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Stable Value Funds

Moderator:
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Presenters:
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About Stable Value Funds

Please try the Stable Value Association
website (www.SVIA.org) for valuable
resources including a helpful GLOSSARY
of terms.

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I. Introduction to Stable Value

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New York State Deferred Compensation Plan

Austin
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What a stable value fund (SVF) is

Definition – a conservative investment vehicle with the objective of maintaining principal stability, liquidity at contract value for participant-initiated withdrawals and generating a positive and reasonably stable rate of return

What it is not...

- Money market fund – money markets invest only in short term securities and provide no wrap protection
- FDIC insured – SVFs are not insured by governmental programs
- Annuity – SVFs do not guarantee an income stream



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Use in defined contribution plans

Offered as a safe option in self directed plans
But not as a QDIA per DOL
(some grandfathering)

\$520b in defined contribution plans (source: SVIA.org)
2/3rds offer, 1/3 of assets

Along side other funds

- Alternative to money market and bond funds
- Target date funds and more aggressive funds



Unique features

Safety of principal

Safe investments coupled with wrap protection

Stable income

Commensurate with intermediate term bonds
Smoothed through wrap agreements and crediting rate
Generally higher than money markets except for spikes
Cash flows may dilute or enhance return

Liquidity

No holding periods or surrender charges
Transfers to competing funds may require "equity wash"

Great diversifier

Low correlation to other bond funds - very low to equities



Components

Investments

Fixed Income – low overall duration, high quality
Goals of modest returns with limited price volatility

Wrap agreements

What they do –

Benefit payments at Book Value (contract)
Income smoothing through crediting rate
Amortize gains/losses, resets

When they don't do –

Protect against loss due to impaired debt and employer initiated events (plan termination, layoffs, early retirement programs, amendments, mapping, poor communications)



Components (cont.)

Wrap agreements were designed to smooth portfolio values due to interest rate fluctuations

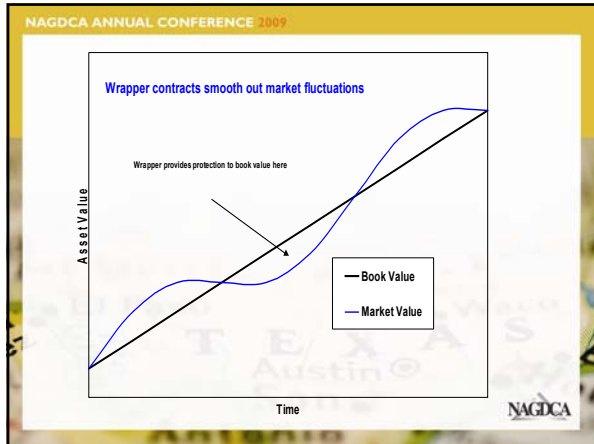
Basic types

Global – covers a group of related products
Individual – covers an individual account

Participating, non-participating, hybrid

They differ by point at which fund receives payments from wrap issuer. "Participating" means the plan participates in the loss.





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Most common structures

STIF – Cash Buffer
 Cash equivalent account for transactions and insulate GICs and/or wrapped accounts
 Does not require wrap agreement

Directly guaranteed

Traditional Guaranteed Interest Contract GICs
 Fixed rate (non-par) and term, zero coupon
 Often laddered maturities
 Backed by insurance co's credit worthiness
 Underlying assets owned by issuing company
 Early termination fees may apply
 No separate wrap agreement

Separate Account GICs/BICs
 Assets in separate account, may be less risk

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Most common structures (cont.)

Commingled (Pooled)
 Collective trusts where plan owns units of pool
 No mutual funds – SEC regulated away
 Can be low cost but must accept manager's strategy
 Combined with wrap agreement

Separately managed – large plans
 Synthetic GIC – finite date or "evergreen"
 Evergreen strategies usually constant duration
 Plan owns assets and hires investment managers
 Plan contracts with wrap providers
 Structure managers may be required

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Fees and Disclosures

Determining costs

- Directly managed – not really possible
- Commingled – usually provided by financial institution
- Separately managed

- Investment advisory – investment management, structure manager

- Operating – wrap fees, trust/custody

Net fees – show investment advisory and operating

Gross fees – net fees less structure manager (if any)

Comparing to alternatives

- Mutual funds especially bond mutual funds
- Bank CDs



Fees/expense disclosures

- Not subject to DOL/ERISA rules but helpful guidelines
- Plan charges against fund

Risk disclosures

What to include -

- Not FDIC insured
- Investment breakdown – level of detail?
 - Cash/GICs/Wrapped Bond
 - Duration, credit quality, sectors
- Discuss inflation and credit risk
- Limits on wrap agreements

What to exclude

- Market Value to Book Value?
- Must be careful not to alarm



Education

What else participants need to know

- Long term investment view – required return
- Understanding other risks like inflation

Coordination with other investment options

- Choices other than 0% and 100% in SVF
- Many TDFs have high equity allocations



The Good Old Days:

Exceptions to the Rule/Seeds of Doubt:

- Occasional fixed income market shocks.
- Gradual, then rapid buildup of derivatives on issuer and wrap provider books and in some stable value portfolios.
- Erosion of due diligence effort by rating agencies.
- SEC decision to allow 40 to 1 leverage at Wall Street firms.

Unmeasured and unrecognized risk began to accumulate in the Stable Value Arena

1974

4Q2007

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The Time of Troubles:

General Characteristics:

- Government action "saves" but distorts markets and economics of suppliers.
- 9/18/07 The Federal Reserve starts easing the Fed Funds rate to 4.75% from 5.25% with the Funds target rate eventually ending at 0 - .25% on 12/16/08.
- 9/7/08 FNMA and FHLMC are placed into conservatorship of the US Government.

4Q2007

1Q2009

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The Time of Troubles:

General Characteristics:

- 9/15/08-9/16/08 Lehman Bros. bankruptcy, BofA buys MLPFS.
- AIG bailed out with \$85 billion credit facility from the Federal Reserve.
- 2/27/09 US Government takes 36% equity stake in Citigroup after a massive November 2008 bailout.
- 3/09 5 year GIC spreads over 5 year US Treasuries reached 300 bps.

4Q2007

1Q2009

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How different portfolio practices played out in the Time of Troubles

- Those who stretched for yield or forgot old wisdom
 - Had underlying assets whose market to book value ratio went below 80%.
 - Had impaired assets.
 - Some had to make participants whole and/or saw significant decreases in their yields to make up for the losses.
 - As of 3/31/09 annualized 1 year returns ranged between 1.92 to 4.44.



How different portfolio practices played out in the Time of Troubles

- Those who didn't
 - Saw the market to book value ratio go below 90%.
 - Suffered none of the other consequences.
 - Maintained better returns.



The New Order Emerges:

How issuers and wrap-providers have adjusted:

- Decreased types of underlying assets that they will wrap.
- Increased wrap fees.
- Require more transparency in underlying portfolios.
- Require more detailed reporting.
- Eliminated the use of money market funds that have structured investment vehicle (SIV) exposure.
- Downward pressure on yield to participants.

1Q 2009 and Beyond



The New Order Emerges:

How portfolio managers have responded to the New Order:

- Shorter duration portfolios.
- Eliminated the purchase of exotic types of underlying securities.
- Had short timelines to clean up their portfolios: fire sale practices put additional pressure on values and yields.
- Overall result is lower yield to participants but improved quality portfolios.

1Q 2009 and Beyond



The Irony of Supply and Demand Inversion

- Participants are increasing their allocation to stable value.
- Less wrap capacity at a time when more is needed.
- Wall Street usually increases supply in response to increased demand. We've seen the opposite in Stable Value.



What might be next

- The Good Old Days will come back.
- Players will emerge to respond to the opportunities.
- Traditional GICs will be more prevalent in portfolios.
- Fewer Evergreen contracts.
- More stability in stable value.



III. Factors to Consider in Selecting a Stable Value Fund Provider

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Homework Before the Search

Select what type of product you want first, then select a provider

- Conducting an open search leads to difficult "apples to oranges" comparisons
- If you cannot narrow your search to a specific type of product, at least determine what terms and features are critical and specify them in your RFP



Critical Terms and Features

- Type of "guarantee" (explicit or implicit)
- Number of guarantors (single or pool)
- Access to collateral (exclusivity of claims)
- Backstops (FDIC, guaranty funds)
- Rate structure (portfolio rate vs. deposit structure)
- Portfolio characteristics (duration, credit quality)
- Rate-setting process (transparency, responsiveness, limits)
- Exit provisions (liquidity, fees, market adjustments)
- Fee transparency
- Look & feel to participants (simplicity, transfer restrictions)
- Fiduciary complexity (ability of governance resources and expertise)



Common Tradeoffs

Different product structures exist because there are tradeoffs among the critical features. For example:

- Money market fund
 - + Simple, liquid, transparent, low portfolio risk, regulated
 - Low return expectation, no backstop
- GIC Pool
 - + Higher return expectation, transparent
 - Exit restrictions, correlated risks, no backstop, collateral conflicts
- Synthetic GIC
 - + Higher return expectations, transparent
 - Requires scale, correlated risks, complex to manage, no backstop



Comparing Alternative Vendors

- Guarantors
 - Financial strength ratings
 - Depth and breadth of firm's balance sheet
 - Business profile
- Asset Managers
 - Quality as a bond manager (experience, performance, risk control, etc)
 - Experience in negotiating with guarantors



Common Pitfalls

- Excessive focus on crediting rate / performance
 - As a rule, higher interest rates come with higher risk
- Excessive focus on relationship
 - Many products require long-term commitments
 - People you like & trust today may not be there when problems arise
 - Read the contract carefully, especially the exit provisions!
- Lack of alternatives in bundled platforms
 - If you bundle, make sure your provider offers at least two credible alternatives



Questions & Answers

(or really good sounding, educated guesses)