Rocaton

INSIGHTS

Conservative Options in Defined Contribution Plans

March 2017

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EXECUTIVE SUMMARY

* Capital preservation options are widely utilized in DC plans and, in fact, data shows participants can over-allocate to these options. For some, capital preservation is the ultimate "sleep at night" option. For others, it's a conservative strategy designed to limit risk to principal and preserve purchasing power of assets.
* There is an evolving spectrum of options in the marketplace to address various participants' needs.
* There are several timely reasons why plan sponsors should revisit these options within their plan line-up including:
  * **Money Market Reform:** New money market regulation took effect in October 2016. All prime money market funds are now subject to potential liquidity fees and redemption gates during certain periods of market stress, and institutional prime funds adopted a floating net asset value (NAV). In a previous Rocaton Insights, we suggested that clients with an existing prime money market fund in their DC plans may want to switch to a government money market fund.
  * **Industry Trends:** In the DC marketplace, there has been a trend toward streamlining the investment menu (by reducing the total number of investment options from which a participant can choose), which is aligned with a best practice of periodically evaluating a plan's investment structure. Further, in light of money market reform, the introduction of money market "alternatives" by managers has increased. Some suggest that there are perfect substitutes available: however, we will outline in this paper that these alternatives have specific risk reward profiles and characteristics that should be evaluated from both a participant and sponsor perspective.
  * **Litigation:** Litigation surrounding capital preservation options was prevalent during 2016 and may continue. Cases continue to focus on fiduciary breach and excessive fees, and the appropriateness of certain capital preservation options relative to others has become a component in newer cases. Further, the structure, features, fees and communications of certain capital preservation options have also been a focus in some litigation. While we do not suggest litigation concerns should drive investment decisions, these developments underscore the benefit of periodically revisiting investment structure decisions and the important role that capital preservation options play within an investment menu.

  * **Interest Rate Environment:** Interest rates continue to remain relatively low. While this environment may or may not persist, currently demand for government securities remains high, keeping nominal yields and real returns on money market funds low.
  * **Changing Stable Value Landscape:** The stable value landscape has evolved in recent years. While there continues to be unique risks and costs associated with the strategy, the option has generally delivered on objectives and emerged stronger following the financial crisis.
* This Insights evaluates the most heavily represented Defined Contribution capital preservation plan options and provides a framework for constructing and communicating the most appropriate line-up for participants.
* There is no one size fits all for DC plans; this paper seeks to provide educational information on capital preservation options. Importantly, developing a process for the evaluation of the appropriate capital preservation option within a DC plan is critical.

INTRODUCTION

What is Capital Preservation?

For some, capital preservation is the ultimate "sleep at night" option. For others, it is a conservative strategy designed to limit risk to principal and preserve purchasing power of assets. Participants may ultimately use a capital preservation option for a variety of reasons, and it may be appealing for those that are risk averse, preparing for a withdrawal in retirement, expressing a market view, or investing additional assets outside a plan such that using a capital preservation option within the plan makes sense.

There is an evolving spectrum of options available in the marketplace to address various participant needs, and while some may not associate capital preservation with a variable NAV, ERISA does not explicitly require a plan to offer a constant dollar option (or even an explicit capital preservation option.)

Figure 1 reflects a comparison across potential capital preservation options in DC plans. The role of such an option may vary, as may certain characteristics about the option (such as the investment universe, duration, return expectations and volatility.)

Figure 1:

	Government Money Market	Stable Value	Short Duration
Objective	"Sleep at night", immediate liquidity and capital preservation	Expectation (but not a guarantee) of principal protection. Short-intermediate bond returns (less the cost of the insurance wrapper) with money market volatility	Avoid loss of principal over the short-term. Higher expected returns relative to money market with modest volatility
Investment Universe	U.S. government agencies, treasuries, and repurchase agreements backed by the same	High-quality, short-intermediate fixed income investments "wrapped" with a bank/insurance guarantee	High-quality short-intermediate fixed income investments
Duration	0.15 years, max 60-day weighted average maturity	2-3 years	2-3 years
10 Year Return Expectations	Similar to 90-day T-Bills	Similar to short- to intermediate bonds over a market cycle	Short Bond Index (2–3% compound based on Rocaton's Forecasts)
Expected Volatility	Limited	Similar to money market due to book value feature	Moderate
Typical Fee Range*	10 – 20 bps	Wrap Fees: 20–25 bps Investment Mgmt Fees: 10–25 bps Total: 30–50 bps	Active: 20–40 bps Passive: 5–15 bps

*Assumes institutional pricing

The capital preservation options above tend to be the most heavily represented in DC plans; however, there are several other options that may be reasonable choices based on plan demographics, availability on one's recordkeeping platform, and investor objectives.

While not prevalent, other capital preservation options could include investments such as:

1. FDIC-Insured Bank Accounts: insured by the FDIC up to $250,000 per participant
2. Bank CDs: certificates of deposit with various maturities; also insured by the FDIC up to $250,000 per participant
3. Ultra-Short Bond Funds: funds with approximate duration of one year, may include money market and non-money market eligible securities

The rest of this paper highlights the benefits and considerations of various capital preservation options available in DC plans:

Money Market Funds

The new SEC rules, which went into effect October 2016, differentiate money market funds based on eligible security types, ability to transact at a stable NAV, and the requirement to implement liquidity fee and redemption gate provisions. We recommended that clients with a prime money market fund within a DC plan who would like to keep a money market fund in the line-up may want to move to a government money market fund that will maintain a constant NAV and not be subject to the mandatory gate and fee provisions.

The benefit of a government money market fund is that it is arguably the lowest risk option within the capital preservation spectrum. The guidelines are extremely conservative requiring funds to invest 99.5% or more of their assets in cash, government securities, and/or repurchase agreements that are collateralized solely by government securities and cash. It is an appropriate option for those seeking maximum liquidity and as little credit risk as possible and under Rule 2a-7, money market funds must maintain a weighted average maturity of 60 days or less, a weighted average life of 120 days or less, and all debt must mature in under 13 months.

Compressed short-term yields have limited nominal returns and have generated negative real returns in recent years. While we cannot predict where rates are headed in the future, given the new reforms, demand for government money funds is robust and will likely remain elevated for the near-term. For those seeking to protect purchasing power, money market funds may not guarantee this protection at the current time. For investors willing to accept incremental risk, other options exist that have demonstrated limited drawdown but offer greater return potential.

Stable Value

Stable value seeks the returns of short-intermediate bond funds with money market like volatility. Volatility is minimized through a smoothing mechanism which amortizes declines in market value rather than recognizing mark-to-market losses immediately. Due to this unique profile, stable value is an appealing option with participants. However, it is a unique asset class with positive and negative attributes.

The asset class has evolved over time and most portfolios today consist of actively managed fixed income portfolios combined with "wrap" agreements from bank and insurance companies that allow most participant-directed transactions to occur at book value, even when market value has declined below book value. Stable value experienced a real-life stress test during the credit crisis of 2008-2009, which highlighted many of the risks of the asset class. While some of these risks persist, stable value managers today are more thoughtful about measuring and mitigating these risks and the market is in better structural shape with an abundance of wrap capacity generally available for new and existing plans.

Following the financial crisis, a significant amount of stable value assets needed to be wrapped or "re-wrapped" with limited supply available. In some instances, funds were terminated due to an inability to obtain sufficient wrap capacity. Today, the supply picture is much improved. Several new providers have entered the market, and from 2012 to 2015 new contract issuer capacity totaled approximately $350 billion[1]. As a result, managers have choices and are enhancing contract terms regarding termination provisions, market value events, reporting requirements, and addressing changes to the marketplace. Wrap fees, however, are generally higher post-crisis at approximately 20-25 bps.

The stable value marketplace has experienced challenges, but in general the asset class has achieved its objectives over the long-term of delivering better than cash returns with stable account balances for participants. Further, while the greatest risk to participants remains—being subject to a market value event when market is below book—even during the crisis instances of this were limited, and greater controls have been put in place by most managers to limit the market to book divergence.

Despite the improved health of the market, the strategy is not without its challenges and risks, which may vary by stable value structure and vehicle. Rocaton highlights the following typical risks:

* **Structural Complexity:** The option, while appealing, is not well understood by plan participants. Participant-directed contributions, withdrawals, and net transfers can adversely affect the market to book value of the portfolio and/or the crediting rate. Also, the true investment risk of the option is obscured by the book value guarantee.
* **Investment Constraints:** Competing options are typically subject to an "equity wash", limiting flexibility to participants. An equity wash requires any transfer a participant makes from stable value be first directed to a non-competing option for a period of time, usually 90 days.
* **Contract Risk:** The investment contract provider could default resulting in a loss of book value guarantee to participants. Additionally, market value events may occur due to employer-initiated events such as layoffs, sale of division, bankruptcy, or general plan changes or actions that may result in large flows in or out of the stable value option.
* **Sponsor Constraints:** The book value contract providers also can exert a significant amount of influence over the overall DC plan design and limit plan sponsor flexibility. For example, following the credit crisis some sponsors were limited in their ability to terminate the stable value option as providers lengthened the liquidity period by a number of years as the market value of the fund was well below book value. Further, discontinuance provisions vary by vehicle type, including guaranteed insurance products, commingled funds and separately managed accounts; therefore, it is important to evaluate different withdrawal scenarios when evaluating a stable value product.

1 Galliard Capital Management, Inc.

* **Fees:** Fees charged by stable value products are less transparent than for money market or short duration options. Further, while many firms have entered the wrap business, fees have risen to a much higher level than in the past increasing the cost of the market-to-market smoothing mechanism that distinguishes this strategy.
* **Participant Cash Flows:** Due to the smoothing mechanism of the crediting rate process, participant cash flows may affect the returns of other participants in a stable value fund. For example, during a period when market value is below book value, a significant outflow by participants (whose distribution is paid out at book value) will reduce the crediting rate paid to remaining participants.

It is also important to note that while included under the stable value umbrella, guaranteed insurance products, either issued by an insurer's general account assets or segregated separate account assets, have additional complexities to consider including often onerous discontinuance provisions, as well as lack of transparency in fees, the crediting rate calculation, and the underlying portfolio investments and guidelines. There has been some litigation with respect to these offerings, mainly targeting the insurers offering products, but in some instances directed to the plan sponsor.

Short Duration Bond Funds

Most short duration options are benchmarked to a 1-3 Year Government Index, 1-3 Year Government/Credit Index or 1-5 Year Government/Credit. However, options with different benchmarks exist. Generally, short duration funds have a higher expected long-term return than money market funds but are accompanied by modest volatility of returns. While these funds do not seek to maintain stable NAVs and offer no guarantees, they are generally designed to avoid loss of principal for investors with intermediate to long time horizons.

Short duration bonds funds are fairly transparent, and invest in similar securities to the underlying bond portfolios within actively managed stable value strategies. These strategies are subject to mark to market volatility, but, given the short duration positioning of these options, historical drawdown experience has been limited in magnitude and length of time.

Participant Considerations:

How a participant uses a capital preservation option, or any investment option in a DC lineup, should be a key consideration. We know that usage of capital preservation options in DC plans varies and there is the potential for misuse, which can often be masked by plan-level statistics. Given this information, Rocaton would make the following observations and recommendations:

* One issue with current capital preservation options is that many participants over-allocate to these options that are not necessarily meant to be a long-term savings option.

* Some participants and assets may only be in those options as a result of prior default options or legacy plan structure decisions. Therefore, if a plan sponsor is streamlining in the future or making investment structure changes, it is not a given that mapping to a like-fund option is appropriate.
* Finally, this information stresses the need for participant communications in conjunction with conservative options.

Communications Considerations

There are several reasons why participant communications with respect to capital preservation options are important.

Given that participants often misuse capital preservation options, the need for targeted communications may be warranted, especially for those younger participants over-allocating to the plan's most conservative option(s). Communications may be needed to de-emphasize the long-term role of a capital preservation option; and rather, the appropriate use in the short-term. For example, communications could highlight the ways in which a government money market fund might be used: for participants seeking ultimate safety of principal, for participants expressing a short-term market view, for allocating assets that may be withdrawn/spent/reallocated in the near-term. When necessary, a recommunication of the role of available plan options may be warranted.

Next, in plans where more than one capital preservation option may be offered, communications are even more important to properly distinguish the differences between the options.

Rocaton generally believes that capital preservation options should not play a significant role in a participant's long-term investment strategy. However, we note in data we've collected that many participants have more than half their balance in the plan's most conservative option. Plan Sponsors should periodically revisit their participant communications and how the role of a capital preservation option is portrayed as part of the larger investment structure, and overall participant investment portfolio.

Structural/Implementation Considerations

The capital preservation options that we have outlined are not perfect substitutes for one another. Plan sponsors need to weigh a variety of factors when designing the line-up from both a sponsor and participant lens. Importantly, it is necessary to have a defined process around evaluating such decisions and communication around it. Rocaton has identified some reasonable structures to consider:

Single-Option Structures

Structure	Pros	Cons
Government Money Market	• High quality, transparent investment with stable $1.00 NAV • Not dependent on a wrap provider • No constraints on sponsor • Lowest credit risk • Greatest liquidity	• Lower return profile, not a long-term savings vehicle • Currently producing negative real returns and future return expectations are low due tochanging supply and demand dynamics • Large gap in the risk/return profile between money market and the next most conservative option (typically core bond)
Stable Value	• Appealing to many participants due to unique profile – short-intermediate term bond like returns with cash-like volatility • Liquidity at book value under most conditions • Historical returns higher than money market	• Complexity related to contract provisions • May limit sponsor flexibility • Limits participant flexibility—mandatory equity wash • Extra fees for bank/insurance guarantee • Circumstances under which participant may transact at market rather than book
Short Term Bond	• Liquid, transparent, higher returning option • Limited risk to principal and better opportunity for purchasing power protection • Cheaper and less complicated relative to a stable value fund • Higher returns than money market but not always stable value	• Potential for short-term volatility—not a constant NAV option • May not satisfy some participants/sponsors definition of capital preservation • Peer risk to sponsor as short term bond as standalone capital preservation option is currently uncommon

Multiple-Option Structures

Structure	Pros	Cons
Government Money Market and Stable Value	• Provides participants with a full suite of constant NAV options	• Too many constant NAV options may encourage over-allocation to capital preservation space • Not allowed by all stable value managers • May limit sponsor flexibility • Limits participant flexibility—mandatory equity wash • Complicated communication needs in differentiating roles among capital preservation options offered
Government Money Market and Short Term Bond	• No restrictions on other DC plan features • Gives participant constant NAV and higher returning variable NAV option	• Too many capital preservation objectives may encourage over-allocation to capital preservation space • Complicated communication needs in differentiating roles among capital preservation options offered

Conclusion

As we are defining a capital preservation option, there is an evolving spectrum of available options. There is no "one size fits all" solution for all DC plans, and we've attempted to highlight potential structures above that are appropriate choices for sponsors to evaluate for their plans and their plan participants. Due to various industry developments, Rocaton believes this is an appropriate time to revisit the DC capital preservation option(s) if such a review has not been undertaken recently, redefine the objectives of that option, document the decision-making process, and importantly, communicate the role and expectations of the capital preservation option(s) to participants.

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