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How Stable Are Your Stable Value Funds?

By Editor Test *Mon, Jun 29, 2009*

"In today's unpredictable market environment, even the 'safest' investments carry considerable risks," the global consulting firm said.

Consultants at Watson Wyatt are advising retirement plan sponsors to review their existing stable value investments and wrap contracts to ensure they are prepared for a repeat of 2008's market shocks. (Watson Wyatt recently merged with Tower Perrin.)

"In today's unpredictable market environment, even the 'safest' investments such as stable value funds carry considerable risks that plan sponsors and participants alike might not be aware of," the global consulting firm said in a statement.

Stable value funds invest in bonds and other fixed-income securities that are protected up to the amount of their book value by "wrap contracts" issued by insurance companies and banks. Recent market turmoil has undermined their stability, however. It has credit rating of the wrap issuer structure and reduced the book value of the funds' investments.

To ensure that stable value investments continue to function as intended, Watson Wyatt advised plan sponsors to:

First, examine the quality and integrity of the wrap structure to better understand the construction of stable value funds and the roles that portfolio managers, wrap contract issuers and recordkeepers play in administering them.

Plan sponsors should "seek answers to the tough questions—What is our contingency plan? How would a downgrade or default of a wrap contract issuer be handled? How much credit exposure does the issuer have?-to make sure they are in a position of strength if the unexpected occurs," said Sue Walton, senior investment consultant at Watson Wyatt.

Second, perform stress tests to gauge the potential damage from events such as interest rate changes, credit spread widening and defaults, and changes in the wrap structure. This will enable an investor to determine risk factors and quantify the possible consequences of further market turmoil.

"It's hard to have the 'stability' in stable value funds without a financially sound wrap contract structure," Walton said. "Without a change in the current market, the trend toward higher fees and fewer providers is likely to continue. Neither of these shifts is beneficial for sponsors and participants."