



Upfront Scrutiny Reveals Stability of Stable Value Fund Assets

ASKING THE RIGHT QUESTIONS IS KEY TO ENSURING
YOUR STABLE VALUE FUND REMAINS STABLE

Is your investment committee asking the right questions when it comes to reviewing your plan's Stable Value Fund offering? It's a fair question considering this money market alternative is prevalent in almost every defined contribution plan and frequently represents the largest allocation of plan assets.

Given its dominance and in light of some of the "red flag" warnings that have emerged in the press regarding Stable Value Funds in the last several months, we thought it would be a good idea to give plan sponsors a little more insight on evaluating this unique asset category.

The Stable Value Funds of today have evolved largely from the guaranteed investment contract (GIC) products that were popular in most retirement plans until the late 80's. That's when two high profile insurance companies – Executive Life Insurance Company and Mutual Benefit Life Insurance Company – went out of business and stopped paying on their guaranteed investment contracts. Needless to say, it quickly became evident that having a guarantee backed by the full faith and credit of a single insurance company carried significant risk. (It should be noted that both companies did eventually pay those invested in their GICs.)

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To satisfy the needs of plan sponsors wanting a product that offered the benefits of the GIC's stable rate of return while reducing single issuer risk, a number of providers began offering separate account GICs. These stable value investments segregated the assets backed in GICs from the issuers general account, thereby reducing issuer insolvency concerns. But they lacked the control and flexibility sought by plan sponsors. Synthetic GICs or "managed stable value funds" were developed to lessen both sets of concerns.

Managed Stable Value Funds can be composed of a variety of fixed income investments, including traditional guaranteed investment contracts (GICs), bank investment contracts (BICs), synthetic GICs, and/or cash equivalents. A synthetic GIC is made up of two components: an underlying bond portfolio (that includes MBS, ABS, Govt., Corps, etc.) and a book value wrap for the insurance component. Utilizing the wrapped bond portfolio strategy (i.e. synthetic GICs) allows the exposure to the insurance wrap providers to be greatly reduced compared to a traditional GIC, now that the fund has ownership of the underlying assets to support the guarantee. These book value wraps are secured from a



variety of issuers, which reduces issuer exposure not only through direct exposure to the individual companies but also through broad diversification. For the last decade, managed Stable Value Funds have emerged as the preeminent low risk investment options for defined contribution plans and their sponsors. But “low risk” does not mean “no risk,” as some plan sponsors discovered the hard way.

Undetected risks have a bad habit of turning up at the worst possible time, which is precisely what happened during the recent credit/financial crisis when a few plan sponsors found themselves with Stable Value Funds having portfolios that were invested in some of the riskiest areas of the bond market. Simply put, poor performance of the fund’s underlying investments resulted in depressed market-to-book value ratios (the value of the underlying portfolio versus the reported book value of the fund). If there were plan sponsor events, such as layoffs, bankruptcy, corporate reorganizations or other employer initiated events that could lead to termination of the fund or mass withdrawals from the fund, there is potential that a Stable Value Fund may be vulnerable to losing its “book value” guarantee. In such cases, the book value wrap providers may not be responsible for making up losses between the underlying market value and the book value that resulted from employer initiated events.

“Low risk” does not mean “no risk,” as some plan sponsors have discovered

More common outcomes for plan sponsors with funds having impaired market-to-book ratios will be lower yields for participants as their stable value fund’s underlying portfolio losses are amortized over time. Additionally, plan sponsors may find themselves limited in their ability to make changes to their plans by

provisions in the agreements of their stable value fund’s wrap provider.

Market-value to book-value ratio

This is a measure of the underlying value of fixed income securities within the portfolio in relation to the reported book value of the portfolio. A ratio of less than 100 percent would indicate that there are securities that are currently trading below their purchase price. This is not uncommon, but the plan sponsor should know where they stand. The lower the market-to-book ratio, the greater the loss in the fund’s underlying holdings that will need to be amortized. It should be noted that although the MV/BV measure is an indicator of value, it does not always mean that the manager has made a mistake. In a rising interest rate environment the MV/BV ratio will be negatively impacted in the short-term, which is often offset by higher overall yields in the future.

Listing of the portfolio holdings

Although pooled Stable Value Funds are not required to provide a listing of the underlying assets on a regular monthly or quarterly basis, plan sponsors should at least obtain a copy of their audited annual financial statement that contains this information. This will provide insight as to what types of fixed income products they are invested and the overall diversity of the portfolio. In addition, periodic reporting during the year should give at least a good snapshot of what the various sector exposures are (i.e. corporate, MBS, etc.).

12-month put on plan level termination of option

All pooled and separately managed stable value products have provisions that outline how assets will be liquidated in the event of a plan level termination. Pooled Stable Value Funds have up to 12 months to pay out the plan sponsor in the event of a plan level termination. Some firms will pay out immediately once they have received the notice, other may pay out



assets over a monthly or quarterly period, and still others will provide the payout at 12 months after receiving the notice. Understanding what methodology that will be employed should be understood upfront. Separate accounts can move contracts and assets as soon as the provisions within the advisory agreement allow – i.e., usually 30 days or less.

Credit risk and overall diversification

As with any fixed income portfolio designed primarily for capital preservation, the plan sponsor needs to have a clear understanding of the credit quality of the overall portfolio.

Good questions to ask include:

- Is the portfolio invested in any structured products?
- How much GIC exposure does the portfolio have and how is the credit quality being measured?
- What are the limitations on any single credit issuer or sector and how is this managed?

These types of questions can help the plan sponsor better understand how risk is being controlled.

Listing of the insurance wrap providers

Understanding which insurance providers are standing behind the portfolio and how the risk is being spread among multiple parties is an important sign of fund strength. Portfolios that are well insured should have multiple firms providing wrap coverage. Ideally, this coverage should be evenly spread among the providers (maximum of 15 to 20 percent per provider), anything higher than the 20 to 30 percent range should be questioned.

Other items that should be investigated include the declaration of trust, which governs the fund structure and is typically included in the participation or management agreement. The plan sponsor should analyze

the document to see what provisions are required of all plans participating in the fund. Also, a conversation with the fund managers on what are the typical limitations within the wrap contracts. Although these contracts are quite proprietary, the manager may be willing to discuss provisions that include liquidation events, quality restrictions and investment guidelines. Some wrap providers are also mandating that stable value managers change their crediting rate methodology to more quickly amortize gains and losses experienced within the portfolio.

Insurance wrap providers furnish the book value guarantee on portfolio assets – an essential to creating a Stable Value Fund.

Due to the recent credit crisis most if not all wrap providers that are still providing insurance coverage to Stable Value Funds are taking a more active role in designing the provisions of their contracts with regard to liquidity for plan level termination events. It is important that the plan sponsor understand what special or unusual liquidity provisions may be placed on the fund by their wrap providers.

The insurance wrap providers furnish the book value guarantee on portfolio assets, which is the essential ingredient to creating a Stable Value Fund. Without this coverage, the FASB would not allow a Stable Value Fund to report at book value. Hence, the terms and conditions wrap providers impose on Stable Value Funds are a key influence on the overall management of the fund.

Remember, if wrap coverage goes away, that portion of the fund will be subject to market valuation: meaning participants in funds with market-to-book ratios of less than 100 percent could experience losses. Obviously this



would be an unfavorable outcome for participants, but it may be an even more troublesome outcome for plan fiduciaries in today's litigious environment.

Stable Value Funds provide a valuable investment alternative and diversifier to almost any defined contribution plan. However, these low-risk options do contain hidden pitfalls that can put the plan sponsor in a difficult spot if they are not asking the right questions. Always remember that "low risk" does not mean "no risk."

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