

# Stable Value: Not all Funds are Created Equal

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## Risk Mitigation

Mitigating risk for plan fiduciaries adds value to your relationships. The more risk you can mitigate, the more value you add in the eyes of your client, especially C-Suite leaders. Products that minimize investment volatility, provide attractive returns and solid guarantees would weigh heavy on the scale of importance for any fiduciary.

## Understanding Fund Structure: What is Important & Why?

### Guarantees

Read your fact sheets and product guides carefully. Investment products with embedded guarantees resonate with many plan participants. A portfolio that invests in guaranteed and non-guaranteed investments is not a guarantee unless it states it in writing. Synthetic wrap funds clearly state in their disclosures that there is no guarantee, and that money can be lost. Does this scare participants away from investing in these funds? Does your participant education program address this topic directly or breeze through it and allude to a guarantee? Funds that carry a guarantee are offered through insurance companies and require a contract that states the terms of the guarantee. The financial strength of insurance companies is rated by Moody's, S&P, A.M. Best and Fitch. The optimal scenario would be to select the insurer with the highest financial strength rating offering the highest crediting rate, but there are several other factors to also consider when selecting a stable value solution.

### Portfolio

It is important to understand how a fund is allocating assets and why. In the current interest rate environment, there are differences between portfolios that need to be taken into consideration. A fund's duration directly impacts a manager's ability to raise capital for liquidations, put new capital to work, and manage the inverse relationship between price and yield for fixed income securities. In a normal interest rate environment, with an upward sloping yield curve, lower duration generally means lower yielding securities. Compared with higher duration funds, lower duration portfolios have greater cash flows from maturing securities and allow managers to track the prevailing rate environment more quickly. A lower duration portfolio will also see less price fluctuation (market value) than a higher duration portfolio (although stable value funds provide participants with some insulation from market value fluctuations). Examining a manager's performance over many interest rate cycles will provide insight to how a particular manager enters and exits the different cycles. Reviewing the management of allocations to the different types of fixed income securities also has an impact on the overall performance, as well as a security's credit rating and its yield over comparable treasury securities. A manager's ability to effectively manage these risks over the long term, while maintaining an attractive rate of return vs. money market rates is what makes stable value an attractive investment for plan participants who seek capital preservation. When doing your due diligence, it is helpful to have access to the underlying securities in the portfolio as well as the market value performance, if available. Knowing the individual issuers of securities held in any portfolio allows for an increased level of due diligence.



## Fees

Today's fiduciary environment has made investment fees a major focal point for litigation. Due to the various structures of capital preservation products, the task of benchmarking fees has not been simple or straightforward. While it has improved, there is still work to do. The majority of capital preservation products fall into either insurance separate accounts, synthetic wrap accounts or money market funds. General account products offered by insurance companies are usually structured as declared rate products with no set fee on assets but are still widely used by 403b, 457 and Taft-Hartley plans.<sup>1</sup> Crediting rates for general account products can be higher than synthetics, and separate accounts due to the nature of the general account product structure. General account investments tend to be longer duration than other funds, which can lead to longer discontinuance provisions for these funds.

When examining fees, you may find management fees, wrap contract fees, trustee fees, and various other fees. Calculating fees can be somewhat challenging because each fund breaks out their fees differently. All of the fees are disclosed, but the task requires research and a final comparison to the stated net return figures to ensure accuracy. Evaluating these additional fees has become more of a focus for plan consultants recently, as scrutiny of proprietary investments has increased. Historically, justification for these fees was the diversification of insurance wrap provider risk, but with a lack of insurance wrap failures and solid historical performance, insurance separate accounts from highly rated insurers have become more popular.

## Performance

Benchmarking performance for capital preservation products has proven to be difficult for plan sponsors and consultants, due to the multiple product structures and lack of an industry standard benchmark. Money market funds were the most popular capital preservation option prior to 2008 because of their simple structure and consistent returns. However, money market funds experienced liquidity issues during the financial crisis in 2008. A number of funds were forced to inject cash to maintain the \$1 Net Asset Value (NAV) and one popular fund "broke the buck" due to the Lehman Brothers bankruptcy. This led to money market reform, which was implemented in 2016.

Stable value funds also faced challenges during the 2008 crisis. During this time, wrap capacity shrank at a time when there was increased demand. Some funds closed, while others stopped taking in new money, and others had to inject cash to shore up. Some insurance companies and banks participated in The Troubled Asset Relief Program (TARP), while others remained financially sound. In general, money market fund performance has lagged since, compared to stable value funds, but still remain a popular option due to the simplicity of their structure.

When evaluating performance, it is important to look at past performance, current performance, and portfolio positioning for future performance. Capital preservation funds with higher or lower than average crediting rates are usually higher or lower for a reason. Duration, credit quality of the underlying assets, discontinuance provisions, fees and market value vs. book value ratios all need to be taken into consideration. Reviewing fees, contract limitations, duration, and asset credit quality should help determine the reason why a crediting rate is higher or lower than average.

## Liquidity

Weighing the liquidity provisions/discontinuance provisions/exit provisions can also be difficult. Understanding the risks and consequences of each are important because they require forethought and an understanding of the employee culture and demographics. While no one can predict the future, it is the job of the plan fiduciaries to plan for both the expected and unexpected events at both a plan-level and participant level. Evaluating how assets are treated for exchanges, distributions, and plan-level events/decisions can save time and potential problems. Most stable value funds are benefit responsive for participant transactions; allowing distributions at book value and fund transfers with limits for competing investment options. However, plan level actions—like selling the fund—can differ greatly, triggering provisions that could yield a loss. This can occur when a stable value fund's market value is less than its book value and the discontinuance provision allows for plan-level distributions at market value only. Most insurance company general account products offer book value discontinuance provisions that liquidate in installments over a number of years. Generally, insurance company separate account products allow for plan level liquidation at book value within 12 months, while both synthetic and separate account wrap funds' liquidity at book value provisions generally range from 12–24 months.

Other liquidity concerns may result from various events that cause participant withdrawals. Stable value funds address this concern in different ways, but many of them include a "corridor" provision, that allows for some level of withdrawals up to the "corridor" limit. These corridor provisions are important and can vary greatly by product. Corridor provisions are put in

place to protect the current clients that are invested in the fund from major corporate events that could affect all contractholders. For example: a \$400MM fund has 100 plans and three of those plans represent 30% of total assets; what might happen to that fund if one plan goes bankrupt and the other two plans decide to exit all at once?

Another standard provision is commonly called an “equity wash” when competing funds are present. While this provision can be completely avoided through careful fund selection, many times plan sponsors and/or consultants may include an investment option that falls under the competing fund rule, which triggers the 90-day equity wash provision. A careful evaluation of what is considered a competing fund definition should always be a part of the liquidity review process.

Researching these provisions and discussing them with a plan sponsor during the review process can save time and money in regard to corporate decisions and considerations that may not be initially apparent.

## Transparency

Generally, the benefits of government money market funds have been their transparent nature, simplicity of the underlying investment portfolio and ease of participant understanding.

Stable value funds are not as transparent but can still be explained and understood. Plan fiduciaries want access to review the investment manager, performance history, and underlying investment portfolio in order to evaluate risk, duration, sector allocation, as well as other significant data. Access to wrap contracts and market value performance may be difficult, but can give deeper insight to investment guidelines, limitations and other important information that all fiduciaries should be reviewing.

## Portability

In the past, stable value funds were often a proprietary investment option that was offered by the recordkeeper, but times have changed and there is far more portability in the industry today. Reviewing portability options can be important for clients who are growing and changing. Companies divest, merge, get purchased, grow and shrink. Understanding a company’s corporate vision and culture can play an important role in choosing a stable value fund, regardless of the recordkeeping platform they are using.

## Educating Plan Participants: Keep it Simple

A plan fiduciary is expected to protect participants by meeting their expectations for each fund that is placed in the investment lineup of a plan. In the case of stable value funds, there is rarely a choice for participants and in some cases, it’s a proprietary product that may have been inherited with the relationship. Many participants see one thing and expect one thing in a capital preservation product. They see interest crediting rates and expect a guaranteed return; contributions in and a steady, predictable, return. Most participants understand how CDs and money market funds work. It is essential to explain products to participants accurately. If it is guaranteed, make sure they understand the source and nature of the guarantee. If it is not guaranteed, do not breach a fiduciary responsibility by misleading participants.

## Educating Plan Sponsors: Documentation, Evaluation, Discussion, Recommendation

When meeting with plan sponsors and fiduciaries to discuss capital preservation options for their plans, add value by taking the time to discuss why an option may meet the needs of their employee demographics and corporate culture. Some plan sponsors have never performed a thorough review process for this asset class, so providing education on the various nuances will be valuable and help secure your relationship as a trusted advisor.

**For plan advisors seeking new relationships, try using capital preservation investment reviews as a conversation starter. Preparation, content and delivery make all the difference to clients seeking new relationships.**

1. These types of retirement plans are defined under the Internal Revenue Code Sections 403(b), 457 and 414.

The stable value option seeks capital preservation, but there can be no assurance that this goal will be achieved. Returns will fluctuate with interest rates and market conditions. All investing involves risk, including the loss of principal.

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