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Investors Looking to Take Advantage of Rising Money Market Yields Beware: Equity Wash Rules May Apply

Ray McGrath, MBA, Investment Consultant
Cammack Retirement Group

With the recent rise in money market yields (2.4%), stable value funds are experiencing unwanted yield competition. Participants who wish to take advantage of higher money market yields may be blocked from transferring assets from a stable value fund into a money market fund by equity wash rules.

WHAT ARE THE RULES?

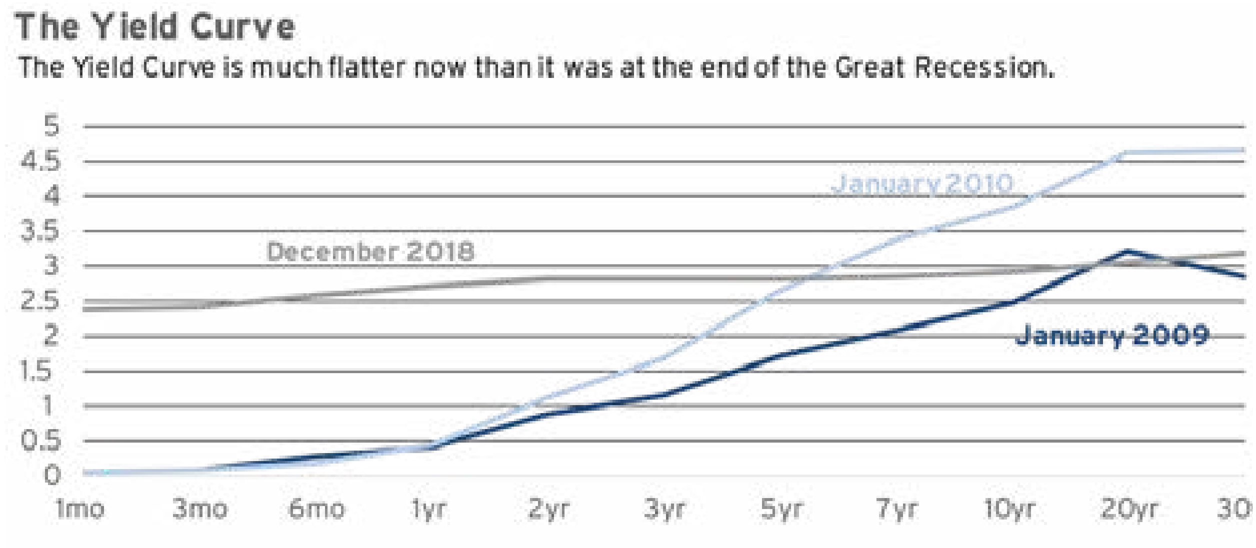
Equity wash rules typically state that participants may not move assets from a stable value fund to a competing fund, unless they put their money "at risk" for 90 days. Both money market funds and bond funds with durations of less than three years are considered to be competing funds (typically, short-term, inflation-protected, and some intermediate-term bond funds have durations of less than three years). Target date funds, balanced, equity and longer duration bond funds are considered "at risk," due to the potential for loss of principal over a 90-day period.

WHY DO THEY EXIST?

Stable value contracts require equity wash provisions to protect the fund from having to liquidate assets in order to honor redemptions, to the detriment of the fund and those who remain in it. Stable value funds attempt to maintain a stable asset value by investing further along the yield curve and with the help of insurance contracts. The cost of liquidating these assets in an environment of rising interest rates is expensive to the fund. For these reasons, many stable value contracts do not allow for a money market fund to exist in the plan's lineup.

THE YIELD CURVE

Money market funds now have yields that are higher than the inflation rate (2%). Short-term rates have soared to their highest level in nearly a decade, as the Federal Reserve continues to normalize interest rates. History has shown that there are times when money market fund yields exceed those of stable value funds. However, if the past relationship between inverted yield curves preceding a recession holds true, we can expect these times to be short-lived. While the yield curve has not inverted, it is the flattest since 2007, as referenced in the chart below.



Source: Haver Analytics/U.S. Treasury Department via Hutchins Center on Fiscal & Monetary Policy at BROOKINGS

CONCLUSION

With the Federal Reserve expected to continue to raise interest rates, the economy strengthening, and inflation on the rise, cash investments and short-term bonds are the most appealing they have been in a long time. This is welcome news for older savers and retirees, whose investment returns have struggled to keep pace with inflation since early 2008. With increasing volatility in the stock market, bond yields are likely to head higher, thus making cash investments a reasonable alternative to equities and bonds.

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