BLUE PRAIRIE

— Group —

WHAT YOU SHOULD KNOW ABOUT GENERAL ACCOUNT STABLE VALUE FUNDS

By: Constantine Mulligan, *Director of Research*

What is a Stable Value Fund?

Stable Value ("SV") funds, as defined by the Stable Value Investment Association, are "a relatively low risk asset class that focuses on capital preservation and liquidity, while providing steady, positive returns to participants…" They accomplish this by using insurance contracts to guarantee the principal and interest rate to investors.

There are three basic types of SV funds, each with its own risk characteristics (Note: 403(b) plans and non-qualified plans cannot use pooled funds that are housed in a collective investment trust). The type that we're focusing on in this paper is the General Account Contract, or "GIC".

General Account	Separate Account	Pooled Fund
• Insurance contract from a single insurer • Backed by general account of insurer • Interest determined by insurance company	• Insurance contract from a single insurer • Obligation backed by a separate account of marketable securities • Interest determined by the underlying asset portfolio	• A fund that owns assets and contracts from multiple insurers • Obligation backed by a portfolio of assets • Interest determined by underlying asset portfolio

Potential Problems Inherent to GICs

A Stable Value investor should select a stable value fund based on a prudent due diligence process. As such, Blue Prairie Group codifies the due diligence process by breaking it into six evaluation criteria (those coded in red represent the risk factors to which GICs may have a heighted risk profile):

Transparency	Flexibility	Structure	Management	Value	Performance
• What am I buying?	• What are my options?	• How does it work?	• Are the managers qualified?	• What does it cost?	• What is my return?

When investing in a GIC, a plan may be more restricted than the Sponsor realizes, specifically with regards to the Put Provision (a Put Provision details how a plan can redeem the investment). Most GICs offer two options: the first is an immediate payout subject to a market value adjustment (meaning the plan could lose money); the second is a 5 year, six-equal-payment option. This option means that the plan will receive its assets over a 5 year period, which is a significant amount of time to worry about participants transacting out of the fund. Additionally, during this 5 year period, some contracts become "non-benefit responsive" meaning that they will not allow participants to redeem during this period.

Additionally, when buying a GIC, there may be an issue of "portability". Portability relates to how easy it is to switch from one custodian/record keeper ("Recordkeeper") to another, if a plan sponsor wants to make a change. GICs are particularly non-portable, as many times they are offered as a "bundled" solution, meaning the issuer of the GIC is also the Recordkeeper. This allows Recordkeepers with GIC products to recruit and maintain plan assets because they can often subsidize the cost of record keeping if the plan uses their proprietary GIC. These issues point to a situation where a plan sponsor investing in a GIC may be invested for longer than they bargained for.

Also, the structure of a GIC can put a plan's assets at risk,as being a part of an insurance company's general account makes the plan a general creditor of the insurer. This means that if the insurer were to be insolvent, a plan would essentially file a claim just like any other creditor. Of course, there is a low probability of default among highly rated insurers, and in case of emergency there are "state guaranty funds" that act as a backstop to insurers, but is that a risk that a prudent fiduciary should take, especially in a fund that is supposed to be "safe" for participants? It also highlights the need to analyze the strength of the insurer.

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Finally, it is important that a fiduciary know the cost structure of any investment in their portfolio. With a GIC, the true cost of the investment is difficult to ascertain. This is because a GIC is a "spread" product. A spread, in this instance, is the difference between the rate of return the insurance company earns on its general account investment activity, and the interest that it pays to the plan. This difference is the amount the insurance company keeps from investing the plan's assets, and could be considered the true cost of the investment. Many times, the spread earned can be several hundred basis points, which, if expressed as an expense ratio, would be egregiously high. Some would argue that the spread doesn't matter as long as participants are getting a fair crediting rate, i.e. the net return. However, it is important to remember that this spread is being earned by investing the plan's assets, the same way that any asset manager earns their fee. In theory, a larger portion of this spread *could* be going to the participants of the plan rather than in the pockets of the insurer.

When Using a GIC Goes Wrong: A Case Study

Just recently, Blue Prairie Group assisted a plan sponsor with a search for a new Recordkeeper. The search was done as a fiduciary best practice, focusing on issues such as lowering administrative costs and increasing service levels.

Unfortunately, the Recordkeeper selected by the plan sponsor did not offer the GIC that the plan was currently using. In an ordinary situation, where a plan is using a mutual fund, the plan would liquidate the fund and map to a new fund on the new Recordkeeper's investment platform. However, in this case, in order to immediately liquidate the GIC, the provider was imposing a significant market value adjustment that would equate to a loss. This meant that the plan sponsor would either have to cover the losses from their treasury, or pass the loss through to participants.

Since neither situation was desirable, the plan decided to explore the other redemption option - six equal payments over 5 years. The plan sponsor reasoned that if the new Recordkeeper could accept the initial 1/6th payment in cash, they could allow their participants to continue using a combination of the old fund (held at the old Recordkeeper) and a new stable value fund. This practice is common and is often called a “blended option.” The sponsor reasoned they could accommodate this arrangement for the next five years until the contract with the GIC expired. Unfortunately, the GIC became non-benefit responsive upon triggering the put provision, and would not allow participants to transact out of the fund. This prompted the new Recordkeeper to refuse to take the stable value assets at all, for fear the redemptions from participants would exceed the 1/6th cash received, and there would be no liquidity.

As of the time of this writing, the plan sponsor has not yet decided what to do, and it has caused a major disruption in their move to the new Recordkeeper. The sponsor will either have to take a loss and make it up from treasury, tell participants they lost money in their “safe” option, or risk illiquidity by leaving the GIC assets at the old Recordkeeper during the wind down and hope that participant withdrawals don’t exceed the liquidity that the GIC is providing.