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Money Market Funds Tackle 'Exuberant Irrationality'

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Current challenges in the short-term credit markets have produced a meaningful change in investor behavior patterns and expectations resulting in depressed pricing and illiquidity. Large institutional money market fund investors have siphoned off much of the liquidity out of the short-term credit markets. While the majority of the 525 money market funds rated by Standard & Poor's Ratings Services have been able to weather the storm thus far by maintaining sufficient liquidity and a stable net asset value (NAV), the ongoing turmoil in the financial credit markets has resulted in significant liquidity and pricing pressures for several prime money market funds, including those rated by Standard & Poor's.

Over the next several days and weeks, we will continue to closely monitor the following four facets of our principal stability fund rating criteria that we believe are crucial to our rated prime money market funds being able to maintain stable net asset values of \$1.00 per share:

- Fund asset balances;
- Individual security pricing (especially for bank and finance company paper held);
- Marked-to-market portfolio NAVs; and
- The impact of U.S. government actions on general market liquidity and the ensuing impact of short-term paper liquidity and valuation.

As market dynamics develop, further deterioration in market prices and diluted asset bases may warrant fund ratings action or additional NAV support from fund sponsors. Alternatively, if prices and asset flows stabilize, the money market fund industry can invest looking forward instead of managing the fallout of "exuberant irrationality."

Fund Asset Balances

After peaking at \$3.58 trillion during the week ending Sept. 10, 2008, total assets for U.S. money market funds have fallen 5.41% to \$3.4 trillion during the week ending Sept. 24, 2008. Over this two-week period, net institutional fund outflows were significant--totaling \$185 billion--while retail money market fund assets were up by \$1 billion. The overwhelming sentiment within the money market industry is that things will take a turn for the better after today's September 30th calendar

quarter-end. Some institutional investors typically exit money funds at quarter-ends to pay state and federal tax bills and to improve the appearance of their balance sheets. On Sept. 16, a spike in redemptions ensued after Reserve Primary Fund "broke the buck" when its shares fell to 97 cents--magnifying the pace of the exodus.

It is likely that certain yield-sensitive institutions commonly referred to as 'hot money' accounts, moved money from one investment to another to capture a higher yielding, or seemingly safer, option. For example, after Lehman Bros. filed for bankruptcy, corporations that issued commercial paper (CP) to fund their business operations were forced to pay a significantly higher premium to obtain funding because of investor concerns with holding debt from any nongovernment issuer. The subsequent "flight to quality" pushed some overnight and 30-day CP rates up by 0.5% (to approximately 3.5%) for issuers whose credit or financial/risk profile did not seem to change. As a result, these hot money accounts moved their investments from money market funds yielding less than 2.75%. When large institutional investors redeem en masse to seek safer and more stable investments, we believe they may actually add to the fund's problems by forcing management to sell securities in an unstable market to satisfy redemptions.

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Individual Security Pricing And Marked-To-Market Portfolio NAVs

The downward slide in the credit quality of banks and other financial service companies has resulted in heightened sensitivity across the credit markets, causing pricing and liquidity problems for highly rated issuers. As investors try to distance themselves from the headline risk associated with credit risk or insolvency--or with specific names or issues in the news, the volatility and pricing in the fixed income markets are putting negative pressure on the mark-to-market of the asset values for prime money market funds. While some pricing deterioration is clearly warranted, fund managers are currently trying to determine the reasons for the extreme asset markdowns occurring across their portfolios. These markdowns are causing a material drop in prime money market NAVs which, when coupled with a steadily declining asset base, further dilutes a fund's NAV.

Prime money market funds rated by Standard & Poor's report daily pricing and asset flows when their NAV falls below \$0.9985. As a fund's NAV hits or drops below this mark, we begin a dialogue with the fund's investment managers to understand whether their plan of action for dealing with the situation is sufficient, in our view, to ensure both a stable NAV and the current rating level on the fund (see "How Are Events In the Financial Markets Affecting Money Market Funds," published Sept. 30, 2008, on RatingsDirect).

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Impact Of U.S. Government Actions On General Market Liquidity

Over the past two weeks, the U.S. government has proposed or provided three mechanisms intended to stabilize the financial markets as institutions navigate through these turbulent times. These include:

- A temporary guarantee program for money market funds;
- The Troubled Assets Relief Program (TARP); and
- The Federal Reserve Board's Asset-Backed Commercial Paper (ABCP) Money Market Mutual Fund Liquidity Facility (AMLF).

It is likely that these programs may help restore investor confidence and improve liquidity if, and when, implemented. However, there could be certain associated adverse consequences--for example, the ABCP AMLF program has resulted in illiquidity for short-term money market paper other than ABCP. This facility enables prime money market funds to increase their liquidity for meeting increased redemptions by providing a buyer for their ABCP paper at amortized cost. Over the past week, ABCP has practically been the only paper trading, and this comes at the expense of the liquidity in all other markets. Although we believe the overall ramifications of these mechanisms will be favorable, we will closely monitor their effects (intended and otherwise) on our money market funds as these programs are rolled out and implemented.

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