

Stable Value Evaluation for Plan Sponsors

Marcia J. Peters, CFA
Director, Research

This paper reviews background information about stable value investments and introduces a method that plan sponsors can use to evaluate and compare stable value investments.

Stable value products continue to be an attractive investment selection. Plan participants find the combination of diversified, high quality assets, stable yields above money market returns, and principal protection very appealing. These stable value product characteristics are derived from GAAP (Generally Accepted Accounting Principles) accounting, which allows stable value products to be carried at book value so that participant payments are also at book value. One main component of the book value return that participants receive is the *Crediting Rate*. The crediting rate is predominately influenced by the yield of the underlying portfolio, but it can also be influenced by changes in the market value of the underlying portfolio, depending on the structure of the stable value product. Hence, market conditions and the fixed income expertise of the product manager can play an important role in stable value management. GAAP accounting does allow the fluctuations (gains and losses) in the underlying portfolio to be amortized, creating a “smoothing” effect on the crediting rate. *As a result, as long as the product has enough liquidity to meet participant withdrawals, assets that are subject to market fluctuations will not have to be liquidated and the potential losses from the change in market value will not have to be realized.*

Stable value products are viewed by participants as an alternative to money market products. As money market rates increase, plan participants expect their returns will increase similarly. *Unfortunately, the crediting rate on the underlying stable value portfolio will not increase in the same manner as the money market fund to the extent the underlying (longer duration) stable value portfolio experiences negative market value effects from rising interest rates.* In other words, the crediting rate will be held down by the decrease in the portfolio market value relative to book value. Conversely, when money market rates decline, the crediting rate will be slow to decline, benefiting from the positive effects the interest rate change has on the underlying market value of the portfolio. In all cases, the crediting rate is floored at zero.

So what exactly is a stable value product? Historically, stable value products were a portfolio made up entirely of GICs (Guaranteed Investment Contracts), insurance contracts that carried a fixed rate over a fixed maturity. The maturity was usually “laddered” to provide a constant source of liquidity to the product. The underlying insurance credit and the extended maturity allowed GICs to carry a rate higher than money market returns. In the early 1990’s, insurance company failures caused product managers to rethink the lack of credit diversity in the “all GIC” stable value portfolio. To compensate for credit concerns, portfolio managers began to unbundle the GIC structure, separating the underlying investment

portfolio from the rate guarantee. The portfolio retains legal title to the assets, typically government, agency and other high quality corporate credit. To mirror the performance of the GIC guarantees, the investment portfolio is wrapped with an insurance contract that provides book value payments to participants, under normal plan conditions. Normal conditions *exclude Material Plan Events* (tax or accounting changes, regulatory changes) and *Material Employer Events* (corporate restructuring that results in mass withdrawals from the plan). The structural benefit of a synthetic wrapped portfolio is twofold: credit diversification, and yield enhancement from extended duration.

Considerations when Evaluating an Appropriate Stable Value Structure

With the inclusion of actively managed assets into the product, market risk should not be ignored. In an effort to increase yield, some managers are resorting to adding low or unrated credits to the portfolio. Others add interest rate derivatives to the mix. Some have even suggested adding equities, international bonds, and currency risk in an attempt to enhance yield. Assets with interest rate risk, duration shortening risk (such as prepayment risk), and illiquid assets that carry high transaction costs will all add volatility to the portfolio returns. In addition, the crediting rate is likely to underperform relative to money market returns. This is of particular concern when looking forward with an inverted yield curve: portfolio yields tied to longer duration assets will be lower than money market returns. Overall, additional risk may be introduced into stable value products as managers incur greater exposure to high risk asset classes in an effort to recapture yield.

Wrap contract structure is also a factor in understanding stable value risk. The wrap contract creates the smoothing effect in the crediting rate and guarantees book value payments in a normal operating environment. Traditionally, wraps were *non-participating*; any realized losses from the sale of plan assets would not be incurred by the plan. As underlying portfolios have become more market sensitive, the non-participating wrap contracts have increased dramatically in cost. To contain these costs, most products use a percentage of, if not all, *participating contracts*. *Participating contracts pass on the losses when below market value assets are sold to generate cash for withdrawals*. This becomes a particular concern as 100% participating contracts are used in conjunction with a 100% managed portfolio; significant market risk is potentially passed along to the participants.

Liquidity is a very important consideration for stable value products. As pointed out previously, to the extent participating contracts are used in the product, the crediting rate is influenced when “below book value” assets are sold to meet withdrawals. This point is important because if a stable value portfolio is properly managed for typical participant cash flows, the actively managed assets never have to be liquidated at an inopportune time. To accomplish this goal, most products have a number of tiers in the product that have priority in liquidation: a cash tier (generally around 5% of the product); a GIC tier that provides for a guaranteed yield with liquidation rights, a liquidity tier comprised of buy and hold (laddered maturity) fixed income securities; and an actively managed, constant duration tier, that provides the extra yield. This actively managed tier can encompass any number of fixed income portfolio strategies, as alluded to previously. It can include a constant duration portfolio indexed to a benchmark such as the Barclays US Aggregate index, or an alpha synthetic portfolio that combines fixed income securities with derivative contracts in an effort to outperform benchmark yields. Over time, *the liquidity tiers in the typical stable value product have shifted*. The allocation to liquid tiers has decreased, and the allocation to actively managed fixed income assets has increased. With this shift, the yield on stable value products has tended to outperform money market products by as much as 100 to 150 basis points in the last 5 years. (See table “Risk Comparison Among Typical Stable Value Product Structures”)

Book value returns is the accepted indicator of a stable value fund’s performance. Book value will in-

crease with the crediting rate, product additions and product withdrawals. Book value will be influenced by very large cash flows into or out of the product. For example, a large inflow will suppress the crediting rate when interest rates are low and new money is invested at lower returns. This situation also makes it more difficult to compare book value performance across products. Beyond book value return analysis, monitoring product performance is difficult for plan sponsors, given the diversity of stable value structures. Two quasi-benchmarks are the Ryan Labs 3 Year GIC Index, which is a benchmark of 100% GIC products, and the Hueler Pooled Products Index, which is a peer group ranking. Some plans choose to measure performance to a constant maturity treasury benchmark plus a spread. Portfolios with a significant allocation to active fixed income management can also be benchmarked against the Barclays US Aggregate Index. Obtaining an overall market value return can give a sense of portfolio performance, but as portfolios include both actively managed and buy and hold assets, the market value of the product is difficult to compute. Given the lack of a single best benchmark, several methods should be considered to get a complete picture of product performance.

Choosing a Stable Value Manager

Given the spectrum of portfolio structures and the number of interconnected issues, there are a number of factors to consider when choosing an appropriate stable value product. First and foremost, the product should reflect the investment policy and objectives of the plan sponsor. (*The plan sponsor must consider where on the risk spectrum of stable value products they feel best fulfills their fiduciary responsibility*). Second, product liquidity is an important consideration. A portfolio manager should be able to project participant withdrawals under various market scenarios. The portfolio should be structured for sufficient liquidity to meet withdrawals without liquidating under performing assets. A product with an appropriate mix of cash, GICs, and buy and hold securities that are laddered is in a better position to meet participant's withdrawal needs. Credit risk is also an important factor. The underlying portfolio should be high quality to minimize credit risk. Government, agency and corporate credit are favored; however, a portion of the portfolio can be allocated to weaker credits for yield enhancement as long as the overall portfolio average is investment grade. The wrap contracts that provide the principal protections and stabilizing factors to the portfolio should be flexible and benefit responsive. The product needs to find the right mix of participating (participants exposed to market risk in adverse withdrawal situations) versus non-participating (participants are protected from market risk) wrap contracts that offer the most benefit responsiveness for the lowest cost. Last but not least, a portfolio should have the appropriate risk management tools (credit, market research, fixed income modeling) to properly evaluate the portfolio risks versus the inherent characteristics of an individual plan and the cash flow needs of its participants.

Risk Comparison among Typical Stable Value Fund Structures

	Traditional GIC Portfolio	Tiered GIC/ Buy & Hold FI Portfolio (Laddered Maturities)	100 % Synthetic Portfolio	Diversified Fixed Income/Enhanced Yield Strategies
Trailing Annualized Return (%)	Lowest	-	-	Highest
Standard Deviation (Risk)	Lowest	-	-	Highest
Fees	Highest	Mid	Lowest	Mid

→
Increasing Book Value Returns

→
Increasing Levels of Portfolio Risk

→
Increasing Withdrawal Effects on Portfolio

Key Characteristics:	<ul style="list-style-type: none"> ▪Fixed Rates ▪Principal guaranteed 	<ul style="list-style-type: none"> ▪Blended Yield ▪Diversified credit ▪Laddered maturity (liquidity) ▪ABS/MBS exposure for yield 	<ul style="list-style-type: none"> ▪Yield enhancement ▪Extended duration ▪Hybrid wrap usage 	<ul style="list-style-type: none"> ▪Increased sector diversification ▪Management style is predominant ▪Wraps fully participating
Liquidity:	<ul style="list-style-type: none"> ▪GIC book value 	<ul style="list-style-type: none"> ▪GIC book value ▪Laddered fixed income 	<ul style="list-style-type: none"> ▪Minimum cash position (can compromise overall fund liquidity) 	<ul style="list-style-type: none"> ▪Minimum cash position (can compromise overall fund liquidity)
Credit Risk	<ul style="list-style-type: none"> ▪Insurance company 	<ul style="list-style-type: none"> ▪Insurance company ▪Wrap provider risk ▪Govt./Agency/Corp 	<ul style="list-style-type: none"> ▪Wrap provider risk ▪Govt./Agency/Corp. 	<ul style="list-style-type: none"> ▪Wrap provider risk ▪Govt./Agency/Corp. ▪Non-rated credit
Market Risk:		<ul style="list-style-type: none"> ▪Interest rate risk 	<ul style="list-style-type: none"> ▪Interest rate risk 	<ul style="list-style-type: none"> ▪Interest rate risk
Option Risk:		<ul style="list-style-type: none"> ▪Call risk (prepayment risk) 	<ul style="list-style-type: none"> ▪Call risk (prepayment risk) 	<ul style="list-style-type: none"> ▪Call risk (prepayment risk)
Additional Liquidity Risk:				<ul style="list-style-type: none"> ▪Illiquid assets
Currency Risk:				<ul style="list-style-type: none"> ▪Currency derivatives
Sovereign Risk:				<ul style="list-style-type: none"> ▪Event risk

Every effort has been made to provide accurate and authoritative information in regard to the subject matter in this report; however, accuracy and completeness cannot be guaranteed and is not warranted as such. Many statements and sources were used in compiling the data for this report (e.g., data from your investment managers, custodian, record keeper, etc.). PEI does not assume responsibility for the accuracy or completeness of such information. In addition, certain information contained in this report is obtained from third-party vendor database subscriptions. Neither PEI nor the vendors warrant that such information is accurate, correct, complete or timely. This information is provided with the understanding that PEI is not engaged in rendering legal, accounting, or actuarial advice. If such advice is required, the services of a competent professional of this kind should be sought. The information contained in this report does not constitute the recommendation of any investment advisor or their services nor does PEI assume responsibility for the conduct of any investment manager including the investment performance or compliance with the laws and regulations to which they are subject. This report has been prepared exclusively for the informational use of the recipient and any other use, including the reproduction of this report in any form, is prohibited without the prior express written permission of PEI, Somerset Hills Corporate Center, 15 Independence Boulevard, Warren, NJ 07059.