Understanding and Evaluating
Stable Value Funds

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— Group —

Understanding Stable Value Funds

What is a stable value fund?

Stable value (SV) funds are capital preservation investment options available only in ERISA retirement plans. They are considered a conservative and "safe" investment compared to other investments and are one of the most popular options around.

Today, participants in defined contribution plans have invested over $550 billion in stable value funds, which usually consist of a portfolio of diversified, high–quality, fixed income securities including U.S. Treasury and government–agency debt, short–to–intermediate term corporate bonds, and mortgage–backed securities.

Stable value funds are offered by large investment firms with an expertise in fixed income management, and by insurance companies which have a majority of their balance sheet assets invested in fixed income securities.

What is book value accounting?

Book value accounting allows participants to move in and out of a stable value fund and to know exactly how much is in their account at any point in time.

The participant's original investment grows daily by the amount of interest determined by the crediting rate (i.e., the fund's rate of return), despite changes in the underlying market value of the fund's portfolio. In other words, participant–directed withdrawals are made at the book value amount, which is determined by the crediting rate rather than market value amount, which is determined by the underlying bond portfolio of the stable value fund.

Are stable value funds safe ?

Investments in SV funds are not insured by the FDIC, the Federal Reserve Bank, the fund managers, or the record keeper of the retirement plan. Depending on the product type, a stable value product's book value—the value of a participant's account including contributions and interest—is protected against loss of principal by either an insurance contract known as a "wrapper" or by the general account of the insurance company offering the product.

Although unlikely, it is possible to lose money by investing in a stable value fund. As a plan sponsor, knowing how to identify a "good" stable value product can also minimize the chance for loss.

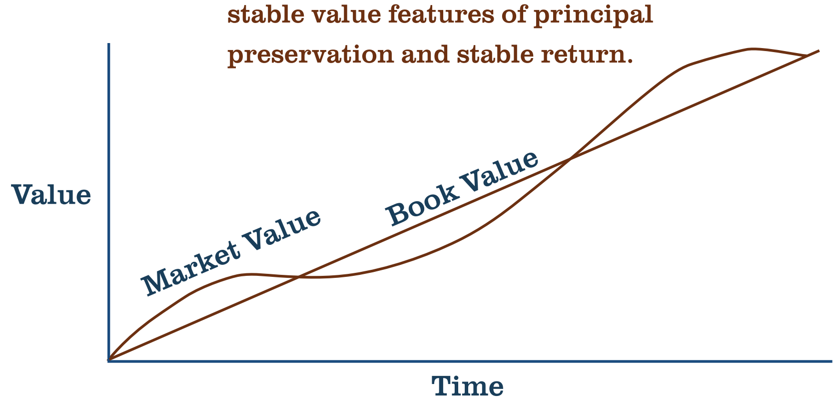
How do stable value funds work ?

Stable value funds possess characteristics of both bond funds and money market funds, but they do not fit neatly into either of these asset classes.

The portfolio of bonds in a stable value fund generally have a duration (a measure of a fund's sensitivity to changing interest rates) of approximately 2–4 years, enabling them to deliver better returns than a money market fund, which typically invest in short–term securities that mature in less than 6 months.

Like money funds, SV funds seek to maintain a constant $1 share price, or net asset value (NAV). To maintain the constant $1 NAV, the funds' managers use book value accounting, which smoothes any difference between a fund's market value and its book value over time.

Accounting principles enable the stable value features of principal preservation and stable return.



The Two Main Types of Stable Value Products: Insurance Company GICS and Commingled Pools

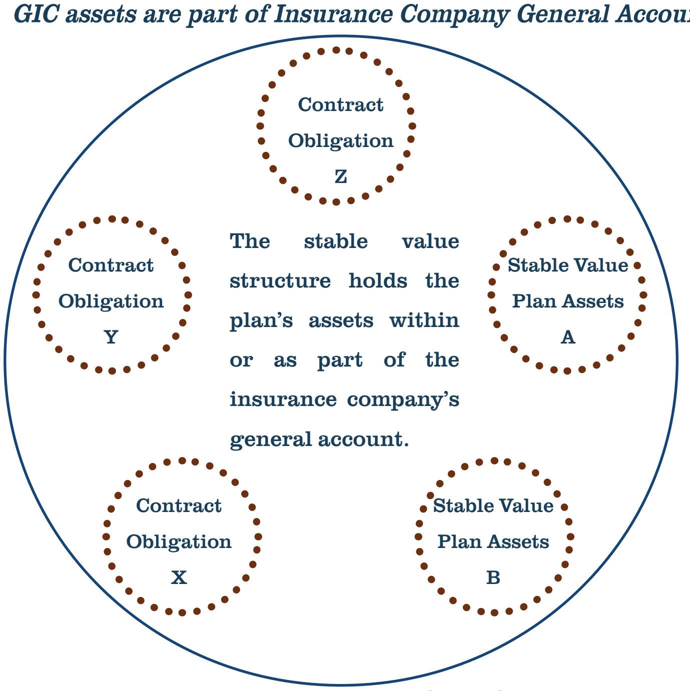
Stable value products can be structured in two main ways in order to protect the book value of the participants' investments:

Insurance Company GICS

An insurance company can structure a stable value fund as a traditional Guaranteed Investment Contract (GIC), which is a group annuity contract issued by the insurance company, providing a guarantee of principal and accumulated interest. With this type of GIC, plan assets are owned by the insurance company, and are part of the insurer's General Account. Stable Value contract holders (the plan sponsor) and participants are creditors of the insurer, and do not have priority claim status on the General Account assets of the insurance company. In this structure, the participant may receive a higher crediting rate, but they are subject to the financial strength of a single insurance company. This means that in the event the insurer goes bankrupt, there is no guarantee how much money, if any, the participant will receive. With this type of SV product, the plan sponsor has less flexibility in terminating the insurance company as the SV fund manager. There is also little transparency regarding the underlying bond portfolio and the product's fees making it difficult to know exactly what the portfolio is invested in and how much the product costs.

Traditional Insurance Company Contract (GIC)*

GIC assets are part of Insurance Company General Account



*Adapted from diagram by Galliard Capital Management, Inc.

Commingled Pools

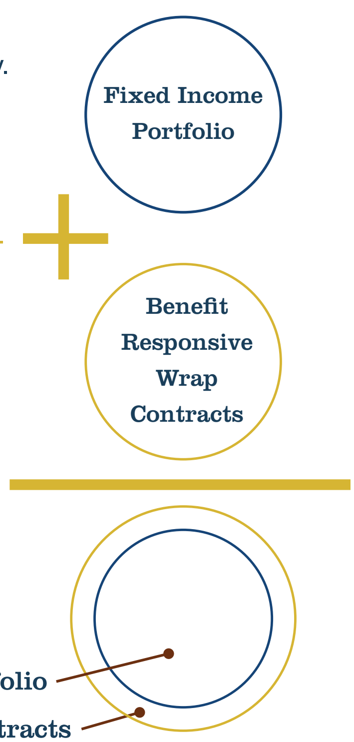
In a "Pooled" or "Commingled" stable value funds product, the largest allocation is to "Synthetic" or Security–Backed Guaranteed Investment Contracts issued by multiple banks or insurance companies. These contracts are comprised of two components: 1) an underlying portfolio of high quality bonds and 2) one or more book value wrap contract(s) issued by a financial institution(s).

The wrap contract ensures that participants can transact at book value, without experiencing the price fluctuations of the underlying bond portfolio. And unlike a traditional GIC discussed above, the portfolio of bonds is still owned by the plan sponsor. When the portfolio of bonds is owned by the insurance company as in a traditional GIC structure, the participant is subject to single insurer risk. In a pooled product, a plan sponsor is not subject to single insurer risk, can determine the product fees easily as well as "see" the underlying fixed income investments of the stable value portfolio.

Key Components of a Stable Value Fund

- Diversified bond portfolio.
- Typically AA/AAA credit quality.
- Managed portfolio/credit analysis.
- Marketable securities.
- 2 to 4 year duration.

- Issued by a bank/ insurance company.
- Offsets price fluctuations in bond portfolio.
- Maintains BV record of covered assets (bond portfolio.)
- Payment obligations of wrappers help ensure that investors receive a positive NAV.



Fixed Income Portfolio

Benefit Responsive Wrap Contracts

Is my stable value fund a mutual fund?

Unlike other investment offerings in a DC plan, stable value funds are not structured as mutual funds, but are offered to participants in a structure known as a commingled trust. Although similar to mutual funds, a commingled trust is a pooled fund operated by a trust company or a bank for the exclusive use of qualified retirement plans. The commingled trusts are designed to combine the assets of unrelated ERISA retirement plans, enabling plan sponsors to gain economies of scale within a single stable value strategy, much like a mutual fund does. They provide participants daily access to their funds without redemption fees. However, typically there are restrictions on transferring from the stable value option to a "competing" fund i.e., a money market fund or a high quality short–term bond fund.

Stable Value Fees: Where's my expense ratio? What's reasonable?

Stable value fees can be confusing. For certain types of products like the pooled funds described previously, they're expressed as an expense ratio making for an easy comparison between products.

For other types of products like traditional insurance company GICS, the underlying costs are not reported as an expense ratio. In fact, they can legally represent their fees as 0 percent to investors.

What's really happening, though, is that the insurance company is making most its money from "spread"—where the investments generate more in profit than the cost of deposits. In this case, the underlying fees are usually netted out of the gross crediting rate making it very difficult for plan sponsors or participants to determine the product's true costs.

Is My Stable Value "Free"?

Unfortunately, no. If you don't see an explicit cost then you can assume that the fees—whatever they happen to be—are being netted out of the gross return.

As a plan sponsor, you want to ask for a detailed breakout of fees in order to make an informed buying decision. The fees for investing in stable value products typically range from 25 basis points (0.25%) on very large plans to 100 basis points (1%) for small plans. Many pooled funds offer multiple share classes designed to provide different levels of revenue sharing to the record keeper, and pay higher expenses to the product provider depending upon the size of the plan's investment. In some instances, a plan's recordkeeper is an insurance company, which also offers its own stable value product, most often a Traditional GIC structure from the insurer's General Account. The fees for that product often consist of both a recordkeeping fee and an investment management fee. However, these fees are implicit, and are typically not disclosed to the participant.

What is the market-to-book (M2B) ratio?

The market-to-book ratio helps a plan sponsor to understand the overall health of the stable value product by identifying whether the portfolio has a "gain" or "loss" based on the current value of securities compared to the "book" value, or the price the securities were purchased at. Stable value funds that are significantly below 1 should be avoided.

Evaluating Stable Value Funds

Key Questions for Evaluating a Stable Value Fund

We have created a series of questions for plan sponsors to ask when evaluating a stable value fund, and comparing different stable value products across a number of important product design dimensions.

1. **What is the fund's current market-to-book value ratio?**

   A ratio higher than 100 is preferable. A ratio lower than 100 indicates that the value of the investments has fallen below the dollar amount contributed by participants, or the book value. Participants who are withdrawing cash from the fund are now relying on the insurer to cover the difference between market value and the book value of the total contributions.

2. **What is the current crediting rate paid to participants, and how does it compare to the rate paid by other stable value funds, and the yield earned on money market funds?**

3. **What are the product's fees?**

   In the case of a pooled fund, it will be expressed as an "expense ratio" but in the case of a guaranteed product, there may be no mention of fees. In this case, you will need to ask the provider for a detailed breakout of fees that are deducted from the fund's gross crediting rate.

4. **Which financial institutions are wrapping the fund, or the bonds owned by the fund? What are the most recent credit ratings and outlooks on these companies from the credit rating agencies?**

   Knowing the financial condition of the wrap providers is an essential step in evaluating the overall risk of the fund. This is critically important when evaluating stable value products offered by the insurance companies, which are "self-insured."

5. **If the plan sponsor decides to terminate a stable value fund, how much time must pass before all the participants can receive their funds at full value?**

6. **Who is/are the underlying fixed income portfolio manager(s)?**

   Plan sponsors should select fund managers with a large, dedicated team to stable value products. How long have they been running the fund? What is their risk-adjusted track record compared to appropriate benchmarks and peer group? Having multiple sub advisors provides participants with diversification of manager risk. Typically, each fixed income manager has a different investment philosophy, and at one point or another, their philosophy may be out of market favor, causing them to perform poorly. In the event the stable value fund changes a sub advisor, it is imperative that thorough manager due diligence is performed. If the stable value fund changes sub advisors frequently, this is a sign that proper manager due diligence may not have been conducted.

Comparison of Stable Value Products

The table below provides an overview of the two most common stable value structures offered to plan sponsors.

	Insurance Company General Account GIC SV Funds	Pooled Stable Value Funds with Multiple Wrappers
Who holds legal title to the assets?	Insurer's General Acount.	Pooled fund manager, which diversifies against single insurer risk.
What type of principal protection is offered?	If structured properly, the participant's principal is protected against market value risk and credit risk by the insurance company.	Does protect against market value risk; typically does not guarantee the return of principal for defaulted securities.
What type of crediting rate guarantee is typically offered?	Minimum crediting rate greater than 0% is guaranteed; rate is reset periodically.	Typically no minimum crediting rate, the rate can fluctuate based on market conditions.
Who manages the assets?	Insurer	One or multiple fixed income managers
Who provides the guarantee?	Insurer	Multiple wrap providers selected from insurers, banks, or other financial products companies.
What is the risk of losing protections offered by the guarantee?	If structured properly, the guarantee is backed by full faith and credit of the single insurer.	Guarantee is backed by the full faith and credit of multiple guarantee providers.
What is the risk of losing access to the assets?	If the insurer becomes insolvent, investors will become a creditor of the insurer's assets	Assets are held by the pooled fund.
What protections are available if a guarantee provider cannot meet its obligations?	If structured properly, state insurance insolvency laws give preferential treatment to policy holder claims.	If any guarantee provider cannot meet its obligations, other providers must step in to fulfill that provider's obligations.
Purchase Decision Criteria	Sponsors seeking a "turn-key" solution can opt for this general account product, which requires only the selection of a single provider to manage the assets and provide the guarantee.	Plans seeking the assurance of multiple wrap providers backing the guarantee can select a global wrap product.

Blue Prairie Group is an independent, fee–only investment advisory firm. We provide unbiased and objective investment consulting within three main practice areas: ERISA, Foundations & Endowments and Wealth Management.

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