

Maintaining Stability in Stable Value

2009
North America

At a Glance

CHALLENGE

The credit crisis of 2008 brought upheaval to the usual tranquility of the stable value market. Currently there are quite a few visible signs of wider systemic changes.

ACTION

Watson Wyatt has devoted substantial thinking to the issues facing stable value funds and suggests eight action steps defined contribution fiduciaries can take.

RESULT

Plan fiduciaries need to understand how the products they have selected have changed and adapt to new investment realities.

In Short

Stable value funds are the “safe” investment option in nearly half of all 401(k) plans and hold more than 17 percent of participant assets.¹ The very name *stable value* conveys that investors expect returns of principal plus interest earned comparable with the yields available on very high-quality investments. The credit crisis of 2008, however, has brought upheaval to the usual tranquility of the stable value market. Currently there are quite a few visible signs of wider systemic changes in this important defined contribution (DC) plan investment option. The two major areas for concern are: 1) a loss of book value accounting status due to irreparable credit rating deterioration in the wrap contract issuer structure that is insuring the difference between fund market and book values, and 2) wrap issuers exiting participation in the wrap structure that could drive the fund’s crediting rate rapidly lower.

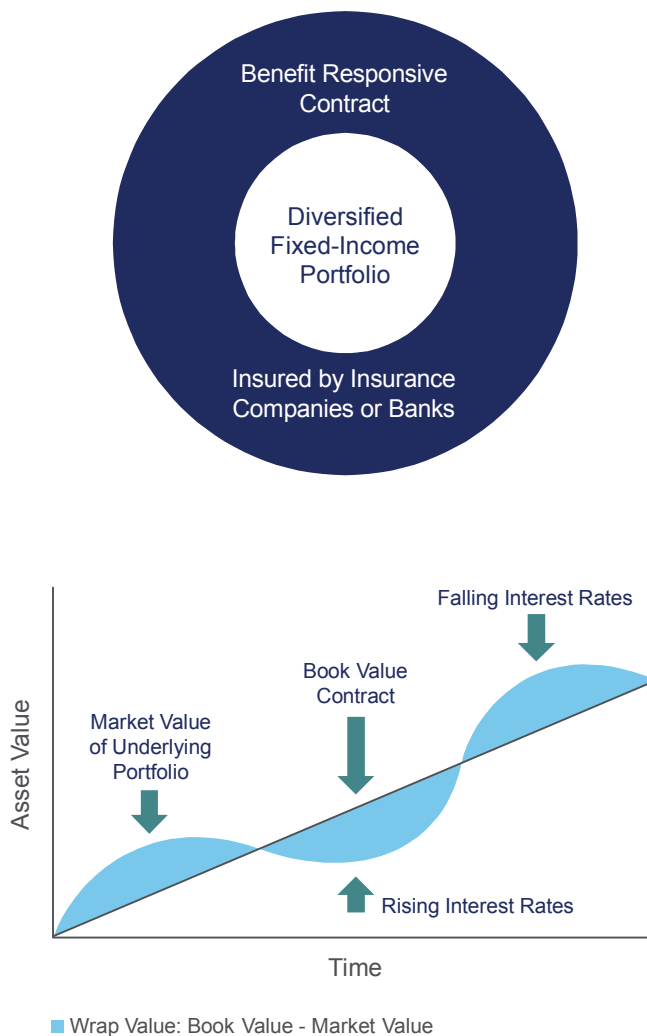
These issues raise quite a few questions about what stable value funds will be able to deliver in the altered credit market. Can stable value still promise safety of principal? Will returns to investors that track prevailing intermediate fixed-income yields stay on track? And can book value liquidity survive in this new marketplace? We address these questions by first identifying the factors that have brought renewed attention to what has historically been viewed as a low-maintenance investment strategy. Then we outline the actions that DC fiduciaries should take to ensure that their stable value options will continue to deliver on their stated investment goals.

What Is Stable Value?

Stable value funds are structured investments combining a portfolio of generally short and intermediate duration fixed-income securities, and wrap contracts issued by multiple insurance companies and banks that ensure book value accounting treatment on the investments (see Figure 1, sidebar and glossary of terms for more information).

¹ Source: EBRI/ICI database. See Employee Benefit Research Institute, Issue Brief #324, December 2008.

Figure 1 | Stable Value at a Glance



The Current Stable Value Environment

No one knows for sure when the current financial disequilibrium will end, but the stable value industry is responding in ways that signal a significant departure from prior business practices. Some key developments include:²

² Compiled from input received by 16 stable fund managers and wrap contract issuers that submitted their views on how the credit crisis has changed the stable value business. Special thank you to the following firms that submitted responses to our stable value product survey: Blackrock, Dwight, Fidelity, Galliard, Hartford, INVESCO, Jennison, John Hancock, JPMorgan, Mass Mutual, Natixis, New York Life, PIMCO, Putnam, SSgA, Standish.

- **Fund market-to-book ratios diverge.** Stable value investment portfolios have experienced unprecedented valuation markdowns due to several factors:
 - A widening of credit spreads due to spiking interest rate volatility
 - A vacuum in trading liquidity
 - A deterioration in fundamentals

Fund market-to-book dislocations of 5-to-10 percentage points below par are widespread and even greater among some separate account portfolios with larger allocations to residential mortgage and other asset-backed sectors, and to “plus” sector investments (high-yield, emerging markets and nondollar debt). It is worth noting that technical market factors have contributed to portfolio valuation markdowns. Securities that are not permanently impaired should experience a price rebound when credit market conditions improve or simply reach maturity with all cash flow obligations met.

- **Shrinking wrap contract capacity.** The second biggest issue in the stable value market right now is a shrinking wrap contract issuer universe and reduced underwriting capacity. Prior to recent events, the industry was quite strong and diversified. Most issuers had shown a long-term dedication to the business, and capacity was available. But the combined effects of issuers exiting the business, extreme dislocations in the financial services industry and management reevaluations of the implicit risks in the historically “low-risk” wrap contract business have caused the majority of remaining wrap issuers to significantly reduce their risk exposure. This condition has elevated the importance of fund investment transparency and solid relationships between wrap providers and stable value fund managers.
- **Wrap issuer supply-driven market.** Asset pricing instability and risk reassessment (principally the higher perceived probability that losses on investments valued below carried book value will have to be “insured” if participant cash flows turn negative before bond prices recover) have: (1) reduced the universe of wrap contract issuers from 12 active participants a year ago to as few as three at the end of 2008; (2) triggered much tighter investment restrictions on the fixed-income securities wrap issuers are willing to underwrite; and (3) set contract fee levels 10-15 basis points higher than the 6-10 basis point range that was charged a year ago.
- **Investment portfolio structure changes.** Stable value funds experienced large positive investor “flight-to-quality” cash flows throughout 2008 – enabling fund managers to not only avoid having to sell illiquid and troubled assets, but also to position portfolios anticipating that some participants would move out of stable value after the markets normalized. Funds that typically shortened durations by 10-15 percent (i.e., approximately half a year), are now reducing

spread duration exposure by allowing the roll down of securitized assets to par and increasing the allocations to floating rate, high-quality corporate and cash equivalent investments. Liquidity targets of 5-to-8 percent or higher are now being used quite commonly to reduce the risk of large investor redemptions. These defensive actions are intended to ensure that investment portfolios have adequate liquidity and can respond more rapidly to changes in market interest rates.

- **Tightened wrapper underwriting standards.** In direct reaction to a supply-driven marketplace, wrap contract issuers are becoming more demanding with their investment underwriting guidelines. They are now requiring higher portfolio credit quality and cash flow power, a strong liquidity position, sector and security diversification, and lower allowances for plus-sector exposures in favor of Treasury/Agency positions. In response to the market's current focus on safety over yield, it is likely that portfolio exposure to plus sectors will be limited to a combined maximum of 5-to-10 percent going forward. Wrap issuers are also evaluating the quality of their stable value fund relationships. They want to work with stable value fund managers that have strong and reliable monthly cash inflows, a diversified client base and a small plan redemption queue.
- **Fund credit rating uncertainty.** At the same time that issuers are limiting the amount and profile of wrap business they are willing to underwrite, they have been undergoing increased internal balance sheet scrutiny – a direct result of the broader financial market conditions. The wrap issuer universe has historically maintained an AA-rated average credit rating. But depending on future rating agency actions, A-rated issuers are likely to represent a much larger segment of the universe going forward. The reliability of credit ratings on stable value funds (i.e., the quality of the underlying fixed-income securities) and the companies used as wrap issuers have been opaque at best throughout this market environment; therefore, a stable value manager's strategy, process, monitoring procedures, reputation and historical track record represent important complements to agency ratings.
- **Fund crediting rates diverge.** Crediting rates on account balances are likely to diverge across stable value funds as a function of client cash flows, underlying fixed-income portfolio duration and quality, and investment strategy. As mentioned previously, some fund managers are shortening durations that require a faster amortization of the gap between fund market and book values, thereby reducing the fund's crediting rate at a faster pace (see sidebar). Finally, there is the investor cash flow variable. The magnitude of investor "flights to quality" cash flows, particularly if invested in very low yielding liquidity instruments, could require even further downward adjustments in the funds' crediting rate.

What Should DC Plan Fiduciaries Do?

Is it falsely comforting that despite immense market challenges, stable value funds have continued to perform as expected? Are the current conditions a wake-up call to act? It will take some time before we know whether the developments identified in the previous section are transitory consequences of this market cycle or signal a new, permanent stable value paradigm; however, waiting for clarity is not an option for DC plan fiduciaries. Watson Wyatt has devoted substantial thinking to the issues and suggests the following action steps:

- **Conduct scenario analysis.** Scenario analysis is a reasonably simple but effective portfolio risk management exercise enabling an investor to “pre-experience” a number of particularly significant shocks to expectations. Plan fiduciaries should be able to work with their manager to determine the relevant risk factors that should be modeled and analyzed, recognizing that the action steps that can be taken may be constrained by the type of investment vehicle currently used. The logical starting point is the fund manager’s “base case” outlook, reflecting the underlying investment portfolio’s current structural characteristics, cash flow expectations and strategy for closing the market-book value gap – all while continuing to track benchmark yields as closely as possible. Some of the questions DC plan fiduciaries might seek answers to include:³
 - How sensitive is the portfolio’s market value to changes in interest rates and yield curve shape? What is the associated impact on the fund’s crediting rate?
 - What could be the consequences of credit spread widening and rising default rates on corporate and asset-backed securities? What other important risk factors are there (e.g., counterparty and liquidity risk, sub-prime exposure and so on)?
 - What would the impact be if improvement in market liquidity and pricing on distressed portfolio holdings occurred more slowly than expected?
 - How would unexpected investor cash flows, (both inflows and redemptions) as an exogenous risk factor, affect “base case” outcomes?
 - What contingency plans have fund managers developed to respond to these and other conditions such as the deterioration in the quality and diversification of a fund’s book value wrap structure and plan sponsor withdrawals?

³ We recommend that clients maintain regular communications with their stable value manager in order to monitor evolving market conditions.

It bears mentioning two weaknesses of scenario analysis: 1) It can be difficult to determine which scenarios to analyze; and 2) It can be difficult to determine what actions to take. Total transparency on the part of the stable value manager is also essential to the accuracy of the analysis. If the manager is conflicted with any aspect of the analysis, plan fiduciaries need to involve alternative sources of expertise.

■ **Review the wrap structure.** Plan sponsors should understand how stable value funds are constructed and the different participants interconnected in the structure. Components include the portfolio manager or managers, wrap contract issuers and recordkeepers. The integrity of the book value wrap issuer structure is critical to the viability and the successful functioning of the stable value fund (whether a comingled vehicle or separate account). Today's wrap issuer business environment requires that plan fiduciaries review this important component of their fund, understand the potential areas of concern to the wrap issuers, and know under what conditions and with what consequences wrap issuers have the right to discontinue book value coverage. We suggest the analysis covers the following areas:

- Fund demographics – What is the client concentration of the fund? Fiduciaries should be concerned with industry concentrations, especially stressed industries that may have to downsize their workforce.
- Contractual structure – Is it a “global wrap” structure in which a consortium of issuers insures on a pro-rata basis the fund’s book value, or is it a “silo” contract structure where each issuer wraps a particular segment of the investment portfolio? Each structure has advantages and disadvantages that can influence contingency planning.
- Is the fund’s current wrap issuer structure of high quality and maximum credit exposure to each issuer in the structure and reasonably diversified? Most stable value managers try to target nominal exposure to each wrap issuer under 25 percent. Lower percentage exposures are a plus in the current environment.
- What are the fund’s “step-up” contingency provisions in the event an issuer leaves the consortium? Are there reasonable limits on issuer rights to terminate its contract or on limiting its exposure so the fund can be prevented from passing along the effect of a market/book dislocation (in the form of an account balance adjustment) to participants?
- How would the impairment of a wrap provider affect the fund? Wrap structures typically have contingency provisions whereby the remaining wrap issuers in the structure will increase their coverage allocation temporarily in the interest of protecting the entire fund as a viable ongoing

option. These “step-up” provisions may last only for a short time, which could present a problem if the environment is not conducive to finding a suitable replacement in the wrap structure. In a supply-driven environment, funds with wide market-to-book value differences might find it very difficult to secure replacement wrap coverage and could even trigger other providers in the wrap structure to exercise their termination rights. Some funds might not have step-up provisions, further compromising the fund’s ongoing viability. Sponsors should investigate what terms have been negotiated with their fund’s wrap issuers limiting their voluntary rights to terminate contacts.

- Does the fund employ hybrid wrap “stop loss” features that would reduce the downside crediting rate impact on the fund in the case of sizable participant withdrawals? If so, the time period and withdrawal percentage threshold should be factored into the scenario analysis.
- How would the downgrade or default (i.e., credit event without issuer replacement) of a wrap contract issuer be handled? There is no established credit rating threshold below which a stable value fund could lose its book value accounting treatment and be forced to write down a wrap contract thereby exposing the plan to a potential liability. But this low probability situation should be examined nevertheless and potential contingency actions developed. It is also important to address what magnitude of impairment in the fund’s underlying investment portfolio would make replacing a wrap issuer impossible.

■ **Review wrap issuer guideline changes.** Wrap issuers are much more stringent now in terms of the guidelines that govern the management of underlying assets – requiring more restrictions, particularly in the areas of asset quality and sector limitations, and treatment of impaired securities. Plan fiduciaries need to determine if the fund’s current asset quality or condition resulting from the scenarios analyzed jeopardizes relationships with the wrap issuers. Specifically, if wrap issuers decide to exit the business or your fund because of its market value impairment, the extended termination arrangements negotiated with the wrap contract providers could produce a crediting rate “death spiral” amortizing the book value shortfall. This is most likely an outlier condition for stable value funds, but one that carries particularly extreme consequences.

■ **Review crediting rate methodology.** Plan sponsors need to understand their fund’s current crediting rate methodology and what changes have been made or are under consideration by their stable value fund manager. This is particularly important if the manager has used any nontransparent methods for reducing the gap between market and book value. The uncertainty concerning

the duration of the credit downturn and the instability of security pricing are leading all managers to re-examine and potentially modify their crediting rate processes. The objective is to mitigate the impact of falling into future significant portfolio loss positions. These changes may involve resetting the crediting rates more frequently to accelerate the amortization of losses when threshold market-book value ratios are breached. Additionally, crediting rate changes should be factored into the scenario modeling exercise because the risk exposures allowed in the management of the investment portfolio must be aligned with how divergence between market and book value will be amortized.

- **Quality of fund reporting.** Is the level of detail and frequency of reporting adequate? Fiduciaries should be able to monitor a range of criteria regarding the fund. These include:
 - Book-market value position
 - Crediting rate
 - Portfolio duration
 - Credit quality and maturity breakdowns
 - Size and makeup of the impaired assets segment of the fund
 - Credit rating of the wrap contract issuers and changes since last reported
 - Composition and changes in the investment manager and wrap issuer structures
 - Client net cash flows and termination queue
 - Any changes in the operations of the fund.
- **Review fund benchmark.** Stable value funds employ a variety of benchmarks and spreads to cover management fees, transaction and wrap contract costs, and active return expectations. These include money market indices, rolling three- and five-year constant maturity Treasury (CMT) yields, 1-3 Year Treasury yields, 1-5 Year government/credit indices and customized benchmarks tied to the fixed-income strategies employed. With wrap contract issuers demanding more restrictive investment guidelines, plan sponsors should make sure the benchmarks historically used to measure the performance of their stable value fund manager remain appropriate going forward.
- **Plan sponsor-directed liquidation options.** Plan sponsors should review terms governing how they might exit their stable value fund, including: notice period, distribution period, asset liquidation options (e.g., cash, securities in

kind), delayed payment provisions, market value adjustments or fee assessments, and the terms for handling employee-initiated withdrawals during the distribution term. In the case of separate accounts, a key issue is portability of wrap issuer contracts and what terms might need to be renegotiated.

- **Plan option changes.** If considering plan changes such as the addition of what might be considered a competing fund (e.g., government money market fund and so on), re-enrollment strategies to better diversify participant accounts, changes to sponsor match, loans, transfers, or contributions and eligibility, plan sponsors must make sure they fully understand the stable value trust agreement. They must also get written acknowledgement from the stable value manager as to whether or not the proposed change or changes could nullify wrap contract coverage. The same examination should be conducted for employer events (e.g., mergers/consolidations, sale of a business unit, spin-offs, restructurings and large workforce layoffs). If plan sponsors are considering the addition of a stable value option to a plan, they should schedule implementation only under the following circumstances: when the credit markets are functioning adequately, fund market values have been restored to par (if a comingled fund is used), the financial condition of wrap issuers is clear and wrap issuer capacity has improved. If plan sponsors are considering switching stable value funds, the transition could be more difficult as not all wrap issuers want to wrap the legacy portfolio.

Conclusion

Stable value funds represent the “safe” option in many defined contribution plans. But these complex investment products are not immune to the souring debt brought on by the economic downturn or the stresses in the financial system ensuring their stability features. Plan fiduciaries need to both understand how the products they have selected have changed and adapt to new investment realities.

***Disclaimer:** The information contained in this article does not constitute legal, accounting, tax, consulting or other professional advice. Before making any decision or taking any action relating to the issues addressed in this article, please engage a qualified professional adviser.*

How Stable Value Works

Stable value is the most popular conservative investment option offered under defined contribution plans because it offers investors the liquidity and principal stability of money market investments combined with the generally higher yields on intermediate-maturity bonds. Three important synchronized structural elements of stable value funds make these investment attributes possible. They are: (1) a diversified fixed-income investment portfolio; (2) benefit responsive wrap contracts issued by insurance companies and banks that maintain the fund's book value, credit interest on that book value, and underwritten specified "losses" between fund market and book values; and (3) a crediting rate formula that "smoothes" differences between the fund's market and book values through time.

The **fixed-income investment portfolio** is typically comprised of high-quality fixed-income securities and insurance company issued private-placement investments (e.g., guaranteed investment contracts (GICs)). Portfolios typically have a duration of 2-to-3 years to produce yields substantially above those available from money market securities while maintaining adequate responsiveness to directional shifts in interest rates. Additionally, portfolios usually ladder investment maturities in order to meet investor withdrawals and reinvest a reasonable percentage of assets regularly at prevailing interest rates. A cash buffer is maintained to meet unexpected participant withdrawals and lower wrap contract risk charges. In the current environment, greater emphasis is being placed on portfolio safety over yield (i.e., reduction in "spread" exposure in favor of Treasury/Agency positions), durations are decreasing and the cash/liquidity buffer allocation is increasing.

The **wrap contract structure** is responsible for maintaining the book asset value of the fund's underlying investments. It is also responsible for crediting interest on the book value balance determined by the fund's crediting rate methodology. The structure is comprised of contracts underwritten by insurance companies and banks based on the stable value fund's investment portfolio characteristics and client demographics. Stable value funds typically employ a global wrap structure in which several institutions (generally 3-6 issuers) are responsible for covering a pro-rata share of the total portfolio book value. The fund's maximum credit exposure to a wrap issuer, therefore, is the proportionate deficit of the market value to book value. Contingency coverage provisions are an important component of most global wrap structures requiring existing wrap issuers to temporarily ensure uninterrupted book value coverage in case a wrap contract must be

replaced. Sometimes “silo” contract arrangements are used where wrap issuers cover a specific segment of the portfolio but without cross contingency coverage. This arrangement may marginally increase the fund’s idiosyncratic risk exposure to specific organizations at a time when maximum credit diversification is important.

The **crediting rate formula** determines the periodic yield (i.e., the interest rate credited to investors) for a stable value fund and is the mechanism for amortizing the difference between the fund’s actual market and book values through time. The crediting rate is derived from the yield of the underlying fixed-income portfolio; the current market value “gain” or “loss” position relative to carried book value; and the portfolio’s duration, which determines how quickly the market/book value difference will be recognized. The specific formula is stated as:

$$\text{CR} = [(1 + \text{YTM}) \times (\text{Market Value}/\text{Book Value})^{1/\text{duration}}] - 1$$

Where:

(1+YTM): Represents the yield of the underlying fixed-income portfolio;

Market Value/Book Value: Identifies whether the portfolio has a “gain” or “loss” based on the current value of securities. A gain (MV>BV) increases the yield credited to participants while a loss (MV<BV) lowers the yield credited over time.

(1/duration): Determines how quickly the MV/BV difference will be recognized/amortized. The shorter the duration of the fund (expressed in years), the more quickly the difference will be amortized by means of a lower crediting rate on fund assets. Stable value funds typically have durations around three years.

Under conditions where a portfolio’s market/book value loss position is deteriorating and there is pressure from the wrap issuers to shorten its duration and increase exposure to higher quality investments that may also have lower yields, the fund’s crediting rate might be adjusted downward more rapidly than would otherwise occur in more normal environments. This might cause participant cash flows to decline or, worse, turn negative, thereby accelerating the loss-amortization process.

Stable Value Glossary

12-month put – The notification lead time commingled stable value funds require plan sponsors to give when deciding to withdraw their assets from the fund at book value. The 12-month put is designed to prevent unplanned portfolio liquidations that could put the remaining investors in the fund and its wrap contract issuers at a financial disadvantage.

Book value accounting – The method by which the valuation of a stable value investment is reported. Book value isolates the plan from the volatility of market fluctuations caused by movements in interest rate or changes in credit ratings.

Competing fund – Another investment option in addition to a stable value fund within a defined contribution plan that offers relative principal stability, such as a money market fund.

Crediting rate – The interest rate credited on the book value of a stable value fund, expressed as an “effective annual yield.” As determined by the contract, the crediting rate may remain fixed for the term of the transaction or may be reset at predetermined intervals.

Duration – A measure of the price sensitivity of a fixed-income security or portfolio to a change in interest rates. Duration is commonly measured in years. The longer the duration, measured in years, the greater the price change volatility is. Historically, stable value funds have had a duration target of approximately three years.

Equity wash – A provision in a stable value fund requiring that any transfers made from the fund must be directed first to an equity fund option of the plan for a stated period, typically 90 days, before the assets can then be directed to a competing fund (see definition above). This plan provision is usually dictated by the book value wrap contract issuers to eliminate interest rate arbitrage.

Guaranteed investment contract (GIC) – A group annuity contract issued by a life insurance company that provides for a guarantee of principal and accumulated interest for a predetermined period of time.

Nonparticipating wrap contract – Provides book value responsiveness without passing the liquidation gain/loss on to the fund. The issuing bank or insurance company will bear the risk experience of the contract.

Participating wrap contract – Provides book value responsiveness but passes the gain/loss on to the fund through the future crediting rate.

Synthetic GIC – The synthetic GIC is an alternative to the traditional GIC (see definition above) whereas the stable value fund is unbundled. Typically, the assets would be managed by a separate entity than those that would provide the insurance wraps which allow for the book value insurance protection.

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