Capital Preservation: Choices & Consequences

By Glenn Macdonald, Corporate Vice President – New York Life Stable Value Investments

Often times, life lessons are accompanied by a multitude of choices and, in turn, consequences. For every choice there is a consequence, and this certainly applies to selecting optimal retirement plan investment options. If everyone saved more than they spent, it would go a long way towards funding the ideal retirement. The simple act of saving more, however, is not a complete retirement strategy; ideally, those savings should be invested. As a plan sponsor advisor, you generally need to recommend investment options across the risk spectrum. For capital preservation or lower risk investment options, the plan sponsor's decision usually boils down to a choice between liquidity and yield. And for most cases, the direction you hear from plan sponsors is "we want both!" If this is the case, then stable value funds may merit strong consideration.

Investment Selection Process: What's Under the Hood

Before we kick the tires and check out what's inside different capital preservation options, let's consider common, prudent practices being used today by investment professionals in making retirement plan investment selections. If you've been in the retirement business long enough, you know the importance of having a process for all prudent fiduciary decision-making. Most plan sponsors and advisors are quite comfortable when it comes to applying a mutual fund selection process. However, when you add a stable value fund to the mix – there are new considerations, terminology and trade-offs to consider. Stable value options are unique in that they are available only through a qualified retirement plan and some 529 college-savings plans. The underlying portfolios of stable value options are largely invested in bonds, and also have insurance protections. They are the only plan investment option that has both investment and insurance components. Historically, plans would virtually walk up to their new recordkeeper, make most of the fund selections and then "flip the keys" to the recordkeeper when it came to suggesting the "boring capital preservation" funds. Today, due in part to the current litigious environment, this is no longer the case. There is now a need to fully understand the benefits and potential risks of capital preservation options with respect to both selection and monitoring.

Right about the time stable value funds were created some 40 years ago, selecting a capital preservation option often meant using money market mutual funds and FDIC insured bank certificates of deposit ("CDs"). Bank CDs have limitations on liquidity under certain scenarios and money market funds generally offer principal protection, modest yields and daily liquidity. Things were simple because plan advisors were familiar with government, prime and municipal money market funds that are widely available outside of retirement accounts. Today, there are more choices, including stable value funds, which offer both protection and liquidity for participants. Stable value funds generally offer higher yields over time than money market funds because they can invest in assets with longer durations.[1] In addition, the insurance protections are designed to provide price stability on a day-to-day basis. Should there be an extreme event, there are insurance guarantees that participants won't lose at least what they have invested – in most circumstances. However, Plan advisors are often less familiar with stable value funds, whose structures and features can vary depending on the insurance contract issuer. In short, when selecting and monitoring capital preservation plan options, consider what you're trading-off for higher yields.

In 2016, new money market fund regulations were implemented that also merit consideration when selecting capital preservation options. The bottom line for many plan sponsors is that while selecting a stable value fund may make sense, the mere existence of the insurance component can sometimes trigger hesitation. Any plan sponsor concerns should be addressed during the initial selection process and subsequent plan reviews, but the question is: How do you, as an advisor, address these concerns with your plan sponsor clients?

Money market funds in plan sponsor retirement plans

New York Life fields a fair amount of inquiries from plan advisors whose clients are evaluating stable value funds versus money market funds, especially when there is an uptick in interest rates. Some advisors believe there may be potential for money market funds to provide yields that are higher than the crediting rates of stable value funds. While money market funds are more sensitive to changes in interest rates in the short term, stable value funds, particularly those with a shorter duration in the investment portfolio, do not typically lag very far behind. Money market funds are permitted to invest only in certain low risk, ultra-short duration and highly liquid instruments. Historically, over full market cycles, stable value funds have significantly outperformed money market funds.[1] Long-term outperformance, coupled with an attractive guarantee of principal and accumulated interest can be seen as a significant benefit of stable value funds, over money market funds.

However, not all plans are created in the same mold, and if, for whatever reason, the plan's demographics are focused solely on the short-term, then money market funds could be a strong consideration. For example, if a plan anticipates the need for substantial liquidity due to a merger with another plan or even a re-enrollment implementation, then money market funds are likely a better choice in these scenarios. However, most retirement plans are built for, and focused on, the long-term and the selected capital preservation option should deliver strong, long-term results. A well-rounded list of plan investment options can be enhanced when a stable value fund is added to the list.

Stable Value, Prudently Speaking

With an eye towards a prudent and well documented process, let's get into the review process for stable value options. This is where the insurance and investment terminology almost take on their own unique language and can become very nuanced to plan fiduciaries. To simplify, below is a list of three broad topics for every plan fiduciary to consider when selecting and subsequently monitoring stable value options:

1. What are you buying, and from whom? Unlike the old days, choice here matters. The stable value market experienced a lot of fear and a flight to quality in the aftermath of the 2008 financial crisis, and clients wanted to know: Who exactly is our stable value fund provider, what is their experience, what kind of shape are they in financially and do they offer a direct guarantee to the plan? Transparency is key here. Is there a minimum guaranteed rate? Plan advisors should be clear about the roles of "issuer", "guarantor', "wrapper", "investment manager" and "insurer". These roles become increasingly important during market crisis events, and periods of rising interest rates – or in short – when insurance is needed the most. What are the insurer's financial strength ratings? How do the ratings agencies determine the financial strength of insurance companies and how does this relate to their ability to back their guarantees? What is the organizational structure of the issuer of the insurance contract? What is the capital surplus of the insurer?
2. Who is managing the underlying investment portfolio? What is their experience as an investment manager of a stable value fund? What is the portfolio's sector allocation and credit quality? Keep in mind that portfolio holdings that show Guaranteed Interest Contracts ("GICs") or Synthetic Investment Contracts ("SICs") provide very little transparency to the investment process. Duration – how far out on the yield curve are they managing the portfolio and how does this relate to the contract terms? What is the crediting rate? While the crediting rate is very important (if it wasn't then all plans would use money market funds), it should be only one part of the evaluation process. Where is the portfolio yield coming from?When evaluating a stable value option, there should be consistency within the investment process of the underlying portfolio. What are the TOTAL investment fees and are these fees fully transparent?
3. What are the rules? Unlike most other plan investments, adding a stable value fund involves signing a contract or participation agreement which governs the client's investment in the option, pool or account. What are the termination provisions of the contract? Does it offer a 12-month put or an extended book value payout? Ideally, there should be a book value payout without a forced market value adjustment (MVA). Is the stable value fund portable and can it be transferred to a new recordkeeper if needed? What are the restrictions and how might they affect the plan sponsor and/or the plan participants under a variety of circumstances?

Recordkeeping Offsets

There may be advantages to using a particular capital preservation option if it can reduce the recordkeeping expenses charged to a plan sponsor. However, do not overlook how those reduced charges may affect the rates of return provided by that particular capital preservation option. Lastly, always confirm how the plan sponsor's recordkeeping expenses might change (increase) if that particular capital preservation option is terminated, for any reason.

Summary

Stable value capital preservation funds have historically provided plan participants with consistent and competitive returns. But every stable value provider has its own unique approach. Understanding the intricacies of the various structures, and the risks associated with these structures is vital when making fund choices. As with all plan funds, the due diligence process should never be a "once and done" task. Periodic, well-documented reviews of the entire plan line-up must be a part of the plan's overall investment monitoring process. Developing, maintaining and following rigorous due diligence procedures along with clear documentation can help to protect a plan's investment strategy for its participants' investments and ensure that plan fiduciary obligations are being met.

Today most people save for retirement for a long time and having choices is one of life's greatest gifts. Best wishes in helping your clients make the right capital preservation investment choice for their plan!

Ready to discuss stable value options with your clients in more detail? Contact your New York Life representative or visit us at stablevalueinvestments.com.

NATIONAL DIRECTOR
Kevin T. Mansfield, Corporate Vice President
kevin_mansfield@newyorklife.com
973.830.7983

EAST
Glenn Macdonald, CFP®, Corporate Vice President
glenn_macdonald@mewyorklife.com
617.771.2549

WEST
Deborah Vince, Corporate Vice President
deborah_vince@newyorklife.com
562.533.3013

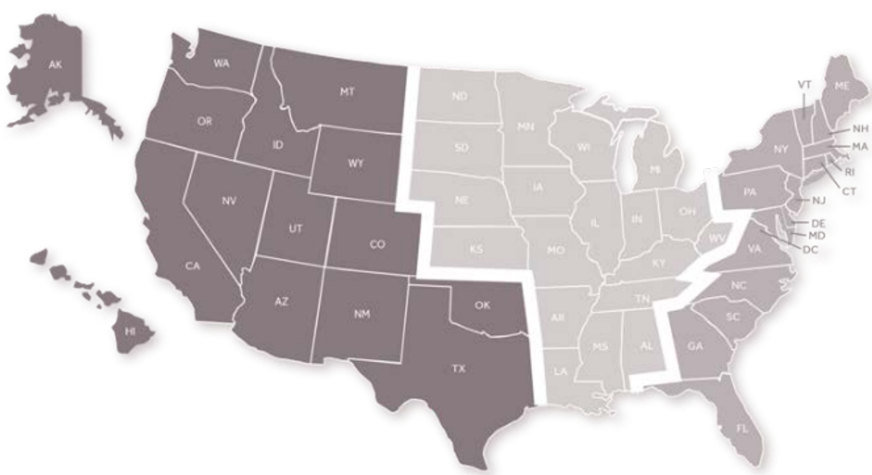
MIDWEST
Fred Spreen, Corporate Vice President
frederick_spreen @newyorklife.com
732.614.7847

KEY ACCOUNTS & RELATIONSHIP MANAGEMENT
Brian Sullivan, Corporate Vice President
brian_j_sullivan@newyorklife.com
617.610.5757

RELATIONSHIP MANAGEMENT
Amanda Savini, CMFC®, Senior Associate
Amanda_savini@newyorklife.com
781.251.2164

MARKETING
Rosanne Dolan, RPA, Corporate Vice President
rosanne_m_dolan@newyorklife.com
201.685.6199

BUSINESS CONSULTANT
Edward Kaminski, CIMA®, Senior Associate
edward_kaminski@newyorklife.com
201.685.6378



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[1]Stable Value Investment Association, Stable Value at a Glance, 3/31/20, www.stablevalue.org.

Stable Value Investments
New York Life Insurance Company
30 Hudson Street, Jersey City, NJ 07302
stablevalueinvestments.com

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