STABLE VALUE
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PERSPECTIVES

Stable Value: Unique Protection in a Rising Rate Environment

At its core, stable value is a fixed income investment, so it stands to reason that plan sponsors, consultants, and stable value investors may be concerned about the prospect of rising interest rates. However, we believe that the unique protections provided by stable value will benefit investors in a rising rate environment.

Should stable value investors brace themselves for a rising interest rate environment?
While certainly a risk in the minds of all fixed income investors, rising interest rates should not be cause for undue concern for those invested in stable value. In fact, we expect that rising rates will ultimately benefit stable value investors. Though essentially a fixed income investment, a stable value fund offers the added protection of investment contracts (issued by banks and insurance companies) that are designed to protect investors from losses resulting from rising interest rates. While an increase in interest rates will typically cause the market value of a bond portfolio to decline, a stable value fund seeks to smooth the underlying bond portfolio's returns, earning a relatively consistent rate that generally tracks market rates over time. Rather than recognize mark-to-market losses immediately, a stable value fund's investment contracts are designed to amortize declines in market value and protect investors from the volatility that a bond fund might experience due to changes in interest rates or other factors.

How would an increase in interest rates benefit a stable value investor?
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. A stable value fund's investment contracts protect its investors from the mark-to-market losses associated with rising rates by smoothing the bond portfolio's returns over time. This is accomplished via the contracts' crediting rate mechanism, which we will discuss later. Because the contracts smooth the return profile

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of the underlying bonds, the yield (or crediting rate) earned by stable value investors tends to generally track current market rates with a lag. As a result, in a rising rate environment, stable value investors gain the benefit of reinvesting at higher rates, while being protected from the associated mark-to-market decline in market value. Looking at historical data, we can see that stable value crediting rates have tracked changes in market rates on a lagged basis. We expect the same to hold true going forward.

The combination of underlying bond investments with these types of investment contracts is unique to stable value. How do these contracts work and how does the crediting rate mechanism insulate participants from movements in bond prices resulting from changes in market interest rates.

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 the ability for participants to transact at contract value under normal circumstances. Typically, contract value is equal to the original principal covered by the contract and then accrues interest based on the contract's crediting rate.[1] Importantly, the issuer guarantees a crediting rate no lower than 0% (thus providing principal protection). Each contract's crediting rate is reset on a periodic basis and is based on the current contract value and the underlying bond portfolio's market value, yield, and duration. As the underlying portfolio's market value fluctuates, the stable value investor does not experience any price volatility directly because the stable value fund's net asset value is determined based on contract value. Instead, the crediting rate resets periodically to amortize gains or losses (differences between contract value and market value) over time, providing the smoothed return profile that is the hallmark of stable value. Thus, investors in a stable value fund can experience returns that are comparable to short- to intermediate-term bonds but with return volatility that has historically been similar to or even less than that of a money market fund.

So the crediting rate is the yield an investor will earn instead of a market value return?

In simple terms, the crediting rate is the interest rate earned by the stable value investor on his or her balance in the stable value fund, and it is expressed as an effective annual yield. For stable value funds that utilize more than one investment contract (and most Galliard-managed stable value funds are diversified among multiple contract issuers), investors earn the average credited rates of interest on all of the investment contracts held in the fund. Because stable value contracts essentially smooth the returns of the underlying fixed income investments, a stable value investor should ultimately earn the long-term market value return of the underlying bond portfolio less the fees paid for the contracts' insurance, investment management fees, and other applicable expenses.

1. Contract value may also be adjusted, as needed, for deposits, withdrawals and certain accounting requirements.

The market-to-book-value ratio of a stable value fund — the ratio of the market value of a stable value fund's underlying assets to the carrying value of its stable value contracts — has been touted as a key indicator in assessing the overall "health" of a stable value fund. Could rising interest rates lead to a market-to-book-value ratio that is less than 100%?

Absolutely. In fact, market-to-book-value ratios will likely drop below 100% in a rising rate environment. This is by design and to be fully expected over a normal interest rate cycle. It is important to note that a declining market-to-book-value ratio is evidence of the stable value contract protecting the fund's investors from mark-to-market declines in the value of the underlying bond portfolio.

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The market's current focus on the market-to-book-value ratio is understandable in light of the pressures certain stable value funds experienced through the 2007-08 financial crisis and the extended period of time since then that the average stable value fund has maintained a ratio above par (greater than 100%). While a ratio above par has generally characterized healthier stable value funds in recent years, a market-to-book-value ratio above par is not the be-all indicator of the overall health of a stable value fund. It is important to understand that stable value funds are expected to experience periods in which the ratio is below par over the course of a market cycle. Since these periods generally also correspond to an upward movement in interest rates, the underlying bond portfolio's earnings power typically increases as the market-to-book-value ratio declines. This increased earnings power means a portfolio can amortize its market value deficit more quickly, all other things being equal. Therefore, a fund's market-to-book-value ratio should be evaluated relative to the prevailing market environment, rather than as a stand-alone measure. With improved economic conditions and a steady pace of Fed policy rate increases, short- to intermediate-term interest rates have increased significantly. Many stable value funds have shifted from operating with a market value surplus to a market value deficit. While the risk exposure to stable value contract issuers is greater when market-to-book-value ratios are below par, a well-managed stable value fund will mitigate these risks via issuer oversight, diversification, and strong contract terms. Plan sponsor-initiated withdrawals from stable value funds are also of greater concern when market-to-book-value ratios are less than 100%; thus, plan sponsors must 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.

Rising interest rate environments aren't new to stable value. How has stable value as an asset class fared during previous periods of rising interest rates?

The stable value asset class has a track record spanning more than 30 years, and Galliard's stable value funds have performed as expected in a variety of market

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environments. For example, our stable value funds have continued to deliver upon their investment objectives through periods where rising rates resulted in a market-to-book-value ratio below par, as was seen in the 1998-1999 and 2003-2005 time periods. Even though the market-to-book-value ratio of Galliard's stable value composite touched 97% during these two time periods, the funds' stable value investment contracts amortized these losses through the crediting rate mechanism and performed as expected, while producing positive returns that were higher than money market funds and comparable to short- to intermediate-term bond funds.

So despite the prospect of rising rates, there isn't concern about the ability of stable value to continue performing as expected?

As fixed income investors, we are keenly aware of the impact of rising interest rates on bond valuations, but we believe that stable value offers investors unique protections against these risks. While dramatically rising rates — characteristic of a hyper-inflationary environment, for example — could negatively affect stable value yields, we expect more moderated increases in rates to be healthy for the stable value asset class. Manageable increases in rates allow reinvestment at higher yields and should result in higher crediting rates and greater earnings potential for stable value investors. That said, we believe the current interest rate environment is unique in the contextual history of stable value, and we are focused on deploying strategies that will enable our stable value funds to meet the challenges of the years to come. Understanding that the stable value funds we manage are often the most conservative option offered to plan participants, we are careful to conservatively position our funds against potential risks in order to provide a principal protected investment that plan participants can count on to meet their retirement savings goals.