The stable value fund is like the quiet, good child. Its returns are always positive and stable — and it rarely gets a lot of attention. Equities, on the other hand, like the wild child of the family, often receive the lion’s share of attention from plan sponsors.

Because the stable value fund’s return is stable and positive, it’s altogether too common for plan sponsors to adopt an “if it ain’t broke, don’t fix it” approach. But with 20% or more of defined contribution (DC) plan assets typically in a stable value fund, plan sponsors neglect it at their own peril.

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Given the increased attention placed on the nation’s broader retirement challenges, the time is overdue to examine the procedures plan fiduciaries use in evaluating their stable value fund options.

The task involves a dual review, as there are two return series to monitor: stabilized book value returns and the market value performance of the underlying investment portfolio. Plan sponsors should be sure to evaluate both; we outline a useful framework on the following pages.

What ERISA expects of fiduciaries

Section 404(a)(1) of the Employee Retirement Income Security Act of 1974 (“ERISA”) lays out the basic responsibilities of fiduciaries, including:

- The Duty of Loyalty — A fiduciary must act solely for the exclusive benefit of the plan participants and beneficiaries;
- The Prudent Person Rule — A fiduciary must use the care, skill and diligence that a reasonably prudent person who is familiar with such matters would use. This rule carries with it the responsibility to seek expert guidance when required.

The duty of loyalty seems clear when applied to the selection of investment options. Helping participants build sufficient retirement savings is the primary purpose of retirement plans, and is reflected in the ever-increasing focus by the plan sponsor community on default options and asset allocation products. But plan sponsors should also consider providing a broad range of investment vehicles, and in fact this is a requirement if they wish to avail themselves of the fiduciary safe-harbor provisions provided under section 404(c) of ERISA. Stable value is usually offered to provide the most conservative option in a fund lineup; capital preservation is not to be questioned. Regardless of whether equity, target date, or stable value — the assets in the plan are intended for retirement and not for liquidity like money market funds. So, ensuring successful stable value returns for participants’ retirement benefit should be recognized by plan sponsors as an objective as critical as any for which they have responsibility.

Applying prudence to the investment actions taken by a fiduciary would include both the selection and monitoring of investment options, and the Department of Labor (DOL) has provided regulatory guidance on the process. In determining whether a fiduciary has fulfilled this obligation, the DOL and the Courts have focused on the following factors:

- The level of expertise that is brought to the analysis, with fiduciaries being held to a higher standard than simply doing their best. If they lack the necessary skills, they must seek expert assistance, leading many to refer to this as the Prudent Expert Rule.
- The processes and procedures established by the fiduciary, with as much weight, if not more, given to these than to the actual investment results. The old adage “it’s not whether you win or lose, but how you play the game” holds true.

A fiduciary satisfies its requirements when it has: “…given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary’s investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan’s investment portfolio with respect to which the fiduciary has investment duties; and has acted accordingly.” DOL Reg §2550.404a-1(b)
Stabilized book value returns
Participants are entitled to stabilized, book value returns, so reviewing that data is the logical first step. Interestingly, when reviewing stable value industry universe data, we find strikingly large return differences among separate account and commingled trust (pooled) fund managers. According to the eVestment universe, the difference exceeds 200 basis points among 25 manager-reported performance series for separate accounts and pooled funds, as shown in the chart below. This dispersion is more than 20 times the range for Money Market Funds, which typically have a high-low variance of approximately 10 basis points.

At its essence, stable value is a fixed income portfolio transformed through companion accounting contracts to produce a stabilized return. We believe that efforts to understand the underlying fixed income investment results, which are the key determinant of performance, receive insufficient fiduciary oversight by a large portion of the industry. The underlying fixed income review process is often not as rigorous as the review of other fixed income or equity strategies in DB or DC plans. Often, it is ignored.

A historical explanation for today’s arguably simplistic oversight of stable value exists. With general account life insurance products (including GICs), which were the exclusive stable value product until the early 1990s, monitoring the insurer’s ability to pay claims was critical because the firm’s capital strength backed the rate guarantee. As a result of credit quality and diversification concerns, many plan sponsors moved from capital-backed rate guarantee insurance products to discretionary stable value management with separately managed investments that were unbundled from the stable value contracts. This alternative approach offers asset ownership with excellent liquidity and diversification, and represents a majority of industry assets today.

Instead of putting the firm’s capital at risk to guarantee a return, the contemporary stable value manager decides whether and how to take investment risk when building a portfolio for the exclusive benefit of participant retirement savings. The nature of making investment decisions has evolved significantly with today’s unbundled products (wrapped fixed income), but the sophistication of the review process has not kept up with the evolution of the product.

Has a fund performed well if the stabilized returns are positive and stable? You can only assume. No plan sponsor can clearly determine what risks were taken and whether the manager’s returns reflect a prudent tradeoff of risks and rewards (fiduciary stuff) by simply looking at the book value returns.
Market value returns
The key lies with market/fair value performance and characteristics, which should be readily available. Fair/market value performance of the underlying bond portfolio is critical to a true fiduciary review, with performance attribution versus a passive market benchmark (not cash or a market yield) and versus fixed income or stable value peers. Outsourced asset management should be reviewed using the same best practices as other institutional fixed income assets.

The fiduciary duty of prudence carries with it an obligation of timely evaluation. Decisions should be evaluated within a reasonable time frame (months or quarters as well as over the longer term) as opposed to simply reviewing consolidated, smoothed data, which defers meaningful review. Market value performance is the correct tool to enable timely oversight of previously made investment decisions.

To build on these points and provide a useful framework for review, we believe three key factors drive a stable value fund’s return:

1. Fund design, which reflects the allocation to components of the fund, such as cash buffer, liquidity strategies, managed portfolios, and benefit responsive contracts. The fund design is typically determined by some combination of the stable value manager, a consultant, and the plan sponsor. The performance impact of a fund’s design reflects the goal to manage participant cash flow effects, as well as the less explicit decision to have investments reside (or not) in specific segments along the yield curve. Our research has shown that the effect of participant cash flows has actually been very modest, while the unintentional yield curve barbell in many funds has been far more costly (+1 basis point versus -30 bps, respectively, over five years).

2. Investment policy, which includes investment guidelines and benchmark. We believe this is the #1 determinant of a fund’s long-term success. Like design, investment policy is often determined by the plan sponsor, a consultant, and/or the stable value manager. Often the investment policy is tied to the stable value manager, and limited to that manager’s areas of expertise. Quantitative measurement of investment policy, such as return and volatility analysis of the total portfolio and passive index alternatives, can also help plan sponsors evaluate whether a fund’s risk profile was too conservative or too aggressive for the return generated.

3. Fixed income investment performance, which reflects day-to-day execution. Unlike the first two factors, the underlying investment performance is determined solely by the discretionary stable value manager. How did the manager’s investment decisions compensate participants for the risk assumed? It’s widely recognized that the way to evaluate this is via market/fair value performance in accordance with CFA Institute best practices. Such practices are applicable to stable value. Further, market value returns eliminate the cash flow distortions inherent in stabilized returns. A good benchmark that reflects the investment opportunity set (as opposed to a Treasury only benchmark) and a robust peer universe help a plan sponsor evaluate whether the portfolio was in the best hands.

Total Fund Review
Consider a fund’s total aggregated characteristics, not just segments, when conducting a comprehensive fiduciary review. It is common for a stable value fund to be split into segments, such as a short duration liquidity strategy and a longer active allocation, each of which is evaluated independently. It’s best to combine the segments and perform a total fund review of risk, cash flow effects, and returns. Plan sponsors clearly look at an equity option’s total fund versus an equity index and peer group; the same should apply for stable value.

Risks should be measured comprehensively and at the total fund level to include:

- The basics of duration, quality, and diversification
- Traditional fixed income measures such as the portfolio’s market volatility
- Unique stable value measures
  - The effect of participant cash flows on the overall fund return
  - The current market/book value ratio
The historical volatility of the market value/book value ratio (we consider this to be the most powerful summary risk measure).

Manager Portability
There is a fear that changing a fund manager could disrupt the stable value return to participants and jeopardize the fund’s capital preservation. This may lead sponsors to accept lack of transparency and suboptimal performance from an incumbent manager. In fact, today’s products are typically highly portable, and the book value/stabilized balances can be seamlessly ported to another manager, with a behind-the-scenes shift in the underlying assets. While separate accounts are simplest to move, even pooled fund transfers can occur quickly today, without disruption to participants.

Conclusions
Stable value has been and will remain an anchor investment within DC plans. As plan sponsors strive to better equip participants for their retirement years, it’s imperative that they not overlook stable value.

Stable value fund management is not a commodity. The underlying investment strategies, manager abilities, and resulting returns of stable value funds vary substantially. The tools to diligently evaluate and optimize results are available today, more so than ever before.

Good parents know that all children need attention, even the quiet ones. Prudent fiduciaries would be wise to show the same concern when evaluating investment options within their plans.

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