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Stable Value Assets Continue to Grow in 2012

By Randy Myers

The stable value market continued to grow again last year as retirement plan participants continued to show enthusiasm for the steady returns and principal guarantees offered by the asset class.

Assets in stable value funds grew 8.5 percent to $701 billion in 2012[1], giving stable value about a 14 percent share of total defined-contribution-plan assets, Jim King, chairman of the Stable Value Investment Association's board of directors, told participants at the SVIA 2013 Spring Seminar. That increase followed growth of 19.6 percent in 2011, and while it was attributable in part to investment gains, King said that with stable value crediting rates averaging about 2.5 percent last year, more of it came from new contributions to the asset class.

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[1]SVIA 17th Annual Investment and Policy Survey

U.S. Interest Rates: What We Should Expect

By Randy Myers

The financial markets appear to be getting it right.

As the Federal Reserve continues to pursue an extraordinarily expansive monetary policy, it is hard to know where interest rates are, where they should be, or how quickly and dramatically they might change once the Fed finally begins to shift to a more normal monetary stance. Michael Simpson, head of strategic portfolio management for Transamerica, asserts that interest rates—both in the spot and futures markets—are behaving the way politics, theory, and history suggest they should. "Barring an economic shock," he told participants at the 2013 SVIA Spring Seminar, "the markets have it right."

One key to understanding where rates are heading, Simpson said, is to pay attention to what the Fed is saying. The Fed has said it

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Fiscal Concerns: Goldman Sachs Asset Management Offers an Update

By Randy Myers

Continued modest economic growth, low interest rates and benign inflation should provide a fertile backdrop for the U.S. equity market in the year ahead, says Samantha Davidson, managing director with the Global Portfolio Solutions Investment Team at Goldman Sachs Asset Management.

Speaking at the 2013 SVIA Spring Seminar in April, Davidson reeled off a string of reasons why the U.S. economy appears poised for further growth. Five years after the 2008 credit crisis, she said, the U.S. financial system is largely healthy. Corporate balance sheets are improving. Consumer spending is on the upswing and so is the housing market. Its improvement should contribute about half a percentage point to GDP growth this year.

The U.S. also is experiencing an energy boom in the form of increased oil and natural gas production, which should make it less dependent on foreign oil and could create a meaningful competitive advantage for domestic companies sensitive to energy costs. By the end of this year, Davidson said, the U.S. could be exporting more oil than it imports.

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King said it also appeared that more plan sponsors were adding stable value funds to their investment menus. They appreciated stable value's unique attributes, including principal protection and predictable returns that outpace inflation, when assessing conservative investment options, King said. They also liked the idea that stable value's predictable returns mean plan participants are less likely to try to engage in market-timing of the sort more volatile investments might encourage. All these factors, he said, are good reasons for plans that offer stable value to continue doing so, and for those that do not to start.

King noted that stable value funds proved particularly attractive during the 2008 credit crisis and its aftermath. Thanks in part to their performance during that stretch, stable value funds returned an average of 6.1 percent annually from 1989 through 2009, outpacing intermediate-term bond funds (5.6 percent), money market funds (3.9 percent) and inflation (3.0 percent).

To encourage further growth in stable value funds, King said the industry must continue to offer crediting rates that outperform money market funds by a clear margin over the long haul. That means the industry cannot allow its investment strategies to become too conservative, he said.

Assuming that demand for the asset class does continue to grow, King said there now appears to be plenty of capacity to meet that demand. In 2012, the market produced more than $60 billion in new capacity, he said, and a recent survey of providers suggests that $100 billion in capacity should be available this year.

"I think the asset class will continue to grow," King said. "I'm finding more and more influential consultants and advisors are recommending the adoption of stable value to their plan-sponsor clients. Things are looking very positive for the industry."

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intends to keep the target for the federal funds rate—the overnight rate at which banks borrow from one another—near zero percent as long as the unemployment rate stays above 6.5 percent and the outlook for inflation stays below 2.5 percent. Trading in futures contracts for both Fed funds and Treasury bonds, Simpson said, indicates that investors are anticipating the Fed will begin to tighten monetary policy in the fourth quarter of 2015. That dovetails with the Fed's forecast that the unemployment rate will be between 6 percent and 6.5 percent by that time. "It is commonly understood that the Fed's growth forecasts have been high," he said, "so it is reasonable to agree with the markets and go with the top end of the Fed's range."

Simpson noted that the Fed has been making an effort to communicate how long it plans to keep short-term interest rates near zero percent so that investors can price that into their thinking. "This has resulted in forward rates that reflect the best estimates of future Fed policy actions," he said.

The Fed also has outlined the exit strategy it will likely use when it begins to tighten monetary policy. Because it has laid out so clearly what it is doing and what it intends to do, Simpson said, the Fed's move toward a tighter monetary stance should not be too disruptive. "Interest rates probably won't jump dramatically just because the Fed says it's going to stop buying Treasuries and mortgage-backed securities and start selling them instead," he said. "Rates could jump drastically if the Fed said it was going to sell everything on its books at once, but it probably won't do that."

In fact, Simpson said, several factors could pressure the Fed not to raise rates too quickly. With about $11.5 trillion in federal debt outstanding, he noted, even a 100-basis-point increase in interest rates would add $150 billion to the federal government's debt service costs. So raising rates is nothing to do cavalierly. Private borrowers, too, would be squeezed. "There may well be some feedback," Simpson concluded, "that constrains the rates at which interest rates can rise."

The economy

Just as interest-rates have been consistent with what the Fed has been doing and telegraphing, so too has the performance of the overall economy aligned with what history tells us. As would be expected, credit and nominal GDP, which surged prior to the 2008 financial crisis, have since fallen by a comparable amount. Real GDP growth is substantially lower, the unemployment rate is significantly higher, real housing prices are down, and the real value of government debt has surged.

Against this backdrop, a number of additional factors are holding back the economy. The defining feature of the financial crisis was the massive amount of debt, or leverage, that had piled up in both the public and private sectors, Simpson said. Leverage accelerates economic growth. But now both the public and private sectors are deleveraging, which inhibits growth. The economy is being restrained by the sequestration cuts in federal spending that began to take effect this year, by slowing productivity growth as

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Regulators Continue to Study Dodd-Frank's Applicability to Stable Value Contracts

By Randy Myers

When Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, it tasked the Securities & Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) with conducting a study of stable value contracts. The goal was to determine whether stable value contracts should be treated as over-the-counter derivatives contracts—what Dodd-Frank calls swaps—under the legislation, making them subject to additional regulation and oversight. At the time of the law's passage, there was concern that the statute's definition of a swap was so broad that it might encompass products, most prominently stable value contracts, that many policymakers felt were never intended to be subject to the law.

Of the two regulatory bodies, the CFTC has been taking the lead in the study, while the SEC has been addressing more pressing imperatives imposed by Dodd-Frank. Recently, the SEC asked some wrap issuers to provide examples of their contracts for the study, suggesting that the Commissions may be devoting more time to the stable value study in the months ahead.

Regulators have three options for how to handle stable value contracts. They can rule that the contracts do qualify as swaps and are subject to Dodd-Frank regulation. They can rule that they do not qualify, and are not subject to regulation. Or they can determine that stable value

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Washington has also been the source of some good news lately, Davidson noted, even if it has gone little noticed. The federal deficit, for example, has been shrinking at a rapid pace relative to the size of the economy. It stood at about 10 percent of GDP in 2009, but should be only about 3 percent of GDP by 2015, Davidson said. Congress and the White House showed some surprising harmony in getting things done in the first quarter, raising the federal debt limit and making sure that the federal government did not shut down.

Goldman Sachs Asset Management is projecting that the economy will grow approximately 2.3 percent this year, Davidson said, although potential pitfalls abound. Key risks include the possibility that the federal government will tighten fiscal and/or monetary policy prematurely or excessively, and that Europe's sovereign debt woes might flare anew. The Euro zone economies are already weak, Davidson said, and GDP there could fall by around 3 percent this year.

Looking to Asia, China is a concern as well. Its economy grew approximately 10 percent annually for the past decade, but the consensus is that it will grow only around 7 percent a year for the next decade, Davidson said. Even that is dependent in part on the country being able to drive consumer spending without excessive reliance on credit.

Closer to home, the U.S. economy faces headwinds, Davidson conceded, including the sequestration spending cuts that began to take effect earlier this year. They will be negative for the economy, she said, but also temporary and manageable, as will recent income tax increases. Meanwhile, she said, improved corporate profit margins should help to offset those negatives. She noted that rising profit margins preceded investment growth during the last two business cycles.

Davidson said interest rates are likely to remain low over the next 12 months, with the yield on the 10-year Treasury bond possibly climbing to 2.5 percent, up from about 1.7 percent in mid-April. Guidance from the Federal Reserve, which has vowed to keep interest rates low until unemployment falls to 6.5 percent, suggests that interest rates may not start to rise in earnest until the 2015-2016 time frame. Inflation, Davidson added, is likely to remain below 2.0 percent through 2015, although the risk that it might unexpectedly accelerate has picked up. Here again, the concern is that the Fed might misread signs of falling unemployment and tighten monetary policy too soon. Alternatively, some geopolitical event could cause commodity prices to spike, which typically spurs inflation.

In light of her firm's economic outlook, Davidson said Goldman Sachs Asset Management in mid-April considered equity valuations "still somewhat attractive," even if they were less attractive in both the U.S. and Europe, due to recent rallies, than they had been several months earlier. "We expect equity markets to be quite strong," she said. Davidson added that her firm was recommending an overweighting in Japanese equities in the wake of the Bank of Japan's recently announced plan to double the country's monetary base.

In the credit markets, Davidson said, strong corporate balance sheets suggest that defaults should remain low. In mid-April, her firm considered high-yield bonds more attractive than either investment-grade corporate debt or emerging markets debt. The firm also saw less risk in shorter-duration assets than in longer-duration assets. "Relative to other asset classes," she said, "muted returns can be expected from emerging markets debt, corporate credit, and government bonds, given their current low yields and potential for rising rates."

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well as a weakened European economy. All this suggests, he said, that we can expect the recovery from the 2008 crisis to continue to proceed at a slow pace, keeping downward pressure on interest rates and inflation for the next few years. While real GDP growth should be 2.4 percent, he said, it is more likely to be in the 1.5 percent to 2 percent range.