GREAT-WEST CAPITAL MANAGEMENT, LLC (GWCM) RESEARCH NOTE
JUNE 2015

GREAT-WEST FINANCIAL

Bright tomorrows begin today®

An Inflection Point for Money Market Funds?

New regulations related to money market funds will have significant impacts to plan sponsors using money market investments in their lineup. The potential impact of these changes should not be taken lightly. The information provided in this material is for general education purposes.

Great-West Capital Management, LLC (GWCM) believes:

- Plan sponsors should consider evaluating their capital preservation alternatives in light of the new regulations. Does a stable value option now make more sense?
- Plan sponsors should consider the impact of fees and temporarily suspended redemptions (gates) in money market funds. How will the new fees and gates be accommodated should a money market fund implement them in the future?
- Plan sponsors utilizing money market investments should consider how to communicate the changes to participants.

Plan sponsors should consider evaluating their capital preservation alternatives in light of the new regulations. Does a stable value option now make more sense?

This document outlines the regulatory changes and provides a guide for how plan sponsors should approach money market funds in their lineup related to the future regulatory environment. This material has been prepared for informational and educational purposes only. It is not intended to provide, and should not be relied upon for, investment, accounting, legal or tax advice.

THE NEW MONEY MARKET REGULATIONS

As the U.S. mutual fund and retirement industries grapple with the implementation of changes to Securities and Exchange Commission (SEC) Rule 2a-7, it is worth considering what, if any, impact the money market fund reform will have on retirement investors.

The rules have evolved from years of deliberations following the 2007-2008 financial crises, which had significant impacts to the functioning of money market funds and the mutual funds that invest in money market securities. The implementation of these rules is intended to better preserve the functioning of financial markets and offer more protection for fund shareholders.

The new rules materially change the operations and structure of money market funds, particularly with respect to retirement plans. Under the new rules, the money market funds are or may be required to:

1. Classify themselves as either (a) Retail, (b) Institutional or (c) Government.[1]
   a. Retail money market funds have policies designed to limit investors to "natural persons," generally meaning individual people. This may allow for continued use by certain types of plans (e.g., 401(k) plans) but not for other types of plans, including many 403(b) plans.

1 A fourth category (tax-exempt money market funds) was also specified in the rules, but it is generally not relevant to retirement investors and, for the purposes of this document, has been ignored.

    b. Institutional funds have beneficial owners who are not natural persons (e.g., corporations, partnerships, etc.).

    c. Government money market funds invest at least 99.5% of total assets in cash, in U.S. government securities, or in repurchase agreements that are collateralized by U.S. government securities or cash.

2. Implement a floating Net Asset Value (NAV).

    a. Institutional money market funds will be required to round their NAVs to four decimal places, effectively creating a floating NAV.

    b. Retail or government money market funds will continue to be allowed to round their NAVs to two decimal places, effectively allowing the fund to maintain a stable $1 NAV.

3. Implement redemption fees and gates.

    a. Retail and institutional money markets funds are required to maintain at least 10% of their assets' weekly liquid (assets maturing in seven days or less). If the weekly liquidity falls below 10%, a default redemption fee of 1% is automatically applied (subject to board override).

    b. Government funds are not required to implement fees and gates but may elect to opt in.

    c. If the weekly liquidity falls below 30%, the fund's board (board) may assess a redemption fee of up to 2%

    d. Additionally, if the weekly liquidity falls below 30%, the board may temporarily impose a gate. The fund may only impose gates for up to 10 days or until weekly liquidity returns to 30% or more.

PLAN SPONSOR CONSIDERATIONS

As plan sponsors and their advisors begin to grapple with the secondary effects for their defined contribution (DC) plans, they will need to consider the place a money market fund has as an investment option within their plan. At a minimum, plan sponsors and their advisors will need to perform short-term and long-term due diligence regardless of the specific money market they select for their lineup.

As plan sponsors and their advisors begin to grapple with the secondary effects for their defined contribution (DC) plans, they will need to consider the place a money market fund has as an investment option within their plan. At a minimum, plan sponsors and their advisors will need to perform short-term and long-term due diligence regardless of the specific money market they select for their lineup.

In a practical sense, plan sponsors and their advisors should consider initial and ongoing reviews of their capital preservation funds by evaluating (but not limiting themselves to):

» Changes to the fund's investment policy and whether the fund may implement fees and gates and under what circumstances they will be triggered.

» Potential fee changes, fund investment style changes and concentration of investments in a single issuer.

» The historical practice of providing participants with balances in dollars and cents and determining how the plan will address fractional penny ownership with a floating NAV going out to the fourth decimal place. The use of a retail money market fund as a valid option. The definition is very narrow, meaning that the beneficial owner of the fund must be a natural person. While generally participants of a DC plan are natural persons, there are many plans that use capital preservation funds for other uses, including:

  – Short-term default investment options.

  – Suspense accounts — a placeholder for funds while awaiting allocation to participant account.

  – Holdings as a "cash equivalent" within other funds, such as a custom target date fund.

Operationally, plan sponsors should consider (but not limit themselves to):

- An open market review of capital preservation options, including stable value funds, ultra short bond funds and traditional money market funds.
- Communicating any impact to participants, including the possibility that normal transactions may be restricted for a period of time and without additional notice.

Approximately 71% of DC plans include a money market fund as an investment option in the plan.[2] Considering many investment providers have not yet made their money market fund classifications public, and given the time constraints on retirement plans to implement recommendations, there is relatively little time to address the new rules prior to the action date of October 2016. To allow for plan sponsors and advisors to complete the necessary due diligence and have enough time to make applicable fund offering changes, we believe these conversations should begin now.

IMPLICATIONS FOR MONEY MARKET FUNDS IN RETIREMENT PLANS

These new rules have a number of potential implications in the retirement space:

1. Some money market fund providers may move toward allowing only their government money market funds in retirement plans. The requisite fees and gates within a retirement plan require recordkeeping technology that often has not yet been developed and recordkeepers may find these technology upgrades overly arduous to integrate with existing systems. This means that funds may not be able to impose gates and fees within retirement plans and cause a move toward government money market funds that do not impose fees and gates.

   Problem: Government money market funds typically have lower yields than nongovernment money markets (i.e., participant returns may decline). Additionally, there has been speculation about the availability of sufficient instruments allowing government money market funds to maintain their 99.5% position.

> *The reforms have created new governance expectations, and plans should be ready to address these and other changes. For example, will plans be able to meet liquidity requirements for core investments options?*

2. Money market funds may move from mutual fund vehicles to other types of legal structures (e.g., collective investment trusts). The SEC rules apply only to mutual fund vehicles. Shifting assets to non-mutual fund vehicles can allow prime funds to remain in plans without the operational difficulties associated with money market funds.

   Problem: Collective investment trusts are available only to certain qualified retirement plans. In addition, the Office of the Comptroller of Currency (one of the regulators for collective investment trusts) has not weighed in on if it will adopt some version of money market fund reform, and it is still unknown whether or not reforms will be adopted in the future.

3. Plans transition away from money market funds and into stable value investments. Stable value funds have long been viewed by many plan sponsors as an appropriate short-term investment alternative for plan participants.

   Problem: Stable value funds can be more complex than a traditional money market fund and may require additional due diligence. This exercise may be unfamiliar to many plans and their advisors and could require further education.

The changes to SEC Rule 2a-7 and the implications outlined above present a number of concerns for plan sponsors, advisors and recordkeepers and create new plan governance expectations that aren't yet clearly defined. For example, how will plans make required mandatory distributions (RMD) if they cannot access funds due to imposed gates? Additional uncertainty remains as to whether or not fees will be implemented midday or by way of current end-of-day pricing practice.

2 Source: Vanguard, "How America Saves, 2014

Furthermore, how will these regulations affect rules that let plan assets be held in money market funds for short-term default investment option purposes, and how will potential fees be applied to safe harbor rollover assets?

As a result of these concerns and challenges, GWCM believes these changes will result in a differing view of funds seeking capital preservation, and stable value funds may become more popular than they have in the past.

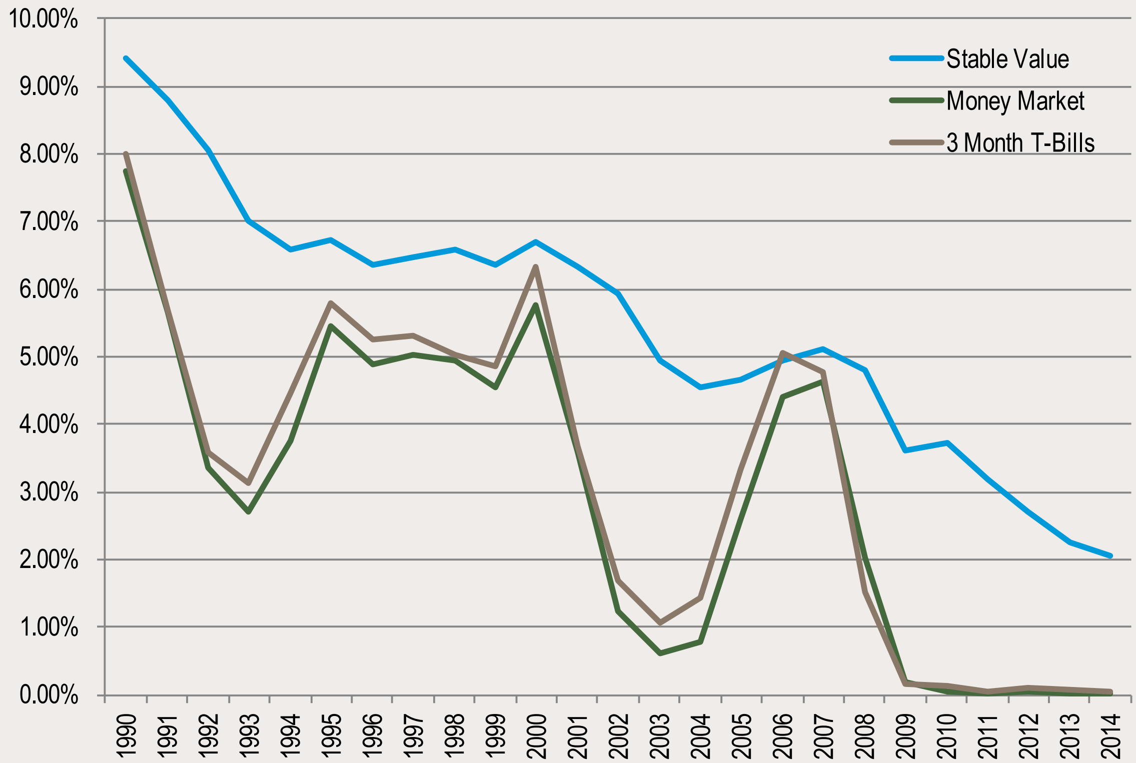
STABLE VALUE FUND BENEFITS

GWCM believes that stable value funds can offer a number of advantages beyond those offered by a money market fund.

POTENTIAL FOR GREATER INVESTMENT RETURN

Stable value and money market fund returns

Calendar year returns from 1990-2014 (net of fees)



Source: Morningstar Direct; GWCM Analysis. "Money Market" reflects the Morningstar U.S. Money Market Taxable Fund category. "Stable Value" reflects the Morningstar U.S. Separate Account Stable Value category.

The money market yield quotation illustrated in the performance data more closely reflects the current earnings of the money market than the total return quotations. The performance quoted is past performance and is not a guarantee of future results. Mutual funds are subject to certain market risks. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be higher or lower than the performance data shown. For performance current to the most recent month-end please call 800-345-2345.

The chart above is an illustration of annual calendar year returns from 1990-2014 for money market funds, stable value funds and three-month U.S. Treasury bills. Stable value funds, on average, have outperformed money market funds every year during this time frame by an annualized excess return of 2.4%.

While money market fund returns tend to follow three-month U.S Treasury bills very closely, stable value funds generally do not. Stable value funds move in a directionally similar manner, but there has generally been a lag period whereby stable value fund returns decline at a slower rate than money market funds.

Despite higher returns over time, certain plans continue to select money market funds over stable value funds.

Despite their history of greater returns year over year, certain qualified plans have continued to endorse money market funds over stable value funds in plan lineups. There are several reasons for this. First, stable value investments may have liquidity restrictions when a qualified plan decides to terminate the position. The two most common forms of these restrictions are market value adjustments and puts. Please note the following:

- **A market value adjustment** may cause plans to receive more or less of a plan's invested assets due to market appreciation or depreciation of a fund's underlying investments. When this happens, the plan's investment assets in the stable value fund will be paid out to the plan in a lump sum at either a depreciated or an appreciated value.
- **A put** can be enforced on a plan when an investor decides to terminate his or her position. A put restricts a qualified plan from removing its position immediately. A put will generally pay a plan's book value in the stable value fund over a period of time. This causes an investor to remain in the stable value fund for a longer time frame than he or she may have wanted when he or she first agreed to be in this investment.

Some investment managers may use this opportunity for product innovation, creating yet-to-be-determined investment offerings that provide the benefits and features of a money market fund without the complexities of administration that traditional money market funds may now bring. This could include ultrashort bond funds that seek to maintain a stable NAV by investing in securities with a duration much lower than what one would find in a traditional short-term bond fund while maintaining full liquidity at the participant level.

Because this innovation is still in the incubation stage, it is too early to weigh in on whether this would be an appropriate capital preservation fund.

CONCLUSION

Which investment should a plan sponsor ultimately select: a stable value fund, a money market fund or a newly created investment option that addresses all of its concerns with money market funds? Stable value funds have historically offered higher returns net of fees; of course, past performance is no guarantee of future results. However, liquidity restrictions may cause concern to certain groups of investors. The decision of investment return versus liquidity risk remains the key decision and a plan-by-plan choice.

GWCM is an investment adviser for both fund types: money market funds offered by Great-West Funds, Inc. and stable value funds offered by Great-West Life & Annuity Insurance Company (GWL&A). It is uniquely positioned to monitor these developments associated with these fund types.

Further, due to the uncertainty of plan governance expectations, Empower Retirement — a recordkeeping service provider owned by GWL&A and the provider of a platform in which GWCM provides investment vehicles — will not offer money market funds by companies that could impose gates or resulting fees.

An investment in a Money Market Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any government agency. Although the Fund seeks to preserve the value of your investment, the value of your investment at $1.00 per share, it is possible to lose money by investing in the Fund.

The opinions expressed in this material represent the current, good faith views of Great-West Capital Management, LLC (GWCM) and its portfolio managers, analysts, traders, and other investment personnel at the time of publication and are provided for limited purposes, are not definitive investment advice, and should not be relied on as such. The information presented in this material was developed internally and/or obtained from sources believed to be reliable; however, GWCM does not guarantee the accuracy, adequacy, or completeness of such information. Predictions, opinions, and other information contained in this material are subject to change continually and without notice of any kind and may no longer be true after the date indicated.

Any forward-looking statements speak only as of the date they are made, and GWCM assumes no duty to and does not undertake to update forward-looking statements. Forward looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual results could differ materially from those anticipated in forward-looking statements. Past performance, where discussed, is not a guarantee of future results. As with any investment, there is a potential for profit as well as the possibility of loss.

The principal underwriter is GWFS Equities, Inc., and securities, when offered, are offered through GWFS Equities, Inc. and/or other broker dealers.