

## Tired of the minimal returns of money-market funds? Here's a safe alternative that may generate more income

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What number is enough, and what's overkill?

Most investors - and many of their advisors - with money parked in money market funds are prudently choosing safe - but they're lathering it on a little too thick.

Maybe they haven't heard of short-term investment grade prospectus credit funds? The name doesn't exactly roll off the tongue, which might explain why more investors haven't made the shift. These strategies have been outperforming broad fixed income for most of two decades. Newer prospectus versions, with a narrow mandate and daily liquidity were approved in Canada in 2019, to meet the needs of everyone from individual investors to corporate treasurers managing working capital. They have now built a compelling track record, and it's time they got a proper introduction. (Disclosure: I run one of them).

A representative group of five of these credit funds averaged 6.3 per cent annually over the last three years and 5.0 per cent annually over five years.

The RBC Canadian T-Bill Fund - one of the largest of its kind and a good money market fund proxy - returned 3.73 per cent and 2.44 per cent over those same periods. That outperformance of roughly 2.5 percentage points annually by the credit funds, after fees, should be meaningful enough to at least read on.

### **What they actually are**

These funds invest in short maturity, investment grade Canadian corporate bonds - the highest quality segment of the corporate credit market. They neutralize the interest rate risk, meaning their returns are not tethered to Bank of Canada decisions the way money market funds are. The RBC T-Bill Fund returned 4.40 per cent in 2023 - that was the peak. As the Bank of Canada has lowered rates, it has taken money market returns with it - and will again when it cuts rates further. That's the way it works.

Short-term credit funds don't have that dependency. What they isolate instead is pure credit spread - the premium that investment grade companies pay above government rates to borrow money. They

buy an investment grade corporate bond and simultaneously short sell a government bond of the same tenor to eliminate the interest rate risk, thereby isolating the credit spread.

That premium has been stable, persistent, and well-compensated over time, especially in shorter tenors in Canada.

This is not high yield. This is not private credit. These are transparent, liquid, short-term, publicly traded bonds issued by well-known Canadian companies. According to S&P Global's long-running default study, even in the worst years on record globally, the default rate for the highest-rated investment grade bonds was near-zero. The historical investment grade default rate in Canada is zero. We can't technically call these securities or funds default-free, but that has been the experience, and is the expectation.

Structurally, these funds hold many of the same short-term, cash-like instruments that a money market fund does - and then do more with the investment. The result is a return stream that looks less like an alternative to a money market fund and more like an upgraded version of one.

### **You're paying for protection you probably don't need**

Some investors - and their advisors - choose money market funds for the ultimate protection, or simply because that decision was made before these better options had proven their merits. Both are understandable. But insisting on SPF 100 when SPF 50 already blocks out virtually everything costs you something every day. Past returns suggests that's roughly 2.5 percentage points per year, compounding indefinitely.

The average annualized standard deviation across this representative group of funds is 2.25 per cent - less than half the 5.18 per cent of the FTSE Canada Universe Bond Index, which most Canadians consider safe and not volatile. (A higher standard deviation means higher volatility, and by definition, riskier.)

In practice, 2.25 per cent means that even in a difficult month most investors wouldn't notice the movement on their statement. Pair that low volatility with an effectively zero Canadian investment grade default rate, and the gap in actual protection between these credit funds and money market funds becomes very difficult to discern.

The gap in protection is narrow. The gap in returns is not.

### **The compounding argument**

2.5 per cent more per year, as past returns suggest, doesn't sound like much. On a \$100,000 position, it compounds to roughly \$35,000 in additional wealth over 10 years and over \$100,000 over twenty. That is the real cost of unnecessary caution - or of not knowing a better option existed - paid slowly and quietly, year after year. That extra return also improves total portfolio utility - through income, meaningful diversification, and a low correlation to traditional bonds, adding ballast when other assets are under pressure.

Money market investors may be protected from risk, but they are accepting a different and less visible one - the near certainty of underperformance, compounded indefinitely.

## Who shouldn't switch

This case does not apply to everyone. If a cash position exists for a specific, near-certain spending need within 90 days - a property closing, a tax payment, business working capital with a known date - a money market fund is the right tool.

Short-term investment grade prospectus credit funds can see temporary, and modest, dips on a short-term basis.

For investors whose cash allocation is a long-term strategic holding, a default parking spot that rarely gets called upon, or a fixed income sleeve that is simply leaving money on the table - the evidence is hard to ignore. The shift is smaller than it may have seemed and the math is not close. For many institutions, this might be more of a policy impediment than an investment decision. If your investment policy hasn't been updated in a few years, this makes it worth a refresh.

Money market funds are not bad investments. They are just over-optimized for a level of protection that most current holders simply don't need. Give up next to nothing - get materially more. Individual investors, family offices, and those managing working capital are sitting on the same overlooked opportunity.

For those interested in a liquid credit fund for their portfolio, here is a starting point for reference. Note that not all of the funds listed here are suitable substitutes for a money market fund, so do your research. Look for a fund with low standard deviation, only short-term investment grade credit, with little or no interest rate risk and a strong track record.

No sunburns here, but most of us look better with a bit of a tan. It's worth a conversation.

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