Key considerations for plan sponsors selecting a pooled stable value fund: a wrap provider’s perspective

There are a variety of pooled stable value funds in the market today, and while each fund provider aims to offer a top-notch stable value solution, there are clear distinctions and important considerations that a defined contribution (DC) plan sponsor must review in order to determine — and before selecting — the best stable value fund for its plan participants.

When conducting due diligence on any stable value fund, we suggest five key areas for sponsors to examine and understand as part of their due diligence process: rules governing exit from the fund; commitment of the fund sponsor; wrap coverage and providers; plan size distribution and demographics; and, investment strategy. A thorough review of each of these components can provide a sponsor with key information to select the best stable value solution for their plan with confidence.

It is important to note that while we will offer a number of recommendations for the evaluation of a stable value fund, no two situations are identical, and knowing the goals and objectives of your individual plan should establish the overall context for this process. In addition, this white paper is not intended to recommend or endorse any particular stable value fund, but to set out factors plan fiduciaries should consider when choosing a stable value fund.

Fund exit provisions

When evaluating a pooled stable value fund, it is important for sponsors to understand the rules governing a plan’s exit from the fund. Since plan sponsors can and do change stable value fund providers, all funds must have plan exit provisions. Plan sponsors should be aware that a variety of exit provisions are available in the market today, and each has its own specific advantages and disadvantages.

In the event that a plan sponsor elects to exit a particular fund, the majority of stable value fund providers offer some version of an exit provision, under which the book value of the plan sponsor’s share of the pooled fund is paid to the successor
fund over a specified period of time, such as 12 or 24 months. This type of provision is commonly referred to as a “put” provision. When reviewing funds with a put provision, it is vital to understand the fund’s current ratio of book value to market value, as well as whether the pooled fund has a “put queue” — that is how many plans, representing what level of aggregate assets, are in the process of exiting the stable value fund. This is because in some market conditions, plans entering or continuing in funds with put provisions can be impacted by plans leaving the fund. More recently, some funds have moved to offering the lesser of market or book value immediately upon exit.

Funds that offer a lower of book or market exit provide increased value for continuing participants for two reasons: first, because continuing plans never impact the value of departing plans and, second, lower of book or market exit reduces the risk of wraps for stable value wrap providers, which allows them to permit longer-duration, generally higher-yielding investment strategies.

Finally, in addition to understanding a fund’s exit provisions, a sponsor may also want to consider how the platform through which the pooled fund is accessed affects the plan’s ability to change platform providers or recordkeepers. Some funds are offered through proprietary platforms, which may require a complete liquidation before moving assets to a competing recordkeeper or platform. Other funds may be made available on a number of recordkeeping platforms, and may offer a plan sponsor the flexibility to move their plan’s assets to another platform without liquidation.

Commitment

The next consideration is commitment — this is one of the most important questions a plan sponsor can address when beginning their search for their ideal stable value fund. While stable value as an asset class has performed very well during its extensive history, fund providers were not immune from the effects of the economic crisis and its aftermath of recovery. A number of stable value funds were dissolved, and others were newly established or restructured in the years following the crisis, making it more important than ever to understand a fund provider’s commitment to both stable value and your plan.

Wrap coverage

In addition to the commitment of the stable value fund provider, a plan sponsor should also consider the commitment of the wrap providers with whom the stable
value fund provider has elected to contract. The benefit provided by the wrap contract(s) is the distinguishing characteristic of a stable value solution; therefore it is important that appropriate due diligence includes the fund guarantee providers.

Furthermore, it is important to understand how a fund’s wrap coverage is structured. For example, while most pooled funds work with multiple wrap providers, others are structured with a single wrap provider that provides the book value guarantee required for the stable value fund. It is important to understand the differences and make the decision that fits best for a particular plan. Perhaps a fund has a single wrap provider that has demonstrated outstanding commitment to stable value and has a history of financial strength and stability. On the other hand, multi-wrap strategies offer diversification of risk among a variety of wrap providers, which would provide a level of protection that would generally outweigh the benefits of the single wrap strategy. A plan sponsor must consider which approach offers the best fit for its particular plan.

**Plan size/demographics**

Plan sponsors that contract directly with wrap providers for their stable value solutions know that their plans’ assets and demographics are core elements of a wrap provider’s typical due diligence process. For sponsors selecting a pooled stable value fund, a similar review of the fund’s participating plans and cash flow patterns is an important part of the due diligence process. There are three important elements to consider: total assets of the fund, the number of participating plans, and the extent to which the fund is diversified from a participating plan perspective. The sponsor should understand how its plan will fit into the pooled fund’s plan base. If it will be a large plan relative to other participating plans, there may be operational or investment constraints imposed by either the fund or its wrap providers; if it is a small plan in a fund with a handful of very large participating plans, the actions of participants in the larger plans may have an impact on that smaller plan.

A sponsor should also conduct a thorough examination of the fund’s cash flow history. While fluctuations in cash flows can be expected in the normal course of business, an understanding of a fund’s historical trends will provide a plan sponsor with the overall direction on the fund. If a fund is growing very quickly in a low interest rate environment, incoming flows may have an impact on the current yield. Ideally, a sponsor should look for a stable value fund that is growing steadily and consistently, which can serve as an indicator of its long-term viability.
Investment philosophy

Understanding a fund’s basic investment philosophy and related investment practices should be a key area of focus. In addition to the investment guidelines, which would be included in the evaluation of any investment allocation option, there are some additional aspects for a sponsor to consider when considering a pooled stable value fund. Pooled funds may appear simple on the surface, but represent a sophisticated combination of multiple wrap providers and asset managers.

The first of these considerations is fund structure from an investment perspective. Sponsors should first understand the product mix selected by the pooled fund. Many pooled funds invest in multiple stable value product types, including traditional guaranteed interest contracts (GICs), separate account GICs and synthetic GICs. This affects both the managers retained directly by the fund to manage the fund’s assets, as well as those retained through the stable value product providers selected by the fund.

Second, once the mix of investment types and managers is understood, the sponsor can focus on the combination of investment strategies that underlie the fund. In some cases, the fund’s assets are managed entirely by an investment affiliate of the plan sponsor; in other cases, the assets are managed by unaffiliated third parties. The pooled stable value fund provider is responsible for making those selection decisions, so it is important that the participating plan sponsor understand its role in, and process for, doing so. Wrap coverage depends on specified investment conditions being met, whether the assets are managed by one firm or by third-party managers.

Third, in addition to an understanding of how the fund is structured, the sponsor should consider the fund’s specific investment objectives, including duration targets, asset quality parameters, derivatives use and counterparty practices. In particular, plan sponsors should understand the impact that a fund’s investment duration can have on fund yields, and the impact interest rates may have on the fund’s performance and crediting rate. The plan sponsor’s investment policy statement may also need to be adjusted to ensure that it correctly reflects the fund selected.

Finally, it is important to understand how the fund handles cash, and to be aware of the fund’s cash holdings. Some funds are fully invested in a particular strategy and do not maintain a cash buffer, while others can, by design, establish a cash buffer. Cash buffers are primarily designed to handle the daily liquidity needs of a fund, but in some funds they may also be used as a portfolio management strategy to protect
the performance of the invested portion of the portfolio from net flows. Such buffers generally range between 5 and 10 percent. A sponsor should ask questions such as: How much does the fund currently hold in cash? What is the target level of cash versus the actual level? Do the liquidity management benefits offset any drag on yield? Is there a negative impact of not having a cash buffer? Are there reasons for a plan to increase or decrease its cash holdings? Understanding how well the asset manager is managing to the stated investment philosophy of the fund and any reasons they may have for deviating from those targets is important in selecting the right fund for your plan.

Conclusion

Overall, the safety and stability that stable value solutions such as pooled stable value funds provide have made them a consistent choice for both sponsors and participants.

We have outlined some of the key ways in which wrap contracts and their provisions are integral to how a stable value fund operates from a number of practical perspectives. MetLife’s Stable Value Study, released in December 2016, shows improvement in some aspects of plan sponsor understanding of stable value contract terms, but also suggests that how these terms actually affect stable value outcomes is less well understood. We recommend that plan sponsors evaluating pooled stable value funds take the time to understand both a fund’s construction and the mechanics of how its terms will work in practice in order to feel confident in the stable value fund option they select.

For more information please visit:
www.metlife.com/stablevalue

1 In this article, “stable value fund” and “stable value fund provider” refer to pooled stable value funds and the entities that manage them. Such funds may be marketed directly to plan sponsors or offered through platforms maintained by third-party administrators.
2 As a consistent market leader, stable value innovator and wrap provider to the majority of large pooled stable value funds, as well as directly to plan sponsors arranging their own custom stable value investment options, MetLife has a uniquely broad and diverse perspective to offer on stable value fund selection.