A CLOSER LOOK AT THE CAPITAL PRESERVATION FUNDS USED WITHIN DEFINED CONTRIBUTION PLANS

Kristen Colvin, Consultant
Christine A. Loughlin, CFA, CAIA, Partner

The typical defined contribution program offers twenty to twenty-five investment choices, if target date funds are counted individually. One or two of those choices will be a capital preservation fund, such as a money market fund or a stable value fund. These funds have a primary objective of providing current income while protecting principal. The risk/return profile can be thought of as modest return with very low risk.

2008 highlighted the fact that capital preservation funds are not risk-free. Money market funds came under pressure when the Reserve Primary Fund "broke the buck", and stable value funds have had plan sponsors on pins and needles for months. The risks that became apparent include market risk, issuer risk, wrapper risk, and ultimately, principal risk. Bottom line, we have all been reminded that money market funds, stable value funds and fixed income funds are not without risk, and a new question has emerged among plan sponsors: whether to offer a risk free investment choice to participants.

This article is part one of a two-part series NEPC is releasing to respond to the unprecedented number of questions we are receiving from plan sponsors about the capital preservation funds within their defined contribution programs. This is the introductory piece, the primer on stable value funds, money market funds and the Treasury department's guaranteed money market program. A second piece titled, "Stable Value: No Free Lunch" will be released in the first quarter of 2009. It will have a more thorough treatment of current issues, including a roadmap of actions sponsors can take to evaluate stable value portfolios and wrappers, and handle weakened or impaired portfolios.

Time will tell the impact of 2008's credit and liquidity crisis on the capital preservation funds offered within defined contribution programs. It is possible that five years from now we will be where we are today, with the same capital preservation offerings available in defined contribution programs. It is also possible that five years from now we will be in a very different place, where the capital preservation choice will be a risk free U.S. Treasury Fund or a savings account. What is clear is that neither stable value funds nor money market funds came through this financial crisis unscathed.

TIME WILL TELL THE IMPACT OF 2008's CREDIT AND LIQUIDITY CRISIS ON THE CAPITAL PRESERVATION FUNDS OFFERED WITHIN DEFINED CONTRIBUTION PROGRAMS.

What is a Stable Value Fund?

Stable value funds are the most common type of capital preservation product within defined contribution programs. According to "Plans in Transition 2008: IOMA's Annual Defined Contribution Plan Report," 46% of plans offer a stable value fund, and these funds hold about 15% of plan assets. No other type of capital preservation or fixed income fund accounts for more than 8% of defined contribution assets. Stable value funds can only be offered in tax-deferred savings plans, such as 401(k) plans and 529 plans.

The key to understanding stable value is to recognize it as having two components, (1) a volatile asset or investment portfolio owned by the plan and (2) wrap agreements (typically provided by

parties other than the investment manager) that guarantee principal value will not be lost, such that participant withdrawals can be paid out at book value.

Like a bond fund, a stable value fund can invest in a wide variety of fixed income securities that experience daily market fluctuations. Unlike a bond fund, stable value funds have an insurance element and a different accounting treatment that allows them to remain "stable" despite fluctuations in the financial markets. So long as a stable value fund is "fully benefit-responsive", its contracts can be reported at book value, which is principal investment plus accrued income. This was originally confirmed at the request of FASB in AICPA Statement of Position 94-4 *Reporting of Investment Contracts Held by Health and Welfare Plans and Defined Contribution Pension Plans* and reaffirmed in 2006 with FSP AAG INV-a.

STABLE VALUE FUNDS TYPICALLY PERFORM LIKE SHORT TO INTERMEDIATE-TERM BOND FUNDS OVER A FULL MARKET CYCLE, BUT WITH LESS VOLATILITY.

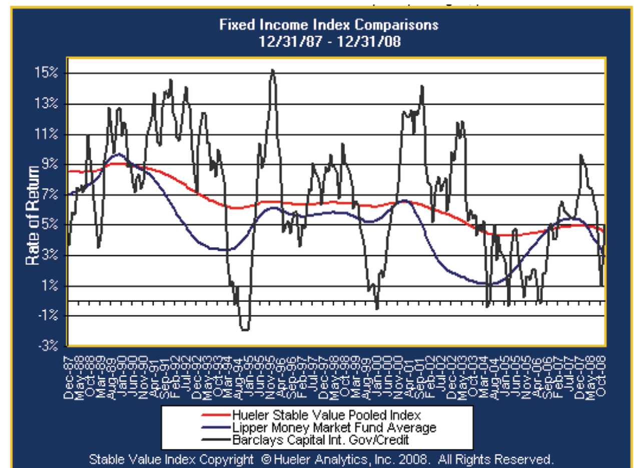
Fully benefit-responsive means that participants can withdraw or transfer their stable value investments at book value regardless of the current market value of the portfolio. Importantly, the benefit-responsive feature applies only to participants; it does not apply to employer or sponsor-initiated events such as lay-offs or the termination or transfer of stable value assets. This is because employer-initiated events can cause withdrawals in masse from a stable value fund and potentially hurt remaining investors.

The insurance element of stable value, known as wrap agreements, are issued by insurance companies, banks and other financial institutions. A wrap is a derivative instrument provided by these parties for a modest fee. The typical stable value fund will have multiple wraps, each insuring a portion of the fund. Contract terms are similar and withdrawal risk is typically shared equally. AIG, the troubled insurer, is a major wrapper of stable value fund assets. Other major players include Bank of America, JPMorgan, AEGON, ING, State Street Bank and UBS until recently.

The wrap agreements also provide for what is commonly referred to as book value accounting. Most wraps are "participating agreements" that guarantee participant liquidity at book value while smoothing gains and losses on assets through amortized adjustments of the future crediting rate (return). "Experience-rated" is another way of referring to contracts with crediting rates (returns) adjusted to reflect the experience on the underlying assets and liabilities.

To recap, stable value funds invest in fixed income instruments and repackage the variable, market-driven returns into a return stream that is stable over time. This is like taking a fixed income (bond) fund, which generally sees low utilization in defined contribution plans, and "repackaging" it to something participants want, a capital preservation fund, and one that happens to have a higher yield than a money market fund.

Exhibit 1



What Do Stable Value Funds Invest In?

Stable value funds can invest in one or more asset portfolios. The asset portfolio(s) of a stable value fund can include corporate bonds, asset-backed securities, collateralized mortgage obligations and government/agency bonds, guaranteed investment contracts (GICs), bank investment contracts (BICs), cash and cash equivalents. "Synthetic GICs" refer to wrapped portfolios of individual investments, or a contract with similar characteristics.

Typical benchmarks for the underlying asset portfolio of a stable value fund are the Barclays Capital Intermediate Government/Credit Index or the Barclays Capital Intermediate Aggregate Index.

What is the Return Profile of Stable Value?

Stable value funds typically perform like short to intermediate-term bond funds over a full market cycle, but with less volatility. Exhibit 1 from Hueler Analytics, Inc. compares the jagged return stream

AS CAN BE SEEN, OVER ALL PERIODS LONGER THAN A YEAR, FIXED INCOME INVESTMENTS OUTPERFORM CASH INSTRUMENTS.

of fixed income, as represented by the Barclays Capital Intermediate Government Credit Index, to the smooth return stream of stable value and money market funds. Exhibit 2 compares the gross of fee returns of the median cash, stable value, intermediate and core plus fixed income managers against a few fixed income indexes. Trailing returns are as of December 31, 2008, and as such include negative numbers for core plus fixed income for the year. As can be seen, over all periods longer than a year, fixed income investments outperform cash instruments. The differential is about 1% to 2% annually over 5 to 10 years, depending on the type of fixed income. Stable value funds are less volatile than fixed income (bond) funds because of the different accounting treatment discussed in the first section of this paper.

Exhibit 2

Fixed Income Returns (12/31/08)	1 Yr	3 Yrs	5 Yrs	10 Yrs
ICC Universe Medians				
Cash Fund Median	2.5%	4.2%	3.4%	3.7%
Stable Value Median	4.6%	4.7%	4.6%	5.3%
Intermediate Median	2.6%	4.8%	4.2%	5.5%
Core Plus Median	-1.7%	3.4%	3.8%	6.0%
Indexes				
91 Day Treasury Bills	1.5%	3.8%	3.2%	3.4%
Barclays Govt 1-3 Year	6.7%	6.0%	4.1%	4.8%
Barclays Intermed. Gov/Credit	5.1%	5.5%	4.2%	5.4%
Barclays Aggregate Bond	5.2%	5.5%	4.7%	5.6%

On any given day, a stable value participant will see a $1 NAV plus a crediting rate determined by the yield and performance of the underlying asset portfolio. From a participant's perspective, stable value funds are not unlike money market funds; they appear riskless. Their NAV doesn't change; losses are not expected.

Are Stable Value Funds Safe?

A primary objective of a stable value fund is to provide book value coverage for participants, essentially guaranteeing that if a participant puts a dollar into the stable value fund, they will get at least a dollar out.

The wrap contracts provide the book value guarantee, and historically there hasn't been any significant risk associated with the wrap providers. What happens if a wrap provider exits the business or goes under? Essentially nothing, accordingly to Kelli Hueler, CEO of Hueler Analytics, who's been quoted as saying, "it doesn't really change anything in the stable value portfolio other than the manager has to decide to reallocate those dollars to a different wrap provider."

If the insurance wrapper goes away, and is *not* replaced, that component of the fund is subject to market valuation. This is perhaps the worst outcome for a stable value fund, because if market value is below book value, the fund would have to recognize losses. The "dollar in, dollar out" feature of stable value would go away, and participants would have to be notified immediately. Because an asset write down would cause participants to lose money and break the implied promise of capital preservation, the risk of litigation by participants may be heightened.

Thinking of the two components of stable value, we can summarize the risk profile as follows:

1. The asset portfolio has risk comparable to a portfolio of short to intermediate term bonds, because that is what most stable value funds invest in; and
2. The wrap contracts have liquidity risk, because there is no secondary market; interest rate risk, because rate increases can prompt investor withdrawals in favor of competing investments; and issuer risk, covering the

range of unsystematic risks associated with the wrap providers. For example, if the insurance wrappers were to exit the business, stable value portfolios would become bond portfolios overnight.

The underlying investments of a stable value portfolio are not guaranteed by the Treasury or the FDIC. If the underlying investments experience losses, as most have in the current environment, those losses are amortized over the duration of the portfolio. The wrap provider provides the calculation. Effectively, any losses act to reduce the crediting rate (return) over time, but the NAV is held at $1.

SHAREHOLDERS INVESTED IN A PARTICIPATING FUND THAT 'BREAKS THE BUCK' WILL RECEIVE THE GUARANTEED $1 PER-SHARE ON ALL SHARES HELD AS OF SEPTEMBER 19, 2008.

What is a Money Market Mutual Fund?

Money market mutual funds are the second most common type of capital preservation fund found within defined contribution plans. According to "Plans in Transition 2008: IOMA's Annual Defined Contribution Plan Report," 33% of plans offer a money market mutual fund. Any one of three types of funds may be offered: a Treasury fund, a Government fund, or a Prime fund. Prime funds are the most common. Money market mutual funds hold an objective of earning interest for shareholders while maintaining a $1 per share net asset value. The funds invest in the money markets, a subsection of the fixed income markets.

The money markets are the global financial market for short-term borrowing and lending. Commercial paper is the most prevalent security in the money market. It is an unsecured promissory note for a specified amount to be paid at a specified date, and is issued by finance companies, banks, and corporations with excellent credit. Normally, commercial paper yields are only slightly higher than T-Bill yields, and commercial paper is sold in round lots of $100,000, limiting access for individual investors.

Money market mutual funds are a means for individual investors to access the money markets. They pool the assets of investors to buy a portfolio of money market securities.

What is the Return Profile of Money Market Funds?

The performance of money market funds is closely tied to the interest rates set by the Federal Reserve. When interest rates are low, money market fund returns will be low, and vice versa. When compared to stable value funds, money market mutual funds have comparable liquidity and stability, but lower average interest rates. This is because money market funds generally invest in high quality, short-term instruments, while stable value funds invest further out on the yield curve, and in instruments of variable quality.

Are Money Market Mutual Funds the Same as Bank Deposits and Money Market Accounts?

A money market mutual fund is neither the same as a bank deposit nor a money market account. A key difference is that bank deposits and money market accounts are insured by the government for up to $250,000 per deposit while money market mutual funds are not. Bank deposits and money market accounts are interest-bearing accounts offered by federally insured institutions. The FDIC insures accounts opened at banks while the NCUA insures accounts opened at credit unions.

Money market accounts are different from bank deposits in that they typically pay a higher interest rate and have higher minimum balance requirements. The money deposited into a money market account will be invested in the money markets by the bank or credit union. The money market account is not as liquid as a regular savings account; withdrawals can be limited to a certain number per month.

On Friday, October 3, 2008, President Bush signed into law the Emergency Economic Stabilization Act of 2008 which temporarily increased the deposit insurance coverage from $100,000 to $250,000 per depositor per insured bank (credit union) through December 31, 2009. The legislation provides that the basic deposit insurance limit will return to $100,000 after December 31, 2009.

What is the Treasury's Temporary Money Market Fund Guarantee Program?

The U.S. Treasury Department announced the establishment of a temporary guarantee program for the U.S. money market mutual fund industry on September 29, 2008. Money market mutual funds are not automatically enrolled in the Treasury program; funds must apply for the program and pay a fee to participate.

The Treasury program provides a $1 per share guarantee to shareholders based on the number of shares held in a participating fund as of the close of business on September 19, 2008. Any increase in the number of shares held after the close of business on September 19th will not be guaranteed.

THE U.S. TREASURY DEPARTMENT ANNOUNCED AN EXTENSION OF THE TREASURY'S TEMPORARY GUARANTEE PROGRAM FOR MONEY MARKET FUNDS UNTIL APRIL 30, 2009.

The Treasury will have to provide the guarantee if a participating fund's net asset value "breaks the buck" and falls below $0.995. However, the participating fund does not simply get a payout from the Fed to bring the net asset value up to $1 and continue with business as usual. Instead, if a participating fund "breaks the buck" and goes to the Treasury for the payout, the fund must be liquidated within 30 days, subject to possible extensions at the Treasury's discretion. The guaranteed payment will be made to shareholders through the fund at the point of liquidation.

The Treasury program is not the same as the FDIC's guarantee of bank deposits up to $250,000, as the Treasury program does not have a cap on the money-fund coverage.

In late November the U.S. Treasury Department announced an extension of the Treasury's Temporary Guarantee Program for Money Market Funds until April 30, 2009 to support ongoing stability in the market.

For sponsors considering adding a money market mutual fund to the investment line-up, it is important to note that the temporary guarantee program will continue to provide coverage to shareholders up to amounts that they held in participating money market funds as of the close of business on September 19, 2008. If a participant moved money into a money market mutual fund (or if a new money market fund was added to a defined contribution program) after September 19th, the temporary guarantee does not apply.

Plan Design Considerations

Section 404(c) of the Employee Retirement Income Security Act of 1974 (ERISA) provides that if certain conditions are met, fiduciaries of plans that permit participants or beneficiaries to exercise control over assets, shall not be liable for any loss, or by reason of any breach, which results from that exercise of control.

The 404(c) regulations are lengthy and formidable, but they provide the basic over-arching guidelines to assist plan sponsors in complying with the requirements so that they can obtain Section 404(c) relief (i.e., limited liability protection from claims by participants and beneficiaries arising from investment losses).

Historically, plan sponsors focused on three aspects of the Section 404(c) requirements, namely: (1) give participants three investment alternatives; (2) let participants make their own choices among the investment alternatives; and (3) allow participants to change their investments at least every three months.

For purposes of this paper, we're interested in revisiting what Section 404(c) says that the three investment alternatives must be:

- Diversified;
- Have materially different risk and return characteristics;
- In aggregate enable the participant or beneficiary to achieve a portfolio with aggregate risk and return characteristics at any point;
- When combined tend to minimize through diversification the overall risk of a participant's or beneficiary's portfolio; and
- Minimize the risk of large losses.

Section 404(c) also refers to one of the investment alternatives being an income producing, low risk, liquid fund, subfund, or account. Low risk is not no risk, and although participants and beneficiaries perceive the capital preservation offerings available in most defined contribution plans today to be safe, they are not required to be risk free.

Plan Design Considerations Part II: Stable Value Illiquidity

As introduced, this is part-one of a two-part series dealing with the capital preservation funds within defined contribution programs. The second paper will be a must-read for any plan sponsor considering getting into a stable value fund, because there are issues not touched in this paper - probably the most important of which is the limitations plan sponsors face with respect to corporate actions if a stable value fund is in the program. Stable value is daily-valued, but it is a relatively illiquid investment. If you wish to terminate it and you are in a pooled fund, you typically face a one-year put queue. If you are in a separate account, you cannot terminate it or re-direct participant assets until the market-to-book value ratio is at or above $1. Further, stable value wrapper agreements may include language restricting a plan sponsor's ability to amend the Plan in any way that may constitute an event or condition giving rise to a payment from the wrap provider. In the current financial crisis, this language has allowed wrap providers to deny plan sponsors the ability to add certain types of funds to their programs (such as a money market or TIPS fund) or re-enroll participants to a QDIA.

STABLE VALUE FUNDS CAN "GRIDLOCK" PLAN SPONSORS' ABILITY TO MAKE CHANGES TO THEIR PROGRAMS.

Participants also face withdrawal restrictions if "competing investments" are in the program. Industry parlance for this is the "equity wash", which is a provision in the stable value fund that any transfers made from the fund must be directed to an equity fund for a stated period of time (usually 90 days) before being transferred to any other competing fixed income fund (such as a money market fund). This limits the stable value wrappers' withdrawal risk from participant yield chasing.

In summary, what we've given here is a very quick treatment of a real tension today with the illiquidity of stable value funds. Stable value funds can "gridlock" plan sponsors' ability to make changes to their programs, which is not an inconsequential thing sponsors have been reminded of in this financial crisis.

Conclusion

Stable value funds are a conservative and low risk investment compared to other investments offered in defined contribution programs. They are not without risk. Money market funds are a conservative and low risk investment, and they too are not without risk (unless they are Treasury Money Market Funds). Recent market conditions have been game-changing to the extent they have revealed risks that had largely gone unnoticed or unappreciated by investors. With the exception of Treasuries, almost every kind of fixed income instrument endured a difficult 2008.

Going forward NEPC expects stable value and money market funds to receive more attention and scrutiny in an effort to better measure and manage the amount of risk taken. But the tools available for this risk measurement exercise, at least those available to plan sponsors and Consultants, are not great. This means we are about to begin a journey of a more pragmatic type, where we recognize that investors will grab for yield, and money managers will provide it, and we as fiduciaries to defined contribution programs have to strike a balance between yield and safety. We know with certainty two things. One, there is only one risk free investment, U.S. Treasuries, and two, there is no free lunch.

Postscript: This paper was originally released in October 2008 and was reissued at year end to reflect performance comparisons through December 31, 2008 and the extension of the Treasury's temporary guarantee program for money market funds.