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Short-Term Fixed Income Research Note

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- **The Reserve Fund became the first money fund manager in 14 years to publicly acknowledge a fund had its NAV fall below \$1. Exposure to unsecured Lehman Brothers debt led to the fall in value**
 - **We do not believe the same degree of exposure to Lehman is present in most prime funds. Many managers are proactively communicating to shareholders about the exposure of their funds**
 - **The Reserve faces a difficult environment in which to liquidate assets. The absence of Lehman as a dealer is a contributing factor**
 - **While we do not expect a massive wave of money fund redemptions tied to this event, managers are likely to build extra-liquidity anyway. Funds managed by smaller asset managers may see a greater rate of redemptions**
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Breaking bad: Reserve breaks the buck

Late Tuesday afternoon The Reserve Fund, manager of the world's first money market fund in 1970, announced that the NAV on its largest prime fund (The Primary Fund) had fallen to \$0.97 per share, and that it was suspending client redemptions for a period of up to seven calendar days.

The Primary Fund's NAV "broke the buck" following the Reserves's write down of \$785mn par value of unsecured Lehman Brothers Holdings Inc. to a market value of zero. A company press release dated September 16 indicated that of all the company's funds, only the Primary fund had broken the buck.

Press reports indicate that investors in The Primary Fund had been concerned about the concentration of unsecured Lehman exposure, and had withdrawn over 60% of the funds assets Monday and Tuesday of this week. We think it is likely that this rapid pace of withdrawals served to aggravate the funds valuation problem as the manager would need to liquidate unimpaired assets to

meet redemptions, leaving the Lehman exposure to grow as a percent of holdings.

In writing off its Lehman exposure, The Primary Fund has become the first money market fund in 14 years to expose shareholders to a loss via breaking the buck. However, it is far from the first fund to run into trouble during that time. We think the number of money market funds that have actually pierced the \$1.00 NAV level since the start of the money market industry fund industry in the 1970s numbers in the dozens, but with only one case of investors losing money, that being the Community Bankers fund in 1994.

When faced with a depressed NAV on a money market fund, asset managers have typically stepped in to support funds in a variety of ways including buying impaired assets out of the fund at par or wrapping them with a letter of credit. Just this past Monday Wachovia stepped in to provide support to three money funds managed by its Evergreen Investment Management subsidiary that were also negatively impacted by the Lehman bankruptcy.

The developments at The Reserve create some immediate challenges in the money markets:

- **Liquidation in a challenging environment.** Over the past week conditions in the money markets have been tenuous as managers have reacted to developments at Lehman and AIG. Concerned about preserving liquidity in their funds most managers have been limiting investments to over night, and there has been very limited activity this week in longer maturities. Now, over the next several days, The Reserve will likely be looking to liquidate most of the remaining holdings of the Primary Fund. According to iMoneyNet the fund had about 57% of its assets in ABCP and 21% of its holdings in domestic bank obligations as of Sep-9, and had an average maturity of 51 days, longer than the 46 day average of similar funds. In this market environment the manager may face challenges realizing full value on its holdings – even the highest quality obligations. Adding insult to injury, as a dealer Lehman was a very significant presence in the money market and its absence detracts from market liquidity.
- **Risk of follow-on redemptions.** News of the developments at Reserve could lead to redemptions at other money funds, particularly in prime funds,

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those that invest in corporate and ABS obligations in addition to Treasuries and Agencies. Already, several large managers have put statements indicating that they have no exposure or limited exposure to unsecured Lehman debt. An analysis conducted by our colleagues in US Equity Research indicates the Lehman exposure of money funds managed by large, publicly held asset managers is very limited (See JPM Equity Research, *US Asset Managers: Largest Managers Avoid Lehman Exposure in Money Funds*, 16-Sep-2008, Ken Worthington and Tim Shea, available on MorganMarkets).

We do not think developments around the Lehman or AIG credits are likely to spark a wholesale shift out of money market funds at the institutional level which comprises about 2/3 of all money fund assets. Most institutional money fund investors have stuck with the product over the past year even as the business has struggled with the much bigger problems of SIVs and extendible ABCP. In fact, assets held in institutional prime funds have increased 35% in the past year. However, this week's developments could accentuate a shift toward government and agency backed funds. These funds are up about 145% since August 2007. At the retail level we would not be surprised to see some investors shift a portion of their assets into bank deposits.

Almost regardless of what the redemption experience proves to be, we expect money fund managers to focus on building liquidity over the next several days to meet potential redemptions. We think this may further limit liquidity in longer-term money products, and shorten the average maturity structure coming into year-end.

Also, the impact of The Reserve's breaking the buck may serve as a catalyst for investors to shift assets to larger, deeper pocketed managers that are more likely to provide support to money funds when they do run into trouble. Managers whose money funds business is heavily tied to electronic portals will likely feel the impact fastest, while those whose business is more relationship based may see relatively little impact.

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