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Strategy Spotlight

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Stable Value: A Solid Option Even Amid Rising Rates

Stable value strategies are among the most popular approaches to capital preservation in defined contribution (DC) plans, with some $700 billion in assets held by millions of participants. For more than three decades, they have focused on delivering steady returns that exceed those of money market instruments over market cycles.

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Stable value strategies typically combine investment contracts, sometimes known as "wraps," with fixed income investments. Because the bonds are usually short-to-intermediate-term investment grade securities, they generally yield more than the short-term instruments commonly held in money market funds. The wraps, issued by large financial institutions, are intended to provide an assurance of principal and income and are designed to smooth the stable value portfolio returns in exchange for a fee.

Given recent market volatility, plan sponsors and consultants are questioning how stable value strategies might perform if interest rates rise in the coming years. These new concerns follow challenges many sponsors faced after the financial crisis, when some wrap issuers were keen to de-risk and demanded extensive renegotiation of contracts and fees, while other issuers simply left the market.

Today, the outlook for stable value strategies has improved thanks to strong fixed income performance and the entrance of several new wrap issuers. PIMCO also believes stable value remains a solid option for plan sponsors and participants. And while sponsor concern over rising rates is not unreasonable given that stable value is, at its core, a fixed income product, past interest rate cycles suggest stable value strategies have the potential to successfully navigate rising rates. Indeed, because stable value allows participants to transact at their invested principal balance plus any accrued interest, no matter the interest rate environment, it can be a very attractive option if rates rise.

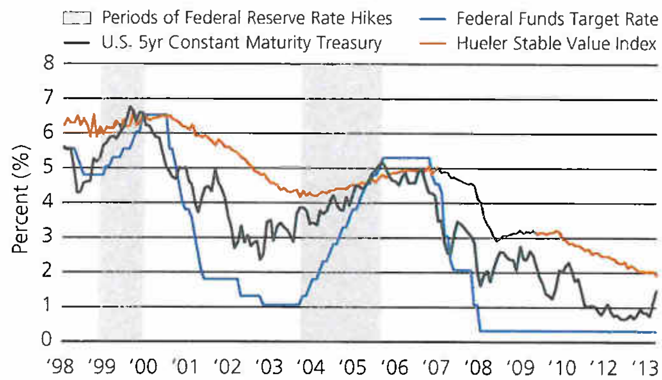
Rising rates should be manageable

Although interest rates have been in secular decline over the past three decades, there have been several intervals when the fed funds rate rose, sometimes abruptly. Although no guarantee of future results, these periods give an idea of how stable value strategies may perform if rates move higher.

In general, stable value's returns, also known as the "crediting rate," historically have followed the broader trend in bond yields, but with a lag. Figure 1 compares the annualized monthly return of a stable value proxy, the Hueler Stable Value Index, with the yield of the 5-Year Constant Maturity Treasury (CMT) Index, which represents the general trend in short-to-intermediate interest rates, and the federal funds rate.

FIGURE 1: STABLE VALUE RETURNS FOLLOW CHANGES IN INTEREST RATES WITH A LAG

Stable Value 5yr CMT performance during periods of Federal Reserve rate hikes over the past 15 years



Source: PIMCO, Bloomberg, Hueler Analytics, Federal Reserve Bank of St. Louis, as of 30 June 2013

The most recent full fed funds rate cycle (January 2001 to June 2006), for example, showed quintessential stable value performance. Once rates established a downtrend in 2001, stable value returns declined. By 2004, after rates had bottomed and started moving higher, stable value began to turn upwards, too, although with a characteristic delay.

Many industry professionals believe stable value would perform similarly should interest rates rise over the secular horizon: After a delay, stable value returns would likely gradually increase, albeit more slowly than the yields of intermediate fixed income or money market investments.

The participant experience: potential for steady growth of an investment

From a participant's perspective, if rates rise, stable value as an investment strategy in theory would provide better outcomes than bond portfolios by avoiding the immediate mark-to-market principal losses experienced by bond portfolios. This is because participants in a stable value strategy are allowed to transact at their invested principal balance plus any accrued interest.

Figure 2 shows a hypothetical $1,000 stable value investment over three years as rates rise. In the first scenario, rates increase by 3 percentage points across the curve in 18 months. In the second scenario, interest rates jump by 3 percentage points in just three months. In both scenarios, the hypothetical investment would have experienced steady growth of invested principal and realized positive returns over the three-year period. Most important, the hypothetical stable value investment would not have seen an investment value decrease at all. (All investments contain risk and may lose value; actual investor experiences will vary.) And, of course, stable value allows participants to transact at their invested principal balance plus any accrued interest, no matter the interest rate environment.

FIGURE 2: STEADY GROWTH AS RATES RISE SLOWLY OR RAPIDLY

Hypothetical growth of a $1,000 investment in Stable Value in various interest rate scenarios

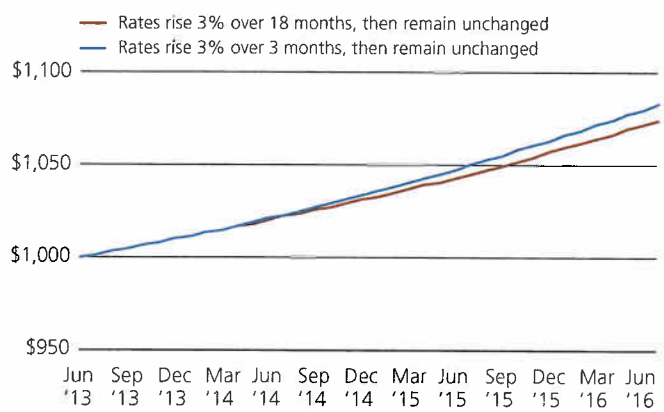


Figure 2 shows a static snapshot of hypothetical stable value performance assuming market characteristics of a 30% blend of the Barclays 1-3 Year U.S. Government Credit Index and 70% Barclays Intermediate U.S. Aggregate Index, representing the market performance of stable value, which is then modeled by a geometric crediting-rate reset formula, an assumption of a 20 basis point fee for wrap contract costs, and a market-to-book ratio of 102.3%, which is the industry average, according to the 30 June 2013 Stable Value Investment Association Quarterly Characteristics Survey. This is not intended to represent any specific PIMCO product or strategy. No manager fees have been applied, which would have reduced performance. Actual results will vary and may be lower.

Hypothetical example for illustrative purposes only. In the analysis contained herein, PIMCO has outlined hypothetical event scenarios which, in theory, would impact the portfolio returns as illustrated in this analysis. No representation is being made that these scenarios are likely to occur or that any portfolio is likely to achieve profits, losses, or results similar to those shown. The scenario does not represent all possible outcomes and the analysis does not take into account all aspects of risk.

Source: PIMCO, Barclays, Stable Value Investment Association

As of 30 June 2013

The plan sponsor experience: getting the structure right

This is not to imply that rising rates pose no risk to stable value. A move up from today's historically low interest rates may present short-term performance challenges. Also, higher rates would likely reduce the market value of the fixed income securities supporting the obligation of the investment contracts, possibly creating credit exposure to the contract issuers. Although this is expected in stable value, it is understandable if plan sponsors have flashbacks to 2008 – when many had large credit exposures to issuers – and become anxious about rising rates.

Some plan sponsors with separately managed accounts (SMAs) may be considering proactively managing this risk, specifically by asking their stable value manager to tactically shorten the duration of their portfolio. The intention is to decrease their portfolio's overall interest rate sensitivity in an effort to minimize the future credit exposure to contract issuers if rates rise.

Although this may be tempting, given the many guideline changes to contracts made since 2008, the durations of many stable value portfolios already have been shortened. In addition, the fixed income sub-advisors likely already have discretion to make (and are better positioned to implement) active duration decisions in a stable value portfolio.

In fact, we believe a stable value manager should already have structured any SMA with a duration and asset allocation that reflects the unique risks and needs of that specific plan's participants, through a robust investment and allocation process. Stable value managers should – as a matter of best practices – regularly collect plan and fund information such as cash flows, demographics, option balances and other plan characteristics for a proper and ongoing assessment of risk in a particular plan. Managers should also communicate with sponsors frequently regarding the likelihood of employer-related events such as significant layoffs or divestitures, which may affect cash flows as well as the ability of participants to transact at book value.

This information is used by an experienced stable value practitioner to accurately assess the risk of a plan and inform client-specific asset allocation and duration decisions. The intended result: healthier stable value portfolios and more consistent stable value experiences for participants across any interest rate environment.

Our past experience and modeling of forward-looking scenarios gives PIMCO confidence that stable value strategies remain an excellent capital preservation-focused solution for both plan sponsors and participants. Even if we enter into a period of rising rates, we believe that stable value can continue to deliver for participants and will be an investment strategy that will likely remain among the most popular capital preservation-focused solutions in DC. However, we encourage plan sponsors to work with stable value managers who have a well-articulated investment process that is designed to result in a stable value option appropriately structured for consistent performance – whether interest rates rise or fall.

Biography

Mr. Gorman is a senior vice president in the Newport Beach office and a stable value account manager in the defined contribution practice. Prior to joining PIMCO in 2010, he was a director and senior portfolio manager with the Deutsche Asset Management stable value team. He was previously a fixed income portfolio manager focusing on institutional clients at Merrill Lynch Investment Managers. He has 19 years of investment experience and holds an MBA from Rutgers University and a bachelor's degree from Syracuse University.

Mr. Kao is a senior vice president and stable value account manager in the Newport Beach office. Prior to joining PIMCO in 2010, he was a product engineer for stable value and corporate cash management at State Street Global Advisors. Mr. Kao was previously an executive director and head of stable value and relative value trading at UBS. He has 25 years of investment and financial services experience and holds an MBA from the Wharton School of the University of Pennsylvania and a bachelor's degree in applied economics from Cornell University.

Past performance is not a guarantee or a reliable indicator of future results. Investing in the **bond market** is subject to certain risks, including market, interest rate, issuer, credit and inflation risk. **Money Markets** are not insured or guaranteed by the FDIC or any other government agency and although they seek to preserve the value of your investment at $1.00 per share, it is possible to lose money. **Stable value wrap contracts** are subject to credit and management risk. Like other actively managed investments, stable value investments are subject to investment management risk. PIMCO does not guarantee the investment performance of the separate account and the separate account may not achieve its stated objectives. Returns on stable value investments can also vary from benchmark indices because gains and losses are amortized over time and due to other portfolio-specific factors, such as the amount and timing of cash flows to the investment and interest rates when those cash flows occur. There can be no assurance that the investment will be able to maintain a stable value or that the investor will receive the same return as may be realized by directly investing in the underlying assets. PIMCO does not offer insurance guaranteed products or products that offer investments containing both securities and insurance features. Investors should consult their investment professional prior to making an investment decision.

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The **Hueler Analytics Stable Value Pooled Fund Comparative Universe** is a 23-year historical return series and is produced on a monthly basis. The **Barclays 1-3 Year U.S. Government Bond Index** is an unmanaged market-weighted index generally representative of all public obligations of the U.S. Government, its agencies and instrumentalities having maturities of up to three years. The **Barclays Intermediate Aggregate Bond Index** is an unmanaged index representing domestic taxable investment grade bonds with an average maturity and duration in the intermediate range, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. This index represents a sector of the Barclays Aggregate Bond Index. It is not possible to invest directly in an unmanaged index.

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