Managing Stable Value
Key Principles
Stable Value Investment Association

Introduction

For more than 30 years, Stable Value Funds have played an important role helping retirement plan participants safely accumulate retirement savings. Stable Value Funds are considered a core investment option, with more than 97,000 defined contribution plans making Stable Value available to more than 25 million participants. Participant assets allocated to Stable Value total more than $413 billion. As an asset class, Stable Value is designed to provide plan participants with stability of principal and accrued interest, daily liquidity, and, over the long term, returns similar to short and intermediate-duration bonds without the volatility associated with bonds.

Stable Value Funds are offered primarily as an investment option within defined contribution retirement or savings plans that provide the plan or plan participants with tax-advantages to encourage long-term savings for specific objectives such as retirement. Examples of such plans include those created to comply with sections 401(k), 403(b), 457, and 529 of the Internal Revenue Code. These plans typically require that participants direct their own investment allocations among choices offered by the plan, although in certain types of plans the trustee or plan sponsor may make the investment elections on behalf of participants.

The intent of this paper is to outline the key principles of prudent Stable Value investment management. Not all Stable Value Funds are created alike, nor should they be. Plan participants benefit from different options in terms of Stable Value Fund formats and Stable Value investment strategies.[1] Ultimately, the appropriateness of a Stable Value strategy is judged by its ability to deliver safety, liquidity, and return to the plan participants it serves in a manner that consistently meets the Stable Value Fund's stated objectives.

This paper includes input from a broad array of industry constituents, including Stable Value managers, Stable Value wrap providers, traditional Guaranteed Investment Contract (GIC) issuers, insurance company General Account and Separate Account providers, fixed income managers, and plan sponsors. This paper summarizes key principles, but it is not intended to be exhaustive in nature. Stable Value is an important asset class that has evolved over the past three decades in response to changing demands from plan sponsors and their participants and to changes in the fixed income marketplace. Stable Value will continue to evolve to meet these changing needs.

Key Principles

Stable Value Funds are often considered the conservative investment or one of the conservative investments in a deferred savings plan's investment lineup. In many cases, a Stable Value Fund is used by a defined contribution plan to meet the 404(c) requirement calling for "…an income producing, low risk, liquid fund, sub fund, or account…" Accordingly, Stable Value Fund investments are managed with the objective of maintaining principal stability, providing liquidity at Contract Value for participant-initiated transactions, and generating a positive and reasonably stable rate of return.

[1] For more information about terminology and specific investment instruments that may be used in a Stable Value Fund, please use the *Stable Value Glossary* and *Help Desk* at www.stablevalue.org.

In order to serve as an income-producing, low-risk, liquid fund, a prudent Stable Value strategy invests in investment-grade, fixed income instruments, which generally need to be combined with an assurance of financial protection, known as a Wrap Contract, issued by a financially responsible party such as a bank or life insurance company. Stable Value Funds can also use GICs or be a portfolio of GICs. The fund may also include investments that are not covered by a Stable Value Wrap so long as these investments are short-term in nature and can reasonably be expected to maintain principal stability on their own without coverage by a wrap (*i.e.* cash- equivalent securities).

In practice, a Stable Value Fund maintains principal stability by valuing the fund's investments at Contract Value – typically defined as the initial principal investment amount plus credited interest, adjusted for subsequent deposits and withdrawals. Plan participants also transact at Contract Value. As a result, Stable Value Contracts need to comply with applicable generally accepted accounting and audit procedures (GAAP) for reporting Contract Value in the financial statements of the defined contribution plan, including the Financial Accounting Standards Board's FSP AAG INV-1 for Stable Value funds that hold the wrap contract as a fund asset or SOP 94-4-1 for funds whose wrap(s) are written directly to a qualified plan or its trustee.

A Stable Value investment portfolio generally includes high-credit-quality, fixed income securities and/or traditional GICs. It favors diversification, balances duration with crediting-rate responsiveness, and maintains a source of ready liquidity. Derivatives may be used but should be in keeping with the investment objectives of fixed income instruments and risk limits for the portfolio. Each element should not simply be viewed individually but in aggregate within the strategy employed, the exposure to each type of asset, and to each individual security. Each of these elements is explained in more detail below.[2]

> *Credit Quality and Currency Exposure.* Stable Value Fund portfolios will have, on average, high credit quality. Portfolios will have an investment grade strategy. Below-investment-grade and non-dollar assets may be included to diversify exposure, manage risk, or enhance returns, provided those assets are consistent with the fund's safety, liquidity, and volatility constraints.
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> *Portfolio Diversification.* In general, the concentration of exposure to any single issuer of investment securities should typically not exceed five percent of fund assets. Obligations of the U.S. Government and its agencies and instrumentalities as well as diversified commingled funds are often exempt from exposure guidelines. For structured securities, the issuing trust is considered the issuer, not the sponsor or servicer of the trust. The concentration of exposure to securities that achieve their credit rating by a guarantee from a third party guarantor should typically not exceed five percent of the fund assets per third party guarantor, on average.
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> *Duration.* In determining an appropriate duration for a given Stable Value strategy, the Stable Value manager should seek to balance the benefits of achieving higher yields by investing in longer duration securities (assuming a normally sloped yield curve) against the desire for a crediting rate that is highly responsive to the level of market interest rates. Consideration should also be given to the expected cash flow of the fund and potential cash flow due to plan demographics. Generally, Stable Value managers find this balance in duration somewhere between two and five years.
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> *Liquidity.* A Stable Value portfolio should include an adequate allocation to assets that can be used to provide for routine liquidity requests made by participants from time to time. Alternately or additionally, the Stable Value manager can procure Stable Value guarantees that fully provide for needed liquidity. In addition, the portfolio should be structured such that participants have sufficient liquidity when needed for plan benefits.
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> *Use of Derivatives.* Derivatives are used to replicate fixed income investments, manage yield curve structure, portfolio duration, and to facilitate investment strategies generally consistent with the Stable Value Fund's investment guidelines and objectives.

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[2] For more information on key elements in a Stable Value Fund, please see SVIA's Annual Stable Value Fund Investment and Policy Survey.

Stable Value Funds generally adopt one of three primary formats – Separately Managed Accounts, Commingled Funds and Guaranteed Insurance Company Accounts.

> *Separately Managed Stable Value Funds* are specifically customized to meet the objectives of a single plan and do not include the assets of other, unrelated plans.
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> *Commingled Stable Value Funds* are designed to combine the assets of unrelated plans, enabling them to gain the economies of scale within a single Stable Value strategy. Commingled Funds are structured similarly to a Separately Managed Account. In contrast to Separately Managed Stable Value Funds, they include the right of a plan sponsor to terminate involvement in the pool over a set period of time, usually 12 months. This put period is the maximum amount of time a fund manager is permitted to pay out a plan that has terminated its participation in the Stable Value Fund. However, plan-participant transactions during the 12-month put period continue to occur at contract value.
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> *Directly Guaranteed Stable Value Funds* generally hold or invest in a single group annuity contract issued directly to the plan, through which the plan sponsor receives a direct guarantee of principal and accrued interest from the issuer. These funds are made as either General Account or Separate Account obligations of the insurance company. General Account Stable Value products are supported by the underlying investment strategy of the insurance company's general account. The General Account stands behind the Stable Value Fund. Separate Account Stable Value products may act like a General Account product while receiving the benefit of Separate Account insulation (assets of the Separate Account are walled off from the General Account and cannot be used to satisfy other obligations of the insurance company issuer). They use fixed income strategies similar to those found in a Separately Managed Stable Value Fund.

Stable Value Funds must comply with a variety of regulatory requirements that guide these funds. Applicable law and regulatory oversight differs by the type of provider and may include the U.S. Department of Labor and specifically the Employee Benefit Security Administration, the Internal Revenue Service, the Office of the Comptroller of the Currency, a number of state insurance commissions, the National Association of Insurance Commissioners, the Securities and Exchange Commission, the Financial Accounting Standards Board, and the Governmental Accounting Standards Board. A guiding principle in all prudently managed Stable Value Funds is that the Stable Value manager must follow applicable rules and regulations as well as the terms of the investment management agreement and wrap contracts.