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WHAT PLAN SPONSORS SHOULD KNOW ABOUT STABLE VALUE FUNDS (SVF)

Historically, SVFs were often considered low risk, “plain vanilla” investment options. While popular, the complexities of these options were often not well understood. The market turmoil during the last several years raised concerns over these complexities for plan sponsors, wrap providers, investment managers, and participants. Although SVFs have survived the storm and, generally, have performed as expected, new issues have surfaced. Plan sponsors have begun to realize that greater due diligence is needed in the management of these options, in addition to a greater need for disclosure and communication to plan participants.

The purpose of this brochure is to provide plan sponsors with a peek at the complexities and key issues surrounding SVFs while providing guidance for both monitoring and evaluating the funds and communicating these issues to participants.

A stable value option is intended to be a conservative investment vehicle with the objective of maintaining principal stability, and liquidity for participant-initiated withdrawals, while generating a positive and reasonably stable rate of return. A SVF is not:

- A money market fund – money market funds invest primarily in short-term securities and provide no wrap protection, or
- FDIC Insured – SVFs are not insured by governmental programs

The primary types of SVFs are:

- Insurance Company General Account SVFs
- Insurance Company Separate Account SVFs, and
- Separately Managed SVFs

Insurance Company General Account SVFs

In insurance company offered General Account SVFs, which are similar to the well-known “traditional” or “general account” Guaranteed Investment Contracts (GICs), the plan sponsor owns an insurance company GIC contract, but not the underlying investments, which are invested in the insurance company’s general investment account. This type of SVF is most commonly utilized by small and mid-sized plans.

Plan sponsors receive a fixed interest rate over a specific period of time, but do not have control over the assets. Due to the fact that the plan sponsor does not own the underlying investments, the portfolio holdings, performance, risk, and management fees are generally not disclosed. This limits the ability of plan sponsors to compare returns with other SVFs. It also makes it nearly impossible for plan sponsors to know the fees (which can be increased without disclosure) paid by participants in these funds – a critical component of a fiduciary’s responsibility.

Although participant-initiated withdrawals are provided at book value, plan sponsors may also need to consider liquidity at the plan level. Plan sponsors may incur a market value adjustment (MVA) on the assets should they decide to transfer the assets to a new option at the end of the contract period. When bond market values decline, the impact of an MVA can be significant to the plan and its participants. While successor vendors can pay MVAs on behalf of the plan, they typically will increase the fees charged to participants to incorporate the added cost of the MVA payment.

The inherent risks associated with General Account SVFs, generally referred to as counter-party risks, include: the credit worthiness of the insurer, the liquidity and credit worthiness of the investments supporting the contracts, and the insurer’s ability to successfully manage assets, liabilities and risks in today’s challenging market environment. The recent credit crisis has lowered the credit ratings on some insurance companies that offer General Account SVFs; this reduction in credit quality may cause concern regarding the chance that an issuer will fail to pay interest and principal in a timely manner. Plan sponsors may want to consider implementing a policy for monitoring the credit quality of their provider, with an option for removal and replacement should the credit quality deteriorate.

Insurance Company Separate Account SVFs

An insurance company offered Separate Account SVF is similar to the General Account SVF; however, a Separate Account SVF identifies a segregated pool of assets held and owned by an insurance company but distinct from the insurer’s general investment account, and therefore,

not subject to claims of creditors should the insurance Company become insolvent. Separate Account SVFs developed as a way to provide plan sponsors with the investment results of a specific asset portfolio rather than the combined results of the insurance company's general account. The insurer still owns and controls the assets. However due to the fact the assets are segregated, the plan sponsor may have additional transparency regarding portfolio holdings, performance and fees.

Separate Account SVFs can provide at least two distinct benefits compared with the General Account SVFs. First, they make it possible to measure and, if desired, to credit the investment results of a specified asset pool. Second, by effectively segregating assets from the insurer's general account, a Separate Account SVF may provide enhanced credit protection for investors in the account.

Separate Account SVFs can be offered in a pooled structure or, for larger plans, as a custom separate account. In a pooled structure, the underlying investment strategy and inherent risks associated with Separate Account SVFs are similar to those found in "synthetic GIC" structures (see definition under "Non-Insurance Company SVFs" below); however the plan sponsor may have limited ability to request changes regarding the investment style. In most cases, the plan sponsor will need to work with the issuing insurance company to transfer the assets to a different pool of assets with a different investment strategy should they become concerned with the current investment strategy. In a custom Stable Value Fund environment, typically the investment policies are customized to the needs of the specific client which for many Government entities, can be a 100% Government security portfolio. Additionally, at termination, transfers can be made either at market value or "in kind."

Non-Insurance Company SVFs

Non-insurance company SVFs, which may be offered in a commingled fund structure or as a separately managed account(s), are typically offered by a third party asset management firm, not insurance companies. However, in some cases, large plan sponsors may manage their plan's separately managed SVF themselves. Smaller plans typically invest in commingled offerings while larger plans may use customized separate account options.

While Separately Managed SVFs may hold insurance company traditional GICs, they primarily invest in synthetic GICs in which the plan owns the assets, hires the asset manager(s) and assumes the investment risk and rewards. In synthetic GICs, the insurance companies, banks or other financial institutions write what is called a "benefit-responsive wrap" for the invested assets, which are managed either by the plan sponsor or by an independent asset manager. In plain language, the wrap provider issues a guarantee to make up any difference that may exist between book value (principal plus accrued interest) and market value due to market fluctuations of the assets when participants withdraw

funds. These agreements, also known as "wrap agreements," smooth the price fluctuations in the portfolio and help maintain a stable net asset value (NAV).

Synthetic GICs provide benefits similar to the Separate Account SVF structures, but also provide the plan sponsor with the greatest amount of transparency, decision making ability and flexibility. Two significant advantages versus the Insurance Company General Account SVFs and the Insurance Company Separate Account SVFs are by using synthetic GICs, the plan owns the underlying investments and can achieve significant issuer diversification over single-issuer insurance products. Plans with limited resources, including staff and third-party investment consultants, may find the management and due-diligence on these customized separate account options very challenging.

Portfolio Construction

All three types of SVF portfolios are generally comprised of high quality short and intermediate duration fixed-income securities. This usually includes treasuries and governmental agency debt, and may also include asset backed securities (ABS), which are bonds or notes backed by financial assets; corporate bonds ('corporates'), which are debt obligations, or IOUs, issued by private and public corporations, or mortgage backed securities (MBS), which are bonds backed by mortgages on commercial and residential real estate.

As with many investments, these securities are subject to market risk or the chance that the fund's price per share will change as a result of the movements in market interest rates, resulting in gains or losses on these underlying investments. The plan sponsor may help reduce this risk by ensuring the portfolio is a diversified mix of high quality investments and monitoring the portfolio's average credit quality and risk.

The portfolio's average credit quality is the average of the credit ratings assigned to the portfolio holdings by each credit rating agency. These Agencies assign credit ratings after appraising an issuer's ability to meet its obligations and grade on a scale, with AAA/Aaa indicating the most creditworthy issuers. Plan sponsors should monitor the average credit quality to ensure the portfolio stays within the thresholds of its investment policy.

Plan sponsors should also consider the duration or average maturity of the fund's underlying holdings. In order to produce yields above money market funds, stable value portfolios typically have asset durations of 2 to 5 years. Duration is an important factor in determining the risk that fund's principal value will fluctuate significantly due to changing interest rates. The longer the portfolio's average duration the greater the interest rate risks. Plan sponsors may want to consider implementing a 'target' average duration as part of its investment policy to ensure that the fund balances a desire for higher yield/crediting rates with the likely

increased volatility in interest rates. For more information please refer to the **Investment Policy** section below.

Monitoring the cash within the SVF is also important. A cash buffer is generally maintained to meet unexpected participant withdrawals and lower wrap contract risk charges. However, currently some stable value managers may be holding more in cash, due to the shortage of wrap contracts; this larger cash component may also result in lower returns for participants.

Wrap Contracts

Wrap contracts are essential to SVFs because they are designed to provide a guarantee to make up any difference that may exist between book value (principal plus accrued interest) and market value due to market fluctuations (not credit impairment) of the assets when participants withdraw funds consistent with plan provisions. This is accomplished by the smoothing or amortizing the changes in the market value of the bonds and other investments in the portfolio over a period of time so that the interest crediting rate is less volatile than the market.

In the unlikely event that participants are requesting transfers out of a SVF when the market value of the fund is less than the book value of the fund, the cash buffer portion of the fund has been exhausted, and the withdrawal requests are not related to an employer initiated event (layoffs, retirement incentives, plant closing, etc.), the wrap contract will partially cover the difference between the market and book value of the withdrawals.

Although SVFs typically hold high quality assets, in the years leading up to the 2008-09 financial crisis, some stable value managers increased allocations to riskier holdings, such as lower-rated corporate bonds or commercial mortgage-backed securities, while reducing more conservative holdings, such as government securities. The increased allocation to higher risk investments assisted funds in the potential for higher yields or crediting rates.

This increased appetite for yield, not only resulted in SVFs adding lower quality bonds, riskier structured credit and even high-yield bonds; it also resulted in plan sponsors experiencing higher 'spreads' or differences between the market value of the portfolio holdings versus the book value. Plan sponsors became concerned as market value fell below 100% of book value for the first time in some cases. This difference in market to book value not only pushed the yield or crediting rate of the funds lower, it also caused issues with liquidity and wrap contracts.

Several factors contributed to the issues between fund managers and wrap providers and in many ways resulted in a 'perfect storm' of events. As the financial crisis snowballed and investors fled the equity market, SVFs experienced increased cash flow, which increased the

amount of assets to wrap. Additionally, wrap providers themselves were affected by the crisis and had less capital to underwrite the new business because market to book value ratios dropped. This forced both fund managers and wrap providers to reevaluate risk. It also forced wrap providers to take a closer look at a fund's underlying holdings and asset allocation mix. This increased transparency assists wrap providers in knowing exactly what they are insuring and help avoid any losses.

The increased focus on due diligence by fund managers and wrap providers has changed the stable value landscape. Many fund managers have reduced risk and returned to safer, higher quality investments in response to many wrap providers that are requiring more-conservative investment guidelines. Similarly, some wrap providers are demanding changes in the wrap contract provisions to reduce their perceived risks.

Unfortunately, these changes lead to lower returns and higher fees for plan sponsors and participants. Given the demand and limited supply of wrap contracts, the wrap issuers have more power to dictate terms, which includes fees. Wrap fees have increased to roughly 0.20% to 0.25% from as low as 0.06%.

Participants may also find tighter restrictions on their ability to move from SVFs to other 'competing' investments. Many SVFs consider certain options, such as money-market funds, 'competing funds' and require an equity wash provision. An equity wash provision states that transfers from SVFs must be directed to an equity fund option for a certain period of time (generally 90 days) before the transferred funds may be directed to any competing fund in the plan. This provision is meant to protect the plan participants in the SVF; however, in some cases, fund managers are including more types of funds, such as brokerage windows, when defining 'competing funds.'

Similar to monitoring the credit quality of the SVF investment portfolio, all wrap contract providers should be subject to ongoing credit quality reviews and monitoring.

Investment Policy

Plan sponsors are also communicating more with fund managers and wrap providers, especially regarding the composition of underlying assets in the portfolio, risk levels and explanations of specific provisions. An investment policy can be an important tool not only to assist plan sponsors in communicating the plan's needs but also for a better partnership between fund managers and wrap providers.

The investment policies for SVFs disclose the investment's objective, strategy, portfolio structure including the sectors and allocations that can and cannot be invested in, the quality, and duration of the underlying securities. The policy can help to ensure the fund maintains the asset allocation mix expected by both the plan and wrap providers. In addition, the fund's

underlying performance can be measured by comparing its returns versus an industry index (i.e. Merrill Lynch 1-3 year Treasury Index, Barclays Capital US Aggregate Bond Index, etc.). Insurance company general account products typically have internal policies that are not publicly disclosed. In addition, actual performance is generally not disclosed; therefore a benchmark cannot be established for these types of SVFs.

Plan sponsors may also utilize the investment policy to help monitor wrap provider(s). Due to the importance of wrap agreements, plan sponsors must also consider the financial health and number of wrap providers associated with the portfolio.

A plan may reduce risk exposure by having multiple wrap providers who each wrap a percentage of the fund or a piece of the investments in the fund. Every wrap provider will have their own contract which lists the employer initiated events (e.g. bankruptcies, layoffs, and diversiture, etc.) that could cause the participants' balances to be paid out at market value rather than book value. Most wrap contracts may provide employers with a "corridor" provision. The corridor would cover a percentage of plan withdrawals at book value after an employer event which would preserve a participant's stable value book value. Insurance company General Account and Separate Account SVFs may have market value payment language as well. This type of information may be indicated in investment policies, including credit rating requirements on wrap providers.

Termination Provisions

Another important aspect of stable funds is termination provisions. Termination provisions can vary greatly by fund and provider. Generally a plan sponsor can liquidate assets at market value with a 30 day notice to the fund manager or provider. However, this could result in market values that are less than 100% and therefore, cause participant losses.

Plan sponsors will want to review termination provisions at book value to ensure participants do not incur losses. Book value termination provisions generally contain a 'put' period or installment payments. A put provides notification lead time that plan sponsors must give when deciding to withdraw their assets from the fund at book value. The "put" period is generally 12 months for a plan sponsor to receive their assets after notifying a provider. The installment payment would pay the assets over a period of time, which sometimes may exceed 5 years. Further, some termination provisions allow for an increase in fees during the period in which installment payments are made. Plan sponsors will want to review these provisions carefully, as longer installment periods or put periods could significantly reduce liquidity.

Participant Communications

Plan sponsors should review their stable value participant communications to ensure that they contain proper disclosures regarding risk, liquidity (including,

equity-wash provisions), and fees. It may also be important to communicate the credit quality of both the underlying holdings of the fund and the wrap provider(s). Participants invested in SVFs expect principal stability and positive, reasonably stable rates of return. While participants may not need to know all the aspects of the fund, such as market value versus book value, termination provisions and other specifics. However, keeping them informed may make it easier for the plan sponsor to implement changes if necessary.

Plan sponsors should also take care not to communicate to participants in such a manner that may induce participants to withdraw from the SVF as many stable value products, such as wrap agreements, have provisions that will not cover withdrawals at book value in such circumstances.

Looking to the Future

Which type of SVF is best for your plan depends on many factors, including, but not limited to plan size and sophistication, wrap contract terms and fees, various risk factors, and potential implications resulting from legislation or regulatory changes.

SVFs should continue to play a valuable role as part of a plan's investment options. However, because of the complexities involved, plan sponsors should make sure that they have the necessary expertise to properly design, monitor, and manage a SVF.

Due to the severe market volatility since October 2008, plan sponsors are more willing to learn about stable value intricacies and are more sophisticated about what stable value is and how it works. Plan sponsors should work with stable value managers and wrap contract providers to construct SVFs based on clear, well-defined guidelines. Ongoing fund reporting and monitoring can help plan sponsors and wrap issuers stay informed about changes over time that might be needed to ensure these investments continue to perform in a manner consistent with fund objectives.

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