# STABLE VALUE ON THE BRINK, BUT SURVIVING

## *THE 2008 - 2009 EXPERIENCE*

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### Introduction

Every stable value offering in the marketplace was under pressure in 2008. Whether plan sponsors were aware of it or not, stable value funds experienced events that had been dismissed as unlikely theoretical outcomes. As the global fixed-income markets were roiled by the credit and financial crisis, stable value funds were found to have exposure to subprime securities, commercial mortgage- backed securities and other distressed debt. Although modern portfolio theory tells us that risky investments can be added to a portfolio without increasing overall portfolio risk, anything non-Treasury felt decidedly risky in 2008.

The "brink" refers to a time or situation just before something happens. In 2008, the something that almost happened was stable value funds failing. Many held poorly performing investments and concerns emerged around the stability of wrap providers. If the metaphorical "other shoe" had dropped, participants could have experienced -5% to -12% returns on their stable value funds last year, reflecting the true market values of the underlying investments. NEPC worked with our clients to understand the situation as it unfolded, and develop contingency plans where possible. We have maintained an elevated "watch" status on stable value funds since the end of 2007.

This paper reports on the 2008 - 2009 stable value experience and how our clients were impacted by the confluence of most unlikely events. It is a follow -up to a paper we published earlier this year, titled *"A Closer Look at the Capital Preservation Funds Used Within Defined Contribution Plans."*

### Background

Stable value funds have been a fixture within defined contribution plans for the past fifteen years, originally developed as a "synthetic" solution to traditional Guaranteed Investment Contracts ("GICs"). GICs, which are offered by insurance companies and promise a fixed rate of interest, experienced trouble in the 1990s. Most notably, Executive Life and Mutual Benefit Life (two very prominent GICs) became insolvent in 1991 due to their respective forays into the junk bond and real estate markets.

### NEPC HAS MAINTAINED AN ELEVATED "WATCH" STATUS ON STABLE VALUE FUNDS SINCE THE END OF 2007

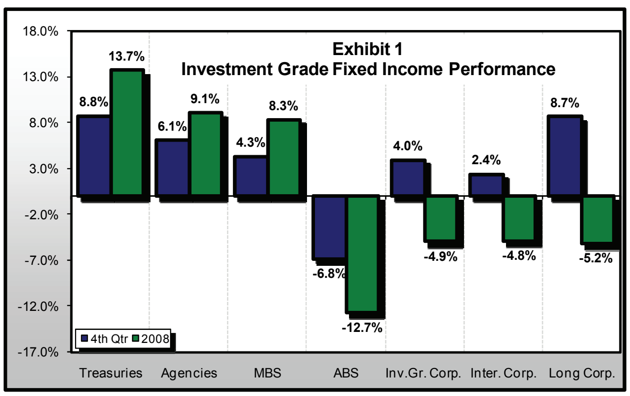
Over time, the industry migrated from the insurance company model to a hybrid money manager and insurance company model. Money managers invest the assets on behalf of the participants, and insurance companies "wrap" the assets, a process which translates variable fixed income returns into stable, fixed returns. To a large degree, the risk of a stable value fund is masked by this accounting treatment. For example, the median stable value fund returned 4.6% in 2008, but the unrealized, unreported losses could easily have been be at least that amount. So long as a stable value fund is "fully benefit-responsive," (participants can withdraw or transfer their stable value investments at book value) contracts are reported at book value regardless of the current market value.

As we release this paper, the DoL's ERISA Advisory Council is studying whether additional regulation is needed around the design and marketing of stable value funds, in part to better address what is in the funds and the resultant issues, as discussed in this paper.

## The Product Experience

### *Market Conditions*

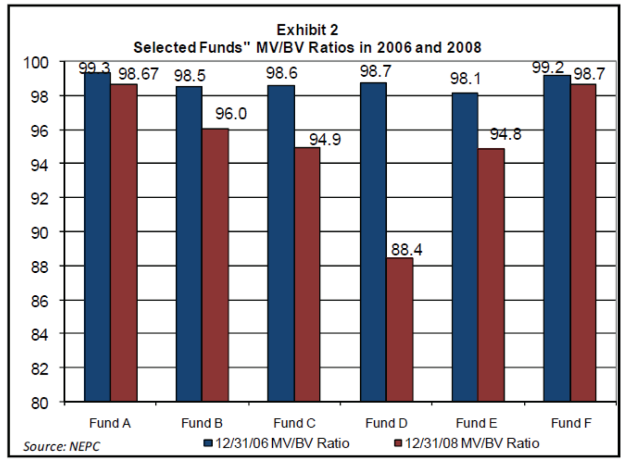
The credit crisis proved so widespread that even highly rated, short duration securities were impacted. While some stable value fund managers attracted immediate attention due to holdings of subprime securities, the impact of the market environment was felt by all managers who invested in non-Treasury fixed income instruments (i.e. corporate credits, agency mortgages, and asset backed securities). By way of illustration, Exhibit 1 shows the 2008 performance of the investment grade fixed income market by sector.




Below investment grade securities suffered even greater losses. The Barclays Capital High Yield Index was down 17.9% for the 4th quarter and –26.2% for 2008. By way of background, it is not atypical for stable value managers to invest the underlying asset portfolio in ABS, MBS and corporate securities, along with some below investment grade corporate debt.

### *Deteriorating Market to Book Value Ratios*

Arguably, the most important information needed to assess the financial condition of a stable value fund is the market to book ratio of each of the wrap contracts, as well as that of the entire fund. As a matter of review, the book value of a stable value fund is the sum of principal invested plus accrued income, less withdrawals and fees. Market value, on the other hand, is the collective "fair market value" of the portfolio's underlying assets that fluctuate as market prices rise and fall. Technically, book and market value are different; practically, the two values only remain the same if a portfolio invests solely in securities always valued at $1.




The market to book value ratio is an important gauge of the fund's well being because it measures what the fund is presently worth compared to the amount originally invested plus accrued interest. Exhibit 2 compares the market to book values of a selection of stable value funds as of December 2006 and December 2008.

As the above chart demonstrates, market values dropped considerably over the 24 month period, from the high 90s to the low to mid 90s, and even lower with some funds. The wrap provider is responsible for the difference between market and book values for participant directed transactions in the event of a run on the fund. The wider the gap between market and book values, the greater the pressure that is felt by wrap providers. Interestingly, in both of these snapshots, MV/BV ratios were universally below $1 and stable value still survived. Wrap providers provide the backstop to honor participant withdrawals at book value, giving funds time to recover fixed income market losses.

### *Wrap Provider Financial Difficulties*

The wrap provider marketplace was experiencing its own problems in 2008. Some of the insurance companies who provide wrap coverage (most notably, AIG) captured headlines detailing their financial difficulties. The combination of rapidly declining fixed income security values, lower market-to-book ratios and wrap provider concerns, prompted sponsors to worry that situations could arise in which their stable value offerings might be unable to meet book value obligations. Exhibit 3 compares the credit ratings of a selection of wrap providers as of December 2007 and June 2009. For ease, we've highlighted in red the downgrades over the period.

**Exhibit 3**
**Selected Wrap Providers' Credit Ratings in 2007 and 2009**

| Wrap Providers | December 2007 | | June 2009 | |
|---|---|---|---|---|
| | S&P | Moody's | S&P | Moody's |
| AEGON | AA | Aa2 | AA- | A1 |
| Bank of America | AA+ | Aaa | A+ | Aa3 |
| ING Life and Annuity | AA | Aa3 | AA- | A1 |
| JP Morgan Chase | AA | Aaa | AA- | Aa1 |
| Natixis Financial Products | AAA | Aaa | A+ | Aa3 |
| Pacific Life | AA | Aa3 | AA- | A1 |
| Rabobank Nederland | AAA | Aaa | AAA | Aaa |
| Royal Bank of Canada | AA- | Aaa | AA- | Aaa |
| State Street Bank | AA | Aa1 | AA- | Aa2 |

*Source: Dwight Asset Management*

At the beginning of 2008, major wrap providers included AEGON, AIG, Bank of America, JP Morgan, State Street Bank, ING, Natixis and PAC Life. This list of providers was already fewer than it was in the 1990s, and amid the crises, additional firms looked to exit the business or freeze capacity. Historically, odds were good that the wrap providers would not be called upon to meet book value obligations. However, while the 2008 financial crisis may ultimately be remembered as a low probability "black swan" event, it reinforced the notion that, while it was a remote possibility, the insurance providers could and would be called upon in adverse market conditions.

### *Positive Cash Flows*

In general, cash flows to stable value products were very positive through the end of 2008 and into 2009. Investors, as they typically do in market downturns, flocked to the safety of stable value and other capital preservation funds as the markets sold-off. This inverse relationship is part of what makes stable value work. In periods of market stress, managers are not forced to sell (and recognize losses) on weakened investments in order to meet redemption requests. The influx of cash also supports the health of the wrap provider industry, as their liability is tied to the likelihood of making payouts when market values are below book values.

### The Plan Sponsor Experience
### *Taking Stock of Their Product*

In light of the enfolding situation with stable value, plan sponsors evaluated their products closely. They arranged for Trustee/Committee training on stable value, scheduled special meetings with their managers, and in some cases, contacted wrap providers directly. Wrap contracts were looked at closely by legal counsel. Valuation ratios which had been received annually, if at all, were requested monthly or quarterly, as were disclosures on subprime and other holdings.

At a high level, seemingly none of our clients had an option to immediately exit their stable value fund or manager without penalty. Nor perhaps was that what sponsors wanted, but it was part of their early discovery. Most plan sponsors found that their options varied considerably based on the vehicle they were invested in, meaning a commingled trust or a separate account. Here's more detail:

– Commingled stable value vehicles typically give the manager up to twelve months to return plan assets at book value. This is typically referred to as a "twelve-month put." In adverse market conditions it is likely a commingled stable value fund will require a full twelve-month waiting period before the assets will be released at book value.

– Separate accounts do not have an exit option, per se. Like any other separate account, a stable value separate account is an individual account run by an investment manager on behalf of a particular defined contribution plan. The plan sponsor cannot "put" the portfolio back to the manager, and therefore cannot exit at book value until market values recover to that amount.

### *Further Due Diligence of Stable Value*

A new area of wrap provider due diligence was added to the normal investment-related reviews that NEPC and sponsors had historically conducted with stable value. Asking the right questions of stable value managers was critical in 2008. Going forward, it will continue to be. We have included a sample of due diligence questions that NEPC and sponsors asked of stable value managers:

- Who are the wrap providers?
- What type of wrap is used and are there any unusual contract provisions?
- What particular assets does each wrap provider cover?
- Do remaining wrap providers have step-up provisions if another wrap providers exits?
- What are the credit ratings of the previously mentioned entities?

For commingled pools, additional questions include:

- How deep is the put queue?
- What is the concentration of the top five or ten plans as a percentage of the fund?

Have your stable value manager notify you if any wrap providers indicate they are looking to exit the business or limit capacity.

Not all stable value funds are created equal, and as the 2008 credit crisis has demonstrated, each stable value fund can be very different in terms of how it invests and operates.

*Plan Sponsor Actions to Date*

About 10% of NEPC's clients took an action with respect to their stable value funds over this period. Most of them, however, did so as part of a larger scale plan redesign that was already underway. We had a handful of clients add money market funds to their programs in order to provide participants with an additional capital preservation choice. While arguably confusing over the long-term, over the short-term, an additional choice provided sponsors a degree of comfort. This was particularly true if it was a U.S. Treasury money market fund.

We also had a few clients enter the put queues of stable value funds, with the intent of monitoring the portfolio in the coming months and initiating a search for a potential stable value or money market replacement.

By and large, NEPC's clients in separate accounts had little ability to make changes to their fund manager or strategy.

*Plan Sponsor Actions Going Forward*

Most plan sponsors structure their defined contribution plan to offer either a single capital preservation fund (a money market or stable value) or both types of funds. The majority of our client base offers stable value, and as we shared above, some of them added a money market fund to their programs this past year.

Adding a money market fund, however, as a replacement or complement to stable value was not particularly straightforward, for reasons including:

- Money market funds were also under pressure and U.S. Treasury money market funds closed quickly to new investors.
- Money market yields dropped quickly, to near zero for U.S. Treasury funds. Sponsors deliberated whether it was appropriate to add such a low returning vehicle to a long-term retirement plan.
- Sponsors feared the "messaging" that would be conveyed by their rolling out a money market fund. They did not want to alarm the participant base.
- Wrap providers are entitled to review plan changes, and in many cases vetoed the addition of a money market fund (fearing increased withdrawal risk to the stable value fund).

Wrap providers view money market funds as competing investments and require an "equity wash" for existing assets in the stable value fund. An equity wash provision will not allow money to flow directly from the stable value to a money market fund. Instead, the assets must be directed to an equity or other non-fixed income fund option within the plan for a stated period of time (typically 90 days) prior to the assets being invested in the money market fund. The equity wash provision helps limit the risk that participants will frequently move assets between the stable value fund and the money market fund to take advantage of interest rate movements.

- Operationally, it would take two to four months to roll out a money market fund to participants. Sponsors on the whole weren't convinced the financial crisis would persist long enough to install and communicate a new fund, let alone for participants to benefit from it given the equity wash rules.

Taken together, the above list presented quite a few hurdles for sponsors, and most concluded that adding a money market fund wasn't necessary or the right move for them at this time. We also think that many sponsors are taking a wait and see approach for the changes that are expected to come from Washington with respect to money market and stable value funds.

*The Externalities of Stable Value*

A member of a pension's staff we were speaking to recently aptly referred to the knock-on effects of stable value as "externalities". In economics, an externality of a transaction is an impact on a party that is not directly involved in the transaction. A positive impact is called an external benefit, while a negative impact is called an external cost. Promptly we renamed this section of the report which concerns the difficulties stable value can present to plan sponsor's design and delivery of their retirement programs:

- For acquisitive companies, stable value has the potential to derail or delay the merger or termination of an acquired defined contribution plan. A weakened stable value fund (MV/BV < $1) cannot be immediately liquidated without loss to participants. Practically, if two pools are merged, one pool will have a higher MV/BV ratio than the other, so the pools will either be sharing accrued gains or losses (e.g. letting an incoming plan buy assets at $1 that are valued at something higher, say $1.03, or making an incoming plan buy assets valued at $0.97 for $1). NEPC works with plan sponsors whose M&A activities have been held hostage to the stable value funds offered in the respective programs.
- Wrap providers can withhold their approval of plan changes. As touched on earlier, wrap providers' greatest risk is withdrawal risk, and if they determine a plan event will increase their withdrawal risk, they can refuse to approve it. In this environment of weakened market to book ratios, wrap providers have in some instances rejected our clients' ability to add a money market or TIPS fund, brokerage, managed accounts or even target date funds to their line-ups. In some cases they have wanted to extend equity-wash rules across more investments, including brokerage. Negotiating with wrap providers to make desired plan changes may feel uncomfortable to sponsors who, as fiduciaries, are trying to do the right thing for their participants.
- For companies downsizing, terminating or spinning off some percentage of their employee population, stable value could present unique challenges. Some wrap contracts cover withdrawals from plan events at book value up to a specified threshold. Outside of that threshold or "corridor", withdrawals could be treated at market value. Two watershed events in 2008 were with Chrysler LLC and Lehman Brothers Holdings. A stable value fund of Chrysler LLC was reportedly paid out at a fair market value of $0.89 when a retirement fund for workers was terminated. At Lehman Brothers Holdings, a stable value fund took a write down of 1.7% in December 2008, as insurers sold securities to meet the redemption requests of terminated employees.

To some extent, the link between corporate actions and stable value wasn't something we thought a great deal about prior to this downturn. We knew that cash flows to stable value funds *increase* during periods of market stress (which is good for stable value), but we were less focused on the fact that plan events like layoffs also *increase* during periods of market stress (which is bad for stable value). Now, with the benefit of perspective, it is important to consider closely those situations that can be viewed as a plan event and seek wrap providers' approval prior to implementation.

It is also important to note that any loss of book value coverage is specific to the individual wrap contract and each contract will have specific language which will discuss how a fund may be terminated. In 2008, many sponsors found themselves and continue to find themselves reviewing the nuances of their wrap agreements.

### Conclusion

Stable value has been a fixture in defined contribution plans from both a prevalence and an asset perspective. Last year, however, reminded everyone that capital preservation and stable value offerings are not without risk. Every client we work with that offers stable value reviewed their fund closely.

We are now mid way through 2009 and while the credit markets have seemingly begun to thaw, market-to-book ratios are still in many cases underwater, insurance companies have broadly been downgraded, and wrap capacity remains strained. Even before the credit crises, many wondered if stable value would face new pressures due to its exclusion from the list of QDIAs. This paper is not meant as a categorical indictment of stable value, however. Although stable value was on the brink, it did not fail.

Despite the spotlight our two papers have placed on stable value's problems, we must highlight several important observations in support of stable value's ongoing viability:

– Stable value funds, with the exception of a handful of unique cases, are still functioning and returns are still positive. Some stable value managers were able to maintain high market to book ratios during an extremely challenging environment.

– Other types of short-term vehicles, such as money market funds, are only bulletproof if they invest in securities backed by the full faith of the U.S. government, such as U.S. Treasuries. If they do invest in these instruments, they generate virtually no yield for participants.

– So long as a prudent diligence process is followed by a sponsor, it would be difficult to argue that stable value is categorically inappropriate. ERISA 404(c) does not require that a plan's capital preservation offering be riskless.

We think there were lessons learned in the crisis about the amount of risk that can be taken in stable value funds, and about the possible externalities that sponsors bear with offering this type of investment in their programs. We look forward to an industry and regulator dialogue about the product, as it is surviving and does appear to be here to stay.