Potential Challenges of Proprietary Stable Value Funds

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Over the past several years, recordkeepers have become more focused on capturing stable value assets for their own proprietary stable value funds. Before this change in focus, the industry generally pursued "open architecture," but stable value funds were not always included. In 2016, many thought the industry was going to undergo a major shift with the implementation of the DOL Fiduciary Rule, but that regulation never quite made it to the finish line. In 2018, it was vacated and officially struck down by the U.S. Fifth Circuit Court of Appeals.[1] The rule's death opened the door for recordkeepers wanting to map assets to their proprietary funds, especially stable value, by offering better pricing. As a result, plan participants receive lower stable value fund crediting rates in exchange for offsetting plan administration fees.

While many industry professionals question this practice and debate its ultimate fairness to plan participants invested in stable value funds, there has been no legal action to date. We advise plan sponsors and plan advisors to carefully consider the efficacy of proprietary stable value funds for the reasons outlined below.

Investment Portfolio Transparency

Most proprietary stable value funds are insurance company general account contracts with little to no transparency with respect to the composition of the underlying investment portfolio. Some refer to these as "black boxes." While these general account stable value funds do have a place in retirement plans, we believe that it is vital to carefully evaluate whether this type of product is a good fit for a retirement plan. Depending on its structure, a stable value fund is not necessarily a good fit for all plans. For example, many general account stable value funds that are used in 403(b) plans offer a 1% guaranteed minimum investment return (GMIR), whereas stable value fund structures available to other types of plans may have GMIR that is as low as zero. Also, due to the lack of transparency, general account stable value funds may be more challenging to analyze from a due diligence perspective. For the most part, a stable value fund is evaluated on the basis of the financial strength of the issuer that guarantees the fund, because information about fees, duration, asset allocation, and other details about underlying portfolio holdings are very often not disclosed. That said, general account contracts are very easy to understand and are often a core holding in the investment portfolios of many collective investment trust stable value funds.

Fee Transparency

Some proprietary stable value funds make the claim that there are no fees associated with the fund. We do not believe this is completely accurate, because the "spread" structure allows these funds to operate on a net basis. A separate fee is not disclosed because it is absorbed into the spread. The inability to clearly determine actual fees can make it difficult for advisors and plan sponsors to review, compare and present an accurate review or a meaningful comparison of contracts issued by different insurers. Additionally, with the use of undisclosed revenue sharing generated from proprietary stable value funds, performance can be quite skewed. I often refer to this scenario as the "Reverse Robinhood Effect" because the money used to offset plan sponsor fees is "paid" by plan participants via reduced returns. So, the plan sponsor and the plan participants that do not invest in the proprietary stable value fund, benefit from the plan participants that do invest in the fund.

Remember, there is no free lunch! We recommend that you always ask your recordkeeper for pricing both with and without the proprietary stable value fund in place.

Recordkeeper Pricing

Another potential pitfall to a recordkeeper pricing strategy that relies on undisclosed revenue sharing to offset administrative fees. In a low interest rate environment, plan administration fees may rise for plan sponsors, as general account products with a 1% GMIR approach the minimum. This phenomenon could potentially reduce the "spread" and impact the profit margin for recordkeeping services, which in turn, could lead to rising fees for both plan sponsors and participants. In a rising rate environment, spread revenue can potentially increase or meet target, which would have an affect on the book value of the portfolio but not necessarily administrative fees.

Portability & Liquidity

Very few proprietary stable value funds offer the benefit of portability. They are proprietary, and it could be difficult and/or costly to change recordkeepers, depending upon the liquidity provisions that are in place. Depending on the interest rate environment, some proprietary general account stable value funds have up to a ten year "crawl out" exit provision, but most are less than five years. In cases where terminating a stable value fund contract is necessary (e.g. a corporate merger or acquisition), we recommend consulting with a stable value specialist to determine the best strategy for liquidating without penalties and in the most expedient manner.

Depending upon the plan type, advisors should review the stable value portability and exit provisions very carefully. For example, 457(b), 409(a), 401(a) and 401(k) plans should consider including separate account and collective trust structured funds in their evaluation process if flexible exit provisions and portability are priorities. Currently, 403(b) plans generally use only general account stable value funds, so make sure to compare the provisions of both proprietary and non-proprietary features and benefits before you walk down the aisle!

Conclusion

Stable Value is a complicated asset class with multiple structures, and each has its own pitfalls and benefits. Understand the variables and provisions that are important to plan sponsors right now, as they evaluate the capital preservation option for both their plans and their plan participants. Choosing a recordkeeper's proprietary stable value option may have been more attractive in the past but may or may not make sense in the future. We recommend that the best way for plan advisors to consider all variables and all potential scenarios, is to connect with a stable value specialist who can help guide advisors to make the best decision for their plan sponsor clients.

1. On June 29, 2020, the Department of Labor ("DOL") released a new regulatory package that included a final rule formally reinstating the 1975 five-part test for fiduciary investment advice and a proposed prohibited transaction exemption for investment advice which, if adopted, could impact retirement plans and IRAs.

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