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Stable Value: A Risk-Free Dilemma

AN ANALYSIS OF THE APPROPRIATE USE OF STABLE VALUE FUNDS IN PARTICIPANT-DIRECTED RETIREMENT PLANS

BY RETIREMENT PLAN ADVISORS

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INTRODUCTION

Insurance company fixed (or general) accounts and stable value funds – we will refer to both as stable value funds going forward[1] – are prevalent across defined contribution retirement plans. Stable value funds often account for a large portion of a plan's total assets, particularly in governmental retirement plans where they commonly account for 20-40% or more. But, is that a sound and rational choice for most investors? What role should stable value play for a person saving and investing for retirement?

If a plan participant wants a balanced portfolio of 60% equites and 40% fixed income, how much of the 40% should be in stable value versus bond funds? What are the relative risks? What about returns? How do stable value and bond funds behave in a diversified portfolio over time? **This paper explores the appropriate use of stable value funds in participant-directed retirement plans.**

WHAT PORTION OF A PORTFOLIO'S FIXED INCOME ALLOCATION SHOULD BE INVESTED IN STABLE VALUE VS. BOND FUNDS?

1 Insurance company fixed/general accounts and stable value funds have significant differences, specifically in the areas of fee structure and rate transparency. For the purposes of this paper, we will treat them the same, focusing on their key similarities of stability of principal, predictable returns, and reduced volatility.

UNDERSTANDING STABLE VALUE

Let's start by defining stable value. Stable value funds offer principal protection, predictable returns, and reduced volatility. They are similar to bank savings accounts and money market funds, but with higher interest rates. Stable value funds are comprised of high-quality, fixed income investments including government and corporate bonds, asset-backed securities, residential and commercial mortgage-backed securities, and cash equivalents. As such, when one thinks of stable value, they think of a steady, low-volatility investment option.

STABLE VALUE FUNDS OFFER STABILITY OF PRINCIPAL. BOND FUNDS DO NOT. HOW MUCH ARE INVESTORS PAYING FOR THAT STABILITY, AND IS IT WORTH IT?

In addition to stable value funds, there are other fixed income investment options available in a retirement plan: bond funds. The underlying holdings of stable value funds are very similar to investment-grade bond funds. There is, however, a critical difference. **Stable value funds use an insurance "wrap" which functionally smooths out the returns of the underlying bond portfolio and allows for the reporting of participant balances without any fluctuations in principal.** With a stable value fund, the participant always has their deposit plus interest, and unless they make a withdrawal, their account value rises every day[2]. **Bond funds do not use insurance wraps and**

2 Insurance company fixed/general accounts do not use an insurance wrap to provide stability of principal. They are spread products where the insurance company guarantees the fund's principal and interest, declares an interest rate, and generates revenue by assuming the investment risk and investing in higher-yielding securities, similar to a bank CD.

therefore pass on to investors the full effect of the underlying bonds' ups and downs. With bond funds, participant balances fluctuate. These fluctuations are due to the price changes associated with the underlying bonds which are impacted by interest rate, credit quality, inflation, duration, and liquidity risks. As a result, bond investments may be worth more or less than the original purchase price when redeemed.

When comparing stable value funds to bond funds, it is important to understand their fee structures and investment constraints.

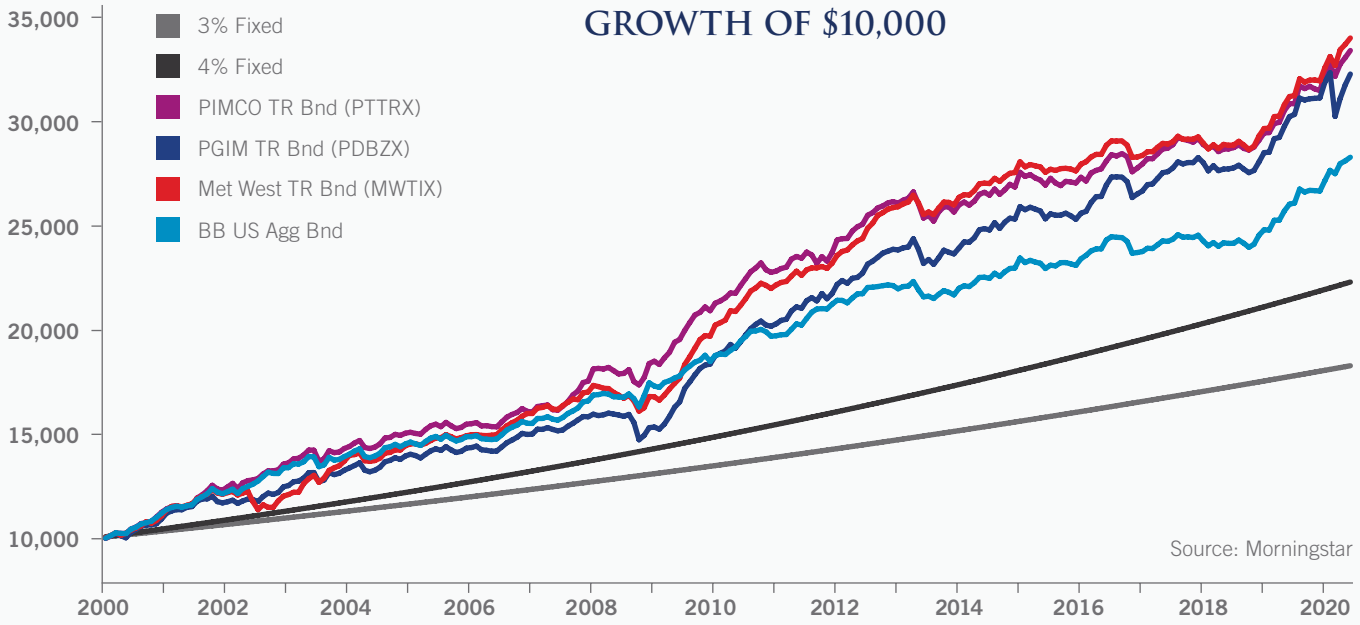
Bond fund fees, which are included in the expense ratio, cover marketing, administrative, and asset management costs and reduce the return of the fund by the total amount of those fees. Bond funds with higher expense ratios subsequently have a higher hurdle to clear before the investor earns a profit. Typically, returns presented by fund companies are net of fees (i.e., the fees are already taken into account in the presentation of the fund's returns). Investment-grade bond funds generally are benchmarked against the Bloomberg Barclays U.S. Aggregate Bond Index and have the flexibility to adjust portfolio duration and credit quality, in either direction, to generate return.

STABLE VALUE FUNDS ARE SUBJECT TO ADDITIONAL FEES AND INVESTMENT CONSTRAINTS THAT REDUCE RISK … AND RETURNS

Stable value fund investors, in addition to being subject to traditional investment fees, **incur an additional fee for the stability of principal – the stable value wrap fee –** which further reduces the net interest rate. Additionally, the wrap providers place investment constraints on the portfolio, namely requirements to limit portfolio duration and raise credit quality. These constraints typically reduce both the risk and investment return on the portfolio.

Stable value funds offer stability of principal. Bond funds do not. How much are investors paying for that stability, and is it worth it?

Given the additional costs and investment constraints on stable value funds, how do their long-term returns compare to those of bond funds? The chart below illustrates the growth of $10,000 for the Bloomberg Barclays U.S. Aggregate Bond Index, three of the largest active bond funds[3], and two stable value funds, one paying a 3% fixed interest rate and one paying 4%[4]. The January 2000 to June 2020 time frame is among the most volatile in the past 100 years and includes the dotcom bubble burst, 9/11 terrorist attack, Great Financial Crisis of 2008-09, and COVID-19.



The investment performance results are clear: bond funds have outperformed stable value funds by a wide margin. Investing in a 3% fixed account grew the initial $10,000 investment to $18,330. The 4% fixed account investor ends

3 As measured by AUM as of June 30, 2020.

4 We elected to use 3% and 4% as proxy returns for stable value funds because many governmental retirement plans had, and some continue to have, legacy insurance company fixed/general accounts with 3%, 3.5%, or even 4% lifetime minimum interest rate guarantees. In practice, very few retirement plans have averaged a 4% net return on their stable value option over the past 20 years.

with $22,345. However, if one had invested in the bond index, their $10,000 would have grown to $28,326, or 27% more money than with the 4% fixed. Notice that all three active bond funds outperformed the bond index[5]. **One of the bond funds grew the initial $10,000 into $34,061, which is 52% higher than with the 4% fixed!**

BOND INDEX & STABLE VALUE COMPARISON

Annualized	BB US Agg Bond Index	4% Stable Value
Avg Return	5.27%	4.00%
Std Deviation	3.45%	0.00%

PORTFOLIO COMPARISON[6]

Annualized	Balanced Portfolio Using Bond Index	Balanced Portfolio Using Stable Value
Avg Return	5.12%	4.61%
Std Deviation	9.55%	9.49%
Return / Risk Ratio	53.6%	48.5%

But what about risk? Isn't stability of principal worth something? Let's explore the risk/return profile of stable value to bonds. When comparing stable value to the Bloomberg Barclay's Agg bond index, we can clearly see the risk/return trade-off: with stable value, you received 76% of the return, with none of the volatility of the bond fund.

On the surface, the trade-off is very appealing. But now let's look at how stable value and bond funds behave in a portfolio over the same time period. When compared within a typical 60% stocks/40% fixed income portfolio[6],

BOND FUNDS OFFER EQUIVALENT RISK MITIGATION IN A BALANCED PORTFOLIO WHILE GENERATING HIGHER RETURNS.

5 The fixed income universe of securities is large and inefficient relative to equity markets. As a result, active bond managers more frequently outperform their index.

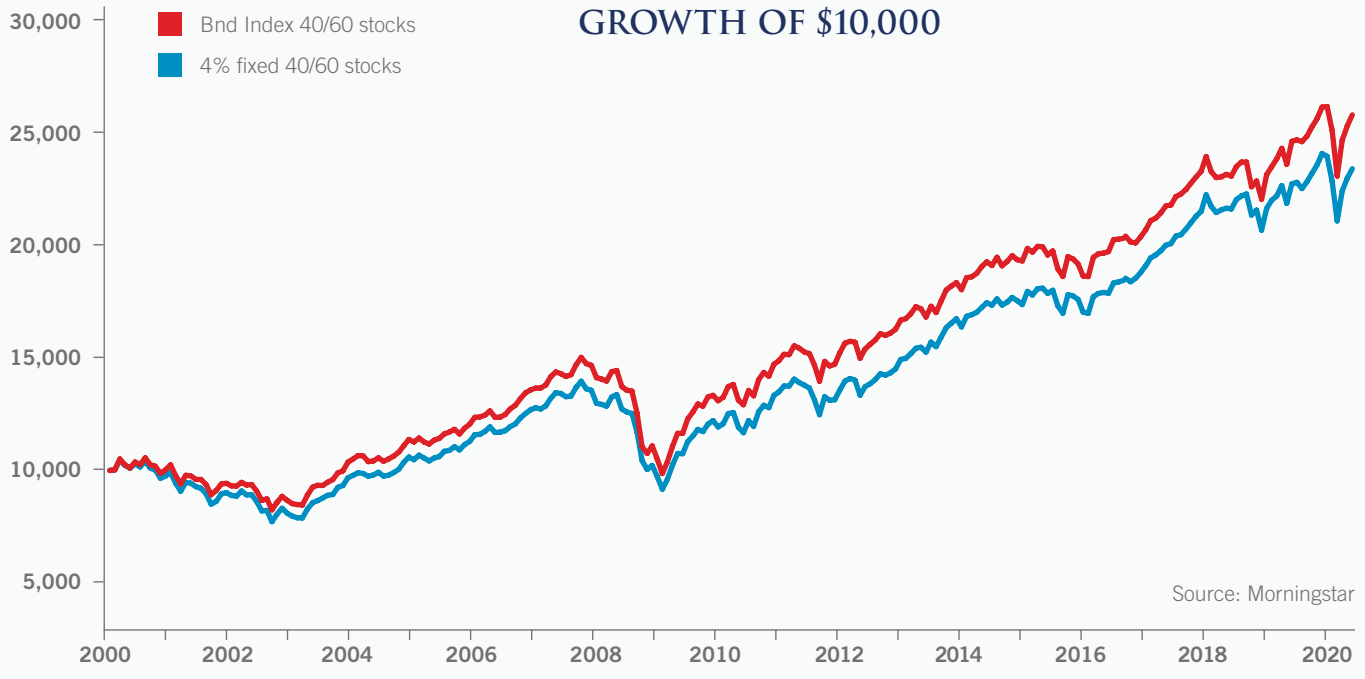
6 Balanced portfolio metrics were calculated from January 2000 to June 2020 using 36% S&P 500 and 24% MSCI ACWI Ex U.S. for the equity portion. For the fixed income portion, we used 40% Bloomberg Barclay's U.S. Aggregate Bond Index in one illustration and the 4% stable value account in the other.

we see a different story. The portfolio with stable value captured 90% of the return, with functionally all of the volatility – essentially no reduction in risk for the lost return.

The risk/return metrics of stable value versus bonds beg the question, **how can a stable value fund have 0% of the volatility of a bond fund, but not reduce the overall volatility of a balanced portfolio?**

Periodically, bonds can deliver outsized returns during stock market drawdowns. Examples of months with a 2.5%+ bond return and negative stock returns include September 2003, November 2008, and August 2019. The higher volatility of bonds versus stable value is mitigated by bonds often generating higher returns at times of downturns in the equity markets, providing portfolio smoothing not available from stable value.

As the chart below illustrates, using stable value in a balanced portfolio did not meaningfully reduce portfolio losses during market downturns over the last 20 years.



CONCLUSION

Given the higher returns of bond funds compared to stable value funds and the functionally equivalent risk mitigation in a balanced portfolio, **plan participants are better served using bond funds over stable value funds for long-term investing.** There are, however, market conditions when stable value funds provide a benefit over bonds. That is when bonds and equities drop in the same year – and that has happened only four times since 1927 (1931, 1941, 1969, and 2018). The safety of a stable value fund draws in plan participants, and they pay a price for that stability. In the long run, investing in a bond fund over a stable value fund means a plan participant is likely to have more money in their account when they're ready to retire.

Stable value funds **do make sense** when a plan participant is within a few years of beginning to take distributions. At that time, maintaining a stable value position will protect the investor from having to sell in a down market, thereby mitigating sequence-of-return risk[7] during their income distribution phase.

However, for a 10+ year investor, one should be hard-pressed to use stable value funds as a vehicle for delivering the optimal retirement nest egg. So, like the Sirens from Greek mythology, when the stable value fund is singing its enchanting song of safety and security, realize that it's a long-term trap and that higher returns and better diversification can be had elsewhere for very little additional risk in a portfolio.

7 Sequence-of-return refers to the risk of receiving lower or negative returns in the early period of taking distributions from a retirement account. When taking systemic withdrawals from a portfolio, the sequence of investment returns can significantly impact the overall investment results.

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ADDITIONAL DISCLOSURES

Indices mentioned are unmanaged and cannot be invested into directly. Fees are not deducted from index returns.

The Bloomberg Barclays U.S. Aggregate Bond Index is an index used by bond traders, mutual funds, and ETFs as a benchmark to measure their relative performance. This index includes government securities, mortgage-backed securities, asset-backed securities, and corporate securities to simulate the universe of bonds in the market.

The S&P 500 is a market-cap weighted index composed of the common stocks of 500 leading companies in leading industries of the U.S. economy.

The Morgan Stanley Capital International All Country World Index Ex U.S. (MSCI ACWI Ex U.S.) is a market-capitalization-weighted index maintained by Morgan Stanley Capital International. It is designed to provide a broad measure of stock performance throughout the world, with the exception of U.S.-based companies. It includes both developed and emerging markets.

A 4% return for stable value was used as a proxy for stable value returns in our comparison analysis since some older stable value plan insurance contracts provide a 4% lifetime minimum interest rate. Further, using a higher-than-industry-average return for stable value options in the best possible light relative to core bond funds.

No specific core bond fund is being recommended, nor are we recommending active over passive investing. Returns for active and passive bond funds were included to provide a broader illustration. The active bond funds, including in our comparison, are among the largest in the industry and are readily available in defined contribution retirement plans.

Mutual funds are sold only by prospectus. Please consider the charges, risks, expenses, and investment objectives carefully before investing. A prospectus containing this and other information about the investment company can be obtained from your financial professional. Read it carefully before you invest or send money. Amounts in mutual funds and exchange traded funds are subject to fluctuation in value and market risk. Shares, when redeemed, may be worth more or less than their original cost.

Past performance is not a guarantee of future results.

Please check with your plan consultant or investment advisor before making any changes to your retirement plan or investment strategy.