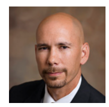
Viewing Stable Value With 2020 Vision

New roles for stable value emerge as the landscape evolves.

February 2020



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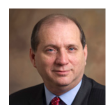

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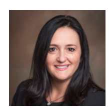

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KEY INSIGHTS

- Stable value investments in defined contribution (DC) plans are increasing amid growing demand for retirement income solutions.
- The capital preservation feature of this investment vehicle can be a useful building block in retirement portfolios.
- We believe stable value, which is only accessible through DC plans, will be critical as the industry and regulatory landscape evolves.

Several key provisions in the recently passed SECURE Act may likely support the central role defined contribution (DC) plans play in the retirement journey. The law pushes required minimum distributions[1] out to age 72 from 70½, provides encouragement for participants to remain in their plans longer into retirement and highlights the importance of retirement income-oriented solutions. Stable value plays a key role among workers moving nearer and into retirement (Figure 1). Our proprietary research reveals that an increasing majority of DC plan sponsors want participants to remain in their plans after retirement, and the numbers appear to bear this out as more DC plan participant assets are remaining in plans after workers vacate their jobs.

The culmination of these factors indicates that plans will develop portfolios for participants in which stable value has an anchor role. Stable value has a potentially important place through the retirement life cycle (Figure 2).

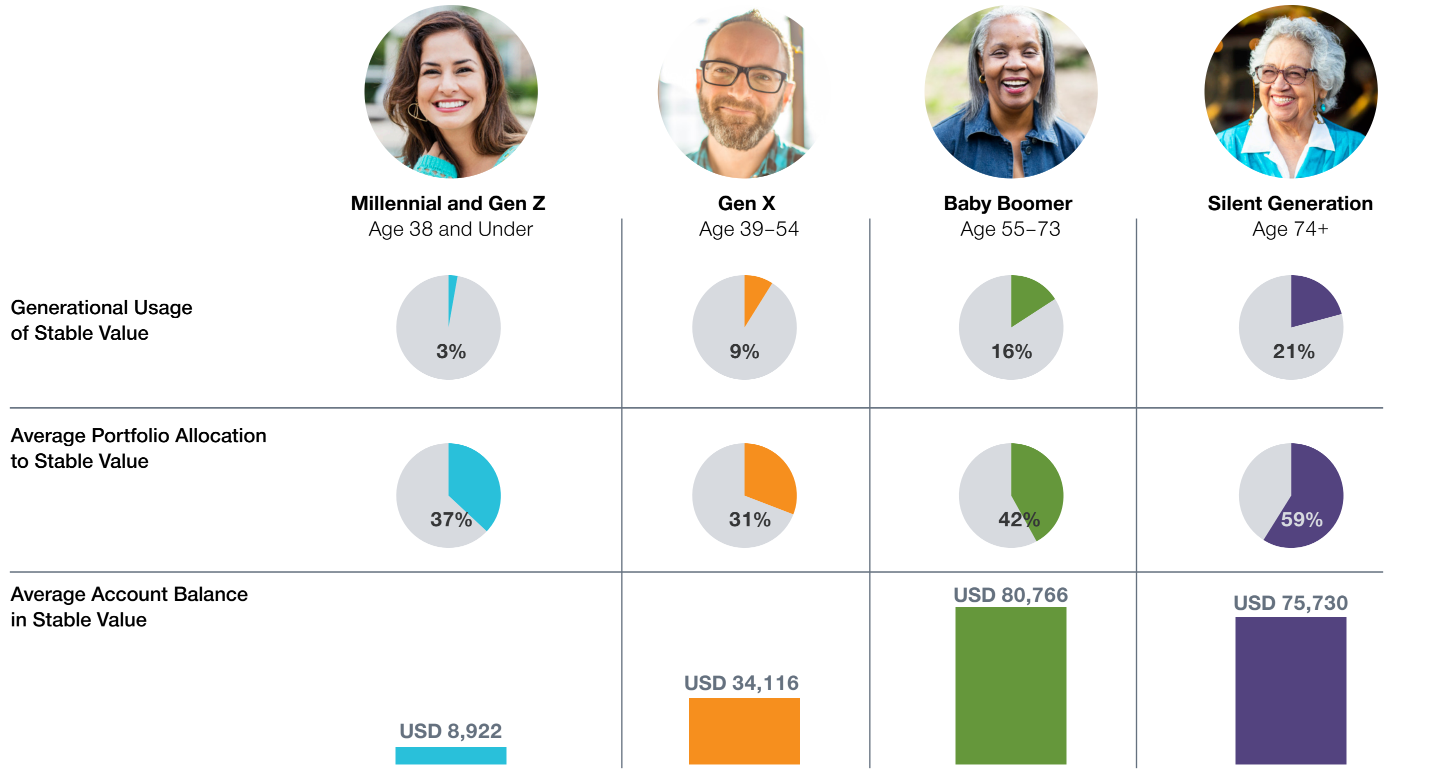
Evolution of Stable Value

The stable value industry has evolved significantly in recent years. Earlier changes included the development of the synthetic investment contract after the bankruptcy of several guaranteed investment contract issuers in the 1990s. The passage of the Pension Protection Act of 2006 shifted plan sponsors' qualified default investment alternative preference to target date funds while slashing a dependable source of cash flows for stable value. More recently, 2016 money market reform was a positive development for stable value flows. The newly passed SECURE Act may increase interest for retirement income portfolio building blocks, in our view.

[1] A required minimum distribution is the amount of money that must be withdrawn from certain retirement savings accounts, including 401(k) plans, by owners and qualified plan participants of retirement age.

Generational Use of Stable Value

(Fig. 1) Participants across generations use stable value as expected.



For illustrative purposes only, not to be construed as investment advice.
Source: 2019, Based on quarterly data for all DC plan participants in retirement plans administered by T. Rowe Price. T. Rowe Price Retirement Plan Services, Inc.

Skillfully Negotiating Through Market Cycles

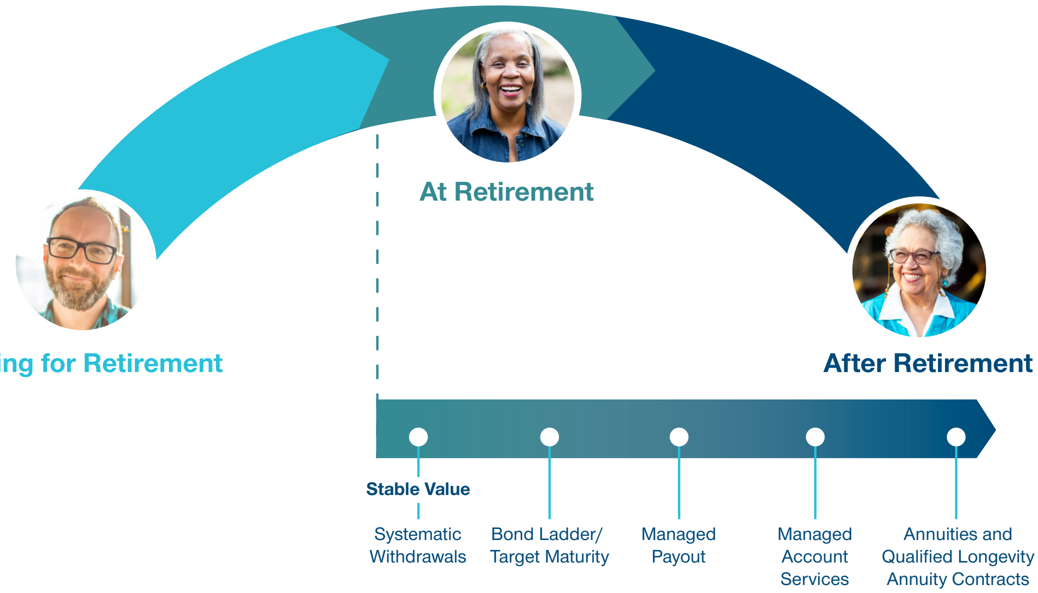
Perhaps the best way to view the adaptability of stable value is to examine the state of the industry before, during, and after the global financial crisis (GFC), a period that represents nearly a full market cycle. Stable value has endured periodic market disruptions, regulatory changes, and vastly different economic conditions. The level of change in the industry is best represented by the swings in negotiating leverage over the past 10 to 15 years (Figure 3). However, we believe stable value's adaptability has been a critical element of its continued growth and appeal.

Before the GFC, investment managers benefited from greater negotiating leverage with lower wrap fees and ample capacity. Investment guidelines were more relaxed by today's standards and often allowed for the inclusion of securities that would be generally considered inappropriate for stable value investment today, such as subprime and private-label mortgages, high yield, and emerging market debt. Once the crisis unfolded, the pendulum swung in the favor of wrap providers. Wrap fees spiked higher and capacity became limited. Wrap providers[2] also became much more risk averse and demanded more conservative investment guidelines. Wrap providers also used templated or standardized

[2] A wrap provider, through stable value investment contracts, "wrap" designated associated assets within a stable value investment option to provide book value protection for plan participants.

Stable Value's Adaptability

(Fig. 2) Stable value has a potential role throughout the retirement life cycle.



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"In this post-GFC period, T. Rowe Price has worked with wrap providers to simplify our stable value strategy and make it more accessible for plan sponsors and participants.

guidelines across investment managers, which did not allow any leeway in tailoring guidelines to an individual manager's strengths.

In today's environment, the stable value industry is more balanced. Wrap fees are more competitive, and wrap capacity, having increased as the market rebounded after the GFC, remains ample. Investment guidelines have become less restrictive, though in our view meet the needs of stable value investors. More importantly, wrap providers have moved away from templated investment guidelines and can be customized for each investment manager.

Simplifying Stable Value by Knocking Down Barriers to Entry

In this post-GFC period, T. Rowe Price has worked with wrap providers to simplify our stable value strategy and make it more accessible for plan sponsors and participants. Our recordkeeping platform includes more than 2 million Retirement Plan Services participants across more than 5,300 plans. Our footprint in the DC space has enabled us to facilitate adjustments between our platform and wrap providers that we believe are helpful to plan sponsors and participants without adding risk to our wrap providers.

We have worked with wrap issuers to relax some of the rules in the competing fund definition for our stable value portfolios. Wrap providers mandate competing fund provisions to prevent participants from arbitraging between stable value and other similar fixed income strategies by using an equity wash.[3] We were able to make the case for lowering the duration (duration measures a bond's or bond portfolio's sensitivity to interest rate changes) of a competing fund's definition down to two years from three years—to help make stable value more accessible and

[3] A provision in a stable value investment option that requires any transfer a participant makes from the stable value investment option to a competing option to first be directed to any other investment option not designated as a competing option for a period of time (usually 90 days).

The GFC's Impact on Stable Value

(Fig. 3) Negotiating leverage between managers and wrap providers is much more balanced.

Fees • Capacity • Guidelines • Contract Terms

Pre-GCF

Investment Manager | Wrap Provider

- Wrap fees: Low at 5–10bps
- Wrap capacity: Ample and dominated by banks
- Investment guidelines: Aggressive
- Contract terms: Require commitment letters

» Pension Protection Act
» Rising interest rates: Steep yield curve
» Economic growth
» Negative cash flows for stable value
» Manager disruption

Post-GCF

Investment Manager | **Wrap Provider**

- Wrap fees: Spiked to 20–25bps
- Wrap capacity: Low, banks exited, insurance companies entered
- Investment guidelines: Conservative and templated
- Contract terms: Strict

» Growth in financial regulation
» Low yields: Negative rates
» Economic recovery
» Positive cash flows for stable value
» Manager consolidation

Current

Investment Manager | **Wrap Provider**

- Wrap fees: Finding equilibrium at 15–20bps
- Wrap capacity: Ample, insurance companies dominate industry
- Investment guidelines: Conservative but appropriate for stable value
- Contract terms: Balanced

» Less regulation: More opportunities
» Low rates: Flatter yield curves
» Economic stability
» Neutral cash flows for stable value
» Manager disruption

For illustrative purposes only.
Note: bps = basis points.

less onerous for participants and plan sponsors. Importantly, on a case by case basis competing fund will also no longer include self-directed brokerage, so plan sponsors may be able to use one of our stable value offerings along with a self-directed brokerage[4] account without having to implement an equity wash.

Increasing Range of Stable Value Usage

Stable value has changed much since its inception (Figure 4). Beyond making stable value look and feel more like other fixed income options, today's stable value solutions are more portable across recordkeeping platforms and more transparent in terms of crediting rates,[5] fees, and holdings. Moreover, as wrap providers become more willing to relax put provisions for non-participant-directed transactions, stable value funds can be used as building blocks in other investment strategies like custom target date funds; managed accounts; and, in the future, retirement income strategies. Because of its focus on capital preservation and unique performance characteristics, stable value has often been used as a

[4] A structure some plan sponsors incorporate into their plan design that gives participants the opportunity to supplement a plan's core investment option menu through self-directed trading access in an in-plan brokerage account.
[5] The interest rate applied to the book value of a stable value investment contract, typically expressed as an effective annual yield. As provided in the investment contract, the crediting rate may remain fixed for the term of the contract or may be "reset" at predetermined intervals. The crediting rate may be expressed as a gross or net crediting rate. For separate account GICs or synthetic GICs, the crediting rate is the mechanism that allows the contract to amortize differences between the book value and market value over time.

As we look forward, we believe flexibility is critical as interest in and usage of stable value expands.

The Evolution of Stable Value

(Fig. 4) The structure and uses of stable value continue to evolve.

	Historical	Future
Product Structure and Features	• Guaranteed Investment Contracts • Opaque • Single-Wrap • Proprietary Manager Only	• Synthetic Investment Contracts • Transparent (holdings, fees) • Multi-wrap • Multi-manager • Active Fixed Income Management • Flexible Contract Terms (exit provisions, liquidity corridors, competing fund definitions)
Use Cases	• Standalone Investment Option • Target Date Funds • Managed Accounts • 529 Plans	• Retirement Income • 403(b) Plans • Nonqualified Plans • International Retirement Plans

For illustrative purposes only. Shows historical and possible future applications.

cash substitute and, in some instances, can replace the entire fixed income allocation in asset allocation models.

In addition to making stable value easier to use, we believe stable value managers must continue to work with wrap providers to ensure stable value is keeping pace with other fixed income strategies in terms of investment innovations and capabilities and to include integrating environmental, social, and governance (ESG) investing into their investment processes. At T. Rowe Price, we recognize the importance in ESG among plan sponsors and have begun the process of integrating ESG across our investment strategies.

To augment our stable value platform's flexibility as a solutions provider, T. Rowe Price added a multi-manager capability to our suite of stable value product offerings in early 2019. As a multi-manager solutions provider, we sought to improve upon existing product offerings to seek better long-term investment outcomes by leveraging the asset allocation and modeling capabilities that power our industry-leading multi-asset team and target date fund products. Moreover, we have focused on streamlining the investment and compliance processes by improving technology and electronic connectivity between T. Rowe Price and external managers.

Conclusion

As we look forward, we believe flexibility is critical as interest in and usage of stable value expands. Wrap providers and stable value managers need to continue to innovate and look for ways to simplify stable value offerings while maintaining attractive qualities that are unique to the asset class.

Stable value investing plays a core role as a standalone offering in DC plans. But as the retirement industry evolves, we believe stable value will gain traction as an anchor in the retirement strategies framework. Possible future applications include the use of stable value offerings as building blocks in custom target date strategies or other default strategies; use as a central lever in a suite of retirement income solutions; and, in time, with the passage of the Portman-Cardin reform bill, use in expanded plan types such as 403(b) plans. We remain vigilant in our approach to be nimble, adaptable, and prepared to meet evolving market needs.

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Important Information

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T. Rowe Price Investment Services, Inc.

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