INVESTMENT INSIGHTS

Back to the future: Why principal protection options are becoming popular again

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Principal protection investment options are poised for renewed popularity in defined contribution plans as more 401(k) participants approach retirement age.

Such investments, the most popular of which are stable value strategies, are seen as less risky and volatile when compared to target-date funds, which mostly invest in traditional stocks and fixed income. In fact, some plan sponsors are incorporating stable value investments as part of customized target-date funds to take advantage of their principal protection and insurance wraps.

"We happen to believe that for participants who are approaching or in retirement, principal preservation should become a more meaningful component of these types of vehicles," said David Starr, managing director and head of stable value at PFM Asset Management. "And you know, stable value funds for structural reasons have not played a meaningful role in target-date funds because most of them are constructed as mutual funds and stable value is not accessible in a mutual fund format."

"There are certainly any number of large plan sponsors who have developed customized target-date funds," he said. "And many of them have chosen to incorporate stable value as a component because they're increasingly utilizing collective investment trusts as the underlying structure for target-date funds." A CIT structure allows for stable value as a principal protection component in those customized funds, while traditional target-date funds are typically constructed based on mutual funds.

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In a way, incorporating stable value in these customized funds returns the strategy to its former role as a qualified default investment alternative for 401(k) plans. The Pension Protection Act of 2006 had allowed stable value to be replaced with target-date funds as QDIAs in retirement plans.

"A stable value fund could be a QDIA or have the safe harbor QDIA under a couple of instances," said Wayne Gates, PFM chief investment officer of stable value. "And I think this might be something that we as an industry should be thinking about."

The further attraction of stable value to plan sponsors, particularly in plans in which there are more participants who are near retirement, is that traditional target-date funds — even those with short-term time horizons — contain more volatile investment components that could suffer investment losses.

"In looking at target-date funds near or even at retirement, there's still close to 50% allocation to equities, and on the fixed-income side you see some things such as foreign bonds and high-yield bonds," Gates said. "In recessionary times, their correlation with equities will grow, so you don't get the diversification benefits you necessarily are looking for. And that's a particular problem for folks that are in or near retirement because they don't have the time frame to make up those losses," he said. "One of the beauties of stable value or the principal-protected options at or near retirement is that you know that the value is there."

"...there's an opportunity to add value through a number of different tools and strategies within principal-protected investments" **David Starr**

That's important "because of what's been going on with short rates in general. Stable value funds have historically outperformed money market funds significantly," said Gates, "so having that available as not only a principal-protected option, but [also as] one that pays a higher return in a retirement income context is important for folks."

Starr said that while some might see traditional fixed-income investments and money market funds as ways to diversify, stable value is uniquely enhanced by its insurance wrap established to protect against losses, while allowing the principal protected strategy to earn income further out the yield curve.

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"Pure fixed-income investments fluctuate in value as interest rates and spreads shift with market conditions," Starr said. "So by definition, principal protection investments are designed to have stability of principal, and that's the primary difference. Money market funds are an example of a principal protection-type of instrument, but they are confined to the short end of the yield curve. The additional income potential and the lack of volatility — due to the combination of the insurance wrap with a fixed-income portfolio — is why we think of stable value funds as an alternative to money market funds and to some extent traditional fixed income in a target-date fund framework."

However, Starr added, principal stability does not mean that stable value funds can't generate returns.

"The underlying fixed-income portfolio is actively managed with respect to sector, security selection and duration," he said. "Having said that, there are typically guidelines that govern these types of portfolios within the insurance contracts or book value wrap agreements that have some constraints with respect to duration and asset diversification."

Most stable value funds are managed with a duration of around 2 1/2 to 3 3/4 years, Starr said, "so there's some latitude with duration as well. But definitely there's an opportunity to add value through a number of different tools and strategies within principal-protected investments."

Gates said stable value investments can also be cost effective for plan sponsors.

"Plan sponsors are trying to reduce fees associated with their defined contribution plans in total, and so one of the things is that there has been a movement toward less costly funds," he said. "The large managers of target-date funds are moving more from a mutual fund format to a CIT format to reduce cost. So that does produce an opportunity for stable value that wasn't necessarily there before."

Along with the broader benefits of principal protection, Starr said stable value can be tailored to the needs of individual DC plans and their participants. Among the client variables considered by PFM are cash flow, history, participants' age, and flows between the stable value option and other fund options, he said.

Starr said such an understanding helps to create a portfolio that responds to interest rate changes, maximizes opportunities for yield and sector selection, and still reflects the risks of a plan's employee cash flows.

"We spend a lot of time and energy understanding the underlying demographics of the plans that have a stable value fund," Starr said. •

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