2016 will be a watershed year for cash management. New rules and market developments continue to dramatically reshape the short-end market. SSGA is urging investors to consider reviewing their cash allocations and adapting to the new realities as soon as possible — well before the implementation deadlines.

Basel III and Dodd-Frank are reshaping the investments that underlie many cash strategies. Additionally, by mid-October new rules on money market funds (MMFs) will be completely phased-in, imposing changes such as floating Net Asset Values (NAVs), liquidity fees and redemption gates that can affect the value, cost and timing of fund redemption. These developments — coupled with Fed tightening (see sidebar) and yield spreads that are poised to expand (see Figure 1) — mean cash management decisions are more important than ever in determining priorities for liquidity vs. yield.

The good news is that there are options for optimizing liquidity and security while earning an attractive yield. To seize the opportunities, investors will need to be proactive in 2016, revisiting objectives and updating investment policy statements (IPS). Given the seismic shifts in so many stalwart cash strategies — money market funds (MMF), repos, commercial paper and even wholesale bank deposits — playing by the old rules is no longer the best option.

**Figure 1: Spread Between Prime and Government MMFs**

![Graph showing yield spread between Prime and Government MMFs](image)

Source: iMoney and SSGA Research.

The above projected yield spreads are estimates based on certain assumptions and analysis. There is no guarantee that the estimates will be achieved.

Past performance is not a guarantee of future results.
LIQUIDITY
The new rules mandate a high level of liquidity in all MMFs

YIELD
Due to asset shortages and MMF reform, yields appear poised to expand between government, prime and short-duration funds.

CHALLENGES

FIXED NAV
For institutional investors, only government MMFs will continue to feature a fixed NAV after 10/14/16.

VARIABLE NAV
All institutional money funds other than government funds will have variable NAV.

RATINGS DOWNGRADES
Post-crisis reforms have led to lower credit scores for banks, despite measures strengthening balance sheets.

REDEMPTION GATES & LIQUIDITY FEES
Non-government institutional money market funds could be subject to redemption gates and liquidity fees. Short-duration bond funds that don't conform to Rule 2a-7 will be exempt.

FUND SOLUTIONS*
Institutional US Treasury TRIXX
US Treasury SVTXX
Institutional US Government GMVXX
60 Day MMF CCDXX
Institutional Liquid Reserves SSIXX
Current Yield SSYDX
Ultra Short Term Bond SSTUX
Conservative Income SSKGX

Source: SEC Rule 2014: Money Market Reform; Amendments to Form PF; SSGA Research, October 5, 2015.
*CCDXX, SSYDX, SSTUX and SSKGX are newly registered SSGA funds.
This State Street Global Advisors (SSGA) playbook is intended to help you understand and capitalize on the changes.

**Part I** reviews how cash management is changing. We note new developments and expectations for 2016.

**Part II** presents strategies for the new world of cash. In particular, we expect that clients will increasingly benefit from dividing cash into operating, core and strategic funds, and deploying optimal investments for each. We also present various innovative options that can produce greater yield for investors willing to look beyond traditional money funds.

SSGA is available to help you review your IPS and identify potential constraints. Your IPS is the foundation of everything you do with your cash. It guides and protects you with an agreed set of rules but may also limit your options based on outdated information and assumptions. But are you sure those rules still apply in the new cash world?

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**Market Impact of Recent Fed Tightening**

On December 16th 2015 the Fed raised rates for the first time since 2006. It was the first change in monetary policy since December 2008. Many, including SSGA, speculated on how rates would perform during the first rate hike and if the Fed would, in fact, be able to push short term yields higher. Using two key benchmark rates the Fed had no trouble moving the target range higher. Using interest on excess reserves (IOER) as the upper bound (0.50%) and the Fed's reverse repo facility (RRP) as the lower bound (0.25%) the Federal Funds Effective Rate reset at 0.35% the first day after the Fed's announcement. Meanwhile short term repo rates (a key source of financing for primary dealer inventory), Treasury Bills, discount notes and commercial paper yields moved in an orderly fashion.

There was a resounding sigh in the market as the long awaited question was answered and an orderly market proved to be the winner.
Here are the ways the new regulations will impact cash management in 2016 and beyond.

**Bank Credit Rating Downgrades**

Since the Global Financial Crisis, Moody’s, S&P and Fitch have downgraded many banks’ credit ratings. Agencies are now applying a tougher methodology, having issued overly generous ratings prior to 2009. Moreover, to protect taxpayers from future bank bailouts, lawmakers have enacted regulations that hold creditors liable for bank failures, eliminating the implicit government guarantee that previously benefitted large banks’ ratings.

In many cases, debt previously rated AAA is now AA, and what was AA is A. As Figure 2 shows, 46% of investment grade financial institutions were rated AA or AAA in 2006; by 2015, 8% were rated AA and none were AAA. In a sense, the new ratings can be thought of as an end to grade inflation.

Despite the downgrades, the banking system is arguably stronger than ever, thanks to rules that strengthen bank funding standards. (For more information, see “Bank Bail-In Regimes: No Longer a Bailout for Bank Credit Ratings” SSGA June 2015.) At the close of 2015, banks appeared healthy, with plenty of liquidity and more than sufficient capital levels, lower credit ratings notwithstanding.

SSGA is advising clients to consider agency ratings as part of an overall analysis, and not a primary determining factor.

Many investors’ IPS still establish stringent minimum ratings for cash investments. In the new cash era, SSGA is advising clients to consider agency ratings as part of an overall analysis, and not a primary determining factor. The Securities and

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**Figure 2: Historical Credit Rating Profile for Banks**

Source: Barclay’s Risk Analytics and Index Solutions, as of 11/30/2015.

The ratings represents the middle rating provided by S&P, Moody’s or Fitch, or the lower rating if only two agency ratings are available. Aaa is the highest rating and Baa is the lowest investment-grade rating.
Exchange Commission (SEC) supports this view: MMF rules taking effect in 2016 eliminate the requirement that 97% of a fund’s assets under management must be in top tier securities. The new rules state that all securities shall pose “minimum credit risk,” in the determination of the fund’s manager. Other restrictions worth revisiting may include client directed restrictions such as specific approved counterparties, primary dealer list, or sovereigns; exclusion of certain asset types; or maturity/tenor limitations.

It should be noted that banks remain inherently vulnerable to market cycles, asset bubbles and liquidity shocks, and in the next crisis senior creditors of Western banks will no longer benefit from a government safety net. Particularly in light of that, the cash credit team’s vigilant analysis of counterparties is critical for the cash investment process. Long before the SEC made it a requirement, SSGA has had a dedicated research team performing independent credit analysis for cash investments, utilizing ratings as an input to their assessment and not the driver of final analysis.

Investors interested in reaching for yield by accepting somewhat more flexible credit ratings should consider State Street’s Current Yield (SSYDX) or Ultra Short-Term Bond Fund (SSTUX), as discussed in Part II, under Core Funds and Strategic Funds.

**Wholesale Deposit Fees**

As 2016 progresses, investors (such as hedge funds) seeking to make large wholesale deposits may be in for an unwelcome surprise. Banks are expected to increasingly charge a fee for such deposits, or to encourage investors to find an alternative destination for their cash. The rationale: regulatory reform standards make it expensive for banks to warehouse that money, since they have to hold tier 1 capital (essentially cash) against those deposits. Even as interest rates rise and spreads continue to widen, wholesale deposits may not reap more yield given that banks will still face regulatory expenses in holding this cash.

**Money Market Funds**

Since their inception in the early 1970s, investors have regarded MMFs as the perfect destination for cash, featuring safety, attractive yields and limitless deposits and withdrawals. That notion came under scrutiny after Lehman Brothers failed and the Reserve Primary Fund – a major holder of Lehman commercial paper — shocked the cash world by “breaking the buck,” or dropping its NAV below $1 per share.

In 2010 and 2014 the SEC enacted major changes to Rule 2a-7, to enhance liquidity and transparency, and to forestall possible asset runs. These changes, coupled with the impact of new banking regulations have on investments underlying MMFs, are completely overhauling the money fund landscape. While some MMF changes have already been phased in, October 14, 2016 is the compliance deadline. To ensure an orderly transition, SSGA is urging clients to study the changes and implement a strategy in the coming months, well before the last-minute rush.

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Note that MMFs holding only risk-free government investments will effectively operate as they always have, with fixed NAVs and limitless liquidity. At least in part because of this, we are seeing a significant shift toward government MMF assets (see Figure 3), and we expect this shift to continue, putting downward pressure on government money fund yields.
Floating Net Asset Values

By October 14, 2016, every institutional prime and institutional municipal MMF will be valued at a floating (or variable) NAV, rather than the fixed $1 per share that they have long used. In other words, it will be possible to subscribe to these money funds at one price and redeem at another, effectively taking a loss or gain on “cash.” This is probably the most dramatic change to MMFs since rule 2a-7 came into effect in 1983.

Because this change doesn’t apply to government MMFs, many investors — accustomed to the convenience and security of the fixed NAV — are expected to move cash into government MMFs. If this happens, yield spreads are likely to expand (see Figure 1). In SSGA’s view, there are compelling reasons to look beyond government funds, particularly for cash not needed for near-term operations.

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State Street funds that will still feature a fixed NAV include the Institutional US Treasury Fund (TRIXX), US Treasury Fund (SVTXX), and Institutional US Government Fund (GVMXX).

Minimum Liquidity Standards

The new SEC rules mandate that MMFs hold at least 10% in overnight liquidity and 30% in weekly liquidity. To ensure they meet the standards, fund managers tend to use this level as a floor and hold an additional buffer. To provide transparency for investors, the weekly liquidity level will be published on a daily basis.

In adopting the new standards, the SEC is seeking to ensure that investors can readily access cash, even in times of stress. But investors should be aware that MMFs’ long-cherished liquidity will face new constraints.

Liquidity Fees and Redemption Gates

A key money fund value proposition has always been the ability to get at all of your cash whenever you need it. With a quick phone call or mouse click, you could redeem billions and have the money the same day. Now potential limits on that liquidity may impact some money market fund investors.

To ensure conformity to the new liquidity standards and thwart potential asset runs, the SEC has armed non-government MMFs with new “liquidity fees” and “redemption gates.” In times of stress, these tools may temporarily block investors’ ability to redeem at-will, or may impose costs to doing so. (The changes apply to all money funds other than government MMFs.) A redemption gate can block fund redemptions for up to 10 business days in a 90 day period. A liquidity fee levies a charge of up to 2% on investors who require cash in times of stress.
Beginning on October 14, 2016, in the event a fund’s weekly liquidity falls below 30%, it may impose redemption gates and/or liquidity fees, if its board finds that such measures are in the best interest of the fund’s shareholders. If weekly liquidity falls below 10%, the fund must impose redemption gates and liquidity fees, unless the board waives them.

In addition to the government MMFs, State Street is offering new money fund options that don’t conform with Rule 2a-7, and therefore are not subject to redemption gates and liquidity fees. These include the Current Yield Fund (SSYDX), Conservative Income Fund (SSKGX) and Ultra Short Term Bond Fund (SSTUX).

A Potential Asset Shortage Fuels Low Yields

The new regulations appear to be making financial markets healthier, but they’re also causing a supply-demand imbalance in short-term, high-quality assets. Heightened liquidity standards mean money funds need more government assets and very short-term high-quality assets. Yet liquidity and capital requirements are forcing banks to hoard government assets and issue less short-term debt. In other words, the rules drive far greater demand for high-quality short-term debt, while discouraging the market from creating debt needed to fulfill that demand. This dynamic is driving down yields independent of the Fed’s zero interest rate policy.

In 2015, yields were so compressed that many investors refrained from attempting to squeeze extra return from cash. Although interest rates are expected to rise in 2016, regulatory changes that push cash toward government MMFs are likely to put downward pressure on yields. On the other hand, there will be more opportunities for those open to somewhat higher volatility or lower liquidity — or, at a minimum, willing to accept breaking with pre-GFC investment policies.

MMF Outlook

These changes will drive many investors out of institutional prime and muni funds and into government funds. This flood of cash will position government funds to satisfy two of the criteria for optimal cash management — security and liquidity — but will likely drive yields down, particularly while interest rates remain low and the shortage persists in securities underlying government MMFs.

On the flipside, as funds flow out of the floating NAV prime funds, yield spreads are poised to increase, rewarding investors able to accept marginally higher risk. For those willing to adapt to the new rules, a constellation of new funds are available. (See Part II: Strategies for Capitalizing on the New World of Cash.)

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Short Term Investment Funds (STIF)

STIF funds will not be impacted by the SEC’s change in Rule 2a-7. STIF funds are governed by the Office of Controller of the Currency (OCC), which has made no announcement regarding the potential for liquidity gates, redemption fees or variable NAVs on such funds. SSGA will continue to monitor communication from the OCC regarding STIF funds and address, if necessary, any changes in the rules that govern those funds.
Part II

STRATEGIES FOR CAPITALIZING ON THE NEW WORLD OF CASH

SSGA has long urged clients to partition cash amongst operational, core and strategic segments, and optimize each with investments featuring an appropriate balance of liquidity, security and yield.

Under the new cash rules, this is more imperative than ever, particularly with new rules that will impose a variable NAV on institutional prime strategies and the potential for gates and fees on all prime MMF strategies. Moreover, spread gaps between Treasury bills and prime money market funds could rise to as much as 20 to 50 bps. For most investors, the days when a single investment fit all of your needs are coming to an end. Today, unless you’re willing to accept rock-bottom yields, cash needs to be allocated according to objectives.

Broadly speaking, the new cash playing field bifurcates investment options into those that ensure liquidity and convenience (i.e., a fixed NAV) at the cost of low yield, and those that offer higher yield at the cost of some near-term liquidity, convenience and a modest increased risk.

SSGA’s cash team remains ready to help you assess your needs and design an appropriate strategy.
Investing Daily (Operating) Funds

Security and Liquidity

This segment funds near-term operations, such as payments to inventory and service providers. The priorities are liquidity and security, with yields a secondary goal. In the new cash environment, we recommend that you review your operating liquidity needs and channel this cash into secure, liquid investments that offer a stable NAV and don’t face redemption gates or liquidity fees.

Traditionally, many companies have used prime funds for operating cash in order to earn extra yield. We feel that there are situations when this will remain appropriate, especially with options such as State Street’s Institutional Liquid Reserves Fund, which is managed to balance high liquidity and yield.

Playbook Options Include

Treasury or Government MMFs These funds are the safest and most liquid. They are free of liquidity fees and redemption gates. They remain unaffected by the regulatory changes, and seek to maintain a fixed NAV. Treasury funds hold only Treasury debt, while government funds include agency debt. SSGA options include TRIXX, SVTXX, GVMXX.

State Street 60-day MMF This fund (CCDXX) serves as a bridge between government and prime options. It conforms to Rule 2a-7, and invests in a wide variety securities maturing in no more than 60 days, with at least 50% rated A1+. This variable NAV strategy ensures immediate liquidity (although redemption fees and liquidity gates can apply), while seeking a gross yield between government and prime funds.

Investing Core Funds

Balancing Liquidity and the Bottom Line

Core funds are in excess of expected daily operating needs. This segment backstops operating cash, and can be tapped for a strategic acquisition or a short-term transaction. Immediate liquidity is important but less vital, and can be traded for a measure of yield.

Playbook Options Include

Prime Money Market Funds State Street’s Institutional Liquid Reserves fund (SSIXX) seeks a market rate of non-government MMF return, with greater than 50% invested in prime assets rated A1+. SSIXX conforms to Rule 2a-7, including a variable NAV, as well as the potential for redemption gates and liquidity fees. The fund is managed for high liquidity, and many corporations find that it is appropriate for their operational cash needs as well. The settlement date will be T+0.

Non-Money Market Options State Street is offering new funds that don’t conform with Rule 2a-7 (and therefore can’t be called money market funds). They maintain a sharp focus on liquidity and preservation of capital, while reaching for additional yield. For example, State Street’s Current Yield Fund (SSYDX) enables investors to benefit from securities issued by quality firms lower on the credit curve, while mitigating default risk by limiting the maturity range.
**Investing Strategic Funds**

**Seeking Yield without Sacrificing Liquidity and Security**

This cash is more permanent in nature. It could be used to fund a new business venture or a large acquisition, or it could be returned to shareholders via dividends or buybacks. Because it is not needed for short-term obligations, it can be deployed for more aggressive cash investments that seek yield at the expense of immediate liquidity, with a somewhat higher risk profile.

**Playbook Options Include**

**Non-Money Market Options** State Street’s Ultra Short-Term Bond Fund (SSTUX) is intended for investors with a 12 to 24 month horizon, who seek to limit interest rate risk, and who are willing to deviate from traditional cash guidelines. Among the investment options are AAA-rated ABS (such as credit cards and automobile trusts).

**Options Conforming to Pre-2010 Rule 2a-7 Guidelines** State Street’s Conservative Income Fund (SSKGX) is appropriate for investors with a 9 to 12 month horizon. Able to source a wide variety of investments (excluding ABS) outside the $2.5 trillion registered 2a-7 market, the fund has a variable NAV but no redemption gates or liquidity fees.

**Separately Managed Account Strategies** These accounts, with customized guidelines, can complement existing MMFs, and may provide an attractive investment option for core or strategic cash reserves.

Given the myriad rule changes and the corresponding array of new options for balancing liquidity, security and yield that we’ve outlined in this playbook, SSGA is urging investors to revisit cash flow needs early in 2016. This is important both for optimizing cash goals and for avoiding possible surprises emerging from such measures as floating NAVs, redemption gates, liquidity fees. Moreover, Fed rate hikes in 2016 appear poised to fuel yield spreads, meaning there will likely be a greater potential for return from well-managed cash stewardship. More than ever, it makes sense to divide your funds into operating, core and strategic segments, and invest appropriately for each segment. State Street Global Advisors is ready to help you assess your needs, to review Investment Policy Statements and prepare for board approvals.
The information provided does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor’s particular investment objectives, strategies, tax status or investment horizon. You should consult your tax and financial advisor. All material has been obtained from sources believed to be reliable. There is no representation or warranty as to the accuracy of the information and State Street shall have no liability for decisions based on such information.

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