STABLE VALUE INSIGHTS

PROVIDING INVESTORS THE SAFETY & SECURITY TO NAVIGATE RISING INTEREST RATES

GALLIARD CAPITAL MANAGEMENT

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KEY POINTS

- The Fed has taken initial steps to unwind its accommodative policy, raising its federal funds target rate and projecting further increases to follow this year.
- Typically, bond portfolio values decline with rising interest rates; however, stable value investments are particularly attractive during periods of rising interest rates because of the principal protection provided by stable value contracts.
- Stable value investments have generated long-term returns that are comparable to short- to intermediate-term bonds, with return volatility that has been similar to money market funds.
- When interest rates increase, the underlying bond portfolio's cashflows can be reinvested at higher rates, which should translate to a higher crediting rate all else equal.
- Historical experience suggests a very small probability of money market funds outperforming stable value on a consistent, long-term basis.
- Stable value's attractive long-term returns and limited return volatility offer significant benefit to savings plan investors, whether stable value is used as a significant allocation for a participant in or nearing retirement or as a diversifying allocation in a portfolio of riskier assets.

CURRENT STATE OF THE MARKET

With the post-pandemic economic recovery and global supply chain constraints sustaining inflationary pressures, interest rates have risen significantly in the last year. Market forces have pushed short- to intermediate-term Treasury bond yields higher, with the yield on the 3-year U.S. Treasury Bond rising more than 250 basis points to 2.87% in the year ending April 30, 2022. Almost 200 basis points of this increase has occurred in 2022 alone[1]. Following initial steps to unwind its accommodative policy stance in 2021, the Fed raised its federal funds target rate for the first time since 2018 in March 2022[2], implemented the first 0.50% increase since 2000 in May 2022, and has projected further increases to be implemented at subsequent FOMC meetings. After more than a decade of tame inflation and relatively low interest rates (from the financial crisis of 2007-08 through the COVID-19 pandemic), financial markets have experienced increased volatility as they grapple with expectations for elevated inflation and higher interest rates. In this climate of elevated inflationary pressures and rising rates, stable value investments' unique combination of return potential and low volatility provides an especially attractive asset for savings plan investors.

STABLE VALUE OVERVIEW

The popularity of the stable value asset class over time derives from delivering upon its primary objective of principal preservation, while generating an attractive rate of return with low volatility. Stable value investments seek to achieve these high risk-adjusted returns through the combination of broadly diversified, high-quality fixed income securities with the use of stable value investment contracts issued by banks, insurance companies, and other financial institutions. The use of stable value contracts (also known as stable value wrap contracts) allow investors to incrementally earn the returns generated by the underlying bond portfolio, while insulating them from market price volatility. This value proposition is particularly attractive during periods of rising interest rates, as we have experienced over the last year and are likely to continue to see in the foreseeable future.

Though essentially a fixed income investment, a stable value fund's wrap contracts are designed to protect investors from losses by amortizing declines in the underlying bond portfolio's market value due to changes in interest rates or other factors. While an increase in interest rates will typically cause the market value of a bond portfolio to decline, a stable value contract seeks to smooth the underlying bond portfolio's returns, earning a relatively consistent rate of return that typically follows the trend of market interest rates over time. When interest rates increase, the underlying bond portfolio's cash flows can be reinvested at higher rates, which should ultimately translate to a higher crediting rate for stable value investors all else equal. As a result, stable value investors are protected from unrealized mark-to-market losses in a rising rate environment, while gaining the benefit of reinvesting at higher interest rates.

Stable value's combination of underlying bond investments with the protection of stable value contracts is unique. Generally accepted accounting principles allow stable value contracts to be valued at contract value (also referred to as "book value"), rather than at the market value of the underlying investments. This treatment is afforded because the contract issuers guarantee that eligible plan participants can transact at contract value under the normal operation of their savings plan. Typically, contract value is equal to the original principal covered by the contract and the interest accrued at the contract's crediting rate[3]. Importantly, the contract's issuer guarantees a crediting rate no lower than 0% (thus providing day-to-day principal protection). Each contract's crediting rate is reset on a periodic basis and is based on the current contract value, the underlying bond portfolio's market value and yield, and an amortization period based on the bond portfolio's duration. The crediting rate resets periodically to amortize gains or losses (differences between contract value and market value), generating the smoothed return profile that is the hallmark of stable value.

STABLE VALUE PERFORMANCE ACROSS MARKET CYCLES

Historically, stable value investments – represented here by the Galliard Stable Return Fund – have generated long-term returns that are comparable to short- to intermediate-term bonds, reflecting the returns of the underlying fixed income securities in which they invest. Importantly, they have generated these returns with return volatility that has been similar to money market funds (see Figure 1). In periods of rising short-term interest rates, stable value investments' return advantage over money market funds tends to narrow, as shorter-term investments typically react more quickly to changes in market rates. In the last 40 years (generally representing the history of the stable value asset class), there have been six full interest rate cycles (see Figure 2), each characterized by expanding economic growth leading to inflationary pressures, more restrictive monetary policy, and rising short-term interest rates. A positively sloped U.S. Treasury yield curve has

FIGURE 1: RISK/RETURN COMPARISON

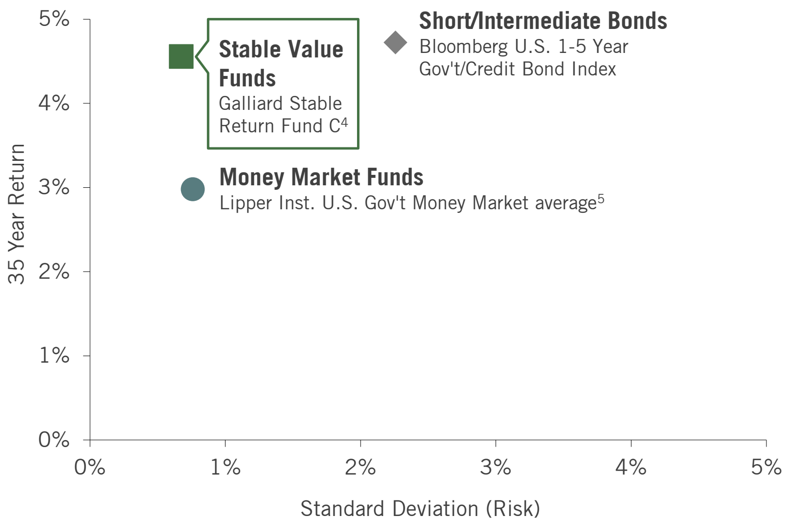


FIGURE 2: CONSTANT MATURITY TREASURY INTEREST RATES SINCE 1982[6]

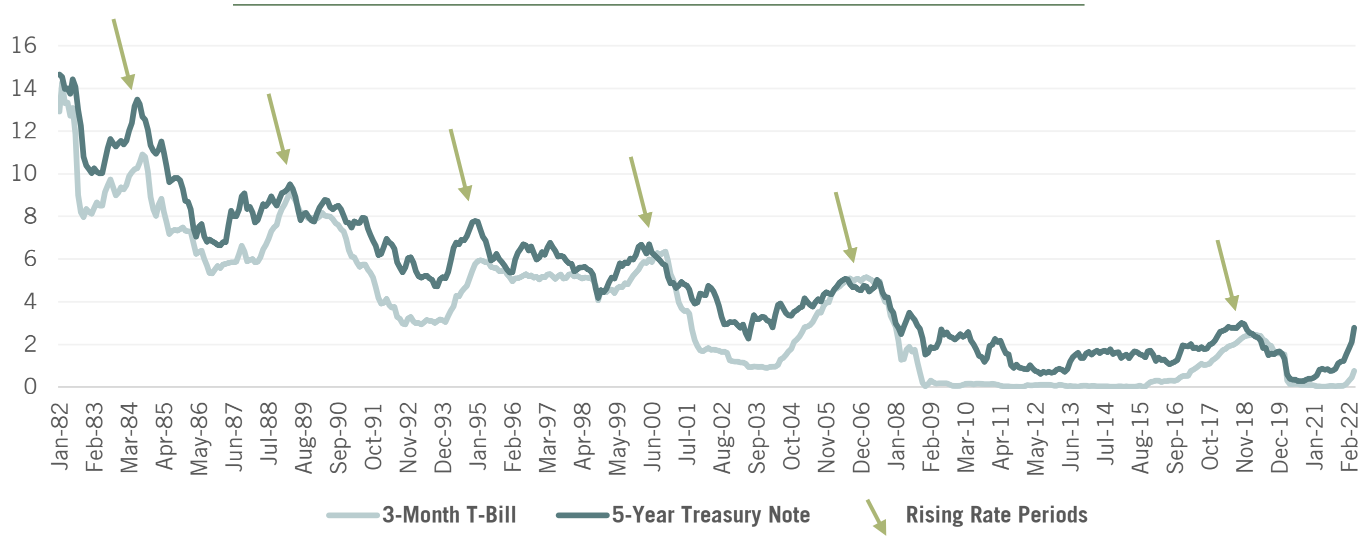


FIGURE 3: PERIODS OF INVERTED YIELD CURVES SINCE 1982

Inversion Period	# of Months	Average Magnitude of Inversion (3Mo vs 5Yr)
June 1989 - Aug 1989	3	0.18%
Aug 2000 - Feb 2001	7	0.42%
July 2006 - May 2007	11	0.35%
March 2019 - Oct 2019	8	0.26%

Average Duration (# of months)	7.25
Average Magnitude	0.30%

FIGURE 4: TOTAL RETURNS DURING PERIODS OF INVERTED YIELD CURVES

	TOTAL RETURNS		
Inversion Period	Money Market Funds[5]	Galliard Stable Return Fund C[4]	Money Market Excess Returns
June 1989 - Aug 1989	2.24%	2.05%	+0.19%
Aug 2000 - Feb 2001	3.59%	3.62%	-0.03%
July 2006 - May 2007	4.71%	4.23%	+0.48%
March 2019 - Oct 2019	1.44%	1.50%	-0.06%

prevailed for most of this period; however, the yield curve occasionally can become "inverted"—a situation in which short-term rates exceed longer-term rates. In such an environment, short-term investments may command higher yields, at least in the short run, relative to stable value investments. While there have been instances during this period when money market funds have outperformed stable value, these periods have been relatively short-lived.

Since the beginning of 1982, there have been four instances in which the U.S. Treasury yield curve remained inverted for a period of three months or more (see Figure 3), as measured by the average monthly market yield on U.S. Treasury securities at 3-month constant maturity relative to the average monthly market yield on U.S. Treasury securities at 5-year constant maturity. The number of curve inversions correlates closely with Fed policy and the U.S. economic cycle. These periods of inversion lasted an average of just over seven months with an average magnitude of 0.30% (the largest average monthly inversion was 0.77% in December 2000). Comparing money market returns with the Galliard Stable Return Fund's returns during these periods shows that money market funds did not dramatically outperform during these periods of inverted yield curves (see Figure 4). In contrast, the Galliard Stable Return Fund outperformed money market funds by an annualized margin of 1.58% annualized over the last 35 years[7].

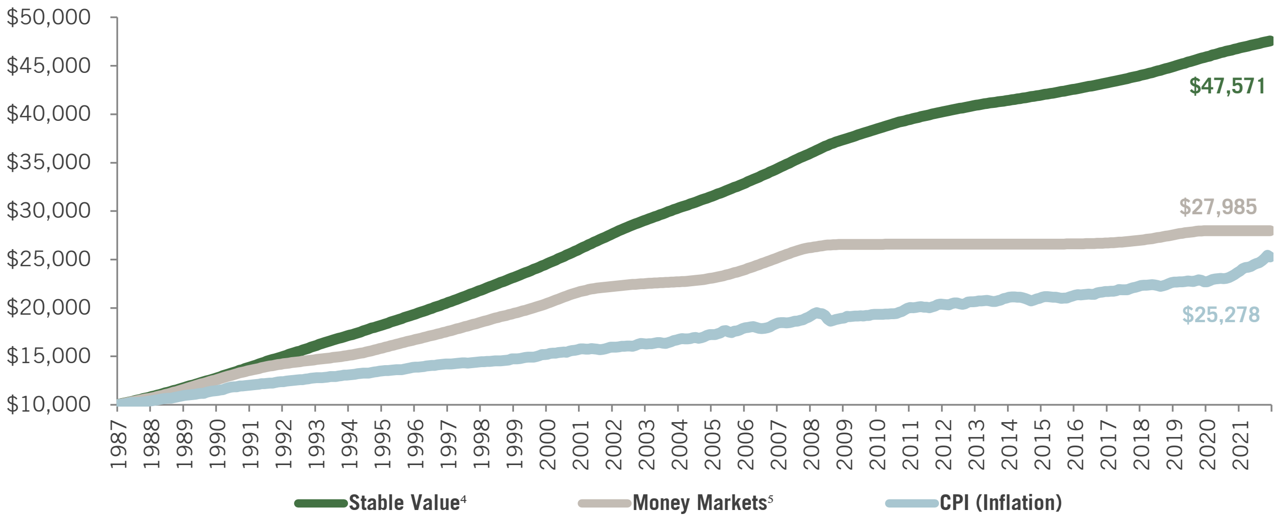
PRINCIPAL PRESERVATION WITH LOW RISK OVER THE LONG-TERM

During each of these periods, stable value investments have generally delivered on their primary objective of providing principal preservation and a competitive yield versus other low-risk alternatives. Though it is likely that short-term interest rates will continue to rise in the near-term and that inflationary pressures will persist, historical experience suggests a very small probability of money market funds outperforming stable value on a consistent, long-term basis. As recent record inflation that has significantly outpaced stable value and other fixed income investments has shown, stable value investments do not provide a hedge against inflation; however, they have demonstrated an ability to generate real returns over the long term (see Figure 5). Additionally, stable value investments have maintained their near-zero correlation to equity investments during these periods in which both fixed income and equity investments have experienced negative returns. Thus, stable value's attractive long-term returns and limited return volatility offer significant benefit to savings plan investors, whether stable value is used as a significant allocation for a participant in or nearing retirement or as a diversifying allocation in a portfolio of riskier assets.

THE IMPORTANCE OF A WELL-MANAGED STABLE VALUE FUND

With the significant increase in interest rates, many stable value funds are now operating with underlying bond portfolio market values that are less than the contract value guaranteed by stable value contract issuers. While the risk exposure to stable value contract issuers is greater when market-to-book-value ratios are below 100% (or "par"), a well-managed stable value fund seeks to mitigate these risks via issuer oversight,

FIGURE 5: GROWTH OF $10,000 OVER 35 YEARS[8]



diversification, and strong contract terms. Plan sponsor-initiated withdrawals from stable value funds potentially require more diligence when market-to-book-value ratios are less than 100%; thus, plan sponsors should work closely with their stable value manager to minimize, to the extent possible, any adverse impact to the stable value fund resulting from such events.

As fixed income investors, we are attuned to the impact of rising interest rates on bond portfolio valuations, but we believe that stable value offers savings plan participants unique protections against these risks. Increases in interest rates provide opportunities for us to reinvest our stable value portfolios' underlying assets at higher yields and should result in higher crediting rates and greater earnings potential for stable value investors going forward. Meanwhile, stable value's unique principal protections give investors the safety and security needed to navigate this volatile period of transition more confidently. With a foundational understanding that the stable value funds we manage are the "safe" option offered in most defined contribution plans[9], we are careful to conservatively position our funds against potential risks to continue providing a principal protected investment that plan participants can count on to meet their retirement savings goals.

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Endnotes

Past Performance is not an indication of how the investment will performance in the future.

1 U.S. Department of the Treasury. "Interest Rate Statistics." *U.S. Department of the Treasury*, https://home.treasury.gov/policy-issues/financing-the-government/interest-rate-statistics. Accessed 12 May 2022.

2 Board of Governors of the Federal Reserve. "Federal Reserve issues FOMC statement." *Federal Reserve Board*, 16 March 2022, https://www.federalreserve.gov/newsevents/pressreleases/monetary20220316a.htm. Accessed 12 May 2022.

3 Board of Governors of the Federal Reserve. "Federal Reserve issues FOMC statement." *Federal Reserve Board*, 4 March 2022, https://www.federalreserve.gov/newsevents/pressreleases/monetary20220504a.htm. Accessed 12 May 2022.

4 Galliard Stable Return Fund C is 100% invested in the Galliard Stable Return Fund Core. While the Galliard Stable Return Fund Core has been in existence since 1985, Fund C has only been available with an Investment Management fee of 30 bps from June 1, 2006 - June 1, 2020, and 20 bps since July 1, 2020. In order to illustrate the impact of these fees against the historical gross performance of the Fund, the historical gross performance of the Fund has been reduced by 30 bps, in addition to certain other fees applicable for the periods reported, and the resulting amount is reported as performance "after fees."

5 Source: Lipper Institutional Money Market Fund performance. The Lipper US Index – Inst U.S. Govt Money Mkt is an average of funds that invest principally in financial instruments issued or guaranteed by the U.S. Government, its agencies, or its instrumentalities, with dollar weighted average maturities of less than 90 days. These funds are eligible to keep a constant net asset value. The total return of the Lipper Average does not include the effect of sales charges. You cannot invest directly in a Lipper Average.

6 Source: Bloomberg

7 Excess return of the 35 year annualized return as of April 30, 2022 for the Galliard Stable Return Fund C (4.56%) and the Lipper US Index – Inst U.S. Govt Money Mkt (2.98%).

8 The growth of $10,000 is a hypothetical illustration based on the growth of returns of the Galliard Stable Return Fund C since April 1987 through March 2022. The growth of $10,000 is shown after all fees. The growth of Money Markets shown is based on the returns of the Lipper US Index – Inst U.S. Govt Money Mkt returns which is net of all fees. The growth of the CPI which is a proxy for inflation is based on the CPI all Urban data from the Bureau of Labor Statistics.

9 Caswell, John R. and Tourville, Karl. *The Handbook of Stable Value Investments - Edited by Frank J Fabozzi*, "Managing Synthetic GIC Portfolios." New Hope, Pa.: Frank J. Fabozzi Associates, c1998.