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Stable Value and Target-Date Funds: Experience and Opportunity

By Randy Myers

"Target-date funds are a freight train running down the tracks," said Brian Haendiges, senior vice president in charge of investment services for MassMutual Financial Group's Retirement Services Division, speaking at the 2014 SVIA Spring Seminar. "We're going to have to find the right way to interact with that phenomenon to stay in business."

Haendiges was part of a four-person panel that explored how target-date funds are being used today, and why, and how the stable value industry can make sure that it is part of the target-date revolution.

In 2012, Haendiges noted, target-date funds captured about 31 percent of all new contributions to 401(k) plans and already accounted for 14.4 percent of total 401(k) assets. By 2018, he estimated, target-date funds will be collecting two-thirds of all new contributions and will account for 35 percent of 401(k) assets. According to Fidelity Investments, he noted, about a third of plan participants have 100 percent of their plan assets in target-date funds—more than twice the percentage of five years ago. Among Generation Y participants—those born between 1979 and 1991—the proportion with 100 percent of their money allocated to target-date funds is even higher at 54 percent. Plan participants prize target-date funds, he observed, for their ease of use, diversification and professional management.

Still, Haendiges said, stable value remains a fundamental component of the 401(k) landscape, with its $700-billion plus in assets accounting for about 25 percent of total 401(k) assets at year-end 2012, according to the Aon Hewitt 401(k) Index. A key reason for stable value's continuing popularity, he said, is that investors have a high degree of risk aversion; they dislike losses more than they like gains, and stable value historically has delivered consistently positive returns with low volatility.

The goal for the stable value industry, Haendiges said, is to find ways to combine two popular investments—stable value and target-date funds—while preserving the favorable attributes of both. Doing that, he said, will require that the stable value industry build upon the recommendations and the approach that an unbiased and independent advisor would provide when looking at each participant and asset class individually.

Target-date weaknesses

Despite their popularity and positive attributes, target-date funds are not without problems. In 2008, in the depths of the credit crisis, funds with target dates between 2000 and 2010 lost an average 22.5 percent of their value, observed Glenn Jensen, managing director with New England Retirement Consultants. That meant a lot of target-date investors approaching retirement suffered big losses at a time when they could ill afford to do so. Compounding their pain, surveys found that about 80 percent of those investors thought they couldn't lose money in those funds.

To get better control of the risk embodied in their target-date funds, Jensen said, many larger plans are creating custom target-date funds from their own core investment options. Unlike off-the-shelf target-date funds that invest only in mutual funds, these custom funds can typically allocate money to stable value. Other benefits of creating custom funds, he said, include gaining flexibility in glide path construction, which can help reduce the volatility of investment returns prior to a plan participant's retirement date, and greater cost efficiencies. Also, while the vendor of an off-the-shelf target-date fund typically does not accept ERISA fiduciary responsibility, he said, plans creating custom funds can engage a registered investment advisor to act as a co-fiduciary to the plan.

Making stable value work with target-date funds

Gary Ward, vice president, institutional stable value for Prudential Financial, said that in its stable-value wrap contract business, Prudential divides the risks associated with target-date products into two buckets. One is simply ongoing product or market risk. The other is what he calls concentrated decision-maker or event risk: the risk that some plan event, such as a reenrollment of plan participants or the introduction of a new asset-allocation product, could result in a lot of money moving from stand-alone funds, including the stable value fund, to an asset allocation product in a very short period of time.

Nick Gage, senior director with Galliard Capital Management, said more than half of his firm's 100-plus stable value separate-account clients—most of them larger defined contribution plans—already offer a professionally managed product or service, such as a suite of target-date funds or managed accounts, that allocates money to stable value. When implementing or changing one of these products, he said, Galliard will advise the client on the potential impact on stable value investors, obtain approval from the stable value contract issuers and make any required contract amendments, modify the investment or liquidity management strategy for the stable value portfolio as needed, and monitor the impact on cash flows into and out of the stable value fund.

"A lot of our clients really like their stable value option and the value it provides to their participants," he said. "But they are concerned that their participants aren't making the best investment choices and won't be prepared for retirement. We need to work together with them to make sure they can continue to offer the stable value product they want to offer their plan participants, while also doing what they feel is their duty as a plan sponsor to prepare their employees for retirement."

More than just target-date "funds"

Both Haendiges and Ward encouraged their colleagues to think about target-date products more broadly than just target-date funds. Almost any product or service that drives asset-allocation decisions, from recommendation services to automatic advice engines to managed accounts, can have an impact on how and where stable value products are used, Ward said. Accordingly, they all represent both an opportunity, and a risk-management challenge, for the stable value industry.

"There's far more work we can do to find different ways to get stable value in asset allocation funds," Ward concluded. SVIA