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Future of Stable Value

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The upheaval in the fixed income markets due to the credit crisis has placed great strain on many stable value funds held in retirement plans. Stable value funds typically represent a retirement plan's most conservative investment option, with participants generally considering them as higher yielding money market substitutes. However, both plan sponsors and participants may have a misperception that these investments can't lose principal.

Current Risks Facing Stable Value Funds

1. Wrap Capacity – The scarcity of capital in the insurance and banking sector coupled with elevated market volatility has increased wrap providers' sensitivity to their exposure in the wrap market. In many cases, companies currently providing wrap contracts are not accepting new deposits to existing contracts. They may also decline to bid on new contracts. Currently, there are 9 major wrap providers, one of which is struggling financially (AIG) and another that will soon exit the business (Rabobank). The remaining wrap providers appear to be well capitalized, with credit ratings between A- and AAA. However, if wrap capacity is static or shrinks and cash flows increase, then portions of stable value funds may go unwrapped. In response to this heightened risk, some wrap providers are increasing contract fees and implementing stricter investment guidelines. While these higher fees and tighter guidelines may result in lower yields to participants, they may also encourage new wrap providers into the market place.

2. Declining Crediting Rates – The crediting rate, or yield to participants, has dropped substantially in recent months largely due to the poor returns on the underlying stable value assets. Fund cash levels are significantly higher due to massive inflows as investors sought a safe haven due to recent market downturns. Additionally, lower wrap capacity and a need to maintain liquidity for future redemptions (both participant and plan sponsor-initiated) have driven cash balances higher. The crediting rate is likely to remain low for some time, weighed down by cash balances yielding very little, lower prevailing reinvestment rates in the bond market generally, and funds working off investment losses. Despite these headwinds, the crediting rate of most stable value funds is still attractive relative to conservative money market funds.

3. Low Market-to-Book Ratios –The market-to-book ratios (M2B) are good indicators of the health of the underlying assets. Due to the recent market conditions, M2B ratios have dropped significantly and, until recently, have been trending lower, which has had a meaningful impact on crediting rates. The management of stable value funds has transformed over the years. In an effort to increase the fund’s crediting rate and attract assets, many stable value funds began increasing their exposure to highly-rated corporate bonds, mortgage-backed securities and asset-backed securities at the expense of Treasuries. Unfortunately, many of these securities have suffered significant price declines amid poor liquidity and market conditions, resulting in many fund’s M2B ratios falling below 95%. In order for these funds to close the gap between market and book value, crediting rates have been decreased sharply. The result is lower income yields to participants, potentially as low as zero, depending upon how compromised the underlying assets are. The low M2B ratios could trigger a vicious cycle. As the crediting rate is lowered in order to increase the M2B ratio, the fund’s return could be less attractive, causing investors to withdraw money. This could force the fund to sell holdings at depressed prices, further worsening the M2B ratio. Lastly, and perhaps most important, the lower the market-to-book ratio, the more dependent investors are on the financial strength of the wrap providers. In the current financial crisis, this is not very comforting.

4. Mass Withdrawals – All stable value funds are susceptible to mass withdrawals. The falling crediting rates could make stable value funds less attractive to investors, especially if equity markets improve, leading to additional withdrawals. In order to meet those participant withdrawals at book value, funds will first use their cash balances, then, in order to raise additional cash, either assets will be sold at depressed levels or high-quality assets will be sold. Either way, the sale of liquid, well-priced assets or the “locking-in” of market losses will have a negative impact on M2B ratios and the future crediting rate. Due to the nature of stable value funds, this negative impact on the market value of the stable value funds will hurt investors remaining in the fund. Proper communication to participants is helpful to minimize the possibility of a “run on the bank”. Most importantly, participants need to understand stable value funds are NOT guaranteed against loss of principal. They may look like cash, but are structured to behave quite differently. While perhaps unlikely, losses are a real possibility, and these risks need to be understood by participants. Participants have limited alternatives for their short-term investments. Further limiting participants is the “90-day equity wash rule”, which prohibits participants from transferring assets directly from a stable value product into a money market or similar competing option.

5. Securities Lending – A minority of stable value funds are actively lending out their securities. While this has been practiced for quite some time, in today’s market environment it bears extra attention. Securities lending may lever up the risk of a portfolio, especially if a stable value fund is using third party lenders. When a third party lender is used, the stable value fund does not have control over the collateral pool. As we have seen, problems with the underlying collateral can lead to uncovered losses within the fund.

Taken separately, none of these issues are likely cause for terminating a stable value fund. However, a fund with problems in multiple areas raises concerns over future crediting rates and potentially the failure to meet future participant withdrawals at \$1 per share.

It’s quite difficult to predict where the stable value structure will be in several years – how it will look, who will be the major providers. If a wrap provider failed and could not meet its obligations, it could trigger a chain reaction of panic that would place additional stress on remaining wrap providers and could ultimately doom the structure. However, if the current wrap providers survive the current crisis and new entrants enter the wrap business, coupled with recovery in the credit markets, it could certainly appear to be a healthy structure again within a few years. Either way, the lessons of credit crisis should spur a reassessment of the risk/reward attributes from holding corporate, mortgage- and asset-backed securities in portfolios designed to provide safe and stable returns for participants.

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