Stable Value: Opportunities, Challenges, and Risk Management

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Presentation Overview

- What is "Stable Value?"
- Current Market Landscape
- Insurance Company Stable Value Products for the DC Marketplace – Features, Risks, and Product Management
- Uses of Stable Value Outside of the Traditional DC Market

What is "Stable Value?"

Within the context of Defined Contribution pension plans, Stable Value is a fund option available to participants with:

- **Protection of principal and accumulated interest**
- **A fixed interest crediting rate that is reset periodically**
- **Daily liquidity (subject to constraints within the plan) for benefit responsive withdrawals and liquidations**

Stable Value Adoption

When selecting a conservative investment option, fiduciaries look for:

- **Principal protection – maximum protection of original investment and earnings**
- **Predictable returns – near and medium term predictability**
- **Sufficient returns – returns which outpace inflation**


The Market Footprint

Approximately how large is the Stable Value market in terms of Assets Under Management?

a. $100 billion

b. $250 billion

c. $650 billion

d. $1 trillion

[1] SVIA 16th Annual Stable Value Investment & Policy Survey

$646 billion in stable value assets[1]

Approximately **14% of total DC assets**[2]

[1] SVIA 16th Annual Stable Value Investment & Policy Survey
[2] Based on data in Investment Company Institute's 'U.S. Retirement Market Report', Third Quarter 2012

Found in 159,000 plans[1],

about half of all plans[2]

In plans with stable value,

represents 20% of total assets[3]

[1] *SVIA 16th Annual Stable Value Investment & Policy Survey*
[2] *Stable Value Investment Association, 2011*
[3] *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2010, ICI Research Perspective, December 2011, Vol. 17, No. 10, Investment Company Institute.*

How Stable Value Compares

Fiduciary Decision to Adopt Should Be Easy

Average Returns from 1989 to 2009

Babbel and Herce Study – Wharton School of Business[1]

Intermediate-term Bonds	5.6%
Money Market Funds	3.9%
Inflation	3.0%
Stable Value	**6.1%**

[1] *Dr. David Babbel and Dr. Miguel A. Herce, "Stable Value Funds: Performance to Date," The Wharton School, January 2011..*

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Average Return in 2008-2009 Crisis

Stable Value[1]

4.75% in 2008

3.52% in 2009

Money Market[2]

2.04% in 2008

0.18% in 2009

- **Virtually every other asset class experienced double-digit declines[3]**
- **Overall 401(k) balances declined by 27.8%,[4] equating to a loss of $1 trillion[5].**

[1] "Stable Value Performs 'As Advertised' During Financial Crisis," Randy Myers, SVIA Stable Times newsletter, from 2010 Spring Forum.
[2] iMoneyNet All-Taxable Average
[3] Indices maintained by S&P, MSCI, Citigroup, Dow Jones and Credit Suisse.
[4] Employee Benefits Research Institute (EBRI) study
[5] Are Retirement Savings Too Exposed to Market Risk,?" Alicia H. Munnell and Dan Muldoon, Center for Market Research at Boston College, October 2008, Number 8-16

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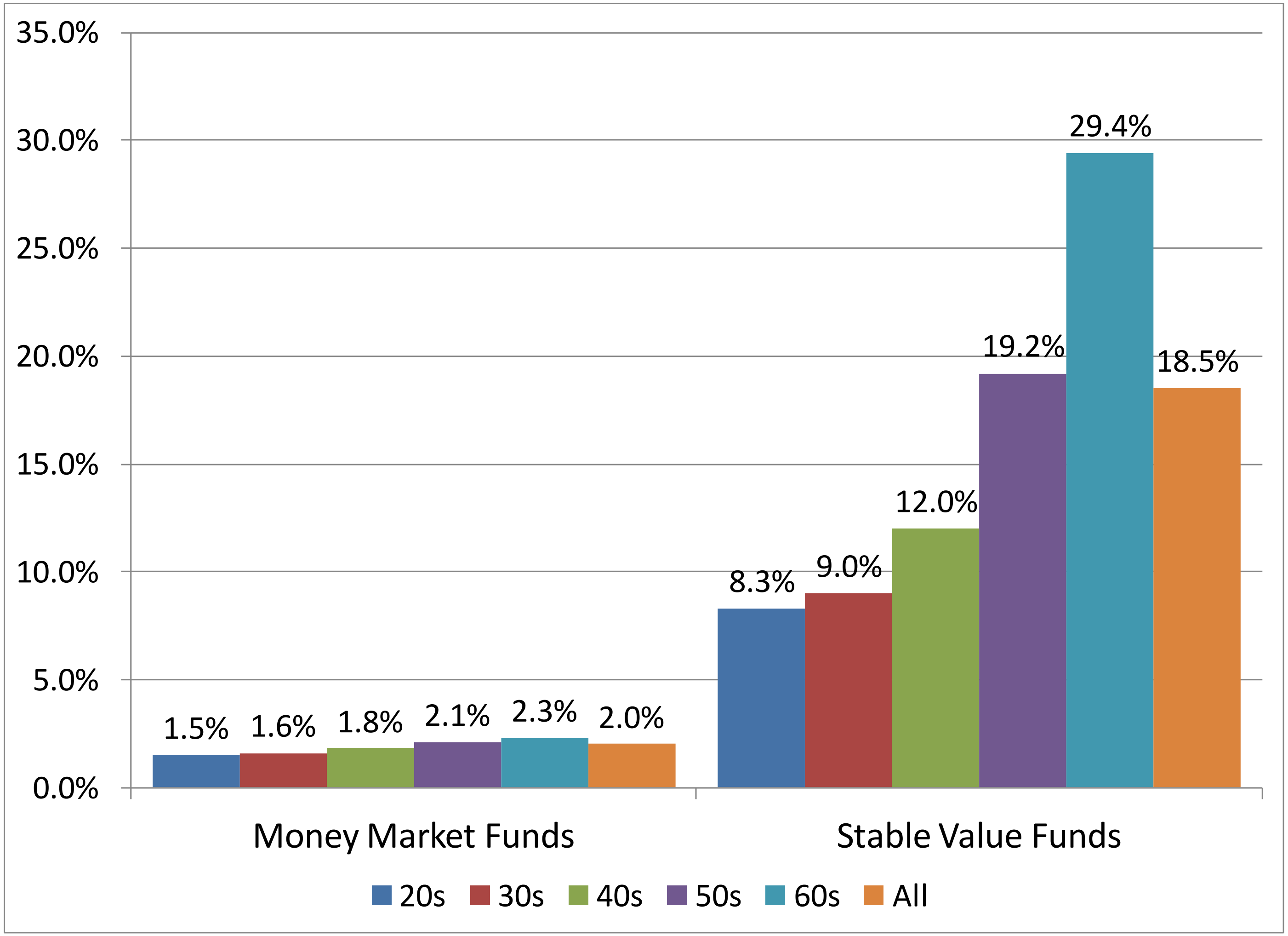
Since the Crisis

[1] SVIA Stable Value Funds Investment and Policy Surveys

Stable Value Adoption by Age



Source: 401(k) Plan Asset Allocation, Account Balances and Loan Activity in 2010, ICI Research Perspective, December 2011, Vol. 17, No. 10, Investment Company Institute.

Evaluating Stable Value Solutions and Providers

Is Stable Value a Fit?

Company and Plan Characteristics:

- Paternalism
- Seeking to complement investment lineup

Participant:

- Large older workforce nearing retirement
- Less investment experience
- Risk averse
- Lack diversification
- Demonstrate poor market timing
- Tend to invest in money market
- Part of overall asset allocation strategy

Evaluating a Stable Value Product

When evaluating....	You should consider...
The guarantor	• Financial strength • Commitment to the market • Single or multiple • Insurance company or bank • Risk management
The portfolio manager	• Experience • Style and philosophy • Risk management • Track record • Assets under management
The portfolio	• Diversification • Asset classes • Duration

Evaluating a Stable Value Product

When evaluating….	You should consider…
Returns	• Current and historical crediting rates • Declared in advance or floating • "Apples to apples" comparison • Interest rate period • Minimum crediting rate
Termination provisions	• Length of time • Book value, market value, or either?
Uncovered events	• Employer initiated events • Plan changes • Defaulted securities

Evaluating a Stable Value Product

When evaluating....	You should consider...
Participant restrictions	• Competing funds • Equity wash
Transparency	• Product structure • Underlying fees • Contractual features • Access to product & portfolio managers

Consider what features are most important to the plan

Current Developments

Since the Crisis:
Changing Market Dynamics

1. **Return to fundamentals:**
   - Conservative investment guidelines
   - Intermediate duration
   - Focus on risk management

Changing Market Dynamics

2. Higher wrap fees

3. Wrap capacity is returning

Changing Market Dynamics

4. **Shift from banks to insurance**

5. **Focus on quality of the guarantee**

6. **Variety of collective fund exit provisions:**

   12 month put, 24 month put, lesser of market or book

Changing Market Dynamics

7. Restrictions on new collective fund clients

- Some still may encounter capacity issues
- Cashflows accelerate convergence to market rates

Types of Stable Value Products

Investment management:	Description:
Insurance company products 43.6%* marketshare	General account or separate account contract issued to the plan; assets are client specific or commingled and managed by insurance company
Commingled Fund 22.8%*	Combine the assets of unrelated plans; investment advisor sources sub-advisors and wrap coverage
Custom 33.6%*	Customized and managed for a single plan

2011 Distribution of Stable Value Assets by Vehicle
Source: SVIA 16th Annual Stable Value Investment & Policy Survey

Current Issues Facing the Market

- **Changing interest rate landscape**
- **Regulations**
- **Fee disclosure**

Changing Interest Rate Landscape

Stable value funds have been through six full interest rate cycles and have performed consistently well

30 years of interest rate reductions appears to have finally and exhaustively come to an end

Low rates are expected to remain until at least 2015

Regulation of Stable Value Products

Stable Value products are subject to multiple layers of regulation:

- Department of Labor (ERISA)
- State insurance regulators (insurance companies)
- Office of the Comptroller of Currency (banks)
- SEC (commingled funds)

Fee Disclosure

408(b)(2) and 404(a) regulations do not change what is disclosed for general account products.

Some stable value fund managers incorporate wrap fees into the expense ratio and others disclose as a footnote.

Changing Interest Rate Landscape

- Active management of the funds also helps to mitigate risk through a reduction in duration, sector re-allocation, and hedging with futures and swaps

- Historically, participants did not pull money out of stable value funds in periods of rapidly rising rates

- Reacting to short term rate increases by transferring out of stable value has unseen risk:
    - No longer protected from loss
    - Money market yield only temporarily higher
    - Miss out on increasing crediting rates

Stable Value Products Offered by Insurance Companies – Features, Risks, and Product Management

Important Safeguards Against Participant Disintermediation are Critical to Stable Value Product Viability

Tax Qualified Retirement Plan Design Limits Participant Liquidity

- Participant withdrawals subject to significant restrictions and rules (determined by Plan and Trust) and subject to tax and ERISA limitations

Stable Value Contract Protections

- Competing Fund Restrictions
- "Equity Wash"
- Anti-arbitrage Restrictions
- Employer Initiated Events
- Annual Plan Underwriting and Contract Termination
- Stable Value Rate Setting

Counter-Cyclical

- Stable Value has experienced substantial inflows during times of stress

Plan Sponsors Hire Multiple Insurers

- Majority of Prudential Stable Value contracts are a component of a Stable Value fund, along with other wrap providers, each wrapping a segregated portion

Participants' Inertia

- Several recent studies (EBRI, ICI, Retirement Services Roundtable, etc.) indicate that defined contribution participants are very reluctant to change their asset allocations once established

Traditional Guaranteed Investment Contracts ("GICs")

- Lump sum and/or "window" (time and/or fixed dollar) deposits
- Fixed maturity date(s) – generally with no early termination or discontinuance allowed
- Fixed rate of interest
- Contracts are often "laddered" by plans
- Benefit responsive – but typically only after a cash buffer fund (maintained as part of the assets supporting the plan's stable value option) is exhausted
- Non-participating – insurance company bears all investment risks including default risks and ALM risks
- Asset/liability management
  - High degree of cash flow matching
  - Diversified, high quality portfolio
  - Often managed in portfolios which support other liabilities with fixed or highly predictable liability cash flows

“Evergreen” Products

- Open ended – no fixed maturity dates
- Accept ongoing cash in-flows into the plan’s Stable Value option
- Benefit responsive
- Interest crediting rates are reset periodically – variations run from fully discretionary “trust me” rate setting to crediting rates tied loosely or contractually to underlying investment experience
- Interest crediting rate can apply to pools of contracts, a single contract, or buckets within pools or contracts (based on generations of deposits)
- Minimum guaranteed rates often apply
- Contract (plan level) discontinuance protections – variations range from payouts with market value adjustments to payout of book value in installments over a period of years, with many variations.
- Most evergreen products are general account liabilities, but these products have also been offered in insulated separate accounts (typically for large, single client contracts).

"Evergreen" Products *(continued)*

- Asset/liability management
  - Segregated assets (general account or separate account)
  - Diversified, high quality portfolio
  - Laddered maturities – length and structure of ladder is highly dependent on product structure, features, and risk protections
  - Portfolio laddering is balancing act…
    - ➢ Too short – less competitive rates, potential spread compression in falling or low interest rate environments (particularly with minimum guaranteed crediting rates)
    - ➢ Too long – portfolio yields and interest crediting rates lag the market in rising interest rate environments (with potential adverse financial exposures for contracts which do not fully protect from disintermediation risks)

Synthetic GICs

- Arose out of desires for (a) "unbundling" and cost transparency of stable value investment management and the provision for guarantees and book value accounting and (b) taking the discretion out of stable value interest credited rate setting.
- Many features and underlying investment characteristics are similar to "Evergreen" separate account products
- "Synthetic" = Bond Fund Management (sometimes with Insurance Company affiliate investment managers) with the plan retaining ownership of the assets held in trust ***plus*** an insurance company wrap contract providing for formulaic, non-discretionary interest rate crediting, principal preservation guarantees (i.e. – minimum credited rate of 0%), and book value accounting for the plan and its participants
- Broadly used by stable value asset fund managers (managing stable value options and funds for single plans or pools of plans)
- Multiple underlying investment funds and multiple wrap providers are generally used for diversification and limiting single issuer exposures.
- In the last decade, Synthetic GICs have rapidly emerged in capturing the largest shares of sales and AUM growth in the Stable Value marketplace.

Synthetic GICs *(continued)*

- **Wrap contracts provide for:**
  - **Formulaic, non-discretionary interest crediting designed to converge book value of funds and market values of assets, generally over a period similar to the duration of the underlying fixed income portfolio**
  - **Last dollar coverage – if the underlying fixed income portfolio is exhausted due to participant-directed benefit responsive withdrawals, the insurance company makes up the difference.**
  - **Fees which are guaranteed for a given lockout period, after which the contract can be re-priced**
  - **Contract holder discontinuance features which provides for wrap dissolution (with plan retaining ownership of assets) or book value payout in lump sum payments or installments for a period equal to or longer than the duration of the underlying fixed income portfolio (with the insurance company having the ability to restructure the underlying assets).**

    The book value discontinuance payout provisions, in combination with the continuation of benefit responsiveness during the payout period, also create economic risk exposure to the insurance company.

  - **Strict protections for adherence to contractually specified investment guidelines (duration, quality, asset allocation, etc.), competing fund restrictions, and other specified actions by the contract holder which could adversely affect experience under the contract.**

Uses of Stable Value Outside of the Traditional DC Market

- **Floating rate GICs and Funding Agreements in money market and other fixed income funds**
- **Notes Programs (or "FANIPs")**
- **Federal Home Loan Bank (FHLB) advances**
- **Bank Owned Life Insurance (BOLI) – bond funds with stable value wraps**
- **529 Plans – Stable Value options**

Disclosures

Retirement products and services are provided by Prudential Retirement Insurance and Annuity Company (PRIAC), Hartford, CT, a Prudential Financial company. Prudential Retirement's group variable annuity contracts are issued by PRIAC, Hartford, CT, a Prudential Financial company.

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