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Stable Value Assets Continue to Grow

By Randy Myers

Assets in stable value funds continue to edge higher, climbing to $801 billion in the second quarter of 2016, up from $770.5 billion a year earlier.

Stable value now accounts for about 11.6 percent of all assets in defined contribution plans, SVIA President Gina Mitchell announced at the opening of the 2016 SVIA Fall Forum in October. While that is down from a recent high of 19 percent during the 2008 financial crisis, Mitchell said the asset class remains a fundamental component of defined contribution plans.

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Brexit and US Politics: What They Say about Voters' Views

By Randy Myers

The first shocking election result in 2016 happened in the U.K., where, voters frustrated with what they viewed as unfavorable trade deals, uncontrolled immigration, and out-of-touch leadership opted by a 52-48 margin to exit the European Union (EU).

Their sentiments were hardly unique, though. In the U.S., many voters voiced the same frustrations in 2016 when they chose an isolationist-minded businessman and reality TV star to be the Republican nominee for President and flirted with choosing an avowed socialist to be the Democratic nominee.

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Board Recognizes James King and Aruna Hobbs

By Gina Mitchell

At the October 10th Board of Directors meeting both James King and Aruna Hobbs were recognized for completing six years of service on the Board. Prudential's James King was the past Chairman of the Board of Directors for four years. During 2016, King served in an ex-officio capacity. During King's tenure as Chairman, he oversaw SVIA's efforts on evaluating and commenting on the Department of Labor's fiduciary rules as they applied to stable value funds, as well as expansion of stable value funds in custom target date funds.

MassMutual's Aruna Hobbs has served for the past four years in an ex-officio capacity as the Treasurer and Chair of the Board's Finance Subcommittee. During Hobbs' term she oversaw the restructuring of the Finance function into a subcommittee of the board as well as the development and implementation of an investment policy and guidelines for the Association. Both are required to take a break from Board service for three years after serving two-consecutive terms. SVIA

Voya Economist Sees Bond Yields Remaining Low

By Randy Myers

U.S. interest rates have been holding at or near historic lows for six years now. That is a long time, but it could be longer still before they climb much higher, says Matt Toms, Chief Investment Officer, Fixed Income, for Voya Investment Management.

Addressing the 2016 SVIA Fall Forum in October, Toms cited a litany of reasons to expect the current low-rate environment to persist. Chief among them are a slow-growing U.S. economy and low inflation. Against this backdrop, the Federal Reserve has maintained an accommodative stance on monetary policy. With growth also slow in Europe and Japan—and slowing in China—so have other central banks across the globe.

"We have a price-controlled world … and unfortunately there is no sign of this reversing," Toms told his SVIA audience. "The Federal Reserve said at Jackson Hole that in response to the next recession they would cut interest rates up to 300 basis points and buy $2 trillion in securities. So the Fed has already told you its game plan for the next economic downturn, and it is more of government-controlled markets."

Since the Fed has indicated it does not want to create negative interest rates, Toms added, its roadmap suggests it does not think short-term rates will move high enough between now and the next recession to allow a cut of more than 300 basis points.

Unlike some critics of Fed policy, Toms did not disparage the Fed's decision to take an accommodative monetary stance after the 2008 financial crisis. In fact, he said, it was "great" for addressing the depression risks of that crisis. Since then, household debt as a percentage of GDP has improved. The U.S. consumer has deleveraged, adding some stability to the economic outlook. The unemployment rate has fallen from a crisis peak of 10 percent to about 5 percent. Household wealth has increased, and so has the savings rate. Equity markets have rebounded, as has the housing market. All that is good for those who own the country's wealth, Toms said, but he also argued that Fed policy is now exacerbating the populist divide between the country's haves and have nots. Those who have not been able to capitalize on low rates—by purchasing a house with a more affordable monthly payment, for example—are falling further behind.

The question now for the Fed, he said, is how long it should stick with its extraordinarily accommodative monetary policy. "Our punch line is, we're staying too long," he answered.

What finally could spur the economy onto a faster growth trajectory? Ultimately, Toms said, growth is a product of how many people are working and how productive they are. And the news is not very encouraging on these fronts. U.S. labor force growth has been trending lower for decades, while productivity growth has recently dipped below 1 percent. In this climate, the Fed is now anticipating economic growth of only 2 percent over the next four years, its least bullish outlook since at least 2011.

Despite the low rate environment and hence the low cost of money, Toms said companies are not funneling much into capital expenditures. Instead, they have been content to reward shareholders more immediately, with stock buybacks. The one bit of good news related to corporations' unwillingness to leverage their balance sheets, he said, is that it should moderate the amplitude of the next economic downturn. However, Voya puts the probability of a recession anytime soon at only about 20 percent or less, he said, with most likely catalysts coming from outside the U.S.—a significant economic downturn in China, perhaps, or a further unwinding of the European Union, which the U.K. has already voted to leave.

In the meantime, Toms said, the impact of the Fed's monetary policy on the economy is in decline while its impact on the financial markets is increasing. "We live more in fear of market volatility created by the Fed than we do in excitement about Fed economic activity improving the outlook for growth, which is different than what it was seven years ago. Said another way, it's time to move on, central banks. You've already answered the crisis."

Until that happens, Toms predicted that investors will look for attractive levels of income relative to the risk they take. His advice for fixed-income investors? "Look for those things that benefit from low rates," he said. "Look for property values beyond your bonds—securitized markets, for example, versus corporate markets. It still takes an awful lot of diligence to determine which to buy, but ultimately that's the tailwind that has been provided. Use it in markets like the non-agency market, the CMBS market, the CLO market, and the ABS market. We think there's a tailwind there that may be underappreciated." SVIA

Stable Value Assets Continue to Grow

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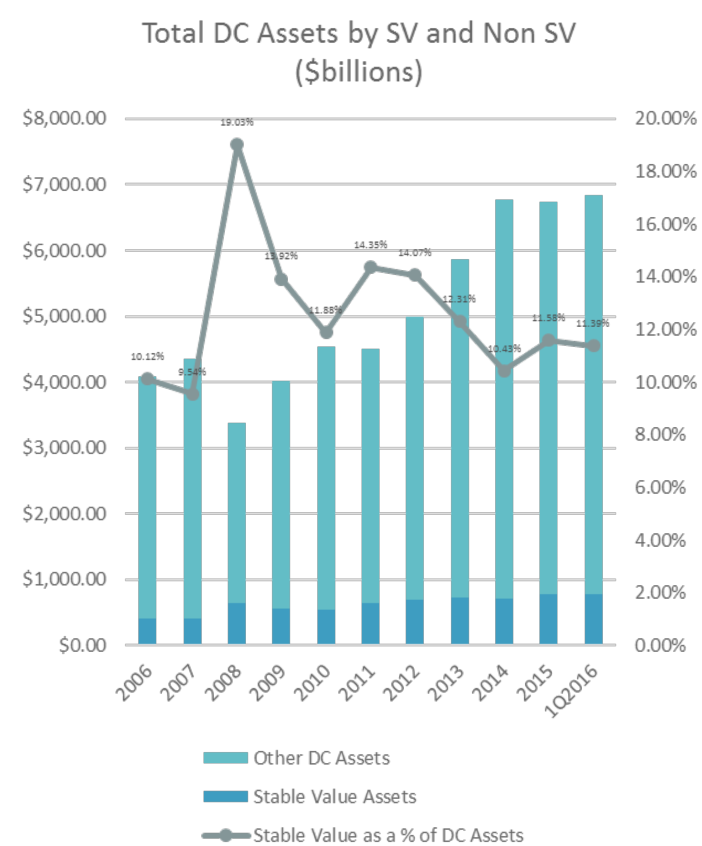
It is valued, she said, for its principal protection guarantees, its steady and predictable returns, and its benefit-responsive liquidity. She also noted that crediting rates for stable value funds—the returns paid to investors—were averaging 2.5 percent at year-end 2015, in line with where they were a year earlier and well above returns for their most common competitor, money market funds.

Stable value funds are used by a wide cross-section of investors, Mitchell noted, including retirees and near-retirees, conservative investors who value attractive returns but also appreciate low volatility and capital preservation, and moderately aggressive and aggressive investors looking to diversify their portfolios and enhance their overall risk-adjusted returns. They also appeal to investors searching for alternatives to money market funds and short-term bond funds.

Across this diverse group, Mitchell observed, older participants remain the heaviest users of stable value funds. According to data from the Employee Benefit Research Institute (EBRI), the average allocation to stable value in plans that offer the asset class is about 20 percent among participants in their 60s, but less than 5 percent among those in their 20s.

Mitchell noted that growth in the stable value marketplace has been constrained since passage of the Pension Protection Act of 2006 (PPA), under which the Department of Labor established a fiduciary safe harbor for plan sponsors that default their employees into target-date funds or any of a small handful of other qualified default investment alternatives. In 2006, before implementation of the PPA, stable value funds accounted for about 60 percent of the assets in 401(k) plans offering them as an investment option, according to data from Employee Benefit Research Institute. By 2014, they accounted for only 49 percent. During the same period, the percentage of 401(k) plans offering stable value as an investment option fell to 35 percent in 2014 from 51 percent in 2006.

Mitchell told industry executives attending the Fall Forum that they have done a superb job navigating these trends. The challenge and opportunity going forward, she said, will be to expand the formats in which stable value is offered. "Stable value has been embraced in target-date funds, particularly in custom target-date funds," she said. "But we've got more work to do on that front. We also need to be thinking about how we can find a place for stable value as baby boomers move from the accumulation to the deaccumulation phase of retirement planning. We need to make this important asset class available to Americans who are trying to do the right thing and take care of themselves during their retirement years." SVIA



Brexit and US Politics: What They Say about Voters' Views

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The parallels are hard to avoid, and may have long-term implications in the U.S. that go well beyond this year's presidential election, according to BBC World News America Lead Anchor Katty Kay.

"This is a more complicated time," Kay told participants at the 2016 SVIA Fall Forum in Washington, D.C., in October, four weeks before U.S. voters shocked much of the world again when they elected Donald Trump to become their country's next president. "Traditional alliances are being stretched. People in the United States and Europe are questioning whether free-market capitalism is necessarily the best model for everybody."

Kay noted that many Americans feel they have been left behind by globalization and trade deals, by lower taxes for the wealthiest, and by immigration. In many cases, they believe politicians have not done a very good job of supporting them as they have fallen behind in this new economic climate. They have been asking if it may be time for the U.S. to look inward and focus on nation-building at home.

"I think we are in for a period of time when the post-Cold War hegemony is going to be exploded on both the Democratic and Republican sides," Kay said. "We're in for a period of huge upheaval, no matter the outcome of the presidential election, and I think the prospect of a one-term presidency in the United States, regardless of who wins, is very real."

All this will have repercussions for the rest of the world, Kay said, observing that "what happens in the United States affects many audiences around the world in a way that is not true of any other country," and that global policy, whether it is about climate change or trade, is still driven by decisions in Washington. Syria is the exception right now, Kay said, with Russia seemingly exerting the most influence there and making other countries nervous that this could become a precedent.

"I think the world still looks to America for leadership, and the world is better off when it does lead," she said. "When President George W. Bush invaded Iraq, it's no secret the world did not like it. It was seen as America throwing its weight around. But we like it less when America retreats. The world's fear of America retreating is greater than the fear of American involvement."

Asked whether the U.K. might hold another vote on leaving the EU—as many people believe the vote would be different this time—Kay said it would be politically difficult, especially anytime soon. What might be possible, she said, would be for U.K. Prime Minister Theresa May to negotiate the terms of the U.K.'s exit from the EU over the next two years and then present those terms to the British people for a re-vote, especially if the terms are onerous to the U.K. "It doesn't look like there's legally a problem to doing that," Kay said.

Still, she said, even that could prove problematic. "The people who voted to leave, who are driving the Conservative Party, may never let May do that," she said. "That may be seen as too undemocratic. And it's true. We voted to leave. At some point you have to respect the democratic process." SVIA

Association Elects Three to Board of Directors

By Gina Mitchell

On October 10th at SVIA's Board of Directors meeting, voting members elected three individuals to the Board of Directors. They were UTC's Joseph Fazzino to a plan sponsor seat, Metropolitan Life's Thomas Schuster and New York Life Investment Management's Cindy Cristello to the two open service firm seats. The three will begin their three-year term on January 1, 2017. Both Schuster and Fazzino will be serving their second term on the Board. SVIA

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Health Savings Accounts: Next Generation Retirement Savings Vehicles?

By Randy Myers

Could a savings account designed to cover medical costs actually be a good way to enhance retirement savings? In some ways, and under some circumstances, yes.

Health savings accounts, or HSAs, are tax-advantaged savings vehicles created to help people who are enrolled in high-deductible healthcare plans pay for out-of-pocket medical expenses. Currently, plans with annual deductibles of at least $1,300 for individuals or $2,600 for families count as high-deductible plans.

While aimed at helping Americans pay for medical expenses, Danny Humphrey, Vice President of Enterprise Sales for HealthEquity, an HSA administrator, notes that HSAs also can be used as long-term investment vehicles. Speaking at the 2016 SVIA Fall Forum, Humphrey observed that HSAs can offer even better tax benefits than traditional retirement accounts in some circumstances. While relatively few people use HSAs as investment vehicles today, Humphrey said, that is partly because many do not understand exactly what they are or how they work.

Authorized by Congressional legislation in 2003, HSAs often get confused with flexible spending accounts, or FSAs, simply because FSAs have been around longer. Like HSAs, FSAs also can be used to pay for out-of-pocket medical expenses. But the two accounts differ in how long money can remain in them. With an FSA, money typically must be used in the year it is contributed. With an HSA, contributions can stay in the account indefinitely, and can even be passed along to the account holder's heirs.

HSAs offer multiple tax advantages. Contributions are made with pre-tax dollars. Interest and investment income are tax-free, and withdrawals also are tax-free if used for qualified medical expenses by the original account holder. This triple tax play can make an HSA a particularly attractive savings and investment vehicle, better, even, than a Roth IRA or Roth 401(k). Withdrawals from those accounts are not subject to federal income taxes, either, but contributions to those accounts are made with after-tax dollars. Only an HSA offers a tax benefit both at the time of contribution and the time of withdrawal.

There are a variety of ways investors can take advantage of HSAs. They can funnel money they otherwise might have put into a traditional retirement account into an HSA, and then use the HSA, rather than the traditional account, to pay for qualified medical expenses in retirement. Or they could continue to fund their retirement account in full, but supplement those savings with an HSA. Because account holders can reimburse themselves for medical expenses years after those expenses were incurred, assets in the HSA can grow tax-free for a long time, and the payoff can be substantial. A couple with a 30 percent tax rate, Humphrey noted, would have to save $370,000 in a traditional IRA or 401(k) to cover $260,000 in medical expenses in retirement, but only $260,000 in an HSA.

Individuals participating in high-deductible healthcare plans can contribute up to $3,400 to an HSA beginning in 2017, or up to $6,750 for a family. Contributions initially count as deposits and are typically held in an FDIC-insured savings account or some type of stable value fund. Once the cash portion of the account reaches $2,000, account holders can begin contributing to a separate investment account, where it can be steered into a wide range of securities, including stocks, bonds, mutual funds, and more.

Humphrey says HSAs are likely to become increasingly popular as more employers begin offering them, a trend he is already seeing among large employers. In 2010, Humphrey said, only 7.6 percent of large employers offered a high-deductible health plan as their only health plan option. By 2014, that percentage had risen to 17.8 percent, and by 2015 it was expected to reach 30 percent.

The use of HSAs is quickly inflating the amount of money held in HSA accounts. In 2010, HSAs held $9 billion in deposits and $900 million in investments. By 2015, deposits had grown to $26 billion and investments to $4.2 billion.

Humphrey is encouraging the HSA industry to do a better job of promoting the investment opportunities in HSA accounts. Unlike HealthEquity, he said, many HSA administrators outsource the investment portion of the business, do not make much money on that part of the

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business as a result, and so do not tend to promote it. Outsourcing also makes things more complicated for account holders, he argued. For example, it forces them to access their accounts through two different web portals, one run by their HSA administrator and the other by their investment manager.

This could change soon. When the Department of Labor issued a new rule earlier this year expanding the definition of a retirement plan fiduciary to include anyone offering investment advice to a plan or its participants, it specified that those rules apply not just to traditional retirement plans but also to HSA accounts. "The DOL rule," Humphrey said, "will force a lot of players in this space to not outsource (investment management) anymore."

If so, it could improve outcomes for account holders, at least judging by HealthEquity's experience handling investment management internally. The average five-year balance in HSA accounts that HealthEquity administers, Humphrey said, is more than $4,700, or about double the industry average. SVIA

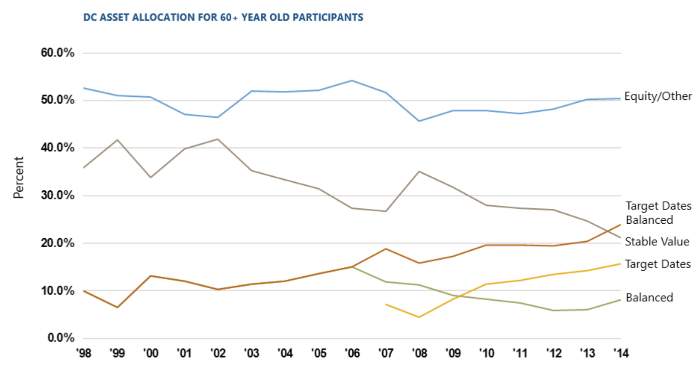
Defined Contribution Plans Evolving as Traditional Pensions Disappear

By Randy Myers

As traditional defined benefit pension plans continue to disappear around the world, the defined contribution plan market in the U.S. continues to evolve—with important implications for the stable value industry.

Speaking at the 2016 SVIA Fall Forum, Stacy Schaus, Executive Vice President and Defined Contribution Practice Leader for investment manager PIMCO, listed a number of key trends in the U.S. defined contribution market from their 10th Annual Defined Contribution Consulting Support and Trends survey:

- Plans, especially larger plans, are shifting away from using off-the-shelf target date funds as their default investment option and are turning instead to custom target-date funds built on open architecture platforms and featuring a broader array of diversified assets.
- Core investment lineups are becoming less equity-dominated and more balanced, and are broadening to include more real assets, diversified bonds, and global offerings.
- Plan sponsors increasingly are encouraging plan participants to leave their balances in their employer-sponsored retirement plans after they stop working, and are adding more investment options and services aimed at retirees.
- Automatic enrollment of eligible employees continues to grow in popularity.



Schaus said the growing number of defined contribution plans that automatically enroll eligible employees has dramatically improved plan participation rates. In a study by Aon Hewitt in 2015, for example, the participation rate reached 86 percent of eligible employees in plans with automatic enrollment, versus 63 percent in plans without it.

On the downside—for the stable value industry, anyway—auto enrollment is feeding a growing percentage of participant contributions into default investment options, such as target-date funds, and away from stable value funds and other core investment options. Partly as a result, target-date funds now account for about 25 percent of the assets in defined contribution plans, Schaus

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Defined Contribution Plans Evolving as Traditional Pensions Disappear

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said, versus about 12 percent for stable value funds. She noted that more than 40 percent of new contributions to plans are being allocated to target-date strategies, while only about 10 percent are going to stable value.

All this, Schaus said, is a reminder that the stable value industry needs to continue pushing to have its products included in target-date funds. She suggested the industry focus its efforts on plans with more than $1 billion in assets, where 57 percent of plan consultants recommend the use of custom target-date funds that can easily accommodate a stable value component.

To make that happen, Schaus continued, the industry may need to further educate consultants about the benefits of including stable value in target-date funds. Right now, 97 percent of consultants recommend that stable value be included among a plan's core investment options, but only 50 percent recommend stable value be included in blended investments, including target-date funds.

Schaus said consultants look first to fees and the diversification of a fund's wrap providers when evaluating stable value funds and managers, followed closely by a clear understanding of a fund's book-value risk, the depth of its investment resources, fixed-income manager expertise, and wrap-provider credit quality. Significantly less important, they say, are current crediting rates and diversification of fixed-income sub-advisors. Barely registering as key factors are past performance, less constrained guidelines, or having a boutique stable value provider.

Schaus noted that with millions of Baby Boomers reaching retirement age each year, plan sponsors increasingly are being urged to think about how they can help plan participants convert their retirement nest eggs into retirement income once they have stopped working. Asked which retirement income strategies they support most, consultants put target-date products with an at-retirement target date at the top of their list (actively promoted by 30 percent of consultants), followed by cash management products, including stable value (29 percent) and multi-sector fixed-income products (19 percent), Schaus said.

Consultants show considerably less enthusiasm for in-plan deferred income annuities (9 percent), in-plan immediate annuities (5 percent), and managed payout funds (5 percent). Concerns about in-plan insurance solutions, Schaus explained, include the cost and portability of the products and the federal government's failure thus far to create a fiduciary safe harbor for plans that offer them.

On a more positive note, Schaus said the stable value industry should be helped by new Securities and Exchange Commission regulations that require non-government money market funds to allow their net asset values to float, rather than maintain a constant NAV as has been standard in the past. Schaus said nearly two-thirds of consultants say they are likely or very likely to recommend that plans with a non-government money market fund replace it with an alternative capital preservation product. Where plan sponsors are seeking an alternative, she said, 81 percent of consultants say they are likely or very likely to recommend a stable value fund. SVIA

How New DOL Fiduciary Rule May Impact Stable Value Industry

By Randy Myers

A new fiduciary rule handed down by the U.S. Department of Labor (DOL) earlier this year will impact a wide range of constituents in the retirement industry, including the issuers of stable value contracts, according to industry experts who addressed the 2016 SVIA Fall Forum in Washington, D.C., in October.

Unveiled in April, the new rule expands the definition of a plan fiduciary under the Employee Retirement Income Security Act (ERISA) to include anyone making investment recommendations to a retirement plan sponsor or plan participant, or to the owner of an Individual Retirement Account (IRA). Those making such recommendations are now responsible for providing impartial advice that is in the client's

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best interest. Fiduciaries cannot accept payments that would create a conflict of interest, either, unless they qualify for any of several exemptions or exceptions written into the rule. The new rule also expands the concept of investment advice to include, among other things, recommendations on account rollovers and account types.

Attorney Michael Richman, a Partner in the Employee Benefits and Executive Compensation Practice Group at Morgan, Lewis & Bockius LLP, said the new fiduciary rule is likely to have the biggest impact in the small retirement plan and IRA markets, where in the past many financial advisors were merely required to recommend investments that were suitable for their clients. He said it will have a profound effect on how products and services are sold and provided to ERISA-governed retirement plans and IRA holders, both by brokers and by recordkeeping and platform providers.

One of the challenges for those providers, Richman said, will be determining what constitutes a "recommendation" that imposes fiduciary responsibility. Pure investment education would not. The DOL also specified that firms and individual advisors can market their services under the so-called "hire me" exception without becoming a fiduciary.

However, advice that could reasonably be viewed as a suggestion to take or not take a particular course of action generally would confer fiduciary status—especially if it was tailored to an individual. So could recommendations as to account types and particular platforms or programs, or to roll over a plan or IRA balance to an advisor. Actions that might not constitute a recommendation individually, Richman cautioned, could be considered a recommendation in the aggregate.

The new rule provides a number of exceptions to the general imposition of fiduciary status, including the independent fiduciary exemption, which is a carve-out for transactions with large retirement plans, banks, insurance companies, and other institutions that are independent fiduciaries on their own. There is also a carve-out for advice given by one employee of a plan to another.

Meanwhile, under the "best interest contract," or BIC, exemption, fiduciary advisors will still be able to receive compensation for a product or service that otherwise would be considered a prohibited transaction, provided they meet certain conditions aimed at protecting their clients' interests.

Within the stable value marketplace, Richman said, exemptions and exceptions to fiduciary status may be available in a number of instances, including sales of wrap contracts, where the independent fiduciary exception may apply; marketing of stable value management or advisory services, where the independent fiduciary or "hire me" exceptions may be available; and communications to plan participants, where an education exception may apply. The BIC exemption may apply, he said, when insurance and annuity contracts are recommended to small plans not represented by a bank, insurance company or registered investment advisor.

Naturally, different firms are likely to make use of these exemptions and exceptions in different ways.

Tom Schuster, Vice President, Stable Value and Investment Products at MetLife, noted that MetLife's stable value counterparties are almost exclusively major stable value managers and large plans. Their characteristics, he said, will allow MetLife to use the independent fiduciary exception when issuing wrap contracts, which in turn means that MetLife will not become a fiduciary when it transacts with a plan or pooled fund. "MetLife believes that relying on the best interest contract exemption, which requires acknowledging that the firm is a fiduciary and will act in the best interests of participants, enhances the risk of litigation," he said. "MetLife will not write business relying on the BIC exemption."

Schuster added that the SVIA is in the conceptual phase of considering a standard acknowledgement template that would outline the factual aspects of a wrap transaction. As envisioned, it would confirm that an issuer's counterparty meets the requirements for an issuer to rely on the independent fiduciary exception. Nick Gage, head of the SVIA Government Relations Committee, is leading the initiative.

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Schuster said he believes the DOL rule will be a major plus for stable value, in part because it imposes fiduciary status on an advisor who recommends that a plan participant roll out of a workplace retirement plan and into an IRA. That fiduciary burden, he said, is likely to cut such rollovers dramatically. If so, it could result in more money staying in defined contribution plans, where stable value investments are widely available, instead of going into IRAs. Further, the availability of the independent fiduciary exception means that operational complications of the rule will be minimal for most stable value market participants.

The new rule is scheduled to become applicable on April 10, 2017. While there has been some speculation that date could be postponed, Richman said a decision on that may not be known until after the general election in November, or even after the next president is seated. In addition to legislative proposals to repeal it, he said, the rule has been targeted by six lawsuits—since consolidated into four—for which hearings have been held but no decisions issued. Richman noted that past legislative efforts to block the rule have not been successful.

Stable Value Industry May Want to Weigh in on Proposed Changes to Form 5500

By Randy Myers

The Department of Labor (DOL) is soliciting public comment on changes it has proposed to Form 5500, the annual report that must be filed by retirement plans subject to the Employee Retirement Income Security Act. Theresa Brunsman, Senior Counsel for Invesco Ltd., suggests that members of the stable value community may wish to take the DOL up on its offer.

Speaking at the 2016 SVIA Fall Forum, Brunsman explained that the main goal of the proposed changes is to get more information from plan sponsors and other direct filing entities that are required to file the form each year, such as master trust investment accounts that hold assets for several different plans. The DOL is counting on the proposed changes to help it better analyze the data in Form 5500 filings, and to better understand where and how retirement plans are investing. Unfortunately, Brunsman said, the changes would make Form 5500 reporting more complicated and more expensive, without necessarily providing any great benefit to the DOL from either a data-mining or plan-disclosure perspective.

Among the more significant proposals is a requirement that plans create an individual Schedule C for each of their service providers, rather than one for all service providers. Plans also would be required to provide more detail about soft dollars and float, which are currently reported as eligible indirect compensation, as well as other factors that Brunsman said would be hard to quantify.

Brunsman said proposed changes to Schedule H of Form 5500 would impact pooled stable value funds. "If you're a direct filer or collective trust, for example, you are going to have to divide your asset reporting in ways you haven't had to before," she said. "Some of the changes about how you report bonds are quite large, and, I think, difficult to implement. For example, you have to report investment-grade and high-yield bonds separately in the corporate bond sector, and you have to base the distinction on the bond ratings in effect at the beginning of the plan year, (which) isn't how most managers keep track of bond ratings."

The DOL also has proposed that retirement plans break out hard-to-value assets, Brunsman said, without providing much detail about what would qualify for that designation. "It's something to have a look at," she advised her audience, "because it is meant to be anything that's not listed on a national exchange or over-the-counter market, or for which quoted market prices are not available. Some stable value assets might fall under that category and have to be considered hard-to-value assets, which would not be a good result."

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States Look to Close Retirement Plan Coverage Gap

By Randy Myers

In a country where defined contribution plans have become the most common way to save for retirement in the workplace, many Americans are being left behind. According to a study by the Pew Charitable Trusts, about 40 percent of full-time private sector workers in the U.S. do not have access to a workplace retirement savings plan. Now, many states are trying to resolve the problem on their own—with some new help from the Obama Administration.

Spurred by the President in August, the Department of Labor (DOL) issued a final rule designed to allow states to offer plans without being subject to the Employee Retirement Income Security Act (ERISA). Under the rule's safe harbor provisions, states could mandate that employers who do not already offer a workplace retirement plan automatically enroll their employees in a state-run plan, with contributions typically going into an Individual Retirement Account. Employees would have the option to opt-out of the plan.

The Obama Administration's insistence on creating this safe harbor has not been without controversy, and the DOL has long seemed unenthusiastic about the idea. The intent of ERISA, after all, was to safeguard the retirement savings of all Americans. The DOL has even acknowledged that while it has created what it considers a safe harbor for states—one that would not be preempted by ERISA—it will be up to the courts to finally decide that issue, not the executive branch of the federal government.

Despite these caveats, the new rule is expected to give impetus to state-led efforts that in some cases have been underway for years.

Speaking at the 2016 SVIA Fall Forum, Jessica Duhamel, director of public policy for Fidelity Investments, noted that since 2012, at least 30 states have considered proposals to study or establish state-run plans. The other key point Duhamel made is that six states have passed laws authorizing state plans (California, Connecticut, Illinois, Massachusetts, Maryland and Oregon) and that two states (New Jersey and Washington) have passed voluntary marketplace bills.

Of note, she said, no plans are operational yet, though Washington State is expected to be operational in January 2017.

In addition to the activity at the state level, Duhamel noted that some large cities, including New York City, Philadelphia, and Seattle, also have been exploring the possibility of creating their own plans.

The push for state-level plans may not be entirely free of self-interest on the part of government. Michael Tobin, Corporate Vice President, Office of Governmental Affairs, for New York Life Insurance Company, joined Duhamel in speaking on the topic. He noted that if Americans are not saving enough for retirement, it boosts the odds that government will need to step in to provide them with assistance after they stop working.

Howard Bard, Vice President, Taxes and Retirement Security, for the American Council of Life Insurers, added that it would not be surprising to see state-run plans challenged in court. Such a challenge might come from an employer who already offers a plan but would be required, by a new state mandate, to enroll part-time and seasonal workers into a state-run plan. The employer's argument, Tobin said, might be that under the state plan, workers would not enjoy the same fiduciary protections enjoyed by participants in traditional, ERISA-covered employer-sponsored plans.

"We could see a patchwork system that ERISA was supposed to prevent," Tobin concluded. SVIA

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Stable Value Industry May Want to Weigh in on Proposed Changes to Form 5500

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Elsewhere, Brunsman said, the DOL has proposed that mortgage-backed securities be reported in the real estate category rather than the debt category, where structured bonds are usually classified. It also has made ample provisions for breaking out insurance products, including stable value wrap contracts, but not bank-issued wrap contracts.

"It's going to be up to industry groups and institutions to offer comment to help the DOL provide better guidance and instructions for the form before it brings the final version out," Brunsman said. The objective of commenters, she added, should be to make sure that "everyone in the stable value industry, as well as any other asset class, can feel confident they know how to categorize their securities, their derivatives, and anything else, into a bucket that makes sense, and will help plan sponsors and the department."

Nick Gage, Senior Director and Head of Stable Value Separate Account Strategy for Galliard Capital Management, noted that the SVIA's Government Relations Committee had a "productive dialogue" with the DOL in June, prior to the announcement of the proposed changes, and that the department seemed open to providing further clarification on some of its proposed changes. But he seconded Brunsman's observation that members of the stable value community may wish to further weigh in on the proposed changes. The changes are scheduled to take effect in 2019.

Wharton Professor David Babbel Finds More Reasons to Like Stable Value

By Randy Myers

David Babbel, Professor of Finance and Professor Emeritus of Business Economics and Public Policy at the University of Pennsylvania's Wharton School, has been a fan of stable value for the past decade. He has written several papers on the asset class since 2007, the first sponsored by the SVIA and the rest written just because he finds the topic interesting. He is now contemplating producing yet another paper, and continues to conduct research on the asset class. His interest goes beyond the theoretical, though. In speaking engagements, Babbel likes to remind his audience that he has invested his own money in stable value funds in his retirement plans at Wharton and global consulting firm Charles River Associates, where he is a Senior Advisor.

In his earliest papers on stable value, written in collaboration with Miguel Herce, Babbel found that for investors with virtually any level of risk aversion, stable value had proved itself to be more attractive than either bonds or cash over the past few decades. He also demonstrated that adding stable value to an equity portfolio had been a better diversification strategy than adding either bonds or cash.

Speaking at the 2016 SVIA Fall Forum, Babbel said his newest research has uncovered several important new findings. It is distinguished from his previous work, he noted, because it relies for the first time on forward-looking expectations for stable value and fixed-income returns rather than past performance. That is important, he argued, because fixed-income returns over the past two and a half decades were skewed by an extraordinary bull market in that asset class—and stable value funds, of course, invest primarily in fixed-income securities. From 1990 through last year, Babbel noted, yields on long-term bonds fell to less than 2 percent from more than 9 percent, producing an average of about 3.5 percentage points of additional return each year over and above bond yields. With interest rates so low now, he said, it would be unrealistic to expect bonds to deliver that extra annual 3.5 percentage points of return in the years ahead, and therefore unrealistic to use the fixed-income returns of the past two and a half decades to compare stable value with other asset classes, or to calculate how stable value should fit in a model portfolio going forward. To perform his forward-looking analysis, Babbel used past levels of volatility as a measure of risk, but substituted the current yields of bonds to serve as a proxy for expected future returns.

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Wharton Professor David Babbel Finds More Reasons to Like Stable Value

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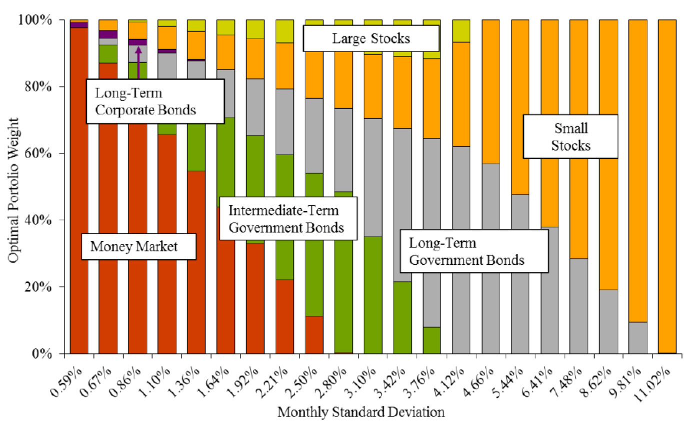
Before delving into the implications of all this at the SVIA forum, Babbel used a simple mean-variance analysis to demonstrate, as he has in earlier studies, that adding stable value to a diversified investment portfolio has produced a more efficient investment frontier. In fact, for most investors, including those with a high tolerance for risk, an optimal portfolio derived from mean-variance analysis would have consisted almost entirely of stable value, long-term bonds, and small-company stocks. That would leave out not only large-company stocks but also money market funds and intermediate-term bonds. "So much for the S&P 500, so much for target-date funds, so much for lots of stuff," Babbel quipped.

Optimal Portfolio Weights <u>without</u> Stable Value
(1988-Q4 – 2015-Q4)

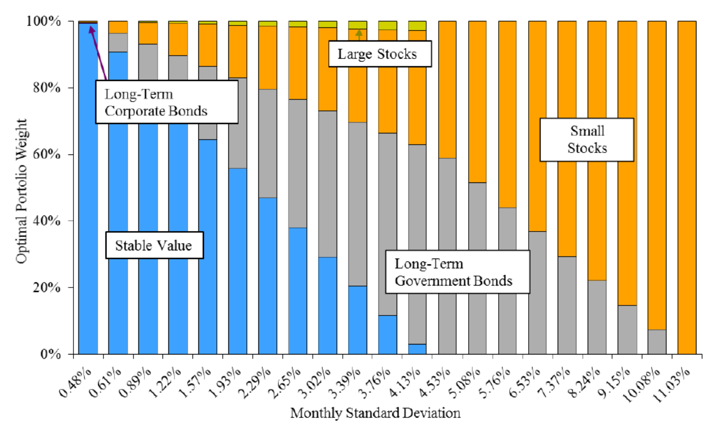


Babbel reminded his audience that mean-variance analysis, while popular, is inherently flawed, in that it penalizes an asset class as much for positive variances as it does for negative variances. Sortino ratios, which measure risk-adjusted return while penalizing only for negative variances, can provide a more meaningful picture of asset class performance. By that measure, Babbel said, stable value has provided about 20 times more "bang for the buck," or return in exchange for risk, than other major asset classes.

Babbel's favored tool for comparing stable value to other asset classes, though, is stochastic dominance analysis, which says in layman's terms that the more money you get, the more you like it. It shows, as Babbel has previously documented, that stable value dominates both money market funds and intermediate-term bond funds for risk averse investors, regardless of how risk-averse they are.

In his latest work, Babbel extended his analysis of stable value by using dynamic portfolio optimization to create optimal investment portfolios for any given level of risk. He focused, though, on the vast majority of people who are neither extraordinarily risk-averse nor extraordinarily aggressive. He then calculated what an optimal portfolio would look like when stable value is available to the investor, using

Optimal Portfolio Weights <u>with</u> Stable Value
(1988-Q4 – 2015-Q4)



two different methodologies: first, using historical return rates for bonds, and then using current yields as proxies for expected future returns. The latter approach addresses the problem cited earlier—the extraordinary bull market in interest rates since 1990.

Using only historical rates of return for a strongly risk-averse investor, Babbel demonstrated that an optimal portfolio would have allocated about 50 percent of its assets to stable value from 1993 through 2004, and about 25 percent from 2004 through 2015. Plugging in forecasted rates of return using current yields as proxies, however, produced portfolios that allocated about 80 percent of all assets to stable value for much of

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Wharton Professor David Babbel Finds More Reasons to Like Stable Value

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the time, and, except for one quarter, never less than 50 percent. Optimal portfolios for someone with a very strong aversion toward risk were even more heavily dominated by stable value, with the asset class almost never accounting for less than 80 percent of all assets. Babbel called these findings surprising.

"You guys have a good product," Babbel told his audience. "This is for Joe Consumer. This is not for the people who play the market; this is for the rest of us."

Recognizing that some people might argue that equity returns had been skewed over the past 10 years by the catastrophic bear market of 2007-2009 and subsequent recovery, Babbel also created optimal portfolios for each quarter of 2015 in which returns for stocks would be calculated by adding an equity premium to the 3-month Treasury bill yield. Returns for small stocks would be based on those figures plus the historical average spread between small and large stocks over the 80 quarters prior to the optimization quarter.

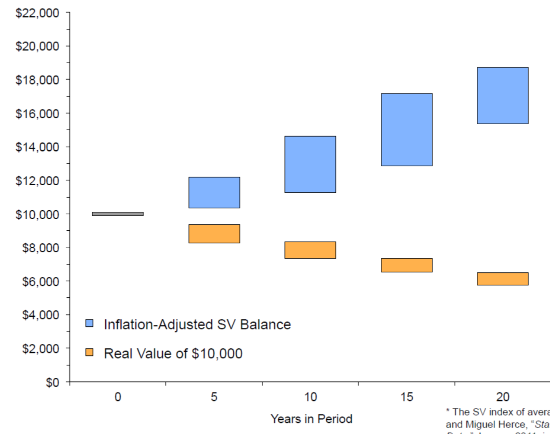
Here again, Babbel said, he was surprised by his findings. For an investor with strong risk aversion, stable value accounted for just over 80 percent of an optimal portfolio using an equity premium of 3 percent. The balance of the portfolio was roughly split between small-company stocks and long-term corporate bonds. With an equity premium of 5 percent, the allocation did not change much, and even with an equity premium of 7 percent, stable value still accounted for about 70 percent of the optimal portfolio for each quarter, or slightly more. Small stocks, long-term corporate bonds, and long-term government bonds, in much smaller proportions, rounded out the portfolios.

"What's missing?" Babbel asked. "Large-company stocks. No S&P 500."

Finally, Babbel conducted one more analysis, again with surprising results. Starting with a hypothetical $10,000 balance, he compared its real, inflation-adjusted value with the inflation-

Stable Value as an Inflation Hedge over Periods of up to 20 Years

(Sample is 1973-Q2 through 2015-Q4)



* The SV index of average crediting rates in David Babbel and Miguel Herce, "*Stable Value Funds: Performance to Date,*" January 2011, is used. Some data, including recent years, are preliminary and subject to revision.

adjusted value of a stable value portfolio for every five-year period beginning with the second quarter of 1973—the first year for which he had stable value return data—through the fourth quarter of 2015. He also looked at those returns for every 10-year period, every 15-year period, and so on, up to 30-year periods. His finding, he said, was that stable value was a good inflation hedge. The real value of a cash portfolio gradually declined throughout the 30 years in every time period studied. The real value of the stable value portfolio declined very slightly in a few of the five-year rolling periods, but generally outpaced inflation. This was even more pronounced over 10-year periods. It increased in value for every longer period analyzed. (A similar analysis, conducted for the 20-year period ending with the fourth-quarter of 2015, showed the stable value portfolio increasing in real value in every period analyzed.) In almost all of the holding periods studied, the value of stable value funds surpassed inflation, and usually by a substantial margin.

For anyone looking for a good inflation hedge, Babbel concluded, this analysis amounted to a clear demonstration of stable value's attractiveness.

Not that he needed any convincing.

Saving and Investing for Retirement: Surprising Mistakes People Make

By Randy Myers

Everybody knows where Americans go wrong in saving and investing for retirement. They start too late. They save too little. They invest too conservatively—or too aggressively. They borrow from their retirement accounts.

True enough. But as personal finance writer Martha Hamilton, now a Senior Editor at the International Consortium of Investigative Journalists, pointed out at the 2016 SVIA Fall Forum, Americans make a few other surprisingly devastating financial mistakes, too. According to financial planners she has interviewed, some of the biggest revolve around late-life divorce and dementia.

Late-life divorce is a rapidly growing trend, Hamilton observed, with the rate of divorce among people 50 and older doubling between 1990 and 2010. The obvious problem: a couple once planning to retire and live together end up living apart, significantly boosting their expenses as they try to maintain two households. Late-life divorce also can be wracked with emotion, leading some people to make less-than-reasoned financial decisions. It is not uncommon, for example, for a higher-earning spouse to be very generous in the settlement, to their own detriment.

In other cases, people just make bad choices. Hamilton recalled the story of one financial planner whose divorced client had fought hard to keep a $200,000 account, only to then go against the planner's advice and add a girlfriend's name to the account. "She'd just moved to where he lived, and they were to buy a house," Hamilton said, "but she cleaned him out and moved home $200,000 richer."

Hamilton said the chances for mishaps are many, especially if one spouse has been handling the family's finances and the other knows little about them.

Hamilton advised anyone contemplating divorce not to visit a divorce lawyer right away, but to see a financial planner or accountant instead. She also said couples might benefit from hashing out—while times are good—how they would handle a divorce in the event their marriage later soured, perhaps going so far as to draft and sign a postnuptial agreement.

If planning for divorce seems unpleasant, dealing with the impact of a dementia diagnosis can be even more depressing, Hamilton said. Friends and family often miss the early signs of the disease, she said, and by the time it is diagnosed it can be too late to save an individual's or a couple's assets. One financial planner she had interviewed had a client suffering from dementia who was still day-trading.

"There's so much to do immediately after the diagnosis that it leaves you exhausted," Hamilton said. "Your first response is treatment, and coping. You may have to move the person with dementia to another home. This doesn't leave you with enough energy to do what needs to be done with finances."

The fallout of dementia can impact not only the person who has been struck by the disease, but also those who step forward to care for the patient. Hamilton cited a study which found that caregivers on average spend more than $5,000 a year of their own money trying to help a dementia patient for whom they are providing care. "Some go without meals. Others can absorb the cost more easily, but it can be really hard."

Hamilton warned that people with dementia tend to develop problems managing money very early in the disease. They also become more susceptible to scams, like paying money to a predator pretending to represent the IRS. Some patients leave bills unpaid, or start donating excessive amounts to charity.

There is a lot of money at stake. The combined household wealth of Americans 65 and older is about $18.1 trillion, Hamilton said, and one in three older Americans dies with Alzheimer's disease or some other form of dementia.

As with divorce, Hamilton encouraged people to plan ahead for how they would deal with a dementia diagnosis. This can include having a lawyer draft a will and a durable power of attorney that gives a trusted person power to take over healthcare and financial decisions if needed. It also can include discussions with a financial planner about retirement.

More broadly, Hamilton encouraged the education community to begin teaching financial literacy as early as grade school. Today, she said, "we don't teach enough, and we don't teach soon enough. As a result, things go in the wrong direction. If you understand compound interest, you're more likely to do the right thing and start saving." SVIA

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Litigation: The New Reality for Defined Contribution Plans

By Randy Myers

For the past decade, sponsoring or servicing a retirement savings plan has been fraught with litigation risk. It could get worse.

The targeting of retirement plans by the plaintiffs' bar began in earnest in September 2006 when the St. Louis-based law firm of Schlichter Bogard & Denton filed lawsuits against several high-profile 401(k) plans. Most of the suits alleged the plans had been paying excessive fees to service providers, to the detriment of plan participants. The Schlichter firm has not prevailed yet in any of these cases, but it has collected more than $300 million in settlements. In the years since, more lawsuits have followed, not only against 401(k) plans but also, more recently, 403(b) plans. These suits allege a range of violations of the Employee Retirement Income Security Act (ERISA), including the increasingly popular claim that plans offered too many actively managed funds and not enough passively managed funds.

Now, plan sponsors, and their vendors and advisors, could be facing even more potential liability as a result of a new fiduciary rule handed down earlier this year by the Department of Labor. Scheduled to become applicable on April 10, 2017, the rule broadens the definition of a plan fiduciary under ERISA to cover anyone who makes investment recommendations to a retirement plan sponsor, plan participant, or owner of an Individual Retirement Account.

"The rule is intended to expand the universe of people who are subject to fiduciary responsibility," said Eric Mattson, a Partner, Class Action Litigation, for the law firm of Sidley Austin LLP, during a presentation at the 2016 SVIA Fall Forum in Washington, D.C. "And just like night follows day, litigation follows fiduciary status."

The most recent ERISA lawsuits have targeted 403(b) plans at prominent private universities such as Yale, the Massachusetts Institute of Technology, and New York University. The suits are similar to the 401(k) lawsuits, but with some new twists. Among other things, Mattson said, they contend that the plans offered too many investment options, which made them confusing for participants, and that they used multiple recordkeepers instead of one, incurring higher-than-necessary expenses. "There's a whole menu of claims and theories in these lawsuits that have not yet been tested, because 403(b) plans tend to have different structures than 401(k) plans," Mattson said.

One of the problems for fiduciaries in this new legal environment, Mattson said, is that guidance on what it means to be a fiduciary is not as explicit as it could be. At a high level, fiduciaries have duties of loyalty and prudence to their retirement plans and plan participants. Typically, this has been interpreted to mean that fiduciaries should make sure investment options offered are prudent, and that fees are not excessive. But attorneys say that guidance is muddy. In Tibble v. Edison International in 2015, Mattson noted, the U.S. Supreme Court confirmed that fiduciaries have a continuing duty "of some kind" to monitor investments and remove imprudent ones, and to conduct a regular review of investments, with the nature and timing of those reviews contingent on the circumstances. "Good luck advising plans on exactly what they are supposed to do," Mattson said of those instructions. He added that if nothing else, it means fiduciaries cannot—if they ever could—just "set and forget" a lineup of investment options for a retirement plan.

Where stable value has been an issue in retirement-plan lawsuits, Mattson said claims often have revolved around the idea that plans breached their fiduciary duty by offering participants a money market fund rather than a higher-yielding stable value fund. To date, he said, courts have generally not bought into this argument. Defendants have successfully argued that they chose money market funds after thoughtful consideration of the pros and cons of each type of investment.

In one case, Mattson added, the plaintiffs argued that because the stable value provider had sole and exclusive discretion to determine its product's crediting rate—and to set that rate below its internal rate of return—the provider was guaranteeing itself a substantial profit and not disclosing this to participants. Like many other defense attorneys, Mattson said he does not put much stock in this argument, but he noted that there has been no ruling in the case to date. He also noted that the more a crediting rate relies on a stated formula, the less risk a stable value provider should run.

In still another case, Mattson said, plaintiffs have argued that a stable value fund invested too

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Litigation: The New Reality for Defined Contribution Plans

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conservatively, leading to lower-than-necessary returns for investors. That case is continuing to wind its way through the court system.

What should fiduciaries do in the wake of all this litigation? Some things are obvious, Mattson said, advising that they:

- Conduct regular reviews of their investment lineup
- Adopt an investment policy statement
- Show their work (show they went through processes and thought about what they were doing in making decisions)
- Consider expenses
- Consider the performance of investment options
- Consider the effect of changes to an investment fund
- Consider hiring a consultant, or perhaps a formal fiduciary investment advisor
- Consider offering a stable value fund as a plan investment option instead of, or in addition to, a money market fund. SVIA

Stable Value Masterclass on Asset TV

By Jane Marie Petty

Four stable value industry experts recently participated in Asset TV's Stable Value Masterclass. The panelists were James J. King, Managing Director and Client Portfolio Manager at Prudential Retirement; Warren Howe, National Director of Stable Value at MetLife; Karl Tourville, Founding Managing Partner of Galliard Capital Management; and Karen Chong-Wulff, Managing Vice President of Fixed Income at ICMA-RC. The moderator was Asset TV's Courtney Woodworth. Following are highlights of two of the topics covered during the 52 minute Masterclass: the impact of Money Market Reform on the Stable Value asset class and the experts' thoughts on why they look forward to higher rates and why rising rates will benefit stable value. The panel also discussed several other issues impacting the industry including the overall health of the industry and where the growth opportunities are for stable value. To view the full informative Stable Value Masterclass, visit Asset TV.com

The Impact of Money Market Reform on Stable Value

The panelists all agreed that Money Market Reform presented significant opportunities for the stable value asset class. "What happened was a lot of the assets came out from prime money market funds into government money market funds. As a result you saw lower rates in government money market funds, so the spread between stable value and government money market funds were even greater. That presented an opportunity for stable value," explained Karen Chong-Wulff. Karl Tourville added that Galliard saw strong new flows into its stable value strategies, particularly from plans that opted to eliminate their money market fund options. MetLife's Warren Howe pointed out, however, that while Money Market Reform definitely served as a trigger point for the reemergence of stable value as an ideal capital preservation option, he emphasized that stable value has always been the right choice relative to money market options and history shows that there has always been a clear quantitative advantage for stable value. "Look at historical one year periods, three year periods, five year periods, ten year periods, and you'll see that stable value significantly outperforms money market funds. So from a quantitative perspective, stable value has always been the right choice relative to money market funds. But now because of Money Market Reform, plan sponsors need to take some level of action, whether it is to choose to stay in a government money market fund or elect to move to stable value. As a fiduciary, they're making a decision now. So it's really the right time when you're doing that analysis and you look at it as a 0% yield versus kind of stable value in the 1½-2+ range, really the time is right and stable value is positioned quite well," noted Howe. Prudential's Jim King also agrees that the spread between stable value and money markets is very attractive. "It's right above the long term average. And what's really good about the opportunity right

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Stable Value Masterclass on Asset TV

Continued from page 16

now is that if the Fed does start to tighten, even if it's very gradual over time, we'll see interest rates rise not only in the short end, but in the short to intermediate part of the yield curve where stable value does most of the investing, that's where we put our money. And so those higher rates should produce even more attractive returns for plan participants going forward." Howe and King anticipate changes and movement from money market funds into stable value to continue well beyond the October 14th Money Market Reform implementation deadline into 2017 and 2018. Howe noted that there are still a number of plans that need more time to conduct due diligence as a fiduciary before making changes to their plans. Therefore even if plans moved to government funds, there is still a significant amount that will move to stable value beyond the October 14th date.

Rising Rates Will Benefit Stable Value

All the panelists welcome higher rates and believe this will benefit stable value. Karen Chong-Wulff explained that stable value is designed to perform well, whether rates go up or down. "What happens with stable value, because of its design, is it will rise with interest rates, not as fast as money market funds, but it is going to go up. I think we should all be excited that it's going to go up because I wouldn't want to be in a prolonged low interest rate environment situation where stable value doesn't even beat inflation. Higher rates would actually be a welcome change. And because of the way the product is designed and what we've gone through all these years, I think we are in a really good position, you know, where we have excess reserves, in terms of the market to book value ratio. We have enough reserves for us to be able to cope with higher interest rates as well." Karl Tourville agreed with Chong-Wulff. " We would love to see an increase in interest rates. I think we have more risk on the downside of a low interest rate environment than we do in increasing rates. And as Karen said, stable value funds will increase or decrease with the market, but at a slightly slower rate." Warren Howe further elaborated that "if interest rates start to rise, money market rates will rise as well. But there's a significant cushion between the returns of a stable value fund and money market. So if you get an orderly increase in rates, you know, 25 here, 25 there, rates start to move, stable value has got a large cushion already. So it will continue to move up as well. The other thing about money market funds is many of the money market funds waived their fees during kind of the financial crisis, and while yields have been zero. So if rates pop 25 basis points, 50 basis points, that isn't all going to come through on a money market fund because they're going to start to reinstate their fees. So they will not get that exact pick up. And lastly, when I think about stable value, while rates rise and it has this inverse reaction to the bond market, it's part of a Defined Contribution plan. There are regular flows of contributions from participants. And as those flows come in, they get reinvested as rates are moving up. So there's always been a concern about stable value in a rising rate, but I think it's a bit muted by all of that." King agreed with the rest of the panelists. "Rising rates clearly will benefit stable value. To Karen's point, which I think is interesting, right now the average stable fund has a yield somewhere around 1½-2%, which is running right at about the rate of inflation. So

I think the Fed could move rates up one or two times you would see the short to intermediate part of the yield curve respond very favorably. And if we got rates up another say 50-100 basis points, it would begin to provide a better premium above inflation.

King also commented on asset classes more broadly than stable value and noted that while a 2% stable value rate may not sound like a lot, most models today on the stock side expect 4-6%, significantly below where they have been historically. And King noted that as rates start to rise, bond prices are going to go down. So stable value, given an increase in yield in a rising rate environment and no principal preservation downside, is going to be very attractive.

The full Masterclass discusses many other timely issues impacting the stable value industry including structural changes in stable value funds since 2008, including more stringent investment guidelines, and improved risk management practices throughout the industry. The experts also discuss future growth opportunities for the stable value asset class including increased usage in custom target date strategies and 529 savings plans.

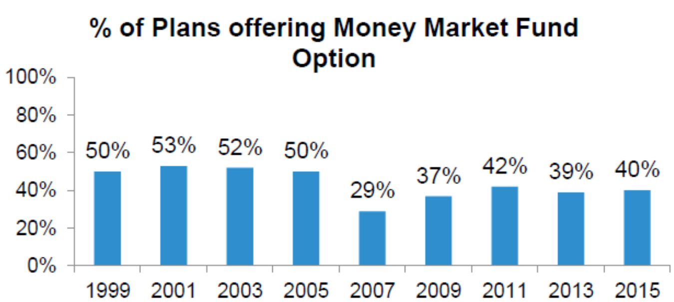
Visit Asset TV Stable Value Masterclass to stay up-to-date on industry trends.

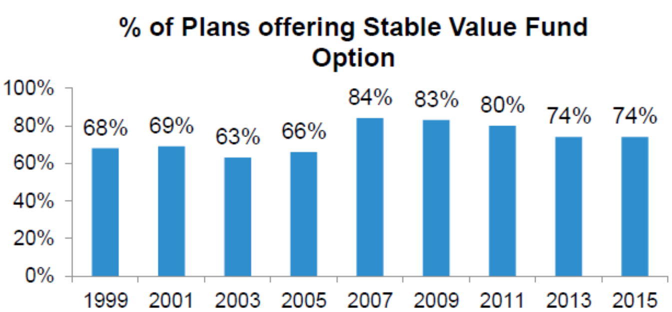
A Consultant's View on Defined Contribution Plans and Stable Value

By Randy Myers

Target-date funds are capturing an increasing share of the assets in defined contribution retirement plans. But Jacob Punnoose, a Partner in Aon Hewitt Investment Consulting, says the future remains bright for stable value funds, too.

Speaking at the 2016 SVIA Fall Forum, Punnoose said that even if stable value's share of the defined contribution marketplace continues to moderate, the ongoing creation of new plans and the continued flow of new money into existing plans means there is still a lot of opportunity for stable value over the near-to-intermediate term.





* Source: Aon Hewitt Biennial 2015 Trends & Experience in Defined Contribution Plans Survey

Longer term, Punnoose said, stable value providers will need to find a way to have their product included in target-date funds, which have become the predominant default investment option at companies that automatically enroll eligible employees into their plans. The easiest way to do that, he said, will be to promote the use of custom target-date funds that can easily incorporate a stable value component into their investment mix. But "easy" may understate the task.

"It's going to be an uphill challenge in terms of converting plans using off-the-shelf target-date funds to custom funds," said Punnoose "By and large, it is the larger plan sponsors who are more amenable to it. Smaller plan sponsors are reasonably happy with off-the-shelf target-date funds, even if there is the potential for more alpha and more asset-class diversification with custom funds."

One arrow in the stable value industry's quiver, Punnoose noted, is that its product serves a true purpose in defined contribution plans. "When we talk with our plan sponsors about the different investment options and investment structures they want in their DC plans, there are a lot of differing opinions. But one common element across almost every plan sponsor we talk to is that they want a stable net-asset-value product. That would be either a money market fund or a stable value fund. And given that stable value has outperformed money market over long periods of time with similar levels of risk, it is not surprising that a majority of plan sponsors use stable value funds."

Punnoose said stable value also could benefit from a relatively new trend to reduce the number of investment options within defined contribution plans. In consulting with plan sponsor clients, he said, Aon Hewitt often promotes the benefits of adopting a streamlined investment menu. Such a menu might include a suite of target-date funds along with four core stand-alone funds: a growth fund, an income fund, an inflation fund and a capital preservation fund. "In that construct, where you're reducing the number of options, the relative importance of stable value increases," he said. "It now becomes one of perhaps four non-target-date funds. So there might be more attention paid to each of those individual options."

Elsewhere, Punnoose documented a number of developments favorable for stable value funds, and others that are worrisome, like the growing incidence of lawsuits targeting stable value funds. The lawsuits allege a diverse range of missteps, from overly conservative to overly aggressive investment management.

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A Consultant's View on Defined Contribution Plans and Stable Value

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Among the positive developments, Punnoose said, are the significant increase in stable value wrap capacity in recent years, and recent rule changes imposing increased transparency and reporting requirements on institutional prime money market funds. Those rule changes are driving some retirement plans to offer stable value funds instead of money market funds. Among plans served by Aon Hewitt, Punnoose observed, 40 percent offered money market funds in 2015, down from 50 percent a decade earlier. During that same period, the percentage of plans offering stable value funds rose to 74 percent from 66 percent.

Punnoose sees potential for significant additional flows of money away from money market funds and into stable value. Where plans have not moved to stable value so far, he said, common stumbling blocks include concerns about future wrap capacity and about employer-initiated events that could put book-value withdrawals in jeopardy, at least temporarily. And some plans, he said, simply find it easier to switch from a prime money market fund to a government fund that is not subject to the new regulations.

In plans that do offer stable value, Punnoose said, the percentage of plan assets allocated to stable value has edged lower over the past 10 years. This is a consequence in part of the bull market in equities, and of the growing popularity of target-date funds as a default investment option for participants who are enrolled in their plans automatically.

The keys to growing the stable value market in the years ahead will include promoting the use of stable value in target-date funds and ensuring that the consulting industry understands the product. Consultants who understand stable value, he said, are more likely to recommend it to their plan sponsor clients and to accentuate the positives of stable value relative to money market funds.

Punnoose said the stable value industry also will want to emphasize the role stable value can play in helping retirement plan participants meet their income goals in retirement, make stable value less operationally complex for plan sponsors, make stable value vehicles available to very small plans, ensure that book value accounting for stable value funds continues to be accepted, and look for growth in the 403(b) retirement plan market and internationally.

Donahue Article Identifies Important Considerations in Selecting Stable Value

By Gina Mitchell

An article, "Fundamental Investment Principles of DC Option Selection Prove Optimality of Stable Value," by Paul Donahue, a proponent of stable value, was recently published in the Society of Actuaries' Pension Section News which is "a medium for the timely exchange of ideas and information of interest to pension actuaries." However, the article should be of interest to all ERISA fiduciaries as well as those interested in stable value.

Besides making the case as to why he believes stable value should be the conservative option in a DC plan, Donahue highlights important considerations in the type of stable value fund used. Specifically, Donahue highlights pooled fund and individually managed account structures by focusing on the importance of contract terms and their potential impact on book value, or, as Donahue describes, "the stable (non-decreasing) net asset value for all transactions permitted by the plan." His article focuses on three areas that can impact participants' stable net asset value: employer events, contract termination, and exit provisions for pooled funds. Donahue also discusses considerations in choosing between pooled funds and individually managed accounts.

The full article can be found on the Society of Actuaries webpage.