

Stable Value

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Stable value funds are fixed income funds that attempt to ensure preservation of principal while providing a higher yield than cash or money market funds. This feature makes them widely used among participant-directed defined contribution plans. Though they offer several advantages, including low volatility and daily transactions at book value, they are not without drawbacks, including guarantee provider default and liquidity risk. Generally, only more conservative investors or investors with short term time horizons should consider stable value funds, as longer-term investors should be willing to accept higher interim volatility in exchange for added return, lower costs, and lower total portfolio risk.

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Overview

Stable value is the term used for a class of investment vehicles that seek to provide both principal preservation and investment grade bond-like income. Specifically, stable value funds attempt to ensure return of principal and, in the interim, pay a periodic rate of interest, known as the crediting rate. They do this by investing in a portfolio of bonds that have a longer duration, and in some cases lower quality, than traditional money market funds. Through this structure, stable value funds attempt to shield the investor from the volatility of the underlying investment portfolio.

Stable value vehicles are typically based on one or more of three types of insurance: traditional Guaranteed Investment Contracts (GICs), separate account GICs, and wrap contracts, which are also known as synthetic GICs. The difference between the first two and the third is subtle: whereas traditional and separate account GICs involve the investor surrendering the principal amount in exchange for interest payments and—it is hoped—the contractually promised return of principal, a wrap (or set of wraps) is used to insure the underlying portfolio of fixed income assets. In most circumstances, the difference can be ignored by the investor: all GICs offer guaranteed interest rates and principal value, as well as book value transactions (“dollar in, dollar out”).

Stable value funds have been used in public and private employer-sponsored retirement plans since the 1970s as a higher yielding alternative to money market funds. In 2004, FASB ruled that defined benefit plans could no longer invest in stable value vehicles and receive book value accounting in the program, though all existing stable value investments by these plans were grandfathered. Currently, stable value funds are only allowed in tax-qualified individual account plans, including defined contribution plans.

Details

Stable value funds are composed of one or more GICs, and they are typically issued by large financial institutions. In this section, the differences between the GICs are discussed, as are other differentiating characteristics of stable value funds.

Traditional, separate account, and synthetic GICs

When an investor enters into a traditional GIC, the issuing company is free to invest the principal as it sees fit, including in (for example) commercial loans, commercial real estate, and asset-backed securities. Companies that issue traditional GICs assume all of the investment risk pertaining to the principal that the investor surrenders. As such, the traditional GIC becomes a liability of the issuer, and the investor has a claim on an issuer's *general account assets*. In this sense, a traditional GIC is similar to a savings account, in that an investor (depositor) gives the issuer (the bank) principal to invest profitably, provided that the investor is able to receive a reasonable return and withdraw his money at any time. Note that while traditional GICs are not FDIC insured like most bank deposits, they are often covered by guaranty associations (e.g., the National Organization of Life & Health Insurance Guarantee Associations).

Separate account GICs are similar to traditional GICs except that the underlying assets are held separately from the insurer's general account assets. There are three advantages to this structure. First, investors in separate account GICs have greater visibility into the underlying assets held on their behalf. Second, separate account GICs can invest in a wider variety of instruments than a traditional GIC, due to the stringent requirements on the general account assets of most traditional GIC providers. Third, in the event of default, the assets of many (*but not all*) separate account GICs are insulated from general account liabilities.

As opposed to the basic mechanics of both the traditional and separate account GICs, synthetic GICs are composed of a portfolio of high-quality fixed income securities *and* one or more wrap contracts that guarantee the principal value of the fixed income securities and allow book value transactions. Unlike the cases of the traditional and separate account GICs in which the investor has varying claims on the provider's assets, the synthetic GIC investor essentially has *many* claims on the liabilities of many different entities (through the direct ownership of many different high-quality fixed income securities). In addition, synthetic GICs permit the greatest flexibility in underlying fixed income portfolio design and strategy, subject to wrap provider guidelines. It is important to understand, however, that most wrap providers will only "write a check" in the unlikely event that total withdrawals exceed the market value of the underlying portfolio. While the wrap contracts allow for book value transactions, losses in the fixed income portfolio due to rising rates or fixed income spreads will ultimately be amortized among remaining participants in the form of a reduced crediting rate.

Synthetic GICs offer two layers of protection, as they are backed by both the financial institution providing the wrap and the issuers of the underlying fixed income assets. .

The subtle distinction between the liability structure of traditional GICs and separate account or synthetic GICs is important in the event that the guarantee provider is unable to maintain the principal value of the fund. In such an event, the traditional GIC investor will most likely need to file a general claim on the insolvent issuer's general account assets, whose primary claimants—in the case of an insurance company—are often policyholders. Even if guaranty associations eventually make the traditional GIC investor whole, the process may take years. The situation for separate account GIC investors is better, but still involves filing a claim on the "separate account" assets, which at the end of the day are owned by the guarantee provider. On the other hand, the synthetic GIC investor still has ownership in the underlying portfolio and may trade in and out of these securities freely (albeit with a potential loss of principal value). Hence, synthetic GICs offer two layers of protection, as they are backed by both the financial institution providing the wrap and the issuers of the underlying fixed income assets. As a result of this advantage—and despite their higher complexity—synthetic GICs have become increasingly popular.

Crediting rate

A stable value fund's crediting rate is set periodically (e.g., annually) and is subject to a floor (i.e., a minimum rate), which is usually zero percent. The crediting rate is based primarily on the returns of the assets underlying the fund. Hence, changes in interest rates, credit events, manager skill, and even investment flows all affect the crediting rate. The setting of the crediting rate allows the issuer to amortize market value gains or losses over the duration of the underlying investments. Over the long-term, the crediting rate should be equal to the performance of the underlying assets minus the cost of insurance and active management fees.

Historical performance

Given the typical nature of their underlying short- and intermediate-term high grade bond investments, and considering the cost of insurance, stable value funds should—over the long term—produce returns above short-term bonds but below investment grade bonds. At the same time, the volatility of their returns should be similar to cash.¹ As shown in Table 1, this has indeed been the case historically: stable value funds have returned 4.9% annualized, slightly less than the 5.8% of investment grade bonds and above the 4.3% of short-term bonds. At the same time, stable value returns have experienced an annualized standard deviation of 0.6%—comparable to the volatility of cash. In addition, stable value has been most correlated on a monthly basis with cash returns. This is unsurprising, given that stable value funds are often considered an alternative to cash or money market funds.

¹ The volatility of the underlying assets is likely similar to a corresponding investment grade bond index, and, therefore, higher than cash. However, when the insurance contract is in force, stable value returns are subject only to volatility in the slowly adjusting income component of returns—and not at all to volatility in the price component.

	Cash	Short-Term Bonds	Stable Value	Investment Grade Bonds	Domestic Equities
1-Year	1.9%	1.6%	1.7%	0.0%	-5.2%
3-Year	1.1%	1.2%	1.7%	2.1%	9.0%
5-Year	0.6%	1.0%	1.7%	2.5%	7.9%
10-Year	0.4%	1.5%	2.5%	3.5%	13.2%
Since Inception Return	2.8%	4.3%	4.9%	5.8%	9.4%
Annual Standard Deviation	0.7%	1.6%	0.6%	3.6%	14.5%
Correlation with Stable Value	0.76	0.19	1.00	0.21	-0.01

TABLE 1
Historical Performance of Stable Value Funds, 1990 Through 2018²

² Cash is proxied by the 91-day T-Bill; Short-Term Bonds by the Barclays 1-3 Year Gov't/Credit index; Stable Value by the average of the Ryan 3-year and 5-year GIC index; Investment Grade Bonds by the Barclays US Aggregate index; Domestic equities by the Russell 3000 index.

Primary Risks

Interest rate risk

In most interest rate scenarios, stable value investments will generally outperform money market funds. First, if rates are rising gradually, money market funds will average into these higher rates more quickly than will stable value funds, potentially leading to stable value underperformance. Second, in most stable interest rate scenarios (e.g., a positively sloped yield curve), stable value investments will outperform money market funds. However, a negatively sloped (i.e., inverted) yield curve would most likely lead to stable value underperformance, as the short-term returns of money market funds would exceed the intermediate-term returns of the stable value funds. Negatively sloped yield curves generally occur at the start of recessions, and are usually only temporary.

Guarantee provider default risk

Stable value funds are guaranteed to the extent that the guarantee provider(s) remain solvent. In reality, guarantee providers can and do fold; without principal guarantees, stable value investors would be exposed to interim volatility. This risk is compounded in the case of traditional GIC issuers, because the general account assets are more likely to be impaired if the guarantee provider defaults. In order to mitigate this relative risk, many traditional and separate account GIC issuers (e.g., insurance companies) belong to state guaranty associations, which are industry-wide organizations that themselves insure the claims on general account assets of their members. These industry-wide organizations have made the claimants whole in the past; however, the delay in reimbursements can take years.

Liquidity risk

Stable value funds typically allow for daily withdrawals at the individual investor level in participant-directed plans, provided they are not transferring assets to a “competing” option such as a money market fund or bond fund. However, at the plan sponsor level, many issuers reserve the right to restrict withdrawals even under relatively benign conditions—not just economic crises. A 6 to 12 month delay, referred to as a “put,” is common for plan-level terminations of a stable value fund. In addition, if book value is greater than market value, *in some cases* this loss would have to be immediately spread across the whole investor base if the plan switches stable value providers. This situation can usually be avoided if there is no permanent impairment of underlying assets and the plan sponsor is willing to be patient. Realizing this loss when switching providers undermines the intent of the stable value program.

Transparency

Stable value funds have less transparency than money market funds. They also do not have as stringent reporting rules as do mutual funds and other publically available retirement products. This is particularly true for traditional GIC structures, where the insurance companies do have to report their fees, but not the profit earned (i.e., the difference between the income generated from reinvesting the assets and the crediting rate paid to investors). While these funds are not as transparent as some other options, they can still be understood by looking into each individual fund and its underlying structure.

Fiduciary risk

As with any plan investment, plan sponsors have a fiduciary duty to monitor the plan's stable value fund. Stable value funds, however, can raise some unique fiduciary issues. Among small and medium sized plans, it is common for the stable value fund to be affiliated with the plan's recordkeeper. A recordkeeper will often promote the firm's proprietary stable value fund as a way to reduce plan administrative costs. If the stable value fund is a traditional GIC structure, the profits from the plan's stable value assets will be undisclosed. In this situation, the administrative costs of the plan become more opaque and participants invested in stable value are indirectly paying a disproportionate amount of the plan's administrative fees. An inherent conflict also exists because the recordkeeper has an incentive to increase or maintain assets in the stable value fund. Plan sponsors should be acutely aware of these potential issues and have a well-documented process to address it.

Implementation

There are significant differences in the various investment strategies that stable value funds pursue. Some emphasize yield, while others emphasize security and low risk. Some stable value funds are actively managed (and involve directional interest rate and yield curve strategies); others mimic a passive fixed income index. Lastly, some stable value managers have established minimum rating requirements, diversification limits, and other restrictions that effectively shrink the universe of available assets—in effect limiting the ability of stable value funds to diversify their portfolio. The bottom line is that all stable value funds are not the same, and plan sponsors should ensure they are comfortable with the underlying asset management strategy.

A risk in the stable value market shortly after the Global Financial Crisis was the decreasing number of wrap providers. Some wrap providers, especially insurance companies, made the determination that the wrap business was not attractive and scaled back or simply stopped offering wraps altogether. Mergers and acquisitions also exacerbated this phenomenon. In recent years, however, the market has stabilized and the cost of wrap insurance has come down considerably.

Recommendation

Because bond-like returns with money market-like volatility and liquidity are especially attractive to individual investors, stable value funds are used primarily by participant-directed defined contribution plans such as 401(k)s. On the other hand, the features that make stable value funds attractive to individual investors are not particularly relevant to most institutional investors, whose long-term horizons allow them to “ride out” the volatility of their fixed income assets.³ Therefore, stable value funds are more beneficial for investors with small equity allocations and large bond allocations, which is usually the case for investors with short-term horizons or conservative investment objectives. Shifting assets from bonds to stable value will make most portfolios less volatile at the potential cost of some give-up of liquidity and return—a trade-off that many conservative or shorter-horizon investors are willing to make.

³ Furthermore, the volatility of investment grade bonds is actually *useful* in that its negative correlation to risk assets helps to limit the volatility of a typical institutional portfolio.

Regardless, the universe of eligible stable value providers is not nearly as broad as that for equity or bond funds. Fees for stable value portfolios are generally in line with investment grade bond portfolios, as they can usually be obtained for no more than 50 basis points. Large plan sponsors have the ability to pay considerably less through a synthetic GIC structure. (The wrap itself is typically priced at around 20 basis points.) Plan sponsors should consider the soundness of the underlying portfolio, the financial strength of the insurer or guarantee provider, and the experience and skill of the underlying asset manager. We recommend that defined contribution plan sponsors who want to include stable value among their plan options do so by choosing among the best providers, use a synthetic GIC structure to reduce counterparty risk and increase flexibility, and if size permits, set up the underlying asset management within a separate account structure.⁴

⁴ A separate account structure for the underlying assets is not to be confused with a separate account GIC.

Summary

While there are various means of implementation, stable value funds are essentially insured fixed income portfolios. While they have produced returns between short-term and intermediate-term bonds while exhibiting money market-like volatility, they are not without potential drawbacks. These drawbacks may include underperformance due to interest rate movements, guarantee provider default, and illiquidity.

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