An unprecedented backdrop for investing in the money market and short-term bond market

With returns in negative territory and increasingly stringent regulations being applied to money market and cash equivalent funds, cash managers are looking to optimise their risk/reward profiles to the very last basis point.

Conditions are unprecedented: the ECB’s deposit facility rate is now firmly in negative territory in the region of -0.5%, while the Ester (the eurozone’s overnight interbank rate replacing the Eonia) stood at -0.58% at 30th September. Institutional investors and corporate treasury departments having to invest cash in products indexed to the money market can soon find their costs spiralling upwards. Yet the yield curve is also showing very little steepening, which means that investors are not automatically guaranteed a positive return even at the longer end of the curve (the best-rated 10-year sovereign bonds are also trading below 0%).

Circumstances are therefore particularly complex for cash managers: banks offering their clients balance sheet products (such as time-deposit accounts or passbook savings accounts) are no longer able to pay out attractive returns, whereas companies have sizeable cash positions which they have built up in response to the effects of the Covid-19 crisis by taking advantage of favourable financial conditions. Given this rather unappealing environment, there are many institutional investors and corporate treasury departments out there wondering where to park their cash so that it remains liquid while also generating a surplus yield without any excessive risk-taking.

Some investors are jumping into short-term bond funds provided their average portfolio maturity remains below 6 months and their portfolio volatility below 0.5%. These short-term bond investments can deliver performance, but it is worth noting that the regulatory framework governing such cash equivalent funds has changed significantly in recent years, particularly since European regulation 2017/1131 on money market funds (MMF) took effect. This MMF regulation was introduced to oversee money market fund management by enforcing stricter liquidity requirements and does not recognise cash equivalent funds. These regulatory changes can hinder the returns achieved by such funds but are also aimed at reducing the liquidity risk taken on by investors.

Money market funds seeking to obtain the SRI label.

Money market fund managers are also concerned by changing European regulations in the area of responsible finance. The SFDR (Sustainable Finance Disclosure Regulation), which took effect in March 2021, requires them to be more transparent as it imposes additional reporting requirements. Moreover, fund managers wishing to obtain the SRI label can opt to scale back their investment universe by 20% in order to exclude those issuers with the lowest ESG (Environmental, Social, Governance) ratings, even though they might offer attractive returns in the short term (longer term, such companies will be more exposed to potential controversies).

Money market and short-term bond investments: heightened competition. Despite more stringent regulations, money market investments remain as relevant as ever for institutional investors and corporate treasury departments that need to keep their investment portfolios liquid and are unable to increase their exposure to asset classes posing too much of a risk (equities in particular). With interest rates in firmly negative territory for the foreseeable future, it has become the norm for investors to adopt an ultra-selective approach to their money market and short-term bond investments. Investors now have to switch between investments in order to extract the slightest basis point while making sure to manage their risk. This is leading to fiercer competition between asset management companies that offer this type of product. Investors will, of course, pay particularly close attention to performance and will seek out those money market fund managers that rank in the top decile, but yield is not their only selection criterion. Those wishing to make stable investments (with a horizon of several months or quarters) are clearly on the lookout for steady returns. So the quality of the performance delivered - the mark of a robust investment process - is what will make all the difference to the investor faced with various options.

The figures cited deal with past years. Past performances are not a reliable indicator of future performances.
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