KEY PRINCIPLES USED TO MANAGE STABLE VALUE FUNDS

STABLE VALUE INVESTMENT ASSOCIATION

INTRODUCTION

For more than 40 years, stable value funds have played an important role helping retirement plan participants safely accumulate and retain retirement savings. Stable value funds are considered a core investment option, with more than 185,000 defined contribution plans making stable value available to millions of participants. Participant assets allocated to stable value total more than $902 billion.[i] As an asset class, stable value is designed to provide plan participants with stability of principal and accrued interest, daily liquidity, and returns similar to short- and intermediate-duration bonds without the volatility associated with bonds.

Stable value funds are offered primarily as an investment option within defined contribution retirement or savings plans that provide the plan participants with tax-advantages to encourage long-term savings for specific objectives such as retirement or higher education. Examples of such plans include those created to comply with sections 401(k), 401(a), 403(b), 457, and 529 of the Internal Revenue Code.

The intent of this paper is to outline the key principles of prudent stable value investment management. Not all stable value funds are created alike, nor should they be. Plans and plan participants have different demographic characteristics, cash flow expectations, risk tolerances, and objectives. Plan participants benefit from different options in terms of stable value fund formats and investment strategies. Ultimately, the appropriateness of a stable value strategy is judged by its ability to deliver preservation of principal, liquidity, and return to the plan participants it serves in a manner that consistently meets the stable value fund's stated objectives.

This paper includes input from a broad array of industry constituents, including stable value managers, stable value wrap providers, traditional guaranteed investment contract (GIC) issuers, insurance company general account and separate account providers, fixed income managers, and plan sponsors. Although this paper summarizes key principles, it is not exhaustive. Stable value is an important asset class that evolves in response to changing demands from plan sponsors and their participants and to changes in the fixed income marketplace.[ii]

FUND CONSTRUCTION

Stable value funds are often one of the conservative investment options in a deferred savings plan's investment lineup. In many cases, a stable value fund is used by a defined contribution plan to meet the 404(c) requirement calling for "an income producing, low risk, liquid fund, sub fund, or account…."[iii] Accordingly, stable value fund investments are managed with the objective of maintaining principal stability, providing liquidity at contract value for participant initiated transactions, and generating a positive and stable rate of return.[iv]

To meet the criteria of income producing, low risk, and liquid, a prudent stable value strategy invests primarily in investment-grade, fixed income instruments. The stable value fund is generally combined with an assurance of financial protection, known as a 'wrap contract', issued by a financially responsible party such as a bank or life insurance company. Stable value funds may use GICs – a stable value investment option offered and guaranteed by a single insurance company, with the underlying assets typically managed by the insurance company or an affiliated investment manager – as well as investments that are not covered by a stable value wrap so long as these investments are short-term in nature and can reasonably be expected to maintain principal stability on their own without coverage by a wrap (i.e. cash-equivalent securities).

In practice, a stable value fund maintains principal stability by valuing the fund's investments at contract value – typically defined as the initial principal investment amount plus credited interest, adjusted for subsequent deposits and withdrawals. Plan participants also transact at contract value. As a result, stable value contracts need to comply with the Financial Accounting Standards Board's FSP AAG INV-1 for stable value funds that hold the wrap contract as a fund asset or SOP 94-4-1 for funds whose wrap(s) are written directly to a qualified plan or its trustee. Transacting at contract value provides plan participants' the desired smooth return streams regardless of the market value volatility being experienced by the bond portfolios covered by the investment contracts used by the fund.

A stable value fund favors high credit quality, balances duration with crediting-rate responsiveness, maintains diversification, and provides a source of ready liquidity. Each element should be viewed holistically with the strategy employed, the exposure to each type of asset, and to each individual security. Each of these elements is explained in the key investment principles that follow.

KEY INVESTMENT PRINCIPLES

CREDIT QUALITY

Stable value funds have an investment grade strategy, typically with a high average credit quality. Below-investment-grade may be included to diversify exposure, manage risk, or enhance returns, provided those assets are consistent with the fund's risk constraints.

DURATION

In determining an appropriate duration for a given stable value strategy, the stable value manager should seek to balance the benefits of higher yields by investing in longer duration securities against the desire for a crediting rate that is more responsive to the changing level of market interest rates. Consideration should also be given to plan events, participant demographics, and expected cash flows, particularly in a stressed environment. Generally, stable value managers find this balance in duration somewhere between two and four years.

PORTFOLIO DIVERSIFICATION

Stable value funds are generally highly diversified across sectors with concentration limits on sectors and sub-sectors. Additionally, single issuer and issue exposure limits are also applied.

LIQUIDITY

A stable value fund typically includes an allocation to assets that can be used to provide liquidity for participant initiated activity, namely a short term investment fund such as a money market. Wrap contracts provide an additional layer of protection for participant liquidity needs, by allowing participant withdrawals to be transacted at contract value.

OTHER ASSET CLASSES

While the above characteristics cover key principles of a stable value fund, many stable value funds use other asset classes to diversify exposure, manage risk, and enhance returns. Derivatives are frequently used to replicate fixed income investments and hedge interest rate, credit, and currency risks. They provide an additional tool to manage yield curve structure, to quickly adjust portfolio duration, and to facilitate investment strategies consistent with the stable value fund's investment guidelines and objectives. Additionally, a stable value fund may include small allocations to non-dollar bonds or equities. Although these asset classes have not traditionally been included in stable value funds, they may offer additional yield and diversification. Regardless of the asset classes included, it is paramount that the stable value fund reflect the risk tolerance and objectives of the portfolio.

STABLE VALUE FUND FORMATS

Stable value funds generally adopt one of three formats – individually managed accounts, pooled funds, and insurance company general and separate accounts.

INDIVIDUALLY MANAGED ACCOUNTS

A stable value investment option in which the assets are owned by and managed for a specific plan's participants. These accounts are usually managed by an independent investment management firm or by employees or affiliates of the plan sponsor. Individually managed accounts allow for a higher degree of customization than other stable value investment options.

POOLED FUNDS

Also known as commingled investment trusts or CITs, a fund that is typically offered by a bank or trust company and combines the assets of unaffiliated plans into one large group. With respect to a stable value investment option that is a commingled fund, the fund would purchase stable value investment contracts and other investments on behalf of the invested, unaffiliated plans.

INSURANCE COMPANY GENERAL AND SEPARATE ACCOUNTS

Also known as guaranteed insurance accounts, a stable value investment option entirely offered and guaranteed by a single insurance company, with the underlying assets typically managed by the insurance company or an affiliated investment manager.

All formats should employ the key investment principles outlined above.

CONCLUSION

Stable value funds serve a valuable purpose in retirement plans, and are managed to provide income, liquidity, and low risk. To achieve these objectives, investments are typically high quality, short- to intermediate-term in duration, and diversified. Applicable law and regulatory oversight differ by stable value fund format. Regardless of the type of saving plan or stable value fund format, a guiding principle in all prudently managed stable value funds is the objective of maintaining principal stability, providing liquidity at contract value for participant initiated transactions, and generating a positive and stable rate of return.

ENDNOTES

i SVIA 2020 Annual Investment & Policy Report

ii For more information about stable value, please visit stablevalue.org/resources

iii 29 CFR § 2550.404c-1 - ERISA section 404(c) plans. | CFR | US Law | LII / Legal Information Institute (cornell.edu)

iv For more information on key elements in a stable value fund, please see SVIA's Annual Investment and Policy Report.