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Stable Value: A History

Capital Preservation's Evolution as an Asset Class

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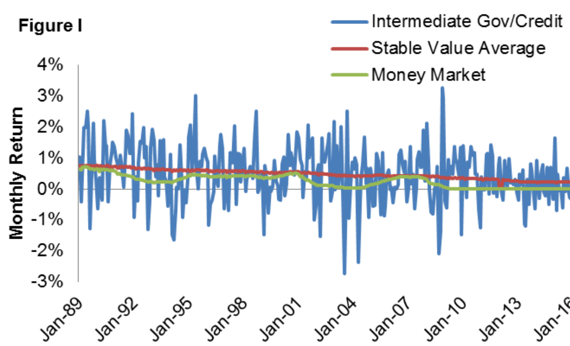
- Stable Value investments have been a staple in retirement plans since the asset class' inception in the 1970's.
- The asset class has evolved from traditional Guaranteed Investment Contracts (GICs), which are provided by insurance companies, to also include pooled synthetic vehicles and customized separately managed accounts.
- Concerns surrounding the viability of the asset class following the global financial crisis in 2007-2009 have largely dissipated.

Since the passage of the 1974 Employee Retirement Income Security Act of 1974 (ERISA), stable value investments, in their various forms, have been a staple in many retirement plans. Today, stable value investments account for an estimated $779 billion in assets held by approximately 165,000 retirement plans, according to the *Stable Value Investment Association.*

The objective of stable value is to seek above money market returns with similar risk characteristics to money market funds. This is accomplished by investing in portfolios that have larger opportunity sets than money market instruments and then paying a fee to insure those assets with an outside guarantor. These insurance "wrapped" portfolios have offered stable rates of return throughout several volatile market environments. To illustrate, the Stable Value Investment Association compared the monthly performance of stable value strategies relative to money market and intermediate government/credit strategies over time. Figure I displays that stable value returns were consistent throughout several notably volatile periods, including the market crash in 1987, the credit and liquidity crisis of the late 1990's, the tech bubble in 2000-2001 and most recently the global financial crisis in 2007-2009. However, despite the consistency of returns over time, stable value has evolved considerably since its inception.

Figure I



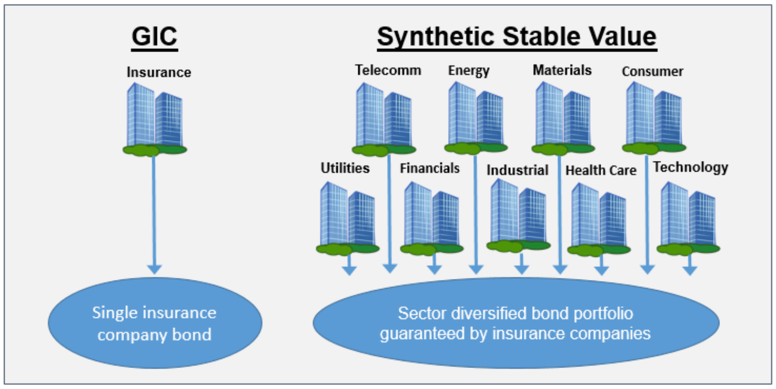
Source: SVIA

At its inception, stable value strategies were offered to retirement plans by purchasing Guaranteed Investment Contracts (GICs). Insurance companies issue GICs which offer investors a guarantee of principal and a bond-like yield. The return of principal and additional yield is secured by the sponsoring insurance company's balance sheet. This means that as long as the insurance company maintains sufficient liquidity and the ability to pay, investors are guaranteed their principal investment. Unlike a traditional bond, GICs do not have market volatility with daily pricing. Instead, the principal remains fixed and investors receive their return based on the rate at which the GIC was offered. This is why participants can receive an above money market yield with similar volatility. The tradeoff, however, is participants are subject to the credit risk of the GIC issuer. If the issuer were not able to repay the principal and/or interest payments to investors, the investment could lose value. Investors originally addressed this by owning GICs from multiple issuers in order to diversify this credit risk across different insurance companies. However, as the Savings & Loan Crisis took hold in the 1980's, it was clear that sector groups, like insurance companies, carry similar risks and the diversification offered from multiple companies within the same sector was somewhat limited. This was the driving force behind the creation of the synthetic stable value portfolio.

Following the well-established path of other investment portfolios, the decision to own assets across multiple differentiated sectors to reduce the risk from owning just one sector was intuitive. However, since other sectors such as technology and healthcare have never offered guaranteed debt-like insurance companies, the synthetic stable value portfolio evolved to fill the void.

At its creation, the synthetic GIC combined the benefits of diversified sector exposure with the guarantee from an insurance company. Synthetic stable value portfolios were a revolutionary advancement in the management of stable value assets and remain common today. Figure II highlights that in a synthetic structure, a stable value provider can purchase the debt from a much wider group of companies and use a "wrap" or insurance contract from a third party to insure the bond, which results in a volatility profile similar to that of a money market fund. The development of this structure and the prevalence of stable value in defined contribution plans attracted many fixed income managers and financial institutions to enter the space. This structure also provided a heightened level of customization in terms of the underlying investments, which had historically consisted of conservative, intermediate and short duration fixed income portfolios.

Figure II

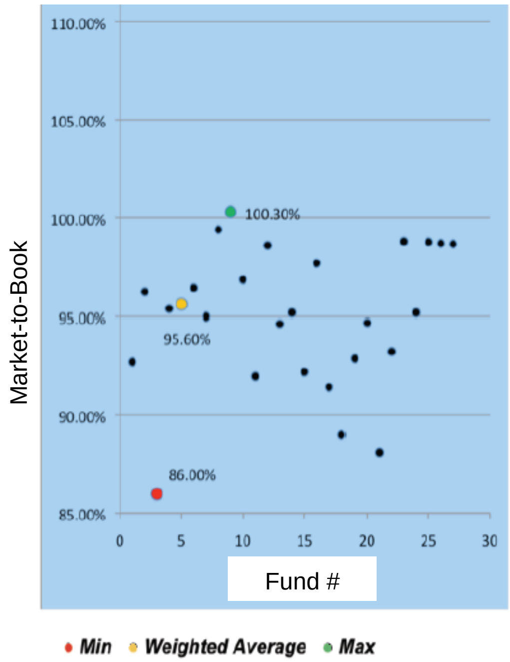


As investors and wrap providers entered the stable value industry, competition grew considerably. As a result, fees for wrap providers fell from approximately 30 basis points to, in some instances, lower than 5 basis points. At the same time, investment guidelines loosened materially, allowing stable value providers to invest in riskier securities. Some portfolios owned junk bonds, private mortgages and levered structured products. While this increased the return profile for investors, it also fundamentally changed the risk profile of some stable value investments.

As the global financial crisis took hold in 2007-2009, stable value portfolios had more risk embedded in them than investors had originally presumed. As investments struggled, the pool of assets set aside to cover the liability for stable value investors fell. The industry's average market-to-book ratio, a metric to judge the dollar value of assets pledged against a promised value, fell to nearly 95% in December 2008. This means that for every $1.00 promised to investors, only $0.95 was available to pay for it. Given today's stable value market size of $779 billion, that would mean stable value portfolios were collectively short nearly $40 billion to pay for promised liabilities to investors. Figure III shows that many market-to-book ratios fell below 95% and as a result, wrap providers were liable for the difference. Many of the more recent entrants into the wrap business, who had entered in a favorable market, did not fully understand the liability they had insured. As a result, many institutions including UBS, Rabobank and Bank of America decided to exit the business. Similarly, Schwab's Stable Value Fund and State Street's Accumulation Return Fund were liquidated following the financial crisis.

Figure III

Market-to-Book Ratios: December 2008



Source: SVIA Stable Value Funds' Characteristics Survey December 2008

As institutions left the stable value wrap business, the ability for stable value portfolios to insure their bonds diminished significantly. Wrap issuers pivoted away from favorable terms and lower fees and those left issuing wrap contracts focused on underwriting portfolios with very conservative investment guidelines and less generous terms, including higher fees. In the midst of the worst financial crisis since the Great Depression, plan sponsors and participants questioned the viability of stable value as an asset class.

As markets recovered, fears surrounding stable value have mostly dissipated. Wrap capacity has come back to provide insurance with a balance between reasonable fees and prudent investment terms and guidelines. Many stable value managers learned from their experience during the financial crisis and are making greater efforts to manage their portfolios as capital preservation strategies, which is far more in line with the asset class' roots as a money market alternative.

We do not expect its evolution to stop either. In today's low rate environment, stable value continues to offer interesting opportunities for investors seeking yield with minimal risk. Additionally, stable value managers wish to expand their footprint by becoming an "eligible" investment in segments of the retirement plan marketplace where regulation has historically blocked its path. As with all asset classes, stable value continues to respond to the market environment around it. Given the intricacies in design and unique objective, stable value might very well change again. This asset class, with volatility characteristics similar to money markets but better returns, should prudently remain an investment plan option. However, sponsors and invested participants alike would be wise to continue to monitor the asset class' evolution.

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Brad co-heads the firm's Core Investment Strategy Group at DiMeo Schneider & Associates, L.L.C, which oversees investment research across long-only mandates in equities, fixed income and cash markets globally. He is the co-chair of the Target Date Committee and is a voting member of the firm's Discretionary Team. He received a BA in Finance and Minor in Economics from The University of Colorado and is a CFA® Charterholder and member of the CFA Society of Chicago and CFA Institute. Additionally, Brad is an active member of Greenhouse Scholars, a nonprofit that provides financial and personal support to under-resourced college students. He joined the firm in 2012.

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