

## The Evolving Definition of Competing Funds

By Randy Myers

**T**here was a time in the stable value industry when the term “competing fund” almost always referred to one thing: a money market fund.

No longer. Over the past decade or so, the financial services industry has rolled out a slew of new investment products for defined contribution plans, from inflation-protected bond funds to target-date funds and self-directed brokerage accounts. Stable value issuers—particularly stable value wrap issuers—have had to think carefully about how plan participants might use these new products during periods of rising interest rates, and whether they should be classified as competing funds subject to the same trading restrictions typically imposed on money market funds.

Those restrictions are aimed, of course, at discouraging plan participants from trying to arbitrage stable value funds and competing funds when interest rates are rising sharply. The most common restriction is an equity wash rule that requires money moving from a stable value fund to a competing fund to first go into an equity fund for a fixed period of time—usually 90 days.

During a panel discussion at the 2013 SVIA Spring Seminar, executives from four firms—two portfolio managers and two wrap issuers—talked about how their definition of competing funds has evolved, how it continues to evolve, and how the industry can make competing-fund restrictions less objectionable to plan sponsors.

Anthony Luna, vice president and portfolio manager for T. Rowe Price Associates, said his firm generally defines competing funds as fixed-income products with a duration of three years or less. However, he noted, some wrap providers also put certain asset-allocation products under the competing-fund umbrella. These can include target-date funds and balanced funds, but typically only when they have a large allocation to fixed-income assets—perhaps 75 or 80 percent of the portfolio—and when the duration of that part of the portfolio is less than three years. “Most of our contracts also view self-directed brokerage accounts as a competing fund,” he added.

Jennifer Gilmore, head of stable value portfolio management for Invesco Advisors Inc., said her firm’s definition of a competing fund is similar to the one Luna spelled out. She added that self-directed brokerage accounts are the investment option that most often prompts discussions with wrap providers over whether they should be placed in the competing-fund category. “We have to look at the specifics over every plan’s self-directed brokerage window,” she said, explaining that her firm typically allows no more than 25 percent of plan assets to be allocated to that investment option.

Christopher Pellegrino, a portfolio analyst for Transamerica Stable Value Solutions, and Tim Grove, vice president of markets-product risk for Prudential Financial, said their definitions of competing funds are similar to those used by T. Rowe Price and Invesco, too. Grove noted, though, that his firm sometimes classifies Treasury Inflation-Protected Securities, or TIPS, funds as competing funds, too, assuming they have a short duration. Most do not, he conceded, although he said duration is not the only factor his firm considers.

“When we think about TIPS funds, we also think about how it’s communicated to plan participants,” he said. “What does the fact sheet say? How does it describe the fund’s objective? Will it be a safe alternative to stable value, even if there might be some underlying characteristics that could cause fluctuation? How is the participant going to view it? We’ve seen similar funds described differently, and how participants see it can be important.”

Grove also conceded that the stable value industry has not reached a consensus on whether to treat self-directed brokerage windows as competing funds. His firm does. “It’s the access they have to money market funds underneath that’s the issue,” he said.

Gilmore said the arbitrage risk embedded in brokerage windows should be a concern to every plan sponsor as they seek to protect the interests of their plan participants, particularly those invested in stable value. Often, she said, it

is the most sophisticated plan participants who are most likely to use brokerage windows and who are, perhaps, most likely to spot and act on arbitrage opportunities. “Overall, plan sponsors understand,” she said. “They just want (any restrictions on the use of competing funds) to be workable. They have to be restrictions their record-keeper can implement, and that they can communicate clearly to participants.”

Luna added that as a stable value manager, it’s easier for him to justify competing-fund restrictions to plan sponsors when those restrictions are workable. “If I don’t believe in what

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## Baby Boomers, the Financial Crisis and the Recession

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To promote better retirement outcomes, Rix encourages Boomers to take advantage of training programs offered by their employers, not only to enhance their value in their current positions but also to make them better qualified for other jobs. From a public policy perspective, she added, training programs should be made more widely available.

Rix also suggested that policymakers and employers do more to promote saving, to monitor and enforce age-discrimination laws, to provide more flexible work arrangements, and to provide advice and support for entrepreneurship among Boomers.

Finally, Rix said, policymakers in Washington must take measures to preserve the financial integrity of the Social Security system. “We need to recognize that Social Security is, and will likely remain, the bedrock of retirement security in the U.S.,” she said. “It is important—critically important—that we encourage savings and provide people with opportunities to save more readily than many of them are doing now. But those savings should be on top of, not in place of, Social Security.” 

## Capacity in Stable Value Industry Up Significantly for Second Straight Year

By Randy Myers

For the second straight year, the stable value industry has the capacity to take on a significant amount of new business—a welcome turnaround from conditions that prevailed in the immediate aftermath of the 2008 credit crisis.

In 2012, the industry absorbed \$66 billion in new business, according to data compiled by LIMRA, an insurance industry trade group, and the SVIA, slightly outpacing the \$60 billion in new capacity that a poll of stable value providers had indicated would be available.

This year, a survey by the SVIA found that providers expect to have net new capacity of \$103 billion in 2013, including \$15 billion from new entrants into the marketplace. To put those numbers into perspective, the SVIA calculates that total assets in stable value funds reached \$701 billion last year.

Speaking at the 2013 SVIA Spring Seminar, Marijn Smit, president of Transamerica Stable Value Solutions, said the March 2013 survey drew responses from 27 of the 30 stable value issuers polled, including six banks. Of the 27 who did respond, 23 were existing issuers, and four were potential new entrants to the market, including three insurance companies and one bank. The existing issuers had \$435 billion in stable value balances as of December 31, 2012.

Whether the industry is able to put all its available capacity to work will depend on demand from retirement plan sponsors for stable value funds, of course, but it also could be impacted by market developments. The issues most likely to inhibit providers from putting their capacity to use, survey respondents said, would be the absence of an equity wash rule in plans that have competing funds, funds with market-value-to-book-value ratios below par, and unattractive duration limits on funds and their underlying investments.

Phil Maffei, a senior director with TIAA-CREF, told Spring Seminar participants that his company has added capacity by providing a bundled offering, meaning that TIAA-CREF

not only provides the wrap contract but also manages, through an affiliate, the underlying investment portfolio. It took in its first deposit in May 2012.

Maffei said the single biggest issue TIAA-CREF had to overcome in entering the wrap side of the stable value business was simply coming to

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you're telling me and you're putting me in front of a client, typically the conversation doesn't go well," he said. By way of example, he said it would be difficult for him to defend a request to classify a TIPS fund with a 9-year duration as a competing fund. "Some sponsors are fairly sophisticated investors; they might run their own bond portfolios," he explained. "When you try to tell them a long-duration TIPS fund is a competing fund, they're not buying it."

Gilmore noted that plan sponsors are sensitive to competing-fund restrictions, especially when the fund in question has been in a sponsor's plan for some time without any restrictions. "Every time a new fund is declared competing, that's another event requiring the sponsor to go in front of a committee and explain it," she said. "And they're making more of these trips, on many different subjects."

"We can help by being more consistent on definitions of competing funds," seconded Grove.

Bradie Barr, senior vice president-marketing for Transamerica Stable Value Solutions and moderator of the panel discussion, asked if there were risk mitigation tools that might be more palatable to plan sponsors and plan participants than an equity wash. Gilmore was not sure. "A lot of plan sponsors are used to the equity wash now," she said. "We did some brainstorming internally and a lot of the alternatives we brought

up were more restrictive than an equity wash. We had started thinking about trading restrictions when market value is below book value for stable value funds, or imposing some type of fee for going to a competing option. But I think those just create more complications and concerns. So I do not know that there's an easy answer to the question."

"From my perspective as a manager, choice for sponsors is always good, especially for our separate account clients," Luna offered. He said one option the industry might consider is increasing the cash buffer in a stable value fund in lieu of imposing an equity wash. That would shorten the duration of the underlying portfolio, make additional funds available to meet redemptions if plan participants tried to arbitrage stable value and competing funds, and help protect wrap issuers. It would, in effect, quantify for sponsors the "cost" of an equity wash. "Clients appreciate a quantitative approach and choice," he said. "It may not be the solution for everybody, and as an investment manager I may not be a big fan of it, but some sponsors may feel it's more appropriate for their participants." Assuming a fund had a strong market-value-to-book-value ratio, Luna said, a bigger cash buffer could be a "fairly easy" solution.

Grove was hesitant to endorse the cash buffer solution, saying it might be difficult to come up with an industry standard for how big cash buffers should be. "A good thing about an equity wash is that there is a common understanding and acceptance of it," he said. And, he added, it effectively provides two protections. First, it forces plan participants to put their money at risk for some period of time—usually 90 days—if they want to engage in interest-rate arbitrage. Second, by the time that period has passed, the arbitrage opportunity may have passed, too.

Pellegrino said one way the industry can minimize controversy over competing-fund restrictions is to work with plan sponsors when they are setting up plans to make sure there are no competing funds in the investment lineup right from the start. "That way, we don't have to go back and have other conversations after the plan lineup is set up," he said. 