



Article from

**Pension Section News**

February 2016  
Issue 88

# Fundamental Investment Principles of DC Option Selection Prove Optimality of Stable Value

By Paul Donahue

## INTRODUCTION

The performance of ERISA fiduciaries operating DC plans has been slow to get the attention it deserves,<sup>1</sup> but that appears at long last to be changing. In the unanimous United States Supreme Court decision *Tibble v. Edison*, the court stated: “Under trust law, a trustee has a continuing duty to monitor trust investments and remove imprudent ones. This continuing duty exists separate and apart from the trustee’s duty to exercise prudence in selecting investments at the outset.”<sup>2</sup> The court also stated: “We express no view on the scope of respondents’ fiduciary duty in this case. We remand for the Ninth Circuit to consider petitioners’ claims that respondents breached their duties within the relevant 6-year period under §1113, recognizing the importance of analogous trust law.”<sup>3</sup>

Investment actuaries and other investment professionals have an enormous opportunity for public service by educating plan sponsors and the courts on what “the care, skill, prudence, and diligence’ that a prudent person ‘acting in a like capacity and familiar with such matters’ would use”<sup>4</sup> means in the context of the selection and monitoring of investment options for a defined contribution pension plan. A clear understanding of what is required will increase the retirement income security of tens of millions of Americans and contribute to increased financial stability for the nation as a whole.

## WHAT IS DC OPTION SELECTION AS AN INVESTMENT PROBLEM?

Proper framing of a problem is nearly always essential to getting the right answer. It is important to recognize that a plan sponsor managing a DC lineup is: “responsible for directing and monitoring a diversified, multiple-asset class, multiple-manager portfolio.”<sup>5</sup> Choosing a lineup is a portfolio optimization exercise: “like the portfolio manager of a stock or bond portfolio, it’s the overall strategy that’s important, not just the individual names in the portfolio. Holdings within a portfolio have different risk, return, and diversification characteristics that contribute to the success of the overall portfolio and strategy. One must understand and acknowledge the implications of these characteristics when evaluating whether or not one component of the overall portfolio is doing what is expected of it.”<sup>6</sup> This is a far more

challenging exercise in the context of a DC plan that it is in the context of a corporate portfolio or even for a DB plan, since the range of participant preferences is far broader.

## ASSET CLASS SELECTION

Asset allocation overwhelmingly drives returns.<sup>7</sup> The asset category selection objective is clear: “When developing a portfolio to meet an identified objective, it’s critical to enable participants to select a combination of assets that offers the best chance for meeting their objective, subject to the investor’s circumstances. This “topdown” asset allocation decision largely determines the success or failure of meeting the objective.”<sup>8</sup> This is a challenging topic, on which there is a wide range of views.<sup>9</sup> However, the point I make is that the ability to construct an efficient frontier portfolio depends on risk/return/correlation characteristics of the investment option or options chosen for each asset category selected.

## WHAT ERISA REQUIRES

Although *Tibble* showed conclusively that the 404(c) safe harbor<sup>10</sup> does not protect plan sponsors against imprudent selection of options, many plan sponsors design their plans so as to be able to take advantage of the safe harbor. The safe harbor requires that there be at least three alternatives, which in the aggregate enable a participant to achieve any risk and return objectives within a “normally appropriate” range.<sup>11</sup> In particular, the safe harbor requires “an income-producing, low risk, liquid” option.<sup>12</sup> Plan sponsors have almost universally chosen either money market or stable value to meet this requirement,<sup>13</sup> though a relatively short bond fund would almost certainly qualify as well.<sup>14</sup>

## INVESTMENT ANALYSIS OF THE SAFE OPTION

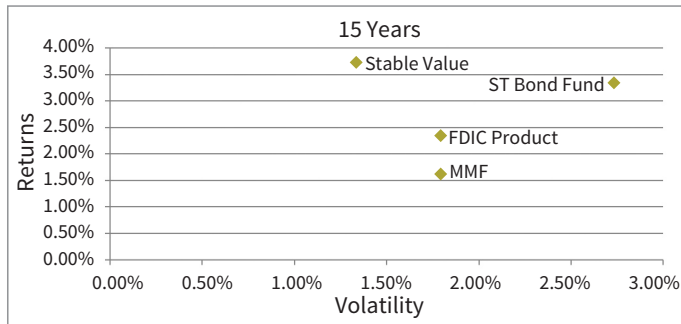
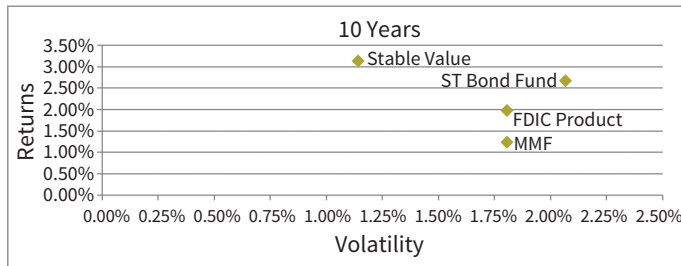
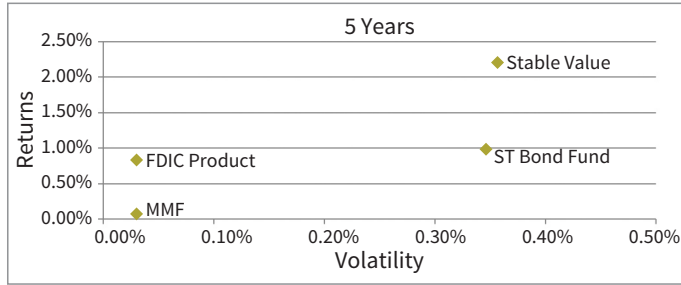
### *What is Stable Value?*

Stable Value is an asset class available only in defined contribution plans created by an accounting rule, an inversion of what might seem the natural order of things.<sup>15</sup> Modern stable value is the creation of SOP 94-4, and stable value must conform to its rules, as it has been amended. The rules basically require that participants be able to transact at a stable (non-decreasing) net asset value for all transactions permitted by the plan.<sup>16</sup> Stable value, bank deposits and money market funds are the only defined contribution options that can be reported at a stable net asset value, and existing defined contribution plans almost universally use either stable value or money market (or both) as a plan’s safe option.<sup>17</sup>

## QUANTITATIVE SAFE OPTION RETURNS<sup>18</sup>

The tables and charts present data on four possible alternatives for a safe option: stable value, money market, an FDIC-insured account and a short bond fund. The stable value returns are from Stable Value Investment Association data. I have used

three-month Treasury bill yields to approximate money market returns. I have chosen a simple approximation to an FDIC product of money market plus 75 bps. I have used the Barclay's U.S. Government 1-3 Index returns less 20 bps to approximate the return of a short bond fund.



Correlations

Correlation (2000-2015)	Stable Value	Money Market	S&P Total Return	World Equity ex US	Barclays US Agg.
Stable Value	1				
Money Market	0.795081442	1			
S&P Total Return	-0.522248438	-0.309966429	1		
World Equity ex US	-0.239144156	-0.101446219	0.874733709	1	
Barclays US Aggregate	0.643634307	0.420308629	-0.535919118	-0.43055794	1

Stable value returns meaningfully exceed those of all safe option alternatives for each historical period, and overwhelm money market returns, averaging more than 2 percent in absolute return higher, with returns double those of money market funds. Obviously, five years of flat line zero money market returns have reduced volatility for money market (and the FDIC model based on it), but low volatility because of constant zero returns, with returns artificially flat because of fees waived to the extent needed to maintain a stable net asset value, cannot be considered a plus. Over the longer periods, even with the reduced volatility of the last five years, stable value volatility is lower than that of all safe option alternatives. Finally, the correlations to other asset classes are lower for stable value than for the proposed alternatives.

There is no plausible quantitative defense for choice of a safe option other than stable value.

ONCE STABLE VALUE CHOSEN, WHAT ANALYSIS REMAINS?

Deciding on stable value as the safe option is the easy part. Plan sponsors consider the needs of their participant populations to make a prudent choice among stable value funding vehicles. Despite the differences in plan populations, I suggest that the vast preponderance of plan participants would want the following two features: 1) full liquidity of their stable value balances for withdrawals, and 2) all withdrawals at contract value.

POOLED FUNDS

Stable value as defined in this article is available in two form forms, stable value collective investment funds, ("pooled funds") and individually managed accounts. Different pooled funds make available an array of contract terms, underlying investment strategies, and stable value contract issuers. Pooled funds are generally aimed at smaller plans, while large plans generally use individual accounts. However, closer attention to design features may lead larger plans to pooled funds as well, should they conclude that design features they value are available in pooled funds but not in individual accounts.

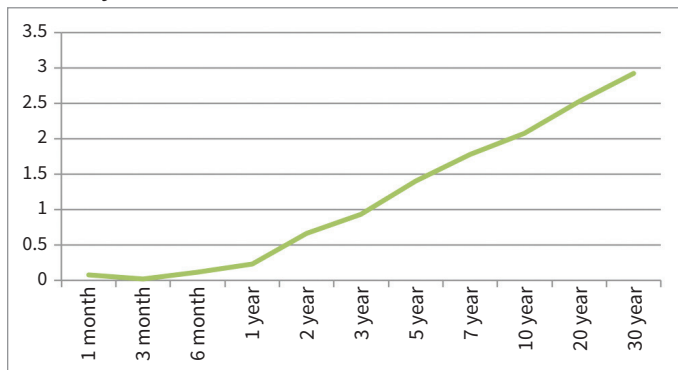
So called "employer event" carve-outs are the best example. Most pooled fund contracts do not restrict contract value payments to participants in the case of employer layoffs or "employer-initiated events." A terminated vested plan participant who had lost his or her job would be entitled to withdraw funds from his or her account balance at contract value, subject to payment of tax and any applicable penalty. The availability of such a provision in a pooled fund, but not in an individual account, would be a perfectly legitimate reason for a plan sponsor to choose a pooled fund (or pooled funds, if the size of the option was too big for a single pooled fund to accept) over an individual account.

## POOLED FUND EXIT PROVISIONS

The most readily apparent differences in pooled funds relate to exit provisions. Most common is the right for a plan to exit at contract value with 12 months' notice, regardless of the market value of the underlying assets. Some pooled funds have two-year put provisions, and some plans require that plans exit at the lower of contract value or market value. The "lower of book or market" exit has encountered market resistance among sponsors.

However, it is clear that the lower of book or market exit is best for plan participants wherever a relatively short-term exit is not foreseen at purchase of pooled fund units. A twelve-month put provision will frequently be in the money. The possibility of a "death spiral" where lower crediting rates spurred additional puts which led to still lower credit rates and still more puts is a legitimate issuer fear, and stable value contract issuers nearly universally manage this risk by limiting the duration of the pooled fund asset portfolio. There is no risk of a death spiral in pooled funds with a lower of book or market exit provision, and so issuers can permit much longer durations, with correspondingly greater expected yields.

Treasury Yield Curve as of 10/20/2015



In the context of a retirement savings program, the difference between a duration of 2.5 years and 4.5 years is significant, and can easily make the difference between returns that exceed inflation and returns that don't keep pace with inflation.

## INDIVIDUAL ACCOUNTS

Economies of scale, and avoidance of the additional layer of trust level expenses, mean crediting rates for individually-managed accounts generally exceed those for pooled funds. Based on SVIA stable value return data, the difference averaged 45 basis points over 15 years. However, cost-effective management of an individual stable value option is best left to a stable value manager. Developing the required internal resources would not be a good use of resources for most plans.



Among the most important considerations are contract termination provisions and contract exceptions to contract value payment for all participant-directed transactions. A contract that can be terminated on short notice, or for a reason not related to the stable value risk, at market value, is worth very little. If a plan sponsor believes full coverage at contract value for all participant withdrawals is important, and cannot obtain it in individual contracts, that could be a legitimate reason to prefer a pooled fund.

## DIVERSIFICATION CONSIDERATIONS

In stable value contracts, various forms of diversification can compete with each other and with the sponsor's plan design preferences for priority. A pooled fund or plan sponsor could rationally prefer choice of investment managers for the fixed income assets underlying a stable value contract as more important than wrap diversification. In particular, a plan sponsor could rationally prefer full coverage for all participant transactions at contract value as more important than stable value contract issuer diversification, even if that coverage came with a yield sacrifice.

## CONCLUSION

Plan sponsors have a fiduciary duty to select plan options, including the safe option. Investment professionals have a public service opportunity to enhance the retirement security of tens of millions of Americans by providing plan sponsors with the reasoned analysis they need to do their fiduciary duties responsibly. This article is my contribution to trying to meet that need. ■

**ENDNOTES**

- <sup>1</sup> See my article, "Plan Sponsor Fiduciary Duty for the Selection of Options in Participant-Directed Defined Contribution Plans and the Choice Between Stable Value and Money Market," 39 AKRON L. REV. 9 (2006), P. 11 [hereinafter "Sponsor Fiduciary Duty"].
- <sup>2</sup> *Tibble v. Edison*, 575 U.S. \_\_\_\_\_ (2015). In November, 2015, cases against Boeing and Novant Health were settled for \$62 million and \$32 million respectively.
- <sup>3</sup> *Ibid.*, at 7.
- <sup>4</sup> *Ibid.*, at 5.
- <sup>5</sup> JOHN P. MEIER, *Investment Performance Appraisal*, CFA Institute (2008), p. 799.
- <sup>6</sup> *Ibid.*, p. 800.
- <sup>7</sup> See *Constructing a defined contribution investment lineup: Vanguard's five best practices* (Vanguard, September, 2012), pp. 2-3. My brother, now comfortably retired while I labor on, has shown uncannily good judgment on when to sell stocks and buy houses, and when to sell houses and buy stocks.
- <sup>8</sup> *Ibid.*, p. 2.
- <sup>9</sup> At one extreme, see *Rethinking Diversification in Defined Contribution Plans*, Northern Trust, 2013, which lists commodities generally, and gold in particular, as possible DC diversifiers. Vanguard, see above note 8, p. 10, suggests two stocks funds, one bond fund and a safe option are enough. I incline more to the Vanguard view. The responsible plan sponsor will take into account the need to educate plan participants, and their ability to evaluate the soundness of nontraditional asset offerings.
- <sup>10</sup> See, e.g., <http://www.fiduciaryawareness.com/404c-safe-harbor/>.

- <sup>11</sup> Sponsor Fiduciary Duty, p. 18.
- <sup>12</sup> *Ibid.* I will in the future refer to an "income-producing, low risk, liquid" option as the "safe option."
- <sup>13</sup> *Ibid.*, p. 19.
- <sup>14</sup> *Ibid.*, p. 19, n. 49.
- <sup>15</sup> See my article *What AICPA SOP 94-4 Hath Wrought: The Demand Characteristics, Accounting Foundation and Management of Stable Value Funds*, 16:1 BENEFITS QUARTERLY 44 (First Quarter, 2000) [hereinafter "Stable Value Funds"].
- <sup>16</sup> See Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans, FASB Staff Position Nos. AAG INV-1, SOP 94-4-1, Posted December 29, 2005 [hereinafter AAG INV-1/SOP 94-4-1]. AAG INV-1 allows some significant qualifications to this one sentence summary, some of which I will discuss below.
- <sup>17</sup> See MetLife Stable Value Study.
- <sup>18</sup> I am grateful to my colleagues Alan Chia and Besim Demiri for the quantitative analysis.



Paul Donahue, FSA, MAAA, is assistant vice president at MetLife in New York, N.Y. He can be reached at [pdonahue@metlife.com](mailto:pdonahue@metlife.com).

# Advancing Retirement Readiness

## THE 2016 RETIREMENT INDUSTRY CONFERENCE

MAY 4 – 6, 2016 • THE WESTIN COPLEY PLACE • BOSTON, MA

Learn about the implications of the DOL's fiduciary proposal on employer plans and retail product design

Boost your knowledge of the impact of robo-advisor technologies on the delivery of retirement planning services

Explore the latest research for applying behavioral finance techniques to advancing retirement readiness

*For complete information, visit either sponsoring association's website or call 800.235.4672*

www.secureretirementinstitute.com

www.soa.org