Understanding stable value funds is no easy task. There are Guaranteed Interest Contracts (GICs), Synthetic GICS, General Account products, Collective Investment Trusts (CITs), Separate Account products, pooled, non-pooled, and custom funds. It’s no wonder many plan sponsors and their advisors might not understand the differences between them, how to compare/review them, and how to determine what fund is best for their plan. It is the intention of this paper to help industry professionals understand the inner workings of stable value funds by deconstructing two of the most common structures; Multi-Wrap and Single-Wrap products, and to challenge a long standing, generally accepted research norm, that may surprise many investment analysts.

Let’s start off by stating the obvious - plan sponsors and their advisors choose stable value funds to provide a safe haven for plan assets. Stable value funds are a popular choice due to their risk profile, historical performance vs. money markets and long-term performance results. Currently, there is no industry standard performance benchmark, and while comparison tools are emerging, it can be a challenge to review this asset class. From a review perspective, this may be why many believe that it is one of the most underserved asset classes - even though stable value is offered in approximately 75% of all defined contribution (DC) plans. Hence, the need for more clarity and attention to this asset class moving forward.

To provide some perspective, I looked at the most difficult period for stable value funds, the 2008-2009 financial crisis. For the first time in more than 20 years, many funds shut down, others stopped taking in assets, some had to be shored up with TARP money, and some continued to function as normal. Examining this period may give us some important insight should this happen again and how plan fiduciaries can best protect themselves from possible losses and potential lawsuits in the future.

My research started with fund closures. Why did they close? Funds that closed, experienced something that could happen to any stable value fund. The loss of wrap contracts. Without wrap contracts, a stable value fund loses the ability to offer a stable Net Asset Value (NAV), and in effect, becomes a floating NAV fixed income fund. The financial crisis prompted more than a few wrap providers to exit the business, which reduced the wrap capacity industry wide. This made it more difficult to replace a wrap provider, and ultimately forced some funds to close and other funds moved to cash in order to maintain a stable NAV. As wrap capacity shrank, prices rose, and portfolio provisions became stricter. Fortunately, the US government stepped in with the TARP program, allowing financial institutions to make stable value fund investors whole. After the financial crisis, the government stated that there will be no TARP the next time around and financial institutions will be allowed to fail. So how will this affect stable value funds if there is another 2008-like financial crisis? Here’s where it gets interesting...

Let’s say, like in 2008, the markets go into a tailspin due to an unforeseen event and a recessionary economy is upon us. Earnings tumble, consumer confidence erodes, layoffs occur, unemployment rises, consumer and capital expenditure spending slows dramatically and a flight to quality follows. The corporate bond market crashes and the credit crunch ensues. Bonds get downgraded from investment grade to non-investment grade. Investment managers of mutual funds, pensions, foundations and endowments would likely force the sale of investments that no longer meet the investment guidelines set forth in the fund’s Investment Policy Statement (IPS), which would cause further price deterioration.

Just like other investment managers, stable value portfolio managers have investment guidelines. They also have wrap contract agreements that contain portfolio requirements (covenants) that can force the sale of downgraded non-investment grade securities or face the consequence of losing wrap coverage. These are called “walk provisions” and allow a wrap provider to sever the wrap relationship if the provisions are no longer being met. So even if a fund wanted to hold on to downgraded securities, it may not be allowed to, based upon the contractual language within the wrap coverage agreement.
This scenario would result in significant realized losses, which would hurt the market value and crediting rate of the portfolio. Things can get worse from here; if wrap providers pull out of the wrap coverage business, funds could have difficulty finding replacement wrap coverage in order to maintain the stable NAV. If wrap capacity diminishes, then the cost of wrap coverage increases; this could lead to stricter portfolio guidelines and would ultimately have a negative effect on returns. If wrap coverage is not available, a fund would have to invest its uncovered assets in cash in order to maintain a stable NAV until wrap coverage becomes available or even close the fund. These scenarios actually did occur in 2009. Now here is where it gets really interesting: if TARP2 does not occur, as promised by the government, then this is where fund structure comes into play. If a stable value fund is forced to close due to a lack of wrap coverage and there is no TARP2, then what happens next? Let’s take a closer look at the two wrap structures available today:

**MULTI-WRAP STRUCTURE**  
*(Commingled or Pooled Collective Trusts)*

Many investment analysts have favored the multiple wrap structured stable value funds for two main reasons:
- Diversification of insurance wrap providers equates to less credit risk.
- Assets are held in trust on behalf of the plan sponsor.

While this has mostly been a successful structure and the points above have merit, without a TARP2, this structure presents some very serious issues and questions for plan sponsors:
- The closure of a fund with a market value of less than 100% means potentially taking a loss in a capital preservation fund if the fund has sold its holdings, as this structure offers no guarantee. Should a plan sponsor want to make participants whole to avoid litigation, how would this contribution be labeled on Form 5500?
- If the fund has not sold its holdings, securities will be placed in the trust account and distributed in-kind to the plan. What would a plan sponsor do with a portfolio of downgraded securities? Who would manage it? How would it be distributed to participants?
- The lack of transparency of the wrap contracts and their "walk provisions" present a due diligence process problem.

**SINGLE WRAP STRUCTURE**  
*(Commingled or Pooled Separate Account)*

Investment analysts have felt that this structure is less attractive due to:
- Single insurance company credit risk.
- Assets are owned by the issuing insurance company and invested in a pooled account.
- Plan sponsor receives a "promise to pay" vs. assets held in a trust.

While these points have merit, and are far more dependent upon the financial strength ratings of the insurer providing the guarantee, this structure has some distinct advantages, especially in a 2008-like credit crisis scenario:
- Greater control, flexibility and transparency of the wrap agreement.
- Greater control, flexibility, familiarity and transparency of the investment process.
- Generally lower fees.
- A guarantee against loss of principal and accrued interest.

**CONCLUSION**

Fiduciary concerns are present here. Mitigation of loss is the hallmark of capital preservation funds and the Multi-Wrap structure has greater potential risk of loss because it provides no guarantee of principal vs. a highly rated insurance company Separate Account product - especially during a financial crisis like 2008-2009. If a plan sponsor doesn’t have access to review “walk provisions” in the wrap contracts, then it is impossible for an investment committee or a plan fiduciary to conduct a prudent review of the stable value fund. Furthermore, in the event of a stable value fund closure - due to a loss of wrap coverage - there is no clear course of action for plan sponsors and a door may be left open for litigation. This point is further strengthened given the historical data available regarding performance history, risk profiles, fees, fund failures, fund closings and soft-closings.

As a result of my research, I believe the single wrap commingled separate account structure, issued by a highly rated insurance company is more attractive than a Multi-Wrap structure. However, advisors and their plan sponsor clients must carefully assess their own needs and determine which structure is most suitable 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.

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1SVIA 3Q2020 Stable Value Quarterly Characteristics Survey.