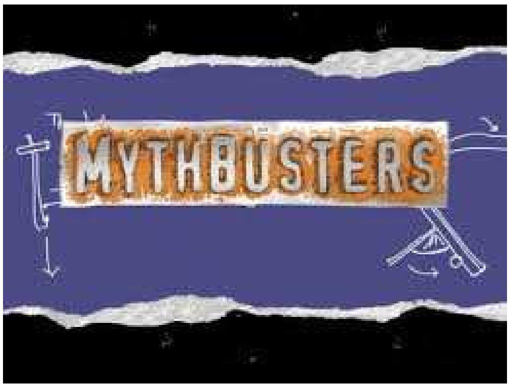

Stable Value Fall 2012 – Myth Busters

By Christopher B. Tobe, CFA, CAIA, Stable Value Consultants –September 21, 2012

I hope we can lay to rest the myths that diversified synthetic stable value somehow has more risks than other fixed income options for 401k plans. These myths are perpetuated primarily by competitors whose products have high fees and either higher risks or lower returns. An excellent new paper by Vanguard busts the myth about the vulnerability of stable value to spikes in interest rates. [i]

I strongly believe that from a Fiduciary Risk standpoint, diversified synthetic based stable value is the superior fixed income choice for DC plans. I believe the alternatives money market funds, bond funds, and general and insurance company separate account products are inferior.

Money market funds have just beat back a challenge by the SEC but their bigger problem is near zero rates. In a case against Southern California Edison plaintiffs brought up that SCE damaged them by offering a lower return money market instead of stable value.[ii] Even though this judge did not go for that argument this time, you can bet someone will sue a plan that is terminating stable value to go into a money market fund for losing return.

Bond funds because of their market value fluctuations have never been popular with 401(k) participants. I believe that it is mostly the plans which do not have diversified synthetic stable value that have significant balances. While participants expect fluctuations in their stock funds, they tend to prefer stability in their fixed income. The only real difference in long term performance is the wrap fees, but even at recent highs of 25bps the SV funds can be competitive fee wise with many bond funds.

General and insurance company separate account products have used the wrap shortage to attempt to turn the clock back to the 90's and recover what they lost from synthetics. I believe they have had only modest success and that it will be short lived. While they have successfully lobbied the DOL to exempt these products from the new 408(b) fee disclosure requirements I do not think it will hold up. In some of the disclosure documents I have seen this week, the general account stable value reports 0% in fees. Currently these higher risk and higher fee bundled products will appear to have lower fees (and higher returns) compared to a diversified low risk low fee product like the Vanguard Stable Value collective trust. All the while the publicly traded insurance companies will brag to stock analysts how they make 200 basis points on this business without disclosing it. Recent I believe vendor influenced research makes the case for insurance company separate account. [iii] Hopefully it will not take an insurance company default to expose these hidden profits.

While synthetic stable value has some challenges, I think they pale to those other fixed income classes they compete with. I feel many of these challenges are being pushed by firms with funds competing with stable value. Even some stable value managers have to compete with other fixed income products at their own firm, and because of the lower profit of stable value higher management may prefer pushing other options.

While there are still some wrap capacity issues, much of this I believe is being pushed by competitors and the few stable value managers who had major investment performance issues. In my May paper I commented on the P&I Conference Call positive outlook for wrap capacity. [iv] Karl Tourville of Galliard said we have gone from "10 active wrap providers in 2008 to 16 in 2012 and that we have $30 to $40 billion in additional wrap capacity. " New wrappers that we know are getting in the market are Bank of Tokyo – Mitsubishi and RGA – reinsurance out of St. Louis.

Competitors I feel have worked overtime to try to spread myths about stable value to Washington regulators. I believe that the SEC-CFTC swap initiative was initiated by Stable Value's competitors. I shared my opinion with both the SEC and CFTC as did others and I think reason prevailed and they are going to drop this misguided initiative.

There was another attack again I believe initiated by competitors with the GAO attacking stable value withdrawal assumptions, and again in this instance after spending time with GAO staff, and Senator Kohl's staff they came to see this for what it was.[v]

Vanguard in their paper "Stable value pooled funds: Scenarios for rising rates and cash **outflows"** puts two hypothetical cash-withdrawal scenarios to the test. **The report states that "**Relatively low volatility makes stable value funds attractive to many defined contribution plans. In general, such funds have performed well during past market crises. However, in the current low-interest-rate environment, some investors and contract providers worry that adverse market conditions and cash flow activity could impair fund performance." [vi]

Many of these myths are perpetuated by a lack of understanding and bias by financial advisors. In several articles I am quoted in, I cannot really understand what some of the advisors are talking about when they discuss stable value. [vii] I believe that some advisors are able to capture more commissions and other revenues through insurance products than they can in a diversified synthetic fund.

Participants in general have it figured out better than the invest press. I also think most Fortune 500 type 401(k) plans have a good handle on stable value. While stable value has its share of issues when you stack it up against the other fixed income options in 401(k) it still comes out on top.

Chris Tobe, CFA, CAIA is a top expert on DC investing and Stable Value and is the founder of Stable Value Consultants. He has worked recently with a number of large DC plans and has been quoted in Wall Street Journal and Barron's on Stable Value and published a number of whitepapers on stable value. He provided written testimony on stable value to DOL's ERISA advisory committee and testified in person at the joint SEC-DOL hearing on Target Date Funds in summer of 2009. He has over 25 years of experience working with DC Plans working as a consultant, money manager and regulator. He was a Trustee for the Kentucky Retirement Systems and served as a Sr. Consultant for BCAP & NEPC. His stable value consulting practice over the last 3 years included 8 clients, with a total of 23 different stable value pools and over $34 billion in Stable Value assets. For nearly 7 years he served as a director for the Pension & Savings Group of AEGON Institutional Markets, where he was responsible for a number of major relationships with the over $40 billion wrapped stable value book. He negotiated over 300 wrap contracts for well over 200 corporate plan sponsors, primarily with 12 major stable value managers, but also directly with a number of corporate clients directly such as General Motors, DuPont, Johnson & Johnson, Halliburton, HCA & Sara Lee. Tobe met with DOL officials and authored the AEGON comment letter on the QDIA in 2006. Tobe has published a number of articles on Stable Value and related topics including "The Consultants Guide to Stable Value," in the Journal of Investment Consulting and "Will the Mutual Fund Scandal Make Equity Washes Easier to Swallow?" in Stable Times. Previous articles include "Stable Value – An Asset for All Seasons" (Plan Sponsor Magazine), "Is Wrapper Capacity a Concern?" (Stable Times) , "Rx for Low Cash Yields" (Health Care Financial Management Magazine), and "Enhance multi-employer plans yields" (Employee Benefit Journal). He has served on a number of committees of the Stable Value Investment Association (SVIA) including a stint as the editor of Stable Times magazine. He has spoken at a number of SVIA conferences and national conferences such as IFEBP, NAST, CIEBA and NAGDCA on stable value and other DC investment. He holds a BA in Economics from Tulane University, and an MBA in Finance from Indiana University – Bloomington. He is the past president of the CFA Society of Louisville and a 10 time grader for the CFA exam

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[i] https://institutional.vanguard.com/VGApp/iip/site/institutional/researchcommentary/article/InvResStableValuePooled

[ii] http://www.groom.com/media/publication/1140_401k_Fee_Cases_Detailed_Chart_4_27_12.pdf

[iii] http://www.nagdca.org/documents/Stable_Value_Funds.pdf
[iv] www.pionline.com/SVwebseminar

[v] http://www.regions.com/virtualDocuments/Kiplingers_Retirement_Report.pdf

[vi] https://institutional.vanguard.com/VGApp/iip/site/institutional/researchcommentary/article/InvResStableValuePooled
[vii] http://www.planadviser.com/MagazineArticle.aspx?id=18294&page=2

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Tobe, Christopher B., Stable Value: Blast to the Past or Too Big to Fail? *Benefits Magazine*, Volume 48, No. 12, December 2011, pp. 34-38. Available at SSRN: http://ssrn.com/abstract=1976453

Tobe, Christopher B., The Consultant's Guide To Stable Value, *The Journal of Investment Consulting*, Volume 7, No. 1, Summer 2004, pp. 81-93.