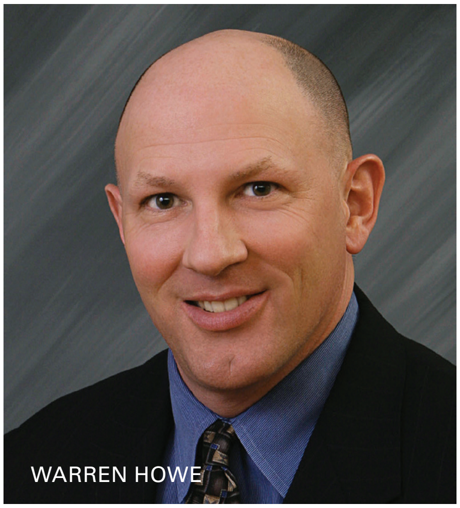
The Case for Stable Value

Why plan sponsors should consider its inclusion in their DC plans



Almost all defined contribution (DC) plans include stable value or money market, or both, as a capital preservation option in their investment lineup. Many participants set a high value on the availability of a safe investment option. Plan sponsors have a fiduciary duty to ensure that the capital preservation option they have selected for their plan is the best fit for their participants. MetLife executives Tom Schuster, vice president, stable value and investment products, and Warren Howe, national sales director of stable value markets, spoke to PLANSPONSOR about the value that stable value offers participants, the importance to plan sponsors of including stable value in their lineups, the current state of the marketplace and why they believe now may be the time for prudent plan sponsors to consider replacing money market funds with stable value.

PS: How do you see the future of stable value?

Schuster: Stable value has a 40-year track record, which has allowed plan sponsors, consultants and advisers who are key decisionmakers on plan design to evaluate the strategy over various economic environments. In periods of rising and then falling interest rates, of economic prosperity or financial stress, stable value has performed as designed—exceptionally well, and certainly far outpacing money markets.

As an asset class, stable value will continue growing because its features—principal preservation, competitive credited rates and a predictable investment outcome—resonate with plan participants saving for retirement. In fact, there's considerable evidence Americans value safety more now than before the most recent recession. Though sound investment analysis has never supported having money market instead of stable value, increased attention to plan sponsor fiduciary duty by the Department of Labor (DOL) and the courts has sharply increased the risk of loss for plan sponsors with money market and not stable value. As a result of these considerations, stable value will continue to play a significant role within the DC plan market.

Howe: I agree. Interest in stable value is strong and growing. Data from the Stable Value Investment Association (SVIA) show that about 50% of all defined contribution plans have a stable value option, comprising an asset class of about $721 billion. Participant allocations to stable value have historically ranged from 17% to 37%. The high water mark of 37% was during the financial crisis, which speaks to Tom's point about participants seeking safety, especially in times of financial stress.

PS: With two rounds of money market fund reform by the U.S. Securities and Exchange Commission (SEC), what are some of the implications for plan sponsors and their advisers?

Schuster: As I already noted, there has never been a sound investment case for money market in a DC plan. Money market reforms have reduced the expected return for money market funds and made them less customer-friendly. Only retail and government money market funds will maintain the stable net asset value. The case against money market funds based on fundamental investment analysis—how the expected return compares with its volatility—is now even stronger. Every plan sponsor with a money market fund should consider replacing it with stable value.

PS: Historically, how has stable value performed vis-à-vis money market funds?

Howe: Extremely well. Stable value remains the most prevalent capital preservation option, that being a core investment objective for DC plans that rely on a safe harbor under Section 404(c) of the Employee Retirement Income Security Act (ERISA). Unlike money market funds, stable value is the only option that was designed exclusively for the DC plan market, and that structure—how it delivers the unique benefits of stable value, including volatility smoothing and a competitive rate of return—makes it especially valuable relative to money market funds.

The strongest argument for choosing stable value over money market funds as a DC option is based on the fundamental risk/return analysis. Historical numbers show that stable value has typically outperformed money market by anywhere from 150 to 300 basis points (bps), giving the returns of an intermediate-term bond fund with the low volatility of a money-market-type option.

PS: What about recent plan litigation, such as *Abbott v. Lockheed Martin* and

Tibble v. Edison at the Supreme Court. Do cases like those prompt plan sponsors to reconsider money market funds as the capital preservation option for their DC plan?

Schuster: The class action suit *Abbott v. Lockheed Martin* was recently settled for $62 million. One claim was that there was too high an allocation to money market funds. Since stable value returns over the last 10 years have been almost triple those of money market, to cite a recent MetLife analysis, the potential exposure for plan sponsors offering money markets is significant.

Litigation concerns will almost certainly result in plan sponsors and consultants re-evaluating their principal preservation option, and the Supreme Court decision in *Tibble v. Edison* found that periodically reviewing an option's appropriateness was an ERISA fiduciary's duty. This comes back to whether it's prudent to retain a money market option.

PS: If plan sponsors are reviewing their capital preservation options in light of money market fund reform, why should they consider stable value?

Howe: First and foremost it's the historical yield advantage that stable value has held over money markets. The average pooled stable value fund is currently returning approximately 1.5% more than money market. Many individually-managed (non-pooled) stable value funds have an even greater return premium than money market. If you ran that out—the old "growth of a dollar over time" scenario—that sizeable return advantage makes a meaningful difference for participants. And, if you look at some of the collective funds in the market that are exclusively invested with MetLife, they're yielding over 2% at this time and are among the highest rated by Morningstar.

Schuster: Right. Plan participants in money market funds sacrifice yield for retail liquidity they don't need. Money market's nominal returns have hovered near zero for years and would have been negative if money market fund managers hadn't reduced their fees. Also, a dollar invested in money market is worth less than it was 10 years ago. An investment that doesn't even preserve purchasing power, much less grow it, isn't prudent when there are superior alternatives such as stable value.

PS: If a DC plan has a money market fund as a designated investment alternative, what steps should plan sponsors take with regard to the fund?

Schuster: They need to consider the potential fee changes and investor concentration that money market reform could pose to their fund. They must determine whether their fund manager may recover fees waived during the period of low interest rates. And they also must evaluate the potential administrative problems posed by liquidity fees and redemption gates.

Howe: A sponsor should also consider whether and how much the manager will or can change its investment practices, to address all the eventualities under which fees or gates could be triggered. How will it handle the change? What is their plan?

If they stay with money market, they'll need to think about and address the challenges of participant communications, such as explaining the potential yield and administrative effects of the reform. What was highly liquid could now have constraints, triggers and gates to stop a run on the bank. They should also be prepared to defend why they chose money market as the capital preservation option in lieu of stable value despite the obvious advantages that stable value offers for participants.

PS: Are there potential limitations with shifting to governmental money market funds for institutional purposes?

Howe: It's natural and easy to think, "We'll shift to the governmental money market fund, because that means these changes won't impact us." But is it the right thing to do? If you move to an all-government money market fund, you will be invested in a structure where all government money market funds will be chasing the same limited basket of securities now, so the yield opportunities will likely be further decreased. That just exacerbates the issue of yield differential between money market and stable value, and that can have an even greater detrimental effect on participant balances.

There can also be negative real returns after fees—an unreasonable cost of liquidity for both plan sponsors and participants.

Schuster: Right. If every investor chases the same government securities, their pricing will likely go up, bringing lower yields on those securities and even lower returns for plan participants. So, stable value's advantage would likely grow due to these changes, which further calls into question the wisdom of retaining a money market option.

PS: When switching from money market to stable value, what are some of the key considerations plan sponsors and their advisers should contemplate when selecting a stable value fund?

Howe: First, they should give consideration to the type of stable value option they may be considering. Is it a pooled fund, a collective or an individually-managed structure? What is its investment strategy? What are its investment guidelines? Who are the asset managers? What's their track record? Who are the wrap providers? Is it a single-wrap or a multi-wrap structure? What's the duration of the fund? What's the current crediting rate? If it's an existing fund, what's the historical crediting rate? Considering those inputs, what's most appropriate for your participants, based on your specific plan demographics? Addressing these questions is an important part of the due diligence process. Plan sponsors that may not be experienced with stable value may be well served to turn to a stable value manager for guidance.

Schuster: I would conclude by underscoring for plan sponsors that reconsidering the appropriateness of a money market fund in their DC plan lineup has never been more important. In their role as a fiduciary, it's prudent for them to take a fresh look at stable value as a better capital preservation alternative. We believe there is only one possible answer from such a review. Stable value is a far superior capital preservation option and one that provides meaningful advantages for their participants. ■