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STABLE VALUE OPTIONS AND ALTERNATIVES

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Introduction

The recent capital markets global recession and resulting de-leveraging has impacted Stable Value Funds. Long accepted methods of structuring and delivering stable value products to defined contribution investors have been altered to accommodate a more "risk averse" approach to investing. This article will provide a review of how providers of stable value funds have changed their offerings and how plan sponsors are reacting to the changes.

What are Stable Value funds?

Stable value investment options have long been a popular choice for many retirement plan participants who desire a low risk investment choice. Stable value is a fixed income investment designed to guarantee "participant–initiated" book value withdrawals. The book value of a participant's investment in a stable value fund is the accumulated value of their contributions and any earnings on those contributions, less any previous

withdrawals. In other words, it's the value they see on their statement and the participant is shielded from the volatility of the underlying investments backing the fund. To be considered stable value and qualify for book value accounting treatment, the fund must be structured using specific types of investments and strategies and adhere to some accounting rules covered under SOP 94-4. Stable value investments can include cash equivalents, guaranteed investment contracts (GICs), separate account GIC contract (SAGICs), and wrapped bond portfolios using a product called a "Synthetic GIC".

Bond portfolios must be covered by wrap contracts to qualify for book value accounting treatment. Plans can be designed to use one or all of these investment types to meet their goals. Additionally, plans must offer daily liquidity in their stable value funds for benefit withdrawals to qualify for book value accounting, but some plans may place restrictions on the timing of withdrawals if a competing fund is an option within the plan. Competing funds are defined by wrap issuers and are usually short duration bond or fixed income investment options. Some wrap issuers also categorize self-directed brokerage options and TIPS Funds as competing funds. Direct transfers to a competing fund are prohibited and must first involve an "equity wash." An equity wash requires amounts transferred from a stable value fund to be invested in a non-competing fund, such as an equity fund or longer duration fixed income fund, for a minimum specified period before being transferred to a competing fund.

"Participant-initiated" is an important term in stable value, also described as benefit responsive, since withdrawals initiated by employer actions may not be provided book value withdrawal treatment. Employer actions could include termination or modification of investment manager contracts, bankruptcy or even layoffs.

A wrap is a form of insurance on a portfolio of securities that has two levels of functionality. The first benefit is the ability of the plan to account for a portfolio of bonds at book or contract value. The wrap issuer is required to provide certain contract terms to allow the plan to hold the underlying assets at book value. The book value is the wrap issuer's liability which is subject to various regulations and requires the posting of capital to back the liability. The second benefit can be described as catastrophic coverage and is invoked when the assets backing the liability have been exhausted. Wrap providers are obligated to and continue to pay claims or benefit withdrawals regardless of the value of the underlying securities. In the end, the wrap provider usually only makes payments making up the difference between book and market value when the stable value contract is terminated. Otherwise, losses realized from security sales to meet distributions are absorbed by the crediting rate.

The second unique feature of stable value is interest rate smoothing. The amount of interest paid, or crediting rate, is based on a formula which amortizes any portfolio gain or loss over a period of time and is used to smooth changes in spot interest rates. If, for example, interest rates decline, the spot rate would decline but it would be partially adjusted upward by amortization of the increase in value of the bond portfolio. Under the accounting process used for the interest rate smoothing, the investors earn a stated return that cannot be less than zero. The formula also works to converge the bond portfolio's book value to its market value. The stable value wrap contracts that provide for the book value accounting and participant-initiated withdrawals are generally considered to be evergreen, meaning these contracts have no fixed maturity. So, the liability is ongoing and can change quickly along with changes in the capital markets. Many issuers of wrap contracts are required to post a dynamic level of capital that is based upon a number of factors that include the fund's "market to book ratio", underlying investment portfolio and historical cash flow profile. The capital markets collapse of 2008/2009 produced significant capital calls which some wrap issuers determined to be either unacceptable or acceptable only if fees could be charged commensurate with the potential risk and capital required to back their book of business. Thus some issuers exited the wrap market and those remaining have by and large increased their fees for providing the wrap contracts.

Another change that has impacted the stable value market is the renewed focus on plan underwriting. Wrap underwriters use plan and stable value fund demographics and historical cash flows to determine if the plan's stable value fund and structure is an acceptable risk. The lapse assumption or the prediction of future benefit withdrawals is also a factor is setting reserve levels. Underwriting has always, of course, been in place but the competition to win business prior to the 2008/2009 collapse caused providers to relax the standards used to price and issue business. With underwriting standards dramatically increasing in the wake of the financial crisis, underwriting is no longer a yes/no exercise; in addition to a fee level, the output now directs what investment strategies, level of cash buffer and contract terms can be offered.

Why is Stable Value Popular?

Over one-half of defined contribution plans offer a stable value fund and, when offered, is often the most popular option after domestic equities. Many participants have a very low risk tolerance and are willing to accept lower absolute returns than available from other less conservative investments. In tumultuous financial times, the volatility of equity investments will drive even investors who consider themselves to be relatively aggressive to allocate some or all of their retirement portfolios to safe havens. Even though the recent financial crisis affected fixed income investments, net inflows to stable value were consistently positive. Stable value also provides benefits that other fixed income options do not. Stable value crediting rates are generally higher than money market rates. This is partially due to the fact that the underlying portfolios have a longer duration than the one year maximum afforded money markets options. Money market funds have the potential to offer relatively higher yields when short term interest rates rise sharply or if the yield curve is inverted to an extreme. Short term bond funds may offer similar yields to stable value but do not offer the protection of book value withdrawals.

Recent Challenges

The recent recession had a wide ranging impact on most financial instruments. The liquidity crisis spread to just about every fixed income asset class except US Treasuries. As result, most diversified fixed income portfolios experienced declines in value. Most of the same financial institutions that were impacted by the liquidity crisis were also the issuers of wrap contracts. The appetite for risk was virtually non-existent and the concept of placing a large liability on their balance sheets in exchange for a stream of payments was suddenly not attractive. The Dodd-Frank Wall Street Reform and Consumer Protection Act commissioned a study to conclude if wrap contracts should be included in the definition of swaps (derivatives) which would potentially subject them to much more stringent regulations. The study was the result of the stable value industry and other industry groups lobbying for a carve-out or further review by the SEC and CFTC. As of June 2012, the CFTC/SEC study has not been completed and no final decisions have been reached on the matter. Recent fee disclosure legislation has also been a complicating issue. Although public sector retirement plans are not subject to these ERISA rules, many plan sponsors consider compliance to be a best practice. Since some of the stable value structures can be very complicated, it can be difficult for Plan sponsors to understand and communicate the costs related to these funds.

The combination of uncertainty, risk aversion and some firms simply consolidating their business lines resulted in a reduction in wrap capacity throughout the system. Prior to the recession, stable value fund managers and plan sponsors could bid out for wrap coverage and select from a large group of bank, insurance and financial guarantee providers. Fees for this coverage reflected the abundant supply. Beginning in 2007, the supply of wrap providers began to contract. Today, the primary source of book value wrap is being generated by insurance companies. The firms that remain in the business have increased fees and demanded changes to investment policy statements. Changes to investment policies could include: reduced or eliminated allocations to foreign and lower rated securities, tighter sector limitations and more stringent rules regarding competing investment options. Plan sponsors have little ability to resist these changes since industry capacity is very limited and the wrap provider often has the ability to exit the relationship over a pre-determined period of time through a process called immunization. The volatility experienced in the fixed income market has spurred a change in what type of fixed income strategies are underwritten and the level of detail required within investment guidelines. "New" investment guidelines are likely to have shorter duration benchmarks, hard caps on the allocation to bond sectors and exposure limits to any one single security and/or issuer. Allocations to certain sectors of the bond market such as non-agency mortgage backed securities, high yield, emerging market and non-dollar fixed income securities have been severely curtailed or eliminated.

Many large plans that were paying as little as five to ten basis points are now seeing contracts offered at fifteen to twenty- five basis points or more. In the current low interest rate environment, these increases in fees have a significant effect on the crediting rates sponsors can offer to participants.

Most plan sponsors have decided to retain their stable value funds and have worked through solutions to the challenges. Even though plans using stable value funds are off their peak, they continue to be offered in the majority of defined contribution plans. Stable value is an investment option that is difficult to replace or replicate with an alternate product. It could be argued that some people participate—especially those that are separated from service or in retirement— because stable value is only available in a defined contribution retirement plan. The SEC determined several years ago that stable value funds cannot be offered outside of a defined contribution plan.

What Might the Future Bring?

It is difficult to say exactly what lies ahead in stable value, but it is very unlikely that the market will return to its pre-financial-crisis heyday any time some. What alternatives are available to Plan Sponsors? The new stable value environment has spurred some change in the design and delivery of stable value funds. Although most sponsors have adapted to the new offerings, some sponsors have elected to change the structure of their fund, some have simply surrendered the option to a different structure. Below is a description of some observed alternatives that have been identified.

Wrap Providers Managing Assets

Most of the insurers now providing book value wrap coverage are requiring that all or a portion of the assets being wrapped be managed by an affiliated manager. In many of these firms, the asset managers have years of experience in managing pension portfolios that require special handling to fund liabilities (defined benefit plans and products backed by the issuer's general account). However, the selection of investment managers remains a fiduciary function and the ability to use a broader, diverse group of fixed income managers may help the plan sponsor to prudently select the investment management without being overly influenced by the availability of wrap services. By keeping these services somewhat separate, it should also be easier to differentiate between fees charged for investment management and wrap services. Some insurance companies prefer to limit the fixed income investment management to affiliates only. Since they are "on the hook" with the wrap guarantees, they may desire greater control over portfolio management especially in the area of risk controls. This more limited structure may create an opportunity for these companies to offer lower combined fees. With these arrangements plan sponsors should be aware of potential conflicts of interest and require that the affiliated manager's activities be transparent and independent of the wrap issuer. The affiliated manager should manage the underlying assets to a published set of guidelines (agreed to by plan sponsor) and provide robust compliance reporting to the plan sponsor. Perhaps some comfort can be gleaned from the fact that regardless of whether the manager of an insurer's wrap is affiliated or not, the same reserve regulations apply.

Hold More Cash

One of the least intrusive of changes taking hold is an increase in cash holdings. Many large stable value funds have a cash buffer. This buffer portion accepts all daily participant directed liquidity. Usually the buffer is somewhere in the 5% range and when the buffer is above or below the range, the sponsor (or a third party) takes action to move the buffer back to the target. Some sponsors and stable value managers have simply chosen to increase the allocation to their fund's buffer. This action eliminates the problem of obtaining wrap coverage but may drive down the overall crediting rate or yield provided to plan participants.

Blended Hybrid Structures

Several stable value funds have altered their stable value funds to combine both "wrapped" and "unwrapped" bond portfolios. The unwrapped portion is marked to market on a daily basis and is often used as the second source of participant directed liquidity (after the cash buffer). The return provided to the participant is a blend of the crediting rates of the "wrapped component" and market value return of the "unwrapped component". Under this structure, the fund is no longer technically a stable value fund and is often renamed. A crediting rate can no longer be announced and the participant principal is no longer protected. These hybrid structures are fairly new and have not been tested under various market scenarios. Depending on the level and underlying strategy of the unwrapped component, it is possible that in certain rising interest rate environments participants would experience a loss of principal.

Money Market Funds

Money market funds have generated extremely low returns for several years. Currently, many money market funds are yielding in the single digit basis point range, dramatically reducing their attractiveness as an alternative to stable value. The legislative trend also is working to prevent these structures from being a suitable replacement for stable value. The possibility that such funds may be required to shorten average maturity, maintain capital reserves, and/or have a floating NAV does not bode well for money market funds' future in DC plans. Still, some plan sponsors are looking to the long term, when rising interest rates could cause money market fund yields to experience a premium to stable value fund yields.

Short Duration Bond Funds

Using a short duration bond fund in lieu of stable value has been another consideration. Short duration bond funds, of course, do not provide a guarantee of principal or any protection from capital market volatility. Depending on the duration and risk parameters of the fund, it could also be argued that the return profile of a short duration bond fund does not provide an adequate amount of return to meet or beat the average inflation rate. However, some plan sponsors feel that the cost and complexity of stable value wrap contracts do not adequately offset the benefits and have chosen to use a short term bond fund instead. In spite of the current shortcomings of money market funds, some plan sponsors offer both a money market fund as the "safe haven" and a short term bond fund to provide some yield.

TIPS Funds

TIPS or funds that primarily invest in Treasury Inflation Protected Securities have long been a good complement to stable value funds. All TIPS funds are structured differently but in their most pure form (100% inflation protected securities) provide a benefit to participants by providing protection against the loss of purchasing power by holding a portfolio of assets that is designed to adjust upwards commensurate with inflation. It's important to note that Treasury Inflation Protection Securities will lose principal when deflation occurs and the return on a TIPS funds can be negative in times when interest rates are rising. The market treats TIPS funds as bond funds and as such the duration of fund is important when assessing the impact of changes in interest rates. A longer duration portfolio may generate capital losses which are not offset by the income component... In other words there is a chance that principal may be impacted by changes in interest rates. Another concern is that not all TIPS funds are alike; many are hybrids that allow significant investment in other types of fixed income securities that may increase risk or not provide the desired inflation protection.

Recent Proposed Regulations and the Marketplace

Although the CFTC/SEC Stable Value Study Commission has not published their final decision on Stable Value Investment Contracts (originally due in October of 2011), preliminary indications are for a positive result. The issue at hand is whether stable value wrap contracts are "swaps" and if so should they be exempt from further regulation.

Over the last 6 months, there has been an increase in acknowledged wrap capacity. The new capacity is being sourced from existing issuers, from some new issuers coming into the market and growing interest from foreign-based banks and financial firms.

The trend seems to be more towards insurance companies returning to the market they created and for banks to pull back and deploy their capital to perhaps more of their respective core businesses.

Competitive forces may help bring down fees for wrap services but it is unlikely that they will reach the low levels of the past. Where wrap fees end up will most likely be a product of the results of the government studies and the costs of any additional regulation, risk appetite from issuers and any comfort that the events of 2007-2009 won't repeat themselves anytime soon.

Conclusions

The stable value fund marketplace may have changed, but the objective remains unchanged. Participants want the utility of a fund that provides a guarantee of principal, the ability to out-yield cash alternatives and to maintain a return profile that keeps up with or provides a premium to the rate of inflation. It would seem that the stable value alternatives being considered today do not meet all three objectives.

The following Appendix (*see page 8*) provides a summary of the similarities and differences among the different varieties of stable value products.

In conclusion, there are no easy answers when it comes to capital preservation vehicles in general and stable value in particular. It's an evolving situation on many fronts. Plan sponsors need to watch this situation closely and make sure they are comfortable with the trade-offs they going to have to make.

Appendix A

Stable Value Products						
		Cashout Options				Availability
Description	Crediting Rate/Minimum	Market Value	Book Value	Fees	Credit Risk - Insurance Component	IRC Code
GIC - Guaranteed Investment Contract	Rate fixed over term of contract	MV formula may be stated in contract - optional	Only paid at maturity	All risk charges/contract fees usually netted from rate - not disclosed	GA - subject to creditors of issuer	457 and 401
Fixed Account General Account	Reset Periodically - annual/lifetime floor	MVA Formula stated in contract - usually tied to Bond Index	Installments paid out over set time period	All risk charges/contract fees usually netted off rate - not disclosed	GA - subject to creditors of issuer	401,457 and 403(b)
Separate Account Participating Contract	Reset Periodically at contract level via contractual formula - 0% floor	Can terminate at Market Value MV = Value of Underlying Assets	Installment payment typically paid out at duration - benefit responsive	All fees are disclosed in contract	SA - insulated from creditors of issuer	401, 457
GIC Pool or Pooled Collective Trust Fund	NAV struck daily - no guarantee	N/A	Typically paid within one year (12 month put)	Wrap fees netted from NAV, Sub-Advisor and Trustee Fees disclosed	Look to credit of underlying book value issuers - no guarantee on structure	401, 457
Synthetic GIC	Reset Periodically at contract level via formula - 0% floor	Can terminate at Market Value MV = Value of Underlying Assets	Installment payment typically paid out at duration - benefit responsive	Wrap Fee, Investment Mgmt Fee, Custody Fee - Disclosed	Plan owns assets in Custody Account - insulated from creditors of Wrap Provider	401, 457,529