

Stable value: Still relevant in DC plans

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Stable-value products, a mainstay of 401(k) plans, have historically presented an attractive alternative to money market and short-duration bond funds. While recent industry developments have decreased the appeal of stable value (SV), its value proposition remains largely intact.

In this paper, we offer a brief history of stable value, how stable-value products work and how the market has evolved in recent years. We conclude with some observations about stable value from the plan sponsor's perspective.

Stable value fast facts¹

- SV funds hold roughly \$560 billion of 401(k) assets
- SV is available in most DC plans
- SV portfolios consist of diversified, high-quality bonds protected from interest-rate volatility by wrap contracts
- SV offers the liquidity of a money market fund with higher return expectations (historically, 200–250 bps annual premium, likely lower going forward)
- SV offers the return of a short-duration bond fund with less expected volatility (1.57% annual return volatility 1989–2008)

Quick history of stable value

Stable-value products have been an investment option in 401(k) plans for more than 30 years. Guaranteed investment contracts (GICs) – the wrapped bond portfolios insurance companies hold in their general accounts for clients – were the first stable-value options, introduced in the early 1980s. Later innovations include separate account GICs, the contracts insurance companies hold for clients in special accounts in order to mitigate the issuer's credit risk, and synthetic GICs, which are owned by 401(k) plans and their participants.

¹ Source: Stable Value Investment Association, "Stable Value Basics through September 2010," <http://stablevalue.org/help-desk/basics/>, accessed 26 January 2011.

Despite heavy lobbying from the stable-value industry, the 2007 Department of Labor (DOL) Qualified Default Investment Alternative (QDIA) regulation did not include stable value among the three safe harbor–covered default options. Prior to the regulation, stable-value and money market funds were often used as defaults in plans with automatic enrollment; the low likelihood of poor performance was perceived to limit sponsors' liability. Even now, about a fifth of large plan sponsors and half of small plan sponsors would likely use stable value as a QDIA if they could elect to do so.² But the DOL reasoned that since most plan participants who are defaulted into an option do not transfer out, sponsors should seek to better diversify their portfolios, not solely to preserve their capital.

Mechanics of stable-value products

Insurance companies, banks or stable-value money managers construct stable-value products by use of an underlying bond portfolio and the book-value guarantees on the underlying ("the wrap"). The objective is to provide stability of principal and a relatively smooth crediting rate (i.e., yield) to investors as interest rates fluctuate. As a result of this smoothing, stable-value funds are slow to adapt to changing interest-rate environments. In today's market, where interest rates are likely to rise, stable-value crediting rate changes could lag money market and short-term bond yield changes.

Instances when the product may not pay out full book value to the plan fall under two broad categories: security-initiated events and employer-initiated events. Security-initiated events include security defaults or downgrades on the underlying bonds. To minimize risk, most contracts have explicit investment guidelines for the underlying bond portfolio, such as a maximum allocation to non-investment-grade bonds. Contracts may also have an allowance for absorbing a certain level of credit losses. Employer-initiated events include layoffs and bankruptcies, during which investors exit en masse from the fund.

For participants who wish to withdraw money from their stable-value accounts, there's generally no penalty; liquidity is daily. However, many contracts impose "equity wash" provisions on in-plan transfers involving stable-value funds. These provisions generally require assets transferring out of the stable-value option to be invested in a dissimilar alternative, such as equity, for a period of time (usually 90 days) before being placed in a competing investment option. (Options considered competitive to stable value are generally fixed income funds with durations of less than three years, although the definition has been expanding lately.) This mitigates the impact to investors who remain in the stable-value fund during periods of interest-rate volatility.

2008's impact on the stable-value market

When the financial crisis hit in 2008, stable value lived up to its name. One of the key metrics for gauging the health of stable-value products is the market-value to book-value (M/B) ratio of the underlying bonds. A ratio above 1 generally indicates a strong propensity toward capital preservation, with anything over 1 reflecting an unrealized gain. Low M/B ratios place pressure on funds if many investors decide to withdraw assets simultaneously.

During 2008, the M/B ratio across all stable-value products fell to about 95.6%, and many fund ratios fell below 90%.³ Yet stable-value products continued to make interest

² MetLife Stable Value Study: A Survey of Plan Sponsors and Stable Value Fund Providers (April 2010).

³ Stable Value Investment Association.

payments to investors, and those investors did not leave stable value en masse. Positive fixed income returns following the crisis led to most stable-value M/B ratios climbing back above 100%. While some funds were greatly stressed, the industry as a whole avoided disaster, and a wrap provider has never been called upon to make a payment.

Nonetheless, the tumultuous experience caused wrap providers to reassess their place in the market. In 2009, three major wrap providers – UBS, Rabobank and AIG – made plans either to exit or to pause their stable-value business. These firms alone still account for about \$46 billion, or 11%, of the wrap market today.⁴ Other providers have become reluctant to take on new risk-protection responsibilities. More specifically, wrap providers now perceive their “wrap capacity” to be much lower than before the crisis. They are also much more selective about whom they will work with.

2008's impact on wrap business

- Reluctance to wrap new funds
 - The wrap-only service model has been abandoned for the investments and wrap model
 - Reasons include wanting to have better oversight of money management and to limit business risk in general
- Tightened standards on the underlying portfolio instruments and strategies
 - Portfolio credit-rating minimums are higher
 - Duration limits have decreased
 - There are new limits on exposures to single securities and single sectors
 - There has been a reduction in use of non-benchmark sectors
- Elevated fees
 - Typical fees have more than doubled, from less than 10 basis points to around 15–25 basis points⁵
- Increased oversight of plan design and participant communications
 - The definition of “competing funds” (e.g., investment-grade bonds) has expanded
 - Sponsors may need to share communications with managers to ensure compliance with wrap agreements

Post-2008 stable-value market: reason for cautious optimism

Fortunately, we can be confident that market forces will restore wrap capacity over time. The recovery of financial firms since 2008, new restrictions on underlying assets, and high wrap fees have been attracting new firms to the market. Insurance companies such as Aviva plc, Prudential Financial, Mutual of Omaha, MetLife and New York Life have stepped up and provided new capacity to the business. In fact, wrap capacity has already recovered from a December 2008 low of \$346 billion to around \$437 billion in

⁴ Steyer, Robert. “Wrap market returns – but with changes.” *Pensions & Investments* (December 13, 2010).

⁵ Steyer, Robert. “Wrap market returns – but with changes.” *Pensions & Investments* (December 13, 2010).

September 2010.⁶ However, many of the new entrants (and some existing providers) now insist on managing underlying assets in-house or with an affiliate in order to better manage risk.

We also expect to see consolidation of stable-value providers in the coming months. Managers who are smaller, and those who did not fare well during the economic crisis, are likely to exit the industry.

Longer-term, fees will likely continue to be higher than before. Yet this may simply reflect both the real risk wrap providers face, and a new willingness among plan sponsors to pay for good wrap.

For nearly 30 years prior to 2008, large balance-sheet losses and underlying defaults were rare, fees were low and capacity was plentiful for stable-value products. Now that we've seen what financial markets are capable of, it would be irresponsible to continue to price risk by use of outdated assumptions. If fees were to stay low at the expense of capacity, plan sponsors could face continued denial of access to stable value. That solution is not palatable to baby boomers approaching retirement, and it should not be palatable to plan sponsors.

At the same time, sponsors have changed their views on stable value. Pre-2008, the stable-value marketplace was somewhat commoditized, with low fees being the most important criteria in choosing wrap providers. Today, the creditworthiness of the wrap provider has replaced fees as being the most important wrap-provider consideration among both sponsors and stable-value managers.⁷ This indicates that while stable value may have been perceived as a commodity before 2008, it certainly is not anymore.

Impact on plan sponsors

These new developments have been a major inconvenience to plan sponsors, for four main reasons:

1. New, tighter provisions in stable-value contracts can spread to other parts of a plan. Examples include "competing funds" transfer restrictions and stipulations for oversight of participant communications.
2. Despite recent improvements, the market for stable-value wrap capacity remains limited. As a result of new restrictions, some sponsors are having trouble getting wrap capacity.
3. This limited capacity has meant higher wrap fees. See the callout box titled "2008's impact on wrap business".
4. Sponsors and providers have different views on recent market trends. For example, while 89% of wrap providers consider self-directed brokerage windows to be a competing option, only 38% of plan sponsors agree.⁸ And 75% of plan sponsors think wrap contract terms should be standardized, but just 50% of wrap providers concur.

⁶ Steyer, Robert. "Wrap market returns – but with changes." *Pensions & Investments* (December 13, 2010).

⁷ MetLife Stable Value Study: A Survey of Plan Sponsors and Stable Value Fund Providers (April 2010).

⁸ Myers, Randy. "Survey Confirms Trend Toward More Restrictive Wrap Contracts." *Stable Value Investment Association* (First-half 2010, vol. 14, issue 1). Available at <http://stablevalue.org/library/>.

What can a plan sponsor do?

Despite stable value's history of excess returns over other low-volatility products, some plan sponsors have elected to eliminate their stable-value funds in favor of money market funds, even though the latter funds, in today's interest-rate environment, will pay out just a few basis points per year. For plan sponsors who are considering plan option changes that involve stable value, we recommend a deliberate approach:

- In light of new, tightened conditions in the stable-value market, we advise sponsors not to rush into making stable-value deals. In the wrap arena, industry experts have noticed, some recent deals are being accepted rather than negotiated. Such hasty actions might backfire for sponsors and their plans' participants in the long run. Similarly, many wrap deals are being renegotiated; again, we encourage plan sponsors to take a thoughtful, rigorous approach to negotiation.
- Consider who will be managing the stable-value fund's underlying assets for the plan. Generally, wrap providers do not want to deal directly with plan sponsors, but rather with one or more respected, conservative stable-value managers. Questions for plan sponsors to ask when evaluating their "stable" of stable value managers include:
 - Can the manager(s) get wrap capacity?
 - Can the plan transition to new managers relatively painlessly?
 - Can the plan expand its number of wrap providers?
 - Is there regular communication with the managers? (This is especially important in advance of termination events.)

The wild card: Washington, D.C.

The recent Wall Street Reform and Consumer Protection Act⁹ ("the Act"), particularly two passages concerning swaps, may have some unintended consequences for stable-value products.¹⁰

Without swaps, stable value may not be a viable investment in 401(k)s. Swaps provide the ability to hedge interest rate risk with more precision than can be achieved with futures and forward contracts, and thus can be a much cheaper option for portfolio protection in times of liquidity crises.

The Act includes provisions to regulate the swaps market. It also expresses regulators' desire to see swaps traded on an exchange, rather than over the counter, and to subject them to new regulations. If this stipulation is applied to stable value, it could at least increase the cost of stable-value options.

The more troubling language occurs in Section 764 of the Act, which suggests that wrap providers who use swaps could be deemed swaps dealers and hence fiduciaries to ERISA plans. This would be a conflict of interest per ERISA, and may cause wrap

⁹ H.R. 4173, available online at <http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>.

¹⁰ For a good summary of the issues, go to "Financial Regulation and Consequences on America's Retirement Savings" at dciaa.org/Fin_Regs_Consequences_Am_Ret_Savings.pdf.

providers to abandon 401(k) plans. The recent revelation that swaps dealers may have to act as fiduciaries to pension plans is not good news for stable value.¹¹

The \$650 billion question is: are stable-value contracts swaps? The Act temporarily excludes stable value from the definition of swaps. Section 719(d)(1) of the legislation calls for the SEC and the U.S. Commodity Futures Trading Commission (CFTC) to jointly conduct a 15-month study into whether stable-value contracts are swaps. If the commissioners determine that they are, it is possible that they will jointly undertake to determine whether the public would benefit from exempting stable-value contracts, in an exception to the rule.

The good news is that industry experts seem to think stable value will live on, given the review period granted to the regulators. Even in the worst-case scenario, stable-value contracts entered into prior to the joint SEC/CFTC decision will be exempt from any regulation.

Plan sponsors should continue to follow this developing story in the coming months.

Value proposition of stable value

Before evaluating whether stable value makes sense for a plan, a sponsor must first determine the investment objective. Does the sponsor need the safest possible investment option? A money-market or short-term investment fund (STIF) makes the most sense. What about a risky asset that can automatically adjust to an investor's risk tolerance? Go with a target date fund. But for sponsors who want something in between those two extremes, they should consider stable value.

For plan sponsors seeking capital preservation or conservative fixed income investments, stable value offers an attractive option compared to the alternatives. When the objective is a low-risk investment, the two broad asset classes available are money market (or STIF) funds and stable value. Stable value offers similar return volatility, but with a much higher expected return premium (historically 2% to 2.5% per year, although closer to 0.5% to 1.5% per year today with higher wrap fees and more conservative investment policies).¹²

On the other hand, if the sponsor has a bit higher risk tolerance, stable value offers a potentially steadier alternative to short- or intermediate-term bonds. Stable value offers returns similar to those of short-term bond funds, but with less interest-rate sensitivity due to the wrap. This provides for predictable returns to participants— a key feature as many Americans approach retirement. Of course, participants and sponsors do pay for this stability with wrap fees and wrap provider restrictions. If a steady NAV at the participant level is not a required objective, then there is a case for merely adding a conservative short-duration bond fund as the most conservative option in the plan.

While the market events of 2008 have increased participant demand for stable value, we don't want to encourage a single-minded focus on capital preservation. For retirement savers, money market funds and even stable-value funds may not provide the return needed to build up the pot of money sufficient for funding retirement. We should be encouraging all investors, including retirees, to consider taking on an appropriate level of risk.

¹¹ Halonen, Doug. CFTC proposal toughens swap dealer responsibility. *Pensions & Investments* (December 15, 2010).

¹² Of course, the capital preservation is merely at the book-value level for stable value, given that wraps allow for the market fluctuations to be smoothed. Nonetheless, this is a very valuable feature for many near-term and current retirees.

Top stable value survey takeaways

Concurrent with this paper, we have surveyed many of our plan sponsor clients about their stable-value products. Here's a list of our top survey takeaways for plan sponsors:

- **Stable value really is causing headaches for sponsors.** Some of the survey respondents have eliminated, or are considering eliminating, their stable-value offerings.
- **Market-value to book-value ratios are generally healthy, especially compared to 12 months ago.** Good market returns since the 2008 crisis have brought stable-value offerings back to a more secure status.
- **Satisfaction with wrap capacity varies widely.** When we asked our clients if they were "very satisfied," "satisfied," "somewhat satisfied," or "unsatisfied" with their wrap capacity, we received at least one affirmative for each of the statements.
- **Wrap provider turnover has been high, but replacements have usually been found.** Plan sponsors and wrap providers have typically been able to find a middle ground.
- **Wrap fees have increased across the board.** Almost no respondents were spared higher wrap fees.
- **Most sponsors would enjoy a roundtable discussion with their peers.** As part of the survey, we've invited the respondents to engage in an in-depth stable-value discussion. Since sponsors face many of the same obstacles, such conversations could be enlightening.

"Wrap"-up

For many years, stable-value products have been a safe option for DC plan participants. Recent market events have shaken up the stable-value industry, causing a gap between demand by plan sponsors and supply from wrap providers. Although this gap is in the process of closing, fees will be higher and excess return potential will be lower than before 2008.

With a record number of participants approaching retirement age, stable-value products should continue to have a place in DC investment lineups. But as the recent crisis proved, they are hardly commodities. As with any investment alternative, plan sponsors have a responsibility to understand stable-value products and to choose the best option for their participants – and to remember to consider plan investment objectives before adding or dropping a stable-value product.

Exhibit 1 / Key attributes and considerations for stable value and its alternatives

	Key Attributes	Considerations
Stable Value Fund	<ul style="list-style-type: none"> • Higher expected yields relative to money market • Capital preservation objective • Low volatility 	<ul style="list-style-type: none"> • Cost of guarantee • Yield premium in decline • Stricter regulations • Wrap provider can impact other plan design features • SEC still investigating stable value with regard to swap regulations • Yields can lag those of money markets in rising rate environments
Money Market Fund	<ul style="list-style-type: none"> • Liquidity • Capital preservation objective • Relatively lower volatility 	<ul style="list-style-type: none"> • Yield volatility • Stricter regulations • Low expected long-term return
Short- or Intermediate-Duration Bond Fund	<ul style="list-style-type: none"> • Access to investment strategies • Higher yield potential • More liquid than stable value 	<ul style="list-style-type: none"> • Costs • Market volatility
Target Date Fund	<ul style="list-style-type: none"> • Higher asset class diversity • Investment strategy tailored to participant risk tolerance • Real-return asset allocations 	<ul style="list-style-type: none"> • Higher volatility • Lacks capital preservation objective

Source: Russell Investments

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Target date fund investing involves risk, principal loss is possible. The principal value of the fund is not guaranteed at any time, including the target date. The target date is the approximate date when investors plan to retire and would likely stop making new investments in the fund.

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