Invesco

Cash Viewpoint

What Do Variable Rate Demand Notes Do for Your Money Market Fund?

Variable Rate Demand Notes (VRDNs) are variable rate securities issued by municipalities with features that help investors in money market funds meet their needs for liquidity, flexibility, and competitive short-term rates, particularly in this low yield environment.

What is a VRDN?

A VRDN is a long-term (20- to 30-year) municipal bond which is offered in a variable interest rate mode – meaning it adjusts to changes in the prevailing money market interest rate, usually adjusting every one to seven days – and provides investors with an option to tender the securities (or "put") back to the financial intermediary in return for repayment of the entire debt amount with as little as one up to seven days notice.

How do VRDNs work?

VRDNs are comprised of three distinct features that may make them an attractive vehicle for short-term money market investors:

Variable interest rate

The interest rate on VRDNs is reset usually every one to seven days off the Securities Industry and Financial Market Association (SIFMA) Municipal Swap Index, which is the municipal equivalent of seven-day Libor, allowing you to continually earn the market interest rate, and reducing risk associated with rising interest rates. During 2011, SIFMA posted index levels ranging from 29 to seven basis points, with an average of 19 basis points for the year.[1]

The "Demand" feature

It is the VRDN's "put" or "demand" feature that makes it eligible for purchase by money market mutual funds that are required to follow special maturity guidelines under SEC Rule 2a-7. Bond holders have the right to put their bonds back to the financial intermediary for payment at par plus accrued interest at any time with appropriate notice.

Liquidity Support/Credit Support

To mitigate the risk associated with loss of principal due to issuer default ("credit risk"), VRDNs are generally supported by external credit enhancements in the form of a Letter of Credit (LOC) from a highly-rated financial institution. By providing an irrevocable and unconditional LOC, a financial institution serves as the liquidity provider of last resort, committed to supporting timely payment of principal and interest.

VRDNs in Invesco's U.S. Institutional Money Market Portfolios

VRDNs are a core position in Invesco's Taxable Portfolios, providing a nice complement to the other security holdings given their increased liquidity and potentially higher yield. Importantly, we invest primarily in VRDNs with one and seven day demand options, and with unconditional and irrevocable LOCs from companies that are on our approved list. The approved list is maintained by Invesco's internal credit research team. Our knowledgeable credit research team, which is independent from portfolio management, follows one of the most stringent credit processes in the industry and is fully dedicated to our cash management products. Invesco's credit research team employs its own proprietary VRDN checklist, to ensure suitable structure, underlying project viability and appropriate credit enhancement from an entity on Invesco's money market fund approved list.

The primary objective for Invesco's U.S. Institutional Money Market Funds remains preservation of capital and maintenance of liquidity. In this regard, VRDNs help investors meet their needs for liquidity, flexibility, and competitive short-term rates, particularly in this low yield environment. We believe we have structured the portfolios with safety and liquidity as our primary focus, investing only in high-quality short-term money market debt, and we continue to carefully monitor the ongoing situation in the municipal markets.

For more information on SEC Rule 2a-7, please visit sec.gov

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

1 Source: "Muni Swap Index Data," Dec. 31, 2011 - simfa.org/research/statistics

SIFMA Municipal Swap Index produced by Municipal Markets Data (MMD), is a 7-day high-grade market index comprised of tax-exempt VRDNs from MMD's extensive database. **Libor** is an interest rate at which banks can borrow funds, in marketable size, from other banks in the London interbank market. The Libor is fixed on a daily basis by the British Bankers' Association. The Libor is derived from a filtered average on the world's most creditworthy banks' interbank deposit rates for larger loans with maturities between overnight and one full year.

One **basis point** equals one one-hundredth of a percentage point.