

The State of Stable Value



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More than three years following the onset of the credit crisis, most investors would have expected a substantial recovery in the stable value markets. It would have been reasonable to expect the return of wrap capacity to the market by now, particularly given the attractive fee levels and more conservative guidelines associated with wrap and insurance separate account contracts. In reality, the market continues to experience a variety of challenges: from the fear that market value to book value ratios will decline as rates eventually rise from historic lows, to uncertainty on the regulatory front. Nevertheless, plan participants continue to enjoy the capital preservation and stable income benefits that the asset class provides, even as bond and equity market volatility generates angst.

Legislation

The Dodd-Frank Reform Act, passed in July 2010, mandated a joint study to be completed by the CFTC and SEC (the “Joint Commission”) over 15 months to determine if stable value contracts fall within the definition of a “swap.” (If included in the definition, the Joint Commission could exercise its exemptive authority to preclude these contracts for purposes of further federal regulations from the Act.) The Joint Commission solicited public responses on a broad range of questions regarding stable value contract terms, providers, and practices. Numerous industry associations responded to this request in the late fall of 2011, and the overwhelming majority noted that stable value contracts should be excluded from the definition of swap agreements, and therefore not subject to further regulations under the Dodd-Frank

Reform Act. Although the 15-month period has expired, the Joint Commission has stated that, while its work continues, the study will not be finalized until after the swap definition is published.

Should the Joint Commission determine that stable value contracts are swaps, subsequent regulations or exemptions would be subject to further notice and comment rulemaking. Until the Joint Commission issues its final regulations, nothing has changed regarding the regulation of stable value contracts, and “grandfathered” provisions exempt wrap contracts currently in force.

Wrap Capacity

Benefit-responsive wrap fees have generally settled in the 20–25 basis point range, an attractive premium for issuers of wrap contracts in return for book value treatment, but at an increased cost to participants. Additionally, providers have fought to de-risk their books of business by implementing more stringent investment guidelines (e.g., eliminating high yield and introducing duration caps), imposing more restrictive and sometimes complex contract terms, and requesting reductions or the elimination of exposure.

Banking entities have taken a more aggressive stance than their insurance counterparts, largely because of the post-credit crisis challenges and regulatory uncertainty the banking industry faces. This ongoing bifurcation of the wrap market has shaped Dwight’s view regarding bank and insurance issuers. We continue to foster partnerships with new and existing providers that have demonstrated a commitment to stable value, while seeking to

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actively reduce our exposure to issuers that have become overly restrictive or whose commitment is uncertain. We believe our pro-active efforts to reduce our exposure to bank issuers over the past 12 months has successfully positioned our clients' portfolios irrespective of the pending regulatory outcome.

Pooled Funds and Market Outlook

In the fourth quarter, Charles Schwab Trust Company made headlines upon announcing its intention to shut down its \$8 billion stable value pooled fund in early 2012. Following the closure of other well-known pooled funds, limited capacity available to pooled vehicles, and wrap provider concerns over the 12-month put liquidity provision, it is increasingly challenging for smaller plans to access the stable value market. Dwight's approach to stable value, which introduces an enhanced liability model and amortizing portfolio structure, can now accommodate many of these plans as we have lowered our minimum separate account size to \$50 million.

Furthermore, the continued development of our technology platform gives us the ability to provide

full transparency for internally and externally managed strategies down to the security level. This technology platform, combined with Dwight's foresight regarding the direction of the stable value wrap market and asset and liability design enhancements, has enabled us to partner with those wrap providers that are committed to the asset class. As a result, we believe Dwight is well positioned to provide efficient and competitive solutions to differently sized plans at attractive fee levels.

Stable value will remain an important asset class for those seeking the preservation of principal and stability of returns and income, particularly amid what we believe is likely to be an ongoing low interest rate environment and sustained volatility in the bond and equity markets. Stable value is a key component of the retirement market as evidenced by more than \$500 billion¹ in invested assets and an approximate 200 basis point² spread over other capital preservation alternatives, such as money market funds. We remain optimistic about the future prospects for the asset class, and we are confident that the portfolios we manage are designed to meet their objectives.

¹ Cerulli "Retirement Markets 2011"

² Based on Dwight Stable Value account book

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