Investing in Money Market Securities

Volume 1, Number 227

From the T. Rowe Price Information Library

The investment world divides the financial markets into two broad categories: the capital market and the money market. The capital market encompasses sources of financing with time horizons longer than one year—essentially stocks and bonds issued by various institutions to raise money for different purposes.

The money market is made up of short-term debt securities that mature in a year or less. It is a vast, "liquid" market in which governments, municipalities, corporations, and other entities finance their short-term cash needs and invest cash positions by buying and selling debt securities.

What Are Money Market Securities?

A wide variety of short-term debt instruments are traded in the money market, some simple to understand and others complex and sophisticated. They are generally characterized by a high level of safety of principal. Maturities range from one day to one year, with the most prevalent being three months or less. They are the most liquid securities because of their short maturities.

Some of the major money market securities include:

- *Treasury bills*—issued by the U.S. government with maturities of four weeks, three months, and six months. They are considered to be completely safe from the risk of default since they are backed by the full faith and credit of the federal government. Interest on them is paid as a discount from par, meaning that you pay less than face value when you buy them and receive the full face value when they mature. The interest is exempt from state and local income taxes.

- *Large negotiable certificates of deposit*—issued by major banks in amounts of $100,000 and higher. Negotiable CDs historically have been extremely safe, and most are sold in bearer form (not registered in the investor's name) because of their short maturities. They are liabilities of banks, which are obliged to pay the face amount plus interest at maturity. Banks issue them to raise money for various purposes, including lending operations.

- *Commercial paper*—unsecured promissory notes issued mainly by the most creditworthy corporations. For many large companies, these notes are a low-cost method of short-term borrowing and one of the most important debt markets in the United States. Interest is primarily discounted in the same manner as that of Treasury bills. Most top-rated commercial paper is considered safe from default, although less so than Treasury bills and CDs, and usually offers slightly higher yields.

- *Asset-backed securities*—bonds with an underlying pool of assets, such as credit card or automobile trade receivables or corporate loans or bonds, that provide interest and principal payments to investors. The underlying assets (e.g., loans) are sometimes subject to prepayments, which can shorten the security's weighted average life and may lower its return.

- *Repurchase agreements (repos)*—contracts enabling money market participants to acquire immediate funds by selling securities, usually Treasury bills, which they agree to buy back overnight or after a few days at a set price. They are referred to as "reverse repos" or matched sale-purchase agreements from the perspective of the original buyer of the securities.

Tax-exempt money market securities are also available, allowing states and municipalities to borrow money for short-term needs. They include bond, tax, and revenue anticipation notes; municipal commercial paper, variable-rate floaters; and other more exotic instruments that provide investors with interest that is exempt from federal income taxes and, in some instances, state taxes as well. Their level of safety depends on the creditworthiness of the issuing state or municipality. Some tax-exempt municipal money market securities include:

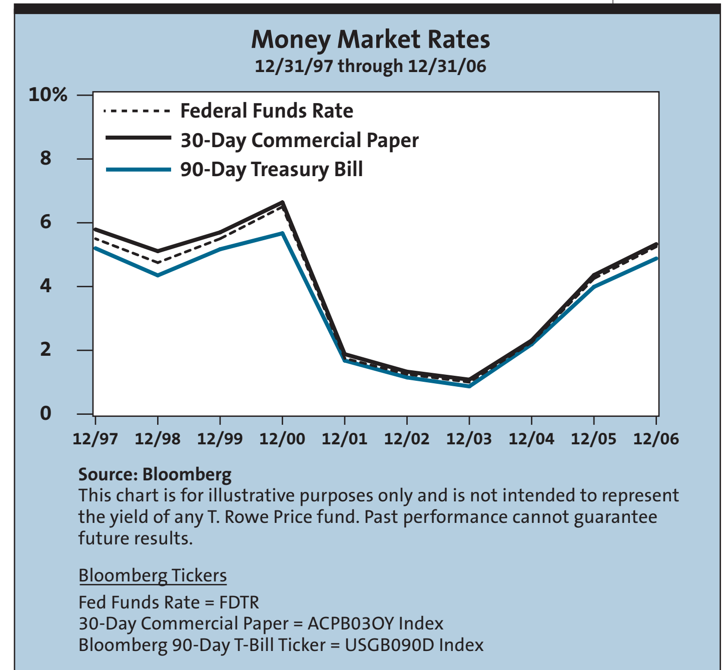
Variable-rate demand notes—bonds with a demand feature entitling the owner to principal and interest in one to seven days, usually enhanced by a bank's irrevocable, direct-pay letters of credit. These securities pay a rate of interest that changes daily or weekly.

Municipal commercial paper—typically top-rated issues maturing in 30 to 120 days.

Prerefunded bonds—longer-dated municipal bonds that have been called by the issuer, then are secured by escrow consisting of U.S. Treasury bonds.

How Are Money Market Interest Rates Set?

The Federal Reserve establishes the general level of money market rates by adjusting the federal funds rate, the basic rate to which all other money market rates are anchored. The fed funds rate is the overnight lending rate among banks and one of the key instruments of the Federal Reserve's monetary policy.



Source: Bloomberg
This chart is for illustrative purposes only and is not intended to represent the yield of any T. Rowe Price fund. Past performance cannot guarantee future results.

Bloomberg Tickers
Fed Funds Rate = FDTR
30-Day Commercial Paper = ACPB03OY Index
Bloomberg 90-Day T-Bill Ticker = USGB090D Index

The Fed ordinarily lowers the fed funds rate in its effort to stimulate the economy when growth is sluggish and inflation is under control ("easy" monetary policy) and raises it when the economy is growing too fast and inflationary pressures are building ("tight" monetary policy). The sharp drop in money market rates in 2001, for example, reflected a series of aggressive rate cuts by the Fed.

Participants in the money market adjust the rates at which they are willing to lend money based on their own cost of borrowing. The prevailing and anticipated fed funds rates have a ripple effect throughout the money market, affecting the yields on Treasury bills, commercial paper, and other money market securities.

Investing in Money Market Securities

Some investors buy Treasury bills directly from Federal Reserve Banks or other financial institutions since they are available in minimum denominations of $10,000. Individual investment in bills is greater than in other money market securities.

However, since most money market securities trade in minimum lots of $1 million or more, the vast majority of individuals invest in them through money market funds composed of a broad variety of these issues.

Characteristics of Money Market Funds

- *Stability.* The SEC requires most money market funds to invest at least 95% of assets in "First Tier" securities—Treasury issues and privately issued securities carrying the highest credit rating by at least two of the five major rating agencies. The funds are also required to operate under strict guidelines regarding maximum weighted average maturity, maximum maturity for any one holding, and diversification of fund assets.

  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. Unlike bank deposits, the principal and payment of interest in money market funds is subject to some risk. Nonetheless, money market funds have an excellent track record overall, and they are popular investment vehicles for cash reserves among large and small investors.

- *Liquidity.* All money market funds are considered to be liquid since the maturities of the securities in them are short enough to classify the securities as "cash equivalents." Funds generally have low minimum investment requirements and allow free checkwriting, providing instant liquidity.

Major Categories of Money Market Funds

Money market funds fall into several broad categories, including:

- *Treasury only.* The safest money market funds are made up of Treasury bills and U.S. government agency obligations that are backed by the full faith and credit of the U.S. government. Since the credit quality of these funds is the highest available, they usually offer lower yields than general money funds.

- *General.* The majority of money market funds contain a wide range of money market securities, including those already discussed and others more complex such as asset-backed and dollar-denominated foreign issues. They do not carry the same virtually risk-free level of credit safety as government-only funds but are generally considered to be low-risk investments.

- *Tax-exempt.* These money funds are designed for investors seeking income exempt from federal income tax (also state and local taxes with state-specific funds) and are composed of short-term municipal securities. Their yields are lower than government-only and general funds to reflect the tax advantage.

Before You Invest

It's worth taking a minute to review your reasons for considering a money fund investment. Here are some things to keep in mind before choosing a fund:

- Make sure the low risk/low return potential profile of a money fund is appropriate for your investment purpose. A money fund can serve as a reserve for contingencies—a rainy day fund—and can be a useful adjunct for your stock and bond investments. You may want to "sweep" interest and dividends into a money fund so they immediately earn a return or perhaps park money you want to invest in stocks or bonds while you look for good opportunities. Conversely, money funds are not the most advantageous investments for long-term growth of capital. Both stocks and bonds have outperformed them over time and have outstripped inflation by a wider margin.

- While money funds must meet certain SEC requirements regarding credit quality and maturity, funds are by no means uniform. Be sure to read the prospectus or fund profile for a fund you are considering to find out the types of securities it buys, its investment practices, and its potential risks.
- Most investors understandably look for a fund with an attractive yield. Before investing in a fund with a significantly higher yield, take a look behind the scenes. Perhaps the investment manager is waiving the management fee or absorbing some or all of the fund's operating expenses. In such cases, you should find out if this is temporary or permanent, as the yield would drop if expenses were to rise. Or perhaps the fund is assuming additional risk to boost yield. Again, read the prospectus or profile and perhaps request a recent shareholder report for more detailed information on the fund's investment program.
- Compare yields on taxable and tax-free funds to see which type of fund is better for you in light of your tax bracket. (To compare the yield on a taxable fund with the yield on a tax-free fund that invests nationally, use the simple calculation shown in the worksheet below. Many mutual fund companies also offer taxable-equivalent yield calculators on their Web sites.)

Worksheet: Finding Taxable-Equivalent Yields

		Example	Your Calculation
Line 1	Enter the tax-free yield	5.0%	________%
Line 2	Subtract your federal tax bracket, expressed as a decimal, from 1.00	1.00 – .25 = .75	________%
Line 3	Divide the tax-free yield (Line 1) by Line 2 to find the taxable-equivalent yield	$\frac{5.0}{.75}$ = 6.67%	____ = ______%

Summary

Long the province of institutions and professional money managers, the money market became accessible to individual investors during the 1970s with the advent of money market mutual funds. Today, many U.S. and foreign investors use these versatile, short-term securities for myriad purposes, helping to make the money market the largest, most efficient credit market in the world.

Request a prospectus, which contains complete information, or a briefer profile by calling 1-800-541-8803; each includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.

Insights *reports provide background information on many aspects of investing. T. Rowe Price Investment Services, Inc., Distributor.*

Insights is printed on recycled paper

T.RowePrice
INVEST WITH CONFIDENCE

100 East Pratt St.
Baltimore, MD
21202
1-800-638-5660
troweprice.com/insights

Z10-227 5/07
62589