Article Title: ARCHIVE | Criteria | Financial Institutions | Fixed-Income Funds: Money Market Fund Insurance Offers Limited Benefits Data: (Editor's note: In the article published on 9/15/98, the phrase claims-paying ability was mistakenly used in the third paragraph. The corrected article follows.) Several U.S. fund companies created or have plans to create insurance protection on varying amounts of credit exposure in money market funds. Fidelity Investments, a subsidiary of FMR Corp., received approval in February 1998 to insure up to $100 million in losses that arise from credit defaults on certain of its money funds. According to industry sources, Fidelity plans to begin implementing this insurance in January 1999. It has also been reported that several other funds are seeking similar policies from unaffiliated insurance companies. LIMITED IMPACT EXPECTED Standard & Poor's believes that although many fund companies may follow suit, this proposed insurance protection will have limited impact for the money fund industry. Although the insurance helps mitigate one of the underlying risks in money funds, it does not protect against other types of losses that funds may suffer or even against all potential credit losses. Investors still must be aware of the other unprotected money fund risks when making investment decisions. Moreover, it comes at a cost in the form of slightly higher expenses, which reduce fund yields. In the event that a default does occur on any security in a money fund, insurance protection may mitigate the impact of the default on the fund's principal value. However, the financial strength rating of the insurance provider must be taken into consideration. An insurance policy is only as strong as the company that issues it. FMR, the parent of Fidelity Investments, is currently unrated, which makes gauging the quality of the money fund's insurance difficult. Also, the amount of insurance coverage available for each fund needs to be analyzed. For example, funds registered under Rule 2a-7 of the Investment Company Act of 1940 are allowed to have up to a 5% exposure to any single issuer. In a $5 billion fund, this amounts to a maximum $250 million exposure. The proposed insurance would cover up to $100 million. OTHER RISKS INVOLVED Most important, credit risk is not the only risk that may affect a money fund's stability. Investors should be aware of some of the other risks in money funds that the current insurance protection would not cover. Market price exposure, which is the fund's sensitivity to changing market conditions, is a risk that cannot be overlooked in money fund analysis. Market price exposure incorporates interest-rate risk, liquidity of the fund's investments, and the dilution risk (flow of money out of the fund), among other risks. Money funds are permitted to issue and redeem shares at $1.00, provided that their market value is between $0.995 and $1.005. Because funds can pay out $1.00 on shares that may actually be worth as little as $0.995, the remaining shareholders in the fund absorb the difference. Dilution can accelerate fund losses in a rising interest-rate environment. For example, assume a fund is valued at $1.00 per share and has a weighted average maturity of 90 days. If interest rates rise by 200 basis points and the fund receives a 10% shareholder redemption, then the fund "breaks the dollar" and is forced to pay out 99 cents to shareholders. In this case, no credit default occurs, yet investors lose principal. Synthetic securities provide another example of how severe price fluctuations can occur based on liquidity and supply and demand factors. When these securities are held in fund portfolios and interest rates are volatile—which occurred in 1994 when several funds held structured notes—money funds may have problems paying out the full $1.00 per share. The proposed credit insurance would not protect against these situations. Another area of fund risk, although to a lesser degree, is the risk of fraud. Registered funds are required to carry a minimum level of fidelity bond insurance to protect against losses through larceny or embezzlement committed by any employee or officer of the fund or company that services the fund. Many funds also have errors and omissions insurance to protect against any negligent breach of duty, errors or omissions, or other negligent acts, but this is not a general requirement. INVESTED PRINCIPAL NOT GUARANTEED The primary objective of a money market fund is preservation of capital and maintenance of liquidity. Money fund insurance adds an additional layer of protection. However, it does not eliminate all money market fund risks. Investors should be aware that this insurance is not analogous to federal deposit insurance, in that invested principal is not guaranteed.