State of Stable Value

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MAINTAINING PERSPECTIVE

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Since the Fed's dramatic inflation-fighting increases in short-term interest rates from March 2022 to July 2023, the U.S. economy's continued strength has led the Fed to be patient in its approach to relaxing monetary policy. As a result, short-term rates have remained at multi-decade highs for most of the last year, buoying the returns of money market funds and other short-term investments. This prolonged period of high short-term rates has also raised questions among defined contribution plan participants, plan sponsors, and their advisors about the competitiveness of stable value investments. While shorter-term investments have indeed outperformed over the near-term (and have done so significantly), we believe that stable value investments remain attractive when viewed over the longer time horizons of savings plan participants and that stable value investments are poised to again outperform as we return to a more normal positively sloped yield curve.

The recent interest rate environment has been uniquely unfavorable for stable value investments and has prompted investors to question why their stable value investments have posted returns that have trailed money market rates and the rate of inflation. The U.S. Treasury yield curve has remained in a record-long inversion since July 2022 (see Figure 1 below) and the term premium for U.S. bonds has been in decline (and often negative) since 2008's great financial crisis (see Figure 2 on next page).

FIGURE 1: U.S. TREASURY YIELD CURVE RATES

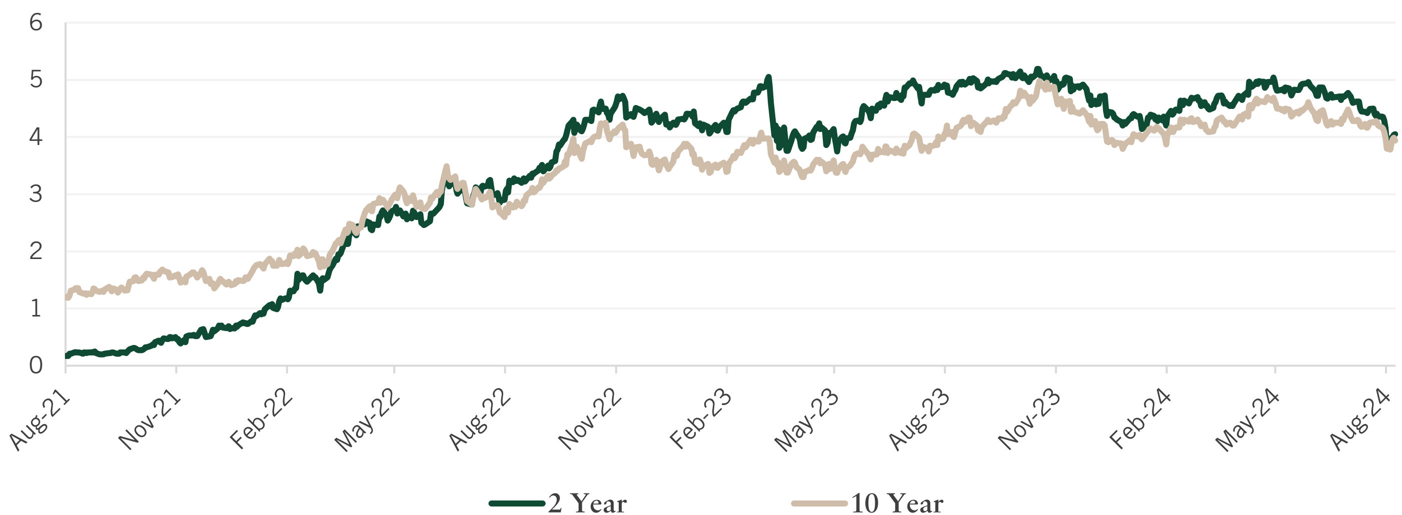

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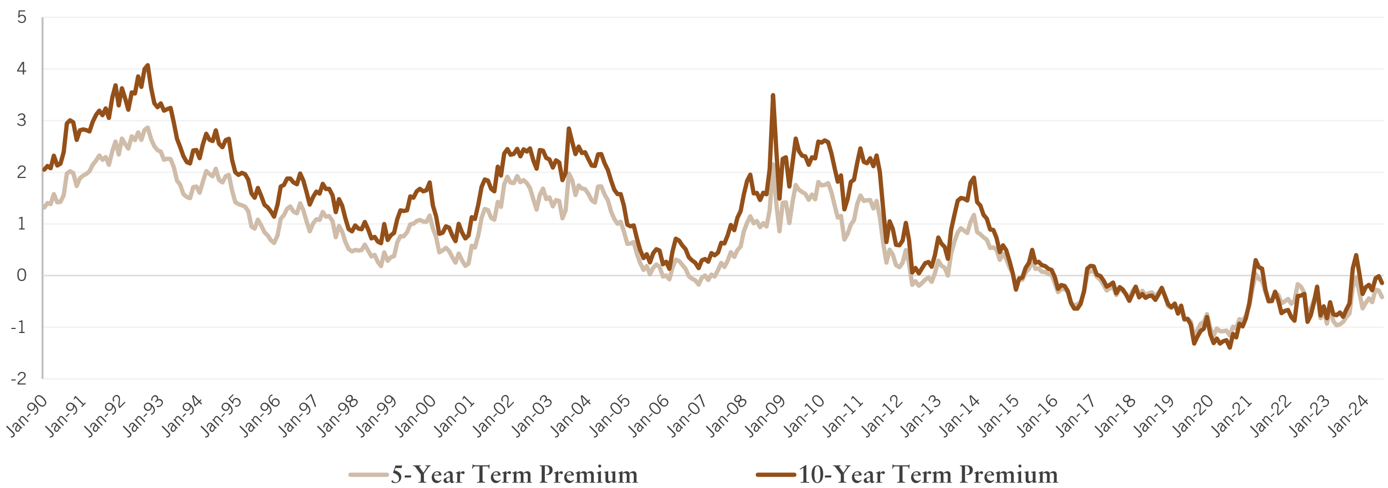
FIGURE 2: U.S. TREASURY TERM PREMIUM SINCE 1990[1]

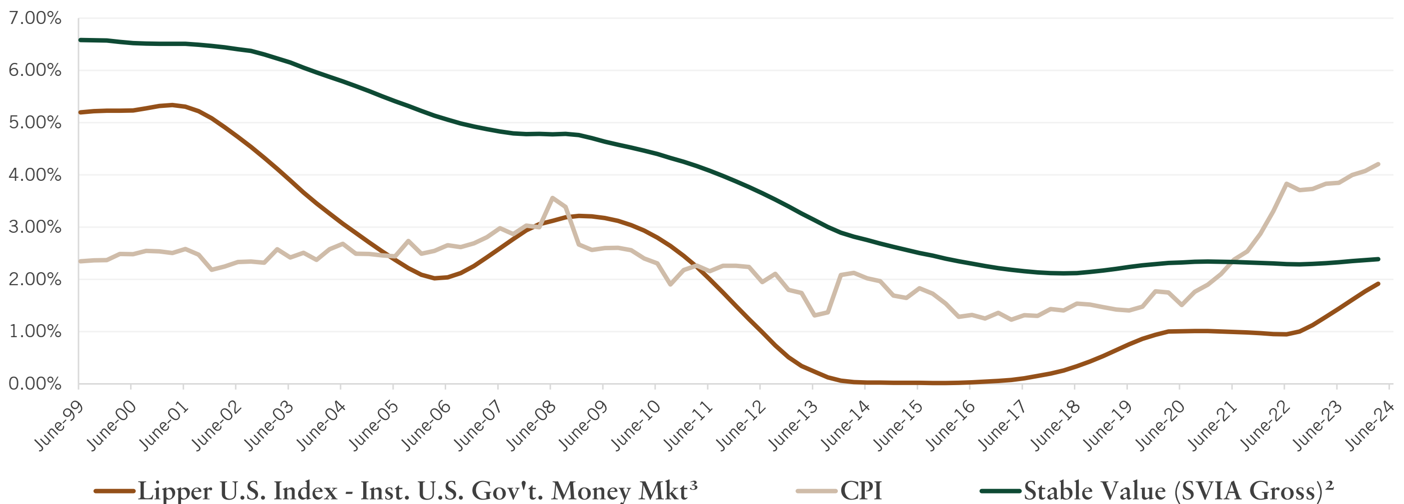


A stable value fund's crediting rate, or current rate of return, has often been described in general terms as following the trend in market interest rates but with a lag. This owes to stable value products' underlying investments in intermediate-duration investment grade bonds and to the smoothing effect of their stable value investment contracts. Historically, this generalized description of expected stable value fund behavior has been sufficient to address questions about their relative performance in transitory rate environments; however, the 525 basis point increase in the Fed's policy rate in 2022-2023 has overwhelmed the historic yield advantage that stable value funds have maintained over principal preservation alternatives – like money market funds – and has created the significant gap in near-term returns.

Despite these recent headwinds, long-term results paint a more constructive picture. Over the longer-term, investors should be compensated for taking the risk of holding longer maturity bonds, and stable value funds were designed to capture this risk premium while providing day-to-day principal protection. When evaluating rolling 5-year return periods over the last 25 years through March 31, 2024 (see Figure 3 below), stable value returns,[2] on average, have outperformed money market funds in every one of the 100 quarterly observations during that period.

Stable value returns[2] have also outpaced inflation in more than 85% of those rolling 5-year quarterly periods over that same 25-year span, with most of the underperformance owing largely to the post-pandemic spike in inflationary pressures that saw annualized rates of inflation exceeding 8% for much of 2022.

FIGURE 3: ROLLING 5-YEAR ANNUALIZED RETURNS



LOOKING AHEAD

When will stable value investments begin to outperform money market funds again? The answer requires predicting the future path of interest rates – a notoriously difficult prognostication. The relative competitiveness of stable value crediting rates in the near-term will most likely be driven by the future path of short-term interest rates, and stable value underperformance is likely to persist until the Fed relaxes monetary policy. Entering 2024, the Fed's "dot plot" projected three 25 basis point rate cuts in 2024, and markets were expecting much more,[4] but the strength of the U.S. economy and elevated (but easing) inflation continued to support higher rates. By its June 2024 meeting, the Fed's projections implied only a single rate cut in 2024, with an additional 100 basis points of rate cuts projected in 2025 and a longer-run Fed funds rate in the 2.5-3.5% range.[5] At its most recent July 2024 meeting, the Fed again left the fed fund target range unchanged, but its accompanying statement cited "moderated" job gains, increased – but low – unemployment, and easing inflation and reflected a more neutral stance that likely paves the way for it to commence cutting rates in September.[6] Since then, a particularly weak July employment report has increased market expectations for the pace and magnitude for Fed easing, and measures of inflation expectations have declined significantly. Citing diminished inflation and increased downside risks to employment, Federal Reserve Chair Jerome Powell cemented market expectations for a September rate cut when he stated during his August 23rd speech at the Federal Reserve Bank of Kansas City's Jackson Hole economic symposium that "The time has come for policy to adjust."[7]

At the projected pace of Fed policy easing indicated by the Fed's June projections, crediting rates for existing stable value funds may not reach parity with money market rates for another year or more. However, as noted above, more recent economic data suggests the Fed will need to quicken the pace for rate cuts that it outlined in June. Stable value funds' underlying yields have averaged more than 5% this year,[8] and the crediting rates for most existing stable value products are designed to gradually rise toward the yield of their underlying portfolios, as they amortize underlying mark-to-market declines that they have insulated investors from as rates have risen. If and when the U.S. Treasury yield curve begins to normalize and if the term premium begins to revert to longer-term averages, stable value's advantage of investing in a broader universe of longer maturity fixed income securities than money market funds should again become more apparent.

GETTING THERE...

Achieving savings plan participants' long-term objectives requires an understanding of current conditions and the patience to maintain a long-term perspective. It is important to understand that stable value's underperformance of short-term investments in this rate environment is indicative of the product behaving as it was designed. Generally speaking, stable value investments provided investors with principal protection as rates rose dramatically. At the same time, they have continued to provide ready liquidity for participant withdrawals resulting from the post-pandemic "Great Retirement", the aging of the Baby Boomer generation into retirement, and plan participants' adjustments to their in-plan asset allocations. With significantly higher interest rates, stable value funds have the opportunity to reinvest at higher yields, which – by design – should translate to higher crediting rates as the stable value contracts' crediting rate formula gradually readjusts toward higher market rates.

In this environment, we believe a conservative approach to stable value management is critical to more responsively delivering higher crediting rates. Maintaining a risk profile commensurate with the potential withdrawal risk, avoiding realized losses resulting from credit quality deterioration, and maintaining diversified stable value contract coverage are keys to providing resilient stable value solutions that plan participants can continue to rely upon into the future. With successful management of these risks, we believe the long-term value proposition for stable value strategies remains strong and that stable value strategies are well positioned to deliver that value for plan participants.

1: Source: Federal Reserve Bank of New York; Estimated monthly term premia according to the New York Fed's ACM (Adrian, Crump, and Moench) model as of August 2, 2024. **2:** "Stable Value" is represented as a composite of the historical returns derived from data collected by the SVIA for its four stable value market segments (individually managed accounts, pooled funds, insurance company general accounts, and insurance company separate accounts). Historical return data is presented as an average. Data from 1989 to 2008 was collected from stable value managers to form a composite for use in research conducted by David Babbel and Miguel Herce, and data from 2008 to present is sourced from the SVIA's Quarterly Characteristics Survey with the period from 2008 to 2015 derived from reported crediting rate data. Returns are gross of stable value management fees but net of fees necessary to deliver the product, such as stable value wrap, third party fixed income management, trust, custody, and fund administrative fees. This composite is composed of varying types of stable value products and, as such, should not be used as a comparison to a specific product. **3:** Source: Lipper Institutional Money Market Fund performance. Returns shown are gross of all fees. The Lipper US Index – Inst U.S. Gov't Money Mkt is an average of funds that invest principally in financial instruments issued or guaranteed by the United States 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 this Lipper Index does not include the effect of sales charges. You cannot invest directly in the Lipper Index. **4:** Sources: Federal Reserve, "Summary of Economic Projections", December 13, 2023, https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20231213.pdf; Bloomberg, "Powell Says Fed Is Just at Beginning of Policy Easing Talks", December 13, 2023, https://www.bloomberg.com/news/live-blog/2023-12-13/fomc-rate-decision-and-fed-chair-news-conference. **5:** Source: Federal Reserve, "Summary of Economic Projections", June 12, 2024, https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20240612.pdf. **6:** Source: Federal Reserve, Press Release "Federal Reserve Issues FOMC Statement", July 31, 2024, https://www.federalreserve.gov/newsevents/pressreleases/monetary20240731a.htm. **7:** Federal Reserve Board, Speech by Chair Powell on the Economic Outlook. **8:** Source: Stable Value Investment Association, SVIA Quarterly Characteristics Survey, June 30, 2024. **Past Performance is not an indication of how the investment will performance in the future.**The information contained herein reflects the views of Galliard Capital Management, LLC and sources believed to be reliable by Galliard as of the date of publication. No representation or warranty is made concerning the accuracy of any data and there is no guarantee that any projection, opinion, or forecast herein will be realized. The views expressed may change at any time subsequent to the date of publication. This publication is for informational purposes only; it is not investment advice or a recommendation for a particular security strategy or investment product. Charts and tables are for illustrative purposes only. Galliard's advisory fees are disclosed in the firm's Form ADV Part 2, which is available upon request.

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