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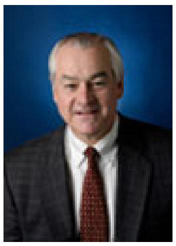
Is Active or Passive Management Better for Stable Value Portfolios?



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Perhaps the biggest shift taking place in the investment management industry today is the broad migration of assets from active management to passive investing. We see this shift in a variety of pockets of the capital markets. As just one simple barometer, indexed mutual fund assets (equity, bonds and hybrid funds) increased by a compound annual growth rate of 19% from 2013 through 2015[1]. Within defined contribution plans, participants have focused their asset allocations on index funds while sponsors have evaluated index-based target date funds as alternatives to actively managed strategies. Likewise, many defined benefit plan sponsors have abandoned alternative assets such as hedge funds and private equity for indexed approaches while some hedge fund managers have thrown in the towel and closed their active strategies.

What does this trend mean for stable value portfolios within defined contribution plans?

Setting the Debate

For years, investors have debated the ability for active managers to generate alpha beyond the return of their benchmark. One side says the higher expense of active management is justified as a fair tradeoff for greater returns and benchmark outperformance. The other side is convinced that while active management may produce alpha in particular sectors and/or over certain time periods, simply buying the index is a better long-term strategy for minimizing costs and maximizing diversification. Historically, few stable value managers have considered an indexed approach to the underlying investment strategy in their funds. Given the shift toward indexing today—should they?

Unique Set of Circumstances for Stable Value Portfolios

Unlike relatively unconstrained fixed income mandates within defined benefit plans, foundations or endowments, stable value funds have unique circumstances that must be considered when evaluating appropriate investment strategies. Stable value funds are typically the most conservative investment option offered within a participant-directed defined contribution plan (such as a 401K plan). Their primary objective is capital preservation, with yield or total return a secondary priority. Within these funds, synthetic GIC[2] wrap contract investment guidelines dictate how the underlying fixed income assets are managed. These guidelines, which are negotiated between the wrap provider and the stable value manager, limit the level of risk that the fixed income manager may take. Restrictions may include but are not limited to: a narrow spectrum of allowed sectors, constrained maximum sector allocations, elimination of non-investment grade assets, and a duration cap of 4.0 years. As a result, many tools that active fixed income mangers typically use to add value are taken away by a stable value fund mandate.

Another unique circumstance in the stable value asset class is the lack of an industry benchmark for manager performance comparisons. Where equity funds and bond funds have well-defined benchmarks such as the S&P 500 and Bloomberg Barclays Intermediate Aggregate indices that can be used by asset managers, no single index is applicable to an entire stable value fund. For a variety of reasons, the industry has generally gravitated to the use of the 3-month US Treasury Bill index, a money market fund proxy, as the preferred performance benchmark. Unfortunately, this creates challenges when comparing returns and

[1] 2016 Investment Company Fact Book, Investment Company Institute®

[2] A synthetic GIC is a stable value investment structure that offers similar characteristics as a guaranteed investment contract. It consists of an asset ownership component and a contractual component that is intended to be valued at book value. Such assets typically consist of a diversified fixed income portfolio, including but not limited to treasury, government, mortgage, and/or corporate securities of high average credit quality.

fund holdings to "the benchmark." However, as described later, sub-components of a stable value fund can readily use an indexed or enhanced indexed approach alongside active mandates.

Standish believes that these restrictions and characteristics offer compelling reasons for stable value managers and their plan sponsor clients to genuinely consider indexing for at least a portion of their portfolios.

The Rationale for a Passive Allocation within Stable Value Portfolios

There are a number of reasons why an index-based investment strategy makes sense for a portion of stable value portfolios. Stable value funds consist of multiple investment contracts that have distinct book value contract crediting rates. The weighted average of these crediting rates determines the return of the fund. Typically, each contract crediting rate is reset on a quarterly basis based on four characteristics—i) the book value of the investment contract, ii) the market value of the underlying investment portfolio, iii) the market yield of the underlying investment portfolio, and iv) the duration of the underlying portfolio. Each of these characteristics has a direct influence on the quarterly book value investment contract crediting rate.

While capital preservation is the primary objective of a stable value fund, earning a steady return is an important secondary objective. To minimize the volatility of investment contract crediting rates, a manager should generally try to maintain consistent underlying portfolio characteristics. This would include maintaining a tightly targeted duration, a relatively consistent asset allocation to avoid significant swings in yield-to-maturity and strict minimum credit quality standards for downgraded securities. Wide fluctuations in quarter-to-quarter portfolio characteristics such as spread sector concentrations and duration can have a significant impact on crediting rates. For this reason, an index strategy offers underlying consistency that may benefit a stable value portfolio over potential swings that may be associated with a more aggressive active investment strategy.

Fees are always a concern for fiduciaries. Including an index-based allocation in a stable value fund can materially decrease the fund's overall expense ratio. Typically, the difference in fees can be 10 to 15 basis points annually for the index allocation compared to an active mandate. Thus, a 25% product allocation can reduce the overall fund expense ratio by 3 or 4 basis points. This is particularly important in a low interest rate environment where management fees represent a higher percentage of expected fund returns.

Like many fixed income strategies, stable value portfolios seek yield by investing in spread sectors. This generally includes corporate bonds, mortgages and certain types of asset backed securities. Although wrap contract investment guidelines drive managers to focus on high credit quality issuers, their portfolios will experience downgrades throughout credit cycles. Index strategies offer structured solutions to address fallen angels. When these distressed credits are removed from the index due to credit quality minimum threshold, they are typically liquidated shortly thereafter by an index manager. There is no consideration to hold the asset—and wrap contract providers are favorably disposed to the process.

Broad diversification is another point in favor of an index product allocation. This is particularly important in the credit sector where hundreds of issuers may be represented through an indexed product. No single issuer represents a large portion of the portfolio. Therefore, it is unlikely that a sudden negative credit event or company bankruptcy would severely impact a portfolio, and by extension, an investment contract crediting rate.

Finally, due to the existence of synthetic GIC wrap contracts, stable value funds are quite easily segmented. In fact, most funds have a number of wrap contracts that have underlying sub-portfolios with a variety of target durations across the yield curve. This structure makes it relatively easy to incorporate multiple active and passive investment strategies and benchmarks within a stable value fund.

Standish's Index-Based Approach

Since 1994, the Standish stable value team has employed an index-based strategy called the Yield Enhanced Strategy. We believe the consistency of an index-based approach can offer a safe way to gain moderate yield and serve as a portfolio anchor, around which active strategies can be structured.

Our Yield Enhanced Strategy combines an active sector overlay with investments in underlying bond index funds that cover five fixed income sectors. The sector funds include US government, credit, mortgage-backed securities (MBS), asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS). The result is a diversified portfolio with underlying exposure to over 6,200 securities, with the credit sector fund diversified across 600 different issuers. With a consistent yield overweight relative to the Bloomberg Barclays Intermediate Government/Credit Index benchmark, the annual targeted alpha is 20 to 30 basis points. The table below illustrates the sector weightings of the Yield Enhanced Strategy as of March 31, 2017.

Yield Enhanced Strategy[3]					Bloomberg Barclays US Int. Gov't/Credit Index				
Sector Funds	% of Total	Yield	Duration (yrs)	# of Securities	Sector Funds	% of Total	Yield	Duration (yrs)	# of Securities
Government					**Government**				
1-3 Year	17%	1.30%	1.94	86					
Intermediate	5%	1.73%	3.87	256	Intermediate	68%	1.71%	3.90	4,167
Credit					**Credit**				
1-3 Year	6%	1.87%	1.89	612					
Intermediate	28%	2.67%	4.20	4,167	Intermediate	32%	2.70%	4.32	652
ABS	18%	1.88%	2.27	350					
MBS	23%	2.85%	4.69	346					
CMBS	3%	2.79%	5.39	617					
Total	**100%**	**2.43%**	**3.46**	**6,434**	**Total**	**100%**	**2.10%**	**4.06**	**4,819**

This product fits nicely within the relatively constrained investment guidelines of synthetic GIC wrap providers, while producing consistent portfolio characteristics that generate steady investment contract crediting rates. Standish's average stable value portfolio has a 33% allocation to the Yield Enhanced Strategy.

Standish firmly believes that this does not have to be an all or nothing approach. In our opinion, an index-based allocation, such as the Yield Enhanced Strategy, provides steady ballast for a stable value fund. Positioned around that core allocation, actively managed total return strategies can be placed with managers who leverage their expertise within a guideline constrained world. In particular, we have incorporated focused credit strategies and modified macro strategies around our indexed approach. We believe a combination of managers with complementary styles and diversified alpha sources is optimal for larger stable value funds.

Conclusion

In the stable value space, Standish supports both the advocates for indexing and the advocates for active management. An indexed approach provides the underlying asset consistency that puts the ***stable*** in stable value. Active management can add value across a variety of sectors. Within the relatively investment guideline-constrained world of stable value, a manager can strategically position selected active strategies to compliment an index-based investment allocation.

[3] Portfolio composition subject to change. The Yield Enhanced Strategy represents the allocation of a segment of our discretionary stable value portfolios between and among various bond index bank collective trusts representing various sectors of the Barclays Aggregate Bond Index.

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