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WHAT IS A MONEY MARKET FUND?

Money market unit trusts, commonly referred to as 'money market funds', have become a synonym for safe, secure and reliable investments. You put your money in and you get it back with a sliver more. But no investment is risk-free. Understanding how money market unit trusts work can help you use them effectively in your portfolio. Beki Mafulela explains their mechanics.

Before we delve into what money market unit trusts are it is probably a good idea to have an understanding of what the 'money market' is. Most of us can conjure up images of the old-school stock market with traders shouting buy and sell prices from the floor, but the money market draws a blank. In simple terms the money market is where companies, governments and banks raise money by getting short-term loans from investors. In practical terms, all transactions are now done electronically through a network of buyers and sellers, sometimes in auctions run by the banks, and there is no central or physical location where the money market exists.

What is a money market instrument?

A money market instrument entitles an investor to receive their loan amount back at the end of the term of the loan with accumulated interest payments from the institution. Let's unpack how this works by using a simple example:

1. A bank (or a company or a government) needs R100 million to cover operating costs for the next 12 months. The bank issues money market instruments to raise this money, which investors then buy.

2. This instrument offers 8.5% interest (which is called the yield) with a maturity of 12 months (the length of the loan period). Investors require that instruments with longer maturities offer them higher interest to compensate them for the risk.

3. Interest will accrue to the investor until the day the fund matures, when the investor will receive the total interest amount plus the initial capital investment.

4. If the investor sells that instrument before maturity, then the new holder picks up where the old one left off.

Some of you may already be asking: what makes this different from a bond? The answer is time. Money market instruments have terms that are usually a year or less. As money market instruments are commonly bought in minimum sizes of R1 million, money market unit trusts allow normal investors, without millions to spare, to access these instruments by pooling together their investments.

What happens if the institution can't pay?

By their nature, money market instruments are short dated, and you can choose to only invest in those issued by large, safe institutions – but this does not make them risk-free. Banks fail, companies go bankrupt and countries default. Recent events, like the collapse of African Bank and the global financial crisis of 2008, underlined the fact that no investment is without risk.

To protect against this risk, the Allan Gray Money Market Fund invests in a range of instruments offered by different issuers, so that it is not over-exposed to any single institution. In the unlikely event that an institution is unable to pay back the money, some money may be recovered in the liquidation process. Money market instruments are considered to be 'senior debt', which means that an institution has to pay these debts off first before other types of debt in case of liquidation.

> **"MONEY MARKET UNIT TRUSTS ARE A GOOD TOOL TO USE FOR MONEY IN TRANSITION OR FOR A SHORT-TERM SAVINGS OR EMERGENCY PLAN."**

When should I use a money market unit trust?

Money market unit trusts are a good tool to use for money in transition or for a short-term savings or emergency plan; they are an effective parking place for your money. They allow you to store money that you will use in the near future, while getting some returns.

In some ways a money market

fund is comparable in use to a fixed deposit account that you get from a bank, with some advantages:

- You can cash out whenever you want. With most fixed deposit accounts you are locked in for a specified period where you may not withdraw your money without penalties. A money market unit trust is more liquid, which is something you should consider when comparing its returns to a fixed deposit from a bank.

- Your eggs are not all in one basket. A money market unit trust has investments across lots of issuers, whereas a deposit is only with a single bank (they guarantee your deposit but banks do sometimes fail), so although your risk is low it is also concentrated.

Investors who need to withdraw on a monthly basis may also find them useful, but beware of the downside of using a money market unit trust below.

The downside

In a word: inflation.

The returns of a money market unit trust often do not keep up with inflation over the long-term. If inflation exceeds the yield you may not lose a cent from the balance you see on your investment statement, but each cent will buy less the longer you keep your money in the unit trust. Put differently, money market unit trusts are usually not appropriate for long-term investing, like saving for retirement or your child's education.

Bekithemba joined Allan Gray in 2013 as a Business Development Manager. He has a Bachelor's degree in Economics, a postgraduate diploma and an advanced postgraduate qualification in Financial Planning. He is also a CFA charter holder and a CFP professional.