How Do Money Market Mutual Funds Work?

Just like individuals, the government, corporations, and banks often need to borrow money for a short time to make ends meet. Unlike most individuals, however, the scale of this borrowing is phenomenal.

The money market is the name given to the arena where most of this short-term borrowing takes place. In the money market, money is both borrowed and lent for short periods of time.

For example, a bank might have to borrow millions of dollars overnight to ensure that it meets federal reserve requirements. Loans in the money market can stretch from one day to one year or beyond. The interest rate is fundamentally determined by supply and demand, the length of the loan, and the credit standing of the borrower.

The money market was traditionally only open to large institutions. Unless you had a spare $100,000 lying around, you couldn't participate.

However, during the inflationary era of the 70s, when interest rates sky-rocketed, people began to demand greater returns on their liquid funds. Leaving money in a bank deposit account at 5 percent interest made little sense with inflation running at 12 percent. The money market was returning significantly higher rates but the vast majority of people were prohibited from participating by the sheer scale of the investment required.

And so, the first money market mutual fund came into being. By pooling shareholders' funds, it was possible for individuals to receive the rewards of participating in the money market. Because of their large size, mutual funds were able to make investments and receive rates of return that individual investors couldn't get on their own.

Money market mutual funds typically purchase highly liquid investments with varying maturities, so there is cash flow to meet investor demand to redeem shares. You can withdraw your money at any time.

For a minimum investment, sometimes as low as $500, money market mutual funds will allow you to write checks. The check-writing feature is most often used to transfer cash to a traditional checking account when additional funds are needed. These funds are useful as highly liquid, cash emergency, short-term investment vehicles.

Money market funds are neither insured nor guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although money market funds seek to preserve the value of your investment at $1 per share, it is possible to lose money by investing in money market funds.

Mutual funds are sold by prospectus. Please consider the investment objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the investment company, can be obtained from your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.