



## Dreyfus Perspectives on Prime Money Market Funds

### Discussion and Overview

The U.S. money market industry is a \$3.75 trillion asset class (accounting for retail and institutional, taxable and tax-exempt funds, collectively), according to the Investment Company Institute. Within the industry, prime money market funds (those investing in the broadest array of taxable money market instruments) account for approximately \$1.5 trillion of total assets. In this report, Dreyfus explores a number of issues that, in our view, are critical to an objective assessment of prime money market funds, the structure and operation of which are governed by Rule 2a-7 under the Investment Company Act of 1940, as amended.

Investors in virtually all managed cash products such as money market funds have been forced to embrace radical change in a short time period, and within markets that previously had been viewed as highly stable and commoditized. Product disruptions and credit dislocations, in the midst of the current global credit contraction, has led to fund closures, liquidations, suspensions or deferrals of rights of redemption, as well as outright losses, related to a handful of funds. Concurrent with the flight to quality, current yields on certain sovereign, treasury and government debt are approaching zero, or even negative territory, further complicating decisions faced by liquidity investors and fiduciaries acting on their behalf.

Despite the magnitude of these dislocations, there are strong fundamental and technical

factors that, on an underlying basis, will begin to benefit prime money funds in the intermediate term and beyond. These include initiatives undertaken by central banks and regulators, as well as ongoing issuer and sector-specific actions taken to enhance bank capital, de-leverage intermediary balance sheets and boost cash liquidity of conventional collateralized products such as multi-seller, cash flow based asset-backed commercial paper.

Within this environment, Dreyfus believes prime funds represent a treasury or government product alternative capable of capturing an array of attractive underlying liquidity attributes: portfolio diversity, underlying liquidity in normalizing short-term markets, and appropriate risk-adjusted high current yield within high-quality short duration yield curves.

### "The Three "R's""

Three underlying factors within key segments of prime eligible funds will contribute to reductions in portfolio risk profiles going into 2009:

- 1) Recovery of short-term markets
- 2) Recapitalization of banking systems
- 3) Return to conventional money fund products

Prime money market funds are eligible to invest in a diversified portfolio of prime-rated, high quality, short-term, dollar-denominated debt instruments,

such as Treasury and Agency securities, repurchase agreements, short-term corporate instruments and bank obligations such as certificates of deposit, time deposits and commercial paper. Market dislocations over the past year, punctuated by the Lehman bankruptcy and events related to the Reserve Funds, introduced extraordinary levels of illiquidity related to certain dominant asset classes utilized by prime money market funds.

#### 1) Recovery of short-term markets

Since that time, there is evidence to suggest that short-duration markets are demonstrating increasing stability, in part based on ongoing capital and liquidity

injections, and secondarily as a result of a significant reduction in riskless yield alternatives. Inter-bank funding spreads have narrowed substantially, and government intervention has demonstrably reduced solvency risk among global and universal banking institutions. (Please see Appendix for overview on government programs.)



## 2) Recapitalization of banking systems

The mutually reinforcing combination of Fannie Mae/Freddie Mac/AIG conservatorship actions, together with Fed/Treasury guarantee programs and backstop liquidity arrangements now means that over 90% of all U.S. banking system liabilities benefit from some form of government support. Similar governmental mechanisms and outright liability guaranties from other central banks and regulators have been established to benefit systemically critical depository institutions globally. Clearly, the challenges faced by most global banks in replenishing capital, restoring loan loss reserves and stabilizing wholesale funding will take time, and earnings visibility at present is poor, given cyclical constraints and further potential mark-to-market write-downs. However, an accelerating pace of asset dispositions, capital raisings and ongoing efficiencies derived by consolidation point to an improving set of bank credit fundamentals going forward. Fundamental bank credit research and prudent due-diligence can assist in the selective identification of 2a-7 eligible and creditworthy institutions.

## 3) Return to conventional money fund products

Complex, late-stage derivative securities placed into the Rule 2a-7 eligible market such as CDO commercial paper, SIV lites and securities arbitrage vehicles were structured on the basis of optimistic asset price assumptions, and designed within low volatility environments. All of these structures have since been demonstrated as imprudent for minimal credit risk asset classes such as Rule 2a-7 funds, and exposures have thus been drastically reduced or eliminated. Going forward, the structural transparency, and the removal of embedded optionality in Rule 2a-7 product offerings will enhance the capability of prime funds to manage

liquidity and redemption risks more effectively. Virtually all of the \$825 billion of outstanding U.S. denominated asset-backed commercial paper (ABCP) today consists of conventional single or multi-seller vehicles, either partially or fully supported, with 100% committed liquidity support. Importantly, a high percentage of these outstanding issues qualify under the Federal Reserve Bank of Boston's ABCP Money Fund Liquidity Facility ("AMLF"), whereby qualifying money funds can access same-day liquidity (on an amortized cost basis) against qualifying ABCP fund holdings. Importantly, though, these facilities are temporary, and their availability can be expected to be discontinued when market conditions normalize.

### **An objective assessment of prime funds and their sponsors; lessons learned:**

Though prime money fund investors and sponsors have benefited broadly from the parabolic 300% growth in net Rule 2a-7 assets over the past 10 years, the events of 2007-2008 have demonstrated that money market funds are not riskless, and in fact can be an extraordinarily counterintuitive asset class to manufacture. As the marketplace has now learned, Rule 2a-7 prime funds are not managed identically, despite a relatively precise regulatory framework, and seemingly minor structural portfolio differentials in non-volatile markets can become critical within markets that suddenly dislocate. An overall understanding of the key differences between prime money market fund portfolios and their sponsors – and the underlying risk appetites that they convey over time – is important. Taken together, these factors should speak to the overall strengths and weaknesses of fund management companies, the scale and commitment demonstrated to the operation, and the integrity and experience of the professionals involved at the operating level.

Critical to the manufacture of prime money market funds is the overall portfolio effort, risk mitigation framework, independent due-diligence capabilities, operational effectiveness and internal risk preferences of managers.

### **We would emphasize the following points regarding prime money market funds sponsored and advised by Dreyfus:**

**Preservation of principal and ready liquidity are paramount.** As with all money market funds advised by Dreyfus, taxable portfolio management practices concentrate on key primary, underlying performance attributes within credit eligible prime funds. These include actively managing weighted average maturities, constructing portfolios on a prudent, laddered basis, and restricting product risks, consistent with prospectus-defined fundamental policies and investment objectives.

- Weighted average maturities for Dreyfus prime money market funds have been reduced from 50-59 days (on a Aaa/AAAm rated fund basis) to approximately 37 days (as of 12-23-08), reflecting large overnight liquidity balances and selective longer-dated term purchases.

**Pre-trade risk management and independent due-diligence protocols are consistently applied and monitored.** Pre-trade compliance and "risk-budgeting" within credit risk management prioritizes research acuties against conventional and liquid product segments of dollar-denominated markets. The control process output is an approved eligible issuer and counterparty list, dynamically managed with centralized oversight.

- *Dreyfus anchors the Rule 2a-7 approved list of issuers strategically between the purchase of select bank liabilities, primarily time deposits, certificates of deposit, and commercial paper, and*

*cash-flow multi-seller ABCP where structural transparency and consistent origination meets internal suitability criteria. Dreyfus is currently adding to staff within short-duration credit research, including professionals to complement our current credit staff of 11 research specialists, five of whom are dedicated, seasoned bank credit analysts.*

## Conclusion

Despite unprecedented market turmoil, the overall record of prime institutional money market funds remains remarkably resilient. The evolution of the product, however, now requires experienced managers, who can

demonstrate a long-term commitment to constructing the necessary scale and control infrastructure required in the proper manufacture of cash products to very calibrated tolerances. Seasoned professionals are needed to navigate the complex portfolio, credit risk, compliance and asset-servicing issues that underlie prime money market funds.

Reduced exposures to complex structured securities, and higher levels of liquidity with which to offset institutional shareholder redemption volatilities, will benefit prime money fund investors going forward. Given cyclical concerns related to ongoing de-leveraging, declining credit access and delinquency experience likely to

escalate, staying positioned in the top-tier, best-of-class segment of these markets – where prime fund investors benefit from liquidity, appropriate fundamentals, capital raises and/or outright government support – continues to be the prudent credit strategy for zero loss tolerance assets.

The original inception of taxable money market funds as open-ended mutuals, providing investors access to high quality, liquid, and higher-yielding eligible short-term obligations – with principal stability and commensurate return – are qualities that remain in today's prime money funds managed by Dreyfus.

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Investors should consider the investment objectives, risks, charges, and expenses of a fund carefully before investing. Call your Dreyfus Investments representative at 1-800-346-3621 to receive a prospectus that contains this and other information about a fund, and read it carefully before investing.

An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although a money market fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in a money market fund. Yields fluctuate. Past performance is no guarantee of future results.

Short-term corporate, asset-backed and municipal securities holdings, while rated in the highest rating category by one or more NRSRO (or even unrated municipal, deemed of comparable quality by Dreyfus), involve credit and liquidity risks and risk of principal loss.

Portfolio composition is subject to change at any time.

The U.S. Treasury Temporary Guarantee Program for Money Market Funds became effective as of September 19, 2008, and is in place until April 30, 2009. The Program may be extended, solely at the Treasury's discretion, but only up to September 18, 2009, and the Funds' potential continuing participation in the Program would be subject to (a) the Program being extended; (b) the Funds' renewal of their coverage; and (c) payment of any applicable fee. The Program covers shares owned as of September 19, 2008, in a covered fund. Any decrease in the number of shares owned after that date would extend coverage only to the value of those shares. Any increase in the number of shares owned after that date is not covered.

# Money Market Support Program Summary

## Initiatives taken by the Federal Reserve, US Treasury, the SEC and the FDIC to address stress in the money markets

Short Name	AMLF	MMMF Guarantee	CPFF	SEC No-Action Letter	TLGP	MMIFF
<b>Long Name</b>	Asset Backed Commercial Paper (ABCP) Money Market Mutual Fund (MMMF) Liquidity Facility	Temporary Guarantee Program for Money Market Funds	Commercial Paper Funding Facility	SEC No-Action Letter to Investment Company Institute. 10/10/08, in re: Investment Company Act of 1940 — Section 2a (41) and Rules 2a-4 and 22c-1.	Temporary Liquidity Guarantee Program	Money Market Investor Funding Facility
<b>Administrator</b>	Federal Reserve (FRB Boston)	US Treasury	Federal Reserve (FRBNY)	SEC	FDIC	Federal Reserve (FRBNY)
<b>Announced</b>	9/19/08	9/19/08	10/7/08	10/10/08	10/14/08	10/20/08
<b>Effective</b>	9/22/08	9/19/08	10/27/08	10/10/08	10/14/08	11/24/08
<b>Sunset</b>	No new credit extensions will be made after January 30, 2009, unless the Board extends the AMLF to a later date.	Initial expiry was 12/18/08. Has been extended to 4/30/09. The Secretary has the option to extend the program to 9/19/09.	4/30/09, the CPFF will cease purchasing CP unless the Board extends the facility.	1/12/09	Bank debt gty expires 6/30/12. Must issue by 6/30/09. Qualifying bank deposits are covered to 12/31/09.	MMIFF will cease purchasing assets on 4/30/09 unless the Board of Governors of the Federal Reserve extends the operation.
<b>Primary Beneficiaries</b>	Rule 2a-7 registered money market funds that own ABCP	Rule 2a-7 registered money market funds	US based issuers of Tier 1 and split rated unsecured CP and ABCP	Rule 2a-7 registered money market funds subject to regularly scheduled mark-to-market	Banks and certain other depository institutions based in the US	Rule 2a-7 registered money market funds
<b>Purpose</b>	This program is intended to help restore liquidity to the ABCP markets and thereby to help money market funds meet demands for redemption.	This program protects shareholder accounts for up to the number of shares owned in such accounts of all money market funds as of 9/19/08, but only for funds that have paid for insurance coverage under the Program.	The CPFF will serve as a funding backstop to facilitate the issuance of term commercial paper by eligible issuers.	Temporarily allows MMMF to substitute amortized cost for market value on certain securities when calculating NAV.	Temporarily guarantees newly issued senior unsecured debt of banks, thrifts and certain holding companies, and provides full coverage of non-interest bearing deposit transaction accounts, regardless of the dollar amount.	By facilitating secondary sales of money market instruments, the MMIFF should give MMMF and other money market investors confidence that they can extend the terms of their investments and still maintain appropriate liquidity positions.

Source: Federal Reserve, US Treasury, FDIC and SEC.