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## **A Guide to Stable Value Funds for Pension Plan Sponsors and Advisors**

### **Overview**

*By Gina Mitchell (Gina@stablevalue.org), the president of the Stable Value Investment Association (SVIA), which is the voice for stable value funds, an asset class in many defined contribution plans. She leads SVIA's initiatives with policymakers and regulators, which include Congress, the Financial Accounting Standards Board, the Commodities Futures Trading Commission, the Securities and Exchange Commission and the U.S. Department of Treasury, among others, on a broad range of issues from accounting to the fundamentals of stable value.*

Stable value refers to a relatively low-risk asset class that focuses on capital preservation and liquidity, while providing steady, positive returns to participants within certain types of defined contribution plans. Stable value is available only in tax-qualified retirement savings plans, such as defined contribution plans, as well as in some tuition assistance plans. It is not available in either mutual funds or Individual Retirement Accounts (IRAs).

Stable value investment options are one of the most common capital preservation options in defined contribution plans. They are offered in more than 160,000 plans and according to SVIA's latest data, participants have invested over \$721 billion, which is 12 percent of all defined contribution plan assets.

Stable value focuses on preserving retirement plan participants' invested capital (or principal) while providing liquidity and steady, positive returns that have consistently bested money market fund returns over their 40 year history (see Chart 3). In fact, over a business cycle, most stable value investment options seek to provide returns similar to short to intermediate-maturity bond strategies without the return volatility associated with those strategies (see Chart 2).

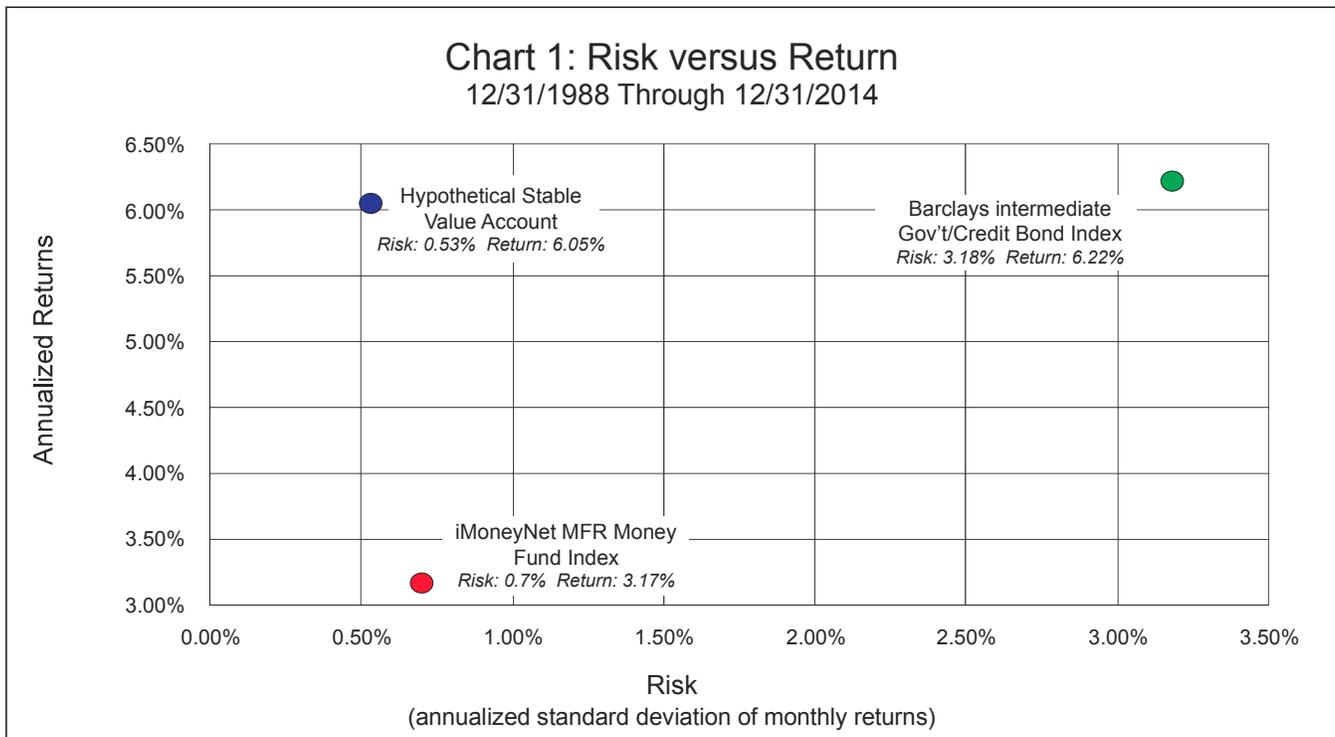
Stable value investment options may have many different names; capital preservation fund, fixed-interest fund, principal protection fund, guaranteed interest contract (GIC fund), guaranteed fund, stable interest fund, or stable value fund are common stable value names. Yet despite this variation in names, stable value investment options all seek to offer participants the same basic benefits: capital preservation, liquidity, and steady, positive returns that have exceeded those found in money market investments.

Among principal preservation assets—stable value funds, money market funds and short-term bond funds—only stable value delivers contract value, which is equivalent to a participant's invested balance plus accrued interest. Stable value thus provides capital preservation and consistent, conservative positive returns in a tax-deferred savings vehicle. Stable value is frequently described as providing principal protection and money market liquidity with bond fund-like returns.

Stable value funds remain a popular choice for plan participants within their defined contribution investment options. The Plan Sponsor Council of America's 57th Annual Survey of Profit Sharing and 401(k) Plans, reflecting 2013 plan experience, found an average asset allocation to stable value among the plans participating in the survey of 7.8 percent. The study, which included both plans offering stable value and plans that did not, showed on Table 75 that stable value was among the four top asset classes to which contributions were made. The survey showed that stable value followed actively managed domestic equity at an average asset allocation of 25.6 percent, target date funds at 16.7 percent, and indexed domestic equity at 10.4 percent. The survey also showed that 59.6 percent of the 613 participating plans offered stable value as a plan option.

## Stable Value Risk Return Characteristics

Stable value funds have favorable risk/return characteristics compared to bonds and money market funds as demonstrated in Chart 1. The combination of a low standard deviation and intermediate bond-like returns allows participants to shield a portion of their balance against volatility and loss of principal while lowering their overall portfolio risk profile. These characteristics also make stable value an excellent choice for the fixed income or cash allocation in target date fund series.

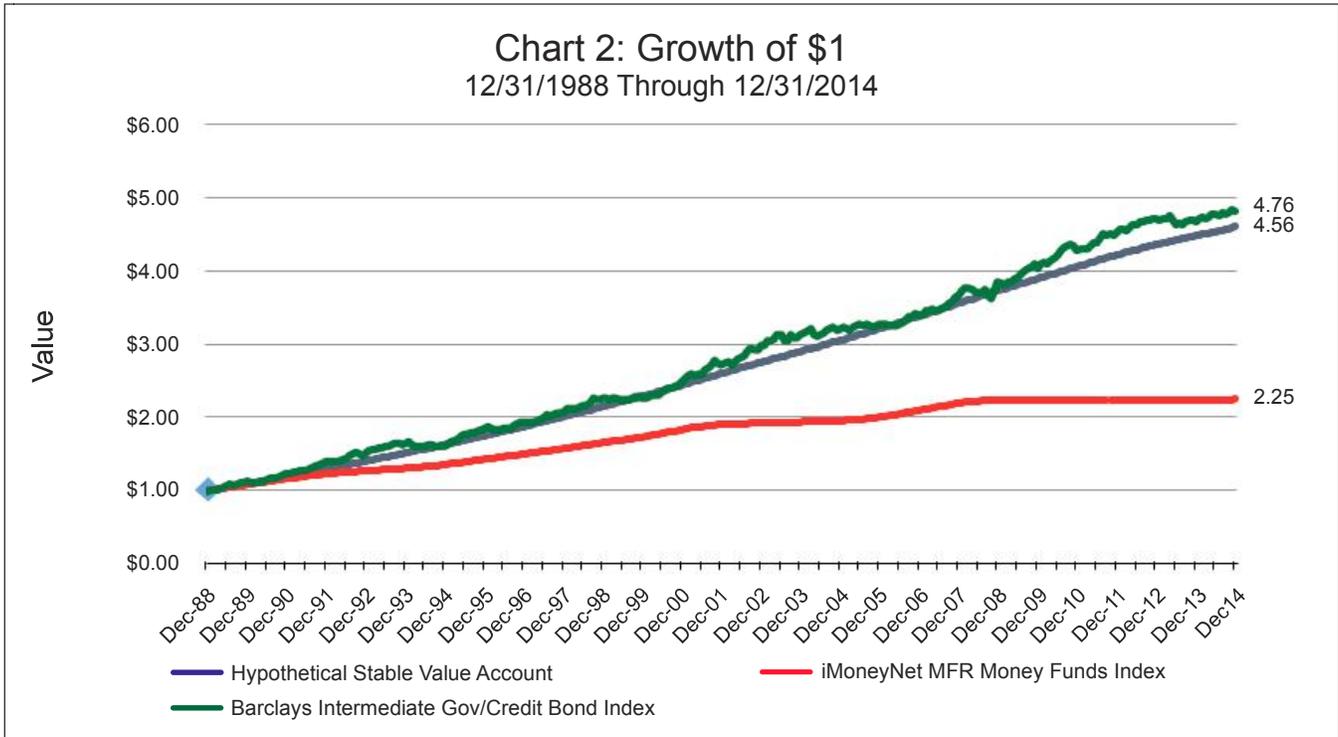


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## Intermediate Bond Return With Lower Volatility

Stable value has performed well over time. Chart 2 demonstrates the steady consistent returns that stable value achieves. Stable value delivered returns that are similar to bond returns but with lower volatility while exceeding money market returns.

Some worry that a rising interest rate environment could present an issue to a stable value portfolio if the rate increases are significantly above the portfolio's crediting rate. It is worth pointing out that the Federal Reserve generally implements shifts in the federal funds rate, which historically has been used to control short term interest rates, in 25-basis-point increments following scheduled Federal Open Market Committee meetings. With the federal funds rate at 0.25 percent, it would likely take over eight increases of 25 basis points each just to bring money market fund yields into equilibrium with current stable value portfolio crediting rates.



Throughout stable value's history, there have been six full interest rate cycles, which have been characterized by increasing inflationary pressures, restrictive monetary policy, and a rise in the level of interest rates. During each of these periods of rising rates, stable value performed as expected and delivered on its primary investment objectives.

### Principal Preservation Options

Typically, a plan will offer only one principal preservation option. The choice is generally between a stable value fund and a money market fund because both share the objective of seeking to preserve principle. Despite the shared objective of principal preservation, there are distinct differences between stable value and money market funds including volatility and return differences.

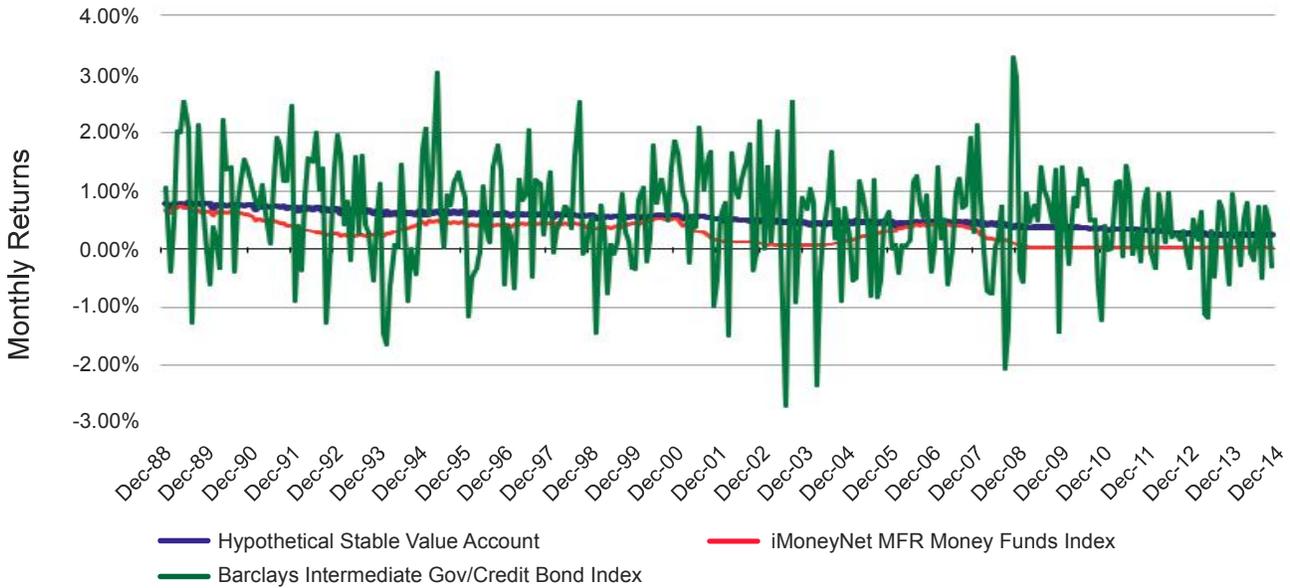
The flat return line shown for Hypothetical Stable Value Account in Chart 3 demonstrates contract value's advantage, which permits participants to transact at principal plus accumulated interest (for more details, see How does stable value deliver principal preservation and consistent, positive returns similar to bonds?). As Chart 3 shows, participants who invest in stable value have achieved consistent positive returns that have outpaced money market funds.

Further, as Chart 4 illustrates, over the long term, stable value has a significant return advantage over money market funds. Additionally, recent changes to money market fund rules such as the potential imposition of liquidity fees and gates, which permit money market fund boards to impose fees or suspend redemptions temporarily if a fund's weekly liquid assets level falls below a certain threshold, have introduced uncertainty and participant communication issues, which plan sponsors may want to consider when choosing a principal preservation option.

### What Types of Investors Use Stable Value Funds?

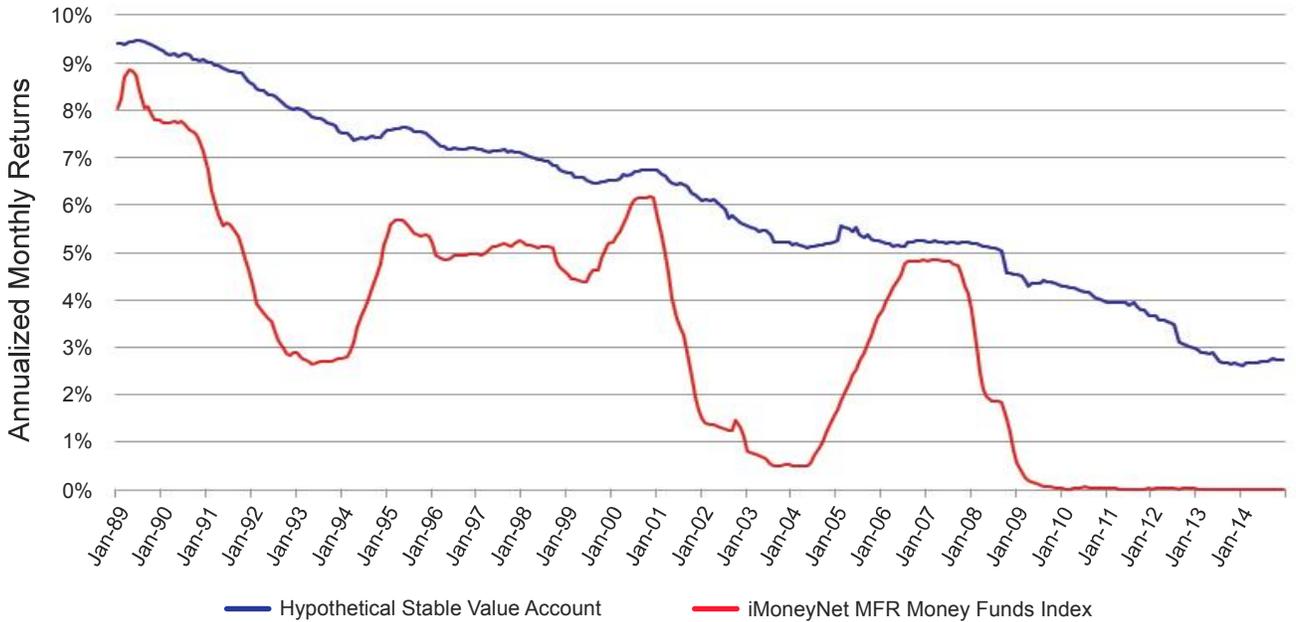
The lack of volatility in stable value funds and their steady growth makes them attractive to risk averse participants in different phases of their working career as well as retired employees in the de-accumulation phase. Participants across all age groups use stable value, with stable value allocations increasing with age.

### Chart 3: Volatility of Monthly Returns 12/31/1988 Through 12/31/2014



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### Chart 4: Stable Values versus Money Market Funds 12/31/1988 Through 12/31/2014



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The Employee Benefit Research Institute, in its 2012 study of tax code Section 401(k) plans (Figure 39), found that, for plans offering GICs and other stable value funds, the asset allocation to stable value funds overall was 3.7 percent for those in their 20s, 5.0 percent for those in their 30s, 7.0 percent for those in their 40s, 11.3 percent for those in their 50s, 19.1 percent for those in their 60s and 8.6 for all age groups.

Age	20s	30s	40s	50s	60s	All
<b>Allocation to Stable Value</b>	<b>3.7%</b>	<b>5.0%</b>	<b>7.0%</b>	<b>11.3%</b>	<b>19.1%</b>	<b>8.6%</b>

Source: Employee Benefit Research Institute

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Stable value also provides an additional benefit for those in retirement or the de-accumulation phase. They can use stable value to create a self-managed stream of payments similar to an annuity without the additional cost or complexity that comes with some annuity products.

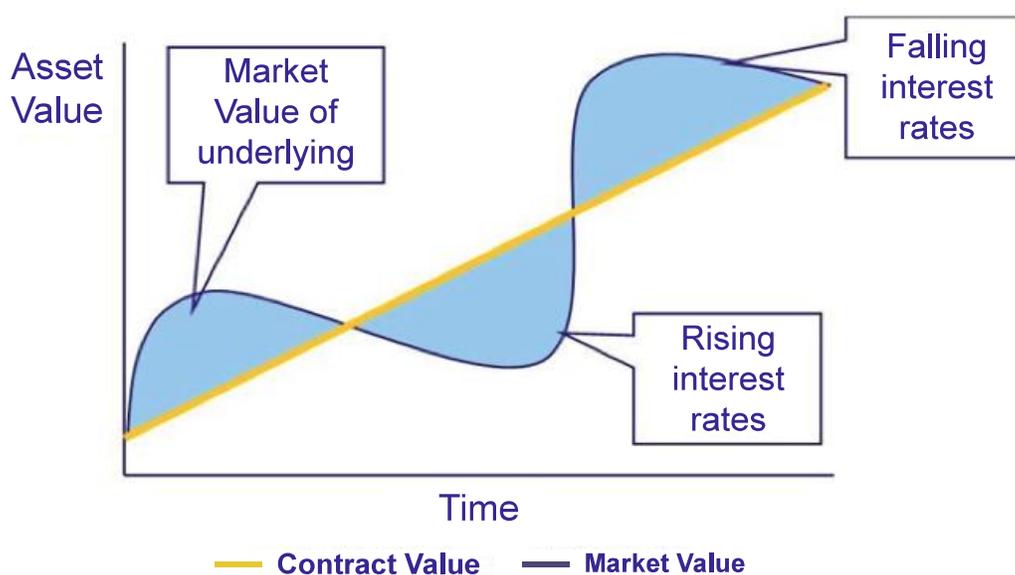
### Plan Administration and Stable Value Funds

Most stable value funds are easy to record keep. The two touch points are daily return and cash flow. Some funds use trading and pricing mechanics similar to registered mutual funds under the Investment Company Act of 1940. Other stable value funds have rates that are declared in advance whereby the recordkeeper can input the daily accumulation value on their administration system. Most, if not all plan administrators in today's market are familiar with the requirements to record keep a stable value fund.

*How does stable value deliver principal preservation and consistent, positive returns similar to bonds?*

Essentially there are two components to stable value investment options: a portfolio of well diversified high credit quality bonds and stable value investment contracts. The contracts used in stable value investing are issued by banks and insurance companies and the mechanics are similar to the way insurance policies like auto, rental or home owners' insurance policies work. With stable value investment contracts, participants are protected from interest rate fluctuations. Essentially, the contracts smooth out the return volatility of the bond fund and provide principal preservation benefits to participants.

### Illustration 1: How Contract Value Works



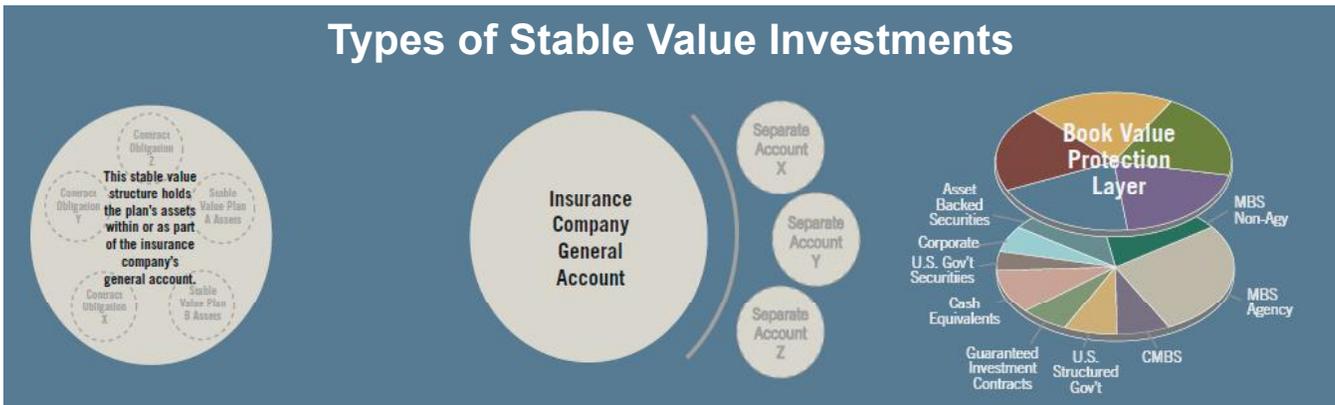
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The key benefit afforded by stable value investment contracts is the participants' ability to transact at contract value (also known as book value). Contract value, as noted earlier in the article, is equivalent to a participant's invested balance plus accrued interest. Contract value is what is known to stable value practitioners as the benefit responsiveness feature and is defined by the Financial Accounting Standards Board (FASB) and Governmental Accounting Standards Board (GASB).

Stable value investment contracts stipulate how the market fluctuations of the underlying investments will be smoothed over the duration of the stable value fund, which typically ranges anywhere between two to five years. In fact, most investment contracts establish a crediting rate formula, which spreads or amortizes the returns of the underlying fixed income investments over the duration of the stable value fund. The crediting rate of these contracts is typically calculated on a monthly or quarterly basis. It is the use of a crediting rate mechanism that shields participants from interest rate volatility and provides the contract value or benefit responsive assurance for participant transactions.

## Types of Stable Value Investments

There are a variety of stable value investment options available to plan sponsors. They may be offered by investment managers, trust companies or insurance companies in a variety of investment vehicles, such as separately managed accounts, commingled pooled funds or guaranteed insurance accounts. Separately managed stable value accounts can be customized to address specific needs of the plan sponsor. Pooled or commingled stable value funds are similar to mutual funds in that multiple investors (plans) are permitted to invest in the fund, but unlike a mutual fund, which is regulated by the Securities and Exchange Commission, pooled funds are regulated by the Office of the Comptroller of the Currency. In a pooled or commingled vehicle, each plan invested owns units in the fund and has a prorated legal ownership of fund assets, similar to a mutual fund. Pooled or commingled stable value funds can offer plans a diversified stable value alternative to a separately managed account vehicle.



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## Contract Value Protection Alternatives

A number of structures designed to provide contract value (book value) protection for stable value strategies have evolved over the past 40 years. The three most common contract value alternatives include: Guaranteed Insurance Accounts: General Accounts (Traditional GICs); Guaranteed Insurance Accounts: Separate Account GICs; and Synthetic GICs. Following is a summary of each contract value protection alternative.

### Guaranteed Insurance Accounts: General Accounts (Traditional GICs)

Introduced by insurance companies in the late 1970s, guaranteed insurance accounts or traditional GICs are still widely used in stable value strategies and are perhaps the most easily understood of the structures available in the marketplace today. This stable value option is a group annuity contract issued and backed by the financial strength of the insurance company. Traditional GIC contracts provide a fixed rate of interest over a specified time period. Upon maturity, the issuer is obligated to repay principal plus accrued income back to the stable value fund. GICs are regulated by state insurance commissions. They offer direct and explicit guarantees from issuing insurance companies.

## Guaranteed Insurance Accounts: Separate Accounts

Separate account structures were created in the late 1980s by insurance companies. This stable value option is generally issued as a group annuity contract and offers certain guarantees from the issuing insurance companies. Like traditional general account GICs, separate account GICs seek to enable participants to make contract value withdrawals that are equal to principal plus accrued interest. Unlike a traditional general account GIC, separate account assets are held in accounts segmented away from the insurance company's general account and dedicated to support the separate account. Separate accounts are supported by the financial strength of the issuing entity as well as the designated assets of the separate account.

## Synthetic GICs

Synthetic GICs were developed in the late 1980s and early 1990s and, like the traditional general account structure and the separate account structure previously described, enable participants to transact at contract value. The introduction of synthetic GICs represented a departure in the stable value world from traditional insurance structures in that contract value was divorced from the underlying investments (the fixed income securities). This division established two distinct components: marketable fixed income securities (i.e. bonds) owned outright by the plan and contract value investment contracts issued by banks and insurance companies. Unbundling the underlying assets from the stable value contract component offers the plan direct ownership of the underlying assets of the stable value fund.

Many stable value investment managers use a combination of the contract value protection alternatives. Thus, it is possible that the stable value vehicle includes one or any combination of contract value protection alternatives described above.

**Table 1: Overview of Stable Value Contract Structures**

Stable Value Contract Structures	Description	Rate of Return	Assets
<b>Guaranteed Insurance Accounts: General Accounts</b>	Contracts and agreements with an insurance company that provide principal preservation, benefit responsiveness, and a guaranteed fixed or indexed rate of return backed by the assets of the insurer's general account.	Guaranteed regardless of the performance of the underlying assets.	Owned by the insurance company and held within the insurer's general account.
<b>Guaranteed Insurance Accounts: Separate Accounts</b>	Contracts and agreements with an insurance company that provide principal preservation, benefit responsiveness, and a guaranteed rate of return backed first by assets held in a segregated account separate from the insurer's general account and then, to the extent there are any shortfalls, by assets in the general account.	May be fixed, indexed, reset periodically, or based on the actual performance of the segregated assets.	Owned by the insurance company but set aside in a separate account for the exclusive benefit of the plan(s) in the separate account.
<b>Synthetic GICs</b>	Contracts and agreements with a bank or insurance company that provide principal preservation, benefit responsiveness, and a guaranteed rate of return relative to a portfolio of assets held in an external trust and backed by assets held in the trust.	Provides a periodic rate of return based on the actual performance of the underlying assets.	Directly owned by the participating plan(s).

## Checklist of Considerations in Selecting Stable Fund Provider

In determining whether a stable value fund is a suitable investment choice to offer in the plan, the plan fiduciary should consider whether the following features can be accommodated by the stable value fund provider:

- Plan design features, such as competing fund transfer provisions and frequent changes to fund line-ups.
- A significant portion of inactive/retired plan participants in the plan, as these balances may not represent longer-term holdings for the plan.
- Plan events, such as merger and acquisition activity, early retirement programs or layoffs.

## Checklist of Considerations in Evaluating Stable Funds

Many stable value fund contracts are backed by a diversified portfolio of fixed income assets. To evaluate the overall stable value fund, the following questions should be asked about the underlying assets as well as the stable value contract. The underlying investments are evaluated along the same criteria as a fixed income fund, with consideration to investment approach, performance versus an appropriate benchmark process, and experience of the management team. Questions pertaining to the underlying investments generally do not apply to general account GICs.

- What is the experience/expertise of the stable value manager or portfolio manager of underlying investments?
  - The stable value manager may also be responsible for managing the underlying investments, or may act in a role of evaluating other fixed income managers.
- What is the investment strategy of the stable value fund and the underlying investments?
  - The primary objective of a stable value fund is principal preservation. The investment strategies used in the underlying portfolios should be consistent with that objective.
- What has been the performance of the underlying investments? What has been the performance of the stable value fund?
  - Relevant benchmarks for each should be presented.
  - The performance of the underlying investments (less fees) is a primary determinant of total return to the participant over time. Information should be available on the breakdown of fees, such as investment management fees, contract fees, etc. Performance of the stable value fund is also influenced by liquidity management of participant cash flows.
- What is the credit quality of the underlying investments? What is the credit quality of the contract issuers?
  - Generally investments underlying stable value contracts will be of investment-grade and higher. Overall credit quality (including contract issuer credit ratings) should be consistent with the goals of preserving principal and providing liquidity.
- What is the experience/expertise of the contract issuers?
  - It is important to understand the contract issuer's commitment to stable value with respect to its tenure in the industry and its size relative to its other business lines.
- How many contract issuers are represented in the stable value fund?
  - Adequate diversification of the investments backing the contracts as well as diversification among contract issuers is an important risk management tool in synthetic GICs.

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## Checklist of Considerations in Evaluating Stable Funds–Continued

- What are the termination provisions in the stable value contracts?
  - There may be certain critical conditions that result in an immediate termination of an issuer's obligation; otherwise there are generally wind-down provisions that enable either party to orderly exit the contract.
- How is risk monitored in the stable value fund?
- In addition to monitoring the duration, credit quality and asset allocation in the underlying portfolios, processes to monitor the stable value fund's risks should also be in place. These risks include but are not limited to:
  - contract and guideline compliance,
  - adequate liquidity for effectively meeting participants' requests, and
  - the credit worthiness of the contract issuers to the fund.
- Another key characteristic to monitor is the market to contract value (MV/CV) ratio. This ratio indicates the amount of gains or losses being amortized through the crediting rate earned by participants. It also is a relative measure of the fund's collateralization in terms of the market value of underlying assets backing the contract value of the contracts.