Why Money Market Funds Break The Buck

by Douglas Rice (Contact Author | Biography)

Money market funds are often thought of as cash and a safe place to park money that isn't invested elsewhere. Investing in a money market fund is a low-risk, low-return investment in a pool of very secure, very liquid, short-term debt instruments. In fact, many brokerage accounts sweep cash into money market funds as a default holding investment until the funds can be invested elsewhere.

Money market funds seek stability and security with the goal of never losing money and keeping net asset value (NAV) at $1. This one-buck NAV baseline gives rise to the phrase "break the buck", meaning that if the value falls below the $1 NAV level, some of the original investment is gone and investors will lose money.

This only happens very rarely, but because money market funds are not FDIC-insured, they can lose money. Find out how this happens and what you can do to keep your "risk-free" assets truly risk free.(To learn more about the FDIC read, *Are Your Bank Deposits Insured?* and *Bank Failure: Will Your Assets Be Protected?*)

Insecurity in the Market

Even though investors are typically aware that money market funds are not as safe as a savings account in a bank, they treat them as such because, as their track record shows, they are very close. But given the rocky market events of 2008, many did wonder if their money market funds would break the buck. (For further comparison see, *Money Market Vs. Savings Account*.)

In the history of the money market, dating back to 1971, there was only one fund that broke the buck until the 2008 financial crisis. In 1994, a small money market fund that invested in adjustable-rate securities got caught when interest rates increased and paid out only 96 cents for every dollar invested. But as this was an institutional fund, no individual investors lost money, and 37 years passed without a single individual investor losing a cent. (Keep reading about this market in our *Money Market* tutorial.)

In 2008 however, the day after Lehman Brothers Holdings Inc. filed for bankruptcy, one money market fund fell to 97 cents after writing off the debt it owned that was issued by Lehman. This created the potential for a bank run in money markets as there was fear that more funds would break the buck.

Shortly thereafter, another fund announced that it was liquidating due to redemptions, but the next day the United States Treasury announced a program to insure the holdings of publicly offered money market funds so that should a covered fund break the buck, investors would be protected to

$1 NAV.

Track Record of Safety

There are three main reasons that money market funds have a safe track record.

1. The maturity of the debt in the portfolio is short-term (397 days or less), with a weighted average portfolio maturity of 90 days or less. This allows portfolio managers to adjust quickly to a changing interest rate environment, thereby reducing risk.

2. The credit quality of the debt is limited to the highest credit quality, typically 'AAA' rated debt. Money market funds can't invest more than 5% with any one issuer, except the government, so they diversify the risk that a credit downgrade will impact the overall fund.

3. The participants in the market are large professional institutions that have their reputations riding on the ability to keep NAV above $1. With only the very rare case of a fund breaking the buck, no firm wants to be singled out for this type of loss. If this were to happen, it would be devastating to the overall firm and shake the confidence of all its investors, even the ones that weren't impacted. Firms will do just about anything to avoid breaking the buck, and that adds to the safety for investors. (For more on this see, *Get A Short-Term Advantage In The Money Market*.)

Readying Yourself for the Risks

Although generally the risks are very low, events can put pressure on a money market fund. For example, there can be sudden shifts in interest rates, major credit quality downgrades for multiple firms, and/or increased redemptions that weren't anticipated. Another potential issue could occur if the fed funds rate drops below the expense ratio of the fund, which may produce a loss to the fund's investors.

To reduce the risks and better protect themselves, investors should consider the following:

- Review what the fund is holding. If you don't understand what you are getting into, then look for another fund.
- Keep in mind that return is tied to risk - the highest return will typically be the most risky. One way to increase return without increasing risk is to look for funds with lower fees. The lower fee will allow for a potentially higher return without additional risk.

- Major firms are typically better funded and will be able to withstand short-term volatility better than smaller firms. In some cases, fund companies will cover losses in a fund to make sure that it doesn't break the buck. All things being equal, larger is safer.

Confusion in the Money Market

Money market funds are sometimes called "money funds" or "money market mutual funds", but should not be confused with the similar sounding money market deposit accounts offered by banks in the United States.

The major difference is that money market funds are assets held by a brokerage, or possibly a bank, whereas money market deposit accounts are liabilities for a bank, which can invest the money at its discretion - and potentially in (riskier) investments other than money market securities. In a money market fund, investors are buying securities and the brokerage is holding them. In a money market deposit account, investors are depositing money in the bank and the bank is investing it for itself and paying the investor the agreed-upon return.

If a bank can invest the funds at higher rates than it pays on the money market deposit account, it makes a profit. Money market deposit accounts offered by banks are FDIC insured, so they are safer than money market funds. They often provide a higher yield than a passbook savings account and can be competitive with money market funds, but may have limited transactions or minimum balance requirements.

Conclusion

Prior to the 2008 financial crisis, only one small institution fund broke the buck in the preceding 37 years. During the 2008 financial crisis, the U.S. Government stepped in and offered to insure any money market fund, giving rise to the expectation that it would do so again if another such calamity were to occur. It's easy to conclude then that money market funds are very safe and a good option for an investor that wants a higher return than a bank account can provide, and an easy place to allocate cash awaiting future investment with a high level of liquidity. Although it's extremely unlikely that your money market fund will break the buck, it's a possibility that shouldn't be dismissed when the right conditions arise.

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In addition to writing for the Investopedia, Douglas Franklin Rice educates individuals about financial matters in a variety of ways. For those interested in learning more from Rice, start with his blog, Taking Risks and Reaping Rewards, which uses current events to teach underlying financial concepts. Beyond that, more information about his books, seminars, and other services can be found at his personal website www.douglasrice.com. There you can collect your free copy of one of his books, *Reflections on Conventional Wisdom*.

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