Insight INVESTMENT

EVALUATING A STABLE VALUE INVESTMENT OPTION

CHOOSING AN APPROPRIATE INVESTMENT VEHICLE

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EXECUTIVE SUMMARY

AN INTRODUCTION TO STABLE VALUE

Stable value investments are a popular investment product offered within participant-directed defined contribution plans (such as 401Ks) and other tax-differed pension savings vehicles. The primary objective of stable value products is capital preservation, with yield or total return a secondary priority. These products provide next day liquidity for participant-directed transactions. However, unlike money market funds, the book valuation of stable value funds is explicitly backed by investment contracts issued through financial institutions. The ability to invest in longer-dated, higher-yielding assets also provides stable value funds with a potential return advantage compared to money market funds. These unique features of stable value products allow investors to target potential returns similar to those of intermediate bond funds with liquidity comparable to money market funds.

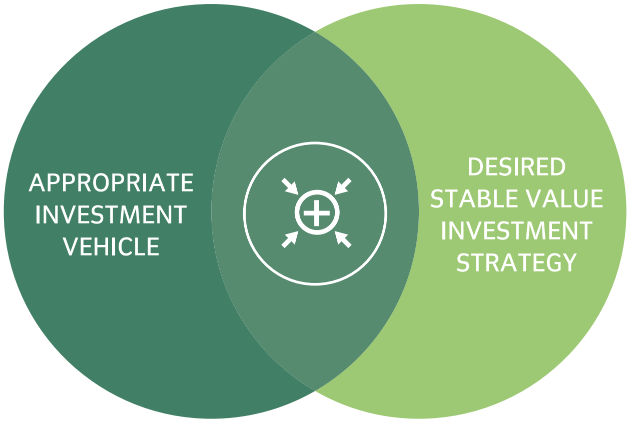
TARGETING THE OPTIMAL BALANCE BETWEEN VEHICLE AND STRATEGY

PROPERLY EVALUATING STABLE VALUE INVESTMENT OPTIONS IS AN ONGOING CONCERN FOR DEFINED CONTRIBUTION PLAN SPONSORS. STABLE VALUE PRODUCTS CAN DIFFER MATERIALLY IN THEIR VEHICLE STRUCTURES, TERMINATION PROVISIONS, PORTFOLIO COMPOSITION, RISK/RETURN OBJECTIVE, FEES, AND ADMINISTRATIVE COMPLEXITY, MAKING APPLES-TO-APPLES COMPARISONS DIFFICULT.

We believe that a two-pronged approach can remove some of the difficulties of making a direct comparison. In our view, the optimal solution lies in the intersection between the preferred vehicle structure and the investment strategy that aligns with a plan sponsor's risk/return expectations.

Part 1: Choosing an appropriate investment vehicle

In this first paper, we take a look at structural factors that we believe a plan sponsor should consider when selecting the appropriate stable value investment vehicle.



Part 2: Choosing an appropriate investment strategy

In the second installment, we explore the investment strategy within the vehicle and dissect the important factors investors should consider.

COMMON VEHICLE STRUCTURES

There are four common stable value account structures that allow most plan sponsors to align their preferences with the optimal stable value product. Some defined contribution plans, such as 401(k) and 457 plans have the option to use any of the four basic products listed below. Product selection for other plans is more limited, however. For instance, 403(b) plans are currently prohibited from using pooled funds (bank collective trusts) so they must offer either mutual funds or insurance products as their investment vehicle.

Common vehicle structures

			401(k)	457	403(b)
1	Insurance Company General Account	An insurance product issued by a single insurance company. The obligation is unsecured and backed by the general account assets of the insurance company.	✓	✓	✓
2	Insurance Company Separate Account	An insurance product issued by a single insurance company that typically manages the underlying assets. The assets are held in a separate account, away from the general account assets of the insurance company.	✓	✓	✓
3	Pooled Fund (bank collective trust)	A diversified portfolio of stable value investment contracts that is designed for plan sponsors who do not have sufficient assets to justify a dedicated separate account.	✓	✓	
4	Dedicated Separate Account	A dedicated account of stable value assets that is managed for a single plan sponsor. Separate accounts typically require $50 million in assets.	✓	✓	✓

THREE KEY CONSIDATIONS WHEN CHOOSING A VEHICLE

1 Exit provisions

A valuable feature of stable value investment products is their stability over time – and this includes the ability to complete transactions at book value[1] (under normal circumstances) without concerns about price volatility. However, this stability comes at the cost of liquidity, and plan sponsors need to be acutely aware of the investment vehicle's provisions on withdrawals:

- Insurance company general and separate accounts may have a variety of termination provisions, including a series of payments over time, the lesser of book or market value payout, or a wind-down period over the duration of the account. Some insurance company products have extended book value payout provisions of three-to-five years (or more) if the level of market interest rates is higher than the book value crediting rate of the product.
- Pooled funds generally require 12 months advance notice for a book value termination – known as a 12-month put provision. Some pooled fund managers have increased the 12-month put notification period to 24 months.
- With dedicated separate accounts, terminations must be addressed directly by plan sponsors working with their stable value manager. Usually this is engineered through a wind-down of portfolio duration over a predetermined period of time. At the terminating point in time, the book value will match the underlying market value of the assets in the portfolio.

[1] Book value is principal plus accrued interest of the underlying securities. Market value is the value of the portfolio based on the current prices of the portfolio holdings.

A roach motel is easy to enter but impossible to exit. Unfortunately, many stable value products resemble such a device. They make entering easy but heavily restrict plan sponsor-initiated terminations. Many fiduciaries inherit products with difficult termination provisions through either acquisition or possibly poor decision making by prior associates. Although the most restrictive products have been less prevalent recently, **plan sponsors must be absolutely clear about the termination clauses of any stable value vehicle**. Simply stated, plan sponsors should seek as much flexibility as possible with termination provisions prior to entering a vehicle.

2 Fees/expense ratio

At the risk of stating the obvious: less is more. Lower fees provide greater returns for plan participants over time, all else being equal. Active strategies will generally have a higher embedded expense structure, though with the potential for greater return. Passive strategies will generally offer a lower expense structure.

Asset size also determines expenses. Smaller accounts that do not have the scale to justify a dedicated separate account (we believe a minimum size of $50 million) will be forced to consider higher-cost solutions such as a pooled fund or an insurance company separate account. Larger allocations can use their scale to negotiate lower fees, particularly in a dedicated separate account.

The total expense ratio of a stable value investment vehicle should include trustee/manager fees, synthetic wrap fees and underlying product/subadvisor fees. When comparing the expense ratios of two stable value investment alternatives, it is important to make sure similar categories of fees are included in the analysis.

Once the expense ratios are on a common footing it becomes an easier exercise. With many very capable stable value managers in this asset class, fees can be a significant differentiator

3 Complexity/Administrative Requirements

With a larger size stable value allocation, a plan sponsor can realize the many benefits of a dedicated separate account. These may include customized investment guidelines, a lower expense ratio than other investment vehicles, and potentially higher returns. Maintaining a dedicated separate account, however, involves some administrative work. Larger plan sponsors will have the staff to sufficiently address these needs while smaller plan sponsors may be challenged.

Along with annual reporting and audit requirements, a dedicated separate account also requires the negotiation and execution of an investment management agreement and custom investment guidelines. Proper fiduciary oversight structure must be created and maintained. A stable value manager can be counted on to bear much of this work and can minimize some of the administrative burden.

Examples of separate account administrative requirements:

- Investment management agreement and investment guidelines
- Establish and maintain sufficient fiduciary oversight
- Trust and custody arrangement for separate account assets
- Form 5500 tax reporting
- Annual audit

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Plan sponsors should seek to match their investment objectives and administrative capabilities with the potential vehicles, mindful of liquidity features and expenses.

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A QUICK GUIDE TO THE ADVANTAGES AND DISADVANTAGES OF EACH VEHICLE

In our view, there are potentially distinct advantages and disadvantages in each of the four basic investment vehicles in the stable value asset class:

	Typical Advantages	Typical Disadvantages
Insurance Company General Account	• May offer higher yields • Low administrative burden	• No credit diversification • Crediting rate calculation and embedded fees are not transparent • Plan sponsor termination provisions can be onerous
Insurance Company Separate Account	• Typically higher yielding • Low administrative burden	• Lack of provider diversification • Assets are frequently lower credit quality • Plan sponsor termination provisions can be onerous
Pooled Fund (Bank Collective Trust)	• Diversified portfolio • High credit quality	• Yields can be lower • Performance may be influenced by investment activity of other fund holders • Plan sponsor termination requires 12-month put notification
Dedicated Separate Account	• Diversified portfolio • Customized investment guidelines • Lower fees • Performance not influenced by other investors	• Generally requires minimum asset level (> $50 million) • High administrative burden

THE BOTTOM LINE

Plan sponsors should seek to match their investment objectives and administrative capabilities with the potential vehicles, mindful of liquidity features and expenses. Once the type of investment vehicle is selected, a plan sponsor can focus on the underlying investment strategy. This topic will be explored in the second part of our series: Choosing an appropriate investment strategy.

FIND OUT MORE

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