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Stable Value Managers See More Flexibility on Investment Guidelines

By Randy Myers

The trend toward ever-tighter stable value investment guidelines appears to be ending.

Following the 2008 financial crisis, issuers of stable value wrap contracts began tightening investment guidelines for stable value managers, typically requiring new limits on the duration and credit quality of the assets held in their stable value funds. In some cases, managers worried that those limits were being applied too broadly, without taking into account their experience and expertise or the unique characteristics of the retirement plans in which their funds were being offered. Now, the pendulum that some thought may have swung too far appears to have reached its zenith. No one is suggesting that investment guidelines are becoming as loose as they were prior to the crisis, but investment managers say wrap issuers are becoming slightly more flexible in their demands.

"Before 2008 guidelines were very broad," said Sean Banai, senior vice president, portfolio management for ING U.S., at the 2014 SVIA Spring Seminar. (ING U.S. will become Voya Financial in 2014.) "Afterward, guidelines became like books; we'd see guidelines that were 10 to 15 pages long and very restrictive. But what we've seen recently is that wrap providers are becoming more flexible and are willing to talk about some of their guideline limitations, especially for separate accounts where we can work with some of the underwriters and figure out a more customized guideline for each plan. We have seen some flexibility in structured allocations and in spread duration limits, and overall that has been good."

"I'd agree with Sean. We're seeing more flexibility come back," said Erik Karpinski, vice president with GSAM Stable Value LLC, who joined Banai in a panel discussion on a wide range of issues facing stable value managers. "I think it's really important for all of us given the historically favorable spread of stable value returns over money market returns. In the current environment, where fixed-income yields are low, we need to remain cognizant of that and see where we can add value."

The panel also discussed the impact that bundled stable value products from insurance companies are having on investment management trends and stable value expense ratios, the impact on stable value funds when plan sponsors decide to reenroll plan participants into their retirement plans, and strategies for dealing with any potential rise in interest rates.

Bundled products

In the wake of the financial crisis, insurance companies increasingly began offering "bundled" wrap coverage for stable value funds, meaning they required that some or all of the assets covered by their guarantees had to be managed by their own affiliates. One consequence for a number of stable value managers, said Steve LeLaurin, managing director, stable value wrap strategy for Invesco Advisors Inc., is that some funds wound up using more subadvisors than they had in the past. While that may have added some incremental cost to those funds, he said, it also will help smooth performance over time by introducing greater diversity of management styles. And that, he said, "is a good thing."

Re-enrollments

Retirement plan sponsors reenroll employees in their plans for a number of reasons, including a change in plan providers or a desire to steer more employees into their plan's qualified default investment alternative, which is often a target-date fund. In either case, reenrollment can result in assets flowing out of stable value funds and into those default options. Susan Graef, a principal with Vanguard Group, said it has been her firm's experience that about 70 percent of the assets in stable value funds are directed into other investment options in reenrollments. And LeLaurin observed that it isn't uncommon to see as much as 75 to 80 percent of stable value assets reallocated to other products.

The idea of reenrolling specifically to steer participants into default investment options "is probably the biggest thing we all have to think about," Karpinski said, given that it results in substantial cash flows out of stable value funds. That's not a terribly difficult issue to manage at the moment, when the market value of most funds exceeds book value, but it could become more challenging when market-to-book ratios fall below 100 percent. To mitigate that issue, Karpinski suggested, the stable value industry should explore mounting a new push to have stable value classified as a qualified default investment alternative, since that would probably reduce the outflow of cash from stable value funds during reenrollments.

LeLaurin observed that plan sponsors are taking varying approaches to dealing with the capital gains in their stable value funds during reenrollments. Some are distributing those gains to participants, others are leaving the gains in the stable value fund for the benefit of those participants who remain in the fund. He also noted that some plan sponsors have inquired about whether now might be a good time to discontinue offering their stable value fund because market-to-book ratios are high. Almost all of Invesco's clients have been persuaded that doing so wouldn't make much sense, he said, especially since yields on the most common alternative, money market funds, are still near 0 percent.

Preparing for rising interest rates

Rising interest rates depress prices for fixed-income assets, a concern for stable value managers who invest almost exclusively in fixed-income securities. With interest rates widely viewed as being at the tail-end of a 30-year bull market, and the Federal Reserve winding down a quantitative easing program that was aimed at keeping rates low, stable value managers have been preparing for the day when rates start to rise again. Banai said his firm has convinced some clients to reduce the duration of their fund's investment portfolio over the past 12 to 18 months, since shorter-duration assets aren't impacted as much by rising rates. In some of its portfolios, ING also has increased allocations to structured products, including short-term commercial mortgage-backed securities and commercial mortgage obligations.

Garth Talbert, senior fund manager for ICMA Retirement Corp., said his firm has taken similar measures, but not aggressively since it wants to preserve as much yield as possi-

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about $35 trillion to be kept alive that long on a pay-as-you-go basis.

Of course, even as the Social Security system was weakening, the private retirement system was changing too. Increasingly unwilling or unable to support defined benefit pension programs, employers in the 1990s began phasing them out in favor of defined contribution plans funded to a large degree by employees rather than employers. By 2011 there were 16.5 million active participants in defined benefit plans, Schieber said, down from 30.1 million in 1984.

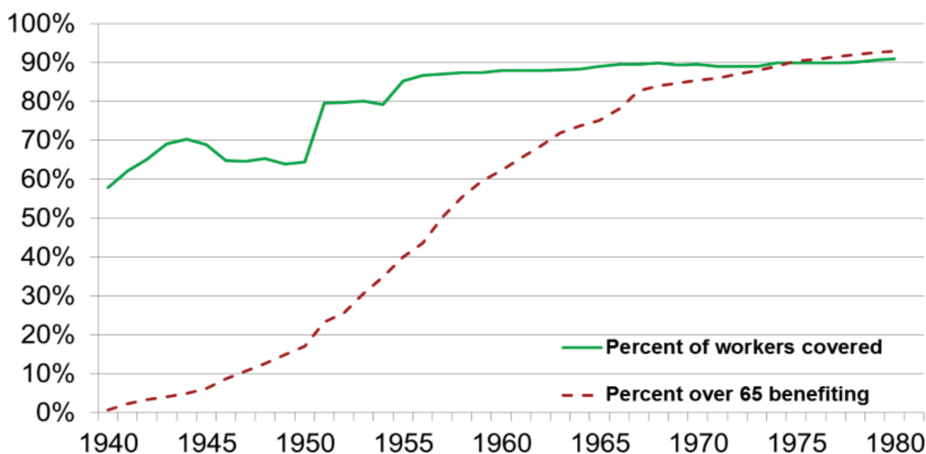
All this has meant is that Americans today must devote a far higher percentage of their income to retirement savings than they did in the past if they want to be financially secure after they stop working. Why might you ask? When Social Security was designed, most workers life spans did not extend to Social Security's eligible retirement age, which made it highly unlikely that the majority of workers would collect Social Security benefits. Today, the Social Security Administration estimates that today's retirees, those who have reached age 65 starting in 1990 will receive Social Security benefits for a little more than 15 years if male and almost 20 years if female.
In 1955, Schieber calculates, workers had to contribute 2.1% of their earnings via payroll taxes to fund Social Security, and save another 4.6% on their own—a total of 6.7% of their income—to support themselves in retirement. Today, he estimates, they must contribute 15.3% in the form of payroll taxes (half provided by employers) and save another 7.5% on their own, for a total of 22.8%. By 2035, he projects the equivalent numbers will be 19.9% and 8.5%, for a total of 28.4% of lifetime earnings. "This is why financing our retirement system today seems so much harder than it did when I was starting in business," Schieber said.

There is good news on the retirement income front, Schieber said, today's retirees are in better shape than popularly cited statistics would suggest. The official yardstick of economic status in the U.S. is based on the Census Bureau's Current Population Survey (CPS), which is used to analyze the potential impact of policy decisions in Washington. Schieber contends that the CPS doesn't fully capture the income received by retirees. In 2008, for example, the survey showed that people receiving Social Security benefits also received $5.6 billion in IRA distributions and $222.2 billion in pension and annuity income. But those same people, on their federal tax returns, reported receiving $110.9 billion in IRA distributions—excluding income from Roth IRAs—and reported another $457.3 billion from pensions and annuities.

Still, Schieber concluded, it's important that the country take steps to improve both its public and private retirement systems. In addition to strengthening Social Security, he said, individuals will have to rethink the work/retirement cutoff point and perhaps stay in the workforce longer.

"The system is out of balance," he concluded. "We have to do something to get it rebalanced, and the sooner we can the better we will be. We have to be extremely careful not to delay this until the only way we can deal with this issue is by levying taxes on the next generation—because they're going to face exactly the same thing we're facing. It's not clear their real incomes are going to be any bigger than ours. All we're talking about is passing along a substantial burden that we've not been willing to pay ourselves." SVIA

Percent of Workers Covered by Social Security and Percent of Persons Aged 65 and Over Receiving Social Security Benefits



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ble for plan participants within the constraints of its investment guidelines. He noted that Wall Street has been worrying about rising rates since the Fed cut its target for the federal funds rates to between 0 percent and 0.25 percent in December 2008, but that anyone who took extremely defensive positions at that point would have given up substantial returns since rates, especially at the shorter end of the yield curve, have generally remained low. "We try not to be too tactical with this," Talbert said. "That's why you have (wrap) insurance, to really absorb those kinds of market changes that go on over time."

Graef said it is critical that stable value managers educate plan sponsors and plan participants about the potential impact of rising rates, not only on their stable value funds but on other investments that may do poorly in a rising-rate environment. LeLaurin added that Invesco reminds sponsors that rising rates can be good for participants in stable value funds in the long run, because over time it will boost the yield on fund assets and hence the fund's crediting rate. SVIA