

May I Super Size Your Money Market Fund, Sir?

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Overview

The stable fund asset class has been in existence for over thirty years. The basic precept of the asset class is to insulate the daily net asset value from asset value changes due to changes in interest rates while providing a competitive rate of return.

The Stable Value Investment Association (SVIA) conducted a study at the end of 2003 which showed that stable value investments in defined contribution plans totaled \$355 billion and accounted for 33% of plan assets. Collective trust funds accounted for \$108 billion of the \$355 billion. By comparison, before their demise stable value mutual funds only accounted for \$7 billion making their total investment less than many of the larger stable value collective trusts. This is especially interesting when one remembers that the stable value mutual funds have been around since 1999.

History

The origin of benefit plans extends back centuries, but it was not until World War II they began in earnest. The Internal Revenue Act of 1928 and the Revenue Act of 1942 allowed tax relief for types of employee benefit plans. In 1974 the Internal Revenue Service and the Department of Labor under ERISA (Employee Retirement Income Security Act), set forth the key variables in establishing defined contribution accounts and individual employee participation in their retirement.

The love affair with Guaranteed Investment Contracts (GICs) dates back to the 1950's. Plan sponsors have used a number of products over time to fund their defined benefit plans and the stable value option in the defined contribution plans. These included deferred annuities, life insurance contracts, and deposit administration/immediate participation guarantee contracts.

GIC issuers were large life insurance companies who offered high rates, a "guarantee" from the insurance company, flexibility and benefit responsiveness. The fund or plan sponsor would build a portfolio by periodic purchases through the year and generating a laddered portfolio of maturities. Contracts were generally fixed rate with a stated maturity, but could be floating rate and evergreen (no stated maturity). Many small plans purchased evergreen contracts and lived to regret their decisions as they tried to exit the GICs and migrate to defined contribution plans of major trustees.

The name Guaranteed Investment Contract is somewhat misleading. The insurance company is "borrowing" money with the borrowing contract being called a GIC rather than a "note" or "debenture." There is no "guarantee" to pay by any party other than the insurance company. Theoretically, a debt issuance by any entity could be considered "guaranteed" by that entity. It is simply a promise to pay. The "guarantee" is only as good as the entity issuing the "guarantee" – there is no other credit back stop.

The key tenet of GICs was benefit responsiveness. This is the ability for fund participants to withdraw money from a contract; at the current contract value based upon certain events such as death, disability, termination, retirement and, in some cases, transfers to other investment options. Benefit responsiveness is the key element to valuing contracts at contract value as compared to some kind of mark-to-market algorithm.

For many years, the early stable value funds (then called GIC Funds) were constructed almost exclusively of two asset types – GICs and a small money market component. The small money market component provided liquidity and functioned well as participants were only allowed to enter and withdraw from the fund on an annual



or semi-annual basis. The manager could net out the cash flows of contributions and withdrawals and use the money market component to cover any shortfalls. Fund valuations were only required on entrance/exit dates.

The GIC is unique in another way. It is the only investment where the entity “borrowing” the money (the insurance company) gets to decide whether the buyer (the fund) is credit worthy enough to complete the transaction. While this “underwriting” mentality may be an extension of the insurance company’s business of underwriting lives or events for insurance purposes, it seems rather arrogant to believe that the buyer of the debt must be credit worthy. In the company’s defense they may; however, be trying to determine whether the benefit responsive provisions might be utilized.

Through the 1980’s and early 1990’s GICs were accounted for in the funds and plans based upon book value with the reasoning that they were illiquid assets without a clear and definable secondary market and without a defined valuation methodology. They became a more important part of the defined contribution investment base with the pronouncement of the American Institute of Certified Public Accountants (AICPA) Statement of Position 94-4 which stated that defined contribution plans could hold benefit-responsive GICs at book value. This provided the impetus for insurance companies to build the more benefit responsive structure into GICs. Defined benefit plans, as the previous large user, carried GICs at “fair value” which was basically market value. GICs are not generally found in DB plans today.

As the funds moved into the early 1990’s, the circumstances facing the funds were changing and the fund managers and offering entities had to adapt to stay competitive. The insurance industry was facing credibility problems with the demise of Executive Life, followed by Mutual Benefit and ending with Confederation Life in mid-1994. These departures brought across the board downgrades of the life company ratings which heightened concerns by fund managers, plan sponsors and participants.

The insurance industry concerns forced the fund managers to create or use other investment vehicles. As early as the mid-1980’s some funds had already begun placing small positions of floating rate securities into the funds. The items provided incremental income, while the positions were not large enough to move the overall daily fund net asset value away from its constancy.

At the same time, the plan sponsor/participant side of the equation was moving away from one or two contribution/withdrawal points each year. The fund buyers wanted the ability to make daily changes to their money. While this change reduced the big cash flow days it required that fund liquidity be available at any time and without notice.

The synthetic contract (I refuse to call it a GIC for the GIC reasons listed above) form became the next asset of choice to fill the void left by the insurance company GICs. As of September 30, 2004 the Hueler Analytics data indicated that synthetics accounted for about 80% of stable value assets while GICs accounted for only about 12% of the assets. Cash and separate accounts accounted for the remaining 8% of the assets.

The synthetic contract (or wrapper agreements) consists of two parts. The first part is an underlying security asset purchased by the fund. This asset can be any type of fixed income security or a fixed income mutual or collective fund. Treasury securities and high quality corporate bonds were the first securities used in the contracts. The fund holds the asset and collects the periodic income and other cash flows. The second part of the synthetic is a guarantee by the counter party – usually a highly rated financial entity – that if the fund is required to sell the asset at a loss for benefit responsive reasons (e.g. participant related fund withdrawals), the counter party will reimburse the fund for the loss. Because the contract is symmetrical, if the asset is sold at a gain from book value the counter party receives the gain. The fact that the fund is guaranteed its book value is why the fund can daily value the security at book value - holding the fund net asset value constant.

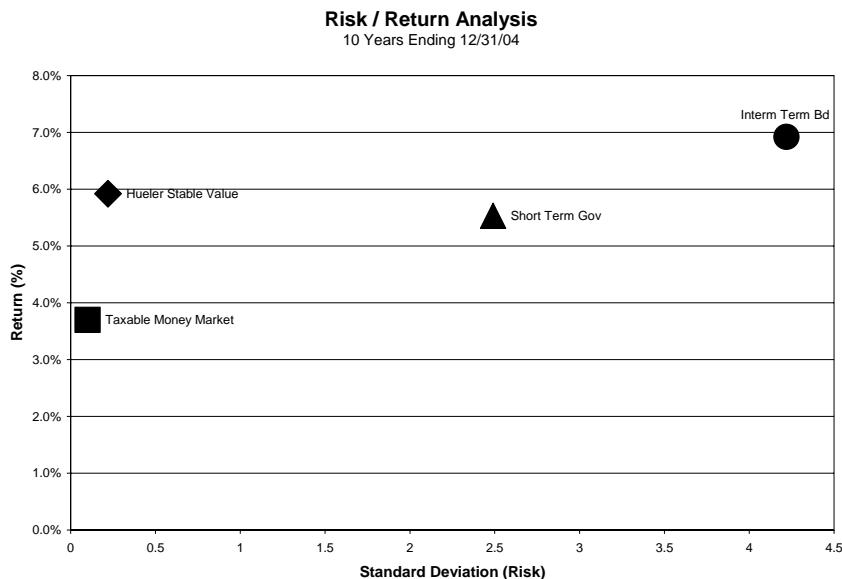
The fund’s exposure to the counter party is limited to the difference between the market value of the asset and the book value of the asset. If a fund owns \$10,000,000 par (called the notional amount) of a security with a book value of \$9,950,000 and a market value of \$9,925,000, the counter party exposure is only \$25,000. The counter party does not insure for the credit risk of the security defaulting. The contracts are very specific about removing declining credit securities from the agreement.



The crediting rate is the final element in the synthetic contract. Daily, the book value of the asset is increased by this rate. The rate calculation takes into account the yield-to-maturity of the asset and the amortization of the difference between the book and market value of the asset. The rate may be reset as often as monthly, but may be adjusted in longer time periods. The impact of the crediting rate computation is to reduce the crediting rate if interest rates go up sharply (a larger loss amortization is required) and increases the crediting rate as interest rates go down sharply (a smaller loss or even a gain to book is being worked off). After twelve to fifteen years in use, the crediting rate methodology has become fairly standardized.

Stable Value Funds Today

As pointed out at the outset of this paper, the stable value asset class is, and has been, popular with participants and plan sponsors because it provides a constant or growing net asset value and a rate of return in line with longer duration bond funds while having a risk measure (standard deviation of returns) similar to money market accounts. Graph 1 shows a summary of the returns and risk for the Hueler Analytics benchmark group of \$70 billion of funds compared to the Morningstar Intermediate Bond Category and Morningstar Money Market Category and Morningstar Short-term Governments.



Source: Morningstar

Today, the only way to invest in stable value funds is through Collective Trust Funds (CTF) or Collective Investment Trusts (CIT). Until recently, a limited number of stable value mutual funds had been available for, primarily, IRA accounts. The SEC raised concerns on the accounting for the wrappers, which led the issuing companies to terminate the stable value mutual funds.

CTF/CIT are set-up and/or managed by trust companies and banks. Unlike mutual funds, they are not governed by the SEC and do not publish a daily NAV in the Wall Street Journal. The funds are marked-to-market daily and a daily NAV is created and available to record keepers for daily entrance and exit to the fund. The funds are regulated by either the Office of the Comptroller of the Currency (OCC) or state regulators depending upon the manner of incorporation of the issuing trust.

What to Consider in Reviewing Stable Value Funds

A number of areas should be considered in reviewing Stable Value Funds. While the rate of return is important it is just one element in the consideration process. By the nature of the funds, there are fewer differences from fund to fund in the returns. Any difference in expenses can materially impact the net returns. The net return of the fund can be compared to the Hueler Analytics Universe after adjusting Hueler for a reasonable expense ratio.



Fund size is important in several respects. While a large fund can be well diversified both in its assets and plan sponsors, it can also be less responsive to the client's needs. The large fund may find itself having difficulty staying fully invested given large cash flows. Small funds, while they may be very responsive to the client, can have issues with too large of an exposure to single plan sponsors as well as being unable to compete aggressively on securities for the portfolio. The fund should have assets of at least \$1 billion. Additionally, fifty percent of the plan's assets should not exceed 2% of the size of the fund.

The age of the fund or the time which the issuer has been managing stable value money will be considered. The fund institution managing stable value money should be at least five years. Unlike mutual funds, there are few start-up stable value funds available which will meet both the minimum size and age requirements.

If available the diversification among the plans holding the fund would be nice to see. A single plan sponsor with a large position in the fund trying to exit the fund can wreck havoc with cash flows and future earnings.

The diversification in the portfolio of the issuers, structures and industries is important. Unlike traditional bond or stock funds, the stable fund may hold individual assets only through the participation in another collective trust fund or mutual fund so industry or issuer breakdowns will not be available. The counter party (the wrapper) becomes the important element. A minimum of four wrappers is appropriate for smaller funds while larger funds easily need twice that number. This diversification is important because if one wrapper should fail (has never occurred) other existing fund wrappers could step in and take over the wrapped positions.

What are the investment policies of the fund, permitted investment vehicles and limits placed on issuers or structures? These areas are non-quantifiable areas which are looked at in investing in any fund whether it is a collective trust fund or mutual fund.

What are the withdrawal provisions of the fund? While participant elections must be immediate, withdrawal at the plan sponsor level will be different. A twelve-month notice of withdrawal by the plan sponsor is the "industry standard," but documents and fund practices vary. Some documents say withdrawals "may" occur within twelve months while others say there "must" be a twelve-month notice. The liquidity, size of the fund and size of investment in the fund at the time of notice will generally govern the fund's willingness and ability to allow for withdrawal. Plan sponsor withdrawal may be at book value, but a mark-to-market out is not unheard of.

While a plan sponsor may object to the withdrawal notice provision, it is also a protective device, which prevents other plans from impacting the fund's liquidity by withdrawing. Liquidations for plan sponsor withdrawals are not part of the benefit responsiveness elements of synthetic contracts and do not trigger reimbursement by the wrapper for sales at a loss to book value.

What are the restrictions on the use of "competing" funds? Competing funds are asset classes which the fund views as providing an arbitrage opportunity for the participant. Competing funds may be as narrowly defined as money market funds or as broadly defined as broad market bond funds. Money markets as competing funds are the most desirable limitation.

Summary

Stable value funds are an example of an investment vehicle, which has changed over time to meet the demand of the client, accounting changes, and changing of security investments within the funds. The funds and their managers have seen the changes, reacted to them and maintain a strong investment presence today.

For thirty years plan sponsors and participants have been choosing stable value funds for three reasons: a stable net asset value; the shielding of the market value fluctuations of the underlying assets with the use of book value accounting; protection of principal; and a greater return than traditional money market accounts can offer. Stable value funds continue to provide those investment requirements today.

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