Gillian: Welcome to Asset TV. I'm Gillian Kemmerer. Many retirees are seeking a steady stream of returns without fear of losing principal. Stable value funds are designed to achieve exactly this outcome offering a combination of safety and income that is unique among riskier assets often seen in a 401(k) plan. With money market reform in the rearview mirror, how has stable value faired and what kinds of innovations are coming next? Today I'm joined by three experts who will help us dive deeper into this investment strategy. Welcome to the Stable Value Masterclass. Thanks so much for joining us, everyone, happy to have you back for our second go. So the last time you were in the studio we were looking ahead to money market reform. Now we are looking back at the passage of it. So, Karen, starting with you, can you give us an overview of what some of the reforms were that were passed and how it's impacted the industry?

Karen Chong-Wulff: [0:00:50] Thanks, Gillian. So what has happened is that Money Market Fund Reform has caused a lot of assets to move from prime money market funds. And we've seen some of that; a lot of it actually goes to government money market funds, so about over a $1 trillion has moved from prime to government money market funds. And the opportunity here for stable value is obviously to capture some of those assets as well. And so there's an opportunity to do that. But I think from our perspective we think that what has happened is a lot of folks have moved to the government money market funds because it's the path of least resistance. And instead of considering other asset classes like stable value, that's something that perhaps we want to continue to educate others out there to do that.

Gillian: [0:01:42] Now, Warren, obviously Karen says the path of least resistance. Do you consider government money market's kind of the easy way out?

Warren Howe: [0:01:50] I do believe it was the easy way out for many plan sponsors. If you look at it now, Gillian, it's about a year, almost a year since these reforms went into effect. And as Karen said, a significant amount of money moved from prime money markets to government money market funds. The primary reason being if they were still in a prime fund, no longer going to have a dollar in NAV, and they were going to have potential for liquidity gates and redemption fees associated. And plan sponsors found that not palatable, especially for an asset class with virtually a zero return at that time. So many plan sponsors had to evaluate the capital preservation option in their plan, most of that is stable value against money market. But doing due diligence on stable value at that time could require a lengthier process to make sure that they chose the appropriate stable value option, versus if they went just from prime into a government money market fund, which many of those funds converted their structure from prime to government, was an easy kind of move in the first step. However, they may still want to evaluate and kind of take that next step of parking from government money market fund and finally choosing stable value.

Gillian: [0:02:53] Karl, I want to bring you into the discussion here. Now, there is a lot of speculation of course, has already been alluded to, that there would be some migration into stable value funds. Have you seen the assets start flowing since October or quite to the degree that you imagined they would?

Karl Tourville: [0:03:06]. I think there was a lot of discussion around how there could be a bigger movement than what we've actually seen. From our firm's perspective it ended up being modest growth. I think it contributed since the reform and last fall, probably $2-3 billion in new assets. So call it a 4% growth. Now we do have a number of plans still in the pipeline to do that. But I think when you talk about a $1 trillion opportunity; it has been a little bit more modest than we otherwise would have anticipated.

Gillian: [0:03:38] Karen, did you feel that the migration has also been more modest than what you were initially expecting?

Karen Chong-Wulff: [0:03:42] Like our firm doesn't have a lot of money market funds in terms of the lineup. And so what has happened is that most of them are already in stable value. But to the extent that this, to our industry's perspective, what has happened is because of the of path of least resistance, and also the fact that the … what happened was, government money market fund yields were not that different from prime money market fund yields at that point of time. Because there was a lot of demand for government money market funds, so because that spread differential was not that big, it was easy to just move to the government money market funds. But when we look at the long run in terms of stable value fund returns versus even prime money market funds, we have seen numbers anywhere from 125 basis points to 200 basis points. And so there is a big difference. And so like Warren said earlier on, as the dust settles, you know, they are going to look at their returns and say, "Hey, you know, there is more of a difference now between prime money market funds and government money market funds." And you may do something about that by considering other asset classes and stable value in particular.

Gillian: [0:04:57] Now, Warren, one thing that I wanted to ask before we move on to kind of how do you move if you took the path of least resistance and want to move forward. When we look at these government money market funds, is there a possibility that we're going to encounter some kind of asset shortage there?

Warren Howe: [0:05:11] It's an interesting point, Gillian, because as Karen said, most of the money was in PPrime money market funds. You had governmentmoney market funds with a certain amount of assets, but they were not being used as predominantly. Now with this shift away from prime and into government, a couple of things happening there, one, most of the historical comparisons of stable value to money market were the prime money market funds. Now as those dollars migrate to government money market funds, that yield disparity is likely to be even larger than it has in the past. But you do have a somewhat limited, I guess that's debatable, basket of government- related securities that may be available at any time. So you could have a lot more dollars chasing less in securities, which could have an impact.

Gillian: [0:05:49] And, Karl, do you agree?

Karl Tourville: [0:05:51] Yeah, I do. And I might also add, too, I think, you know, some of the reluctance to move out of government money market funds into stable value could just be due to the fact that we've been in this environment since the crisis where everyone's expecting The Fed to start raising rates. So you know, so these plan sponsors and folks making the decisions are looking at low rates with the possibility of interest rates normalizing. So I think there has been a little bit of let's just be cautious right now, see how it starts to unfold or does unfold ultimately and then assess.

Warren Howe: [0:06:25] I think it was interesting too, Gillian, the expectations, because I think people think, “Did as much money move as was expected due to money market reform?” And I think we would all say not quite as much has moved. The question is, is it still yet to move? Because you have to understand, when a plan sponsor makes a decision, there may be investment committees. There’s due diligence that has to be performed, there is documenting to make sure they’ve covered their fiduciary duty. So the fact that there is this year delay doesn’t mean that these dollars that have gone to government money markets will stay there. It just means they’re there now. And we still think there’s a significant amount that will then do that analysis and make the move to stable value.

Karl Tourville: [0:07:01] I might add just one other interesting note as we dig into the numbers of how much we actually got from money market funds. About half of the growth in our assets was from existing customers that used that as an opportunity to eliminate a money market fund. So half our growth came from that versus just folks that were looking to move out of money funds, stand alone with no stable value.

Gillian: [0:07:25] Okay. That’s an interesting point about the asset flows there. Now, Karen, let’s imagine the scenario that Warren has outlined which is that there is money yet to move. For those who are considering making that move, what are some of the things that they need to consider before they come into stable value?

Karen Chong-Wulff: [0:07:39] Well, like anything in terms of when you make some shifts from one asset class to the other, you’ve got to do your due diligence. You’ve got to be able to go through a process to look at what are some of the pros and cons in terms of moving to another asset class. In the case of stable value versus money market funds, it’s pretty obvious that the return differential is enough. So I said earlier on, 125 basis to 200 basis points. If you compound that over the long run it does make a big difference. So I think it’s important for plan sponsors and other fiduciaries to consider, not just returns, returns is a very important component for your retirees. But also all the other factors involved in terms of evaluating an asset class, and in this case because returns and given that stable value has the capital preservation aspect, similar to money market funds, I think it’s really important that returns be one of the leading factors that they consider as well.

Gillian: [0:08:37] In addition to performance, Warren, what else do you think they need to think about?

Warren Howe: [0:08:39] Well, it’s interesting because you had the quantitative analysis. What’s the performance been? What’s the difference? But if you’re a plan sponsor there’s a number of things you need to consider. If you’re going to make that move and go to stable value, what type of stable value? Are you going to go to a collective fund or a pooled fund? And if you’re in a small to mid- size, are you large enough to have an individually- managed portfolio? Who are you going to hire? Are you going to do it directly yourself? Are you going to hire a firm such as Karl’s at Galliard? Are you going to hire ICMA and go into the pools? You know, what are the different structures that are available? Are they single wrap, multi-asset manager? Are they multi- wrap, multi- asset manager? So there’s a lot of different variations of stable value, and it’s not just stable value that’s being considered. A plan sponsor needs to do their fiduciary due diligence on all of that.

Gillian: [0:09:27] And I'm looking forward to diving into some of those distinctions a little further in the conversation. But, Karl, before we leave this point, I feel like there's this generalized feeling, and perhaps it's starting to dissipate as we educate more that there's a lack of transparency around stable value. So if you're talking to these assets that might still be considering the move, how do you talk to them about the issue of transparency and what they need to consider?

Karl Tourville: [0:09:46] Well, I would say transparency has really not been an issue in stable value for many years. It used to be that folks didn't really understand what was going on underneath the covers, so to speak, of the wrapped contracts. There has been a lot more education in the industry over the last 20 years, synthetics and wrapped contracts have become the predominant vehicle used. So I think people are quite a bit more knowledgeable around the underlying assets, the underlying strategies, how the wrap contracts work. Some of that can even be traced to the '08/'09 time period when there was strain in the market. And, you know, necessity is the mother of, you know, all necessity. Necessity is the mother of all innovation. And that really caused people to dig deep and dive into their stable value funds and really come to understand them. So I don't think the transparency is really much of an issue anymore.

Karen Chong-Wulff: [0:10:46] Yeah, I would agree with you. I mean I think it's all relative. You know, in a money market fund, it's pretty straightforward. Here's the yield, here's the expense ratio. Here are the underlying investments. In stable value, it is similar in many ways. But there are a lot more layers to go through. And so it's just a matter of being relative. But, you know, disclosure, I think all of us disclose as much as we can in terms of what is needed as well as what is required for the funds.

Gillian: [0:11:15] So the capability of doing that due diligence more than available for anyone that's making that switch?

Karl Tourville: [0:11:19] Even a lot of the required disclosures that we have now, you know, necessitate us providing detailed look-throughs on expenses. We've even noticed consultants and plan sponsors over the last two years not even focusing solely on investment management expenses, which was always kind of the first cut at it. So when we go in and we're evaluated as a manager now for certain of our products, they look at what is the management fee? What are the wrap fees? What are trustee fees? What are any other fees that all come together.

Warren Howe: [0:11:53] Right. And it is the transparency as it relates to fees and, as Karl said, over time that has gotten much clearer and it's readily available for plan sponsors to see what that is. But even within the holdings of the portfolio, they're signing investment management agreements. So they're kind of understanding what's the strategy to be run, what are the investment guidelines going to look like, what types of holdings are permissible. So they have a much clearer understanding of all aspects.

Gillian: [0:12:18] And, Warren, staying with you for a moment. Karen referenced some performance figures that probably bear repeating about stable value versus money market. Can you give us a quick look back at let's say the past couple of years. What has driven some of that outperformance in stable value? And are we talking about performance net of fees?

Warren Howe: [0:12:33] Well, if you look at it on any metric, if it's net of fees, certainly gross of fees, you're looking at significant outperformance. So to the extent the numbers that Karen was citing, that's really on a net of fee basis. And it ranges 125 to 200 basis points over different time cycles. So you know it certainly has been an outperformance. But when you think why, money market funds are extremely short duration. People think of just Money Market Reform in terms of the 2016 Money Market Reform, which kind of forced government money market as the option. But prior to that, the SEC implemented Money Market Reforms that shortened the duration on the portfolios for money market, higher credit quality. So you know, it kind of had an impact on them at that time, so very short duration money market. Stable value, what it gives you is more of an intermediate term bond fund strategy, but kind of the comparable volatility of a money market fund.

Karl Tourville: [0:13:24] You know, I might just say, when you look historically, and you could look at data going back six decades around the shape of the yield curve. And some of the work that we've done over the years, if you look at the actual amount of time the yield curve is inverted between say a three- month Treasury bill and a five- year Treasury note, which would be the area that we'd be investing in. In stable value, it's only been like 55 months in the last 60 years. And the average amount of the inversion during that time period is only 50 basis points. So that whole just story around the maturity, the amount of risk premium that you receive for moving out the yield curve, is pretty powerful. And then when you start adding on structure and credit premium on top of that you end up with a pretty compelling number. And I think historically over time our work suggests about 100 basis points just for moving out from three months to five years and another 80 basis points just in terms of structure of credit premiums. So you're building in a huge advantage right out of the gates before you're adding active strategies that could improve performance even more, relative to shorter maturity alternatives.

Gillian: [0:14:35] I want to shift to the performance conversation to a little bit of a look ahead. And, Karen, obviously we just had the Federal Reserve speaking yesterday, and we have an expectation now of perhaps another rate hike before the end of the year, obviously a balance sheet trim as well. Talk to us a little bit about how stable value generally performs in different interest rate markets, particularly the one we're entering or let's say we're already in the rising rate environment.

Karen Chong-Wulff: [0:14:56] So rates have started to rise already, and we're in an environment where just from the Federal Reserve; you talk about stable rising interest rates. So in that environment it's great for stable value because stable value, in terms of the way it works and how rates are reset, will rise with interest rates as well. So a greater rise in the interest rates is kind of a perfect environment for stable value in a sense that it will also go up in terms of the returns from stable value. There's always some offset to returns when rates go up in terms of your bond portfolio. So as you know, when rates go up, the value of your bond portfolio goes down. But to the extent that the way the formula, in terms of how our stable value funds are credited, the rising interest rates is going to have a larger impact than the value going down slightly, which is amortized over the duration of the portfolio. So I'm pretty excited, at last perhaps rates are going to up and returns for stable value are also going to go up as well.

Karl Tourville: [0:15:59] I might just throw in, too, I think a real opportunity that really gets, I think, not really discussed a whole lot is the benefit to stable value as real rates of return improve. You know, we have been in this historically anomalous period where basically when you look at CPI and you look at an intermediate to long Treasury out to 10 years, real rates of return are almost zero. And if you go back through economic history, normally you might expect that to be anywhere from 1½%-3% depending on the maturity. So what I think our hope would be that, as The Fed starts to pare down its balance sheet and raise interest rates, we might start to see real rates of return above inflation become better. And that's, I think, the real opportunity for participants of in stable value because, you know, it wouldn't do much good for them to get a higher rate, you know, say 3% instead of 2% if now inflation's 3%, you know, instead of 2%, because that's really the game is all about after inflation returns return.

Gillian: [0:17:04] As we say, inflation's the elephant in the room. I think even Janet Yellen referred to it as a mystery, which begs the question, if she doesn't know where it's going how are we supposed to know where it's going. So, Warren, what if they stoke the coals, what do you see for next year?

Warren Howe: [0:17:158] Well, I think to Karen's point, stable value is built for all interest rate environments. It's not just a declining rate product. It is built to track the general target of interest rates. So if rates are going up, stable value is going to go up over time as well. And if rates are tracking down, stable value will lag down as well, but kind of at a lesser pace. So it's built to work in all these different interest rate environments. So you start to see things happening, and people worry that if rates rise, they almost think of it as a static portfolio. So, yes, you may have some losses on the bonds, which get amortized in. But the beauty about stable value through a defined contribution plan, they're ongoing participant contributions. So those dollars are now coming in kind of at the current market of where the bonds are and where interest rates are. So that helps mitigate some of that as well.

Gillian: [0:18:00] Excellent, great points. So let's talk a little bit about the opportunity set within fixed income, even just from a bird's eye view. , Karen, can we start with you, give us a little bit of a sense of how your stable value funds are allocated right now?

Karen Chong-Wulff: [0:18:104] So you're talking about the bonds backing up a lot of the stable value products, right?

Gillian: [0:18:15] Yes, exactly.

Karen Chong-Wulff: [0:18:15] So in terms of allocation, I would say that corporate bonds are still, even though they are rich, they're still very attractive on a, you know, when we're talking about PE ratios and all that, you talk about corporate bonds and where they are from a spread perspective. This is like, for example, equities, equities are even more expensive than corporate bonds. So within fixed income, you know, corporate bonds are expensive but they still out-yield Treasury bonds. And so I know there's a great demand in terms of corporate bonds out there, because yields are low. And what is really important is security selection. So you're in an environment where everything is kind or rich, but it is still the better yield out there, where you want to do really well is make sure that you select the securities appropriately and find and pick the right bonds. And so we are still invested in corporate bonds and other spread products like mortgage- backed- related securities in the portfolio, because you know, if you're going to invest all in Treasuries, you know, you're going to give up a lot, too, in terms of the yield differential.

Gillian: [0:19:17] What are some of the things that you're looking at in the corporate bond universe, how are you doing your due diligence on them?

Karen Chong-Wulff: [0:19:22] So our philosophy is we use … we manage some of the assets in-house as well as we use outside managers. And I know you're going to talk about this later, but we tend to want to hire manages with that process in terms of our process, in terms of screening them to make sure they do a good job in terms of how do you select, not just securities, but how do you sector allocate amongst their portfolios. So we are looking for managers who do a really good job. And we're looking at their process to make sure that that's what is done.

Gillian: [0:19:52] Now, I'm going to stay on corporate bonds for just another second and then we can talk about some of your other allocations. But, Karl, as Karen already alluded, there's a lot of demand out there for corporate bonds. Are you worried about a shortage? I know some of the pensions are but there's also been a lot of issuance, .right?

Karl Tourville: [0:20:04] Yeah, a tremendous amount of issuance in relation to just corporations wanting to lock in these low interest rates. So no real problems with supply as we see it. Frankly, I agree with Karen, the corporate bond market is pretty rich right now, if you look at risk premiums relative to Treasuries on a long term basis. I would say we're not going to be too concerned about that, because for stable value you tend to invest in shorter duration corporates. You're not as vulnerable to spread widening, you know, in that case. So we still see corporate bonds being very attractive. We generally, for stable value, focus on A and above. And we'll only have up to say 5% of a portfolio in BBBs. So we really tend to skew ourselves in corporate space, you know, probably to an average quality of A+ or AA-.

Gillian: [0:20:57] And is credit quality looking okay broadly speaking in the market?

Karl Tourville: [0:21:00] We think it's pretty good. I think the first thing to crack whenever you look at the markets is high yield. So you always want to keep your eye on high yield spreads, default rates, where things are there. And I think you certainly need to be cognizant of the fact that we are probably getting toward the end of the credit cycle. We've been growing basically since 2010 call it, right after the crisis. So we're long in the tooth in a recovery that's going on seven years. It hasn't been all that strong in terms of GDP growth. But I think you have to start to think about being a little bit more defensive.

Gillian: [0:22:43] When you think about it, you know, do you find that we're more prepared as an industry than ever before for a crash like 2008 or, you know, how do you see it, what's the risk?

Warren Howe: [0:22:52] I do think, I think stable value is in the best position it's ever been. I think there were a lot of lessons learned kind of across the asset class, if you will, whether it be the fixed income managers managing the underlying portfolios;, whether it be the wrap providers and what they're comfortable having under their wraps; whether it be the plan sponsors who are kind of taking a closer look and paying more attention as a fiduciary to what can the manager do and what latitudes are being given under the guidelines. And to Karl's point, I think people kind of experience that when things are all moving up, that's great, but it's kind of what happens when things start to move out a little bit and what's the potential impact. And I think there's a longer- term memory of where things were and an understanding of let's not get back there again. So prudence, and do things that make sense.

Gillian: [0:23:36] Karl, you would agree?

Karl Tourville: [0:23:38] I do, and you know, Warren and I are, and Karen, we're all old hands in this industry. I go back to the '80s in this and have seen many, many different things occur over that time period. And I would have to say in my own judgment, I completely agree with Warren. I think Karen agrees with this too, that we are in the best shape we could possibly be as an industry that I've ever seen. Generally speaking, portfolios are managed conservatively. We've got a healthy supply of wrap providers, pricing, well, I think it's going to come down a little bit. It needs to continue to move down a little bit. I think it's at an attractive level for really all participants, which is good for healthy markets.

Gillian: [0:24:17] I think this is a good place to go a bit more granular, particularly if we're addressing those who didn't make the move to stable value after Money Market Reform but are considering it. So, Karen, I'm going to start with you, could you just walk us through the basics of participating versus non-participating structures, really understanding the differences between them?

Karen Chong-Wulff: [0:24:32] Sure. So when you say participating structure, typically what we mean in the industry is that it participates with the performance of the portfolio, the underlying portfolio. So there is a fixed income portfolio, if it does well it's going to participate in terms of liquidity rates being higher. And on the converse, you know, if it's non-participating it would be like a traditional gate where a rate is provided and that rate doesn't change regardless of the environment. So that really kind of in a nutshell is the difference. And what we see out there are both types of structures, Warren has alluded to the fact that his firm provides all structures, both participating and non-participating. And from that perspective too, it's important for us since these products are available, to evaluate the pros and cons of participating and non-participating structures. We personally, in our portfolios, you know, we will use both in terms of what makes sense for the portfolio. So for example, for a non-participating structure like a traditional GIC, we use that because the market to book value ratio for a non-participating structure doesn't really move really at all. And is very helpful in an environment where rates go up or spreads blow out that the market to book value ratio actually remains more stable if you use some non-participating structures.

Gillian: [0:25:49] Now, it sounds like they can coexist and live together. It's not a question of one versus the other as Karen's alluded to. Warren, can you give us an example of how they can coexist and what purposes they serve in a portfolio?

Warren Howe: [0:25:59] Sure. And they certainly can coexist. And I think people use the kind of non-participating and the participating. There's different philosophies, different percentages, different exposures. But in the end it's kind of a relative value analysis -- where's the rate in a GIC relative to what might available kind of in the, call it the intermediate duration market under a wrap, net of wrap fees. Part of it is liquidity, built in liquidity. So if you're sitting there and you have a laddered GIC portfolio you have set maturities with ours that are coming due. Now, that can either be used to handle any liquidity needs being paid or to kind of dollar cost average on reinvestment as you go along. So it kind of does build in that built in liquidity component. And you see a lot of value in that.

Gillian: [0:26:41] And, Karl, do you agree that they can kind of coexist or do you tend to default to one or the other?

Karl Tourville: [0:26:45] You know, we really don't use non-participating structures such as GICs. And I think, frankly, what we've … our belief has been over time is that you really trade liquidity for potentially a little bit higher yield. And we like the flexibility of having all of our assets, except the wrap contracts, potentially marketable at some price. And if we ever did get into a situation where a GIC issuer became distressed, and we haven't seen it in, you know, since the mid-1990s pretty much. But you don't want to be in a position where there's not a potential exit strategy. But that's been our philosophy and I think, you know, it's for investors to really evaluate, you know, the merits of each approach. But that has been our philosophical underpinnings for the better part of two decades on that.

Karen Chong-Wulff: [0:27:40] And I think for us, we have a little difference in philosophy where we tend to use all products that are available out there, both participating and non-participating. We think like, to your point about non-participating and illiquidity, I mean like we have a laddered gate portfolio. You're going to be getting liquidity out of that on a monthly basis or a periodic basis. And, to the extent that you have credit concerns, I mean what's really important is that you do the due diligence in terms of the credit analysis, just like you buy any bond, you know, you're worried about the credit quality too. But you can sell it before, whereas in a traditional gate you can't really sell it. At the same time what you can do is also work with the issuers to have market value out-language, you know, maybe onerous but there is also make up provisions that you can work with them as well in terms of making sure that they are there when they are needed. So there's a variety of ways of overcoming some of these liquidity concerns.

Warren Howe: [0:28:39] Well, and just kind of to your point earlier when you talk about the different holdings and the different thoughts that a plan sponsor as a fiduciary needs to do when evaluating stable value, you know, I talked about certain types of who the managers are, who are the wrap providers. But perfect example, some funds will have a philosophy of a basket of different investment structures and others will not have that. And that's one of the types of things that a plan sponsor, when they're looking at would want to understand, do you use GICs? Do you not use GICs? Why? There may not be a right answer but there's certainly obviously going to be some opinions as to why, what's the benefit. And then the plan sponsor can use that as part of their due diligence to make their decision as to which one's the more appropriate for their specific demographic base.

Karl Tourville: [0:29:18] You know, and I think just probably, Warren, you might have a little more of the industry data on this. But just my general sense in terms of who would principally use non-part products. It's been our experience that we find that it's a plan that tends to just hire an insurance company as one general account GIC for the entire stable value option that provides maybe some kind of a floored guarantee. I think my sense is that would be where the vast majority of traditional GIC assets would reside, and I'm not sure if you guys have data around that.

Warren Howe: [0:29:54] Sure. And there is the traditional GIC market, fixed rate, fixed maturity over time has certainly come down; Karen, you've seen kind of the overall market size, the number of insurance companies that are issuing in that market. So it has come down. The remainder of what you see in general accounts tends to be some of these evergreen non-maturing general account structures that insurance companies offer. Many times it's full service, whether it's a 40(k) plan or a 403(b) plan. You can have all of your money just in that structure, that general account structure with no maturity, so, not quite participating, like we see in this world with synthetics and separate accounts. But there is a rate that resets on a regular basis based on the insurance company strategy.

Gillian: [0:30:39] While we're on the theme of due diligence I just want to segway slightly. Karen, you've already referred to it before, but you make use of outside sub advisors. It would be interesting to know how you make the decisions on those advisors and how you really blend them in the underlying strategy?

Karen Chong-Wulff: [0:30:50] So like participating and non-participating products, we have a blend of those products. We have the same thing for outside sub advisors or fixed income managers. One thing to remember is our firm, in terms of our DNA, we use outside managers, whether it is for stable value or all other products, we're using outside managers. We're also managing a little bit of the assets internally as well. But the combination, I think what we try to do is how do you mix these sub advisors together? And so doing some quantitative analysis in terms of optimization, a combination of that and just trying to make sure that we have best in breed managers in terms of combination. So I am looking for managers that don't correlate with each other in terms of the excess returns. I'm also looking for managers that can give me, what I call a high beta in terms of returns. So this is relative for how well they do. But in terms of certain benchmarks that I'm going to be using, so a combination of those, getting the right mix of managers too is really important. And then also being sensitive to fees as well, and that combination is real key in terms of making sure that we have a mix of managers that are performing well for the portfolios.

Karl Tourville: [0:32:06] I might add too, just a key criteria that one should take when assessing any external managers to a portfolio is just their familiarity with stable value and how consistent their approach is with the philosophy of stable value, which is return of principal and minimal crediting rate volatility. What you really want to avoid is adding these managers that are really moving durations around a whole lot, which can create volatility, quarter to quarter on crediting rates. Or taking big bets in individual corporate issuers that could go, you know, could go south pretty quick. And the example I always use is, you know, 2% position in an individual corporate maybe doesn't sound like a whole lot, but when corporate bonds go down, you know, you can easily lose 30% on that, if there was a default or a big price drop like an Enron situation, etc. That would hit the stable value portfolio, that 2% on 30 points, to the 2% and 60 basis points, which would be catastrophic for … to see a participant, you know, have a hit like that, if that were the high allocation. And that's a little bit of an extreme example. But you know, I think that the point is you've got to be very selective on who you use as an external manager. And you know look at things beyond just expected alpha.

Warren Howe: [0:32:53] And that's a great point, from a wrap provider's perspective that's exactly what we look at. It's important to look at who is going to be the underlying manager and what is their experience, not just in the mandate for which they're being asked to manage the portfolio, but just in general. Are they more of a total return manager who's not used to having any investment guidelines or very broad investment guidelines, so they can kind of shoot for the stars? Or do they understand, to Karl's point, this is all -- the stable value is all -- about capital preservation and a reasonable return and running more constrained portfolios that are more appropriate for that kind of a risk profile.

Gillian: [0:33:27] And, Warren, staying with you for a second, it's funny talking about the blending of underlying managers, it reminds me of all the target date fund conversations that we have here. So it actually reminds me that custom target date funds have a place for stable value. And can you talk to us a little bit about what the value add would look like for stable value within a target date fund construction?

Warren Howe: [0:33:44] Well, it's very interesting because if you look at stable value now, it's about $820 billion or so are the numbers that we see for the size of the asset class. And if you went back 10/ to 15 years, stable value got the predominant amount of the kind of the default investments, if you will. But then target dates have come along and over a 10- year period they have gone from virtually zero to somewhere north of a $1 trillion, kind of in that time. So they have grown dramatically. And because they're mutual funds, stable value has not been a component of that. So kind of during this ramp up period, plan sponsors found it very easy to kind of just look at a mutual fund company series of target dates and kind of offer that series of target dates. But if you think about it, as a fiduciary, when you select the investment options for your plan, you're doing, to Karen's point, due diligence on each of those different offerings that you're going to have. And you've spent the time and you've done the due diligence and you've selected the investment options. When you select a target date fund, you're not really doing that, you're kind of just selecting the target date fund and maybe the firm that's doing it. So it gives you the ability to kind of go to custom target date and what we have seen is about a doubling of that. I think it's up to about $200 billion now have gone into custom target date. And that gives a plan sponsor flexibility, it gives them more control, and if they want to change out a component within their core lineup that they're overlaying the glide path on, they can change that out. They have that control. With an off-the-shelf target date they don't have that control. It's kind of a one- size- fits- all mentality.

Gillian: [0:35:13] And with let's say stable value in your fixed income portfolio, if you're looking at your equity side, could you be a bit more aggressive then?

Warren Howe: [0:35:19] Sure. You have the ability to do one of two things. You have a lower volatility with stable value than with the purer fixed income component. So you can kind of lower the volatility with the returns. Or if you want to kind of take a look at that and say, "Well, we've got, this is a little smoother with our stable value allocation. We don't have to worry about negative returns." Maybe the glide path now has a little bit more exposure to equities to kind of take advantage of that sector as well.

Gillian: [0:35:43] Karl, have you seen an increase in the pick up of custom target date funds in stable value within or are you still kind of waiting for that pick up to take place?

Karl Tourville: [0:35:49] Yeah, I think that represents a modest opportunity for the industry going forward. As Warren mentioned, you know, $1 trillion, most of it in mutual funds, which puts this out of our space. But to the extent that collective comingled funds, CITs become more predominant, people become comfortable with their own separate accounts, it could. We have about 20% of our separate account base uses custom target date funds with their stable value option that we manage in them. So it's clearly there and an opportunity. But I think we also do have to remember that the allocation of stable value within a custom target date fund is probably going to be 15% on average, so a component. But that said, growth is good and, you know, we'll take opportunities where we can find them.

Gillian: [0:36:43] And, Karen, it begs the question, where can further growth come for this stable value market? Obviously we do have some laggards from the Money Market Reform that may eventually migrate. But what else are you looking at?

Karen Chong-Wulff: [0:36:54] So I mean in addition to custom target date funds, I think to the extent that are complex and offer a series of comingled trust funds or CITs, you could actually offer a target date fund series with stable value as part of it. This is something that may be a good growth for anyone who may be offering it alongside perhaps with target date funds sit on mutual funds, depending on how they are looking at it. So I think that's really important in terms of potential growth. And I think it behooves us an industry to make it happen as well. I think number two, too, is just going forward, I think about like we're so worried about the accumulation phase and making sure we have stable value. One thing I think about is what's going to happen to the decumulation phase? Could we insert stable value in there as well? And I know, I'm sure we're going to be trying to talk about this as an industry to also be able to garner more assets under management and other applications in terms of stable value, whether it is health savings plans or something of that sort. I think we need to also be open what with folks like Warren, in terms of product providers, to be able to see whether it is conducive to offer stable value.

Gillian: [0:38:09] Now, Warren, one thing that I just thought of is actually we're still waiting about the future of the DOL Fiduciary Rule, could this potentially give a tailwind to stable value providers and how?

Warren Howe: [0:38:19] We do think that that's a high likelihood. So now when you look at this increased fiduciary standard that goes on financial advisors when they may recommend a rollover out of a 401(k) plan and into an IRA, the data that we have seen indicates it's about

$400 billion a year leaving defined contribution plans and going to rollovers. And if you have advisors who now have this higher fiduciary threshold when they're making that recommendation to participants, and if you're in your 401(k) plan, you're not paying the transaction cost. You've got institutionally priced funds, kind of the lower fee structure. When you move into an IRA, a lot of that goes away and you're going to have some of the higher fees, and you're going to bear the cost of the transaction costs. So that may make it less likely. And some of our estimates are if it just got cut in half what rolled out, that would be $200 billion a year staying in DC plans and stable value tends to be 10%, 12%, 15%. You can start to do the numbers. And you're talking $20-30 billion a year that remains in, gives you a lot more assets to kind of help grow. And then that brings in Karen's point about decumulation, because now you will have people who are retired remaining in retirement plans and have a need to drawdown and the important role stable value can play there to decumulate those assets.

Gillian: [0:39:32] And I think a lot of our advisor watchers are laughing a little bit because they've never thought about the DOL Fiduciary Rule as a tailwind for anything. But it could be for stable value. Karl, when you look ahead to the future both in terms of the growth of the industry, maybe DOL, but do you see any kind of changes coming in fee structures as well, where is wrap pricing going?

Karl Tourville: [0:39:58] You know, wrap pricing we're starting to see begin to move down. I know Warren takes a big exception to this information. But you know, nonetheless, pricing pressures are predominant in every aspect of this business right now, for ETFs etc. And I think that we need to see wrap pricing come down, not maybe in such a major way, I'd say the average right now call it 20-22. I think over the next number of years if that pricing could come down to call it 17/18 on average. I feel like that that's a pretty decent equilibrium level that will compensate folks for taking the risk of doing wraps and maintaining a health supply, without, you know, without having fees excessively high because as I mentioned earlier in the conversation, there is an increased focus on all fees, not just manager fees. So we've been squeezed forever. Now they're kind of dialing in on the rest of them.

Gillian: [0:40:47] Everyone else is feeling your pain.

Warren Howe: [0:40:49] Yeah, it's across, it's everything, it's recordkeeping fees, it's investment management fees, it's wrap fees, just in general there is a pressure on fees going down. And that comes into should you have passive management versus active. So it's all about fees, fees, fees. So to Karl's point I think the direction of wrap fees has been down, not necessarily quickly. But you know, it will kind of migrate and level out at where the market price should be.

Gillian: [0:41:15] And, Karen, any further thoughts on where they're going?

Karen Chong-Wulff: [0:41:17] Yeah, I definitely agree to that as well. I think an offset to that is flexibility in terms of guidelines and contractual provisions as well. So if I'm, you know, asking for lower fees I should be expecting more flexible guidelines to some extent. So there's kind of a balance. And like Karl said, you know, this is an industry that we want to maintain it to be healthy. And we don't want to push fees so low that people like Warren cannot offer a profitable product. It just doesn’t make sense at all. So it is really important to kind of strike that balance across.

Karl Tourville: [0:41:48] And that’s, you know, I’ll just say, that’s what really put the industry in a bit of a problem scenario back in ‘08/’09, because pricing had come down so low, and I’d say probably the average price was 8-10 basis points. And what happened then is you had supply just compress down so people could get scale and be able to make money at the lower rates. And so then you go from, you know, kind of down to seven to eight wrap providers that really dominate the market. And then we have ‘08/’09 happen, suddenly five of them pull out. Pricing hasn’t been good enough to attract other players and then you’ve got a supply shortage, which we did. And as rates, as fees came up, supply and demand kicked in perfectly. We have a lot more wrap providers today; I want to say I think there’s 16. So it really did bring in and stabilize the market more.

Warren Howe: [0:42:40] And it’s interesting because it is, to Karen’s point, it’s a more holistic approach. Fees are one component. And as Karl said, there’s fee pressure. So fees will be a component. But it’s what’s the credit quality of who’s providing that wrap? What’s the flexibility of the guidelines? What’s your contract language look like? How committed is your wrap provider to the market in all different scenarios? So all of that goes together but, yes, fees are kind of … the trajectory is a little bit down. But all these other things kind of come into value, not just fees on their own.

Gillian: [0:43:11] And it really comes down to that theme of due diligence that we’ve had again and again. We’re coming to the end of our discussion. So first of all I want to thank you all for taking the time to share your views with us. But I just want to give you each an opportunity to give us some closing thoughts, maybe a call to action for someone that’s considering stable value and, Karen, I’ll kick it off with you.

Karen Chong-Wulff: [0:43:26] I think I’m going to repeat what I said earlier on. I think we need to be innovative. And we need to make it happen. This target date funds about mutual fund format and therefore we cannot penetrate, I think it’s so important for us to look at CIT structures and think about, hey, how do we offer stable value here? So I think that’s first and foremost very important. I also think that this industry is very healthy. You know, we’ve talked about this earlier on about being healthy. And I think the ingredients are there to help us facilitate the growth that we need. And then, of course, we talked about decumulation and how we should seek products that give us stable value as well.

Gillian: [0:44:03] So in a good place, time to push forward, Warren.

Warren Howe: [0:44:07] I would agree with what Karen said. I think target date funds are an important component given, you know, that’s where a significant amount of the dollars are going. And the growth is projected to be astronomical over time. Having stable value find a way to get in that, not just a custom portfolio but in more of an off-the-shelf offering, whether it’s in a CIT structure, that’s extremely important. And then kind of a call to action for plan sponsors is if you’ve only gone into government money market to kind of park your money, take your time to do your fiduciary duty, do the analysis, understand the return differences between a government money market fund and what stable value can provide for your participants. And what that means to their retirement, and take a fresh look and be sure. You might want to consider the move to stable value.

Gillian: [0:44:47] Excellent. And Karl, take us home.

Karl Tourville: [0:44:49] Well, might just say just from the standpoint of stable value, as I mentioned earlier. I don’t think this industry has ever been in a stronger position than it is today. Portfolios are healthy, performance is strong versus alternatives. We’ve got a health supply of wrap providers, transparency in the market has never been higher, understanding of the product. But I think the value proposition is, as it always is, and that’s been really strong. And so I think it’s an industry that has a lot of legs, a lot of staying power and, you know, we expect it to continue to do very well in the future.

Gillian: [0:45:24] Okay. So we’re in a good place. And we look forward to looking ahead to some of the new innovations coming for stable value. And we’ll have you all back to recap in a couple of months to find out where we’re headed. So, thank you for coming in. And thank you for tuning in. From our studios in New York, I’m Gillian Kemmerer. And this was Asset TV Masterclass.