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Short-Term Investing Gets Complicated

Advisers mull choices as they await a possible rate hike and money-fund reforms

ILLUSTRATION: BARI GOODMAN FOR THE WALL STREET JOURNAL

By **DAISY MAXEY**

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When it comes to investing clients' short-term cash, financial advisers now face an unusual quandary.

They can stick with money-market accounts that pay little, invest in low-yielding money-market funds as they head toward reform or reach for a bit more yield in short-term bond funds, which could lose money when rates rise.

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regulatory changes that will affect money-market funds—a result of the financial crisis—won't go into place until October 2016, but many money-fund providers are announcing changes to their lineups now to bring them into compliance.

Others have launched or are planning new bond funds to serve as alternatives for investors who might be uncomfortable with money-market funds that will be forced to deviate from their stable $1 share price or to adopt gates and fees.

But not all of the changes planned by mutual-fund providers have been put in place.

For now, many advisers are waiting and watching to see what new products will be available and what indications the Federal Reserve will give on its plans to raise interest rates.

John Fowler, a wealth manager with McElhenny Sheffield Capital Management in Dallas, says he's more cautious now than he was before the financial crisis and is investing clients' extra cash in money-market accounts. The money isn't earning much, but it's not worth investing a client's emergency cash in a more risky instrument for a bit more yield, he says.

"We remember what happened to ultrashort duration bond funds, high-yield short duration funds and municipal auction-rate securities back in 2007 to 2008 when liquidity dried up completely and people weren't able to get access to their 'cash-like' securities," says Mr. Fowler, whose firm manages more than $200 million.

But David Demming, president of Demming Financial Services Corp. in Aurora, Ohio, is willing to take a bit more risk with short-term bond funds in lieu of money-market accounts or money-market funds.

The bond funds typically return anywhere from 0.5% to 2% more than other cash equivalents, says Mr. Demming, whose firm manages $370 million. While a money-market fund might earn 0.25%, he's typically earning 1% to 2.5%.

Among the funds he's using are Franklin Federal Limited-Term Tax-Free Income Fund

and Pimco Low Duration Fund.

There's no question that such funds take on more risk than money-market funds, but they also offer more return, Mr. Demming says. He's not seeking the highest return, he says, but "the best blend of return and safety."

He's also not appreciably concerned about a rise in interest rates, saying that under such a scenario he would expect "a nominal loss" as the fund's net asset value declines. But if investors are reinvesting, that decline should be largely mitigated, he says.

Greg Fayvilevich, a director at Fitch Ratings' fund and asset-management group in New York, says those considering short-term bond funds as an alternative to money-market funds should be aware the market remains small and fragmented. Unlike money funds, short-term bond funds have no clearly defined regulatory guidelines and typically have only loose limitations in their offering documents, he says.

As a result, short-term bond funds aren't as standardized as money-market funds, and their duration, maturity and portfolio credit quality vary greatly, he says.

"The risk is that the adviser thinks that short-term bond funds are the same as money-market funds, that they're boxed into certain things they can and can't do," Mr. Fayvilevich says. "If you have that mentality, you might buy into something that has more risk than you expect."

Portfolio duration for short-term bond funds ranges between zero and three years, while average durations for ultrashort funds are typically less than one year, Fitch says. U.S. and European money-market funds, in contrast, are required to maintain portfolio maturities lower than two months. In addition, while money-market funds primarily invest in highly rated debt, some short-term bond funds invest in securities at the lower end of the investment-grade range or high-yield bonds, Fitch says.

Some investors may believe that the higher returns offered by short-term bond funds compensate them for the risk, Mr. Fayvilevich says. Fitch reviewed a sample of U.S. dollar denominated ultrashort bond funds at the end of 2014, and found an average yield of 0.80% compared to 0.04% for institutional prime funds in the same currency.

For those who stick with money-market funds, there's another wrinkle. The industry is expecting assets to shift from prime money funds to government funds as a result of regulatory changes that will require the net asset value of prime institutional funds to deviate from their stable $1 share price.

Those flows have been muted so far, Fitch says, but anecdotally, it's aware that a small

number of institutional money-fund clients have switched to government funds from prime funds. Increased demand for government funds may exacerbate shortages in supply and lead to wider yield differences between government and prime funds, Mr. Fayvilevich says.

David Haraway, a financial adviser with Substantial Financial in Colorado Springs, Colo., used to invest in short-duration bond funds. But with interest-rates so low, holding bonds of any duration is losing its appeal, he says. For now, he's putting clients' cash reserves in money-market funds and money-market accounts.

"Its function is dry powder, and I want to know that I have a constant amount of dry powder that's not going to vary," Mr. Haraway says. "I have more important things to do than to worry whether my cash reserve is available."

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