesses have further compounded a pronounced deterioration in credit quality. Corporate treasurers and pension fund trustees, along with many others faced with the responsibility of handling and managing large pools of liquidity, can no longer rely on cosy relationships with favoured or house banks and, instead, must seek to diversify their counterparty relationships.

DIVERSIFICATION

For many European and offshore investors in cash, the need to diversify has taken on new urgency as clients, investment committees, executive boards and trustees have applied a far greater degree of scrutiny to the investment of core cash assets than has hitherto been the custom.

Perhaps the most obvious sign of this fundamental reappraisal of cash management has been the huge growth in the use of stable net asset value money market funds over the past few years.

With its antecedents in the steady evolution of the rated money fund sector in the US over the past 30 years, non-US domiciled money market funds have been one of the spectacular asset management growth stories of the immediate past.

KEY BENEFITS

Beyond the allure of cash as a safe haven asset class, the usually AAA-rated money market fund structure has certain key appeals from which many of the groups identified earlier in this article have sought to benefit.

The US experience is particularly relevant in any analysis of the surge in popularity of this product: there is more than $2000bn (€1850bn) invested in money market funds in the US alone, with around 50 per cent of this total invested by institutional wholesale investors. This is a phenomenon which has begun to repeat itself outside of the US; as measured by the independent analysis of iMoneynet, the offshore market has grown by more than 50 per cent annualised for the past three years.

What appeals most to the users of the AAA-rated money market fund is its simplicity and ease of use.

From provider to provider, there will be nuances in the way in which they manage their money market funds, or how much importance strategically is given to the money fund business as a part of their overall asset management business.

Investment objectives

Essentially, all funds promoted as AAA-rated money market funds are designed to meet three core investment objectives at all times:

- **Stability of principal invested (the stable net asset value)**
- **Daily, same day liquidity**
- **Competitive yield**

CORPORATE STATEMENT

Goldman Sachs is one of the leading global investment banking, securities and investment management firms that provides a full range of services worldwide to a diversified client base including corporates, financial institutions, governments and high net worth individuals. Founded in 1869, it is one of the oldest and largest investment banking firms. Goldman Sachs Asset Management was founded in 1988. Globally, the firm manages assets totalling some $309.2bn as at December 31 2002.

Goldman Sachs Asset Management

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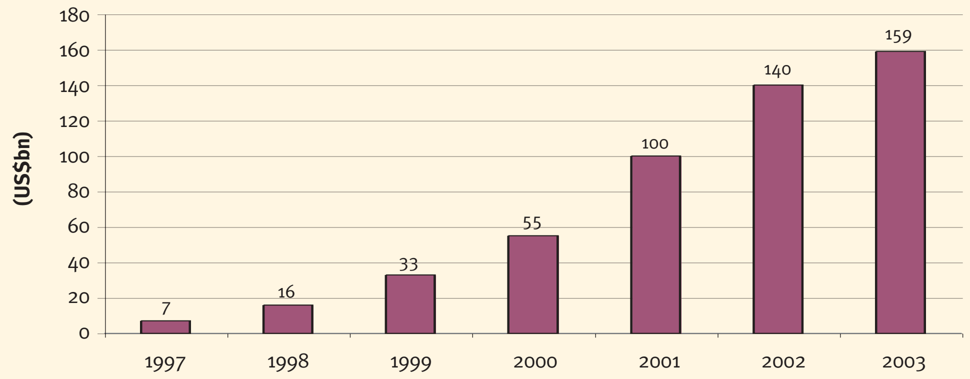
Offshore money market fund industry: growth (US$bn)



Source: Goldman Sachs

The funds are not designed as complex investment vehicles. Nor are they burdensome, time-consuming or expensive to use.

RATING AGENCIES

Investment objectives generally seek to be met by a strict adherence to the rules governing the management of money market funds laid down by the various ratings agencies (predominantly S&P, Moodys and Fitch).

It is important to note that there is no specific regulation governing the management of these funds within the offshore environment. Many investment management companies, including Goldman Sachs Asset Management, have however drawn extensively on the limitations in place in the US via the SEC's rule 2a7, governing the management of stable net asset value money market funds.

Outside the US it is the ratings agencies who monitor the activities of the fund groups: as part of their due diligence process the agencies will ask for a regular breakdown of rated funds to ensure compliance with their stringent requirements.

MANAGING RISK*

Many fund management groups, given the significant proportion of total assets under management which their money market fund products represent, will overlay the requirements of the agencies with additional risk measures to limit exposures to individual issuers, securities and sectors more aggressively.

For example at Goldman Sachs Asset Management, subject to Chinese Wall policies, we use the resources of Goldman Sachs' 150 credit research analysts to determine the relative attractiveness of individual credits. In practice this means that our portfolio managers cannot invest in securities that have not been pre-screened and pre-cleared by the credit research teams. Such measures should, we believe, bolster the overall safety and security of the product. It is the reputation of the provider, in addition to the formal rating, that we believe give the investor most comfort.

How have money market funds managed to capture the mood of cash investors so quickly?

Amongst the biggest users of the money market fund structure, following well-established US trends, has been the corporate treasurer.

Long accepted as a tool for day-to-day cash management by US corporates, it has not meant a major leap in corporate treasury policy for the offshore subsidiaries of many US multinationals to use these vehicles within their overseas treasury centres, for example from Dublin, the Netherlands, Bermuda and (prospectively) Belgium.

Their attraction has also caught the imagination of major UK corporates. For prudent cost-conscious and risk-aware corporate treasurers, the money market fund has provided a vehicle that diversifies credit, investment and counterparty risk.

Treasurers will also benefit from the additional capacity they can generate from their team by reallocating resource from the daily round of calls to counterparty banks enquiring after overnight deposit rates.

The minimum credit quality of any security held by funds will be A1/P1.

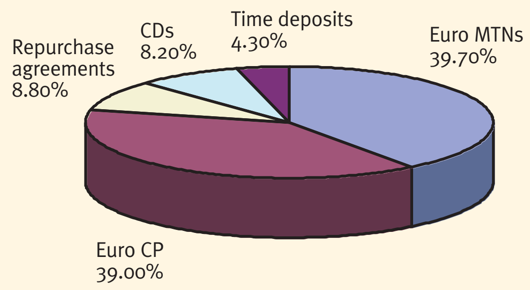
Rules permit the funds to take positions on the yield curve out to a maximum of 13 months for any one

Fund mechanics

Money market funds are invested in the types of securities that the majority of regular institutional cash investors have regarded as standard investments for short-term cash management:

- **Commercial paper**
- **Asset-backed commercial paper**
- **Certificates of deposit**
- **Repurchase agreements**
- **Medium-term notes**

Sample portfolio allocation (%)



Source: Goldman Sachs

security although the weighted average maturity of the entire fund cannot exceed 60 days (to ensure that there is enough liquidity within the fund at any one time to meet investors' cash requirements).

Many funds will seek to establish a high (and necessary) level of dialogue with their leading investors to ensure a sound understanding of their liquidity needs and investment patterns. Size of fund is therefore of importance when reviewing potential providers.

Rates of return net of total expenses on many institutional money market funds should be comparable to, if not better than, short-term deposit rates at the bank. Many fund companies use a seven-day LIBID comparison as a meaningful benchmark. Most asset management firms make a virtue of the conservative manner in which their cash funds are managed.

The money markets are extremely efficient and, as a rule, excessive returns will be accompanied by increased risk. Investors should also check features such as cut-off times, minimum investments and minimum transaction size.

'Investment objectives are pursued by strict adherence to rules laid down by the ratings agencies'
Andrew Ellis

DECISIONS

These days the scale, credit, yield and flexibility benefits of the money market fund structure have been recognised by regular cash investors across many disciplines: corporates, hedge funds, portfolio managers, discretionary private asset managers, corporate and personal trustees, pension funds, local government, insurance companies and brokers.

At Goldman Sachs Asset Management we have also taken the step of providing investors in our funds with the option of trading with us online via our Global Cash Portal.

The ability to handle multi-currency fund investments and account management in a secure Internet environment has been extremely well received and we continue to work on enhancing the system to allow it to generate feeds to and from proprietary treasury and account management systems.

Choosing to invest

While each specific instance of usage may have been motivated by very individual needs, the decision to use an AAA-rated money market fund structure will ultimately have been taken as a result of due consideration of its key features:

- **Objective of stability of principal/capital protection**
- **Daily liquidity and ease of access to cash invested**
- **Historically competitive yields**
- **Credit quality and risk diversification**
- **Administratively and operationally straightforward to use**

In an era of uncertainty and risk aversion, the AAA-rated money market fund industry has benefited from the wholesale shift away from risk in portfolios and from the traditional providers of cash products.

As the lines blur and as the risks of over-reliance on traditional counterparties mount, the prudent cash manager will investigate the benefits that regular use of money market funds could bring to his activities.

Andrew Ellis, Goldman Sachs Asset Management

* The portfolio risk management process includes an effort to monitor and manage risk but should not be confused with and does not imply low risk.