As the coronavirus pandemic topples stock markets, many U.S. investors have sought safety in money market funds. They may be forgetting that during the financial crisis of 2008, the net asset value of one large money market fund dropped below $1 per share. This event, called "breaking the buck", triggered a stampede out of money market funds — except for those investing primarily in U.S. Treasurys.

Are money market funds any safer now for investors? The debt markets are being riled by the threat of defaults and illiquidity. Yet in my view, the answer is definitely yes, money market funds are safe — not only funds investing only in U.S. government-guaranteed securities, but also funds investing in top-quality commercial paper and funds investing in top-quality municipal securities.
Shares in money market funds are not generally backed by federal insurance, unlike bank deposits, which are covered up to $250,000 per account. Instead, money market funds are designed to produce relatively attractive, short-term yields while maintaining a constant value of $1 per share. They achieve this stability by holding a diversified portfolio of top-quality securities with an average maturity of 60 days or less.

Thus, if investors want to make sure they never suffer losses in their cash portfolios, they can invest in money market funds holding only U.S. Treasurys and other government-backed securities ("government money market funds"). But these investors must accept low yields because the interest rate on Treasury bills with maturities less than 60 days is today substantially below 1%.

The risk-return tradeoffs for other types of money market funds are more complex. The yields on the so-called "prime" money market funds — investing in top-quality commercial debt of large companies — are currently about 30% higher than yields on government money market funds. The yields on so-called "muni" money market funds — investing in top-quality paper of states, cities and their instrumentalities — are 10% to 30% higher than government money market funds on an after-tax basis for investors at state income tax maximums.

On the other hand, the risks to investors in both prime- and muni money market funds are greater than those in government money market funds. The most significant risk is that several securities in the fund’s portfolio may default or, more likely, drop sharply in price due to concerns about the creditworthiness of the issuer. SEC rules prohibit these money market funds from investing more than a specified percentage of their assets in the securities of any one issuer. Nevertheless, if several of a fund’s largest holdings experience a sharp price drop at the same time, this could result in the fund “breaking the buck.”

To address this risk, the COVID-19 legislation reinstated the U.S. Treasury’s authority to offer government insurance against shareholder losses in a U.S.-based money market fund. However, the new Treasury authority for money market fund insurance expires at the end of 2020. Moreover, the scope of the government insurance offered by the U.S. Treasury is limited to “the value of a shareholder’s account in the participating fund as of the close of business on the day before the announcement of the guarantee.”
The other significant risk is that a money market fund may not have enough liquid assets to meet a barrage of redemption requests. In 2014, the SEC adopted rules allowing independent directors of a money market fund with liquid assets below 30% of its total portfolio to impose redemption fees of up to 2% of assets redeemed, or to temporarily suspend redemptions for up to 10 business days. The possibility of such fees and suspensions may scare away investors in prime- and muni funds.

To address these liquidity concerns, the Federal Reserve in March established the **Money Market Mutual Fund Liquidity Facility.** This provides low-cost loans to banks for the specific purpose of buying high-quality, but illiquid, securities from money market funds. Eligible securities include secured and unsecured commercial paper of companies as well as short-term notes of cities and states.

The SEC also authorized sponsors and managers of money market funds to purchase troubled assets or illiquid securities from their own funds. For example, Bank of New York Mellon bought troubled assets from an affiliated muni fund that was about to “break the buck.” Goldman Sachs paid cash for illiquid securities in its affiliated prime fund to meet a flood of redemption requests.

In short, these extraordinary steps recently taken by the federal government should effectively protect shareholders of all types of money market funds. Under the COVID-19 legislation, the Treasury will soon offer federal insurance against losses for shareholders in money markets. The Fed has created a major facility to help money market funds sell illiquid assets for cash. And the SEC has allowed sponsors and managers of money market funds to purchase troubled or illiquid assets from their own funds.

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