BOOSTING YIELDS SEEN AS ONE PATH TO DRIVING GREATER USE OF STABLE VALUE

FALL FORUM 2021: SHAPING THE NEW NORMAL

By: Randy Myers

After decades of declining interest rates, yield is tough to come by in the fixed-income markets. The stable value sector is no exception; it invests primarily in high-quality intermediate-term bonds, a corner of the market where yields over the past year have hovered well below 2%. But boosting yield is not impossible, as evidenced by the experience of Raytheon Technologies Corp., the aerospace and defense conglomerate formed by the 2020 merger of United Technologies Corp. and Raytheon Co. United Technologies had taken the unusual step of including equities in its stable value fund more than two decades ago, and its fund has delivered higher crediting rates than most stable value funds ever since. Its success points to a potentially promising path forward for those who would like to see stable value become even more popular in defined contribution retirement savings plans.

Speaking at the Stable Value Investment Association's 2021 Fall Forum in October, Thomas Borghard, a United Technologies veteran who became director of pension investments for Raytheon Technologies upon its creation, noted that since 1994 United Technologies has included an allocation to stocks in its stable value fund's portfolio. Today that fund also invests in other sectors of the market not traditionally used by stable value managers, including private placements and commercial mortgage loans. One result is that its stable value fund currently has a crediting rate around 3.5%. That is approximately 150 basis points higher than the crediting rate on the legacy Raytheon Co. stable value fund, which is being merged into the United Technologies fund. And it means that participants in the legacy Raytheon stable value fund are going to benefit from a nice pickup in yield.

Capturing those sorts of outsized returns in more stable value funds could make the asset class more attractive to some investors moving forward and win it a bigger role as a component of target-date funds, says John Ruth, CEO of Build Asset Management, an investment advisory firm specializing in alternative risk mitigation investment strategies. Ruth and Borghard were two of five participants on a Fall Forum panel exploring the challenges and opportunities facing the stable value industry. Joining them were moderator and SVIA Chairman Nick Gage, senior principal and head of stable value separate account strategy for Galliard Capital Management; Jacob Punnoose, partner and head of stable value research at Aon Investments; and Tom Schuster, senior vice president for stable value management at MetLife.

Punnoose observed that most of the plan sponsors his firm works with continue to value the stable value asset class for its principal protection guarantees, regardless of shrinking crediting rates as interest rates have fallen. But he also sees room for innovation in the asset class as the retirement industry continues to focus more intently on helping retirement plan participants with the decumulation phase of the retirement journey.

"We work with a lot of (asset) aggregators and large-cap independent registered investment advisors who are innovating today around Target Date 2.0," agreed Ruth. "And that's an opportunity ripe for stable value to elevate its position. But it is going to take, in our opinion, some adjustment in how the return profile is achieved." His own firm, Ruth said, is a proponent of including some alternative investments in wrapped stable value portfolios, with a bias toward a long-only options strategy. If interest rates remain at the historically low levels that have now persisted for more than a decade, he cautioned, it could be challenging for traditionally managed stable value funds to win wider use.

Borghard attributed his company's success with including equity in its stable value portfolio to several factors. They include working with trio of accommodative wrap providers, including MetLife, who have allowed it to be innovative, and a policy of encouraging employees to stay in the company's 401(k) plan or even roll additional money into it after retiring. That latter feature has had a beneficial impact on the stable value fund's liquidity. The fund has operated smoothly through a wide variety of market environments since introducing the equity component, Borghard added, including periods when the stock market fell sharply, and the fund's book-to-market ratio temporarily fell below 100%.

Schuster noted that MetLife charges a higher fee to wrap a stable value portfolio that includes equities, reflecting the additional capital requirements and the heightened risk it assumes in doing so. But he said the arrangement is mutually beneficial because while MetLife charges a premium, the participants of Raytheon Technology's fund benefit with an increased crediting rate given the long-term allocation to equities. He also observed that while there is additional risk, Raytheon's portfolio is well positioned given its allocation of high-quality and highly liquid fixed income securities.

In summarizing what many investment advisors are seeking in the current low-yield environment, Ruth said they are effectively looking for a bond replacement or bond surrogate to serve as the conservative anchor of their clients' investment portfolios. He argued that a stable value fund incorporating strategic diversifiers in its portfolio—while still anchored around safer assets—"could help the stable value issuer hug the higher side of quality and keep duration modest without having to stretch or get too cute in their search for yield." And that, he said, "is a fantastic growth opportunity for the stable value community."