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### Credit Market Conditions Yield Concerns over Stable Value Funds

Dear Investor,

For another quarter, coverage of the credit crisis has continued to dominate the news. Industry professionals and everyday investors alike are eagerly awaiting signs of the financial sector “turning the corner” regarding the sub-prime lending crisis. One reason why financial recovery has not yet taken place is because loan securitization is involved. Loan securitization is the process by which loans, such as mortgages, are bundled into marketable securities and sold to investors. When the housing market turned down, home prices dropped and home buyers began defaulting on their mortgages. Instead of mortgage default losses being confined to the banking sector, securitization allowed the losses to spread into the fixed-income markets.

Fixed-income markets are continuing to feel the effects of high rates of mortgage defaults and home foreclosures. Year-to-year comparisons of monthly foreclosure rates indicate the subprime mess is not over yet. Uncertainty and volatility in the financial markets is expected to continue. In this type of economic environment, the way investors respond is a concern. Lest we be tempted to hop into the deep well when the marsh dries up, we should be like the wise frog who advised “Look before you leap”. Likewise, caution should always be exercised when making investment decisions, especially when considering instruments that appear more attractive after other investments have underperformed. In the present economic environment, Stable Value Funds are among those investments that might warrant closer scrutiny than would be carried out during prosperous times.

Stable Value Funds are investment options offered by 401(k) and other defined contribution plans. Roughly two-thirds of all defined contribution plans offer a Stable Value investment option. The issuer of the Stable Value Fund provides a guarantee to the investor, safeguarding the principal and a specified rate of return over a given time period. The issuer will use contributions to the fund to make investments in a wide variety of assets. These assets can have longer maturities and lower credit quality (subjecting the portfolio to more market risk) compared to money market fund assets. If the Stable Value Fund is classified as a Collective Investment Fund (CIF), it can require up to twelve months notice by participants wishing to liquidate their positions with the fund. Another important consideration is how the issuer organizes the portfolio.

Stable Value Funds are almost never registered through the Securities and Exchange Commission; as a result there is a lack of standardization in how fund investments are pooled and accounted for and a lack of transparency in how investments are reported on. Unregistered investments are not subject to the same strict “mark to market” regulations as are registered investments. Inadequate standardization and transparency result in difficulties assessing the quality of the portfolio and the scope and strength of the guarantee. To illustrate, an issuer may (1) incorporate Stable Value contributions into the general assets of the company or may (2) create a separate designated account for the fund. Depending on the option, the guarantee may represent (1) the full force and backing of the assets of the entire company or may represent (2) only the backing represented by the assets of the designated fund account. Furthermore, other questions can arise regarding the guarantee when the designated fund account is co-mingled with contributions from other plans.

Yet another facet of Stable Value Funds has to do with the way issuers employ the use of “wrappers” to further insure the value of the portfolio. Wrappers are insurance companies and banking firms that contract to provide guarantees regarding the book value and specified rate of return of the assets against losses. Most often, multiple wrappers are used to guarantee the Stable Value Fund. The total dollar amounts of guarantees each wrapping firm is extending itself, is not a well-known figure. In times of economic upheaval, it stands to reason that wrapping firms themselves would not be immune to losses if large numbers of guarantees were activated at once. The wrapping firm’s capability to insure all guarantees could become compromised.

Overall, Stable Value Funds do not provide the same degree of transparency as do registered investments. In addition, the risk associated with these funds is illusory. The risk of any stable value fund contract varies on the extent of the guarantee provided by the issuer of the fund and any wrapping contracts. The guarantees may be limited by the issuer in scope to a finite dollar amount of insurance or a finite set of assets. During times of economic uncertainty, wrappers might be hard-pressed to fully satisfy all outstanding guarantees they have made to Stable Value Funds.

Because Stable Value has a history of delivering consistent and relatively high returns, full consideration of the underlying risks embedded in these funds may not have been a priority for all investors. We encourage plan fiduciaries to maintain due diligence in monitoring all investments, including Stable Value Funds. No explicit threat to the health of Stable Value Funds has been identified at the industry, firm, or plan levels at this time. Hindsight shows that unforeseen predicaments are more likely to arise during times of vulnerability. Advice is being provided now, in order to encourage awareness and alertness during this period of financial volatility that is now coupling with a general economic slowdown. By remaining diligent in evaluating market positions and heeding economic bellwethers we have every reason to believe that investors will be able to look back on these times with no regrets.