MEKETA

INVESTMENT GROUP

California ABLE Act Board

March 19, 2020

Stable Value

Overview

- Stable value funds are fixed income vehicles that:
  - Make regular interest payments, at yields usually above money market accounts.
  - "Guarantee" preservation of principal.
  - Permit daily transactions at book value.
- Offered exclusively within defined contribution plans
  - Defined benefit plans may *not* invest in stable value funds.

Types of Stable Value Vehicles

- Traditional Guaranteed Investment Contracts (GICs)
  - The issuer of a traditional GIC (often an insurance company) is free to invest received funds in any permissible way, and the stable value fund and payments become liabilities of the issuer.
  - The issuer provides book value accounting and owns all the securities in the underlying portfolio.
  - The stable value investors have a claim on the issuer's general account assets.
- Separate Account GICs:
  - Separate account GICs are similar to traditional GICs, except that the assets underlying the stable value fund are held separately from the general account assets.
  - The issuer provides book value accounting and still owns all the securities in the underlying portfolio.
  - Separate account GICs provide more visibility into the underlying assets, and—in some cases—more protection in the event of issuer default.
- Synthetic GICs:
  - A synthetic GIC is composed of a portfolio of high-quality fixed income securities and one or more "wrap" contracts, which guarantee principal value and provide book value accounting.
  - The stable value investors own all the securities in the underlying portfolio.

Typical Structure of the Underlying Portfolio

- The underlying portfolio is similar to an intermediate-term bond fund:
  - Generally investment grade.
  - 2- to 4-year duration.
  - Coupon similar to that of a 5-year Treasury.
- Overall fees are typically around 40-50 basis points, but can be less for larger plans with separate accounts.
  - Management and operational expenses are about 25 basis points.
  - Insurance costs 17-20 basis points.
- To maintain book value accounting, stable value funds have different liquidity restrictions at the plan and participant level.
  - At the total plan level, withdrawals typically require six months to one year's notice.
  - Individual participants are typically able to withdraw their assets at any time, but are usually restricted from transferring assets between stable value and other fixed income or money market options within the plan.

Historical Performance
1990-2018[1]

	Cash	Short-Term Bonds	Stable Value	Investment Grade Bonds	Domestic Equities
1-Year	1.9%	1.6%	1.7%	0.0%	-5.2%
3-Year	1.1%	1.2%	1.7%	2.1%	9.0%
5-Year	0.6%	1.0%	1.7%	2.5%	7.9%
10-Year	0.4%	1.5%	2.5%	3.5%	13.2%
Since Inception Return	2.8%	4.3%	4.9%	5.8%	9.4%
Ann. Std. Deviation	0.7%	1.6%	0.6%	3.6%	14.5%
Corr. w/ Stable Value	0.76	0.19	1.00	0.21	-0.01

- Stable value funds have historically behaved as expected.
  - Returns have been between short-term and intermediate-term investment grade bonds.
  - Volatility has been similar to cash.
- Stable value is weakly correlated to most investments, except for cash.

[1] Cash is proxied by the 90-day T-Bill; Short-Term Bonds by the Merrill Lynch 1-3 Year Gov't/Credit index; Stable Value by the average of the Ryan 3-year and 5-year GIC index; Investment Grade Bonds by the Barclays Aggregate index; Domestic equities by the Russell 3000 index.

Primary Risks

- Interest Rate Risk
  - In most environments, stable value funds will outperform money market funds.
  - In times of “negatively sloped” or “inverted” yield curves, stable value funds may underperform.
- Guarantee Provider Default Risk
  - Guarantee providers may not be able to either preserve principal or provide book value transactions, exposing investors to market volatility.
  - In the case of traditional or separate account GICs, the issuer itself may also be insolvent.
  - Traditional or separate account investors are typically protected by state guaranty associations that will almost surely make investors whole. However, the process could take years.
- Liquidity Risk
  - Providers reserve the right to restrict withdrawals at any time.
  - Furthermore, a plan-wide shift out of a stable value fund could incur mark-to-market losses that must be spread over the entire participant base—undermining the initial point of the stable value fund.

Primary Risks (continued)

- Transparency
  - Less stringent reporting rules than traditional money market mutual funds
  - In traditional GIC structures, the insurance companies do have to report their fees, but not the profit earned (i.e., the difference between the income generated from reinvesting the assets and the crediting rate paid to investors).
- Fiduciary Risk
  - For small and medium sized plans, the stable manager is often also the plan's recordkeeper, and the revenue generated from stable value is used to offset recordkeeping expenses.
  - This creates an inherent conflict of interest, especially in traditional GIC structures where the revenue is not disclosed.
  - Certain participants (i.e., those with relatively large stable value balances) may be paying a disproportionate amount of the plan's expenses as a result.
  - Fiduciaries can protect themselves by demonstrating an understanding of these nuances through detailed processes and documentation of their decision making process.

Summary

- Stable value funds are fixed income vehicles that attempt to preserve principal and provide daily transactions at book value, while at the same time providing a higher yield than money market funds.
- The primary risks to stable value investing include negatively sloped yield curves, guarantee provider default, and illiquidity.
- Nevertheless, Meketa Investment Group believes that stable value funds represent an attractive option for most participant-directed defined contribution plans.
- CalABLE has exposure to stable value through TIAA Funding Agreement
- Meketa believes TIAA is a top-teir stable value provider and CalABLE is well served with it's current exposure
- Meketa would be supportive of a potential move from FDIC to stable value
  - Doing so would significantly increase the interest rate earned by participants
- Meketa would also be supportive of using the TIAA Funding Agreement as the stable value product
  - It is uncertain to us the degree of market place interest there would be, given current asset size, in a RFP for the mandate
  - May be able to get better terms than offered through the TIAA Funding Agreement but unlikely at similar credit quality