Insights

Investing in Money Market Securities

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Library

The money market consists of short-term debt securities that mature in a year or less. It is a liquid market in which governments, municipalities, corporations, and other entities finance short-term needs and put short-term money to work.

Today, largely through money market mutual funds, many millions of U.S. and foreign investors take advantage of this efficient, versatile market. In fact, there is a role for money funds in nearly every investor's portfolio. Before you invest, however, you should know something about what these securities are and how they work, and how they can be used appropriately in a diversified portfolio.

The basics of money market securities

A wide variety of short-term debt instruments are traded in the money market. They are generally characterized by a high level of liquidity and safety of principal. Maturities range from one day to one year, with the most prevalent being three months or less.

Major money market securities include:

- *Treasury bills*—Issued by the U.S. government with maturities of four weeks, three months, and six months. They are considered completely safe from the risk of default since they are backed by the full faith and credit of the federal government.

- *Large negotiable certificates of deposit*—Issued by major banks in amounts of $100,000 and higher as a means to raise money for various purposes, including lending operations.

- *Commercial paper*—Unsecured promissory notes issued mainly by creditworthy corporations. For many large companies, they are a low-cost method of short-term borrowing and one of the most important debt markets in the U.S.

- *Asset-backed securities*—Bonds with an underlying pool of assets, such as credit card or automobile trade receivables or corporate loans or bonds that provide interest and principal payments to investors.

- *Repurchase agreements (repos)*—Contracts enabling money market participants to acquire immediate funds by selling securities, usually Treasury bills, which they agree to buy back overnight or after a few days at a set price.

Tax-exempt money market securities are also available, allowing states and municipalities to borrow money for short-term needs. They include bond, tax, and revenue anticipation notes; municipal commercial paper; variable-rate floaters; and other more exotic instruments that provide investors with interest exempt from federal income taxes and, in some instances, state taxes. Their level of safety depends on the creditworthiness of the issuing state or municipality.

Money market interest rates

The Federal Reserve establishes the general level of money market rates by adjusting the federal funds target rate—the basic rate to which all other money market rates are anchored. The fed funds rate is the overnight lending rate among banks and one of the key instruments of the Federal Reserve's monetary policy.

The Fed ordinarily lowers the fed funds rate to stimulate the economy when growth is sluggish and inflation is under control and raises it when the economy is growing too fast

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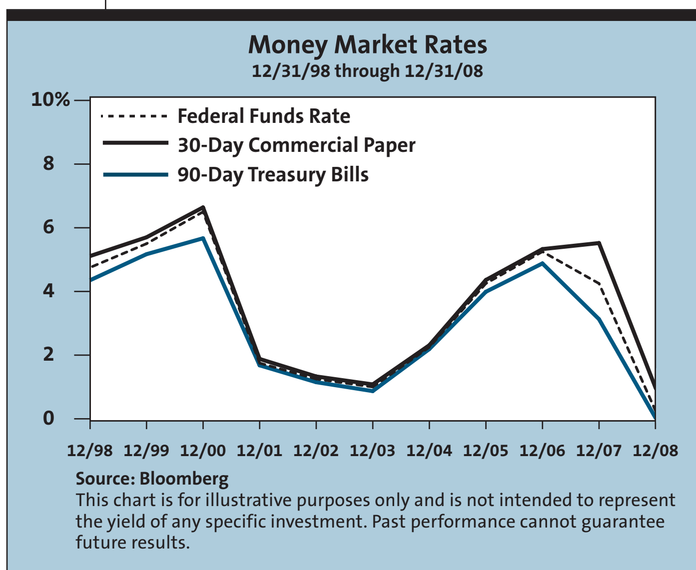
and inflationary pressures are building. At the end of 2008, in an attempt to address a severe credit crunch and a weakening economy, the Fed effectively reduced interest rates to near zero by creating a band for the fed target rate between 0% and 0.25%. Though extraordinary by the Fed's standards, central banks in other parts of the world had taken this step in prior financial or economic crises. A zero interest rate policy is, by its nature, a temporary fix—once the crisis passes, rates can be expected to rise once again.



Source: Bloomberg
This chart is for illustrative purposes only and is not intended to represent the yield of any specific investment. Past performance cannot guarantee future results.

Investing in money market securities

Since most money market securities trade in minimum lots of $1 million or more, the majority of individuals invest in them through money market funds. There are money funds that invest only in Treasuries, or in tax-exempt municipal securities, but a large number of money funds invest broadly across the range of money securities.

Money funds are among the most stable and liquid investments you can own. The SEC requires most money funds to invest at least 95% of assets in securities carrying the highest credit rating by at least two of the five major rating agencies. The funds are also required to operate under strict guidelines regarding maximum weighted average maturity, maximum maturity for any one holding, and diversification of fund assets.

However, be aware: *An investment in a money fund is not insured or guaranteed by the FDIC or any other government agency. Although a money fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in a money fund.* Unlike bank deposits, the principal and payment of interest in money funds is subject to some risk. Nonetheless, money funds have an excellent track record overall.

Fitting money market securities into your portfolio

Money funds are low-risk, low-return vehicles, which makes them a better fit for some investment goals than others. Money funds should be featured prominently in portfolios geared toward near-term goals, such as a down payment on a house. Because their liquidity is high and the risk to your principal is so low, money funds can also be a good place for your rainy day funds.

However, money funds are poor vehicles for long-term growth, since their returns will barely compensate you for inflation. The amount your portfolio should have in money funds versus bonds or stocks will vary depending on your time horizon; visit troweprice.com for more information.

Before you invest in a money fund, take a close look at the prospectus to verify the fees being charged. Since money fund yields tend to be so low, high expenses can have a disproportionately negative impact on your returns. However, if the yield on a given fund seems relatively high, that should also be investigated; funds will sometimes waive fees for a short period of time as a way to temporarily make their yield more attractive.

Insights reports provide background information on many aspects of investing. *Call 1-800-638-5660 to request a prospectus, which includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.* T. Rowe Price Investment Services, Inc., Distributor.

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100 East Pratt St.
Baltimore, MD
21202
1-800-638-5660
troweprice.com/insights
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