Revitalizing Stable Value

Evolving financial markets call for a new approach

The credit crisis of 2008 and ongoing market volatility in 2009 highlighted several aspects of modern stable value portfolio strategy that must be addressed to ensure that the asset class continues to thrive in the future. Stable value market dynamics have changed given wrap capacity limitations, and the industry has been unable to resolve the current market stalemate. The capacity limitations that arose during the credit crisis and a lack of new entrants dedicated to the wrap market are beginning to test the patience of many plan sponsors and consultants. Dwight's view is that wrap capacity will continue to be constrained for a protracted period of time and that fundamental changes are needed to bring the risk/reward paradigm back into balance.

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Dwight Asset Management Company LLC has invested considerable resources to analyze the current market dynamics, back-test various investment strategies, and engage plan sponsors, consultants and wrap providers in the development of a new approach to stable value that will lead the industry into the next decade. By altering the fundamental stable value portfolio structure and introducing a standardized, finite maturing wrap component, the approach aims to reduce overall risk, unlock wrap capacity and increase flexibility for plan sponsors.

While diminishing wrap capacity has been a significant factor in our assessment of the asset class, it is important to consider the disparate risk allocation endemic to most stable value funds. Benefit-responsive wrap contracts are contingent in nature; a capital contribution from the wrap providers is likely to occur only after the book value crediting rate declines to zero percent. This type of event is not commonplace—in order for such a decline to occur, the fund's liquidity must be exhausted and participants will have already borne material interest rate, credit, and cash flow risks. Nevertheless, because the wrap contracts provide only withdrawal protection, the participants ultimately bear the risk. Dwight's proposed approach is designed to reduce risk to participants while continuing to offer a strategy consistent with the long-term capital preservation objective that has been a fundamental tenet of stable value investing.

DWIGHT
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Criteria for success

The future of the stable value asset class will depend largely on a portfolio structure that addresses three main issues:

- **The capital preservation objective of plan participants is paramount.** Portfolios must continue to be conservatively managed, consisting of high-quality securities and enhanced liquidity to help ensure that all distributions can be covered at book value.
- **Plan sponsors must have the flexibility to implement plan modifications within a reasonable timeframe.** Contract terms must be configured in a manner that allows plan sponsors the flexibility to govern their plans.
- **All constituents must be presented with a compelling risk/reward scenario.** Portfolio and contract structures must be attractive in order to unlock wrap capacity and bring new entrants to the market.

The next-generation stable value model

Stable value funds can achieve consistent and competitive performance through a foundation of high-quality fixed income investments paired with finite maturing and evergreen wrap agreements. A unique aspect to this new approach is that it directly connects the asset strategy to a more detailed quantitative and qualitative analysis of plan liabilities.

Enhanced Liability Modeling

The Dwight Enhanced Liability Model (ELM) is a new platform used to determine and continually evaluate the appropriate asset allocation among cash, amortizing, and broad-market strategies based on the unique liability profile of each client's plan (see Figure 2, page 4, for target allocations). While risk and liability analysis has always been an important step in constructing our stable value portfolios, the ELM employs a more sophisticated liability model that provides a granular, comprehensive risk assessment of each plan. The model incorporates ten risk factors focusing on three primary risk categories:

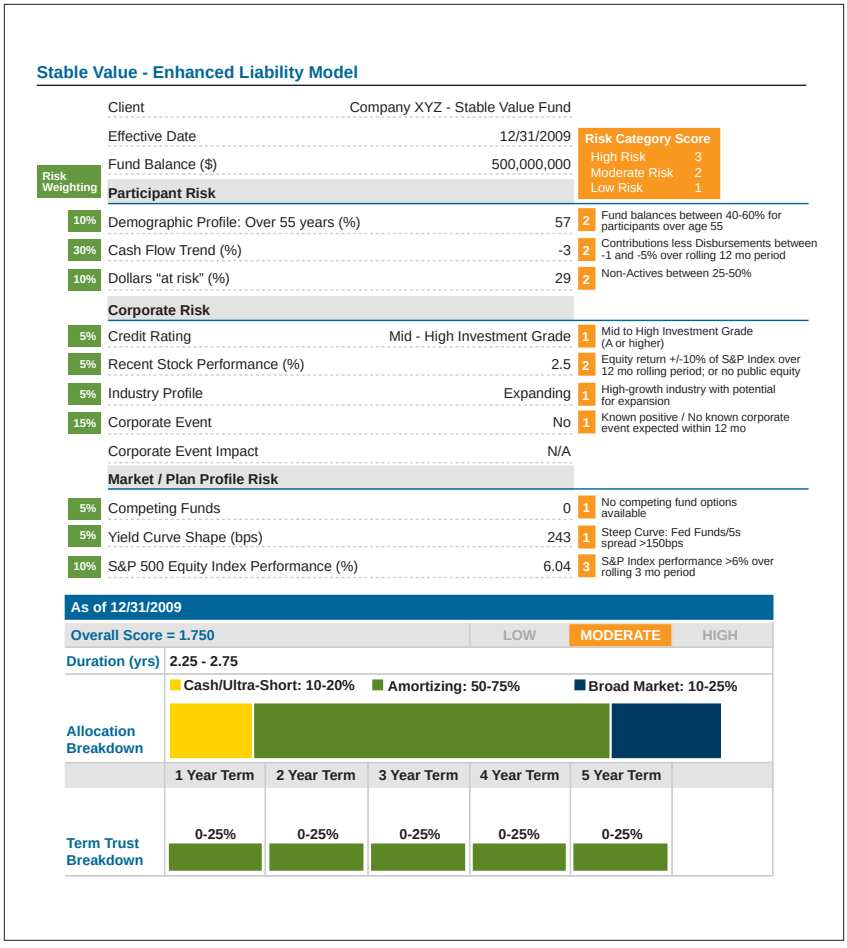
Participant Risk: Participant risk can be used to assess the magnitude and timing of potential withdrawals. This analysis considers and documents participant-specific factors such as age distribution, the breakdown between active and inactive employees, and historical cash flow patterns.

Corporate Risk: Corporate risk can materially impact the timing of the fund's cash flows. This analysis involves a detailed review of each client's industry profile based on traditional credit analysis in conjunction with recent corporate stock performance, if applicable. Any anticipated or known employer-directed events will also be factored into this component of the analysis because of the potentially critical impact on the plan's liability profile.

Market/Plan Profile Risk: Market factors such as the shape of the yield curve and general equity market performance, as well as additional plan-specific risks such as the number of competing investment options, will be evaluated at this stage and factored into the liability analysis.

The ELM is designed to provide a transparent duration and allocation methodology for both plan sponsors and wrap providers. Each of the ten risk components is assigned a weighted score, which is then combined to yield a total weighted score. This total score guides the overall duration, the level of liquidity, and the underlying asset mix for both the amortizing and broad-market components of the strategy. At the time of wrap contract placement and on an ongoing basis, Dwight will provide wrap providers and plan sponsors an ELM "tear sheet" as shown in Figure 1.

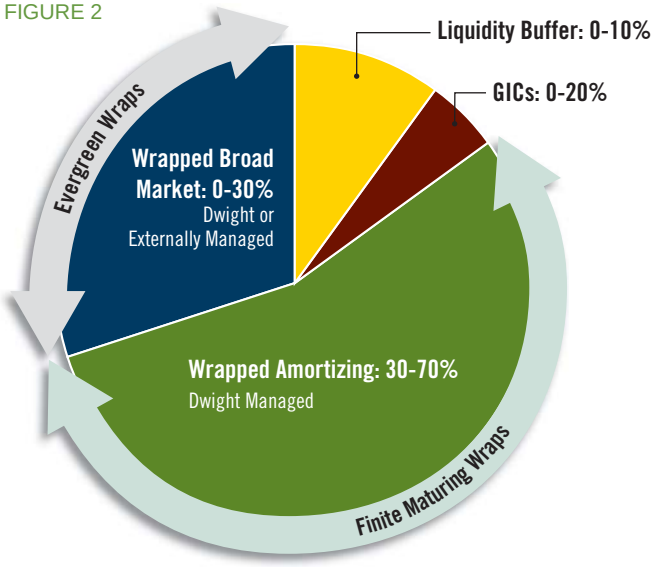
FIGURE 1



Asset Allocation

The stable value portfolio that results from the plan's risk assessment and liability analysis will consist of three primary components: (1) a liquidity buffer, (2) an amortizing portfolio paired with a finite maturing wrap, and (3) an evergreen wrapped broad-market portfolio. In addition, guaranteed investment contracts (GICs) may be utilized on an opportunistic basis. The target allocations will be determined in the client-specific risk assessment and will generally be within the ranges shown in Figure 2.

FIGURE 2



Liquidity Allocation

The liquidity component serves as the primary buffer used to accommodate overnight liquidity needs. This position insulates the balance of the portfolio from normal liquidity demands, reducing the need to access book value wrap agreements.

Historically, as the stable value industry migrated to evergreen wrap contracts, the size of the contractual liquidity buffers began to abate. Although smaller liquidity buffers reduce the cash drag on portfolio returns, they also place higher liquidity demands on the benefit-responsive wrap agreements. By building a larger liquidity buffer into the portfolio, the overall book value liquidity will increase and the reliance on the wrap agreements as a liquidity source will decrease, reducing the overall risk to plan participants. This will be accomplished primarily through the use of money market funds, but customized separately managed cash portfolios may also be utilized, depending on the needs of each client.

Wrapped Amortizing Allocation

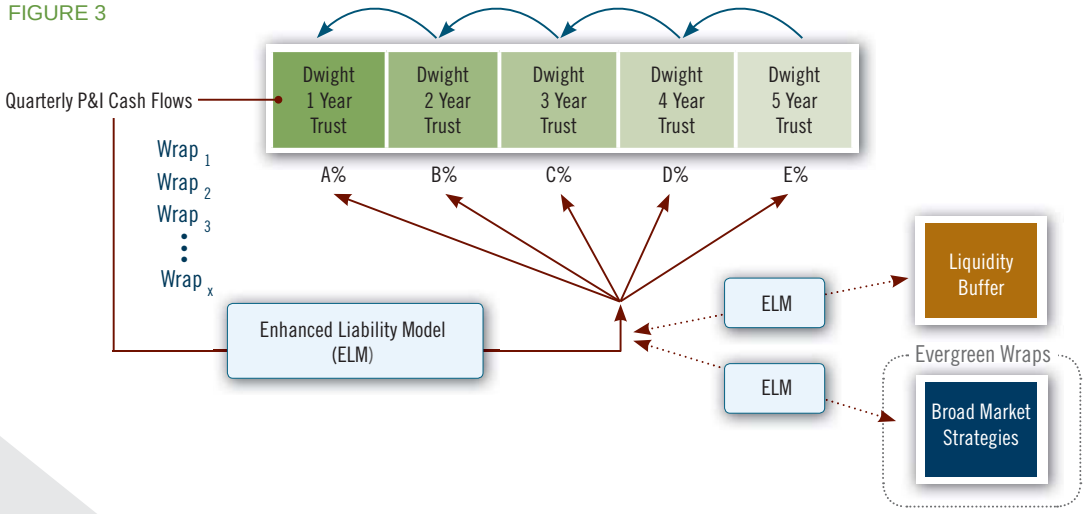
The proposed amortizing allocation will consist of a series of five commingled trusts with target maturity dates of 1, 2, 3, 4, and 5 years, respectively. Based on the initial risk assessment of the plan, each stable value portfolio will be assigned a total risk score that will be utilized to determine which unique combination of the amortizing trusts should be used. This will allow each portfolio to use the combination of trusts that is best aligned with the plan's liability profile. A new 5-year trust will be created on an annual basis to accommodate longer-maturity assets as the existing trusts roll down the curve, such that there will always be five commingled trusts in which to invest.

In similar fashion to Dwight's current construct, each trust will be valued daily and provide participants with daily liquidity as necessary. This will allow for rebalancing among the trusts as client liability profiles change, as well as for replenishment of cash buffers from the maturing 1-year trust, which will pay quarterly principal and interest to all investors on a pro-rata basis as market and book values converge to par. Investment guidelines for each of the trusts will be substantially similar, with the exception of the maturity and duration constraints. The guidelines will emphasize high-quality, liquid, and well-diversified assets.

Implementing a Finite Maturing Wrap Structure

Importantly, this amortizing trust structure utilizes finite maturing wrap contracts. These contracts will operate as "window" wraps, accepting the reinvestment of principal and interest payments from the expiring 1-year trust and any positive cash flow for a period of 12 months. After the 12-month period, the window closes and the wrap contract will have an expected final maturity date in four years. A new finite maturing wrap will be placed every year as necessary should there be cash available for reinvestment. Figure 3 depicts how the amortizing portfolio would operate when paired with a finite maturing wrap.

FIGURE 3



Book value payments from the amortizing structure may be used to supplement the liquidity component as necessary and thus increase buffer protection to the wrap agreements. The amortizing structure also allows for portfolio repositioning if plan sponsor events or cash flow changes are on the horizon.

Performance Measurement

Similar to typical broad market strategies, each of the maturing trusts will have a performance benchmark so that the market value performance of the strategy can be evaluated on a monthly basis. As the portfolios move closer to maturity, benchmarks will change to reflect the roll down along the yield curve as shown in Figure 4.

FIGURE 4

	1 Year Trust	2 Year Trust	3 Year Trust	4 Year Trust	5 Year Trust	
Barclays Capital Index Weightings *data as of 12/31/09*	**100%** Barclays Capital Short-Term Govt/Corp Index	Barclays Capital 1-3 Year Government Index	Barclays Capital 1-5 Year Government Index	Barclays Capital Intermediate Govt Index	Barclays Capital Government Index	**60%**
		Barclays Capital 1-3 Year Credit Index	Barclays Capital 1-5 Year Credit Index	Barclays Capital Intermediate Credit Index	Barclays Capital Intermediate Credit Index	**20%**
		Barclays Capital Conventional 15-Year MBS Index	Barclays Capital Conventional 15-Year MBS Index	Barclays Capital Conventional 15-Year MBS Index	Barclays Capital Conventional 15-Year MBS Index	**10%**
		Barclays Capital 1-3.5 Year CMBS Index	Barclays Capital 1-3.5 Year CMBS Index	Barclays Capital 3.5-6 Year CMBS Index	Barclays Capital 3.5-6 Year CMBS Index	**5%**
		Barclays Capital ABS Index	Barclays Capital ABS Index	Barclays Capital ABS Index	Barclays Capital ABS Index	**5%**
Effective Duration	0.55 years	2.01 years	2.59 years	3.66 years	4.34 years	
Yield to Worst	0.59%	1.88%	2.19%	2.74%	2.91%	

Wrapped Broad Market Allocation

The proposed approach will continue to feature a complementary broad-market fixed income allocation. This component of the portfolio would be managed relative to traditional fixed income benchmarks such as the Barclays Capital Intermediate Government/Credit, Intermediate Aggregate, or Aggregate Indices, and provide additional alpha generation to help increase the overall book value yield of the stable value strategy. For clients seeking additional style diversification, independent fixed income managers can be employed to manage portions of the broad market allocation.

The broad-market fixed income portfolio will continue to be wrapped with evergreen wrap contracts. These contracts will be standardized, and will incorporate many unique features that are similar to those of the finite maturing wrap contracts.

A closer look at wrap structures

Stable value investments gradually moved away from maturing structures, such as traditional GICs and maturing synthetics, to evergreen wraps paired with constant-duration fixed income strategies. Evergreen contracts have become the predominant investment vehicle in most stable value portfolios. One drawback, however, is that they do not provide liquidity without impacting the market value-to-book value (MV/BV) ratio of the contract (this impact can be positive or negative).

To demonstrate, let's assume that a portfolio has a 97% MV/BV ratio. If the liquidity buffer has been depleted, the wrap contracts must be accessed to generate additional liquidity. If we assume a 10% distribution from evergreen wrap contracts, the MV/BV ratio will decline from 97% to 96.7%. Although in this example the impact on the MV/BV ratio is relatively modest, it illustrates how distributions can have an adverse impact on the financial position of the wrap contract and ultimately the book value crediting rate when the MV/BV ratio is less than 100%. In 2008 and early 2009, declining MV/BV ratios in stable value funds highlighted the need for a liquidity source that would not adversely impact the crediting rate of the fund. This type of book value transaction is of particular concern when facing higher expected interest rates that will put pressure on market values.

While evergreen wrap agreements continue to be an important component of stable value portfolios, they can create some underwriting challenges for providers. They are the only financial instruments issued that do not feature finite maturity dates, and they also do not feature provisions that allow for effective fee re-pricing as plan liability profiles change over time.

By replacing a portion of the evergreen wrapped fixed income portfolio with a series of amortizing trusts, the corresponding benefit-responsive wrap agreements can be structured to mature along with the underlying assets. This structure, which replicates the structure of the maturing GIC ladders prevalent in the early 1990s, would be created using synthetic investments. The structure will generate book value liquidity that can be used to pay participant benefits, replenish the liquidity buffer, or be reinvested in either the amortizing or broad market allocations, as warranted.

Conclusion

The stable value asset class has proved to be an effective investment vehicle for capital preservation in the face of an unprecedented level of market volatility. Throughout the recent market turmoil, stable value has provided uninterrupted, consistent, and positive performance. As part of an overall investment program, stable value funds offer benefits to participants in the form of a high-quality investment option with positive and steady returns. Moreover, stable value has generally provided a significant return premium relative to money market funds, supplying participants with a superior hedge against inflation in most market environments. While bond funds have provided similar long-term returns to stable value, typical 401(k) plan asset allocations indicate that participants generally prefer the safety of stable value to the volatility profile of unwrapped fixed income options.

Dwight's new approach to stable value portfolio management provides wrap providers with a more attractive risk/return profile, which we expect to translate into greater flexibility for plan sponsors in the form of contract features that will facilitate smoother plan operation. We have been engaged with wrap providers to develop wrap contracts that are standardized and offer a unique set of contract provisions. These provisions would include a customized approach to resetting crediting rates designed to have less disparity between book and market values, and fees on the finite maturing wraps that would be fixed for the term of the contracts.

Plan participants continue to support stable value, as evidenced by the significant allocations to stable value funds typical of most 401(k) plans that utilize the asset class. In today's capacity-constrained environment, it is even more important to partner with wrap providers to structure portfolios in a manner that minimizes risk for all constituents. Relying on the hope that wrap capacity will materialize is not a solution to the challenges facing the industry—we believe that ongoing changes in the financial landscape call for a re-assessment of how industry stakeholders approach stable value. Dwight's next-generation stable value model is designed to lower overall risk, increase flexibility, and unlock wrap capacity, which will allow the asset class to continue to meet the needs of plan sponsors and their participants for years to come. ■

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