Evaluating & Recommending Bond & Stable Value Funds for 401k Plans Ahead of a Rising Interest Rate Environment

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AEPG WEALTH STRATEGIES

About the Presenters

- **AEPG Wealth Strategies™**
  - Managing wealth for over 30 years as an independent fiduciary and registered investment advisor.
  - $800M in assets under management, with over 90 qualified retirement plans.
  - One of PLANADVISOR's Top 100 Retirement Plan Advisors in 2014
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Agenda

- Challenges faced in the current environment.
- Getting to know the plan and managing expectations
- Stable Value fund decision and considerations.
- Core Bond fund decision and considerations
- Other bond fund menu options to consider
- Bonds within Target-Date funds
- Summary
- Questions?

Challenges Faced in the Current Environment

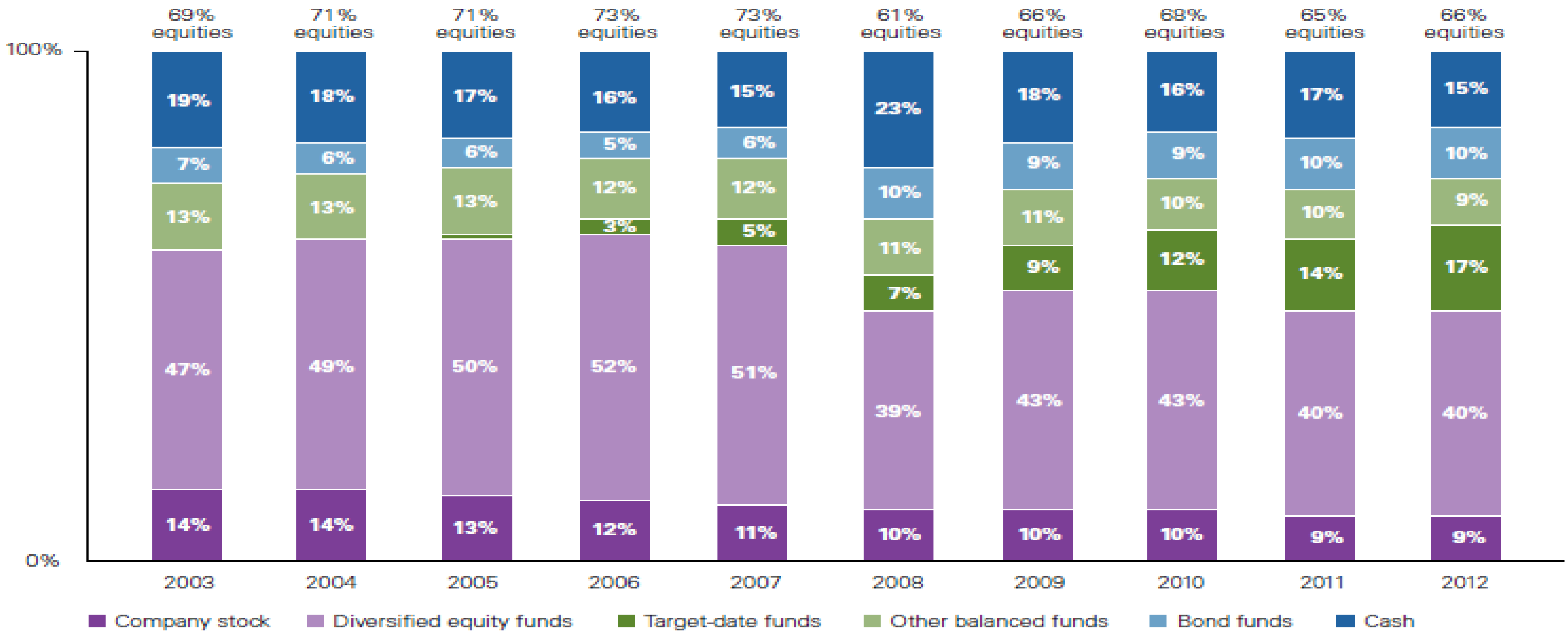
- **The problem is NOT** that interest rates are going up!
- **The problem IS** that participant perceptions and expectations are skewed!
- **Participant Perceptions and Expectations**
  - "Bond funds can't lose money."
  - "Similar to the past, bond funds should provide me with 4 to 5% returns."
- **Challenges faced by Plan Sponsors**
  - Participant expectations need to be managed
    - Communication and education reduces 'participant expectation shock'
  - Selecting bond funds that are in line with plan/participant objectives
    - Stable Value fund? Core Bond fund? Other bond fund menu options?

Challenges Faced in the Current Environment

Fixed-Income Investment Options Offered in Plans Today	
Fund Type offered	**in% of Plans**
General/Core Bond	~80%
Stable Value/Guaranteed Investment Contract	~70%
Money Market	~60%
High Yield Bond/Treasury Bond	~50%
TIPS	~30%
International	~5%
Source: Deloitte Annual 401k Benchmarking Survey 2012 (2012 data)	

Challenges Faced in the Current Environment

Fixed-Income Investment Options Offered in Plans Today



Source: Vanguard, How America Saves Report 2013 (2012 data)

Getting to Know the Plan and Managing Expectations

- **Culture of the company**
- **Overall philosophy and mission of the retirement Plan.**
- **Participant demographics and behaviors.**
  - Predominantly Gen Y, Gen X or Baby Boomers? Even balance?
  - Asset allocation to bond investments (Plan and Participant level)
  - Withdrawal activity
- **Bond fund investment objectives and priorities**.
  - Safety? Return? Retirement income? …all of the above?
  - What are participant expectations for their bond fund?
  - Fund Tracking-Error vs. Participant Expectation Tracking Error!!!

Stable Value Fund: Decisions

- **Whether to use a Stable Value fund or a Money Market fund…**

	Pros	**Cons**
Stable Value	• Provide a much higher current yields (1.0% to 2.5%). • Over long time periods, typically provide higher returns. • Explicit principal protection offered by insurance company(s) to cover any market value below book value gap.	• Typically higher fees • Restrictions on the addition of new investment options. • Increasingly constrained investment guidelines. • Market value events tied to more restrictive termination provisions.
Money Market	• Yields typically adjust quicker in the beginning phases of a rising (short-term) rate environment.	• Currently yielding zilch. • Typically underperform Stable Value over long time periods. • No explicit principal protection in the event of a 'breaking the buck'' scenario.

Stable Value Fund: Decisions

- **What type of Stable Value fund to use…**

Typical Profiles of…	**Relatively conservative Stable Value funds (e.g.,CITs/Pooled Funds)**	**Relatively aggressive Stable Value funds (e.g.,GICs/GA Funds)**
Crediting Rates (Yields)	1.0% to 1.5%	2.0% to 2.5%
Average Credit Quality (of underlying portfolios)	A+ to AA-	AA to AA+
Average Duration (Years)	2.0 to 2.5	4.5 to 5.0
Market/Book Value Ratios (Average Ranges)	98% to 102%	95% to 105%
# of Wrap Contract Issuers	Several	One

Stable Value Fund: Considerations

- **Creditworthiness of the wrap provider**
  - Especially if using a single insurer GIC product
- **Plan Termination provisions**
  - The existence (or lack thereof) "put" provisions.
  - Put provisions that extend beyond 12-months.
- **The potential for unexpected "market value adjustment events"**
  - Necessary platform/fund changes.
  - Company/plan mergers.
  - Plan re-enrollment.
- **The ability to make future portfolio changes**
  - Tighter investment guidelines set forth by wrap providers.

Stable Value Fund: Due Diligence Case Study

As of 03/31/12	ABC Stable Value Fund	XYZ Stable Value Fund
Type:	Commingled Pool	Commingled Pool
Assets:	$800,000,000	$6,300,000,000
Inception:	1999	1994
Expense Ratio	0.68%	0.50% - Less than $20M 0.45% - $20M to $100M
Fund Portfolio Profiles		
Market/Book Ratio	103.58%	101.99%
Crediting Rate	2.40% (net)	1.26%(net)
Average Quality	AA-	AA+
Average Duration (years)	4.71	2.11
# of Sub-Advisors:	3	9
Protections		
Asset Held in a Trust?	Yes	Yes
Trustee Name:	BCD Trust Company	XYZ Trust Company
Asset Subject to Claims of Company Creditors?	No	No
Stated Guarantee:	Book-Value and accrued interest.	Book-Value and accrued interest.
Plan Termination Provisions:	Lesser of Book-Value or Market-Value. GIC contract available (up to 10 years). GIC contracts are held in ABC's General Account (subject to company creditors).	Book-Value up to 12 months notice of plan sponsor termination ("12-Month Put Option").
# of Contract Issuers:	1	12
Contract Issuer (s):	ABC Insurance Company	Prudential Insurance Company of America Aviva Life & Annuity Metropolitan Life Insurance Company State Street Bank & Trust New York Life Insurance Company AIG Financial Products Corp Massachusetts Mutual Life

Core Bond Fund: Decisions

- **Whether to use a Core Bond Fund or not…**
  - The decision should depend on the type of Stable Value fund used.

- **What type of Core Bond fund to use…**
  - **Only U.S. investment-grade bonds?**
    - "Traditional" bond fund benchmarked to the Aggregate Bond Index
  - **Expand the opportunity Set?**
    - "Unconstrained" bond fund with specific risk and return objectives
    - "Flexible" bond fund
    - Hybrid Unconstrained/Flexible

Core Bond Fund: Considerations

- **Interest rate risk is not the only risk to consider…**

	Interest Rate Risk	Equity Market Risk	Credit Risk	"Return Surprise Risk"
Traditional bond fund	• High	• Diversifies equity risk	• Low	• Low
Unconstrained bond fund	• Low (?)	• Not designed primarily to diversify equity risk.	• High	• High
Flexible bond fund	• Medium	• Diversifies equity risk, but muted	• Medium	• Medium

Other Bond Fund Menu Options to Consider

The Good News!

- **There are many strategies to mitigate interest rate risk**
  - ✓ Protect principal through insurance (e.g., Stable Value funds)
  - ✓ Diversify across all bond segments (e.g., Core bond funds)
- **…however, some may not be appropriate for 401k plans**
  - Shorten duration (e.g., Short-Term bond funds)
  - Increase yield (e.g., High-Yield, Floating-Rate bond funds)
  - Protect from rising inflation (e.g., TIPS funds)
  - Holding bonds to maturity (e.g., Target-Maturity funds)
  - Diversify geographically (e.g., International bond funds)

Other Bond Fund Menu Options to Consider

- **Considerations for each strategy…**

	Pros	**Cons**
Short-Term bonds funds	• Can reduce volatility • Can reduce some principal risk	• Reduces yield income. • May not keep up with inflation over time. • Does not provide much equity market risk offset.
High-Yield bond funds	• Provides additional income • Can provide higher returns. • Can reduce some principal risk	• Higher volatility than investment grade bonds funds. • High correlations with equities, particularly during declines..
Inflation-protected bond funds	• Potentially reduces principal risk (assuming inflation is rising!) • Can diversify equity market risk during flight to quality (Treasuries).	• Relatively high interest rate sensitivity of treasuries can offset inflation adjustment. • Higher volatility than diversified bonds funds.

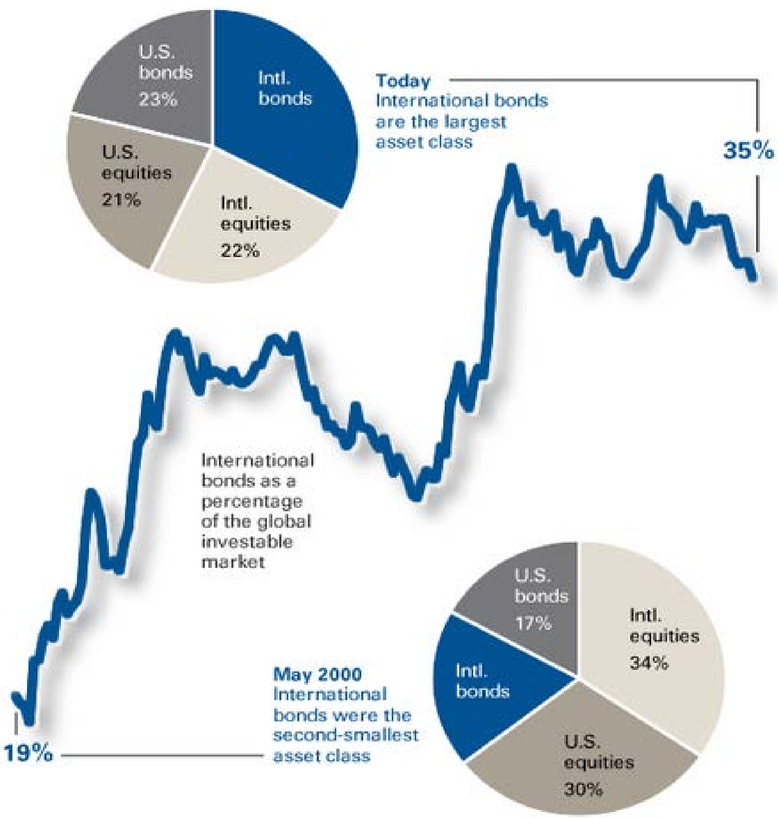
Other Bond Fund Menu Options to Consider

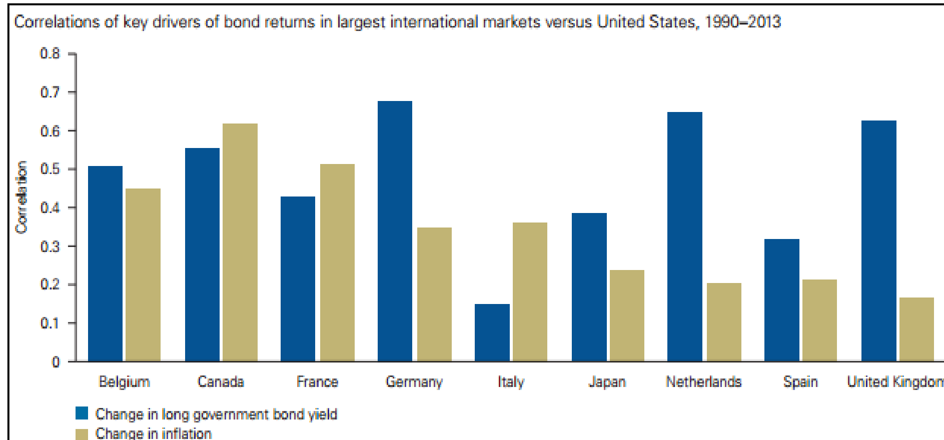
- **Considerations for each strategy…**

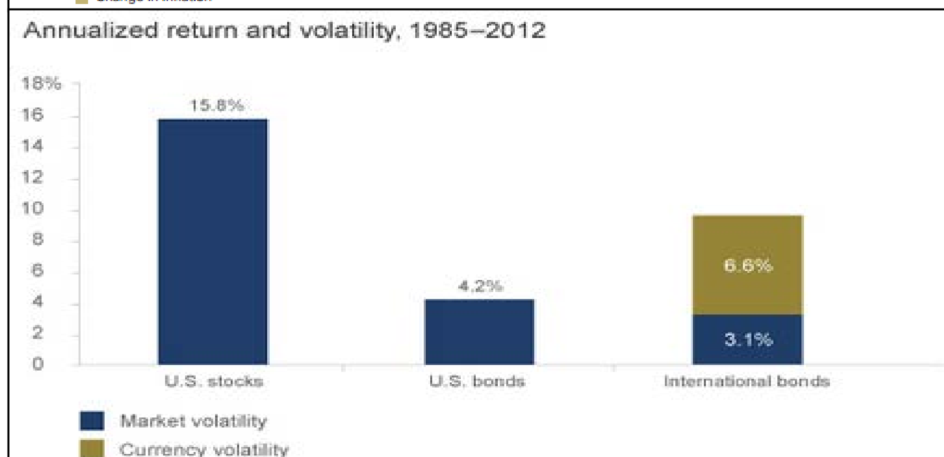
	Pros	Cons
Target maturity bond funds	• Perceived benefit of principal returned at maturity.	• Can have higher volatility than diversified bond funds. • Can be hard to administer in a 401k plan.
International bond funds	• Can reduce volatility (if currency hedged) • Can reduce some principal risk since not directly tied to U.S. interest rates. • Can diversify equity market risk during flight to quality	• Currency effects can increase volatility if unhedged. • Emerging markets bonds can have high correlations with equities. • Relatively high expense ratios.

Other Bond Fund Menu Options to Consider

- **The interesting case for international bond funds… but**







Source: Vanguard

Other Bond Fund Menu Options to Consider

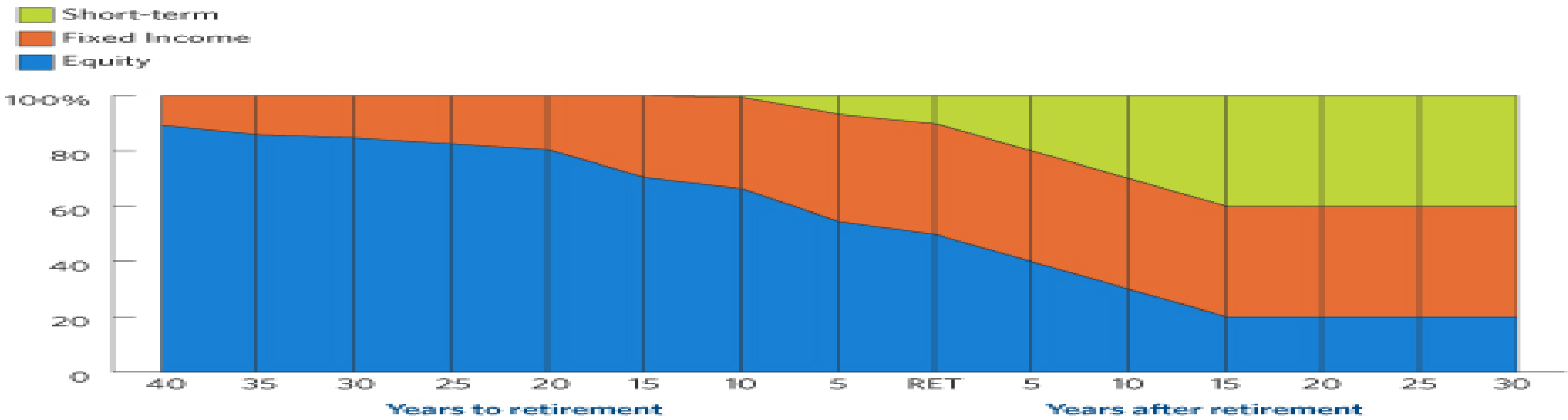
The Bad News!

- **Participants don't know how to implement most of these strategies!**
  - By themselves, some of these strategies can be risky!
  - Some of these strategies might not be good long term investments.

- **But there are some potential solutions:**
  - Consider using fund options only with "participant balance limits."
  - Consider broadly diversified ("all in one") bonds funds.
  - Education and professional advice/management solutions.

Bonds within Target-Date funds

- **Target-Date funds will be the most widely used 401k investments soon!**



- **Be aware of what is being done in bond allocations within them.**
  - Plan Sponsors need to be aware of what is under the hood.
  - How is a target-date fund adjusting ahead of rising rates?
  - How will these adjustments affect risk! You may be surprised!

Summary

1) Participant perceptions and expectations of bonds funds are skewed
2) Understand the Plan, determine bond fund objectives, and manage expectations.
3) Strongly consider the importance (and potential issues) of using Stable Value funds.
4) Evaluate the Plan's Core Bond fund, and consider available alternatives.
5) Be careful about recommending non-diversified (or single strategy) bond funds.
6) Consider recommending diversified strategy/asset-class bond funds.
7) Consider recommending professional advice/management solutions.
8) Be aware of the approach to bond allocations within the Plan's target-date funds.

Questions?

planadviser's 2014 TOP100 RETIREMENT PLAN ADVISERS

"Top 100 Retirement Plan Advisors in 2014"

by PLAN ADVISOR
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