PFM’s Margolis & Rowe Discuss Cash Market, LGIPs

This month, MFI interviews Marty Margolis, CIO of PFM Asset Management, and Jeffrey Rowe, Co-Head of PFM Asset Management’s money market portfolio management team. We ask them about their firm, which is based in Harrisburg, Pa., and about recent developments in the money markets and the LGIP, local government investment pool, marketplace. Our Q&A follows.

MFI: Give us a little history.
Margolis: We began managing LGIPs in Pennsylvania in 1981, and we now manage 17 state-specific pools with total assets approaching $35 billion, as of 12/31/2018. They range in size and are across the country, and they’re part of our fixed-income strategies, which total about $85 billion. Our strength over this long period has been in the short-intermediate, fixed-income market. We’ve always been focused on bringing value to the public sector, and more recently as we’ve grown, we found relevance and interest in the broader institutional marketplace. We are an institutional-only manager, and cash, enhanced cash, and short-intermediate duration remains the area that we have the most resources devoted to.

I started the business that eventually became PFM Asset Management in 1978. I’d been on the staff of the Governor of Pennsylvania at that point for about five or six years. His second term was running out and I needed a job… So, I went off with a colleague and we started a public sector financial advisory business in the attic of his house in Harrisburg. When we opened the first LGIP in Pennsylvania in 1981, the first trade was a repo done at a level of 18% and change.

Rowe: My background is a bit less interesting than Marty’s. I’ve spent my entire 14 year career here at PFM. After majoring in finance, I started out as a trader and had the privilege of learning from Marty and others. I earned the CFA designation early on in my career, and have just been growing with PFM ever since.

MFI: What’s your main focus now?
Margolis: The best thing I can say is, ‘We’re minding our business.’ That may sound like a smart comment, but we’ve got a lot of success built around managing cash, managing short-intermediate fixed-income, and we’ve expanded a bit beyond the public sector. We are working really hard to serve existing clients in the public-sector space, where we have this long track record and client loyalty. We learned a lot during the Great Recession — as observers — not participants in the debacle. We escaped unscathed, I’m happy to say.

There are a couple of things we’ve done since then. As we’ve grown, we’ve really expanded our capabilities in the last 10 years; first in credit and more recently in the structured space to support our core strategies. And as these efforts matured, we expanded our client base and our investment lineup. We’re now managing broad investment-grade and stable value portfolios, as well as cash and short/intermediate separate accounts.

Rowe: Before SEC money market reform, we sponsored a 2a-7 Prime fund, as well as a 2a-7 Government fund. What we found with our client base is that there wasn’t a significant appetite for a money market fund with fees, gates, and floating NAVs… So the Prime fund merged into the Government fund, and that’s the 2a-7 offering we have today. Most of our clients have found better alternatives to a 2a-7 Prime fund, whether it be in liquidity SMAs that we manage, or our local government investment pools.

MFI: What’s your biggest challenge?
Rowe: There are always challenges in the front end; there’s always something new facing us that we have to deal with. [That’s] one of the things I enjoy most about being a fixed-income portfolio manager. As we sit here today in early 2019, the main challenge of managing short-term portfolios is simply the current environment we have with a very flat yield curve and tight credit spreads. There’s not many compelling investment opportunities at the moment.

As an active manager, we prefer market conditions with a little bit of volatility, and the opportunities that typically come with that. Last year was characterized by an active FOMC, steep money market curve, and credit spread volatility — this provided a ripe opportunity to actively add value. But again, the challenges are always changing. Looking back a few years, we had to deal with significant regulatory changes and a zero interest-rate environment in the post financial crisis period. We just have to be able to adapt as markets change.

MFI: What are you buying?
Rowe: There are a number of key things on our mind, such as new structures that we, and other market participants, are evaluating here in early 2019. Two notable ones would be SOFR-based floaters, and opportunities related to the evolution of the repo market — FICC-sponsored repo comes to mind. On the SOFR topic, like other investors in the front end, we’re watching and selectively participating in SOFR-based instruments…. With just over $50 billion in issuance so far, there seems to be wide participation on the investor side. GSEs

(Continued on page 2)
(PFM’s Margolis & Rowe from p. 1)

have really led the way here with about 80% of the issuance of SOFR-based securities thus far. We’re seeing these GSE-syndicated deals being very well received, two to three times oversubscribed, and driven by strong 2a-7 Government fund demand.

It makes sense to us that a government fund would be interested in SOFR-based floaters since it’s a close substitute for short-term bills, discount notes and repo. I think the challenge we and other participants may face going forward is looking at SOFR-based instruments from the perspective of a credit investor. Credit products tied to a risk-free reference rate can present a challenge. We haven’t seen it thus far in the six or nine months that SOFR based bonds have been in existence. But in an environment where credit is under pressure, you could see, of course, SOFR-linked bonds significantly underperform as credit spreads widen.

**MFI: What are customers asking about?**

Margolis: I would say in the pool space, rates above zero have been a great eye opener for many clients. After years of assets being stable, when rates got up to 1%, 1.5% and north of 2%, investors started paying attention to cash. The result of that has been more growth in our cash-based strategies, particularly in the LGIPs, in the last two years or so. I think the second thing is for clients who were used to using Prime money market funds. Post-2016 with the money market fund reforms, they’ve been doing a reassessment of alternatives for investing cash.

As you know, LGIPs generally may offer a stable NAV, and that’s been a real advantage. We’ve been very diligent about working with clients in tailoring the accounting in the LGIPs to GASB requirements, because our client base within LGIPs is basically governments.

We also think that clients are really concerned about safety, particularly cyber-security safety. So we’ve mounted a big effort this year to enhance protections related to our investors moving money in and out of funds we administer and receiving secure investment reports.

**MFI: What about fees and waivers?**

Margolis: We waived fees in some of the funds when rates were hovering around zero; we’re not in that situation at this point. The fees for the LGIPs we manage are generally in line with the fees for large institutional money market funds that are offered as alternatives to the LGIPs. Some of our funds have significant cash-management services that are included within the fund expense ratio. Bearing the cost of these services was challenging during the zero interest-rate environment; it’s less challenging now. For insight into fees in the LGIP space, you can look at ... the S&P LGIP Index returns for gross and net yields for local government funds. We’re right where I think our investor clients want us to be on that scale.

**MFI: Are cash flows seasonal?**

Rowe: Absolutely. Each one of our LGIPs is unique, not only in permitted investments, which is primarily driven by state statute, but in the seasonal liquidity pattern. It’s not uncommon to have a fund that doubles in size over the course of the year. We, of course, factor this into our strategy on the trading desk.... We have a rich history with LGIPs — we’ve been managing the funds for 20+ years. So we have a keen insight into what those flows typically are, and can incorporate likely seasonal effects into our strategy.

**MFI: Are clients using SMAs?**

Margolis: One of the things about the funds is that, for smaller investors, that’s the place that they rely on. I would say there’s been a fair amount of interest in SMAs for investors that are larger, public and not-for-profit investors that had been using Prime money market funds. Today our SMA business is bigger than our pool business. In the short duration SMA area, we have approximately $40 billion of assets under management. AUM has grown in the single digits in each of the last several years, so we’re pretty happy with the success of our SMA business.

**MFI: What about your outlook?**

Rowe: Looking into 2019, investors are faced with a much different landscape. It’s not only a question of, ‘When will the Fed next move?’ which was of course the question for the last several years, but ‘In which direction?’ So, our base case is the Fed is going to be patient here.... So with that, at least for the first half of the year, we think rates are going to be range-bound in the front end, and there’s not going to be a whole lot of rate volatility.

Margolis: As Jeff observed we think rates are going to be confined to a fairly narrow range here no matter what the news.... We’re positioned, as Jeff said, with the view that there’s not going to be an imminent change in short-term rates. This has been a good market for cash and short-intermediate strategies. The cash market has experienced very solid growth going on four years now. As soon as rates got above zero, investors started paying attention to their cash and will continue to do so.

---

**Crane Data**

measures money markets ...
+1-508-439-4419
http://www.cranedata.com

---

Reprinted with Permission from the March 2019 issue of Money Fund Intelligence with permission of Crane Data. The opinions expressed are those of Marty Margolis and Jeffrey Rowe and are current through March 7, 2019.

An investment in a money market fund is neither insured nor guaranteed by the FDIC or any other governmental agency. It is possible to lose money by investing in a money market fund.