

The Money Market

The general slump of the equity market has forced investors to adopt a very cautious outlook regarding their investments in stocks. While some companies have been producing outstanding financial results, in some cases recording double digit growth, this has not always been reflected in the companies' share prices on the local stock market today. On the other hand, some companies have been consistently underperforming and thus not providing much incentive to new investors interested in entering the stock market as well as to those already with vested interests in the equity market. As a result, investors are left wondering where they might be able to get returns on their investment dollar.

One alternative is the money market. The money market is an organized exchange that allows members to lend and borrow large sums of money and consists of short-term debt instruments, such as treasury bills, certificates of deposit and money market funds, with a maturity date of approximately one year or less. While, the money market is an important forum for governments, banks and other large institutions to manage funds, individual investors can invest smaller amounts of money and also reap the benefits associated with holding these types of instruments. Some of the more popular money market securities are explored below, each offering different returns and risks.

Money Market Securities

Treasury Bills

Treasury Bills, more commonly referred to as T-bills, are short-term securities that are issued by The Central Bank of Trinidad and Tobago. They are sold in denominations of \$1,000 and are normally issued with three month, six month, and one year maturities. Through a bidding process, T-bills are purchased at a price less than their par (face) value and upon maturity, the holder of the T-bill is paid the full par value. This means that instead of receiving regular interest payments, as in the case with bonds, the return to the investor is the appreciation in value from the discounted value originally paid and the amount received upon maturity of the T-bill. The three month issues are generally published in the newspapers by The Central Bank every other week on a Wednesday while the six month issues are generally issued every other month on a Monday. The average rate of return on these securities is currently in the range of 7 per cent.

Open Market Operations

Open Market Operations or OMOs, are short-term instruments that can be purchased directly from brokerage companies and banking institutions. OMOs are similar to T-bills except that they are made available on very short notice by The Central Bank. Although minimal, OMOs offer slightly better returns than those available with T-bills.

Certificates of Deposit

A certificate of deposit (CD) is essentially a savings instrument that is held for a fixed period of time. CDs can be issued in any denomination and are also available in foreign currencies; United States Dollars, Canadian Dollars, British Pound and EURO. The funds invested in CDs cannot be withdrawn on demand like a regular savings account and harsh penalties are incurred if the deposit is accessed before maturity. CDs also carry a specific maturity date; one month, two month, three month, six month and one year terms at a specified interest rate. The interest accrued is paid at maturity in the currency of the original deposit. While the returns offered on CDs aren't very high, they are more attractive when compared to a regular savings account. Another added benefit is that CDs carry the Deposit Insurance Guarantee for investments of up to TT\$50,000, however the 2007/2008 Budget proposes an increase in this coverage to TT\$75,000. The rate of return offered on CDs is tiered, according to the amount of money invested and the length of time of the investment. The average rate of return is between 3 and 5 per cent.

Money Market Mutual Funds

A mutual fund is an investment vehicle where the funds of numerous investors are pooled together in order to buy and sell various securities on behalf of the investors. A money market mutual fund is simply one that invests only in money market instruments. The pool of funds is managed by fund managers whose primary objective is to maximize income and preserve capital. A fund's portfolio generally consists of government bonds, corporate bonds and cash and other short term investments. Redeemable units, equivalent to a proportion of the fund's portfolio, are issued to investors and interest is usually paid monthly or quarterly. Investors are typically given the option to automatically re-invest the interest received in additional units if they would like. One of the key features of the money market mutual fund is that investors can withdraw all or a part of their investment at any time without incurring any charges or penalties.

While money market mutual funds carry a relatively low risk, investors are always advised to read the prospectus of the fund to be aware of the risks associated with this investment. The prospectus is a document which outlines the fund's objective, the historical performance of the fund, the management of the fund and also contains the financial statements of the fund. The average rate of return on money market mutual funds is in the vicinity of 6 per cent

Advantages

Liquidity – The most attractive feature of money market instruments is that they are very liquid, which means that the funds held in the money market security can be readily converted to cash if needed.

Safety of capital – The money market is one of the safest places that investors can have their capital when compared to the risk that can be incurred with equity. This is because these short-term investments are backed by the government, financial institutions and large corporations.

Disadvantages

Lower returns – There is generally less risk associated in owning money market instruments than in owning stocks and as such there are lower rates of return on these types of investments.

Inflation – Money market instruments may not always keep up with inflation and therefore the purchasing power of an investor can be eroded if funds are kept in money market securities for an extended period of time.

Due to the current volatility of the market, investors with low risk tolerance can therefore find some comfort by investing in less risky investments through money market instruments or can simply use these investment vehicles to enhance their current portfolio. In cases where individuals already have investments in equities and are simply waiting for the right time or security to buy, these short-term debt instruments can be used to temporarily house their cash. Think of it this way, by holding on to those funds in cash, the opportunity cost would be the interest that could have been received if those funds were invested. Thus, by investing those same funds into the money market, investors can benefit from the interest income while maintaining the liquidity of cash. Investors are reminded however of the importance of diversification in their investment portfolios and since it is not prudent to invest all available funds in money market instruments, these short-term securities can be used to enhance an investor's portfolio based on their asset allocation mix.

Nancy Chen

Research Analyst

West Indies Stockbrokers Limited (WISE)

nancyc@wisett.com