What Plan Sponsors Should Know About Stable Value Funds

Considerations regarding money market funds and stable value funds in your DC plan investment lineup.

By Robert E. Pike

PSCA Note: This article follows the publication of "Money Market Fund Reform" in the Spring 2016 edition of Defined Contribution Insights. *It is the second and final publication by PSCA around the topic of money market reform, and is provided to inform members about a popular and long-established capital preservation investment vehicle that plans may use instead of a money market fund.*

Stable value funds (SVFs) are a capital preservation vehicle only available to participants in 401(k) and other types of savings plans. They are possible as a result of the American Institute of Certified Public Accountants (AICPA) Statement of Position AAG INV-1/94-4-1, which defines a set of rules under which book value accounting may be used for investment contracts issued to defined contribution plans.

SVFs invest in a diversified portfolio of high-quality, short-to-intermediate-term bonds. They are protected from interest rate volatility by contracts issued by banks and insurance companies, which "credit" returns to a participant's account balance in a positive, steady manner so as to maintain a stable net asset value.

SVFs are generally offered in two forms: a **separate account** (for a specific large 401k plan — not to be confused with an insurance company separate account), or a **collective investment (commingled) fund** (which pools together the assets of many smaller or intermediate size plans).

SVFs are considered to be conservative, low risk options for 401(k) plans, and are most often seen as an alternative to a money market funds (MMF) as a plan's primary capital preservation option. The stable value market is currently $705 billion in size.[1]

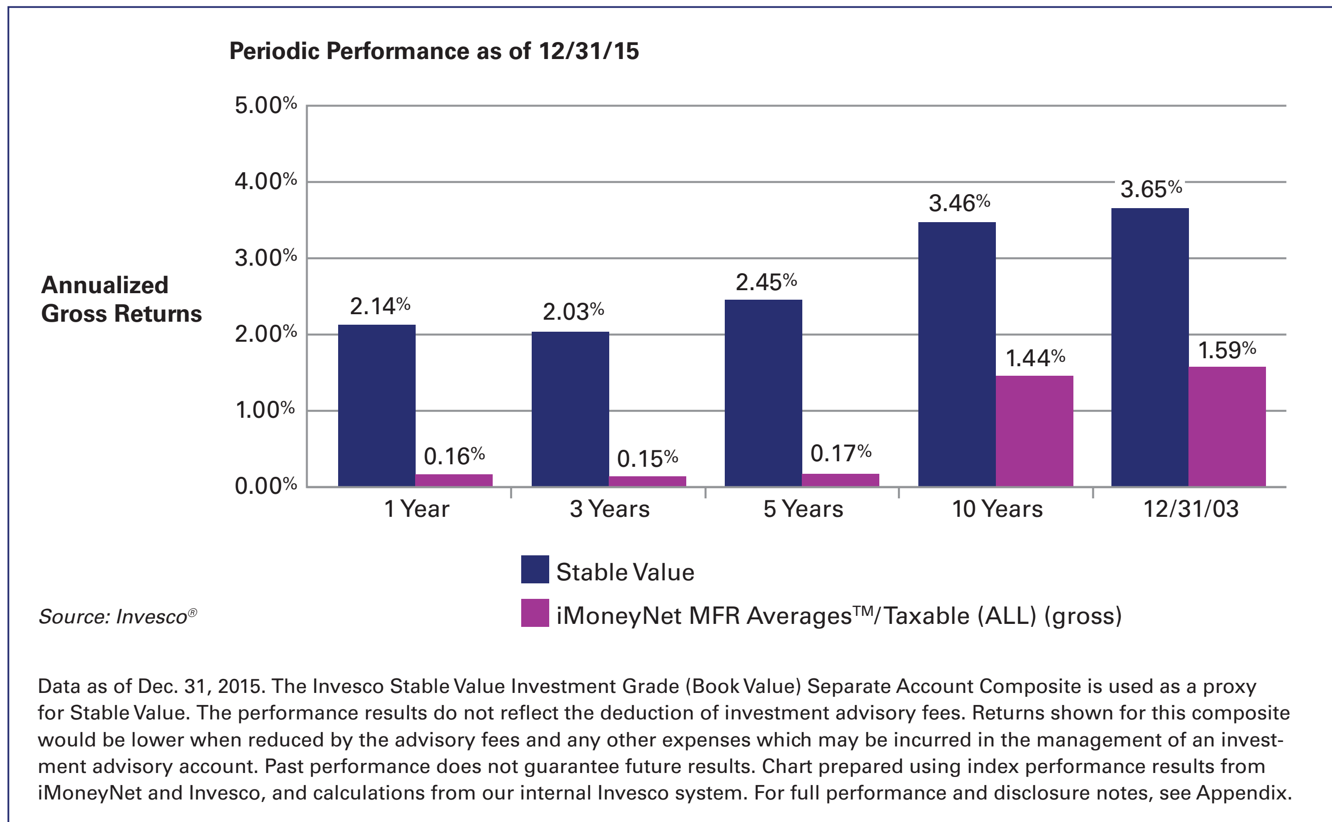
Differences Between SVF's and MMF's

SFVs differ from MMF's in three primary ways:

1. SVFs are not a Regulated Investment Company (i.e., a "RIC" or "mutual fund") like a money market fund. However, bank and insurance company contracts that fund stable value options must comply with the securities laws. When a bank provides a stable value investment structure, the Comptroller of the Currency also has regulatory authority. In the case of an insurance company, the state insurance department provides regulatory oversight.
2. A MMF has a share price which reflects the net asset value of the underlying portfolio, and it distributes income to shareholders through a "dividend" (usually monthly). A SVF has a "book" or "contract value" at which all transactions occur, which reflects the value of all assets supporting the SVF plus accrued interest by application of the crediting rate formula of the contractual protection against interest rate volatility. The crediting rate formula for the most common stable value contracts reflects both anticipated interest earned by the underlying portfolio, and an amortization of market gains and losses over the average duration of the supporting assets.
3. SVFs invest in a broad maturity range of bonds (usually between 2–10 years), and maintain an average duration between 3–7 years. MMF's can only invest in securities with less than 397 days to maturity. In normal interest rate environments (i.e., with a positive or "upward-sloping" yield curve), a SVF portfolio will therefore have a significant income advantage over a MMF. However, under the new money fund rules, the maximum weighted average portfolio maturity for a MMF was reduced from a 90 days to 60 days, which will exacerbate this "yield gap" even more.

[1] SVIA 19th Annual Stable Value Investment & Policy Survey

Exhibit: "Money Fund Reform & DC Capital Preservation Options"/Invesco/April 26, 2016



Data as of Dec. 31, 2015. The Invesco Stable Value Investment Grade (Book Value) Separate Account Composite is used as a proxy for Stable Value. The performance results do not reflect the deduction of investment advisory fees. Returns shown for this composite would be lower when reduced by the advisory fees and any other expenses which may be incurred in the management of an investment advisory account. Past performance does not guarantee future results. Chart prepared using index performance results from iMoneyNet and Invesco, and calculations from our internal Invesco system. For full performance and disclosure notes, see Appendix.

Advantages of SVFs vs. MMFs

SVFs have significantly outperformed MMFs over the last 1, 3, 5 and 10 years. See Exhibit above.

Plan sponsors are increasingly being targeted by plaintiff's attorneys who seek class action relief for alleged fiduciary breaches. Central to many of these claims is "underperformance" of a plan's investment options. Suits alleging breach of fiduciary for choosing money market over stable value have been filed against major plan sponsors.[2] Since MMFs have yielded near zero for some time (and may continue to do), there is justifiable concern that providing a MMF as a sole capital preservation option when equivalent higher-yielding funds are available may continue to invite litigation.

SVFs can provide the same participant-level liquidity as a money market fund. For withdrawals permitted by the plan, and transfers to equity or long bond funds, stable value provides the same liquidity as money market funds.

For plans with competing short bond funds or money market funds alongside stable value, there can be a requirement of a "90-day equity wash." (However, there are strong arguments that there is no investment justification for including those options when a plan offers stable value.[3])

In addition, government MMFs are allowed to impose "fees and gates" during stressful market conditions under the new money market fund rules (with proper notice). SVFs are not subject to this rule. Instead, the insurance "wrapper" provides necessary liquidity to insure full and timely redemption should a decline in the portfolio market value not be sufficient.

Due Diligence Differences In Evaluating SVFs vs. MMFs

Depending on the stable value structure, there may be a need for additional due diligence. Even the largest plans with an in-house investment staff are unlikely to find it cost-effective to get into the business of managing a stable value option. Large plans that want the economies that individually-managed plan options can provide will almost certainly want to retain a stable value manager. The criteria for selecting a manager will be similar to that for

[2] http://www.investmentnews.com/article/20160303/FREE/160309968/money-market-funds-come-under-fire-in-spate-of-401-k-suits

[3] See Paul J. Donahue, Fundamental Investment Principles of DC Option Selection Prove Optimality of Stable Value. 88 PENSION SECTIONS NEWS 15, (Pension Section of the Society of Actuaries, February, 2016)

selecting a manager for any other investment mandate: track record, firm compliance procedures, financial strength, etc.

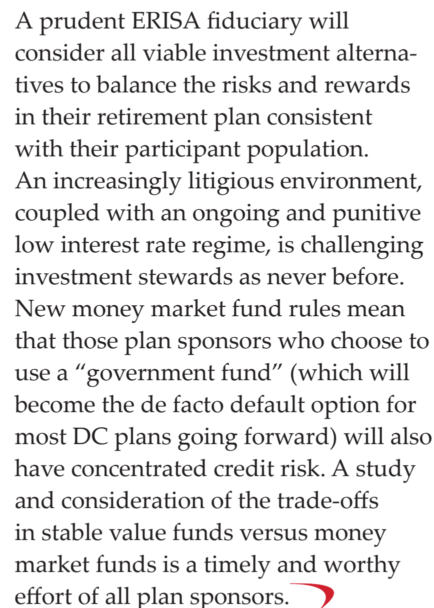
Intermediate and smaller plans will generally choose to participate in stable value collective investment trusts to gain economies of scale. Even smaller plans can benefit from the assistance of an investment advisor familiar with the different types of stable value funds and their strengths and weakness. A qualified investment advisor will not confuse what is convenient for plan sponsors with what is best for participants. For example, desired returns or the elimination of restrictions may require choosing a fund backed by a single stable value contract issuer.

It is the duty of the fiduciary choosing stable value contract protection to examine and document the financial condition of any bank or insurance company that provides a guarantee in a SVF. Generally, in a pooled fund that will be the pooled fund sponsor, plan sponsors need only concern themselves with the choice of the pooled fund. For plans that manage the option directly, they will want a copy of the latest A.M. Best ratings report, or similar credit analyses, for their fiduciary file, and any additional information they feel is relevant. (Note that many SVFs now feature multiple contract issuers, or "wrappers," to decrease their exposure to any one guarantor).

In choosing a pooled fund or in managing an individual plan stable value option, there is a need to consider the underlying portfolio and strategy of the SVF or option. Most large, sophisticated plans and pooled funds prefer to delegate asset management duties among several investment managers, to diversify style and strategy. In any case, the basic tenets of fixed income risk analysis still apply (duration, credit, yield curve, etc.), and plan sponsors and their advisors should document their analysis.

There is a need to review and understand the liquidity provisions of the SVF. Not all SVFs are the same, especially when it comes to "cashing out." Plan sponsors should understand the liquidity provisions of their particular fund. Most pooled funds offer an exit after notice at contract value, but are those provisions best for participants? The funds that offer the highest returns only allow plans to exit at the lower of book or market, which can pose transition problems for plan sponsors.

There may be an inability to offer a MMF alongside a SVF. Some providers do not allow a similar "competing fund" such as a MMF to be used in a plan's investment line-up ("competing funds clause"), or they may place trading restrictions on other similar investments (called "equity wash" rules). If a short-term bond fund is permitted, for instance, there is usually a 90-day holding period required before switching back to a SVF, to prevent disruptive short term trading. The SVF provider has the say-so on what they will allow — protection against arbitrage is key to maintaining the economic viability of stable value contracts. However, when stable value is in the line-up, a plan sponsor might consider if there is a sound investment rationale for even including a short bond or money market fund.



Conclusion

A prudent ERISA fiduciary will consider all viable investment alternatives to balance the risks and rewards in their retirement plan consistent with their participant population. An increasingly litigious environment, coupled with an ongoing and punitive low interest rate regime, is challenging investment stewards as never before. New money market fund rules mean that those plan sponsors who choose to use a "government fund" (which will become the de facto default option for most DC plans going forward) will also have concentrated credit risk. A study and consideration of the trade-offs in stable value funds versus money market funds is a timely and worthy effort of all plan sponsors.

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