USI ADVISORS, INC.

COVID-19 UPDATE

Stable Value in an Unstable Environment

May, 2020

To say that the current environment is unstable is a bit of an understatement. Market volatility is rampant, investor confidence has been shuddered, and the outlook for the global economy is relatively bleak, to say the least. While equities have tumbled and fixed income has generated mixed results in recent months, one investment option, stable value, has proved resilient.

Stable value funds, which offer capital preservation, stability, and benefit-responsive liquidity for participants, are quite prevalent in defined contribution plans, with over $839B invested across 179,000 plans as of year-end 2019, per The Stable Value Investment Association (SVIA). For more than a decade, as equities enjoyed the longest bull market on record, participants who invested a substantial portion of their retirement assets in a plan's stable value option missed out on considerable gains. However, when the bear market returned with a vengeance at the end of the first quarter of this year, bringing with it heightened volatility, the distinct possibility of significant negative returns and capital losses, and an overall sense of unrest in the markets, it was those same participants who were able to sleep quite a bit better at night, as even during a bear market, stable value returns are generally, as the name indicates, stable.

During the Financial Crisis of 2008-2009, stable value products continued to generate positive returns without interruption, with the net crediting rate for stable value funds at an average of 4.17% per The Stable Value Investment Association. Moreover, the stable value wrap providers proved to be "quite resilient" with "no providers needing to cover losses," according to a paper published by Russell Investments titled, "Guidelines for Investing In Stable Value Post-2008". Yet as the economy and markets continue to feel the effects of the COVID-19 pandemic, participants and plan sponsors alike are surely wondering if the stable value option in their plan is generally "safe".

The short answer is yes, stable value funds are relatively safe. However as with any investment, there are some embedded risks which include, but are not limited to, the following:

- **Interest rate risk:**

  There are two issues to consider with interest rate risk. The first is that interest rate changes can affect the market value of the fund if these changes cause the underlying securities to lose value. This could cause the market value to be lower than the book value. Another issue to consider is that when interest rates rise or fall quickly, a stable value fund's return will be affected more slowly than that of a money market fund. This is a positive in a declining interest rate environment, as we have observed as of late. In a rapidly rising rate environment, however, a stable value fund will take a longer time to adjust its rates than would a money market. It is important to note, however, that over time the returns of stable value funds have outpaced the results of money market funds.

  - **Why interest rate risk is relatively low:**

    Similar to bond funds, stable value funds typically invest in high quality corporate and government bonds. However, unlike bond funds, stable value funds purchase insurance wrappers (contracts from banks and insurance companies) that guarantee the principal and accumulated interest even if the underlying investments decline in value. As such, a stable value offering carries the value of the portfolio at book value even if the market value of the portfolio as a whole is below its book value. Compared to the Financial Crisis, market-to-book ratios have been stronger so far during this pandemic crisis.

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- **Contract risk:**

  This is a risk associated with the wrap contract issuers. The stable value contracts are designed to allow for participant driven transactions to be conducted at book value. A contract could lose its book value withdrawal features if the following occurred: an issuer defaults on its obligation, an event of default occurs that renders the contact invalid, the contract lapses before a replacement wrap can be found with favorable terms, and/or employer-initiated events.

  - **Why contract risk is relatively low:**

    The assets in a stable value fund are owned by the retirement plan, not the insurance companies or banks that issue the wrap contracts. Therefore, in the event one of these wrap providers filed for bankruptcy, creditors would not have access to the stable value fund's assets. Moreover, many stable value funds have numerous wrap providers and, as a result, their exposure to a single wrap provider is typically low. Even those backed by a single insurance product are backed by large insurance companies where the risk of default is relatively low.

- **Cash flow risk:**

  Cash inflows can have an impact on a stable value fund's return. Cash flows out of the fund, like withdrawals or terminations, have an effect on the fund, potentially causing gains or losses for the underlying portfolio that will now be spread among the remaining investors in the smaller asset base.

  - **Why cash flow risk is relatively low:**

    The fact that these stable value funds are offered in tax-deferred retirement plans makes the odds of mass withdrawals less likely, considering that participants really only have two options: either move the money to another, more risky fund in their plan (which is not likely given typical participant behavior in bear markets), or take the money out, which would generate taxes and early-withdrawal penalties. In other words, a "run on the bank" is unlikely.

As the world is seemingly falling apart around us, and investors everywhere are searching for some sort of stability, stable value strategies are working as intended and offering those invested in the asset class a bit of comfort. However, while stable value may be offering the stability that investors crave now as markets remain volatile, one never knows when and if the equity markets will skyrocket. As such, it is always prudent to remain focused on the long-term and always keep your strategic allocation in mind when making these decisions.

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