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EVALUATING A STABLE VALUE INVESTMENT OPTION

PART II: CHOOSING AN APPROPRIATE INVESTMENT STRATEGY

DECEMBER 2024

BNY | INVESTMENTS

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.

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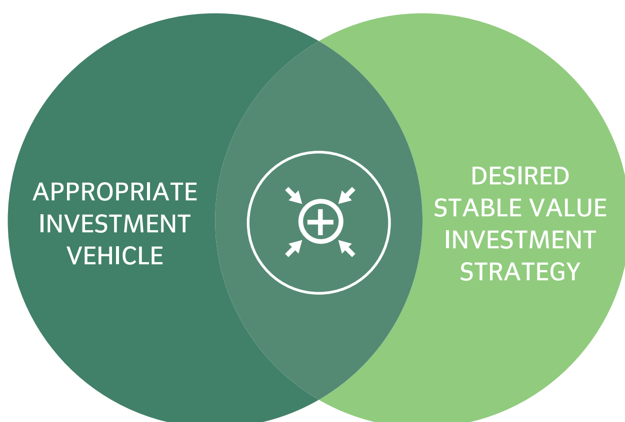
TARGETING THE OPTIMAL BALANCE BETWEEN VEHICLE AND STRATEGY

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 the first paper, we examined the structural factors that we believe a plan sponsor should consider when selecting an appropriate stable value investment vehicle.



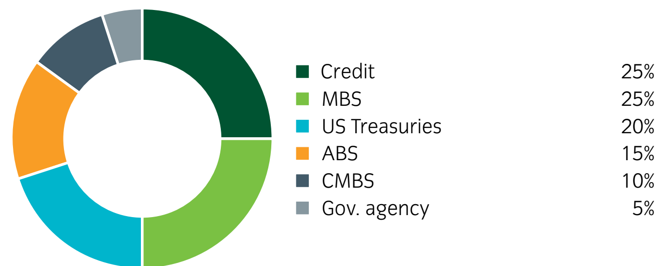
Part 2: Choosing an appropriate investment strategy

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

A RANGE OF UNDERLYING INVESTMENT STRATEGIES ARE AVAILABLE

Stable value investment contracts are governed by guidelines put in place and enforced by the wrap-provider universe. Underlying investment strategies typically have benchmarks ranging from the Bloomberg 1-3 Year Government Index to the Bloomberg Intermediate Aggregate Index. The Bloomberg Intermediate Government/ Credit Index is one of the most widely used benchmarks in this space. Stable value portfolios typically consist of investment grade assets with significant allocations to US Treasuries, government agencies, corporate bonds and mortgage backed securities. Allocations to asset backed securities and commercial mortgage backed securities are also common (See Figure 1).

Figure 1: A typical stable value portfolio[1]



Sector allocations are reasonably restricted and portfolio duration is typically capped at four years. Within this framework, there is not much differentiation among managers. Any non-investment grade allocation is noteworthy, and caution can also be raised if macro active managers are allowed to shift portfolio allocations significantly. Such shifts can have a material impact on a portfolio's yield-to-maturity and duration – which directly influences book value crediting reset rates (see sidebar for standard crediting-rate formula).

The Global Financial Crisis (GFC) proved that it was more important to focus on what stable value managers did not own rather than what they owned. At that time, portfolios were spared distress as long as they had no exposure to sub-prime loans, Alt-A mortgage backed securities or non-agency mortgage backed securities. Managers who had large exposures to these types of assets are no longer managing stable value portfolios. A reach for additional yield through more esoteric assets is inconsistent with the main objective of this asset class and should be avoided.

Crediting rates

Crediting rates (CR) are designed to pass through the performance of the underlying bond portfolio and smooth the volatility caused by interest rate fluctuations. Crediting rates are generally calculated using the following formula and portfolio-specific data: market value (MV), book value (BV), current yield-to-maturity (YTM), and duration (D).

CR = (((1+YTM) * ((MV/BV)^(1/D)))-1

[1] For illustrative purposes only.

FIVE KEY CONSIDERATIONS FOR STRATEGY SELECTION

1 Introducing lower quality credit can significantly impact volatility

The primary objectives of a stable value investment option are capital preservation, liquidity, and steady, positive returns. In order to achieve these objectives, most managers structure stable value portfolios with high quality credit assets, concentrating on the full spectrum of the investment grade rated credit universe (AAA to BBB-). As a result, the overriding majority of portfolio guidelines permit only investment grade assets. A select few managers, however, do incorporate non-investment grade bonds (rated below BBB-) in an effort to enhance portfolio yield.

Figure 2: Credit rating, quality and yield

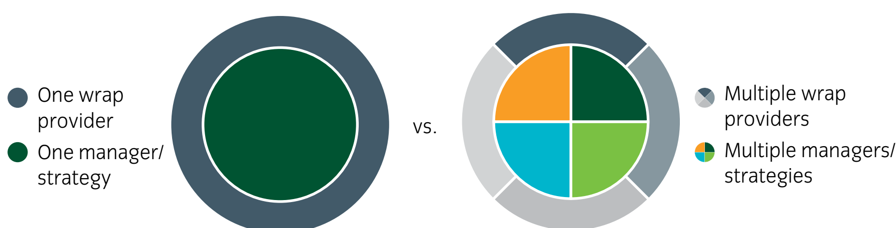
	MOODY'S	S&P / FITCH	GRADE	
Highest quality	Aaa	AAA	Investment grade	Lowest yield
	Aa	AA		
	A	A		
	Baa	BBB		
	Ba / B	BB / B	High yield	
	Caa / Ca / C	CCC/CC/C		
Lowest quality	D	D	Defaulted	Highest yield

While a modest allocation (typically 5% or less) to non-investment grade bonds may be acceptable, plan sponsors and consultants must be cognizant of this exposure. The inherent risks associated with non-investment grade exposure – downgrade risk, default risk and price risk – introduce significant potential for return volatility. As stable value is designed to be the most conservative investment option in a defined contribution plan, plan sponsors should be aware of potential consequences from non-investment grade exposure.

2 Diversification must be adequate

Diversification may be the last truly free lunch, and we strongly believe in a diversified approach to stable value asset management. Diversification can be applied to all levels of a portfolio – including investment contracts (wrap providers/issuers), underlying asset managers/strategies and underlying assets. Stable value products' diversification approach varies. Insurance company separate accounts offer little diversification as they are issued by a single insurance company (single wrap provider) and the assets are frequently managed by the insurance company's portfolio management team. Dedicated separate accounts and pooled funds, on the other hand, are typically well-diversified, utilizing multiple wrap providers and underlying managers/strategies.

Figure 3: Diversification can be applied to all levels of a portfolio[1, 2]



[1] For illustrative purposes only.
[2] Diversification does not assure a profit or protect against loss in a declining market.

3 Interest rate bets should be avoided

Duration, and duration management, is crucial when selecting a stable value manager. As with fixed income portfolios with a total return mandate, duration represents the amount of interest rate risk inherent in a portfolio. A longer duration typically generates a higher yield (when the yield curve is positively sloped). However, with stable value portfolios the implications of duration are twofold. Due to the nature of the crediting rate formula (sidebar), duration is not only a measure of interest rate risk but is also a factor that determines how quickly market value gains or losses translate into the crediting rate. Specifically, any market value gains or losses relative to the book value of the portfolio are amortized over the duration of the portfolio ((MV/BV^(1/D)).

To illustrate the impact of duration on the crediting rate, we compare two portfolios that are identical except for their duration (see Figure 4). The portfolio with the two-year duration has a crediting rate that is 132 basis points lower than the four-year duration portfolio. This occurs because the market value losses are amortized over a shorter period of time.

Figure 4: The impact of duration on crediting rate[3]

Sample portfolios	Market value	Book value	MV/BV	Yield	Duration	Crediting rate
Portfolio A	$95	$100	95%	4.50%	2.00	1.85%
Portfolio B	$95	$100	95%	4.50%	4.00	3.17%

In our view, there are two considerations that plan sponsors should understand. The first is recognizing the ideal part of the curve to target. A shorter duration portfolio is likely to have a lower yield yet will be more responsive to movements in interest rates than a longer duration portfolio. Conversely, a longer duration portfolio is likely to be higher yielding, yet less responsive to changes in interest rates. The second point to consider is how active a role the manager should take in positioning duration. This is important because, as we've seen, changes in a portfolio duration can result in large swings in a portfolio's crediting rate.

We believe that the optimal duration of a stable value portfolio is between 2.5 and 3.5 years. Outside of that range, a portfolio may be making an interest rate bet—which is something that we believe should be avoided. Further, it is our goal to maintain a consistent duration over time so that the portfolio enjoys a smooth, consistent crediting rate commensurate with the investment objectives of stable value investors.

4 Look for consistent performance over time

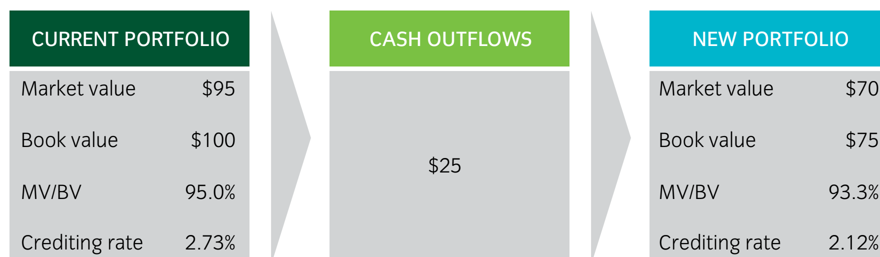
The objective of a stable value portfolio is to generate returns similar to intermediate bond funds with return volatility comparable to money market funds. When considering an investment strategy, current crediting rate and historical book value returns are two related metrics that can be used to evaluate a stable value manager's effectiveness. Thus, a peer group evaluation of both would be appropriate. Not surprisingly, a higher-than-average crediting rate over a period of time will typically translate into higher-than-average book value returns. However, it is important to note what is driving the higher crediting rate.

Referring to the crediting-rate formula found in the sidebar on page two, the main driver of the crediting-rate calculation is portfolio yield. If the yield on the underlying assets is consistently higher than average, the crediting rate will also be high. A high yield can be achieved through a number of strategies, including extending portfolio duration further out

[3] Based on November 2024 data.

on the yield curve (in a normally sloped environment), increasing allocation to riskier assets, or identifying undervalued sectors or individual bonds. Successfully employing any one of these strategies, or a combination, will likely result in a higher crediting rate, and over time will drive book value returns higher. It is important to ensure that reaching for yield is within the risk tolerance appropriate for a stable value fund. In fact, experience through the GFC provided a useful example of stable value managers overreaching for yield by including assets that were inconsistent with the main objective of capital preservation. Many of those higher performing funds/managers experienced material asset impairments are no longer in existence.

A secondary driver of the crediting rate can be the fund's market-to-book (MV/BV) ratio, which measures the market value of the underlying assets held in a stable value fund relative to the book value of the investment contracts that wrap these assets. Per the crediting rate reset formula noted on page two, a MV/BV ratio below 100% suggests there is a market value discount to amortize into the future (1/D) crediting rate of a stable value fund compared to a fund with a MV/BV ratio at or above 100%. Through a normal interest rate cycle, the MV/BV ratio generally fluctuates between 97% to 102% as interest rates fluctuate. Participant-directed cash flows can also influence the MV/BV. For instance, if there are participant-directed withdrawals at a time when market value is below book value, this will decrease the MV/BV ratio of the portfolio and in turn have a negative impact on the crediting rate. While the example on the preceding page highlights the impact of duration on the crediting rate, the graphic below illustrates how significant cash outflows can also affect the crediting rate of a portfolio with a yield of 4.50% and a duration of 3.00 years.



CURRENT PORTFOLIO		CASH OUTFLOWS	NEW PORTFOLIO	
Market value	$95	$25	Market value	$70
Book value	$100		Book value	$75
MV/BV	95.0%		MV/BV	93.3%
Crediting rate	2.73%		Crediting rate	2.12%

Conversely, new cash inflows when there is an MV/BV discount will increase the MV/BV ratio. Thus, a manager or portfolio that experienced significant cash outflows in a rising interest rate environment will have a lower-than-average crediting rate compared to a similar portfolio that experiences more modest cash outflows.

The takeaway is that that a cursory glance of crediting rates and historical returns may not reflect the effectiveness of a stable value manager. A more in-depth examination into what is driving crediting rates and a manager's style are required to get the full picture. We would argue that good historical consistency is more important than absolute top marks.

The selection of an optimal stable value investment solution is not an easy evaluation. It is important not to lose sight of the main investment objective of this type of strategy – capital preservation.

5 Stable value is a specialist strategy that needs specialized expertise

Tenure and experience are important for any asset manager. With stable value's nuances and idiosyncrasies, these qualities are paramount. Book value wrap contracts and the restrictions that go with them are an integral component of stable value management and are distinct from the core competencies of broad fixed income management. As a result, it is important to make sure an investment manager specializes in stable value and that the investment team is knowledgeable about the asset class.

Historically, large defined contribution plan administrators have offered a stable value pooled fund to plan sponsors regardless of size. It has been easier for plan administrators to manage stable value assets in a single pooled fund rather than in multiple dedicated separate accounts, despite the fact that it may not be optimal for the plan sponsor. Today, more open architecture allows plan sponsors to choose preferred managers and investment vehicles. An experienced team accustomed to working within varied structures can potentially enhance the stable value experience.

Relationships matter. The stable value industry is a small community where personal interactions between manager and wrap provider can be pivotal. In this tight-knit environment, we believe a management team with a long tenure in the asset class will have an advantage based on the relationships they have built over time.

In short, experience and tenure are important. We believe investors should know how long the manager has managed stable value assets, whether their assets under management have grown over time, the tenure of their stable value team, and any turnover. We believe dedication, experience and passion are valuable for this niche asset class.

THE BOTTOM LINE

The selection of an optimal stable value investment solution is not an easy evaluation. It is important not to lose sight of the main investment objective of this type of strategy – capital preservation. Plan participants want surety that they will be able to move into and out of this investment at a constant net asset value. It is our opinion that an experienced team with a consistent strategy that focuses on high credit quality assets and broad portfolio diversification will serve plan sponsors well.

FIND OUT MORE

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