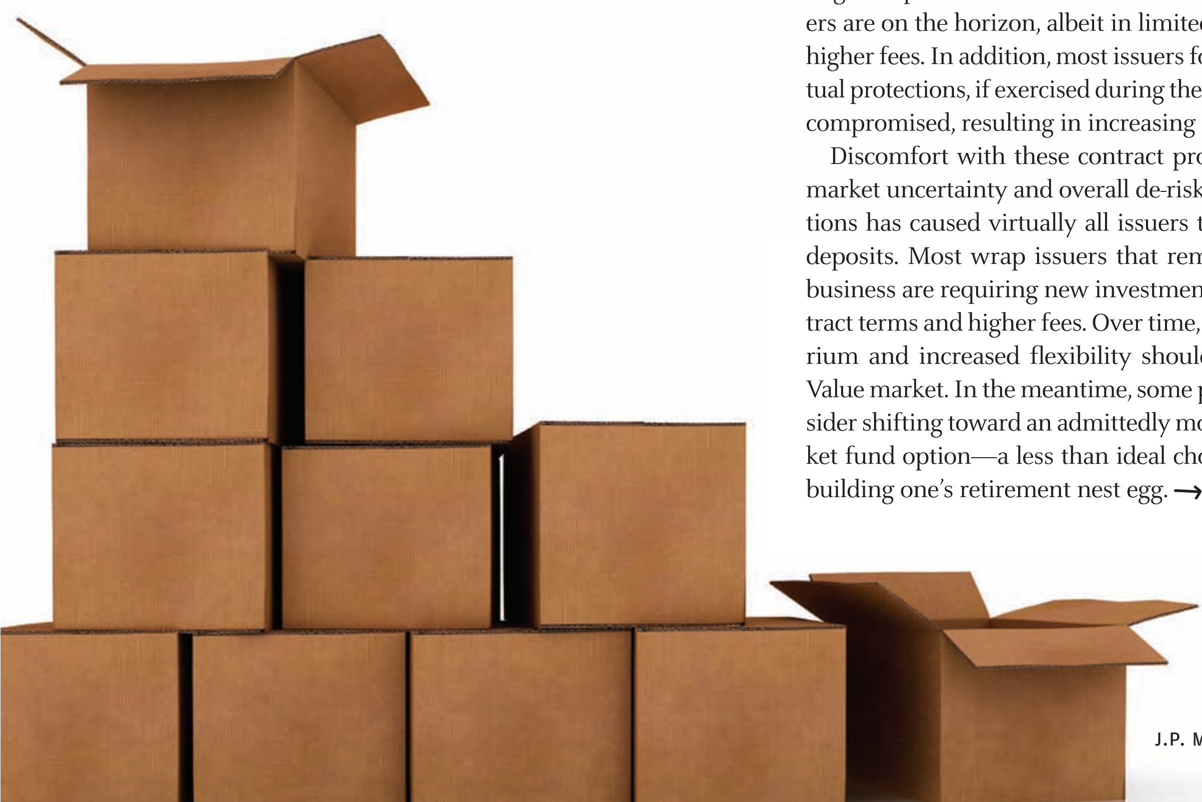
Outside the *(Stable Value)* Box

Innovative alternatives for traditional stable value funds

Although Stable Value is the largest conservative option in the DC market, recent market conditions have highlighted inherent constraints faced by plan sponsors when offering a Stable Value fund. It has become apparent that the traditional Stable Value option (a popular option with participants) will need to evolve to improve flexibility and to better meet the needs of both participants and plan sponsors.



Traditional Stable Value

Tested by the recent severe market downturn, Stable Value funds performed admirably, offering participants a place to shelter balances from market declines, while still earning a yield substantially higher than most money market funds. Stable Value contracts were the key ingredient that enabled these funds to perform as expected, even in the recent market crisis. However, these same contracts contain embedded protections that are sometimes viewed by plan sponsors as too constraining and by wrap issuers as ineffective.

Today, wrap supply and demand are out of balance: three large wrap issuers have left the market since 2008. New issuers are on the horizon, albeit in limited scale and demanding higher fees. In addition, most issuers found that their contractual protections, if exercised during the crisis, would have been compromised, resulting in increasing the issuer's risk of loss.

Discomfort with these contract protections coupled with market uncertainty and overall de-risking at financial institutions has caused virtually all issuers to cease accepting new deposits. Most wrap issuers that remain committed to the business are requiring new investment parameters, new contract terms and higher fees. Over time, a more normal equilibrium and increased flexibility should return to the Stable Value market. In the meantime, some plan sponsors may consider shifting toward an admittedly more flexible money market fund option—a less than ideal choice in the construct of building one's retirement nest egg. →

Alternatives to Stable Value

For plan sponsors seeking more flexibility than traditional Stable Value currently affords, two alternative approaches may be considered based on blending unwrapped assets with Stable Value assets.

a. **Cash Plus Fund (Stable Value plus money market)** One alternative is to allocate a meaningful portion, perhaps 20%–30%, of fund assets in an unwrapped cash vehicle like a money market fund. By doing so, the overall fund would maintain its stable daily price. The wrapped Stable Value assets would continue to produce returns that exceed cash during most market environments. In a period of sharply rising short-term rates or an inverted yield curve, the money market assets would enable the fund's return to rise more quickly than that of a dedicated Stable Value Fund. The plan would benefit from a significant source of unconstrained liquidity and should have more flexibility for plan events such as corporate downsizing or plan changes.

There are many benefits to implementing such a blended fund, including a stable daily price, meaningful outperformance versus money market funds and increased flexibility (relative to traditional Stable Value) for plan changes or other employer events. However, in the long run, the dilution effect of money market returns on the fund's performance could meaningfully impair a participant's retirement savings success. (Note: Pending Congressional legislation may impact the use of derivatives within this structure.)

b. **Stable Income Fund (Stable Value plus bonds)** Another alternative is to allocate a meaningful amount of unwrapped assets in bonds similar to the wrapped assets.[1] Through this approach, the fund would be expected to achieve a higher long-term return that is more appropriate for retirement savings (similar to traditional Stable Value). These unwrapped assets would experience daily fluctuations in price. However, because the unwrapped assets would represent a smaller portion of the fund than the wrapped assets, volatility would be muted at the total fund level and offset by the steady daily income from Stable Value contracts. The performance of such a fund would likely be dominated by the Stable Value allocation.

In this structure, a plan has the freedom to pursue actions—e.g. communication, plan changes, employer events—that would normally be constrained by the wrap contracts in a traditional Stable Value fund, but with the understanding that the downside might be a price adjustment consistent with the normal price changes of the fund. This flexibility would materially liberate the plan sponsor from reliance on wrap issuer approval, while still maintaining an investment strategy that has long-term principal preservation goals and retirement investment objectives.

Compared to the Cash Plus strategy, this fund construct targets higher long-term returns while aiming to preserve the objectives of traditional Stable Value funds: providing principal preservation and returns in excess of cash.

PLAN DESIGN DECISION TREE

Stable Value and its Siblings

Option	Price behavior	Long-term return expectation among these three options	Plan sponsor view
TRADITIONAL STABLE VALUE FUND	Daily price stability	Highest	Believe the benefits of daily price stability and higher return potential outweigh constraints
STABLE INCOME FUND	Price stability, but not daily	Close to highest	Seek improved flexibility while maintaining enhanced long-term return objectives
CASH PLUS FUND	Daily price stability	Lowest	Seek flexibility and price stability over the cost of diluted return potential

Decisions, Decisions

Even as the financial crisis has waned, the events have revealed shortcomings in portfolios and contract structures. Investment strategies are evolving. But beyond the logical investment evolution, some plans may be looking for more flexibility while keeping the traditional benefits of a Stable Value option.

As with any decision, there are trade-offs to these alternatives. Given each option's unique features, the trade-offs (see chart) can help plan sponsors determine which of these options may make the most sense for their plan.

[1] Underlying wrapped assets and unwrapped assets are available with a range of risk and return characteristics.