Revisiting Stable Value Investments

A guide for plan sponsors.

By Marcia J. Peters

This article reviews background information about stable value investments and provides important guidance that plan sponsors can use to evaluate and compare stable value investments. This article also discusses important current issues confronting stable value funds and plan sponsors.

Stable value investments are a dichotomy; while predicated on the premise of capital preservation, the structure of the investment class can be varied, complex, and built with some risks that are not well understood by plan sponsors. When we analyzed this asset class in 2006[1], many complexities were evaluated and recommendations included a detailed due-diligence process that may have appeared as over-kill to a plan sponsor at that time. However, as the events of 2008 and beyond have shown, a plan sponsor can never be too diligent when reviewing this asset class. In the current low yielding, highly volatile environment, investors continue to be pulled between a search for higher yield and concern about investment structure and hidden risks in an investment portfolio. Many plan sponsors thoroughly evaluate and monitor the mutual funds in their line-up, but pay little attention to the stable value fund. That is soon changing. For example, recent fund closures in the stable value industry, such as Charles Schwab's decision to terminate their stable value offering, is forcing some plan sponsors to liquidate current holdings and take a closer look when selecting a new stable value fund. Therefore, it is time to revisit stable value investments and reflect on some of the current issues in the stable value investment environment in order to provide renewed guidance for plan sponsors as they contemplate and evaluate stable value investments.

Before reviewing criteria plan sponsors should use to evaluate and monitor this investment class, it is beneficial to review the stable value structure.

What is a Stable Value Investment?

At the core of a stable value investment are the underlying principles of:

- Capital preservation
- Liquidity
- Stable income

A stable value fund invests in a diversified portfolio of high quality, short duration fixed income instruments, including Guaranteed Investment Contracts (GICs); which are insurance contracts that carry a fixed rate over a fixed maturity. Portfolios include synthetic GICs, which are fixed income and money market securities wrapped with an insurance contract that protects principal and stabilizes return. Built into the overall structure of a stable fund is a predetermined pattern for income, and how interest accrues to the book value, contributing to the stability and capital preservation of the fund.

Below the surface, an analysis of stable value funds can reveal another story; the underlying portfolio, although on average, is investment grade, the underlying holdings can be varied in terms of risk and return.

A portfolio can include conservative Treasuries and GICs, and can also include private mortgages, non-dollar and emerging market holdings and long duration derivative contracts. Liquidity and volatility can vary within individual holdings, making it necessary for the fund managers to build laddered liquidity and risk tiers into the portfolio.

A stable value fund can be organized in a few ways. Smaller plans, in order to achieve economies of scale, typically participate in a commingled pool of diversified assets belonging to multiple plans. Larger plans form a customized separate account of diversified assets, and are generally preferred due to the direct ownership of the underlying assets. A third type, which is a guaranteed insurance company account, is an annuity-like contract that offers a guaranteed interest rate and principal protection. The underlying assets in this type of structure are from either the general account of the insurance company or a separate account, where assets are segregated from the general obligations of an insurance company. While the asset holdings in the first two vehicles are generally disclosed to the plan sponsor on a regular basis, in the third structure, the lack of holdings transparency further emphasizes the importance of reliance on the full faith

[1] Peters, Marcia, Stable Value Evaluation for Plan Sponsors, June 2006.

and credit of the insurance company issuing the GICs.

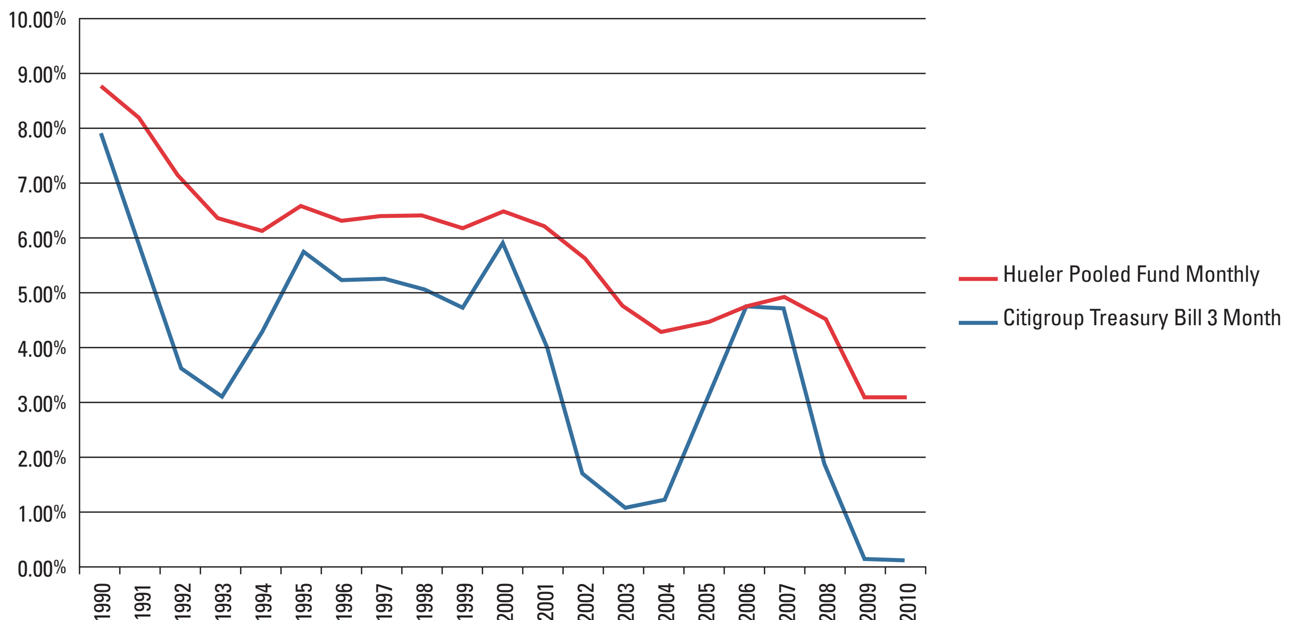
Stable value funds continue to be a popular option in 401(k) plans. Plan sponsors have often favored stable value products over money market funds in their 401(k) line-up due to the fact that stable value yields have historically been above money market returns. In many cases, only a stable value fund is offered to participants. This situation has led to the reality that participants generally view stable value products as money market funds. As money market rates increase, plan participants expect their returns will increase similarly. However, the return participants receive is in the form of the crediting rate, which is influenced by the yield of the underlying portfolio (accrued interest plus market returns), and will not change in the same way as that of a money market fund. Stable value portfolios, being more diversified and of longer duration than money market assets, have generally benefited from an upward sloping yield curve environment. In addition, the declining interest rate environment over the last 30 years has also contributed favorably to stable value performance. These effects have led to the crediting rate surpassing the money market rate. Even during periods of rising rates or yield curve inversion, accrued interest kept stable value returns from declining, and provided a cushion until the yield curve returned to normalcy. It should be noted that conversely, in a rising interest rate environment, the crediting rate will be held down by the decrease in the underlying portfolio market value, and stable value returns will lag as money market rates move up. However, the accrual methodology built into the structure will smooth out the pace of changes in the stable value rate, so it may take some time for rates to catch up.

Considerations When Evaluating and Monitoring a Stable Value Fund

Due to the core principles, stable value funds are viewed by plan sponsors and participants as being on the same, conservative end of the investment spectrum as money market funds. Due to the structure, stable value funds must be viewed as fixed income funds, susceptible to changes in interest rates, although buffered by an insurance contract that protects (but does not guarantee against) loss of principal and accrued interest. When understood in this context, a plan sponsor can apply many of the good practices used to evaluate fixed income funds. Market conditions and fixed income manager expertise play an important role in stable value performance, and the way that stable value funds are placed on the risk-reward spectrum.

At various times, market conditions have caused some managers to add low or unrated credits to the portfolio, while others have added international, currency or interest rate derivatives to the mix in an attempt to enhance yield. Assets with interest rate risk, duration shortening risk (such as prepayment risk), and illiquid assets may provide a needed boost in return, but carry high transaction costs that will add volatility to the portfolio returns. As seen in 2008, when credit markets froze, more aggressively structured portfolios fell into the market to book value range of

Comparison of Stable Value vs. 3 Month T-Bill Total Return



90–95%. Therefore, the portfolio manager must have the expertise to blend an investment grade portfolio to generate above money market yields, and enough liquidity to satisfy book value redemptions.

Due to these complexities, as a plan sponsor evaluates and monitors their stable value option, it is important to consider the structure of the stable value fund across a number of parameters:

- Liquidity structure of the portfolio
- Credit quality
- Diversification of holdings
- Monitoring performance and market-value to book-value
- Risk management capabilities
- "Exit" liquidity for withdrawals for both participants and the plan
- Wrap structure
- Fees

Fund Structure, Liquidity and Credit Quality

Fund liquidity structure is an important consideration. In order to meet book value withdrawals without needing to tap into the insurance contract provisions, a fund manager should be able to project participant withdrawals under various market scenarios. The portfolio should be laddered for sufficient liquidity to meet withdrawals without needing to liquidate under performing assets. Funds will typically have a cash tier of about 5% of the total assets, and a liquidity tier of buy and hold fixed income securities of different maturities. Less liquid securities that are held for additional return are usually held in a separate, actively managed tier. During times of market volatility, the amount of assets dedicated to each tier will shift to accommodate changing liquidity needs.

Credit risk in a fund is also an important factor to evaluate. The underlying portfolio should be high quality to minimize risks of default, which may not be covered under wrap contract provisions. Generally, government, agency, and corporate credit are favored, but it is acceptable to have a portion of the portfolio allocated to weaker credits for yield enhancement as long as the overall portfolio average is investment grade. In addition, while the wrap contract serves as a buffer to the portion of the portfolio subject to credit and market risk, they are only as good as the overall state of the wrap/insurer market. As a result wrap issuers and diversity of wrap providers should also be evaluated as part of the fund credit review.

Both liquidity and credit risk play directly into the performance of a stable value fund. Prior to 2008, funds that outperformed money market funds by significant margins had greater diversification and allocation to less liquid, lower rated credits. Post 2008, funds have taken a more conservative allocation and reversed some of this exposure, as needs for liquidity and concerns that arise from global credit issues have increased. Diversification in a portfolio is widely agreed to be beneficial, but understanding how a fund's holdings were structured and managed prior to and post 2008 provides interesting insight into the fund's investment process and how a fund manager generates returns.

Monitoring Performance

Monitoring fund performance on an ongoing basis is more difficult than it appears. Typically the book value return is the accepted indicator of a stable value fund's performance. However, book value returns 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 (as seen in the years since 2008). Market value returns are not fully applicable due to the asymmetric nature of the principal protection that arises from the wrap contract. This situation makes it difficult to compare fund performance across products or to a standard benchmark. Plans may choose to measure performance to a peer group based benchmark, or to a constant maturity treasury benchmark. If a fund has significant allocation to active fixed income management, that portion of the portfolio can be compared to the Barclays US Aggregate Index. It is also helpful to monitor changes in market value to book value as an indicator of overall portfolio performance, and the effectiveness of the manager in creating a portfolio that can weather volatility and credit situations.

Risk Management

Due to the complexities in structuring and managing a stable value fund, a portfolio should have the appropriate risk management tools (credit analysis, economic research, fixed income modeling and stress testing) to properly evaluate the portfolio risks versus the inherent characteristics of an individual plan and the cash flow needs of its participants. Typically, to uncover information about this aspect of the investment process requires a probing conversation with fund managers. In addition to items addressed previously, a manager should be asked questions regarding geographical exposure, market outlook, client diversification, and typical cash flows, all of which factor into the overall risk of the portfolio.

Understanding the "Exit" Clause

Regardless of the structure of the fund and the market value of the underlying portfolio, individual participants in most instances will be able to withdraw from their stable value investment at book value due to the contractual obligations inherent in the stable value fund. However most plans have equity wash rules which prohibit transfer into competing (typically money market or short duration bond) funds for 90 days.

In some cases, guaranteed insurance vehicles can restrict withdrawals to pre-determined dates. There may also be some exceptions to book value withdrawal. For example, if underlying securities default or there is a "material plan event" driven from tax, accounting, or regulatory changes. Another exception to book value withdrawals can come from a "material employer event" and the plan sponsor "exits" or drives an early termination of the fund from the plan line-up due to layoffs, corporate restructuring (mergers, bankruptcy), or when an employer changes a vendor. While a plan sponsor cannot foresee plan events or defaults, and relies on manager skill to manage these risks, understanding how a fund handles employer events is imperative for a plan sponsor in order to properly manage the timing and selection of a stable value fund option.

While all investment funds in a plan line-up require an administrative waiting period to exit, many stable value products have a unique, 12-month notification window. This allows the fund to be able to execute an orderly selling of investments, and maximize the market to book value at liquidation, negating the need to tap into the insurance/wrap contract provisions. Some funds may have additional termination fees, including charges to terminate GIC contracts within the fund. Unfortunately, most plan sponsors do not realize these costs until they cause a material event; understanding these issues in advance could alter investment decisions.

The Nature of the Wrap Contract

A wrap contract preserves principal and provides a stable return to participants, so understanding wrap contracts is a key element in understanding stable value risk. Historically, as non-insurance companies entered the stable value market, they bifurcated the traditional GIC contract. The diversified fixed income portfolio was at the core of the stable value fund, along with it a protective insurance contract, called a wrap contract. This insurance, guaranteed by an insurance company or large bank, provided book value protection if indeed the market value of the underlying portfolio deviated below par at the time of a withdrawal, barring material plan events. The existence of a wrap contract also permits a smoothing effect in the crediting rate which is especially appreciated during volatile financial markets. However, some wrap contracts can be structured to pass along a portion of market risk to participants via the crediting rate, because it lowers the contract cost, at the expense of increasing the market risk of the portfolio. In volatile markets, there could be situations where principal protection may be difficult to achieve. Although stable value funds have moved well past the events of 2008, there was a point at that time if participants panicked and withdrew funds en-mass, the below par market-to-book value of many funds could have put tremendous strain on the wrap providers and jeopardized the entire stable value industry. As a result, thorough due diligence of a stable value fund involves detailed questions about the nature of wrap contracts that underlie the fund.

From the perspective of the wrap contract provider, prior to 2008 portfolio risk was not well understood. It soon became apparent to providers that they took on more risk than they appreciated when they charged only 7–10 basis points for their services. The combination of low market-to-book ratios (some funds saw in low 90's), along with credit issues associated with wrappers such as AIG, caused funds and wrap providers to renegotiate terms. Out of concern for potential liability, most wrap contracts now contain more restrictive provisions, such as limits on credit exposure, duration, and liquidity, as well as expanding the definition of competing funds to TIPS. Still, many wrap providers decided that the wrap business was not worth the risk and exited the market. It is only as wrap capacity demand has driven fees up to 20 basis points that new providers have entered the market over the last year. Some funds have moved back to investing in traditional GIC holdings to avoid these issues. For other funds, it is too late; confronted with a lack of wrap capacity or overly restrictive investment limitations, many funds have chosen to liquidate and terminate.

Fees

Management fees are readily available, but underlying, or indirect fees are

Plan Sponsor Check List

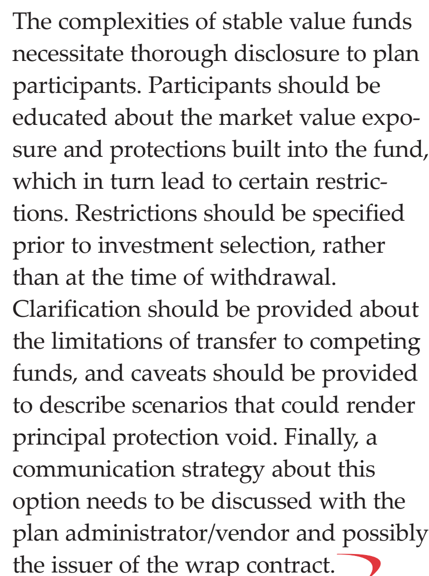
When Selecting a Stable Value Manager…

- Determine the type of stable value investment that works best for your plan
- Consider the cash flow needs of your participants
- Review the stable value fund manager's experience managing fixed income portfolios
- Evaluate the structure of the stable value investment with regards to credit quality, liquidity and holdings
- Request a history of the market to book value
- Understand the "Exit" clause
- Disclose equity wash rule provisions and other restrictions to participants
- Examine fees, both direct and indirect

more difficult to assess. Fees such as wrap contract fees, sub-advisory fees and administrative expenses, which are all taken out of the book value return, are not transparent. In addition, GIC and guaranteed contracts embedded fees in an additional level of opaqueness. Federal regulations 404(a)(5) and 408(b)(2) that go into effect January 1, 2012, will require new disclosures for both participants and plan sponsors that will hopefully help plan sponsors better understand stable value fees.

New Concerns

Following the events of 2008, stable value funds were able to adhere to its principles of stable return and principal protection. Although money market rates dropped dramatically, stable value funds were still yielding in the 3–5% range at that time which led to renewed investment interest in the last three years. As previously discussed, when interest rates decline, stable value returns are slower to decline, benefiting from the amortization of market performance and higher historical rates. However, with new cash flows into portfolios, lower reinvestment rates have caused the amortized yield on portfolios to move lower. The longer rates stay at historical lows, and new investments are made at low rates, the accruals and hence the returns also are also reduced closer to money market returns. In addition, increased wrap contract costs and restrictions are also suppressing yield. Currently, stable value returns have moved into the 1.5–3% range, and while still above the negligible money market returns, this situation will not improve for the foreseeable future. Looking forward, as the yield curve flattens, portfolios with longer-duration assets may find it difficult to justify the risk premium over money market returns. This could lead to additional risk being introduced into stable value products in an effort to recapture yield. Given the current state of the U.S. deficit, a rapidly rising interest rate and inflationary environment could serve to push money market yields above stable value. These market scenarios, combined with either a limited wrap market, or increasingly tighter wrap restrictions and higher fees will reduce overall yield, and possibly reduce holdings transparency as more GICs and separate accounts are added to the portfolios. These scenarios could render stable value funds less attractive than money market funds.



How a Plan Sponsor Communicates Information about a Stable Value Investment

The complexities of stable value funds necessitate thorough disclosure to plan participants. Participants should be educated about the market value exposure and protections built into the fund, which in turn lead to certain restrictions. Restrictions should be specified prior to investment selection, rather than at the time of withdrawal. Clarification should be provided about the limitations of transfer to competing funds, and caveats should be provided to describe scenarios that could render principal protection void. Finally, a communication strategy about this option needs to be discussed with the plan administrator/vendor and possibly the issuer of the wrap contract.

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