Expanding Stable Value's Reach

By Randy Myers

It's time for the stable value industry to think outside the 401(k) box.

While the vast majority of stable value assets are held in 401(k) plans, the benefits of stable value funds are too great to be limited to that sector of the marketplace, according to a panel of stable value executives who spoke at the 2014 SVIA Spring Seminar.

The 403(b) market

Stable value funds are already found in various types of defined contribution retirement plans: 401(k), 401(a), 403(b) and 457 plans. The 403(b) market, which caters to tax-exempt organizations such as schools, hospitals and religious groups, is a particularly ripe opportunity for the stable value industry, said Robin Andrus, marketing director at Prudential Financial. From the fourth quarter of 2012 to the fourth quarter of 2013 assets in 403(b) plans grew by 7 percent and the number of participants in those plans grew by 6 percent. Regulatory changes and the trend away from defined benefit retirement plans to defined contribution plans will translate to growth in this market for at least the next few years, she opined. One challenge: federal regulations generally prohibit 403(b) plans from using collective, or pooled funds, which means plans will have to be large enough to make a separate account product economically viable for both them and stable value providers.

Andrus also encouraged her industry colleagues to look for opportunities within the K-12 sector of the education market. And, she said, investment-only asset managers may wish to consider offering stable value funds through other providers' open architecture platforms in the healthcare and higher education segments of the retirement plan market.

529 plans

LeAnn Bickel, head of stable value contract administration for Invesco Advisers, said the 529 college savings plan market also offers opportunities for stable value providers to broaden their client list. Her firm already provides stable value products for three 529 plans offered by the states of Virginia and West Virginia, which have combined plan assets in excess of $6 billion and stable value assets of nearly $900 million.

Stable value makes sense for 529 plans, Bickel argued, because participants in those plans need an investment option that provides safety of principal, especially during the beneficiary's later years of high school and college; competitive returns, especially in light of current market conditions; and liquidity for qualified withdrawals at book value. Stable value offers all of that.

For stable value providers, Bickel said, the 529 market has attractive underwriting characteristics relative to the 401(k) market, including generally smaller account sizes, more stable and certain cash flows, less transferring of assets from one investment option to another, and a smaller incidence of participants rolling money into a competing account. She also noted that plan sponsors and their program managers are very willing to provide the data needed by stable value wrap issuers to underwrite funds for them.

Assets in 529 plans grew by $36.4 billion in 2013 to a record $227 billion, Bickel said, with $22 billion of that growth attributable to contributions by plan participants. The average account size grew to a record high $19,584, a 14 percent increase. Behind the growth: the ever-leaping cost of college tuition, which has been increasing about 8 percent annually. Tuition for a public four-year institution now averages $18,391 per year, Bickel said, and parents and grandparents are eager to capitalize on the tax advantages that saving for higher education in a 529 plan offers.

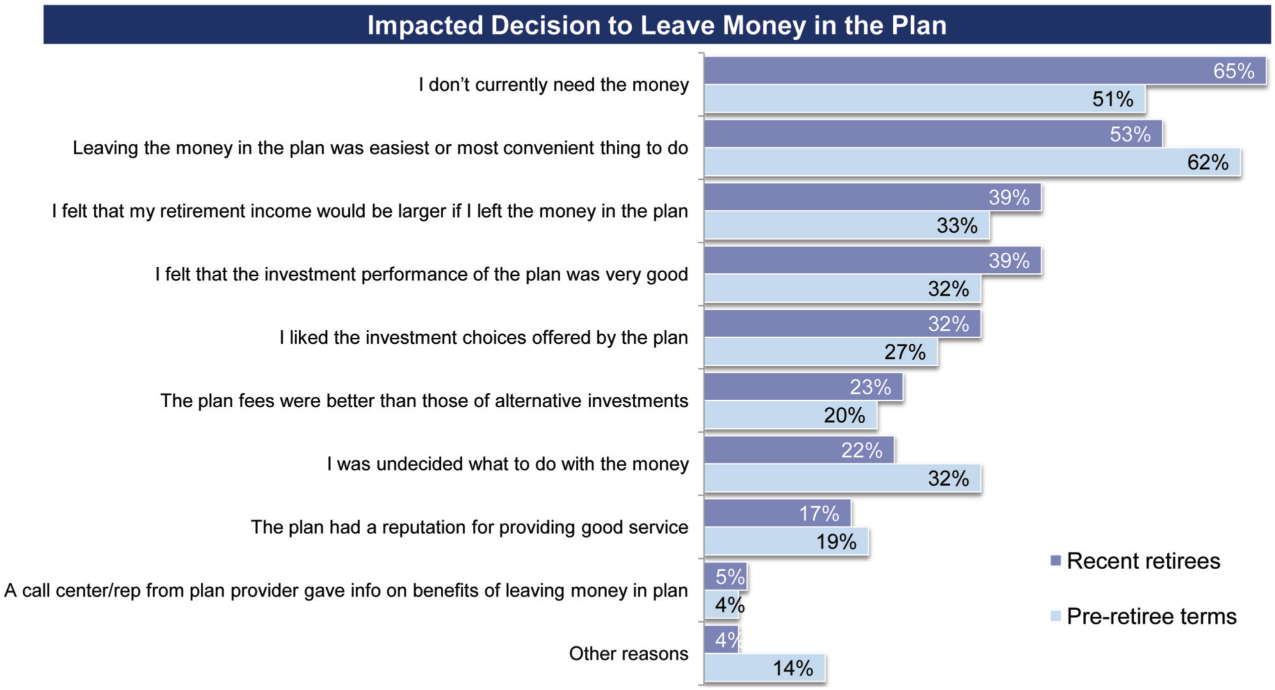
Unfortunately, she said, some may not be getting the best value. Many 529 plans continue to use money market funds as their low-risk investment option, and while money market funds share the low volatility characteristic of stable value funds, their returns have historically lagged behind those available from stable value.

One of the challenges the stable value industry faces in trying to penetrate the 529 market more deeply, Bickel said, is simply finding enough wrap issuers who are familiar with and interested in it. It's not that they are overly concerned about the risks, she said, but rather that they think of it as a new product with all the attendant startup demands. Also, 529 plans cannot use commingled funds, so the plans need to be of sufficient size to make it economical to offer a separate account product. Nonetheless, Bickel said, "we see this as a growth area."

"Hybrid" funds

Some stable value opportunities lie not in broadening the industry's reach into other types of savings plans, but in delivering a diverse range of stable value options, including so-called "hybrid" stable value funds. That's a term that Brett Gorman, a senior vice president in the defined contribution practice at asset manager PIMCO, says he doesn't like, but it nonetheless seems to have gained traction. Gorman said the term can refer to an otherwise standard stable value fund that allocates an unusually high percentage of its assets to a short-term investment fund (STIF), allocates some portion of its assets to bonds that are not covered by a stable value wrap contract, or both. In either case, the structure would call for the alternative holdings—the STIF or the unwrapped bonds—to be accessed for withdrawals alongside of, or even before, the fund's wrapped bonds.

Gorman said his firm continues to believe that a true stable value fund is a better capital-preservation solution for plan sponsors that are comfortable with the associated risks and the requirements of the product's wrap contracts. Still, he conceded that hybrid structures, while not common, have been around a long time, and that there may be instances where a hybrid approach makes sense. Perhaps the sponsor has demographic or cash-flow challenges that would make it difficult to offer a stable value fund, he said. Maybe it is engaged in a lot of merger-and-acquisition activity or divestitures, or from a legal perspective just isn't comfortable with the terms of wrap contracts. "Whatever the reason, there is a growing preference for customization and white-labeling by both consultants and especially larger plan sponsors for the options in their funds," Gorman said. "This may mean we as an industry



Note: Multiple responses allowed.

start to see more opportunities to engage with sponsors on these types of structures."

Stable value providers should consider several factors when deciding whether to offer hybrids, Gorman added. "The first is what type of investment risk, and therefore volatility, is acceptable in the unwrapped portion of the fund, if there is one? Second, do underwriting standards need to change? For instance, how are plan design features such as competing options or advice or structural mitigants that we might have, such as equity washes, viewed by the wrap issuers? Next—and I think we're all agreed that calling such product stable value is not appropriate—is what to call the option. Also, how is the investment structure communicated to participants? That's really key. Finally and perhaps most importantly, are there reputational risks to traditional stable value products associated with offering these hybrids?"

With interest rates low and at the end of a 30-year bull market, Gorman also observed that any firm launching a hybrid structure now won't have as much carry to offset the fund's mark-to-market volatility as has been common in the past, suggesting a higher probability of daily, monthly or quarterly negative returns. In that case, he said, it's not unreasonable to consider whether there is a potential for higher rates of withdrawals from such a product.

Although still a proponent of traditional stable value products, Gorman said he recognizes that hybrids offer some benefits for retirement plan sponsors, plan participants and even the stable value industry. For participants, he said, even a hybrid fund will offer some of the attractive benefits of book-value accounting. For plan sponsors, a hybrid structure should have slightly lower fees than a pure stable value product, and provide yet another option for their investment menus. For wrap issuers, having more assets available for withdrawal ahead of the stable value contract should be comforting. Finally, for the stable value industry, having plan sponsors who aren't comfortable with a traditional stable value fund opt for a hybrid would at least mean that more sponsors overall are using, and are committed to, the benefits of book-value accounting. "More plan sponsors than fewer vested in the ongoing success of benefit-responsive contracts is generally a very good thing for all of us," he said.

Stable value and "de-accumulation"

Perhaps the most obvious strategy for boosting stable value assets is to hold onto the business you already have. Anthony Camp, vice president of the Stable Value Product Group at ING U.S. (which will become Voya Financial in 2014), noted that the first wave of the nation's approximately 78 million Baby Boomers reached age 65 three years ago, and that the Boomers have accumulated significant assets in defined contribution and individual retirement accounts (IRAs). At the end of 2013, he said, assets in defined contribution plans totaled $5.9 trillion, and in IRAs $6.5 trillion.

Unfortunately, Camp noted, many investors roll their money out of their defined contribution plan and into an IRA when they stop working—about 43 percent did so in 2012, according to the LIMRA Secure Retirement Institute. And stable value funds are not available to IRA investors. To the extent the stable value industry can help convince more participants to stay in their defined contribution plans—as 41 percent did in 2012—more retirees will have a chance to continue reaping the benefits that stable value funds offer.

"I think this is a huge opportunity," Camp said. So too, he said, would be exploring the possibility of again getting regulatory approval to offer stable value funds in mutual-fund format to IRA investors. "It sticks out as a large opportunity," Camp said. "Maybe not enough time has gone by, but if we were looking for ways to expand stable value outside traditional defined-contribution plans, this sticks out to me." SVIA