NATIXIS INVESTMENT MANAGERS

MARKET INSIGHT

The HUB

NEWS AND VIEWS FOR INSTITUTIONAL INVESTORS

Time for a fresh look at money markets

As yields rebound, investors seek high credit quality and strong SRI credentials.

Alain Richier
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Key takeaways:

- Money markets are in a good place, offering low volatility, near zero rate sensitivity and an interesting yield. Amid rising rates and high volatility, money market investments offer investors a sound temporary portfolio solution.
- Well-resourced teams and rigorous risk control are key to a good risk-return ratio. Active management of interest rates and credit selection increases returns and reduces volatility in net asset values.
- SRI should be a significant component of asset selection too. Even though money market assets are short-term, long-term SRI issues can impact returns.

There is good news for investors wishing to park their cash short term before deploying capital for the longer term. As central banks raise rates, so yields in money markets are rising, with the likelihood of further rises to come.

Of course, money markets are not all about yield. In addition to higher yields, money market investors demand protection of their capital, very low volatility and sufficient liquidity that they can take advantage of investment opportunities whenever they arise.

“Our aim is to improve on average yields in money markets without compromising at all on security and liquidity,” says Alain Richier, head of money markets at Ostrum Asset Management (Ostrum AM), an affiliate of Natixis Investment Managers.

Yields above 3,5% into view

Amid recessionary and inflationary conditions, many investors are looking to keep powder dry while they wait for greater visibility in equity markets and other long-horizon investments.

Money markets are more interesting than they have been for many years as central banks raise rates. In Europe, 10 years of negative rates are giving way to strongly positive yields, with the market anticipating an ECB deposit rate of around 3.5% by mid-2023.

“Our target is to add a credit premium to that, bringing yield between 3% and 4% over the coming months and years,” says Richier.

Richier sees credit as one of three ways Ostrum AM can add value to money market returns. His team invests exclusively in investment grade issuers from world-selected countries, using a large credit analyst team to find high quality issuers with strong credit fundamentals.

That bottom-up approach is complemented with a top-down approach, implementing macro views to adjust maturities and optimise the balance between fixed and floating rate instruments.

The third value-add is a Socially Responsible Investment (SRI) approach which excludes names with the lowest extra-financial ratings in their industry.

Credit ratings are key

Even with very short maturities, the main risk to a money portfolio is credit. That is, the likelihood that investors will get their principal back when they divest. “The key is to avoid defaults in the portfolio,” says Richier. “This necessarily entails a cautious approach to every company and every issue in our universe.”

Ostrum AM invests predominantly in securities issued by private-sector entities like banks or industrial companies and every issuer must be located in an OECD country. In Europe, Ostrum AM considers companies only in the European Economic Area, excluding former Eastern Bloc countries but with the addition of the UK and Switzerland. In Asia, it invests only in Japan, Australia and New Zealand. In the Americas, it allocates to the US and Canada. "These geographical restrictions are not in evidence in all money market portfolios, which may contain assets issued in politically complicated countries," notes Richier.

In addition, every asset must be issued by an entity rated "high-quality" by Ostrum AM's analysts. Ostrum AM's proprietorial evaluation and rating process is distinct from the rating agencies in that it is forward-looking, whereas the main agencies rely on historical data.

Regulation driving up quality

How participants in European money markets operate is tightly regulated. The Money Markets Funds Regulation 2019 makes it clear that investment firms must rate issuers themselves, rather than relying on agency ratings. They must adopt a cautious approach, investing only in "high credit quality issuers", as identified by investment firms. Firms must use their own resources to analyse issuers, requiring sufficient numbers of staff with the appropriate qualifications. The intended result is a wide range of profiles across money market portfolios, rather than clustering around the same names.

This approach allows it to rate instruments that are not evaluated by the agencies, leading to an active and convictions-based approach to money markets.

The proprietary ratings give Ostrum AM's portfolio managers an indication of a company's level of credit risk and volatility. "As opposed to rating agencies, which have a tendency to rate within the cycle, we rate throughout the economic cycle of the company," says Richier. "This additionally allows our portfolio managers to identify arbitrages between our assessment of the risk and that of the rating agencies."

Wide coverage requires a large team

To evaluate and rate so many issuers, and create portfolios from the best issuers requires hugely-resourced credit teams.

Ostrum AM rates about 1,200 issuers a year globally across its credit and money market portfolios and more than 1,000 direct engagements are undertaken with issuers every year.

Globally, Ostrum AM has four money market portfolio managers, supported by a team of 23 credit analysts and a strong credit risk department.

The majority of this team is based in locations across Western Europe, while five credit analysts operate in the US, where 400 issuers are monitored. In Asia, a discrete Asian-based and Asian-focused credit team monitors more than 130 Asian issuers.

Opportunity arises from strong macro views

Money market investments must be highly risk-aware. Changes in the market environment – currently manifested in the Ukraine conflict, recessionary conditions and high inflation – can represent an opportunity to seek higher yields.

Each month, Ostrum AM's macro team establishes its central macroeconomic scenario which includes forecasts on growth, inflation, currencies and interest rates. The money market committee then analyses market data relative to current and anticipated interest rates curve and generates views on short-term yields.

"If we can anticipate central bank policy, we can adjust maturities and rebalance our fixed rate versus variable rate assets," says Richier.

Ostrum AM has been repositioning its portfolio since the third quarter of 2021, switching into variable rate assets in anticipation of central bank rates rising. "We think the rate will continue to go up for the first half of this year with the ECB deposit rate reaching 3,5% by the end of June," says Richier.

SRI as risk-reducer

SRI should be a significant component of asset selection. Even though money market assets are short-term by nature, long-term SRI issues can have an impact on returns.

"We have found a material correlation between issuers with a good SRI rating and those with resilience in the money markets," says Richier.

Taking extra-financial criteria into account minimises the industrial and financial risks that could potentially impact the credit risk of issuers in a legal and regulatory environment which increasingly takes these same constraints into account.

In addition, while money market assets have short maturities, some companies issue a series of short-term assets over a multi-year period as an alternative to issuing long-term bonds. This made particular sense when money market yields were negative and long-term yields positive, even if the company had to refinance every few months. So long-term financial health is paramount.

Ostrum AM's process is guided by Label ISR, an SRI designation operated by French regulators. The designation demands that investment firms have their own internal SRI processes. These processes must mainly support a best-in-universe approach in order to select the most virtuous issuers.

"The label's guidelines mean we finance only those issuers with better SRI scores," says Richier.

Liquidity requires planning

Maintaining a high level of liquidity to meet redemptions on a daily basis under all market conditions is essential to meet the needs of money market investors.

With €52 billion in assets under management in money markets (at end-December 2022), Ostrum AM has considerable capacity to absorb large-scale subscriptions and redemptions. The comprehensive range of offerings, from short-term to standard, covers all investment horizons.

Maturity schedules are set so cash is available on a regular and planned basis. "Good knowledge of our client base enables us to adequately build the cash bucket in order to satisfy upcoming redemptions," says Richier. Large corporates, for instance, typically take their money out at the end of reporting quarters.

In addition to the mandated regulatory ratios for assets with very short-term maturities, a large proportion of Ostrum AM's assets is invested in securities with less than three months' maturity.

To further enhance liquidity, Ostrum AM holds shares of other money market funds, which can be sold rapidly if redemptions suddenly spike.

And emphasis on high credit quality with assets valued at market price, means assets can be sold quickly.

Finally, even though securities are generally held until maturity, Ostrum AM's portfolio managers take into account current market conditions and select securities perceived as interesting so they can sell them back into the market rapidly, if required.

Low volatility, interesting yields

Money markets are in a good place. Investors can now allocate to money market investments with low volatility and near zero rate sensitivity, and with an interesting yield.

But nothing in markets is certain and portfolio managers must be alive to current and future risks. “We give absolute priority to the safety of our investments in terms of both financial and extra-financial credit risk,” says Richier.

Published in February 2023,
updated in April 2023

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HUBINT6EN-0423