HARRISON FIDUCIARY

Fiduciary Alert: Stable Value

Plan Participants view Stable Value Programs as inherently riskless. They do not expect to incur investment losses in these programs. And yet, Stable Value Programs continue to present serious challenges and risks to Plan Sponsors and Plan Participants which, in fact, could lead to investment losses. Unfortunately, most investment and retirement professionals continue to focus their energy and analysis on other traditional and alternative asset classes.

Ongoing turmoil in the financial markets has spurred plan sponsors to review investment strategies with greater vigor over the past few years. With the help of investment consultants and managers, plan sponsors have educated themselves on the nature and risks of a wide variety of strategies and asset types, with a particular focus on many of the relatively new– and often complex– derivatives. The effort requires significant time and effort on the part of those shouldering the responsibilities for the management of the plans.

Given the challenges of the environment it is not surprising that the longstanding and straightforward stable value offerings have not been scrutinized as energetically as their more complex and risky brethren. We are concerned that this complacency poses a very significant risk to the plans and those responsible for them.

Stable Value: High Exposure, Low Understanding

According to the Stable Value Investment Association, approximately 50% of US defined contribution plans offer Stable Value Programs, totaling about $520 billion[1] as of 2009. While they no longer dominate participant balances the way they did twenty years ago, for most plans they garner a greater percentage of assets than any other offering; when they are not in first place they are virtually always in the top three.

Stable value programs generated positive returns in the dismal 2008 environment, reinforcing the attractiveness of the option for participants who are risk averse. This strong commitment to stable value by plan participants reflects a preference for consistent, if modest, positive returns to the risks of other strategies, even when other strategies hold the promise of significantly greater returns over time.

Paradoxically, despite the importance of the Stable Value Program in most plans a solid grasp of the features and functions of the program is lacking:

> ...many plan sponsors do not have an adequate understanding of the critical features of Stable Value Funds. In some cases, this lack of understanding is due to the plan sponsor's insufficiency of due diligence or basic understanding regarding the features of Stable Value Funds."[2]

The same report cited similar concerns for participants:

> "...plan participants often view Stable Value Funds as the effective equivalent of a money market fund without appreciating the important differences. Many participants do not understand the difference between book value and market value and potential risks related to a fair market value adjustment upon the occurrence of an employer-initiated event, if and when it would occur. Many participants also do not understand that payment of plan funds invested in Stable Value Funds could be a delayed upon the occurrence of an employer-initiated event."[3]

Perhaps the knowledge gaps exist because significant problems in stable value funds are rare. Nonetheless, we believe it is critical for both plan sponsors and participants to understand the features of these program which set them apart from any other offerings.

Failure to understand these programs can result in significant investment losses where no losses were otherwise expected.

1 http://www.dol.gov/ebsa/publications/2009ACreport3.html

2 ibid

3 ibid

The Mechanics of Stable Value Programs

Stable Value Programs generally incorporate one or more of the following types of investment contracts, each of which can be structured in a variety of forms:

- Traditional Guaranteed Investment Contracts (GICs)
- Separate Account Contracts
- Synthetic GICS

For our purposes we will highlight important issues relating to all stable value options while noting that each type requires deeper analysis.

STABLE VALUE PROGRAM	
ASSETS	INSURANCE CONTRACT(S)

What sets Stable Value Programs apart from other investment options is that they are comprised of two distinct elements: (i) the underlying assets and (ii) the contract which "wraps" (or guarantees) the book value of the assets.

The assets generate the underlying investment returns of the program. These asset pools are almost always high-quality fixed income holdings. Beyond typically high average credit quality (which investors now know is not always as indicative of safety as previously believed), the types of fixed income assets and their maturity varies.

When investing in a typical bond fund, investors know that the price of the fund varies based upon market liquidity, prevailing interest rates and other variables which determine market value. Stable Value Programs, on the other hand, employ book value accounting –the unit price of a Stable Value Program remains constant.
Stable Value Programs are unique because they require maintaining two sets of accounting records –market value and book value records.

If market value of the underlying investments always equalled book value there would be little need for a wrap contract. The importance of the wrap contract comes into play when the market value of the investment assets fall below the book value. In such cases the wrap contract provides the guarantee of the book value of the investment assets which permits participants to make redemptions from Stable Value Programs at the higher book value. In other words, plan participants are not required to absorb the loss in market value of the underlying assets.

To compensate for the variations between book and market value, the crediting rate, or "interest" earned on the participants' investments may be adjusted downward to equalize the difference over time.

What are the Unique Risks in Stable Value?

As with any investment there are a host of risks which wax and wane over time, depending upon market conditions. In certain cases if these risks reach certain extremes, the Stable Value Program will "fail" and plan participants will be forced to recognize real investment losses in their otherwise "safe-from-investment-risk" –Stable Value – investment option. We highlight three related risks which we find are not well understood:

- **The "Market to Book" Ratio.**
  Whenever market value drops below book value, the wrap contract becomes much more important, since it is the wrap contract that permits participants to essentially transact at a value higher than what the underlying assets would fetch in the marketplace. When the market value of the assets fall relative to the book value as interest rates rise or other market events occur, the role of the wrap contract increases in importance to the performance of the program. The financial crisis of 2008-2009, for example, caused market values in most funds to drop precipitously. Plan sponsors need to understand and monitor this ratio because substantive changes in the ratio can grant important rights to the provider of the wrap contract.

- **Counterparty Risk**.
  The wrap contract associated with a program is generally provided by an insurance company or other financial institution. The creditworthiness of the wrap provider is a critical component of the effective functioning of the program. Under adverse market conditions wrap providers' financial condition may come under pressure as the value of either the funds they wrap or their own investment portfolios-- or both-- decline. After the recent crisis, many wrap providers exited the business, reducing the number of companies (counterparties) offering the stable value contracts. Plan sponsors need to carefully follow the financial health of their providers and diversify their providers to mitigate risk.

- **Contractual Risk.**
  Wrap contracts contain a number of clauses which may diminish the wrap providers' responsibility to fund the gap between book and market values. A number of "employer initiated" events, such as bankruptcy or changes to the plan can reduce or eliminate the obligation of the wrap provider to permit participants to transact at book value. In many cases asset managers or bookkeepers execute the wrap contracts with the providers, and a decision on the part of the plan sponsor to initiate certain changes could unintentionally trigger the termination of the wrap contract and its benefits.

Implications of Dodd-Frank Financial Reform Act

The final implications of the Financial Reform Act for Stable Value Programs has yet to be determined. The new legislation requires the Securities and the Exchange Commission and the Commodity Futures Trading Commission to conduct a study of the impact of regulating Stable Value products under new provisions of the Act relating to the regulation of swap (derivative) contracts. The study is due 15 months after enactment of the Act. All plan sponsors offering a Stable Value Program need to monitor developments in this area in order to determine if a new set of regulations will be imposed on these programs.

HFG -- The Expert Fiduciary For Stable Value Programs

Stable Value Programs proved enormously successful during the recent financial crisis. Plan participants appreciated the preservation of capital feature of stable value programs when they opened their monthly statements and viewed significant declines in value in their other investment options. Plan Sponsors who offer Stable Value Programs within 401(k) plans are providing a real value to their employees and retirees.

However, as outlined in this Alert, Stable Value Programs are very complicated and involve numerous players setting their own terms and conditions: wrap providers, investment managers, and record-keepers. The HFG fiduciary team can assess, analyze and mitigate significant risks associated with Stable Value Programs. Based upon years of stable value experience (both fiduciary and investment related)HFG has the confidence and expertise to serve as a fiduciary to plans. HFG is a fiduciary, not merely a consultant.

Contact **Harrison Fiduciary** for more information:

www.harrisonfiduciary.com | info@harrisonfiduciary.com

— COFOUNDERS —

BARBARA SHEGOG, CFA, CPA
bshegog@harrisonfiduciary.com

MITCHELL H. SHAMES, ESQ.
mshames@harrisonfiduciary.com