

# Perspectives

## Assessing Stable-Value Strategies

What Plan Sponsors Should Consider

## Executive Summary

Stable value is an investment strategy that has been around for a number of decades and one that has, over time, experienced its high and lows. Overall, stable value has performed relatively well, and investors have appreciated the benefits offered through stable value: principal protection, benefit-responsiveness and liquidity. Stable value also offers consistently higher returns than money markets while taking on modestly higher amounts of interest rate and credit risk exposures. However, more recently, a changing economic climate with greater regulatory uncertainty, diminishing wrap capacity and consistently lower yields has seemingly reduced the stability and value that investors have come to expect from stable value. Plan fiduciaries face not only less stability, but also an increased governance burden. We believe that this is a time to ask tough questions about stable value, because it's important to understand the risks associated with this investment strategy. Regardless of upcoming regulatory decisions, we believe there has been a structural shift in competitive advantage away from plan sponsors and stable-value managers over to insurance providers as the investment strategy faces unique market and regulatory headwinds.

## Background

As markets unraveled after the global financial crisis began, the investment industry faced enormous pressures to revisit the regulation of a number of established investment strategies and securities. The stable-value investment strategy did not escape regulatory reform, specifically, the July 2010 passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). This paper discusses the challenges and potential implications that Dodd-Frank may have on the stable-value market, stable-value market alternatives and ideas for plan sponsors to consider.

Stable value has been a popular investment option in defined contribution (DC) plans for many years. Participants have appreciated the principal preservation, benefit responsiveness, liquidity and

consistently higher returns compared with money market options with a similar risk profile. The popularity and perceived security of stable-value strategies prompted investors to allocate more than \$500 billion,\* or roughly 10% of all DC assets,\*\* into the strategy. From a high-level perspective, stable value is an investment strategy that has performed well throughout the credit crisis when compared to other strategies. However, investors should be aware of a few notable changes brought to the fore by a combination of its underlying structure and recent economic and market stress: limited wrap capacity, tighter investment guidelines, higher fees and the potential for an increasing interest rate scenario, to name just a few.

More importantly, plan sponsors should educate themselves about the type of events that may trigger a violation of the wrap agreements and cause a potential market-value adjustment, such as a workforce reduction or the addition of a competing option (money market or self-directed brokerage option) within the DC plan. Wrap insurers are spending more time on making sure their exposures are limited and paying greater attention to their exposure to potential risk. As a plan sponsor fiduciary, it's not only important to understand the structure of stable value, such as the underlying investment strategies, but also the wrap issuer market and covenants in place with the wrap insurer. During and after the credit crisis, many investors found out that the stable-value investment option is one that deserves greater attention, and as a plan fiduciary, one must decide how much governance budget should be dedicated to stable value.

Prior to the global financial crisis, wrap capacity was abundant, and the market supply of wrap insurance contracts greatly exceeded demand. The imbalance drove wrap fees all the way down into single-digit territory as many wrap providers appeared willing to insure a wide variety of plans and asset classes without much regard for potential risks. This really created an advantageous scenario for investors: low fees, solid yields/returns and a high degree of perceived security.

\*"Plan Sponsors Taking More Nuanced View of Stable Value," Randy Myers, <http://stablevalue.org/wp-content/uploads/2011/07/Stable-Times-Vol15-No1.pdf>

\*\*The U.S. Retirement Market, First Quarter 2011, Investment Company Institute [http://www.ici.org/pressroom/news/ret\\_11\\_q1](http://www.ici.org/pressroom/news/ret_11_q1)

## After the Global Financial Crisis

When the global financial crisis struck and credit spreads on fixed-income securities widened out to historic levels, market-to-book ratios for many stable-value portfolios slumped well below 100%. The combination of underperforming fixed-income portfolios with the mispricing of credit insurance (where there were minimal levels of capital required to back the insured credit positions), along with greater capital requirements and elevated market volatility, led many wrap providers to reassess whether or not they were willing to continue to take on the embedded risks involved in stable value for the relatively small premium they were receiving. Their role of insuring the difference between the market-to-book value of a plan made wrap providers increasingly concerned that the probability of having to step in to provide capital was rising rapidly. While the spread differential that the insurer is responsible for may be small in some cases, this is not a part of the business to which many insurers would like to dedicate capital resources. While many stable-value managers note that the number of times that a wrap provider has had to step in to provide capital is low, that number and the amount paid out over time are not known because of the lack of transparency in the stable-value world.

The credit crisis started a call for regulatory reform, and the introduction of Basel III and Dodd-Frank prompted wrap providers, specifically bank wrap providers, to reconsider insuring stable-value portfolios, historically dominated by insurance companies.

Dodd-Frank is a wide-ranging law that could affect stable value because it will define whether or not stable-value wrap contracts should be included within the definition of a swap security. This is a concern throughout the stable-value market since Dodd-Frank could be very harmful to the future of the stable-value industry. Reform could include capital and margin requirements for banks' swap transactions as well

as new clearing and reporting requirements. If stable-value contracts were to fall under this definition, the additional requirements may deter certain wrap providers from issuing new wrap capacity, which would put even greater pressure on a market that is trying to cope with an already-limited supply of insurance wrap capacity. However, regulators may also decide to exclude stable-value wrap contracts from consideration under the definition of a swap. Fortunately, future regulations would not retroactively apply to existing contracts. A study is currently being conducted by the Commodity Futures Trading Commission and the Securities and Exchange Commission (SEC).

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Under proposed regulations, insurance companies would not fall under the strict definitions mandated for banks. It is rumored that the proposed regulations may have forced the hand of a few bank wrap issuers to wind down their wrap insurance exposure in an orderly fashion. As a few banks began to exit the wrap business, a number of insurers decided to reenter the market. Unfortunately, the amount of new wrap capacity coming into the market cannot match the amount that is exiting. Insurance companies entering the market are charging double, or even triple, the fees they charged prior to the credit crisis. With the high demands being placed on wrap issuance, many insurers identified an opportunity to require providers to use their asset management services as part of the stable-value program in order to gain access to wrap capacity.

## Looking forward

As an investment strategy, stable value has performed relatively well over the years when compared with its most common competing investment, money market strategies. Stable value's consistent out-performance is largely due to the ability to position underlying investments farther out on the yield curve than is allowed for in a money market strategy. A comparison of the three-year Treasury rate and the three-month Treasury rate indicates that the yield curve has been positively sloped 90% of the time dating back to 1990, creating a carry advantage that benefits stable value over money market funds. Stable value has also benefited from the persistent decline of interest rates over the past two decades (see figure). More recently, the steepness of the short end of the yield curve has provided stable-value structures with a yield carry of more than 2% per annum, according to the Towers Watson quarterly stable-value questionnaire.

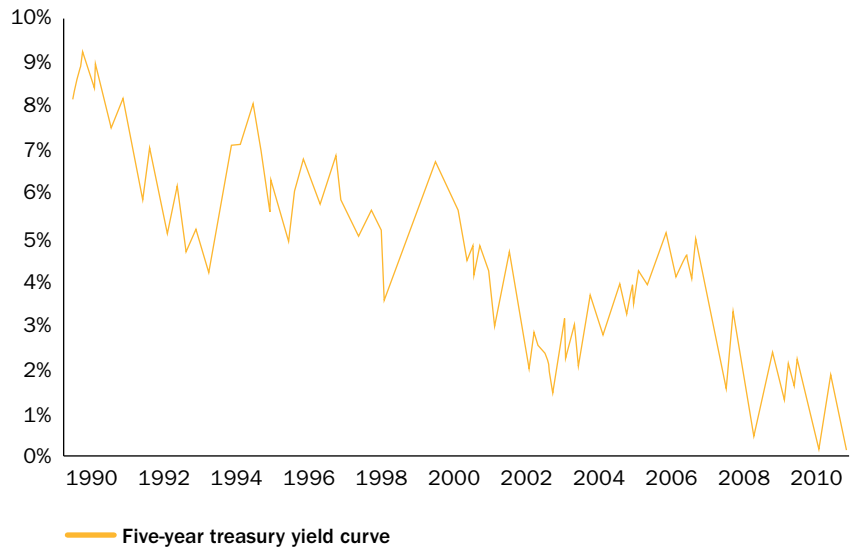
While stable value is currently enjoying a comfortable spread over money market yields, there is concern over maintaining this advantage when interest rates rise. Some market participants (and especially wrap insurers) question whether actively managed stable-value portfolios will be able to manage the lag time experienced when short-end rates rise and money markets outperform stable value. This is a core reason why many wrap insurers have introduced and paid close attention to tighter investment guidelines and competing fund options.

It is difficult to predict how long money market rates might outpace stable-value rates and whether stable-value participants that have the flexibility to move assets will decide to remove funds from their company plans into third-party accounts. Considering these questions may help:

- Are you affected by other companies and plans in a pooled fund, or do you only have to worry about your own plan demographics in a separate account?
- What would it take for stable-value participants to take advantage of the yield arbitrage that presents itself in stable value versus money market funds when rates rise above crediting rates?
- Would that arbitrage opportunity be long lasting or would it be short lived?

Of course, this last scenario would be especially troublesome if market-to-book ratios were to fall below 100% during a time when nonactive participants began pulling their money out at book value. In this

## Historical interest rates (Jan. 1, 1990 – Aug. 31, 2011)



Source: <http://www.treasury.gov/resource-center/data-chart-center/interest-rates/pages/textview.aspx?data=yield>

particular instance, active participants would be subsidizing nonactive participants at the expense of future crediting rates because nonactive participants' withdrawals would be at book value. Book-value withdrawals would continue to put downward pressure on the market-to-book ratio, forcing it further below par. This is the core reason why stable-value wrap issuers have paid greater attention to the definition of competing funds, plan demographics and the equity wash rule included in wrap covenants. Wrap contract regulations seek to limit the ability to time interest rate movements by moving quickly between asset classes to realize inherent advantages, especially those between stable-value and money market funds if both are offered within an investment lineup.

Ultimately, stable value does have some attractive features valued by participants, but they come with a price. Risks include those already mentioned as well as investment risks such as counterparty, term, credit and liquidity (at the plan level). These risks are exacerbated by:

- Complexity
- Lack of standardization
- Less-than-ideal transparency
- Changing markets prompted by uncertainty over Dodd-Frank, swap legislation, diminishing capacity and evolution of the wrap market, and the reality of higher wrap fees and lower yields

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In some cases, the time spent on stable-value options has rivaled more esoteric alternative investment strategies. In the future, we expect the industry to evolve, with diminishing terms of trade for participants — lower-risk investment portfolios, higher wrap fees, and perhaps fewer and different wrap providers than exist today.

Alternative investment opportunities to stable value often include a money market fund or a short-duration investment grade portfolio. Money market funds are investment funds with the desired objective to earn interest for shareholders while maintaining a net asset value (NAV) of \$1 per share. Portfolios are comprised of short-term (less than 13 months) securities representing high-quality, liquid debt and monetary instruments. Money market funds are more responsive to changes in market interest rates and react much more quickly to rises in interest rates from a yield perspective than what an investor would experience with a stable-value fund. A stable-value fund often lags interest rate movements (hence the concern over risks from rising rates discussed earlier). Money market funds are similar to stable-value funds, although there is no absolute guarantee of principal, and they are not a riskless investment option nor guaranteed by the Federal Deposit Insurance Corp.

The history of money market 2a-7 funds during the crisis is fairly well known. The trouble began with the Lehman Brothers bankruptcy in the fall of 2008, when the well-respected money market fund, the Prime Reserve Fund, was forced to “break the buck” and fell below \$1 a share. Shortly thereafter, the U.S. Treasury put the Temporary Liquidity Guarantee Program (TLGP) in place. TLGP has since expired, but in January 2010, the SEC implemented much more stringent regulations for credit quality, liquidity and maturity requirements.

Although money market funds have much stricter investment requirements, concern has been raised about risks within this industry. The SEC held a roundtable on May 10, 2011, where major proposed changes to the money market industry were

discussed. Some of the items discussed were the potential for a floating NAV, a self-funded industry-wide liquidity bank and capital buffers provided by the fund sponsor for its respective money market funds. There appears to be an expectation in the market that there will be further money market regulation in the coming quarters.

Another potential replacement option for a stable-value fund would be a short-term bond fund — an investment fund with the objective to provide current income with limited price volatility. Short-duration strategies are often comprised of short-term, high-quality corporate, government and agency bonds with maturities typically between one and five years, and overall portfolio duration between two and four years. These funds typically hold underlying bonds that are similar to those held in a stable-value portfolio, but they do not have the same objective of providing liquidity and safety. There is no absolute guarantee of principal or stability of NAV in short-term bond funds, and market value volatility is significantly higher than with a money market fund. Short-term bond funds are also more responsive to interest rate movements than stable value, but less responsive than money market.



## Next steps

With all these developments within the capital preservation investment strategy, the question that plan sponsors may be asking is: “What should we be doing?” Towers Watson has been discussing stable value with our clients for over two years, with an emphasis on education and the oversight of the complex structured product. As a plan sponsor fiduciary, it’s important to understand the wrap issuer market and the developments within the wrap market, as well as what risks are associated with stable value.

Plan sponsors should educate themselves on what events may trigger a violation of the wrap agreements, causing a potential market value adjustment. For example, events may include a workforce reduction or the addition of a competing option (money market or self-directed brokerage option) within a DC plan. They should also be aware of any clauses that could impair the coverage provided by wrap providers. Plan sponsors should then confirm the appropriateness of a stable-value option within the existing investment structure and affirm whether or not stable value still makes sense knowing the risks associated with the option. Finally, a plan sponsor should have access to enhanced reporting regarding the investment option during a periodic review. It should also dedicate more time during periodic investment committee meetings for stable value to ensure an appropriate level of governance is being dedicated to this investment option. Over the past two years, Towers Watson has spent a substantial amount of time with our clients helping them gain a greater understanding of both the benefits and risks associated with this investment strategy.

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