

## Reviewing Stable Value Funds in Light of Media Scrutiny

The vast majority of participant-directed defined contribution (DC) plans offer a capital preservation option. Typically, the most conservative option is a stable value product. This is particularly true if the plan's bundled service provider is an insurance company. This year, as the viability of some large insurance companies has come into question and the investment performance of their underlying assets is under pressure, the stable value option is receiving increased scrutiny in the media. Because the stable value option typically has the largest account balance within the DC plan, participants and plan sponsors are taking notice. In this issue of *Research Note*, Segal Advisors details the questions that sponsors of DC plans should be asking their investment consultant and service provider regarding the stable value option.

### What is the investment structure of the stable value option?

Knowing whether the stable value option is offered through a general account, a separate account or a non-proprietary commingled product is important because each has advantages and disadvantages. For example:

- The **general account** typically provides higher minimum crediting rates<sup>1</sup> and current crediting rates. However, fee disclosure and organizational risk are areas of concern. Since the assets of the plan's stable value account are commingled with the general assets of the vendor, the fees being charged to manage the plan's assets can be unclear. Moreover, if the vendor files for bankruptcy, then the stable value assets would be included within the general assets of the firm and the stable value investor would be a creditor of the firm (second in line to the administrative/legal expenses of the bankruptcy and at the same level as insurance policyholders).

<sup>1</sup> Crediting rates are the declared rates of return for a specified period, typically monthly, quarterly or annually.

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- The vendor's **separate account** product typically provides greater portability, the ability to dictate investment guidelines and a more transparent fee disclosure. In general, these advantages over the general account are accompanied by lower returns. The minimum credit rates and current crediting rates tend to be lower. In addition, the vendor and plan sponsor must monitor the book-to-market<sup>2</sup> ratio of the stable value fund and seek to maintain a 100 percent ratio. An additional advantage of the separate account structure is that it mitigates the negative consequences of insurer insolvency.
- The **non-proprietary commingled products** typically provide greater liquidity, daily valuation, clear fee disclosure and diversified wrappers<sup>3</sup> on the guarantees, but lower minimum crediting rates (often no minimum) and greater volatility in the crediting rate. The daily liquidity is the main reason for the lower minimum guarantees, and there are no book-to-market value concerns. Like separate accounts, non-proprietary commingled products mitigate the negative consequences of insurer insolvency.

<sup>2</sup> "Book to market" refers to the value of the stable value account's book value relative to value of the underlying portfolio at current market prices.

<sup>3</sup> Wrappers protect participants by guaranteeing the difference between the book value and the market value. Wrappers take various forms, including guaranteed annuity contracts. In the current market environment, the price for wrappers has increased.

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**What are the withdrawal provisions of the stable value product at both plan-sponsor and participant levels?**

The aspects of the withdrawal provisions vary across vendors and should be clearly understood.

Restrictions for plan sponsors might include the vendor's right to do the following:

- Delay the payout (typically 0-5 years),
- Make annual installment payments, and
- Send securities to the plan sponsor in-kind<sup>4</sup> at market.

Any of these restrictions may apply regardless of the investment structure.

If the contracts are at the participant level, the plan sponsor may not have the right to terminate a vendor.

At the participant level, the main restriction is the 90-day equity-wash provision. An equity wash means that, when participants want to withdraw, they must transfer those assets to an equity option for a minimum of 90 days before they can transfer the assets back into the stable value option. In addition, the equity wash provision prevents a participant from transferring assets to a competing fund, such as a money market fund. However, there may be more restrictive limitations to participants, including maximum percentages that can be transferred

<sup>4</sup> "In-kind" is defined as transferring the physical securities to the new provider.

over a specified period (*i.e.*, up to 20 percent of the participant's stable value account may be transferred out over any 12-month period).

**Who is providing a guarantee on the book value of the stable value accounts?**

For general account products, the guarantee is backed by the general assets of the vendor. For the vendor's separate account product, the guarantee of book value is also backed by the vendor. The non-proprietary commingled stable value product typically has multiple providers guaranteeing the fund, helping to mitigate this risk. Firms charge higher fees to provide these guarantees due to increased market volatility and uncertainty.

**Concluding Observations**

Understanding these distinctions is vital for the appropriate analysis and monitoring of DC plans' stable value option. Plan sponsors should seek to have a clear understanding of the characteristics of their stable value option to determine whether it is a good fit for the needs of the plan and the plan's participants.



*For more information about stable value funds or for assistance in comparing the current option offered to alternatives, contact your Segal Advisors investment consultant, the nearest Segal Advisors office from the list in the box below or Gino Reina at 212.251.5910 or [greina@segaladvisors.com](mailto:greina@segaladvisors.com).*

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